Fiscal Rules and Risk Premia: National and Subnational Evidence

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Abstract: The most recent debt crisis in the Euro area has demonstrated that a lack of trust of the market participants in the sustainability of public debt can affect the countries access to the capital markets. There are good arguments suggesting that fiscal rules, such as the German debt brake, positively impact the trust of the market participants. Using the European Commission's "Fiscal Rule Index" and data for 16 European countries for the period 1993 to 2008 we find some evidence that stronger fiscal rules reduce yield spreads against German federal bonds. This effect is particularly driven by balanced budget rules and also debt brakes. In another approach, the relationship between fiscal rules and risk premia is studied at the subnational level in Switzerland (period 1981 – 2007). We also find empirical evidence for a negative relationship. Both the existence as well as the strength of fiscal rules reduces cantonal yield spreads compared to Swiss federal bonds.

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