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Article

The politics of the ECB's market-based approach to government debt

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Abstract

The European Central Bank's (ECB) market-based treatment of government debt was an important cause of the 2010–2012 eurozone crisis. This article analyses the political dynamics that govern the ECB's approach to government debt from the earliest discussions on Economic and Monetary Union to the COVID-19 pandemic. The first part of the article traces the process of institutional transformation that led the ECB to introduce its strict market-based approach in 2005. I explain this development in terms of a strategy of depoliticization that brings the ECB to introduce a rigid and rule-based approach to designing its collateral framework. The article's second part explains why the ECB stuck to the market-based approach in the eurozone crisis but not in the pandemic crisis. Although its ill-defined constitutional role led the ECB to disavow its agency earlier, in March 2020, it had become clear that this strategy had stopped working and it was quickly abandoned in the face of a new bond market panic.

Key words: technocracy, collateral, financial institutions, political economy, Europe

JEL classification: E58—central banks and their policies, H63—debt, debt management, sovereign debt, N2—financial markets and institutions

1. Introduction

The European Central Bank's (ECB) market-based treatment of government debt was at the root of the 2010–2012 Eurozone crisis (De Grauwe, 2011; Saka et al., 2015; Gabor and Ban, 2016; Orphanides, 2017; Constâncio, 2018; Orphanides, 2018). Like most central banks, the ECB implements its monetary policy by lending against collateral. Collateral is an asset pledged by a borrower, which a creditor acquires if the borrower defaults. By asking counterparties to pledge collateral, the central bank protects itself against financial losses. In 2005, the ECB's treatment of government debt became market-based in the sense that their

value as collateral became conditional on private credit ratings. Although in place for only a few years when the eurozone crisis started, this policy quickly became a key driver of the bond market panic. In 2020, in stark contrast, the ECB acted quickly to provide support to governments, reflecting distinct lessons learned in the preceding years. In this article, I analyse the political dynamics that governed the ECB's approach to government debt and explain the ECB's evolving crisis management.

Despite its vague legal provisions, ECB's treatment of government debt is a highly sensitive topic from the start of monetary integration. In most jurisdictions, a domestic sovereign owns the central bank, and its debt has a pivotal role in implementing monetary policy. For the eurozone, however, there is no single safe asset and individual member states can default on debt to the ECB (Constâncio, 2018; Gabor and Vestergaard, 2018). At the same time, the central bank's mandate says very little about how to deal with government debt and the financial risk that it exposes the ECB to. Although the ECB is allowed to purchase public debt and accept it as collateral as part of its operations, its mandate also prohibits monetary financing; a nebulous concept for the use of monetary policy to support government spending. The treatment of government debt constitutes an 'authorization gap' in the sense that the ECB faces choices with far-reaching consequences for which there are no clear provisions in its mandate (de Boer and van 't Klooster, 2020).

The ECB's treatment of sovereign debt and other forms of public debt has always been an issue with considerable stakes, but these rose dramatically with the start of the eurozone crisis. Collateral rules are of existential importance to banks, which pledge debt instruments to borrow from the central bank—a bank that loses access to central bank credit defaults. Collateral rules are also crucial for governments who rely on their domestic banks to buy their debt. These stakes are interlinked: banks typically hold a large volume of debt held by their domestic sovereign, while states serve as implicit guarantors for their banks. As European governments' credit ratings slowly dropped, the ECB raised doubt about future eligibility. In the face of that possibility, uncertainty came to drive spreads between yields for individual member states (De Grauwe, 2011; Gibson et al., 2017; Gennaioli et al., 2018). However, to accept bonds from a government deemed insolvent would raise accusations of monetary financing and of acting 'politically'. It took the ECB years of crisis fighting to find a way to deal with this conundrum.

How did the ECB navigate its ill-defined constitutional role in dealing with government debt? This article analyses how the ECB's rigid and rule-based approach originated in efforts in the mid-2000 to depoliticize the treatment of sovereign bonds. The term depoliticization is sometimes used to denote the act of delegating monetary policy to an independent central bank, which operates at arm's length of elected government (Burnham, 1999; Flinders and Buller, 2006). More recently, the term has come to refer more broadly to decision-making in a context of narrowed political participation and limited political contestation (Hay, 2007; Flinders and Wood, 2014; Fawcett et al., 2017). The procedures and practices that govern choices can be politicized in the sense that representatives of a broad range of interests and political bodies shape decision-making; either through a formal procedural role or through effective informal strategies of activism, lobbying and use of public media. Decisions can also be depoliticized in that the actors involved and the considerations that shape decision-making are limited. I rely on this broader notion of depoliticization to study central banks not only as *beneficiaries* of depoliticization but also in particular as *agents* who seek to bring

about depoliticization (Krippner, 2011; McPhilemy and Moschella, 2019; Bressanelli et al., 2020; van't Klooster and Fontan, 2020).

The history of the ECB's collateral framework is one of depoliticization, where the ECB relied on three types of strategies. The first strategy is to present monetary policy decisions as merely following a legal requirement imposed by the central bank's mandate (Goodhart and Lastra, 2018). As I show, the ECB used a selective reading of the relevant legal provisions to present the market-based eligibility criteria for government debt as a legal obligation. The second strategy of depoliticization is to present the central bank's role as immutable and governed by longstanding traditions (Johnson et al., 2019; Braun and Downey, 2020). As I show, the ECB denied the novelty of the market-based approach, thereby further obfuscating its agency in imposing it. The third strategy of depoliticization involves adopting policies that assign key decision-making roles to market actors (Krippner, 2007, 2011; Fontan et al., 2016; Gabor and Vestergaard, 2018; Walter and Wansleben, 2020; Braun et al., 2021). Rather than conducting its own, unavoidably political assessment of solvency, the ECB made eligibility conditional on private credit rating agencies.

