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# Dealing with Legacy Debt in the Euro Area

To strengthen the euro area's resilience to crises and guarantee its sustainability, member states will need to agree on a model for the long term. Regardless of the direction they choose, however, current high levels of public debt and large differences between member states in this respect may constitute an obstacle to implementation. They make it difficult to reconcile national positions on the future of the euro area and are one of the reasons discussions are so difficult to advance.

True, the high levels of public debt can still be corrected by sustained budgetary adjustment. This strategy is nevertheless not without risk. It will only bear fruit in fifteen or twenty years, leaving highly indebted countries in a state of vulnerability should an economic shock occur on the path to adjustment. If a large member state were to default, for example, the consequences for the area would be disproportionately high. Lastly, because lower levels of public debt are one of the preconditions for a coherent, stable and sustainable architecture for the euro area, there is a risk the completion of the reforms that would make this possible will be postponed indefinitely.

The current strategy of budgetary adjustment should be pursued, but other possible ways of addressing the problem of high levels of public debt should also be explored, should unforeseen events in the future call for quicker remedies. This is a difficult exercise and requires some unconventional thinking. In this note, we suggest three non-mutually exclusive avenues of resolving this predicament.

In the first, countries would jointly commit to supporting a member state engaged in a process of budgetary adjustment in the event of lower-than-expected economic growth. Solidarity would be limited and conditional on reform and budgetary adjustment but would nevertheless contribute to joint "ownership" of national efforts. It would also strengthen the credibility of the budgetary adjustment paths.

While public debt has increased over the past twenty years, so has household wealth – particularly when it comes to real-estate – with large distributional consequences. A second avenue could therefore consist of a highly indebted country decreeing that it becomes part-owner of all lands on which dwellings are built, up to a given fraction of their value (establishing a leasehold in effect on part of the land). The payment for the right of occupancy by the homeowner would generate an annual revenue stream for the state. Homeowners could choose to differ annual payments, the total amount of which would become due only upon the sale or inheritance of the home.

A third and final solution would be to rely on the European Central Bank. It could repurchase part of highly indebted countries' sovereign debt, exchanging them into perpetual non-interest bearing bonds and keeping them on its balance sheet.

These three proposals are inevitably novel and radical in nature, and some may even consider them dangerous. They raise obvious political and legal challenges. The debate should nevertheless be tackled head-on to avoid hasty and unprepared decisions should another large-scale crisis hit the euro area in the future.

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## INTRODUCTION

In just 10 years, the ratio of gross public debt to GDP in the euro area has increased from an average of 65% to more than 90% of GDP today. Several countries have debt ratios in excess of 100% of GDP. Others, such as France, are not far from this threshold. For some countries, the increase is first and foremost the result of the steady buildup of budget deficits before the crisis, made possible by market nearsightedness and the failures of EU budgetary surveillance to counteract inappropriate price-signals. For other countries, public debt increased when national housing bubbles burst and overleveraged banking sectors came crumbling down, leading losses to be transferred to the public sector balance sheet and causing tax- and job-rich sectors of the economy to be wiped out.

**The notion of the sustainability of public finances is not always well understood and can lead to an exaggeration of the risks posed by the current situation.** A sovereign's debt can be considered sustainable when fiscal policy does not put the country at risk in the long term of not being able to meet its commitments towards creditors or ensuring the continuity of public services. This, of course, depends not only on the current levels of the debt and deficit but also on the future paths of GDP growth, inflation, deficits and the interest rate demanded by markets. These trajectories are subject to considerable uncertainty; they may be revised upwards or downwards, depending on policy decisions and external shocks that can escape the government's control. They also leave ample room for judgement, especially regarding the acceptability of policies – and the ability of governments to pursue them for significant lengths of time. The probable reactions of other economic agents (i.e. member states, financial assistance mechanisms, central banks, etc.) to a crisis situation can also have an impact. A country's debt may therefore be deemed sustainable under one set of assumptions but not under another. This is why it is impossible to define a permanent threshold that would apply to all countries at all times and under all institutional configurations, beyond which the level of public debt must be considered non-sustainable. The diversity of situations around the world and the fact countries such as Belgium or Japan have been able to maintain market confidence despite comparatively high debt levels for extended periods of time illustrate this. A recent study by the IMF even went so far as to suggest that the maximum level of public debt for advanced countries, if such a notion makes any sense, could be greater than 200% of GDP.<sup>1</sup>

**The current situation in the euro area is no less worrying because of this.** The sovereign debt crisis of 2010-2014 proved the risk of a sovereign default is not the preserve of developing countries, and current debt levels could, rightly or wrongly, lead financial markets to question the solvency of euro area countries.

## THE DIFFICULT TRANSITION TO A MORE ROBUST ARCHITECTURE

The euro area reacted to the crisis by strengthening its architecture (creation of the European Stability Mechanism [ESM] and reform of economic and fiscal governance), and indeed it continues to do so today with progress on the Banking Union and Capital Markets Union. Along with member states' own efforts to bring their public finances into line and current favorable economic conditions, the situation today may appear less critical than in previous years.

