COVID-19 update: Euro area policy response

Overcoming constraints

Apolline Menut,
Eurozone Economist,
Core Investments

Key points

- The flexibility and proactivity of the European Central Bank (ECB) since the beginning of the COVID-19 crisis has been a positive surprise. Generous liquidity measures, easier collateral requirements, increases in asset purchases programmes and the creation of the Pandemic Emergency Purchase Programme, have helped the ECB maintain smooth credit flow to the private sector, stabilise markets and reduce fragmentation risks.

- The Next Generation EU package is also a genuine step forward. Joint debt issuance, fiscal transfers and proposed joint tax revenues are politically meaningful. But the package is too small (around 5% of EU GDP) and slow (peaking in 2023-2024) to be a proper cyclical-stabilisation tool.

- In the meantime, governments will remain on the hook. Fiscal responses should move from damage control to demand stimulus. Here Germany is leading the way, but other governments remain in 'backstop' mode.

- Overall, we expect fiscal stimulus of around 4% for the Eurozone this year, far from the 9% needed to offset the COVID-19 induced permanent income loss.

The COVID-19 pandemic has resulted in an unprecedented response from governments and central banks worldwide. In previous papers, we looked into US fiscal and monetary stimulus to alleviate the shock on the economy[1], considered the impact of policy measures in China[2] and dissected Japan's 43% stimulus claims[3]. In this piece, we focus on the Eurozone, considering the positive developments that have surrounded intra-governmental stimulus, as well as national measures.

ECB: Swift actions despite hurdles

The European Central Bank (ECB) has reacted swiftly and forcefully to the crisis, deploying multiple policy measures (Exhibit 1). The first line of action was to safeguard liquidity conditions in the banking system and ensure the smooth provision of credit to households and corporates. The highly accommodative pricing of the targeted longer-term refinancing operations (TLTRO) III programme – with interest rate as low as -1% from June 2020 to June 2021, if lending criteria, which have been eased as well, are satisfied – together with collateral easing measures provide strong incentives for banks to maintain credit flows to the real economy. TLTRO III take up in June has been massive, at €1.3tn, adding net liquidity of €548.5bn.

Credit is flowing – growth of the broad money supply measure M3 surged to its highest level since 2008, at 8.3% year-on-year (yoy) in April from 5.5% in February. The increase was driven by higher

[1] Page, D., "COVID-19 update: US policy response", AXA IM Research, 3 June 2020
[2] Yao, A., "China: Fuelling recovery with an extra policy kick", AXA IM Research, 9 June 2020
[3] Le Damany, H., "Japan's COVID-19 response: Crisis met with strong economic package, but is it enough?", AXA IM Research, 19 June 2020

deposits from both non-financial corporates (NFCs) and households, and was matched, in the NFC sector, by stronger provision of loans. Yet, if the ECB's support through ultra-cheap medium-term liquidity provision, was a necessary contributor to a sustained supply of credit, it is not a sufficient condition for its continuation.

Exhibit 1: ECB monetary policy decisions: A long list

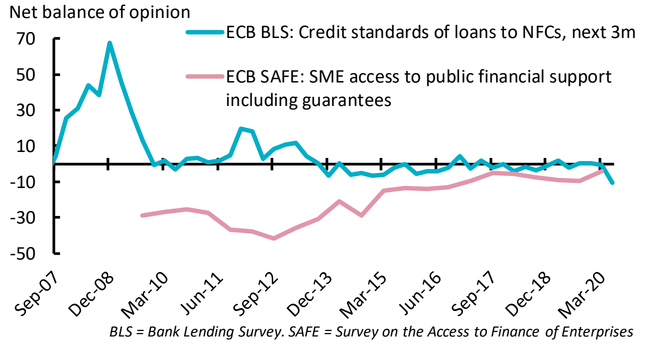
Date	Decisions
12 Mar	€120bn temporary envelope of additional net asset purchases Weekly "bridge" long-term refinancing operations (LTROs) at the depo rate (-0.5%) Looser TLTRO III terms from June 2020 to June 2021 – 25 basis point (bp) cut in TLTRO rate; borrowing capacity up to 50% of eligible loans
15 Mar	Weekly US dollar swap lines (pricing lowered to Overnight Indexed Swap +25bp)
18 Mar	€750bn Pandemic Emergency Purchase Programme (PEPP) Corporate Sector Purchase Programme expanded to non-financial commercial paper Expansion of the Additional Credit Claims framework
20 Mar	Daily seven-day US dollar swap lines
07 Apr	Collateral easing measures (scope, loan size, requirements, and a 20% reduction in collateral valuation haircuts, Greek waiver)
22 Apr	Grandfathering collateral eligibility until Sept 2021
30 Apr	Looser TLTRO-III terms from June 2020 to June 2021 (50bp rate discount) New Pandemic Emergency Longer-Term Refinancing Operations at -0.25% (main refinancing operations -25bp) between May and December 2020 Publication of PEPP breakdown on a bi-monthly basis
04 Jun	PEPP envelope increased by €600bn to €1.35tn and extended until June 2021 PEPP reinvestment at least until end of 2022

