

Improving economic policy



Bruegel event on ECB collateral

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I want to make 4 points:

- I. On which parts of the analysis of Y and O do I agree
 - II. On which parts I disagree and why
 - III. My practical conclusions about the ECB collateral framework
 - IV. Some minor points, with a different reading about ECB actions and statements
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I. I agree on two important points in the paper:

- The “small country assumption” does not hold for the ECB
 - This consideration also applies to collateral management, which is a relevant component of monetary policy. But the effects of collateral should not be exaggerated, because the risk of the assets remains with the counterparty posting them.
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II. Here my agreement ends.

My understanding of the model:

- Banks post government bonds first for their liquidity needs, while non-government assets are only posted when no more bonds are available.
- If the haircut grows up to 100 per cent, banks suffer an important liquidity shock and the yield on government bonds increases significantly aggravating debt sustainability and creating the risk of default and a financial crisis.

- I see L and O's ingenious model as a way to dramatize the effect of collateral: Orphanides in 2017, “ *the ECB inadvertently planted the seeds of the euro crisis ...* ” because of its collateral policy.
 - The transformation of a relevant effect of collateral on market equilibrium into dramatic crisis risk is based on two assumptions, which are factually wrong.
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The two factually wrong assumptions are:

- Banks depend mostly on government bonds to satisfy their liquidity needs, for instance to redeem withdrawn deposits, by accessing central bank liquidity by means of temporary operations ($L=(1-h)B/r$) and
- Banks are the only purchasers of government bonds ($G=B/r$)

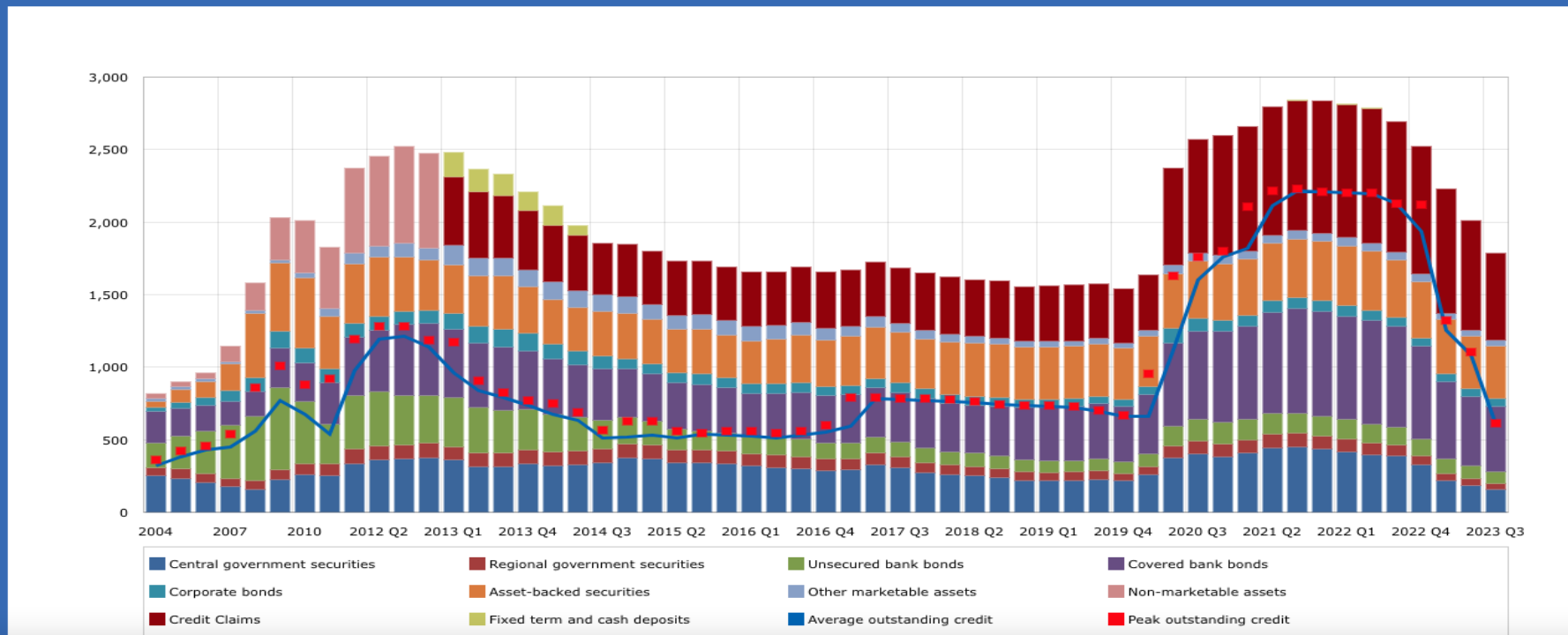
Showing that both assumptions are wrong is easy.

Fig. 1 Minimal posting of government bonds as collateral



Credit: based on daily data

Since Q1 2013, the category "Non-marketable assets" is split into two categories: "Fixed term and cash deposits" and "Credit claims".



