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# Accounting treatment of a cancellation of public debt held by a central bank

by

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The *Agenda 2030* Policy Briefs series mobilizes economists and practitioners to identify an economic and financial reform agenda to achieve the 2030 Agenda at the territorial, national and supranational levels. Contact: thomas.lagoardesegot@kedgebs.com

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## 1. Introduction

The call by many economists, officials and citizens to cancel all or part of the public debts held by the European Central Bank[2] (see https://annulation-dette-publique-bce.com/) has generated many political, ideological, legal and accounting objections. The purpose of this note is to discuss the accounting treatment of such a debt cancellation.

## 2. Central bank accounting framework

The reference framework for central bank accounting within the ESCB is formed by the following documents

1. *"Central Bank Finance*", which was published by the Bank for International Settlements[3] ,
2. *"Protocol No. 4 on the Statute of the European System of Central Banks and of the European Central Bank*
3. *"The European Central Bank's guidance[4] on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34) (2016/2249/EU)".*

"***Central Bank Finance***" provides a conceptual framework that aims to harmonize the principles and practices of central banks around the world. It is the result of the work of an international working group of central bankers.

In its conclusions, this paper highlights the following:

- **The balance sheet of a central bank cannot be equated with that of any commercial bank**. "*Central banks are not commercial banks. They do not seek profit and are not subject to the same financial constraints as private institutions*[5]. "*The gains and losses of the central bank belong to society as a whole.* [6]
- **A central bank can very well operate with negative capital**. "*It is far from clear to everyone that a central bank's book equity can be negative without causing alarm*[7].
    - **Financial markets, policymakers and the general public may have misperceptions about a central bank's balance sheet, which is** why, despite the fact that it may operate with negative equity, "*It is important that the*

[2] In reality, these debts are held by the national central banks (NCBs) and are consolidated in the balance sheet of the European System of Central Banks (ESCB)
[3] *"Central Bank Finances*," BIS Papers No. 71, Bank for International Settlements, Monetary and Economic Department, April 2013, https://www.bis.org/publ/bppdf/bispap71_fr.pdf
[4] A Guideline is a legal text issued by the ECB which gives binding instructions to the national central banks. The concept of a Guideline is defined in Protocol No. 4 on the Statute of the ESCB and of the ECB, in particular Article 14.3, which states that "*The national central banks shall form an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB. The Governing Council shall take the necessary measures to ensure compliance with the guidelines and instructions of the ECB and shall require that all necessary information be provided to it*.
[5] Central bank finances, p.1.
[6] Central bank finances, p.3.
[7] Central bank finances, p.1.

*central bank remain financially independent*[8]. For this reason, "*Retentions and distributions of surpluses should be closely linked to a financial resource target that is itself adjusted to the potential need for resources in times of crisis, and unrealized revaluation gains and income from particularly risky assets should not be subject to distributions because they do not constitute final profits*[9].

- **The objective of a central bank is long-term, it is normal for accounting to deviate selectively and transparently from short-term financial reporting standards** because "*Central banks hold many assets and liabilities whose changes in value are not relevant even under International Financial Reporting Standards (IFRS*)[10]." "In terms of accounting policies, selective but transparent departures from International Financial Reporting Standards (IFRS) may be necessary[11].
- **In the final analysis, the soundness, solvency and therefore the confidence in the central bank and its currency are essentially assessed by external elements** such as confidence in institutions, political stability, the quality of political personnel, economic and fiscal policy, the structure and size of the economy, the state of public finances or ... military power. These are attributes external to the central bank and the currency that underpin its confidence. *"The financial soundness of a central bank, as a stand-alone entity, can therefore enhance its credibility, particularly if it is weakened by its history, institutional arrangements or the political climate. Conversely, if its credibility is not challenged, financial strength will not enhance its ability to carry out its strategy. It is therefore extremely difficult to determine the level of financial support that a central bank needs*[12].

