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BULLETIN

ECB to the Rescue, Again: Ideas on Debt Relief in the Euro Area

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The pandemic has exacerbated the dispute over public debt in the euro area. The supporters of restructuring propose to redeem or extend the maturity of the bonds purchased by the European Central Bank (ECB) in recent years. Opponents of this idea point to legal problems and economic threats. This is another edition—after negotiations on the reconstruction fund—of the discussion on the future of the monetary union and the limits of financial solidarity between the Member States.

The pandemic has forced eurozone countries to boost public spending. However, the price for stopping the wave of bankruptcies and job losses is a further increase in the already high public debt. According to data from the European Commission (EC), in the third quarter of 2020 euro area debt reached 97.3%, an increase of 11.5 percentage points, year on year. The situation of Greece worsened the most, with its debt approaching 200% of GDP, followed by Italy, at 154.2% of GDP.

The fact that these figures have not caused panic in the markets can be attributed mainly to the ECB. The Pandemic Emergency Purchase Programme (PEPP) launched last year and extended recently made it possible to increase the bank's capacity to buy government bonds by €1.85 trillion by March 2022, which brought calm to the situation. In the background, however, there is an intense discussion of what to do with the Member State debt accumulated on the bank's balance sheet. Radical proposals assume full cancellation of the liabilities or limitation of the repayment obligation only to interest. The idea of restructuring was supported, among others, by David Sassoli, the president of the European Parliament, and advisors to the former Italian Prime Minister Giuseppe Conte. The camp of supporters is also joined by well-known economists, including Thomas Piketty, whose call from February this year for debt relief was signed by more than 100 experts. These ideas, though, quickly encountered harsh reactions, especially from the countries of the "frugal" North.

Arguments for Reduction. Proponents of radical solutions to the debt problem emphasise that the recent increase is not the result of imprudent economic policy by one or another Member State. For example, the Italians have been maintaining primary budget surpluses since 1992 (the amount excluding debt servicing costs), and in view of the positive foreign trade balance, reaching even €60 billion, so it is difficult to accuse them of low competitiveness. The cause of the collapse is the pandemic, which has hit countries with large tourism sectors particularly hard. In this situation, the answer, they argue, should be a common approach to debt reduction, or at least the part of it that has risen in connection with the current crisis.

This is also supported by more objective arguments. The enormous debt complicates economic policy throughout the euro area; the price for the fragile stability maintained by the super-expansionary monetary policy of the ECB is the continued dependence of markets and countries on cheap money, which weakens banks and discourages households from saving. Central bank interventions are also conducive to speculation on the stock and real estate markets, and to keep enterprises alive that would normally have declared bankruptcy long ago (so-called zombie companies).

Restructuring supporters also argue that the conservative idea of fighting debt is unrealistic. It assumes strong economic growth, thanks to which the real value of liabilities will start to decline. However, the reality will more likely resemble "financial repression"—a combination of high inflation and low interest rates. It will hit less-wealthy social groups savings in banks and particularly expose them to the consequences of rising consumer prices. The result may be a further decline in confidence in democratic institutions and the strengthening of anti-system political movements. A better alternative would be to cancel the debt and allocate—as Piketty postulated—the spending capabilities of states released in this way to the energy transformation and social coherence.

Against Reduction. Opponents of restructuring point out that there is no reason to radically change course. While Italy's debt has increased significantly, it can issue its 10-year bonds at a rate of 0.5%, and other countries even benefit from negative interest. In such favourable conditions, financial stability is not at risk. In addition, the reconstruction fund agreed by the EU for a total amount of €750 billion offers an opportunity to accelerate economic growth and thus gradually "grow out" of debt.

Legal issues also speak against debt relief. While the purchase of government bonds was still within the framework of ECB monetary policy, their unilateral redemption would be open support for governments, prohibited by Art. 123 part 1 of the Treaty on the Functioning of the EU (TFEU). Undermining the confidence of the markets can become a big problem, too. The more speculation about possible debt relief, the more private buyers of bonds will treat them as securities at risk of loss. Therefore, they will plan their subsequent purchases more carefully, expecting, for example, a much higher risk premium from the issuers, which would be a dangerous trend for indebted countries. The ECB itself will also have a problem if, for example, in order to fight inflation, it wants to sell some bonds on the market. Investors will expect lower prices.

Another argument, often raised in Germany, for example, is the problem of incentives in the economy that arise in connection with debt relief. The cancellation of bonds could be a signal to politicians that there is no point in undertaking difficult reforms for economic growth and conducting responsible financial policy: it is easier to incur debts and then demand their reduction or easing of repayment terms. Opponents of restructuring also warn that bond cancellation actually be an invitation for governments to increase spending, which could lead not to productive investment but to political give-aways and rising inflation.

Conclusions. The eurozone is consumed by an internal dispute between the North, which prefers a restrictive approach to public finances, and the South, which is inclined to more flexible rules and risk-sharing in this area. It is also a dispute between structural creditors and debtors. During the previous financial and economic crisis, it nearly broke up the zone due to the North's pressure for a policy of cuts in public spending. It also manifested itself during last year's discussions about the "reconstruction fund" and the issue of common bonds, as well as in the dispute over the limits of the ECB's mandate, which was provoked by the judgment of the German Constitutional Court in May last year. Its next phase may be the question of what to do with the "great debt".

Due to legal considerations, at least for now, a redemption of bonds by the central bank is unlikely. However, the issue of debt relief will be used by the South as a political tool to obtain concessions in negotiations on the reform of fiscal rules in the EU, among others. More and more supporters are getting behind the idea of a "recalibration" as Economic Commissioner Paolo Gentiloni put it, which means giving states more time to pay back debt and flexibility to increase spending in a crisis. The problem is that the most principled members of the euro area—for example, Germany, the Netherlands, Finland—must be persuaded to change their positions. That is the purpose of bringing the debt relief issue into the debate.

The discussion on this subject will be of great internal importance in the Member States. In Italy, the opposition could use it to pressure Mario Draghi's new government. In turn, in Germany it will be used by the far-right party AfD to scare voters with the threat of a "debt union" to gain support in the autumn Bundestag elections. The problem of restructuring may also become an important point of reference for euro area candidates. In countries already sceptical about monetary integration, such as Sweden, Czechia, and Poland, it can serve as an additional argument against adopting the single currency. The discussion about the future of debt in the EU also has a non-European dimension. The pandemic has exacerbated the debt crisis in developing countries, especially in Africa, and there are more and more demands for an international agreement on a moratorium and restructuring of liabilities. The situation in the euro area is therefore not unique: it is part of a global economic problem, the solution of which will require political determination and creativity.