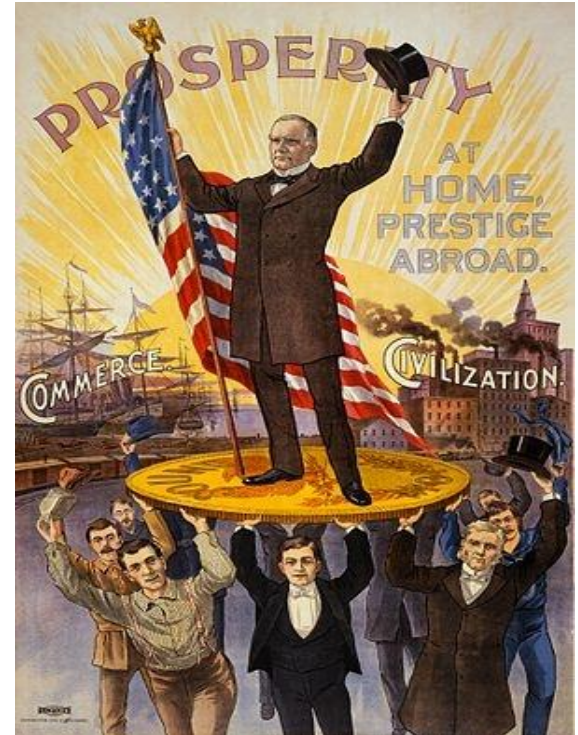


**REVISITING THE “GOOD HOUSEKEEPING
SEAL OF APPROVAL” HYPOTHESIS: HOW
DO BOND INVESTORS PERCEIVE
EXCHANGE RATE POLICIES OF EMERGING
MARKETS?**

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Motivation

- Adherence to the Gold Standard (1870-1914) was equivalent to a “good housekeeping seal of approval” (Bordo and Rockoff 1996) → lower borrowing costs.
 - The European Monetary Union has reduced bond spreads across its member countries.
 - Dollarized economies observed declines in bond spreads.



Motivation

- Do exchange rate regimes matter for bond investors?
 - Only a few studies explore the linkages between exchange rate policies and the pricing of sovereign debt.
 - Focus on the pre-World War era: Bordo and Rockoff (1996), Obstfeld and Taylor (2003), Ferguson and Schularick (2012), Sussman and Yafeh (2001).
 - Mixed results: Barajas, Erickson, and Steiner (2008), Gumus (2011), Jahjah, Wei, and, Yue (2013), Arrelano and Heathcote (2010).

Research Questions

- Why and how do sovereign bond markets respond to exchange rate policies?
 - ▣ Do hard pegs enhance the creditworthiness of emerging market countries?
- What are the implications of the discrepancy between words and actions in exchange rate policy for country risk?

Argument

- “Tying one’s hands” (Drazen and Mason 1994) is not automatically rewarded by markets.
- The impact of an exchange rate regime on country risk is mediated by the quality of domestic institutions (e.g. government stability, corruption, bureaucratic quality, law and order).
- Domestic institutional quality has perceptive effects on a government’s adherence to its promises of “tough” monetary policies.

Argument

- The market assessment of exchange rate policies is contingent on the “stability, predictability and transparency of a country’s political institutions” (S&P 2008).
- Historical support for the argument: The Gold Standard did not increase policy credibility of poor peripheral countries (Ferguson and Schularick 2012).
 - *H1: Countries with good institutions reap credibility gains from submitting policy to a strict monetary rule (hard pegs and inflation targeting).*

Argument

- Alesina and Wagner (2006): Fear of floating (de jure float but de facto peg) as a signaling device.
 - Countries with good institutions declare a float but manage it more than announced to signal rigor to international markets.
- *H2: Bond investors reward countries displaying fear of floating in the form of reduced country risk.*
 - Fear of floating as a signal that the promises of strict monetary policies will be sustained.

Empirical Analysis

- 31 emerging markets, 1994-2011.
- Interviews with analysts at credit rating agencies (Standard & Poor's and Moody's) and senior executives at large European banks.
- Fixed-effects regressions; time fixed effects.
- Dependent Variable: Sovereign spreads measured by J. P. Morgan's Emerging Market Bond Index (EMBI).

