

None!

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Bruegel panel discussion:  
Government bonds in the ECB collateral framework:  
What role for credit ratings in the new normal?  
Brussels, 15 November 2023

# At the European Parliament's Monetary Dialogue

Q: "... In short, I have two questions. **First, in your opinion, can the ECB framework on collateral contribute in some way to fuel the risk of fragmentation?** Second, when you talk on discretion, what are you talking on? Don't you think predictability, uncertainty [read: certainty] are better attributes for a central bank?"

A: "... **This is work in progress at the moment**, but we have our framework, we can get away from it if necessary and called for by circumstances. And in any event, we are very attentive and do not blindly take the ratings produced by the rating agencies. Thank you."

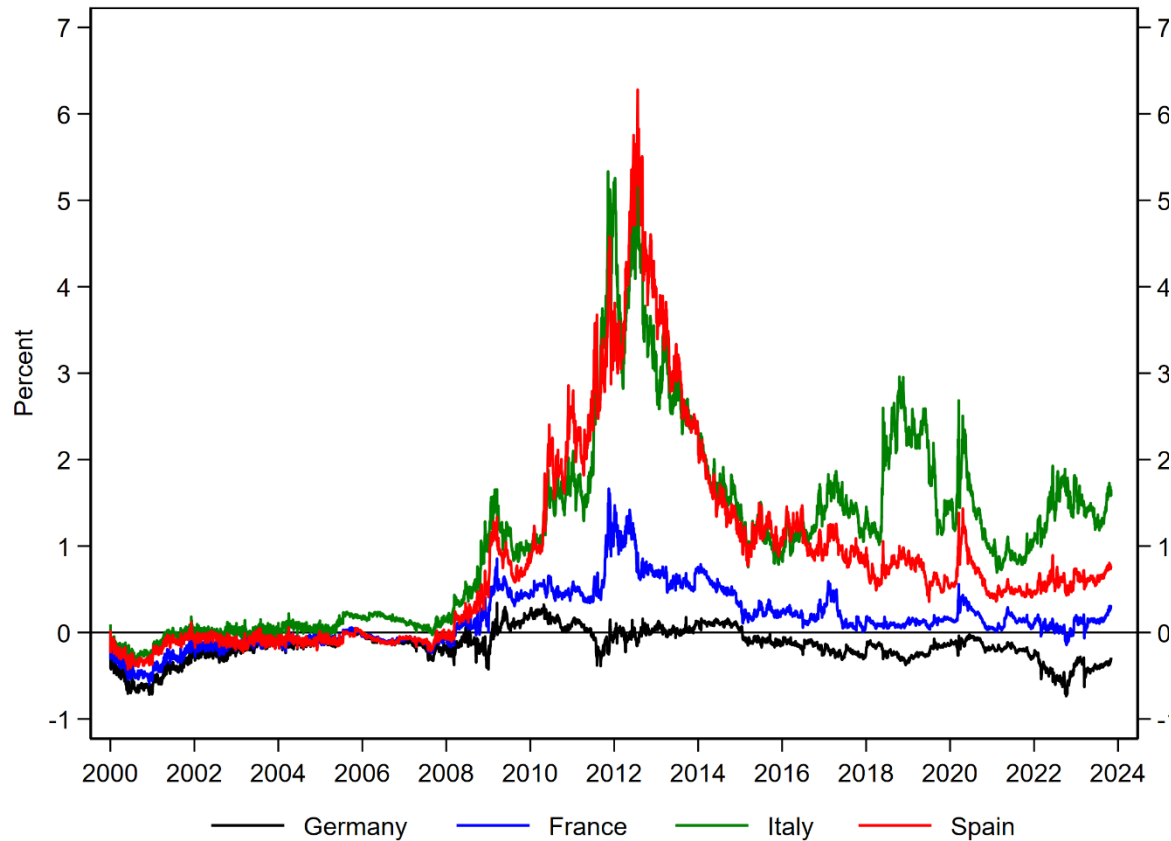
Committee on Economic and Monetary Affairs. *Monetary Dialogue with Christine Lagarde, President of the European Central Bank*. Brussels, 20 June 2022.

