Impact of Climate Risk on Fiscal Space: Do Political Stability and Financial Development Matter?

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Outline

Research question

Motivation

- How do climate vulnerability risk impact fiscal space?
- Big natural disasters is likely to necessitate large fiscal outlays for relief and recovery efforts
- Climate change-related fiscal expenditures pose a major threat to fiscal space / stainability in the future
- Examine the link between climate risk and fiscal space in a systematic and rigorous way
  - Levels of Vulnerability: Climate risk premium
  - Levels of Political Stability
  - Levels of Financial Development
- More stable political environment is likely to reduce the impact of fiscal cost of climate shocks
- Financial development is also expected to mitigate climate-related fiscal risks
  - Confirmation of the climate risk premium (Beirne et al., 2021; Cevik and Jalles, 2022; Zenios, 2022)
  - **Do Political Stability and Financial Development Matter?**

Research question

Literature overview

- **Climate risks:** economic growth (Oppenheimer et al., 2004; Tol et al., 2004; Mendelson et al., 2006; Diffenbaugh and Burke, 2019; Dasgupta et al., 2023)
- Exacerbates inequality in developing countries (Cappellia et al., 2021; Dasgupta et al., 2023)
- Mitigate the socio-economic impact of climate change and rising temperatures, countries must possess a high adaptive capacity (Tol et al., 2004), a diversified economy (Dissart, 2003), political stability (Dell et al., 2012), and strong institutional leadership (Pike et al., 2010)
- You et al (2014) examine the link between democracy, financial openness, and carbon dioxide emissions

Research question

Testable Assumptions

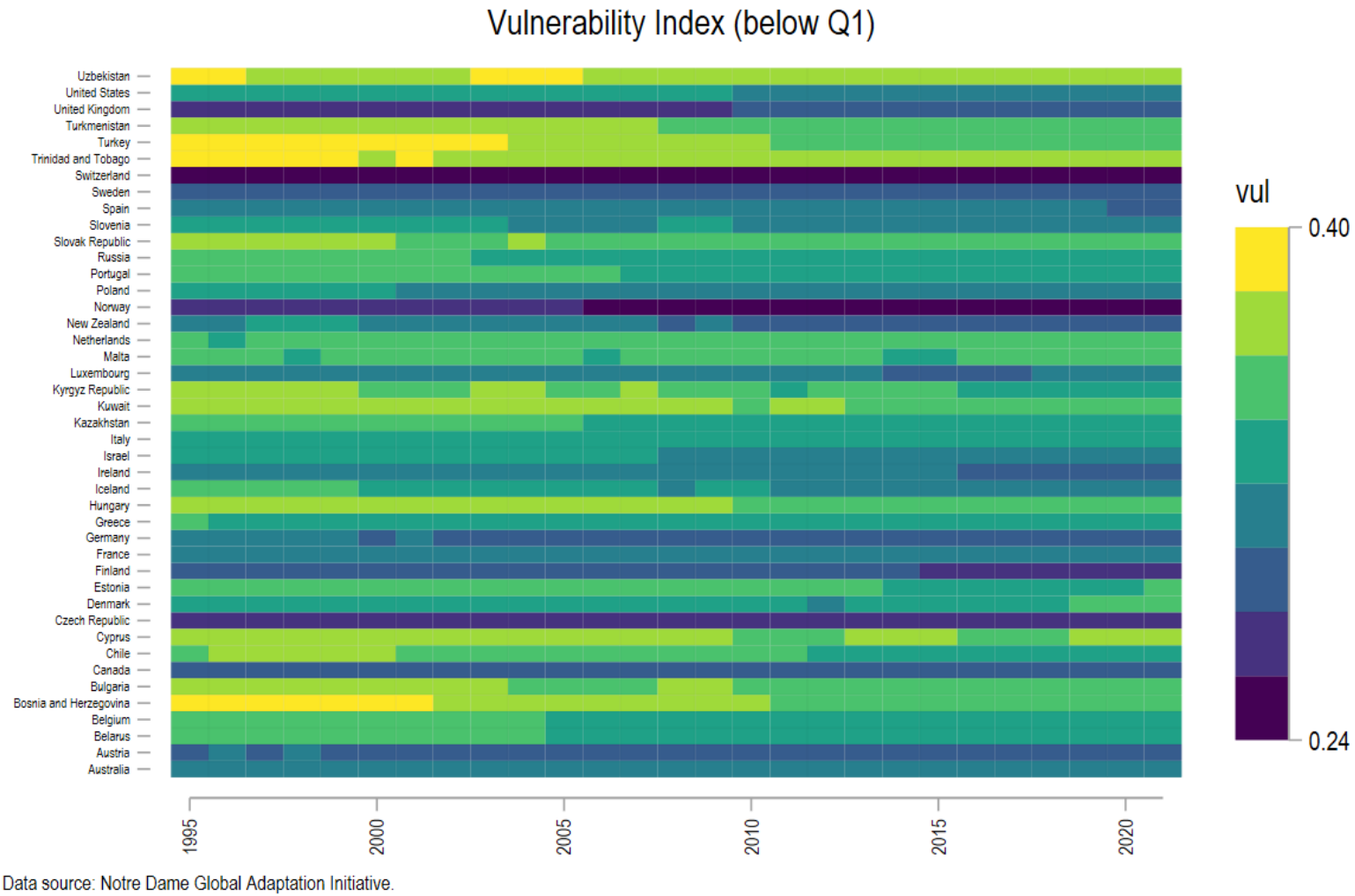
- **H1:** Climate risks adversely affect fiscal space (Higher bond Yields (climate risk premium) / Lower sovereign ratings);
- **H2:** Financial development is mitigating factor for the climate risk premium: perception of better capacity to deal with transition and physical risks;
- **H3:** Political instability (Conflicts, Religious tensions) induces a perception of a lower capacity to deal with transition and physical risks

Preview of the results

- A unit increase in vulnerability causes an increase in bond yields between 0.5 and 1 percent and a maximum decrease of 1 for the sovereign ratings (S&P: 21 AAA, 20 AA+, ..., 5 CCC+,...) at the horizon of 1 and 2 years;
- **Contribution 1:** Political stability reduces the adverse spillover effects of climate risks on fiscal space;
- **Contribution 2:** Financial development also weakens the link between climate risks and fiscal space;
- **Contribution 3:** Asymmetric effects in the sense that the most fiscally constrained economies are subject to the largest climate-related risk premia

