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Sovereign risk premia: The link between fiscal rules and stability culture

Friedrich Heinemann[a,d], Steffen Osterloh[c,*,1], Alexander Kalb[b,1]

[a] Zentrum für Europäische Wirtschaftsforschung, L7, 1, 68161 Mannheim, Germany
[b] Bayerische Landesbank, Department of Country Risk & Sector Analysis, Brienner Straße 18, 80277 Munich, Germany
[c] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (German Council of Economic Experts), Gustav-Stresemann-Ring 11, 65189 Wiesbaden, Germany
[d] University of Heidelberg, Germany

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A B S T R A C T

There is a growing empirical literature studying whether permanent constraints on fiscal policy, such as fiscal rules, reduce sovereign risk premia. Nevertheless, it remains an open question whether these rules are effective genuinely or just because they mirror fiscal preferences of politicians and voters. In our analysis of European bond spreads before the financial crisis, we shed light on this issue by employing several types of stability preference related proxies. These proxies refer to a country's past stability performance, government characteristics and survey results related to general trust. We find evidence that these preference indicators affect sovereign bond spreads and dampen the measurable impact of fiscal rules. Yet, the interaction of stability preferences and rules points to a particular potential of fiscal rules to restore market confidence in countries with a historical lack of stability culture.

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* Corresponding author. Tel.: +49 611 752668; fax: +49 611 7522538.
E-mail addresses: steffen.osterloh@destatis.de, steffen.osterloh@web.de (S. Osterloh).

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1. Introduction

The credibility crisis regarding the sustainability of public debt has transformed the markets for government bonds in the Euro area. A new sensitivity of creditors for the risk of sovereign default has pushed up financing costs of several euro member countries or has even cut them off from market access. This fundamental change in risk awareness has multiplied the interest rate costs associated with a deteriorating fiscal position.

Politics have reacted in various ways ranging from drastic consolidation efforts over European emergency credit lines to the search for a framework for orderly defaults. Apart from these approaches, one strategy is to establish fiscal reputation in the short term through measures which improve the long-term sustainability of public finances. In this context, important actors like the Commission's president José Manuel Barroso or the German chancellor Angela Merkel have called for a "new stability culture" in Europe,[2] which is supposed to reassure the bond markets about the new reliability of consolidation strategies and a brighter fiscal future.

A crucial question in this context is, of course, to which extent 'stability culture' can swiftly be changed by politicians or legislators. The answer depends on the precise definition since this term has at least two connotations. First, it can be related to the rules which constrain a country's fiscal policy. Second, it may point to long run fiscal preferences of citizens and/or politicians as well as national institutional characteristics, which are a heritage of a country's history. Both dimensions are fundamentally distinct. Whereas preferences can hardly be changed through short-run political measures, fiscal rules are open for such adjustments.

Currently, policy makers try to foster fiscal reputation through the establishment of better European and national fiscal rules. In particular, the Fiscal Compact which was agreed by the European Heads of State of Government in December 2011 prescribes that all participating countries (all EU member states without the United Kingdom and the Czech Republic) will have to introduce national fiscal rules by the end of 2013 (European Central Bank, 2012). These rules have to be introduced in the national legislation, preferably in the form of constitutional provisions, and they have to fulfil certain requirements, in particular they have to limit the structural deficit of the general government at 0.5% of GDP. The hope is that, independent from the current budgetary performance, such fiscal rules send out credible signals and cut short the way towards lowering the risk spread. Indeed, there is some empirical evidence in the context of US states, EU countries or Swiss cantons that properly designed fiscal rules can actually reduce risk spreads (see survey below). The available empirical evidence, however, is limited to the rules-dimension of stability culture so that all conclusions are necessarily preliminary.

The essential problem is that these rules may reflect stability oriented preferences of a country's voters and politicians and, thus, the effect of fiscal rules on risk premia can be a result of a common-cause-interdependence: Conservative fiscal preferences might have led both to the establishment of rules and to lower risk premia. This criticism is well known from the literature on the effectiveness of fiscal rules (Poterba, 1996): A correlation of strict fiscal rules and low public deficits cannot necessarily be interpreted causally. Voters who dislike public debt will also favour strict debt limits. If this is the case, the observed fiscal link between rules and fiscal policy outcomes could be spurious. This methodological problem is of immediate policy relevance. A new rule as such does not change preferences, in particular if it is established as a consequence of external pressure. If the markets rather pay attention to preferences than to written rules, they could remain sceptical vis-à-vis a high debt country. Rules which seem to work in one country might then fail in another. Hence, we have to address different empirical questions: First, is the establishment of fiscal rules largely driven by stability-oriented preferences? Second, does the impact of fiscal rules on risk premia survive if fiscal preferences are taken into account through appropriate proxies? And third, could fiscal rules have a different impact in countries with high and low stability preferences?

[2] Barroso: "Our priority is putting order into our public finances. We need fiscal consolidation and a new financial stability culture in Europe." (Introductory remarks at a joint press point with the German Chancellor Angela Merkel, June 11, 2011); Merkel proposed a "new stability culture" in Europe to overcome the turmoil that has battered the euro on the foreign exchange markets (AFP, May 19, 2010).

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