However justified the EU may have been in averting a breakup of the euro area, **the reforms it has undertaken since 2010 have nevertheless deprived the zone of a coherent architecture**, leaving euro area countries dangerously vulnerable in the event of a large economic or financial shock. **Guaranteeing the euro area's longer-term resilience will require member states to choose between three robust and internally consistent models**, as set out in "What model for the future of the Eurozone?", a paper published by France Stratégie in December 2016:

- **A model of stronger integration**, featuring some form of joint liability on all or parts of member states' public debt, in exchange for a radical strengthening of fiscal discipline at the European level. This scheme, which would lead to an additional loss of national sovereignty in the area of fiscal policy, would require a deep rethink of euro area governance to establish its democratic legitimacy.
- **A Maastricht 2.0 model**, which would mark a return to the original founding principles but under a purer form. Financial markets would be charged with policing fiscal discipline through appropriate price signals, fiscal rules would be scaled back if not eliminated, and any form of joint liability on national public debts would be excluded. The credibility of this setup, which relies on the effectiveness of market discipline, would require clear ex ante rules on debt restructuring and would need to explicitly provide for this possibility. In case of a sovereign debt crisis, debt restructuring

1. See Ostry J.D., Ghosh A.R. and Espinoza R. (2015), "When Should Public Debt Be Reduced?", IMF Staff Discussion Note, SDN/15/10.



would be made a prerequisite for temporary support from the ESM to bridge the gap until market access is resumed.

- **A hybrid model**, which would leave member states responsible for their own debt and provide for the possibility of debt restructuring as in the previous model but would supplement it with a centralized instrument to ensure macroeconomic stabilization under the form of a euro area budget.

**Euro area member states must, as a matter of priority, decide on what they want for the future** and choose the model they wish to see emerge in the medium term. **However, whichever model they choose, they will inevitably come up against an obstacle that precludes short-term progress: the high levels of public debt in the euro area and the large differences between member states in this respect.**

**The problem is obvious in the first model, where a form of mutualization of sovereign risk is put in place.** For risk-sharing to be politically acceptable, a necessary condition is that all participating member states be put behind a “veil of ignorance” at the time of the transition – i.e. no country is able to determine with any degree of certainty they will be net beneficiaries or contributors to the system of joint responsibility on public debt.

This condition obviously isn't met today. True, no country in the euro area is in a situation where it is possible to say that its level of public debt is not sustainable. But given the very different starting points, it is politically impossible to imagine any form of liability sharing given that risks are ex ante unevenly distributed among countries. The only feasible and politically acceptable solution would be for all countries' public debt to be brought down to moderate levels before transitioning to the new system. A logical target might be the threshold of 60% of GDP set out in the Maastricht Treaty. A higher threshold of 80% of GDP, for instance, might constitute a more realistically attainable objective. Neither of these thresholds make any economic sense, but the orders of magnitude illustrate the debt levels that might make a form of mutualization politically acceptable.

**The obstacle of high levels of public debt and large differences between countries also arises in the second and third models. Unambiguously announcing that**

**member states will be solely responsible for their own debts, without any form of assistance at the European level other than meeting liquidity needs, and only in exchange for debt restructuring explicitly provided for by a dedicated mechanism, could precipitate an immediate crisis.** Interest rates demanded on euro area sovereign bonds reflect the markets' assessment of debt sustainability based on their appreciation of economic fundamentals and the likely future paths of key variables. But they also reflect – in proportions that are impossible to determine – the likely reaction of European institutions and other member states should a new crisis occur. Eliminating ambiguity on the extent of assistance could rekindle the crisis. A sovereign debt restructuring mechanism can only constitute a realistic prospect if at the moment of transition debt levels are unequivocally perceived as sustainable by markets for all countries. Here again, the thresholds that would meet this condition are impossible to determine. But the crisis has shown that even current levels of public debt could cause concern under certain conditions. This calls for a cautious approach and suggests that a model explicitly providing for debt restructuring is not possible at the current juncture.

**Solving the problem of legacy debt would also help to meet one of the other necessary conditions for a model with stronger fiscal sovereignty at the national level:** ensuring that banks are able to withstand a sovereign default. With member states on a more equal footing with regards to creditworthiness, progress in reforming the prudential treatment of sovereign debt on banks' balance sheets (exposure ceilings, zero risk weight for sovereigns, etc.) could be a lot quicker.<sup>2</sup>

It is without doubt that if sufficient progress is to be made on a deeper reform of the euro area's architecture, solutions for the problem of high public debt must be found. **The most obvious solution – pure and simple sovereign debt restructuring, with losses entirely borne by creditors – is a nonstarter**, for it would immediately ignite a massive economic and financial crisis and endanger the euro's survival, thereby entirely defeating the purpose debt restructuring was meant to serve. Somewhat paradoxically, the path towards strengthening market discipline and forcing investors to factor in a non-zero risk of debt restructuring first requires an unambiguous demonstration of the fact that the risk is, in fact, negligible, and is set to remain so.

2. An alternative proposal by Corsetti *et al.* (*Reinforcing the Eurozone and Protecting an Open Society*, 2016, Monitoring the Eurozone 2, CEPR Press) recommends the creation of synthetic securities backed by a diversified portfolio of sovereign bonds. Prudential regulation would be reformed to ensure these bonds incur lower capital costs than national bonds. Banks would therefore hold bonds of this type rather than maintain exposure to individual countries.

## LIMITS TO THE CURRENT FISCAL FRAMEWORK TO REDUCE PUBLIC DEBT

There are no foregone conclusions in the current levels of public debt, and they will be brought down organically through the combined effects of fiscal adjustment, economic growth and the return of inflation to slightly higher levels (these variables interact with the level of the deficit but also impact the debt ratio through the denominator effects of GDP). This is true for all countries, including the most indebted. An unresolved question, however, is whether this programmed reduction in debt ratios, supported by sustained fiscal adjustment in line with the requirements of the European fiscal framework, will be sufficient both in size and speed.

