Governing the Varieties of Sovereign Risk in EMU: The Rise of State-Contingent Common Public Policies

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Abstract

The 30-year old Maastricht Treaty on European Union (EU) is based on the political vision that a stable euro requires sound budgetary policies and sustainable public finances in all the participating countries. This paper reviews the evolving European framework for governing the varieties of sovereign risk in the Economic and Monetary Union (EMU). The main finding is that a growing body of EU/EMU public policies with provisions contingent on the state of national economies, sustainable financial integration, or effective monetary transmission, works against fiscal discipline. EU fiscal rules allow for state-contingent compliance and include ample flexibility to account for a mitigating relevant factors. EU financial governance provides public entities with a privileged access to private finance contingent on prudential considerations. The European Central Bank introduced contingent monetary policy tools for managing government bond spreads. Member States draw on EU/EMU quasi-fiscal agencies to create common contingent liabilities which escape EU fiscal oversight. The European response to the economic fallout from the Covid-19 pandemic added an EU-debt financed fiscal redistribution scheme contingent on national funding needs. Member States can also draw on this public risk-sharing tool to absorb the energy shock following the Russian invasion of Ukraine. The rise of state-contingent governance to suppress the varieties of sovereign risk in EMU marks the political transition from the Maastricht Treaty’s focus on public risk reduction to a ‘Next Generation EMU’ which favours public risk-sharing. The challenge for the future will be to balance the need to stabilise the eurozone with the need for fiscal discipline.

Keywords: Maastricht Treaty, Economic and Monetary Union, fiscal discipline, sovereign risk, state-contingent public policies.
1. Introduction

The Maastricht Treaty on the European Union (EU) established the legal foundations for the euro as the single currency of the Economic and Monetary Union (EMU) which came to life on 1 January 1999.\(^1\) The EMU architecture combined the single monetary policy of the European Central Bank (ECB) with EU coordination of the economic, budgetary, and financial policies of the Member States. Given its focus on price stability, the task of macroeconomic management in the eurozone was left to the ECB. A central government with a capacity to issue eurobonds in order to fund a countercyclical fiscal policy, bridge the national varieties of sovereign risk, and assist member countries in distress, was missing (van Riet, 2022). The founders of the single currency rejected the benefits of fiscal activism and firmly believed that maintaining fiscal sustainability in each and every participating country was fundamental for monetary stability.

The EU legal framework actively tried to promote the common status of euro area countries as issuers of risk-free sovereign securities which together could function as a stable cornerstone for the financial and monetary system. The Maastricht Treaty concentrated on realising a high intrinsic quality of national public debt, grounded in market-based and rules-based fiscal discipline. To ensure sound budgetary policies, borrowing governments were exposed to investor scrutiny in open capital markets while the Stability and Growth Pact (SGP) laid down the details of EU fiscal surveillance. EU financial governance in turn ‘manufactured’ a high systemic quality of national public debt, making financial stability a function of sovereign safety in all euro area countries. The effectiveness of the ECB’s single monetary policy also depended on a unified government bond market to secure an even monetary transmission across the eurozone.

This paper reviews the evolving European framework for governing the varieties of sovereign risk in EMU. The main finding is that over time a whole body of EU/EMU public policies came to apply provisions contingent on the state of national economies, sustainable financial integration, or effective monetary transmission, which as a

\(^1\)The Maastricht Treaty on European Union (also EU Treaty) was agreed by the European Council in its meeting on 9-10 December 1991 in the city of Maastricht in the Netherlands and was signed in the same city on 7 February 1992. The Maastricht Treaty entered into force on 1 November 1993.
permanent backstop effectively undermine the national fiscal discipline that was supposed to underpin the stability of the eurozone.

First, the EU fiscal rules comprise state-contingent observance of the fiscal reference values which varies with a country’s economic growth and interest rates (Jaillet and Pfister, 2022). Moreover, the Maastricht Treaty and the SGP give the European Commission and the EU Council ample opportunity to account for exceptional circumstances and other relevant factors. The flexibility embedded in the EU legal provisions allows the Member States to protect public expenditures of political interest and to escape financial sanctions for non-compliance with the fiscal requirements (Heipertz and Verdun, 2010; van der Veer, 2022).

Second, EU financial governance contains many regulatory incentives for investors to hunt for sovereign securities and to assume that all euro area government bonds are risk-free assets in money and finance (Gabor and Ban, 2016). This regulation-driven ‘captive demand’ for sovereign securities sustains the public sector’s privileged access to private creditors, contingent on prudential considerations (van Riet, 2023).

Third, the ECB made its minimum requirements for sovereign collateral – which since late 2005 are based on external credit ratings – contingent on preserving market access for downgraded governments (Orphanides, 2017). The ECB also committed to conditional interventions in crisis-hit government bond markets to sustain an even monetary transmission. Large-scale public sector purchase programmes were activated with few strings attached both to provide quantitative easing and to counter market fragmentation. These state-contingent balance sheet operations – which were originally presented as an exceptional measure – have become a standard instrument of monetary policy (ECB, 2015; Cour-Thimann and Winkler, 2016; Orphanides, 2021). Meanwhile, they are also used to contain the volatility of government bond spreads during episodes of monetary tightening.

Fourth, Member States make increasing use of EU/EMU quasi-fiscal agencies such as the European Investment Bank, EU budget facilities, and the European Stability Mechanism to address economic and financial challenges, thereby creating a growing pool of contingent liabilities. This ‘shadow debt’, which is recorded off-balance, leaves national
budgets largely untouched and escapes EU fiscal oversight (Guter-Sandu and Murau, 2022).

Fifth, the EU’s response to the economic fallout from the Covid-19 pandemic involved all the aforementioned state-contingent public policies and was combined with large-scale EU borrowing in the capital market to arrange a redistribution of the acquired resources via the EU budget in the form of grants and loans, in particular to the hardest-hit countries. The EU loans that remain unrequested and some new EU grants are made available to Member States requiring extra fiscal space to absorb the energy shock following the Russian invasion of Ukraine. This successful blueprint for future crises has the character of a ‘state-contingent fiscal union’ (Lane, 2021). Discussions are ongoing to establish a European Sovereignty Fund based on the same principle of EU financing to cover the fiscal costs of common industrial policies.

European policymakers have always struggled to discipline the euro area countries in a universe comprising both safe and risky sovereign borrowers but lacking a central government issuing a single safe sovereign asset to safeguard the euro (van Riet, 2021). Confronted with the need to respond to urgent economic, financial, and monetary challenges, they choose to suppress the varieties of sovereign risk in EMU apparent in government bond spreads in order to stabilise national economies, sustain financial integration, or secure monetary transmission. These EU/EMU public policies have in common that they effectively undermine the principle of fiscal discipline that 30 years ago was placed at the heart of the Maastricht Treaty in the belief that a stable euro requires sound budgetary policies and sustainable public finances in all the participating countries.

