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Smoke and Mirrors: on cancelling public debts held by the Eurosystem*

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A number of economists have recently called on the Eurosystem to cancel the public debts on its books, claiming that this operation would be painless and would give governments much needed room for maneuver on the fiscal front. Jef Boeckx and Xavier Debrun show that debt cancellation would be useless, costly and risky. It is useless because the debt of the consolidated public sector would not change, while the budgetary impact would be nil. It is costly because the government would still pay for a supposedly canceled debt in the form of lesser dividends from their central banks. It is risky, because destroying assets that back money issuance is akin to debasement, potentially undermining confidence in the currency.

* This article is adapted from a column originally published (in French) in the Belgian newspaper *L'Echo* under the title "Effacer les dettes publiques serait inutile, coûteux et risqué," on Saturday 20, 2021.

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The abysmal fiscal deficits caused by the COVID-19 pandemic are certainly worrisome. Do they carry the seeds of prolonged future austerity to pay off the Himalayan public debts left by the crisis (and for many countries, decades of relative fiscal profligacy)? How will governments square the debt burden with the need to pay for inexorably rising retirement benefits, ambitious climate change mitigation policies, high-quality education, and productivity-enhancing public spending programs?

Answers to these essential questions will shape the welfare of present and future generations. Clarity is therefore a must. Unfortunately, misleading arguments based on the always dubious principle that there must exist simple "common sense" solutions to complex problems regularly distract us from the real trade-offs.

One much-debated proposal is to write off all government bonds currently on the books of the Eurosystem (i.e. the ECB and national central banks of the euro area). The potential impact is dizzying. For instance, in Belgium alone, that would amount to about 120 billion euros of debt instantly purged from public sector's liabilities. According to its supporters, this operation would be painless and would give governments much needed room for maneuver on the fiscal front.

That kind of argument reflects a profound misunderstanding of the nature of central banks and their main function: the creation (and destruction) of money. We will skip over the fact that such cancellation would be illegal (debt monetisation is effectively prohibited by European treaties) to focus on its economic uselessness, its costs, and the risks it entails.

Useless

Debt cancellation is a solution in search of a problem. Euro area governments can easily borrow considerable amounts at rates close to zero or negative, and this even for long maturities. Hence, even very high debts do not come in the way of ambitious fiscal policies. Not only maturing debt can be seamlessly rolled over, but interest payments leave an insignificant footprint on the annual budget. For instance, Belgium, despite chronically posting public debt ratios in the triple digits for most of the last 50 years, devotes less than 4 cents out of every euro of government revenue to cover interest payments. This pales in comparison to the 23 cents allocated to retirement benefits and the more than 26 cents spent on civil service wages. So, if space is to be found in the budget, the "easy" way out seemingly offered by debt cancellation is nothing but an illusion.

The obvious counterargument is that interest rates are bound to rise in the foreseeable future, prematurely squeezing the fiscal space available for continued support to a sustainable recovery. Such concern is overblown. The considerable lengthening of average debt maturity since the advent of very low rates has made it possible to preserve the benefit of cheap borrowing costs for some time, ensuring the sustainability of current debts even if rates were to rise. Besides, rate increases would not be of the sudden, uncontrolled type driven by random shifts in market beliefs. Since 2012, the European Central Bank has made it clear that it would coordinate expectations away from such "bad equilibria." As long as governments are committed to pro-growth fiscal measures, structural reforms, and safe debt levels in the long term, "fundamental" solvency issues can be kept at bay.

Thus, blind austerity, which is not desirable during a fragile and uncertain recovery, is not necessary either. Instead, an "organic" reduction of the debt ratio is achievable through the power of growth compounding: over 20 years, an average real GDP growth of 1.5% combined with 2% inflation contributes to halving any given inherited debt ratio. Once again, this can be done unless governments make the preventable mistake to pander to low quality fiscal measures (often political quick wins) and send the wrong signals about their commitment to manageable debt paths in the longer term. Any pre-crisis structural budgetary imbalance should be handled by

compressing unproductive outlays. Between the staggering largesse of the Biden plan and the dogmatic austerity advocated by others, there is indeed an ocean.

On a slightly more technical note, let us also recall that the central bank, regardless of its operational independence in the conduct of monetary policy, is part of the broader public sector. Hence, government debt cancellation by the monetary authority has no impact on the public sector consolidated balance sheet, a fact that feeds into the next argument.

Costly no matter what

Borrowing money always costs money, even for the government. Central bank holdings of government securities are an asset for the bank. Simply cancelling it would thus entail massive losses reflected on the liability side of the bank's balance sheet. To restore the original equity position, those losses would have to be gradually mopped up by future profits, preventing the bank from paying dividends to the state. Thus, with debt cancellation, the government would end up trading interest payments to the central bank for losses in dividends from the bank. To put it bluntly, the government would still pay the costs of a supposedly "cancelled" debt.

Here too, the counterargument could be that the state budget would be spared the burden of higher interest rates in the future. And here too, the logic of the consolidated public sector balance sheet would strike back with a vengeance. Indeed, the central bank paid for government bond purchases by issuing its own liability: money—in this case, interest-bearing sight deposits of commercial banks. Since public debt cancellation does not imply the destruction of those deposits—unless causing a banking crisis is the purpose, which is not a great idea—the central bank will also have to pay higher interest on these deposits, reducing its profits in the process and the dividend paid to the State.

Risky business

Even if the central bank itself were to freely take the initiative to cancel the debt—again an illegal move constituting outright debt monetisation—the "risk-free" status of government liabilities would likely be put into question. Risk premia would rise, inevitably leading to tighter financial conditions for private investors and consumers.

In the extreme, this could undermine confidence in the value of money. Unlike cryptocurrencies (a creation ex-nihilo with zero intrinsic value), modern money is a bank liability backed by corresponding assets. In the past, these were metal reserves; in some countries, they are foreign exchange reserves expressed in hard currency; and in this case, they are government bonds, among other assets. Deleting part of the central bank's assets is therefore reminiscent of the princes of yesteryear, who regularly debased their monies by reducing the metal content of coins without altering their face value. In the end, it would be other countries issuing hard currencies (United Kingdom, Switzerland, United States, Japan, or even China) that would reinforce their privileged status, courtesy of European taxpayers.

In the end, debt never disappears by magic and the central bank is not the Great Houdini.

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