Post-corona Public Debt: A Challenge for Fiscal and Social Policies in the Euro Area

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The coronavirus pandemic came as a huge shock to European economies. In many countries, public life and economic activity were almost completely shut down. Businesses had to close and curfews were imposed. The Member States of the euro area had no choice but to take massive fiscal measures by supporting businesses and certain groups most affected by the crisis. To allow active intervention by the Member States, the European Commission suspended the deficit rules.

Since the beginning of the pandemic, there has been a general consensus among economists that only an active fiscal policy has a chance of averting an economic catastrophe: a massive wave of bankruptcies and a sharp rise in unemployment. All this would have devastating social consequences, especially for the poorest parts of society. In addition, health expenditure has been considerably higher. Despite massive fiscal support for their economies, EU Member States have experienced the worst recession in decades. The southern countries of the euro area, which are still struggling with the aftermath of the euro crisis, including high levels of public debt and unemployment, have been particularly hard hit, with the tourism sector in southern Europe basically grinding to a halt. Declining economic growth combined with higher government spending has caused a spike in public debt (see Chart 14). In the case of Spain, the euro area country hardest hit by the crisis, an increase of 24 percentage points to 119% of GDP was forecast for 2021. In Greece, debt levels would reach a ceiling of 208%. There, public finances are also under pressure from military spending. The high level of public debt is also a challenge for Portugal and Cyprus. Even Germany does not meet the Maastricht criterion of 60% of GDP, as its debt ratio currently stands at 73%. In June 2021, the European Commission extended the suspension of the fiscal rules until 2023. Rising debt levels pose a challenge to existing fiscal rules. In most cases, public debt levels will be well above the Maastricht reference value of 60 percent of GDP. Therefore, the framework can hardly be expected to be sustainable and will have to be reconsidered.

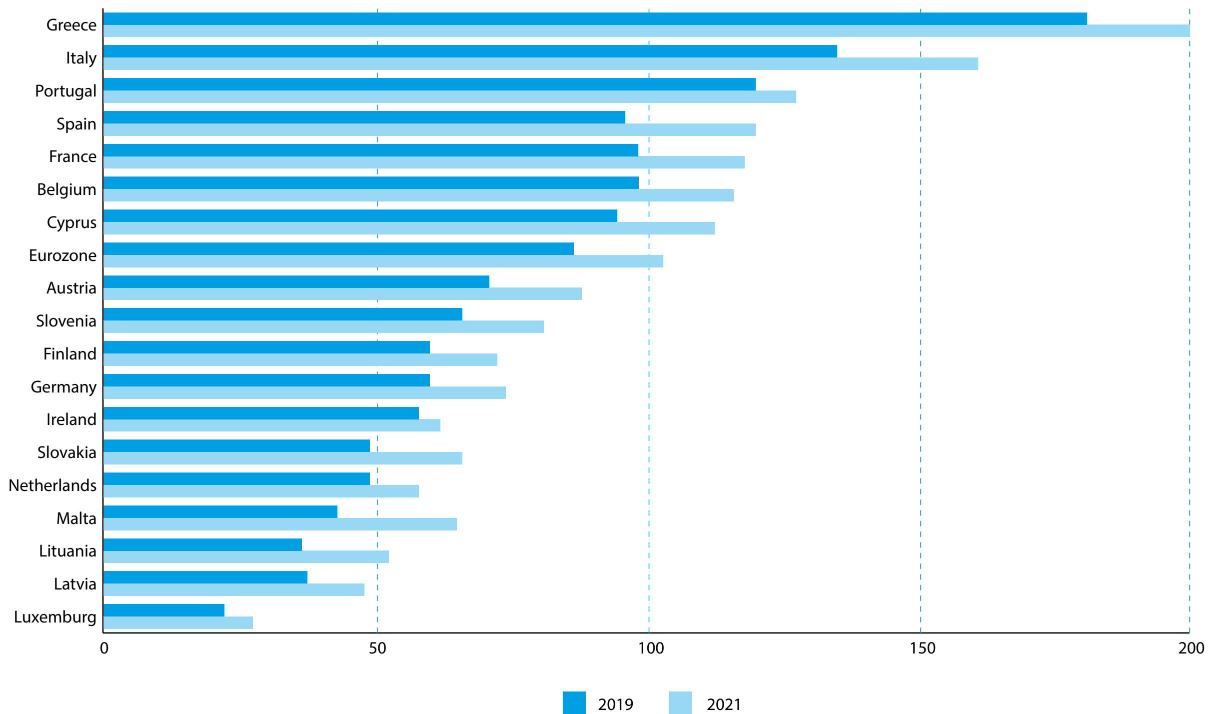
In this context of increased levels of public sector debt, three questions are worth examining. Is increased public debt likely to become a real problem in the euro area? What is the significance of the adopted Recovery and Resilience Facility for fiscal integration? And, finally, how will the elevated public debt impact the social aspects of European integration?