Source: ECB and AXA IM Research, June 2020

Indeed, cheap liquidity – against which collateral needs to be pledged – does not insure against credit risk. That's why governments' decisions to pledge their own balance sheets by guaranteeing emergency loans originated during the pandemic have been so important (more on that below). A key benefit of a state guarantee on a loan is not only that it provides effective support if the borrower defaults, but that it also protects the banks' capital ratio. This complements the monetary policy liquidity support measures and has been one of the factors behind the expected easing in credit standards (Exhibit 2).

Another line of action was to ramp up asset purchases programmes (APP) to help market stabilisation and reduce geographical fragmentation. The ECB first opted for an increase in the envelope of its main purchase programme by €120bn until the end of the year, before announcing the creation of the Pandemic Emergency Purchase Programme (PEPP) with €750bn planned purchases initially, scaled up to €1.35tn more recently. This temporary tool is not subject to the usual constraints faced by the traditional APP – it can deviate from ECB capital keys and issue/issuer limits do not apply. This has facilitated the much larger-scale intervention, while its flexibility has helped to cap the spread and close the volatility across euro area countries (Exhibit 3).

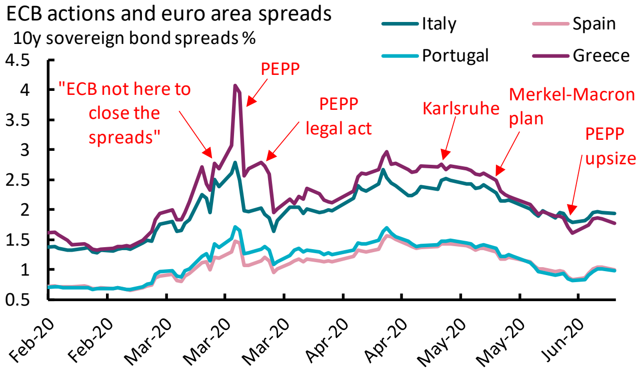
Exhibit 2: Banks' credit standards and public sector support for small and medium-sized enterprises (SME)



Source: ECB and AXA IM Research, June 2020. Note: negative ECB BLS credit standards and positive ECB SAFE access to public financial support mean easier financial conditions.

But financial conditions remain tighter than before the escalation of COVID-19, and a fast depletion of the PEPP envelope and significant deterioration in ECB inflation forecasts called for further action. At its June meeting, the ECB surprised positively by announcing a larger-than-expected €600bn top-up of the PEPP and a six-month extension of the programme to June 2021. At the recent pace of purchases – around €5.6bn per day on average over the past four weeks – the ECB would exhaust this new quantum by March 2021. This suggests that the Governing Council probably expects some "peace and quiet" to return to markets once the worst of the pandemic is behind us, allowing a slower pace of asset purchases. But we suspect the June 2020 Governing Council meeting will not be the last one to "top up" the PEPP – a further increase at the September or December meeting is likely.

Exhibit 3: PEPP capping the spread and closing the vol



Source: Bloomberg and AXA IM Research, June 2020

Another positive decision at the June meeting was the pledge to reinvest PEPP proceeds until at least the end of 2022, and in any case to avoid "interference with the appropriate monetary policy stance". This provides quite a lot of visibility to markets on loose policy accommodation for a long time. But key questions remain.

What is the horizon of the PEPP and what happens next? As emphasised by the ECB, the PEPP is a temporary tool to fight the pandemic shock and its disinflationary effect – it should stop when inflation returns to its pre-Covid-19 path, around mid-2021. The ECB will then have to transition from Covid-19 fighting to dealing with much depressed medium-term inflation outlook. According to the ECB's forecasts, inflation would still be significantly below target (0.8% and 1%yoy in the second and third quarters of 2021 respectively), which would call for the traditional asset purchase programme to pick up the baton.

