Sovereign Risk, European Crisis Resolution Policies and Bond Yields

And a couple of words on fiscal limits

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Introduction

- Euro-area was created in 1999, after which we witnessed rapid nominal convergence, particularly those of nominal long-term sovereign bond yields.
- Perception of ”risklessness” of euro-area government bonds strenghened:
  - zero risk weights in capital adequacy regulation
  - ECB’s collateral policy (form of ”level playing field”)
- The period of rapid nominal convergence was followd by a period of stable sovereign bond yields (markets), despite non-converging or even diverging macroecoomic fundamentals and fiscal developments
- Investor perceptions on sovereign risks changed after the Lehman’s collapse

Introduction cnt’d

- As the financial crisis deepened and spread to the real economy
  - governments had to provide support to their weakening banking sectors
  - governments had to design fiscal measures to support aggregate activity
- Deteroriating macroeconomic fundamentals: heterogenous developments
- Persistent deficits and accompanied public debt accumulation before the crisis suddenly became a problem for countries with little room for fiscal manoevre
  - sovereign bond yields started to rise rapidly in these latter countries

Introduction cnt'd

- Euro-area sovereign crises has been followed by a number of policy initiatives from the policy makers, eg
  - European Financial Stability Facility (EFSF)
  - European Financial Stability Mechanims (EFSM)
  - European Stability Mechanism (ESM)
  - Inititatives to improve fiscal coordination and discipline
  - ECB's standard and non-standard monetary policy measures
- The latter has taken the form of
  - short- and long-term liquidity support
  - historically low policy rates
  - security market programmes (supporting policy transmission)

Introduction cnt'd

- There is an increasing literature dealing with the macroeffects of fiscal policy in a liquidity trap as well as non-standard measures of monetary on the economy
- Fiscal policy and the liquidity trap (fiscal multiplier):
  - Christiano – Eichenbaum – Rebelo (2010)
  - Leeper – Traum – Walker (2011)
  - Leeper – Walker – Yang (2010)
- Non-stardard monetary policy:
  - Gertler – Karadi (2011, 2012)
- The list does not include empirical studies: data still not fully conclusive about the effects of eg. non-standard monetary policy measures

Introduction cnt'd

- There's also an interesting literature on the trade-off between fiscal policy stabilization and sustainability of public finances, see e.g. Leeper *et al* (http://mypage.iu.edu/~eleeper/).
- The latter literature emphasizes, in particular, the importance of a country's *fiscal limit* (max indebtedness) on the macroeffects of fiscal stabilization measures and sees a trade-off between stabilization and sustainability of public finances once the country is staring at its fiscal limit.
- But what can we say about the effects of European crisis resolution measures on the euro-area sovereign bond markets?

Credit risk or not, that is the question!

- Kilponen – Laakkonen – Vilmunen in their paper *Sovereign risk, European crisis resolution policies and bond yields* (BoF wp no 22/2012) tries provides empirical estimates of the European crisis resolution measures on 10 year sovereign bond spreads.
- The paper runs a regression of sovereign 10 year bond spreads – the difference between 10 year government bond yield and the10 year euro swap rate – on a number of
  - non-policy controls and
  - on dummies measuring identified crisis resolution decisions and measures in seven Euro-area member states (Germany, France, Spain, Italy, Portugal, Ireland and Greece)

Credit risk or not cnt'd

- Controls for credit risk, liquidity risk and general risk appetite (as suggested by the relevant background literature)
  - CDS spreads
  - Bid-ask spreads
  - VIX-index/iTraxx Europe index (atmosphere in European mkts)
- Lagged bond spreads were included to capture potential contagion effects
- The paper identifies 50 policy decisions over the sample period 2007.1.1 – 2012.3.21
  - too many, runs the risk of multicollinearity
  - group policy decision into 11 categories

Credit risk or not cnt'd

- Policy dummies include
  - ECB's interest rate decisions, liquidity support measures, covered bond purchase programme and security market programme
  - requests for support packages, decisions over support
  - announcement on creating ESM
  - decisions on widening the mandate of EFSF
  - announcement of European Economic Recovery Plan
  - other decisions on European economic governance
    - mainly to strengthen the stability and growth pact
- Authors well aware of the difficulties in identifying non-anticipated effect/surprise effect of these measures

