EXECUTIVE BOARD MEETING

SM/20/173
Correction 1

December 18, 2020

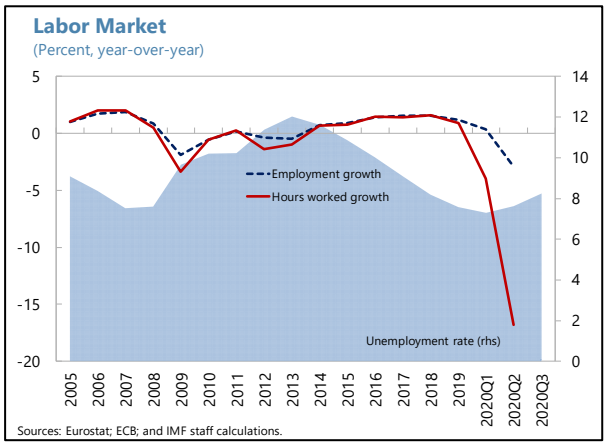
To: Members of the Executive Board

From: The Secretary

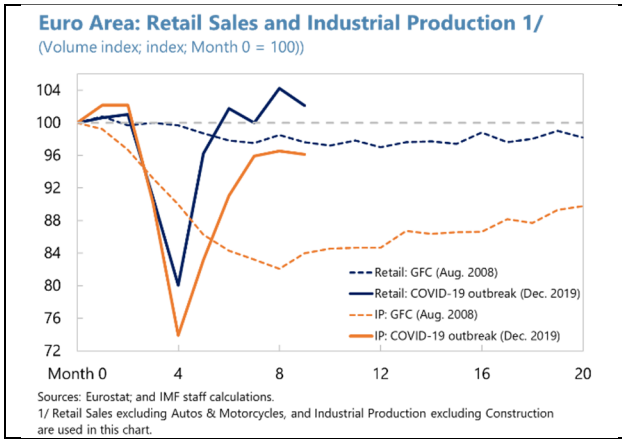
Subject: **Euro Area Policies**

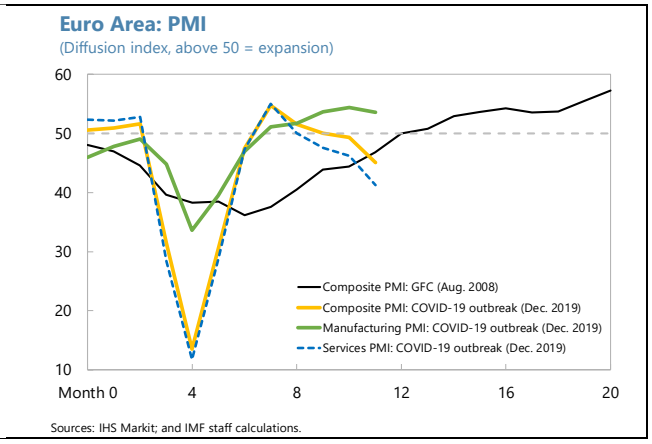
Board Action:	The attached corrections to SM/20/173 (12/4/20) have been provided by the staff:
Evident Ambiguity	**Pages 7, 9, 12, 13 (Box 1, first para.; third para., line 3; fourth para.; charts; footnotes 1 and 2), 15, 20 (para. 30), 27 (chart), 28 (Box 4, first chart; first para.), 29, 31 (chart), 35 (Box 5 second chart), 39**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 8, 13 (Box 1, third para. line 1), 20 (para. 31), 25 (para. 48, line 10), 26 (para. 48), 27 (para. 54 and 55), 30 (para. 62, first bullet, line 1)**
Typographical Errors	**Pages 14, 24, 25 (para. 48, line 3), 26 (para. 50), 28 (Box 4, footnote 1), 30 (para. 62, first bullet, line 4), 31 (para. 63), 33, 35 (Box 5, third para.)**
Questions:	Mr. Balakrishnan, EUR (ext. 35590) Mr. Klein, EUR (ext. 36706) Mr. Jobst, EUR (ext. 38736)

6. Despite the historic economic contraction, the unemployment rate has increased only modestly thanks to widespread use of job retention schemes. The extensive use of short-time work programs, which provide income support on reduced working hours while maintaining worker-employer ties, has been particularly effective in facilitating an unprecedented adjustment in hours worked without accompanying job destruction. Indeed, so far in 2020, the euro area unemployment rate has only increased by one percentage point to 8.4 percent (October, seasonally adjusted). By comparison, the U.S. unemployment rate has increased by about 3½ percentage points during the pandemic. The recent decline in the participation rate, which partly reflects labor market stress and the related exit of discouraged workers from the labor force, also dampened the increase in the euro area unemployment rate.



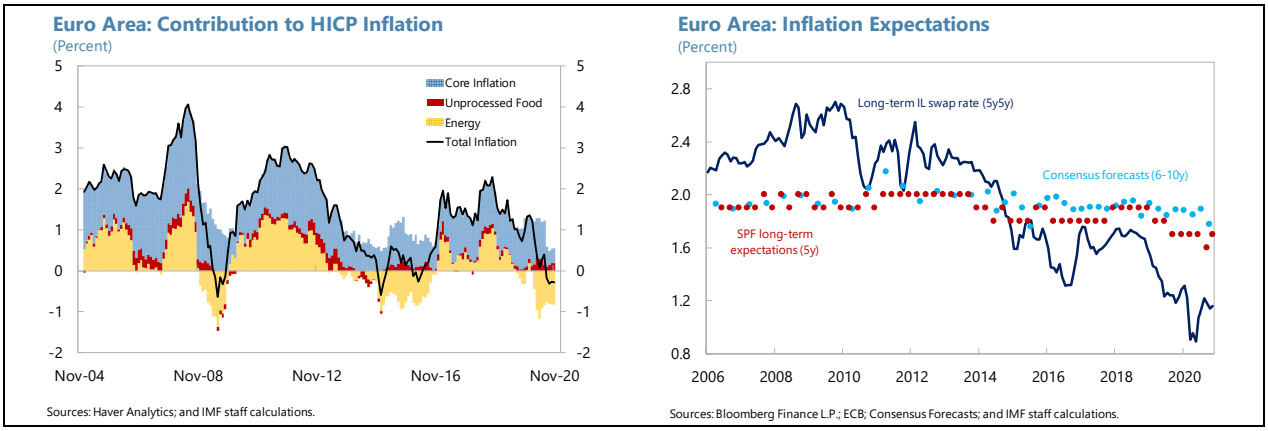
7. High-frequency indicators suggest that the economic recovery has lost momentum in 2020Q4. After several months of modest expansion, the composite PMI shifted into contractionary territory (November) as activity in services further deteriorated amid rising infections. Manufacturing continued to expand, however, albeit at a slower pace. While retail sales have rebounded to above pre-crisis levels, mobility indicators have shown a decline following the re-imposition of lockdowns. Economic sentiment indicators continue to be weak, with consumer confidence deteriorating in October and November.



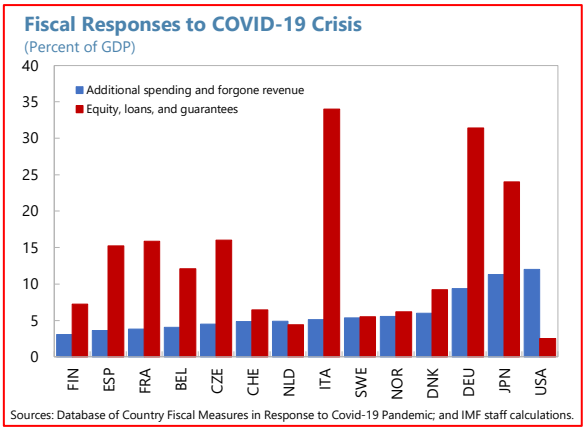


8. Inflation has fallen into negative territory for the first time since early 2016. The initial decline in headline inflation from 1.4 percent (y/y) in December 2019 to 0.1 percent in May mainly reflected a steep drop in energy prices. In recent months, headline inflation has descended into negative territory (-0.3 percent, November) as temporary factors such as Germany's temporary VAT cut came into play. The recent euro appreciation has also contributed to disinflation pressures. While remaining broadly stable at just above 1 percent in the first seven months of the year, core

inflation (HICP excluding energy and unprocessed food) weakened sharply to a record low of 0.4 percent in recent months. Meanwhile, market-based long-term inflation expectations have partly recovered from the initial effects of the crisis but remain well below their historic averages.