Research question

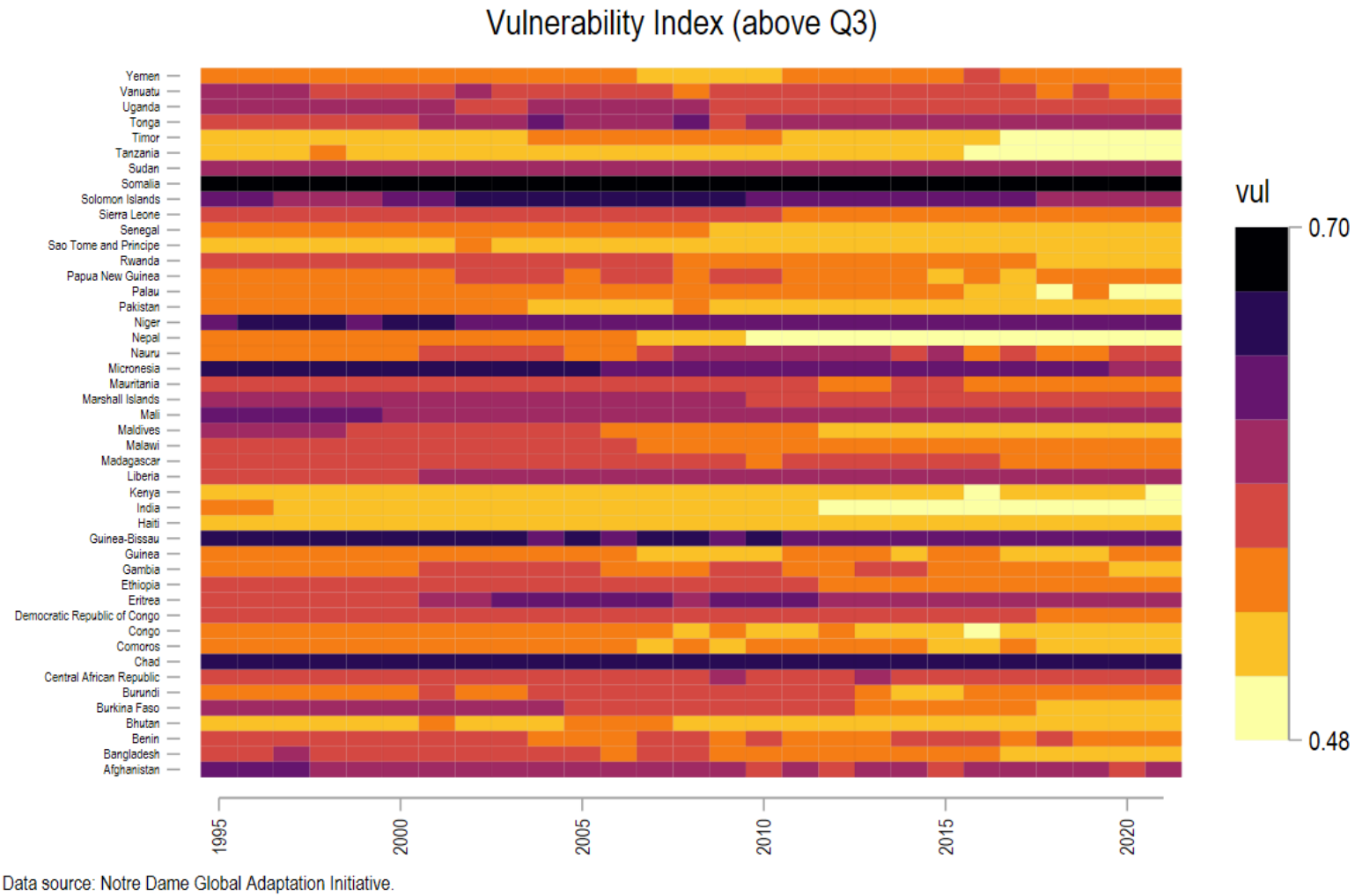
Figure 1. Heat plot for the low vulnerability score



Source: authors' calculations.

Research question

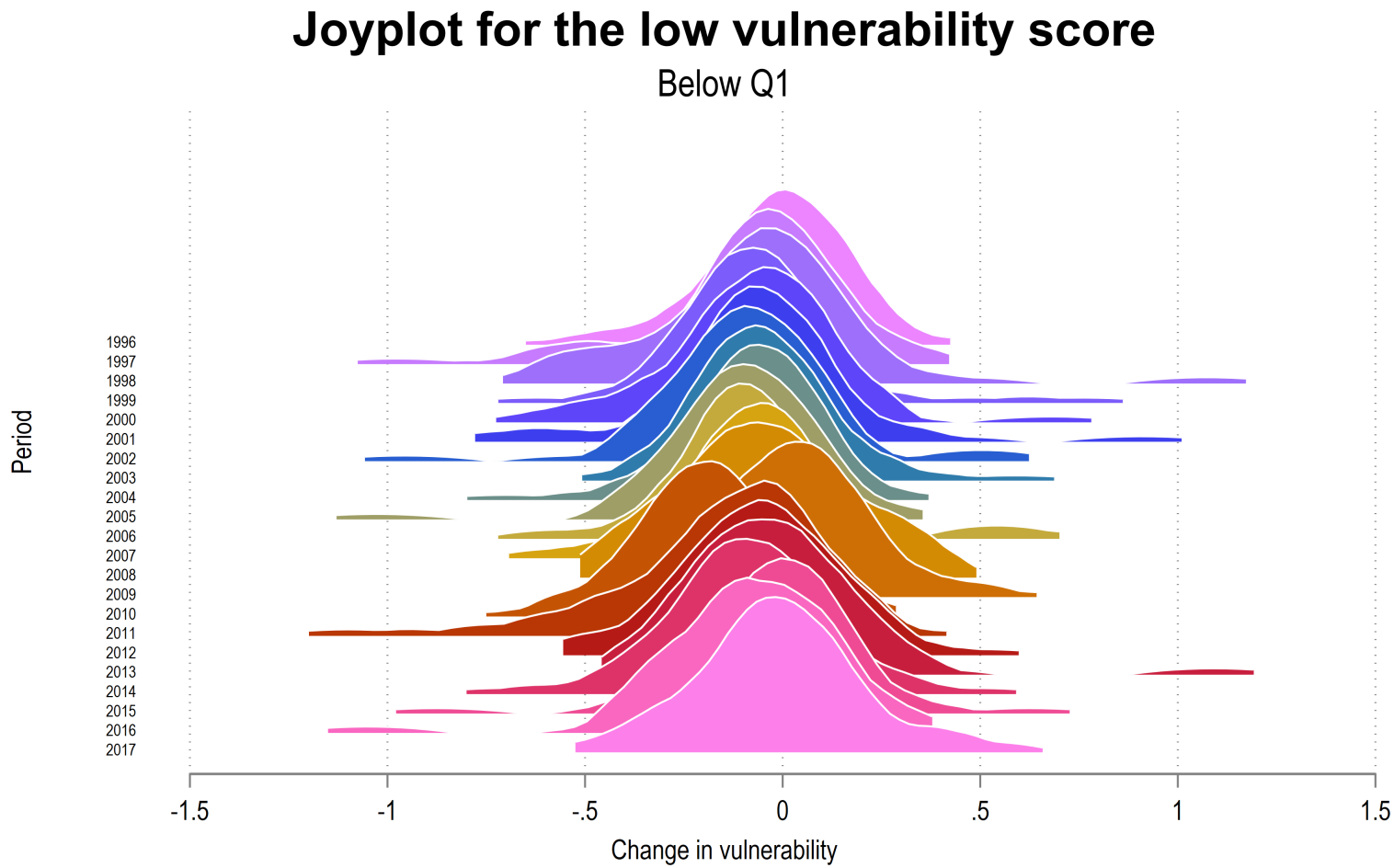
Figure 2. Heat plot for the high vulnerability score