Could Rising Public Debt Become a Pressing Problem?

During the COVID-19 pandemic, the perception of public debt changed. The growing financial obligations of the state were no longer regarded as a problem, but began to be seen as a means to save jobs and economies from complete collapse. With rising levels of public debt, there was also no element of blame. COVID-19 is an exogenous factor, the emergence of which the Member States had no influence on.

The debt-to-GDP ratio gives some indication of the fiscal situation, but the future sustainability of the debt depends on many other factors. We cannot set a specific debt ceiling. However, we must ask wheth-

CHART 14 **Gross Public Debt in the Euro Area in 2019 and 2021 (forecast)**



Source: Ameco.

er the economies will be able to service higher levels of debt in the future. This requires, above all, a rapid rate of economic growth. It also requires flexibility in economic models and their ability to adapt to new challenges, such as the digital economy or the consequences of climate change. The latter may be particularly painful for the countries of the EU Med Group, due to the exposure of their economic sectors, including agriculture, to climate risks. Debt sustainability depends on a country's ratio of assets to liabilities. In particular, long-term liabilities are important. It should be noted that some of the negative effects of the Corona crisis on public finances will only become apparent later. In many European countries the COVID-19 crisis has led to a sharp decline in the birth rate. This may increase implicit debt in the future, for example the costs of health care, welfare and the pension system. The outlook for highly indebted eurozone countries such as Italy, Portugal and Greece is unfavourable in this context. According to the European Commission, the old-age dependency ratio, i.e. the ratio of the number of people over 65 to the number of people aged between 20 and 64, is rising alarmingly.

All this will have a negative impact on public finances. The higher the level of public debt, the more sensitive public finances are to increase servicing its costs. In the event of an economic downturn, countries would face a dilemma between stabilizing the business cycle and debt sustainability. Finally, if a government is no longer able to meet some or all of its debt obligations on time, it risks losing access to financial markets. Currently, the entire debt sustainability of over-indebted euro area countries relies solely on the expansionary monetary policy. This strategy of stabilizing debt through the intervention of the European Central Bank is the only way to prevent the destabilization of Member States' public finances. However, it has side effects, including the growth of speculative bubbles in the stock or property markets. This leads to specific redistributive effects, for example making property owners richer, while excluding certain social groups from this market, such as young people starting their careers.

Current prognoses show that post-crisis levels of public debt in many southern eurozone countries will remain a problem for longer. According to a May 2021 report by Euler Hermes, it will take decades to

return to public debt levels prior to the COVID-19 crisis.[1] In the case of Spain, it will take 89 years to return to pre-pandemic levels of public debt to GDP. In the case of Italy, this time has been estimated at 27 years. Of course, in the meantime, it is difficult to rule out the occurrence of periods of economic downturn or collapse that will cause the debt to build up again. On the other hand, the cost of servicing public debt in euro area countries is still at a low level. This is thanks to interventions by the Eurosystem, which consists of the ECB and the 19 national central banks of the euro area. To this end, a special programme for the purchase of mainly government bonds (Pandemic Emergency Purchase Programme, PEPP) was launched. The ECB has announced that debt market interventions will continue until at least 2022. On the other hand, however, with inflation rising considerably in the first quarter of 2021 and the huge US cyclical package pushing up bond yields in Europe, it could become increasingly difficult for the ECB to justify further interventions to stabilize the debt market.