In the first part of the article, I draw on new archival evidence and interviews to explain the ECB's market-based approach to sovereign debt as the outcome of its efforts of depoliticization. I show that central bankers involved in creating the ECB at the European Monetary Institute (EMI) (1994–1998) disagreed vehemently over the treatment of government debt. The Bundesbank's opposition to the use of private credit ratings gave rise to a compromise involving a minimum credit rating requirement, which, however, 'should not be made public in order to avoid giving undue power to the rating agencies' (EMI, 1997a, p. 2). In 2005, renewed debate over the treatment of sovereign debt led the ECB to abandon this compromise in announcing a minimum credit rating for government debt. The ECB, thereby, forfeited the discretion it had left itself to diverge from private credit ratings. I argue that this turn of events reflected the ECB's efforts to disavow its agency concerning the treatment of government debt.

The second part of the article analyses how the ECB's market-based treatment of sovereign debt informed its response to the eurozone crisis and the COVID-19 pandemic. Throughout the eurozone crisis, the ECB continued using its pre-crisis depoliticization strategies—with disastrous consequences. It led the ECB to adhere to pro-cyclical risk controls for government debt and make eligibility dependent on the financial market fortunes of individual member states. By documenting the continuity of its positions with pre-crisis strategies of depoliticization, I challenge accounts of the ECB's role in the crisis that interpret its rigid adherence to the market-based approach as a strategy to impose fiscal discipline onto individual member states (Randall Henning, 2016, 2017; Orphanides, 2017; Varoufakis, 2017; Schmidt, 2020). In 2020, the ECB abandoned this strategy. The ECB's treatment of government debt had become self-consciously political, making way for a pandemic response that no longer denied its agency in shaping bond markets (Gabor, 2021; Tooze, 2021).

The article traces a process of gradual institution building within the ECB from 1988 to the present. It is based on a systematic review of regulations and policy documents concerning the ECB collateral framework and risk management, as well as not previously disclosed ECB document requests (van 't Klooster, 2021a). The article also draws on background interviews with 18 EMI, ECB and Eurosystem central bankers and with participants in debates on the collateral framework in the mid-2000s.

Building on its historical narrative, the article makes three broader contributions to the existing literature. First, it analyses the unique politics of central bank collateral as a neglected but highly consequential field of economic policy. It is well understood that the central bank's collateral policies shape its operations as a lender of last resort (ECB, 2013; Murau, 2017; Barthélemy et al., 2018). Much less attention has gone to the politics of central bank collateral in normal times and to the way in which it shapes crisis-fighting operations (Gabor and Ban, 2016; Orian Peer, 2019; Braun, 2020; Gabor, 2021). Secondly, the article contributes to theorizing the political agency of independent central banks. In contrast to accounts that portray the ECB as a strong actor pushing its own agenda of austerity, I emphasize reluctance to act. That insight, finally, is also relevant to perennial debates over the role of expert rule in a democracy (Parkinson and Mansbridge, 2012; Moore, 2017; van 't Klooster, 2020). These debates typically concern whether depoliticization is an adequate means to ensure dispassionate and fact-based decision-making (Pettit, 2004; Holst and Molander, 2019) or rather weakens the democratic process and leads to undue influence of well-organized interest groups (Urbinati, 2010; Downey, 2020). In studying technocrats as agents of depoliticization, the article highlights how efforts to maintain the central bank's constitutional independence undermine the substantive quality of monetary policy.

2. EMU and the eligibility of government debt before the crisis

This section analyses how the ECB came to introduce its strict market-based treatment of government debt. Only in 2005 did the ECB commit itself to a set of rules, in which it largely deferred decisions on eligibility to private credit rating agencies (Section 2.1). I show that the ECB used a new market-based approach to financial risk to depoliticize its treatment of government debt (Section 2.2).

2.1 The initial compromise and the introduction of the minimum rating requirement

The 1988 Delors Committee, which set out the blueprint for the Economic and Monetary Union (EMU), and the 1992 Maastricht Treaty that codified it, say little about how the ECB should deal with government debt. A defining feature of the monetary union envisaged by the committee is that a 'European System of Central Banks' decides on monetary policy, while fiscal policy remains almost exclusively a member state competence. The individual member states retain budgetary autonomy and are to ensure individually that tax receipts match government expenditures. This setup quickly raised questions over how to deal with the macroeconomic and financial market consequences of public borrowing. In theory, markets provide some incentives for governments to bring down their debt level, in particular for governments that no longer issue debt in their own currency. However, in a passage that presages the events of the eurozone crisis, the report cautions against relying on bond markets for fiscal constraints:

[M]arket views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive. (Delors Committee, 1989, p. 20)

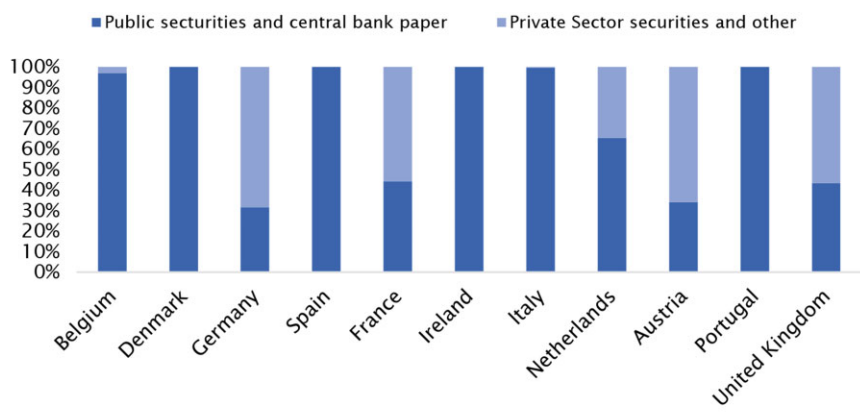


Figure 1 Collateral usage in monetary policy operations before EMU.

