The Feasibility of Sovereign Debt Cancellation: Calls for the ECB to Cancel Eurozone Debt Ignite Debate

Alessandro Pedrazzini

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A bold plan to cancel the European Central Bank's $3 trillion in public debt, presented as an alternative way to reduce Eurozone debt ratios after a pandemic spending spree, has been dividing economists. It is a law in finance that when government deficits balloon, so do demands for debt forgiveness. And, indeed, this time is no exception. Already in November, Riccardo Fraccaro, an Italian cabinet undersecretary and close aide to Prime Minister Giuseppe Conte, proposed that the European Central Bank cancel government bonds purchased during the pandemic. Putting our skepticism aside for a moment, there are sound reasons for such calls. Some argue that cancelling the ECB's public debt might prevent the feared return of austerity measures, which would cause a subpar recovery and lead to a rise in political extremism because people are economically challenged. Others argue that the possible threats to financial stability are too great, and the economic benefits are insufficient.

In February, a consortium of 140 economists from 13 countries sent a letter to several European newspapers recommending that the ECB write off the sovereign debt that it holds. Indeed, the Eurozone's government debt has skyrocketed during the Covid-19 pandemic. About a fifth of Eurozone government debt is now owned by the Eurozone's central bank. "We owe ourselves 25% of our debt," the economists wrote in their letter. They suggested an agreement between European countries and the ECB in which the central bank would cancel the debts or convert them into perpetual debts with a 0% interest rate.

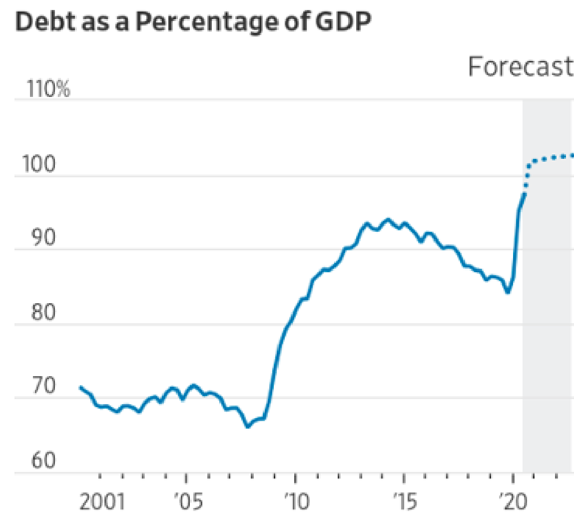

Figure 1: Source: Wall Street Journal

Massive government spending schemes to cushion the economic impact of the pandemic have resulted in sharp rises in government deficits, with debts in many European countries reaching 100 percent of GDP. While the EU's fiscal rules, which require governments to hold deficits under 3% of GDP and total debt under 60% of GDP, have been suspended since the pandemic began, they are likely to be reactivated in some form once the crisis is over, increasing pressure on governments to deleverage. A debt cancellation would relieve member states from these budgetary constraints and could help to avoid the need for austerity in the aftermath of the Coronavirus crisis. The economists claim that the debt-cancellation plan will allow the ECB to redirect funds towards combating climate change, bolstering its credibility. The write-off of debt could free up significant fiscal resources (about 2.5 trillion euros) that could be used toward the bloc's transition to cleaner energy, which urgently requires massive investments. What they argue is that the European recovery plan, based on barely €300 billion of subsidies over three years, is already far from the €2 trillion requested by the European Parliament. Need it be reminded that before the health crisis, the European Court of Auditors already pointed to a minimum of €300 to 400 billion in additional investments every year to finance the ecological transition in Europe? This recovery plan falls far short of expectations, particularly in the aftermath of the pandemic. Moreover, experience suggests that low interest rates and a relaxation of budgetary restrictions are insufficient to entice member states to invest. Despite the fact that the Eurozone had negative real interest rates prior to the pandemic, European nations did not spend and instead concentrated on debt reduction. Therefore, what would make member nations more willing to invest significantly in the green recovery when they already have to heal the severe social, cultural and economic damages undergone during the devastating Covid-19 health crisis?

The ECB's response to the economists' proposal

was negative. Christine Lagarde, president of the European Central Bank, responded two days after the letter was published in major European newspapers in French, English, German, Italian, and Spanish. “It’s unthinkable to cancel the debt,” she said. Ms. Lagarde also stated that the plan would be in violation of European law because the Treaty on the Functioning of the European Union forbids direct monetization of fiscal spending. Canceling the debt would call into question the ECB’s commitment to its price stability mandate. It would also undermine the rule of law and could jeopardize the ECB’s independence.

