Box 2
Policy uncertainty and the risk of market repricing

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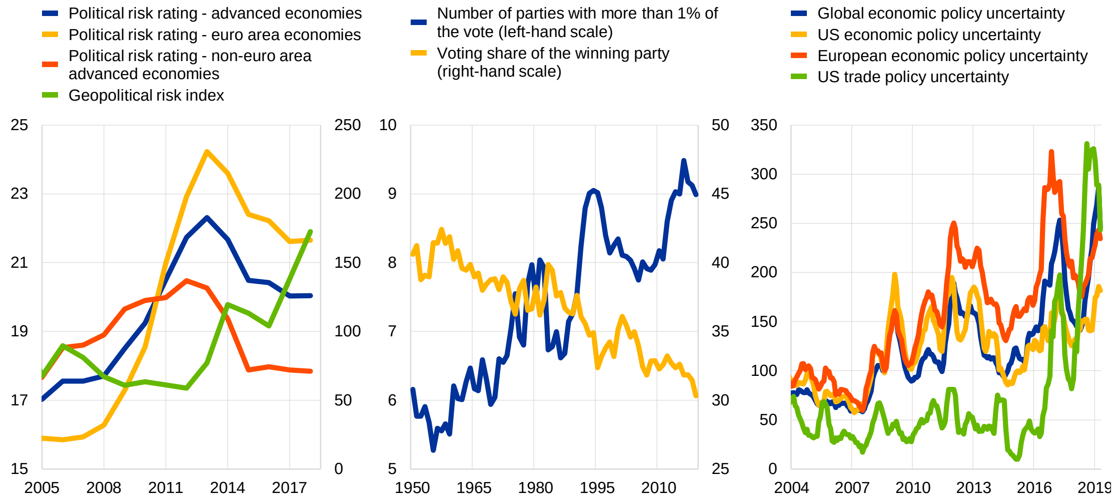
Policy uncertainty has remained elevated in recent years for the euro area and the broader global economy, at a time when the political landscape has become more fragmented. Political uncertainty has increased considerably since the global financial crisis in advanced economies (see **Chart A**, left panel). While political uncertainty is hard to capture in any single measure, heightened political fragmentation may complicate decision-making in national parliaments and could in certain instances potentially lead to policy instability. On this basis, a secular increase in the number of political parties during the past decades and a gradual decline in the voting share of the winning party suggests less cohesive political processes across constituencies (see **Chart A**, middle panel). Independent of the attribution of political uncertainty to an underlying cause, swings in policy uncertainty have grown in recent years, with trade policy uncertainty gaining prominence due to growing trade protectionism (see **Chart A**, right panel).

Chart A

Various metrics indicate a high level of uncertainty amid increasing signs of political fragmentation

Political risk rating and geopolitical risk index (left panel), number of political parties per election and voting share of winning party in the European Union (middle panel) and news-based measures of economic policy uncertainty (right panel)

(left panel: 2005-18, index points; middle panel: 1950- 2019, five-year moving averages; right panel: Jan. 2004-Apr. 2019, index points, six-month moving averages)



