

# APP vs PEPP: Similar, But With Different Rationales





# APP vs PEPP: Similar, But With Different Rationales

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## **Abstract**

ECB's asset purchase programmes have been implemented at different times in different economic environments and may pursue different objectives. From the point of view of removing financial fragmentation and taming sovereign stress in the euro area, the PEPP has been successful so far. Moreover, this outcome was obtained without fully using its potential resources. To date and contingent on the available set of information, the current monetary stance has not gone too far and it retains some ammunitions.

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## **CONTENTS**

<b>LIST OF ABBREVIATIONS</b>	<b>4</b>
<b>LIST OF FIGURES</b>	<b>5</b>
<b>EXECUTIVE SUMMARY</b>	<b>6</b>
<b>1. INTRODUCTION</b>	<b>7</b>
<b>2. THE ECB AND THE COVID-19 CRISIS</b>	<b>8</b>
<b>3. THE DIFFERENT RATIONALES FOR APP AND PEPP</b>	<b>11</b>
<b>4. WHAT ARE THE RISKS ASSOCIATED WITH PEPP?</b>	<b>17</b>
4.1. Going too far	17
4.2. Not going far enough	18
4.3. In what direction does the balance of risks go?	18
<b>REFERENCES</b>	<b>22</b>

## LIST OF ABBREVIATIONS

<b>APP</b>	Asset purchase programme
<b>CJEU</b>	Court of Justice of the European Union
<b>ECB</b>	European Central Bank
<b>FCC</b>	Federal Constitutional Court
<b>PEPP</b>	Pandemic emergency purchase programme
<b>PELTRO</b>	Pandemic emergency longer-term refinancing operations
<b>PSPP</b>	Public Sector Purchase Programme
<b>QE</b>	Quantitative easing
<b>TFEU</b>	Treaty on the Functioning of the European Union
<b>TLTRO</b>	Targeted long-term refinancing operations
<b>ZLB</b>	Zero lower bound

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## LIST OF FIGURES

Figure 1:	Flows of asset purchases	8
Figure 2:	Sovereign interest rate spread with Germany	9
Figure 3:	Assets of the Eurosystem	10
Figure 4:	Lending to euro area credit institutions for monetary policy purposes	10
Figure 5:	Euro area inflation measures	11
Figure 6:	Euro area inflation expectations	12
Figure 7:	Sovereign interest rate volatility	13
Figure 8:	Flows of PEPP asset purchases	15
Figure 9:	Share of cumulated PEPP purchases at the end of July 2020	16
Figure 10:	Euro area household saving rate	20
Figure 11:	Financial stress dynamics: the CISS index	21

## EXECUTIVE SUMMARY

- **The ECB's asset purchase programmes have been implemented at different times in different economic environments and may pursue different objectives.** We review these considerations to analyse the consequences of such programmes.
- **The APP arrived at a moment when the euro area was facing strong deflationary risks whereas the PEPP was implemented when the inflation outlook was uncertain** (because the Covid-19 crisis is a mix of a supply, demand and uncertainty shocks) but fragmentation risks were on the upside and sovereign risks and increasing spreads could impair the transmission of monetary policy across euro area countries.
- **The declared will to tackle the fragmentation of the euro area** and the removal of the self-imposed limits suggest that the ECB sets a sort of "spread targeting" objective to the PEPP.
- From the point of view of this "spread targeting" objective, the **PEPP is successful with both the level and volatility of sovereign spreads at low levels.**
- **This outcome was obtained without a full utilisation of the potential resources of the PEPP.** The weekly flow of purchases is indeed decreasing since July. This suggests that the signalling effect of the PEPP was strong and credible in taming sovereign stress.
- **Ultra-loose and "disproportionate" monetary policy raised the risk of overshooting the inflation target and exceeding the price stability mandate.**
- The effectiveness of monetary policy decisions, asset purchases in this context, has to be **assessed with respect to the objective of the programme and the economic context in which it was implemented.**
- **The transmission of monetary policy relies on various interactions between macroeconomic and financial variables** such that the price stability objective cannot be insulated from the real economy.
- **In the situation where the pandemic crisis prevents fiscal consolidation and makes a rise in inflation or in real GDP uncertain,** an accommodative monetary policy that reduces nominal yields and so financing conditions, is undeniably relevant to ensure public debt sustainability.



## 1. INTRODUCTION

The role of central banks is crucial to limit the economic and financial consequences of crises. By lowering policy rates, buying assets, or supporting liquidity, monetary policy can be quickly decided and implemented. However, the action of policy makers – central bankers and governments – should also take into account the features of the crisis. With the COVID-19 crisis, the world economy has been hit by a negative shock, which has triggered the most important fall in output since the Second World War. The nature of the shock is also unprecedented since it has, to a large part, been the consequence of decisions to restrict economic activities (closure of shops, schools and encouragement to stay at home). Even if those restrictions have been partially lifted, some constraints remain. In 2020-Q2, the GDP has plummeted by 11.8% and inflation was close to zero.<sup>1</sup> There are signs of rebound for 2020-Q3, but economies will still suffer from the crisis and from the remaining prophylactic measures. There is consequently a need for an economic stimulus that rests, at least partially, on expansionary monetary policy.

It may yet be noted that the ECB decisions are taken in special circumstances. The stance of monetary policy in the euro area was already loose before the outbreak of the COVID-19 crisis and the ECB found itself with less ammunition than the Federal Reserve Board for instance. More importantly, the ECB asset purchases have been criticised within the Governing Council itself one year ago and by the German Constitutional Court, which has asserted that ECB's asset purchasing policy could have disproportionate effects on related objectives and could be relatively ineffective at achieving the objective of price stability. Such a situation may hamper ECB's actions. There is then a need to explain the rationales and objectives of the decisions taken by the ECB to deal with the specific nature of the crisis and to assess the balance of risks of these decisions. The ECB's asset purchase programmes have been implemented at different times in different economic environments and may pursue different objectives. We review these considerations to analyse the consequences of such programmes.

