



# Sovereign Spreads and Fiscal Consolidations

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# Motivation

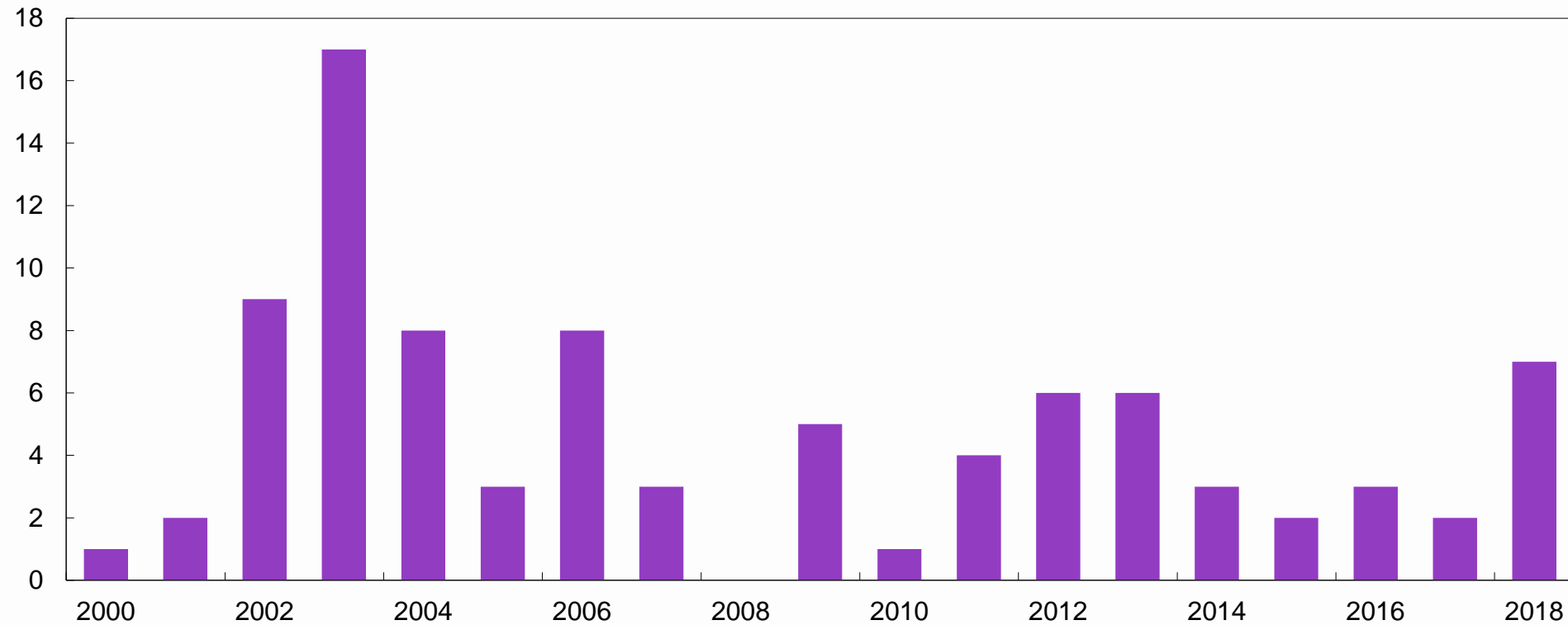
- A combination of factors has eroded fiscal space in several economies in Latin America and the Caribbean (LAC), precipitating the need for fiscal adjustment.
- Lively debate on the macroeconomic effects of fiscal consolidations, particularly following “austerity” policies in the Euro zone and Britain.
- EMs typically have higher sovereign default risk, implies scope for reductions in interest rates, so-called “*confidence effects*” (Blanchard, 1990; Giavazzi and Pagano, 1990).
- But, empirical evidence on the success of fiscal consolidation in lowering sovereign spreads has been elusive (Born, Muller, Pfeifer, 2019).
- Using a dataset on fiscal news, the chapter shows the behavior of sovereign spreads after the announcement of fiscal consolidation packages.

# Identifying Fiscal Policy Shocks

- Disentangling the causal effects of fiscal policy actions is challenging.
  - Timing restrictions, forecasts errors, and other approaches used in the literature have important limitations.
- This chapter employs a high frequency identification approach.
  - Exploits a novel database on fiscal consolidation announcements constructed by David, Guajardo, and Yépez (2019).
  - Compilation of announcements based on news articles contained in the Dow Jones' Factiva online database for 21 Emerging Market and Developing Economies (EMDEs) over the period 2000 to 2018.
  - Cross-checked against narrative dataset of David & Leigh (2018), including “endogenous” consolidations.