Source: authors' calculations.

Research question

Figure 3. Changes in the vulnerability score

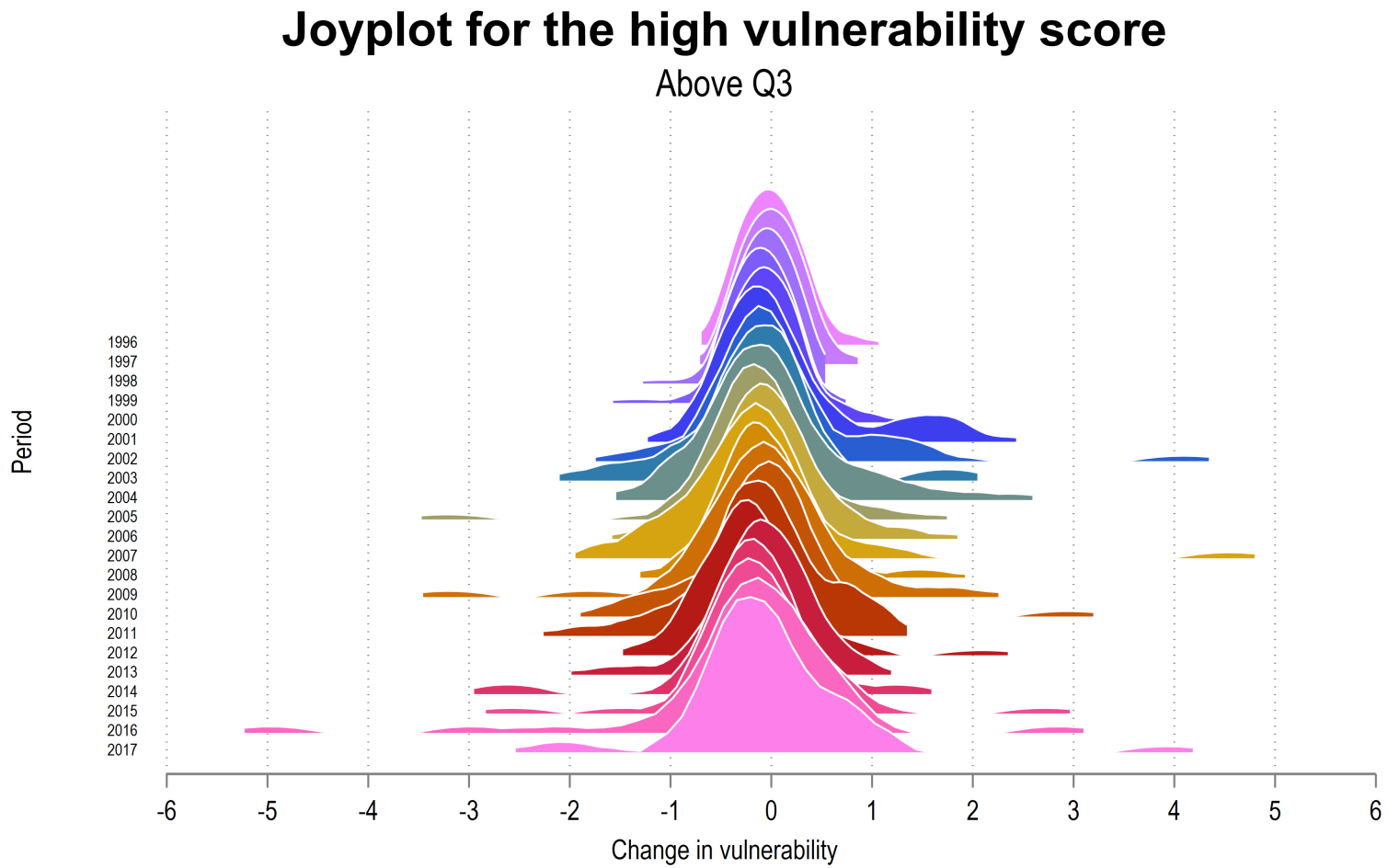


Data source: Notre Dame Global Adaptation Initiative.

Source: authors' calculations.

Research question

Figure 4. Changes in the vulnerability score



Data source: Notre Dame Global Adaptation Initiative.

Source: authors' calculations.

Research question

Table 1. Contemporaneous-correlation table

Variables	Variation in vulnerability score
Government bonds yields	-0.05
P-values	(0.04)
Nb. Obs.	2052
Foreign currency long-term sovereign debt ratings	0.09
P-values	(0.00)
Nb. Obs.	3007

Source: authors' calculations.

