

Trust Us to Repay: Social Trust, Long-Term Interest Rates and Sovereign Credit Ratings

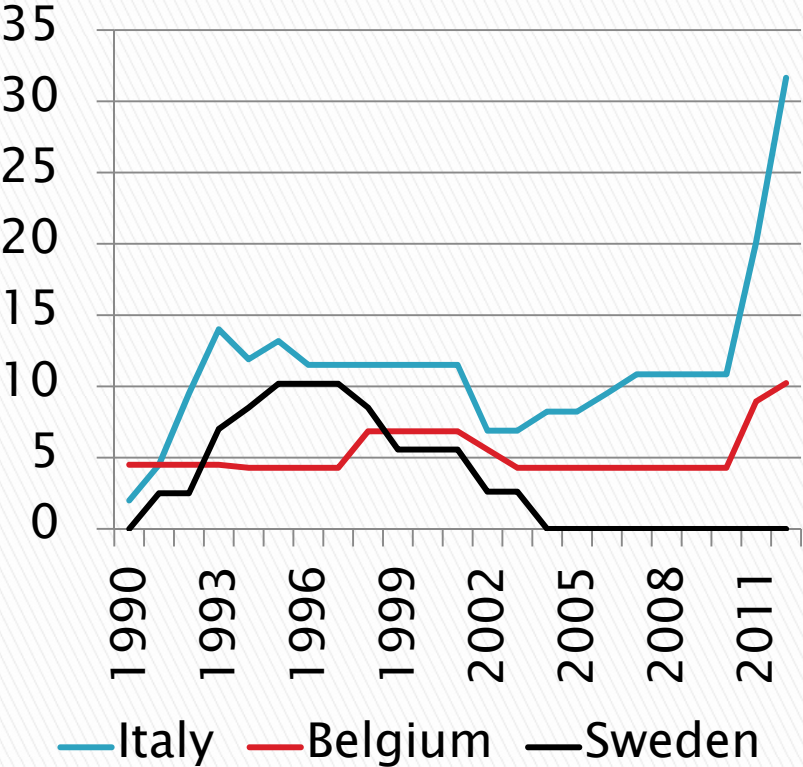
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Differences in sensitivity

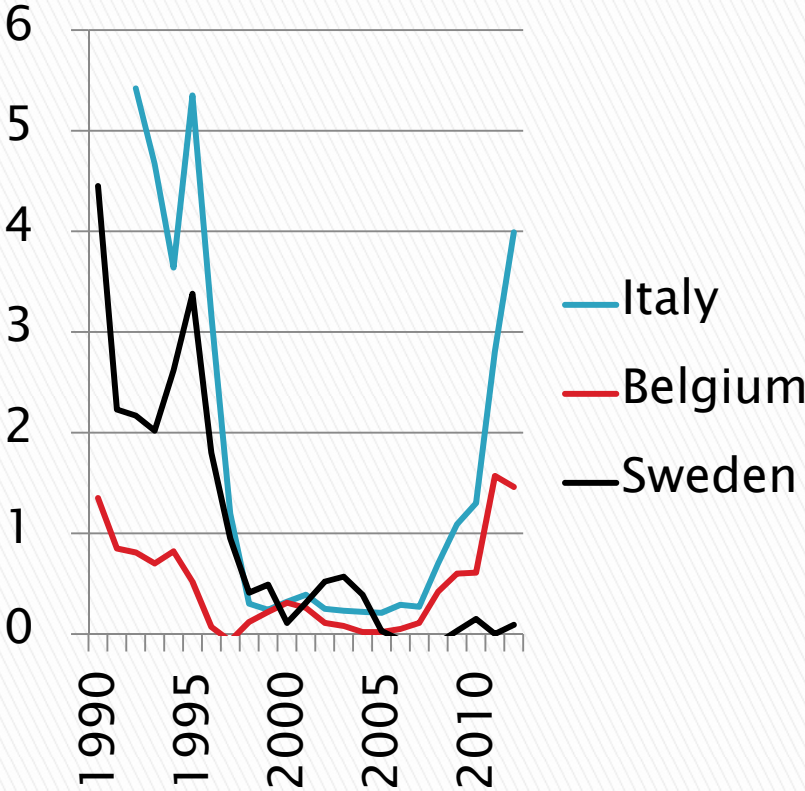
- ▶ Two countries with similar objective problems
 - France was downgraded in December 2011 and November 2013
 - The United Kingdom maintained a perfect AAA rating throughout the crisis
 - Much criticism from France and the EU (and Paul Krugman)