# Chapter Focuses on 90 Announcements in LAC Countries

**Number of Fiscal Consolidation Announcements in Latin America and the Caribbean**



Source: IMF staff calculations.

# Estimation Approaches

- Jordà (2005) Local Projections Method. The benchmark specification for spreads at different horizons ( $h=0,\dots,30$ ) in days:

$$r_{i,t+h} - r_{i,t-1} = \alpha_{i,h} + \gamma_{t,h} + \beta_h D_{i,t} + \delta X_{i,t} + \varepsilon_{i,t+h} \quad (1)$$

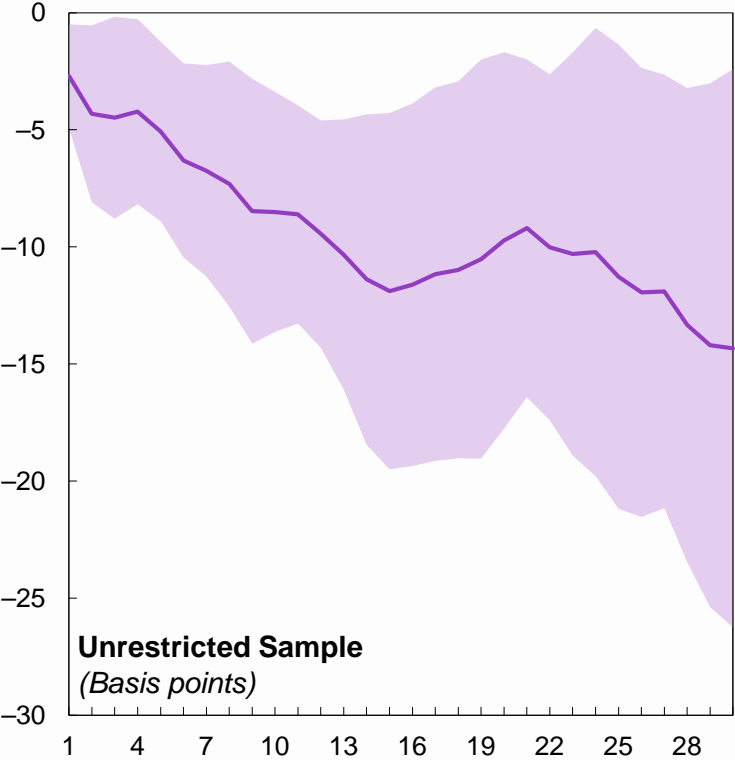
- Also consider state-dependent specifications:

$$r_{i,t+h} - r_{i,t-1} = S_{i,t-1}^j [\alpha_{i,h}^j + \gamma_{t,h}^j + \beta_h^j D_{i,t} + \delta^j X_{i,t}] + (1 - S_{i,t-1}^j) [\alpha_{i,h}^j + \gamma_{t,h}^j + \beta_h^j D_{i,t} + \delta^j X_{i,t}] + \varepsilon_{i,t+h}. \quad (2)$$

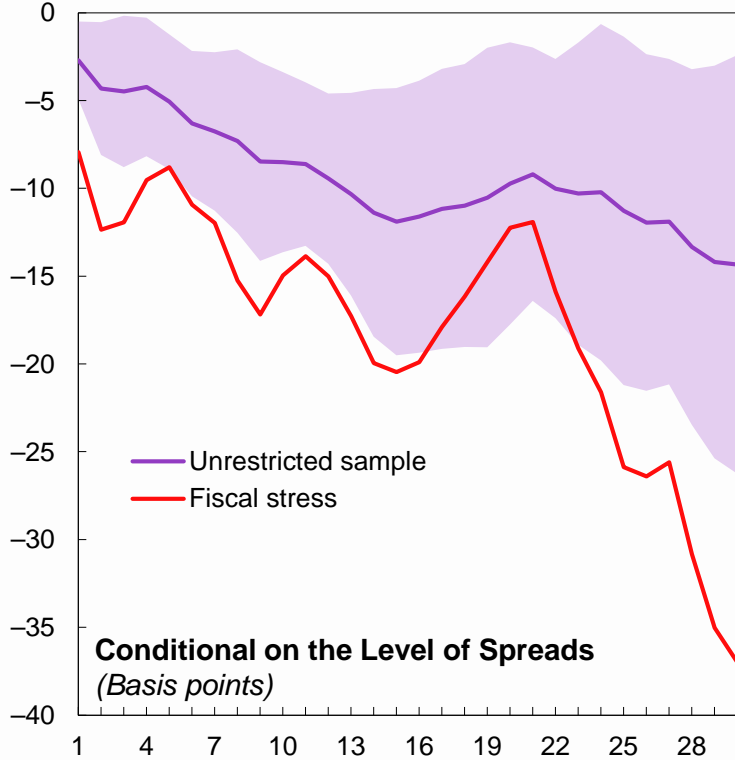
- Finally, the chapter presents results from monthly Panel VAR models with interaction terms (IRFs conditioned on the level of spreads) to gauge transmission channels to economic activity.