9. National fiscal policies have provided critical support for workers and firms, markedly dampening the socio-economic impact of the crisis. Alongside large automatic stabilizers (worth about 5 percent of GDP), the discretionary fiscal response has been both rapid and sizable, with above-the-line measures worth over 5 percent of euro area GDP overall, ranging from ~~2.6~~3.1 percent of GDP in ~~France~~ Finland to 9.4 percent of GDP in Germany. Measures include increased health spending, expanded or new short-time work schemes, and temporary tax cuts and/or deferrals for workers and firms. Governments have also provided substantial financial support to firms and offered guarantees for bank lending to businesses. These commitments could exceed 20 percent of euro area GDP if all guarantees were called. There is little evidence so far that differences in countries' capacities to provide state aid to their firms have created an unlevel playing field. In particular, take-up rates of financial support for firms have been lower in countries that have announced some of the largest packages (e.g., Germany).

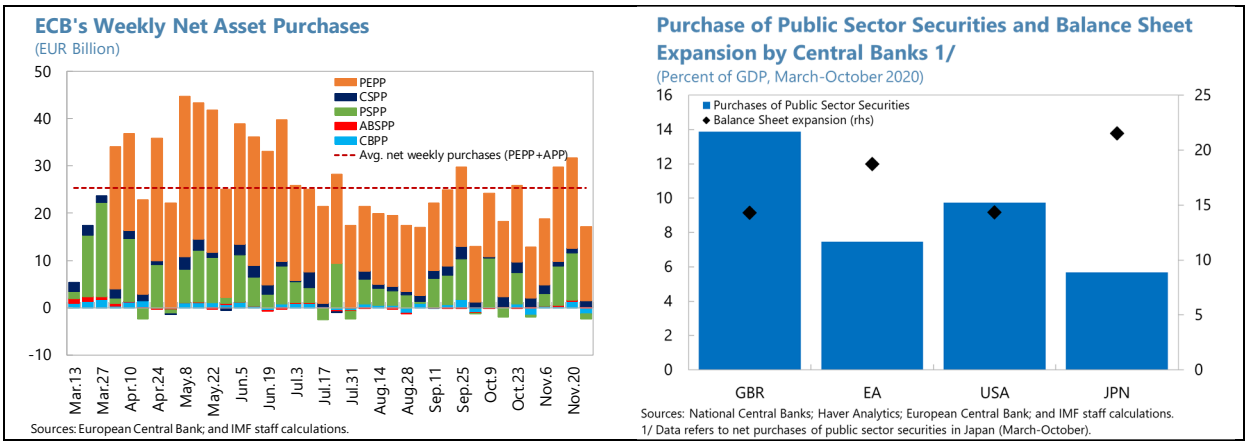


10. National fiscal responses have been supported by a rapid and sizable EU response aimed at providing flexibility and financing to countries. In March, the EU moved quickly to support countries by providing greater flexibility in their use of EU funds to combat the pandemic (Coronavirus Response Investment Initiative Plus), and by activating the escape clause in the fiscal rules and temporarily allowing state aid to firms. This was followed in May by a package of financing support worth over 4 percent of EU27 GDP (table). The EU has moved quickly to implement the package, already approving €87 billion in loans from the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE) to support countries' short-time work schemes. Finally, in July, the European Council reached an historic agreement on the €750 billion Next Generation EU (NGEU) package. Once legislated, this will provide grants and loans to EU members over the next few years to help accelerate the recovery.

Available and Potential EU Support

SURE	European Investment Bank	European Stability Mechanism	Proposed Recovery Fund "Next Generation EU"
✓ Temporary Support to mitigate Unemployment Risks in an Emergency (SURE) ✓ Provides loans to Member States of up to €100 billion ✓ Cover part of the costs related national short-time work schemes and other similar measures.	✓ A Pan-European Guarantee Fund that will enable EIB to scale up on-lending to SMEs, mid-caps, and corporates by up to €200 billion ✓ Resources are expected to be deployed until end-2021, with a possible extension till end-2022.	✓ A Precautionary credit line (Pandemic Crisis Support) with access of up to 2 percent of member states' GDP to cover direct and indirect health expenses ✓ Simplified process, lowered fees, light monitoring, no conditionality ✓ All euro area countries are eligible	✓ Temporarily lifting the own resources ceiling to 2 percent of EU GNI ✓ Joint debt issuance of €750 billion, of which €390 billion will be disbursed as grants and the rest as loans ✓ This funding would be paid back from future EU budgets in 2028-58 with new own resources including new EU-level taxes.

11. The ECB has responded forcefully to ease financial conditions and safeguard monetary transmission. As the severity of the crisis became apparent, the ECB adopted a series of measures to support confidence and avoid an adverse feedback loop between the financial system and the real economy. This included topping up the asset purchase program (APP) by €120 billion in 2020 and introducing a new pandemic emergency purchase program (PEPP) with an initial envelope of €750 billion, almost half of which was deployed within the first three months. Given its extensive use, PEPP was later augmented to €1.35 trillion and its minimum expected horizon for net purchases was extended by half a year to mid-2021 (Table 2). PEPP's flexible design, which allows purchases of sovereign securities at shorter maturities and with lower credit quality, than under the APP has helped stabilize markets and enabled a substantial easing in the monetary policy stance. The ECB has also relaxed collateral requirements and provided substantial liquidity to the financial sector through targeted and untargeted long-term financing operations (LTROs).[1] This, together with the sizable expansion of asset purchases, contributed to a sharp expansion of its balance sheet, on par with those of central banks of other large advanced economies.



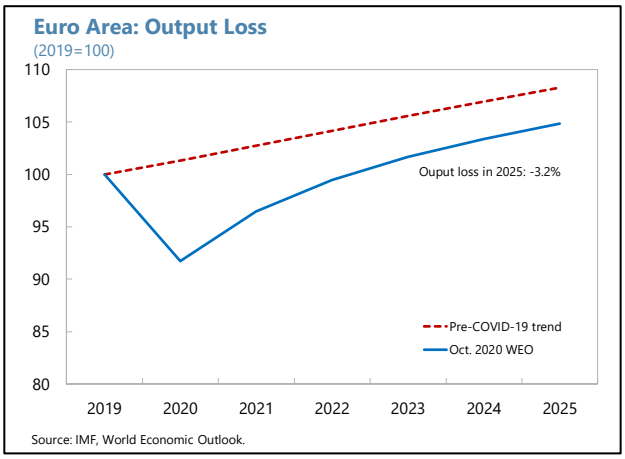
[1] Liquidity provision under the June targeted long-term refinancing operations (TLTRO) registered the highest amount to date, with 742 banks participating for a total of over €1.3 trillion, of which €548 billion was fresh liquidity. The strong demand for liquidity continued in the September allotment, although the net uptake was significantly lower at €158 billion.

2021, with almost all demand components growing even as precautionary saving continues and private investment is muted given continuing elevated uncertainty. Sluggish global demand is projected to weigh on export-oriented economies, with both imports and exports recovering only slightly in 2021. At the end of 2021, real GDP is projected to remain below its end-2019 level.

17. Notwithstanding the waning of temporary supply-side effects, inflation is expected to remain subdued. The collapse in aggregate demand in 2020 is projected to exceed the fall in potential output, resulting in a sizable output gap and downward pressures on prices. Combined with a drag from negative energy price growth and other temporary factors (e.g., the German VAT cut), this will drive down average headline inflation to just above zero in 2020. Average core inflation is also projected to hit an historically low level of below one percent in 2020. In 2021, headline inflation is expected to recover gradually as some of the temporary disinflationary effects fade, but average core inflation is projected to remain broadly unchanged due to the high degree of inflation persistence in the euro area.

Medium-term Prospects

18. The gradual recovery will likely leave permanent output losses relative to the pre-crisis trajectory, with inflation remaining low. Sluggish growth in private consumption and investment from 2022 onward will drag on the recovery. The contribution of net exports to growth is projected to remain broadly neutral over the medium term, despite a modest recovery of exports. Reflecting long-term scarring effects on potential growth, output is expected to remain well below its pre-COVID trend throughout the medium term. Given a high degree of inflation persistence and a flat Phillips curve, inflation will only gradually pick up with the recovery, and is forecast to remain well below the ECB's medium-term aim throughout most of the projection horizon.

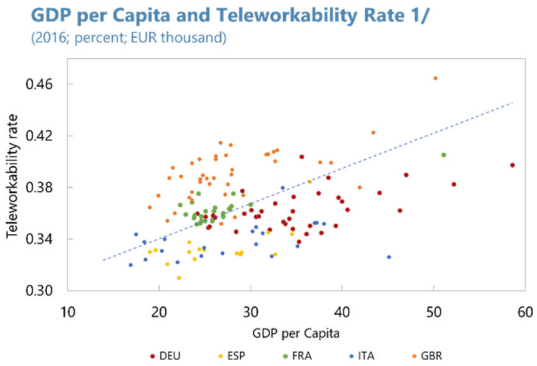


19. The pandemic is expected to exacerbate regional disparities and inequality in the euro area. Following the GFC, disparities across countries and across regions within the same country have sharply increased—mainly due to divergences in employment rates and productivity—reversing the pre-GFC downward trends. These patterns will likely be amplified by the current crisis as the pandemic and the lockdown measures are disproportionately ~~affecting~~ impacting workers in ~~nonessential~~ highly affected sectors, who are more likely to be young and lack the liquidity buffers needed to weather the crisis. Moreover, the income gaps faced by poorer regions, which already confront formidable structural challenges, are likely to further increase given their higher share of non-teleworkable jobs (Box 1).

