



Contents lists available at ScienceDirect

Emerging Markets Review

journal homepage: www.elsevier.com/locate/emr



Bond yields in emerging economies: It matters what state you are in[☆]



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ARTICLE INFO

Article history:

Received 26 August 2013

Received in revised form 5 September 2013

Accepted 23 September 2013

Available online 29 September 2013

JEL classification:

E44

E62

G15

H63

O16

Keywords:

Bond markets

Emerging market economies

Fiscal deficit

Public debt

ABSTRACT

While many studies have looked into the determinants of yields on externally issued sovereign bonds of emerging economies, analysis of domestically issued bonds has hitherto been limited, despite their growing relevance. This paper finds that the extent to which fiscal variables affect domestic bond yields in emerging economies depends on the level of global risk aversion. During tranquil times in global markets, fiscal variables do not seem to be a significant determinant of domestic bond yields in emerging economies. However, when market participants are on edge, they pay more attention to country-specific fiscal fundamentals, revealing greater alertness about default risk.

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1. Introduction

Domestic sovereign debt markets in emerging economies have grown markedly and currently represent governments' main source of financing (Bank for International Settlements, 2007; Burger et al., 2010; Mihajjek et al., 2002). While many studies have looked into the determinants of the yields of externally issued sovereign bonds of emerging economies, the analysis of domestically issued bonds has hitherto been limited, despite their growing relevance (Peiris, 2010). The aim of the present paper is to shed some light on the determinants of long-term domestic bond yields in emerging markets, with a particular focus on the impact of fiscal policy and global risk aversion.

[☆] The views expressed here are those of the authors and do not necessarily represent those of the IMF or IMF policy.

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Since the theoretical literature is inconclusive about the sign of the effect of fiscal policy on long-term domestic bond yields, the question of its impact becomes very much an empirical one (Friedman, 2006). In theory, the effect of a fiscal expansion on domestic interest rates depends on the reaction of domestic private saving and the size and openness of the economy. If households are Ricardian, then a rise in government debt that leads to an anticipation of future tax hikes would be offset by a rise in private savings, thereby leaving long-term rates unchanged (Barro, 1974). If non-Ricardian features are instead incorporated, then an increase in the fiscal deficit and public debt would, all else equal, drive up long term bond-yields (Blinder and Solow, 1973; Modigliani, 1961). Another approach stresses the importance of international capital mobility, claiming that in an open economy fiscal policy will not affect interest rates except indirectly through its impact on the risk premium (Mundell, 1963): In an environment where there is a large amount of uncertainty relating to the growth prospects of the economy, larger deficits and public debt could also raise concerns about the ability of the sovereign to repay its debts, lifting risk premia and therefore the government's long-term financing costs.

A vast empirical literature exists on the determinants of long-term bond yields in advanced economies, with a majority of papers finding that higher fiscal deficits and public debt raise interest rates. While many studies employ U.S. data, there is now also an increasing literature that focuses on European and OECD data. Gale and Orszag (2003) report that out of 59 studies, 29 find that weaker fiscal variables increase interest rates, while 11 had mixed results and 19 found that the effect was not significant. Moreover, a majority of studies finds that the effect of fiscal policy on interest rates is larger when the fiscal deficit rather than public debt is included as an explanatory variable (Faini, 2006; Laubach, 2009). In addition, the effects of fiscal policy are larger when expectations of future fiscal policy rather than actual values of the debt and deficit are used (Laubach, 2009) and when single country studies rather than cross country studies are performed. The estimated impact on interest rates of a change of 1% of GDP in the fiscal deficit ranges from 10 basis points to 60 basis points (Laubach, 2009). The estimated impact of a change of 1% of GDP in the debt ratio on interest rates ranges from 1 to 8 basis points (Haugh et al., 2009).

Studies analyzing the determinants of sovereign foreign currency spreads in emerging markets are also widespread. For foreign currency spreads, many empirical studies have looked at the impact of domestic factors, including indicators of external vulnerability like external debt, debt service or current account (Cantor and Packer, 1996; Edwards, 1984); fiscal variables, like fiscal debt and deficits (Cantor and Packer, 1996; Rowland and Torres, 2004) or their composition (Akitoby and Stratmann, 2008); and other macroeconomic variables like inflation, the terms of trade and the real exchange rate (Min, 1998).

Fewer studies have focused on emerging market domestic sovereign bonds, notwithstanding their growing relevance as a source of government financing. Peiris (2010) conducts a panel analysis of 10 emerging market economies using quarterly data and finds that the annualized impact on long-term bond yields of a 1% increase in the fiscal balance-to-GDP ratio is about 20 basis points, while domestic monetary aggregates and real economic activity do not have a significant impact. Moreover, long term yields are found to respond to changes in policy interest rates, inflationary expectations, and foreign participation in domestic bond markets. Baldacci and Kumar (2010) estimate a panel of 31 advanced and emerging economies over the period 1980–2007 and also find that higher fiscal deficits and public debt raise long-term domestic bond yields in both advanced and emerging markets, with an impact similar to that found by Peiris (2010). Baldacci and Kumar (2010) also find that countries with higher initial fiscal deficits and public debt experience larger increases in bond yields when the fiscal position deteriorates. Based on monthly observations of annual data, Miyajima et al. (2012) show that domestic factors, including expectations of the short-term interest rates and the fiscal balance, have tended to dictate the dynamics of the emerging market local currency government yield.

Meanwhile, the effect of global risk aversion on financing costs in emerging economies has hitherto typically been analyzed within the context of the literature on the determinants of sovereign foreign currency spreads. McGuire and Schrijvers (2003) find that global risk aversion is a significant factor driving spreads, while Eichengreen and Mody (2000) and Bellas et al. (2010) show that changes in market sentiment affect spreads. Gonzalez-Rozada and Levy-Yeyati (2008) find that in addition to global risk aversion, global liquidity plays a central role. Hartelius et al. (2008) and Dailami et al. (2008) provide similar results when looking at U.S. interest rates. For domestic bond yields, Baldacci and Kumar (2010) find that in periods of financial distress—defined as periods of high levels of the VIX index, high inflationary pressures, and more adverse global liquidity conditions—fiscal deterioration has a larger impact on bond yields. The VIX threshold used in their analysis is chosen exogenously.

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