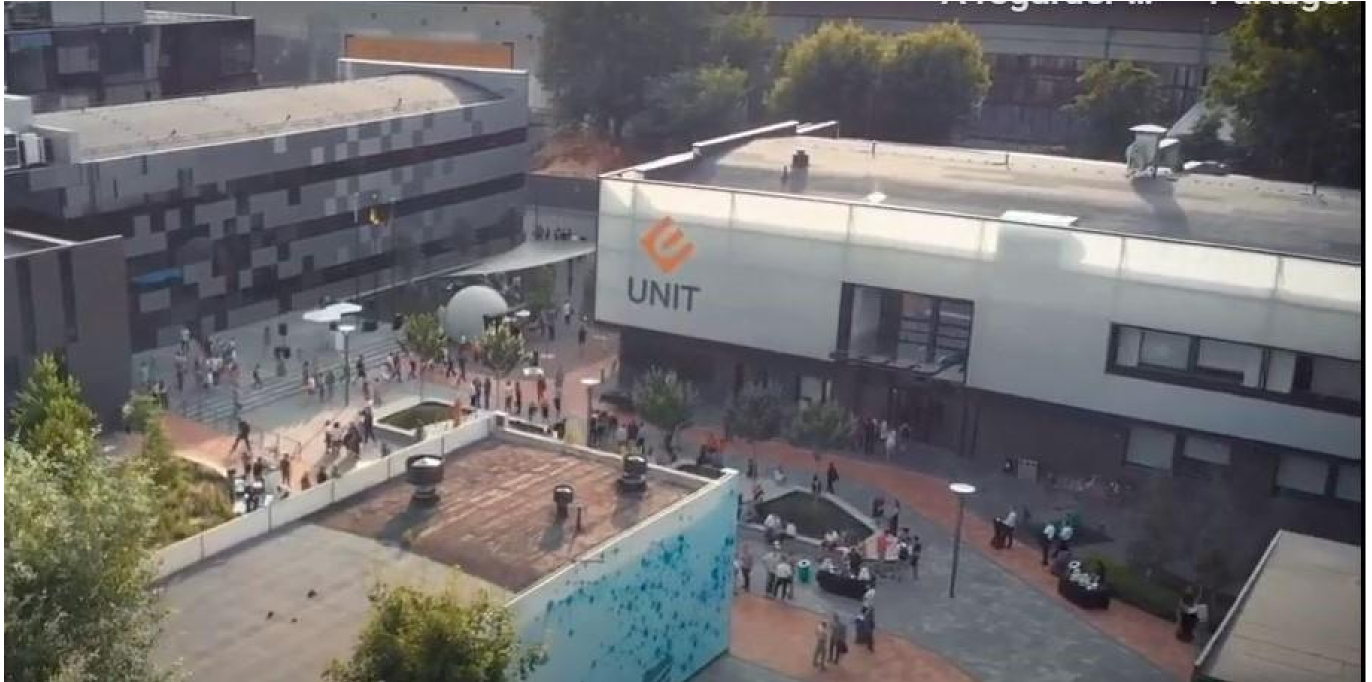
Ukraine: InnovFin Science Programme: EIB supports Ukrainian Innovation Campus Project in UNIT.City



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- **€50 million loan to finance the development of a state-of-the-art technology campus in Kyiv**
- **The facility will include a non-profit IT education academy and multifunctional office space for technology-driven companies**
- **The project will generate 549 full time and 2 400 temporary jobs and indirectly support some 15 000 jobs around UNIT.City**

The European Investment Bank (EIB) has agreed to lend €50 million to Ukraine's first vertically integrated innovation park UNIT.City. The EIB loan is to finance the Ukrainian Innovation Campus Project, which will cover the design, renovation and construction of new, tailored facilities and structures in UNIT.City, a part of the holding company UFuture.

The project will benefit from the support of InnovFin Science, a joint initiative from the EU Commission and the EIB that promotes research and innovation (R&I) investments by public and private bodies. The loan is backed by Horizon 2020, the EU Framework Programme for Research and Innovation and is managed by the EIB.

The project will contribute to creating one of the biggest hubs merging dedicated infrastructure with an innovation ecosystem for IT and technology companies in Central and Eastern Europe. It will put together start-ups and IT training, high technology companies and R&D centres, incubators and accelerators within a 25 ha inner-city site, boosting the development of Ukraine's high-tech industry.

The project involves a private non-profit IT training facility, multifunctional flexible floor space offering a variety of office accommodation, digital fabrication laboratories (fablabs), communal and interaction spaces, and seminar and meeting room spaces for events plus other supporting facilities and infrastructure. Within the innovation campus, tenants will have access to the campus facilities, multifunctional office space, mentorship and training programmes, and cooperative tools and services to support their business' growth.

EIB Vice-President Lilyana Pavlova commented: *"Ukraine has among the largest and fastest-growing populations of IT professionals in Europe with about 200 000 people working in this field. In addition, most clients of Ukrainian IT companies are from Western Europe and the United States. Despite these remarkable achievements, Ukraine and more specifically the Kyiv urban area lack a proper ecosystem for R&D and IT companies at all stages of development, from start-ups to expanding high-tech companies. With its dedicated InnovFin Science support, the EIB is now helping Ukraine to bridge this gap. This will strengthen the competitiveness of the country and its capital city and enable it to take full advantage of its skilled workforce."*

Mariya Gabriel, Commissioner for Innovation, Research, Culture, Education and Youth, said: "*As part of our shared commitment to creating a more inclusive, connected and resilient European Research Area, it is important to enhance our support for research and innovation actions in the Eastern Partnership countries. We need to bridge existing gaps and promote the involvement of researchers and technology companies from these countries in the EU research and innovation framework. The investment announced today for an integrated innovation campus in Ukraine will contribute to achieving this goal, helping to boost the country's innovation and entrepreneurial ecosystem*."

