

THEMATIC



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Certain asset characteristics are possibilities that are never realised

Bonds that are not really binding

Should the €2,800 billion in sovereign bonds or the equivalent* that are on the European Central Bank's balance sheet be treated just like any other bonds? This question, which has come up regularly over the past several months, is far from being of mere academic interest. In fact, it is symptomatic of a wish to forgive or even cancel a portion of the public debt being raised to cope with the Covid-19 crisis. But, rather than simply ignoring it, a more standard solution for the financial markets would be to regard such debt as virtual for the moment and to exclude it temporarily from public debt ratios.

Emergency spending, followed by economic support plans launched in 2020, has sent public debt up sharply, to worrisome levels in many euro-area countries. However, most of the newly issued bonds are being bought up by the ECB; the market is absorbing only a little more than usual¹. Government borrowers and the ECB have said repeatedly that such debt cannot be cancelled and will one day be paid back. Moreover, this is in the public interest, as cancelling or restructuring some or all of this debt would devalue all European debt. Rather than simply ignoring the question or putting forth unrealistic solutions, it is worth asking how financial markets should treat it.

Do the characteristics of a financial asset change when it switches owners? From the strictly legal point of view, the obvious answer is no. Moreover, this is a fundamental principle that ensures equal treatment of bondholders, shareholders, creditors, etc. But **if the rights or obligations embedded in a financial instrument are never exercised, can they be considered as more virtual than real?** The financial markets often incorporate this parameter when the use that is made of an asset restricts *de facto* some of its characteristics.

Markets constantly adjust to reality

Take, for example, the number of a company's shares that are in free float calculation, which are often the only ones included in its weighting in market indices. The **company's own shares held in treasury are often excluded**, along with those held by pact-bound shareholders or by governments². These shares exist, but they are regarded as not being freely traded on the market and are therefore left out of certain indices. This is the case, for example, of EDF, which is not in the CAC 40 index, even though its market cap exceeds €40 billion, as the French state holds 84% of its shares.

There is another type of exclusion involving the voting rights embedded with shares. As some shareholders don't vote at general meetings, a simple or qualified majority is necessarily different from a theoretical majority. In the case of most publicly traded companies, approval of the accounts or a major amendment to the articles of incorporation never require a theoretical majority. An average of just 70% of shareholders vote at general meetings³. Hence, a simple majority is reached with 35% of the votes and not 50%. **In fact, 30% of voting rights don't actually exist** except when a takeover bid requires that all rights be acquired. In the case of bond debt, the mechanism of forfeiture can be used to exclude bondholders who might be in a conflict of interests with others. This is a temporary exclusion of voting rights but a substantial change to the asset's characteristics. The accounting principles applying to consolidated debt or available assets also modify the characteristics of the liabilities arising from financial instruments, depending on the bondholder. The list is long and there are many such situations.

So, it can be seen that in daily practice on the financial markets, the nature of an asset's owner can temporarily modify an asset's characteristics in certain situations or in the way in which it is accounted. The right or obligation embedded with the asset then become possibilities that are never realised or that are realised only in extreme cases. **These are characteristics in potentiality but not in actuality.**⁴

Central Banks & Treasury special relationships

In the special case of European or US sovereign debt, an additional parameter must be included – the bond issuer and bondholder are of the same nature, i.e. public, not-for-profit institutions. The

* As of the end of September €2,290bn under PSPP and €510bn under PEPP. Source: ECB: [link](#)

¹ Bertoncini, Sergio: *Eurozone government bonds a supportive mix of remarkable funding progress and ECB QE still to come*

² See, for example, the methodologies of the MSCI and S&P indices

³ The rate is slightly higher for professional investors. In France for example, according to the French Asset Management Association (AFG) in 2019 "wealth managers exercised their voting rights for 78% of their shares in their portfolios". [Rapport AFG 2019 Exercice des droits de vote par les sociétés de gestion](#)

⁴ Aristotle, *Physics II*

The central bank has pledged to permanently refrain from selling its bonds

Excluding sovereign debt is virtual and temporary... but for a very long time

Federal Reserve's response to the US Treasury's issuance programme or the ECB's launch of the PEPP while euro zone governments are expanding public deficits substantially, demonstrate **close coordination and even conditionality between fiscal and monetary policy**⁵. Not to mention the monetisation of public debt, an implicit pact is binding the government debtor with its central bank creditor. The central bank **has pledged to permanently refrain from selling its bonds** on the market and, moreover, to participate systematically in refinancing maturing debt, unless justified by financial conditions.

