Research Fellowship Programme - Future of the EMU

Essay on The disciplining effect of financial markets on public finances: Can the genie be put back into the bottle?

Background

Economists regard market discipline as a powerful device to prevent fiscal profligacy. The original fiscal architecture of EMU acknowledged a role for both market pressure and fiscal rules in ensuring sound public finances. The convergence to very low interest rate spreads observed in the first years of EMU turned out ex post as hardly justifiable in the light of prevailing debt levels and cross-country differences in macroeconomic fundamentals. Though the divergence of spreads encountered during the sovereign debt crisis may reflect a correction of excessive past convergence, the ensuing market discipline has been considered too harsh for the management of public finances, suggesting some overshooting in the opposite direction. Moreover, signs of contagion across national euro-area sovereign markets would be indicative that market prices do not always properly reflect country-specific fundamentals, but are also driven by common factors which may be outside the control of the national policy makers concerned. Since the EMU policy framework and the behaviour of market participants have evolved considerably with the sovereign debt crisis, there is a need to re-evaluate the role of market discipline in the conduct of public finances, in conjunction with the incentives set by fiscal rules as well as the regulatory treatment of sovereign debt securities.

Aims of the essay and key questions to be tackled

The general objective of the essay is to explore how euro-area sovereign bond markets will perform after the sovereign debt crisis in terms of exerting market discipline on public finance. The essay should also analyse how fiscal rules and possible institutional settings of public finances influence the effectiveness of markets in disciplining national policy makers, and how both financial markets and political rules interact.

The essay should first provide an analysis of the main reasons for the low spreads in the initial phase of EMU, trying to assess empirically to what extent they were due to the introduction of EMU, to abundant liquidity on global markets or a consequence of other factors at play during the "Great Moderation". In this context, it could be investigated whether "too low interest spreads" were also observed outside the euro area or whether markets were only "over-optimistic" on euro-area Member States.

The essay should also derive empirical lessons from the sovereign debt crisis. This could be done by establishing how important country-specific and fundamentals factors versus contagion or common factors are in explaining the spreads between euro-area sovereign bonds. It could also try to shed some light on the contribution to the widening of spreads of structural financial factors such as the role of debt owed to external investors, home bias of domestic banks, the loss of highest-quality ratings, the link between ratings/CDS of sovereigns and domestic banks, withdrawal of investor groups, impaired use of sovereign bonds in repo and other security lending markets. Of particular interest would be an attempt to quantify the contribution to bond market developments of policy developments such as bail-out clause of the Treaty, bail-out of financial institutions, programme negotiations, anticipation of PSI, among others.

The essay could also analyse what form of institutional changes could allow a better disciplining role for financial markets and reduce the potential for contagion. Issues to be possibly investigated cover (i) actual institutional changes that have been brought forward by the financial crisis such as the provision of public money with conditionality to vulnerable Member States via the ESM, the fiscal compact and other new EU fiscal surveillance structures, (ii) measures that impact on market functioning such as the introduction of CAC, CDS short-selling restrictions, treatment of sovereign risk in capital and liquidity regulation and (iii) proposals that introduce further institutional changes, for example Eurobonds, Redemption fund, bail-in of debtors in bank resolution.

From the findings, the author would be invited to derive policy conclusions about the requirements for efficient financial markets to incentivise fiscal discipline. This may include implications for the design of fiscal rules in reinforcing the disciplining role of financial markets while reducing the potential of market signals to overshoot. An assessment of the Greek debt restructuring and questions related to the optimal design of restructuring rules could also be studied, investigating to what extent the disciplining effect of financial markets would be improved by the establishment of a restructuring framework.