The projections below describe the evolution of the debt ratio and the structural budget balance until 2040 for a subset of euro area countries with public debt ratios in excess of 80% of GDP, under simple and common hypotheses (see Box 1). We assume strict compliance with Stability and Growth Pact requirements and set inflation and interest rates at their average over the 2000-2007 period. Potential growth is equal to its latest value in the European Commission's forecasts. Over a period of a little over ten years, the drop in public debt ratios is substantial (around 20 percentage points on average). The results assume a yearly structural adjustment of 0.5 percentage points until the minimum structural balance of -0.5% of

GDP is reached (the minimum target set out in the Treaty for Stability, Coordination and Governance).<sup>3</sup> Due to the gradual increase in interest payments, the adjustment lasts until the end of the next decade for most countries, though at a lower pace.

### Box 1 – Assumptions underlying the projections

Projections are based on macroeconomic data from the European Commission and start in 2018. They are based on a standard deterministic model of debt dynamics and on exogenous hypotheses as regards the path of GDP growth, inflation, the implicit interest rate and structural adjustment. Inflation and implicit interest rate are equal to their average levels over 2000-2007 for all countries, after a convergence period of five years (for inflation) and a little over ten years (implicit interest rate). The economy grows at a constant rate, equal to the 2018 potential growth rate as estimated in the European Commission's forecasts, after a catch-up period that closes the output gap over five years. Structural adjustment is set at 0.5 percentage points (pp) of GDP per year until the target of -0.5% of GDP is reached (where the structural balance is already greater than -0.5 pp of GDP, countries are assumed to stay at this level). Structural adjustment remains positive even after the target is reached. This is in order to compensate for the deterioration of the structural balance due to the increase in interest payments.

Table 1 – Debt levels in the euro area and gap-to-target ratios (2017)

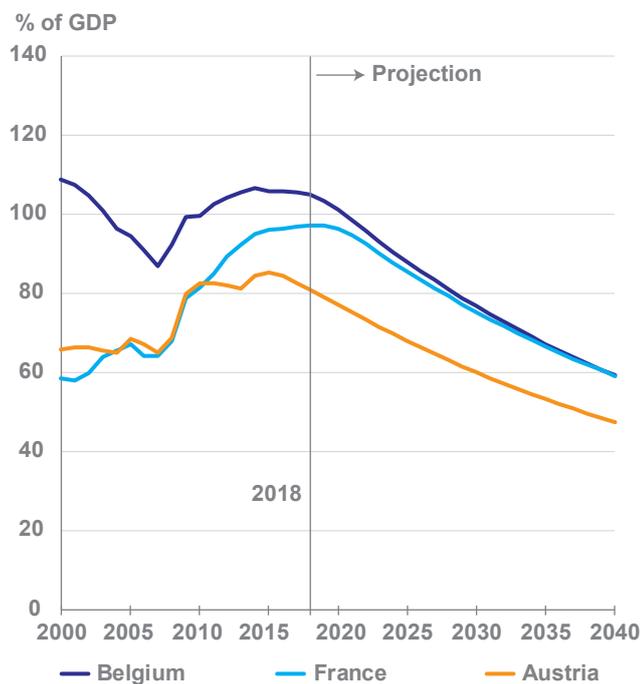
	Debt % of PIB	Gap to 80 % % of GDP	Gap to 60 % % of GDP	Gap to 80 % € billions	Gap to 60 % € billions	Gap to 80 % % of euro area GDP	Gap to 60 % % of euro area GDP
<b>Greece</b>	178.8	98.8	118.8	179	216	1.6	2.0
<b>Italy</b>	133.1	53.1	73.1	904	1244	8.2	11.2
<b>Portugal</b>	128.5	48.5	68.5	93	131	0.8	1.2
<b>Belgium</b>	105.6	25.6	45.6	112	199	1.0	1.8
<b>Cyprus</b>	103.4	23.4	43.4	4	8	0.0	0.1
<b>Spain</b>	99.2	19.2	39.2	222	453	2.0	4.1
<b>France</b>	96.4	16.4	36.4	374	832	3.4	7.5
<b>Austria</b>	82.8	2.8	22.8	10	82	0.1	0.7
<b>Slovenia</b>	77.8	-	17.8	-	7	-	0.1
<b>Ireland</b>	73.5	-	13.5	-	38	-	0.3
<b>Germany</b>	65.8	-	5.8	-	188	-	1.7
<b>Finland</b>	65.5	-	5.5	-	12	-	0.1
<b>Total</b>	-	-	-	1,898	3,410	17	31

Source: Eurostat, calculations by France Stratégie.

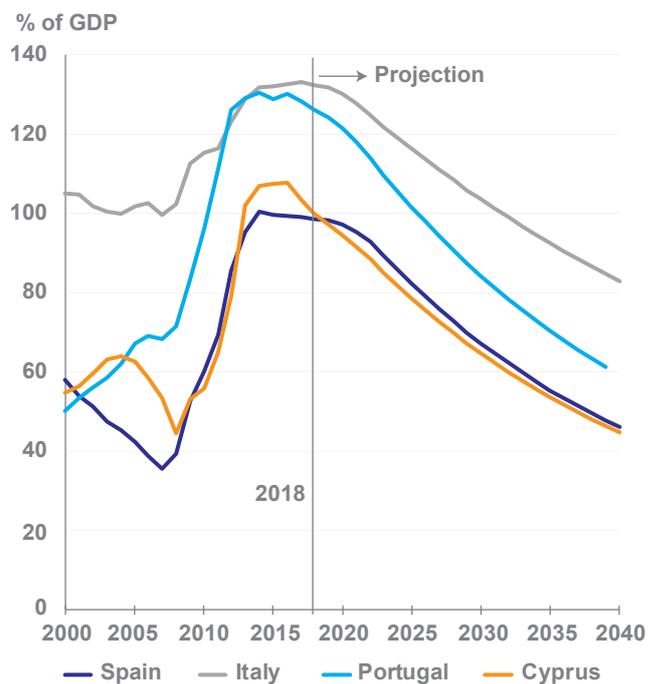
3. Some member states may have more ambitious targets set out for them in their Medium-Term Objectives (MTO), but for reasons of comparability and simplicity the projections assume a common target for the structural balance of all countries.