Research question

Table 2. Contemporaneous-correlation table

Variables	Variation in vulnerability score
Market cap. of listed domestic companies (% of GDP)	0.05
P-value	(0.06)
Nb. Obs.	1690
Chinn-Ito index	0.00
P-value	(0.97)
Nb. Obs.	4470
Financial Institution index	0.04
P-value	(0.00)
Nb. Obs.	4576
Financial Market index	0.04
P-value	(0.01)
Nb. Obs.	4576
ICRG index - External Conflict	-0.02
P-value	(0.16)
Nb. Obs.	3489
ICRG index - Internal Conflict	0.01
P-value	(0.73)
Nb. Obs.	3489
ICRG index - Government Stability	-0.04
P-value	(0.03)
Nb. Obs.	3489
ICRG index - Law and Order	0.02
P-value	(0.32)
Nb. Obs.	3489
ICRG index - Ethnic Tensions	0.01
P-value	(0.71)
Nb. Obs.	3489
ICRG index - Religious Tensions	0.00
P-value	(0.85)
Nb. Obs.	3489

Source: authors' calculations.

Research question

Table 3. Reverse causality: Bond yields

Variables	D.vul100
Bonds	0.01
	(0.34)
L.Bonds	-0.01
	(0.41)
L2.Bonds	0.01
	(0.32)
L3.Bonds	-0.01
	(0.22)
L4.Bonds	0.00
	(0.73)
Constant	-0.09
	(0.13)
Observations	1,670
R-squared	0.02

Note: authors' calculations. P-values in parentheses. Country and time-FE included.

Research question

Table 4. Reverse causality: Sovereign ratings

Variables	D.vul100
Sovrate	-0.01
	(0.25)
L.Sovrate	0.01
	(0.51)
L2.Sovrate	-0.01
	(0.72)
L3.Sovrate	0.02
	(0.16)
L4.Sovrate	-0.01
	(0.27)
Constant	-0.11**
	(0.04)
Observations	2,632
R-squared	0.05

Note: authors' calculations. P-values in parentheses. Country and time-FE included.

Outline

Data and Methodology

Empirical approach

- Annual data from 1995 to 2021 for a sample of 199 countries, $n \times T = 199 \times 27 = 5373$ (maximum possible observations).
- Panel local projections, State-dependent local projections *à la* Ramey and Zubairy
  - The **shock** on the climate variables: Variation in ND-GAINS vulnerability scores; Variation in the first principal component in the less correlated dimensions in ND-GAINS vulnerability scores subcomponent;
  - The **response** of fiscal variables: Bonds yields on government bonds and Sovereign ratings on foreign currency long-term sovereign debt
  - **State-dependence/subsampling** along: Financial Development (FDI indexes, Svyridzenka, 2016); Political Stability (ICRG indexes for Political Risks);
- Baseline specification:

$$y_{i,t+h} = b_h S_{i,t} + \gamma_h y_{i,t-1} + \alpha' z_{i,t-1} + v_{i,t+h}$$
$$\text{IRF}(h) = \hat{b}_h, \quad h = 0, 1, \ldots \tag{1}$$

- Impulse/Treatment variable, S: change in the vulnerability score; Response variable, y: bond yields or sovereign ratings

Empirical approach

- **Recent papers on the LP's / VAR's IRFs:**
- Lloyd and Manuel (2024): One-step (with appropriate controls) vs Two-step approach in the LP approach (OVB)
- Olea Montiel, Plagborg-Møller, Qian and Wolf (2024): LP's are more robust to various form misspecification, while VAR's are not (No free lunch for VARs: need to increase the lags to achieve correct coverage, and not necessary to get the lag length exactly right to achieve correct coverage in LPs)

Data and Methodology

Table 5. Descriptive statistics for the involved variables

Variables	Count	Mean	Q1	Median	Q3	SD	Min	Max
Climate risk vulnerability variable								
ND-GAIN overall vulnerability	4,784	0.442	0.372	0.43	0.517	0.0955	0.244	0.696
Fiscal space variables								
Government bonds, yields %	2,052	6.078	3.97	5.256	7.351	3.656	0.438	23.31
Sovereign debt ratings, index	3,300	12.36	8	11.87	16.67	5.181	1	21
Domestic controls								
Current Account Balance	4,510	-2.276	-7.167	-2.773	1.739	14.01	-148	311.7
Gov. Net Lending/Borrowing	4,859	-2.02	-4.613	-2.335	0.016	6.551	-59.74	125.1
General Gov. Gross Debt	4,694	55.83	29.48	46.25	69.83	44.59	0	600.1
CPI % year-on-year	3,607	0.501	0.132	0.291	0.592	0.843	-1.223	8.925
Banking crises dummy	4,356	0.012	0	0	0	0.109	0	1
Currency crises dummy	4,356	0.018	0	0	0	0.132	0	1
Debt crises dummy	4,356	0.006	0	0	0	0.079	0	1
Global controls								
MSCI World index	4,440	0.524	0.006	0.89	1.285	1.42	-4.297	3.184
US Government bonds, yields %	4,440	3.686	2.386	3.697	4.675	1.332	1.778	6.048
CBOE Volatility Index: VIX	5,373	20.48	15.48	19.66	25.6	5.903	11.09	32.7

Source: authors' calculations. Global controls are replaced by time fixed effects in the most recent version of the paper.