Box 1. The COVID-19 Crisis and Its Potential Impact on Regional Disparities and Inequality

The COVID-19 crisis ~~has the potential~~ is likely to exacerbate disparities across geographic areas and across workers. With persistent social distancing and continued containment and mitigation measures, the impact on contact-intensive (e.g., tourism sector; transport) and some other sectors ~~and "nonessential" sectors~~[1] is likely to be more severe, resulting in disproportionate effects on some regions and segments of the euro area population, despite the exceptional policy support deployed by the authorities.

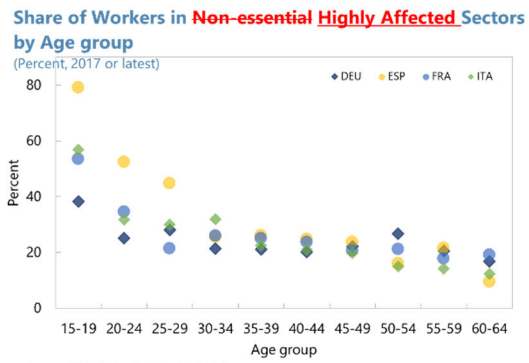
European regions with lower GDP per capita and subdued economic performance prior to the pandemic appear to be more exposed to the effects of the crisis. These so-called *laggard* regions are characterized by a disproportionally higher share of contact-intensive sectors, large dependency on SMEs, lower productivity, and lower shares of employment in teleworkable occupations. These large structural differences could exacerbate existing regional disparities across regions as well as within and between countries.



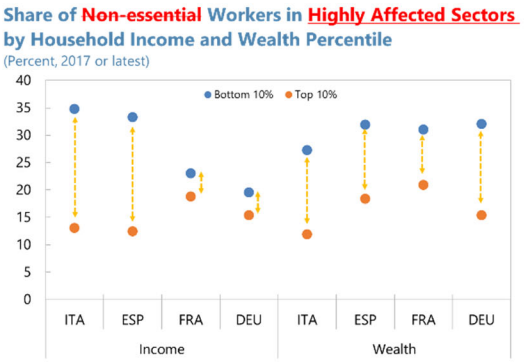
Sources: Eurostat; OECD - PIAAC Survey of Adult Skills; and Dingel and Neiman (2020).
1/ Each data point refers to a NUTS 2 region.

The pandemic also has the potential to exacerbate intergenerational ~~inequities~~inequality. At the household level, the young and poor appear to be hit doubly hard. First, young workers are more likely to be employed in ~~nonessential~~ highly affected[1] and non-teleworkable sectors,[2] which were hit hardest by the containment measures. Second, younger workers are concentrated in the lower quintiles of both income and wealth distributions. This lack of buffers will undoubtedly hinder their ability to weather the crisis, especially if the recovery is delayed. These same households also experience more credit constraints. Women, especially those aged 25 or younger, experienced a larger employment loss than men, even though several indicators of employment risk suggest that they were not more vulnerable prior to the crisis.

Disproportionality varies greatly across countries. Among the four largest economies in the euro area, the gap in the share of ~~nonessential~~ highly affected workers between the top 10 percent and the bottom 10 percent in the income distribution reaches almost 20 percentage points in Italy and Spain but less than 5 percentage points in Germany and France. The wealth gap is more homogenous across these four countries, with those in the bottom 10 percent of the wealth distribution more likely to work ~~nonessential~~ highly affected sectors.



Sources: ECB HFCS; and IMF staff calculations.



Sources: European Central Bank HFCS; and IMF staff calculations.

1/ The selection of highly affected ~~nonessential~~ sectors is largely based on the OECD's classification of nonessential sectors. Those include construction, wholesale and trade, accommodation and food services, real estate, arts and entertainment, certain manufacturing, and transportation.
2/ There is some overlap between ~~nonessential~~ highly affected and contact-intensive or non-teleworkable sectors. However, some contact-intensive sectors such as healthcare, food related, early and special education are considered essential.

Text Table. Euro Area: Main Economic Indicators, 2019–25
World Economic Outlook (October 2020), Percent

		Projections					
	2019	2020	2021	2022	2023	2024	2025
Real GDP growth	1.3	-8.3	5.2	3.1	2.2	1.7	1.4
with contributions from (ppt):							
Private consumption	0.7	-5.0	2.9	1.7	1.0	0.8	0.7
Public consumption	0.4	0.4	0.2	0.1	0.2	0.2	0.2
Gross fixed investment	1.2	-2.6	1.6	1.1	0.7	0.5	0.4
Net exports	-0.5	-1.0	0.5	0.3	0.2	0.1	0.1
Current account (%GDP)	2.3	1.9	2.4	2.5	2.5	2.6	2.5
Unemployment rate	7.6	8.9	9.1	8.4	7.9	7.7	7.6
Potential GDP growth	1.3	-3.2	3.1	1.4	1.2	1.3	1.2
Output gap	0.2	-5.1	-3.2	-1.6	-0.6	-0.2	0.0
Inflation	1.2	0.4	0.9	1.2	1.4	1.6	1.7

Source: IMF, *World Economic Outlook*.

B. Substantial Known and Unknown Risks

20. Risks to the outlook are sizable and their impact depends materially on the policy response. Finding the right balance between measures to contain the pandemic and those aimed at supporting the recovery is extremely challenging given the extraordinary degree of epidemiological uncertainty. Yet the robustness of the recovery will depend critically on how effective policies are at mitigating the economic damage of containment measures in the near term while facilitating the necessary economic restructuring and reallocation of resources across sectors and regions over the medium term. Providing insufficient fiscal support, delays in implementing the NGEU recovery package, or withdrawing support too early would weaken the recovery.

21. Output growth is expected to be lower through ~~2020Q1~~ 2021Q1 than projected in the October *WEO* but may rebound beyond then in light of recent promising news on vaccine development. The greatest risks remain further major resurgences of infections in the near term and delays in developing or distributing effective vaccines and therapies (Risk Assessment Matrix, Table 4). These would result in deeper scarring effects, a slower recovery, and a further output loss. Even if the virus is contained in euro area countries, a widespread outbreak in key trading partners would significantly lower external demand and undermine growth prospects. A longer and deeper-than-expected crisis would exacerbate scarring, and potentially lead to social discontent, especially if vulnerable groups are left behind.

- **Households**. Short-time Work Schemes (STWs), wage subsidies, and payroll tax relief have helped prevent a massive increase in unemployment. However, if the crisis drags on, more layoffs and a substantial increase in unemployment are inevitable. Absent policies to facilitate a rapid reallocation of workers, significant labor market hysteresis is likely, which could be a drag on productivity growth for years and may result in higher poverty rates and inequality in Europe. Household income losses could also result in sizable mortgage defaults, home foreclosures, and downward price pressures on residential properties.

- **Nonfinancial corporate sector**. With a prolonged crisis and support measures expiring, firms' liquidity problems could morph into credit defaults, while delays in insolvency proceedings and inefficient bankruptcy procedures in some countries will stifle the recovery (Box 2). Higher corporate debt also exposes firms to more market volatility and changes in financial conditions and could potentially result in adverse macro-financial feedback loops.
- **Banks**. The sharp deterioration in asset quality given rising bankruptcies, mortgage defaults, and falling property prices could result in sizable capital shortfalls and higher risk aversion, potentially impairing the lending channel with concomitant feedback effects. While banks are likely to benefit from favorable funding conditions, structurally low profitability combined with a slow recovery and adverse market conditions will constrain their ability to rebuild capital buffers or raise fresh capital, markedly reducing their resilience to future shocks.

22. The crisis has exacerbated fiscal vulnerabilities. Debt levels have risen considerably in all euro area countries and are expected to remain above or close to 2019 levels for the foreseeable future in most countries. While helping to mitigate the immediate pandemic impact, the provision of government loan guarantees and other liquidity support has created potentially sizable contingent liabilities—averaging around 20 percent of GDP in euro area countries with government debt already above 100 percent of GDP. The current favorable financing conditions are helping governments finance large deficits and rollover needs this year and next. However, countries' budget plans were drafted without accounting for a major second wave, suggesting deficits in 2021 will be higher than forecast in October, further eroding fiscal space. Larger increases in public debt will leave currently highly indebted sovereigns even more vulnerable. ~~Any~~ Large ~~unexpected~~ changes in market perceptions could threaten the ability of high-debt countries to roll over and service public debt. Moreover, if a prolonged crisis were to undermine the solvency of the banking sector, this could lead to pressure on sovereigns to bail out their banks, which for some countries could precipitate a spike in sovereign borrowing costs.

