



## Rules and risk in the Euro area <sup>☆</sup>

Anna Iara <sup>a,\*</sup>, Guntram B. Wolff <sup>b,1</sup>

<sup>a</sup> European Commission, Directorate General for Taxation and Customs Union, SPA3 06/23, B-1049 Brussels, Belgium

<sup>b</sup> Bruegel, Rue de la Charité 33, B-1210 Brussels, Belgium



### ARTICLE INFO

#### Article history:

Received 7 March 2013

Received in revised form 19 January 2014

Accepted 7 February 2014

Available online 15 February 2014

#### JEL classification:

E62

G12

H63

#### Keywords:

Fiscal governance

Numerical fiscal rules

Sovereign spreads

Sovereign risk

Euro area

### ABSTRACT

We show that stronger fiscal rules in Euro area members reduce sovereign risk premia, in particular in times of market stress. Using a unique data set of rules-based fiscal governance in EU member states, we estimate a model of sovereign spreads that are determined by the probability of default in interaction with the level of risk aversion. The legal base of the rules and their enforcement mechanisms are the most important dimensions of rules-based fiscal governance.

© 2014 Elsevier B.V. All rights reserved.

## 1. Introduction

Differences in government bond yields have sharply increased in the Euro area in the course of the sovereign debt crisis. Part of this increase can be attributed to developments in public debt (von Hagen et al., 2011) and contingent liabilities related to the banking sector (Gerlach et al., 2010; Ejsing and Lemke, 2011). Beyond these factors, the price of government bonds also reflects market confidence in governments' commitment towards sustainable fiscal policies. The trust of investors in such commitment may be enhanced by a strong fiscal framework (Fatás, 2010), which may help anchor fiscal policy expectations (Leeper, 2010). Indeed, strengthening national fiscal governance has been an important item both of national reforms in the Euro area<sup>2</sup> and the economic governance reform at the EU level (Council of the European Union, 2011).

We investigate whether national fiscal governance and numerical fiscal rules in particular help reduce the interest required on government bonds, specifically accounting for different levels of risk aversion over time. We argue that fiscal governance has an impact on the sovereign yield spreads by reducing the probability of default, and that this in turn has a twofold effect on the sovereign spreads. First, a lower probability of default will reduce the risk premium that compensates for the possibility of default no matter

<sup>☆</sup> The views expressed in this paper are those of the authors and do not necessarily represent those of the European Commission.

\* Corresponding author. Tel.: +32 2 295 38 04.

E-mail addresses: [anna.iara@ec.europa.eu](mailto:anna.iara@ec.europa.eu) (A. Iara), [guntram.wolff@bruegel.org](mailto:guntram.wolff@bruegel.org) (G.B. Wolff).

<sup>1</sup> Tel.: +32 2 227 42 83.

<sup>2</sup> Germany adopted a constitutional rule to limit government debt in 2009; Hungary and Spain have followed suit. After initially embracing this idea, the introduction of a constitutional debt brake has been postponed in France, but has now been implemented with the Fiscal Compact.

what the extent of risk aversion is. Second, it will also reduce the variance of the payments from the risky bond. Markets will ask for a compensation for assuming the risk associated with this variance; this second component is amplified with risk aversion. Using a unique dataset on fiscal governance in EU member states, we test the effects of fiscal governance on sovereign spreads and provide empirical support to our predictions. We find strong and economically sizeable effects of the quality of national rules-based fiscal governance on sovereign spreads. We further show that the legal base of the rules appears to be the most important dimension of their effectiveness in containing sovereign risk premia, while the mechanisms to enforce compliance are highly important as well. The type of the bodies in charge of supervising compliance with the fiscal rules, in turn, appears to matter less.

Numerical fiscal rules are defined as permanent constraints on summary indicators of fiscal performance, such as the budget deficit, debt, or a major component thereof (Kopits and Symansky, 1998). They are aimed at reducing the policy failures due to which budget process outcomes tend to be biased towards deficits: namely, the common pool problem of governments without centralised spending powers, the short-term orientation of governments due to short electoral cycles, and the possible short-term orientation of voters. In the EU, fiscal rules further aim at mitigating the incentives for deficits resulting from a common currency.