# Does Fiscal Consolidation Trigger Confidence Effects?

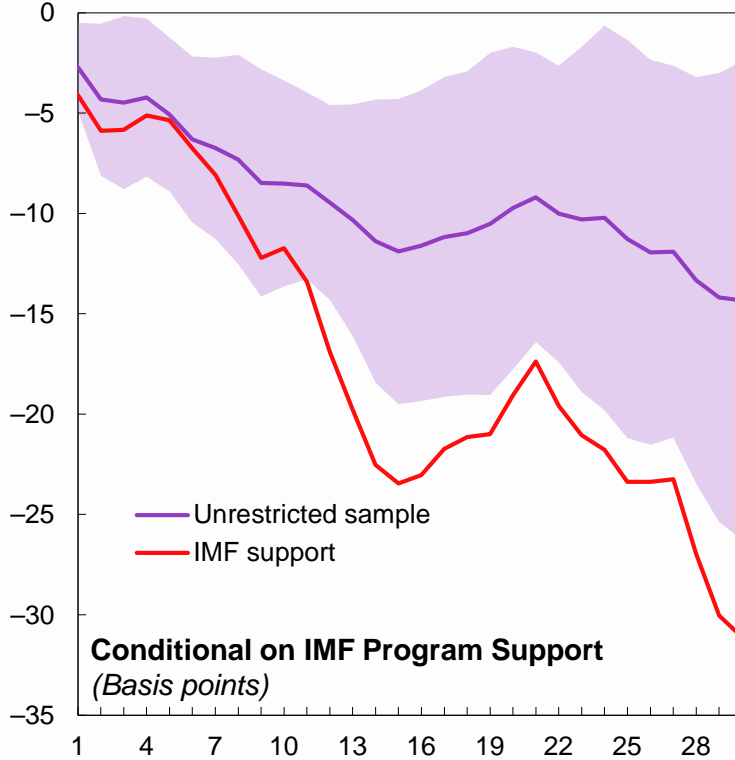
Typically, spreads fall by around 15 bps in a 30-day window after an announcement.



But declines in risk are substantially larger during periods of fiscal stress (i.e. high EMBI).



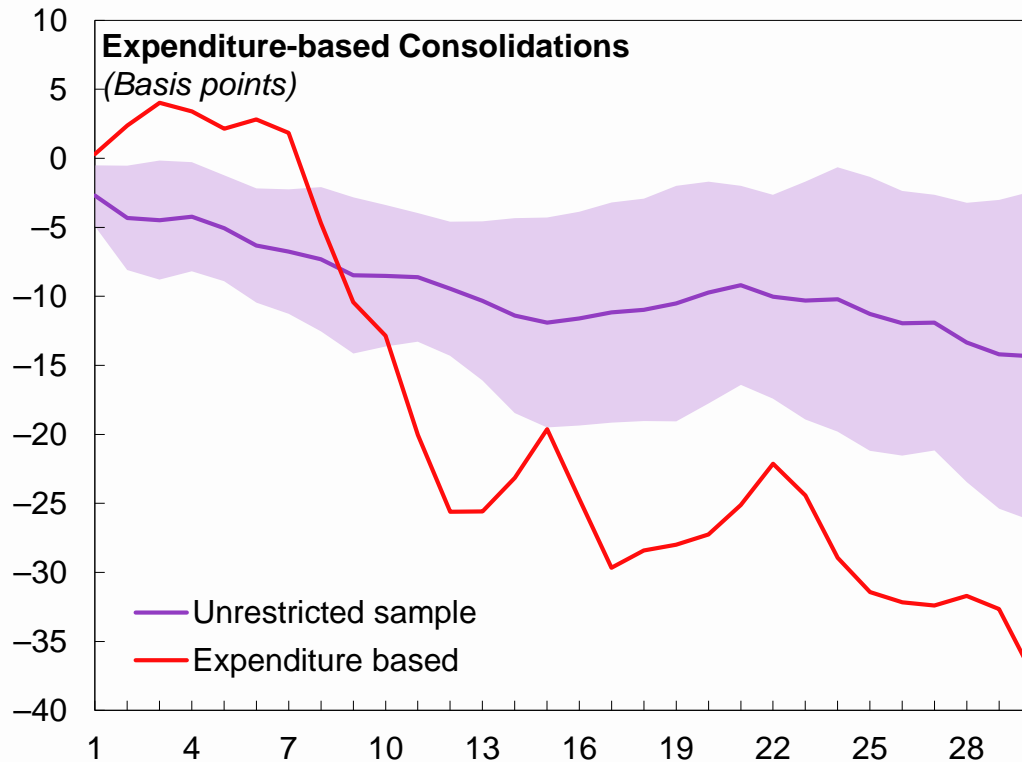
Declines in spreads are also larger if fiscal measures are supported by an IMF program.



