Opinion **FT Alphaville**

Sorry, but debt forgiveness is not going to happen

Cancelling the debt central banks have bought is not a fair way to address the economic challenges we face today, argues Rui Soares.

Parliamentary Affairs and Direct Democracy Minister Riccardo Fraccaro, who has called for the ECB to cancel the sovereign debt it has bought during the pandemic. © Getty Images

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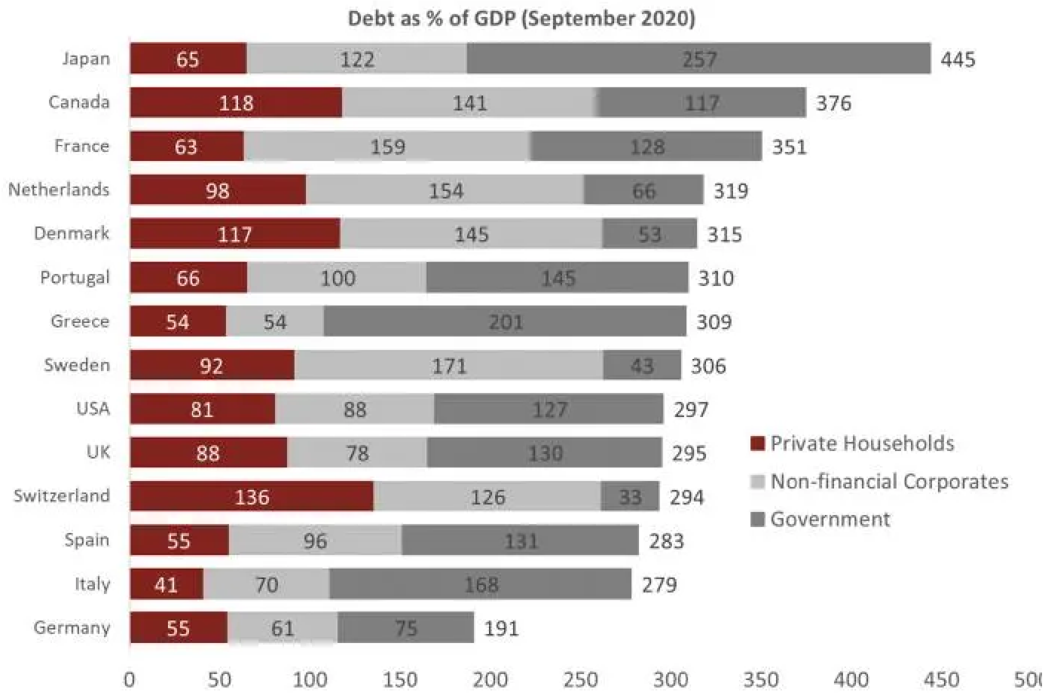
The following guest post about the practical and ethical arguments against debt cancellation is by Rui Soares, an investment analyst and member of the investment team at FAM Frankfurt Asset Management – a firm that specialises in high-yield bonds and options-based equity strategies. The views expressed here are his personal opinions and do not necessarily reflect the views of FAM.

It is a law of finance that as government deficits balloon, calls for debt forgiveness grow. And, sure enough, this time is no different. In November, Riccardo Fraccaro, Italian cabinet under-secretary and close aide to Prime Minister Giuseppe Conte, floated the idea of the European Central Bank cancelling government bonds bought during the pandemic.

Putting our cynicism to one side for a moment, there are sound reasons for such calls. Chief among them is that debt cancellation would allow for a normalisation of monetary policy: one could end quantitative easing by in effect pretending it never happened, raising interest rates back closer to their historical norms with no fear of stirring a financial meltdown, and restoring the global economy to the world we knew prior to the great financial crisis. One might also argue that the growing inequality triggered by asset price inflation could be brought under control too.

Alas, this is all way too optimistic. And the reason is this:



Across advanced economies, debts have piled up. All of those countries listed above have, to varying degrees, significantly higher burdens now than they did in 2002. But, as the chart above shows, the nature of the current debt boom differs spectacularly from state to state.

Switzerland is a case in point: perceived (rightly) as a bastion of fiscal prudence, it is actually more leveraged than Italy — seen as a case study in profligacy — when you consider sources of debt beyond the state. Swiss mortgages, it turns out, are a formidable debt burden indeed.

And herein lies the problem. Most of the calls for debt forgiveness focus on forgiveness of sovereign debt. But, while that would enable a country such as Italy to handle higher interest rates, the same cannot be said about Switzerland -- Swiss homeowners would remain highly indebted and face real difficulties in a higher interest rate regime making it eventually unsustainable.

One might argue that, with central banks' buying sprees including ever more corporate debt, mortgage-backed securities and other assets, at some point enough debt from all economic sectors will be held by them that we can then cancel debt across the board.

Sounds easy. But it isn't. How could you possibly justify cancelling the debt of highly leveraged company A and not of its competitor company B, which happens to only have bank loans but no bonds outstanding that the central bank can buy? Not to mention the adverse impact of debt cancellation on the competitive position of company C, who happens to be debt-free. This question is especially pertinent given the inability of smaller firms to tap bond markets — especially in Europe — which has meant that they have not benefited directly from quantitative easing, under which only bonds have been purchased.

You can apply much the same logic to the distributional effects of cancelling mortgages. Could citizens who have mortgages, many of whom tend to come from higher income brackets, be favoured over those who don't? One might argue that QE, by raising asset prices, favours the rich. But central banks such as the ECB have also argued that, by raising growth, the policy also helps the most vulnerable by lowering unemployment. Cancelling debt, on the other hand, would involve very explicit income distribution policy choices being made by non-elected public servants. Don't count on that happening any time soon. Central bankers' independence to set monetary policy as they see fit has already come under enough pressure since the financial crisis; officials will not want to risk further public anger.

There are plenty of reasons why we need to rid ourselves of the low-rate, high-debt world we've ended up in. From income inequality to low productivity growth, the economic problems befalling the world's largest economies should be at the top of the political agenda. But solving them will require tools other than debt cancellation.