Founder of UFuture Vasyl Khmelnytsky added: *"The EIB credit line will help us to expedite the development of UNIT.City in Kyiv. It's an important signal for the entire market, and it proves that we are moving in the right direction with the support of the European institutions. We are ready to share our experience and scale this concept of creative economy hubs across the country".*

CFO, Partner UNIT.City Kirill Bondar said: *"The partnership with the European Investment Bank for UNIT.City is not only necessary financing, but also a valuable reputational contribution. It is an unprecedented case for Ukraine, which opens up opportunities for new financial partners and investors both in UNIT.City and across the country. We are demonstrating to the whole world: Ukrainian business can be trusted"*.

The EIB credit line provides up to 10 tranches of at least €5 million each. The funds are allocated for nine years with a very competitive annual interest rate for Ukraine. Money will be allocated for the construction of new campuses of the innovation park – B15, B16, B17, U1 – with a total area of 70 000 m2. The total cost of the project (including components financed by the EIB) is estimated at €110 million. Thus, about half of the estimated costs will be financed by the EIB.

The project promoter and the EIB loan borrower is Unit Holdings LLC, a company established by the UBO of UFuture Group. The project is expected to be completed by 2023 and it will generate up to 2 400 temporary jobs and increase permanent employment within the promoter's business by 549 full time jobs. Indirectly, the project will support around 15 000 jobs in the tenant companies present at the UNIT.City innovation park.

The legal partner of the transaction was Everlegal Law Firm. The financial partner is Ukrgasbank.

Background information:

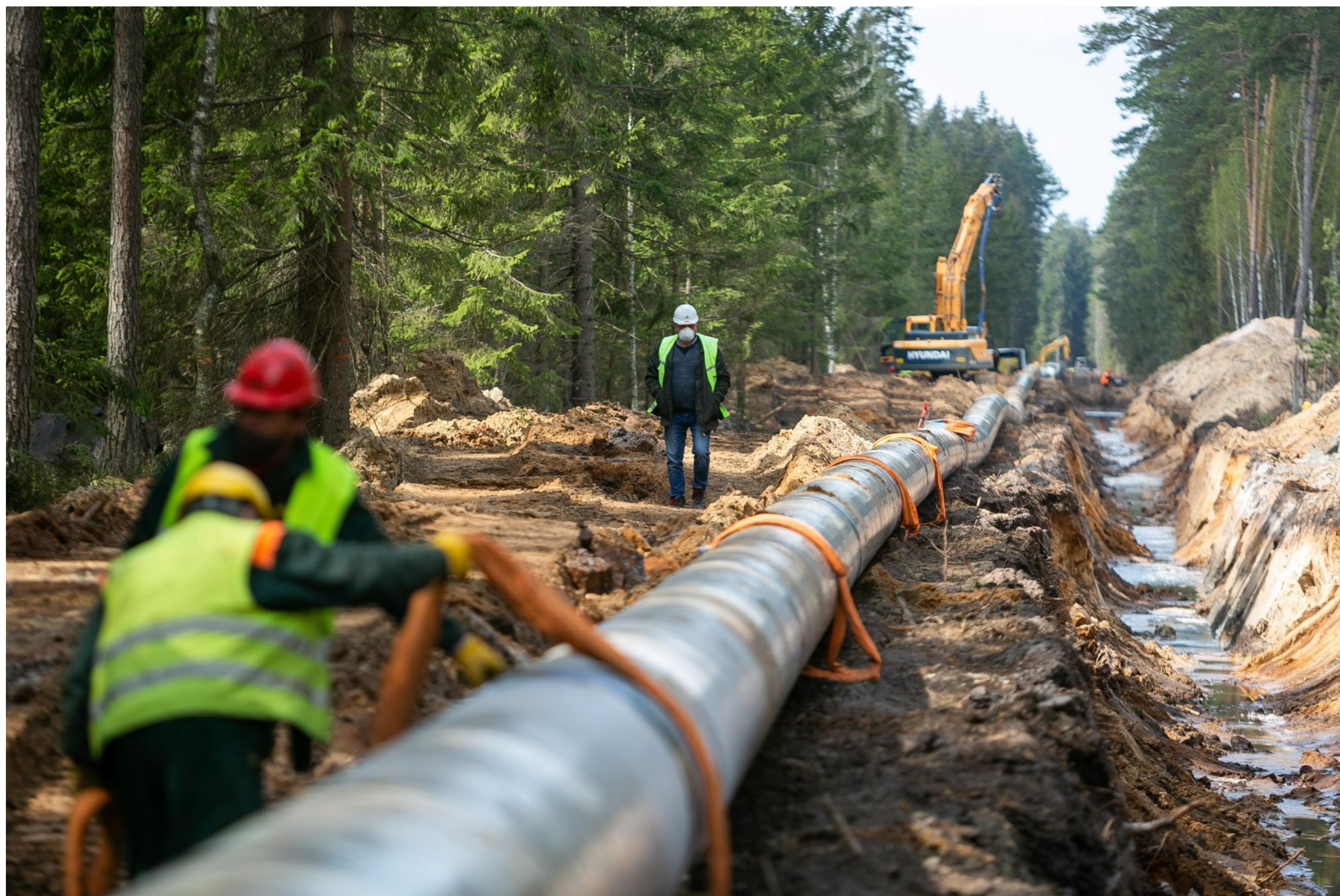
The EIB finances projects in Ukraine on the basis of the EU External Lending Mandate. This provides the EIB with a guarantee covered by the EU budget for projects of significant interest to the EU and its Eastern Neighbours in the areas of social and economic infrastructure, local private sector development and climate action.

InnovFin Science provides loans and equity-type financing for research Institutes, universities and research organisations. The EU improves access to finance for R&I projects emanating from public and private entities such as R&I infrastructures (including the financing of buildings and other infrastructure directly related to R&I activity); R&I activities; activities eligible under the EUREKA network, the European Research Area (ERA) or the Euratom fission programme. Financing is deployed directly by the European Investment Bank from € 25 million to eligible beneficiaries in EU Member States and Horizon 2020 Associated Countries.