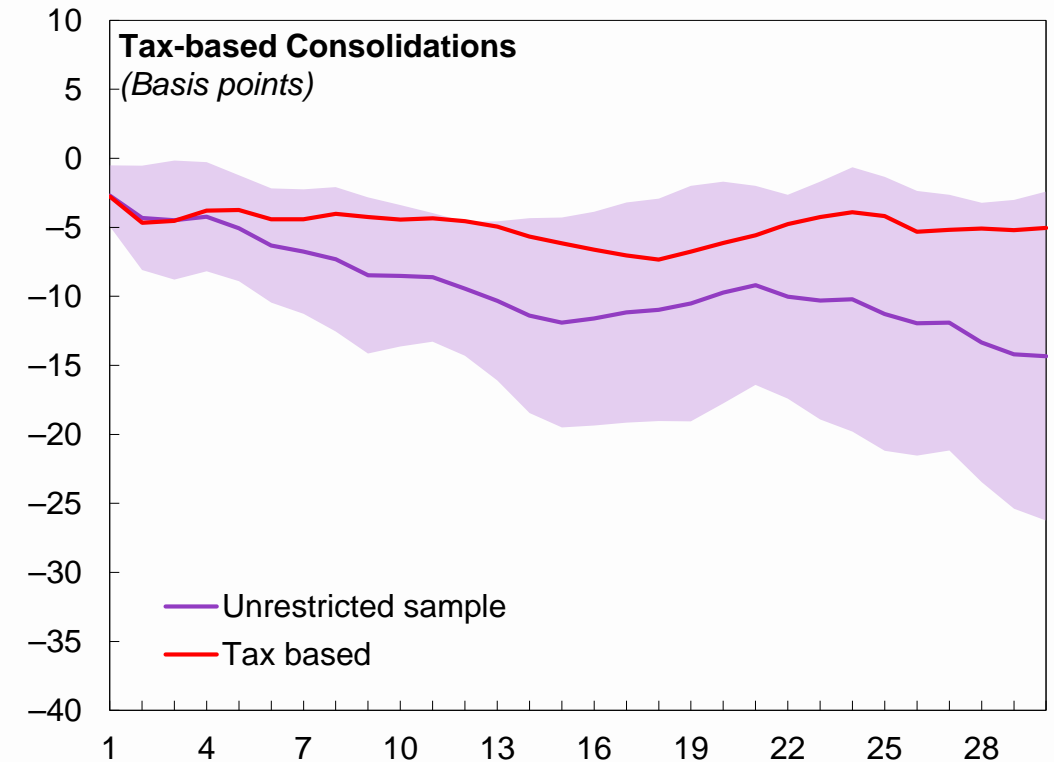
Source: IMF staff calculations.  
Note: Estimates based on local projection methods. Shaded area indicates 90 percent confidence intervals using HAC standard errors.

# The Devil is in the Details: Does the Composition of Fiscal Adjustment Matter?

*Expenditure-based consolidations lead to higher and more persistent reductions in spreads...*



