Summary for non-specialists
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Do Sound Public Finances Require Fiscal Rules Or Is Market Pressure Enough?

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This paper discusses the balance between market pressure and fiscal rules in order to keep public finances on a sustainable path. The critical factors are the financial markets' ability to provide accurate measures of the stance of fiscal policy and the availability of enforceable rules to act as effective constraints on fiscal policy.

Reviewing the record of EU countries we find both that fiscal rules are associated with better performance of public finances and that the supranational rules stated in the SGP have not been fully implemented. Specifically, using the EU Commission Fiscal Rules index, in our empirical analysis we find a significant positive effect from tighter fiscal rules on public policy variables such as primary balance and primary expenditures. Countries with tight fiscal rules have larger primary balance surpluses and lower primary expenditures as a percentage of GDP.

An alternative to fiscal rules is to let public policy be guided by signals from financial markets. For financial markets to provide appropriate signals it is necessary that they price risk appropriately. New information should be reflected by valid responses that can be used by policy makers when designing economic policy.

Against that, the paper provides empirical evidence on market assessments of sovereign default risk, measured by CDS spreads, to economic news, announcements of national austerity programs, EU programs designed to support government finances, and banking fragility emanating from several countries in the euro area affected by the European sovereign debt crisis. We also measure market responses to "common" policy announcements emanating from the EU/ECB and international institutions, both the direct effect of announcements on perceptions of sovereign default risk, and the indirect effect transmitted from other countries (contagion), during pre-crisis and European sovereign debt crisis periods.

Focusing on four southwest euro area periphery (SWEAP) countries (Portugal, Ireland, Italy and Spain) we find that market signals may not be fully reliable and the market response to policy announcements is at times inconsistent, depending upon whether the actions were anticipated and credible in light of their stated objectives. In general, we find that CDS spreads react to news announcements in the expected way. For example, negative news and credit rating downgrades lead to increases in the CDS spread whereas the establishment of ESM led to a sharp fall in CDS spreads. The covered bonds programs had a calming effect on CDS spreads; they fell significantly whereas the suspension of these programs increased the spread. Increased bank fragility, reflected by credit downgrades of banks, greatly increased risk perceptions of sovereign bonds.

From a policy perspective, the quality of market signals thus appears to be an insufficient indicator alone to accurately guide the conduct of fiscal policy, particularly during the crisis period. Specifically, markets frequently provide mixed signals in response to policy announcements of programs designed to shore-up government finances or banking sectors, partly due to perceptions about the credibility of the programs.

Even though markets often send proper signals, we find that they also tend to overreact and at times may send confusing or inconsistent signals. This may be explained, in part, by a structural shift in how markets respond to news in crisis periods compared to more tranquil periods. For example, good news did not seem to move market perceptions while bad news moved spreads substantially higher during the crisis.

However, expectations and the credibility of policies may also play a role. Announcements of the EFSF and "six-pack" led to increases in sovereign risk assessments by the market, perhaps because markets had expected stronger action and questioned whether they would prove effective. The response to the ESM announcement, replacing the EFSF and EFSM, was much more positive, reducing CDS spreads substantially and setting up expectations for a resolution of the sovereign debt crisis in Europe.

One of the most striking findings in this study is how markets respond to developments across national boundaries, i.e. the importance of contagion across EU countries. Austerity programs in one SWEAP country transmitted strongly and lowered CDS spreads throughout the group. Increased fragility of one nation's banks transmitted immediately throughout the SWEAP. For example, credit downgrades in one SWEAP country did not transmit to other SWEAP during the pre-crisis period but transmitted strongly during the crisis, raising sovereign default risk perceptions.

Overall, we conclude that market signals are clearly important, yet policymakers providing clear and consistent signals to markets — in terms of well-designed, internally consistent, and credible regulations and fiscal reforms that have broad political support — may be at least as important to calming markets as the role of markets in providing signals to policymakers in guiding policy. In sum, our empirical evidence on the response of CDS spreads to news suggests that market signals can be used as complement to fiscal rules but they should not be used as substitutes. Supranational fiscal rules complemented by national fiscal frameworks are more efficient ways to attain long-term sustainable public finances.