The ECB response to corona virus

The main points in the ECB response yesterday made sense and were similar to the Bank of England's approach the day before. The ECB announced a major increase to its version of the Funding for lending scheme, the LTRO facilities advanced to Euro area banks. It announced that Euro area banks can borrow from the ECB with the ECB paying them 0.75% a year for the money, so they can lend it on to businesses and individuals.

They also announced an expansion of Quantitative easing, adding another Euro 120bn this year. They reduced the required capital commercial banks need to hold for any given amount of lending, and allowed a wider range of assets to be used against the lending. They did not cut their main interest rates, which are at zero or negative already.

The ECB has two problems the Bank of England does not share. The ECB thinks a fiscal stimulus is needed at the same time, as the UK authorities arranged. The ECB cannot be sure this will happen. The Treaty rules make it unlikely, unless they find a way of authorising temporary extraordinary measures.The ECB wants governments to make banks lending to distressed businesses more likely by offering loan guarantees financed by taxpayers. Again, it cannot guarantee this will happen.

The ECB has gone some way in weakening its prudential regulation of the commercial banks. It will allow them delay in implementing requirements imposed on them by Regulatory Inspection, and it will put off the next set of stress tests they need to meet. It is relaxing the type of capital they need to hold and it will allow them to go under the Pillar 2 Capital requirements anyway in order to keep lending going. It needs to be careful this does not build more future problems into the commercial banking sector.

The ECB has done a better job at keeping money growth at a sensible level than the Bank of England over the last couple of years, offering more support for the Euro economy. It now needs to be careful it does not dilute its regulatory standards too far and allow banks to build loan problems for themselves on a scale out of proportion with their capacity to absorb the subsequent losses when some of the loans go bad.