*... when compared to packages predominantly based on tax increases.*

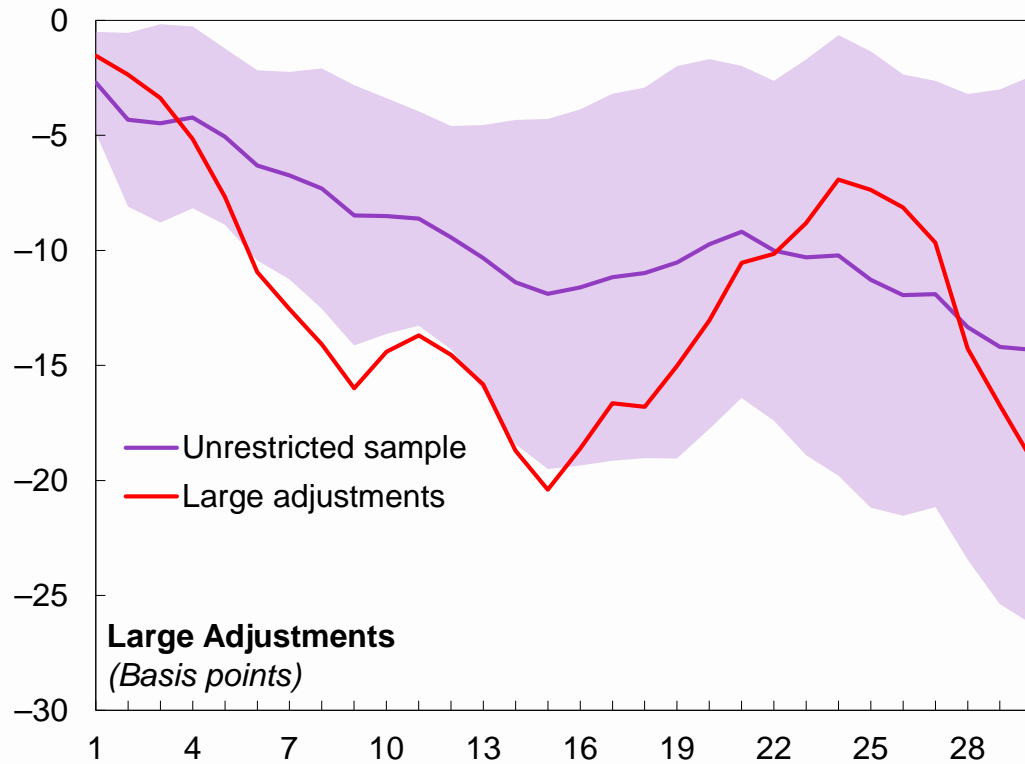


Source: IMF staff calculations.

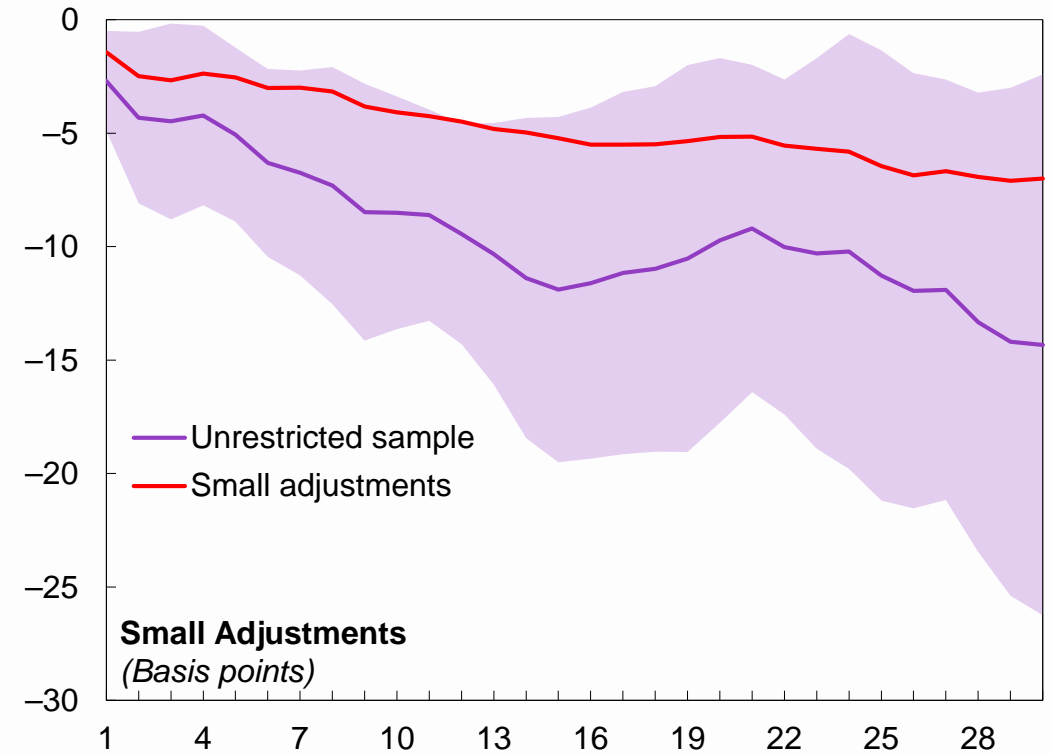
Note: Estimates based on local projection methods. Shaded area indicates 90 percent confidence intervals using HAC standard errors.