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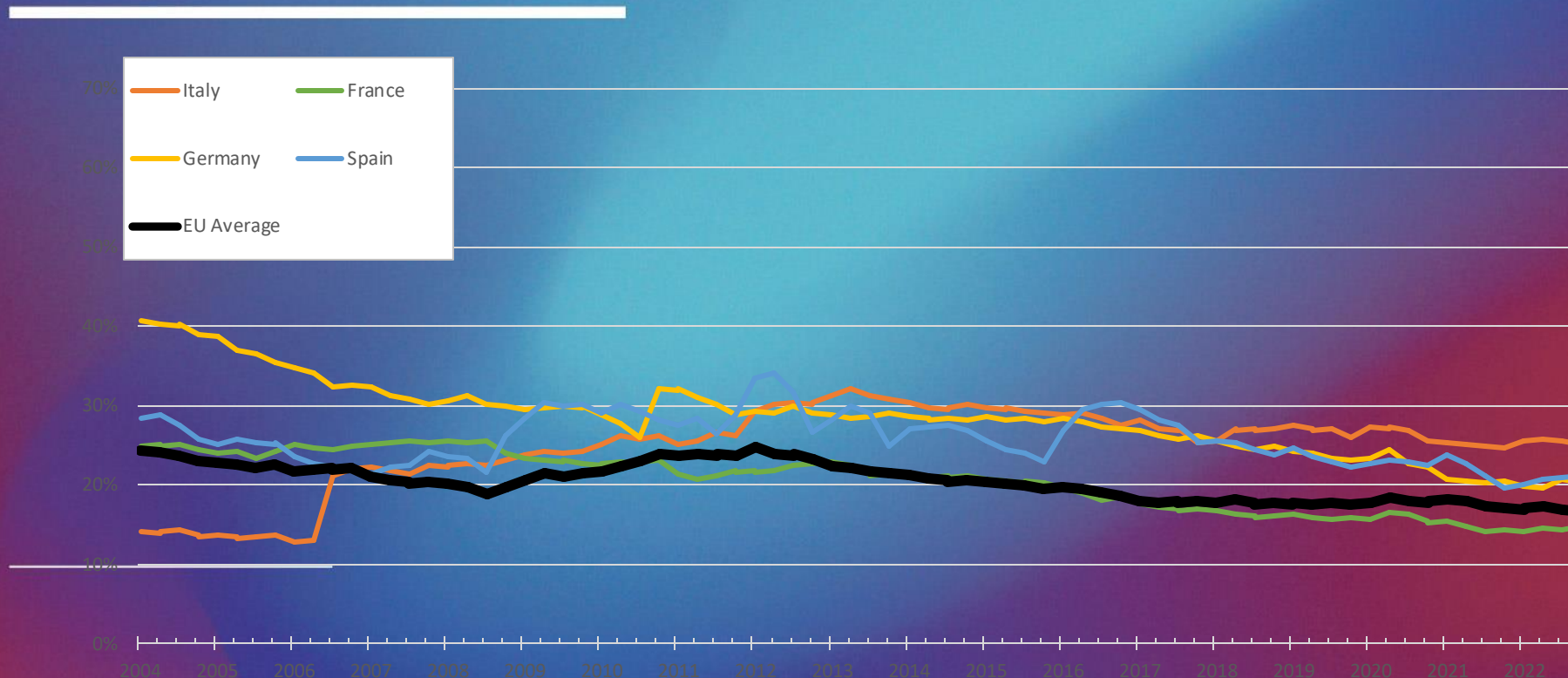
Table 1. Liquidity depends on the counterparty

Hypothetical liquidity levels



	Sovereign	Not sovereign
ECB	4	3
Market	5	1

Improving economic policy Fig. 2. Non-banks in the euro area hold more than 80% of the stock of government bonds. In Italy, they hold 75%.



The effect of haircut increases, up to 100 % ineligibility, is muted:

- The haircut is little relevant for banks, which use bonds in a very limited way for refinancing, and
- It is irrelevant for other investors in the sovereign bond market, which cover a large share of purchases,
- So the overall effect of changes in the haircut , up to ineligibility, is attenuated.

III. My practical conclusions about the ECB collateral framework (I):

1. The ECB has a basic problem about its risk management.
2. Unlike what is claimed, the paper, says nothing about the use of ratings for the eligibility of government bonds. Its conclusions apply to any system foreseeing the possibility to exclude, in some circumstances, the eligibility of government paper as collateral.
3. I am not in principle against using other sources to assess credit quality.
4. Stressing the weaknesses of the current system is not enough.
5. The only possible approach consistent with O and L is the ECB accepting in all conditions government paper as eligible;

My practical conclusions about the ECB collateral framework (II):

6. I do not think that in all circumstances government debt should be eligible (Buiter and Sibert 2005).
7. I cannot see any better system than the current one, which is very bad except for all the others.
8. The ECB follows the FSB suggestion to *“avoid mechanistic approaches that could lead to unnecessarily abrupt and large changes in the eligibility of financial instruments and the level of haircuts that may exacerbate cliff effects.* The ECB did this for Greece in 2010 and 2020, it allowed the use of Greek collateral for ELA and uses the best of 3 ratings,.

IV Some minor points:

- There was no temporary suspension of the collateral framework in April 2020, just an adaptation of it.
 - The rating was not introduced in 2005, it preexisted. This was, however, not properly communicated.
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Thanks, and ready for discussion

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