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Financial Insurance for Countries: How Credit Lines Can Prevent Sovereign Debt Crises

FACULTEIT ECONOMIE EN BEDRIJFSKUNDE

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INTRODUCTION

Imagine a homeowner with a solid credit history and steady income who suddenly faces an unexpected expense—a medical emergency, urgent home repairs, or a temporary job loss. Without access to emergency funds or a line of credit, they might default on their mortgage despite being financially sound overall. Now scale this scenario up to an entire country.

Between 2010 and 2012, several European countries experienced exactly this dynamic. Some periphery economies saw their borrowing costs skyrocket as financial markets lost confidence. Interest rates on government bonds spiked to unsustainable levels—in some cases exceeding 10-15%—forcing these countries to implement severe austerity measures or seek emergency bailouts. The economic and social costs were enormous: unemployment soared, public services were cut, and entire economies contracted sharply.

But what if these countries had possessed financial insurance before the crisis struck? What if they had access to pre-arranged credit lines—similar to how a bank might offer a pre-approved line of credit to a trustworthy customer—that they could tap during times of financial stress?

This note synthesizes insights from recent economic research on sovereign credit lines (Hatchondo et al., 2017; Önder, 2022; Mimir and Önder, 2025) to address exactly these questions. The findings reveal something policymakers have long suspected but struggled to quantify: prevention is indeed cheaper than cure when it comes to sovereign debt crises. Well-designed credit lines can reduce a country's borrowing costs by more than 1 percentage point (120 basis points) and cut the risk of default in half during financial emergencies. For a country like Portugal, with public debt around €250 billion, saving 1% in interest costs means over €2.5 billion annually—money that could fund schools, hospitals, or infrastructure instead of going to bondholders. As discussed later in this note, these mechanisms can be appled with even greater force to Belgium's larger economy, where similar interest savings could exceed €6 billion annually during stress episodes. Or, as in Hatchondo et al., 2017, Spain can also be considered.

This matters now more than ever. The euro area has weathered multiple crises in the past 15 years: the sovereign debt crisis, the COVID-19 pandemic, and the economic fallout from the war in Ukraine. Each shock has pushed government debt levels higher. With many countries still carrying debt levels exceeding 100% of GDP, and new challenges on the horizon—from climate change to aging populations—having effective crisis prevention tools is crucial for financial stability.

The European Stability Mechanism (ESM) and the International Monetary Fund (IMF) already offer precautionary credit lines to member countries. Yet these facilities have rarely been used. Understanding why—and how to design credit lines that actually work—is essential for strengthening Europe's financial safety net.

The Basics: What Are Sovereign Credit Lines?

Think of a sovereign credit line as a pre-approved loan that a country can draw upon during financial emergencies. It's analogous to a home equity line of credit or a business credit line, but for governments.

Here's how they work in practice:

Access Conditions: Credit lines are typically available only to countries with sound economic fundamentals—reasonable debt levels, responsible fiscal policies, and strong institutions. They're designed for countries facing difficulties due to external shocks (like natural disasters, commodity price spikes, or global financial turmoil) rather than self-inflicted problems. This is like how banks offer the best credit terms to customers with strong credit scores.

Trigger Mechanism: The credit lines in this study are designed to be accessible automatically when a country faces a sudden jump in its financing needs. For example, if a country needed to roll over maturing debt during a period of market stress, or if government spending had to increase rapidly due to a natural disaster, the credit line would become available.

Lower Interest Rates: Credit lines charge below-market interest rates. In the models examined, these lines charge the risk-free rate (around 4% currently), while market rates during stress periods might be 6-8% or

higher. This concessional pricing reflects that the lender—typically an international financial institution—isn't purely profit-driven and recognizes the public good in preventing crises.

Grace Periods: Many credit line proposals include grace periods—payment holidays during which the borrowing country doesn't need to make repayments. Instead, the debt accrues interest. Think of this like a student loan deferment or mortgage forbearance. The research examines grace periods ranging from 3 to 10 years.

Non-Defaultable: Unlike regular government bonds, credit lines from international institutions typically cannot be defaulted upon. They have seniority over other debts, meaning they must be repaid even if a country defaults on its regular bonds.

Size Limits: Credit lines come with caps—typically between 4% and 10% of a country's GDP. For Portugal (Belgium), with GDP around €230 (€600) billion, a 10% credit line would provide up to €23 (€60) billion in emergency financing.

