

ESM Working Paper: A Comprehensive Scorecard for Assessing Sovereign Vulnerabilities

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This paper presents a new framework for the early identification of sovereign vulnerabilities, based on a wide set of economic and financial indicators

Authors: Rudolf Alvisé Lennkh, [Edmund Moshhammer](#) (European Stability Mechanism) and Vilém Valenta (European Stability Mechanism)



Abstract:

This paper aims to contribute to the ESM's capacity to monitor sovereign vulnerabilities in the EFSF/ESM programme countries. The purpose is to early identify a build-up of sovereign vulnerabilities, which may threaten countries' repayment capacity. The assessment is based on a wide set of indicators comprising (i) government borrowing needs, conditions and debt structure, (ii) economic strength, (iii) fiscal position, (iv) financial sector and other contingent liabilities, (v) institutional parameters, and (vi) private sector leverage, credit flows and real estate developments. We apply a scoring system based on thresholds from the literature, where available, or derived from the historical distribution of a pool of OECD and EU countries. The aggregation scheme for an overall vulnerability score is informed by the available literature, correlation and principal component analyses, as well as expert judgement. The results of the framework as such are, however, free of judgement. We complement the numerical results with a system of traffic lights that allows assigning individual countries one of four broad categories reflecting degrees of their vulnerabilities.

The framework can be used for a real-time vulnerability assessment, for an analysis of the evolution over time, as well as for an identification of areas where policy action may be needed. Back-tests for the countries that eventually requested EFSF/ESM financial assistance show that, with the benefit of hindsight, the tool would have identified the build-up of vulnerabilities well ahead of the onset of the crisis. The assessment, summarised in the form of a heat map and a scorecard, can be regularly updated.

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Contacts



[Cédric Crelo](#)

Head of Communications and Chief Spokesperson

+352 260 962 205

c.crelo@esm.europa.eu



[Anabela Reis](#)

Deputy Head of Communications and Deputy Chief Spokesperson

+352 260 962 551

a.reis@esm.europa.eu



[Juliana Dahl](#)

Principal Speechwriter and Principal Spokesperson

+352 260 962 654

j.dahl@esm.europa.eu