UFuture is a holding company of Ukrainian entrepreneur Vasyl Khmelnytsky that integrates his business and impact-investment projects. The company has a diversified portfolio of assets in the fields of real estate, infrastructure, industry, renewable energy, pharmaceuticals, and IT. Currently, UFuture's assets are estimated at $550 million, and the total capitalisation of the businesses it has invested in is more than $1 billion.

UNIT.City is Ukraine's first innovation park. It is a place where unparalleled infrastructure and an all-inclusive ecosystem enable high technology, innovative and creative businesses to happen and flourish. Here the concentration of companies, startups, students, professionals and research laboratories creates the conditions for businesses within the park to grow faster than elsewhere.

European loan for gas interconnection project between Poland and Lithuania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- **The EIB has signed a €65 million loan agreement with Amber Grid to support the Poland–Lithuania gas interconnector.**
- **The operation concerns an EU Project of Common Interest as it integrates the Baltic States and Finland into the wider EU gas market.**
- **The interconnector will diversify gas supply sources, and increase security and reliability of supply for Lithuania and the region.**

The European Investment Bank (EIB) has signed a €65 million loan agreement with Lithuanian gas transmission system operator AB Amber Grid to finance the construction of the Lithuanian section of the planned gas interconnection between Poland and Lithuania. The interconnector will be the first high-pressure gas pipeline between Poland and Lithuania, integrating the Baltic States and Finland into the wider EU gas market and diversifying gas supply sources. The project will also increase security and reliability of gas supplies for the local and regional market.

EIB Vice-President **Thomas Östros** remarked: *"Security of energy supply is a recurring theme in the EIB's investments in the Baltic States. This interconnection with Poland is a key step in the real integration of the European energy market, as it will allow all of the Baltic States and Finland to fully connect to European gas networks."*

On a technical level, the project will see the construction of a 700 mm diameter, 165 km long high-pressure bi-directional underground gas transmission pipeline, with a maximum potential capacity of 2.4 bcm/y (27 TWh/y), running from the border with Poland in the Lazdijai District to the Jauniūnai compressor station located in the Širvintos District, north of

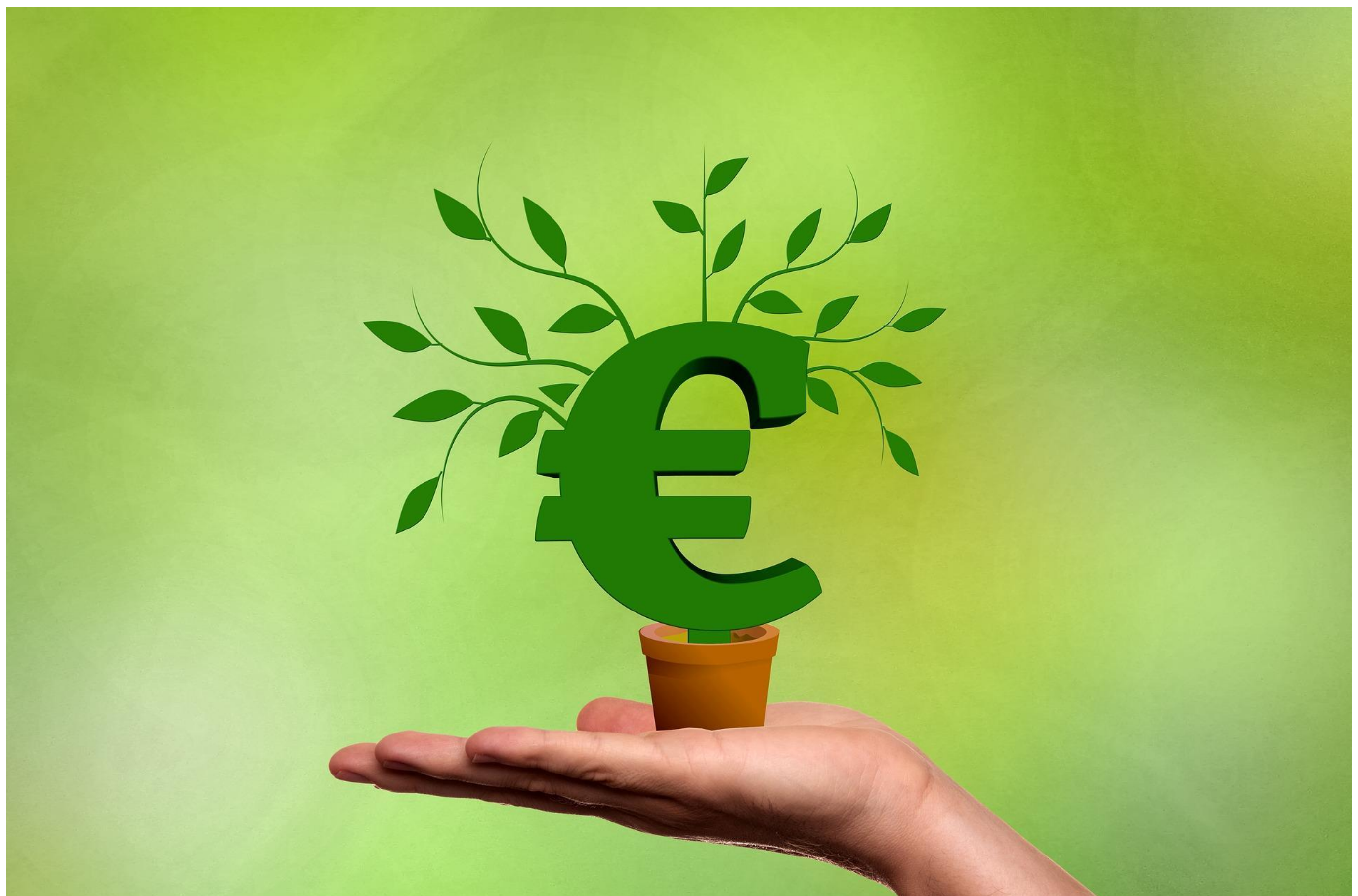
Vilnius.

