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Looking beyond Coronabonds

IN FOCUS

What COVID19 means for the future of the Eurozone

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Summary

The pandemic has created an unprecedented level of uncertainty, mainly because we do not know how long it will last. This affects the economic implications. Two facts are clear: there will be a recession and budget deficits will have to soar. This note draws some implications beyond the immediate health concerns. In many ways, they challenge the architecture of the Eurozone. Either the architecture will change or the Eurozone as we know it will cease to exist. During the sovereign debt crisis from 2010 to 2015, the architecture was changed just as the Eurozone was on the verge of losing one or more members, with unmeasurable consequences. Will history repeat itself?

The public debt issue

Nearly all countries have chosen to lock their citizens down in order to “flatten the curve”, that is to limit the number of severely sick people that hospitals must simultaneously treat. Lockdowns thus save lives but they impose huge economic costs.

At the time of writing, the number of deaths in Italy stands at about 25,000. Assuming that it will rise to 30,000, it represents 0.05% of the total population. A lockdown, instead, instantaneously stops large segments of economic activity and, the longer the drop, the deeper the reduction. Because we do not have yet reliable measures of the drop and no clear view of the duration of the lockdown, estimates of the ultimate impact are essentially wild guesses.

At the same time, it is well understood that the depth of the instant drop and, more importantly maybe, the speed of the recovery critically depends on the economic measures that accompany the lockdown. It is essential to prevent that large swathes of the population fall into poverty and that enterprises, especially the smaller ones that do not have financial resources, are forced into bankruptcies. This is why all governments, at least in the developed world, have embarked on unprecedented actions. Ideally, firms and people, at least the most fragile ones, must keep earning what they normally do. This represents a huge amount of money.

The numbers game

Just how much money is needed is not straightforward to evaluate. For a start, many kinds of support are possible: transfer, direct loans, bank loan guarantees and corporate share acquisition. Different governments can make different choices. In addition, central banks can also get involved.

Table 1 shows the amounts of additional spending officially announced by April 9, 2020. These numbers are likely to increase very significantly in weeks to come. The likely cost could be somewhere between 5 and 20% of GDP, or even more. This ignores the fact that tax receipts will deteriorate, quite sharply, as incomes fall. It also ignores loan guarantees which generally range between 30 and 50% of GDP. As not all emergency loans to households and firms will be paid back, governments will have to pay up, adding to the total bill.

Table 1. Announced policy spending (% of GDP, as of April 9, 2010)

It follows that countries that ran budget surpluses before the onset of the pandemic will now run deficits, and that deficits will deepen elsewhere. At the same time, GDPs will decline. The combined effects of this evolution will significantly worsen the much-watched ratio of public debt to GDP. How high will public debts have to grow? Given how uncertain the forecasts of budgets and GDP growth are, any prediction is highly dubious.

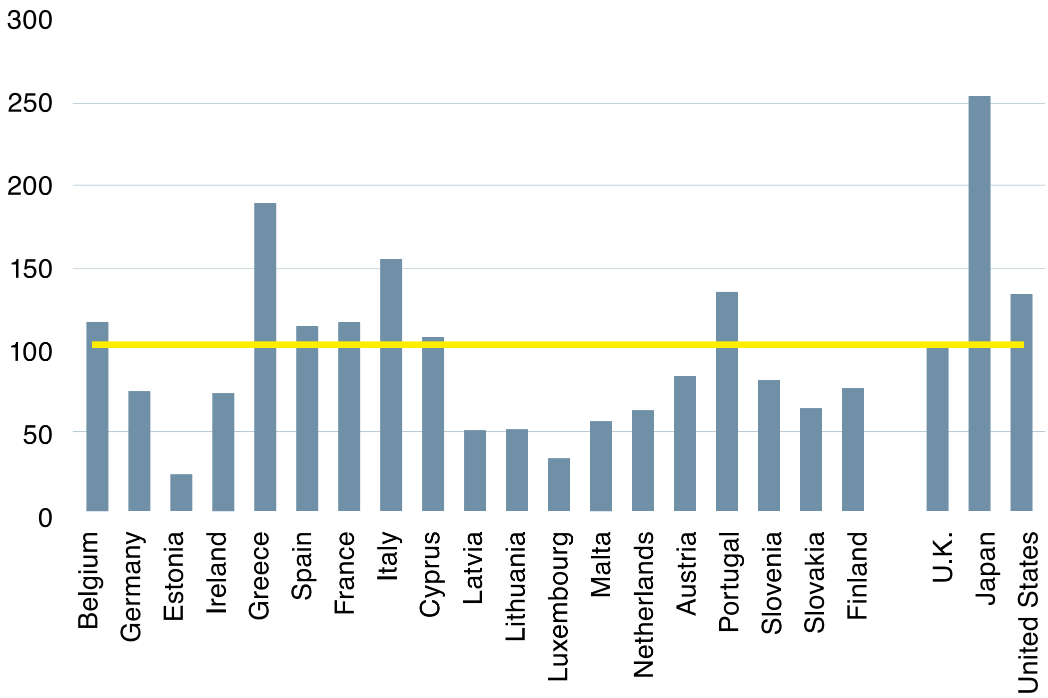
	Spending
Austria	9
Finland	8
France	4
Germany	4,9
Greece	7,5
Italy	1,4
Ireland	2
Australia	9,7
USA	11