[https://www.europarl.europa.eu/cmsdata/250567/1259176-3\\_EN.pdf](https://www.europarl.europa.eu/cmsdata/250567/1259176-3_EN.pdf)

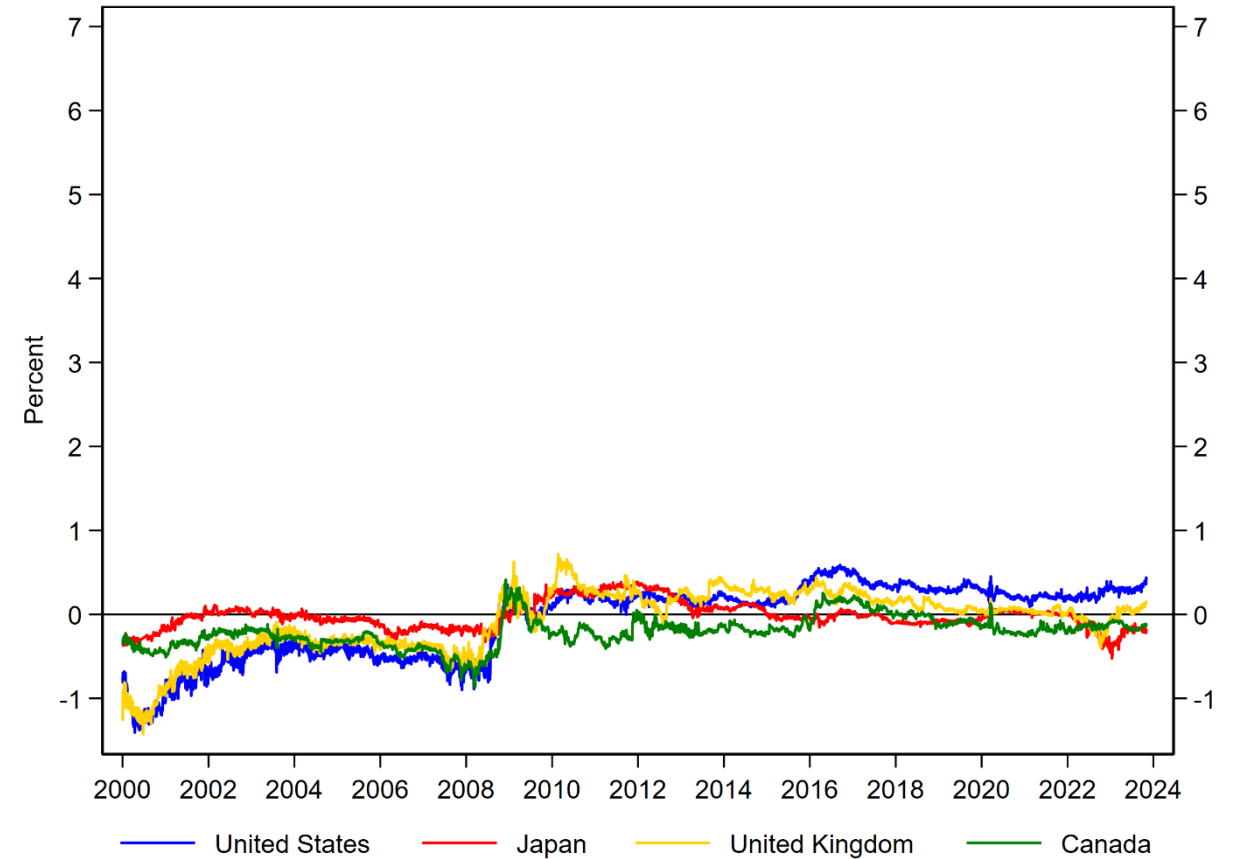


# Spreads: 10 year government yield over OIS rate

## ECB



## Fed, BOJ, BOE, BOC



“How does the ECB's reliance on external credit assessments affect bond yields, government vulnerability, and potential sovereign debt crises?”