Ratings and interest rates



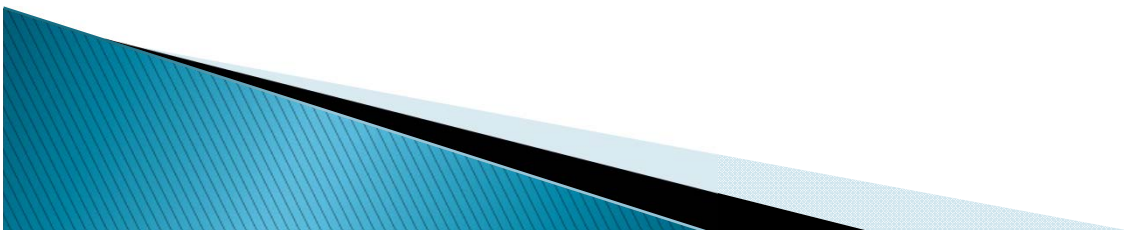
Credit ratings



Interest rates

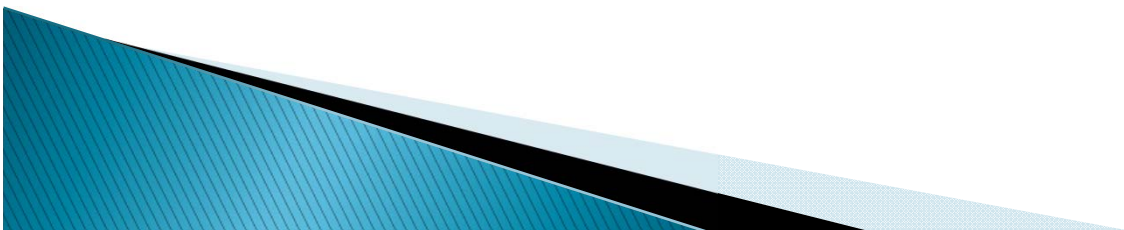
Our main hypothesis

- ▶ Trust insulates economies from problems
 - Sophisticated consumers of politics (Putnam 1993, Boix & Posner 1998)
 - Easy enforcement of policies (Knack & Keefer 1997)
 - Community-oriented concerns (Uslaner 2002, Aghion et al. 2012)
 - Bureaucratic efficiency (Knack 2002, Bjørnskov 2010)
 - Accommodative practices among antagonistic elites