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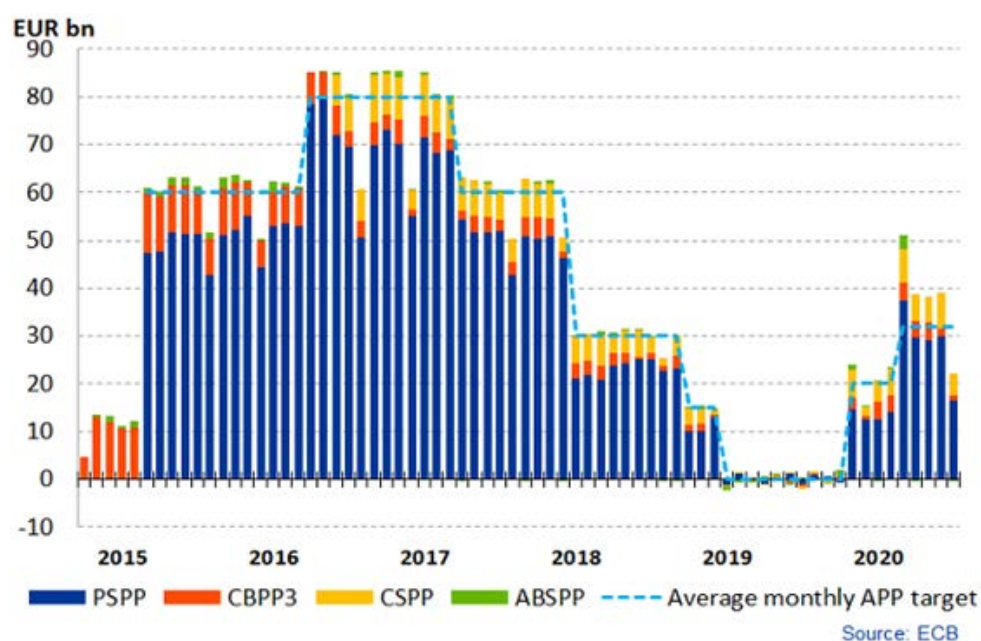
<sup>1</sup> It would even be in negative territory in August according to the Eurostat flash estimate.

## 2. THE ECB AND THE COVID-19 CRISIS

As in 2008-2009 during the subprime crisis, central banks have been on the front line to provide a response to the COVID-19 crisis. Where the policy rate had not already reached the zero lower bound (ZLB), central banks first decided to cut it as in the United States and in the United Kingdom. The Federal Reserve held two unscheduled meetings on 3 and 15 March 2020 to implement a first package of emergency measures beyond the interest rates cuts. It mainly consisted in the re-activation of liquidity provision programmes that were launched during the subprime crisis and in a new wave of asset purchases.

In the euro area, the first decisions were taken on 12 March 2020 and consisted in the extension of existing programmes. The ECB had indeed not started to phase out from unconventional measures. The initial asset purchase programme (APP) started in March 2015 and was initially supposed to last until September 2016. It was yet extended multiple times both in terms of its length and of the flow of monthly purchases (see Figure 1) and it was still effective at the outbreak of the COVID-19 crisis. Consequently, the net flow of purchases was brought back to zero during most of 2019, so that the stock of assets held by the ECB was kept constant but resumed after the decisions taken in September 2019. It was also the case for the Targeted long-term refinancing operations (TLTRO) that enabled banks to obtain liquidity from the Eurosystem conditionally on the supply of credits to non-financial agents.

Figure 1: Flows of asset purchases

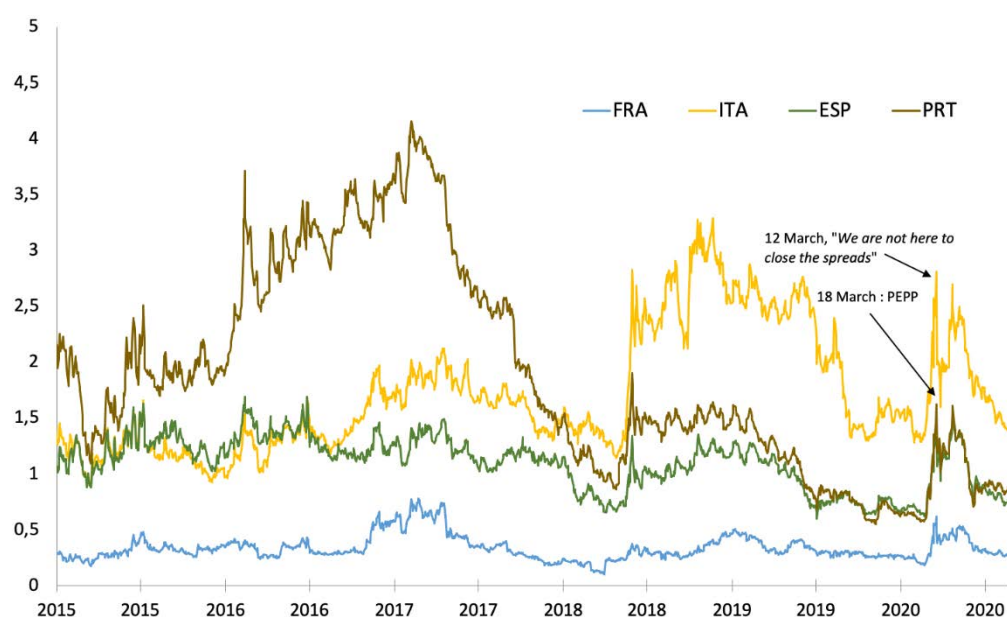


Source: ECB.

On 12 March 2020, the ECB increased the envelope of net assets purchases within the APP by EUR 120 billion. The aim was to support financing conditions by weighing down on sovereign yields. Moreover, TLTRO were granted at more favourable conditions for banks to stimulate credit and new long-term refinancing operations (LTRO) were announced to meet liquidity needs and address potential risks of self-fuelling crises.

Despite rising tensions on the sovereign debt market and notably on the Italian yield, the ECB did not initially communicate on this issue. During the press conference held at the end of the 12 March 2020 meeting, ECB President Christine Lagarde answered a journalist's questions that "We [the members of the Governing Council] are not here to close spreads", which immediately amplified tensions in financial markets (Figure 2). Later, President Lagarde went back on this issue re-affirming that the ECB aimed to avoid fragmentation in the euro area and would pay attention to any impairment of the transmission of monetary policy. One week later, on 18 March 2020, the ECB took decisions in accordance with these words. A new asset purchase programme was launched: the pandemic emergency purchase programme (PEPP) with an overall envelope of EUR 750 billion extended to EUR 1.35 trillion on 4 June 2020. It was notably asserted that these purchases would be conducted in a flexible manner regarding the allocation across countries. While the overall envelope should comply with the capital key of the national central banks, it may temporally deviate from it if there is a need to reduce sovereign spreads for a given country.