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The issue of tackling public sector over-indebtedness has been the subject of much discussion in recent times. Unfortunately, this discussion has not led to any concrete result, due to the lack of good alternative options. The proposals to write off the bonds purchased by some Eurosystem banks and the debt restructuring do not seem to be the way to solve the problem. Debt forgiveness by the ECB is questionable on legal grounds. On the other hand, debt restructuring, in the case of Italy, where the largest part of the debt is held by residents, would cause measurable damage to the domestic economy and financial system. For these reasons, the problem of public debt will require an urgent solution at supranational level. It seems that the development of a mechanism to stabilize the public debt of euro area Member States will become one of the political priorities after the current phase of the pandemic. Given the gravity of the problem, the introduction of mechanisms that would lead to the partial common public debt issuance should be considered. Without this, it will be difficult to replace the ECB in its role as debt market stabilizer. Besides, the issuance of common bonds could be beneficial for strengthening the international role of the euro. On the other hand, fiscal stabilization plans should take into account the voices of those countries that fear excessive risk sharing, particularly in those where support for the euro remains relatively low (the Netherlands). Otherwise, further plans for fiscal integration could deepen political divisions in the euro area.

Recovery and Resilience Facility at the Centre of the Anti-crisis Strategy

In addition to the huge public aid packages of the Member States and the aid package adopted by the Eurogroup, France and Germany proposed, on 18 May, the creation of a special financial aid instrument. The agreement negotiated in July was for the creation of a €672.5 billion Recovery and Resilience Facility (RRF), consisting largely of grants. The facility was based on the EU budget, so it applies to all Member States. The RRF is a financial mechanism without precedent in the history of European integration. Using the EU budget as collateral for joint debt issuance has happened before, for example in the early stages of the eurozone debt crisis. However, the EU has never issued debt on this scale to finance the non-repayable grants that make up a large part of this mechanism. Besides, basing the mechanism on the EU budget has opened it to all Member States, which could have a decisive impact on plans for further fiscal integration, which so far have focused on the EU-19.

[1] Allianz/Euler Hermes, *Eurozone government debt: quo vadis from here?* 20 May 2021, accessed at: www.eulerhermes.com/content/dam/onemarketing/ehndbx/eulerhermes_com/en_gl/erd/publications/pdf/2021_05_20_EurozoneGovernment.pdf

In the case of the MED region, the problem with the use of RRF funds is the ability to effectively absorb them in the very short term. It has already been problematic for the latest EU financial perspectives. Estimates by the European Central Bank in its May 2021 Financial Stability Report indicate that EU MED countries may have difficulties in using RRF transfers.[2] Therefore, a massive mobilization of countries in the region is needed to put these funds to good use, not only to create a development momentum after the COVID-19 pandemic, but also to prepare their economies for the new challenges of digitization and green transformation. When it comes to the effective use of RRF funds, special attention will be paid to Italy. The new government under the leadership of former ECB chief Mario Draghi increases the likelihood that these funds will be planned and used effectively. Besides, Mario Draghi enjoys great confidence from the financial markets, which means that Italy's active fiscal policy is not reflected negatively on the interest rates of the country's debt securities. On the other hand, Italy's medium-term political prospects are a cause for concern, especially as a right-wing populist coalition is expected in the upcoming elections. All this is likely to have a negative impact on the country's fiscal sustainability. It may also undermine the willingness of other euro area countries to further fiscal integration.

