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The effects of fiscal opacity on sovereign credit spreads[☆]



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ABSTRACT

Using the Open Budget Index of 45 advanced and emerging countries and their sovereign credit default swap (CDS) spreads, we find evidence that the sovereign credit market differentiates countries with higher fiscal opacity than others, by way of an opacity premium. We further show that the premium is levied on the entire credit spread term structure but not uniformly over the range of the opacity measure and across countries. While we identify market disciplinary effects on fiscal opacity, it does not replace the need for efforts to set global standards and promote compliance.

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1. Introduction

It is well understood that dissemination of quality fiscal information coupled with sound fiscal management by governments promotes confidence in capital markets, thereby reducing the risk of economic distress. However, some governments elect to be more opaque than others in revealing their fiscal positions, particularly the two headline numbers – deficit and debt. Although fiscal opacity has largely been a concern for emerging countries, the recent sovereign debt crisis exposed the vulnerability of opaque government balance sheets to external shocks and demonstrated wide-spreading economic consequences for advanced countries.¹ To tackle the lack of accountability and effective scrutiny of government level accounting and reporting, the IMF has begun its work on the new Fiscal Transparency Code to be released in 2015.

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¹ For example, the Greek government filed several deficit revisions to Eurostat in 2009. According to [European Commission \(2010\)](#), “These most recent revisions are an illustration of the lack of quality of the Greek fiscal statistics”.

In this paper, we investigate a complementary and cost effective way of imposing accountability on governments for their financial decisions – financial market disciplinary effects. Specifically, we investigate whether the sovereign credit market differentiates countries with higher fiscal opacity, by way of imposing an opacity premium. Why should the capital market distinguish countries with high or low fiscal opacity? Economic theory suggests a positive relationship between opacity and the cost of capital, as i) investors are reluctant to hold securities due to the risk of adverse selection (Diamond and Verrecchia, 1991); and ii) due to the non-diversifiable risk of uncertainty (Barry and Brown, 1985). Our first objective is to re-examine the hypothesis that countries with higher fiscal opacity experience a higher borrowing cost through wider credit spreads, through the use of contemporaneous data for a large sample of developed and emerging countries.

Duffie and Lando (2001) proposed a credit risk pricing model that accounts for incomplete financial reporting by firms. The model predicts a sigmoid-shaped relationship between credit spreads and the degree of opacity, which is intuitive as investors may be oblivious to small degrees of opacity, and as the market becomes conscious of a large increase in opacity, it seeks compensation for holding risky securities. At a high level of opacity, the market may become oblivious to marginal increments. Our second objective is to investigate a possible non-linear effect of fiscal opacity on sovereign credit spreads.

The Duffie and Lando (2001) model also predicts that opacity has the largest impact on short-term debt, and the effect diminishes as maturity lengthens. This is because in the far future, economic fundamentals are equally uncertain under a transparent environment as under an opaque environment. The arrival of information overtime reduces uncertainty in fundamentals, increasing the relative impact of opacity. Yu (2005) empirically tested the theory using corporate data and confirmed the term structure effect. Our third objective is to investigate this theory in the sovereign space. If the theory holds on government credit spreads, then the incentive for fiscal transparency would be relatively stronger for countries that borrow short-term. Our result would have fiscal policy implications for countries that have relied on short-term financing since the sovereign debt crisis.

There are just a handful of studies that examine the financial cost of government opacity. Examples include Arbatli and Escolano (2012), who show that fiscal transparency is associated with better credit ratings, Bernoth and Wolff (2008) find that creative accounting activities in the European Union increased the euro area government risk premia, and Glennerster and Shin (2008) show that countries that adopted the IMF's fiscal transparency reforms since 1998 had later experienced lower sovereign bond spreads.

Our study benefits from the availability of a direct measure of fiscal opacity – the Open Budget Index, which covers a wide basket of countries from 2006 to 2012. Unlike previous studies, this rich dataset allows us to conduct our analysis on emerging and advanced countries separately. This is an interesting comparison to make as the governments of both types of countries were criticized for fiscal opacity and mismanagement, but at different times. Earlier studies also do not test for credit spread impacts across different levels of opacity at different maturities. In terms of impact measurement, we benefit from a growth in the trading of sovereign credit default swaps (CDS), which circumvent issues relating to tax, optionality, shortening maturity and the appropriate benchmark rate (Houweling and Vorst, 2005). Recent evidence shows that during episodes of market stress, sovereign CDS spreads dominate sovereign bonds in the price discovery process (Delatte et al., 2012).

Consistent with our conjectures, our analysis reveals a positive and nonlinear relationship between fiscal opacity and sovereign credit spreads. Additionally, analysis of the term structure indicates an opacity premium across all maturities on the credit curve. By splitting the sample into advanced and emerging countries, we observe stronger nonlinear and term structure effects on advanced countries. This can be explained by the level of attention some of the advanced countries have been exposed to in recent periods.

2. Variable selection

2.1. Fiscal opacity

To empirically analyze the extent to which the sovereign credit market differentiates various levels of fiscal opacity, we need to first understand what fiscal opacity entails and ways it can be measured. A widely accepted definition of the closely related concept of fiscal transparency given by Kopits and Craig (1998) is

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