

COMMENTS ON SESSION 1
NEW METHODOLOGIES FOR ASSESSING FISCAL SUSTAINABILITY

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Comments on “Tangos, Sambas or Belly Dancing? Or, Do Spreads Dance to the Same Rhythm? Signaling Regime Sustainability in Argentina, Brazil and Turkey” by Santiago Herrera and Ferhan Salman

The paper’s declared objective is to investigate primary fiscal balances’ suitable role as a signaling device when governments (sovereign debt issuers) are not fully credible. In order to meet the goal, the authors resort to an econometric panel and pool estimation of the Drudi-Prati Model,¹ seeking to assess the performance of governments in three emerging economies (Argentina, Brazil and Turkey) whose macroeconomic experiences in the recent past offer numerous insights worth analyzing.

They depart from the definition of dependable (strong) governments as those having the capacity of signaling willingness to honour debts by running primary balances and also, and contrariwise to the so called “weak” governments, of achieving higher ratings than the latter even with higher debt ratios, to later consider the model’s three main testable hypotheses: that there exists a positive correlation between sovereign spreads and debt ratios and a negative one between the former and primary balances ratios, that primary balances amplify their effect upon sovereign spreads when debt ratios reach high figures and that the primary balance raises with dependable governments following debt ratio increases.

Next, the authors relate fiscal sustainability and risk premia levels, by stating the widely accepted knowledge that countries’ risk premia have an indirect relationship with governments’ fiscal sustainability to immediately recall that the intertemporal government budget constraint is expressed as:

$$S_{i,n} a^i G_i = S_{i,n} a^i T_i - (1 + r_{-1}) Bg_{-1}$$

which amounts to saying that the present value of receipts (right hand side in the above expression) must match the present value of public spending and debt obligations and in turn implies the non-possibility of running Ponzi games.

Herrera and Salman enrich their application of the Drudi-Prati model by posing the challenged questions of whether fiscal variables, on their own, can or help to substantially explain sovereign spreads’ behaviour or it is rather the firm commitment to reforms, economic, political and social stability, together with the impact of fiscal variables and exchange rate regimes, what constitutes in fact a signaling device.

Given the scientific high standard showed by the authors in setting the paper’s goals and the underlying conceptual framework, as well as the methodological rigour with which hypotheses were econometrically tested, it does not come as a surprise that regressions yield in turn sound results with important policy implications. In particular, econometric results show that estimated coefficients for debt and primary balances ratios are significantly different from 0, and carry the expected signs, in all the three countries; nevertheless, the signaling ability of primary balances

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¹ Drudi, F. and A. Prati (2000), “Signaling Fiscal Regime Sustainability”, *European Economic Review*, Vol. 44.

Table 1**Argentina**

	1995	1998	2000	2001	2002	2004	2006	2007
Public Debt/GDP	34.4	38.2	45.0	52.9	150.8	124.8	64.1	55.6
Interest Payments/GDP	1.6	2.2	3.4	3.6	2.2	1.3	1.8	2.0
Interest/Tax Revenue	13.2	16.4	23.7	25.9	17.0	6.8	9.3	15.0
Interest/Current revenue	8.5	11.9	17.2	18.8	12.4	5.4	7.3	10.0
Overall Fiscal Balance/GDP	-0.5	-1.4	-2.4	-3.1	-1.5	2.6	1.2	1.1
Primary Fiscal Balance/GDP	1.1	0.8	0.9	0.5	0.7	3.9	3.5	3.2

Source: Own estimates on the basis of information from the Ministry of Economy of Argentina.

Table 2**Brazil**

	1998	2000	2001	2002	2004	2005
Public Debt/GDP	32.7	49.6	53.3	56.0	51.7	53.7
Interest Payments/GDP	6.2	7.2	7.3	7.6	7.1	7.3
Interest/Tax Revenue	31.0	30.9	29.8	31.9	28.2	28.1
Interest/Current Revenue	19.6	18.0	16.5	21.8	20.0	20.0
Overall Fiscal Balance/GDP	-5.9	-3.6	-3.6	-5.3	-3.3	-3.4
Primary Fiscal Balance/GDP	0.3	3.6	3.7	2.3	3.8	3.9

Source: Own estimates on the basis of information from diverse Brazilian Ministries and the National Institute of Statistics.

differs between Brazil and Turkey, on the one side, and Argentina on the other, what falls in line with the Drudi and Prati's assertion concerning the signaling role of primary balances in dependable governments.

In sum, the paper's content and conclusions fulfill the authors' expectations and constitute a worthy empirical contribution to the analysis of the macroeconomic analysis of emerging economies and, particularly, to the study of the role of primary balances as signaling devices.

This having been said, and by no means attempting to play down the authors' conceptual treatment of the subject or the paper's main findings, there are however some drawn conclusions

derived from the analysis of stylized facts which which may deserve a revision or at least a more careful inspection of series. As an illustration, contentions that Argentina and Brazil exhibit similar public indebtedness indicators, that primary balances are substantially different in all the three countries and that Brazil and Turkey were running primary surpluses whereas Argentina was not do not seem to coincide with showed patterns in Figure 1 in the paper. By the same token, the performance of Argentina in the period considered does not seem to completely avail the suggestion that contagion effects of international crises increased the country's risk premia and worsened debt ratios, as shown again by Table 1 and Figure 1 in the paper and Tables 1 and 2 opposite, specifically built for this commentary.²

In the light of stylized facts, the authors correctly assert that confidence crises, coupled with political instability and lack of commitment to reforms, led the Argentine authorities to a debt default and the abandonment of convertibility³ whereas in Brazil economic stability and commitments to tighter fiscal policy and reform respectively raised sovereign spreads and decreased the country's risk premium. The analysis permits also to confirm the authors' assertion that Turkey exhibits the highest debt ratios as well as the largest primary fiscal balances compared with the other two countries.

Finally, and as stressed above, the paper by Herrera and Salman permits to derive a number of important lessons from the three countries' macroeconomic experience while in turn answers the question of why primary balances served as a signaling tool in Brazil and Turkey but they did not in Argentina:

- first answer: tight fiscal policies, in isolation, fall short of encouraging countries' higher ratings (smaller spreads);
- second answer: the perception exists that primary balances can be easily eroded in the future by an excessive rate of growth of public spending;
- third answer: the nature and composition of primary balances also matter;
- fourth answer: the country's economic history also matters (defaults and hold outs may sometimes become mortal sins);
- fifth answer: economic, political and social stability as well as sound policies regarding rate of exchange regimes and investment have a direct impact upon sovereign spreads;
- sixth answer: last but not least, there is a straight relationship between the country's rating and the quality of its economic environment.

Congratulations are conveyed again to the authors for the fine piece of empirical work submitted to this workshop and the encouragement for them to further this interesting line of research which policy implications and applications are well proven.

² Tables 1 and 2 replicate figures for 2000 and 2001 from Table 1 in the text, but a number of years have been added in order to offer a wider temporal framework for the analysis of stylized facts.

³ This took place in 2002.