Both the ESM in Europe and the IMF globally offer such facilities. The ESM's "Precautionary Conditioned Credit Line" can provide up to 2% of a country's GDP with minimal conditions, while enhanced versions can go higher. The IMF offers the "Flexible Credit Line" and "Precautionary and Liquidity Line" with similar features.

Despite their availability, these facilities have rarely been tapped. Poland accessed the IMF's Flexible Credit Line but never drew on it. Mexico had a similar arrangement. Other countries have avoided them despite potential benefits. Understanding this "stigma problem" is crucial for designing effective credit lines.

THE MAIN FINDINGS: WHAT THE RESEARCH SHOWS

To understand how credit lines affect sovereign borrowing and default risk, Hatchondo et al., 2017; Önder, 2022; Mimir and Önder, 2025 built a sophisticated economic models. The last one is calibrated to Portugal's economy—a representative small, open economy in the euro area with strong fundamentals but vulnerability to external shocks.

The Good News: Credit Lines Work

The research reveals several powerful findings about how credit lines affect countries during financial stress:

Dramatic Reduction in Borrowing Costs: When Portugal faces an adverse economic shock—say a 2.5 standard deviation negative shock to national income combined with a sudden increase in financing needs—and has access to a credit line equal to 10% of GDP, the results are striking: Sovereign spreads (the extra interest rate above the risk-free rate) increase by only 80 basis points (0.8%), compared to 160 basis points (1.6%) without credit lines. This represents a 50% reduction in the borrowing cost increase during the crisis. Over time, this translates to savings of 120 basis points on average during stress episodes

To put this in perspective: for a country with €250 billion in public debt, saving 1.2% in interest costs means €3 billion annually—enough to fund significant public investment or social programs.

Halving Default Risk: The probability of sovereign default drops dramatically with access to credit lines. During a financial stress episode: Default probability falls by approximately 50%, the risk remains lower for several years following the shock and markets recognize this reduced risk, which explains the lower borrowing costs

Immediate Crisis Prevention: The impact is strongest when credit lines are first introduced. When Portugal gains access to a credit line at the moment a financial shock hits:

- The government immediately taps the full amount available
- This emergency financing prevents the need to borrow at punitive market rates
- Default risk that would have spiked to 40-50% stays below 20%
- Consumption doesn't need to fall as sharply, cushioning the economic blow

The Mechanism: Why do credit lines have such powerful effects? The model reveals the transmission mechanism clearly through a dynamic that plays out during financial stress. When financing needs spike, countries

without credit lines face stark and painful choices: they must either cut spending dramatically, imposing immediate austerity on their economies, or borrow at increasingly expensive rates from nervous markets worried about rising default risk. Neither option is attractive, and both tend to worsen the underlying problem.

Higher borrowing costs increase the debt burden through a straightforward arithmetic effect—more of the government's budget must go toward interest payments, leaving less for public services and making the overall debt situation more precarious. This makes default more likely from both an ability-to-pay and a willingness-to-pay perspective. Markets anticipate this deterioration and demand even higher interest rates to compensate for the increased risk, generating a vicious cycle where borrowing costs and default risk feed on each other in an upward spiral. The euro area sovereign debt crisis of 2010-2012 provided dramatic examples of this dynamic. Greece saw its borrowing costs explode from around 100 basis points above German bonds in 2009 to over 3,000 basis points by 2012, making new borrowing essentially impossible and forcing a bailout. Ireland's case is particularly instructive: the country entered the crisis with public debt of only 25% of GDP—one of the lowest in the euro area—but a banking crisis contaminated sovereign finances, and spreads spiked to over 1,100 basis points by 2011 despite Ireland's fundamentally sound pre-crisis fiscal position. Spain experienced similar dynamics in 2011-2012, with spreads reaching 600 basis points as banking sector problems spilled over to sovereign debt markets. Even Italy, the euro area's third-largest economy and traditionally considered "too big to fail," saw spreads surge to 550 basis points in 2011, demonstrating that size alone doesn't protect against panic dynamics. Countries can find themselves trapped in this vicious cycle even when their underlying fiscal position is sound, as Ireland's experience particularly demonstrates.