On several occasions, the European Court of Justice approved this state-contingent governance because it supports economic, financial, or monetary stability for the euro area as a whole. This constitutional transformation could reflect the emergence of fiscal solidarity of the stronger member countries with their weaker partners (Borger, 2020) to complement the monetary solidarity on which they originally relied to deal with crisis conditions (Schelkle, 2017). The rise of state-contingent public policies at the European level in this view marks the political transition from the Maastricht Treaty fiscal framework focussed on public risk-reduction to a ‘Next Generation EMU’ centred around public risk-sharing (see also Cabral, 2021; Larch et al., 2022). The challenge will be to
ensure that future reforms of the EMU architecture balance the need to stabilise the eurozone with the need for fiscal discipline (see also Benassy et al., 2018).

This paper is organised as follows. Section 2 reviews how the EU legal framework seeks to ensure the intrinsic quality of national public debt and how state-contingent common public policies try to engineer sovereign safety as a condition for euro area stability. Section 3 discusses the European public policy response to the Covid-19 pandemic, the energy crisis after the Russian invasion of Ukraine, and the future of state-contingent governance of the varieties of sovereign risk in the eurozone. Section 4 concludes that EMU is in a political transition to a more complete fiscal architecture.

2. **The rise of state-contingent common public policies**

2.1. **The Maastricht Treaty framework for fiscal discipline**

The Maastricht Treaty sought to ensure sound budgetary policies through a combination of market forces and peer pressure. First of all, with the establishment of the European internal capital market Member States lost the sovereign privilege to ‘encapsulate’ their domestic financial markets (Preunkert, 2017) and to establish privileged access to financial institutions as a cheap source of public credit. Henceforth, borrowing governments had to compete for savings, facing the full force from ‘bond market vigilantes’ which deter a borrower from pursuing an unsustainable fiscal policy (Lane, 1993). To strengthen the role of market discipline, the Maastricht Treaty also blocked the option for the ECB to provide governments with direct monetary financing and for EU institutions or Member States to bail out a partner country in trouble.

Second, European policymakers – in particular central banks – realised that governments’ access to a large and open capital market when borrowing in euro could also facilitate the financing of budget deficits, in particular when private investors placed a blind trust in public debt repayment. Market participants might not set the correct (higher) interest rate and give high-debt governments more fiscal ‘room to move’ than desirable (Mosley, 2004; James, 2012).2 Doubts about the effectiveness of market discipline motivated the

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2 As the Delors Committee for the study of economic and monetary union had highlighted in its report (1989, p.24): “[M]arket views about the creditworthiness of official borrowers tend to
introduction of EU fiscal rules and surveillance in the Maastricht Treaty to ensure the sustainability of public finances. More detailed provisions for coordinating national fiscal policies were laid down in the Stability and Growth Pact of 1997 (SGP 1.0).

The EU’s fiscal rules prescribe that Member States must avoid excessive government deficits and will face procedural steps in case the European Commission identifies ‘gross errors’ with regard to fiscal discipline, which for euro area countries could lead to financial sanctions for persistent non-compliance. The excessive deficit procedure is triggered when one or both of the fiscal reference values are exceeded, consisting of a maximum of 3% of GDP for the government deficit and a maximum of 60% of GDP for the government debt unless this ratio is sufficiently diminishing towards that value. The SGP also obliges Member States to maintain a close to balanced budget or a budget surplus over the medium-term. Aligning national budgetary positions towards concerted fiscal discipline was regarded as essential to prevent adverse interest rate spill-overs of fiscal laxity on other Member States, to protect the credibility of the ECB’s monetary policy, and to guarantee a balanced euro area macroeconomic policy mix (Artis and Winkler, 1998).

Taking a closer look, the EU fiscal framework appears more stringent in theory than it is in practice. Although the EMU architecture is grounded in ‘disciplinary neoliberalism’ (Gill, 1998), the original vision of the Maastricht Treaty ‘has not come to fruition’ (Kari, 2021). During the first years of EMU, the adoption of the euro had no dramatic impact on the relationship between euro area countries and financial markets (Mosley, 2004). As the euro matured, the Maastricht Treaty offered European policymakers ample flexibility to address new challenges facing EMU, contingent on the evolving economic, financial, and monetary landscape. As discussed below, the EU/EMU authorities are increasingly utilising this discretion all along the public policy spectrum and thereby circumvent the enforcement of fiscal discipline.

The EU’s flexible fiscal governance has become so complex and incoherent that it is ineffective in securing fiscal discipline (Kamps and Leiner-Killinger, 2019). EU financial regulation includes many sovereign funding privileges which further undermine EU fiscal change abruptly and [could] result in the closure of access to market financing. The constraints posed by market forces might either be too slow and weak or too sudden and disruptive‘.
governance (Ojala, 2021; van Riet, 2023), the ECB’s flexible sovereign collateral requirements and contingent public sector bond purchases secure market access for all euro area governments (van Riet, 2022), and the political recourse to EU/EMU quasi-fiscal agencies transfers on-balance national public expenditures into off-balance common contingent liabilities (Guter-Sandu and Murau, 2022). All these state-contingent European public policies were activated to address the Covid-19 pandemic in conjunction with a large-scale programme of EU borrowing in the capital market to fund a fiscal redistribution scheme as integral part of a future ‘state-contingent fiscal union’ (Lane, 2021).

2.2. **EU fiscal governance: state-contingent compliance**

Although EU fiscal governance is rule-based, its practical application leaves considerable scope for state-contingent compliance. Over the 25 years of the SGP’s history, the balance between rules and discretion in EU fiscal surveillance was subject of a permanent political debate. Observers often characterise the SGP as a ‘straightjacket’ that prescribes fiscal austerity and removes the freedom for Member States to counter a domestic recession with a fiscal expansion. The ‘one-size-fits-all model’ of the SGP is believed to constrain in particular the euro area countries, without access to monetary policy. However, the stringency of the EU fiscal rules varies with the circumstances, because compliance with the fiscal reference values is state-contingent (Jaillet and Pfister, 2022) and fiscal surveillance always takes account of national contingencies (Heipertz and Verdun, 2010; Rother, 2010; Buti and Pench, 2012).

The contingent nature of the fiscal reference values arises from their fixed values. For Member States it is much easier to keep the government deficit below 3% of GDP when economic growth is strong and much more difficult when they face a recession. Moreover, a country where the average interest rate paid on government debt outstanding is lower than the nominal GDP growth rate has much more fiscal leeway to stabilise its government debt ratio below 60% of GDP, or to place it on a steady downward path towards that reference value, than a country facing the reverse configuration of interest and growth rates. EU fiscal surveillance nevertheless tends to accommodate the specific circumstances of over-indebted countries with higher interest rates and/or lower output growth rather than incentivising them to accelerate budgetary adjustment and structural
reforms (especially in economic good times) as preconditions for a more favourable interest rate-growth constellation.

The Maastricht Treaty explicitly states that the European Commission, when preparing a report on a country exceeding the fiscal reference value(s), must consider for the government deficit whether the excess is ‘only exceptional and temporary’, for example due to ‘an unusual event outside the control of the Member State’ or a ‘severe economic downturn’. The Commission’s report must also consider whether the government deficit exceeds government investment (a reference to the so-called ‘golden rule’) and take ‘all other relevant factors’ into account. Moreover, the EU Council’s decision on the existence of an excessive deficit must consider any observations put forward by the Member State concerned. This political discretion has enabled profligate countries to avoid or delay a fiscal correction without ever being confronted with a financial sanction.