23. Brexit and trade tensions remain significant risks to the recovery. Gaps on key issues remain between the U.K. and EU27 in defining their future relationship. Moreover, the U.K.'s proposed unilateral modification of the Withdrawal Agreement has raised strong opposition from the EU and is perceived to have increased the likelihood of a no-deal Brexit, which could lead to sharp disruptions in trade and adversely affect output when the transition period expires at the end of 2020.[3] ~~While a waiver arrangement~~ Temporary equivalence grants EU-based financial institutions continued access to ~~the~~ U.K. market infrastructures for clearing and settlement services until mid-2022 and mid-2021, respectively; however, there is still no agreement on regulatory equivalence. The latter requires trading of certain liquid derivatives by EU firms- to occur within the EU or jurisdictions that have been granted equivalence, and places any U.K.-based activities of EU financial institutions under the U.K. supervision. Trade tensions with the United States pose additional risks. Even if they abate, tensions with China could grow in the coming years, particularly as the EU seeks to use trade and investment policies to address any industrial subsidies that it thinks distort the single market.

[3] While conditional on specific assumptions regarding financial conditions, border disruptions and immigration policies, staff's analysis suggests that a no-deal Brexit (default to WTO rules) would result in an EU output loss (relative to the baseline) of 0.5 percent within three years and 0.3 percent over the longer term.

30. NGEU funds should be used to accelerate Europe's green and digital transformations. In the near term, using NGEU funds for investments aimed at addressing climate change and increasing digitalization would boost growth by supporting aggregate demand (see October 2020 WEO Chapter 3). Over the medium term, such investments could deliver substantial productivity improvements, especially in countries where productivity growth has lagged. To this end, the European Council agreed that 30 percent of the combined EU budget and NGEU package, or up to €555 billion over 2021–27, should support ~~sustainable development~~ measures, including mitigating climate change. Moreover, the RRF would allocate at least 37 percent of its spending envelope to climate change and 20 percent to digitalization, though countries should aim to exceed these targets given the potential of such investments to raise productivity.

31. However, achieving the EU's emission reduction goals will require combining public investment, more robust carbon pricing, and more ambitious implementation than currently envisaged (Annex I). The Green Deal has raised the EU's ambition in tackling climate change and is the signature policy initiative of the current European Commission. It seeks to reduce EU carbon emissions by 55 percent by 2030 and reach net carbon neutrality by 2050, though many details remain to be determined. ~~One e~~Essential measures for achieving this ~~would be~~ include expanding the Emissions Trading System (ETS) to other sectors and setting a sufficiently binding carbon price floor for the ETS. This will need to be complemented by nonprice policies at the EU and national levels, including regulatory measures (e.g., tighter vehicle emission standards, binding targets for efficiency improvements in buildings) and fiscal support (e.g., feebates incentivizing the purchase of low emission vehicles, means-tested low-interest loans/grants for renovations, making Common Agricultural Policy payments "greener"). In combination, such measures should catalyze sizable investment by the private sector and lead to economic and health benefits for decades to come. It is critical however that transfers be used to protect lower-income households and countries that are more affected by a rising carbon price. A carbon border adjustment mechanism (CBA) may also be needed to help address "emissions leakages" (i.e., production in greenhouse gas-intensive industries moving abroad to avoid paying higher carbon prices and then exporting output to the EU).

National Fiscal Policies

32. Countries draft budgetary plans suggest fiscal policies will remain supportive next year. The draft budgetary plans published in mid-October likely do not fully reflect the fiscal support needed next year given the pandemic's resurgence. However, they already envisioned a slightly expansionary aggregate fiscal impulse, abstracting from the planned expiration of temporary pandemic-related measures. Of course, such temporary measures may need to be extended next year. Much of the October forecast for the improvement in the headline fiscal balance is the result of automatic stabilizers unwinding as growth improves. If 2021 growth is lower than projected in October, then deficits will be larger and debt levels higher.

33. With the resurgence in the pandemic, national fiscal policies will need to provide more broad-based support for longer than initially envisioned. The immediate priority is to contain the pandemic in a coordinated manner, including by ensuring that national health care systems can cope and secure adequate resources for testing, contact tracing, personal protective equipment, and

accommodation will be needed to counteract the pandemic's disinflationary impact and lift inflation expectations. In this regard, the ECB Governing Council's commitment to recalibrate its instruments once the December round of Eurosystem staff macroeconomic projections is available is welcome.

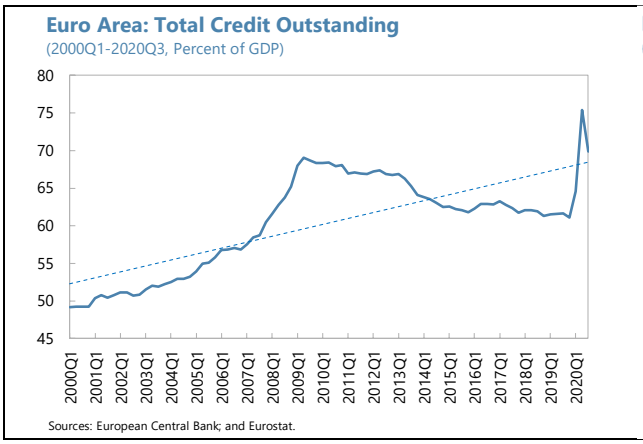
44. An expansion of asset purchases should remain the main tool to offset further disinflationary pressures, but effective communication is critical. PEPP can be further expanded, both in size and duration, to counter possible market fragmentation and the larger medium-term inflation gaps that could emerge.[7] An extended period of asset purchases may face some implementation challenges, however, as evidenced by the recent German Constitutional Court ruling on aspects of the ECB's public sector purchase program. In assessing issues related to the PSPP, the Court stressed the centrality of the ECB's self-imposed safeguards for price formation—including the capital key and minimum standards of credit quality. This underscores the need for effective communication about proportionality assessments that consider the full range of possible effects arising from asset purchases, the rationale for any capital key deviations and expected convergence back to the key, and the planned exit from asset purchases and reinvestment strategies.

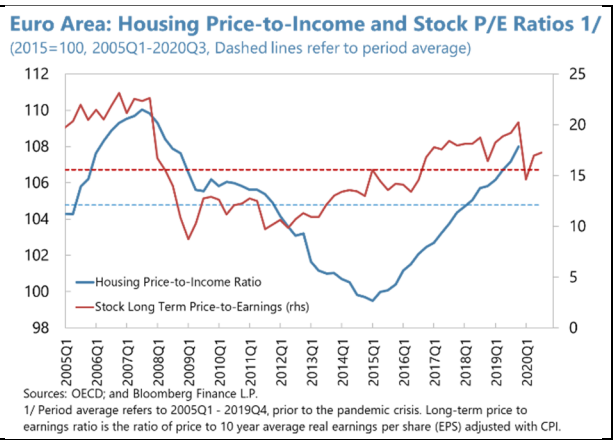
45. Interest rates can be reduced, but the impact of new cuts would likely be limited. The ECB reduced the deposit rate by 10 bps to -0.5 percent in September 2019—the first policy rate cut since 2016. While additional rate cuts seem technically feasible—as most likely the reversal rate has yet to be reached—they may have a limited effect on bank lending in the face of higher credit risk and potentially lower profitability. Adjusting the tiering multiplier and continuing to provide targeted and untargeted LTROs with effective funding costs below the deposit rate could reduce the adverse effects on the lending channel. These measures would need to be backed by forceful forward guidance on the path of the policy rate and the ~~asset purchase programs~~APP, including the reinvestment of principal from maturing securities.

46. The benefits of an accommodative monetary policy stance continue to outweigh possible adverse side effects, although close monitoring is needed. Prolonged periods of unconventional monetary policy (UMP) can fuel financial stability risks, including by inflating asset prices and increasing risk taking by banks. Indeed, financial stability risks—while not excessive—were building up in some areas prior to the crisis, requiring continued close monitoring and proactive use of macroprudential tools to address segments of risk. Moreover, despite concerns about the pernicious effects of UMP on the distribution of income and wealth, evidence suggests that these effects were negligible in the pre-crisis period, and UMP could in fact help reduce inequality in the post-crisis era by supporting sizable employment gains, which normally have greater impact on lower income groups.[8] Lastly, even if UMP did trigger undesirable side effects, these could nevertheless be an acceptable price to pay to avoid an extended period of very low growth that could result from a failure to forcefully address the impact of the crisis now.