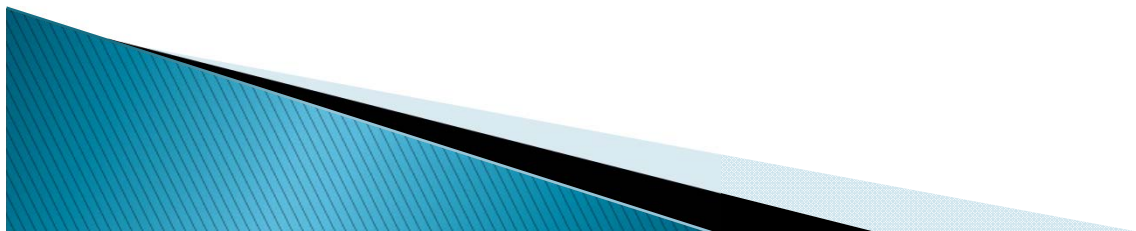
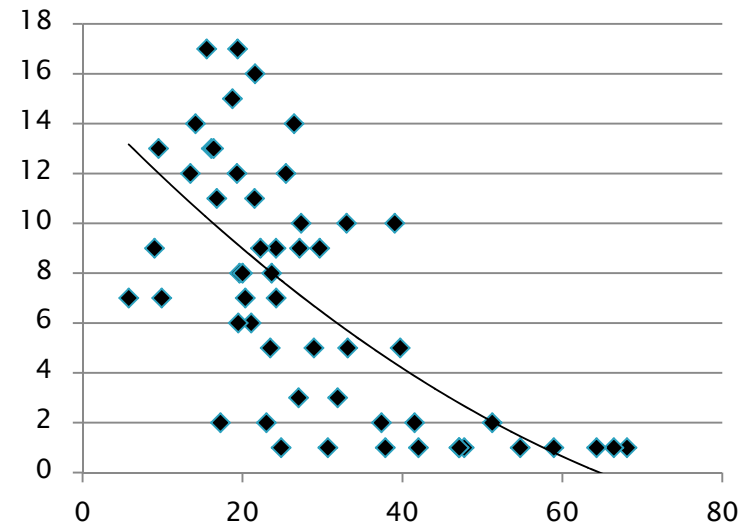
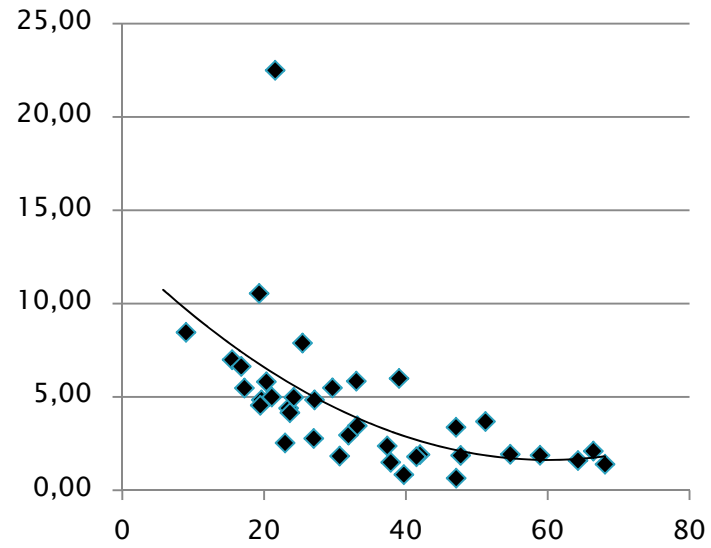


The data, 38 countries x 23 yrs

- ▶ Dependent variables
 - 10-yr sovereign bond rates
 - Credit ratings – S&P (Fitch, Moody's)
- ▶ Main controls
 - Lagged dependent
 - Inflation, savings, growth, ideology
 - Social trust and *interaction*
 - Government structure, exchange rate regime, trade

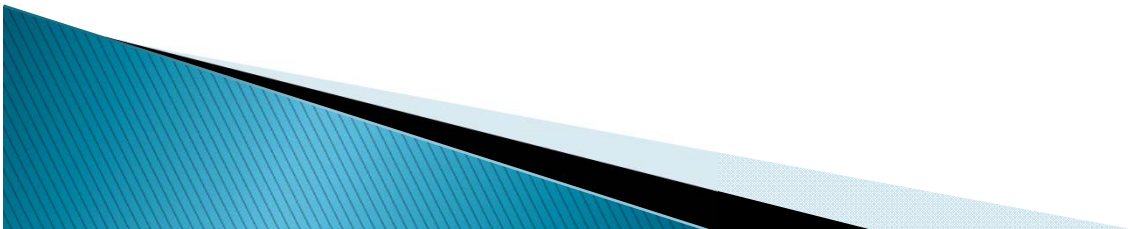


Trust and evaluations, 2012



Empirical strategy

- ▶ We estimate
 - $I_t = aI_{t-1} + bX_t + cZ_t + dT_t + e Z_t T_t + fD + \epsilon$
- ▶ Only focus on pure *dynamics*
- ▶ No worries about endogeneity since we observe changes over time and sensitivity to a time-invariant moderating factor