# The Devil is in the Details: Does Size of Fiscal Adjustment Matter?

*Splitting the sample in half using “large” and “small” adjustment bins shows that ...*



*... large adjustments are linked to greater reductions in sovereign spreads.*



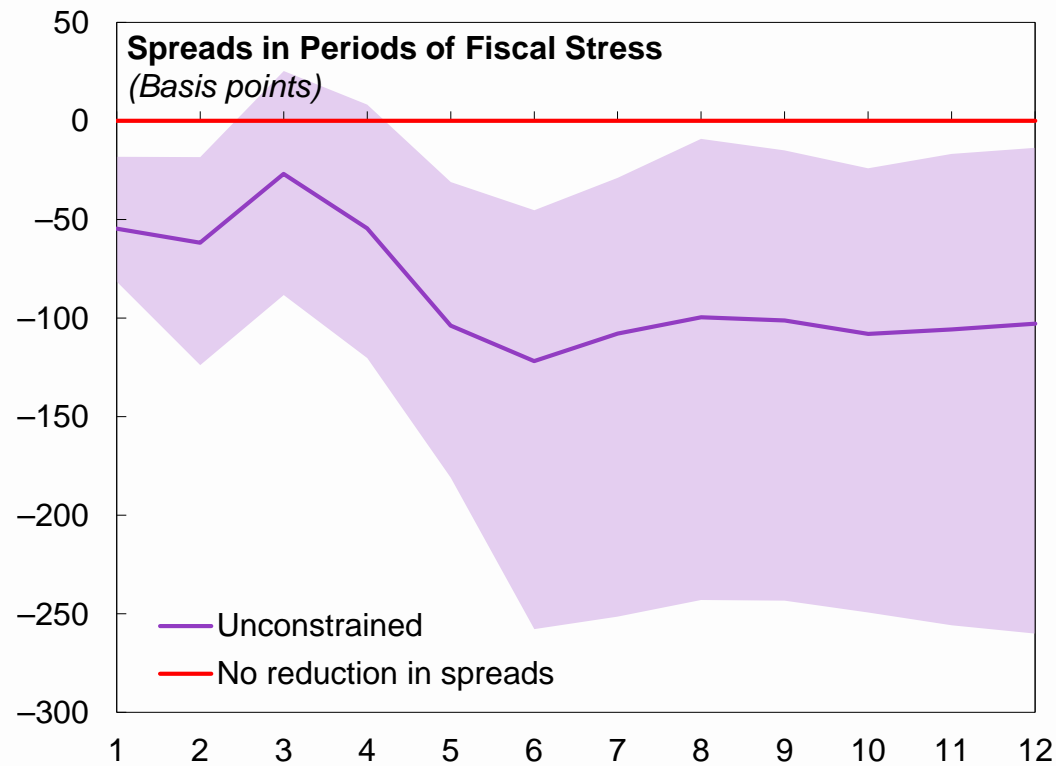
Source: IMF staff calculations.

Note: Estimates based on local projection methods. Shaded area indicates 90 percent confidence intervals using HAC standard errors. The LAC sample is split at the median of the empirical distribution for the size of the adjustment package.