Source: Policy Tracker, IMF

An alternative way to proceed is to look at the likely evolution of public debts in 2020 under various scenarios. The Appendix Table examines diverse combinations of Covid-related increases of deficits and of GDP growth rates in the Eurozone countries. GDP is assumed to decline by 2 to 10% over 2020. In each case, the table considers that the budget balance deteriorates by 5 to 20% of GDP. The table makes it clear that, under any scenario, the public debt ratio will remain moderate in countries that start from a low level and with a budget in surplus (the Baltic state, Germany, Ireland, Malta, the Netherlands, Slovenia). The opposite holds for already highly indebted and large deficit countries (Greece, Italy, Portugal). For the others, the outcome ranges from possible to worrying.

Figure 1 summarises the results by looking at a 'realistic' scenario: a GDP contraction of 5% and an increase of the budget deficits of 10% of GDP. It bears to remember that, at the outset of the global financial crisis, in late 2007, the Greek debt ratio stood at 103%.[1] This is the level represented by the horizontal line. Just before its debt crisis in early 2010, it had increased to 126.7%, and the financial markets refused to lend more to the Greek government, triggering the Eurozone crisis. This provides an indication of when a country becomes acutely vulnerable to financial market concerns. Several Eurozone countries are now likely to reach such levels.

Figure 1. Debt ratio at end of 2020 under a 'realistic' scenario



Note: 'Realistic' scenario: GDP contraction = 5%, increase of the budget deficit = 10% of GDP.
Source: Appendix Table.

[1] This is the correct number, different from the doctored number indicated at the time.

The policy issue

One solution is not to allow the deficit to rise. The low increase announced by Italy so far suggests that this could be a course of action but the economic recovery might be both delayed and durably weak as a consequence, which would prevent the debt from declining and therefore keep the country in the vulnerability zone for years to come.

The other solution is to somewhat co-finance the coming debt accumulation. This would remove the threat of a new debt crisis. But this solution rekindles decade-old disagreements often described as a clash of interests and doctrine between the North and the South of the Eurozone.

At the heart of these divergences lies the fact that the countries from the North have managed to bring their debts down while those from the South have not. Why has this happened? One view is that some countries disregard the need for fiscal discipline, which is a requirement, not an option, indeed a pillar of the Maastricht Treaty. Another view is that fiscal discipline is a long-term concern that should not be allowed to interfere with immediate concerns.

I develop a third view: fiscal discipline is a permanent requirement but the current architecture of the Eurozone is poorly designed to enforce it. Indeed, the Stability and Growth Pact stipulates that public debts must be less than 60% of GDP. Since its creation, member countries' public debts have almost always exceeded this threshold. This has led the Commission to de-emphasize this objective, but its focus on budget deficits has been accompanied over and over again by failures in that dimension too. True, there have been shocks (the global financial crisis in 2008, the Eurozone sovereign debt crisis in 2010 and now the Covid-19 mega-crisis). It is a fact that the world is unstable. A good rule is one that can cope with such shocks, not one that is designed for 'normal' years. The Stability and Growth Pact is demonstrably not a good rule.