CEO of Amber Grid **Nemunas Biknius** added: *“The favourable terms of the loan clearly indicate the EIB’s recognition of our commitment to the timely implementation of the GIPL project, which will create long-term value for the region’s gas market integration, benefiting consumers and gas market operators across the borders.”*

In terms of regional connections, the EIB previously financed the electricity interconnector between Poland and Lithuania, known as the LitPol Link.

Amber Grid (AB Amber Grid) is the owner and operator of the gas transmission network in Lithuania and is almost wholly owned (96.6%) by the Republic of Lithuania through UAB EPSO-G, a state-owned holding company under the supervision of the Ministry of Energy.

EIB and ESM lead discussion on how to connect capital markets with a post-coronavirus sustainable recovery



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- **First joint webinar organised by the two European institutions starts today**
- **High-level speakers shed light on EU's recovery measures and COVID-19 crisis implications for energy policies and sustainable finance, among others**

The European Investment Bank (EIB) and the European Stability Mechanism (ESM) are hosting today and tomorrow a joint online seminar on capital markets in the midst of the COVID-19 crisis. Aimed at their investor bases, the first day of the program will cover experts' views on the macroeconomic and structural impact of the current crisis, as well as the role of sustainable finance in the economic recovery and the role of public and private investment in continuing to sustain the transition to a greener and low-carbon economy. The second day will be focused on Europe's financial resilience highlighting its journey from banking union to capital markets union.

Both institutions are playing a key role in Europe's response to COVID-19 crisis. Within the EUR 540bn rescue package approved by the European Council in April 2020, the EIB is establishing a European Guarantee Fund that will mobilise up to EUR 200bn, mainly to support SMEs. The ESM has made available a EUR 240bn credit line, Pandemic Crisis Support, for euro area Member States to cover their direct and indirect healthcare costs related to COVID-19.

The EIB brings to the discussion its expertise and role as a large multicurrency borrower. To date, the EU bank has already raised EUR 51.4bn, or 85% of the total program announced for this year. The EIB is also the largest multilateral institution lending to climate change projects. In 2019, it devoted 31% of its lending to climate-related projects. It has committed to raise its lending target to climate action and environmental sustainability projects to 50% by 2025 and to align all its lending activity with the Paris Agreement by the end of this year.

The ESM has extensive expertise in raising funds to help crisis-hit countries. Although financial assistance programmes have now completed, with Greece successfully concluding its three-year ESM financial assistance programme in August 2018, the ESM and its sister institution, the European Financial Stability Facility (EFSF), remain active borrowers in capital markets to roll over bond issues as part of loan management. The ESM currently has remaining lending capacity of EUR 410bn for future crises, of which up to EUR 240bn is available for combating COVID-19.

Werner Hoyer, EIB President: *"Both institutions – EIB and ESM – are financed in the capital markets, face similar challenges and opportunities, and bring an EU lens to market developments. Both institutions have been called on as part of the European institutional reaction to the pandemic. The EIB as the EU Bank has developed a rapid, timely and concerted response, both inside and outside EU. It is crucial that citizens see solidarity in the different reforms and response packages. In this context, the role of Sustainable finance and Energy Transition are essential for a green and socially just recovery."*

Klaus Regling, ESM Managing Director: *"The ESM is pleased to be a co-organiser of this event. We consider it important to be part of this event: it gives central bankers and international private investors a platform to meet with European institutions that are significant bond issuers. The ESM and the EIB have also been at the forefront of Europe's concerted response to the COVID-19 pandemic. Together with the European Commission, our three institutions take charge of a EUR 540bn package of measures to complement national efforts in the fight against the effects of coronavirus."*

Key data and recent EIB issuances:

- The EIB has issued **EUR 6.5bn in Climate and Sustainability Awareness bonds** (CABs and SABs) since the beginning of the year.
- On 18 June 2020, the same day of the approval of the EU Sustainability Taxonomy Regulation by the European Parliament, the EIB issued a EUR 1bn CAB bond due 2035, announcing CAB **extended eligibility criteria within climate change mitigation objective.** Link here.
- Since the outbreak of the pandemic, the EIB has issued **EUR 2.4 bn equivalent in SABs,** contributing to environmental- and social sustainability objectives in line with evolving EU sustainable finance legislation and contributing to the United Nations' sustainability development goals, **including Universal Access to Affordable Health Services** (SDG 3). **SAB-eligibilities are being extended to other financing areas directly related to fight against COVID-19 pandemic.**

Key data and recent ESM issuances:

- ESM/EFSF have a total of €300 bn in the market. ESM has issued EUR 6.5bn in long-term funding so far in 2020, which provides for roll over of maturing bonds as part of the long-term loans made to euro area Member States. Additionally, the EFSF has issued EUR 9.5bn in long-term funding so far in 2020.
- ESM introduced 12-month maturity bills in April to augment its existing 3- and 6-month bills and help build the yield curve at the short end. ESM is the most capitalised IFI, with EUR 80bn paid in capital, which is not on lend and invested in markets and with central banks.
- Since 15 May 2020, the ESM provides a credit line, Pandemic Crisis Support, to help euro area Member States cover healthcare costs related to COVID-19.
- In June 2020, the ESM published its Social Bond Framework. This allows the ESM the option to issue Social Bonds in response to applications for Pandemic Crisis Support.

Background information

About ESM

The mission of the European Stability Mechanism (ESM) and its predecessor European Financial Stability Facility (EFSF) is to safeguard financial stability in the euro area by providing financial assistance to euro area countries experiencing or threatened by severe financing problems.

About the EIB&ESM Capital Markets Seminar

- If you are a current or potential investor and wish to participate in the conference, please contact investor.relations@eib.org
- See detailed program here

Fabio Panetta: The price of uncertainty and uncertainty about prices: monetary policy in the post-COVID-19 economy

SPEECH

Keynote speech by Fabio Panetta at a Capital Markets webinar organised by the European Investment Bank and the European Stability Mechanism

Frankfurt am Main, 1 July 2020

The coronavirus (COVID-19) shock creates a uniquely high degree of uncertainty about the economic outlook[1]. We lack clarity about when the virus will be tamed and when social distancing measures can be relaxed; about the effects of the lockdown on confidence and growth; and about how the

structure of the economy itself will evolve in response to the shock.

