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Fiscal space and sovereign risk pricing in a currency union

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A B S T R A C T

We examine how membership in a currency union affects public debt sustainability and market assessments of default risk in eurozone countries. We argue that there exist offsetting effects: expectations of bailouts tend to make a given level of debt more sustainable, lowering bond yields and CDS rates, but constraints on the use of monetary policy would tend to have the opposite effect, pushing rates up especially as room for fiscal maneuver gets exhausted. We develop a formal concept of fiscal space (which takes account of the notion of fiscal fatigue under which there are limits to the government's ability to raise the primary surplus in response to higher debt), and apply it to the eurozone countries, investigating in particular how currency union membership affects CDS and bond rates during both quiet and turbulent times for a given amount of fiscal space. We find that in quiet times, CDS and bond rates for eurozone members were below what would be expected given their fiscal space (a bonus from currency union membership). But when the crisis erupted, CDS and bond yields rose more sharply for eurozone members than would be predicted based on their available fiscal space. Our interpretation is that sovereign bailouts did not occur with the hoped-for alacrity in euro-crisis countries, generating sharper penalties for sovereigns that belong to a currency union.

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1. Introduction

Events in Europe over the past couple of years have rekindled interest in the public finances of monetary unions. Although eurozone members with debt sustainability problems are not the only advanced economies to be facing such concerns (among others are Japan, the United Kingdom, and the United States), their membership in the monetary union may bring particular challenges (as well as advantages) in dealing with their unsustainable public finances. In this paper, we examine how membership in a currency union (CU) affects debt sustainability, and what this implies for market pricing of default risk of eurozone members, given their available fiscal space.

There are three key implications of CU membership for the conduct of fiscal policy and the sustainability of the public finances. First, and most simply, because CUs typically reflect more than just economic considerations, and often represent important historical and political ties as well, members of the union may expect to receive assistance (financing or transfers) from the rest of the union in times of economic or financial distress. In other words, when the budget constraint binds, there is some likelihood that it will be shifted outwards. Second, because CU members do not have their own independent monetary policy, macroeconomic stabilization will need to rely more heavily on fiscal policy. The corollary is not just that CU members should normally try to keep more fiscal space than countries with independent monetary policy, it is also that their risk premium will rise more steeply as their fiscal space is exhausted because they lack policy instruments to help offset the impact of fiscal consolidation on economic activity (and hence on revenues). Third, the fiscal theory of the price level means that CU members must have “money dominant” policy regimes since they cannot rely on higher inflation or engineer a change in the price level in order to erode the real value of their debt. As such, CU members must be willing to raise taxes or reduce spending to ensure that the intertemporal budget constraint is satisfied.

These three implications go in opposite directions for market assessments of debt sustainability. The possibility that a CU member will be bailed out by other members of the union pushes out its budget constraint and makes a given level of debt more likely to be sustainable.[1] Conversely, the greater need to rely on fiscal policy for macroeconomic stabilization implies higher government bond yields – or credit default swap (CDS) rates – especially when the government’s room for maneuver (its “fiscal space”) is low. Likewise, the limited scope for raising the inflation tax or eroding the real value of government debt means that CU members do not have the same “safety valve” as non-CU members, and should therefore face correspondingly higher spreads on their public debt.[2]

To what extent are these implications reflected in market’s assessment of eurozone sovereign risk? To answer this, we compare the behavior of government bond yields and CDS rates for eurozone countries with those of other advanced economies, controlling for fiscal space.[3] Intuitively, market assessment of risk should depend on the government’s ability to service its debt – that is, its available fiscal space – and any systematic divergence from the fiscal-space implied rates for eurozone countries should reflect peculiarities associated with membership in the CU.

While several recent studies analyze the market pricing of sovereign risk for the eurozone countries in the context of the global financial crisis – examining implicitly or explicitly the role of macroeconomic fundamentals, notably, fiscal space (e.g., Attinasi et al., 2009; Fontana and Scheicher, 2010;

[1] More generally, the provision of liquidity by the common central bank could also contribute to lower spreads. In principle, if the prospect of bailouts reduces spreads for countries expected to receive such bailouts, then it should raise them for countries expected to provide the bailouts. But one implication of the model discussed below is that risk spreads only rise as debt approaches the country’s debt limit. Therefore, unless the prospective bailouts threatened the debt sustainability of the stronger members of the union, it is unlikely that there would be any appreciable increase in their spreads.

[2] While the risk of being exposed to higher inflation in non-CU member countries could lead investors to require higher nominal yields than otherwise, the ability to inflate away debt lowers the likelihood of a discrete default (which is likely to be more disruptive and value-destroying than modestly higher inflation), thereby implying lower risk premia than otherwise. (For CDS rates, there is no reason for inflationary expectations to lead to higher spreads for non-CU members because inflation is not a “credit event.”) Moreover, especially during crisis, the absence of a monetary policy tool to stimulate the economy to counteract the contractionary effects of fiscal consolidation could weaken growth, making adjustment more difficult, and increasing the likelihood of default, which would also imply higher spreads.

[3] The earlier literature on this topic focused on emerging market economies, which were more susceptible to debt problems; for references to that literature, see Attinasi et al. (2009).

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