Empirical Analysis

- Independent Variables:
 - Exchange Rate Regime: De facto and de jure using Reinhart & Rogoff (2008) and Ghosh, Ostry and Qureshi (2015).
 - Exchange rate dummies: hard pegs, intermediate regimes, floats.
 - Inflation targeting (Rose 2014, Fouejieu and Roger 2013).
 - Institutional Quality: The Political Risk Ratings of the International Country Risk Guide: bureaucratic quality, government stability, corruption, law and order.

Empirical Analysis

- Control variables:
 - GDP growth
 - Inflation
 - Trade openness
 - External debt
 - Foreign exchange reserves
 - Volatility index (VIX).

Table 2: Exchange Rate Regimes and Bond Spreads	(1) RR	(2) RR	(3) IMF de jure (GOQ)	(4) IMF de facto (GOQ)	(5) IMF de facto (GOQ)	(6) Inflation Targeting
De Facto Hard Peg	2.436*** (0.869)			1.370 (0.953)	0.706 (0.448)	
De Facto Intermediate Regime	0.657 (0.837)			0.135 (0.602)		
De Facto Fixed Regime		2.492*** (0.618)				
De Jure Hard Peg			2.159** (0.952)			
De Jure Intermediate Regime			1.212* (0.623)			
Inflation Targeting						1.267** (0.627)
Institutional Quality	-0.016 (0.012)	-0.011 (0.008)	-0.010 (0.009)	-0.019* (0.010)	-0.025*** (0.007)	-0.037*** (0.005)
De Facto Hard Peg and Institutional Quality	-0.040*** (0.013)			-0.027* (0.014)	-0.015** (0.007)	
De Facto Intermediate Regime and Institutional Quality	-0.010 (0.013)			-0.005 (0.009)		
De Facto Fixed Regime and Institutional Quality		-0.040*** (0.009)				
De Jure Hard Peg and Institutional Quality			-0.036** (0.014)			
De Jure Intermediate Regime and Institutional Quality			-0.019* (0.010)			
Inflation Targeting and Institutional Quality						-0.022** (0.010)

Table 3: Fear of Floating and Fear of Pegging and Bond Spreads	(1) Fear of Floating – RR	(2) Fear of Pegging – RR	(3) Fear of Floating – GOQ	(4) Fear of Pegging – GOQ
De Jure Float	0.365*** (0.129)		0.388** (0.154)	
De Jure Intermediate Regime	0.303*** (0.094)	0.037 (0.064)	0.334** (0.144)	-0.042 (0.086)
De Jure Peg		-0.127 (0.092)		-0.274* (0.148)
Institutional Quality	-0.040*** (0.006)	-0.044*** (0.006)	-0.026*** (0.006)	-0.026*** (0.006)
Fear of Floating	-0.231*** (0.079)		-0.174*** (0.056)	
Fear of Pegging		0.311* (0.170)		0.325** (0.126)

Robustness Checks

- Different classifications and coding of exchange rates.
- The inclusion of additional variables:
 - Membership in international organizations
 - Government partisanship
 - Sovereign default
 - Currency crisis.
- Alternative method of estimation: Panel corrected standard errors (PCSE).

Table 4: Robustness Checks using Reinhart and Rogoff (2008)	(1) Members hip in Internatio nal Organizat ions	(2) Partisans hip	(3) Default	(4) Currency Crisis	(5) PCSE Model
De Facto Hard Peg	2.406*** (0.871)	2.394*** (0.867)	1.933** (0.915)	2.722*** (0.893)	1.863*** (0.557)
De Facto Intermediate Regime	0.691 (0.840)	0.656 (0.835)	-0.173 (0.905)	1.312 (0.860)	0.572 (0.511)
Institutional Quality	-0.016 (0.012)	-0.014 (0.012)	-0.020* (0.012)	-0.017 (0.012)	-0.021*** (0.007)
De Facto Hard Peg and Institutional Quality	-0.040*** (0.013)	-0.039*** (0.013)	-0.032** (0.014)	-0.041*** (0.013)	-0.026*** (0.009)
De Facto Intermediate Regime and Institutional Quality	-0.011 (0.013)	-0.010 (0.013)	0.003 (0.014)	-0.018 (0.013)	-0.009 (0.008)

Conclusion

- Fixed regimes *can* effectively enhance policy credibility of sovereign borrowers but only if domestic institutions are good.
- Credibility gains through the adoption of hard pegs may be low in countries with poor institutions because political risk remains high.
- Bond spreads tend to be lower in countries displaying a fear of floating behavior.