Source: EMI (1995b)

Instead of trusting market discipline, the 1992 EMU architecture introduced a host of rules and governance mechanisms to constrain public borrowing. The member states strengthened these provisions through the 1997 Stability and Growth Pact (SGP).

At Maastricht, the member states agreed on a terse central bank mandate, which tasks the community of European Union central bankers with creating an entirely new institution. In the years that followed, the ECB collateral framework quickly became one of their most divisive dossiers (Galvenius and Mercier, 2011; van 't Klooster, 2021a). A crucial provision governing the instruments of the ECB calls for adequate collateral, but what 'adequate' means is left unexplained.¹ Although the monetary financing prohibition bans 'direct purchase' of public debt, the Treaty permits trading in government bonds to implement monetary policy. In all member states, public debt had an important role in the implementation of monetary policy and as a sizable share of pre-EMU central banks only accepted government debt as collateral (see Figure 1). The provision also reflects an acknowledgement of a central bank's historical role as lender of last resort to governments (CoG, 1990, p. 11). However, the mandate does not address what tasks, if any, the ECB would have in responding to a gradual build-up of imbalances, and a sudden correction.

The treatment of government debt was one of the earliest authorization gaps that the ECB struggled with as a consequence of its vague mandate provisions (de Boer and van 't Klooster, 2020). The ECB was designed to focus its efforts on price stability by influencing financial market conditions. Drafted with this narrow objective in mind, the mandate does not cover many important choices that the ECB could face, nor does it empower it to make its own policies on topics typically within a central bank's remit. The ECB itself would need to set rules for whether to accept sovereigns if their debt is no longer safe collateral and what to do if a panic disrupts markets. The treatment of government debt is an authorization gap in the sense that the ECB faces an important choice that its mandate does not cover.

1 ESCB and ECB Statutes, Article 18.1.

As a consequence of the authorization gap, the decision on how to deal with government debt initially went to the EMI, which from 1994 onwards set out to design the new central bank (Galvenius and Mercier, 2011; van 't Klooster, 2021a). The EMI left discussions on the treatment of sovereign debt to a specialized taskforce, where deliberation took place on a much more technical level. Debates focused on the eligibility of individual issuers and what risk-control measures to impose on eligible assets. The individual member states already had a strong interest in both continued eligibility as well as low haircuts. A valuation haircut is a reduction of the value of an asset for the purposes of determining how much a counterparty can borrow against that asset when pledged as collateral. If the haircut on an asset is 10%, the counterparty can lend up to 90% of the value of the loan by pledging it as collateral. However, accepting sovereign bonds at low haircuts would in theory allow member states to rely on their domestic banking sector to effectively monetize their debt. The monetary financing prohibition itself cannot stop this since it only bans the ECB from providing funds to governments directly. Hence, initial discussions focused on the use of private credit rating agencies for determining credit quality of government debt—a strategy already pioneered by the Basel Committee in its Market Risk Amendment (BCBS, 1996).

A minority position, most vigorously championed by the Bundesbank, held that no minimum credit rating should apply to governments.² For one, its representatives invoked the Delors report's plea for policy constraints over market discipline. The SGP is meant to ensure creditworthy sovereigns:

all debt instruments issued by central and regional governments of countries participating in the euro area should be eligible [...] since the growth and stability pact would ensure a sufficient degree of creditworthiness of these instruments. (EMI, 1997b, p. 2)

Central bankers also argued that the methodologies of private rating agencies are crude and that the central bank should not tie itself to their decisions (EMI, 1995a, p. 6). As the Bundesbank stated, '[a]n extensive use of rating by market agencies would risk partly transferring ECB sovereignty to a few, profit-oriented agencies' (EMI, 1997a, p. 1). Its alternative approach combined institutional criteria (i.e. what type of issuer) with other eligibility criteria such as in-house credit assessments and financial market prices. The majority of central banks opposed this proposal because it is tied to the Bundesbank's push to develop Eurosystem in-house credit rating facilities for private debt. This, the majority of taskforce members thought, 'would entail excessive administrative burdens' and impede market price discovery (EMI, 1997a, p. 1). It would also burden the ECB with judging the creditworthiness of individual member states; an issue that could hardly be settled on mere technical grounds (Paudyn, 2013; Stellinga and Mügge, 2017).

The compromise that the members of the responsible taskforce reached in April 1997 is to define a minimum credit rating requirement, which essentially has no teeth. The requirement 'should not be made public in order to avoid giving undue power to the rating agencies' (EMI, 1997a, p. 2). The ECB, moreover, should retain the power to deviate from the assessment of rating agencies by adding further eligibility criteria. In line with this compromise, the ECB's internal procedures always contained a list with minimum eligibility

2 The other central banks are those of Belgium, Greece and Italy.

requirements formulated in terms of private credit ratings (ECB, 1998a Annex 6).³ However, it was kept secret. The first published edition of the General Documentation merely specifies that in deciding credit quality 'the ECB takes into account, inter alia, available ratings by market agencies as well as certain institutional criteria which would ensure particularly high protection of the holders' (ECB, 1998b, p. 39). Until 2005, it was not just unclear what the rating threshold is, but even that there might be one to begin with (cf Bindseil and Papadia, 2006, p. 9n). No member state had come anywhere near a rating where it would fall below the ECB's internal rating requirement.

