None!

Athanasios Orphanides
MIT

Bruegel panel discussion:

Government bonds in the ECB collateral framework: What role for credit ratings in the new normal?

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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?”

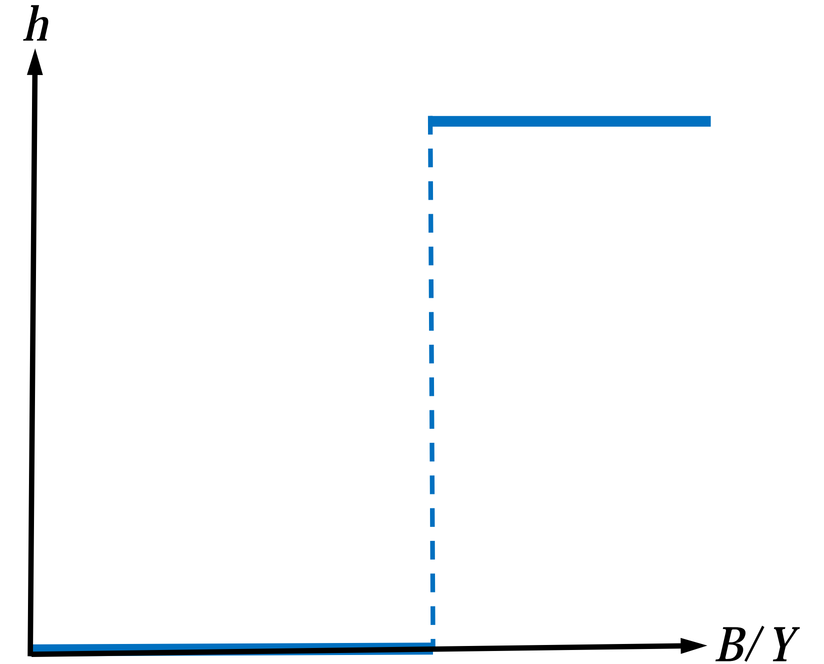
A: “… This is work in progress at the moment, but we have our framework, we can get away from it if necessary and called for by circumstances. And in any event, we are ve attentive and do not blindly take the ratings produced by the rating agencies. Thank you.”

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-EN.pdf

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 an 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.

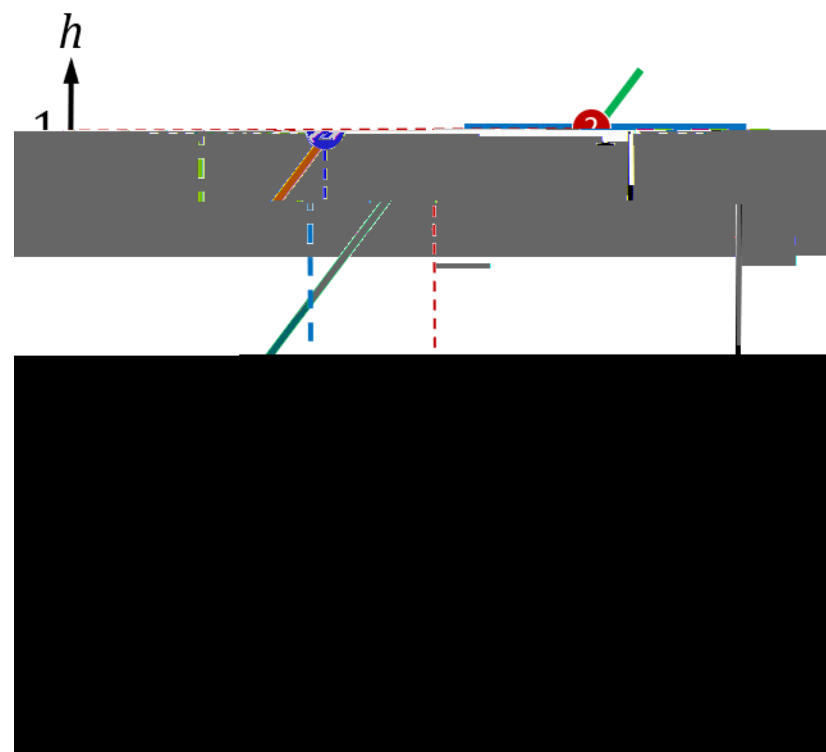
Analytical background



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

Two equilibria with the same fundamentals and no uncertai

- 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%).



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 sho
- 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.

Temporary suspension of source of fragility

Key decisions on the ECB’s collateral policy during pandem

- 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

Did the 24 March 2022 decision reduce fragmentation risks

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.