Fiscal institutions and sovereign risk perceptions

Do investors value stronger fiscal institutions?

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IPES-Conference, University of Virginia, November 9th, 2012

Outline

Motivation

Current debate on delegation of fiscal policy and on fiscal rules in the EU

- Does institutional centralization work?

  −> Suppose it does: which institutions do investors rely on as *information short cuts*?

- What can we learn from earlier crises (in EMEs)?

Budgetary institutions and sovereign risk

Literature on fiscal *policies* and sovereign risk perceptions:

- fiscal restraint reduces sovereign risk spreads...but mostly if budget cuts exclude public investments (Baldacchi et al. 2008, 2010)
- how to implement *good* adjustment policies under economic pressure/in a highly contested political situation?

  –> degree of fiscal policy centralization (delegation, rules)

  –> budgetary institutions

PE of Sovereign Risk

What do we know about political and institutional determinants of sovereign risk?

- Investors use information short cuts (Mosley 2000, 2003, Bernhard and Leblang 2006)
- They rely on *narrow* or *broader* sets of indicators, depending on type of country (Mosley 2000, 2003)
- Risk evaluation based on heuristic ("peer group"-status) (Brooks and Mosley 2012)
- (Contested) elections are unpopular among investors (Block and Vaaler 2004, Martinez/Santiso 2003, Spanakos/Renno 2009)
- So are left-wing candidates, however, less so when:
  - elections are uncontested (Hays/Franzese 2007)
  - experienced left wing governments run for re-election (Brooks/Mosley 2008)
  - left-wingers come in times of (currency) crisis (Campello forthcoming)

Research question

Maybe investors are less concerned about partisanship and other attributes of government when budgetary institutions are solid?

Sovereign risk and institutions...in the EMU

Evidence from Hallerberg/Wolff (2008) suggests that sovereign risk premium a country has to pay is:

a) generally lower in countries with more centralized budgetary institutions
b) temporary changes in fiscal policy (expansion) are perceived as less risky in countries with centralized institutions

$\Rightarrow$EMEs: does it pay off to reform budgetary institutions?

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⇒EMEs: does it pay off to reform budgetary institutions?

Budgetary institutions and the cpr-problem

According to Alesina et al. (1999) centralized budget process is one that establishes hard budget constraints by:

- delegation of fiscal decision powers within the government to a single budget authority with a veto over line ministries and legislatures (delegation)
- introduction of objective fiscal targets, balanced budget rules, debt ceilings, and expenditure ceilings (statutory approach)
- inclusion of all items with an impact on the fiscal stance in a single budget bill, including all borrowing activities of public agents (transparency)
- borrowing constraints on public agents including subnational governments

Several studies on LAC and other EMEs show that centralization is linked to lower deficits and public debt (Alesina et a. 1999, Filc/Scartascini 2004, Hallerberg et al. 2009)

How could reforms of b.i. affect investor risk perceptions?

- Direct effect on bond spreads
- *Conditional effect $\rightarrow$ change in fiscal stance perceived as less risky if country$_i$ reformed its budgetary institutions*

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Market reaction, conditional on institutions

Potential sovereign bond market reactions to changes in public debt, depending on centralized and transparent budget process:

Dynamic model:

Pb debt ▲

$\nearrow$ market reacts: risk premium ▲

- $\nearrow$ govt reacts: B.I. reform market pressure ▼ as govt reduces debt
- $\searrow$ govt reacts: no reforms weak repaym. capacity $\searrow$ markets react: risk premium ▲ pb debt ratio ▲ sov debt crisis

$\searrow$ market calm: govt manages to reduce pb debt

Argentina and Brazil

Some case evidence on reforms of budgetary institutions (lack thereof) in Argentina and Brazil (1990-2006)