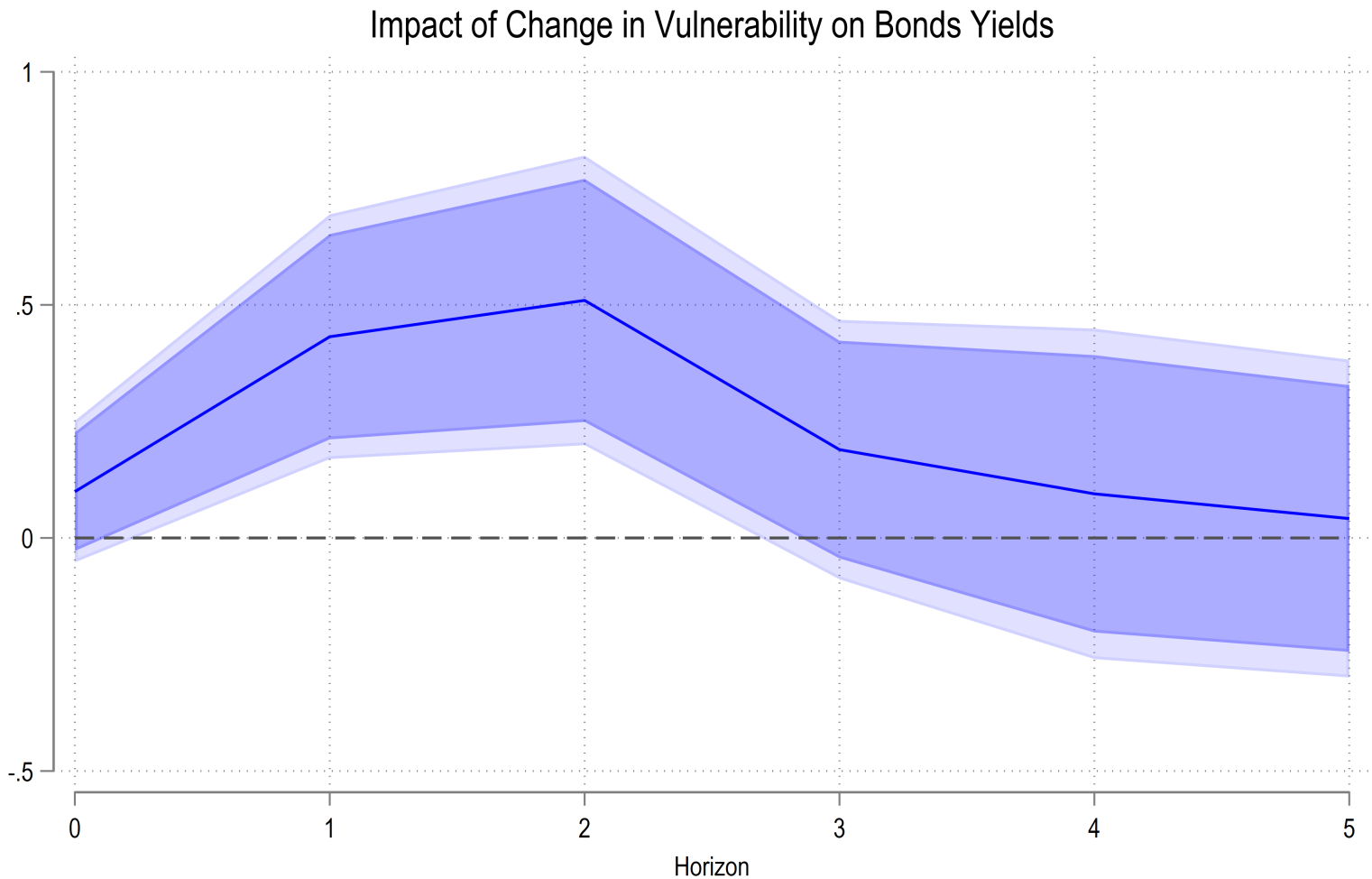
Table 6. Comparing fundamentals and institutional features for different levels of vulnerability

	VUL High (Above Q3 of VUL) 1,196 (25.0%)	**VUL Low (Below Q3 of VUL)** 3,588 (75.0%)	**Total** 4,784 (100.0%)	**Test**
ND-GAIN overall vulnerability	0.57 (0.04) 0.07	0.40 (0.06) 0.16	0.44 (0.10) 0.22	<0.001
Government bonds, yields %	7.67 (3.55) 0.46	5.93 (3.63) 0.61	6.08 (3.66) 0.60	<0.001
Treasury Bills, yields %	9.83 (6.34) 0.65	6.36 (6.03) 0.95	7.01 (6.24) 0.89	<0.001
Foreign currency sovereign debt ratings	7.30 (1.38) 0.19	12.64 (5.14) 0.41	12.23 (5.15) 0.42	<0.001
Chinn-Ito index, normalized	0.34 (0.32) 0.94	0.57 (0.37) 0.65	0.52 (0.37) 0.72	<0.001
Exchange Rate Stability Index	0.57 (0.28) 0.48	0.62 (0.31) 0.50	0.61 (0.31) 0.50	<0.001
Financial Institution index	0.18 (0.07) 0.41	0.45 (0.21) 0.48	0.38 (0.22) 0.57	<0.001
Financial Market index	0.03 (0.08) 2.48	0.26 (0.26) 1.03	0.20 (0.25) 1.24	<0.001
ICRG index: External Conflict	9.11 (1.64) 0.18	10.10 (1.32) 0.13	9.92 (1.44) 0.14	<0.001
ICRG index: Corruption	1.95 (0.78) 0.40	2.91 (1.22) 0.42	2.74 (1.21) 0.44	<0.001
ICRG index: Bureaucracy Quality	1.22 (0.81) 0.66	2.44 (1.03) 0.42	2.22 (1.10) 0.49	<0.001
ICRG index: Democratic Accountability	3.19 (1.32) 0.41	4.22 (1.65) 0.39	4.03 (1.64) 0.41	<0.001
ICRG index: Ethnic Tensions	3.08 (1.06) 0.34	4.24 (1.19) 0.28	4.03 (1.25) 0.31	<0.001
ICRG index: Government Stability	8.09 (1.66) 0.21	8.17 (1.58) 0.19	8.16 (1.60) 0.20	0.258
ICRG index: Internal Conflict	7.76 (1.62) 0.21	9.48 (1.64) 0.17	9.17 (1.76) 0.19	<0.001
ICRG index: Law and Order	2.80 (0.98) 0.35	3.98 (1.29) 0.32	3.77 (1.32) 0.35	<0.001
ICRG index: Military in Politics	2.08 (1.32) 0.64	4.24 (1.56) 0.37	3.85 (1.73) 0.45	<0.001
ICRG index: Religious Tensions	3.67 (1.34) 0.36	4.78 (1.21) 0.25	4.58 (1.30) 0.28	<0.001
ICRG index: Socioeconomic Conditions	3.23 (1.38) 0.43	6.22 (2.28) 0.37	5.68 (2.43) 0.43	<0.001
ICRG index: Investment Profile	6.68 (1.77) 0.27	8.65 (2.11) 0.24	8.30 (2.19) 0.26	<0.001

Source: authors' calculations.

