European Journal of Political Economy 39 (2015) 288–304

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

The impact of fiscal policy announcements by the Italian government on the sovereign spread: A comparative analysis☆

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ARTICLE INFO

Article history:
Received 30 September 2014
Received in revised form 27 May 2015
Accepted 6 July 2015
Available online 14 July 2015

JEL classification:
E43
E62
G01
G12

Keywords:
Fiscal policy announcements
Political communication
Sovereign debt crisis
Interest rate spread
GARCH models

ABSTRACT

This paper attempts to evaluate the impact of fiscal policy announcements by the Italian government on the long-term sovereign bond spread of Italy relative to Germany. After collecting data on relevant fiscal policy announcements, we perform an econometric comparative analysis between the three administrations that followed one another during the period 2009–2013. The results indicate that only fiscal policy announcements made by members of Monti's cabinet had a significant impact on the Italian spread. We argue that these findings may be partly explained by a credibility gap between Monti's technocratic administration and Berlusconi's and Letta's governments.

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1. Introduction

The recent economic crisis challenged the ability of national governments to guarantee economic stability and the sustainability of sovereign debt. There is empirical evidence that countries that do not have sound public finance, such as substantial fiscal deficit or an excessively high debt level, are likely to face higher risk premia required by financial market participants (Schuknecht et al., 2009). Since 2009 the spread between long-term government bond yields of some euro area countries vis-à-vis the German ones experienced not only a dramatic increase, but also an augmented differentiation among countries. Recent contributions show that the determinants of the widening of sovereign bond premia in euro area countries during the debt crisis were related to both general factors, such as liquidity risk, international risk aversion and contagion effects, and country-specific factors, such as fiscal positions and macroeconomic fundamentals (Attinasi et al., 2011; Gerlach et al., 2010; Arghyrou and Kontonikas, 2012; De Santis, 2012; Giordano et al., 2013). De Grauwe and Ji (2012) argue that the recent movements of government bond yield differentials cannot be explained only using economic and financial determinants. They show that the surge in the spreads of Portugal, Ireland, Greece

☆ The views expressed in this paper are those of the authors and do not necessarily reflect the views of the European Central Bank, the Eurosystem or Prometeia Associazione. We thank Anil Ari, Massimo Bordignon, Jacopo Cimadomo, Lucia Cossaro, Paolo Manasse, Steven Trypsteen, Mustafa Yeter, the editor and three anonymous referees for valuable suggestions. We also thank the participants at the 2015 ZEW Public Finance Conference. Any errors remain our responsibility.
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http://dx.doi.org/10.1016/j.ejpoleco.2015.07.002
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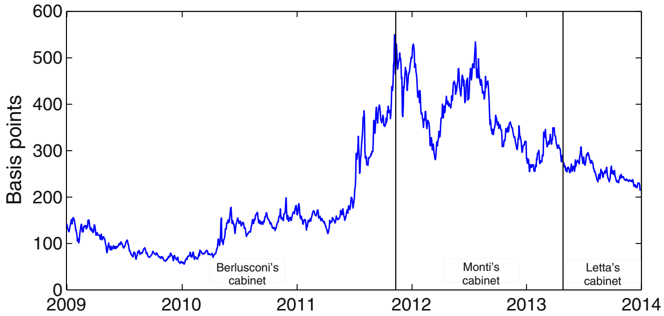

Fig. 1. Evolution of the Italian spread vis-à-vis Germany (2009–2013). *Notes:* Italian sovereign bond yield spread vis-à-vis Germany in basis points. *Source:* Data from Thomson Reuters-Datastream.

and Spain in the period 2010–2011 was not linked to the underlying increases in the debt-to-GDP ratios, but was connected to negative market sentiments.

A factor that may play an important role in driving sovereign spread movements is political communication. Although a formal definition seems to be difficult to provide, Denton and Woodward (1990) and McNair (2011) define political communication in a broad sense, as a discussion about the allocation of public resources with a particular emphasis on the purpose and intentionality of political actors in affecting the political environment. This includes discussions that are public and, therefore, could be related to public speeches, interviews and press releases. Clearly, mass media play an important role in transmitting political communication and thus making them public knowledge (Gade et al., 2013). The provocative article "*Loose lips sink the euro?*" published in The Economist on the 16th of September 2011 increased the attention on the effects of political communication in the context of the euro area sovereign debt crisis.

The financial market effects of statements made by policy-makers have been the objective of many recent studies. Overall, the literature points to the importance of political communication in influencing financial markets. For instance, Carmassi and Micossi (2010) analyse critical changes in the 10-year government bond spread of Portugal, Italy, Greece, Spain and France versus Germany between December 2009 and June 2010, pointing out that communications by governments fuelled the financial turmoil. In particular, the messages by policy-makers were not able to convince the markets about their ability to effectively address economic imbalances. Mohl and Sondermann (2013) consider news agency reports from May 2010 to June 2011, finding that a higher level of statements' frequency from different euro area governments generated an increase in the bond spreads. In addition, they show that statements from AAA-rated countries' politicians had a significant impact on sovereign bond spreads. Goldbach and Fahrholz (2011) assess whether political statements that worsened the credibility of the Stability and Growth Pact generated a shared default risk premium for euro area countries. They show that the European Commission played an important role in affecting investors' evaluations, where its statements signalling a weakening of fiscal credibility sparked uncertainty on financial markets. Gade et al. (2013) investigate the extent to which political communication, defined as "policy-makers' pronouncements on fiscal policy and public finance", had an impact on the sovereign bond spreads in euro area countries, showing that this effect is evident in Greece, Ireland and Portugal. Büchel (2013) finds that communication by representatives of Germany, France, and the EU as well as ECB Governing Council members had an immediate impact on the GIIPS' CDS and bond yield spreads. The study by Ehrmann et al. (2014) on the determinants of the euro exchange rate during the European sovereign debt crisis shows that the exchange rate volatility was increasing in response to news on days when several politicians from AAA-rated countries went public with negative statements. The impact of the European Central Bank (ECB) communications about unconventional monetary policy measures on the sovereign spread of stressed euro area countries is the focus of the analysis by Falagiarda and Reitz (2015). They find that the announcements of these operations reduced the long-term government bond yield spread of these countries during the recent euro area sovereign bond crisis.[2]

This paper intends to study the impact of political announcements by the Italian government on the Italian sovereign bond spread, i.e. the differential between the benchmark Italian 10-year government bond yield and the German one. As depicted in Fig. 1, the Italian spread experienced very high volatility between 2009 and 2013, increasing from around 140 basis points at the beginning of 2009 to more than 500 basis points at the peak of the sovereign bond crisis in 2011. It then declined to about 220 basis points at the end of 2013. As already mentioned, the volatility of sovereign risk is potentially connected to the ability of governments to address their duties in terms of sound public finance and debt obligations, and to provide credible long-term prospects. The recent Italian political experience motivates an intriguing comparison among the three administrations that followed one another during the period 2009–2013: Berlusconi's cabinet, in office until the 12th of November 2011, Monti's cabinet, in office until the 27th of April 2013, and Letta's cabinet. Therefore, it seems natural to conduct a comparative econometric analysis to assess the effects of the announcements by members of the three different administrations.

[2] Beetsma et al. (2013) do not restrict the analysis to political communication, and investigate the effect of "news" on sovereign bond spreads. They find that more news on average raised the interest spread of GIIPS countries since September 2009. They also report evidence of spillover effects among these countries and from GIIPS countries to non-GIIPS countries.

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