This does not come without difficulties, especially since the German Constitutional Court ruling highlighted the crucial importance of the 33% issue/issuer (from which Germany is already very close to). But despite likely hiccups on the road, we expect the ECB to raise the issue/issuer limit to closer to 50% during the course of 2021, and thus to maintain its role of "buyer of last resort". In 2020, the enlarged PEPP envelope will almost fully absorb the heavy debt issuance related to COVID-19. Preliminary estimates for 2021 signal that ECB asset purchase programmes could cover the net issuance related to deficits of around 4-5% of GDP – a non-negligible support to euro area governments.

EU response: Big political signal, small immediate economic effects

The European Union (EU)'s initial response to the COVID-19 shock was slow, small and lacked a mutualisation component, reflecting persistent divergence across member states. It started with a three-legged approach of €540bn. This represents around 5% of euro area GDP if all instruments are fully used, but they won't be - as we show below.

The first safety net, called Pandemic Crisis Support (PCS) is a European Stability Mechanism (ESM) credit line with little conditionality (spending merely needs to support domestic financing of direct and indirect healthcare), a long maturity (maximum 10 years), a low interest rate (around 0.1%) and is available until the end of 2022 and capped at 2% of member states' GDP - €240bn in total. It is already fully operational, and all euro area countries are eligible, but based on current 10-year government bond yields, only 10 would benefit from using the scheme. Assuming all 10 countries request the full amount available (2% of 2019 GDP), total ESM disbursements would amount to €74bn – far from the €240bn headline. But none, except Cyprus, has expressed interest in applying for it. It seems that so far, the political stigma attached to an ESM support request – dating back to the sovereign crisis and heavy conditionality – tends to offset the gains, which are small anyway (Exhibit 4) from lower interest payments. Spain has currently rejected the idea, while Italian Prime Minister Giuseppe Conte said that such a request should be put in front of the country's Parliament, where the issue is highly divisive. We believe that Italy will eventually activate the credit line, although the recent compression in spread as a result of ECB actions and EU Next Generation proposal has made the case for ESM recourse less compelling.

The second safety net announced by the EU is the Support to mitigate Unemployment Risk in an Emergency (SURE) mechanism. It provides loans to member states of up to €100bn by covering part of the costs related to the creation or extension of national short-time working schemes. Politically less toxic than the PCS, Italy and Spain have already shown interest in this scheme. But like the PCS, the programme is too small to lead to meaningful savings in interest costs. In addition, it is not yet available as all member states need first to provide direct irrevocable callable guarantees to the EU, amounting to €25bn. It is unclear when this will be finalised.

The third safety net is a pan-European guarantee fund of €25bn from the European Investment Bank (EIB), which could support €200bn of financing for companies with focus on SMEs. The structure and financing of the fund were approved by the EIB board at the end of May, but contributions are pending. The tool will be operational only when member states accounting for at least 60% of the EIB capital have signed their contributions agreements.

Exhibit 4: Small gains from using the EU safety nets

	Max. amount available under PCS	10y Spread as of June 15	Maximum interest gains from using different mechanisms of support				
	€ bn	Basis point	PCS	EIB*	SURE**	Total	Total
			€ mn				% GDP
Belgium	9.5	39.4	37.3	26.8	6.3	70.4	0.01
Germany	68.7	0.0	0.0	0.0	0.0	0.0	0.00
Ireland	6.9	56.3	39.1	28.1	6.6	73.7	0.02
Greece	3.7	177.0	66.4	47.6	11.1	125.1	0.07
Spain	24.9	99.9	248.8	178.6	199.8	627.3	0.05
France	48.4	39.9	193.0	138.6	79.8	411.4	0.02
Italy	35.8	194.0	693.6	498.0	388.0	1579.6	0.09
NL	16.2	20.0	32.5	23.3	5.5	61.3	0.01
Austria	8.0	28.5	22.7	16.3	3.8	42.8	0.01
Portugal	4.2	98.3	41.7	30.0	7.0	78.7	0.04

*Note: * Assuming the EIB financing is allocated at the prorate of the country share in EU GDP. ** Assuming Italy, Spain and France get €20bn each, while the €40BN left would be allocated according to the country share in EU GDP.*

