Monetary Policy During the Pandemic: Fit for Purpose?

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In a recent Monetary Dialogue Paper for the European Parliament, we review and assess the different policy measures introduced by the ECB since the inception of the COVID-19 crisis in Europe, mainly the extension of Asset Purchase Programme (APP) measures and the development of Pandemic Emergency Purchase Programme (PEPP) measures.

APP and PEPP have had *distinct* objectives in comparison with former policies. APP has been oriented towards price stability while PEPP has been oriented towards the mitigation of financial fragmentation.

To this end, we start by analysing the effects of APP announcements (including asset purchase flows) on inflation expectations via an event-study approach. We show that they have helped steer expectations upward.

Then, we analyse the impact of PEPP on sovereign spreads and show that PEPP has had heterogeneous effects that have alleviated fragmentation risk: PEPP has had an impact on the sovereign spreads of the most fragile economies during the pandemic (e.g. Italy) and no impact on the least fragile (e.g. the

Netherlands). However, sovereign spreads have not completely vanished, making monetary policy transmission not fully homogeneous across countries.

On a broader perspective, we also show that overall macroeconomic effects have been in line with expected outcomes since the mid-2000s: ECB monetary policy measures have had real effects on euro area unemployment rates, nominal effects on inflation rates and financial effects on banking stability. These results are in line with recent estimates at Banque de France (Lhuissier and Nguyen, 2021).

As a conclusion, an increase in the size of the PEPP program, as recently decided by the ECB, will be useful if financial risks re-emerge. Meanwhile, we argue that an ECB decision to cap the sovereign spreads during the COVID-19 crisis would alleviate the crisis burden on the most fragile economies in the euro area, where sovereign spreads remain the highest.