Outline of what has to be done

Europe will be judged by the staggering costs – human, social, economic, psychological – of the Covid pandemic. Solidarity matters in times of hardship but the arguments that follow are based on a narrower and longer-run evaluation of common economic interests. Health and social order policies are national competences so the challenge is not what Europe can do. Rather the challenge is to ensure that Europe does not stand in the way of what national authorities can and should do. With limited differences, they all take similar measures, which are extremely costly. A first risk is that membership of the Eurozone restricts the ability to face these costs. A second risk is that the long-run impact permanently cripples the Eurozone.

Funding the policy responses

Figure 1 makes a simple point: some Eurozone countries will need to borrow amounts that markets may refuse to offer. It also makes another point: with much larger debts, countries such as Japan or the US are unlikely to be in the same situation. The reason is well-known: the markets trust the central bank of a country to underwrite the public debt in a crisis, and the Eurozone countries do not own their central banks, they only share one.[2]

The conclusion is unescapable: either there is one form or another of collective borrowing or some countries will not be able to support firms and people adequately, with dramatic consequences, or they will face a debt crisis that will rip the Eurozone apart. There are various solutions under negotiations but it must be clear that the amounts needed are of the order of € 1 trillion or more. In addition, the ECB must make it clear that it will back all public debts, whatever it takes.

[2] Paul de Grauwe (2012) “The Governance of a Fragile Eurozone”, *Australian Economic Review* 45(3): 255-68.

The impossible longer run

Assuming that these problems are solved, it remains that a number of countries will be highly indebted once the sanitary crisis is over. They will be vulnerable to any new shock that might come their way. This was already the case for some countries after the debt crisis. The problem was well understood but nothing has been done and now these countries face a precarious situation. Nobody could have guessed the Covid-19 crisis and nobody can guess the next shock. Facing distant threats, the response often is benign neglect. Europe can hardly afford being once again caught unprepared.

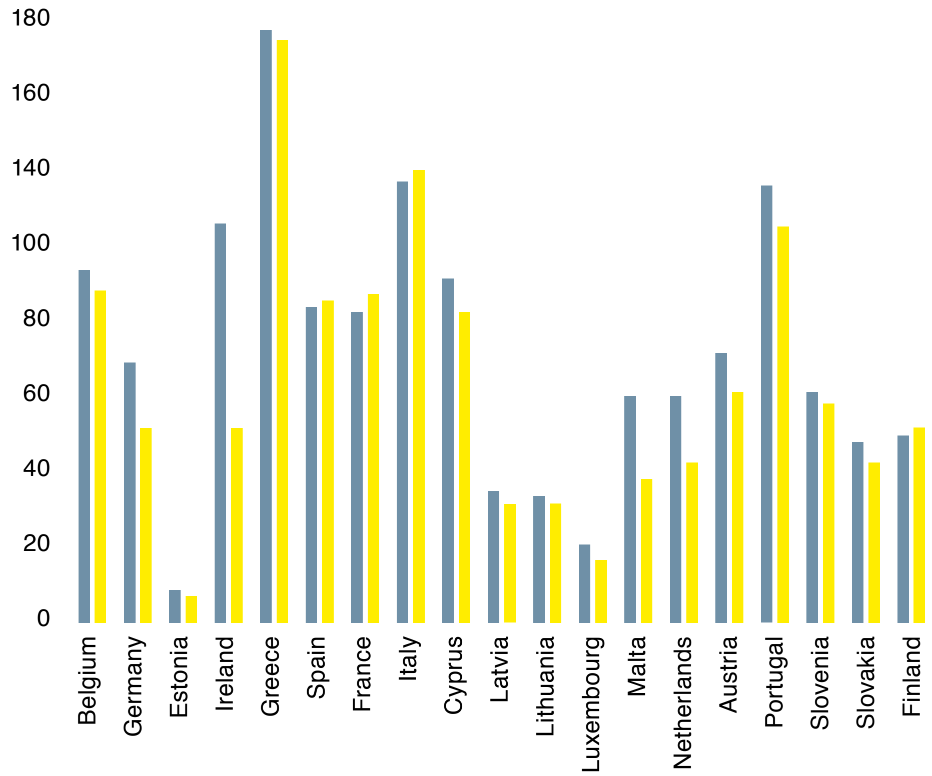
A major challenge will therefore be to bring public indebtedness down. As is well known, there are three ways of doing so: 1) austerity, sustained over many years, possibly decades; 2) inflation, since it erodes the value of existing debts; 3) write-downs, which come in various forms. None is appealing, and that is a major challenge.

