Finance Watch

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The Debts We Need

Reinforcing Debt Sustainability with Future-Oriented Fiscal Rules

A Finance Watch report

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Executive Summary

Fears of financial market reactions to public debt limit policymakers' ambitions. Europe faces serious environmental, economic, and geopolitical challenges requiring reforms and significant public investment. Meanwhile, the ghost of the euro area crisis still shapes perceptions around public debt, preventing needed actions. This report aims to alleviate some of these fears and proposes aligning European fiscal rules and financial markets reality.

1. Financial markets can absorb the debt we need

Expanding sovereign debt is needed to provide European public goods that private actors won't. Whilst financial markets and central banks need sovereign safe assets to function correctly, investors' demand for euro-area sovereign bonds is twice as high as its supply. **Investors can easily finance the additional green public spending required to achieve the EU's climate objectives**, which is estimated at 1-3% of EU GDP annually. Additionally, the euro's global role would be strengthened by expanding and rolling over EU debt stock – instead of reimbursing it – and striving to improve ratings of lower-rated sovereigns through future-oriented investments and reforms.

2. Financial markets care less about debt stock than about strength and resilience

Investors rely on credit rating agencies for evaluating sovereign default risk. **A country's credit rating is not correlated with its debt stock, but with the strength and resilience of its economy and institutions, and with its debt affordability**. Rating agencies assess government debt sustainability by weighting its debt stock (debt-to-GDP) with its affordability (interest payment-to-revenue), composition (average maturity, owner base), dynamic (up, down), its origin (productive investment, mismanagement), government financial assets, fiscal risks (e.g. banks bailout, climate risks) and, crucially, the support of its central bank.

3. Member States can afford the debt they need

European economies, except Greece, benefit from **investment-grade ratings (BBB and higher) due to their strong and resilient economies, institutions, and affordable debt**. Despite comparatively high debt stock, Italy's debt-servicing costs are manageable at 8.4% of its public revenue – the UK stands at 8.1%, the US at 14.3%, and India at 23%. In the 1990s, Italy successfully dedicated 27% of its revenue to debt servicing without default or restructuration. ECB's recent interest rate hikes have had limited impacts on governments' debt affordability due to high average debt maturity that limits rollover frequency. The IMF expects European interest rates to return to pre-pandemic low levels once inflation is tamed.

4. The European Central Bank manages yields and financial market fears

ECB policies drive euro area sovereign yields. Yield spreads rise in times of financial stress as higher risk aversion reinforces investors' fear of sovereign default and exit from the euro area, leading them to rebalance their portfolio toward sovereign debts perceived as safer. The original sin of establishing a monetary union without lender-of-last-resort created this fear. **Establishing a European system of conditional lenders-of-last-resort dissolved investors' fears** – the European Stability Mechanism (2012) and the ECB's Outright Monetary Transaction (2012).

5. Policymakers should focus on future-oriented investments and reforms

Whilst financial markets care little about debt-to-GDP ratios, the European economic governance framework made it its main compass. Instead, **boosting future-oriented investment and reforms that improve European economies' strength and resilience** is the right priority of a reformed European economic governance.

Recommendations

The European economic governance reform proposal was unveiled on April 26th 2023. Under the proposed system, countries whose debt exceeds 60% of their GDP would negotiate a country-specific four years debt reduction plan based on a debt sustainability analysis and resulting in annual expenditure ceilings. The plan can be extended to seven years in exchange for growth-enhancing reforms and investments that improve debt sustainability whilst addressing national challenges and EU priorities such as the green and digital transition.

Addressing concerns for a future-oriented framework. Some governments worry that the proposed new European fiscal rules would lead to excessive bilateral political bargaining and unsustainable public finance. This fear has reintroduced quantitative debt and deficit reduction targets in the Commission proposal. Other governments, joined by trade unions and civil society, fear a lack of space for needed investment in Europe's future. Addressing both concerns requires holistic debt risk analysis and stronger incentives for future-oriented investments.

1. Include market-relevant indicators in debt risk identification

Fiscal rules are so far built on arbitrary targets and numerical debt reduction rules. By being more granular and dynamic, debt sustainability analyses (DSA) have the potential to be far superior. Meanwhile, the European Commission's DSA remains overly focused on debt-to-GDP dynamics. A **DSA working group** should be set up to improve EC's DSA methodology, with periodic revision. The final methodology must better include **financial market-relevant indicators, such as debt affordability** (interest-payment-to-revenue), debt flows (average debt maturity, gross financing need), debt structure (domestic, foreign; term structure), and fiscal risks (contingent liabilities) linked to possible banking bailouts and climate change. These indicators should better impact medium-term risk identification and classification (cf. low, medium, or high debt risk).

2. Incentivise future-oriented investments and reforms

Debt due to budget mismanagement is an unfair burden on future generations. However, debt from qualitative investments in tackling European economic, social, environmental and geopolitical challenges would weigh less on future generations' shoulders than failing to address them. Therefore, the Commission framework to assess the quality of national plans should be improved. First, **the 'do no significant harm' principle (DNSH)** should become its cornerstone. Second, **"resilience-enhancing"** should be put on equal footing with "growth-enhancing" as an assessment criterion, as resilience-enhancing investment and reforms lower fiscal risks (e.g. climate mitigation and adaptation lower climate-related fiscal risks). Third, **green budgeting** should be better included in national budgetary frameworks.

3. Liberate future-oriented investment from arbitrary limits

Investors would absorb more European debt. **Future-oriented investments should be excluded from deficit and expenditure limits** as part of Member States' fiscal structural plans, especially in the absence of new EU investment funds and debt sustainability risks. The decision to exclude such investment should be part of the proposed broader process of **ex-ante technical assessment** by national Independent Fiscal Institutions (IFIs) and by the European Commission (e.g. debt sustainability analysis, fiscal impacts, respect of the 'do no significant harm' principle, EU objectives), and **political validation** by the Council. Investors and credit rating agencies would welcome such reform as ambitious and well-designed macro-fiscal plans would increase economic strength and resilience.

Introduction

Europe faces serious challenges that require reforms and investment. Europe is coping with compounding crises, such as the cost of living crisis, the Russian invasion of Ukraine, climate change and biodiversity loss.[1] Meanwhile, Europe must resolve additional long-term challenges around economic, energy and digital security and sovereignty, decaying infrastructure, lack of convergence and ageing populations. Tackling these challenges requires bold legislative reforms and significant public investment to catalyse private capital towards these socially desirable goals.[2]

Debt financing these investments would benefit future generations. Private actors alone won't bridge European funding gaps. Significant public investments are needed today to ensure future generations of Europeans benefit from a sustainable, safe and prosperous life. These investments can be financed through taxation, borrowing, or monetisation. While taxation would impose the full cost on current taxpayers and create disincentives[3], direct monetisation by the European Central Bank is prohibited by European Treaties. Conversely, debt-financing these investments offers a more desirable short-term approach, distributing costs across benefiting generations. Debt resulting from qualitative investments in tackling European challenges would weigh less on future generations' shoulders than failing to address them.

Fear of financial markets' reaction to public debt limits policymakers' ambitions. Current generations of European citizens and policymakers have been deeply impacted by the euro area crisis of 2010-12. While the original flaws of the euro area architecture behind this crisis have been mostly fixed by establishing a European system of conditional lenders-of-last-resort in 2012[4], fear still prevails to an excessive degree. This significantly shapes the public debate over the reform of the European economic governance framework and its fiscal rules, limiting what is perceived as fiscally responsible.

This report aims to alleviate undue fears whilst proposing ways to reform the European economic governance framework considering financial markets mechanics.

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1 For more on biodiversity loss and nature depletion, see: SUTTOR-SOREL, L., HERCELIN, N.,(*2020*).

2 The European Commission's services estimate funding gaps to amount to €520 billion a year until 2030 to meet EU environmental objectives, €142 billion a year for social infrastructure such as hospitals and schools, along with €190 billion a year to stabilise the stock of public capital – such as publicly-owned roads, buildings, bridges and ports.

