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Policy Debate - Special Issue

"Policy Mix in the Eurozone facing Covid-19"

Advocating public debt forgiveness by the ECB to build the world to come

Partial public debt write-offs, held by the ECB, conditional on the reinvestment of the same amounts in "green" investments, appear to be an economic and ecological exit solution to the Covid-19 crisis. It needs to be politically discussed.

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I. ENCOURAGING STATES TO RUN INTO DEBT TO FINANCE THE WORLD TO COME, WITHOUT DISCOURAGING PRIVATE ECONOMIC AGENTS TO FOLLOW SUIT

Public debt levels are currently rising in many European countries, rightly taking on debt to offset the immediate effects of the Covid-19 crisis. However, while this present debt is absolutely necessary to keep today's world afloat (guaranteeing workers' purchasing power, avoiding a banking crisis and keeping the production capacity ready to resume activity quickly), it should not be a substitute for taking on the debt necessary for investing in tomorrow's world. States will need to invest in the future for two reasons. Even before the pandemic, deflation and the collapse of potential growth were symptoms of a secular stagnation, against which monetary policy, even in its unconventional forms, cannot fight alone (Acharya et al., 2019 ; Borio and Zabai, 2016 ; Elbourne and Ji, 2019 ; Jannsen et al., 2019). It requires public spending support, while many studies show that fiscal multipliers are high (Blanchard and Leigh, 2013 ; Gechert and Rannenberg, 2014). Moreover, this public expenditure is all the more appropriate as some public investments prove to be absolutely necessary, in public services, as the situation in hospitals proves, but also for the ecological transition. States may decide to move in this direction, to go further into debt after this crisis, which is itself debt hungry. Indeed, they can survive with very high debt-to-GDP levels, like Japan, so long as the economy's growth rate is higher than the interest rate paid on debt securities, and so long as financial markets allow them to rollover their debt. This is all the more probable as the ECB makes holding public securities low-risk by fulfilling its role as an investor of last resort on these markets. The ECB buys excessively large amounts of public debt, on which governments do not pay interest, since the ECB on-lends it to them. Moreover, it is possible that the ECB postpones the repayment date of government debt indefinitely by purchasing new debt when the old debt matures. All the debt purchased by the ECB would therefore in theory be free of interest and repayment: a kind of "free" debt.

Therefore, the question is whether governments will seek to reduce their debts as soon as possible, just as they sought to do so in 2010, to cope with debt overhang. This strategy did not work as it contracted the economy and public revenues as well, as in Greece. The ECB could encourage governments to borrow, by promising to repurchase their debt securities ad vitam aeternam, so that they would never have to be repaid and would not charge interest. This promise, however, only commits those countries that believe in it. The ECB could stop buying back public debt, for fear that the cash issued to finance them, flooding financial markets, would inflate financial or real estate bubbles about to burst. Faced with the non-zero risk of having to repay their debt one day, are governments going to add more debt to their mountain of debt? Many political leaders and technocrats are already promising that their countries will have to repay their public debt generated by Covid-19[2]. So, there is every chance that the Covid-19 indebtedness will wipe out any desire for debt to finance the world to come. The agreement for a European recovery plan presented by Angela Merkel and Emmanuel Macron on Monday 18 May, which provides for the Commission to go into debt to the tune of EUR 500 billion and to transfer it to the regions and sectors most affected by the coronavirus, is, however, a step in the right direction, even if the terms of repayment have yet to be determined and the European partners to be convinced.