The question naturally arises from the above examples: **does this debt held by the ECB or the Fed have the same characteristics as debt held on private investors' balance sheets? The answer is probably no.** For, if the bond issuer is certain that, over a horizon that surpasses the maturity of its issue, the bondholder will never sell it and will subscribe to a new issue upon maturity regardless of the price, it may rightly consider that this is not just any other bond. This is due to the central bank's clearly announced intention but is also to the institutional nature of the two entities. For, if the state is assumed to be eternal it can forego paying off its debt and instead refinance it, or roll it over. The central bank, meanwhile, can keep buying it forever as part of its monetary policy mandate.

The matter of legitimacy is even more pressing in the case of euro-area sovereign bonds, as the ECB's buying programmes are conducted essentially at the level of national central banks (the Eurosystem). Can the Banque de France sell a substantial amount of OATs without the French state's approval? Theoretically (in potentiality) yes, but in fact (in actuality) no. Meanwhile,

when these bonds are issued at an interest rate of zero, there are no intermediate flows or ultimate value adjustments that would materialise the state's commitment. Moreover, for many countries, such as France, **the interest received and profits generated by the national central bank are passed on to the Treasury** in the form of taxes and to the government in the form of dividends⁶. So, what comes around, goes around. In fact, the bond's payment stipulation has been transferred into central bank money and is held by economic agents. Government debt becomes central bank debt owed to currency holders, a sort of perpetual, zero-coupon bond.

Change of paradigm

As is the case for other assets, the markets **should legitimately exclude sovereign debt that is on central bank balance sheets** from the calculation of state liabilities, as some of its characteristics have been altered for some time to come. Such an exclusion is as virtual as the debt is, and as temporary... but for a very long time. However, the currency issued by the central bank in exchange, is quite real. So, this matter should be approached less from the point of view of debt/GDP ratios or the equivalent, and more from the standpoint of the monetary base and monetary aggregates (M1, M2, M3 and L) and their counterparts (foreign debt, the state and the economy). Hence, non-conventional policies, when pushed to the extreme, can result in a new paradigm. They will force the **financial markets to switch analytical frameworks and return indirectly to monetary theory notions that had been somewhat cast aside**. There is even talk of a return to the 1970s⁷.

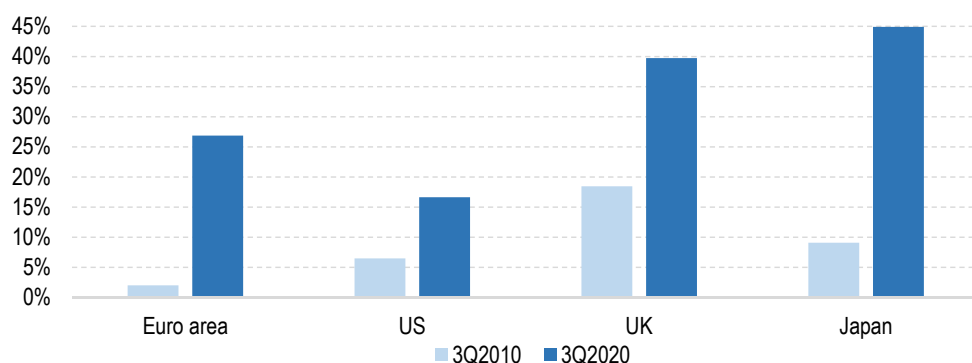
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⁵ See article "Should Central Banks Save us from Ourselves?", Amundi Research [link](#)

⁶ Annual Report of the Bank of France, 2019, pages 110-112: €2,650 million in corporate income tax, and €3,478 million in dividends paid to the state. [link](#)

⁷ Pascal Blanqué (2020), "Covid-19: the invisible hand pointing investors down the road to the '70s" Amundi [link](#)

1/ Change over 10 years of national holdings of sovereign debt (% total debt outstanding)



Source: BIS, Fed, US Treasury, ECB, Eurostat, BoE, HMRC, BoJ, Amundi Research - Data as of 31 September 2020