Figure 2: Sovereign interest rate spread with Germany

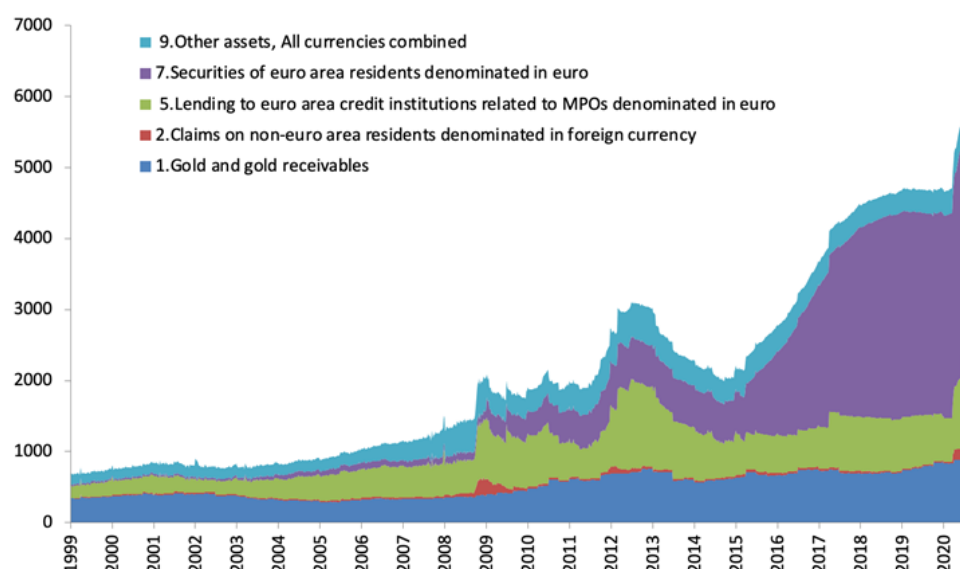


Source: Datastream. In percentage points.

Moreover, given the role of the US dollar in international financial transactions, the swap lines between the main central banks have been renewed to maintain liquidity in the international interbank market. Finally, on 30 April 2020, the ECB announced 7 long-term liquidity granting operations between May 2020 and December 2020 (PELTRO: pandemic emergency longer-term refinancing operations), with a maturity ranging from 16 months for the first - which took place in May - to 8 months for the last.

These measures have triggered a new rise of the Eurosystem's balance sheet (Figure 3). Under the APP, Treasuries represented more than three quarters of the asset purchased since the 13 March 2020. The total amount of assets held under the APP went from EUR 2.639 trillion to EUR 2.819 trillion. It may also be noticed that the ECB increased its holdings of private securities with a total outstanding reaching EUR 228 billion by the end of August 2020. However, the bulk of assets purchases have been implemented under the new PEPP programme.

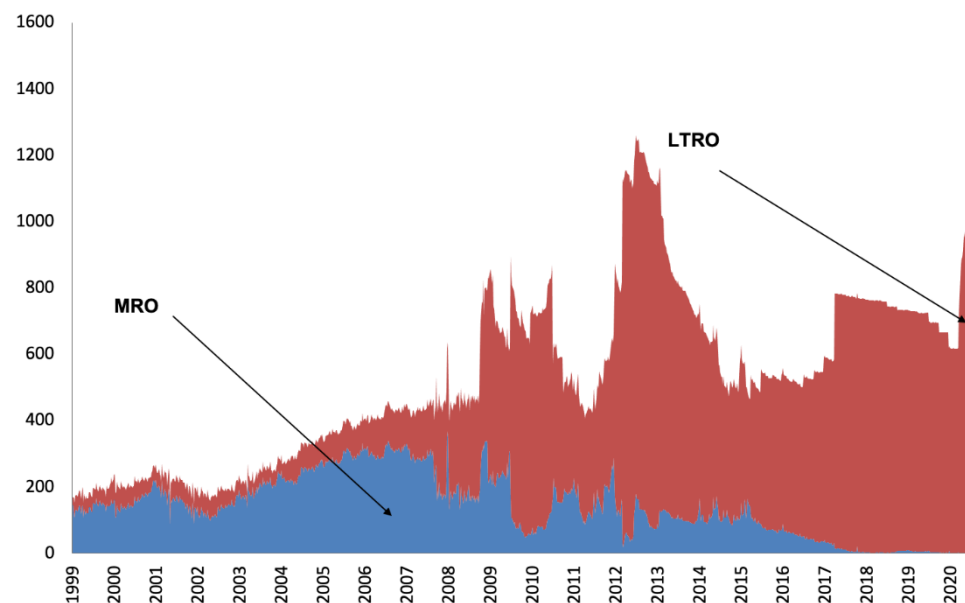
Figure 3: Assets of the Eurosystem



Source: ECB. In EUR millions.

Figure 3 also illustrates that lending to euro area credit institutions has also jumped to a new record high as a consequence from the allocation of liquidity through the PELTRO, suggesting that there was a need to avoid a liquidity squeeze since long-term refinancing operations have increased by EUR 563 billion after 19 June 2020 (Figure 4). It may also be noted that claims, denominated in foreign currency, have risen by EUR 125 billion in March-April following the swap operations.

Figure 4: Lending to euro area credit institutions for monetary policy purposes

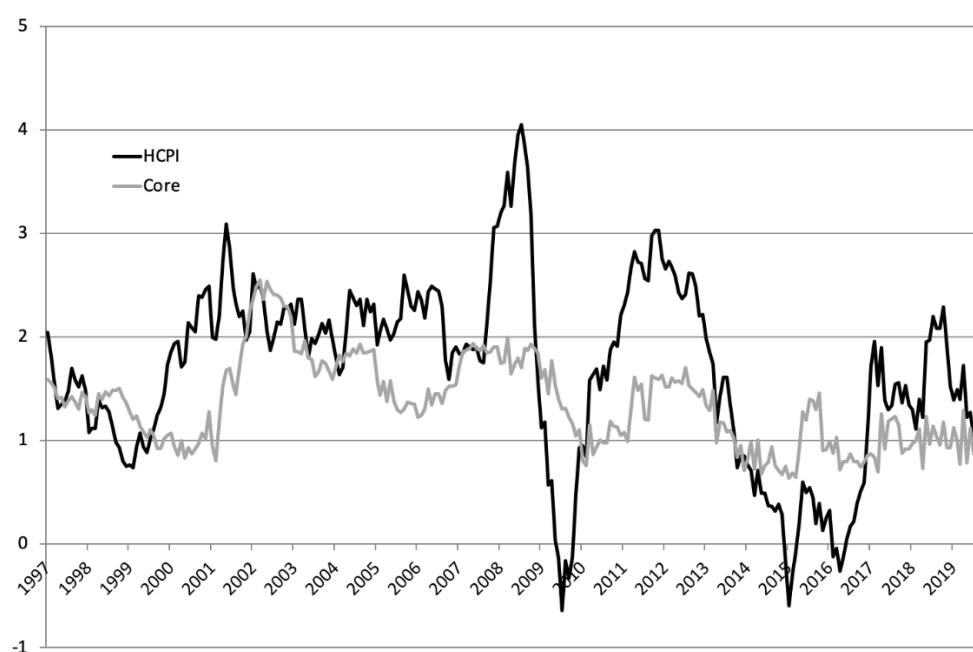


Source: ECB. In EUR millions.