Protocol No. 4, Article 26, but above all **the ECB Guideline** provide the principles and operational framework for the ESCB's accounting. Article 3, in particular, defines the **qualitative characteristics of the accounts**. The following elements are highlighted here:

*"1) **economic reality and transparency**: accounting methods and financial information reflect economic reality, are transparent and are defined with respect to intelligibility, relevance, reliability and comparability. Transactions are recorded and presented in accordance with their nature and economic reality, and not merely their legal form;*

*"2) **prudence**: the valuation of assets and liabilities and the recognition of income are carried out prudently. In the context of this guidance, this means that unrealized gains are not recognized as income in the income statement, but are recorded directly in a revaluation account, and that unrealized losses are recognized in the income statement at*

[8] Central bank finances, p.1.
[9] Central bank finances, p.1.
[10] Central bank finances, p.2.
[11] Central bank finances, p.3.
[12] Central bank finances, p.3.

*the end of the year if they exceed the previous unrealized gains recognized in the corresponding revaluation account."*[13]

Article 4 defines the **accounting principles, of** which the following is particularly noteworthy:

*"1) **going concern principle**: the accounts are prepared on a going concern basis;*

Article 9 defines the **rules for the valuation of the balance sheet**, it mentions that :

*« 1. Current market rates and prices shall be used for balance sheet valuation, except in cases covered by the special rules specified in Annex IV.*

*« 4. Revaluation entries are reversed at the end of the following quarter, except for unrealized losses, which are charged to the income statement at the end of the year; during the quarter, all transactions are reported at transaction prices and rates."*

Article 15 regulates the **recording of results**, and states that :

*« 1. The recognition of results is carried out according to the following rules:*

*a) realized capital gains and losses are recognized in the income statement;*

*b) Unrealized gains are not considered as income, but are recorded directly in a revaluation account;*

*c) at the end of the year, unrealised losses are taken to the profit and loss account if they exceed the previous unrealised gains entered in the corresponding revaluation account;*

*(d) unrealized losses carried in the income statement are not reversed in subsequent years against new unrealized gains;"*

### 3. Accounting treatment of perpetualization and cancellation of public debt held by a central bank

The February 5 call proposed two alternative conditional measures[14]:

1. The pure and simple cancellation of the public debt held by the ESCB;
2. The perpetualization of this debt at an interest rate of 0%, i.e. the transformation of the stock of public debt securities with variable terms and interest rates into a single stock of public debt of unlimited duration bearing an interest rate of 0%.

In the minds of the proponents, these two measures are identical; they aim to make the public debt held by the ESCB ineligible. From their point of view, it is possible legal and administrative constraints that should govern the choice of one or the other solution.

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[13] The principle of prudence aims, in good faith, to give the most conservative picture possible of the balance sheet. Thus, in application of this principle, income is only recorded when it is finally realized, not before, while any future losses are recorded directly in the income statement.

14 It is beyond the scope of this note to discuss the conditional aspect of the proposal. However, it should be remembered that the proposal was to cancel or "perpetuate" the debt as green reconstruction investments were made for an amount identical to the amount of debt cancelled/perpetuated

### *3.1. Simple accounting approach*

The amount of government debt to be cancelled is recorded on the assets side of the balance sheet under item 7.1 "Securities held for monetary policy purposes" (see Annex - Simplified balance sheet and profit and loss account of an ESCB member central bank).

If we follow a simple approach in line with the ECB's guidance, then the cancellation of[15] the debt would consist of recording its disappearance from the asset side of the balance sheet as a realised loss on the liability side of the balance sheet in accordance with Article 15(a). The entry would then be:

| | Debit | Credit |
|---|---|---|
| 2.1. Capital gains/losses on financial transactions | | |
| à 7.1. Securities held for monetary policy purposes | | |

The securities would immediately disappear from the assets and their disappearance would then simply be recorded in the income statement, which, by carrying forward the final result, would be deducted from the liabilities of the central bank's balance sheet. Depending on the amount of the cancellation, the level of the capital and the reserves previously constituted, the bank's equity could become negative. In other words, the paid-up capital and reserves are not sufficient to absorb the loss.