	Phase 1 (1990-1997)	Phase 2 (1997-2002)
Argentina	B.P. relatively centralized (on paper) CB financing deficits –> inflation (Treisman 2000) After move to convertibility –> public expenditure and debt rise looming Provincial fiscal problem budget transparency (off-budgeting)	Failed attempts at reforms: e.g. Zero-Deficit Law in 2001 Lack of control over SNGs, borrowing of concern Failed attempts: IMF-agreed prim.balance goals + to control Provincial deficits
Brazil	Budget process less centralized CB involved in deficit financing $\rightarrow$ inflation lack of budget transparency looming state fiscal crisis	series of SNG fiscal crises Federal bailouts, followed by: Law 9646, SR 78 of **1997** and FRL and FCL of 2000: defictis rules, expendture ceil., debt limit, spending ceilings, transp. rules, borrowing

First difference regression with change of yearly EMBI Plus stripped bond spreads as DV.

- Sample: 13 emerging market borrowers, 1993-2006
- Procedure:
  1. only change in public debt
  2. adding dummy for REFORM
  3. including REFORM lagged by two periods
  4. interaction of shift in pdebt with lagged REFORM

Following baseline estimation equation:

First difference model

$$\triangle \text{LSPREAD} = \alpha_1 \triangle \text{PDEBT}_{it} + \alpha_2 \text{Reform}_{it} + \alpha_3 \text{INTERACTION}_{it} + \triangle Z \alpha_{4\,it} + \triangle \varepsilon_{it}$$

Reforms

"REFORM" captures whether a govt in a given year engaged in a reform with aim of enhancing centralization.

Three ways in which budgetary institutions can be centralized:

1. Fiscal targets: fiscal limits, medium term fiscal frameworks, borrowing limits, reserve funds
2. Procedural rules, i.e. veto powers of Fin Min vis-à-vis line ministers, legislatures, sub-national govts
   - They vary between "hierarchical" and "collegial"
   - rules on decision making within the executive branch, executive-legislative relations, cash management
3. Transparency of the budget process

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First results

DV= $\triangle$LSPREAD

	Baseline	Reform	Lagged Reform	Interaction
$\triangle$PDEBT/GDP$_{it}$	0.008** (0.00)	0.008**(0.00)	0.007*(0.00)	0.012*(0.00)
REFORM$_{it}$		0.222***(0.07)		
REFORM$_{it-2}$			-0.088(0.07)	-0.098(0.07)
INTERACTION				-0.007(0.01)
$\triangle$GDP	-0.18**(0.01)	-0.019**(0.01)	-0.027**(0.01)	-0.026*(0.01)
$\triangle$VIX$_{it}$	0.008(0.01)	0.005(0.01)	0.003(0.01)	0.003(0.01)
$\triangle$Default$_{it}$	0.128(0.10)	0.136(0.10)	0.270**(0.10)	0.284**(0.10)
$\triangle$Moodys$_{it}$	-0.102*(0.05)	-0.105(0.06)	-0.098(0.06)	-0.119*(0.06)
$\triangle$LEFT$_{it}$	-0.083(0.11)	-0.016(0.14)	-0.040(0.14)	-0.011(0.14)
Obs	144	95	93	93
R^2	0.24	0.48	0.46	0.48

Summary

Do investors  reforms that lead to more centralization of B.I.?

Answer: they do to some extent, after a while...

- new evidence for EMEs, pointing in similar direction as observation on developed countries (Hallerberg/Wolff 2008)
- as expected, govts pay a higher risk premium following a change in the fiscal stance
- at first look, the immediate effect of reforms of B.I. appears counter-intuitive (pos.correlation with bond spreads)
- however: effects turns around after 2 periods
- some evidence that investors are less concerned about temporal swings in fiscal stance in reform countries (marginal cond. effects)

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Outlook

1. Improved measurement of the independent variables
   - which institutions matter most for bond market investors (delegation, structural deficit rule,...)?
   - improved coding of a “reform” variable
2. Modeling: disentangle ST and LT effects (ECM?)
3. Tests using different DVs (bond spreads, CDS as ST indicator of market reactions during crisis)