### 3. THE DIFFERENT RATIONALES FOR APP AND PEPP

The APP was initiated “to support the monetary policy transmission mechanism and provide the amount of policy accommodation needed to ensure price stability” (ECB webpage). This policy, rejected many times by Governing Council members between 2009 and 2012 when the Federal Reserve and the Bank of England implemented their first quantitative easing (QE) programs, was eventually adopted by the ECB in face of the deterioration of the economic outlook. The ECB therefore aimed at strengthening the means implemented to fight deflationary risks in the euro area. These risks had indeed increased with the fall in inflation, the continued high level of unemployment and the possibility of a drop in expectations around 2014-2015 (Figure 5). In doing so, the ECB hoped to ensure that inflation expectations would remain anchored, to reduce risk premia and financing conditions and to push the euro down.

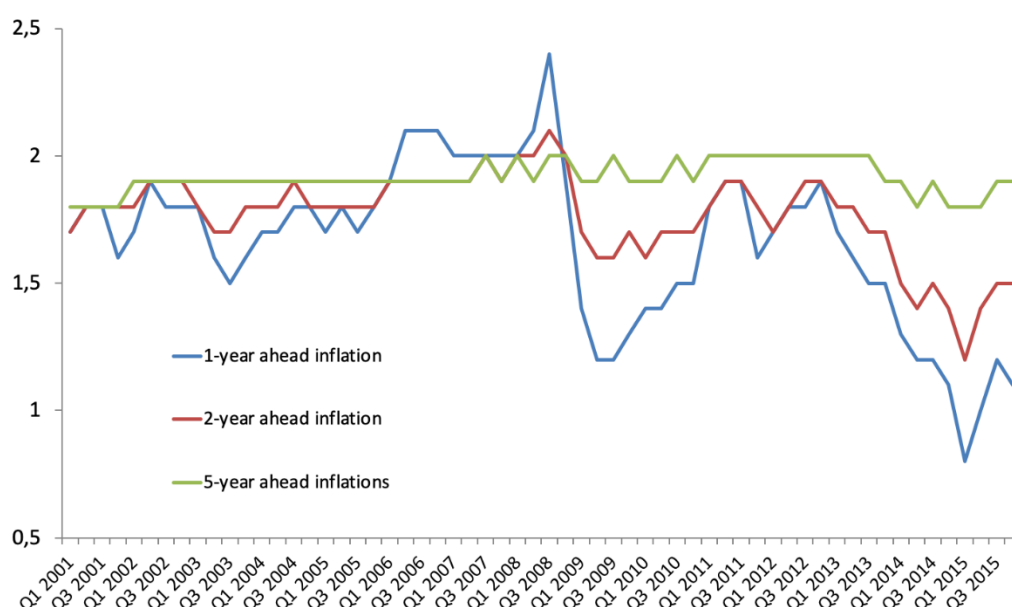
Figure 5: Euro area inflation measures



Source: Eurostat. In %.

The deflationary risk was significant in the euro area in 2014. It had intensified with the drastic fall in oil prices that pushed inflation down, which in turn called into question the anchoring of expectations. Inflation turned negative from December 2014, with a contribution from the energy subindex of -0.7 percentage points over the last quarter. Surveys conducted among professional forecasters (the ECB's Survey of professional forecasters, SPF) indicated a sharp fall in expected inflation over the next two years and five years (Figure 6). This evolution was an important source of concern for the ECB, which targets inflation close to 2% in the medium term. This showed that in the medium term, forecasters favoured a low inflation scenario and thought that the ECB would be unable to bring inflation back to its target despite the policy decisions implemented so far. Even at the worst of the Great Recession of 2009, inflation expectations did not go down to such a low level.

Figure 6: Euro area inflation expectations



Source: Eurostat. In %.

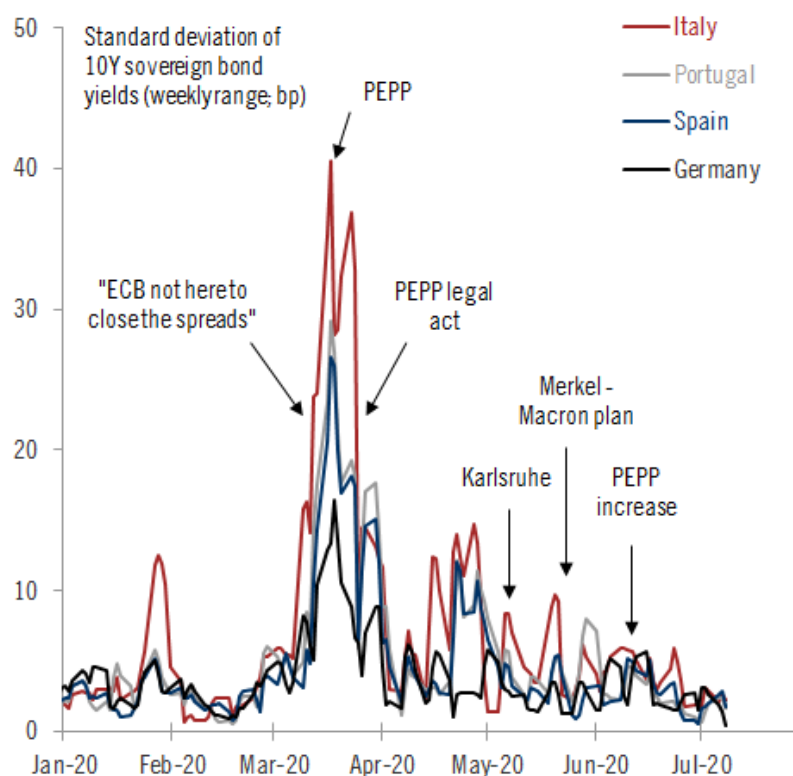
Five years later, the euro area and the world economy have faced an unprecedented situation and the measures announced by the ECB aimed at dealing with the specific consequences associated with COVID-19 crisis (see Section 2). In the present situation, the negative demand shock has triggered a fall of output and a slowdown of inflation calling for a more expansionary monetary policy. However, the fall in demand mainly stem from the inability to spend as a consequence of lockdown measures. In parallel, lockdown measures have also created a supply shock that may amplify in the future in the event of mass bankruptcies. There is certainly a need to implement an expansionary monetary policy but standard measures should account for the features of the crisis. Keeping interest rates low is yet still important to support spending after the lockdown is lifted and to ease the debt burden on indebted agents. The measures should also prevent financial constraints from pushing non-financial agents to cut back on their spending. It is indeed crucial to prevent the risk of a liquidity crisis. The outbreak of the crisis, even if it is not financial in nature, causes great uncertainty about the degree of exposure of economic actors to future losses. There is therefore a risk of default which can cause mistrust and reduce access to market liquidity. Central banks must therefore play the role of lender of last resort to avoid a liquidity crisis and limit financial stress. The interest rate cuts are therefore needed to send a signal that access to central bank liquidity will remain favourable. It should also be accompanied by liquidity operations as those contemplated with the PELTRO.

