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CANCELLING ECB-HELD DEBT? THE WORST IDEA OF THE YEAR

Berenberg Macro View

In response to the Covid-19 mega recession, debt ratios are surging across the advanced world. At the same time, central banks are gobbling up most of the increase in public debt through their asset purchases. Perhaps unsurprisingly, a few pundits and mid-level officials in Southern Europe have started to ponder a seemingly attractive idea: to reduce the debt burden of Eurozone member states, the European Central Bank (ECB) should simply cancel all or much of the public debt it has bought. With less of a legacy debt burden, Italy, France and other heavily indebted countries would face a brighter future. No harm would be done as the ECB could simply print any money it would need to recapitalise itself. The amounts at stake are huge. By the end of 2020, the ECB will likely have bought sovereign debt (excluding supranational paper) worth c€2.9trn, equivalent to 26% of Eurozone GDP.

The supposed benefits are easy to grasp. By the end of 2020, the ECB and its de facto agent in Rome, Banca d'Italia (BdI), will likely hold close to €550bn of Italian sovereign bonds bought under the ECB's monetary policy initiatives, up from €364bn at the end of 2019. Cancelling this debt would reduce Italy's gross public debt from c161% to c128% of GDP at the end of 2020. Thanks to a stroke of the pen, Italy's public finances would look more sustainable. Nonetheless, the idea makes no economic sense. Any serious attempt to pursue it, let alone a decision to actually go ahead, would pose serious risks to the financial stability of heavily indebted countries of the Eurozone and equally serious risks to the political cohesion of the Eurozone and the European Union as a whole. Top ECB officials have firmly rejected the idea, which would likely constitute a breach of the European Treaty.

Consider the economics first. The central bank is part of the public sector. The argument that no harm would be done because cancelling public debt held by the central bank would be no more than a reshuffling of balance sheets within the public sector can be read the other way round: the finance minister would have nothing to gain from it. Servicing the debt held by the central bank does not strain public finances at all. The finance minister pays the interest on the bonds to the central bank, which then sends the money back to the finance minister upon distributing the central bank profit to its owner, the state. Cancelling the debt would not make it less onerous for the country to service its public debt.

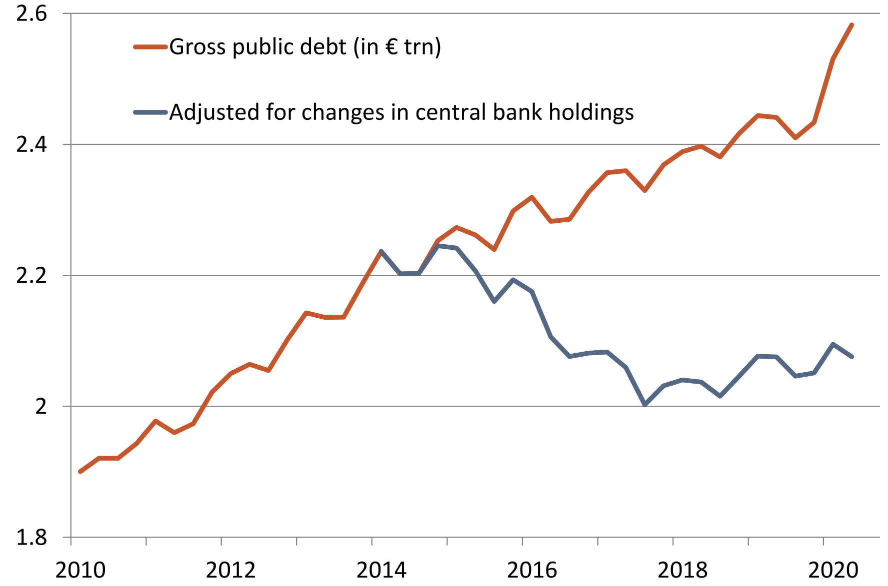
In the context of the Eurozone, the exercise would be mostly pointless anyway. The European Central Bank in Frankfurt is indeed an institution that can print money. In theory, it could thus find a way to cover any losses it may incur if some of its assets denominated in its own currency are cancelled. However, 80% of the risk associated with the sovereign bonds acquired as part of the ECB's monetary policy initiatives resides with the national central banks of the Eurosystem, not with ECB headquarters. While the ECB directs the programmes, the national central banks do most of the actual purchases for their own balance sheets. In the case of Italy, the Banca d'Italia (BdI) in Rome rather than the ECB in Frankfurt would have to take most of the hit from cancelling

Italian public debt. Unlike the ECB, the BdI cannot print money itself. It would have to be recapitalised by its owner, the Italian state. Rome would have to issue bonds to raise the funds for that. As an aside, even the ECB would almost certainly insist that it would need to be recapitalised by member states for such losses instead of de facto printing money to repair its balance sheet.

In financial terms, cancelling public debt held at the central bank could backfire badly. It would breach a taboo. Because it would not confer any serious benefits to any government, investors may see it as a trial run for a broader debt restructuring at their expense. As a result, risk premia for bonds of highly indebted countries may soar. That would make it more difficult for the public sector as well as for households and companies in the country concerned to finance themselves. Instead of debt relief, the result may be a greater risk of a debt crisis. In 2011, a decision to „voluntarily“ restructure Greek debt triggered massive contagion to other peripheral Eurozone debt markets, turning a well-contained Greek calamity into a euro crisis that brought the entire region to the brink of recession. Tinkering with public debt in the Eurozone can be dangerous.

In political terms, a serious attempt to pursue such an option could be toxic. It would confirm the worst suspicions of parts of the public in the less-indebted members of the Eurozone. The cohesion of the Eurozone could suffer badly. In a similar vein, the political resistance against any future bond purchases by the ECB could surge in many countries east of the Rhine and north of the Alps. As a result, the ECB might be unable to use its legitimate tool of monetary policy, namely to buy bonds in order to inject liquidity into the financial system and to ensure a smooth transmission of its monetary policy to the real economy across the Eurozone, again in the future. A suspicion that the ECB's room for manoeuvre would be more constrained in the future than it has been so far would most likely hurt the weaker Euro member countries more than the stronger ones. Once again, the supposed beneficiaries of the exercise would end up as the major losers. In their own interest, the weaker Eurozone members should better squash the low-level debate before anybody starts to take it serious.

A dangerous temptation: Italy's public debt, in € trn, gross and central bank adjusted



Italian total public debt and debt adjusted for changes in central bank holdings since the start of major ECB public sector asset purchases, in € trn. Source: ECB, Haver Analytics, Berenberg

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