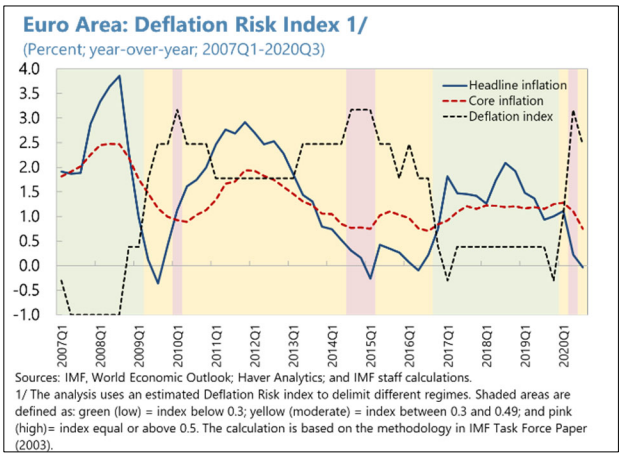
[7] PEPP's high degree of flexibility regarding the maturities and credit quality of its secondary market sovereign bond purchases also helps alleviate potential pressures in primary markets and prevent loss of market access.

[8] Lenza and Slacalek, 2018.





47. Substantial additional monetary policy accommodation via existing and new policy tools would be needed if the inflation outlook were to be materially downgraded. The risk of prolonged low inflation or even deflation is nonnegligible, especially if downside risks materialize. Even under the October *WEO* projections, the euro area deflation index shows a moderate probability of headline inflation remaining in negative territory for several quarters.[9] To prevent the risk of prolonged deflation or sharp deterioration in the inflation outlook in a downside scenario, the ECB would need to further ramp up support, including by considering new policy tools. [10]



48. Direct support to the nonfinancial corporate sector could be envisaged should monetary policy transmission become impaired. As banks are likely to deleverage and reduce risk taking in an adverse scenario, the ECB could fully or partly finance a s~~S~~pecial p~~P~~urpose v~~V~~ehicle (SPV) to deliver temporary bridge financing to viable firms facing COVID-related liquidity shortages, and/or purchase loans originated by eligible lenders (learning from recent experience with the Main Street Lending Program in the United States).[11] All these facilities need to include appropriate screening procedures and thresholds to avoid lending to so-called "zombie firms." Expanding the range of eligible assets under the PEPP by including high-yield corporate bonds, "fallen angels", or equity exchange traded funds (ETFs) could also be considered to provide greater support to the nonfinancial sector and tackle possible stresses in different market segments. However, ~~as the Bank~~

[9] The aggregation method for the deflation index may not, however, capture the changing relationship between indicators for slack and inflation in the recent years.

[10] Introducing yield curve control (YCC) is likely to face considerable legal and operational complexities given the implicit commitment to buying unlimited amounts of sovereign paper and the need to target the yield curves of 19 member states or the euro swaps curve.

[11] The European Investment Bank (EIB) could also take the lead in setting up, financing, and managing the SPV, potentially allowing the option of providing credit protection on pools of bank loans to SMEs.

~~of Japan experience shows, the latter~~ this may generate losses ~~while the former~~ and could have limited effectiveness given European firms' heavy reliance on bank financing.

ECB Strategy Review

49. Given a persistent inflation undershoot, long-term structural trends, and the pandemic shock, the ECB's planned review of the monetary policy framework is timely. The review is scheduled to be concluded by mid-2021—with the aim of assessing monetary policy objectives and instruments, studying inflation measurement, and analyzing long-term issues such as digitalization, climate change, and automation. As in Japan and the United States, with declining neutral rates, inflation has undershot the medium-term objective for an extended period. Given this, the strategy review will analyze the merits of moving away from the current "below, but close to, 2 percent" aim and the extent to which the ECB needs to react to large and persistent deviations from its aim, while also examining other objectives such as financial stability and employment.

50. Preliminary analysis suggests that a clear and well communicated symmetric point inflation target would be desirable. Staff's analysis clearly illustrates that a symmetric point target formulation outperforms an asymmetric inflation objective in an environment marked by a secular decline in real interest rates and a weak sensitivity of inflation to economic activity (Annex II). This suggests that the ECB's recent emphasis on their aim being symmetric has been appropriate and should be clearly codified and articulated around a specific point inflation target. Adopting a lower inflation target or an inflation range would be undesirable as it would carry higher deflation risks. Regarding makeup rules, the analysis suggests that especially after an extended period of undershooting the medium-term aim, allowing inflation to overshoot the target for some time (i.e., adopting a flexible average inflation targeting regime) could be beneficial to better anchor inflation expectations closer to the target. But the long-term benefits of such a regime remain uncertain, given that it can generate higher output volatility (e.g., when average inflation is above target because of cost-push rather than demand shocks) and because of its potential implications for financial stability risks. A continued medium-term orientation would allow the ECB to consider broader objectives, such as employment and financial stability, within its price stability mandate.

Authorities' Views

51. The ECB broadly agreed that a highly accommodative monetary policy stance is necessary in light of the second wave of COVID-19. The ECB stands ready to assess incoming information in the context of its new macroeconomic projections in December and recalibrate its toolkit, as appropriate, to safeguard favorable financial conditions and ensure a return of inflation to its aim. In the meantime, it will continue to use the PEPP flexibly across asset classes, time, and jurisdictions to ensure a proportionate response to the current risks and secure a smooth transmission of monetary policy and an appropriate accommodative monetary stance.

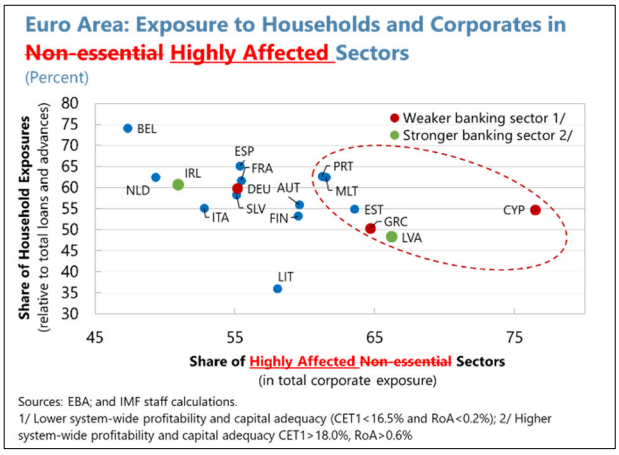
52. Financial stability risks from the negative interest rate environment appear limited. The ECB noted that macroprudential policies are the first line of defense against any build-up of financial vulnerabilities but stressed that there are no signs of excessive risk taking or stretched valuations in

the housing market at this stage. Policy innovations, such as tiering reserves and the TLTRO, along with higher credit growth, have mitigated the impact of negative rates on bank profitability.

53. The ECB considers the strategy review as an important step to reflect on its monetary policy tools and aims. The ECB has taken note of the outcome of other central banks' strategy reviews but emphasized that its strategy review is guided by the specific mandate of the ECB, as stated in the Treaty on the Functioning of the European Union, and the characteristics of the single market. The ECB pointed to the importance of a clearly codified symmetric aim for anchoring inflation expectations to its medium-term inflation aim, and stressed that, in practice, there has already been a commitment to symmetry by the Governing Council, as highlighted in past press statements.

C. Financial Sector Policies: Safeguarding Financial Stability and Supporting Lending

54. Pandemic-related capital relief and conservation measures helped maintain the flow of credit. During the first lockdown and subsequent reopening, banks were able to slowly absorb rising impairments without a significant change in their capital ratios given continued borrower-support and effective capital conservation measures. Moreover, the release of capital buffers of more than €~~156~~ 120 billion expanded banks' lending headroom. After accounting for potential loan losses based on the October *WEO* projections (Box 4), which would consume more than three-quarters of current surplus capital, banks' capacity for net lending would still amount to about €0.3~~4~~ and €0.9 trillion to households and nonfinancial corporates, respectively (equivalent to 4~~5~~ and 9~~11~~ percent of the current stock of loans).