However, the main measures to face the crisis must undoubtedly be budgetary as it can be more precisely geared to agents suffering more from the consequences of the lockdown. The role of monetary policy must therefore also - and above all - support the action of governments, which consists in supporting the incomes of the most deprived people and exposed to the risk of job loss (under partial unemployment or full unemployment), the activity of companies which cannot absorb the shock linked to the closure and to the decline in demand and public health expenditure. This will result in an increase in debt which may cause tensions in the financial markets, push interest rates upward and therefore constrain the effectiveness of fiscal policy but also that of the transmission of monetary policy. By purchasing sovereign securities, the central bank guarantees the government in the short term against liquidity risk. It is indeed essential that there be coordination - at least implicitly



- between monetary policy and fiscal policy. This was the aim of the decision taken on the 18 March 2020 by the ECB, with the announcement of the new asset purchase program - the PEPP – which is a temporary non-standard monetary policy measure designed “to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the coronavirus (COVID-19) outbreak” (ECB webpage). It is reasonable to think that the implementation of this program was, if not due to, at least brought forward because of President Lagarde’s comment on sovereign spreads (Figure 7). The program initially planned EUR 750 billion of asset purchases until the end of 2020. The purchases would be spread over the different asset classes already acquired by the ECB and, for purchases of government securities, continuing to respect the holding limit per issuer and the ECB capital key, which would lead the ECB to buy a higher proportion of German securities than of Italian or Spanish securities.

Figure 7: Sovereign interest rate volatility



Source: Pictet. In basis points.

On 26 March, the ECB announced that it will not apply its self-imposed purchase limits on the PEPP scheme in its programme legal act<sup>2</sup> (Article 5). Asset purchases were previously capped at 33% of each country’s debt issuances. The ECB added that its purchases would be made according to each country’s shareholding in the ECB, the so-called capital key, but that these purchases would be done in a “flexible” manner across time allowing for deviations. These removals of the ECB self-imposed limits for the PEPP make it possible through these deviations from the capital key to effectively reduce spreads in sovereign interest rates. Overall, the PEPP therefore looks like a scheme to reduce tensions that emerged in sovereign debt markets. These purchases will make it possible to ease financing conditions

<sup>2</sup> Decision (EU) 2020/440 of the European Central Bank of 24 March 2020 on a temporary pandemic emergency purchase programme.

for the private sector as well as for Member States in the euro area, which will support the efforts made by governments to support activity.

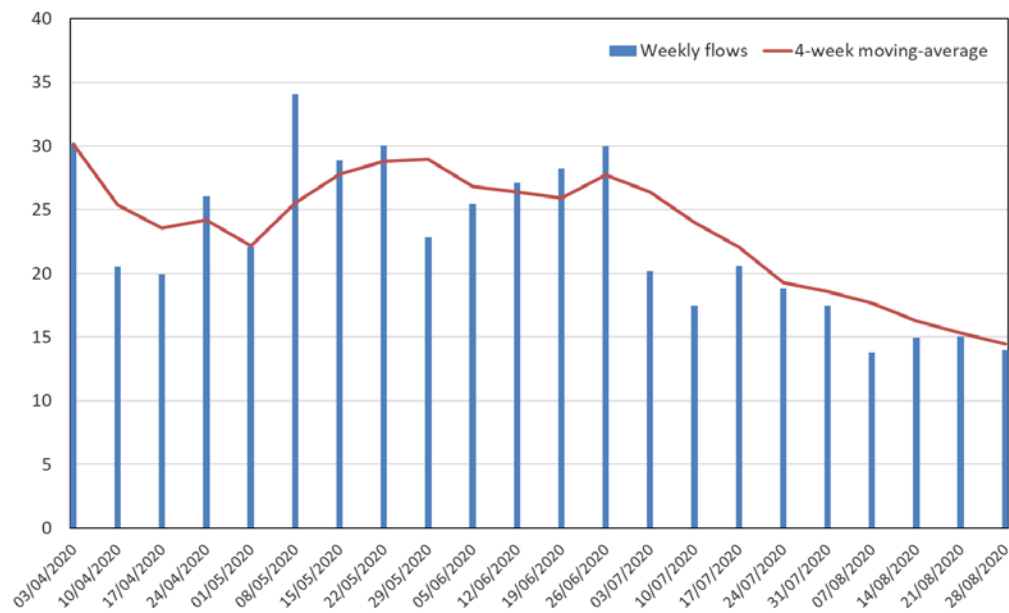
On 4 June 2020, not only did the ECB increase the envelope for the PEPP by EUR 600 billion but also reiterated that the benchmark allocation across countries would be the capital key of national central banks and that purchases would be conducted in a “flexible manner”, allowing for fluctuations in the distribution of purchase flows over time. The Governing Council also stated that it would not terminate net asset purchases under the PEPP before the end of June 2021 and that maturing bonds will be reinvested until at least the end of 2022. President Lagarde, in the press conference of 4 June 2020, stressed the dual role of the PEPP: “on the one hand, it has a monetary policy stance about it, but on the other hand – as you know because that was the one that certainly predominated in the early phase of the crisis – it is critically important because of its flexibility in order to transmit monetary policy, in order to reduce market stress in order to avoid fragmentation”. This statement reinforces the idea that the PEPP is more about closing sovereign spreads than the inflation spread with the inflation target. Meanwhile, it is not contradictory with the ECB mandate since inflation remains below the target. The aim of the PEPP was clarified again at the meeting of the 16 July 2020. President Lagarde insisted on the first objective of the PEPP, which is to “address the risk of market fragmentation and impairment to monetary policy transmission”.

