Talking Markets: Calls for ECB to Cancel Eurozone Debt Ignite Debate

Some economists want the European Central Bank to write off the $3 trillion owed by the nations it serves, but the bank's chief says the proposal is 'unthinkable'

An anti-austerity protester burns a euro note during a demonstration in Athens in 2015. Some economists argue that the European Central Bank should write off the debt owed to it by countries in the eurozone in order to avoid austerity.

PHOTO: ALKIS KONSTANTINIDIS/REUTERS

By
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A bold proposal to cancel the $3 trillion of public debt held by the European Central Bank, touted as an alternative way to bring down eurozone countries' debt ratios following a pandemic spending spree, is dividing economists.

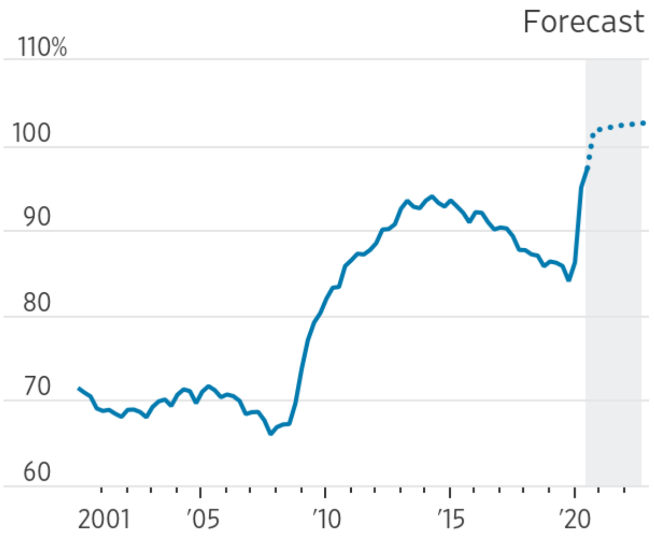
Cancelling the ECB's public debt could avoid the feared return of austerity measures, some economists argue. Others say the potential risks to financial stability are too high and the economic benefits too low.

In February a group of 140 economists from 13 different countries wrote a letter to various European newspapers proposing the write-off of sovereign debt held by the ECB.

Eurozone Debt Jumps

Pandemic Response Leads to Sharp Increases in Government Borrowing

Debt as a Percentage of GDP



Source: Statistical Data Warehouse of the ECB and European Commission

Eurozone government debt has soared during the coronavirus pandemic

Around a quarter of eurozone government debt is now held by its own central bank.

"We owe ourselves 25% of our debt," the economists said in their letter.

They proposed a deal between European states and the ECB, in which the central bank would cancel the debts or transform them into perpetual debts with a 0% interest rate.

Massive government spending programs to cushion the economic hit from the pandemic have caused sharp increases in government deficits, with several European countries' debts exceeding 100% of their gross domestic product.

The budgetary constraints imposed by the European Union's Maastricht rules require bringing public debt ratios down to 60% of GDP. A debt cancellation would liberate member states from these budgetary constraints and could be a way to prevent a need for austerity to return in the aftermath of the coronavirus crisis.

The response from the ECB to the proposal was negative. Two days after the letter was published in major European newspapers in French, English, German, Italian and Spanish, ECB's president Christine Lagarde replied.

"Cancelling that debt is unthinkable," she said.

Ms. Lagarde said the proposal would contradict European law, as the Treaty of the Functioning of the European Union prohibits the direct monetization of fiscal spending.

Luis Garicano, head of Spain's Ciudadanos party at the European parliament and economic coordinator of the centrist Renew Europe alliance there, warned that this would be "a credit event from the point of view of the market."

However, Laurence Scialom, an economist and professor at the University Paris-Nanterre at the forefront of the calls to write off the ECB's debt, doesn't think the bank's credibility would be called into question by such a move.

"Actually, I think that it is the current policy that may ultimately damage the credibility of the ECB," Mrs. Scialom told The Wall Street Journal. Instead, the debt-cancellation proposal would enable the ECB to divert funds toward tackling climate change, strengthening its credibility, she said.

She said that in addition to avoiding lasting fiscal austerity, European countries could commit an amount equal to the cancelled debt--almost 2.5 trillion euros ($2.976 trillion), according to the economists--toward a widespread social and ecological recovery plan.

"It's the macroeconomic, environmental and institutional context of the European Union that justifies our proposal," she said. The write-off of debt could free significant fiscal resources that could be used toward the bloc's transition to cleaner energy, which urgently requires massive investments, she said.

For Mrs. Scialom, experience shows that having low interest rates and a relaxation of budgetary constraints isn't enough for member states to invest. "The eurozone had negative nominal interest rates before the pandemic and still, governments didn't invest and they focused on reducing their debt instead," she said.

Economists are increasingly arguing that austerity would be too economically punishing and wouldn't allow the economy to recover.

"The textbook says that after spending a lot you need to retrench but that does cause a subpar recovery," April LaRusse, head of fixed-income investment specialists at Insight Investment told the Journal. Austerity can also lead to a rise in political extremism "because people are economically challenged," she said.

Although debt forgiveness immediately reduces the debt burden, it also typically damages credibility in financial markets and will usually restrict the future access to private capital, Oxford Economics said.

Mr. Garicano fears that canceling debt would make it more costly for European governments to finance themselves. "If we are paying zero for our debt, even a small increase in interest rates would already leave us worse off," he told the Journal.

"The economic benefit would be very low," he said. Such a move could also set a dangerous precedent, encouraging governments to cancel debt in future in order to spend more, he said.

Oxford Economics' Daniela Ordonez and Angel Talavera argue that low interest rates mean member states have scope to increase fiscal stimulus if they need it, regardless of debt levels.

EU's Maastricht rules have been temporarily suspended due to the coronavirus, but those in favor of debt forgiveness fear that the reimplementation of these rules would mean a return to the austerity policies that marked the aftermath of the 2008 financial crisis.

Oxford Economics says reworking Europe's fiscal rules would be a better alternative to prevent the return of unjustified austerity policies. Similarly, Mr. Garicano advocates simpler spending rules, instead of difficult debt calculations.

For Mr. Garicano, Europe has been successful in its monetary and fiscal response to the pandemic. The ECB's pandemic emergency purchase program ensured sufficient liquidity and financial stability, while its Recovery and Resilience Facility was a big step forward as the European Council, the European Parliament and the European Commission arrived at an agreement to protect the economy by introducing a joint, Europe-wide countercyclical fiscal policy for the first time.

"I expect them to protect what they have done, instead of putting it at risk," Mr. Garicano said.

Whatever they opt for, however, policymakers may still have to think outside of the box, according to some economists.

"The European Union is going through such extraordinary times that would in turn call for extraordinary measures," the economists in favor of debt cancelation said in their letter.

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