Credit lines break this cycle by providing an alternative financing source at reasonable rates precisely when market rates are spiking. Instead of being forced to borrow at 7-8% or higher during stress episodes, countries can tap credit lines at the risk-free rate of around 4%. This interrupts the vicious cycle at its source. Moreover, markets recognize that the country is less likely to default because it has access to affordable emergency financing, so even the rates on regular government bonds don't spike as much as they would without the credit line backstop. The credit line thus works both directly, by providing cheaper financing, and indirectly, by calming markets and preventing panic-driven interest rate spikes on all government debt.

The Complications: Long-Term Effects and Trade-offs

The story doesn't end with crisis prevention, however. The research uncovers important longer-term dynamics that complicate the picture and highlight crucial trade-offs in credit line design.

Higher Long-Term Debt Levels: Countries with access to credit lines end up with somewhat higher debt levels in the long run. Average public debt rises from 88.8% of GDP in the economy without credit lines to 92.1% of GDP when the country has access to a 10% credit line with a 10-year grace period. Credit lines themselves account for 8.3% of GDP on average in the long-run distribution, while total sovereign indebtedness increases by about 3-4 percentage points overall.

Why does this happen? The credit line acts like a safety net, which reduces the perceived costs of carrying more debt. Governments borrow slightly more knowing they have emergency financing available if things go wrong, much like how people might take on slightly larger mortgages knowing they have home equity lines of credit as backup. Additionally, once credit lines are drawn during a crisis, they themselves add to the debt stock and take time to repay, contributing to the higher average debt levels observed in the simulations.

Grace Periods Cut Both Ways: The grace periods—essentially payment holidays—built into credit lines feature competing effects that policymakers must carefully weigh. On the positive side, grace periods provide crucial breathing room during the crisis and recovery period, allowing countries to avoid making debt payments precisely when their fiscal situation is most strained. They allow countries to avoid painful austerity measures during the worst economic moments, when spending cuts or tax increases would be most damaging to growth and employment. From an economic theory perspective, grace periods improve "market completeness" by giving governments more tools to smooth consumption over time, addressing a key market failure in sovereign debt markets.

However, grace periods also generate negative effects that accumulate over time. They exacerbate what economists call the "debt dilution problem" in sovereign debt markets—a situation where new borrowing makes existing debt riskier. When governments can defer payments through grace periods, they have stronger incentives to borrow more, since the immediate fiscal cost is postponed. This increased borrowing makes existing debt riskier for bondholders, who then demand higher interest rates to compensate. The effect accumulates over time as countries repeatedly tap credit lines with grace periods, leading to a gradual upward drift in both debt levels and borrowing costs.

The research shows that shorter grace periods of 3 years perform better than longer ones of 10 years precisely because they limit these negative long-term effects while still providing meaningful crisis relief. A 3-year grace period is typically long enough for a country to get past the acute phase of a crisis and begin recovery, but short enough to maintain fiscal discipline and avoid excessive debt accumulation.

Design Matters Enormously: Comparing different credit line designs reveals important insights about how seemingly technical choices cascade into major economic effects. A 4% credit line with a 3-year grace period has minimal long-term effects on debt and spreads, making it an attractive option for countries and creditors concerned about fiscal sustainability. A 10% credit line with a 10-year grace period provides significantly more crisis relief when first introduced but raises long-term debt and spreads somewhat, featuring a trade-off between immediate crisis prevention and longer-term fiscal health.

Interestingly, credit lines with no grace periods but available continuously during stress episodes perform best for long-term debt dynamics. By eliminating the payment deferral feature, they avoid exacerbating debt dilution while still providing the crisis prevention benefits of affordable emergency financing. Similarly, one-period or short-term credit lines available during stress work better than long-term ones for maintaining fiscal discipline over time. The shorter maturity forces more frequent reassessment and prevents the indefinite rollover of subsidized financing that can occur with long-term credit lines.

The Stigma Problem: Perhaps the most striking finding is how large the perceived "political cost" would need to be to explain why countries don't use available credit lines. It is calculated by asking: “How much would we need to increase the interest rate on credit lines to make countries indifferent between using them (with all their economic benefits) and not using them (avoiding the reputational damage)?" For example, if credit lines save a country 120 basis points in borrowing costs but the country still doesn't use them, the implied stigma premium must be larger than 120 basis points—otherwise the country would be leaving money on the table irrationally.