Sources: EBA; and IMF staff calculations.
1/ Lower system-wide profitability and capital adequacy (CET1<16.5% and RoA<0.2%); 2/ Higher system-wide profitability and capital adequacy CET1>18.0%, RoA>0.6%

55. As borrower support measures expire and default risk increases further, however, banks have started to tighten lending conditions, especially in some countries with legacy NPLs. Regulatory flexibility and credit guarantees have cushioned the immediate impact of potential impairments but have not altered the underlying deterioration of credit risk. According to the ECB's latest Bank Lending Survey, banks have raised their underwriting standards as the impact of higher risk perceptions and balance sheet constraints have outweighed that of lower funding costs. While bank capitalization is appropriately high, a broader deterioration of asset quality is likely to adversely affect banks' already low profitability, especially given significant credit exposures to commercial lending in vulnerable sectors. Indeed, banks in vulnerable countries have increased their loan loss provisions on precautionary grounds, and already report a net tightening impact of higher NPL ratios as the effect of the initial pandemic-related containment measures on borrowers is becoming increasingly apparent.

Box 4. Impact of COVID-19 on Bank Capital in Europe

The COVID-19 crisis has intensified the profitability challenges of many euro area banks, with potentially adverse implications for their lending capacity next year. Prior to the crisis, most banks' business models were already under pressure due to compressed net interest margins and inefficient cost structures amid legacy assets from the last crisis. The pandemic has amplified these pre-existing conditions as banks are likely to: (1) raise provisions for higher loan losses and lower collateral expected from the economic shock; (2) write off a rising share of nonperforming loans due to corporate insolvencies; and (3) face lower income from nonlending activities. Over 60 percent of banks' corporate exposures are to ~~nonessential~~ highly affected sectors, especially to real estate and trade (and to a lesser extent, construction and transport; table). In addition, more than half of bank lending is to households, especially via mortgages, which are increasingly affected by the distributional impact of adverse aggregate income and employment effects. These exposures have already adversely impacted banks' profit and capital positions and will continue to do so as the crisis evolves.

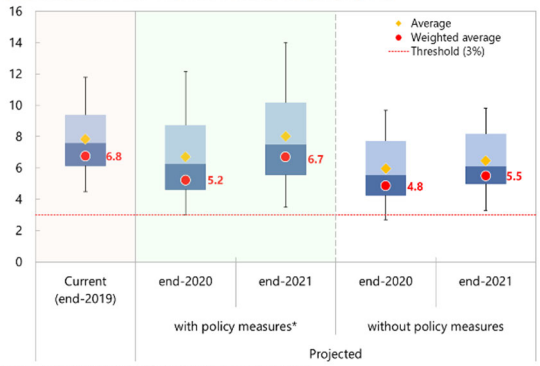
Loans to ~~Non-essential~~ Highly Affected ~~Sub-~~Sectors 1/

	Construction	Wholesale & Retail Trade	Transport & Storage	Accommodation & Food Services	Real Estate Activities	Arts & Entertainm	Other Services
AT	29	56	18	16	116	2	4
BE	26	40	15	4	41	3	4
CY	39	59	17	46	44	2	3
DE	10	42	28	4	177	2	11
EE	14	59	24	4	86	3	7
ES	29	70	24	18	48	3	24
FI	20	30	30	4	167	3	10
FR	18	53	25	9	90	2	28
GR	40	91	51	40	29	6	10
IE	6	25	13	21	60	4	8
IT	47	77	24	16	66	3	28
LU	9	3	2	3	22	0	5
LV	12	33	33	14	72	1	5
MT	16	24	10	12	32	4	1
NL	15	68	33	7	88	2	21
PT	34	41	19	18	38	3	19
SI	16	52	39	6	11	1	4
EA SSM	22	47	23	15	90	3	11

Source: EBA Transparency Exercise; IMF staff calculations.
1/ Cells ≥100 (50) are colored red (orange).

Staff's analysis suggests that euro area banks are likely to remain broadly resilient under the October *WEO* projections thanks to a wide range of mutually reinforcing financial policy measures, but a significant decline in capital could constrain their lending capacity next year.[1] Public bank-level data from statutory filings as of end-2019 is combined with information from the 2020 EBA Transparency Exercise to project bank profits, the scale of potential corporate defaults in each sector on bank capital, and their interaction with borrower support measures until end-2021.[2] Under the October *WEO* projected path for growth and unemployment, the aggregate capital-to-asset ratio would almost fully recover by end-2021, after an initial drop. However, two banks remain below the indicative threshold of 3 percent, even after considering the effect of debt moratoria and credit guarantees (chart), which provide a substantial cushion of about 1.2 percentage points. Under an illustrative downside scenario (with GDP growth -0.9 and -2.7 percent below the baseline in 2020 and 2021, respectively), the capital-to-asset ratio declines by an additional 0.2 percentage point in 2020 and barely improves in 2021—even with the current policy measures in place (with six banks falling below the threshold).[3] These results are consistent with the ECB's recent COVID-19 Vulnerability Analysis (July 2020), which found that banks remain stable under baseline conditions but that under a severe scenario, several banks would need to take action to maintain compliance with their minimum capital requirements.

Euro Area Banks-Stress Test of the Capital-to-Asset Ratio
(Baseline Scenario with Corporate Sector Shock; percent) 1/ 2/



Sources: EBA; ECB; ESRB; FitchConnect; and IMF staff estimates.
1/ The blue shaded area of the boxplots shows the inter-quartile range (25th-75th percentiles), with whiskers at the 5th and 95th percentiles. */ Debt repayment relief (moratoria) and credit guarantees (without excluding cash and reserves from assets as temporary adjustment to the leverage ratio until mid-2021). 2/ WEO October 2020 baseline forecast for GDP growth and unemployment plus single-factor shock of expected firm bankruptcies (of which about 15 percent occur in 2020 on average). The analysis examines the change of the capital-to-asset ratio (as proxy for the leverage ratio) of 90 large euro area banks through the decline in profitability (net interest income and provisions) and the change in net lending (after accounting for write-offs). The crisis-specific factors influencing the results are: (1) extraordinary write-offs of exposures to illiquid and insolvent non-financial corporates, (2) lower provisions for guaranteed loans to solvent firms (and a limited increase of provisions for eligible loans for the duration of moratoria), and (3) the decline in interest income due to debt moratoria.

1/ Based on IMF (forthcoming), "The Impact of the COVID-19 Pandemic on European Banks," EUR Departmental Paper.
2/ Based on IMF, 2020, "Corporate Liquidity and Solvency in Europe During the COVID-19 Pandemic: The Role of Policies," Chapter 3, Regional Economic Outlook (October).
3/ The adverse scenario is based on Chapter 1 of the IMF's World Economic Outlook (October 2020).

56. A slower recovery could result in sizable capital shortfalls in the banking sector. Subdued economic activity due to delayed reopening would exacerbate pervasive liquidity problems and increase debt overhang, especially in vulnerable sectors. This would result in potentially much larger bank credit losses. In turn, banks' diminishing capacity to lend would likely weigh on financing for consumption and investment at the time when it would be needed most. Rising fiscal vulnerabilities in countries that are most affected by crisis could strengthen the sovereign-bank nexus, raising the cost of borrowing and limiting credit availability.[12] Some banks might be able to raise new capital at manageable costs, while others would need their viability carefully assessed, ideally in the context of the ECB's annual bank capital planning review and evaluation. The ECB's 2021 ~~should prepare a~~ system-wide stress test ~~to~~ secures full flexibility for potential public financial support without burden sharing to banks that are vulnerable under a downside scenario (Box 4).

57. Unwinding capital relief measures during the recovery period will require a careful balancing act. Supportive financial sector measures, including restrictions to dividend payouts and share buybacks, should be maintained until the recovery is well underway, while capital and liquidity buffers should be rebuilt gradually to ensure banks' continued capacity to extend credit. Borrower support, mainly aimed at staving off liquidity shortfalls, would need to remain available until the recovery is underway. However, eligibility criteria should be tightened over time to better target illiquid but solvent firms and the most vulnerable households. Moratoria should be targeted and extended only if needed to prevent widespread insolvencies and without distorting classification and provisioning requirements of banks.

58. Swift balance sheet repair will be critical to maintain confidence and support intermediation, especially in a downside scenario. As the recovery takes hold, prudential standards should be normalized—and clearly communicated—to incentivize the timely recognition of problem assets. Supervisors should enhance their monitoring and ensure that banks' have the capacity to resolve NPLs with credible reduction strategies. Uncertainty over the crisis' impact requires such strategies to cover a longer time horizon than usual. Banks that face capital shortfalls should present plans to restore their capital. Insolvency regimes should be strengthened to address high numbers of cases, and the capacity of court systems should be supplemented by an intensive use of out-of-court restructuring (Annex III). Swiftly implementing the European Restructuring and Insolvency Directive and reaching an agreement on extra-judicial collateral enforcement would increase the efficiency of national systems.

59. Asset management companies (AMCs) could support these efforts but would likely face significant political and operational challenges. The European Commission's blueprint for national AMCs provides a roadmap for their establishment, yet the large expected deterioration in credit quality might make them unattractive in countries with fiscal space at risk. A pan-European AMC could potentially overcome the funding limitations in fiscally constrained countries, while also helping to further deepen the distressed debt market and reduce the pricing gap for bad loans.