The success associated with the effective use of this instrument may be a serious argument for making it a permanent stabilization mechanism for EU countries in the future. If the use of RRF funds produces clear benefits for Member States, this solution could also be resorted to in the future in case of external shocks or the need to accelerate green and digital transformation.

In response to the COVID-19 crisis, the EU has also created other instruments to reduce the negative social impact of the crisis. The southern countries of the eurozone will also be among the main beneficiaries of the Special Employment Maintenance Instrument (SURE), created by the European Commission with a focus on the self-employed. Spain and Italy are the main beneficiaries of this mechanism. On the other hand, no euro area Member State has requested assistance from the European Stability Mechanism (ESM), despite the creation of a special credit line there (Pandemic Crisis Support). Particularly in Italy, the use of this instrument is difficult to imagine for political reasons. Given the previous experience with financial assistance to Greece and other countries that focused excessively on the fiscal dimension, assistance from the ESM is difficult to accept for political reasons. This raises the question about the future role of this institution as a tool for fiscal stability. The involvement of the ESM in, for example, stabilizing the debt of the euro area would require not only treaty changes, but above all making it a supranational institution. Currently, it is under the direct control of the Member States.

The problem of public debt will require an urgent solution at supranational level, the development of a mechanism to stabilize the public debt of euro area Member States will become one of the political priorities after the current phase of the pandemic

Public Debt and the Social Aspects of Economic Integration

The sovereign debt problem can hardly be seen in isolation from the social problems caused by the successive crises that have afflicted the euro area since 2008. Many of the structural reforms and fiscal consolidation carried out in countries affected by the debt crisis translated into a permanent or temporary decline in living standards. An important date was 2017, when the EU announced the European Pillar of Social Rights in 2017. This pillar includes 20 key principles for paving the way to a strong social Europe, including equal opportunities and access to the labour market, fair working conditions; and social protection and inclusion. The Covid-19 crisis has considerably increased the importance of this topic.

[2] European Central Bank, *Financial Stability Review*, May 2021, p. 24-25.

The pandemic has had negative social consequences. A crisis of this magnitude, the effects of which on the economies of the currency area are largely asymmetric, risks increasing economic divergence between Member States. Economic divergence leads to social divergence. The consequence of the latter is political divergence, i.e. the divergence of objectives and expectations between the Member States. It is clear that there will always be a divergence of political interests among the countries of the euro area, due to their different economic models. However, if these divergences increase, particularly in the area of the benefits of monetary integration, these may one day reach such a level as to threaten the maintenance of the monetary area's integrity.

In order to reduce the impact of the pandemic, an active fiscal policy is required, despite the deterioration in the budgetary situation of Member States. Budget support can help mitigate the impact of pandemic-related restrictions, especially on the most vulnerable groups: young people, women, the less educated, the unemployed and the elderly. Special emphasis should be placed on students and graduates recently entering the labour market. A major task for governments will be to avoid the possibility of a "lost generation" of young people who, because of the lower quality of education associated with online education, may face difficulties in the labour market in the future.[3] These problems have particularly affected the labour markets in the countries and regions of southern Europe, which were already facing huge structural problems before the pandemic, as can be seen, for example, in the results of the PISA studies. The Member States should take advantage of the post-pandemic growth cycle in the economy to reform inefficient institutional mechanisms in the economy concerning, for example, labour market institutions. These will require multi-year recovery programmes, backed by substantial public funding.

In March 2021, the EU Commission presented an action plan for the implementation of the European Pillar of Social Rights and, at the special European Council of 7-8 May, organized by the Portuguese Presidency, adopted the so-called Porto Declaration.[4] On the one hand, the declaration commits to working towards a "social Europe" and recognizes the European pillar of social rights as an essential element in exiting the crisis. On the other hand, the declaration did not foresee a specific programme or concrete measures. The term "social Europe" remains very general in its definition. Besides, the differences in the economic models of the EU countries are so great that it is difficult to reduce social issues to one common denominator. Some states fear an extension of EU competences in this area, while others, particularly the Nordic states, fear a lowering of their own social standards through the adoption of common, lower ones. Despite attempts at deeper integration in this area, most social policy tasks will remain the preserve of the Member States. Nor does it seem that the conference on the future of the European Union, being held at the time of writing, will make any difference to social integration in Europe.