The issue resurfaces in the mid-2000s in response to two developments. First, in November 2003, the Council of Ministers blocked the initiation of an excessive deficit procedure against France and Germany. The Council's decisions raised questions over whether legal constraints on government spending are adequate (Howarth, 2004). The matter was put into sharp relief by the second development, which confirmed the Delors Reports assessment that markets would be hesitant to price sovereign default risk. During the period from the Maastricht Treaty onwards, yields on sovereign bonds converged (see Figure 2). This convergence fitted the ECB's ends since it contributes to financial market convergence and

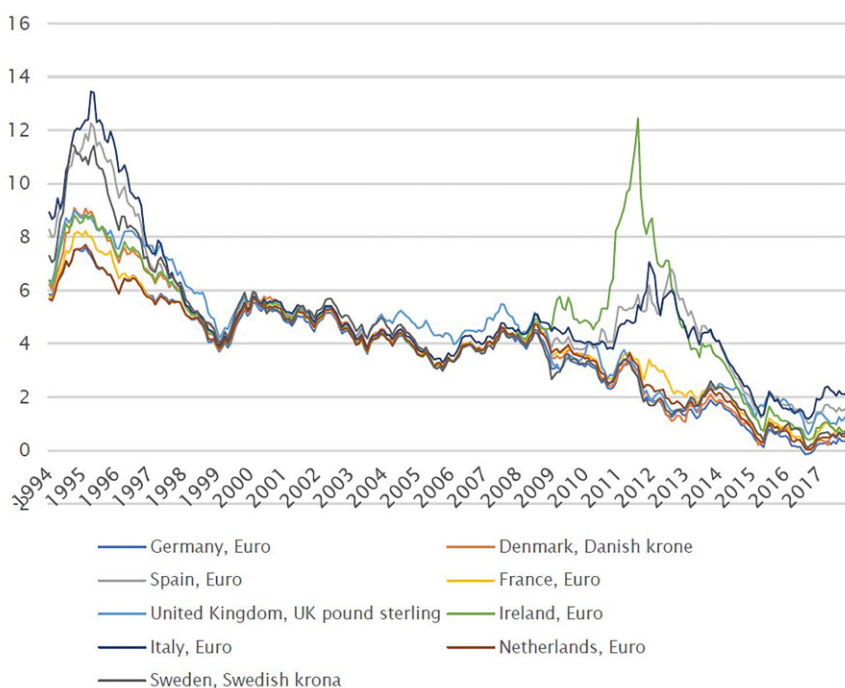


Figure 2 The 10-year government bond yields (selected member states).

Source: Thomson Reuters 10 Years Government Benchmark

3 The ECB released this harmonized list in response to a recent document request ([AsktheEU.org](https://asktheeu.org), 2018).

the integration of money markets (ECB, 2002; Gabor and Ban, 2016; Braun, 2020). It was also striking since the member states were clearly distinct in terms of debt levels and other traditional debt sustainability indicators.

The developments triggered a debate on government bonds and the ECB collateral framework, in which academics and private sector financial analysts argued that its rules were unduly lenient to profligate member states (Pattanail, 2003; Allen, 2005; Buiters and Sibert, 2005; Fels, 2005a; Allen, 2007). As one of them, Joachim Fels, put it in a Financial Times op-ed:

Now that the European Union's stability and growth pact has been officially buried and replaced by toothless waffle, it is imperative to enable markets to punish fiscal sinners in the eurozone. (Fels, 2005a)⁴

On Fels's account, whose proposal is comparatively moderate, the ECB should introduce differentiated haircuts on sovereign bonds to better reflect the credit rating of each member state. Willem Buiters and Anne Sibert go further and suggest that the ECB should exclude the bonds of member states in violation of the SGP from central bank eligibility entirely.

Around that time, the ECB Governing Council discussed making eligibility of collateral conditional on compliance with the SGP, but the proposal is soundly rejected. Minutes of the February 2005 meeting conclude that the ECB would not 'include compliance with the SGP as an additional criterion of eligibility or for additional risk management measures' (ECB, 2019). In fact, in the two months after the publication of Fels' FT op-ed, the ECB's president, vice-president and chief economist all publicly rejected this proposal (Issing, 2005; Papademos, 2005; Trichet, 2005a). The ECB's market operations division wrote a longer policy paper to back their statements the following year. It reiterates the objections of the board members and argues that more differentiation of haircuts would not reduce the effect of the collateral framework on risk spreads (Bindseil and Papadia, 2006).

The debate on converging yields forced the ECB to articulate its approach to the public for the first time. Instead of a policy to punish profligate governments, which it had also been hesitant to do in other ways (Howarth, 2004), the ECB announced a new approach where the value of government debt as collateral became conditional on private credit ratings. The credit rating determines both whether debt issued by an individual government should be eligible and what haircuts should be applied. Rather than relying on its own assessment of debt sustainability or their compliance with the SGP, the ECB transferred authority over this crucial parameter of its monetary policy to US-based private firms.

2.2 Pre-crisis strategies of depoliticization

The debates in the mid-2000s led the ECB to do away with the discretion available within its internal rules. I explain the introduction of the minimum credit rating requirement in terms of the ECB's efforts of depoliticization.