European Commission President Prodi nevertheless argued in October 2002 that the SGP was ‘stupid, like all rigid decisions’. His remark was intended to initiate a debate on a more flexible and more intelligent interpretation of the SGP, while acknowledging that strict fiscal rules were necessary for a stable euro (Heipertz and Verdun, 2010, p.135). The credibility of the SGP was undermined when in 2003 Germany and France refused to follow the European Commission’s recommendation to correct their excessive government deficits on a timely basis. The European Court of Justice confirmed the EU Council’s discretion in this regard.

The SGP was amended in 2005 (SGP 2.0) to focus more on country-specific situations and to make the elements of flexibility more concrete, in exchange for a greater focus on government debt (Rother, 2010). Under the corrective arm of the SGP, the relevant provisions allowed the EU Council to extend the standard time frame for the correction of an excessive deficit in case there are ‘special circumstances’, an assessment which should again reflect ‘all relevant factors’. After the country concerned had taken effective corrective action, the deadline for correcting the excessive deficit could be further extended by one year in case of ‘unexpected adverse economic events’.

Under the preventive arm of the SGP, Member States could determine their own medium-term budgetary objective of a close to balanced budget or a budget surplus consistent
with fiscal sustainability, taking account of public investment needs and the projected budgetary costs of ageing, but disregarding other fiscal risks and contingent liabilities. This objective was defined in terms of the structural budget balance, which corrects for cyclical movements as well as for one-off and temporary measures. The structural budgetary adjustment towards this objective should be at least 0.5% of GDP per year in ‘good times’ while it could be less in ‘bad times’. The SGP 2.0 thus allowed Member States to respond to business cycle fluctuations by letting automatic stabilisers in the budget operate freely along the structural adjustment path to their medium-term budgetary objective.

The start of the sovereign debt crisis in 2010 triggered initiatives for more effective EU enforcement of sound public finances based inter alia on automatic procedures, correction mechanisms, and outside intervention (see also Kamps and Leiner-Killinger, 2019).

European leaders initiated a broad-based reform of EU economic governance to regain market trust in the sustainability of public finances. The ‘six-pack’ of 2011 and the ‘two-pack’ of 2013 – embedded in a new European Semester of economic policy coordination – reinforced the preventive and corrective arms of the Stability and Growth Pact (SGP 3.0), introduced a new Macroeconomic Imbalances Procedure (also covering fiscal imbalances), and accelerated the process leading to financial sanctions for euro area countries not observing the rules of EU economic governance.

Moreover, all euro area countries were obliged to submit their annual draft budgetary plan for scrutiny to the European Commission and the Eurogroup before the final budget is adopted by the national parliament. Furthermore, the enhanced surveillance of euro area countries receiving financial assistance was given a legal basis. To strengthen national ownership of the EU fiscal rules, Member States agreed on new requirements for national budgetary frameworks.

The Fiscal Compact of February 2012 further required the signatory parties to enshrine a structural balanced budget rule and an automatic correction mechanism for breaching the rule in binding national legislation. Moreover, it required the introduction of independent national fiscal councils with a monitoring role. The European Commission
later added a European Fiscal Board to advise the Eurogroup on the appropriateness of the euro area fiscal stance, signalling the revival of fiscal policy as a discretionary tool of macroeconomic management (van Riet, 2022).

Among other amendments, the SGP 3.0 operationalised the reduction of the government debt ratio that is required under the corrective arm if it exceeds 60% of GDP and added a new expenditure growth benchmark to the preventive arm, both with a focus on structural developments. But the assessment on the existence of an excessive government deficit and of a significant deviation from the adjustment path to the medium-term budgetary objective comprised an even longer list of relevant mitigating factors. The SGP 3.0 also accentuated the flexibility to modulate a fiscal consolidation requirement, both in terms of the initial prescription of the correction or adjustment and its subsequent adaptation, to take account of economic shocks and unusual events (Buti and Pench, 2012). Considering the need to coordinate a supportive fiscal stance after the great financial crisis of 2008, a general escape clause was formulated which in case of a severe economic downturn hitting the euro area or the EU as a whole could lead to a temporary suspension of the SGP procedures, provided that medium-term fiscal sustainability was maintained.

Soon after, the European Commission reached an agreement with Member States on how to make best use of the flexibility that is built into the SGP (General Secretariat of the EU Council, 2015). The first goal was to better align a required structural budgetary adjustment under the SGP’s preventive arm with the cyclical economic situation while also considering the government debt ratio and fiscal sustainability risks. The second goal was to make a fiscal allowance for the short-term costs of public investments in bad times that are co-funded by the EU and of major structural reforms that are fully implemented, provided that these measures would raise potential growth, translate into long-term budgetary advantages, and preserve fiscal prudence.

The European Commission (2018) concluded from a review in 2018 that the new approach to flexibility ‘worked and delivered’. At the same time, it had introduced a new ‘margin of discretion’ to further reduce the structural budgetary adjustment required under the preventive arm when it believed that the output gap used for the calculation understated the true weakness of the country’s economy (Kamps and Leiner-Killinger, 2019).
Overall, the politicisation of EU fiscal rules steadily pushed the European Commission and the EU Council towards a more flexible interpretation and a more frequent non-application of the SGP, in particular with regard to its corrective arm (van der Veer, 2022). The stepping-up of multilateral surveillance of national fiscal policies became ever-more contingent on the state of the economy and the absence of exceptional circumstances and other relevant factors, allowed by the letter and the spirit of EU law. Abstracting from the many exceptions and elements of discretion, Member States complied with the numerical fiscal constraints only in slightly more than 50% of the cases, with important cross-country differences (Larch et al., 2023). The new expenditure growth benchmark was regularly exceeded and for many Member States it proved very difficult to reach and maintain a close to balanced budget, let alone a budget surplus. As a consequence, government budget deficits and debt ratios remained (too) high. The mechanism to sanction euro area countries with a persistent excessive government deficit was never applied. Although in theory the SGP was tightened, in practice it was perceived as too complex to be enforced.

As a solution, it has been suggested that euro area countries could agree on a ‘new fiscal order’, including prior approval at the European level of planned government deficits that exceed 3% of GDP, an automatic correction of fiscal slippages, automatic fines for recording an excessive government deficit, and placement in financial receivership of members needing financial assistance but failing to keep their economic adjustment programme on track (Schuknecht et al., 2011). Alternatively, an ‘economic and fiscal federation by exception’ could hold euro area countries to account for their ‘sovereign signature’ and allow the EU to take over national budgetary powers in case of ‘gross errors’ in fiscal policy that threatened the stability of EMU (Trichet, 2013). Going well beyond the EU legal framework, such proposals impinge on national fiscal sovereignty and never received broad political support.