**Graph 1 – Evolution of the debt-to-GDP ratio**

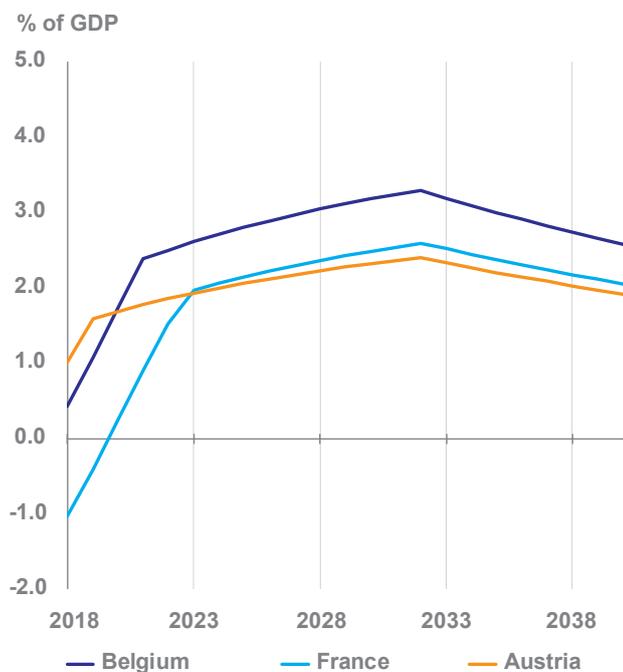


Source: Simulations by France Stratégie.

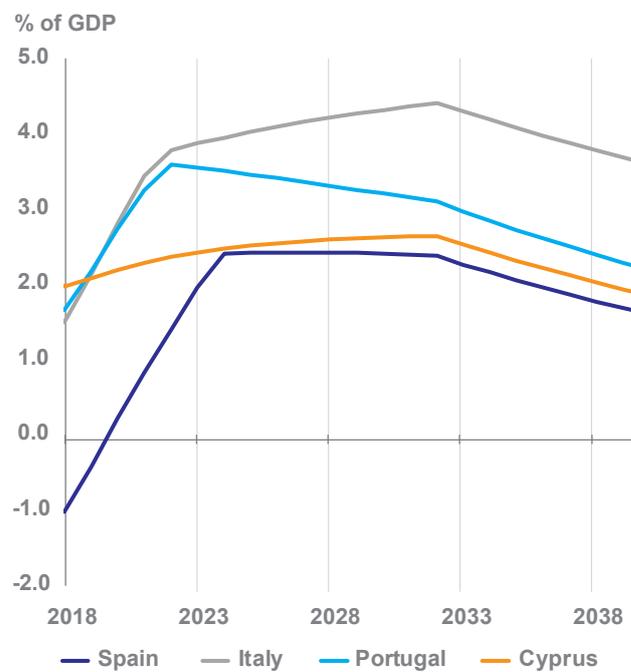


Source: Simulations by France Stratégie.

**Graph 2 – Evolution of the structural primary balance**



Source: Simulations by France Stratégie.



Source: Simulations by France Stratégie.

**Whether these scenarios are realistic or sufficient is a matter of judgement.** They assume that the countries concerned are able to maintain high primary surpluses (i.e. excluding interest payments) for extended periods of time. While historical experience shows that sustained efforts of this magnitude are possible, precedents are limited.<sup>4</sup> With few exceptions, all of these countries are small open economies that have little in common with highly indebted euro area countries. Moreover, these projections do not account for the growth effects of fiscal adjustment. In that sense, they can be considered optimistic. This is a deliberate methodological choice, designed to show that it is not necessary to assume a negative feedback loop between growth and fiscal adjustment to show the challenges posed by the reduction of high public debt ratios in Europe.

**Higher inflation would be one way to speed up the reduction of public debt ratios.** The European Central Bank's inflation target is currently set at 2%. Some economists, including former chief economist of the IMF Olivier Blanchard, have recommended a higher inflation target of 4% for monetary policy purposes, which they argue would have only limited effects on economic activity.<sup>5</sup> By way of example, Italian public debt would hit 60% of GDP four or five years sooner if the inflation rate were 2 percentage points higher, as the stock of public debt would be eroded by higher inflation and would only be impacted in the opposite direction by rising interest rates when previously issued debt instruments come to maturity. The benefits are far from negligible and historical experience has shown that the largest debt reductions in the past were based on episodes of high inflation and low real interest rates.<sup>6</sup> But this description implicitly assumes a general rise in inflation in the whole of the euro area. If it were circumscribed to highly-indebted countries, who face the double challenge of reducing debt levels while shoring up competitiveness, it would have a negative impact on growth and the expected benefits would vanish.