The removal of the self-imposed limits suggests that the ECB gave a sort of “spread targeting” objective to the PEPP. This objective can be seen to follow two broader goals: the first one is specifically related to a monetary union and consists in avoiding the fragmentation of the economic zone as expressed by President Lagarde, the second one is more macroeconomic and aims to lower financing conditions for firms and governments. Avoiding a snowball effect enables firms and governments to devote resources to cushion the effect of the COVID-19 crisis rather than to increased interest payments. Overall, the COVID-19 crisis being both a supply and a demand shock, the effect on inflation appeared mixed initially such that inflation was not necessarily going to decrease further. The rationale for the PEPP initially might not have been about inflation per se. As of now, the recessionary effect of depressed demand seems to dominate the inflationary effect of the supply shock. A second objective of the PEPP about inflation would be consistent with the macroeconomic situation.

One interesting fact to highlight is how successful the PEPP policy has been with regard to this objective (Figure 7), especially when looking at the decreasing flow of asset purchases during the last months. The flows went from more than EUR 25 billion per week from April to the end of June, and slowed down to EUR 15 billion per week in July and August (Figure 8). Sovereign spreads are at a relatively low level despite the overall economic and sanitary uncertainty, the sharp increase in unemployment rates, the drop in GDP levels and the jump in public deficits and sovereign debts across the euro area. The ECB has thus enabled to avoid the fragmentation of the euro area and adding a sovereign debt crisis to the economic and sanitary crises. It also helped ensure the smooth transmission of monetary policy to all countries. Eventually, this outcome has been reached quickly and with only a small share of the overall package announced on 18 March. In addition, one can note that the flow of PEPP asset purchases has decreased in the most recent period which suggests either that the private demand for sovereign bonds is high enough for the ECB to step down or that the signal conveyed to investors through the PEPP is strong enough beyond actual purchases to calm down tensions.



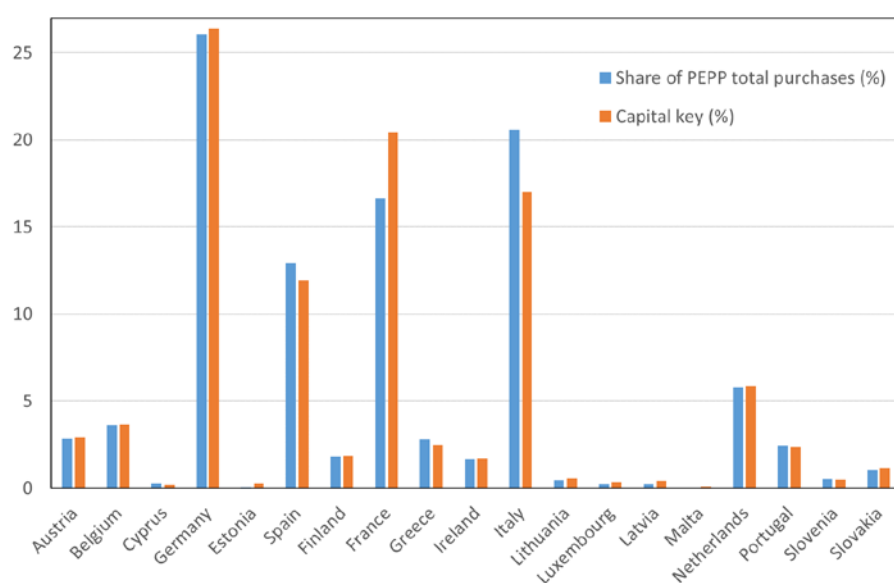
Figure 8: Flows of PEPP asset purchases



Source: ECB. In billions €.

It is interesting to note that while Italian and Spanish bonds have been bought in higher quantities than the respective capital key of these two countries (Figure 9), German sovereign bonds have not been bought less than the German capital key. In fact, they have been bought consistently with the German capital key. As of July 2020, German bonds represent a bit more than 25% of the overall PEPP total purchases while the German capital key relative to euro area countries is of 25%. This suggests that the ECB would not have to buy relatively more German public debt in the future which might have widened spreads. As the flow of PEPP purchases reduces, the ECB could slowly rebalance purchases relative to capital keys for Italy and Spain to assess whether financial market stress have effectively reduced. In the absence of new spread increases, the suggested objective of “spread targeting” of the PEPP would therefore be met and the ECB could gradually continue reducing its flow of purchases in order to keep ammunition for the future.

Figure 9: Share of cumulated PEPP purchases at the end of July 2020



Source: ECB. In %. Capital key are recomputed relative to Eurozone countries only, dropping the capital share of the ECB owned by national central banks outside the euro area.

## 4. WHAT ARE THE RISKS ASSOCIATED WITH PEPP?

There has been several criticisms against the expansionary measures implemented by the ECB in September 2019.<sup>3</sup> Concerns were notably related to the risks for financial stability to keep interest rates – policy and markets yields – so low for so long and to potential undesirable redistributive effects. The implementation of the new measures to deal with the Covid-19 crisis may also raise some risks. It may yet be noticed that those decisions were taken in a different context changing the nature of risks associated with the PEPP. The euro area economy faces two mutually exclusive risks related to the implementation of the PEPP: first, the PEPP may go too far; second, it may not go far enough. We discuss these two risks more explicitly in the following subparts, and we propose an appraisal on the balance of risks.

### 4.1. Going too far

The criticisms raised against the APP can nevertheless hold for the PEPP as well. Even if the ECB does not create currency but central bank reserves (that do not enter monetary aggregates) to implement these purchases, in a monetarist tradition, the first criticism to monetary expansion is the inflation risk that this policy embeds. An ultra-loose monetary policy may hamper the mandatory achievement of price stability in the euro area.