2.3. EU financial governance: contingent sovereign privileges

According to the Maastricht Treaty, the public sector is not allowed to have privileged access to private credit, unless it is based on prudential considerations and this exemption
is not used as a cover to establish privileged access in disguise.3 The exception made for prudential considerations refers to financial regulation designed to promote the soundness of financial institutions and to strengthen the stability of the financial system as a whole.

EU financial governance, covering prudential regulation of financial institutions and financial markets, includes a broad-based preferential treatment of public securities compared to private securities (van Riet, 2023). European authorities actively ensured that the government bonds from all Member States would receive an equal treatment as risk-free assets for regulatory purposes. Following the Basel Accord of 1988, the EU capital requirements directives explicitly allowed credit institutions to consider claims on or guaranteed by the public sector in most cases as a safe investment which was not subject to the large exposure ceilings that applied to bank claims on the private sector. Similarly, the EU directives governing pension funds, insurance companies, and investment firms, exempted government bond portfolios from concentration limits and asset diversification requirements. These sovereign privileges in finance are in fact based on the political promise to investors that sovereign securities will always hold their value, i.e. it takes fiscal discipline for granted.

With the start of EMU in 1999, the EU’s preferential regulatory treatment of sovereign exposures received an additional euro area dimension. Exchange rate risk no longer acted as an investment barrier within the eurozone, transaction costs were lower, and the banking industry could make full use of the legal incentives to buy government bonds of other euro area countries. In addition, the regulatory requirements for institutional investors were revised to allow them to match the currency denomination of their assets and liabilities in terms of the euro. This regulatory incentive stimulated asset managers to diversify the country risk of their government bond portfolios by including sovereign issuers from the whole euro area.

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3 See TFEU Art. 124 (ex Art. 104a) and Council Regulation (EC) No 3604/93 of 13 December 1993 specifying definitions for the application of the prohibition of privileged access referred to in Article 104a of the Treaty.
For consistency reasons, the EU financial collateral directive of 2002 supported a repo market-driven development of general collateral pools in which the sovereign securities of all euro area countries were considered to be of equivalent value, marked daily at market prices. Adopting similar market practices, the operational framework of the ECB accepted the government bonds of all euro area countries that banks pledged as equivalent collateral for refinancing purposes, subject to daily market valuation. This equal treatment greatly facilitated the development of the euro area repo market that formed the backbone of the integrated and liquid euro area government bond market that was necessary for an even monetary transmission (Gabor and Ban, 2016). As a result, governments issuing euro-denominated bonds enjoyed a ‘captive’ investor base across the single financial space of the eurozone, which also set the stage for a sovereign-bank ‘doom loop’ in the euro area crisis.

The overhaul of European financial legislation implemented from 2008 to 2019 broadened the supranational scope of the preferential treatment of sovereign securities (van Riet, 2023). Apart from tightening prudential requirements or creating barriers to open speculation, EU regulators labelled government bonds as high quality liquid assets and exempted government bond-related transactions from market restrictions. Whereas EU fiscal governance relied on financial markets to promote fiscal discipline, EU financial governance achieved the opposite by promoting a ‘false belief’ that governments cannot fail (Cœuré, 2016; Ojala, 2021).

Looking back, EU financial governance manufactured the high systemic quality of public debt, making investors hunt for the highest yield on sovereign assets with a zero-risk label and undermining the role of markets in imposing fiscal discipline. EU prudential legislation interacted with the introduction of the euro in making investors believe that virtually all debt issued by euro area governments was safe regardless of actual credit risk, while EU collateral policies enabled the profit-driven financial sector to exploit the liquidity of sovereign collateral in the repo market to secure the expansion of credit across the whole eurozone.

Accommodating the varieties of sovereign risk in the eurozone to speed up financial market integration assumes the existence of sound public finances as a stable anchor for sound private finances. Giving the public sector privileged access to private finance
instead encourages excessive public debt and a fragile financial sector exposed to variable sovereign risk. EU financial regulation therefore appears to be based on the premise that the (independent) ECB will always backstop market access for euro area governments in trouble.

2.4. ECB monetary policy: contingent sovereign yield control

The Maastricht Treaty banned direct monetary financing of public sector entities. Hence, the ECB could not purchase public sector bonds in the primary market or provide other forms of financial assistance to Member States, as this support for the national fiscal authorities could undermine the credibility of a single monetary policy geared towards price stability. Yet, the ECB’s statutes that are annexed to the Maastricht Treaty grant it a wide discretion to enter into credit and open-market operations involving public sector securities when needed to achieve its monetary policy objectives.

First, the ECB may conduct credit operations with credit institutions against adequate collateral. The reference to ‘adequate’ collateral (to avoid losing money) gives public sector securities a considerable advantage over private sector securities in these credit operations, especially as the functioning of repo markets against secure collateral underpins the liquidity of government bond markets. Second, the ECB may buy and sell outright or under repurchase agreement in financial markets as well as by lending or borrowing claims and marketable instruments. This option includes secondary-market purchases of the public sector instruments from all euro area countries, which anchor the financial system and as such perform a vital role in monetary transmission.

Over the first decade of EMU, the ECB’s standard approach to monetary policy was to steer money market liquidity and short-term interest rates by offering repo-based credit operations priced at its main refinancing rate to participating euro area banks pledging collateral (Rostagno et al., 2021a). The ECB’s collateral eligibility criteria signalled to market actors that national government bonds were broadly similar in nature, which enhanced their attractiveness for market participants and hampered fiscal discipline (Buiter and Sibert, 2005). At the same time, its market-based risk control measures (mark-to-market valuation, haircuts and margin calls on a daily basis) implied a modest market-driven differentiation between government bonds pledged as collateral in terms
of their credit quality and market liquidity (Bindseil and Papadia, 2006; Gabor and Ban, 2016).

As from late 2005, the ECB nevertheless established a new euro area collateral framework requiring a minimum external credit rating (A-) both for public and private sector assets. Even from the start of EMU, it would have comprised the government debt of all member countries. The ECB clearly favoured the ‘market-based’ judgement of external credit rating agencies over ‘politically sensitive’ internal credit risk assessments to determine the value of sovereign collateral (Orphanides, 2017).

During the second decade of EMU, the ECB adopted a range of non-standard monetary measures (Rostagno et al., 2021a). Amid the great financial crisis of 2008, the ECB assumed the role of lender of last resort for euro area banks to offset the liquidity-squeeze in interbank lending markets. Ever since, the definition of ‘adequate’ collateral is applied with a margin of flexibility to balance the banking sector’s demand for collateral and the supply of collateral available in the market (Bindseil et al., 2017).

At the start of the sovereign debt crisis in 2010, the ECB relaxed the collateral eligibility criteria by lowering the credit rating threshold for sovereign securities to the investment grade level (BBB-). The central government bonds of the crisis-hit countries with a lower credit rating received a waiver provided that their economic adjustment programmes agreed with the EU and the International Monetary Fund (IMF) were on track (a condition which at that time excluded the acceptance of Greek central government bonds).

The ECB also assumed the role of market-maker of last resort and started in 2010 with ‘exceptional’ open-market operations with the intention to secure an effective transmission of monetary policy across the whole eurozone. The temporary Securities Markets Programme (SMP), which was in force until 2012, concentrated on purchasing limited amounts of government bonds in the dysfunctional secondary markets of euro area countries in trouble, based on their fiscal adjustment and structural reform commitments.