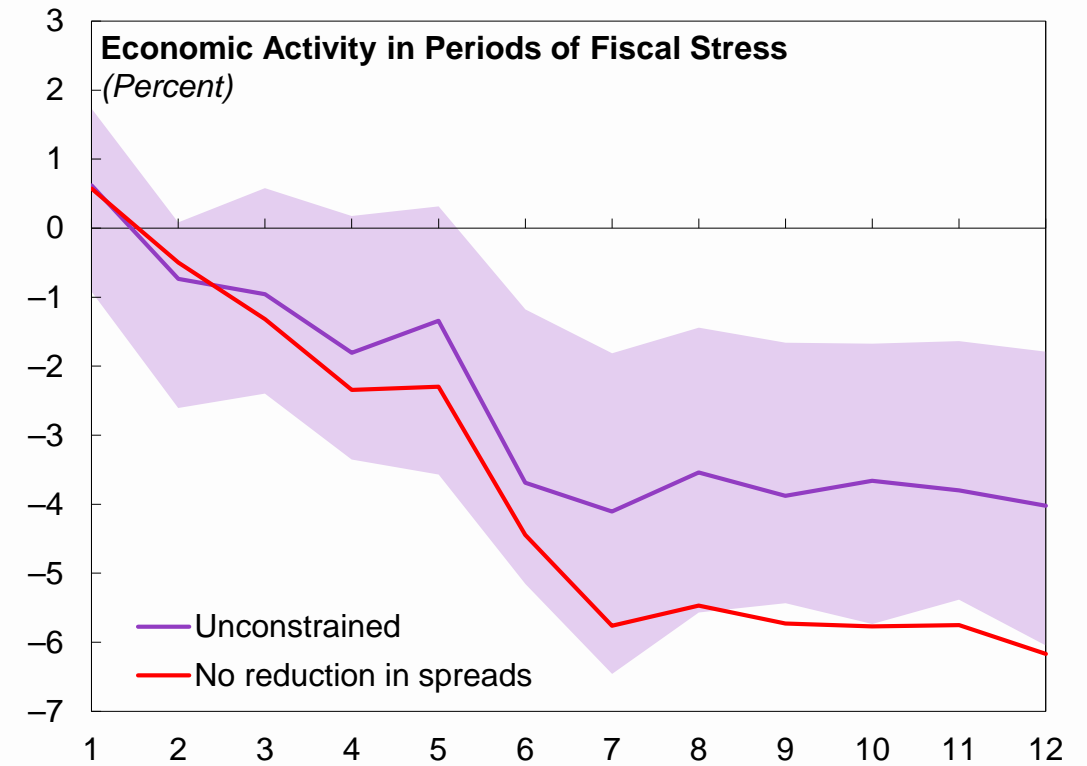


# Assessing the Transmission Channels: from Confidence to Economic Activity

Use IPVAR to examine the transmission channels. In periods of fiscal stress, spreads decline by 100 bps after announcement.



Counterfactual analysis shows that consolidations are significantly less harmful when spreads decline.

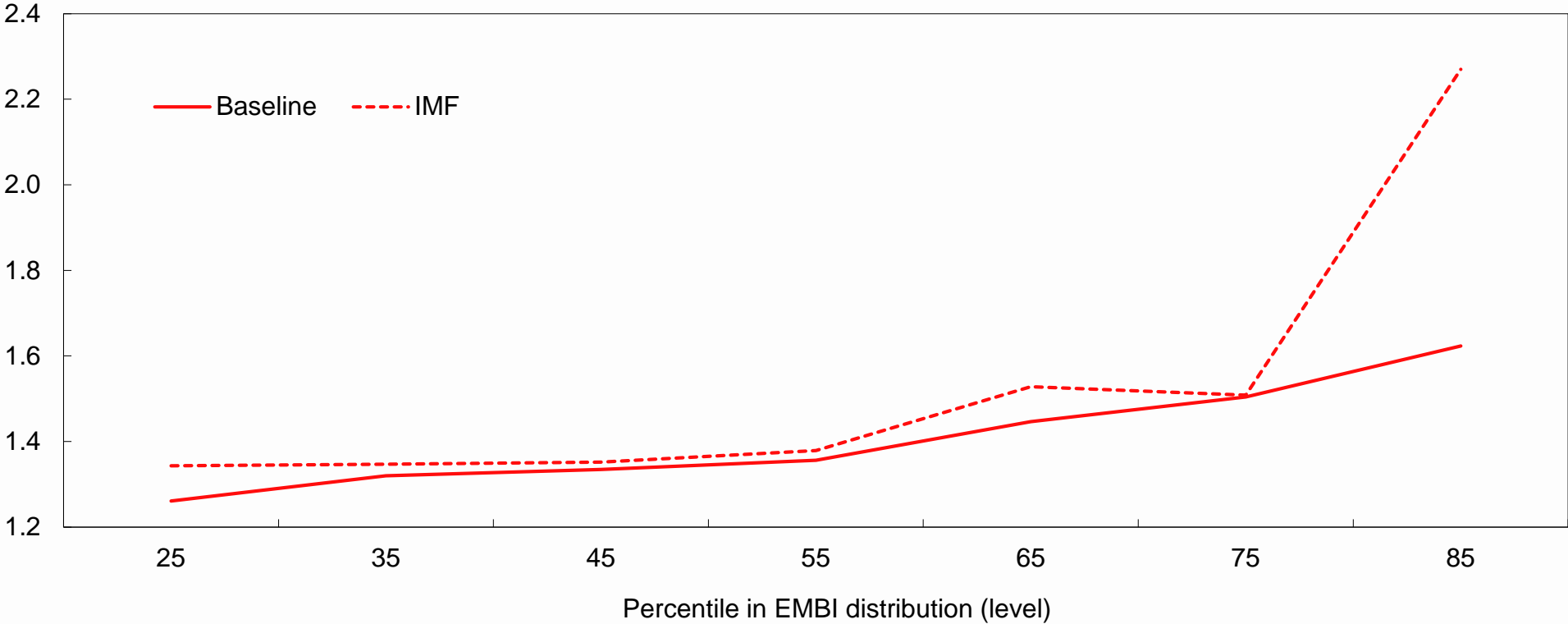


Source: IMF staff calculations.