The second criticism relates to the side effects that an ultra-loose policy may pose: the trade-off between price stability and real activity may change and may not be consistent with the ECB mandate where price stability remains a primary objective while real activity is only part of a set of secondary objectives. This issue of monetary policy's side effects has certainly been revived by the ruling of the German Federal Constitutional Court (FCC) in May 2020.<sup>4</sup> The FCC has requested a review of the proportionality of the ECB asset purchase policy between the “monetary policy objective” and “the economic policy effects arising from the programme”. These latter effects relate to “public debt, personal savings, pension and retirement schemes, real estate prices and the keeping afloat of economically unviable companies”.<sup>5</sup>

The FCC ruling on the public sector purchase programme (PSPP) on 5 May 2020 did not oppose a former judgment by the Court of Justice of the European Union (CJEU) on the PSPP: “(the FCC) did not find a violation of the prohibition of monetary financing of Member States budgets”. Therefore, it disagrees that PSPP “effectively circumvents” provisions of the Treaty on the Functioning of the European Union (TFEU). The FCC judgment argues that “a manifest circumvention of the prohibition of monetary financing is not ascertainable, especially because (...) the purchase limit of 33% per international securities identification number is observed (and) purchases are carried out according to the ECB's capital key”. The FCC goes on and argues that “the PSPP does not provide (...) a risk-sharing programme – which would (...) be impermissible under (German) primary law – in relation to bonds of the Member States purchased by national central banks”.

Meanwhile, the FCC considers that the judgment of the CJEU is “incomprehensible” for it was not based upon a clear and prior diagnosis of the economic policy consequences of the implementation of PSPP. The lack of prior review of the “proportionality” between the core objective of monetary policy and its side effects undermines, according to the FCC, the principle of conferral of monetary delegation to the ECB and therefore requires “closer scrutiny”.

<sup>3</sup> See Blot and Hubert (2019) for a critical analysis of these concerns.

<sup>4</sup> See BVerfG, Judgment of the Second Senate of 05 May 2020 - 2 BvR 859/15 -, paras. 1-237.

<sup>5</sup> The latter are commonly named “zombie firms”.

Lastly, the effectiveness of monetary policy at pushing inflation up can be questioned. Does the large monetary stimulus compensate for the low elasticity of prices to interest rates or does it reveal the lack of monetary policy effectiveness?

## 4.2. Not going far enough

Due to the large uncertainty surrounding the world and euro area economy in 2020 and 2021, the risk remains that the ECB response to the crisis is insufficient to restore inflation and real activity in the euro area. The OECD and IMF outlooks for 2020 and 2021 point to an unprecedented recession despite large fiscal and monetary expansions. In this regard, the extension of PEPP in 2021 may have to be pursued further.

Moreover, the evolution of forbearances in the third and fourth 2020 quarters will also help signal the liquidity needs of firms in the euro area and may either give another rationale to 2020 TLTRO measures if these operations have not been fully used yet, or it may require looser monetary policies if ammunitions are missing.

Last, the distribution of forbearances and unemployment rises across euro area Member States will shed light on the even or uneven capacity of Member States to cope with the economic consequences of the pandemic. The approval of the Recovery Plan by the European Council in July 2020 will certainly reduce the needs for further monetary intervention but the depth of the crisis may still remain high and beyond the fiscal capacity to tame the crisis of some Member States. The protracted economic, social and financial divergences between euro area Member States may feed the risk of a split of the euro area itself.

## 4.3. In what direction does the balance of risks go?

There are two counter-arguments to the inflation risk of ECB monetary policies. First, these policies have not led to an increase in money creation *per se*, but to an increase in central bank reserves. These reserves are not prone to generate inflation pressures for they do not circulate in the economy. Second, the inflation expectations have remained low and below the inflation target, even at a long-term horizon.

On the side effects of ECB policies, there are two different angles worth following to discuss the FCC judgment. The first one relates to the application of the proportionality principle by the ECB, as exposed in the judgment. The FCC's distinction between "monetary policy objective" and "the economic policy effects arising from the programme" is a bit puzzling for macroeconomists. It looks as if the FCC thought that achieving the monetary policy objective of the ECB did not require interactions with other macroeconomic and financial variables. Actually, monetary policy can deliver its objective via the usual functioning of the transmission channels of monetary policy. The most direct one is the interest rate channel: if consumer price inflation goes up and above the target, the central bank can raise its policy rate and it will in turn push the long-term interest rate up and dampen aggregate demand. What works when consumer price inflation goes up works symmetrically when it goes down and below the target... unless the policy rate has reached the zero lower bound. If it happens (and it did), the central bank must resort to other instruments. But for both conventional and non-standard tools, the transmission of monetary policy relies on credit, asset price, exchange rate, and balance sheet channels and the effectiveness of those channels hinges on the response of aggregate demand. Hence, "the economic policy effects arising from the programme" are the very reason behind the implementation of the PSPP for there are part of the transmission channels that will (try to) make monetary policy effective at achieving price stability. Remember that disentangling monetary effects from economic effects is not an easy task, for the interrelationships are many. Moreover, the "monetary policy

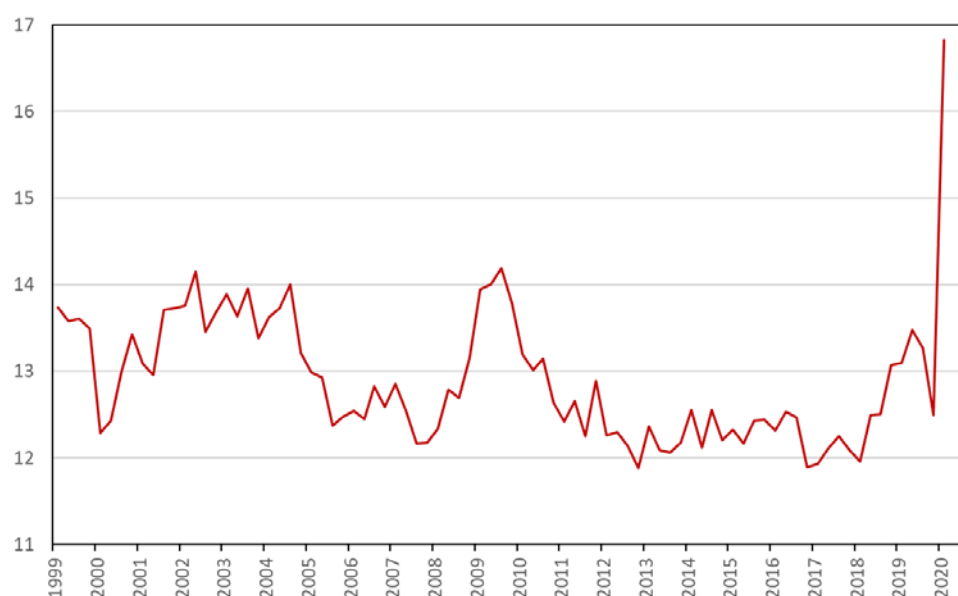
objective" that the FCC isolates is the price stability objective. In so doing, the FCC fails to give due consideration to the secondary objectives that the TFEU attributes to the ECB, like "aiming at full employment and social progress" and "the promotion of economic, social and territorial cohesion, and solidarity among Member States". We argued earlier that there was scope for clarifying the status of these secondary objectives in the ECB mandate because some of them can help achieve price stability (Blot et al., 2020).