My account contrasts with accounts that explain the crucial 2005 policy change in terms of a strategic objective of imposing fiscal discipline on the member states. For example, Athanasios Orphanides (2017, 2018) claims that the minimum credit rating was introduced

4 Although the debate over yield convergence entered the English language debate with Fels's op-ed, he had raised the issue at least since October 2004 (FAZ, 2004; Fels, 2005b).

as an attempt of ECB to enforce the rules of the SGP. By threatening to withdraw eligibility from governments that borrow too much, he claims, the ECB used 'the discretionary authority relating to its collateral framework as a disciplining device against member states' (Orphanides, 2017, p. 9). It is true that ECB central bankers felt that giving up on the fiscal rules of SGP was a mistake and they did not shy away from pointing that out (ECB, 2003, 2005). However, the ECB's executive board strongly opposed using the collateral framework to influence the fiscal policy of the member states. Its members did this not only in public, but as we saw, they also agreed on this behind closed doors in a meeting of the ECB's Governing Council in February 2005. In fact, they even made their hostility to such a policy known to the external critics in private phone calls.⁵

Should the introduction of the minimum credit rating requirement then be understood as a purely technical choice in managing risk? As such it would be part of what is known as the *scientization* of monetary policy during the mid-2000s, where central banks used increasingly technical methodologies to estimate output gaps and predict price developments (Marcussen, 2009; Abolafa, 2012). Reflecting this broader technical turn, the ECB incorporated increasingly sophisticated risk management techniques into its collateral framework (van 't Klooster, 2021a). The market-based treatment originates in these efforts, which aim to harmonize collateral frameworks across the Eurosystem.⁶ Its Single List of Eligible Collateral was devised to get rid of the so-called Tier-II lists designed by the national central banks (ECB, 2004). The persistence of national lists reflected earlier unresolved disagreement over the treatment of non-marketable private debt and ratings issued by the Austrian, French, German central banks (EMI, 1995b). To harmonize the treatment of collateral, the ECB made eligibility conditional on ratings produced by a Eurosystem Credit Assessment Framework (ECAAF) (ECB, 2006; González and Molitor, 2009). The ECAAF, which remains in force to this day, requires that any eligible asset meets a credit quality standard defined in

Table 1 ECAAF credit quality requirements

Credit quality step	Fitch/S&P	Moody's	Bundesbank credit rating
CQS 1 and 2	AAA to A-	Aaa to A3	1 to 3-
CQS 3 (eligible since November 2008)	BBB+/BBB/BBB-	Baa1/Baa2/Baa3	4+ to 4-
CQS 4 (eligible at some NCBs since 2012)	BB+	Ba1	5+
CQS 5 (eligible for assets CQS3 before 7 April 2020)	BB	Ba2	5

Source: BuBa (2020), ECB (2020).

5 In background interviews, two critics of the ECB's haircut policy for sovereign debt confirm this. Interview I, 22.10.2019 (Florence, by phone). Interview II, 25.10.2019 (Florence, by phone).

6 The Eurosystem consists of the ECB and the national central banks of the EU member states that have the Euro as their currency.

terms of an annualized probability of default (See [Table 1](#)). Inputs to estimate ECAF scores include the in-house credit assessment facilities of the national central banks (NCBs) as well as internal models of counterparties and private credit ratings. From then on, haircuts would be set based on credit ratings, maturity and liquidity as measured for individual asset categories.

The introduction of the minimum credit rating requirement, however, cannot be explained as a mere process of scientization. In introducing the requirement, the ECB applied the rules it had created to get rid of the Tier-II assets to the entirely distinct issue of government debt eligibility. It would have been possible for the ECB to introduce the minimum credit rating without the ECAF, since the eligibility criteria depend on only one type of rating provider: the private credit rating agencies. Conversely, the ECB could have used the ECAF to abolish the Tier-II lists, while at the same time leaving the ECB's policy for government debt unchanged. Scientization involves emphasizing novelty and sophistication. However, where it comes to the minimum credit rating for government debt, the ECB, as we will see, was at pains to deny that anything about it is new. This denial raises the question: why did the ECB introduce the requirement it had come out against only a decade earlier?

The introduction of the market-based approach in 2005 did reflect a political strategy, but one motivated by the ECB's tenuous legitimacy concerning the issue of government debt. In the face of authorization gaps, central banks confront political choices, which fit uneasily with their constitutional role. Central bank independence serves to remove decisions over the issuance of public money from the domain of democratic contestation ([Burnham, 1999](#)). As a consequence, however, central banks lack an independent democratic basis of legitimacy. Instead, they rely on legal mandates conferred to them by legislatures as well as strong public reputations. Although their mandates are often incomplete, to act in ways that go beyond the faithful implementation of the legal mandate exposes the central bank to a range of political hazards ([Torres, 2013](#); [Braun, 2016](#); [Högenauer and Howarth, 2016](#); [Ronkainen and Sorsa, 2018](#)). External critics can damage the central bank's reputation, which is built on its technical expertise and narrow focus on price stability. The absence of clear authorization for specific choices also opens the central bank up to the accusation of breaking the law or acting on behalf of specific constituencies. Once the view takes hold that the central bank acts on its own volition, governments may as an ultimate remedy seek to limit its independence. Hence, central banks have an institutional interest in depoliticization itself ([Hay, 2007](#); [Flinders and Wood, 2014](#); [Fawcett et al., 2017](#)) and, hence, seek to limit contestation.

In 2005, as we saw, the issue of sovereign debt had become an object of increasingly polemical outside contestation. Had the ECB announced a collateral policy geared towards punishing profligate governments, it would immediately have become embroiled in the messy politics of the SGP. So far, however, the actors who weighed in on the ECB's collateral policy had been limited to the national central banks and a few financial market pundits who pointed to the benefits of the ECB's collateral rules for individual member states. Internally, too, the Governing Council remained able to agree on a common stance. Rather than fanning the flames, the ECB successfully avoided further politicization by downplaying and obfuscating its agency on the issue. Consider three distinct aspects of the ECB's successful efforts at depoliticization, which reoccur in the public statements of Jean-Claude Trichet, Otmar Issing and Lucas Papademos as well as the policy paper of the markets division on this topic.

First, the ECB presented the minimum rating as following directly from its legal mandate. Central bankers argued that Article 18 of the ECB's Statutes required that the objective of the ECB's collateral policy, also in relation to sovereign bonds, should solely be to protect the ECB against financial risk. It should not be treated as a policy tool in its own right, since 'such a measure would exceed the mandate of ECB's collateral policy, which is to manage risk in monetary policy operations' (Issing, 2005). Central bankers also ignored other passages in the mandate that suggest a different approach. The ECB's mandate, for example, implores it to support the economic policies of the member states (TFEU, article 127) (de Boer and van 't Klooster, 2021).