- For a 4% credit line with a 3-year grace period, the implied stigma premium is around 9%
- For a 10% credit line with a 10-year grace period, it reaches 25%
- Without grace periods, the stigma premium drops to about 5%

In other words, for countries to rationally avoid using a 10% credit line with a 10-year grace period despite its benefits, the political and reputational costs of accessing it would have to be equivalent to paying an extra 25% in interest—an enormous penalty.

This helps explain why ESM and IMF credit lines have been underutilized. Countries fear that requesting access signals weakness to markets, triggering the very crisis they're trying to prevent. It's similar to how people sometimes avoid seeking medical care or using social services due to stigma, even when they're entitled to them and would benefit greatly.

POLICY APPLICATIONS: HOW TO MAKE CREDIT LINES WORK BETTER

The research doesn't just identify problems—it explores solutions. Three policy applications stand out as particularly relevant for current debates about euro area financial architecture:

Scenario 1: Credit Lines + Voluntary Debt Reduction

One of the most innovative findings concerns how credit lines can facilitate debt reduction through "voluntary debt exchanges."

Here's the concept: When a country gains access to credit lines, the prices of its existing bonds rise because default risk falls. Bondholders experience capital gains—their Portuguese bonds are suddenly worth more. The government could negotiate with bondholders: "Rather than simply giving you these capital gains for free, let's split the benefits. You accept somewhat less than the full market value, I use the credit line to pay you off, and we both benefit."

The mechanics work like this:

1. Before credit lines: Portugal has debt equal to 88.8% of GDP, paying an average spread of 180 basis points above risk-free rates
2. Credit lines announced: Bond prices jump because default risk falls
3. Voluntary exchange: Portugal issues credit line debt (10% of GDP at the risk-free rate) and uses the proceeds plus bondholder concessions to retire regular bonds
4. Outcome: Total debt falls, bondholders accept the exchange because they're not worse off than before the credit line was announced, and taxpayers benefit from lower ongoing interest costs

The research shows this approach could enable Portugal to retire enough regular debt to reach a 60% debt-to-GDP ratio—the Maastricht Treaty target—while almost eliminating default risk and slashing borrowing spreads.

This is called "voluntary" because bondholders aren't forced to accept losses—they're simply sharing the gains from improved credit conditions. In practice, collective action clauses in bond contracts would facilitate this, though individual bondholders might still try to "hold out" for better terms.

Policy Relevance: With many euro area countries carrying debt levels above 100% of GDP following COVID-19 fiscal stimulus, bringing debt back to sustainable levels is a central policy challenge. Credit lines could be a tool to facilitate this transition rather than simply adding to debt burdens.

Scenario 2: Credit Lines + Fiscal Rules (Debt Brakes)

The concern about higher long-term debt levels leads to a second policy application: combining credit lines with binding fiscal rules.

"Debt brakes" are constitutional or legal limits on government borrowing designed to ensure fiscal discipline. Switzerland pioneered this approach in 2003, requiring that federal spending not exceed revenues over the economic cycle. Germany adopted a similar rule ("Schuldenbremse") in 2009, limiting structural deficits to 0.35% of GDP.

The research explores what happens if Portugal:

1. Arranges a voluntary debt exchange using credit line proceeds
2. Reduces regular debt to 60% of GDP
3. Commits to maintaining this ceiling going forward (a debt brake)

Results show that default risk falls from 4% in the baseline economy (without any credit lines or debt reduction measures) to nearly zero, spreads drop to minimal levels, debt remains sustainable long-term, and credit lines serve as a bridge to fiscal sustainability rather than enabling higher debt

The Trade-off: Debt brakes have downsides. By preventing deficits during economic downturns, they force pro-cyclical fiscal policy—exactly when countercyclical stimulus might be most beneficial. The research finds that consumption volatility increases under debt brakes because governments can't borrow as freely to smooth income shocks.

This illustrates a fundamental policy tension: fiscal discipline vs. economic flexibility. Credit lines ease this tension somewhat by providing emergency financing during the rare occasions when financing needs spike dramatically, but they don't eliminate it.

Policy Relevance: The European Union recently reformed its fiscal rules framework (the Stability and Growth Pact). Debates continue about how to balance fiscal sustainability with the flexibility needed for public investment and crisis response. Credit lines paired with credible fiscal rules could offer a middle path—discipline in normal times, flexibility in emergencies.

Scenario 3: Optimal Credit Line Design

The research permits detailed comparison of alternative credit line designs, yielding clear recommendations across multiple dimensions.