In theory, this is not a problem since, as noted above, a central bank can operate with negative equity. However, financial markets, policy makers and the general public may have misperceptions about a central bank's balance sheet, so despite the fact that it can operate with negative equity, it is important that the central bank remains financially independent. Therefore, this simple accounting approach does not seem desirable.

### *3.2. Creation of permanent money free of debt*

This simple approach is all the more undesirable because it masks the phenomenon of permanent money creation free of any debt in the form of reserves held by commercial banks. Indeed, the public debt held by the central bank was acquired through the creation of central money transferred to the sellers of the debt securities via the banking sector.

When the central bank cancels these securities, it can no longer sell them on the market at a later date and can therefore no longer recover the money in circulation. The law of reflux no longer applies, and the central bank money put into circulation at the time of the initial purchase then circulates permanently and no longer has a counterpart in the central bank's accounts. This is why we are witnessing the creation of a stock of permanent, debt-free money. It is "*permanent*" because it no longer obeys the law of reflux, and is condemned to remain in circulation "*ad vitam aeternam*", and "*free*" because it no longer corresponds to a claim on the central bank.

[15] As a reminder, this note does not comment on the legal or political nature of this issue.

With this first accounting approach, this stock of permanent free money cannot be explicitly identified in the central bank's balance sheet, it can only be identified implicitly through the analysis of past results. Given the public purpose of the central bank, in the case of a debt cancellation, an alternative accounting method must be proposed that deviates "*selectively*" and "*transparently" from* the usual standards and develops a method that allows the stock of debt-free permanent money to be explicitly identified, a method that, moreover, would avoid going through the profit and loss account in order to avoid *"misperceptions of the central bank's balance sheet*" and that, consequently, would meet the "*going concern principle*".

### *3.3. Improved accounting approach*

Starting from the situation described in the simple approach, we need to cancel securities and transfer them to the balance sheet so that it gives us the exact expression of the amount of debt-free permanent money. To do this, we need to create a new accounting item[16] on the assets side that could be called "10. *Definitive contribution to the nation's objectives*"[17], which could be placed in front of liability items such as capital and reserve funds, in order to emphasize the immobilized nature of this contribution.

The accounting entry would then become,

| | Debit | Credit |
|---|---|---|
| 10. Final contribution to the nation's goals | | |
| à 7.1. Securities held for monetary policy purposes | | |

**This entry transfers the claim on the public sector held for monetary policy purposes to a heading where it is no longer considered a claim but an accounting asset[18] .**

However, the amount to be transferred between the accounting headings must be correctly valued. Should you record :

1. The nominal value of the public debt cancelled?
2. The market value of the cancelled debt as recorded before its cancellation in the account 7.1. Securities held for monetary policy purposes ?

Obviously, the nominal value of the cancelled public debt must be recorded. This recording has the advantage of being fully consistent with the amount of debt that will be cancelled in the public accounts. Moreover, the nominal value is not supposed to be modified in the future according to market values. However, this poses a small accounting problem, since these debt instruments are recorded in the balance sheet under item 7.1. at their market value. There is then a discrepancy between the nominal value to be recorded under "10. Final contribution to

[16] This requires a change in the guideline setting out the accounting procedures within the ESCB.

[17] "Final contribution to the nation's objectives", which is the amount of money that is permanently put into circulation without compensation.

[18] At the same time, in accordance with the treatment philosophy defined by the European System of National Accounts (ESA2010), which does not provide for this situation of debt cancellation by the central bank, the national accounts will record in the general government accounts a "*capital transfer in kind*" aimed at cancelling the amount of government debt. It will apply, mutatis mutandis, the rules set out in Chapter 20 of ESA2010 on government accounts, in particular paragraphs 20.221 and following on debt transactions.

the nation's objectives" and the market value recorded under "7.1. Securities held for monetary policy purposes". Any unrealized loss must be definitively recorded, whereas any unrealized gain will never be realized.