Secondly, rather than introducing the policy as new and justifying it, the ECB denied its own agency in obfuscating its novelty. It was, strictly speaking, true that the minimum credit rating had already been part of ECB operations before 2005, but inaccurate to say, as Trichet did, that

it is not a new decision. [...] And the market people – the specialists observing what we were doing, looking at our website – could see that there was no change. It was what we had done since the very beginning; it was embedded in our policy. It has been made more visible, but there has been no change. (Trichet, 2005b)

Although an internal credit rating requirement had been in place from the beginning, it was not public. It could also not be read from ECB market behaviour because before 2005, sovereigns had simply never gone below the ECB's minimum credit rating. Announcing the policy had three important consequences. First, the mere act of communicating it committed the ECB to the rule. As the *Financial Times* correctly observed, although the ECB 'already has a list of eligible collateral, which does not include assets rated below A- [...] the new stance will make this floor formal and explicit.' (2005). It also meant that the ECB gave up the discretion it had created within its internal procedures to diverge from private credit ratings. Finally, since valuation haircuts depend in part on credit ratings, this also meant that the ECB gave up its discretion over how to apply risk controls.

A third way in which the ECB depoliticized the issue is that it deferred the decision of whether to accept debt to the rating agencies, thereby denying its own responsibility for the eligibility criteria. To diverge from credit rating agencies would have highlighted the ECB's agency in relation to its collateral rules. The reliance on private issuers, in contrast, obfuscated it. In 2005 and 2006, ECB officials highlighted various ways in which the risk management strategy follows, rather than shapes, market prices and practices. Although haircuts on sovereign bonds were comparatively low, this is justified with reference to their market liquidity. Because they are easier to liquidate in the event of counterparty default, they are subject to lower haircuts. Hence, the central bankers argued, the ECB simply followed the market, rather than making its own choices. Asked why the ECB 'shifted so much power to the private agencies', Trichet's answered that

we mentioned also very clearly to market people that we were taking the paper at its market value, so that if the markets would assess that the paper was less credible and the spreads would augment, then the value of the paper that we would take as collateral would diminish. (Trichet, 2005a)

3. The ECB's crisis management

In 2005, its ill-defined constitutional role led the ECB to adopt a political strategy of depoliticization. The ECB developed a narrow interpretation of its mandate, presented its strict technical criteria as immutable while deferring to decisions made by private rating agencies. This earlier approach is crucial for understanding how the ECB's risk management strategy could become an important driver of the bond market panic (Section 3.1). By 2020, in contrast, the ECB's agency with regard to the collateral framework had become undeniable, paving the way for a much more effective response to the 2020 pandemic (Section 3.2).

3.1 The 2010–2012 eurozone crisis

The great financial crisis of 2007–2008 gave rise to the eurozone crisis through the specific dynamics of a Bank-Sovereign 'doom loop' (De Grauwe, 2011; Grauwe and Yi, 2012; Gibson et al., 2017; Gennaioli et al., 2018). The doom loop is a self-enforcing negative spiral between the finances of the individual member states and the stability of their domestic banking sector. Governments serve as important implicit guarantors for banks, while banks often hold a considerable volume of bonds issued by their sovereign. Rising sovereign yields (hence, decreasing value of the bonds) and rating downgrades lead to losses on bank balance sheets and deteriorating credit ratings. Bank credit ratings also depend on those of the domestic sovereign (Moody's Investors Service, 2012).

Crucially, governments do not need to be in any way unable to repay their debts for this dynamic to give rise to a sovereign default (De Grauwe, 2011; Aizenman et al., 2013; Miller and Zhang, 2014; Saka et al., 2015). The doom loop depends on expectations such that the anticipation of losses itself affects market prices. Sovereign yields affect the sustainability of government finances, because rising funding costs make previously sustainable debt levels increasingly difficult to repay. With interest rates at 4%, even Greek debt levels of 119% of GDP are sustainable, but the same is not true for rates at 7% or even over 20%. Once rates reach such levels, a costly restructuring or default becomes unavoidable. However, the mere possibility of reaching such levels itself increases risk premia. Investors that anticipate default can impact financial markets without the anticipated event ever materializing.

Due appreciation for the ECB's pivotal role reveals that it was not merely inactive while the panic unfolded. Rather, the bond market dynamics could only unfold because of the ECB's approach. Instead of intervening in markets and removing the more fundamental fears that drove the underlying negative spiral, the ECB's market-based approach exacerbated the panic.

In line with its pre-crisis strategies of depoliticization, the ECB continued to adhere to earlier practices and mechanically adjusted its policies when ratings dropped, leaving the crisis to play out in markets (see Figure 3). The rules of the ECB collateral framework itself contributed to the doom loop in two ways. First, rating downgrades affect the value of sovereign bonds as collateral in part through the ECB's financial market haircuts (Gabor and Ban, 2016). In a repo transaction, market participants impose higher haircuts on bonds with lower credit ratings. Thus, it is less attractive to hold bonds that are subject to high haircuts (Cassola and Koulischer, 2019; Nguyen, 2020). That would not need to affect prices if the same asset could still be pledged at the central bank without the same steep haircuts. However, although the ECB lowered its minimum credit ratings requirement to provide liquidity to the banking system, it also sought to protect itself against potential financial risk