3 Improving tax revenues and efficiency of public spending will be part of the solution, but won't be sufficient.

4 The European Stability Mechanism and the ECB's Outright Monetary Transaction programme.

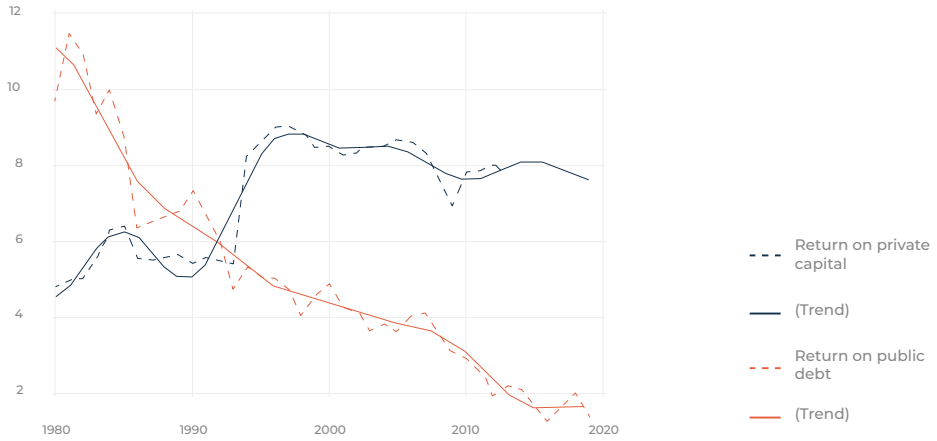
1. Investors can absorb the debt we need

Financial markets rely on safe assets. A safe asset is of high credit quality and liquidity, retains its value even in times of crisis and is denominated in a currency that maintains purchasing power. These assets play a crucial role in financial transactions, which often require posting safe asset as collateral. Banks, pension funds and insurance companies must hold safe assets to meet their liquidity requirements under liquidity regulations.[5] Lastly, central banks' monetary policy operations are conducted by exchanging central bank liquidity against safe assets.

Sovereign debts act as safe assets. For financial market participants, investing in sovereign debt securities of advanced economies appears at first glance to come with an opportunity cost as these securities have been less profitable over the last three decades than average stock or bond investments – see Figure 1.[6] But these sovereign debt securities have other desirable attributes that make their attractiveness from a financial market perspective – they provide enough safety and liquidity to act as safe assets.

Figure 1 - Return on public debt and private capital in the G7 (%)

(Source: REIS, 2022)



Euro-area sovereign debt is in high demand among investors. Government bonds are the primary source of high-quality liquid assets in the euro area.[7] While European investors have access to sufficient sovereign safe assets to comply with prudential and liquidity requirements, the appetite for these assets remains strong. Combined with robust global demand, this results in a demand (bid) for euro-denominated sovereign debt that is twice as high as the supply (cover), as demonstrated by the average bid-to-cover ratio of 2.25 in Figure 2.[8]

5 Prudential and liquidity regulations, such as CRD/CRR, LCR delegated regulation and Solvency II in the EU, play a critical role in shaping the demand for safe assets by establishing liquidity requirements and defining what constitutes a safe asset.

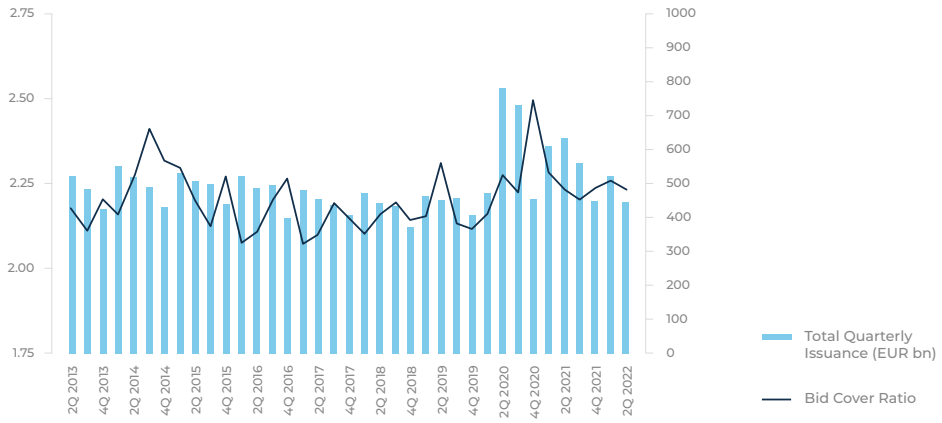
6 For the US example, see: REIS, R.,(*2021*); For a deeper dive in the wedge between the return on capital and risk-free rates for a broad group of high-income economies since 1990, see: BAILEY, A., et al.,(*2022*).

7 GRANDIA, R., et al.,(*2019*).

8 The success of bond auctions is measured by the bid-to-cover ratio, which represents the total amount of bids received compared to the amount of new debt issued.

Figure 2 - Average bid-to-cover ratios for euro area sovereign bonds

(Source: AFME 2022)

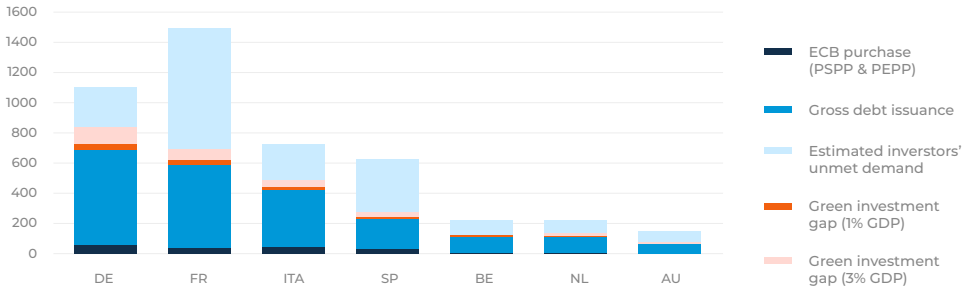


Note: Detailed on country-specific bid-to-cover ratio for debt securities of the main euro area countries can be found in annexe 1.

Investors can absorb the debt needed to finance the green transition. Achieving the EU's climate and energy objectives requires additional investment, estimated at 2% to 6% of EU GDP annually.[9] Approximately half of this additional investment should come from the public sector, amounting to 1-3% of GDP.[10] Figure 3 shows that the estimated unmet investor demand for euro-area sovereign bonds would easily cover the additional sovereign debt needed to bridge the climate mitigation funding gap.[11]

Figure 3 - Green investment gaps and unmet demands for EA sovereign bonds in 2022 (bn €)

(Source: Author, based on: ECB; EFC's ESDM; Eurostat; AFME 2022; EIB 2021; JOBST 2022)



Note: The annual debt issuance is based on data retrieved from the Economic and Financial Committee's Sub-Committee on EU Sovereign Debt Markets (ESDM). The unmet demand is estimated based on country-specific average bid-to-cover ratios (AFME 2022; annexe 2).

9 DARVAS, Z., WOLFF, G.,(*2021*) ; WILDAUER, R., et al.,(*2020*).

10 E.g. EIB (*2021*); DARVAS, Z., WOLFF, G., (*2021*); JOBST, A. (*2022*).

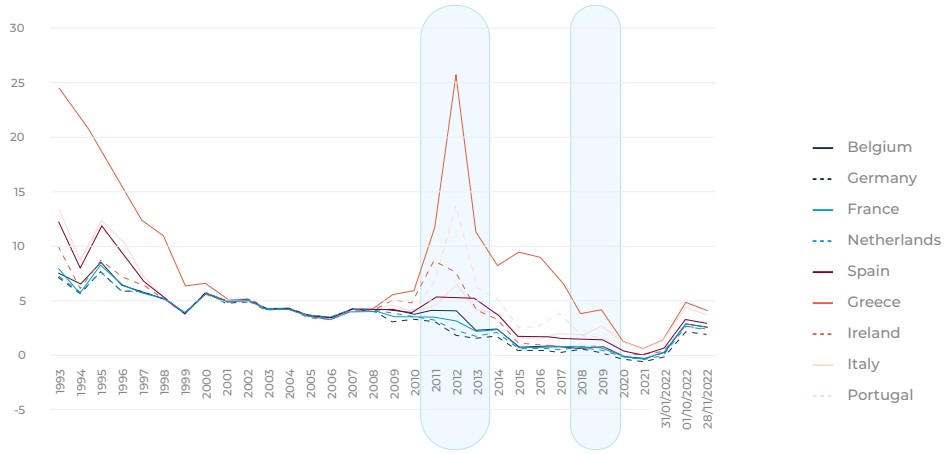
11 Whilst estimations are always to be taken with caution, constant large bid-to-cover ratios during bond auctions gives us some indication on investors' appetite. For more on available country-specific bid-to-cover ratios, see Annex 1.

2. The ECB manages yields and financial market fears

European governments face different interest rates. European countries experienced a several decades-long interest rate decline due to structural trends (see Figure 4).[12] Despite this common trend, interest rate differences exist between Germany, considered the risk-free rate within the euro area, and other European countries – the so-called "yield spread". As the memory of spiralling spreads in 2010-12 continues to drive doubts about the debt sustainability of some sovereigns, understanding what drives these spreads is vital for evidence-based policymaking.

Figure 4 - Evolution of long-term sovereign interest rate (10Y)

(Source: ECB (1993-2021); Refinitiv (2022). 31 January of each year)



Investors' fears drive interest-rate differences – or yield spreads. As illustrated in Table 1, sovereign yields consist of a risk-free rate, topped up with several premia to compensate investors for a series of real or perceived risks – inflation, default, redenomination, and liquidity risks – and a segmentation premium that represents investor preference for liquidity and safety.[13] Whilst fear of default is the primary driver of yield spreads, all six yield components matter when investors' risk aversion is higher. In periods of financial stress, Italian and Spanish yield spreads are driven mainly by investors' fear of a default and exit from the euro area, leading to the redenomination of their debt in a devalued currency.[14] Mirroring this, a phenomenon of "flight-to-safety" drives French and German yields down by raising segmentation premia.