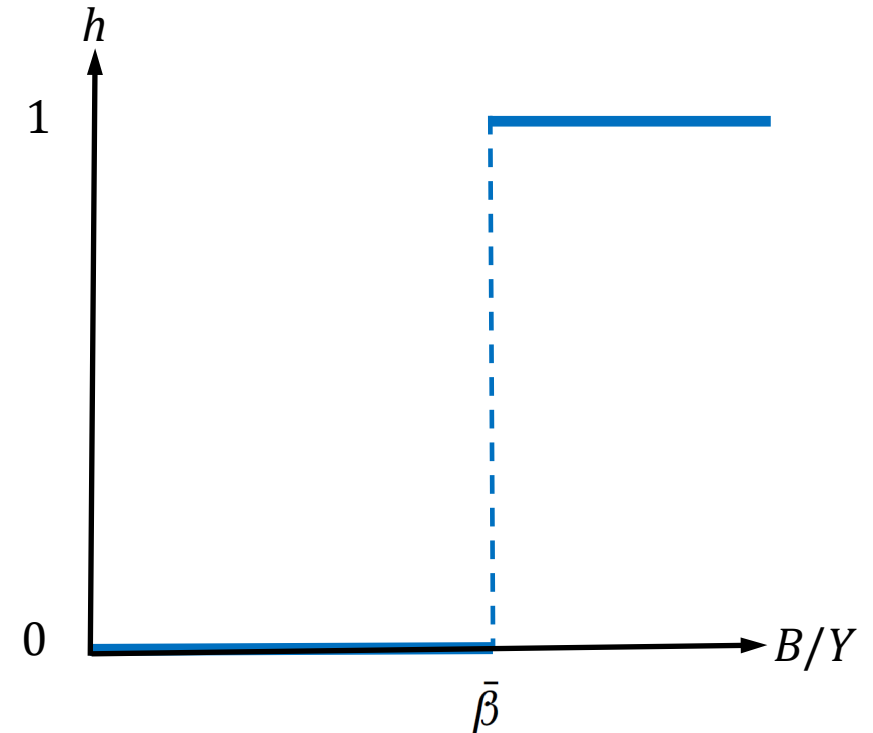
# What drives spreads?

- “Spreads” in markets reflect beliefs about economic fundamentals, market functioning, **as well as the central bank’s policy framework.**
- The central bank **collateral framework** is a key determinant of spreads.
- Collateral eligibility and haircuts affect liquidity premia and roll-over risk.
- As a rule, central banks are very careful to protect liquidity of government bonds and government debt enjoys a liquidity premium.
- **The ECB is an exception:** It relies on credit ratings to determine collateral eligibility of government debt. As a result, concerns of a downgrade can depress government bond prices and, by worsening the fiscal burden, can be self-fulfilling.
- The **cliff effect** in the ECB collateral framework introduces a fragility in government bond markets in the euro area that is absent in other economies.



# Analytical background

- A simple model of conditional eligibility.
- An example with a **cliff effect**: Suppose a debt ratio limit determines eligibility:
  - If debt ratio is below  $\bar{\beta}$  then  $h=0$ .
  - If debt ratio is above  $\bar{\beta}$  then  $h=1$  (debt is not eligible collateral).



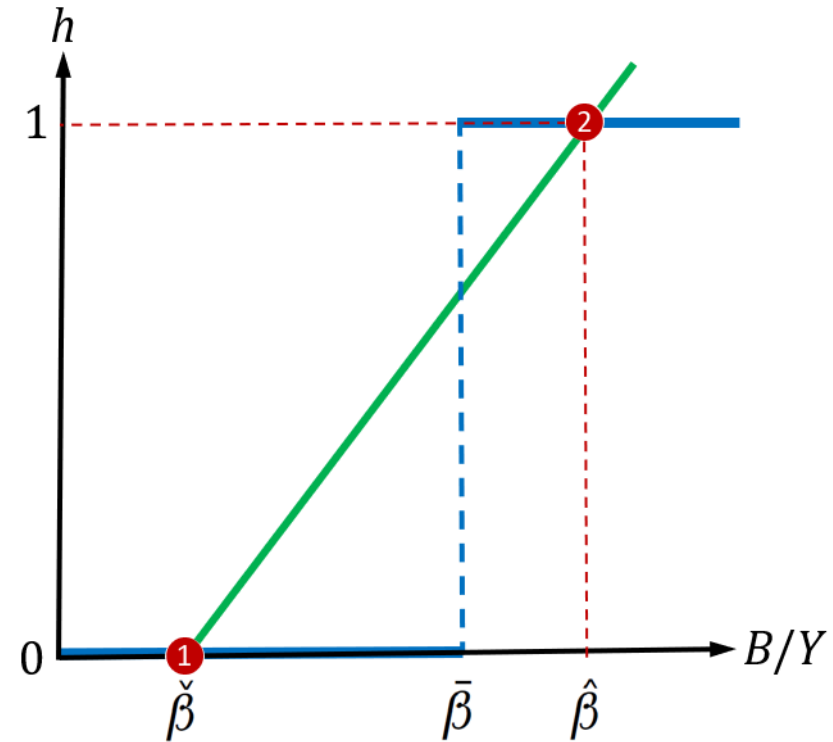
Source: Lengwiler, Y. and A. Orphanides. “Collateral Framework: Liquidity Premia and Multiple Equilibria.” *Journal of Money, Credit and Banking*, forthcoming.

