Reputations, Revisited: What Do Investors Count as a Credible Commitment?

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How Do Credible Commitments Work, Post–Financial Crisis?

- Research on how governments make credible commitments to markets
  - Domestic as well as international
    - Democratic institutions; independent central banks; federalism; IMF agreements; World Bank graduations; BITs; PTAs; PTAs with nice countries; IO accession; presence of foreign banks
  - Most looked at market data from 1980s onward
    - For emerging markets, in practice this meant 1990s onward (new bond issues; deepening capital markets)
      - An exceptional time: end of Cold War, market optimism, high appetite for risk, QE
1. “Pull” factors: Emerging Markets
   - EMs growing more resilient to crises (shallower impact, quicker rebound) (Didier et al 2012)
     - As crises of credibility hit OECD countries, less of a gap between EMs and developed countries
     - Less of a need to ‘signal’ credibility through political or economic commitments
     - Fundamentals, not heuristics, may drive yields post-crisis
2. “Push” factors: The Evolution of Audiences for Those Commitments

- Market sentiment from 1990-2008 may have been unusual
  - Overly dependent on heuristics
  - More incentives to follow herd
  - High appetite for risk

- Post-crisis investor dynamics may have shifted
  - New actors, including institutional investors and rating agencies from Japan, China
    - Heterogenous perceptions of risk
3. The Nature of the Commitment

- Many commitments that seemed to tie a government’s hands may not endure
  - Gaps between *de jure* and *de facto* commitments
    - PTAs can go unimplemented; governments can have fair elections but tamper with opposition in other ways; countries can renege on commitments (CBI and BITs)
  - Perceptions of international commitments may have changed
    - With exits and reversals, IOs may not seem so durable

- Saturation effects
  - Commitments may be less “separating” and more “pooling” if countries sign too many of them ...
  - ... or if they’re signed by too many countries in the world
Hypotheses

- **H₁** “Pull” factors: Changes in country fundamentals should be associated with changes in sovereign risk
  - More so *post-crisis*

- **H₂** Effect of credible commitments should attenuate post-crisis
  - Saturation effects for country and for world

- **H₃** “Push” factors: Changes in buyers of debt should be associated with changes in the impact of international commitments on sovereign risk
  - Domestic buyers might be less swayed by international heuristics than foreign ones
  - As investor base diversifies, the effects of “commitments” may attenuate (heterogenous perceptions)
Operationalization

- **DV:** Sovereign yields for 35 emerging markets, 1985-2015
- **IVs:**
  - Credible commitments: BITs, CBI, PTAs with good countries
    - Look at saturation through number of such commitments in the world, and number of commitments a country has taken on
  - “Pull” factors: Inflation, growth, current account balance, government debt/GDP, oil exports/GDP
  - “Push” factors: Domestic vs foreign investors, domestic central bank as purchaser, investor diversity — interacted with credible commitments
    - Lots of missingness (only 2003-2015, only 24 countries), but plausibility test

→ Across specifications, look at pre- and post-crisis dynamics
## Results for $H_1$ (Pull factors): Effects on Yields

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<thead>
<tr>
<th>Variable</th>
<th>Pre-crisis</th>
<th>Sig.</th>
<th>Post-crisis</th>
<th>Sig.</th>
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<tr>
<td>Inflation</td>
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<td>Income</td>
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<td>Growth</td>
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<td>Current Account</td>
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<td>Government Debt</td>
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<td>Fuel Exports</td>
<td>+</td>
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Results for $H_2$ (Credible Commitments): Saturation

- Saturation in the world: CBI, BITS, PTAs with good countries had strongest and deepest effects in late-1990s
  - Those commitments had been adopted by fewer countries; ‘signal’ was more meaningful
- The fewer commitments a country had signed, the stronger their effect
Results for H$_3$ (Push Factors)

- Ns are very small, but:
  - More domestic central bank investors in EMs post-crisis
  - Foreign investors seem most influenced by “credible commitments” (especially BITs and CBI) pre-crisis
    - Possibly more driven by heuristics, herd
    - Relationship attenuates post-crisis
  - The more domestic CBs purchase debt, the less of an effect the “credible commitments” have
Preliminary Conclusions and Continuing Research

- The strength of “credible commitments” in the 1990s–early 2000s may have been exceptional
  - Commitments had not yet eroded; post-Cold War, pro-globalization investor sentiment

- More work to be done on:
  - Expanding number and kind of commitments
    - Separating out *de jure* and *de facto* nature of commitments; changes in membership; uses of adjudication mechanisms in PTAs and BITs; etc.
  - More information on investor composition of EM debt
    - Currently gathering data on sovereign debt purchasers for EMs
The effect of BITs on sovereign risk, by year

Year-on-Year Effect of BITs on sovereign yields

Controls: inflation, growth, current account balance, government debt/GDP, oil exports/GDP
The effect of CBIs on sovereign risk, by year

Year-on-Year Effect of CBI on sovereign yields

Controls: inflation, growth, current account balance, government debt/GDP, oil exports/GDP
The effect of PTAs on sovereign risk, by year

Controls: inflation, growth, current account balance, government debt/GDP, oil exports/GDP