12 Low interest rates – also called low neutral rate of interest or low equilibrium real rate of interest – are driven by a combination of high saving, low investment, low productivity growth and high demand for safety. See: BLANCHARD, O.,(*2022*).

13 CORRADIN, S., et al.,(*2021*).

14 Political developments can also activate these fears. Spread hikes in Italy in mid-2018 were driven by the leak of a draft Lega-M5S coalition agreement mentioning a mechanism to exit the single currency, and further tensions between the Italian government and the European Commission. More in: BALDUZZI, P., et al.,(*2020*).

Table 1 - The six components of sovereign yields

(Source: Author, based on CORRADIN; S. et al. (ECB), 2021)

Sovereign yields components	**Contribution to yields & spreads in time of stress (%)[15]** *(Jan-July 2020)*			
	ES	**IT**	**FR**	**DE**
1. Risk-free rate *This minimum rate of return that an investor can expect on investment with zero risk is captured by different benchmarks (e.g. €STR, EONIA).*	**32%**	**21%**	**45%**	**46%**
2. Term premium *The term premium is the excess return that an investor requires to hold a long-term bond instead of a series of shorter-term ones.*				
3. Credit default risk premium *This premium captures the risk that an issuer defaults on its obligations. Perceptions of default risks are driven by global events (e.g. financial crises) and country-specific factors (e.g. economic, institutional and fiscal fundamentals).*	**28%**	**45%**	**13%**	9%
4. Redenomination risk premium *This covers the risk of the redenomination of euro-denominated bonds into a devalued legacy currency in the event of the break up of the euro area or of a country's exit. This systemic risk was caused by structural flaws of the EMU, i.e. the lack of fiscal and monetary backstops before the establishment of the European Stability Mechanism (ESM) and the ECB's OMT programme.*	**16%**	**20%**	10%	4%
5. Segmentation premium *The segmentation premium corresponds to the non-financial benefits that investors derive from holding a particular sovereign debt, such as safety or liquidity. It reflects the difference in valuation among investors due, for example, to home bias, portfolio constraints, difference of treatment in the ECB collateral framework, etc.*	19%	11%	**26%**	**37%**
6. Liquidity risk premium *This is an extra compensation for assuming the risk of selling a bond at a lower price due to the challenge of finding a counterparty that wants to buy it. Usually assessed via country-specific features (size of the bond market; bid-ask spreads and trading volumes)[16], liquidity can be heavily impacted by global factors (e.g. financial turmoil, ECB asset purchase programmes).*	5%	3%	6%	4%

Legend: Percentages in blue (red) represent a positive (negative) impact on yields over the chosen period. The darker the value, the stronger the effect. Note: Over the covered period, the trend was a multi-decade-long decline in the risk-free rate and inflation risks. This explains the choice of colour for the two first points.

15 Yield decomposition results for Spanish, Italian, French and German five-year sovereign bonds. The reported percentages refer to the share of each component in the sum of all risk premia, averaged over all trading days between 31 January and 31 July 2020. Source: CORRADIN, S., et al.,(*2021*).

16 ECB,(*2014*).

The European Central Bank controls interest rates and investors' fears via different channels and policies that impact the six yield components.

1. The **risk-free rate** is determined by central banks' interest rate policy to maintain price stability and attain the so-called neutral rate of interest – the theoretical interest rate that allows the economy to operate at full potential and with price stability. Recent interest rate hikes by the ECB and other major central banks are driven by excessive headline inflation. Lower global interest rates are expected once core inflation is tamed, in line with a structurally-low neutral rate of interest.[17]

2. The **term premia** investors require to hold long-term sovereign bonds instead of a series of shorter-term ones are driven by their expectations about future inflation rates and central banks' interest rate policy. Initiated in mid-2014, the ECB's unconventional monetary policies (asset purchase programmes, negative interest rate policy and forward guidance) have compressed term premia and incentivised governments to expand the average maturity of their debt.[18]

3. The **liquidity premia** represent a tiny share of all risk premia in advanced economies as financial market participants expect central banks to prevent sovereign liquidity crises - a situation where government financing needs are larger than what financial markets can or want to absorb – as they always do.[19]

4. The **redenomination risk** is made explicit to bond investors by the ECB's decision in 2005 to reform its **collateral framework**.[20] By making the eligibility and value of euro-area sovereign bonds as collateral conditional on **external credit ratings**, the ECB signalled to financial markets the potential ineligibility of some EA sovereign bonds for its main market refinancing operations.[21] This decision created the condition for the financial market panic that led to the euro area crisis.[22] The ECB finally dissolved the redenomination risk, and most of the undue default risk, by launching the Securities Market Programme (SMP) in 2010 and its successor, the **Outright Monetary Transactions (OMT)** programme, in 2012.[23] They both involved the discretionary purchase of sovereign bonds in secondary markets.

5. The **segmentation premia** reflect investors' preference for sovereign debt over other types of assets – also called 'convenience yield'. Differences in segmentation premia applied to different EA sovereigns correspond to the so-called sovereign bond market fragmentation. The ECB decided in July 2022 to tackle fragmentation risk by adding a new instrument to its

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17 Low neutral rate of interest, also called equilibrium real rate of interest, is driven by a combination of high saving, low investment, low productivity growth and high demand for safety. For in-depth discussion, see: BLANCHARD, O.,(*2022*).

18 ESER, F., et al.,(*2019*); ROSTAGNO, M., et al.,(*2019*).

19 Major central banks balance sheet expansions occurred in 17 major economies over 400 years, to support government finance in geopolitical emergencies and to provide liquidity during financial turmoil. In: FERGUSON, N., et al.,(*2023*).

20 The collateral framework consists of a set of rules and requirements (eligibility criteria, minimum credit quality, haircuts, etc.) that financial assets have to satisfy in order to be used to secure refinancing operations with the European Central Banks.

21 VAN 't KLOOSTER, J.,(*2022*).

22 E.g. DE GRAUWE, P.,(*2011*); GABOR, D., BAN, C.,(*2016*).

23 The ECB announced on 10 May 2010, the launch of a "Securities Market Programme" (SMP) which involved the discretionary purchase of sovereign bonds in secondary markets. This programme was replaced in 2012 by a similar one, the Outright Monetary Transactions (OMT), topped up with strict conditionality – such as an ESM programme.

policy toolbox – the **Transmission Protection Instrument (TPI)**.[24] This instrument can be used to prevent self-reinforcing spread-widening dynamics by neutralising yield spreads that are not related to country-specific fundamentals, levelling the segmentation premia playing field.

6. The **credit default risk** is nonexistent for sovereigns of advanced economies with a central bank acting as lender-of-last-resort, such as the US, the UK or Japan. It required a paradigm change inside the ECB to finally assume the traditional central bank's (conditional) **lender-of-last-resort** role with the SMP and OMT programmes. Meanwhile, this risk still explained most of the spread during the Covid-19 crisis, as illustrated in Table 1. Remaining credit default risk link to the main conditions attached to OMT support – participating in an ESM programme which entails potential debt restructuring. Markets price in the risk of **debt restructuring** as part of default risk.[25]

ECB supports governments in severe circumstances. If none of the twenty sovereign states can force the ECB's hands, its support can be reasonably expected. First, the European Treaties' provision on monetary financing prohibition (Article 127 TFEU) was deliberately written to allow the ECB to prevent liquidity crises by acting as a lender-of-last-resort via secondary markets – reflecting Bundesbank and other EMU central banks' established practice.[26] Second, ECB's programmes that deal with redenomination risk (the OMT) and undue sovereign spreads (the TPI) are here to stay. Although initially challenged, the OMT has been ruled legal.[27] The president of the German Bundesbank presented the TPI as able to stand up to any legal challenge.[28] Third, the ECB included "stable financial markets as a precondition for long-term price stability" into its analytical framework during its 2021 monetary policy strategy review. This gave a foundation to the TPI as a tool to fight market fragmentation resulting from undue spiralling spreads and future actions deemed needed.

Whilst most drivers of euro area sovereign yields are in the hands of the European Central Bank, perceived credit default risks can be reduced by improving a country's economic and institutional strength and resilience.

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24 Approved by the ECB's Governing Council on 21 July 2022, the TPI is designed to counter any unwarranted and disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area.

25 Since the inclusion of collective action clauses (CACs) in European sovereign bond contracts in January 2013, European governments are able to restructure debts by a majority voting (Art. 12 ESM Treaty). Investors demand a "CAC premium" to compensate for the increased debt restructuring risk. The lower the credit rating of the country, the higher the CAC premium. In: LAYHER, N., et al.,(*2021*)

26 BATEMAN, W., VAN T' KLOOSTER,(*2023*).

27 OMT has been legally challenged in front of the German Constitutional Court and of the European Court of Justice. Their judgments have deemed OMT legal.