Sustained austerity has been the solution adopted after the Eurozone crisis, under visible pressure from the European Commission. Figure 2 shows that a few countries have succeeded in significantly reducing their debt ratios (Belgium, Germany, Ireland, Malta, the Netherland, Austria, Portugal). Elsewhere the debt ratios did not diminish much or even increased. We know that political conditions make it difficult to sustain political austerity and the accompanying low growth has generally contributed to the rise of European sentiment. It is quite unlikely, therefore that sustained austerity can remain the only solution to a much larger problem.

Inflation is sometimes described as a silent tax. The tax is ‘paid’ by the bondholders who see the value of their assets decline. The most efficient inflation tax involves a sudden burst of the inflation rate that catches the bondholders by surprise. Lower and sustained inflation is not efficient as bondholders react and require higher interest rates to compensate for their losses. Given its price stability mandate, the ECB is most unlikely to engineer a burst of inflation.

Debt write-downs involve the expropriation of debt holders, either partially or completely when a state defaults. Shocking as it may seem, a partial default was required from Greece in 2012. In general, however, states default in the aftermath of a crisis, when the financial markets sell their debt holdings as they panic after having concluded, rightly or wrongly, that the government will not be able to honour its commitment.

Figure 2. Debt ratios since the Eurozone crisis (% of GDP)



Source: AMECO online, the European Commission.

The conclusion at this stage is that debt reductions are impossible and yet the debts of many country will have to be reduced. The risk is that the financial markets also reach this conclusion and start panicking, as in 2010-12. Figure 1 indicates that three large countries (France, Italy, Spain) figure among those that could face the markets' wrath. Given the sizes of their debts, it is difficult to imagine that the euro would survive.

So, what should be done? Since each of the three solutions are unpalatable, it stands to reason (from an economic viewpoint, at least) that the best course of action is to pursue a little bit of each. That would profoundly transform the Eurozone, however.

Austerity would be replaced by long-term, quasi permanent, attention to limit deficits and sustained efforts to run surpluses whenever possible. Actually, this was the aim of the Stability and Growth Pact but it has failed, and not only since the Eurozone crisis. Several proposals have been put forward – including by the Commission in order to simplify what has become a highly complex and opaque procedure – but action has not followed.

In recent years, the ECB has battled a too low inflation rate with a range of innovative instruments, including negative interest rates and massive injections of cash. Could it succeed in engineering a brief burst of inflation? The answer is currently unknown but it will not be attempted with its current mandate.

Finally, there are many ways of reducing national debt ratios. Here again, many proposals have been suggested. They include various forms of debt mutualisation, large interventions by the European Stability Mechanism or the transfer of parts of the debts to the ECB which would repay itself by withholding serving its profits to the member states to avoid transfers across countries.[3] Here again, the proposals have been ignored.

Conclusion

The economic difficulties faced by many countries to respond to the Covid-19 crisis are not caused by bad luck. They are the consequence of an obsolete institutional architecture and of problems ignored because they were seen as not urgent. At best, deep controversial reforms were delayed and replaced by marginal changes, at worst they were deemed unnecessary.

The stakes now are much higher because of the economic, financial and political risks that threaten the European construction. Some actions are urgent, to make it possible to go through the sanitary crisis and to renew with growth once it is over. Others concern the long run, to make the Eurozone better able to cope with unpredictable shocks. Reforms that were thought unachievable before the crisis now need to be considered in great haste. The challenge is that long-running disagreements stand in the way of a new consensus. Overcoming old disagreements will require a degree of political will commensurate to the stakes. It is also essential to avoid focusing on traditional conflictual issues such as debt mutualisation or Euro/Coronabonds since alternative solutions exist.

[3] This latest proposal is developed in Paris and Wyplosz, PADRE: *Politically Acceptable Debt Restructuring in Europe*, CEPR and ICMB, 2014.

