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Public debts held by central banks: what are the consequences?

Today, central banks hold huge amounts of public debt. This is geared at legitimate monetary policy objectives, but the situation may change more rapidly than usually thought.

The origin of this massive intervention of central banks on public debts markets is the quantitative easing (QE) that has been used by central banks after the financial crisis. The reason was simple: in the pursuit of their statutory objective of price stability, central banks were confronted with an extraordinary and persistent disinflationary context. The use of traditional tools, i.e. interest rates, met with a limit, the zero-lower bound: attempts to move below zero, although conceivable in theory, and achieved in practice by a few central banks, in particular the ECB, has proven to be little effective, simply because the transmission is very limited. It also generates many counter-productive consequences.

Therefore, the main tool used to increase the accomodation of monetary policy has been the pressure on long term interest rates and the flattening of the yield curve, via the purchase of bonds. And because Government bonds are usually the safest, the most liquid pool and the benchmark of any currency's market, they have been the main instrument used by central banks.

Whereas central banks were progressively trying to normalize their policies, and at least stop increasing their bond portfolios, the pandemic crisis forced them to start new purchase programs. Indeed, with a huge recession triggered by the freeze of many activities, with durable effects on several key sectors, new deflationary pressures were threatening to push inflation significantly below the objective of price stability. What Central banks have done is therefore clearly linked to their remit, i.e. maintaining price stability. And so far, they are still confronted with a weakness of price developments, which vindicates their monetary policy action.

But of course, this happens in a very specific context, where Governments have tried to counter the unprecedented recession by a temporary but huge increase of public expenditures, in particular massive support to corporates and entrepreneurs with a view to limit to the lowest possible extent layoffs and bankruptcies, and avoid a spiraling move into depression. Governments are bound to accumulate enormous amounts of public debt during the year 2020, that will need to be kept and rolled over for a long period of time, and their amortization is likely to take decades.

From the point of view of central banks, there does not seem to be a real danger per se. It is not unlikely that inflationary pressures start to rise again in the coming years, under the combined effect of huge liquidity and possibly less deflationary pressures from globalization. But if needed, provided that central banks stop buying bonds, increase as necessary their interest rates, and withdraw the excess liquidity they have poured into the market, they should be able to strictly adapt monetary and financial conditions so as to maintain price stability. And to withdraw liquidity, no need to sell bonds massively on the market: they can easily achieve the same objective by using reverse repos for instance.

For Governments, it means that they might not be put under pressure for this extraordinary debt issuance linked to the pandemic crisis. All this debt kept in the books of central bank is in fact of no cost, whatever the interest rate paid in the future (when this debt is eventually rolled over), since the amounts paid by a Government to its central bank increases its profits which are distributed to the former. This is true in particular for the governments of the euro area, the bulk of QE purchases decided by the ECB being done by the National central banks of the Eurosystem, each on its own national government debt.

At the same time, thanks to the flexibility it gave itself within the PEPP, the ECB has provided effectively the necessary degree of accomodation throughout the euro area, ensuring the resilience of the entire currency zone.

But Governments should clearly see the following: these extraordinary purchases by central bank will have an end, maybe sooner than often thought; and interest rates will eventually increase, and with them the cost of newly issued debts that will have to be kept by the private sector. Therefore, ensuring sound public finance for the years to come is of the essence. ●