28 BARWICK, D.,(*2022*).

3. Financial markets care less about debt stock than about strength and resilience

Investors outsource sovereign risk assessment to credit rating agencies, reducing information asymmetries at low costs. Despite efforts to reduce rating agencies' influence on investors' decisions,[29] rating downgrades still impact countries' cost of borrowing.[30] Several factors explain it. First, EU banking stress tests link sovereign ratings to banks' exposure risk.[31] Second, the European Central Bank uses ratings to determine eligibility for sovereign debt securities and collateral value as part of its refinancing operations and asset purchase programmes – see Annexe 2. ECB's use of ratings impacts investors' appetite for these assets and their prices. European banks, incentivised to hold zero risk-weighted EA debt, still use ratings as input when investing in non-domestic debt.[32] Lastly, non-bank financial institutions use external ratings for risk assessment when investing in sovereign debts.

Institutional and economic strength are the main determinants of a country's rating – see Table 3. Sovereign credit ratings have a strong correlation with institutional and economic strength (governance indicators; GDP per capita), a moderate correlation with debt affordability (interest-to-revenue) but no correlation with debt stock (debt-to-GDP) – see Table 3.[33] If a highly non-linear relationship between debt-to-GDP and credit rating is repeatedly found, it's simply because other components matter more, mitigating the impact of higher levels of public debt on ratings.[34]

Table 2 - Correlations between ratings and variables (2010-2019)

(Source: Adapted from ZWART, S. (EIB) 2022)

	Debt stock (debt-to-GDP)	**Debt affordability** (interest-to-revenue)	**Primary balance** (% of GDP)	**Current account** (% of GDP)	**Governance indice** (WGI score)[35]	**GDP per capita** ($ 2017 PPP)
Fitch	-0.04	-0.32	0.09	0.38	0.55	0.61
Moody's	-0.09	-0.30	0.06	0.38	0.53	0.59
S&P	-0.06	-0.31	0.08	0.40	0.54	0.62

Legend: Values in blue (red) represent a positive (negative) impact on ratings. The darker the colour, the stronger the effect. The absence of colour means an insignificant impact.

29 In October 2010, the Financial Stability Board (FSB) issued Principles for Reducing Reliance on CRA Ratings in standards, laws and regulations, to end the mechanistic reliance on CRAs ratings by financial market participants whilst recognising their important role as input. 13 years later, ratings are still directly or indirectly referred to in the main EU prudential regulations.

30 For evidence of correlations between rating downgrades and yield spreads pre- and post- euro area crisis, see: BUTTLER, A. W., FAUVER, L.,(*2006*); AFONSO, A., et al.,(*2011a*); CANDELON, B., et al.,(*2011*); BLOMMESTEIN, H., et al.(*2016*) ; BINICI, B., et al.,(*2018*) ; EL-SHAGI, et al.,(*2018*).

31 ESRB, (2015).

32 According to the European Banking Authority (EBA), at least 12% of the risk-weighting attributed to sovereigns by EU banks using the standard approach (SA) is derived from an external rating. We can reasonably assume that this 12% covers non-domestic debt from countries deemed more risky. In: EBA,(*2021*) .

33 ZWART, S., (*2022*).

34 "[...] in countries with the highest potential growth and strongest institutions, the marginal effect of government debt on spreads would be close to zero. [...] policies aimed at reinforcing potential growth and government effectiveness can be expected to improve investors' perception of sovereign risk and their forbearance of higher debt." in: PAMIES, S., CARNOT, N., PĂTĂRĂU, A., (*2021*).

35 The World Bank World Governance Indicators is constructed as the simple average of the six factors (Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption).

Ratings agencies assess countries' institutions, economies and budgets. Sovereign credit ratings are condensed assessments of governments' ability and willingness to repay public debt in full and on time. As illustrated in Table 3, credit rating agencies analyse four main dimensions via a mix of quantitative indicators and qualitative assessment[36]:

1. **Institutional strength** refers to the quality of a country's legal and political institutions and is crucial in determining sovereign credit ratings.[37] It is captured via qualitative indicators of governance quality, corruption, the rule of law and government default histories. These factors indicate a government's willingness to repay its debt and influence its capacity to do so.[38]

2. **Economic strength** is the second most relevant analytical pillar as wealthy, diversified and resilient economies provide the government with a greater potential tax base and, therefore, a more stable and predictable source of income that can be used to service its debt. Whilst the most statistically significant indicator of economic strength is GDP per capita, growth performance, potential and economic diversification have gained importance in the last decade.[39], [40]

3. **Fiscal strength** weights generally less in the final rating than the first two analytical pillars – see Table 3. Agencies mostly based their debt sustainability assessment on indicators of **debt stock** (government debt-to-GDP or -to-revenue) and of **debt affordability** (interest payments-to-GDP or -to-revenue). Indicators of budget balance (deficit-to-GDP) are almost irrelevant. Rating committees can adjust a fiscal score based on the **debt dynamic**, the **debt composition** (currency, holders, maturity), **government financial assets** and **fiscal risks** – the so-called contingent liabilities are exposures that could end up on the government's balance sheet, such as the cost of possible banking bailouts, government guarantees or climate-related fiscal risks.

4. **Other factors**, such as differences in **monetary policy regimes**, have come into sharper focus in the aftermath of the great financial crisis. Sovereigns with a flexible exchange rate regime, reserve currency status, and an independent monetary policy have higher ratings for a given level of debt. **When Moody's rates countries that issue a reserve currency, only 10% of the fiscal strength score is determined by debt stock indicators, while a significant 90% depends on debt affordability**.[41] Consequently, these reserve currency countries can considerably expand their debt stock with minimal impact on their rating as long as their debt servicing costs remain under control. Despite the euro being considered a reserve currency, **Germany and France are the sole beneficiaries of the reserve currency status within the euro area**. This preferential treatment can only be

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36 Source: AMSTAD, M., PACKER, F.,(*2015*); AFONSO, et al.,(*2011b*); MELLIOS, C.,(*2006*); AFONSO,(*2003*).

37 BUTLER, A.W., FAVER, L., (*2006*).

38 Moody's (*2019*, *2022*)

39 Moody's changed its methodology in 2013 to recognise that potential growth can be just as important as per capita GDP when accounting for economic strength.

40 By contrast, economies relying on a unique sector (e.g. fossil fuel extraction) can face difficulties in raising taxes, and therefore servicing their debt, in case of economic chocs affecting this sector (e.g. transition, international sanctions).

41 A reserve currency is a currency held by central banks as part of their foreign currency reserves and is widely used in international trade and in pricing international contracts. Moody's considers that "Australia, Canada, Japan, Switzerland, the UK and the US are currently reserve currency countries.". While the euro is considered a reserve currency, Moody's considers "only the two largest member states, Germany and France, to benefit from reserve currency status" (in: *Moody's (2022)*, p.33-34).

explained by Moody's expectation of unlimited ECB support for these countries. The ECB's commitment to (conditionally) backstop all the euro area members seems, oddly, not taken into account by the agency.

Future-oriented investment and reforms can improve ratings, reducing yield spreads. Rather than over-focusing on debt reduction through consolidation[42], policymakers should prioritise future-oriented investment and reforms that enhance EU Member States' economic and institutional strength and resilience. This strategy not only secures the high ratings and low yields of certain countries but could also lead to upgrading some countries' ratings, such as Spain (A) and Italy (BBB), increasing the supply of euro-denominated highly safe assets. The European economic governance framework should strive to promote that.

42 Consolidation has, on average, negligible effects on debt ratios. See: SOLLACI, A. B., (*2023*), IMF

Table 3 - Presence and weight of different indicators in sovereign credit rating methodologies

(Source: Author; Standard & Poor's (2017), Moody's (2022), Fitch Ratings (2022), Scope Ratings (2022))

