

Context-Conditional Impact of Fiscal Imbalances on Sovereign Bond Yields: An Interacted Panel VAR Analysis

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Abstract

While according to standard economic theory fiscal imbalances should raise sovereign yields for many reasons, the observed relationship is rather unclear. This paper empirically show that the impact of fiscal imbalances on sovereign bond yields is context-conditional using an interacted panel VAR and a panel of OECD countries. Our empirical approach takes account of cross-country heterogeneity and allows coefficients to vary continuously with an exogenous conditioning variable. We examine several politico-economic factors as potential conditioning variables, e.g, initial level of public debt, speed of population aging, government stability, share of non-residential holdings, and independence of central bank. We find the responses of sovereign yields to fiscal imbalances crucially depend on political or institutional environment as well as economic ones.

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