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Debt cancellation by the ECB: Does it make a difference?*

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In February this year, several major newspapers published a letter from more than a hundred economists calling for the ECB to cancel the government debt it holds. Paul De Grauwe argues that even if the ECB did cancel this debt, nothing of substance would change economically for national governments.

The recent publication of a proposal made by more than a hundred economists to cancel the government debt held by the European Central Bank has reignited the discussion about the role of the central bank in supporting the government. The question that many ask themselves is whether this proposal is to be taken seriously. In order to answer this question, it is good to go back to the basics of fiat money creation.

When the central bank buys government bonds, say in the context of quantitative easing, it substitutes interest bearing government bonds for monetary liabilities (the money base typically taking the form of bank reserves). In the old days, these liabilities of the central bank were not remunerated. For around the

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last ten years, however, central banks have fallen victim to lobbying by the banks and have started to remunerate these bank reserves. Nothing in the statutes of the central banks forces them to do so, and they could quickly reverse this policy. In fact, over the last couple of years major central banks have been applying negative interest rates on these bank reserves, indicating how easy it is to reverse the remuneration policies.

At the moment when the central bank buys government bonds, it creates “seigniorage”. This is the monopoly profit arising from the creation of money. This “seigniorage” is transferred to the national government budget in the following way: the government pays interest to the central bank which now holds the bonds, but the central bank returns this interest revenue to the government. Thus, when the central bank buys the government bonds, de facto, the government does not have to pay interest any longer on its outstanding bonds held by the central bank. The central bank’s purchase of government bonds is therefore equivalent to debt relief granted to the government.

What happens when the government debt held by the central banks is explicitly cancelled? I will argue that economically nothing of substance happens.

As long as the government bonds are on the balance sheet of the ECB, these bonds do not exist anymore from an economic point of view. This is so because, as I argued earlier, when a government bond is on the central bank’s balance sheet, a circular flow of interest payments is organised from the national treasury to the central bank and back to the treasury. So, the burden of the debt for the national government has become zero. The central bank can cancel that debt (i.e. set the value equal to zero) thereby stopping the circular flow of interest payments. This would not make a difference for the burden of the debt. Put differently, the profit of the money creation has been transferred to the government at the moment of the purchase of the bonds by the central banks.

What happens when the bonds that are kept on the balance sheet of the central bank come to maturity? The ECB has promised that it would buy new bonds to replace those that come to maturity. Again, no difference with outright cancellation. Thus, as long as the government bonds remain on the balance sheet of the central bank, it does not make a difference from an economic point of view at what value these bonds are recorded on the balance sheet of the central bank. These can be recorded at their face value, their market value, or they can be given a value of zero (debt cancellation): from an economic view this does not matter because the government bonds on the balance sheet of the central bank cease to exist.

What matters is the size of liabilities of the central bank. This is the money base that has been created when the bonds were purchased. As long as the money base is kept unchanged, the value given to the government bonds on the balance sheet of the central bank has no economic consequence. If these bonds were to be set equal to zero (so-called debt cancellation) the counterpart on the liabilities side of the central bank would be a decline in equity (possibly becoming negative). But again, this is of no economic consequence. A central bank issuing fiat money does not need equity. The value of equity on the books of a central bank only has an accounting existence.

Thus, debt cancellation is fine, but it is equivalent to no-debt cancellation as long as the bonds are held on the balance sheet of the central bank. The problem may arise in the future if inflation surges and if the ECB wants to prevent the inflation rate from exceeding 2%. In that case it will have to sell the bonds, so as to reduce the money base (and ultimately the money stock). If the bonds are still on the balance sheet (because they have not been cancelled) the central bank will sell these. As a result, they will be held by the private sector and the burden of the debt of the governments will increase because the interest paid on the bonds will go to private holders who do not return it to the treasuries.

If the bonds have been cancelled, they cannot be sold anymore and the central bank will have to reduce the money base in another way. It could issue its own interest-bearing bonds in exchange for the outstanding money base. But this means that the central bank will have to pay interest in the future. As a result, it would transfer less profit to the treasuries. Again, no (or little) difference with outright cancellation.

The conclusion here is that if the ECB wants to keep inflation at 2%, it does not make a difference whether it cancels the debt or not today. In that case if inflation surges beyond 2%, it will have to reduce the amount of outstanding money base by either selling government bonds or issuing its own interest bearing bonds, thereby taking back the seigniorage it granted to the government when it bought the bonds.

Things would be different if the ECB were to allow more inflation in the future; in other words, if it decided that it will do nothing when inflation exceeds 2%. Then it would not have to sell the bonds (or issue its own bonds). In that case, the higher inflation would reduce the real value of the government debt that is not on the balance sheet of the central bank, and that was issued during the last few years at very low interest rates. The government would gain. But note again that this gain would accrue to the government whether or not the debt was cancelled.

Who would pay for this inflationary policy? The investors. Nominal interest rates would increase, thereby reducing the price of the long-term bonds that these investors were foolish enough to buy at negative or zero interest rates.

Two last comments. First, the hundred-plus economists proposing debt cancellation have created the illusion that debt cancellation reduces the debt and therefore allows governments, unburdened by old debt, to issue new debt to finance great projects. I have argued that the debt relief occurs at the moment of the bond purchases by the central bank and not when the central bank puts the value of these bonds equal to zero on its balance sheet. The illusion is to think that you can have debt relief of the same debt twice.

Second, except if at the moment of the debt cancellation governments force the ECB to cancel its commitment to an inflation target of 2%, future increases of inflation will necessarily force the ECB to reduce the amount of money base thereby undoing the debt relief it organised when it bought the debt. Thus, as long as the ECB remains committed to its inflation target, explicit debt cancellation is likely to only reduce the debt burden temporarily. Only if the ECB reneges on its inflation commitment will debt cancellation permanently lower the government debt burden. But somebody will then pay for the inflation tax. One may still argue, however, that some more inflation is worth the price for permanently reducing the government’s debt burden. Maybe this is what the hundred-plus economists had in mind.

About the author

*Prior to joining LSE, **Paul De Grauwe** was Professor of International Economics at the University of Leuven, Belgium. He was a member of the Belgian parliament from 1991 to 2003. He is honorary doctor of the University of Sankt Gallen (Switzerland), of the University of Turku (Finland), the University of Genoa, the University of Valencia and Maastricht University. He obtained his PhD from the Johns Hopkins University in 1974. He was a visiting professor at various universities- the University of Paris, the University of Michigan, the University of Pennsylvania, Humboldt University Berlin, the Université Libre de Bruxelles, the Université Catholique de Louvain, the University of Amsterdam, the University of Milan, Tilburg University, the University of Kiel. He was also a visiting scholar at the IMF, the Board of Governors of the Federal Reserve, the Bank of Japan and the European Central Bank. He was a member of the Group of Economic Policy Analysis, advising President Barroso. He is a research fellow at the Centre for European Policy Studies in Brussels and the Centre for Economic Policy Research, London.*