	Analytical pillars			
	Institutional strength	**Economic strength**	**Fiscal strength**	**Other**
Fitch Ratings (US)	• Governance indicators (***20.3%***) • GDP per capita (***13.3%***) • Share in world GDP (***13.2%***) • Years since default or restructuring event Broad money supply Qualitative overlay: • Political stability and capacity • Financial sector risks • Other structural factors **Weight: 53,2%**	• Real GDP growth • Real GDP growth volatility • Consumer price inflation • GDP growth outlook (5 years) Qualitative overlay: • Macroeconomic policy credibility and flexibility • Macroeconomic stability **Weight: 10,4%**	• **Debt-to-GDP (8.3%)** • Interest-payment-to-revenue • Deficit-to-GDP • Share of debt in foreign currency Qualitative overlay: • Fiscal financing flexibility • Public debt sustainability (debt dynamic, average debt maturity, etc) • Fiscal structure **Weight: 17,9%**	External finances: • Net foreign assets (% of GDP) • Commodity dependence FX reserves • External interest service • Current account balance + FDI (% of GDP) **Weight: 18,5%**
Moody's (US)	• Quality of institutions (***20%***) • Strength of civil society and the judiciary (***20%***) • Fiscal, monetary and macroeconomic policy effectiveness (***60%***) Adjustments: • Government default history	• GDP per capita (PPP) (***35%***) • Average real GDP growth (+ volatility) (***35%***) • Nominal GDP (***30%***) Adjustments: • Economic diversity and adaptability • Labour supply challenges	• Debt-to-GDP (***25%***) • Debt-to-revenue (***25%***) • Interest-payment-to-GDP (***25%***) • Interest-payment-to-revenue (***25%***) Adjustments: • Debt trend (t-8 to t+2) • Government assets-to-GDP • Share of debt in foreign currency	Susceptibility to event risk: • Political risk • Government liquidity risk (ease to access funding, debt composition and maturity, etc.) • Banking sector risk • External vulnerability risk
S&P (US)	• Policy effectiveness • The existence of checks and balances between institutions • Level of corruption • The independence of statistical offices and the media	• GDP per capita • Growth prospects • Economic diversity and volatility	• Change to debt-to-GDP • Government financial assets • Net debt-to-GDP • Interest payment-to-revenue Adjustments: • Share of debt in foreign currency • Share of non-resident debt holders • Share of banking sector exposure to domestic sovereign debt • Contingent liabilities • Ability to raise revenues/taxes • Basic services and infrastructures	External assessment: • Controlling a reserve (or an actively traded) currency • Gross external financing needs Net external debt • Balance of payments • Etc. Monetary assessment: • The exchange rate regime • Monetary/fiscal coordination • Inflation trends • Use of foreign currency Etc.
Scope Ratings (EU)	Governance indicators (as part of the ESG pillar): • Control of corruption • Voice and accountability • Rule of law Governance effectiveness • Political stability and absence of violence • Regulatory quality	Domestic economic risk (**35%**) • GDP per capita • Nominal GDP • Real GDP growth • Real GDP volatility • Inflation rate • Unemployment rate	Public finance risk (**20%**) • Interest payments-to- revenues • Debt-to-revenues • Primary balance-to-GDP • Debt-to-GDP	ES(G) (**ESG weight=25%**): • Transition risks • Natural disaster risks • Resource risks • Old-age-dependency • Income inequality • Labour force participation External economic risk (**10%**) Others (**10%**)

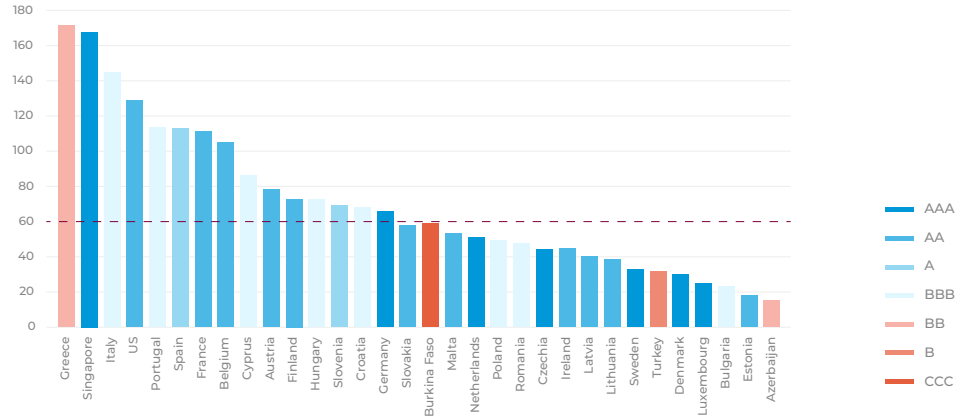
Legend: When the information is available, the table indicates the weight of each category of factors. The darker the colour, the more important the set of indicators. For Fitch Ratings, the exact weighting is indicated. For Moody's, an indicative weighting is inferred from their "dynamic weighting" of the economic resiliency score (that covers both economic and institutional strength) with the fiscal strength score. Moody's methodology gives more importance to the former score than the latter (see Moody's (2022), p.38). For S&P, an indicative weighting is realised based on their "indicative rating level" (see S&P (2017), p.6).

4. Member States can afford the debt they need

Debt stocks alone do not predict credit default risk. All European economies, except Greece, benefit from ”investment grade” ratings (BBB and higher) despite higher debt-to-GDP than most ”non-investment grade” emerging and developing economies (BB and lower) – see Figure 5. Higher ratings are primarily due to their economies and institutions’ strength, diversity and resilience. As highlighted in section 3, debt-to-GDP also needs to be balanced with other indicators of fiscal strength, such as those capturing debt affordability (Figure 6) and debt maturity (Figure 7).

Figure 5 - Debt stocks and sovereign credit ratings

(Source: Author; Debt-to-GDP based on Eurostat, White House and CEIC; Sovereign credit ratings based on S&P)

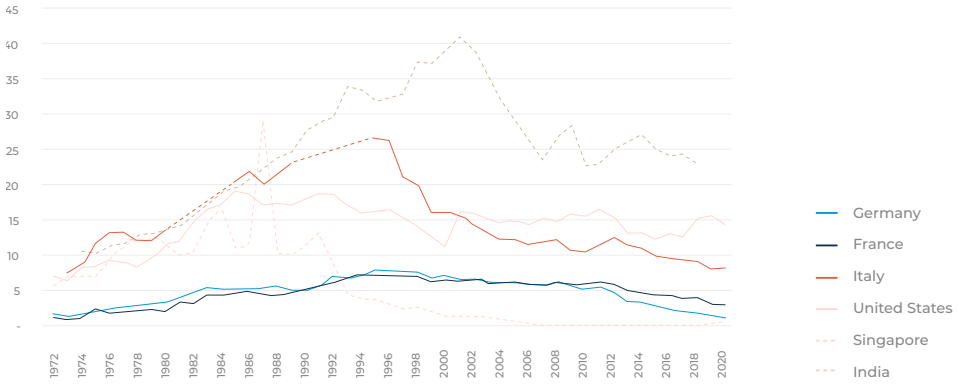


Legend: Sovereign credit ratings in blue are ‘investment grade’ (BBB and better), whilst those in orange are deemed ‘non-investment’ grade or ‘junk’ bonds (BB and lower).

European debt stocks are affordable, with average interest payments at 3.1% of EU Member States’ public revenue. Despite Italy’s higher debt stock, its manageable debt-servicing costs of 8.4% of revenue are comparable to the UK (8.1%) and below the US (14.3%) and India (23%). As illustrated in Figure 6, Italy could withstand 27% of its public revenue being dedicated to debt servicing in the 1990s without default or restructuring.

Figure 6 - Evolution of debt affordability

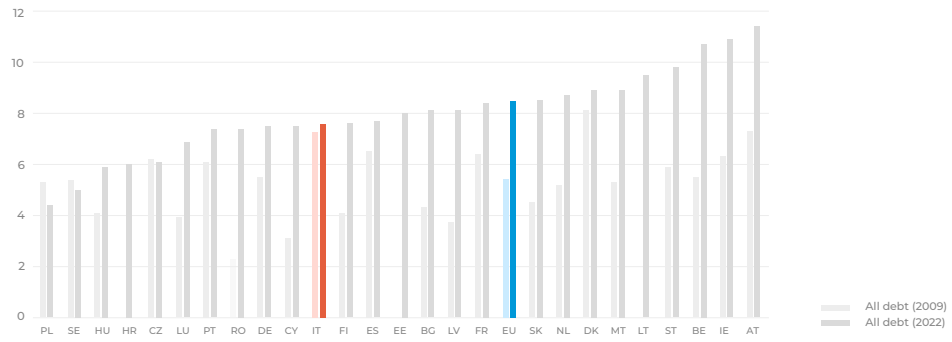
(Interest-payment-to-revenue, in %, 1972-2020; Source: Author, based on World Bank)



Long-term debts make interest rate hikes manageable. Higher average debt maturities results in less-frequent debt rollover, reducing the transmission of rate hikes to overall debt servicing costs. Over the last decade, European economies extended their average debt maturity from 5.5 to 8.5 years (see Figure 7). Italy's government debt maturity reaching nearly eight years makes current ECB's rate hikes manageable, as the German development bank Kfw highlighted in recent research.[43] Additionally, once inflation is tamed, the IMF anticipates a reduction in interest rates.[44]

Figure 7 - Average residual maturity of government debt (years)

(Source: Author, based on EC, ECB, and national sources)



Note: Data for Greece have been removed, as the ultra-long maturity of its debt stock (22,1 years) due to the conditions of the ESM/IMF financial assistance falses the EU average.