Source: Eurostat and AXA IM Research, June 2020

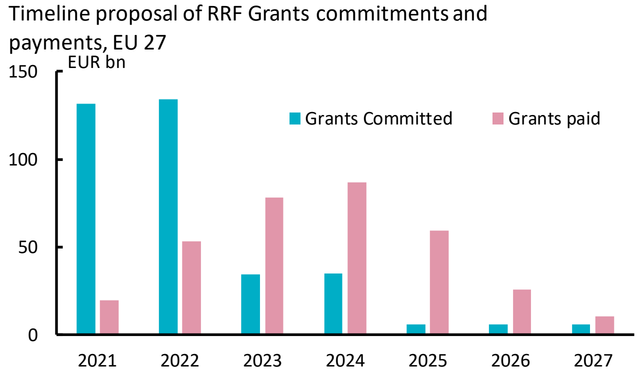
So out of the three instruments agreed by the EU Council in April, only one is operational and it is the one which meets most resistance by member states. Focusing on loans, none of these instruments is helping to share the fiscal burden of the COVID-19 shock.

We had to wait for mid-May to see a change in momentum with the Franco-German proposal, followed by the European Commission plan. The Next-Generation EU package envisages long-term EU borrowing to finance €440bn of grants, €250bn of loans, and €60bn of guarantees. Joint debt issuance and fiscal transfers constitute a very significant breakthrough from a political point of view, especially as the former was a red line for Germany. It is helping to restore trust in Europe and to abate fragmentation risks.

But beyond the positive sentiment effects of the EU crossing a "mutualisation" Rubicon, here again we believe the numbers of the specific package are too low and the process too slow. Totalling around 5% of EU GDP spread over at least six years, the Next Generation EU programme does not have a massive cyclical stabilisation capacity. The Recovery and

Resilience Fund (RRF), accounting for €560bn (€310bn in grants and €250bn in loans) is the biggest element of the fiscal stimulus. But according to the Commission's regulation proposal, the process to get funding could be quite bureaucratic and lengthy. Governments would have to wrap the various projects up for funding in a "Recovery and Resilience plan" in which they would have to show how the intended measures would contribute to dealing with the economic and social consequences of the pandemic crisis, with due respect to the green and digital transitions. The Commission would have the power to reject those plans, as well as suspending payments if pre-agreed milestones are not met. This sounds like a slow-moving machine.

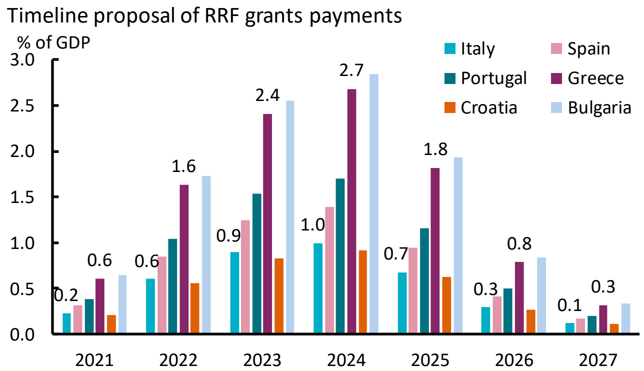
Exhibit 5: Commitments front-loaded but disbursements delayed



Source: European Commission and AXA IM Research, June 2020.

Furthermore, the Commission's documents suggest a very slow lift-off (Exhibit 5). Commitments would be front-loaded – the proposal shows that around 75% of the RRF grants would be agreed in the 2020-2022 period. But only about 21% of them would be spent during that time. Italy would receive only €4bn in grants in 2021, less than 0.2% of its GDP (Exhibit 6). This is puny compared with the severity of the ongoing recession. Also note that the proposed allocation key (subject to discussion in the coming weeks) contains no variable representing the severity of the pandemic impact or the scale of ongoing contraction in activity, leaving a country such as Bulgaria receiving a stronger boost (in terms of GDP) than Italy.

Exhibit 6: RRF beneficiaries: Look South and East



Source: European Commission and AXA IM Research, June 2020.

The symbolism of the Next Generation EU package is hugely important but its ability to fight the current downturn seems limited. National governments will have to bridge the gap on their own before federal support becomes available. Only Germany has advanced in this way.