Empirical research in the past two decades has shed light on the role of numerical fiscal rules for sound public finance. While earlier research concentrated on the experience of the US states, sometimes in view of deducting insights for the nascent EMU (von Hagen, 1991; Bayoumi and Eichengreen, 1995; Alesina and Bayoumi, 1996; Bohn and Inman, 1996), the focus of analysis then shifted to Europe. The effectiveness of national fiscal rules with respect to fiscal performance has been shown to depend on the mechanisms established to enforce compliance with the rule (Inman, 1998; Ayuso-i-Casals et al., 2009), as well as on the type of the rule, where budget balance and debt rules appear to outperform expenditure rules (Debrun et al., 2008). Fiscal rules have also been found supportive to the adherence to medium-term fiscal plans presented in the Stability and Convergence Programmes of EU members, which is a central plank of EU budgetary surveillance (von Hagen, 2010). The role of fiscal rules in the budgetary process has been scrutinised as well: empirical evidence is not fully conclusive whether fiscal rules serve as commitment devices to effectively tie the hands of governments, or whether they merely have a signalling role and remove information asymmetries between governments and the electorate, without changing the behaviour of policy-makers (Debrun and Kumar, 2007b,a; Debrun, 2006; Debrun et al., 2008). Budgetary rules enshrined in national constitutions specifically have been found to be correlated with lower government expenditure (Blume and Voigt, 2013). On the EU level, fiscal rules have been shown to be effective, but to lead to significant creative accounting aimed at their circumvention (von Hagen and Wolff, 2006; Buti et al., 2007). Theoretically, it has been elaborated that supra-national rules are welfare improving relative to merely national regimes, but that they cannot fully eliminate the deficit bias: therefore, strong national rules should complement a supra-national framework (Krogstrup and Wyplosz, 2010).

The past several years witnessed a surge of research on the impact of fiscal variables on spreads in government bond yields as well. In an international context, a positive relationship between public debt and interest rates has been consistently confirmed (Edwards, 1986; Alexander and Anker, 1997; Lemmen and Goodhart, 1999; Lonning, 2000; Copeland and Jones, 2001; Codogno et al., 2003). In the Euro area, sovereign spreads are found to be determined by debt, deficits, and debt-service ratios (Bernoth et al., 2012) as well as by hidden fiscal policy activity, creative accounting practices, and transparency of government budgeting (Bernoth and Wolff, 2008). On the sub-national level, the price of public debt is confirmed to reflect fiscal fundamentals (Schuknecht et al., 2009; Heppke-Falk and Wolff, 2008; Schulz and Wolff, 2009). The impact of risk perceptions has also received significant attention in recent research (Codogno et al., 2003; Favero et al., 1997; Barrios et al., 2009); variations over time of the importance of various determinants have been analysed most recently as well (Bernoth and Erdogan, 2012).

The impact of fiscal restraints on the cost of public borrowing has been studied by looking at US states. Bayoumi et al. (1995) show that the impact of constitutional controls on the cost of debt depends on the level of debt: at average levels, the presence of such controls is found to be associated with a reduction of the interest cost by 50 basis points. Eichengreen and Bayoumi (1994) confirm the negative impact of fiscal rules on the cost of government borrowing. Poterba and Rueben (1999) uncover that expenditure, deficit, and debt rules (negatively) as well as tax limitations (positively) impact on state bond yield differentials; debt rules appear to be the least effective. Differentiating this result, Johnson and Kriz (2005) show that revenue limits have a direct impact on state borrowing, while the effect of numerical fiscal rules is indirect via improved credit ratings. For the Euro area, Hallerberg and Wolff (2008) reveal that government bond yields are also determined by institutional characteristics of the fiscal process.

Our analysis adds to the body of research in several ways: it is the first to empirically investigate the role of numerical fiscal rules on sovereign bond spreads in the Euro area, and it uses a rich dataset maintained by the European Commission. It adopts an approach that allows for an amplifying effect of risk aversion on the impact of fiscal rules on sovereigns spreads. Finally, it focuses on five dimensions of rules-based fiscal governance.

The remainder of the paper is structured as follows. Section 2 outlines our analytical approach and the empirical strategy adopted. Section 3 describes our dataset and the construction of the fiscal rule index in particular. Section 4 presents the panel data estimations and a set of robustness checks. Section 5 concludes.

## 2. Analytical framework

We investigate the impact of rules-based fiscal governance on risk premia in Euro area government bond markets in a simple framework accounting for risk aversion.

We start from the standard case of risk neutrality. Specifically, we consider an investor who can buy a risk-free bond that pays interest  $r^*$ , or a risky bond of country  $i$  that delivers repayment with the same interest plus an interest spread  $s_i^0$  to compensate for the possibility of default. The probability of default is  $\theta_i \in [0;1]$ , and we assume that there is no re-payment of principal if the sovereign defaults.  $\tau_i = (\theta_i)/(1 - \theta_i)$  is the odds of default.

Download English Version:

<https://daneshyari.com/en/article/5068101>

Download Persian Version:

<https://daneshyari.com/article/5068101>

[Daneshyari.com](https://daneshyari.com)