Policymakers need nonetheless to form a view on the balance of risks in the economy. This is essential to communicate their reaction function, to decide how to act today and to influence expectations about tomorrow. Demonstrating to the public that macroeconomic policies are in control is crucial in conditions of high uncertainty. Insofar as it creates confidence, this is itself a form of stimulus. This imperative has guided the ECB's response to the crisis, and Europe's response more broadly.

Today I would like to discuss, first, the economic outlook for the euro area; second, the competing forces weighing on inflation; and third, how macroeconomic policies should react in this environment of heightened uncertainty. My main message is that downside risks are prominent, but a pre-emptive and decisive policy response has put us in a much better position to avoid more severe scenarios.

The uncertain economic outlook

Since the start of the crisis, the ECB's monetary policy has stepped in forcefully to prevent vicious feedback loops between financial markets and the real economy that could have derailed the outlook for inflation. The expansion of our pandemic emergency purchase programme (PEPP) in June further secures the financial conditions currently needed to shore up the economy through the crisis.

Fiscal policy has in turn capitalised on supportive financial conditions to absorb, in large part, the loss in private sector income, preventing a much steeper surge in unemployment. Guarantee schemes and banking supervision crisis-relief measures have avoided a credit freeze, supporting a record uptake of liquidity during the latest round of the ECB's targeted long-term refinancing operations (TLTROs).

As a result, the euro area has so far weathered the consequences of the shock about as well as could be expected. Recent survey data suggest that the economy may have bottomed out and we are already seeing tentative signs of recovery.

But these positive indications need to be taken with a pinch of salt, since the high levels of prevailing uncertainty make it difficult to rely on past regularities. Moreover, recent PMI releases only signal a stabilisation or improvement in the rate of contraction of activity from the very low levels reached in April. We should bear in mind that the Eurosystem's macroeconomic projections require a strong growth bounce back in the third quarter to achieve our baseline scenario.

The key question remains whether we are really on course to quickly recover our pre-crisis GDP level and then return to a healthy growth and inflation path.

The uncertainty surrounding this question is evident in our projections. Our baseline scenario sees the economy broadly returning to its pre-crisis level

of output by the end of 2022. In our severe scenario, however, output would still be around 5% below its pre-crisis level at that time (Chart 1).[2] Likewise, survey data indicate that uncertainty about the outlook for inflation over the medium term remains elevated (Chart 2).

I see three main risks to growth and inflation that warrant a cautious outlook. The first risk is that the synchronised contraction in economies worldwide – and the likely asynchronous pace of recovery – could severely depress growth and inflation.[3] This puts a much greater onus on achieving a strong domestic recovery.

We saw a similarly synchronised European recession after the Lehman crash, but an effective policy response by the Chinese authorities supported the global economy at large and emerging markets recovered relatively quickly, allowing euro area countries to redirect their production to satisfy external demand. Today, that does not appear to be feasible to the same extent. Indeed, the sharp fall in the euro area trade surplus and the weakness of forward looking indicators for world trade – such as the global PMI for export orders – corroborate the view that we will not be able to export our way out of this crisis (Chart 3).

This leads to the second major risk to growth, namely the risk that a tepid recovery could set off endogenous recessionary forces which take longer to reverse, and which could adversely affect the financial sector.

The main factor underlying this risk is that the worst of the impact on labour markets may be yet to come. According to ECB estimates, the euro area unemployment rate could exceed 10% in the third quarter. Some workers on short-time work schemes and temporary lay-offs may not be able to return to their jobs and hiring looks likely to stay subdued. Survey data already point to a sharp deterioration in firms' employment expectations (Chart 4).

If job losses were to continue to rise, it could upset the employment-income-consumption cycle that was the driver of the post-2013 recovery.[4] That could in turn spread the pain of the downturn from the sectors most severely affected by COVID-19 – such as retail, transportation and tourism – to more cyclical services like business services and real estate.[5] Recent evidence suggests that there have been significant spillovers, reducing demand also in sectors that have not been directly affected by the lockdown measures.[6]

These second-round domestic risks to the economic outlook could in turn be exacerbated by the third factor, which is heightened uncertainty and its effect on investment and consumption. Faced with such uncertainty, many firms are postponing capital spending.[7] Likewise, household consumption has fallen, bringing the propensity to save to historical highs (Chart 5). This partly reflects "forced saving", as during the lockdown people have been unable to spend to the same extent in shops or restaurants. But we are also seeing significant precautionary saving.

Uncertainty is partially being driven by concerns over the structure of the economy after the crisis, especially in such vulnerable sectors as tourism, entertainment or transportation. It is possible that people working in these

sectors will start to revise down not only their current earnings, but also their permanent income. COVID-induced uncertainty might leave scars even after the economy recovers: after a shock to industrial production, for instance, two-thirds of the effect persisting after five years is due to the response to uncertainty.[8]

Such effects typically diminish only slowly, because firms and households need to be convinced that the shock was a tail event.[9] As a result, the consequences of the COVID-19 crisis will likely be more persistent than those of standard recessions.[10]

Demand- and supply-side forces on inflation

For monetary policymakers, the key question in this environment is what impact these developments will have on medium-term inflation.

The various risks weighing on aggregate demand that I have described, if they materialise, will be unambiguously disinflationary. ECB research finds that in a situation of labour market disruptions, heightened uncertainty and financial amplification, inflation would be 0.8 percentage points lower by 2022 than under the pre-crisis macroeconomic outlook.[11] Absent appropriate policy responses, a revival of COVID-19-related tensions could therefore push the euro area into deflation. Indeed, after the outbreak of the crisis in March, the probability of deflation over the next five years increased abruptly; it has subsequently more than halved following the announcement of the ECB’s policy measures.[12]

But it has also been argued that COVID-19 may have inflationary effects because the strong demand-side stimulus by central banks and fiscal authorities could run up against a less efficient supply side.[13] In my view, however, this possibility does not correspond with the situation we face.