There is an argument to be made that the European Union is being systematically impeded by its own rules. Other states in the world, such as China, Japan and the USA, are using their monetary policy tool to its full extent and complement their fiscal policy. The Bank of Japan also goes so far as to use its discretionary money-making power to buy stocks directly from the market through listed index funds (ETFs), becoming the country’s largest investor in the process. The European Union is going through such extraordinary times. That would in turn call for extraordinary measures. Hence, the ECB could leverage its money-printing capacity to fund ecological and social restoration under democratic control. The cancellation of the European Union’s public debts in return for investments by the member states would be the first clear indication of the European Union’s ability to reclaim control of its destiny.

On the other hand, although debt forgiveness decreases the debt burden instantly, it generally undermines trust in financial markets and limits future access to private capital, making it more difficult for European governments to fund themselves. For instance, if countries initially pay close to zero for their debt, even a small increase in interest rates would already leave them worse off, making the economic benefit of debt cancellation low. Such a move could also set a dangerous precedent, encouraging governments to cancel debt in future in order to spend more. It would also that mean member states have the possibility of increasing fiscal stimulus if they need it, regardless of debt levels. Another argument put forward by the economists is that debt cancellation would allow for monetary policy to be normalized: one could end quantitative easing by effectively pretending it never existed, increasing interest rates back closer to historical norms without fear of causing a financial meltdown, and returning the global economy to the world we knew before the Great Financial Crisis. One might also argue that the growing inequality triggered by asset price inflation could be brought under control too. However, this is overly optimistic.

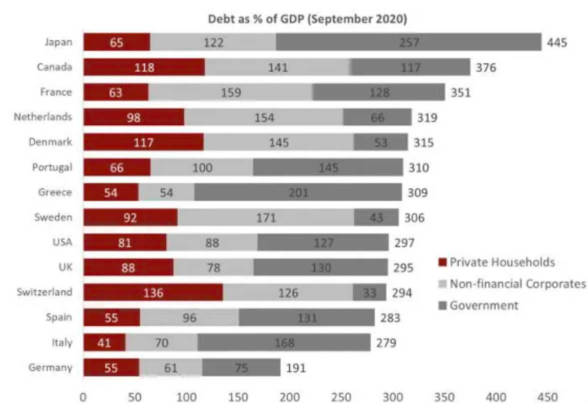

Figure 2: Source: Financial Times

Debts have accumulated across advanced economies. To varying degrees, all of the countries mentioned above now have considerably higher burdens than they did in the past. However, as the chart above indicates, the nature of the current debt boom varies dramatically by state. This is the case with Switzerland, viewed as a bastion of fiscal prudence, which is currently more leveraged than Italy, if we consider sources of debt beyond the state. Swiss mortgages are a colossal debt burden and this is where the problem lies. The majority of debt-forgiveness calls focus on forgiving sovereign debt. However, while this would allow a country like Italy to manage higher interest rates, the same cannot be said for Switzerland. Swiss homeowners would remain highly indebted and face real difficulties in a higher interest rate regime, rendering it unsustainable in the long run. One might argue that central banks are increasingly including corporate debt, mortgage-backed securities, and other assets in their purchases. Hypothetically, they would eventually hold enough debt from all economic sectors to cancel debt across the board. It appears to be easy, however this is not the case.

How do you justify cancelling the debt of highly leveraged company X but not of its rival company Y, which has bank loans but no bonds that the central bank can buy? Not to mention the negative effect of debt cancellation on company Z’s competitive position, despite the fact that it is debt-free. This question is especially pertinent given smaller firms’ inability to access bond markets, particularly in Europe, which means they have not gained directly from quantitative easing, which typically targets bonds. The same principle can be applied to the distributional consequences of mortgage cancellation. Could people with mortgages, many of whom come from higher-income families, be given prefer-

ential treatment to those who do not? One might point out that QE benefits the wealthy by raising asset prices. However, central banks such as the European Central Bank have argued that by increasing inflation, the strategy often benefits the most vulnerable by lowering unemployment. Cancelling debt, on the other hand, would necessitate non-elected public servants making very clear income distribution policy decisions. The independence of central bankers to set monetary policy as they see fit has already come under scrutiny after the financial crisis; officials may not want to risk more public outrage. Therefore, it is unlikely that this decision will be made any time soon. There are numerous reasons why we must exit the low-rate, high-debt environment we have developed. From income inequality to low productivity growth, the world's largest economies' economic challenges should be at the top of the political agenda. However, to address them, resources other than debt cancellation need to be considered first. For example, reworking Europe's fiscal rules would be a better alternative to prevent the return of unjustified austerity, instead of complex debt calculations.