<https://onlinelibrary.wiley.com/doi/full/10.1111/jmcb.13048>



# Two equilibria with the same fundamentals and no uncertainty

- Equilibrium (1) is the “good” equilibrium with a low interest rate, low debt ratio and no haircut on debt.
- Equilibrium (2) is the “bad” equilibrium with a high interest rate, high debt to GDP (above  $\bar{\beta}$ ) so that the debt is not eligible collateral (haircut is 100%).



# Role of collateral framework with uncertainty

- Suppose productivity is uncertain and the government faces a max tax rate.
- Public finance is fragile if max tax revenue is insufficient to cover bond payment in case of a negative productivity shock.
- A collateral framework that raises the cost of public finance becomes the cause of avoidable defaults—defaults that would not otherwise occur.



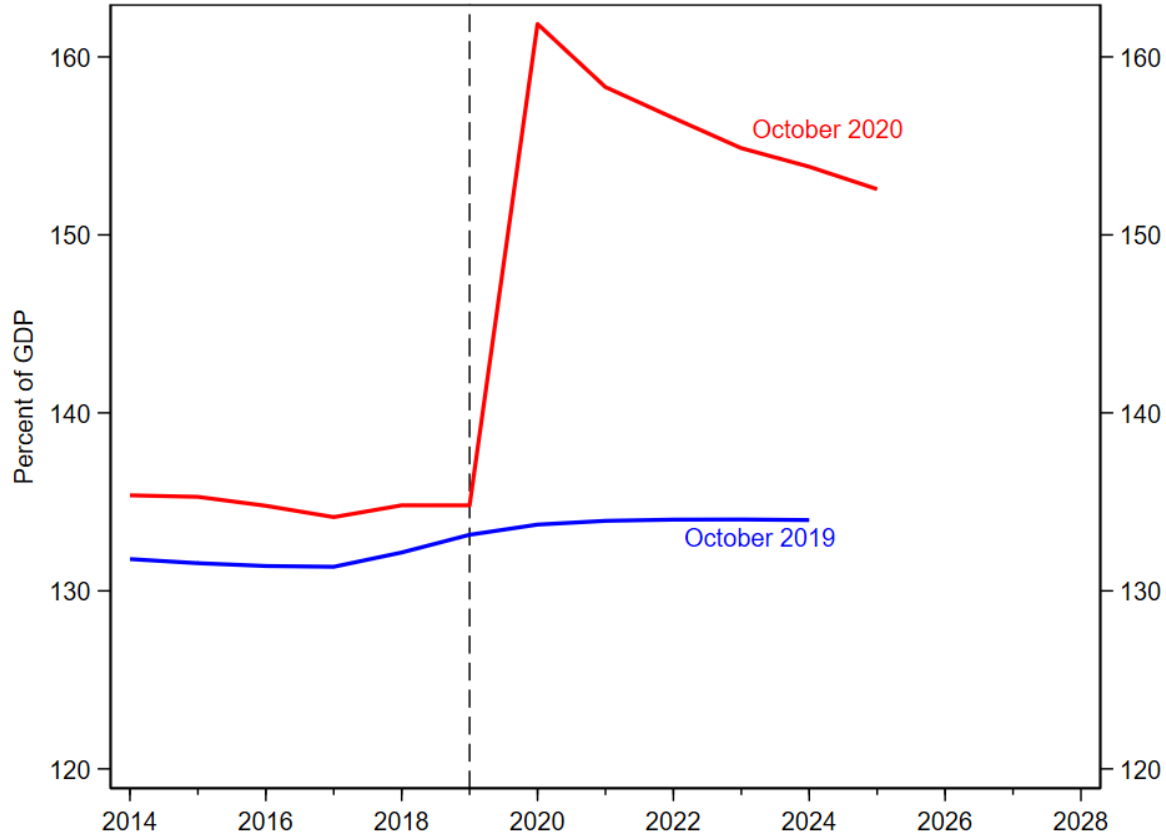
# How important is the problem in practice? A case study

- How did the ECB avert a disaster in Spring 2020, when faced with the pandemic shock?
- Pandemic shock resulted in a 20 percentage point spike in projected debt ratios.
- Market reaction?
- ECB response?

