Comments on:

Stéphanie Pamies, Nicolas Carnot and Anda Pătărău: Do Fundamentals Explain Differences between Euro Area Sovereign interest Rates?

Friedrich Heinemann

Franco-German Fiscal Policy Seminar, Paris
November 10, 2021

ZEW

ZEW

CONTRIBUTION

- Understanding **longer-term determinants** of euro area spreads annual data (less interested in short-term fluctuations of high-frequency event-study perspective)
- **Broad perspective** since the study looks at the following drivers:
    - fiscal fundamentals including government effectiveness
    - growth potential
    - financial market volatility (risk on – risk off)
    - Eurosystem involvement through PSPP
- Very **rich set of specifications** exploring:
    - debt non-linearities
    - Interactions that could impact on spread-debt gradient
- A very **informative and comprehensive literature review**
- **Policy relevance**
    - Fiscal fundamentals matter; bad fiscal data are associated with a significant threat for spread increases.
    - Markets reward good fundamentals, but also high growth potential and government effectiveness.

COMMENTS – TECHNICAL LEVEL

Possible refinements of controls/specifications:

Almost all ideas/questions that came to my mind are addressed through one of the specifications:

- Non-linearities (various kinds)
- Fiscal fundamentals include: maturity structure, official lending (ESM etc.), debt net of debt hold by Eurosystem and official lenders, private debt
- ECB controls: not just PSPP aggregate but also country-specific PSPP purchases to allow for asymmetries in the programme (2013 dummy could on top be sold as „whatever it takes“-regime identifier)
- Structural breaks

Remaining suggestions

- Interest burden (market and official lending, forward-looking, changed fundamentally e.g. for Greece)
- Risk appetite indicator: S&P volatility – unusual? No direct measure of credit risk appetite such as US sovereign-corporate bond spread.

THE PAPER IS TOO MODEST ON ITS HIGH POLICY RELEVANCE

It provides a thoroughly derived idea of a fundamentally justified spread, i.e. a spread that we could expect

- in a quiet (non-crisis) market environment of the „good equilibrium“ (since models extensively control for impact of crisis environment)
- without emergency support from official lenders and Eurosystem programmes (since models extensively control for the impact of these interventions).

Why is this so important?

- DSA: We can only meaningfully assess the fundamental debt sustainability if we have an idea of a spread that neither reflects the panics of the „bad equilibrium“ nor the European assistance employed to address the crisis.

- Appropriateness of ECB spread targeting: ECB wants to compress inappropriate spreads – this papers would help to find out where this border is located.

WHY DON‘T YOU ADD A FURTHER SECTION THAT ..

.. simulates „fundamentally justified spreads“ as the best performing models’ predictions for a country‘s fundamentals (fiscal, growth, government effectiveness, debt management)

- in a non-crisis environment (risk-off)
- under the counterfactual of no official lending / ECB support

This would be highly informative, for example, to

- assess whether the ECB is in a terrain of artificial spread compression (relevant for the Art. 123 TFEU controversy)
- execute non-tautological DSAs (tautological DSA is one where sustainability results from the spread reducing official assistance – and official assistance is justified by the positive DSA result).