43 KfW, "Italy's debt sustainability in the new interest environment: More challenging but still doable", *2023*

44 NATAL, J-M, BARRETT, P., "Interest Rates Likely to Return Toward Pre-Pandemic Levels When Inflation is Tamed", IMF, *2023*

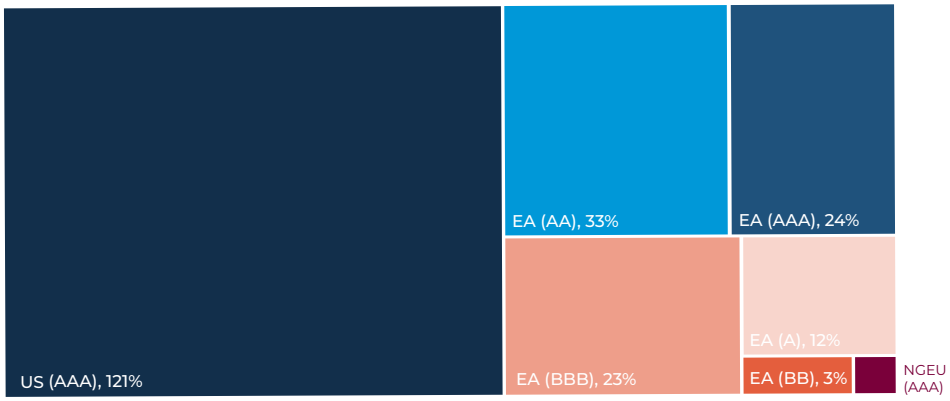
5. Future-oriented fiscal rules can make debt safer

Investors value absolute safety. An "absolutely-safe" sovereign asset, such as US Treasury bonds, benefits from a large and liquid bond market and a central bank acting as a lender-of-last-resort. Initially missing in the euro area architecture, a system of conditional lenders-of-last-resort arose from the euro area crisis – the €500bn European Stability Mechanism (ESM) and the related potentially unlimited ECB's support under its Outright Monetary Transaction (OMT) programme.[45]

Investors prefer some euro area sovereign debt over others. EU prudential regulations qualify all EA sovereign debt securities as safe assets. In practice, investors prefer some euro-area sovereign debt securities with a rating of AA/Aa or higher due to lower perceived credit risks and related lower haircuts in ECB's refinancing operations – see annexe 2. These "highly-safe" sovereign assets amount to 58% of the euro area GDP, compared with USD-denominated absolute safe assets representing 121% of the United States GDP. These highly-rated sovereign issuers benefit from lower interest rates than lower-rated issuers.

Figure 8 - Supply of sovereign safe assets in the EA and the US in 2022 (as a share of GDP)

(Source: Author, based on Ameco, S&P, US treasury)



Expanding the supply of euro area "highly-safe" assets would benefit the EU. While expanding sovereign debt is needed to provide European public goods that private actors won't and would be absorbed by investors, increasing the overall stock of "highly safe" assets could also benefit European economic and financial integration and the euro's global role. *Four mutually non-exclusive options* appear feasible to attain these objectives:

1. **Increasing debt issuance by highly-rated countries** such as Germany, the Netherlands (AAA/Aaa), Finland, Austria, Belgium or France (AA/Aa) would work to boost the Euro's global role. While cultural perceptions of debt in most of these countries make this unlikely, investment needs are more significant in other countries.

45 The ECB Governing Council defined strict and effective conditions which would be attached to an appropriate ESM financial assistance programme for the activation of OMTs. Both tools have therefore to be considered as intertwined.

2. **Expanding the supply of EU debt** (AAA/AA[46]/Aaa) and the rollover of existing stock (e.g. NGEU) would boost the euro's global role, benefit European integration and lower overall borrowing costs. The EU experienced slightly higher yields in some of its debt issuances than highly rated countries because of the difference in liquidity.[47] This liquidity differential will be resolved by rolling over the estimated €900 billion of EU debt stock of EU debt instead of reimbursing it, as all sovereigns do.

3. **Making all EA sovereign assets "absolute safe assets"** by setting the ECB commitment to support all euro area members in stone. Whilst this would fulfil all objectives, fears exist that it would propel moral hazard. An intermediary solution was found in the ECB's commitment to tame financial market irrationality (see section 2) and in establishing an EU system of conditional lenders-of-last-resort.[48]

4. **Incentivising future-oriented reforms and investments** could improve the ratings of lower-rated sovereigns of significant sizes, such as Spain (A/Baa1), Portugal (BBB+/Baa2) and Italy (BBB/Baa3). All these countries benefit from conditional support of the ECB (see section 2) with haircuts relative to their ratings in ECB's monetary operations. **Their ratings could be improved by implementing future-oriented reforms and investment** (see section 3), **incentivised by future-oriented fiscal rules** (see sections 6 and 7).

46 Whilst Fitch Ratings and Moody's gave their best long-term issuer rating (AAA/Aaa) for the EU, Standard and Poor's provides a long-term issuer rating from its second-best rating bracket (AA).

47 BLETZINGER, et al.,(*2022*).

48 The European Stability Mechanism (2012), the ECB's Outright Monetary Transaction (2012) and Transmission Protection Instrument (*2022*).

6. Policymakers should focus on future-oriented investments and reforms

Economic coordination is critical for the European Monetary Union (EMU), as euro-area members have distinct economic structures and fiscal policies yet share a single monetary policy. The Treaty on the Functioning of the European Union (TFEU) enshrines the EMU, requiring Member States to coordinate their economic policies and consider them a matter of "common concern" (Article 121 TFEU). Economic coordination focused primarily on securing sustainable public finance, per TFEU Article 126. This was seen as essential to prevent negative spillovers to other EMU members such as debt crises, contagion and bailouts.

Prior to the establishment of the EMU, fiscal rules were preferred to financial markets. At the establishment of the EMU, fiscal rules were chosen over financial markets to incentivise sustainable public finance. The Delors Report of 1989, which paved the way for the EMU, pointed out the short-term focus and erratic reactions of financial markets, raising doubts about their suitability as a disciplining force.[49]

Fiscal rules are legitimate but poorly designed. Current European fiscal rules consist of two arbitrary reference values – 60% debt-to-GDP and 3% deficit-to-GDP limits –, a structural deficit limit of 0,5 to 1% of GDP, and mechanisms to ensure countries reach these values (such as the 1/20th debt reduction rule).[50] However, these arbitrary limits lack economic justification and incentivise undifferentiated public spending reduction without considering EU objectives, euro area needs, and spending quality – with public investment as collateral damage.[51] Moreover, their overfocus on debt-to-GDP ratios ignores other indicators of debt sustainability risks.

Debt sustainability goes beyond a simple debt-to-GDP ratio. Japan's ability to service a debt-to-GDP ratio of 250% demonstrates that debt sustainability requires more than just reaching any debt-to-GDP ratio. The European fiscal rules cannot explain this situation. Still, credit rating agencies identify factors such as the strength and diversity of the Japanese economy, GDP per capita, institutional stability, rule of law, reserve currency status, and support from its central bank.

Financial markets have refined sovereign credit default assessments. Financial markets have developed a more sophisticated approach to assessing sovereign creditworthiness, incorporating a range of analytical indicators. By contrast, the European economic governance framework appears simplistic in its emphasis on debt-to-GDP ratios and arbitrary fiscal limits. Credit rating agencies recognise that institutional and economic strength are at least as important as fiscal strength in assessing sovereign creditworthiness. When evaluating fiscal strength, these agencies balance a country's debt ratio with its affordability, composition, dynamics, use, government financial assets, and fiscal risks (see details in section 3).

Strengthening a country's economy and institutions is at least as important as reducing debt. Poorly timed public spending cuts to reduce debt stock can be economically and socially

49 DELORS, J. et al.,(*1989*).

50 For more, see: SUTTOR-SOREL, L.,(*2021b*).

51 While the 60% debt-to-GDP limit is a rough average of the then 12 EU countries, the 3% deficit limit is the heritage of its prior usage in France. For more, see: SUTTOR-SOREL, L.,(*2021c*).

harmful.[52] Whilst reducing debt ratios is desirable – among other things as it gives more leeway to ECB to raise rates to fight inflation – it should not be done at the expense of institutional and economic strength and resilience. Resilience- and sustainable growth-enhancing investment and reforms should be incentivised and protected from fiscal rules pressures as they increase debt sustainability whilst allowing the EU to reach its objectives.

The European fiscal rules require fundamental upgrades to effectively ensure sustainable public finances supporting EU objectives – such as environmental protection, sustainable economic development and convergence.

52 FATAS, A., SUMMERS, L. H.,(*2017*); GECHERT, S., HORN, G., PAETZ, C.,(*2017*).

7. Reform proposals

The European Commission unveiled its proposed reforms for the European economic governance framework on April 26th, following two years of extensive debates, an orientation paper in November 2022, and a position by the Ecofin council in March 2023. Under the proposed system, countries whose debt exceeds 60% of their GDP would negotiate a country-specific four years debt reduction plan based on a debt sustainability analysis and resulting in annual expenditure ceilings. The plan can be extended to seven years in exchange for growth-enhancing reforms and investments that improve debt sustainability whilst addressing national challenges and EU priorities such as the green and digital transition.