**In the end, debt levels in the euro area have not reached the point where their reduction through sustained fiscal adjustment is out of reach – and this also goes for the most heavily indebted countries.** The question, however, remains of how long it can be sustained politically. Implicitly, the cost of adjustment is borne by resident economic agents, households and companies alike, through lower public spending, potential scaling back of social trans-

fers or public services or higher taxes. Because the effects will only materialize over the medium term, the strategy leaves countries in a state of vulnerability for the duration of the adjustment should an economic or financial shock occur. Lastly, if lower public debt levels are indeed a prerequisite for a substantial overhaul of the euro area's architecture, the strategy de facto postpones reform to a distant and uncertain point in the future.

This strategy can succeed, but there are risks. Complementary measures may help to strengthen the credibility of member states' adjustment paths and commitments towards creditors, especially in the event of a large economic shock. This is why the issue deserves further exploration. There are not many alternatives, but they exist and are not mutually exclusive of one another. Because these proposals are exceptional in character, they go against many commonly held views, and they may cross the bounds of what appears politically acceptable.

## JOINT BUT LIMITED SUPPORT OF MEMBER STATES' ADJUSTMENT EFFORTS

**A first possibility to enhance the ability of some states to deal with high levels of public debt would be to strengthen the credibility of the current approach,** based on a rigorous approach to fiscal policy in line with the rules of the Stability and Growth Pact. This strategy can be successful, but even if rules are followed by the letter, risks exist because of the uncertainty related to future economic conditions. A solution could therefore be to make the sustainability of public debt less sensitive to unexpected cyclical fluctuations and changes in market sentiment.

**GDP-linked bonds could, in theory, contribute towards this objective. Part of the risk related to lower growth would be taken on by investors,** in the form of higher coupons in periods of high growth, lower coupons in periods of low growth, or perhaps through an indexation of the principal on the level of GDP. By these means, GDP-linked bonds would help to avoid bad equilibriums, where self-fulfilling expectations can amplify economic shocks and transform cyclical downturns into full-blown sovereign debt crises. Illustrative calculations for Spain suggest that financing debt through the issuance of GDP-linked bonds could reduce the probability that debt exceeds a given threshold (140% in the example provided) and therefore reduce the probability of default (which would go from 4% to

4. A recent study for example finds only 12 cases of countries having managed to maintain primary surpluses above 3% of GDP for more than ten years. See Eichengreen B. and Panizza U. (2015), "A Surplus of Ambition: Can Europe Rely on Large Primary Surpluses to Solve Its Debt Problem?", CEPR Working Paper.

5. See for example Ball L. (2014), "The Case for a Long-Run Inflation Target of Four Percent", IMF Working Paper WP/14/92.

6. Sometimes with the help of tools designed to keep nominal interest rates at low levels, i.e. "financial repression". See Reinhart C. and Brancia S. (2015), "The Liquidation of Government Debt", IMF Working Paper WP/15/7.



near 0% with GDP-linked bonds).<sup>7</sup> Other simulations carried out by the IMF suggest that if 20% of the public debt of advanced countries were issued in this form, the level of debt that a state could sustain without endangering long-term solvency could increase by up to 15 percentage points of GDP.<sup>8</sup>

**Although it has received increased attention following the sovereign debt crisis, it raises a number of practical challenges.**<sup>9</sup> Large-scale issuance of GDP-linked bonds has so far never taken place outside of debt restructuring operations. The instrument raises at least two types of difficulties. For one, given its innovative nature, the market would – at least in the beginning – be relatively shallow, with low liquidity and higher volatility than conventional bonds given the lack of standardized benchmarks and lower demand from private investors. This could lead to a significant risk premium in the early stages, reducing the benefits to states in terms of improved solvency prospects. At the same time, if the market were to reach a large-enough size, offloading part of macroeconomic risk to private investors could amplify the negative feedback loop between sovereigns and private-sector bondholders and increase the severity of recessions.

**To improve the resilience of sovereigns to macroeconomic shocks, an alternative could consist in sharing the risk with other euro area member states, strictly conditional on a sustained commitment to fiscal adjustment and structural reform via the European Stability Mechanism (ESM).** A debt buy-back on the secondary market with existing bonds exchanged for GDP-linked ones or direct financing by the ESM would in all likelihood consume too large a part of its resources. Above all, it would lead the ESM and member states to bear too large a share of risk, as the ESM would be exposed not just to the risk of lower growth but also the risk of default. It should therefore be excluded for reasons of technical feasibility but also and especially for reasons of political acceptability.

An alternative would be to allow the ESM to enter into an **interest rate swap agreement** with highly indebted states conditional on a credible commitment to fiscal adjustment and a verified track record. **In this scheme, the ESM would receive a coupon indexed on the economic growth of beneficiary countries and would pay existing creditors the fixed-rate coupon attached to bonds issued on the primary market.** The beneficiary country would pay the

same fixed-rate coupon to the ESM, corrected for the difference between expected and actual growth. Through this mechanism, the path of debt-reduction that a beneficiary country has committed itself to would be made more credible because it would be less dependent on future economic conditions. Solidarity between member states would be increased through joint ownership of reforms and of the fiscal adjustment path deriving from the European fiscal framework. But it would also be limited and conditional. Solidarity would be conditional because eligibility to the mechanism would depend on strict compliance with existing legal provisions. It would be limited because it would only cover risks related to unexpected cyclical fluctuations and not the risk of default.

The following graph illustrates the potential benefits arising from such a mechanism in the case of Italy, based on a simple indexation rule and considering a situation where future growth is permanently lower than projected in a baseline scenario. Gains for the beneficiary member states can be high, and they are proportional to the share of debt covered by the swap agreement.

