EDITORIAL

THE COST OF (TALKING ABOUT) PUBLIC DEBT CANCELLATION

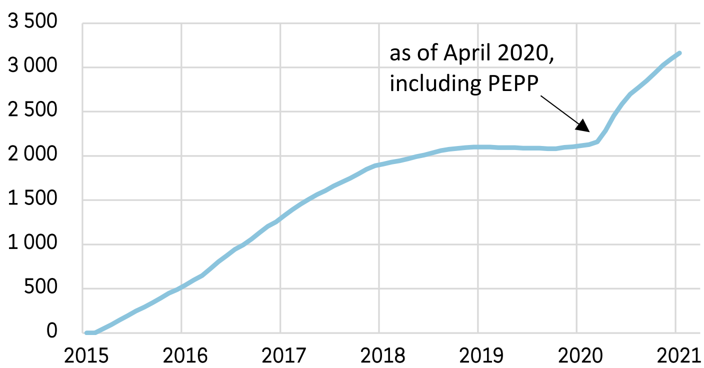
Recently, several calls have been made for the ECB to cancel part of its government debt holdings. Such an operation would violate the EU Treaty. On economic grounds, it is unnecessary, given that the interest paid on the debt to the ECB flows back to governments in the form of dividends. It would actually entail a cost: higher inflation expectations and/or a higher inflation risk premium would cause an increase in bond yields. The extreme nature of the measure could also undermine confidence. In reality, the very low levels of interest rates imply that governments have a lot of time to bring their finances in better shape. Finally, should senior policy makers merely talk about the possibility of debt cancellation, this could also entail a cost: financial markets could consider that the unthinkable is gradually becoming less unthinkable.

The policy reaction to the Covid-19 pandemic has led to a big concomitant increase of public indebtedness and the volume of government bonds on the balance sheets of the central banks. In the eurozone, this has led to several calls for the ECB to cancel part of its government debt holdings. Back in December, Italian officials as well as the prime minister's economic adviser had made suggestions in this sense[1]. More recently, 150 economists signed a press column advocating a deal between the ECB, which would cancel the debt that it holds or transform it into perpetual debt with zero interest rate, and the European states, which would commit *"for the same amount to a widespread social and ecological recovery plan."*[2] Considering that the proceeds of the debts currently on its balance sheet have already been used by the various governments, this proposal actually implies that the ECB would buy even more debt and cancel it soon thereafter. Unsurprisingly, the ECB was quick to react, its President Christine Lagarde arguing that "*cancelling this debt is inconceivable. It would be in violation of the EU Treaty which strictly prohibits monetary financing*."[3]

What about the economic rationale? A first set of arguments states that cancellation is unnecessary. One, cancellation of public debt held by the central bank does not improve government finances. The interest paid on the debt to the central bank is paid out to the State in the form of dividends. Debt cancellation implies cancelling interest payments as well as dividends. Two, the argument could be made that the reduction in the outstanding stock of government debt would lower the required risk premium and hence cause a decline in bond yields. However, to the extent that investors expect that the central bank will forever reinvest maturing debt, they will not take into account the public debt on the central bank's balance sheet in setting the price they are willing to pay for the bonds. Three, for the same reason, the argument of Ricardian equivalence –whereby rising public indebtedness acts as a drag on consumption because households anticipate higher taxes- should not apply.

A second set of arguments considers that debt cancellation would actually entail a cost. One, investors could consider that it sets a precedent: do it once and it will happen again. It would weaken the credibility of the central bank and could raise inflation expectations[4]. Two, even if inflation expectations would not increase –e.g. because of a large negative output gap-, debt cancellation could still cause an increase in the inflation risk premium. This premium compensates investors for the uncertainty around the future path of inflation.

ECB: HOLDINGS UNDER THE PUBLIC SECTOR PURCHASE PROGRAMME PLUS THE PANDEMIC EMERGENCY PURCHASE PROGRAMME (BN EUR)



SOURCE: ECB, BNP PARIBAS

1. *"The case against cancelling debt at the ECB"*, Financial Times, 9 December 2020.
2. *"Annuler les dettes publiques détenues par la BCE pour reprendre en main notre destin"* (*"Cancel the public debt held by the ECB and "take back control" of our destiny"*), published in several newspapers on 5 February 2021.
3. Interview of Christine Lagarde with Le Journal du Dimanche, 7 February 2021, source: ECB website.
4. Benoît Coeuré, *"Si on annule une fois les créances des banques centrales sur les Etats, on le refera inévitablement"*, Les Echos, 1 July 2020

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Concretely speaking, although investors may not have revised upwards their expectations about the inflation path, bond yields could still move higher if investors consider that the risk of upside inflation surprises has increased compared to the risk of downside surprises.[5] Debt cancellation clearly increases this risk. Three, cancellation of debt on the central bank's balance sheet could be interpreted as a worrying signal: the state of public finances must be very dire to warrant such an extreme measure. Such an interpretation could undermine confidence. In reality, the very low levels of interest rates imply that governments have a lot of time to bring their finances in better shape.

A rise in bond yields due to higher inflation expectations and/or a higher inflation risk premium would eventually be costly. To illustrate this point, a permanent 50 basis points increase in the average cost of borrowing would lead to an annual increase in interest charges of 0.75% of GDP in a country with a 150% debt/GDP ratio. It would also require a larger primary surplus or a smaller primary deficit[6] to stabilize the debt ratio. It should be emphasized that should senior policy makers merely talk about the possibility of debt cancellation, this could entail a cost because of its signaling value: financial markets could consider that the unthinkable is gradually becoming less unthinkable. It would also put pressure on the ECB, leading to a debate on how long it should reinvest maturing debt. It would also raise the bar for fiscal solidarity of the type seen under the Next Generation EU plan. Some countries will be reluctant to agree on transfers if others were to push for debt cancellation. For all of these reasons, the required risk premium could increase somewhat causing a rise in the level of government bond yields in general and/or sovereign spreads. Christine Lagarde, in her recent interview, hit the nail on the head by saying "*Rather than expending so much energy asking for debt to be cancelled, it would be much more worthwhile to focus instead on how this debt should be used*."

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5. *"For empirical research which shows this relationship, see Inflation risks and inflation risk premia"*, ECB working paper 1162, March 2010.
6. Stabilising the public debt/GDP ratio requires a primary surplus if the average nominal cost of borrowing ® is larger than the average nominal growth rate of GDP (g). If r < g, a primary deficit is allowed for.