National fiscal impulse: Hoping for a shift from damage control to demand stimulus

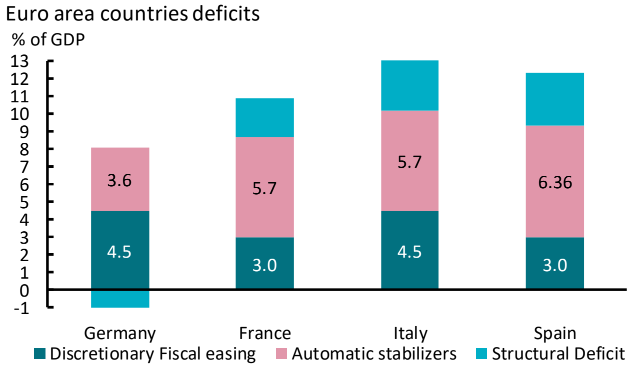
Our euro area growth forecast sees GDP contracting by 7.1%yoy in 2020, before rebounding by 5.9% in 2021. This means that GDP in the fourth quarter of 2021 will be 4% lower than it would have been without COVID-19. On the way we would have lost 6% of cumulative GDP. This calls for massive fiscal stimulus. Indeed, fiscal multipliers – i.e. the growth return for every 1% of GDP of discretionary easing – are assumed to be around 0.7 and would imply that a fiscal impulse of about 9% of GDP is needed to offset permanent income loss. We are far from there.

Most euro area countries' fiscal responses were announced during the early phase of the COVID-19 crisis from March to the beginning of April and focused on emergency support measures. At that time, governments opted for a broadly similar mix of policies, including support for job and income losses (mainly through enhanced short-time working schemes), support to corporates via liquidity measures (credit lines, state guarantees programmes) and some boost to health expenditures. But the sizes of the national fiscal packages differed – at the end of March, the €25bn "Cura Italia" decree (1.2% of GDP) paled in comparison to the German €156bn (4.7% of GDP) supplementary budget.

Further fiscal support has been announced since then, but asymmetries in terms of size have not been corrected, while fresh asymmetries around composition have emerged. We estimate that euro area discretionary stimulus (excluding automatic stabilisers and liquidity support measures) is close to 4% of GDP – well below the required 9% we mentioned above – and ranges from about 3% of GDP in France and Spain to 4.5% in Italy and Germany (Exhibit 7). But the later number should be put into perspective: Italian growth is expected to tumble by 9.3%yoy in 2020, but the German contraction in GDP is expected to 'only' be 5.2% lower. Fiscal support in Italy should thus be much higher than in Germany.

Moreover, Italy's stimulus is still focused on "backstopping the economy" – more than half of the €55bn Relaunch Decree (3.3% of GDP) is targeting short-time working scheme, self-employed bonus payments and corporate liquidity support. Meanwhile, Germany is shifting to demand stimulus with its latest €130bn package (3.8% of GDP). Not all of it will be spent in 2020, but there is a welcome mix of short-term support – via a temporary three percentage point (ppt) decline in VAT off the normal rate (two ppt for the reduced rate) and one-off payments to families – and more structural, longer term incentives to investment programmes supporting the green and digital transition. The VAT cut alone would bring €20bn to the economy (1.2% of GDP over the second half of 2020) – not an unsubstantial boost for an economy which so far has done comparatively well through the pandemic shock.

Exhibit 7: Euro area fiscal stimulus



Source: European Commission and AXA IM Research, June 2020

We are still waiting for the response of the other member states. This is becoming ever more pressing as some flagship measures of the "emergency response" are temporary. The generosity of the short-time working scheme *chômage partiel* has already been reduced in France, while there are ongoing tense discussions in Spain on the length of another extension of the furlough scheme (government is offering a three-month extension, employers and unions are calling for a six-month one). We need to hear quickly about a more sustained fiscal push. But most countries do not enjoy the low debt level and general credibility of Germany. Therefore, the quantum of support other members will be able to provide beyond the emergency measures is very dependent on the conviction that debt sustainability conditions are not jeopardised. This brings us back of course to the fundamental role of the ECB.

Credit backstops: Monetary and fiscal synergies

We acknowledge that many states have provided large state-guarantee lending schemes. These are not deficit-raising at this stage – though they might be in the future if loans are not repaid. But they are a key part of euro area policy support – nearly 20% of euro area GDP has already been committed to loans guarantee schemes to reduce banks' credit risk and support the corporate sector. As emphasised in the latest ECB Financial Stability Review, beyond the differences in the schemes design (covering 86% of NFC loans in Germany vs. just 23% in Spain) what will matter for the efficiency of the schemes are the take-up and the speed at which these loans are made available.

Exhibit 8 provides a summary that shows that while the take-up of new loans has been relatively moderate in Germany at roughly 5% of the outstanding NFC loans, it is more than triple in Spain, where the envelope is also lower. This makes sense as Spain is facing a sharper economic contraction than Germany, while Spanish NFCs are more indebted (72.8% of GDP vs. 51.5% of GDP) and SMEs play a more prominent role (60.9% of value added in the non-financial business economy vs. 54.7% in Germany).