Outline

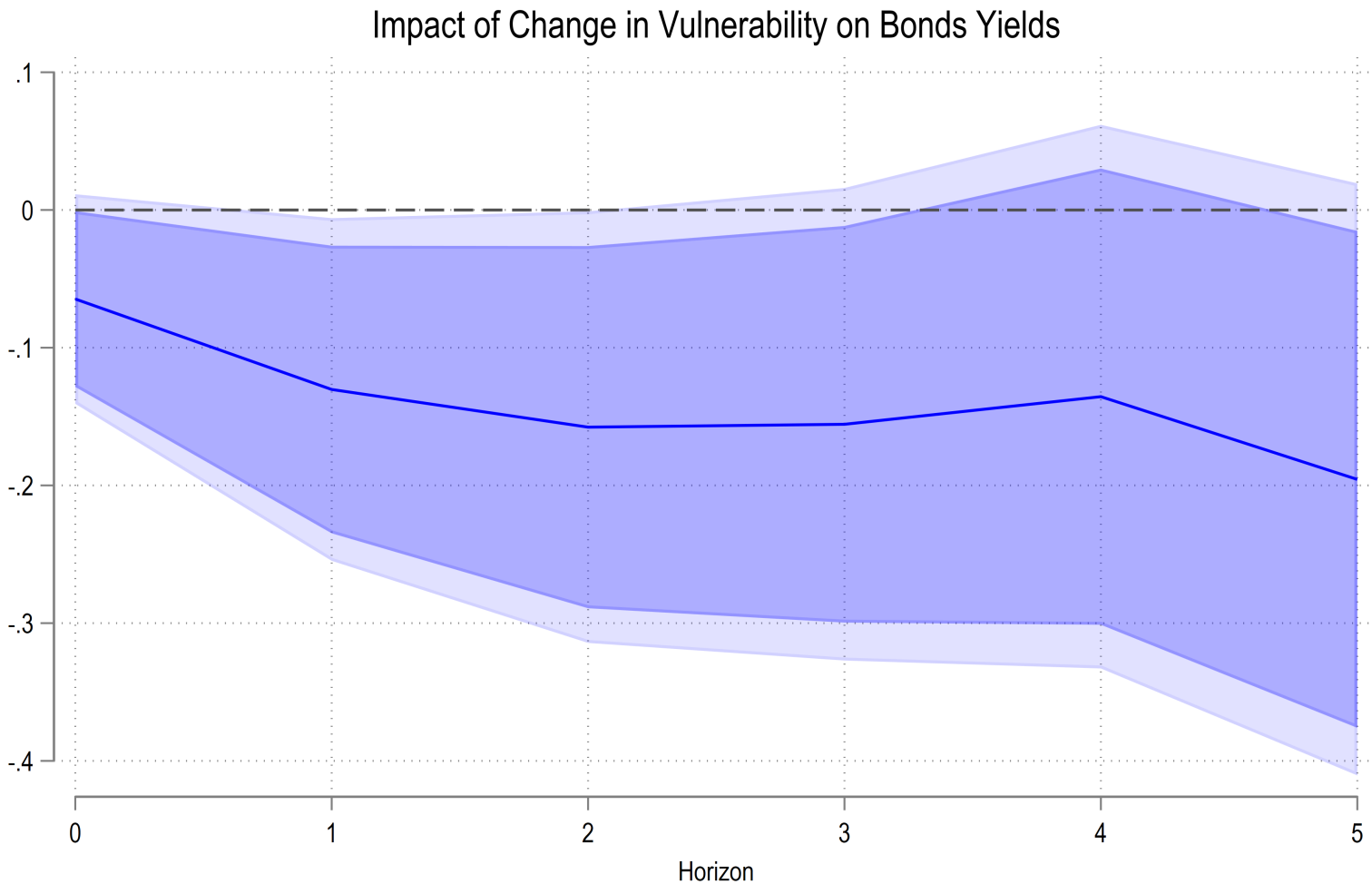
Figure 5. Panel LP for the bond yields (No control)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results

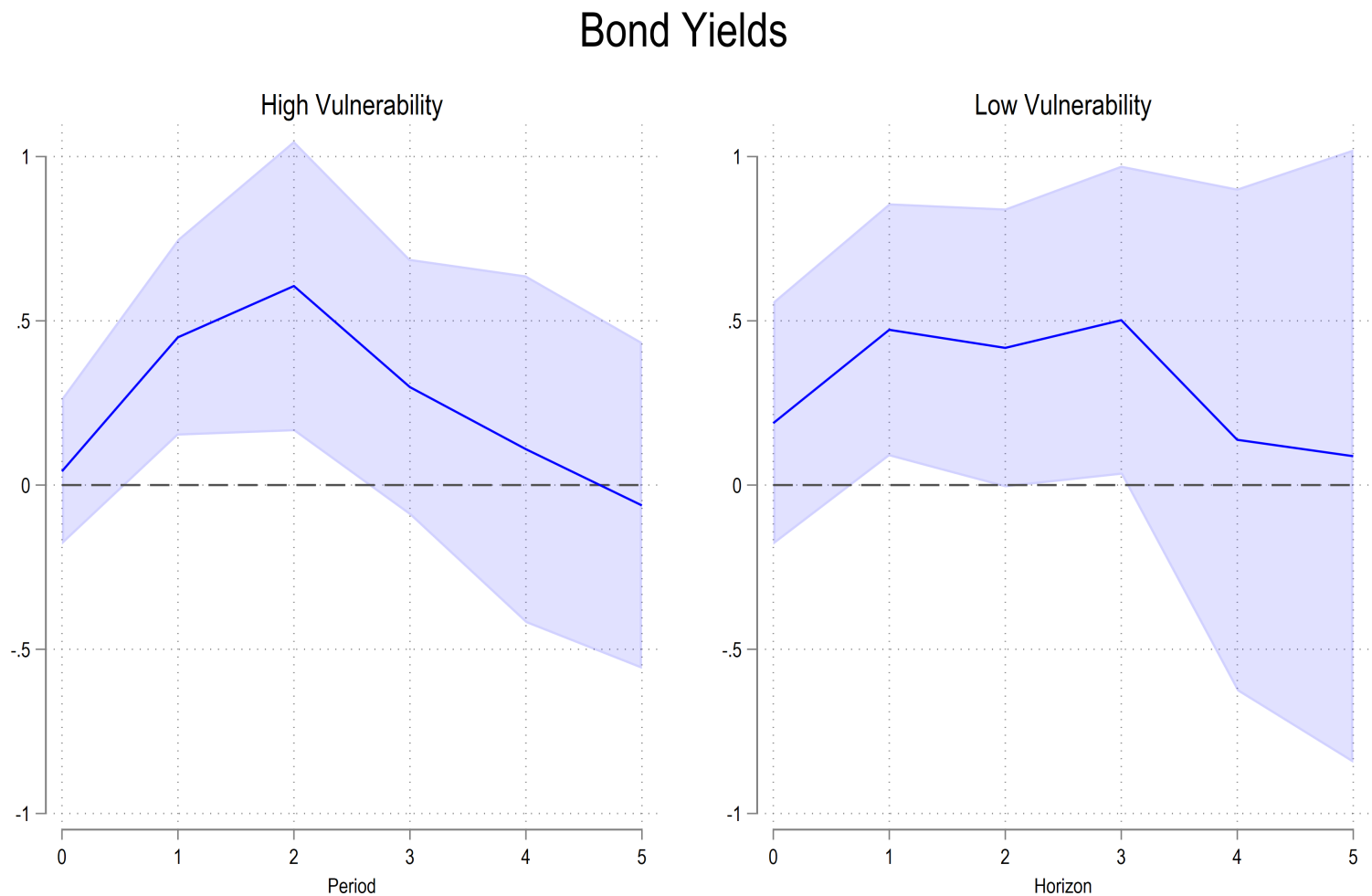
Figure 6. Panel LP for the sovereign ratings (No control)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