[12] Recent regulatory measures, such as lower capital requirements for the credit and market risk of government debt securities, have significantly reduced the extent to which higher sovereign risk can affect bank solvency.

Nevertheless, different insolvency and collateral enforcement frameworks across EU countries and hurdles related to asset purchases, funding, and the potential for mutualization of losses would make agreement on a pan-European AMC unlikely. A network of nationally established AMCs, however, relying on common NPL data templates, transaction platforms, and valuation methodologies could be more politically acceptable and still facilitate cross-country transactions.

60. Addressing structurally low profitability in the banking system could help facilitate "self-healing" once the recovery gains traction. In addition to current cost pressures from rising impairments and provisioning requirements, cost structures weigh on returns on equity (RoE). An increasing number of banks are now reporting earnings below their cost of capital. While many banks have started investing in digital technologies to reduce structural margin and cost pressures, this adds to short-term expenses. Supervisors will need to intensify assessments of business model sustainability. Absent bold actions to cut operating costs, RoE is likely to remain subdued over the medium term, especially given the prolonged scarring effects of the crisis. Increased consolidation through mergers and acquisitions could improve banks' efficiency and profitability.

61. The pandemic underscores the need to rapidly close existing gaps in the crisis management framework. As recommended by the 2018 FSAP, several reforms would significantly strengthen the EU's crisis resolution capacities. These include: (i) greater harmonization and centralization of emergency liquidity arrangements; (ii) making the powers of the Single Resolution Board more usable for smaller banks and in systemic crises (including introducing a systemic exemption to burden-sharing rules; adjusting interpretation of the "public interest test;" and introducing an EU level administrative bank liquidation tool to address situations in which banks may fail the public interest test but still be too large for national insolvency proceedings);[13] and (iii) providing an operational financial backstop for the Single Resolution Fund (SRF) by finalizing the European Stability Mechanism (ESM) treaty reform.[14]

62. The specter of potential fragmentation calls for advancing financial sector architecture reforms to support the recovery and strengthen resilience:

- *Banking Union*. The ~~emerging~~ potential consensus on the design of the European Deposit Insurance Scheme (EDIS) offers an opportunity for removing remaining obstacles. The interim report (June 2019) of the High-Level Working Group proposes concrete steps towards implementing the ~~European Deposit Insurance Scheme (~~EDIS. The current proposal centers on a hybrid model, relying on the existing national deposit guarantee schemes, which are reinsured by a central fund. The implementation of the EDIS co-insurance would allow risk-sharing to evolve in parallel to risk reduction and should be implemented swiftly.

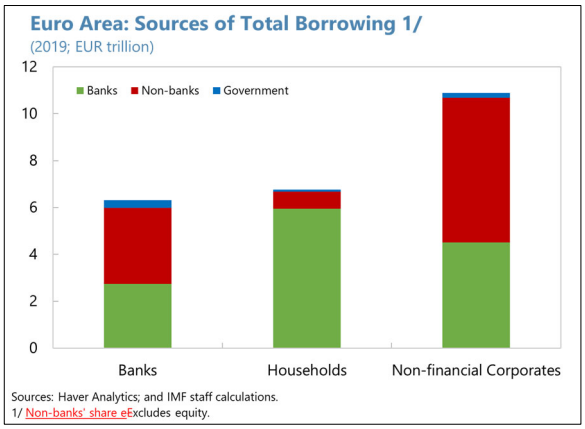
[13] Banks are resolved by the Single Resolution Board if liquidation is not warranted because they provide a critical function or liquidation could threaten financial stability ("public interest test").

[14] On November 30, the Eurogroup agreed to proceed with the ESM reform and introduce a common backstop for the SRF by early 2022, pending ratification of the amended ESM treaty by member state parliaments.

- *Capital Markets Union (CMU).* The new 2020 CMU action plan published by the European Commission in September has identified several steps needed to "reboot" the EU's push for greater capital market integration. These include fostering access to comparable company data through a single pan-European portal, facilitating company listings, developing adequate pension products, centralizing supervisory power in some areas, and ensuring converging outcomes in national insolvency proceedings. These are in line with previous staff recommendations, which further urged a data-driven upgrade of insolvency proceedings following minimum EU-level standards. Fast implementation of these recommendations would ease access to market-based finance and lessen firms' reliance on bank borrowing, hence increasing private risk sharing and strengthening the resilience to shocks.

- *Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT).* To ensure harmonized and consistent AML/CFT oversight, the European Commission has laid out plans to establish a single AML/CFT rule book and expressed support for a single supervisor. Full transposition by member States of the 5th AML Directive's provisions on central bank account mechanisms and publicly available beneficial ownership registers with high-quality data should further strengthen the region's AML/CFT safeguards.

63. Prudential measures should be strengthened to address vulnerabilities in nonbank financial institutions. Nonbank financial institutions provide sizable funding to firms and banks, and yet many of them fall outside the prudential perimeter of macroprudential surveillance. A rising share of illiquid asset holdings make investment funds, especially those exposed to real estate and alternative assets, more vulnerable to redemption pressures as risk sentiment changes. Moreover, supervisory fragmentation prevents timely identification of liquidity risks and proper activation of liquidity management tools. While current liquidity risks remain limited, some long-term institutional investors have become more active in repo markets to leverage their returns, which raises their susceptibility to adverse financial conditions. In the absence of a comprehensive safety net for nonbank financial institutions, these risks should be carefully monitored, including those that emanate from increased exposure to lower-grade corporate debt and real estate. As recommended in the 2018 FSAP, borrower-based tools could be legislated where they are currently unavailable and national macroprudential supervisors should have the authority to use these tools for all financial institutions. Efforts should continue to reduce data gaps in the measurement of the other financial institutions ~~OFI~~ sector. For investment funds, ESMA should be given more authority to bring about supervisory convergence on liquidity management tools, and greater coordination across national supervisors on the use of leverage restrictions.



Authorities' Views

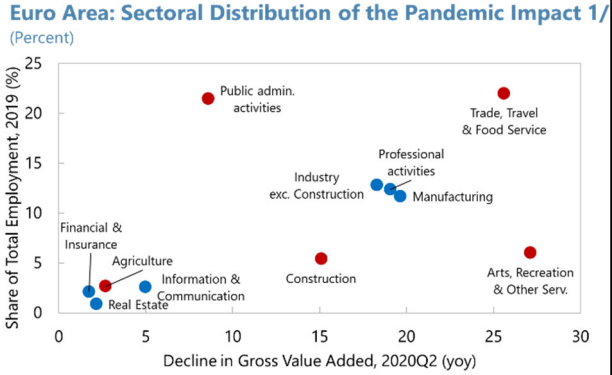
64. While the crisis impact on the banking sector has remained limited so far, the authorities are concerned that a new round of lockdowns could adversely affect credit

centralizing supervisory power, would take time and require intensive preparation. Finally, the ECB has set up a new coordination function to exchange information with AML/CFT supervisors more systematically and to address the prudential implications of AML/CFT risks. They stressed their support for creating a single oversight body for AML/CFT, but recommended setting up a separate institution given the ECB's mandate only covers the prudential supervision of credit institutions.

67. The authorities were mindful of emerging risks from the non-bank sector and the need to develop a macroprudential framework. Cognizant of the greater role of non-bank lenders and some vulnerabilities in the investment fund industry, they stressed that some member states have passed legislation to broaden the toolkit available in their jurisdictions. They also indicated that, together with the national competent authorities, they have been carefully monitoring investment funds with significant exposures to less liquid assets while seeking greater coordination on liquidity management tools.

D. Structural Policies: Facilitating Resource Allocation and Boosting Productivity

68. The crisis is likely to have persistent effects on many countries' economic structures. The severity of the pandemic, its duration, and its sectoral impact remain highly uncertain. Yet social distancing and behavioral changes are likely to persist for some time, reducing the demand in contact-intensive sectors and constraining their operations. The potential reallocative and distributional consequences could have significant implications for labor and product markets, especially given that contact-intensive sectors in some countries account for a large share of economic activity and employment.



Euro Area: Sectoral Distribution of the Pandemic Impact 1/
(Percent)

Sources: Eurostat; and IMF staff calculations.
1/ Red dots indicate most contact-intensive sectors based on IMF staff calculations using Koren and Peto (2020) methodology and data from Eurostat and OECD.

