**Chapter 13**

**COVID-19 and a new debt crisis in the euro periphery?[[1]](#footnote-1)**

Although the corona shock hit all countries in the world, both in terms of public health and national economy, its effects are asymmetric on both frontiers. This is because, on the one hand, the speed of governments’ response in flattening the pandemic curve differed among countries and, on the other hand, because of different initial conditions and timing of the appropriate monetary-fiscal policy mix.

It is true that Southern economies, more dependent on sectors severely affected by the corona shock (tourism, transport etc.), are up against a bigger recession, which could lead to a rapid increase in government debt and deficit in these countries and, more generally, in the euro area.

According to the IMF, Global Government debt will rise by 19% this year as opposed to 10% in 2019. Public debt in the Eurozone could rise by about twenty percentage points of GDP in 2020 from 84% of GDP in 2019 (e.g. Italy 21% of GDP, Spain 18%, etc.). This is translated to an additional €2.5 trillion public debt this year, partly reflecting the economic costs of the covid crisis so far. These debt and deficit forecasts for the euro area point to potential increases in credit risk premia, especially in countries with high debt/GDP ratios, like those in Southern Europe. It is a fact that a simultaneous new government debt issuance in the euro periphery will exert upward pressure on yields; we may have an upward shift of the yield curve, a few sovereign rating downgrades - but not the sort of the 2011 negative spiral - and a possible increase in euro periphery bond spreads vis-à-vis core euro area countries, but that is it.

Contrary to some pundits who talk about a forthcoming debt crisis in the Eurozone, there exist seven distinct arguments leading to the conclusion that there is a clear difference between what is happening now and what had happened during the 2012 Eurozone debt crisis, suggesting at the same time that a new debt crisis is a remote, if not negligible, scenario. These arguments are:

1. The 2010-12 euro debt crisis highlighted the vicious circle between banks and sovereigns. Since the introduction of the single currency, both EU officials and markets kept a false sense of safety as they failed to recognize that the elimination of exchange rate risk would lead to another systemic risk caused by either chronic structural problems or elevated government debt and deficits, being incorporated as credit risk premium in a county’s borrowing cost.
2. This time the origin of the crisis is not sovereign risk, market failure or overheating. It is rather an exogenous symmetric shock in the real economy with negative externalities diffused outside borders, driven mainly by governments’ measures introduced rightfully so to contain the deadly corona virus and its contagion effects. That in turn, contrary to 2010, points to a common European action and some form of debt mutualization.
3. Europe is better prepared today, through the creation of new institutions, like the ESM, the SSM, the SRF, the ESRB with an aim to break the Gordian knot between banks and sovereigns. On top of that it is the trillions of the first and the second QE, the €1.35 trillion of corona QE and the very low interest rates which are here to stay, and are now part, together with forward guidance and TLTROs, of the normal monetary policy toolkit. Note that QE alone will supply about €1 trillion for purchases by the end of 2020, on top of the large liquidity in the global financial system, which secures a satisfactory absorption of new debt.
4. The activation of OMT by the ECB with unlimited support to front-end yields with or without the ESM conditionality (so far any OMT intervention would require first the country in question to access the precautionary credit line of ESM). Unlike 2010-12, there exists today broader political agreement in the euro area, a sort of commitment to support countries during the corona crisis period. In view of the real threat posed by poisonous relations among Member-States that could ultimately lead to the collapse of the Eurozone, moral hazard, a core concept in the no risk-sharing argument of northern countries has been replaced by pro-cohesion EU politics. Such a favourable political stance, together with a real risk of deflation in the Eurozone (due to the collapse in all private sector components of demand and significantly lower oil prices) would make it easier to reach a (unanimous) decision at the General Council on OMT, on which programme, by the way, the ECB has spent literally zero so far. Most likely, things will not change even this time since the signaling effect to the markets, given QE purchases, would be stronger than the real demand effect: the very existence of the bazooka of an open-ended purchase programme for those countries with high public debts would be quite impactful upon market expectations, which in turn would reduce the probability of any purchases having to be made at all.
5. Greece is no longer the Achilles’s heel of the system. The reinstated waiver for Greek government bonds and the ‘protection’ afforded by their inclusion in the corona QE is sort of a game changer for the Greek bond market On account of the ECB capital key, which for Greece is 2.47%, Greek government bonds that could be purchased by the ECB amount to a total of €18.5 billion. Up to 28 April 2020, the Bank of Greece had purchased bonds with a nominal value of €1.8 billion.
6. In the future, any question of debt sustainability would inevitably involve large, ‘too - big - to - fail’ Eurozone countries; it would thus be expected that this matter would be addressed more smoothly, not only in terms of austerity - like in the debt crisis of 2010-12 - but also by using some form of risk-sharing. It will be an existential matter for the present and future of the Eurozone as a whole.

Last but not least, because of the large scale of the recession, the nature of the driving force and the uncertain duration of the propagation mechanism (demand and supply and sectoral shock, repeated lockdowns, etc.), this time a whole arsenal is now available to confront the corona crisis. This, in turn, requires close coordination between fiscal and monetary authorities.

1. Closing remarks at a virtual Roundtable on the European economy organized by OMFIF on 2 July 2020. [↑](#footnote-ref-1)