Exhibit 8: Credit guarantee schemes parameters and take up: Italy stands out

Parameters of loan schemes vary significantly across countries

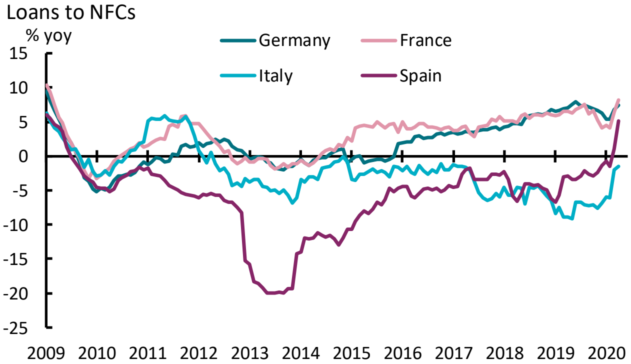
		Germany	France	Italy	Spain
Size of guarantee	€ billions	822	300	450	100
	% of 2019 GDP	23.9	12.4	25.2	8.0
	% of bank assets	9.9	3.2	12.1	3.7
	% of NFC loans (stock)	86.0	28.4	71.3	23.0
Pricing of guarantee		In line with EC framework	In line with EC framework	Partly free, partly with cost to firm	20-120 bps paid by banks
Share of loan guaranteed		80%/90%, limited amounts up to 100%	90%/80%/70 % depending on firm turnover	From 70% to 90% for new loans, limited amounts up to 100%	80% for SMEs & self-employed. 60-70% for large NFCs
Max. amount per borrower		25% of 2019 turnover	25% of 2019 turnover	Up to 25% of 2019 turnover or 2x annual wage bill	Up to 2x last annual wage bill or 25% of 2019 turnover
Eligibility criteria		Different for different schemes; in line with EC framework	In line with EC framework (company not in insolvency proceeding as of 31 Dec. 2019)	Different for different schemes; in line with EC framework	In line with EC framework
Loans approved	€ billions	47.8	101.1	13.1	69.0
	% of NFC loans (stock)	5.0	9.6	2.1	15.9
	% of envelope	5.8	33.7	2.9	69.0

Source: ECB Financial Stability Review, KFW, ICO, MISE, French Ministry of finance and the economy and AXA IM Research, June 2020

But Italy clearly stands out, with a low take-up and slow delivery. Despite generous parameters, this is probably driven by banks' uncertainty in their responsibility in assessing the sustainability of the new loans and debt. The Bank of Italy reports that approved guaranteed loans to SMEs amount to only €13.1bn as of May 19, 2020, while €18.5bn are reportedly in the pipeline.

With less access to borrowing (Exhibit 9), Italian businesses failed to build up additional liquidity buffers. In April the outstanding level of their cash reserves had risen by only 2.1% relative to their pre-pandemic level, against 14.3% in France. This highlights the risk of impaired monetary policy transmission and could affect the speed of the rebound upon exiting the lockdown.

Exhibit 9: NFC loans by country: Italy lagging behind



Source: ECB and AXA IM Research, June 2020

Looking to the next stage

The ECB is leading the European response to the pandemic. Its proactiveness and flexibility since the beginning of the COVID-19 crisis has been a positive surprise. Via generous liquidity measures, easier collateral requirements, an increase in APP and creation of the PEPP, the ECB has overcome some of its constraints and helped to maintain a smooth credit flow to the private sector, stabilise markets and reduce fragmentation risks.

The road ahead will likely be bumpy, with an August deadline from the German Constitutional Court and a necessary increase in issue/issuer limits in 2021, but we expect the ECB to maintain its buyer of last resort role.

The Next Generation EU package is also a genuine step forward. Joint debt issuance, fiscal transfers and proposed joint tax revenues are politically meaningful – the EU is crossing many former red lines. But the size of the package is too low, at around 5% of EU GDP, and the process too slow to be a proper cyclical-stabilisation tool. According to the proposal, stimulus would peak only in 2023-24.

In the meantime, national governments will remain on the hook. Fiscal responses should move from damage control to demand stimulus – Germany is leading the way, but other governments remain in "backstop" mode. They will hesitate to emulate Germany if they consider their debt sustainability conditions are jeopardised. This brings us back to the central role of the ECB. Overall, fiscal stimulus stands at around 4% for the Eurozone this year. More is needed to offset the COVID-19-induced permanent income loss.

Our Research is available on line: http://www.axa-im.com/en/insights

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
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