Looking at the fundamental determinants of inflation, the euro area economy entered the crisis with a widening output gap and inflation hovering around 1%; inflation expectations were at historically low levels. The correlation between inflation and economic activity had markedly decreased (i.e. the Phillips curve had flattened).[14] And natural rates of interest had fallen continuously, pushing policy rates towards their effective lower bound.

This suggests that a severe downsizing in production capacity would be necessary to produce broad-based supply shortages, since there was already excess supply. And even if capacity constraints were to appear, they would not necessarily produce significant inflationary pressures, owing to the flatness of the Phillips curve, the rise in the unemployment rate and the downward trend of inflation expectations – although there may be some heterogeneity across countries depending on their starting positions.[15]

In other words, faced with a large negative supply shock, the forces that have been holding back inflation over the last decade would likely continue to do so.

And, in fact, these dampening forces might even be strengthened insofar as

COVID-19 triggers feedback loops from supply to demand. The COVID-19 shock has the peculiar feature of being a negative supply shock that, paradoxically, could end up producing excess supply. For example, a set of firms closing their doors due to the lockdown might not only compress production, but simultaneously reduce demand in other sectors producing complementary goods.[16]

Moreover, past experience suggests that negative supply shocks can worsen “supply-side secular stagnation”,[17] where firms become pessimistic about future growth and invest less, causing natural interest rates to fall and inflation expectations to weaken. Past pandemics – going back to the 14th century – have been found to lead to lasting declines in the European real natural interest rate of almost 2 percentage points, which are only fully recovered after 40 years.[18]

But inflation can also be affected by one-off structural factors that emerge gradually and therefore have persistent effects on prices. Over the past 20 years, both globalisation and technology have tended to depress prices in this way. COVID-19, however, could now lead to these forces pulling in opposite directions. We may well see de-globalisation as adoption of digital technology accelerates.

How this shift in the balance of forces will play out is uncertain. But my suspicion is that the net effect will still be disinflationary.

Certainly, if firms seek to increase supply chain resilience and manufacturing is re-shored, it could increase cost pressures by mitigating international competition, reducing margins and inducing firms to pass on cost increases.[19]

But reshoring manufacturing firms tend to accelerate automation, in order to avoid higher labour costs.[20] And the impact of COVID-19 on digitalisation could contain inflation through several channels.

First, it may broaden the market for tradeable services and expand the pool of workers available to firms, generating downward wage, cost and price pressures. Second, it could increase the market share of “superstar” firms, which tend to have a lower share of labour in value-added[21] and higher negotiating power in the labour market, which in turn weakens workers’ bargaining power. Third, the pandemic is accelerating the shift towards e-commerce, which will further sharpen competition between online and traditional retailers;[22] for the euro area, the disinflationary effect of e-commerce is estimated to have been 0.8 percentage points cumulatively between 2006 and 2018, with larger effects in more digitalised economies.[23]

Finally, the COVID-19 crisis is influencing work patterns in ways that could have persistent downward effects on prices in specific sectors. For example, remote working will probably become more widespread, which could depress rents for commercial real estate (since less office space will be required) and for residential real estate in large cities (as people can now live outside towns). This could have a meaningful impact in countries such as Germany, where rents make up close to 15% of core inflation and have added

0.2 percentage points to inflation on average since 1999.

Our latest projections are consistent with the view that medium-term pressures on inflation will ultimately be downward: after the outbreak of the crisis, our inflation projections for 2021 and 2022 were revised down by 0.6 and 0.3 percentage points, respectively; moreover, projected inflation falls monotonically with the severity of the crisis scenario (from 1.7% in 2022 under the mild scenario to 0.9% in the severe scenario – Chart 6).

Financial markets agree with this view: five-year forward five-year ahead inflation swaps are currently trading at around 1.1%. Accordingly, policy rates are expected to remain low, with the EONIA forward rate standing at around -0.3% and 0.1% in five and ten years' time, respectively (Chart 7).

Policy responses under uncertainty

Disinflationary risks and lower growth justified – indeed, *required* – the vigorous reaction of macroeconomic policies in the euro area. With interest rates already close to their effective lower bound, providing the necessary accommodation for the ECB meant engaging in large-scale asset purchases under the PEPP.

But the argument for acting decisively was also strengthened by a further factor: the singular features of the crisis mean that the benefits of acting aggressively to ward off downside risks exceed the costs of potential overshooting.

To start with, heightened uncertainty increases the likelihood that the economy could shift between multiple equilibria, including a scenario of protracted low growth, low employment and low inflation. In these conditions, providing policy certainty through forceful actions becomes critical.

Macroeconomic policies are today playing a pivotal role – perhaps more so than ever before[24] – in stabilising financial markets and supporting private incomes. For example, how quickly precautionary saving diminishes and investment recovers hinges crucially on whether policies are perceived to be commanding and credible. This is visible in survey data collected by the ECB, which show that households with more confidence in government support expect lower future unemployment, higher income growth and display lower precautionary behaviour.

Likewise – with net private and public debt issuance in the euro area expected to increase dramatically in the coming years – financial market dynamics rest heavily on confidence in the overall policy mix. Deploying a rapid, determined and credible response – as the ECB has done – can produce a virtuous circle, where risk taking is restored and more investors choose to buy alongside the central bank, reinforcing its policy, rather than using its interventions to sell to it.

Such a response in turn eases financial conditions for all sectors, removing doubts about agents' ability to finance necessary spending, and thereby lifts private expectations of future demand, moving the real economy into a better

equilibrium.

By contrast, if financial conditions were allowed to tighten, evidence points to a significant non-linearity in the reaction of the economy – the effects are much greater during downturns and recessions. Had the ECB therefore not reacted strongly, the impact on GDP and inflation of the shock in financial conditions could have been much greater, up to three times larger than what we typically see.