Note: Estimates based on a PVAR. Shaded area indicates 90 percent bootstrap confidence intervals. The red line is the counterfactual scenario in which spreads do not respond.

# Benefits Increase with the Level of Spreads and under IMF Programs

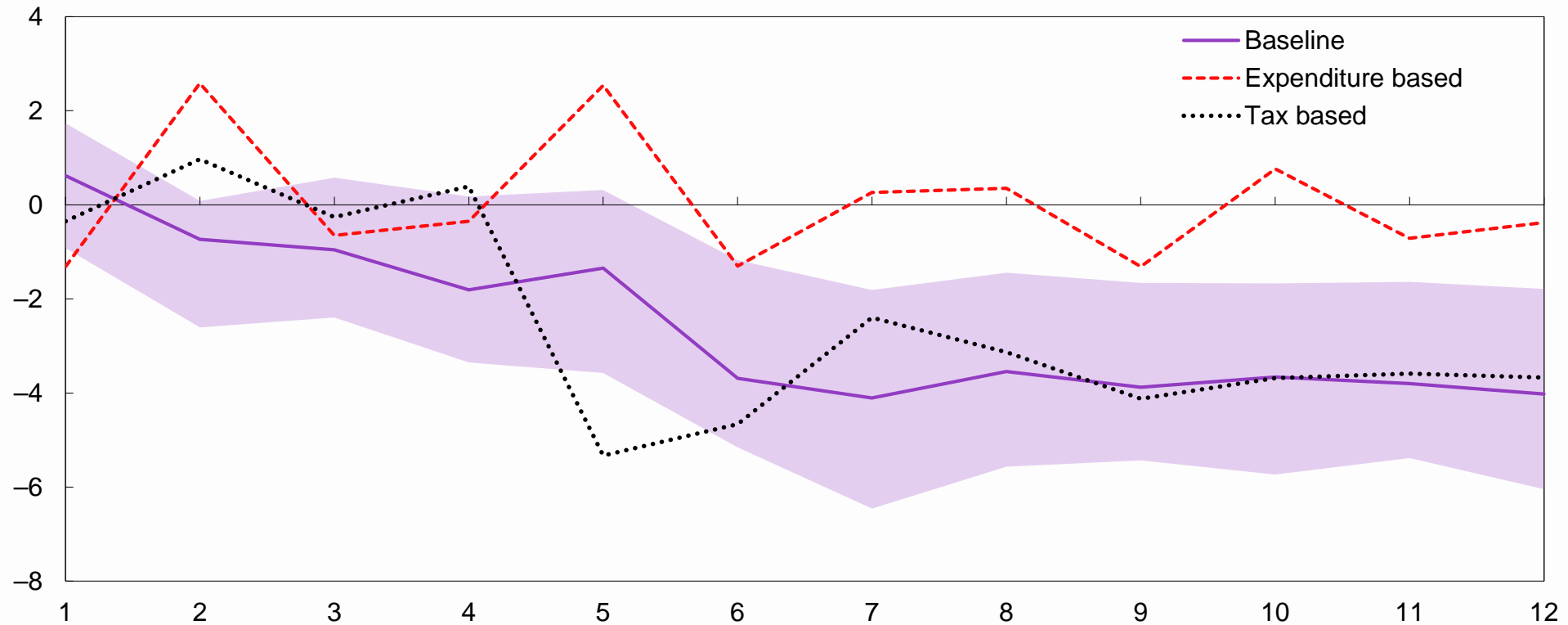
**Ratio of the Response of Output in Unconstrained Specification  
Relative to Counterfactual and EMBIG Levels  
(Percent)**



Source: IMF staff calculations.

# Expenditure-Based Consolidations are Less Harmful to Economic Activity

Effect of Fiscal Consolidation on Economic Activity by Consolidation Type in Times of Fiscal Stress  
(Percent)



Source: IMF staff calculations.

# Conclusions and Policy Takeaways

- Periods of high sovereign risk are opportune moments for fiscal consolidations. The contractionary effects of adjustment packages are mitigated by easier financial conditions.
- Given the relatively high spreads in LAC, greater scope for these effects in the region.
- The design of adjustment packages matters. Some evidence that consolidations implemented mainly through expenditure cuts lead to smaller output losses.
- But need to account for institutional constraints (budget rigidities) and political economy.
- Successful adjustment relies on building public support. Need for transparency and clear communication about the rationale and scale of fiscal challenges.

Thank You