## Box 2 – Assumptions underlying the simulations

*The simulations are based on a standard and deterministic model of debt dynamics. The high growth and low growth scenarios are based on assumptions of long-term growth higher (viz. lower) by 1 percentage point than that in the baseline scenario. In this example, it is assumed that 40% of Italian debt is covered by the swap agreement. The interest rate is increased or decreased by the difference between growth projected in the baseline scenario and actual growth. In practice, a wide range of indexation rules of varying complexity may be considered. The example given here is illustrative. Other indexation rules may be more workable or desirable in practice.*

## AN EXCEPTIONAL ONE-OFF TAX ON RESIDENTIAL REAL ESTATE

**To enhance the sustainability of public debt in highly-indebted member states without outside support, the only solution would be to increase a country's ability to levy taxes one way or another.** The challenge here lies in making this possible without depressing growth, given the already high tax burden in many member states.

7. Blanchard O., Mauro P. and Acalin J. (2016), "The Case for Growth-Indexed Bonds in Advanced Economies Today", Peterson Institute for International Economics, Policy Brief 16-2.

8. IMF (2017), "State contingent debt instrument for sovereigns", IMF Policy Paper, May.

9. See for example the G20 Finance Ministers and Central Bank Governors Communiqué of July 26, 2016, at the Chengdu Summit, calling on the IMF to undertake further analysis on the potential of GDP-linked bonds.

The last twenty years have been marked by a sharp increase in public debt but also by an even sharper increase in household net wealth, driven by the increase in real estate prices. In the case of France, for example, public debt rose from 56% of GDP in the mid-1990s to nearly 100% of GDP today. At the same time, the net assets of French households increased from 285% of GDP, of which 125% of GDP was in real estate, to 485% of GDP today, of which 255% of GDP is in real estate.<sup>10</sup>

Real estate wealth, in reality, comprises two distinct types of assets: the dwellings owned by households (i.e. the physical constructions themselves) and the land on which these dwellings are built. The boom in property prices that many European countries have experienced over the past decades mostly reflects the increase in land prices. Today, the value of this land represents almost half of the value of net real estate wealth of French households (135% of GDP) and a little more than half that of Italian households (170% of GDP). For a homeowner, the share of net real estate wealth that can be attributed to the value of the land itself depends on the asset's locational characteristics and the nature, abundance and quality of public services and infrastructure nearby.

The sustainability of public debt could be enhanced by transferring part of this wealth onto the state's balance sheet which, conceptually, could be likened to an exceptional one-off tax on capital. In practical terms, a state could decree that it becomes a partial owner of all land on which dwellings are built, up to a fixed fraction of the land's value. This property right would be non-trans-

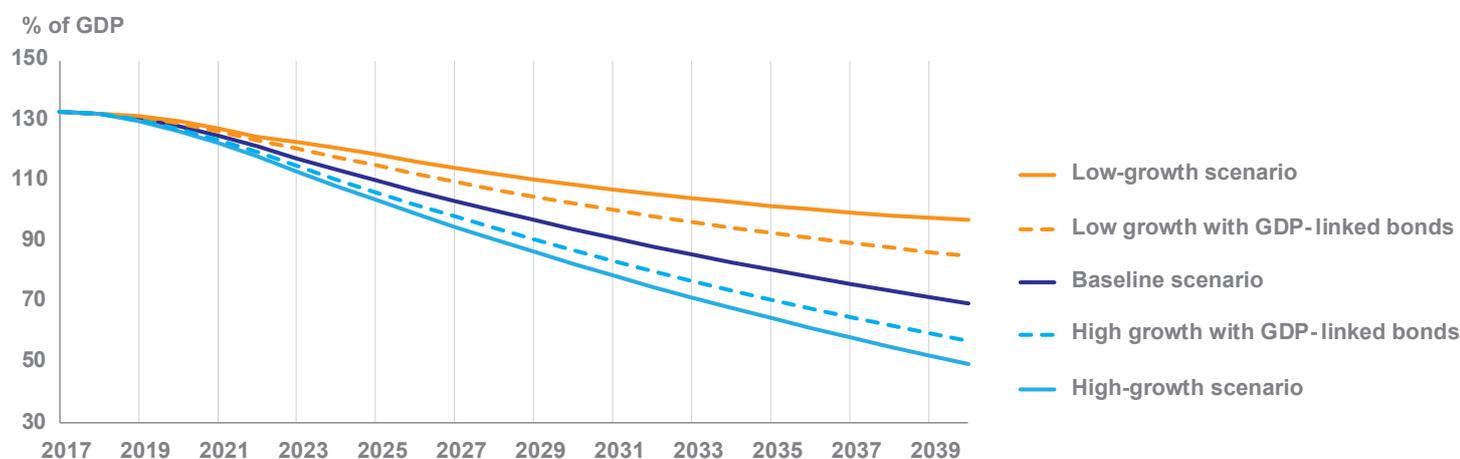
ferable. As a result, the payment of the right of occupancy for this share of the land by homeowners would generate an annual revenue stream for the state. This right of occupancy, conceptually, would be equal to the share of the rent for compensation of land occupancy a homeowner might receive if renting out their property (the other part of the rent would correspond to compensation for the production of housing services in national accounting terms).

