Bailouts and Credibility in the European Union

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Motivating Question

- Common assumption that international institutions can confer credibility on their members
  - But predicated on idea that members follow the rules of the institution (through whatever mechanism)

  $\rightarrow$ So are bailouts a sign of enforcement of rules, or of a *lack* of ability to enforce?

  $\rightarrow$ Even in post-financial-crisis world, are perceptions of third parties still based on signals, heuristics?

EU Financial Crisis

- Members had been breaking fiscal and convergence rules with no repercussions for years (Bearce 2009)
- Starting in 2007, EC coordinated bailouts with IMF for eight countries
  - One eurozone member (Greece), three non-eurozone EU members (Latvia, Hungary, Romania), four non-EU members (Ukraine, Serbia, Moldova, Iceland)
  - IMF mostly more prominent than EC — conscious decision from Brussels
- At the same time, similar policy measures announced by countries not under EU/IMF bailout program (Portugal, Spain, Ireland)

Research Design: Variation in Programs

- Very little variation in design and targets of program, but institutional branding varied
  - Jointly executed by IMF and EU, but IMF much more visible (except for Latvia)
  - IMF plus Scandinavian countries bailed out Iceland
  - Countries not under IMF/EU programs (Ireland, Portugal, Spain) simultaneously enacted very similar economic reforms
    $\rightarrow$ Program content strongly comparable; variation only in institutional "stamp"

Countries in Crisis

	IMF/EC Bailout	No Bailout
EU	Greece ($145 bil) Hungary ($25 bil) Latvia ($10.5 bil) Romania ($30 bil)	Spain Ireland Portugal
Non-EU	Serbia ($4 bil) Ukraine ($30 bil) Moldova ($574.4 mil) Iceland - IMF Only ($2.1 bil)	Everyone Else

Hypotheses

- If perceptions of institutional "credibility" matter:
  1. Positive investor reaction to IMF-branded programs; less strong to IMF/EC; less strong to reforms taken independently, even if reform content is similar
     - ★ EC has less of a track record than IMF on balance of payments stabilizing
  2. No investor reaction to revisions in program content
     - ★ Perceptions still elastic to most visible signals

Empirical Strategy

- Event studies on IMF/EC bailouts
  - Calculate cumulative abnormal returns on ten-year sovereign bonds within a 30-day "event window"
  - Test statistic $= (1\ /\text{n}\Sigma\text{AR})/\text{AR\_}\sigma)$

Results

- No significant difference between IMF/EC bailout programs in EU vs non-EU states
  - Bailouts not necessarily an expected part of EU membership?
- Investors slightly more positive when IMF, not EC, announces joint bailout program
  - IMF as more credible bailout player? Or simply more visible brand?
- Investors slightly more responsive to similar policy announcements from countries in IMF/EC programs than those without $\rightarrow$ Institutions matter, a little bit
- But investors most responsive to *initial* program announcements — not to subsequent revisions (or even program suspensions)

Countries Under IMF/EC Programs

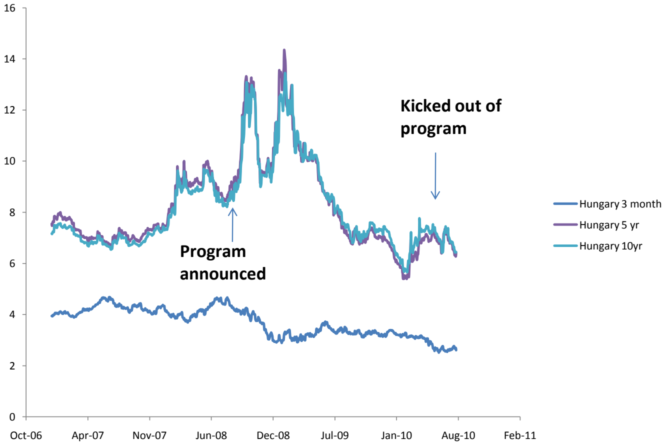
Country	Date Announced	Who Announced?	Change in Risk	MoU 1	MoU 2	MoU 3	LoI 4	Amount ($)
Iceland	10/08	IMF	**-1.32**	11/08	10/09	4/10	-	2.1 bn
Ukraine	10/08	IMF	-**.99**	10/08	7/09	-	-	30 bn
Hungary	10/08	IMF/EC	-**.78**	11/08	9/09	12/09	3/10	25 bn
Latvia	12/08	EC	-**.51**	7/09	1/10	4/10	-	10.5 bn
Romania	3/09	IMF	-**.81**	4/09	9/09	2/10	6/10	30bn
Serbia	4/09	IMF	**-1.01**	12/09	3/10	-	-	4 bn
Moldova	1/10	IMF	-**.98**	6/07	2/08	6/08	1/10	574.4 mil
Greece	5/10	IMF/EC	**-4.21**	5/10	-	-	-	145 bn

- Difference in means between IMF- and EC-announced programs: -0.12
- No significant reactions to MoU/LoI revisions

Changes in Risk as Investors React to Comparable Announcements of Reform (Spending Cuts)

	IMF/EC Bailout	No Bailout
EU	Greece (-2.25) Hungary (-1.24) Latvia (-2.01) Romania (-1.04)	Spain (-0.58) Ireland (-1.01) Portugal (-0.44)
Non-EU	Serbia (-1.11) Ukraine (-1.03) Moldova (-.89) Iceland - IMF Only (-2.05)	

Risk in Hungary



Conclusions, and Caveats

- Financial markets still put extra faith in international organizations as symbols of credibility
  - Information story? (Markets less responsive to reform in Portugal, Ireland, Spain because of longer histories)
  - Too early to tell? (But markets should be paying attention now!)
- Future and continuing research:
  - Investigate changes in EU credibility as countries break rules
  - More examination of variation in programs in terms of amount committed, changes in perceived previous state