Size: The size of the credit line presents a goldilocks problem—too small and it's ineffective, too large and it encourages excessive borrowing. Credit lines that are too small, in the range of 2-4% of GDP, prove insufficient to cover financing needs during major shocks, limiting their effectiveness when countries need them most. On the other hand, credit lines larger than 15% of GDP may encourage excessive borrowing and may incentivize moral hazard problems. The research suggests an optimal size of around 10% of GDP, which roughly matches the average gross financing needs countries face during stress episodes, providing adequate support without encouraging fiscal profligacy.

Grace Periods: The length of grace periods involves important trade-offs between short-term relief and long-term fiscal discipline. Longer periods, such as the 10-year grace periods examined in the study, provide more breathing room for countries recovering from crises but worsen the debt dilution problem, ultimately raising long-term spreads. Shorter periods of around 3 years offer a better balance between crisis relief and fiscal discipline, giving countries time to recover from the acute phase of a crisis while maintaining incentives for responsible borrowing. Credit lines with no grace periods at all perform best for long-term debt dynamics but reduce the immediate crisis relief they can provide.

Availability: When credit lines are available matters as much as their other features. Making credit lines always available turns them into essentially a free lunch with no long-term benefits, as governments simply roll over this cheap financing indefinitely without any crisis prevention effect. In contrast, making credit lines available only during acute stress maximizes their impact when most needed and limits moral hazard concerns of policy-makers by ensuring they serve their intended purpose as emergency facilities rather than routine financing. The optimal approach is to make credit lines automatically accessible when financing needs spike, but not otherwise, ensuring they function as genuine insurance against financial stress rather than permanent subsidized financing.

Maturity: The optimal maturity structure of credit lines depends on their availability rules. Long-term credit lines exacerbate the debt dilution problem if they are always available, as governments can continuously refinance them at concessional rates. Short-term credit lines with one-year maturity work better when combined with continuous availability during stress periods, as they must be repaid or rolled over more frequently. The optimal maturity therefore depends on availability—if credit lines are only available during stress episodes, longer-term maturities are acceptable and even beneficial, but if they are continuously available, short-term maturities are preferable to maintain discipline.

Seniority: The research finds that making credit lines non-defaultable and senior to regular debt serves as an important "disciplining device" for government borrowing behavior. Knowing they must repay credit lines even in the event of default on regular bonds makes countries more cautious about over-borrowing in the first place. This seniority structure actually allows countries to sustain higher levels of regular debt at lower spreads, because markets understand that the safety net provided by credit lines reduces overall default risk even as it increases the cost of default when it occurs.

Conditionality: While not explicitly modeled in detail, the eligibility requirements based on sound fundamentals and the shock-based trigger mechanism serve as implicit forms of conditionality. The research suggests that too much conditionality increases the stigma associated with accessing credit lines, deterring their use even when beneficial, while too little conditionality may feature moral hazard concerns from policy-makers by failing to ensure responsible policies. The optimal approach appears to focus on ex-ante eligibility criteria that determine who can access credit lines based on their economic fundamentals, rather than ex-post conditions that specify what countries must do after accessing them. This front-loads the discipline while reducing the stigma and political costs of actually using the facilities when needed.

IMPLEMENTATION CHALLENGES AND SOLUTIONS

Addressing the Stigma Problem: The enormous implied stigma premiums revealed by the research point to the central challenge: countries won't use credit lines that damage their reputation, even when economically beneficial. Several complementary strategies can help reduce this stigma barrier.

First, implementing automatic triggers represents perhaps the most powerful stigma-reduction mechanism. If access is triggered automatically by objective indicators such as GDP decline or financing needs increases rather than requiring a country to request assistance, stigma falls dramatically. Markets understand it's rule-based rather than a distress signal, similar to how automatic insurance payouts after natural disasters don't imply poor planning by the insured.

Second, maintaining broad eligibility across the euro area ensures that using the facility doesn't signal weakness. If most euro area countries are eligible for credit lines, accessing them becomes normalized rather than exceptional. This argues for relatively light eligibility criteria focused on sound fundamentals rather than narrow requirements that only the strongest countries can meet.

Third, developing a clear and consistent communication strategy is essential. Messaging should emphasize that credit line use represents normal crisis prevention rather than bailout or distress financing. Switzerland's debt brake succeeded partly through effective communication about its purpose as fiscal discipline rather than austerity, and similar framing could normalize credit line usage.