A second problem, that of private indebtedness, unfortunately arises when the first problem, that of recovery through public debt, is "partly solved". Economic agents could anticipate an increase in the fiscal pressure following a stimulus of public spending through debt. This is a Ricardian equivalence effect, not emerging from the expectations of perfectly rational agents, but rather of people building on the austerity experience of the past decade, and believing in the pernicious, often-hammered out idea, that they will have to suffer the consequences of their "failed states". Faced with the increase in debt-to-GDP ratios, which were wrongly supposed to give an indication of public debt sustainability, it is possible that economic agents brake the recovery by being cautious and by increasing their savings, while governments would be trying to restart the economy. Here again, the ECB's promise to buy back public debt ad vitam aeternam, i.e. to prevent State from ever having to bear the burden of its repayment, only engages private agents who would believe in it. And these are very few, since it is obvious that economic agents are attached to heuristics such as the debt-to-GDP ratio, and do not go into the technical and accounting details of central bank balance sheets. An explicit way must therefore be found to show economic agents, even those with the least knowledge of monetary mechanisms, that the additional debt issued after the crisis will not have to be repaid. It must be anchored in their expectations that they will not have to bear the fiscal burden of the "whatever it takes" cost of the recovery. The best way to do this is to cancel the debt that the ECB holds towards governments, to avoid a short-term increase in the debt-to-GDP ratio, on which all eyes are focused. The ECB must not only promise to buy back government debt indefinitely, which in accounting terms will mean not making them pay for it, but cancelling it with great fanfare. Two accounting situations that are comparable may be perceived by economic agents in completely different ways, depending on the manner in which they are presented. Monetary policy is also about forward guidance, leading economic agents through this period of radical uncertainty. If the ECB were to decide to write off public debts once and for all rather than promising to buy them back indefinitely, it would act through communication, which is perhaps the most important way to do monetary policy. Remember that Draghi's "whatever it takes" alone did more than half the job!

To do this, we[3] propose a very simple incentive mechanism, which 1) encourages States not to run out of debt too quickly, 2) without this additional public debt being offset by a parallel debt reduction by private agents: that the ECB cancel as much old State debt, already held on its balance sheet, as States would issue new debt to finance the world to come. These investments would therefore be "free", the debt-to-GDP ratio would not change, and yet there would be more public investment to revive the economy and finance certain strategic sectors

II. THE FAKE PROBLEM OF CENTRAL BANK SOLVENCY

The argument that the ECB would become insolvent, since it would realise losses, is not admissible. The ECB's liabilities almost entirely consist of central bank money, which falls within its seigniorage power, i.e its ability to purchase assets by creating means of payment at will. It therefore has no debts on its liabilities side since they are composed of money which it creates itself *ex nihilo*. If the ECB were to make losses on its assets, it would not have an insolvency problem, since it is not indebted. Central banks therefore cannot become insolvent the same way as commercial banks and can survive without difficulty with assets smaller than their liabilities (BIS, 2013).

To be perfectly right, so as not to owe anything to anyone, a central bank only needs to refrain from paying interest on the deposits of commercial banks with it. This is possible, and even desirable in times of deflationary pressures, as evidenced by the negative rates on banks' excess reserves with the ECB today. Though, debt-based investment, conditional on the ECB cancelling public debt, could generate inflation by boosting public demand. It would be the role of the Central Bank, which is independent, to ensure that this does not get out of hand. The right amount of debt cancellation is a matter of proportion, and the ECB is perfectly capable of doing so. In the event of excessive inflation, the ECB would no longer be able to sell as many government securities to dry up the outstanding central bank money, since it would first have cancelled some of these securities. But if inflation were to become too high, the ECB could increase the rates at which it pays interest on commercial bank deposits with it, so that banks would raise the cost of credit. Then, and only then, would this cost something to the public sector, of which the central bank is a part. But this would mean that the central bank would have won its wager to restart inflation, by means of a public expenditure that would hopefully have already made possible an economic recovery, as well as a social and ecological transition. In the event of excessive inflation, and if the ECB did not have sufficient resources to pay interest on commercial bank deposits with it, it could always increase the non-interest-bearing reserve requirement ratios (Turner, 2013). This "financial repression" would certainly have a cost for the banking sector, but this cost would be more than offset by the fact that growth would have resumed, and that the risks of financial instability caused by the ecological transition would be lessened, phenomena which actually strengthen banks. The fact remains that it is still better to revive public demand without raising too much inflation, which makes it possible to keep this mechanism viable for as long as possible. How can this be done? By directing investments conditional on the cancellation of public debt towards the financing of productive investments by the State because the supply capacity would be expected to increase. So, there would certainly be more public demand, but there would also be an increase in production, so no necessary inflation. In this respect, the thermal renovation of buildings, the development of electrical charging networks for clean vehicles, and investments in rail infrastructure, particularly in peri-urban areas, would probably be among the most promising candidates for these "green" investments.

III. CONDITIONAL PUBLIC DEBT WRITE-OFFS, FOR WHOM AND FOR WHAT?

Should the rule of equality for public debt cancellation apply among member countries? Not necessarily, because the ECB could proportion public debt write-offs according to the magnitude of recessions countries experience, which would finally provide the euro area with a mechanism to tackle asymmetric shocks. Not all would necessarily benefit from it in the same proportions.

