Prospects of a eurozone recovery

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The speed and effectiveness of the massive pan-European vaccination programme stands out as the most important factor defining the outlook for the European economy in 2021. The herd immunity threshold will likely be reached around spring. Returning to a (relatively) Covid-19-free summer season, or (in the opposite case) having restrictions extended into the second half of 2021, will make a big difference to the speed and scope of economic recovery in 2021. This is especially the case for the economies most dependent on tourism, such as those of the European South, which were also the ones most vulnerable to the pandemic-induced recession.

The expansionary fiscal stance of governments will continue in 2021, largely financed through the far-reaching 'Next Generation EU' programme. Putting these EU funds to good use will be a momentous challenge for the collective governance structures of member states and the monitoring capacities of the European Commission. Normally, the economies most in need of funding for job creation and their digital and green transformation tend to be the ones with the weakest governance structures and a dearth of eligible projects. The year 2021 will be a historical opportunity for these economies not only to upgrade their productive potential and transform their economic growth models, but also to enhance their institutional and governance competence.

The return to fiscal discipline will (and must) be a matter to be addressed after 2022. The pandemic crisis leaves behind a legacy of ailing banks, with EU-wide stress testing of systemically important banks to be launched in 2021. The huge debt overhang of the private sector will inevitably further raise the debt burden of the sovereign sector. The public debt/ GDP 'stock' of several countries (especially Greece, Italy, Spain and France) will reach headline levels which, under normal debt market and monetary conditions, would border on unsustainable. However, what matters is the ability of the economies to generate the financial flows to service their high debt levels, and on that the European Central Bank (ECB) role will be indispensable.

The debt overhang will force the ECB to continue its quantitative-easing programmes throughout 2021, and retain near-zero interest rates for a long time after the recession is over, to contain debt-servicing costs for governments. Some have tabled the proposal of public debt restructuring, but this would raise overall risk premia and could not be accepted by the ECB. However, a gradual reprofiling of officially held debt might be on the cards, and the ECB might accept to roll over maturing sovereign debt – indeed, the bank is not prohibited from doing this. In other words, the magnitude of the debt overhang, and the fact that 'too-big-to-fail' economies are affected, will lead the eurozone to muddle through and show broad flexibility within its given institutional rule framework.

The overall fiscal stance will thus remain expansionary in 2021, and the Stability and Growth Pact rules will remain suspended, to support a strong recovery. An effort will unfold not only to prolong the suspension of these rules but also to revise them formally. This is always easier said than done, as it requires Council unanimity and supermajorities that are far from given.