The case for acting pre-emptively and forcefully becomes even clearer when one considers the potential “hysteresis” effects which the COVID-19 shock could trigger.

Since the sectors currently most affected by the pandemic are those that traditionally invest the most in productive capital,[25] there is a tangible threat of “capital hysteresis”. And if the most severe scenarios for growth materialise, employment could fall significantly over the coming years, presenting a serious risk of rising structural unemployment. Participation rates might also be impacted, not least because women – who have contributed in large numbers to rising labour force participation in recent decades[26] – are represented to a greater extent in those sectors that are primarily affected by the pandemic.[27]

Yet another important reason for forceful monetary policy measures is the high degree of complementarity among macroeconomic policies today. It is clear that monetary policy cannot be the only force countering the shock.

This is partly due to the asymmetry of monetary tools in dealing with downside risks when policy rates are close to their effective lower bound. It also reflects the unique conditions of the COVID-19 recession. For example, with the private sector essentially shut down for a period of time, banks are facing higher credit risk and may therefore be reluctant to make new loans, irrespective of financial conditions; similarly, monetary policy cannot improve health conditions or induce people to go on holiday. These problems can only be addressed by fiscal policy.[28]

In this environment, monetary policy needs to act proactively to prevent fragmentation of financing conditions, as in doing so we create the conditions for underpinning aggregate demand. This, in turn, allows us to achieve our price stability goal.[29]

Since the start of the crisis monetary and fiscal policies in the euro area have acted – independently – as complements, reinforcing each other and effectively removing tail risk from the market. The monetary policy measures taken by the ECB, especially the introduction of the PEPP, and the fiscal measures at European level – from the €540 billion safety nets agreed by finance ministers for workers, businesses and sovereigns, relying on the expertise of the European Investment Bank, the European Stability Mechanism and the Commission, to the announcement by the Commission of the €750 billion Next Generation EU recovery plan – have guided investors away from a bad equilibrium. As a result, systemic stress has decreased significantly.

By acting vigorously to avert financial fragmentation, the ECB has made its credit support policies more effective, allowing the transmission of monetary policy to regain traction faster.

Conclusion

The European response to COVID-19 has been remarkable. The ECB’s policy measures have avoided fragmentation in the euro area, dispelled tail risks in financial markets and stabilised the economy, thereby preventing inflation from falling even further below our aim. As a result of our actions so far, we are now in a better position to watch how key developments play out.

Our reaction function should nonetheless be clear: the ECB will respond to any significant tightening in financing conditions for as long as the negative effects of the COVID-shock persist. We remain ready to adjust all our policies depending on how incoming data affect our assessment of the medium-term inflation outlook.

We may be now moving from the first phase of the crisis – which was about protecting our productive capacity – to the second phase, which is about rebuilding and modernising the European economy in response to the shock. COVID-19 will inevitably lead to structural changes. It is the responsibility of governments to master and accompany them with the necessary reforms.

In order to avoid exiting this crisis with further economic divergence, concerns about competitiveness and long-term sustainability will have to be addressed. We now have the opportunity to move towards an economy that is more agile, more digital, more green and more inclusive – supported by substantial European resources provided by the recovery fund. Seizing this chance is crucial to ensure a more resilient recovery today and more sustainable growth tomorrow.

Luis de Guindos: Interview with La Stampa

INTERVIEW

Interview with Luis de Guindos, Vice-President of the ECB, conducted by Marco Zatterin on 26 June 2020 and published on 1 July 2020

1 July 2020

The International Monetary Fund has just revised down all of its projections. How is the European economy looking from the ECB's perspective?

The level of uncertainty is very high, so various scenarios need to be considered while acknowledging that it is difficult to produce projections. In reality, one thing is certain: we have experienced a deep fall in economic activity. This fall was very rapid, very sharp, and took place within the space of two-and-a half-months. As governments have started to reopen their economies, we have begun to see a recovery in activity, with indicators pointing towards a rebound in a number of countries.

And yet there is persistent uncertainty.

It's normal that that there should be a recovery when economies reopen, just as it's normal not to know what will happen after the summer. Many unknowns and question marks remain. But the most worrying thing is that a two-speed recovery seems to be starting to emerge. The fall has been sharp everywhere, but in some countries it was steeper. There is a group of more resilient economies that reacted better than others. For this group, GDP will therefore increase at a faster pace. This could lead to two-speed growth in Europe. We must keep a close eye on this.

What lessons have you learned from the pandemic?

That, to a large extent, countries weren't ready to deal with it at the beginning. This task falls to governments and public health authorities, it is not just an economic issue. The ECB acted quickly and effectively. But other EU tools, including fiscal instruments, would ensure that we are never taken by surprise again. We have understood that we need to complete Economic and Monetary Union. If we had completed the banking union, progressed towards a genuine capital markets union, and if we had had a common budgetary instrument for the euro area, the shock would have been more contained. The only way to avoid asymmetries in the fallout from the pandemic would have been to have had a single response in place at the European level.

Essentially, are you saying that with greater unity, Europe would have been stronger?

Exactly. That is what I mean.

The ECB's response has nevertheless been massive. What is your assessment of its impact?

The ECB's response focused on three pillars. We significantly increased our bond purchases, mostly sovereign bonds, we provided banks with huge amounts of liquidity to grant loans to the real economy, and together with the competent national authorities we introduced support measures for bank capital to avoid a credit squeeze on companies. The impact on the financial markets has been very positive. In addition, the measures taken have avoided fragmentation in the dynamics of bond prices, particularly for sovereign bonds, to ensure the smooth functioning of the monetary policy transmission mechanisms. Now the situation has improved, and financial conditions are not as tight as they were only two months ago. That means that the measures we have taken have had a positive effect. We have avoided a credit crunch which, when the economy was plummeting in the midst of a public health crisis, would have had significantly adverse consequences.

Is "Whatever it takes" still the ECB's motto?