69. The scale of the COVID-19 shock and uncertainty about its persistence argue for carefully expanding solvency support. As demand firmly recovers, policies would need to gradually transition from general lifelines for businesses to supporting firms with good post-pandemic viability prospects, while facilitating the exit of unviable companies.[15] Implementing such triage is inherently difficult, however, given the uncertainty surrounding the post-pandemic landscape, likely justifying erring on the side of caution at this point and preserving some firms that will ultimately prove to be unviable. To tackle this challenge, government support should be selective and provided to firms with solid pre-crisis average profitability or turnover ratios whose operations have been impaired by health risks or social distancing restrictions. To limit the cost to the taxpayer and incentivize necessary reallocation, support should be targeted and temporary, with

[15] See October 2020 Fiscal Monitor, Chapter 1.

Box 5. Short-time Work Programs During the Pandemic Crisis

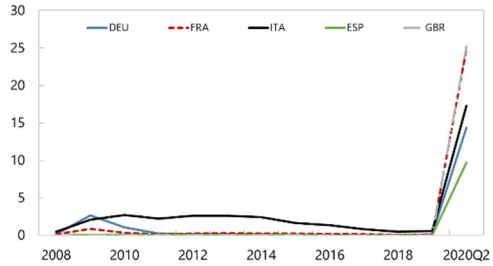
Job retention schemes were utilized at unprecedented levels during the initial phase of the crisis. Many countries expanded existing short-time work programs (STWs), including by simplifying access, extending coverage, and raising generosity, or introduced new programs (e.g., the U.K.). Wage subsidy programs were also used in some countries. These schemes, which support the income of workers on reduced working hours while maintaining worker-employer ties, allow firms to quickly return to their normal operations once economic activity recovers.

These schemes successfully prevented an immediate unemployment surge. Despite the much larger decline of output in 2020H1 compared to the global financial crisis, unemployment rates barely budged in the large euro area economies and the U.K., while take-up of the STW programs surged. Indeed, the sharp reduction in overall hours worked in these economies during 2020Q2 was mostly driven by a reduction in hours per worker and not by extensive job losses.

The usage of STW schemes varies substantially across sectors, partly reflecting the impact of the crisis on sector activity. The incidence of STW schemes,[1] which measures the sector's take-up of the programs relative to its size, is generally higher in sectors that were most affected by the crisis. Specifically, since the beginning of the year, the STWs incidence was higher in contact-intensive sectors in most countries, especially the wholesale, transportation and accommodation and food sector. However, some sectors, such as construction in France and Italy, and manufacturing in Germany and Italy, do appear overrepresented in the allocation of STW schemes funds given the decline they faced in sectoral value added.

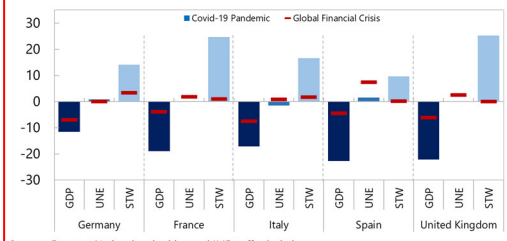
Long-lasting usage of broad-based STW programs could hamper resource reallocation and delay the recovery. While STW schemes are a successful tool in preventing large adjustments in labor markets during a downturn, they may impose a sizable fiscal cost if continued untargeted, and could risk supporting unviable jobs in sectors in decline, slowing down the recovery (WEO 2010). Unwinding their use as the recovery begins would require a delicate balancing act, especially given the uncertainties about future pandemic dynamics.

Short-Time Work Take-Up 1/
(Percent of employment)



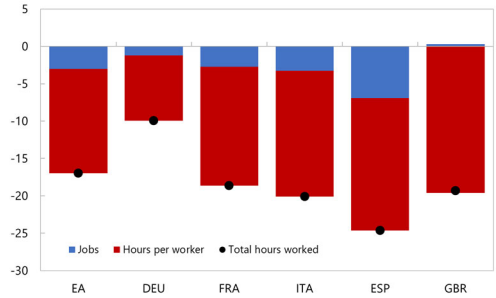
Sources: Eurostat; national authorities; and IMF staff calculations.
1/ STW take-up rates are calculated as the share of people effectively in the STWs in total employment, except for Italy where it is the ratio of authorized hours under the CIG over total working hours. Annual figures are presented, except for 2020Q2 where end-quarter data are used.

Output Loss and Labor Market During the Pandemic vs. GFC
(change in ppt during 2020H1 vs. the GFC)



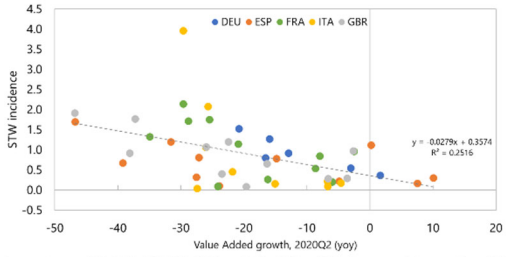
Sources: Eurostat; National authorities, and IMF staff calculations.
Note: The bars show the output losses in percent and changes of unemployment rate and STW take-up rate in percentage points during 2020H1. The red segments mark the corresponding changes of the variables during the GFC recessions for each country which is defined as the period from peak to trough of the real output during 2008-09. The STW take-up rates are the share of people effectively in the STWs in total employment, except for Italy where it is the ratio of authorized hours under the CIG over total working hours.

Working Hours Growth Decomposition
(Percent, year-over-year, 2020Q2)



Sources: Eurostat; and IMF staff calculations.

STW Schemes Incidence and Value Added Growth 1/
(Share of STWs in each sector; and 2020Q2 percent growth year-over-year)



Sources: Eurostat; NFO (DEU), INPS (ITA), Ministry of Labor (FRA and ESP), Revenue and Costume Dept. (UK).
1/ STWs measures vary by country. Germany: effective number of workers in Kurzabeit as of April 2020. Spain: number of cases resolved and reported by the labor ministry as of May 2020. France: estimate of the number of employees effectively in partial activity in April 2020 from the Acemo Survey. Italy: total authorized STWs hours in 2020. UK: workers furloughed per day by sector.

1/ The incidence of STW schemes is measured by the sector's share of STW programs to the sector's share of employment. A ratio higher than one indicates an overrepresentation of the sector in the allocation of STW programs.

83. With the resurgence of the pandemic, national fiscal policies should continue to provide the first line of defense. National authorities should resist pressures for a premature withdrawal of fiscal support, as this would risk derailing any incipient recovery. However, as a recovery gradually takes hold and the pandemic abates, governments should focus on facilitating reallocation of labor and capital towards sectors and businesses that will likely be viable post-pandemic, as well as on sustainably boosting inclusive growth and reducing fiscal vulnerabilities. Should the outlook materially deteriorate further, additional fiscal stimulus would be needed. If existing untapped EU-level facilities are exhausted, further centralized support may also be needed. The escape clause from EU fiscal rules should remain activated until the recovery is on a firm footing, and the rules themselves fundamentally reformed to address well-known shortcomings and reflect the post-pandemic landscape.

84. The monetary policy response has been appropriately bold, but further support is needed to counter disinflation risks. In this respect, the ECB Governing Council's commitment to recalibrate its policy instruments in its next meeting, once the December round of the Eurosystem staff macroeconomic projections are available, is welcome. Asset purchases should remain a go-to instrument, but other options, including a policy rate cut and further relaxation of the terms of the targeted and untargeted LTROs should also be considered. A marked deterioration in the inflation outlook would require substantial further accommodation where new policy instruments—for example, providing direct support to nonfinancial corporates—could be considered.

85. The ECB's recent emphasis on its aim being symmetric should be clearly codified and articulated around a specific point inflation target during its ongoing strategy review. A clear and well-communicated symmetric point inflation target has significant benefits compared with an asymmetric target. Adopting a lower inflation target or an inflation range would be undesirable as it would carry higher deflation risks. A flexible average inflation target could also be explored to better anchor inflation expectations given the prolonged inflation undershoot. A continued medium-term orientation would still allow the ECB to consider broader objectives such as employment and financial stability within its price stability mandate.

86. Recent financial sector measures have supported credit growth and prevented widespread insolvencies but unwinding them will require a careful balancing act. Capital relief and conservation measures, including restrictions on bank dividend payouts and share buybacks, should be maintained until the recovery is well underway, while capital and liquidity buffers should be rebuilt gradually to ensure banks' continued capacity to extend credit. Borrower support would need to remain available if the recovery stalls but should become more targeted over time and extended only if needed to prevent widespread insolvencies and without distorting loan classification and provisioning requirements. The ECB's next system-wide stress test could be used to identify potential capital shortfalls in a downside scenario, helping secure potentially needed support via precautionary recapitalizations.

87. Swift balance sheet repair will be critical to maintaining confidence and supporting intermediation, especially in a downside scenario. As bank asset quality is set to deteriorate, supervisors should ensure that banks have credible medium-term strategies for NPL reduction.