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An important social aspect of the functioning of the single currency project is its perception by the citizens of the Member States. In the past, due to the various phases of the eurozone crisis and its social costs, support for the single currency project has declined. In recent years, despite the pandemic crisis, we have seen a reversal of this trend. The latest European Commission Eurobarometer surveys indicate that support for the euro has reached its highest level for the last ten years. In 2021, 80% of respondents were positive about the single currency,

[3] Pirozzi, Nicoletta; Argenta, Luca and Tokarski, Paweł, "The EU One Year after the Covid-19 Out-break: An Italian-German Perspective," *SWP Working Paper*, Research Division EU/Europe, 2021.

[4] European Council, *The Porto Declaration*, 8 May 2021.

compared to only 66% in 2021. Importantly, support for the euro has increased markedly in the EU MED countries, while it is lowest in the Benelux countries. There, too, the biggest declines in support since 2019 have been recorded. Although support for the single currency in Greece, Cyprus and Italy is lower than the eurozone average (80%), support has increased and remains above 75%.[5]

Outlook

In mid-2021, the economic forecasts for southern members of the euro area were very positive. The economies of these countries should grow at a fairly fast pace after the pandemic. The prospects for further growth and recovery of post-pandemic economies will be critically dependent on the pandemic situation, including the number of fully vaccinated people. In May 2021, Malta became the first EU country to announce the achievement of so-called herd immunity. However, this will be more difficult to achieve in larger countries. The degree of vaccination, and the speed with which updated vaccines against new variants of the virus become available, will have a decisive impact on the economic and social situation. Disturbing developments in the UK in May/June 2021, associated with a new variant of the virus, indicated the real possibility of another phase of the pandemic and the related negative economic consequences.

Questions remain open about consumer behaviour, whether the tourism and service sectors in southern European countries will manage to recover from the pandemic. In this context, continued active and effective fiscal policy will be crucial, but they will have their consequences in terms of increased debt. As a result, the shape of future fiscal policy in the eurozone and reforms to the Stability and Growth Pact will be among the most important topics in European politics in the coming years. The evolution of German domestic policy will have a huge impact on this debate. Currently, the issue of "normalizing" fiscal policy after the COVID-19 crisis is one of the most controversial issues in the debates among German economists. However, most will depend on the outcome of the Bundestag elections, if the German Green party is co-ruling in a future governing coalition, then Berlin's greater flexibility regarding Stability and Growth Pact reforms can be expected. While there is undoubtedly a need to make fiscal rules in the euro area more realistic, it does not seem to be a good idea to start this discussion now. Given the unfavourable political situation (elections in Germany will be held in 2021, in France in 2022) and the very different positions, it would be difficult to find a constructive solution.

The challenge for the EU MED countries will be to prepare for the next challenges facing their economies and societies, which are at this point a priority for the EU itself: digitalization and climate change

In view of the unprecedented nature of the crisis and its wide-ranging impact, the Member States must monitor its effects closely, including in the long term. It also seems necessary to examine more closely the effects of the pandemic on specific sectors, such as education, which has been particularly affected by the pandemic. In this context, in view of the ongoing struggle with the economic and social impact of the pandemic, the challenge for the EU MED countries will be to prepare for the next challenges facing their economies and societies, which are at this point a priority for the EU itself: digitalization and climate change. In these areas, support through an active and effective fiscal policy that promotes, among other things, investment in these areas will be crucial. The eurozone, in turn, faces two challenges: the need to find a consensus on the redefinition of fiscal rules and an alternative to the stabilization of the debt market by the European Central Bank.

[5] European Commission, *Flash Eurobarometer 488, The euro area*, Report, May 2021, p. 5-6.