Uncertainty increases bond yield spreads

- Overall the results seem to suggest that these measures have had stabilizing effects on sovereign bond markets in Europe
  - results are not, however, uniform and always of expected sign (or the same sign across countries)
- Controls:
  - CDS and bid-ask spread mostly of the expected positive sign, ie. bond yield spreads increase as either (perceived) credit risk increases or liquidity falls
    - Ireland and Portugal provide exceptions: ECB policy intervention in secondary mkts to fight liquidity dry up the cause?

Uncertainty and spreads

- Of the risk appetite measures, only German bond yield spread responds to them significantly, and the estimated effect of the VIX-index is negative for almost all the bond yield spreads
  - VIX-index captures the general risk mood in the stock mkt; it peaked at the beginnning of the crisis; hence, bond mkts then perceived to be safer?
  - However, neither of these measures of risk aversion seem to capture current uncertainty among investors in the European sovereign bond mkts
- some contagion among sovereign bond yield spreads

- Policy measures:
  - ECB's interest decision affect long bond yield spreads only weakly and asymmetrically with reductions having larger effects

Bond spreads respond strongly to ESM

- liquidity support measures as well as the covered bond purchase programme have not generally affected the long bond yield spreads, wheres bond mkts seem to have responded strongly to the ECB's SMP
  - caveat: the decision over the €750 billion rescue package was made on the same day as the decision over the SMP
- estimated effects on the government support package are mixed
  - decisions to request financial support do not generally affect long bond spreads, as these are mostly anticipated by investors
  - decisions to grant support have effects, which, however, seem to be mixed: spreads fell in countries receiving support, but increased in Spain and Italy
    - contagion effect due to re-evaluation of sovereign bond risks?
    - falling German spreads: safe haven effect?

Stabilization vs sustainability? Opposing effects of EFSF and ESM

- the decision over the ESM seem to have increased bond yield spreads in some countries, while the corresponding decision over the EFSF appear to have the opposite effect
  - estimated coefficients on EFSF for Ireland and Portugal are large and negative, suggesting the policy decision on EFSF was successful
- European Economic Recovery Plan seem to have increased bond yield spreads in almost all countries, as should perhaps have been expected
  - short-run stabilization vs uncertainty over long-run sustainability potentially explains the positive effect
  - Ireland and Portugal exceptions: SOEs benefiting from the perceived expansion in their export markets after the fiscal stimuli?

If it is credit risk, is it looming fiscal limits?

- There seems to be some evidence of non-linear effects of uncertainty on bond yield spreads.
- Now, the overall conclusion seems to be that the crisis resolution measures have had a stabilizing effect on sovereign bond yields, at least in the short-run.
- The effects differ across countries, as perhaps expected.
- However, it is important to understand, which part of the bond yields spreads is caused by expectations about changes in economic fundamentals and which part by changes in risk appetite.

Looming fiscal limits?

- In particular, if long yields have gone up because of higher perceived credit risk, then are likely to stay high for an extended period.
- In this case, it is not enough to provide liquidity to the sovereign bond mkts, but to contain investors' fears and win their confidence, fiscal expectations have to anchored via sustainable public finances and credible public policy, ie. through fiscal policy reform.

Looming fiscal limits? Cnt'd

- The above result may also indicate looming fiscal limits: as eg. argued by Bi through model simulations that fiscal austerity measures, once the economy stares at its fiscal limit, aim to balance the government budget in the short-run, fail to contain the bond default risk premium, even with sizable government expenditure cuts.
- Bi also emphasizes that in this case only a long-term plan for fiscal reform, if it credibly changes market expectations about future fiscal policy, can alleviate the rising bond risk premium.
- But then again, at the fiscal limit, fiscal expansion works differently relative to the case of low government debt, so Europe's growth programme may face challenges …

THANK YOU FOR YOUR ATTENTION