View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Research Papers in Economics

Summary for non-specialists
Economic Papers No. 433 / December 2010
Economic Papers index

Rules and risk in the euro area: does rules-based national fiscal governance contain sovereign bond spreads?

by Anna Iara and Guntram B. Wolff

The ongoing economic and financial crisis has put public budgets world-wide under extraordinary strain. Large public spending packages designed to support domestic consumption and the financial sector coincided with sizeable drops of growth and public revenue and resulted in soaring public debt in many countries. At the same time, euro area Member States have come under increasing scrutiny by financial markets. In fact, differences of government bond yields relative to German bonds have increased markedly in euro area members.

A part of the increase in sovereign spreads can be attributed to rising risk aversion, different developments in explicit debt and government liabilities due to potential banking liabilities. Going beyond these factors, investors' expectations regarding the credibility of the commitment of governments to ultimately correct unsustainable fiscal policies could be a further central determinant of increased sovereign spreads. National fiscal rules could be one way of guiding investors' expectations and increasing their trust in governments. In theory, fiscal rules should lower risk premia in particular in times of high uncertainty. As fiscal rules reduce the uncertainty regarding the possible future paths of fiscal policy, they reduce the uncertainty of investors about the sustainability of public finances. This should reduce risk premia demanded by investors. Indeed, several governments in the euro area are currently contemplating the introduction of stronger fiscal rules. A legislative proposal to strengthen numerical fiscal rules at EU member states' level has also been made by the European Commission on September 29, 2010.

The present paper investigates whether national numerical fiscal rules can contribute to containing the interest required on government bonds. Based on a unique dataset on fiscal governance in EU member states, we show that stronger numerical fiscal rules contribute to lower government bond spreads, in particular in periods of higher risk aversion of market participants. The legal base turns out to be the most important dimension for the perceived effectiveness of the rule. The stronger the statutory base establishing national fiscal rules (that may vary between mere party coalition agreements and constitutional law), the lower risk premia will be. But also the enforcement mechanisms of the rules turn out to be important while the body in charge of the supervision of compliance with the fiscal rule appears to be somewhat less important. Our results thus show that rules become the more credible to market participants the stronger their binding character is, and the more effectively they can be enforced. Moreover, the results point to significant benefits in terms of interest rate cost on public debt.