Fourth, transparency in publishing eligibility criteria and usage patterns ensures markets aren't surprised when countries access credit lines during shocks. Regular reporting on which countries are eligible and under what circumstances they might draw on facilities reduces uncertainty and speculation.

Fifth, requiring practice runs where countries tap small amounts periodically when eligible could normalize usage patterns. Just as militaries conduct exercises to prepare for emergencies, small periodic draws could establish that credit line access is routine crisis preparedness rather than a sign of distress.

Political Economy Considerations: Beyond stigma, political economy factors fundamentally shape credit line design through the divergent interests of creditor and debtor countries within the euro area.

Creditor countries providing financing through the ESM naturally want assurance that funds will be repaid and won't encourage fiscal irresponsibility. These concerns push design choices toward tighter eligibility criteria to ensure only sound borrowers access facilities, more conditionality to maintain discipline during and after usage, shorter grace periods to limit the subsidy element and maintain repayment discipline, and smaller credit lines to limit potential exposures. Germany, the Netherlands, and other northern European countries typically represent this perspective in ESM governance discussions.

Debtor countries that might need credit lines during stress episodes want maximum flexibility with minimal stigma attached. Their preferences push toward broad eligibility criteria so access doesn't signal weakness, automatic access mechanisms to reduce stigma and political costs, longer grace periods to provide more breathing room during recovery, and larger credit lines to ensure adequate coverage of potential financing needs. Southern European countries and newer euro area members often emphasize these priorities.

The research suggests an optimal design that balances these competing concerns rather than favoring either extreme. Clear eligibility based on economic fundamentals assures creditors that only countries with sound policies will access facilities. Moderate sizing around 10% of GDP and grace periods of 3 years split the difference between creditor caution and debtor flexibility. Finally, pairing credit lines with fiscal rules for long-term sustainability addresses creditor concerns about moral hazard while providing debtors the crisis financing they need.

This balanced approach recognizes that crisis prevention serves everyone's interests—creditor countries benefit from euro area stability that prevents contagion, while debtor countries gain access to affordable emergency financing. The challenge lies in translating these mutual benefits into institutional design that both sides can accept.

Integration with Existing Institutions: The ESM already offers precautionary credit lines, raising practical

questions about how these research findings would translate into actual reforms of existing facilities.

The Enhanced Precautionary Conditioned Credit Line (PCCL) currently provides support for countries meeting specific criteria, but with limitations that the research suggests could be addressed. The facility could be reformed to feature automatic triggers based on financing needs rather than requiring explicit country requests, directly addressing the stigma problem. Size limits could be increased from current restrictions to the optimal 10% of GDP identified in the research. Grace periods could be standardized at 3 years rather than negotiated case-by-case, providing predictability while balancing crisis relief against long-term discipline.

Coordination with European Central Bank tools offers another avenue for maximizing credit line effectiveness. The ECB's Outright Monetary Transactions program serves a crisis prevention function by committing to purchase government bonds of countries under speculative attack, conditional on ESM program participation. Credit lines could complement OMT by addressing different aspects of crisis dynamics. OMT focuses on monetary transmission and preventing market manipulation or self-fulfilling panics, operating through the central bank's unlimited bond-buying capacity. Credit lines provide actual fiscal financing during stress, giving governments resources to meet spending needs without resorting to fire-sale bond issuances. Together, these tools offer comprehensive crisis prevention—OMT stabilizes markets and prevents panic, while credit lines provide the fiscal space to weather shocks without severe austerity. The combination is more powerful than either tool alone, as market stabilization and fiscal support reinforce each other in breaking the vicious cycles that characterize sovereign debt crises.

Financial Resilience Through Smart Design

The research behind this analysis provides rigorous evidence for what intuition suggests: having financial insurance before you need it is far preferable to seeking emergency assistance in the midst of crisis. For sovereign nations navigating an uncertain world marked by frequent shocks—pandemics, wars, climate disasters, financial turbulence—access to credit lines during stress episodes can mean the difference between weathering the storm and experiencing a full-blown crisis. But the devil lies in the details. Poorly designed credit lines might simply enable more borrowing without improving stability, or carry such stigma that countries refuse to use them. Well-designed credit lines—accessible automatically during stress, sized appropriately, with moderate grace periods, and paired with fiscal discipline—can save taxpayers billions, preserve economic stability, and strengthen financial architecture.