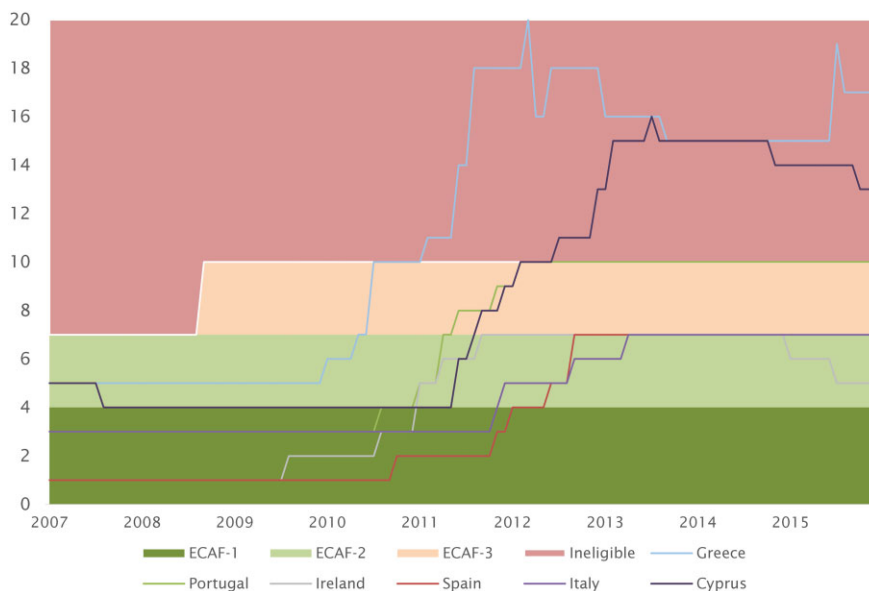


Figure 3 ECAF credit evaluation steps for selected member states.

Source: [Claeys and Goncalves Raposo \(2018\)](#).

Note: This graph shows the highest credit rating provided by S&P, Moody's, Fitch and DBRS mapped on the ECAF credit quality steps.

by raising haircuts. During the crisis, average ECB haircuts went up from 3% in 2008 to 14% in 2014 ([Whelan, 2014](#)).

Secondly, collateral eligibility requirements also directly affect the value of bonds, as eligible assets trade at a premium over those that are not ([BIS, 2015](#)). Losing the status of eligible collateral has a negative impact on the value of a bond, since it is no longer useful for banks who hold it to access central bank credit. A decision in 2008 to lower the minimum credit rating requirement helped to reduce pressure on sovereign bonds, but it was motivated by the objective of providing banks with adequate liquidity. As credit ratings of individual member states went down, the risk of ineligibility grew. Rather than counteracting the procyclical effects of rating downgrades, the ECB amplified their effects through its own risk management strategy ([Gibson et al., 2017](#); [Claeys and Goncalves Raposo, 2018](#); [Constâncio, 2018](#)).

Why did the ECB continue to adhere to the minimum credit rating requirement despite these devastating effects on the member states? In line with Orphanides's claim concerning the use of the collateral framework as a disciplinary device in 2005, the ECB is widely held to have used its collateral framework in the crisis to force fiscal discipline onto governments. Orphanides himself states that in the crisis the ECB used its 'discretionary authority to address moral hazard and fiscal discipline' (2017, p. 11). [Ban \(2016\)](#) and [Randall Henning \(2016, 2017\)](#) argue that the ECB sought to extract more stringent rules for fiscal expenditures. [Varoufakis \(2017\)](#) suggests that the ECB used its collateral framework to weaken the negotiating hand of crisis-struck member states. Although they invoke different strategic

aims, these authors converge in portraying the ECB as a political agent that used the rules of the collateral framework to pursue political ends.

Understanding the ECB's market-based approach as aimed at depoliticization again serves to complicate this picture. While it is not possible to divine the 'true' motivation for ECB crisis-fighting measure (at least, before archives open), we need not assign such motives to explain the ECB's reluctance to act. Its earlier positioning itself had locked the ECB into a strategy of disavowing agency. This constrained its room for manoeuvre and contributed to a cumbersome and slow response to the developing panic.

First, the ECB had publicly committed itself to an interpretation of its mandate that precluded any tweaks to the rules of the collateral framework to support bond markets. While expanding the eligibility criteria for collateral to facilitate access to credit for banks, it also continued to tighten its rules in line with the pre-crisis risk management strategy (Gabor and Ban, 2016; Fontan, 2018). Throughout the crisis, the ECB raised haircuts for sovereign bonds whose ratings dropped to the ECAF-3 rating. The Bank of England, which does not make its haircuts dependent on credit ratings, kept its haircuts stable over the same period (Claeys and Goncalves Raposo, 2018). Under the leadership of Trichet, the ECB's broader monetary policy stance remained focused on warding off inflation, even going so far as to raise interest rates in 2011.

When sovereign credit ratings started to drop, the ECB did issue waivers for the minimum credit rating requirement. These waivers served to retain the eligibility of government debt issued by crisis-struck countries, but they were discretionary and the conditions under which the ECB provided them were vague. Consider the ECB press release on the April 2010 Greek waiver:

'The Governing Council has assessed the programme and considers it to be appropriate. This positive assessment and the strong commitment of the Greek government to fully implement the programme are the basis, also from a risk management perspective, for the suspension announced herewith' (ECB, 2010).

The suspension of the ECAF-3 requirement was not just conditional on the Troika's structural adjustment programme, itself highly discretionary, it was also conditional on the ECB Governing Council's risk assessment, reached in secrecy, based on that programme. Almost identical press releases went out for Ireland in March 2011 and for Portugal in July 2011 (ECB, 2011a, 2011a). Portugal only remained within the ECAF-3 requirement as a consequence of a fourth rating agency DBRS, which was added to the ECAF in 2009.