Given the limited effectiveness of the SMP, following the ‘whatever it takes’ speech by ECB president Draghi (2012), the ECB set up a contingent programme of Outright Monetary Transactions (OMT) and pledged to undertake conditional, yet unlimited
purchases in those secondary government bond markets were price formation was distorted by currency redenomination risk. The ECB president explicitly excluded monetary interventions to tackle liquidity and default risk premia that were inherent to the sovereigns themselves. His credible commitment to support the proper functioning of government bond markets, if needed for monetary policy purposes, succeeded in restoring market stability. At the same time, the OMT resulted in a new bond-pricing regime characterised by a weaker link between government bond spreads and fundamental sovereign risk (Afonso et al., 2018; Eijffinger and Pieterse-Bloem, 2022).

The ECB judged in June 2014 that additional monetary accommodation was warranted to push the then very low level of euro area inflation back up to a level near 2% over the medium term. The ‘exceptional’ measures announced in subsequent months also comprised a large-scale asset purchase programme (APP) of public and private sector securities. This quantitative easing over the period 2014 to 2019 was effective in lowering and flattening the euro area risk-free sovereign yield curve as deemed necessary to further relax private credit conditions and raise the rate of inflation. The Public Sector Purchase Programme (PSPP) and ongoing reinvestments of the acquired maturing public securities made the largest contribution (Rostagno et al., 2021b).

At the country level, the decline in government bond yields was stronger, the lower the sovereign credit rating (Fendel and Neugebauer, 2019). The compression of government bond spreads contributed at times to negative long-term interest rates even for the weaker economies and was driven by the ECB extracting sovereign risk rather than by member countries pursuing fiscal consolidation and structural reforms. Despite the ECB’s large-scale capital market interventions, sovereign credit ratings and interest rate differentials never fully returned to their pre-2008 levels (Eijffinger and Pieterse-Bloem, 2022).

The European Court of Justice confirmed that the ECB had the discretionary powers to establish such a monetary backstop for fulfilling its mandate and that it was compatible with the EU Treaty; first, because the OMT has a clear monetary policy objective, and second, because the strict conditions preserved ‘the impetus of the Member States concerned to follow a sound budgetary policy’ and thereby provided sufficient safeguards against monetary financing.
The ECB (2015) initially referred to the PSPP as a ‘contingent balance sheet expansion’, i.e. an exceptional form of monetary accommodation contingent on monetary policy rates reaching the zero lower bound and/or the need to counter temporary threats to financial stability. The conditions attached to the PSPP were meant to preserve market-based fiscal discipline and counter the perception of monetary financing (Praet, 2015).

The longer the PSPP was in force, however, the more public sector bond purchases became a standard monetary policy tool that the ECB can apply with a high degree of flexibility to ensure the effectiveness of monetary policy in achieving and maintaining its inflation target (Lane, 2020). Yet, monetary operations in the capital market to counter non-fundamental volatility (in the form of market segmentation risk and currency conversion risk) also tend to reduce fundamental signals about national fiscal positions (in the form of credit risk and liquidity risk) and could be a source of moral hazard for euro area countries.5

2.5. EU/EMU quasi-fiscal agencies: off balance contingent liabilities

The Maastricht Treaty excluded the possibility for the EU countries and the EU institutions to guarantee or take over the financial commitments of (other) Member States. This reflected the basic principle of national responsibility for economic and financial policies and a fear that EMU might otherwise turn into a transfer union to the benefit of profligate members. However, various EU/EMU agencies carry out quasi-fiscal functions on behalf of the participating countries, especially covering public investment and economic stabilisation, to relieve the fiscal burden on national balance sheets (Guter-Sandu and Murau, 2022).

The European Investment Bank (EIB) was established in 1958 as an autonomous European body with the task to contribute to the balanced and steady development of the internal market in the interest of the EU. For this purpose, it borrows in the capital market and utilises its own resources to grant loans and give guarantees which facilitate the financing of investment projects in all sectors of the European economy, in particular when these projects cannot be entirely financed by the individual Member States.

5 For a decomposition of these four risk factors in government bond yields see Corradin et al. (2021).
Over the first decades of its existence the EIB functioned mostly as an infrastructure investment bank, complementing the European Structural Funds to better integrate less-developed regions and new EU members. Over time, the Member States expanded the EIB’s capital base and enlarged its financing capacity in order to leverage the modest resources of the EU budget and to compensate for their own limited fiscal space in a recession. The risk-bearing capacity of the European Fund for Strategic Investments (EFSI), which was created in 2015 as the EU’s venture capital arm with an EU guarantee and the EIB as majority shareholder, allowed the EIB to make more risky investments. Capital contributions by the Member States to the EFSI and their co-financing of projects together with the EFSI are considered favourably under the flexibility offered by the SGP (General Secretariat of the EU Council, 2015). As a result, the EIB intensified its cooperation with the European Commission and the national development banks and became the central node of an EU network aimed at mobilising public and private investments through quasi-fiscal actors (Mertens and Thiemann, 2019).

Ever since the mid-1970s, the European Commission has regularly accessed the capital market on behalf of the European Community/European Union to borrow relatively modest sums – guaranteed by the own resources of the EC/EU budget – which were passed on as financial assistance in the form of balance-of-payments support to Member States (and as financial assistance to third countries) facing difficulties caused by natural disasters or exceptional occurrences beyond their control (Horn et al., 2020). EU countries lost access to this common support mechanism after joining EMU and adopting the euro.

As the sovereign debt crisis erupted in 2010, the EU established a new European Financial Stability Mechanism (EFSM) guaranteed by the EU budget to grant concessional loans under strict conditions to the affected Member States, complementing official bilateral loans and financial support from the IMF. The EMU authorities on their part created a European Financial Stability Facility (EFSF) in the form of a special purpose vehicle with a temporary mandate to borrow in the capital market and to provide conditional financial assistance to euro area countries that had lost market access. Although not directly affecting the budget balance of the contributing member countries, the EFSF’s debt issuance was statistically reallocated to their stock of government debt.
In addition, the EU authorities added a new paragraph to the EU Treaty enabling the euro area countries to establish a permanent stability mechanism with a mandate to grant required financial assistance under strict conditionality if this was indispensable for safeguarding the stability of the euro area as a whole. Following ratification of an intergovernmental treaty, the European Stability Mechanism (ESM) became operational in October 2012. The euro area members endowed the ESM with paid-in and callable capital such that it can operate as a self-standing public entity with the ability to attract market capital for funding country-specific support operations without formally violating the no bail-out clause.\(^6\)

The ESM has various tools, including back-to-back loans, market interventions, and precautionary credit lines, to address (threats of) a liquidity crisis in a troubled member country and/or to recapitalise its failing banks. As a condition, the country concerned must have ratified the Fiscal Compact. Furthermore, an analysis of fiscal sustainability must show that it is solvent (if necessary, after a public debt restructuring involving private creditors) and it must follow an economic adjustment programme.