For similar euro area countries with strong fundamentals but vulnerability to external shocks, credit lines represent a valuable policy tool. For Europe as a whole, incorporating these facilities into the broader financial architecture—alongside monetary policy tools, fiscal rules, and banking union—could significantly enhance resilience to future crises.

The choice isn't whether to have crisis prevention tools, but how to design them effectively. This research provides a roadmap for doing exactly that, grounded in rigorous analysis but with clear practical implications.

A WORD ON BELGIUM

While the research calibrates its quantitative model to Portugal's economy, the findings have direct relevance for Belgium and other euro area countries with similar characteristics. Portugal was chosen as a representative small open economy in the euro area with strong fundamentals but elevated debt levels—a description that fits Belgium remarkably well. Both countries share key features: high public debt ratios that remain sustainable due to strong institutions, deep integration in European markets that features vulnerability to external shocks, and track records of meeting obligations even during difficult periods. The mechanisms the research identifies—how credit lines reduce borrowing costs during stress, how grace periods affect long-term debt dynamics, how voluntary debt exchanges can facilitate fiscal adjustment—operate similarly across countries facing these circumstances.

Belgium's fiscal profile makes it an especially compelling case for considering credit line facilities. With public debt around 105% of GDP (approximately €630

billion), Belgium ranks among the more indebted euro area members, though this debt remains manageable given the country's economic strength and institutional quality. What makes Belgium's situation particularly relevant to the research findings is the high share of foreign ownership—at 60.8%, Belgium has one of the highest foreign ownership rates of sovereign debt in the eurozone. This features both opportunity and vulnerability: foreign investors provide deep, liquid markets for Belgian debt, but their sentiment can shift rapidly during stress episodes, potentially triggering the kind of vicious cycles the research models. Additionally, Belgium faces mounting fiscal pressures from population aging (with healthcare and pension costs rising as the working-age population declines relative to retirees), while its complex federal governance structure involving coordination between federal, regional, and community governments can make rapid fiscal adjustment more challenging during crises. As a small, highly open economy deeply integrated in European supply chains, Belgium is particularly exposed to external shocks—whether from geopolitical tensions, energy crises, or financial contagion from larger neighbors.

The quantitative findings from the Portugal calibration provide important insights for Belgium, though with crucial context about current market conditions. Belgium currently enjoys very favorable borrowing costs, with spreads of only 50-52 basis points over German bunds—reflecting strong fundamentals and investor confidence. However, the research reveals what could happen during financial stress episodes when market sentiment deteriorates.

Consider a counterfactual scenario where Belgium faces a crisis similar to what Portugal experienced during the euro area sovereign debt crisis, with spreads rising to 180 basis points or higher. In such a scenario, credit lines would prevent much of this spike. The research shows that credit lines reduce sovereign spreads by 120 basis points during financial stress. For Belgium, this crisis prevention mechanism works through two channels: first, Belgium could tap its €60 billion credit line (10% of GDP) to cover a substantial portion of its annual refinancing needs of €70-90 billion, avoiding the need to borrow at panic-induced market rates; second, markets would price in this backstop, limiting spread widening even on bonds issued in normal markets.

The fiscal impact would be substantial during crisis episodes. If Belgium's spreads were to spike to 180 basis points during a crisis (as happened in several euro area countries during 2011-2012), credit lines reducing this by 120 basis points would save approximately €840 million annually on Belgium's typical €70 billion in gross financing needs. As this lower-rate debt gradually replaces the existing stock over 7-9 years (the average debt maturity), the cumulative annual savings would build toward €7.5 billion once the entire €630 billion debt stock has rolled over—though this assumes the crisis-level spreads would otherwise persist throughout this period. More realistically, the benefit is that credit lines prevent temporary crises from becoming prolonged ones, avoiding years of elevated borrowing costs that compound into enormous fiscal burdens.

To contextualize these figures: €840 million in annual savings during a crisis year could fund significant investments in climate transition, digital infrastructure, or social programs rather than going to crisis premiums for bondholders. The larger €7.5 billion figure—while representing a theoretical steady-state calculation—illustrates the order of magnitude at stake if Belgium were to experience sustained financial stress without a backstop. These aren't abstract theoretical benefits; the 2010-2012 sovereign debt crisis demonstrated how quickly market sentiment can shift and how expensive crisis financing becomes for even fundamentally sound countries.