Overall findings

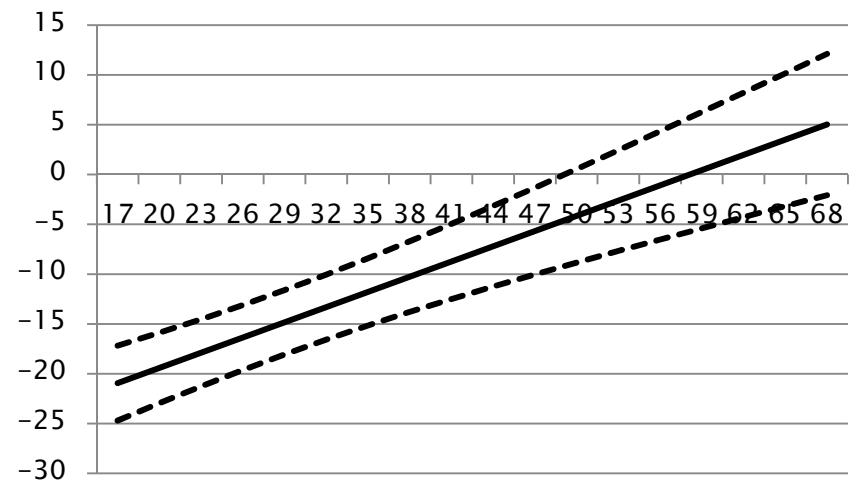
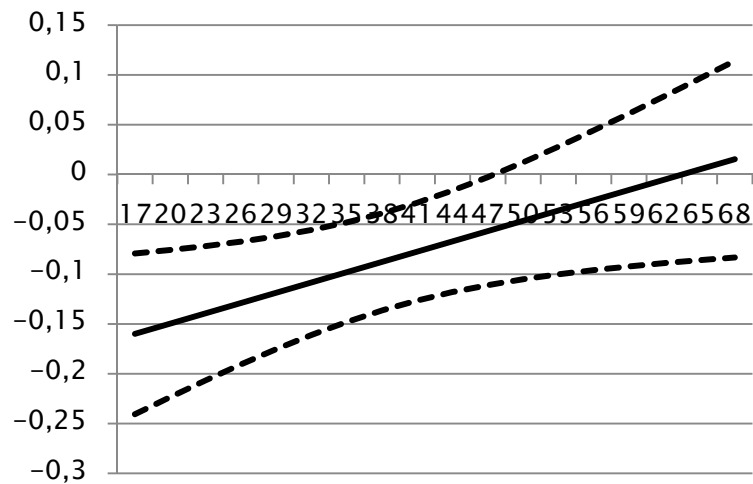
| | Interest rates | Credit ratings |
|---------------------|-----------------------|-----------------------|
| Lagged dependent | .731*** (.026) | .991*** (.017) |
| Young population | .034*** (.008) | -.044 (.027) |
| CPI inflation | .092*** (.026) | -.116 (.091) |
| Government ideology | -.333*** (.118) | -1.066*** (.403) |
| Gross savings | -.018** (.007) | -.085*** (.025) |
| Postcommunist | .505*** (.146) | -.228 (.536) |
| Growth rate | -14.879*** (1.702) | -41.184*** (5.857) |
| Social trust | -.003 (.003) | .001 (.012) |
| Observations | 572 | 573 |
| Countries | 38 | 38 |
| R squared within | .795 | .599 |
| R squared between | .971 | .997 |
| Wald Chi squared | 3118.06 | 8624.99 |

Main findings, interest rates

- ▶ Risk sensitivity is heterogeneous
 - Economic growth, inflation, savings
- ▶ A one-std decrease in growth
 - -2.1 % in France, -1.2 % in Germany, -.7 % in Australia
 - One-point downgrade takes 2.8, 3.5 and 4 yrs, respectively



Savings and growth responses



Conclusions

- ▶ Market reactions to objective, economic problems depend on
 - The size of the problems
 - The expected reaction to the problems
- ▶ Social trust does not diminish the problems but affect the expectation that they are properly addressed