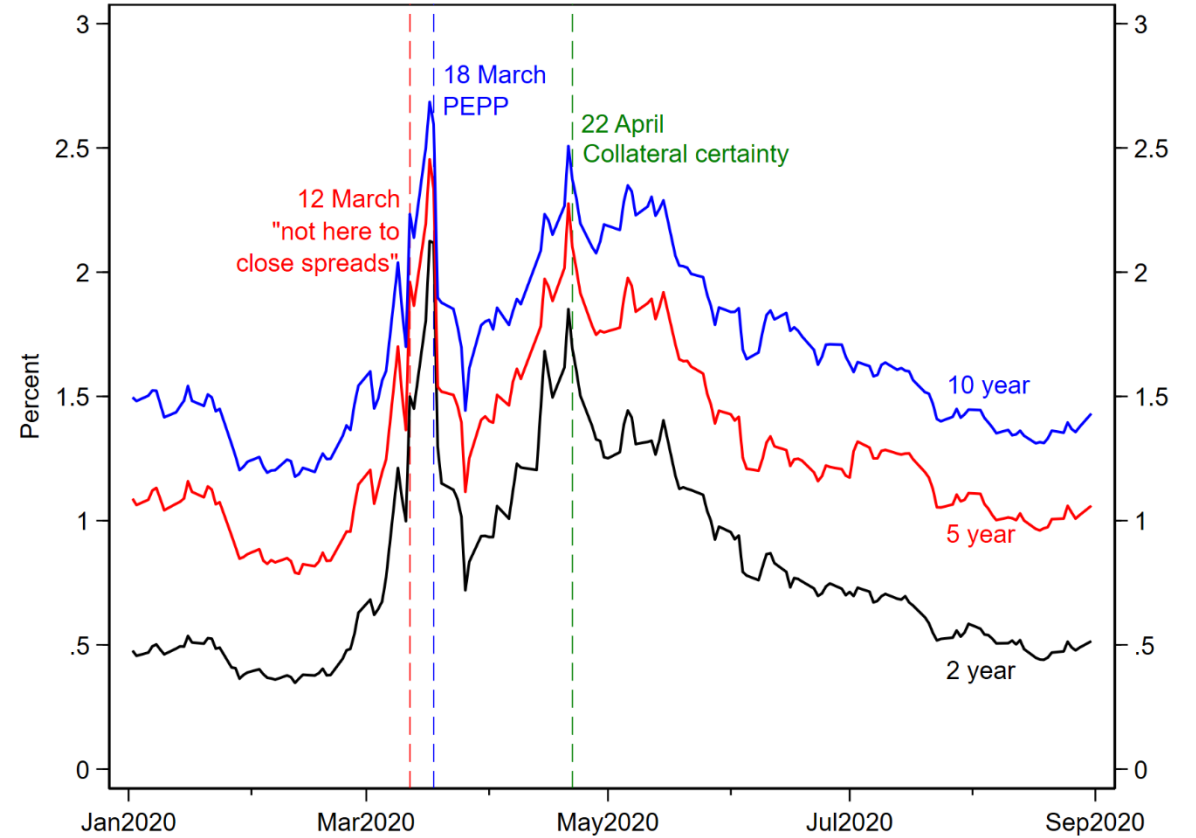




# How did the ECB avert a crisis during the pandemic?



Italy: Debt-GDP ratio data/projections.  
IMF WEO, dates shown.



Italy: Government bond yields over OIS.



## ECB takes steps to mitigate impact of possible rating downgrades on collateral availability



22 April 2020

- › ECB to grandfather **until September 2021** eligibility of marketable assets used as collateral in Eurosystem credit operations falling below current minimum credit quality requirements
- › Appropriate haircuts will apply for assets that fall below the Eurosystem minimum credit quality requirements
- › Decision reinforces broader package of collateral easing measures adopted by the Governing Council on 7 April 2020, which will also remain in place until September 2021
- › ECB may decide further measures, if needed, to continue ensuring the smooth transmission of its monetary policy in all jurisdictions of the euro area



# Key decisions on the ECB's collateral policy during pandemic

- **April 22, 2020:**  
ECB announced suspension of reliance on credit ratings until **September 2021**.
- **December 10, 2020:**  
ECB prolonged suspension until **June 2022**.
- **March 24, 2022:**  
ECB decided to return to pre-pandemic collateral framework, starting in **March 2024**.



