Sovereign exposures and low interest rates - article by Rolf Strauch

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“Sovereign exposures and low interest rates”
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The EU fiscal framework provides a line of defence against fiscal profligacy. The rules aim to limit fiscal deficits and prevent excessive government debt that risk destabilising the monetary union. Since the creation of the Stability and Growth Pact, economic and financial conditions have evolved considerably. The rules have been fine-tuned and have become more complex. Now there is an opportunity to review them. The European Commission has launched a public consultation to collect feedback and ideas.

Market discipline can help limit unsustainable public finances, but failed to do so in the run-up to the sovereign debt crisis. Before 2008, sovereign credit risk was not priced in appropriately, as government bond spreads were compressed. Markets believed that the fiscal rules would ensure sustainability or countries in distress would be bailed out. The mispricing of risk was one of the deficiencies dis-incentivising adequate fiscal policies.

In times of stress, markets can swing into the other extreme and spreads can widen abruptly. Even if market volatility is not due to fundamentals, it can have negative effects on a sovereign and aggravate a crisis. Erratic and irrational moves, particularly when driven by herding behaviour, can lead to market failure. Additionally, perceptions of redenomination risk can exacerbate contagion in the euro area. A constellation of different mechanisms can lead to pro-cyclical price spirals and market closure in crisis times. Liquidity may evaporate quickly in a sovereign bond market and this may lead to liquidity shortages across markets.

We should foster complementarities between fiscal rules and market discipline. On the one hand, market reactions can contribute to fiscal discipline because market developments inform policymakers about the consequences of their decisions. On the other hand, a rule-based fiscal framework can tame market capriciousness by managing expectations. An effective framework should encourage proper risk pricing by markets.

Fiscal rules can serve as a sign-post for markets, and flag risks to investors. More predictable and transparent rules can help the appropriate pricing of sovereign risk and temper the binary perceptions of “risk-on” vs “risk-off” mood or risky versus safe assets. Investors can anticipate and internalise (“price in”) the policy reaction when rules are transparent and credible, even without disciplinary action. This works the better the more transparent and consistent rules are, and the more credible the enforcement.

More well-behaved and risk-guided markets support policy responsiveness to markets. Policy adjustment often comes too late when market moves are extreme. Signals may be there earlier, but are often blurred and the bar for policymakers to react can be high. In other words, policymakers are better informed about market signals and their implications with more predictable and credible rules giving clearer signals to investors. This creates better conditions for adequate policy responsiveness to fiscal vulnerabilities and less pro-cyclical fiscal policy.

The ongoing review provides an opportunity to improve fiscal rules. For instance, gearing rules towards observable variables can improve the clarity of the guidance both for policymakers and for markets. It also increases transparency. A number of institutions propose an expenditure rule to set operational targets, combined with a debt rule, as a fiscal anchor. This could be a way forward to explore further.

At the same time, other steps are needed to deepen Economic and Monetary Union (EMU) and increase its robustness to shocks. The completion of banking union and more capital market integration would support private sector risk-sharing. A central fiscal capacity and a European safe asset would support financial stability in the euro area and also the international role of the euro.

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