Ideally, the ECB should follow a Taylor rule, by cancelling more public debt in countries where inflation is too low and unemployment too high. Taking unemployment into account would require a change in its statutes. But if we stick to the framework of its current mandate, we could make debt cancellation conditional on inflation in each country, because not all countries have the same inflation rates. Assuming that inflation is lower in eurozone countries with weak demand, a sluggish economy and high unemployment, debt cancellations conditional on new debt investment would help to boost demand there, improving the country's economic situation, even if it means generating some inflation.

One can guess the reluctance of some and others. If we take the example of Germany, what could be its advantage in having Italy's debt cancelled, but not its own? Certainly, Italy would benefit from the economic gain of debt-based investment conditional on the cancellation of its public debt. However, the idea is that the social benefit of this Italian investment would serve all Europeans and extend beyond Italy's borders. To this end, the European Parliament should set out major areas in which to invest, which would benefit everyone, wherever they are actually implemented, that is to say, global public goods.

This solution would therefore make it possible to address a triple crisis. Economic, because it would make it possible to invest in the countries that need it most. Political, because it would reintegrate into a democratic debate the issue of the allocation of the liquidity created by the Central Bank. Ecological, because it would make it possible to invest in goods whose usefulness would extend beyond the borders of the recipient country.

IV. A TREATY-COMPATIBLE IDEA?

At first glance, debt write-offs are not credits to Member States, nor are they purchases of securities on primary markets; in this respect, they are not supposed to hinder Article 123 TFEU which says that the European Central Bank is prohibited from granting "overdraft facilities or any other type of credit facility […] in favour of […] central government" and that "the purchase directly from them by the European Central Bank […] of debt instrument" is also forbidden. Howev-

1 This policy brief is based on my ongoing PhD thesis, supervised by Laurence Scialom. See also B. Bridonneau et al. "L'annulation de la dette publique détenue par la BCE libèrerait les acteurs économiques de la crainte d'une future augmentation d'impôts", Le Monde, May 26, 2020 ».

2 Christine Lagarde on France Inter (radio) on 9 April: "Over time, we will have to gradually repay our debts and get back on a more stable path that is more conducive to balanced public finances, but we must not do so abruptly". Bruno Le Maire, French Minister of the Economy, on Europe 1 (radio) on 10 April: "This debt must be temporary and we must reduce it as quickly as possible, as soon as the economy can get back on its feet" (statements that we have translated from French).

3 Bridonneau B et Scialom L. (2020a), Crise économique et écologique : Osons les décisions de rupture, Avril

http://tnova.fr/system/contents/files/000/001/955/original/Terra-Nova_Cycle_Covid-19_Crise-ecologique-et-economique-osons-les-decisions-de-rupture__020420.pdf?1585843205

Bridonneau B et Scialom L. (2020b), Des annulations. De dettes publiques par la BCE : lançons le débat, Avril

http://tnova.fr/system/contents/files/000/001/982/original/Terra-Nova_Cycle-Covid19_Des-annulations-de-dettes-par-la-bce_170420---.pdf?1587132547 er, it is understandable that the spirit of this article may significantly exceed its letter, and that public debt write-offs by the ECB may be subject to legal challenges.

So are these cancellations of public debt by the ECB legal? It is difficult to say beforehand: the legal interpretation of treaties is not just a simple act of knowledge, which the interpreter has no choice but to make. The interpreter has a certain margin of freedom in interpreting. There is no pre-existing meaning, before the Supreme Judge has provided his interpretation, on which all members of the political body would agree and which would have to be discovered. The true spirit of a law only becomes apparent when the supreme judges render their conclusions. For example, it was not really possible to know whether the ECB had the right to buy securities on secondary markets until the Court of justice of the EU issued its conclusions in the Gauweiler and Henrich Weiss rulings in 2015 and 2018, long after the contested acts had been put in place.

Yet, rather than leaving the supreme judges responsible for interpreting ambiguous treaties, the most transparent solution is to politically amend the treaties. According to Jürgen Habermas (1997), treaties, like any fundamental law, must be a project in perpetual updating, a substance that each generation refreshes. It is all the more important that the European treaties can now be seen to face deflationary tensions and ecological challenges, where they were clearly designed to cope with inflationary pressures and without any particular consideration for the environment. The best solution would therefore be to find a political consensus to amend Article 123 TFEU and make these conditional public debt forgiveness by the ECB explicitly legal, in order to finance the world to come.

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