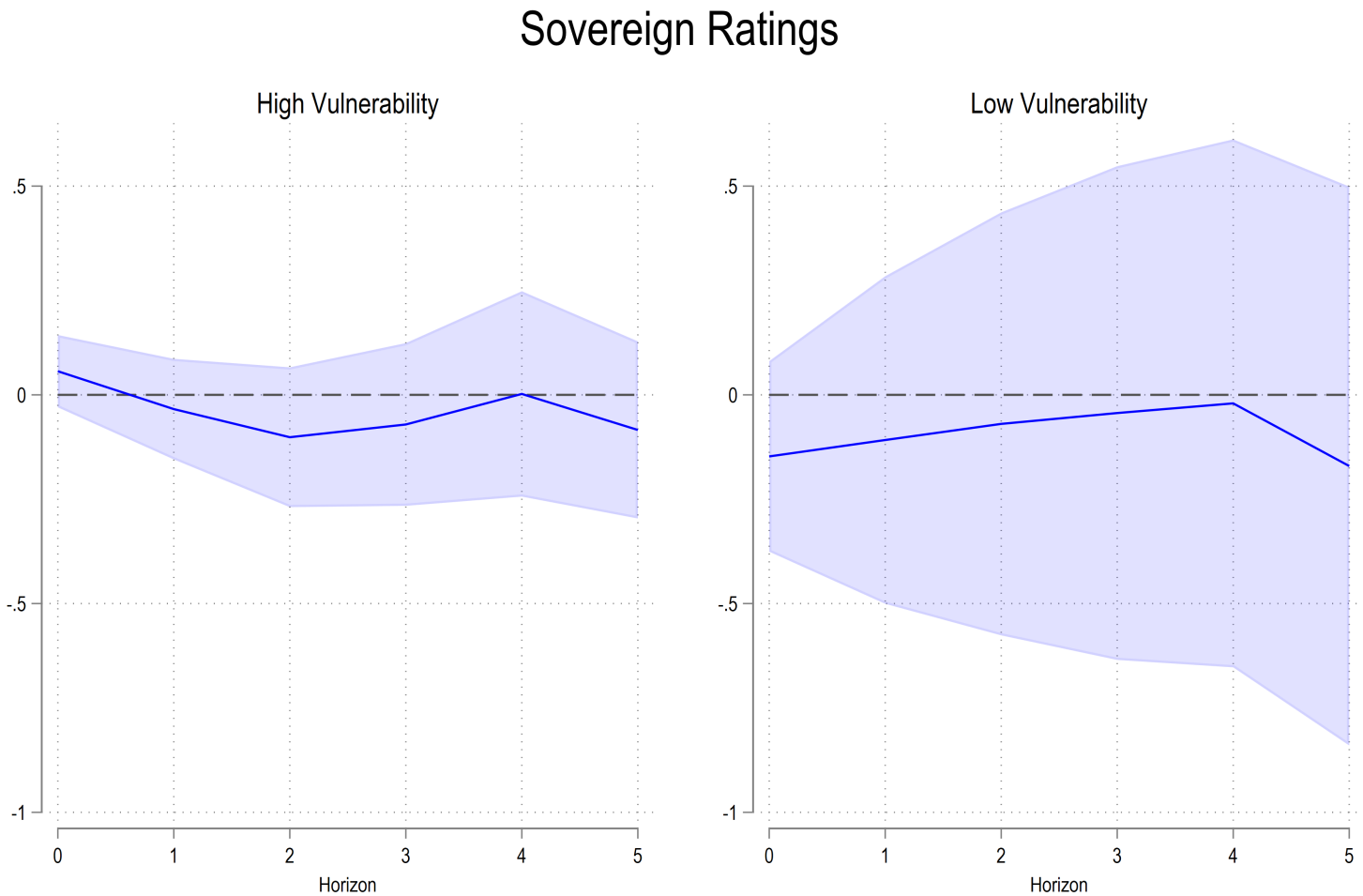
Results

Figure 7. Panel LP for the bond yields (Vulnerability - Threshold Q1)



