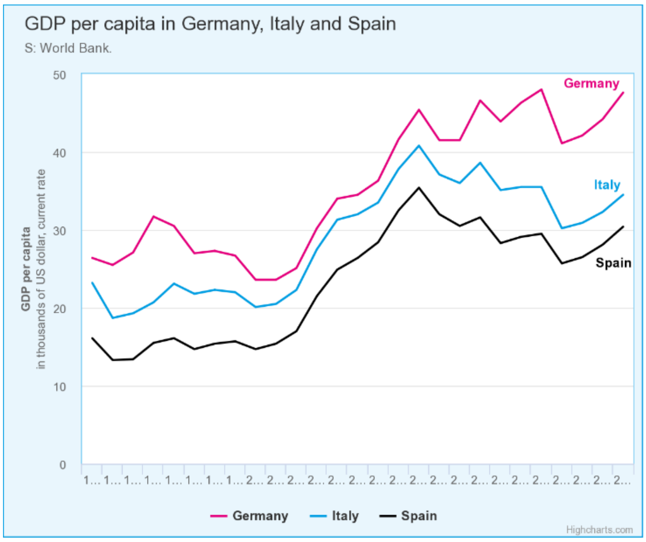
Will the coronavirus induce another eurozone crisis?

The spread of the coronavirus across Europe has put whole countries in lockdown, caused factories to stand still and turned busy streets eerily quiet. What at first seemed to be a psychological crisis based on fears of what might come has now affected the real economy. As businesses close and unemployment rise, workers, business leaders and investors desperately seek support from their national governments. A negative shock to the economy is certainly not ideal at this time as the EU, and the eurozone especially, is still wounded by the past crisis. The countries that got hit the worst in the eurozone crisis are also the ones that will suffer most of the corona pandemic. Several southern countries, such as Italy, are initially heavily indebted and strongly dependent on tourism, which has been and will continue to be severely affected by the pandemic. In a time where Europe would benefit from coordinating both political action and medical supplies – countries have put their own needs first and a new tone of economic nationalism has emerged. Is the coronavirus the last drop that causes another eurozone crisis?

The eurozone crisis can be divided into three parts – the growth crisis, the banking crisis and the sovereign debt crisis. The latter two was mitigated by support from the EU and the ECB, but the growth crisis is deeper rooted and harder to solve. When creating the European Monetary Union there were major macroeconomic differences among the member-states. Due to lower inflation and higher productivity in the northern countries, it became relatively more expensive to produce goods in the southern countries. These differences between north and south drove down the competitiveness over time in the southern part of the euro-area, which is one of the major factors behind the growth crisis in the south. The southern countries have continued to grow slowly, which is clear when looking at Italy´s net growth measured in GDP per capita, which is negative compared to what it was before the financial crisis in 2008-2009. The parts of Italy that have been hit the worst by the coronavirus are in the industrial north, which is the powerhouse of the Italian economy. Every day that Italy (and other countries as well) is locked down to slow the spread of the virus, economic growth falls further. The underlying growth crisis was the part of the eurozone crisis that was the hardest to combat – and there is no question that the corona pandemic will lead several southern eurozone countries into a serious recession. One might even argue that the growth problems that will follow this pandemic alone could trigger a new phase of the eurozone crisis.



It is not only the growth part of the eurozone crisis that risks coming to life once again as the coronavirus infects the European economy – increasing debt problems are also to expect. When entering the European Monetary Union in the late 90s, it became relatively cheaper to borrow in the southern countries. The market considered an investment in these countries to be less risky than before with the muscles of the ECB as a security, and the risk associated with currency fluctuations for lenders and borrowers within the union was eliminated. Not surprisingly, both private and government debt increased in many countries soon after joining the euro in domestic but also international markets. Most of the capital ended up in the housing market and construction industry, which led to higher asset prices. The more loans were given, the more prices rose. This, in turn, resulted in a credit boom with capital flows from the northern to the southern European countries, which reinforced the macroeconomic divergences within the union even more.

The debt-increasing behaviour of the southern European countries might have seemed problem-free as long as the market is stable and interest rates remain low, but when the U.S Subprime crisis hit in 2007 it shook the global economy and the financial crisis that followed did not spare the financial institutions in Europe. Banks in the euro-area suffered from the financial crisis partly because of the U.S subprime crisis but also because of domestic property booms and housing bubbles inside the eurozone. The euro-area banking crisis was a fact in 2008 and many banks soon needed help from their governments. About the same time, in late 2009, the Greek government disclosed that Greece had lied about its public deficit for many years, which created a sudden stop in lending from the northern European countries to the southern European countries. Borrowers got a hard time repaying their loans and started to default on them. The loans were mainly private loans to private borrowers but evolved to a national debt problem, due to approaches used by the states to bail out troubled banks and private bondholders. When the governments needed to bail out the banks they needed to borrow even more. Debt accumulated further. When government bonds rose, many states needed help to be able to pay the interest rate on their loans. This resulted in a national debt that soared in countries like Greece, Ireland and Portugal.

It is clear that the macroeconomic differences between the southern and northern countries created a transition into easy credit conditions that encouraged high-risk lending to the southern countries when the euro was introduced – which in turn contributed to the sovereign debt crisis. The banking crisis was solved relatively direct after its outbreak, but it was made at the cost of worsening the sovereign debt problems. Even though the immediate symptoms of the sovereign debt crisis have been mitigated, the deeper problems remain.

Today, several southern countries still have high levels of public debt. The corona pandemic not only freezes the European economy, but it also puts a lot of strain on national governments expenditure which leads to new loans – and so the debts accumulate. If just one country has problems, the EU could experience financial market instabilities just as it did when Greece got into trouble – only this time it will probably get worse. The level of public debt is generally not as high in the northern countries, but private debt has increased a lot in the last 10 years – which historically leads to increased public debt in times of crisis. When adding the overwhelming risk of deepening the growth problems in the south with the threat of increased public debt in the whole EU - the prospects are indeed grim. We stand before what could be a crisis even worse than the three-headed beast that was the eurozone crisis.

CONTACT

Ms. Sara Snöbohm
Prognoscentret AB
ss@prognoscentret.se
www.prognoscentret.se