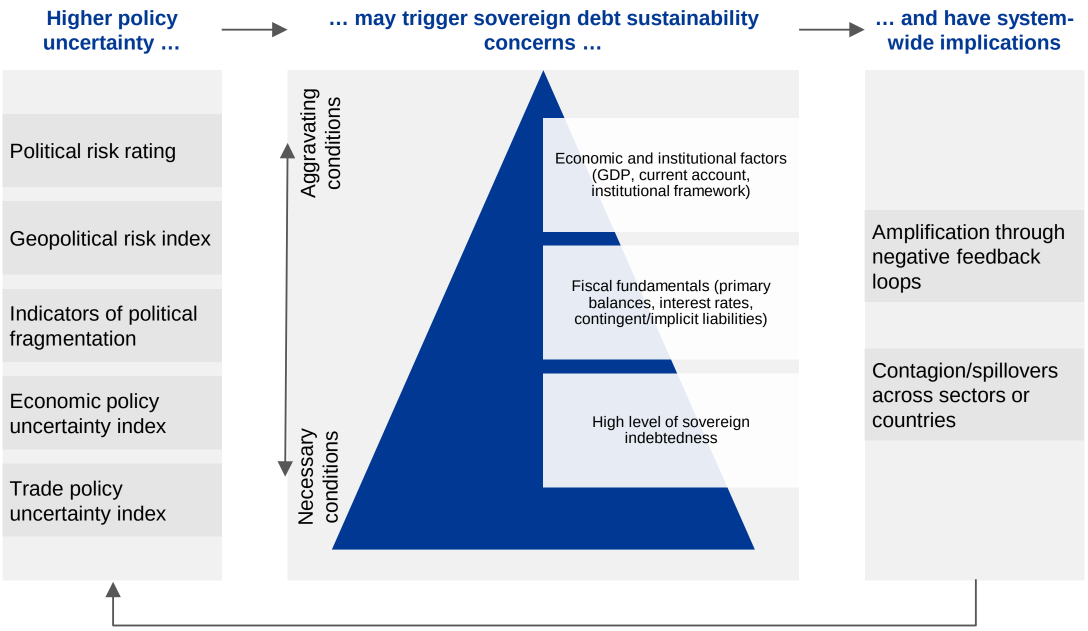
Sources: International Country Risk Group (ICRG), Caldara and Iacoviello (2017), Baker, Bloom and Davis (2013) and ParlGov database.
Notes: Left panel: the political risk rating is a synthetic index from ICRG measuring variables such as political unrest and the presence of conflicts, government stability, the investment climate, corruption, the rule of law and the quality of bureaucracy. For ease of exposition, the original index from the ICRG has been inverted so that an increase in the index indicates greater political risk. For the geopolitical risk index, see Caldara, D. and Iacoviello, M., "Measuring Geopolitical Risk", working paper, Board of Governors of the Federal Reserve Board, November 2017. Middle panel: European and parliamentary elections in the 28 current EU Member States (up until April 2019). Right panel: measures of economic policy uncertainty are taken from Baker, S., Bloom, N. and Davis, S., "Measuring Economic Policy Uncertainty", Chicago Booth Research Paper No 13/02, January 2013.

Policy uncertainty may lead to market concerns about sovereign debt sustainability amid still fragile fundamentals for many sovereigns. Policy uncertainty can have an impact on economic and financial outcomes (see **Chart B**). More uncertainty about future policy decisions may affect market perceptions of sovereign risk, with system-wide implications if fiscal or economic vulnerabilities weaken the sustainability of public debt. Financial markets tend to have considerable difficulty in pricing event risk, often leading to spikes in risk pricing when event risk materialises. Such changes in market sentiment can have significant impacts on sovereign debt sustainability. Three elements may explain the extent to which risk repricing in credit insurance against sovereign default may occur. First, fiscal fundamentals are key in determining vulnerability to sovereign debt sustainability concerns – most notably the stock of public debt relative to GDP. In fact, a high level of debt is a necessary condition for debt sustainability concerns to arise. Second, economic risk can govern the extent to which weaker growth can unearth concerns about these underlying fiscal fundamentals, and challenge debt sustainability. Such economic risk can be captured by variables, such as fiscal and current account balances, as well as economic growth and inflation. Third, political uncertainty can further exacerbate debt sustainability concerns, including not only traditional factors such as political unrest and the presence of conflicts, but also government stability, the investment climate, corruption, the rule of law and institutional quality.

Chart B

Policy uncertainty can trigger sovereign debt sustainability concerns

Interlinkages between policy uncertainty and sovereign debt sustainability concerns



Source: ECB.

A simple analysis of this interaction of fiscal, economic and political uncertainty explains the considerable variation in market perceptions of sovereign creditworthiness. An examination of the price of insurance against sovereign credit risk across 30 advanced economies offers two main takeaways. First, the impact of political risk on credit default swap (CDS) spreads across all advanced economies examined was limited before the global financial crisis, but increased strongly in 2010-12 as market concerns about euro area sovereign indebtedness gained prominence. While lower compared with its peak in 2010-12, the sensitivity of CDS spreads to political uncertainty has remained higher than before the crisis in recent years (see **Chart C**).[11] Second, CDS spreads in euro area economies seem to be more sensitive to political uncertainty than in other advanced economies. This finding may reflect market concerns about the incompleteness of the institutional framework of the monetary union in combination with the sustainability of public debt in some euro area economies. Such concerns were particularly evident at the height of the euro area sovereign debt crisis in 2010-12, when sovereign CDS markets put an additional premium on political uncertainty, as well as public debt, for euro area economies compared with other advanced economies.

