Chapter 7
Importance of Fiscal Fundamentals for Sovereign Risk Spread

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ABSTRACT

The chapter examines the importance of fiscal fundamentals for sovereign risk spread in the period of 1995-2015, and its goal is to test whether stronger fiscal discipline reduces sovereign risk premiums. The empirical evidence is based on unbalanced annual panel data of 15 EU countries (its time span is divided into a pre-crisis and a post-crisis period). The study applies the generalized method of moments. Evidence shows that before the financial crisis, investors generally ignored bond risk factors in individual countries, but that the spreads sharply diverged starting from the year 2008. The results confirm a statistically significant impact of fiscal fundamentals on government bond yield spread. The improvement of the governments' fiscal position reduces sovereign yield spread. In a post-crisis period, findings report the raising of the importance of fiscal variables for spread, and GDP growth became a major determinant of government bond yield spreads, followed by the budget balance and debt development.
INTRODUCTION

Generally, a government bond is issued by a national government and is denominated in the country`s own currency. The yield required by investors to loan funds to governments should reflect inflation expectations and the likelihood that the debt will be repaid. It means that that the price of government bonds should be expected to reflect, among other factors, market confidence in governments` commitment towards ensuring sustainable fiscal policies. The financial and economic crisis has been associated with heterogeneity in financial conditions, following a period of low and more homogeneous financing costs. Money markets have become impaired, especially across national borders; and government bond yields have diverged significantly. Overall, there is increased evidence that country-specific effects have become more important in driving financial conditions (European Central Bank, 2012). As Gerlach et al. (2010) remark, part of this increase can be attributed to developments in public debt and contingent liabilities related to the banking sector. Iara and Wolff (2014) argue that fiscal governance has an impact on the government yield spreads by reducing the probability of default.

The underlying causes of the government yield spreads increase begin in the accumulation of fiscal, macroeconomic, and financial imbalances in several countries prior to the crisis, driven in particular by decreasing interest rates around the start of the EMU and by inadequate national and European policy responses. When the crisis recrudesced, the unsustainable nature of these imbalances became evident. The rapid acceleration in government borrowing needs was boosted by the fiscal response to concerns about the possibility of a severe economic slump and the re-pricing of risks which caused the real imbalances to spill over into financial developments.

In the last years, differences in government bond yields have sharply increased. That is why the chapter examines the role of fiscal fundamentals for sovereign risk spread in selected European Union member states. The aim of the chapter is to test the impact of GDP growth, budget balance, debt, and the fiscal rules index on government bond yield spread and to verify whether stronger fiscal discipline reduces sovereign risk premiums.

BACKGROUND

There is no doubt that government bond prices are closely linked to real economic activity through a variety of channels, though the theory does not clearly identify the direction of the causal relationships between variables. Already, Morck et al. (1990) identified main channels through which bond prices are linked to real economic
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