Therefore, consider:

- That the unrealized loss previously recorded on the securities being cancelled has now been realized. Consequently, in application of article 15.a, it is recorded in the income statement as a capital loss and
- That the unrealised gain, previously recorded in the revaluation account, in application of article 15.b), will never be realised and that, consequently, it must be taken to the profit and loss account in application of article 15.a)

We then have the following accounting entries:

- In the presence of an unrealized loss

| | Debit | Credit |
|---|---|---|
| 10. Final contribution to the nation's goals | | |
| to 7.1. Securities held for monetary policy purposes | | |
| 2.1. Losses on financial transactions | | |

- In the presence of an unrealizable capital gain :

| | Debit | Credit |
|---|---|---|
| 10. Final contribution to the nation's goals | | |
| 2.2 Unrealized losses on financial assets | | |
| to 7.1. Securities held for monetary policy purposes | | |

## 4. Conclusions

We see that the improved accounting approach meets all the constraints of central bank accounting:

- The new account "*Final contribution to the nation's objectives*" contains exactly the amount originally created to subscribe to the public debt currently cancelled. There is a perfect identity between the accounting movement of the central bank and the movement recorded in public accounting.
- The principle of "*economic reality"* is fully respected since the amount of permanent money recorded in the balance sheet is correct and representative of the economic reality.
- *The principle of "transparency"* is perfectly respected by all readers of the central bank's balance sheet, who can easily and correctly evaluate the amount included under the item "10. *Final contribution to the nation's objectives*".
- This balance sheet will appear to some as a transgression of "*financial reality*" since, in fact, the amount shown under "10. *Final contribution to the nation's objectives*" is

no longer a realizable asset of the central bank. It should be remembered, once again, that the central bank's balance sheet is of general interest and that it must contain all the financial information that gives a correct idea of the circulation of money and the conditions of its circulation, and that this latter reality is certainly more important than the "*financial reality*.

- The advantage of the enhanced accounting approach is that it uses the income statement only incidentally to record what are, after all, incidental accounting losses. As a result, it cannot have the much feared devastating effect of misperceptions by financial markets, policy makers and the general public. The balance sheet remains totally balanced.

By the same token, it should be noted that the conversion of the public debt into a perpetual debt at zero interest rate results, mutatis mutandis, in the same operations. If necessary, separate sub-accounts of "10. *Final contribution to the nation's objectives*" could distinguish the amounts of cancelled debts from the amounts of perpetual debts. The structure would then be as follows:

| | Debit | Credit |
|---|---|---|
| 10. Final contribution to the nation's goals | | |
| 10.1. Definitive contribution to the nation's goals through cancellation of public debts | | |
| 10.2. Final contribution to the nation's objectives by perpetuating public debts | | |

Similarly, it should be noted that any monetary issuance in the form of a monetary donation, whether a direct monetary donation to public authorities or a monetary donation granted to individuals, commonly known as a "monetary helicopter", would also pass through this permanent money issuance account.

**Appendix 1 Other solutions**

Technically, other solutions are also possible:

a. Consolidation of the national central bank's balance sheet in the general government account within ESA2010
b. The repurchase of national public debt securities held by national central banks (NCBs) by the European Central Bank (ECB)

**a. Consolidation of the national central bank's balance sheet in the general government account within ESA2010**

The ESA2010 methodology is based on a breakdown into institutional sectors. The central bank is classified within sector S12 - Financial corporations, and more specifically within sub-sector S121 - Central bank, a sub-sector in which is the only institutional unit. General government is classified in sector S13 - General government. If one were to classify the central bank within the general government sector - which would seem logical to the vast majority of the population - for example, in a specific sub-sector of general government, the question of the public debt held by the central bank would be less acute.