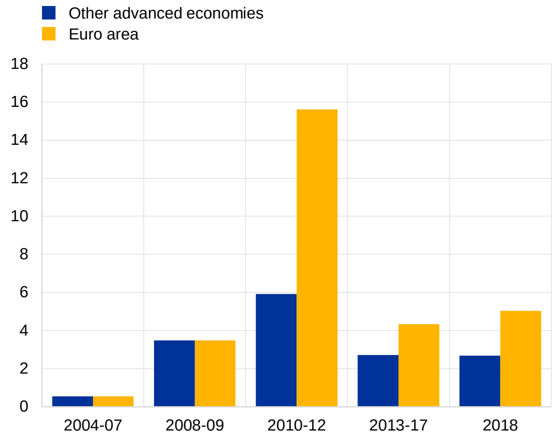
[11] These results are consistent with earlier findings of the literature. See, for instance, Beirne, J. and Fratzscher, M., "The pricing of sovereign risk and contagion during the European sovereign debt crisis", *Journal of International Money and Finance*, Vol. 34, 2013, pp. 60-82.

Chart C

Euro area CDS markets have been sensitive to political uncertainty since the sovereign debt crisis

Impact of political uncertainty on CDS spreads between 2004 and 2018

(left panel: CDS spreads, basis points; right panel: complete regression results)



	(1) 2004-07	(2) 2008-09	(3) 2010-12	(4) 2013-17	(5) 2018
Public debt	-0.02	-0.33**	-0.14	-0.00	-0.01
	(0.02)	(0.15)	(0.22)	(0.06)	(0.05)
Public debt * EA dummy	0.03	0.47	2.65***	0.18*	-0.07
	(0.04)	(0.33)	(0.43)	(0.09)	(0.10)
Economic risk	0.09	1.82***	3.73***	0.44	-0.13
	(0.09)	(0.61)	(1.17)	(0.57)	(0.54)
Economic risk * EA dummy	0.25	1.25	-2.04	-1.06	-0.78
	(0.22)	(1.36)	(2.11)	(0.86)	(0.98)
Political risk	0.54***	3.48***	5.92***	2.71***	2.69***
	(0.10)	(1.02)	(1.66)	(0.49)	(0.50)
Political risk * EA dummy	-0.40	-1.83	9.69***	1.62*	2.35**
	(0.30)	(2.17)	(2.85)	(0.87)	(0.94)
Observations	100	61	92	155	30
R-squared	0.45	0.46	0.72	0.51	0.85

Sources: Bloomberg, ICRG and ECB calculations.
Notes: The chart shows the estimated impact of political uncertainty on CDS spreads for 30 advanced economies between 2004 and 2018. In particular, the chart in the left panel shows the increase in CDS spreads, in basis points, corresponding to a one-unit increase in the political risk index. The model controls for the impact of economic fundamentals and the presence of outliers (right panel). Political risk is a synthetic index from ICRG comprising variables such as political unrest and the presence of conflicts, government stability, the investment climate, corruption, the rule of law and the quality of bureaucracy. Economic risk is a synthetic index from ICRG including the following variables: real GDP growth, inflation, fiscal deficit, current account deficit and GDP per capita. The original ICRG indices have been inverted so that an increase in the index indicates greater political or economic risk.

While political disagreement is a natural part of the democratic process, strong political fragmentation can lead to policy uncertainty. From a financial stability perspective, one potentially destabilising aspect of this uncertainty is the perception of debt sustainability for highly indebted sovereigns. Based on past experience, the sensitivity of sovereign risk premia to fundamentals in euro area economies could potentially increase in the case of a repricing of risk in global bond markets, thereby underscoring the need for consistent, clear and credible policies underpinning public finances.