Appendix

The debt ratio under various scenarios

	Debt	Budget Balance	Growth rate: -2%				Growth rate: -5%				Growth rate: -10%			
			Covid Effect on budget balance				Covid Effect on budget balance				Covid Effect on budget balance			
	End 2019	Forecasted End of 2019	-5%	-10%	-15%	-20%	-5%	-10%	-15%	-20%	-5%	-10%	-15%	-20%
Belgium	99.5	-2,3	108.8	113.8	118.8	123.8	111.8	116.8	121.8	126.8	116.8	121.8	126.8	131.8
Germany	59.2	0.6	65.5	70.5	75.5	80.5	68.5	73.5	78.5	83.5	73.5	78.5	83.5	88.5
Estonia	8.7	-0,2	15.8	20.8	25.8	30.8	18.8	23.8	28.8	33.8	23.8	28.8	33.8	38.8
Ireland	59.0	0.3	65.7	70.7	75.7	80.7	68.7	73.7	78.7	83.7	73.7	78.7	83.7	88.7
Greece	175.2	1.0	181.2	186.2	191.2	196.2	184.2	189.2	194.2	199.2	189.2	194.2	199.2	204.2
Spain	96.7	-2.2	105.9	110.9	115.9	120.9	108.9	112.9	118.9	123.9	113.9	118.9	123.9	128.9
France	98,9	-2.2	108.2	113.2	118.2	123.2	111.2	116.2	121.2	126.2	116.2	121.2	126.2	131.2
Italy	136.2	-2.3	145.5	150.5	155.5	160.5	148.5	153.5	158.5	163.5	153.5	158.5	163.5	168.5
Cyprus	93.8	2.6	98.2	103.2	108.2	113.2	101.2	106.2	111.2	116.2	106.2	111.2	116.2	121.2
Latvia	36.0	-0.6	43.5	48.5	53.5	58.5	46.5	51.5	56.5	61.5	51.5	56.5	61.5	66.5
Lithuania	36.3	0.0	43.2	48.2	53.2	58.2	46.2	51.2	56.2	61.2	51.2	56.2	61.2	66.2
Luxembourg	19.6	1.4	25.2	30.2	35.2	40.2	28.2	33.2	38.2	43.2	33.2	38.2	43.2	48.2
Malta	43.3	1.0	49.3	54.3	59.3	64.3	52.3	57.3	62.3	67.3	57.3	62.3	67.3	72.3
Netherlands	48.9	0.5	55.4	60.4	65.4	70.4	58.4	63.4	68.4	73.4	64.4	68.4	73.4	78.4
Austria	69.9	0.2	76.7	81.7	86.7	91.7	79.7	84.7	89.7	94.7	84.7	89.7	94.7	99.7
Portugal	119.5	0.0	126.5	131.5	136.5	141.5	129.5	134.5	139.5	144.5	134.5	139.5	144.5	149.5
Slovenia	66.7	0.5	73.2	78.3	83.3	88.2	76.3	81.2	86.2	91.2	81.2	86.2	91.2	96.2
Slovakia	48.1	-1.2	56.3	61.2	66.3	71.3	59.3	64.3	69.3	74.3	64.3	69.3	74.3	79.3
Finland	59.2	-1.4	67.7	72.7	77.7	82.7	70.7	75.7	80.7	85.7	75.7	80.7	85.7	90.7
Sweden	34.6	0.1	41.5	46.5	51.5	56.5	44.5	49.5	54.5	59.5	49.5	54.5	59.5	64.5
United Kingdom	85.2	-2.4	94.6	99.6	104.6	109.6	97.6	102.6	107.6	112.6	102.6	107.6	112.6	117.6
Japan	236.7	-2.7	246,5	251.5	265.5	261.5	249.5	254.5	259.5	264.5	254.5	259.5	264.5	269.5
United States	110.8	-6,7	124.5	129.5	134.5	139.5	127.5	132.5	137.5	142.5	132.5	137.5	142.5	147.5

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Charles Wyplosz is Professor Emeritus of International Economics at the Graduate Institute of International and Development Studies in Geneva where he served as Director of the International Centre for Monetary and Banking Studies (ICMB).

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