To limit the attendant moral hazard, euro area countries included as of 2013 a collective action clause (CAC) in the terms and conditions of their government bond series to be activated if necessary to restore fiscal sustainability. This contractual provision should allow all public debt securities issued by an insolvent country to be considered together in negotiations and thus make it easier to get a qualified majority of bondholders to accept a public debt restructuring offer rather than to hold out against it. On balance, government bond yields were hardly affected and the CACs were ineffective in generating market discipline (Committeri and Tommasino 2018). A revised CAC for all government bonds issued as of 2022 should further facilitate reaching agreement with bondholders on a public debt restructuring, but a proposal to make it automatic and predictable for private investors was rejected (van Riet, 2021).

European leaders also agreed to initiate steps in June 2012 towards a European Banking Union in order to break the vicious feedback loop between vulnerable sovereigns and

\(^6\) The European Court of Justice argued that the tasks and functions of the ESM are compatible with the provisions of the EU Treaty, in particular those related to the no bail-out clause.
fragile banks. This important agreement led to the transfer of euro area banking supervision to the ECB in 2014 and a new role for the ESM – laid down in the revised ESM Treaty of 2021 (which at the time of writing is still to be ratified by all euro area countries) – as a temporary fiscal backstop for the single bank resolution fund.

Overall, the euro area countries have outsourced the protection against a possible revival of the sovereign debt crisis and the sovereign-bank doom loop to an intergovernmental quasi-fiscal agency with sufficient tools to function as a lender of last resort outside the EU Treaty context. This contingent public risk-sharing through the ESM balance sheet (Jaillet and Pfister, 2022) entails the accumulation of off-balance contingent liabilities for the member countries (Guter-Sandu and Murau, 2022).

3. The transition to a Next Generation EMU

3.1. Contingent public risk-sharing in pandemic and war

The European public policies affecting euro area sovereign bond markets came together in the common response to the economic fallout from the Covid-19 crisis as of March 2020, complementing the national budgetary and non-budgetary measures to address the pandemic (Fabbri, 2022; van Riet, 2022). The EU Council temporarily relaxed the EU limits on giving state aid to firms getting into financial trouble. In addition, it activated the general escape clause of the SGP 3.0 and suspended the normal budgetary requirements for 2020-2022 in view of the expected severe economic downturn affecting the EU as a whole and the need to coordinate a supportive fiscal stance. The corresponding provision that a large-scale fiscal stimulus should not put medium-term fiscal sustainability in danger received no attention; meeting this condition was effectively outsourced to European public policies.

The expected net financing needs of the Member States increased dramatically. Although the pandemic was a symmetric exogenous shock, with long-term interest rates and CDS premia rising all across Europe, the scale and duration of the negative market reaction was asymmetric; risky sovereign borrowers witnessed a stronger and more persistent adverse impact than safe sovereign borrowers (Carnazza and Liberati, 2021).

The ECB’s monetary policy response was initially limited to an intensification of the ongoing monetary easing measures and was accompanied by the message of the ECB
president that 'we are not here to close spreads' (Lagarde and De Guindos, 2020). When the market sell-off of public and private securities intensified, the euro area risk-free sovereign yield curve moved higher and government bond spreads rose markedly, the ECB leadership quickly changed its tune. The ECB pledged to do as much as necessary and for as long as needed within its mandate to stabilise financial markets in the interest of monetary transmission and to deliver extra monetary accommodation to ensure favourable financing conditions, both for the private sector and the public sector (Lane, 2020).

The ECB stepped up the ongoing APP (focusing on the PSPP) and introduced a new pandemic emergency purchase programme (PEPP) also covering both public and private sector bonds of at least investment-grade (with a waiver for public securities issued by Greece), while committing to roll-over the acquired maturing assets for as long as necessary. The more flexible design and execution of the PEPP in terms of the time, asset class, and jurisdiction, took account of the substantial increase in net issuance of both public and private securities related to the Covid-19 crisis and the need to counter market fragmentation (Lane, 2022). The ECB also accepted Greek central government bonds below investment-grade as eligible collateral and grandfathered the collateral eligibility of all downgraded public and private assets that no longer satisfied the minimum credit quality requirements in its targeted longer-term refinancing operations with euro area banks.

The further monetary easing countered the upward pressure on the euro area risk-free sovereign yield curve, helped to reduce sovereign risk premia, and improved public debt sustainability for vulnerable euro area countries with lower credit ratings (Corradin et al., 2021; Alberola et al., 2022; Hondroyiannis and Papaoikonomou, 2022).

The ECB’s pandemic-related monetary interventions were accompanied by a range of European financial and fiscal support measures. EU banking supervisors released countercyclical buffers and encouraged the banking sector to use the available capital and liquidity reserves to sustain the flow of credit to the private sector. They also (re)activated sovereign privileges in banking legislation to provide temporary capital relief and to postpone the recognition of realised losses related to falling government bond prices (van Riet, 2023). This prudential filter made it easier for banks to absorb the large
amount of government bonds issued to fight the Covid-19 crisis. As a result, the close embrace between banks and their own sovereign became tighter again, now also involving households and firms, creating financial stability challenges in the event of a future economic-fiscal crisis (ECB, 2020).

Member States further agreed to activate the EU budget and their EU/EMU quasi-fiscal agencies in order to establish common safety nets for firms, workers, and sovereigns, that would not directly burden their own budgets (Guter-Sandu and Murau, 2022).

First, the EIB activated emergency funds of up to €40 billion and created a guarantee fund of €25 billion to support €200 billion of corporate financing with a focus on small and medium-sized enterprises.

Second, EU funding was made available for national short-time work schemes until end-2022, or with a later end-date if the pandemic persisted. This temporary support mechanism to mitigate unemployment risks in an emergency (SURE) could reach €100 billion in total and was financed by issuing EU debt under a special guarantee of the Member States.

Third, the ESM established a new credit line for fiscally-constrained euro area countries in the form of Pandemic Crisis Support of up to 2% of their GDP (which could add up to nearly €240 billion). These ESM loans with a maturity of up to 10 years were to be used specifically to cover the healthcare costs related to the pandemic without further conditions attached.

As the Covid-19 pandemic intensified, European leaders reached agreement in July 2020 on a temporary ‘Next Generation EU’ (NGEU) recovery plan worth €750 billion (in prices of 2018) to be financed by EU borrowing in the capital market. The total available amount was split into a maximum of €390 billion in non-repayable grants and up to €360 billion in concessional loans, channelled through EU budget programmes, in particular to the EU countries characterised by economic and political vulnerabilities (Armingeon et al., 2022).

Each Member State wishing to apply for funds from the core component of the NGEU, that is the Recovery and Resilience Facility (RRF), had to submit a recovery and resilience plan, setting out how it intended to use the requested EU loans and/or grants for
undertaking green investments, accelerating the digital transformation, and strengthening economic flexibility and social cohesion. After approval, the Member State received a pre-financing tranche; subsequent disbursements were made conditional on compliance with agreed milestones and rule-of-law requirements.