When the balance sheets of companies belonging to the same group are consolidated, the debt held on its parent company by a subsidiary disappears for accounting purposes - not legally - when the group's consolidated balance sheet is drawn up. This same principle of consolidation exists for public accounts. Thus, the debt of a government held by another government disappears for accounting purposes - not legally - through the phenomenon of accounting consolidation. The debt continues to exist but is not expressed outside the scope of consolidation. It becomes an internal matter of the public sector, removed from the logic of the market. This accounting - not legal - consolidation of the central bank's balance sheet in the public sector can be seen as a form of minimal integration, whereas other theories, such as the modern money theory (MMT)[19], promote total integration.

**b. The purchase of national public debt securities held by NCBs by the ECB**

The mechanisms presented so far are limited to national solutions under European coordination. In concrete terms, so far we have only considered the case of cancellation of a country's public debt held by the NCB of that country. For obvious reasons of fairness between eurozone member states and monetary stability, the amounts of debt to be cancelled per country should be decided within the ECB by the Governing Council. Therefore, it is not without interest to consider a mechanism for the repurchase of national public debt securities held by the NCBs by the ECB. It would then be the ECB that would hold the total amount of public debt to be cancelled for all the member countries of the euro zone. This joint holding of public debt could be seen as an expression of European solidarity and of the will to advance in European integration. Technically and from an accounting point of view, the operation does not present any difficulty. Politically, it is probably different.

[19] See on this subject Stéphanie Kelton, "Le mythe du déficit. La théorie moderne de la monnaie et la naissance de l'économie du peuple", Editions Les liens qui libèrent, 2021.

## Annex 2: Balance sheet and profit and loss account of an ESCB member central bank

- In bold type, the accounting items mentioned in the note
- In italics, the new accounting item to be created as a result of the proposed cancellation of public debt held by the European System of Central Banks (ESCB)

### Balance sheet

| **ASSETS** | **LIABILITIES** |
|---|---|
| 1. Gold assets and receivables | 1. Tickets in circulation |
| 2. Claims on non-euro area residents denominated in foreign currency | 2. Euro-denominated commitments to credit institutions<br>of the euro zone related to monetary policy operations |
| 3. Claims on euro zone residents denominated in foreign currency | 3. Other euro-denominated liabilities to euro area credit institutions |
| 4. Euro-denominated claims on non-euro area residents | 4. Euro-denominated liabilities to other euro area residents |
| 5. Euro-denominated loans to euro area credit institutions related to monetary policy operations | 5. Euro-denominated liabilities to non-euro area residents |
| 6. Other receivables in euros from credit institutions<br>of the euro zone | 6. Foreign currency liabilities to residents of the euro zone |
| 7. Euro-denominated securities issued by residents of the euro zone | 7. Foreign currency liabilities to non-euro area residents |
| 7.1. Securities held for monetary policy purposes | 8. Counterpart to the special drawing rights allocated by the IMF |
| 8. Intra-Eurosystem claims | 9. Commitments to the Eurosystem |
| 9. Other assets | Other commitments |
| | 10. |
| | 11. Provisions |
| | 12. Revaluation accounts |
| ***10. Final contribution to the nation's goals*** | 13. Capital, reserve fund and available reserve |
| | **14. Profit for the year** |
| Total | Total |

## Income statement

1. Net interest income
2. Net income from financial operations, unrealized losses and provisions
    - **2.1. Capital gains/losses on financial transactions**
    - **2.2. Unrealized losses on financial assets and foreign exchange positions**
3. Net commission income/expenses
4. Income from shares and equity securities
5. Balance of monetary income distribution
6. Other products
7. Personnel costs
8. Other operating expenses
9. Depreciation of tangible and intangible assets
10. Ticket Production Department
11. Other expenses
12. Corporate tax