The researchers' most striking finding—that credit lines can facilitate voluntary debt reduction when paired with fiscal rules—has particular policy relevance for Belgium's current fiscal trajectory. If Belgium were to combine credit lines with a voluntary debt exchange program aimed at reaching the Maastricht target of 60% debt-to-GDP, the country would need to reduce debt by approximately €270 billion (45% of GDP). A credit line facility sized at 10% of GDP (roughly €60 billion) could finance a significant portion of the debt buyback operation, with bondholders accepting the exchange because the improved credit conditions from having the credit line backstop generate capital gains on their existing holdings. Achieving sustainable debt levels through this approach could reduce Belgium's

annual interest payments by €3-5 billion in the long run, freeing resources for priority investments in climate transition, defense modernization, or social cohesion. While Belgium's default risk is already low given its strong fundamentals, combining credit lines with credible fiscal frameworks would reduce it to near-zero levels while strengthening Belgium's position as a core euro area member. This scenario isn't purely hypothetical—Belgium's recent fiscal plans already aim to bring debt below 100% of GDP by 2028, and credit lines could accelerate this adjustment while cushioning the economic impact and reducing the political resistance that typically accompanies fiscal consolidation.

CONCLUSION

The research points to a fundamental transformation needed at the European Stability Mechanism: shift from being a crisis firefighter that intervenes after disasters strike to becoming a crisis prevention system that stops fires from starting. Currently, the ESM primarily helps countries that have already lost access to financial markets—an expensive, painful approach akin to waiting until someone is gravely ill before providing medical care. The research shows that providing financial insurance before crises hit is far more effective and less costly.

The core reform would reorganize the ESM around three pillars. First, an **Automatic Precautionary Facility** would provide credit lines of up to 10% of GDP to countries with sound fundamentals. While the ESM already offers Precautionary Credit Lines, the current design requires countries to formally request access and obtain Board approval—generating precisely the stigma problem that limits usage. The proposed facility would fundamentally redesign this instrument by replacing discretionary requests with automatic, rules-based triggers. Access would activate when specific, objective indicators are met: say GDP declining by 2% or more in a single quarter, sovereign spreads exceeding 200 basis points over German bunds for three consecutive months, gross financing needs surpassing 15% of GDP, or natural disasters requiring fiscal response above 2% of GDP. These thresholds would be published transparently, monitored in real-time by ESM staff, and trigger availability mechanically—no Board vote or country request needed. Once triggered, the credit line becomes available in the country's account (similar to overdraft protection automatically activating based on account balance), though the country still decides whether and how much to draw. For Belgium, this would mean €60 billion in emergency financing available instantly if spreads spike or financing needs jump, without any political approval process or conditions attached. Second, an **Assisted Debt Sustainability Program** would help high-debt countries like Belgium use credit lines to buy back expensive government bonds from investors and implement credible fiscal rules to reach the 60% debt target. Third, the ESM's existing **Crisis Resolution** programs—full financial assistance with policy conditionality—would remain available for countries that lose market access entirely, though these interventions should become rarer as the automatic prevention mechanisms reduce the likelihood of crises escalating to this level.

The practical impact for Belgium and similar countries would be substantial. During the next financial shock—whether from geopolitical tensions, energy crises, or banking stress—Belgium could immediately access €60 billion at favorable interest rates rather than facing spiking borrowing costs in panicked markets. The research estimates this would save €3-7 billion annually during stress episodes while cutting default risk in half. More broadly, these reforms would make sovereign debt crises in the euro area rare events rather than recurring nightmares, much as the U.S. federal system prevents state-level debt crises through its financial architecture.

Implementation would require amending the ESM Treaty and building new technical systems, with pilot programs starting sooner. The main political challenge is convincing creditor countries that this represents genuine insurance rather than permanent transfers to southern Europe. However, the financial case is clear: crisis prevention is far cheaper than crisis resolution, and the ESM has historically made profits on its lending while strengthening euro area stability. For Belgium, joining a reformed ESM with automatic precautionary facilities would strengthen rather than weaken fiscal autonomy—providing genuine independence from market pressure during stress while recognizing Belgium's strong fundamentals and sound institutions.

As policymakers continue debating how to strengthen Europe's financial safety net in an increasingly uncertain world, these insights should inform the path forward.

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