The future repayment of the EU debt securities with accrued interest, in particular the part that is used for grants, will take place over a 30-year period commencing in 2028 and is secured by an increase in the EU’s own resources and the introduction of EU taxes.

This political agreement on the NGEU demonstrated an unprecedented unity and solidarity among the Member States, which helped to counter the prevailing market uncertainties. Following the EU’s financial and fiscal policy announcements, government bond yields uniformly declined, complementing the ECB’s flexible monetary policy to contain non-fundamental volatility in government bond spreads (Corradin et al., 2021).

Coming out of the pandemic, the EU reacted to Russia’s invasion of Ukraine on 24 February 2022 with a series of economic sanctions and import restrictions on coal and oil from Russia. Russia responded with a reduction in natural gas supplies to Europe, setting the stage for an energy crisis. Moreover, the interruption of Ukrainian grain exports led to worries about global food supplies. The vigorous post-pandemic recovery of aggregate demand amid persistent supply constraints coupled with the jump in energy and food prices triggered an unexpected inflation shock.

With euro area inflation steadily rising above its target of 2% in the second half of 2021, the ECB initiated the exit from its quantitative easing in December 2021. The conditional provisions offered the ‘optionality’ to make adjustments along the way consistent with the goal to steer public and private funding conditions in uncertain times. The ECB also reserved the flexibility to change the country composition of its still ongoing asset purchases and reinvestments in order to contain government bond spreads and preserve an even monetary transmission (Lagarde, 2022). Moreover, the flexibility of the reinvestments under the PEPP could include Greek public sector bonds over and above rolling over redemptions, if necessary to avoid an interruption of purchases in the Greek secondary market.
The persistence of high euro area inflation forced the ECB to rapidly raise its key interest rates, starting in July 2022, on the path of normalising monetary policy. Market participants at that time began to worry about the adverse budgetary consequences of rising government bond yields for euro area countries with high public debt ratios. The ECB therefore also announced a new Transmission Protection Instrument (TPI), which can be activated to counter ‘unwarranted, disorderly market dynamics’ that pose a serious threat to the transmission of monetary policy across the euro area (ECB, 2022). This new tool to address volatility in national financial markets unrelated to country-specific fundamentals is targeted at secondary-market purchases of public sector securities, but may also include private sector securities. To activate the TPI, the beneficiary euro area countries should pursue sound fiscal and macroeconomic policies, follow a sustainable trajectory of public debt, and comply with the commitments in their recovery and resilience plans submitted under the RRF. These criteria appear less stringent than the rules of the OMT, which demand ESM involvement and strict observance of an economic adjustment programme.

The ECB’s pandemic collateral easing measures were gradually phased out after mid-2022, but on a temporary basis Greek central government bonds continued to be accepted as eligible collateral. The net asset purchases under the PEPP and APP were discontinued in March and June 2022, respectively. As of March 2023, the ECB also reduced the reinvestment of redemptions coming due in the APP portfolio at a measured pace determined over time in order to maintain a continuous market presence and influence over financing conditions. The principal payments from maturing securities held in the PEPP portfolio were still expected to be reinvested in full at least until the end of 2024, followed by a managed roll-off to counter risks to monetary policy transmission related to the pandemic.

Considering the coordination of fiscal policies, the European Commission noted that the high downside risks from the disturbed supply chains, the war in Ukraine, and the energy price hike, warranted the continued application of the general escape clause in 2023 – even when it could no longer be based on the existence of a severe economic downturn in the euro area or the EU as a whole. The EU Council followed the assessment of the European Commission and moved the reactivation of the normal procedures of the SGP
that was foreseen for 2023 to 2024. This gave Member States room for budgetary
manoeuvre to counter the negative economic repercussions of the war with targeted and
temporary measures while ensuring medium-term fiscal sustainability.

Calls for European solidarity to address the energy emergency (Breton and Gentiloni,
2022) were largely met with existing budgetary resources in order not to fuel inflation
with more EU debt-financed fiscal spending. EU legislators reached an agreement in late
2022 on a REPowerEU plan to save energy, accelerate the transition to clean energy,
diversify the EU’s energy supplies and phase out its dependence on Russian fossil fuels.
Member States requesting extra funding for their energy measures were asked to
incorporate the REPowerEU objectives as a new chapter in their recovery and resilience
plans under the NGEU. Financing was mobilised in particular by reallocating the
unrequested NGEU loans (€225 billion) and by raising the financial envelope for grants
(€20 billion) with frontloaded revenues from the EU emissions trading scheme and the EU
innovation fund for low-carbon technologies.

Overall, the ECB introduced new monetary policy instruments (the PEPP and the TPI)
which contain non-fundamental volatility in government bond markets to ensure that the
monetary policy stance is transmitted smoothly across all euro area countries in uncertain
times. This expression of monetary solidarity amounted to contingent public risk-sharing
through the Eurosystem balance sheet. Alongside, the NGEU programme effectively
introduced a new institutional framework grounded in contingent public risk-sharing
through the EU balance sheet, with the European Commission taking on a temporary role
as EU treasury to address common financing needs in a state of pandemic and war
(Marimon and Wicht, 2021; Jaïllet and Pfister, 2022). The enhanced European
‘architecture of (public) risk-sharing’ also supported a more even monetary transmission
and thus more uniform macroeconomic outcomes across EMU (Hauptmeier et al., 2022).

3.2. The future of a state-contingent governance of sovereign risk

The economic fall-out from the Covid-19 crisis and the war in Ukraine caused a jump in
government deficit and debt ratios, pushing them in most EU countries well over the
Maastricht Treaty’s fiscal reference values. The structural costs of higher public spending
on climate change, energy transition, digitalisation, food security, military defence, and
strategic industries, will lead to further upward budgetary pressures. A concerted fiscal
consolidation to return to the reference values could dampen euro area output growth over a long period of time. At the same time, over-indebted euro area countries remain exposed to new negative shocks which could again raise government bond spreads and destabilise the eurozone.

Looking ahead, the European authorities will likely continue with state-contingent public policies in order to address common challenges and national constraints while compressing the varieties of sovereign risk in EMU to preserve economic, financial, and monetary stability.

First, Member States are being advised to recognise that ‘[w]e are no longer in the world of Maastricht’ and to use the ongoing review of the SGP 3.0 to simplify the EU’s fiscal rules while introducing more flexibility in the numerical fiscal targets to account for the state of the economy and country-specific vulnerabilities (Martin et al., 2021).

The fiscal reference values for triggering the excessive deficit procedure are defined in a protocol annexed to the Maastricht Treaty. The EU authorities could therefore in principle also decide to raise one or both of these trigger points to better reflect the post-pandemic fiscal reality. One suggestion is to increase the reference value for government debt to 100% of GDP, i.e. about the EU average (Francová et al., 2021). Alternatively, numerical fiscal targets perceived as too stringent could be turned into qualitative fiscal standards which focus on the risk that a country might default on its public debt (Blanchard et al., 2021).