Addressing concerns for a future-oriented fiscal framework. Some governments worry that the proposed new European fiscal rules would lead to excessive bilateral political bargaining and unsustainable public finance. This fear reintroduced quantitative debt and deficit reduction targets in the Commission proposal. Other governments, joined by trade unions and civil society, fear a lack of space for needed investment in Europe's future. Addressing both concerns calls for holistic debt risk analysis and stronger incentives for quality investments.

1. Include market-relevant indicators in debt risk identification

Debt sustainability analyses (DSA) are superior to magic numbers. Fiscal rules so far are built on magic numbers. By being more granular and dynamic, debt sustainability analyses (DSA) have the potential to be far superior to arbitrary debt-to-GDP ratios. Therefore, Finance Watch welcomes the Commission's intention to use DSA as the basis for country-specific debt pathways. As discussed, debt sustainability and access to the market do not depend on any debt-to-GDP level taken individually but on assessing several complementary indicators and, crucially, the potential support of a central bank.

The Commission's DSA should be improved. The Commission's DSA is built around three layers: a debt risk identification system, a deterministic DSA and a stochastic DSA that accounts for uncertainty in future interest, growth and inflation rates. The risk classification system presented by the European Commission to EU finance ministers is based on debt-to-GDP level, debt trajectory, and "fiscal consolidation space" (derived from past data). Risk identification should be better based on the broad set of indicators assessed by financial markets.

Put European brains at work. DSA design choices are not neutral. Considering the importance DSAs should take in the new EU economic governance, we make several proposals:

A. A **DSA working group** should be set up to improve EC's DSA methodology, with periodic revision. Naturally, the Commission's methodology was built over a long period and discussed with finance ministries' civil servants as part of the Economic and Financial Committee (EFC). Meanwhile, DSAs are too important not to benefit from a broader open debate ensuring state-of-the-art methodology and, ultimately, buy-in from European citizens, policymakers and experts.

B. **Expand debt sustainability risk identification**. The final methodology will need to better include indicators relevant to financial market access, capturing not only the debt stock

(debt-to-GDP) and its dynamic but also **debt affordability** (interest payment-to-revenue), **debt flows** (average maturity, gross financing need), **debt composition** (domestic or foreign) and **fiscal risks** (contingent liabilities).

C. **Independent forecast and fiscal risk assessment**. The European Commission has rightly proposed that Independent Fiscal Institutions (IFIs) produce or endorse, among others, macroeconomic and budgetary forecasts, and debt sustainability assessments, but also estimate the fiscal and growth impacts of policies proposed by governments in their medium-term macro-fiscal plans. It will be of particular importance that IFIs forecasts properly account for the **fiscal multiplier of public investment**[53] and prepare scenarios based on different levels of investment. Finance Watch welcomes the EC proposal that Member States, supported by their IFIs, publish information on **climate-related fiscal risks** – i.e. the fiscal impacts of failing to make the precautionary investment and reforms required to mitigate and adapt to climate change – a long-term CSO demand.[54]

Table 4 - Debt sustainability indicators, EU fiscal rules and sovereign credit rating

(Source: Author)

Debt sustainability indicator	EU fiscal rules - Current	EU fiscal rules - EC proposal (2023)	Sovereign Credit Rating (CRAs)
A. Debt stock			
1. Gross debt-to-GDP	Yes	Yes	Yes
2. Net debt-to-GDP	No	No	Yes
B. Debt flow			
3. Debt trajectory	No	Yes	Yes
4. Deficit-to-GDP	Yes	Yes	Yes (non-relevant)
5. Structural deficit-to-GDP	Yes	No	No
6. Expenditure growth	No	Yes	No
C. Debt affordability			
7. Interest-pay-ment-to-GDP or -revenue	No	No	Yes
8. Effective interest rate	No	No	No
D. Debt composition			
9. Average maturity	No	No	Yes
10. Investor base	No	No	Yes
E. Fiscal risks			
11. Contingent liabilities	No	Yes, but not in DSA	Yes
12. Tail risks	No	No	Yes

53 Fiscal multipliers of public investment in most European countries are associated with permanent and positive impacts on the level of economic activity (*Gechert, S., 2015*), in particular public investment in infrastructure (*Espinoza, R., et al., (IMF) 2020*). This multiplier effect becomes considerably higher during recessions (*Gechert, S., Rannenberg, A., 2018*), when economic resources lay underutilised (*Delong, J.B., Summers, L., 2012*), as well as when interest rates are low (*Bonam, D., De Haan, J., Soederhuizen, B., 2020*). Some research also suggests that fiscal multipliers are, in general, country-specific (e.g. *OECD, 2012*).

54 SUTTOR-SOREL, L.,(*2022*);

2. Incentivise future-oriented investments and reforms

Quality of investments and reforms is key. If debt resulting from public budget mismanagement is an unfair burden on future generations, debt from qualitative investments made today would weigh less on future generations' shoulders than failing to tackle current challenges. Ensuring they are of quality and future-oriented is crucial.

Improving Commission assessment framework. Whilst the proposed assessment framework (Annex VII) is an important step in the right direction to ensure investments and reforms in national plans support debt sustainability and EU environmental, social and economic priorities, it can be improved:

A. **The 'Do No Significant Harm' principle** (DNSH)[55] should become its cornerstone. Support should only be given to investments and reforms that leave future generations better off.

B. **Resilience-enhancing reforms and investments**, such as those related to climate adaptation, increase long-term debt sustainability as they lower fiscal risks, whatever their effect on growth. "Resilience-enhancing" should therefore be put on equal footing with "growth-enhancing" as a criterion (SGP's preventive arm, Annex VII, criteria 2.1.).

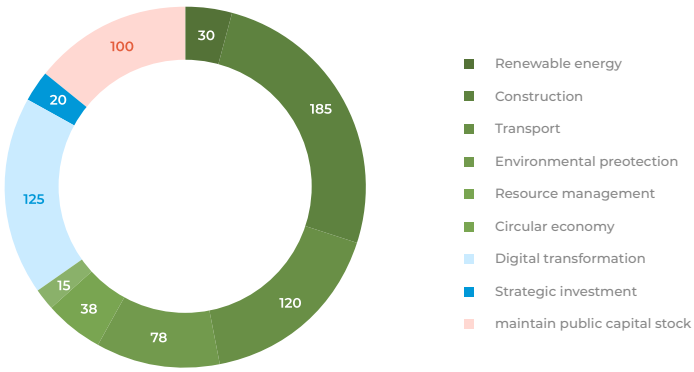
C. **Green budgeting** is mentioned in the Commission proposal (requirements for budgetary frameworks of the Member States) but only in recitals 5 and 19. These provisions should be integrated into the core of the legislation.

3. Liberate future-oriented investment from arbitrary limits

Public debt is not necessarily a burden for future generations. The cost of failing to invest now in tackling challenges facing Europe might weigh more on future generations' shoulders than the cost of debt resulting from investments made today. As a large share of these "future-oriented" investments would not solely benefit the present generation, debt-financing them would spread their costs across all benefiting generations. The most notable examples include investment and spending on climate mitigation and adaptation, education, research, development and innovation (R&D&I), industrial policy and public infrastructures.[56] Furthermore, the scope of existing annual EU funding gaps is significant – see Figure 9.

Figure 9 - Estimated annual EU funding gaps in 2020 (in billions of euro)

(Source: European Commission, SWD(2020)98 final)



55 'Do no significant harm' means not supporting or carrying out economic activities that do significant harm to any environmental objective, where relevant, within the meaning of *Article 17 of Regulation (EU) 2020/852* (EU Taxonomy).

56 On the positive impact of R&D&I and industrial policy, see: GULOGLU, B., TEKIN, B.,(*2014*); BLANCO, L., et Al.,(*2015*); YIFU LIN, J., WANG, Y.,(*2020*).

A. **Exclude future-oriented spending from arbitrary constraints**. To ensure sufficient fiscal leeway to bridge related funding gaps, Member States should be allowed to submit a list of future-oriented expenditures to be excluded from deficit and expenditure limits as part of their national medium-term fiscal-structural plans. Indeed, in the absence of European investment capacities and debt sustainability risks, there is little rationale for applying arbitrary limits to debt-financed national future-oriented investments and productive spending that improve debt sustainability.

B. **Ensure their quality**. To address concerns that any mechanism automatically excluding some categories of spending could create negative incentives to circumvent the rules, the decision to exclude such spending should simply be part of the proposed broader process of ***ex-ante* technical assessment** by the European Commission and by national Independent Fiscal Institutions (e.g. the debt sustainability analysis, fiscal impacts, respect of the do-no-significant-harm principle, EU objectives and country-specific recommendations), and **political validation** by the Council. To create real incentives and deeply embed quality as a new compass, failure to use additional fiscal space for quality investment could be **sanctioned**.

Investors and credit rating agencies would welcome such reform as ambitious and well-designed macro-fiscal plans would increase economic strength and resilience.