It was crucial in 2012. The crisis is different this time, and we have proven our determination by avoiding a squeeze on credit to the private sector and by improving financing conditions in general. Our commitment is unwavering. As is clear from our communication, we stand ready to recalibrate our non-standard measures and pandemic programmes – such as the pandemic emergency purchase programme (PEPP) – so that they can be adapted to suit the circumstances. The last time we did this was at the beginning of June when we increased volumes and extended the horizon.

Are you ready for a second wave of the virus?

I am not a virologist, but as a central banker, I know that we must prepare for the worst while hoping for the best. A second wave is a distinct possibility.

And if it comes?

Monetary policy is not the only tool we have. National fiscal policy has been

the first line of defence this time around. It has worked well, but the reaction has been asymmetric because the same measure cannot be applied everywhere and not all countries have the same amount of fiscal space. That's why I believe that a pan-European fiscal response is important to avoid what I mentioned earlier, i.e. a two-speed recovery. That's why we need to complete monetary union, and have a genuine banking union, a single capital market and a common budgetary instrument.

The measures you have taken have suffered a blow following the ruling of the German Federal Constitutional Court. How do you feel about that?

I don't want to comment on the rulings made by the national courts. It is important to remember that the ECB falls under the jurisdiction of the European Court of Justice. We are a European institution. We are accountable to the European Parliament and, from an operational standpoint, we are subject to scrutiny by the European Court of Auditors. We do not answer to the national courts, but only to EU bodies. That said, through the Bundesbank, documents that explain the suitability of our actions were provided to German institutions. This happened already in the past. We have decided to cooperate while at all times respecting the principle of the ECB's full independence.

A principle for which, when the EU treaties were being drafted, the Germans fought tooth and nail.

That's exactly right. I don't think anyone can disagree.

What would a two-speed recovery mean for Italy?

For Italy, the problem is primarily related to growth, which was already close to zero before the coronavirus. It's a question of productivity, competitiveness and structural reforms that are still to be completed. In this phase of the crisis, national fiscal policies have to be expansionary. In the short term there is no alternative but to spend. But once the emergency is behind us, all countries with high debt levels – not just Italy – must resume their efforts to address the problem of medium-term sustainability and compliance with the parameters set by the EU.

The ECB has been criticised for being too "pro-Italy". It has been said by the "frugal" countries that you helped Rome to not implement reforms.

I have no objections to being described as "pro-Italy" because it would mean being "pro-Europe". I am pro-Italy, or pro-France, or pro-Spain, I am also pro-Germany. We are all in the same boat.

From the perspective of a politician, do you envisage or do you fear that there will be social tensions when the pandemic is over?

When I was a minister I was called a "technocrat" and now I am being asked to speak as a "politician"! That's life. But, now seriously, this crisis will leave scars and we must minimise the potential damage. This calls for major action in terms of fiscal policy. The new reality will be more complex because GDP will fall significantly and there will be an impact on employment

and on standards of living for Europeans. The main antidote will not be monetary policy – which of course we will conduct being mindful that we are not almighty – but reforms and fiscal measures by governments. In our work, we will also aim to reduce the effects on inequalities.

Let's talk about the banks. You have avoided a credit crunch. But the banks have been criticised for being slow to provide liquidity to firms.

The banks are not to blame in this crisis, and they should be part of the solution. The shock has created uncertainty and the fear of a financial market crash. The need to avoid a credit crunch required the combination of two factors: ensuring that liquidity reaches banks, which we have done, and activating the public guarantee schemes that are necessary to channel funds to firms. At the start there were actually many doubts as well as bureaucratic problems. It was not an easy task. Now, however, the national guarantees have started to operate. Liquidity is flowing. We have avoided the worst.

The return of the virus could cause an explosion in banks' non-performing loans (NPLs).

According to staff analysis, government loan guarantee schemes, if fully deployed, could transfer about 30% of losses from banks to the public sector, on average across euro area countries. The impact of NPLs would be reduced, even if NPLs are set to rise. Bank profitability is very low and will be further dented by the crisis. A first measure to support the banking sector would be completion of the banking union with the approval of the missing third pillar, namely the common European deposit insurance scheme (EDIS). This would provide reassurance for citizens, savers and markets. I hope it can be achieved soon.

Do you believe that the capital requirements for banks need to be increased?

In this temporary emergency, things are moving in the opposite direction. The ECB has temporarily eased the capital requirements for banks, which were in a better position at the start of this crisis than they were for the previous crisis. We ask this flexibility to be used to grant loans and to avoid a credit crunch. The more solid capital position must be used, in conjunction with the buffers, to support the economy.

Are there too many banks? Should there be some consolidation?

Banks should address the issue of low profitability which, for the European banking system, is extremely contained and will suffer from the effects of the crisis. They should double or triple efforts to cut costs, make structural changes and increase efficiency. This process in many cases would ultimately require consolidation, which will be key at the national level for small and medium-sized credit institutions, but also at the European level for larger credit institutions.

There is talk of a bad bank for NPLs. What do you think of that?

The priorities need to be clear. The first is to complete the banking union

with the third pillar. Reopening and concluding the debate on EDIS would send a very strong signal. Other solutions can then be considered. When I was Minister for the Economy in Spain, a bad bank was shown to be a valid tool. But there are other things to do first. Having this discussion now is premature.

Looking ahead, do you subscribe to the notion of the "new normal" when the pandemic is over?

I don't like talking about a "new normal". Normal is normal. There's the new and the old. I prefer to think of a new reality. We have learned a lot from the threat of the virus and its consequences for globalisation. I am in favour of globalisation, but it has its pros and cons, particularly because a pandemic can now spread more rapidly. We have learned the importance of the role of the healthcare system, that the world economy was not prepared for lockdown and that the security of the global supply chain needs to be considered. I hope that a vaccine will soon be found. It will be a more digital world, which will bring advantages but will also have an impact on inequalities. Europe will have a competitive advantage in terms of combatting the climate emergency. All in all, we will have a "new reality" rather than a "new normal", which I hope will be as close as possible to the "old normal".

What have you missed the most during lockdown?

The most novel experience was not meeting up with friends. I missed football and Atlético de Madrid. But above all I missed my two grandchildren.