The orientations from the European Commission (2022) for a reform of the EU economic governance framework maintain the fiscal reference values, but also consider the country-specific risks to public debt sustainability. The EU’s new risk-based surveillance framework would let Member States determine their own net expenditure path based on medium-term fiscal and structural reform commitments which take account of their public debt challenges. They would in return have to accept enhanced enforcement of compliance with their own medium-term fiscal-structural plans, which are to be agreed in advance with the European Commission and approved by the EU Council. For euro area countries, the reform orientations envisage a broader range of possible sanctions (including smaller
fines, reputational costs, and suspended EU financing) in the event of non-implementa-
nion.

The Commission further proposes to introduce a new ‘country-specific escape clause’ to allow an individual Member State to temporarily deviate from its medium-term fiscal path when exceptional circumstances outside the control of the government have a major negative impact on domestic public finances. The existing general escape clause of the SGP would be kept. However, allowing Member States more time for fiscal adjustment increases the likelihood that market actors will demand higher interest rates on public debt to account for the additional sovereign risk. The Commission observes in this context that the ECB’s eligibility criteria for activating the TPI acknowledge the complementarity between a euro area country’s adherence to rule-based fiscal policy and the need for coordination to address exceptional situations.

Second, EU financial supervisors are of the opinion that EU prudential regulation needs to be amended to compel money market funds not dealing in public debt – which were short of cash in the Covid-19 crisis – to maintain public debt quota as a liquidity buffer against strong redemption pressures. The European Systemic Risk Board (ESRB, 2022) recommends that these private debt money market funds should hold a mandatory portion of their liquid assets in the form of public debt from a diversified group of (EU) issuers so as to enhance their portfolio diversification and stability. While such new liquidity requirements are grounded in prudential concerns and should make the money market fund sector more resilient to episodes of market stress, they also further broaden the ‘captive demand’ for sovereign securities labelled as safe and liquid.

Third, some academics argue that each euro area country should be able to issue safe public debt guaranteed by the ECB, unless it would run an unsustainable fiscal policy (Mathieu and Sterdyniak, 2022). They believe that the ECB should take on the task to always keep national government bond yields at levels below the nominal GDP growth rate in order to reduce the cost of public borrowing consistent with macroeconomic needs. The consequent fine-tuning of transactions in national public sector securities to administer state financing conditions on a permanent basis would override country-specific market signals about fiscal sustainability and could conflict with monetary policy requirements.
Fourth, it has been suggested to give the ESM a greater operational role in macroeconomic management using its contingent public risk-sharing tools. To this effect, the ESM could host a fiscal stabilisation fund of €250 billion based on its existing capital base to provide long-term (conditional) loans of up to 4% of GDP at a relatively low interest rate to euro area countries confronted with a large external shock but with limited fiscal space to absorb the adverse impact on the domestic economy (Misch and Rey, 2022). Yet, the tools of the ESM were not designed for macroeconomic stabilisation purposes (Jaillet and Pfister, 2022).

Fifth, NGEU was hailed as a 'state-contingent fiscal union', a fall-back option which could be used again to address new tail risks hitting Europe in the future (Lane, 2021). The fiscal solidarity expressed among the Member States might lead to a new paradigm of economic governance in the context of an exogenous crisis, assuming that the mix of national and supranational policies is effective and national reforms are successfully implemented across electoral cycles and promote convergence on EU objectives (Buti and Fabbrini, 2022).

At the political level, the trend is towards Member States exploiting the collective power vested in the EU, i.e. the EU’s capacity for collective action, to ‘harness the whole and the parts’ in the pursuit of common goals (Laffan, 2023). Following the NGEU model, the EU budget might be turned into a permanent tool of ‘pragmatic federalism’ for financing common public goods through grants and loans to Member States conditional on quality-checks of national spending (Draghi, 2022). EU leaders could also broaden the scope of the SURE instrument to provide less expensive loans to EU countries needing extra resources to mitigate the effects of rising energy costs as Europe banned energy supplies from Russia. The President of the European Commission, Von der Leyen (2022), proposed a new European Sovereignty Fund for common financing of European industrial policies like the Green Deal that complement national budgets in strategic sectors and seek to protect the Single Market as well as Europe’s competitiveness vis-à-vis the United States and China. Although the Member States are collectively responsible for EU borrowing in the capital market for providing grants to countries with limited fiscal space, some governments tend to see the new EU taxes and other own resources necessary for EU...
debt repayment as a concern for the future rather than a fiscal liability that needs to be accounted for in all national budgets.

Altogether, the rise of state-contingent European public policies appears to represent the political transition from the Maastricht Treaty fiscal framework with a focus on public risk-reduction to a ‘Next Generation EMU’ with a fiscal architecture centred around public risk-sharing to provide for common public goods, improve area-wide macroeconomic management, protect the integration of national economies, and guarantee a stable euro (Cabral, 2021; Larch et al., 2022). Although EMU started off with a strong political favour for market-oriented and rule-based fiscal discipline, Europe’s response to the many critical challenges it had to face since 2008 has tilted the balance towards more interventionist common public policies which prioritise contingent concerns over fiscal prudence.

4. Concluding remarks

At the 30st anniversary of the Maastricht Treaty, this paper reviewed the European governance mechanisms that work to limit the varieties of sovereign risk in EMU as a precondition for a stable euro. The main finding is that the stringent EU legal framework to support national fiscal discipline is steadily undermined by state-contingent common public policies which work against this objective.

First, the EU fiscal authorities fully use their discretion to deviate from enforcing EU fiscal rules and surveillance procedures contingent on exceptional and other relevant circumstances.

Second, the EU financial authorities grant the public sector a privileged access to private finance contingent on prudential considerations, i.e. they create a regulation-driven ‘captive demand’ for government bonds to maintain financial stability.

Third, the ECB shields the weaker euro area countries from market pressure by waiving minimum requirements for sovereign collateral for downgraded governments and purchasing national public debt instruments contingent on market barriers to monetary transmission.
Fourth, Member States circumvent the budgetary requirements of the SGP and the no bail-out clause of the Maastricht Treaty by entering into off-balance contingent liabilities of EU/EMU quasi-fiscal agencies.

Fifth, European leaders took recourse to large-scale EU debt issuance to finance a fiscal redistribution scheme that supports the recovery from the Covid-19 emergency and they further use this contingent public risk-sharing tool to address the high fiscal costs of the energy crisis after the Russian invasion of Ukraine.

These European state-contingent public policies to suppress the varieties of sovereign risk in EMU reflect the missing interventions of a central government issuing a safe sovereign asset for the eurozone to provide for common public goods, enhance area-wide macroeconomic management, protect the integration of national economies, and to anchor the financial and monetary system. Political proposals to make common public debt a permanent source of financing for addressing common challenges would turn EMU into a state-contingent fiscal union also requiring area-wide taxation. Taken together, this evolution marks the transition from the Maastricht Treaty fiscal framework without a central government and a focus on public risk-reduction to a ‘Next Generation EMU’ with a more complete fiscal architecture centred around public risk-sharing. The challenge in designing the future EMU architecture will be to balance the need to stabilise the eurozone with the need for fiscal discipline.
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GOVERNING THE VARIETIES OF SOVEREIGN RISK IN EMU: THE RISE OF STATE-CONTINGENT COMMON PUBLIC POLICIES

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