Annex 1 - Bid-to-cover ratio

Government bonds are commonly financed through auctions in advanced economies. The success of such auctions is measured by the bid-to-cover ratio, which represents the total amount of bids received compared to the amount of new debt issued. A higher bid-to-cover ratio indicates a greater demand for government bonds.

Table 5 - Bid-to-cover ratios for the ten-year bonds of core euro area countries (1999-2017)

(Source: R. BEETSMA et al., 2020, based on Bloomberg and national DMOs),

	Mean	Maximum	Minimum
Germany (10y)	1.64	4.12	1.06
France (10y)	2.40	5.28	1.39
Belgium (10y)	1.98	5.12	1.14
Italy (10y)	1.57	4.09	1.07
Spain (10y)	2.22	7.11	1.20

Note: The data cover hundreds of auctions of sovereign bonds with a maturity of 10 years over the period from 1 January 1999 until 31 December 2017.

Table 6 - Average bid-to-cover ratios in selected jurisdictions (2014-2022)

(Source: AFME, 2022; based on Thomson Reuters Eikon)

Annex 2 - Risk-weighting and haircuts

On the use of credit rating agencies in the ECB's collateral framework, see: *Consolidated text - Guideline (EU) 2015/510 of the ECB*; On the haircut, see: *Consolidated text - Guideline (EU) 2016/65 of the* ECB.

Table 7 - Equivalence between sovereign credit ratings, risk-weighting and haircuts

(Source: Author, based on: CRR; EBA ECAIs mapping; ECB collateral framework 2022)

Example	**Rating scale**			**Credit quality step** (CRR; ECB)	**Risk weighting** (CRR, Art. 114)		**Haircut** (ECB collateral framework)
	Moody's	*S&P*	*Fitch Ratings*		Non-EA	EA	
DE, FR	Aaa, Aa	AAA, AA	AAA, AA	1	0%	0%	0.5-6.3%
ES, PL	A	A	A	2	20%	0%	0.5-6.3%
IT, PO	Baa	BBB	BBB	3	50%	0%	5.4-14.4%
EL	Ba/ B/ Etc.	BB/ B/ Etc.	BB/ B /Etc.	4/ 5 /6	100%	0%	Ineligible

Annex 3 - Summary of the European Commission's legislative proposals

I. SGP's CORRECTIVE ARM

1. **The 'deficit-based' Excessive Deficit Procedure (EDP)** remains broadly unchanged. But the proposal streamlines the list of relevant factors to be assessed before launching an EDP, differentiating between Member States (MS) below (<) or above (>) 60% debt-to-GDP. For MS >60% debt-to-GDP, relevant factors are only considered if the deficit is temporary and close to 3%. But no such conditionality exists for MS <60%.

2. **The 'debt-based' EDP** is focused on departures from the agreed fiscal path by MS >60% of GDP, replacing the "1/20th rule". A "substantial public debt challenge" is a crucial factor leading to the opening of a debt-based EDP.

3. **Relevant factors** to take into account when assessing the existence of an excessive deficit include:
    1. The debt challenge, position, composition and risks (maturity, currency, contingent liabilities);
    2. The developments of the medium-term economic position (inflation, etc.);
    3. The size of the deviation from the net expenditure path and its origin (e.g. due or not to severe economic downturn in the EU/EA or exceptional circumstances in an MS);
    4. The implementation of reforms and investment (related to MIP, EU growth strategy – e.g. EU Green Deal –, EU employment strategy, quality of public finance).

4. **The corrective net expenditure paths in EDP** must:
    1. Bring or maintain the deficit below 3% of GDP;
    2. Put debt-to-GDP on a plausibly downward path, or keep it at a prudent level;
    3. Minimum annual adjustment of at least 0,5% of GDP for the years where the deficit >3%; *Comment: The minimum adjustment benchmark was already present in the rules. Whilst it applied to the structural deficit (MTO), it seems to apply now to the deficit or the net expenditure path.*
    4. Include Independent Fiscal Institution (IFI) opinion in the MS report that shall be made publicly available;
    5. Escape clauses for exceptional circumstances and severe economic downturns are maintained and improved (remove quantitative criteria for the severe economic downturn).

5. **Sanctions:** The proposal removes the minimum amount for fines and proposes that they accumulate every six months until effective action is taken, up to a maximum of 0.5% of GDP.

II. SGP's PREVENTIVE ARM

1. **Technical trajectory** for MS above 60% or 3% (cf. Annex 1):
    1. National plans of a period of 4 years (+ possible extension of 3 years);
    2. The 10yrs debt trajectory is on a plausible downward trend at the end of 4-7 years;
    3. The deficit is brought or maintained at < 3% of GDP;
    4. The trajectory is consistent with a -0.5% reduction benchmark (cf. corrective arm);
    5. The adjustments are not back-loaded;
    6. The net expenditure growth < medium-term output growth.

2. **Technical information** for MS below 60% and 3% is provided by EC regarding the structural primary balance necessary to ensure that the headline deficit is maintained at < 3% of GDP.

3. **Process medium-term fiscal-structural plans:**
    1. Technical dialogue between EC and MS;
    2. MS submit its plan by end-April;
    3. EC assesses the plan based on criteria;
    4. Council has four weeks to validate or reject the plan;
    5. MS presents annual progress report;
    6. If failure to make investments/reforms, EC proposes a more stringent net expenditure path.

4. **Content medium-term fiscal-structural plans:**
    1. The national net expenditure path (excluding unemployment benefit + EU programmes);
    2. The projected growth and public debt ratio paths;
    3. The fiscal risks (implicit and contingent liabilities);
    4. The main macroeconomic assumptions;
    5. The justifications in case of deviation from EC trajectory;
    6. The reforms and investment priorities (more details if MS requests a three-year extension);
    7. The share of total public investment;
    8. The quantification of impacts of reforms & investments;
    9. Information on consultation of CSOs, social partners and stakeholders.

5. **Conditions for extension (+ max. three years):** MS commits to a relevant set of reforms and investments commensurate with the degree of public debt challenges and challenges to medium-term growth. Taken together, they should be:
    1. Growth-enhancing;
    2. Support fiscal sustainability;
    3. Address EU common priorities and CSRs;
    4. Ensure that the overall level of public investment is higher at the end of the plan;
    5. Be sufficiently detailed, front-loaded, time-bound and verifiable.

6. **Monitoring process:**
    1. EC monitors criteria/requirements and makes recommendations to Council;
    2. Council has four weeks to decide;
    3. If failure to make investment/reforms, then EC proposes a revised net expenditure path with a more stringent adjustment period;
    4. MS submit an annual progress report.

7. **Significant risk of deviation.** If there is a risk of an MS >3%, EC can issue a warning to the MS. Based on the EC recommendation, Council adopts recommendations for necessary policy measures.

8. **Expansion of the role of the IFIs** (assessment of compliance with net expenditure path + analyse factors underlying deviation).

9. **Severe economic downturn clause:**[57] "On a recommendation from the EC, the Council may adopt a recommendation allowing MS to deviate from their net expenditure path, in the event of a severe economic downturn in the [EA/EU], provided it does not endanger fiscal sustainability in the medium term. The Council shall specify a time limit for such deviation.". Quantitative criteria for a "severe economic downturn" have been removed.

10. **Exceptional circumstances clause:** "On a recommendation from the EC, the Council may adopt a recommendation allowing an MS to deviate from its net expenditure path where exceptional circumstances outside the control of the Member State lead to a major impact on the public finances of the Member State concerned, provided it does not endanger fiscal sustainability in the medium term. The Council shall specify a time limit for such deviation."

11. **The EC can amend Annexes II to VII via delegated acts**

57 Also known as the "general escape clause"

III. NATIONAL BUDGETARY FRAMEWORK

1. **Expanded IFIs tasks:** Independent Fiscal Institutions (IFIs) must produce or endorse:
    1. The (multi-) annual macroeconomic and budgetary forecasts (ex-ante, ex-post, public);
    2. Debt sustainability assessments;
    3. Fiscal & growth impacts of policies; IFIs shall also:
    4. Monitor compliance with numerical fiscal rules and EU fiscal framework;
    5. Conduct a review of the national budgetary framework;
    6. Participate in regular hearings in the parliament.
    7. Furthermore, MS needs to abide by the comply-or-explain principle.

2. **Protect IFIs independence and quality:** IFIs independence must be ensured (not taking instruction, capacity to communicate publicly, adequate and stable resources, adequate/timely access to data, regular external review). IFIs shall be composed of members nominated and appointed based on their experience and competence and employing transparent procedures.

3. **Increase communication on fiscal impacts and fiscal risks:** MS shall publish information on the following:
    1. The impact of tax expenditures on revenues;
    2. Contingent liabilities with a potentially large impact on public budgets;
    3. Economic losses due to disasters and climate-related shocks, “including the fiscal costs borne by the public sector and the instruments used to mitigate or cover them.”

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