# The return to fragility

PRESS RELEASE

## ECB announces timeline to gradually phase out temporary pandemic collateral easing measures

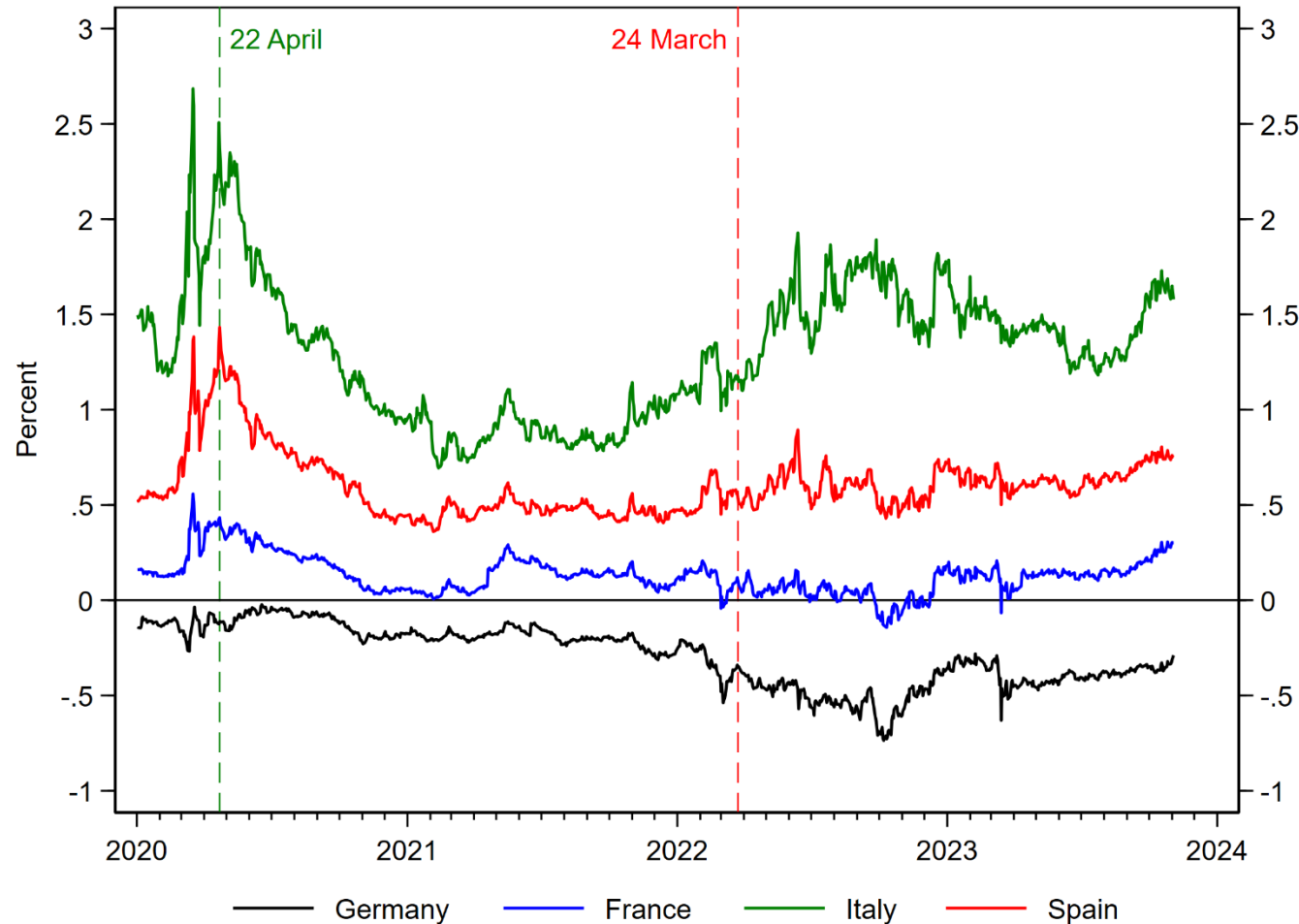
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*24 March 2022*

- > Pandemic collateral easing measures introduced in April 2020 will be gradually phased out in three steps between July 2022 and March 2024



# Did the 24 March 2022 decision reduce fragmentation risks?



22 April 2020: Suspension of using credit ratings to determine collateral eligibility of government debt.

24 March 2022: Re-introduction of credit ratings, as of March 2024.

Spreads between 10 year government bond yields and OIS (to 3 Nov. 2023)

# Government bonds: What role for credit ratings in the new normal?

- None!
- The “work in progress” should lead to a better framework.
- The ECB should embrace the lessons from its success during the pandemic and stop using credit ratings for government debt.