Homeowners could choose not to pay. If so, their due would increase year after year.<sup>11</sup> In this case, the portion of land owned by the state would increase. The full amount would become due upon the sale of the property or its transfer to an heir. In any case, the proposed mechanism, which could be assimilated to a higher tax on property and/or the transfer of assets, would not simply add to existing taxes, as it would also reduce the tax base (through lower property valuations and lower rental income for renters).<sup>12</sup>

For illustrative purposes, the implementation of this measure on 25% of the value of residential land would increase Italy's solvency by up to 40 percentage points of GDP. The decision to implement the mechanism would, quite obviously, constitute a large political shock, but its cost should be weighed against the challenges faced by highly indebted member states.

From an economic and political point of view, it should be possible to argue that the negative consequences of an exceptional levy of this kind are much lower than the alternatives should a large-scale sovereign debt crisis occur. In this event, drastic cuts in public spending

Graph 3 – Debt-to-GDP ratio under different growth scenarios, with and without GDP-linked bonds



Source: Simulations France Stratégie.

10. A full 295 percentage points of GDP in gross real estate assets and around 40 percentage points of GDP in mortgages.

11. The measure would apply whether owners are households or private companies.

12. If required for reasons of legal feasibility, the operation could be presented in this way rather than as a transfer of property from the private sector to the state.



and sharp tax increases in a recessionary environment could have far-reaching economic consequences, potentially leading to a sovereign default or even a disastrous euro area exit.

**The capital transfer considered here exclusively rests on non-produced assets**, i.e. the land on which houses and apartments are built. These assets do not give rise to a service recorded in GDP but do generate a stream of income (an economic rent) for landowners corresponding to the right of occupancy.<sup>13</sup> **In addition, because the costs are mostly borne by wealthier households with a higher marginal propensity to save, the short-term impact on consumption would be comparatively low.** This is all the more true as the annual payment could be deferred until the sale or transfer of the property, thereby not impacting current disposable income. The negative demand shock would be minimal, especially compared to that which would occur if taxes were raised and public spending were slashed.

**The immediate effects of announcing a measure of this sort would be twofold.** On the one hand, the measure would enhance the credibility of a state's commitment to repay its debts, thereby increasing its creditworthiness and lowering the interest rate demanded on its debt. On the other hand, it would in all likelihood lead to a drop in property values as future transactions would only cover part of the land on which a dwelling is situated.<sup>14</sup> This decline would be most pronounced in areas with low supply and high demand, where the share of the value of a property that reflects land scarcity and locational characteristics is highest. In these areas, property values are also closely related to nearby amenities – infrastructure and public services – that have, more often than not, benefited from public funding.

**A one-off levy of this sort would place the largest share of the burden on the wealthiest households, in due proportion of their real estate wealth.** For this reason, the burden would be shared in the most equitable way possible: it would have no impact on current household income, i.e. the current ability to pay, but only on household wealth – which reflects both past savings and unrealized gains related to the increase in property prices. True, financial wealth and business assets would be sheltered, and these are also very unevenly distributed in the

population and are source of wealth and income inequality. But given their key role in financing investment and future growth they should be protected to the extent possible. Lastly, this proposal would de facto mostly weigh on wealthier households and less-so on small homeowners, as wealthy households tend to be the largest owners of prime real estate, i.e. assets whose value mostly reflect that of the land on which they are located.

## A SOLUTION OF LAST RESORT: THE CENTRAL BANK

If euro area member states were to refuse to share the macroeconomic risk arising from budgetary adjustment and the inherent uncertainty of future economic conditions through interest rate swap agreements, as described in the first option, and were reluctant to engage in the balance-sheet operation described in option two, the prospect of debt restructuring might become inevitable in the case of a large and unexpected economic or financial shock.

The main obstacle to debt restructuring – which leads to potentially significant losses being borne by creditors – comes from the costs to financial systems. European banks hold a large share of their assets in government bonds for regulatory reasons and because of the role these presumably safe assets play in financial transactions. Their bond holdings are, moreover, insufficiently diversified. In these conditions, the restructuring of a sovereign's debt would directly and instantly endanger large financial intermediaries, potentially setting off a chain-reaction of the like that the world economy experienced in 2008 when Lehman Brothers was allowed to fail.

To prevent this from happening, the euro area may as a last resort turn to the central bank.

**Central banks are economic agents of a particular nature, as they can create potentially unlimited amounts of central bank money *ex nihilo*.** Unlike normal economic agents, who must finance purchases with their own balance sheets or by borrowing money they will ultimately have to repay, a central bank is in theory unconstrained in its ability to issue central bank money to fund purchases.

13. In practice, national accounts record the full amount of rents (regardless of whether they are paid by tenants or correspond to imputed rents of owner-occupied dwellings) as a production of housing services, increasing GDP. Going by the principles and rules set out in the 2008 System of National Accounts standard, this is a conceptual mistake: only the share of rent corresponding to the compensation for the production of housing services should be accounted for. The remaining share of rent corresponds to compensation for the right of occupancy of the land, which increases the income of homeowners and reduces the income of tenants, without impacting total income or the level of GDP. This means that for all countries GDP is probably lower than currently measured (by about 4% in the case of France).

14. This drop in property prices might increase non-performing loans on banks' balance sheets, given that a fraction of homeowners are still paying back their mortgages. Further analysis should be carried out on this point. However, the risk appears minimal. The capital tax would only impact a share of the property's value and an even smaller share for low-income households given the fact they do not own prime real-estate where the share of land value in the total valuation is highest. Moreover, in practice, this tax would only materialize when the property is sold or inherited.

This is, in fact, what the ECB and the Eurosystem have been doing with the Public Sector Purchase Programme (PSPP) initiated in March 2015. As of September 1, 2017, more than €1700 billion of bonds of public sector entities were held on the Eurosystem's balance sheet (approximately 17% of euro area public debt, equivalent to 15% of the eurozone's GDP), with an equivalent increase in central bank money. This operation does not reduce the debt of beneficiary member states, as debtors continue to pay interest and will pay back the principal when the bonds mature. It only improves debt sustainability to the extent that it contributes to the decline in interest rates.