Beyond the specific interpretation of its mandate that the ECB put forward, it had also largely disavowed its agency to put forward such interpretations. Central banks traditionally take on a role as lender of last resort exactly so as to prevent self-enforcing expectations from getting out of hand. The ECB did not assume that role in the sense that it did not make liquidity support to sovereigns itself into a policy objective. Instead, the central bank initiated an ad hoc purchase programme geared towards stabilizing bond market yields. From May 2010 onwards, the ECB buys Greek, Portuguese and Irish bonds as part of its 'Security Markets Programme' (SMP). In 2011, the ECB extends the programme to Spanish and Italian bonds, leading executive board member Jürgen Stark to resign in protest. The SMP is motivated by the objective of stabilizing sovereign bond markets and enabling the ECB to achieve its price stability objective. The ECB also introduced the so-called Long-Term

Refinancing Operations, which provide banks with cheap credit at maturities up to 3 years (ECB, 2011b). Banks willing to buy sovereign bonds could (and indeed did) use these funds to buy sovereign bonds. These measures, however, failed to calm bond markets and yields continued to reach unsustainable levels in an increasing number of member states. More forceful action would have been needed, but the ECB rejected such calls invoking its pre-crisis narrative of strict legal rules, credit quality requirements and the autonomy of markets.

3.2 The 2020 pandemic crisis

As a panic again struck European bond markets in 2020, the ECB quickly put an end to its attempt at depoliticization. Instead, it responded with a dramatic display of agency.

Already in the later stages of the eurozone crisis, the ECB gradually moved away from a strict market-based approach. In the spring of 2012, the ECB replaced its SMP with a new programme called 'Outright Monetary Transactions' (OMT), which supports bonds of member states that are part of the European Stability Mechanism (ESM). For eligible states, the ECB also suspended the minimum credit rating requirement (ECB, 2012). However, it still involved displacement of agency in the sense that who is eligible for ESM funds is decided by the member states. Around the time of the OMT programme, Draghi put the efforts of the ECB in the context of a wider aim, namely that of saving the single currency: 'Within our mandate, the ECB is ready to do whatever it takes to preserve the euro' (ECB, 2012). This announcement, which is widely seen as the ECB solving the bond market panic, can equally well be understood as the announcement that the central bank would stop causing it. Even after announcing the OMT, the ECB retained its minimum credit rating requirement, which led to the suspension of emergency credit to Greek banks and the imposition of capital controls in the summer of 2015. In a private conversation, Greek finance minister Yanis Varoufakis asked Mario Draghi to diverge from the ECB's restrictive rules. As Varoufakis describes Draghi's response:

'It does not matter much, Yanis, when we pull the waiver since the Greek banks have run out of most eligible collateral.' He spoke as if the waiver decision was inevitable, beyond his control, an act of God. (Varoufakis, 2017, p. 203)

The public debate about the Greek debt crisis, however, marked the final act of the market-based approach. The public no longer accepted that decisions such as the withdrawal of Emergency Liquidity Assistance to the Greek banks were forced on the ECB by its mandate. Instead, the decision was debated on its merits: had the ECB rightly sought to protect its balance sheet and avoided providing undue support to a profligate left-wing government? Or, as Varoufakis asserted, had it strategically used its power to shut down the Greek banking system and help the Eurogroup ministers enforce their memorandum? Strategies of depoliticization developed in the mid-2000s for an audience of financial market pundits had limited purchase on the evening news. Denying its agency no longer helped the ECB to protect its reputation and respond to outside critics.

Acknowledgement of agency is pivotal to the 2020 response to the pandemic (Gabor, 2021; Tooze, 2021). On March 12, 2020, Christine Lagarde still confidently invoked the earlier rhetoric in asserting: 'we are not here to close spreads'. However, as a repeat of the eurozone crisis became a live possibility, the ECB's Governing Council made a different

calculation and quickly reversed course. Where the SMP had peaked at €220 billion in early 2012, three years after the record 2009 deficits, the ECB's government debt purchases in 2020 totalled €901 billion, which corresponded to 92% of the total expected deficit of the eurozone governments in that year (van 't Klooster, 2021b). The ECB also announced a reduction of credit quality requirements for eligible collateral going as low as ECAF-5. Despite its ECAF-4 rating, Greek debt once again became eligible. More strikingly, Christine Lagarde also endorsed the ECB's responsibility for providing 'supportive financing conditions for all sectors in the economy' explicitly mentioning 'governments' as one of its beneficiaries (Lagarde, 2020). In doing so, the ECB cast aside the earlier restrictive interpretations of its role by pointing out that these had been 'self-imposed' and could, hence, be dropped. As the ECB stated in announcing its Pandemic Emergency Purchase Programme:

'To the extent that some self-imposed limits might hamper action that the ECB is required to take in order to fulfil its mandate, the Governing Council will consider revising them to the extent necessary to make its action proportionate to the risks that we face.' (ECB, 2020)

Within days, a renewed bond market panic had effectively been averted.

4 Conclusion

This article analysed the political dynamics that governed the ECB's treatment of government debt from its creation to the present. It documented the complex interactions between central bank operations and sovereign debt markets to show that operational details of monetary policy have far-reaching impact on governments. In studying the politics of collateral, I highlighted how the ECB's ill-defined constitutional role leads it to downplay and obfuscate its agency in relation to government debt—portraying itself as bound by a legal mandate, relying on immutable internal procedures and deferring risk assessment to credit rating agencies. This approach constrained the ECB's room for manoeuvre in the eurozone crisis, leading to its overturning in the face of the 2020 pandemic. The ECB's more effective pandemic response was made possible by accepting a political role. However, the fundamental issue of how to deal with government debt in the EMU remains unresolved, and (at least formally) the ECB's minimum credit rating requirement remains in place. Rather than following the seemingly attractive path of technocratic depoliticization, the question of how to deal with government debt needs a genuinely political answer.

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