The second angle relates to the management of public debt and the interactions with ECB policies. The FCC judgment argues that "a manifest circumvention of the prohibition of monetary financing is not ascertainable, especially because (...) the purchase limit of 33% per international securities identification number is observed (and) purchases are carried out according to the ECB's capital key". The FCC goes on and argues that "the PSPP does not provide (...) a risk-sharing programme – which would (...) be impermissible under (German) primary law – in relation to bonds of the Member States purchased by national central banks". The FCC arguments on the purchase limit and respect of the capital key in the PSPP will act as a Damocles' sword on the PEPP. The FCC's ruling of 5 May 2020 comes as a threat to the capacity of the ECB to implement the measures it has taken in the context of the coronavirus crisis.

Actually, on 18 March 2020, the ECB announced that, "while the benchmark allocation across jurisdictions will continue to be the capital key of the national central banks, (PEPP) purchases will be conducted in a flexible manner. This allows for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions". It continued arguing that "to the extent that some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, the (ECB) Governing Council will consider revising them to the extent necessary to make its action proportionate to the risks that we face". It is clear that the FCC implicitly objects to these new monetary settings. As for the requirement of European solidarity, as laid down in Article 3 of the Treaty of the European Union (TEU), the FCC also rules out a risk-sharing mechanism. This latter outcome may be another hurdle to the management of the current coronavirus crisis.

During a few weeks in the spring of 2020, the decision of the FCC left doubt about the ability of the Bundesbank to continue to be involved in unconventional monetary operations. At the end of June 2020, the Bundestag pronounced itself in favour of the ECB and its new unconventional policies which, in the short term, removes the threat of an early end to monetary easing. This will however not prevent a further appeal by German plaintiffs against the ECB and, in the longer term, a new judicial episode.

Figure 10: Euro area household saving rate



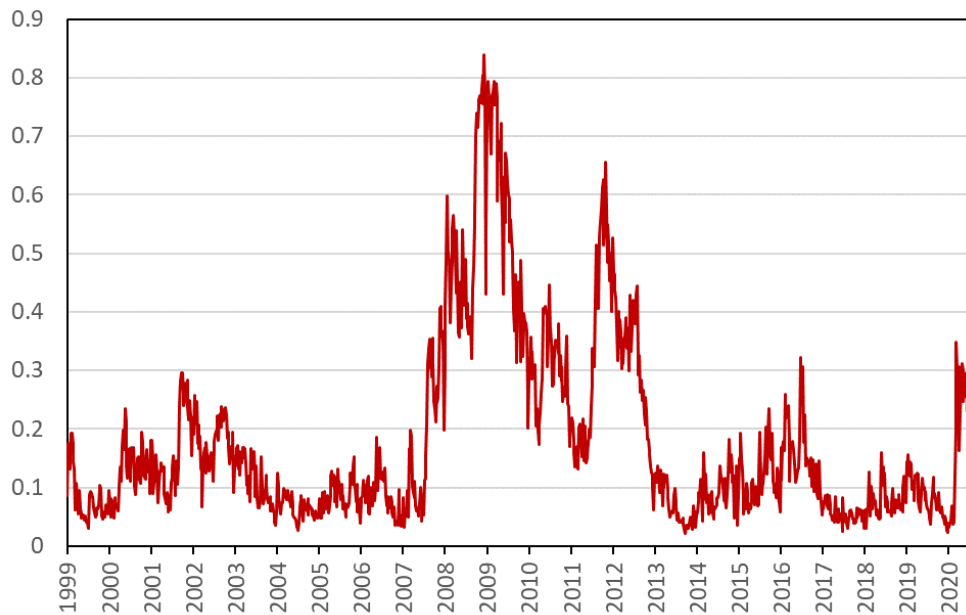
Source: Eurostat. In % of gross disposable income.

Last, the accommodation of monetary policy is undeniably important for currently growing public debts to remain sustainable. The sustainability of public debt requires primary surpluses, a surge of nominal GDP or low real interest rates that reduce interest charges. In the short run, the uncertainty surrounding the real consequences of the pandemic prevents fiscal consolidation and makes a rise in inflation or in real GDP very unlikely. Consequently, the only instrument left to ensure debt sustainability is the nominal yield on government bonds: the lower the nominal yield, the lower the risk of unsustainability.

Low interest rates disfavour private savings, a considerable concern in ageing societies. Without objecting the argument at the micro level for those holding net saving positions, a macro perspective may better help shed light on recent monetary decisions. Indeed, the pandemic and the lockdown have been followed by a substantial increase in private savings and a sharp decline in private investment (Figure 10). The balance between savings and investment has certainly been in favour of the former, hence legitimising a rebalancing via an accommodative monetary policy.

Regarding financial instability that monetary policy may generate, a glance at the CISS (Figure 11) does not seem to testify for a persistent surge in financial instability. While the rough evolution of stock markets does not give insights in “abnormal” evolutions, indicators of bubble like the one developed by Blot et al. (2020) give a better proxy of financial instability.

Figure 11: Financial stress dynamics: the CISS index



Source: ECB. Systemic Stress Composite Indicator, Index.

All these elements point to the conclusion that the current monetary stance has not gone too far, to date and contingent on the available set of information. Has it gone far enough? Only the release of real GDP and inflation data in next quarters will tell but the convergence of nominal yields on government bonds across euro area countries may already reflect that the ECB policy has done enough – jointly with public policies – to remove the risk of a break-up of the euro area.

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ECB's asset purchase programmes have been implemented at different times in different economic environments and may pursue different objectives. From the point of view of removing financial fragmentation and taming sovereign stress in the euro area, the PEPP has been successful so far. Moreover, this outcome was obtained without fully using its potential resources. To date and contingent on the available set of information, the current monetary stance has not gone too far and it retains some ammunitions.

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