The risk of default and associated losses are borne by the ECB and national central banks, whose shareholders are euro area member states. An outright cancellation of part of the debt currently held on the Eurosystem's balance sheet would wipe out its capital (for comparison purposes, capital and accumulated reserves of the Eurosystem are of the order of €100 billion), making a recapitalization necessary.<sup>15</sup> If the recapitalization were done in proportion to the ECB's capital key (roughly corresponding to the share of member states in euro area GDP), it would indirectly lead to transfers between member states.<sup>16</sup>

**Instead, a solution might consist in holding the bonds on the Eurosystem's balance sheet indefinitely.** The ECB or national central banks would buy a share of member states' debt, exchanging the bonds for perpetuals with a zero interest rate.

**Many economists are today advocating solutions of this kind, some of whom would have been considered mainstream economists in the pre-crisis world.** Adair Turner, former Chairman of the UK Financial Services Authority, has for example argued the accumulation of private debt is today at least as dangerous as public debt, and commercial banks should be constrained in their ability to create money through credit.<sup>17</sup> In a low-growth world, he argues, countries should consider monetary financing of public deficits by central banks. Pâris and Wyplosz have also advocated using the central bank to take public debt off the markets, not through monetary financing per se but through the issuance by the ECB of interest-bearing securities.<sup>18</sup> Given that central banks can fund their liabilities by creating central bank money at will, these securities would have the guarantee of being repaid and would

not be subject to rollover risk (i.e. the ECB would not run the risk of not being able to rollover the securities at maturity). As the zero-interest perpetuals would be backed by an interest-bearing instrument, the operation would reduce the ECB's seigniorage income (i.e. the income derived from monetary policy operations that are redistributed to member states in proportion of their capital shares). Depending on the distribution of debt purchases, the operation may lead to transfers between euro area member states. The mechanism suggested by Pâris and Wyplosz, which allocates purchases on the basis of the ECB's capital key, avoids these transfers. If a different key were used to allocate purchases - or if they were to concern only a small number of highly indebted member states - avoiding transfers would still be possible by waiving the right to all or part of seigniorage income only for countries benefiting from the scheme.

**One of the advantages of this scheme is that it explicitly provides for the sterilization of central bank purchases and the withdrawal of an equivalent amount of central bank money by the issuance of interest-bearing securities.** Indeed, one of the risks commonly associated to large-scale asset purchases by central banks is that of inflation and exchange rate depreciation, even though the mechanical link between central bank money and inflation is not clear-cut.<sup>19</sup> Inflationary risks from monetary creation, in the end, might not be the main issue; **instead, the largest risks may come from the impact of massive asset purchases on central banks' credibility, which is decisive in its ability to maintain price stability, anchor expectations and ensure the proper transmission of monetary policy.** The risk is not easily quantifiable, but it is perhaps where the real problem lies.

This operation would raise several challenges.

**The first and most obvious challenge is a legal one, given the fact the ECB's mandate is enshrined in the Treaties.** The Eurosystem's asset purchases have been undertaken with the sole aim of buttressing inflation in a deflationary and low-growth environment. Effects on the monetary base will normalize as the programme is tapered off and when the bonds held on the Eurosystem's balance sheet reach maturity and are paid back by member states. A monetary policy operation carried out with any other objective than ensuring price stability and the proper trans-

15. In theory, a central bank can continue operations despite negative equity. See ECB (2016), "Profit distribution and loss coverage rules for central banks", Occasional Paper Series No. 169; or de Grauwe P. (2014), "Why the European Court of Justice should reject the German Constitutional Court's ruling on Outright Monetary Transactions", blog, LSE European Institute.

16. Under the PSPP, potential losses on sovereign bonds are not pooled within the Eurosystem but borne by national central banks backed by their sovereigns (apart from the share purchased by the ECB itself).

17. Turner A. (2015), *Between the Devil and the Debt: Money, Credit and Fixing Global Finance*, Princeton University Press.

18. Pâris P. and Wyplosz C. (2014), *PADRE: Politically Acceptable Debt Restructuring for the Eurozone*, Geneva Reports on the World Economy Special Report 3 ICBM / CEPR.

19. See for example ECB (2012), "The relationship between base money, broad money, and the risks to price stability", *ECB Monthly Bulletin*, May.



mission of monetary policy would violate the ECB's mandate and Treaty provisions. The operation would probably have to be implemented by national central banks to avoid mutualization (as in the PSPP), but this may not be sufficient to solve the legal hurdle.

**Another challenge would be to ensure that the operation is designed in such a way that its exceptional nature is clear and credible to economic agents.** This would probably require new legal provisions to deal with the issue of moral hazard. The proposal by Pâris and Wyplosz includes a provision whereby the perpetuals can be converted back into interest-bearing securities if a member state's debt starts to rise again.

**Lastly, the operation would come up against a major political obstacle;** it is unconventional in nature and may potentially only apply to a limited number of highly indebted countries. **It would be a radical change in paradigm and would touch upon one of the cornerstones of the Maastricht Treaty, namely the characteristics of the central bank's mandate.** Overcoming this political obstacle would certainly require a shared vision of the future, a strong will to go forward with euro area integration and a high degree of trust between member states. Only a leap towards a coherent, stable and sustainable architecture could justify an operation of this type.

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