**Profit for the year**

**Annex 3: Consolidated balance sheet of the ESCB after cancellation of 100% of public debt held by NCBs**

This annex presents the consolidated balance sheet of the ESCB as of December 31, 2020, assuming that EUR 3,704 billion, or 100% of the public debt held by the national central banks (NCBs), would have been cancelled by that date.

| | **Heading** | 2020-12 | |
|---|---|---|---|
| | **(in millions of euros)** | **BEFORE** | **AFTER** |
| A | Assets | 7 014 661 | 7 014 661 |
| A1 | Gold assets and receivables | 559 281 | 559 281 |
| A2 | Claims on non-euro area residents denominated in foreign currency | 356 743 | 356 743 |
| A21 | Claims on the IMF | 87 079 | 87 079 |
| A22 | Accounts with banks, securities, loans and other foreign currency assets | 269 664 | 269 664 |
| A3 | Claims on euro zone residents denominated in foreign currency | 24 535 | 24 535 |
| A4 | Euro-denominated claims on non-euro area residents | 12 966 | 12 966 |
| A41 | Accounts with banks, securities and loans | 12 966 | 12 966 |
| A5 | Euro-denominated loans to euro area credit institutions related to monetary policy operations | 1 792 839 | 1 792 839 |
| A51 | Main refinancing operations | 262 | 262 |
| A52 | Longer-term refinancing operations | 1 792 574 | 1 792 574 |
| A52 | Fine-tuning temporary assignments | 0 | 0 |
| A54 | Temporary assignments for structural purposes | 0 | 0 |
| A55 | Marginal Loan Facility | 3 | 3 |
| A56 | Margin calls paid | 0 | 0 |
| A6 | Other euro-denominated claims on euro area credit institutions | 31 920 | 31 920 |
| A7 | Euro securities issued by residents of the euro zone | 3 900 861 | 3 900 861 |
| **A71** | **Securities held for monetary policy purposes** | **3 704 857** | **0** |
| A72 | Other titles | 196 004 | 196 004 |
| A8 | Euro-denominated claims on general government | 22 773 | 22 773 |
| A9 | Other assets | 312 783 | 312 783 |
| **A10** | ***Definitive contribution to the objectives of the nations*** | - | **3 704 857** |

| | Heading | 2020-12 | |
|---|---|---|---|
| | (in millions of euros) | BEFORE | AFTER |
| L | Liabilities | 7 014 661 | 7 014 661 |
| L1 | Tickets in circulation | 1 433 564 | 1 433 564 |
| L2 | Euro-denominated liabilities to euro area credit institutions related to monetary policy operations | 3 570 863 | 3 570 863 |
| L21 | Current accounts | 2 979 440 | 2 979 440 |
| L22 | Easy to deposit | 591 423 | 591 423 |
| L23 | Unsecured cash withdrawals | 0 | 0 |
| L24 | Fine-tuning temporary assignments | 0 | 0 |
| L25 | Margin calls received | 0 | 0 |
| L3 | Other euro-denominated liabilities to euro area credit institutions | 17 801 | 17 801 |
| L4 | Debt certificates issued | 0 | 0 |
| L5 | Euro-denominated liabilities to other euro area residents | 621 330 | 621 330 |
| L51 | Liabilities to public administrations | 540 119 | 540 119 |
| L52 | Other commitments | 81 211 | 81 211 |
| L6 | Euro-denominated liabilities to non-euro area residents | 349 241 | 349 241 |
| L7 | Foreign currency liabilities to residents of the euro zone | 7 966 | 7 966 |
| L8 | Foreign currency liabilities to non-euro area residents | 4 055 | 4 055 |
| L81 | Deposits, accounts and other liabilities | 4 055 | 4 055 |
| L82 | Credit facility under ERM II | 0 | 0 |
| L9 | Counterpart to the special drawing rights allocated by the IMF | 55 888 | 55 888 |
| L10 | Other liabilities | 301 658 | 301 658 |
| L11 | Revaluation accounts | 543 498 | 543 498 |
| L12 | Capital and reserves | 108 797 | 108 797 |