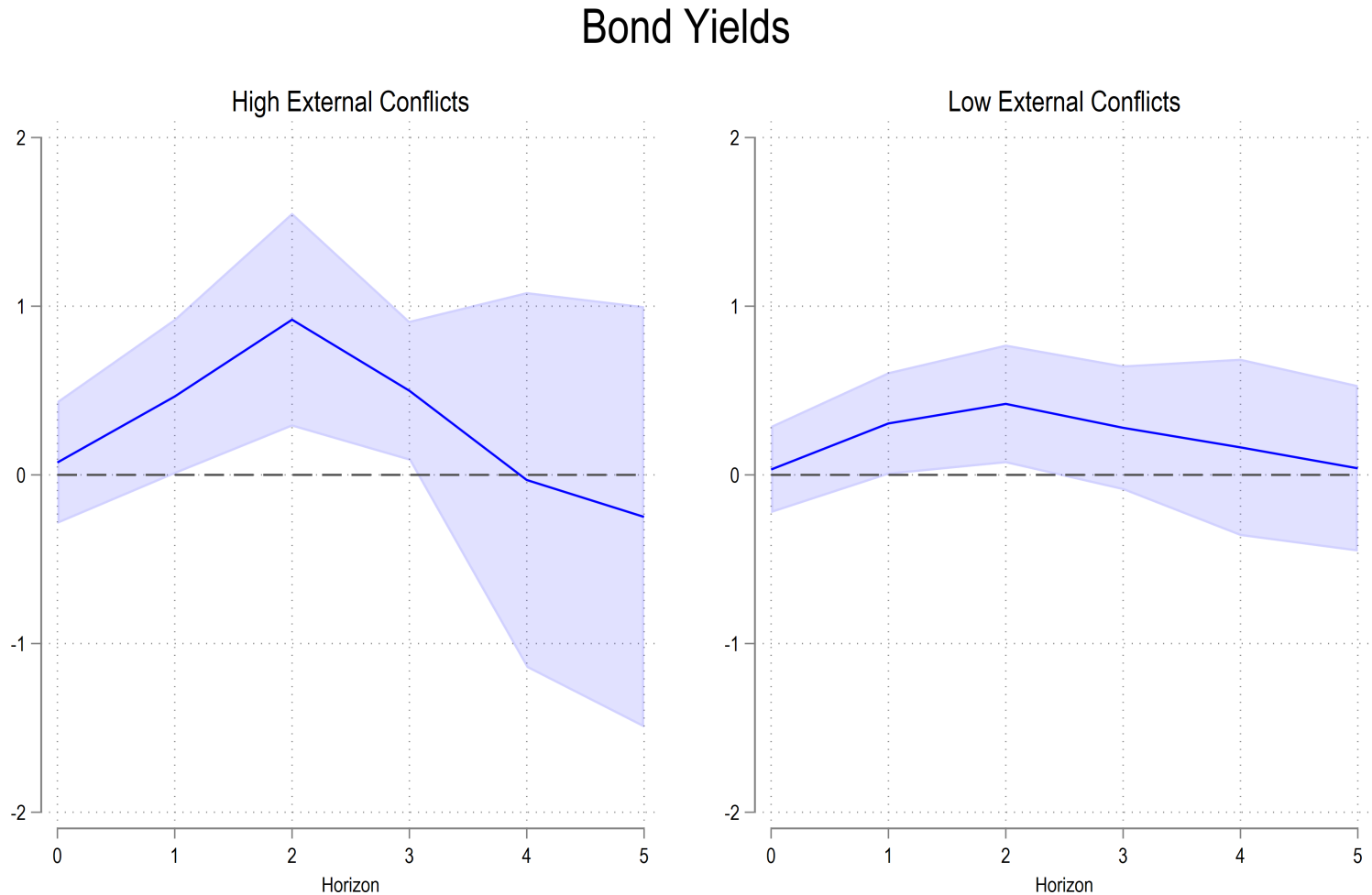
Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Figure 8. Panel LP for the sovereign ratings (Vulnerability - Threshold Q1)



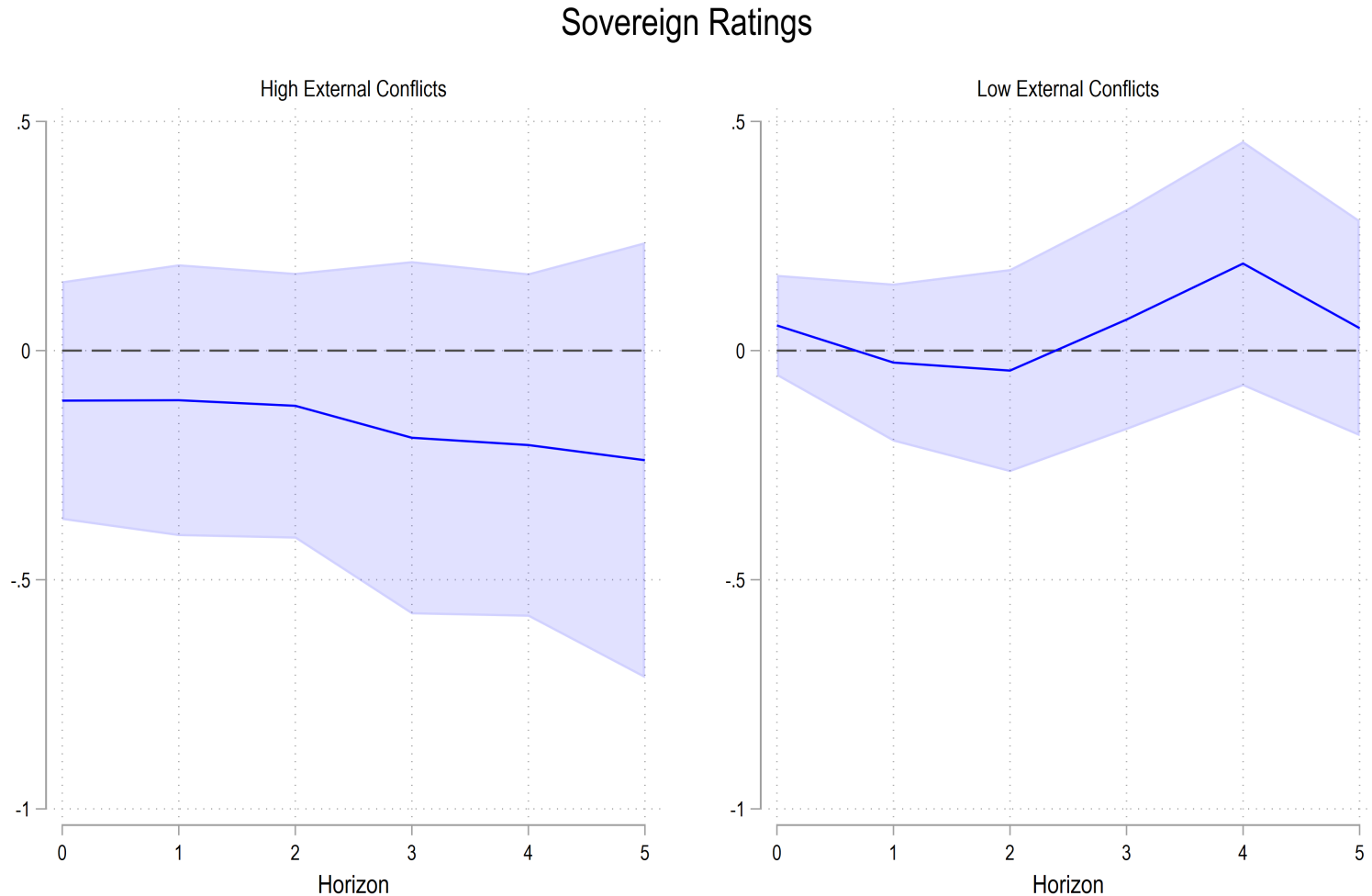
Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Figure 9. Panel LP for the bond yields (External conflict - Threshold Q2)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Figure 10. Panel LP for the sovereign ratings (External Conflict - Threshold Q2)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

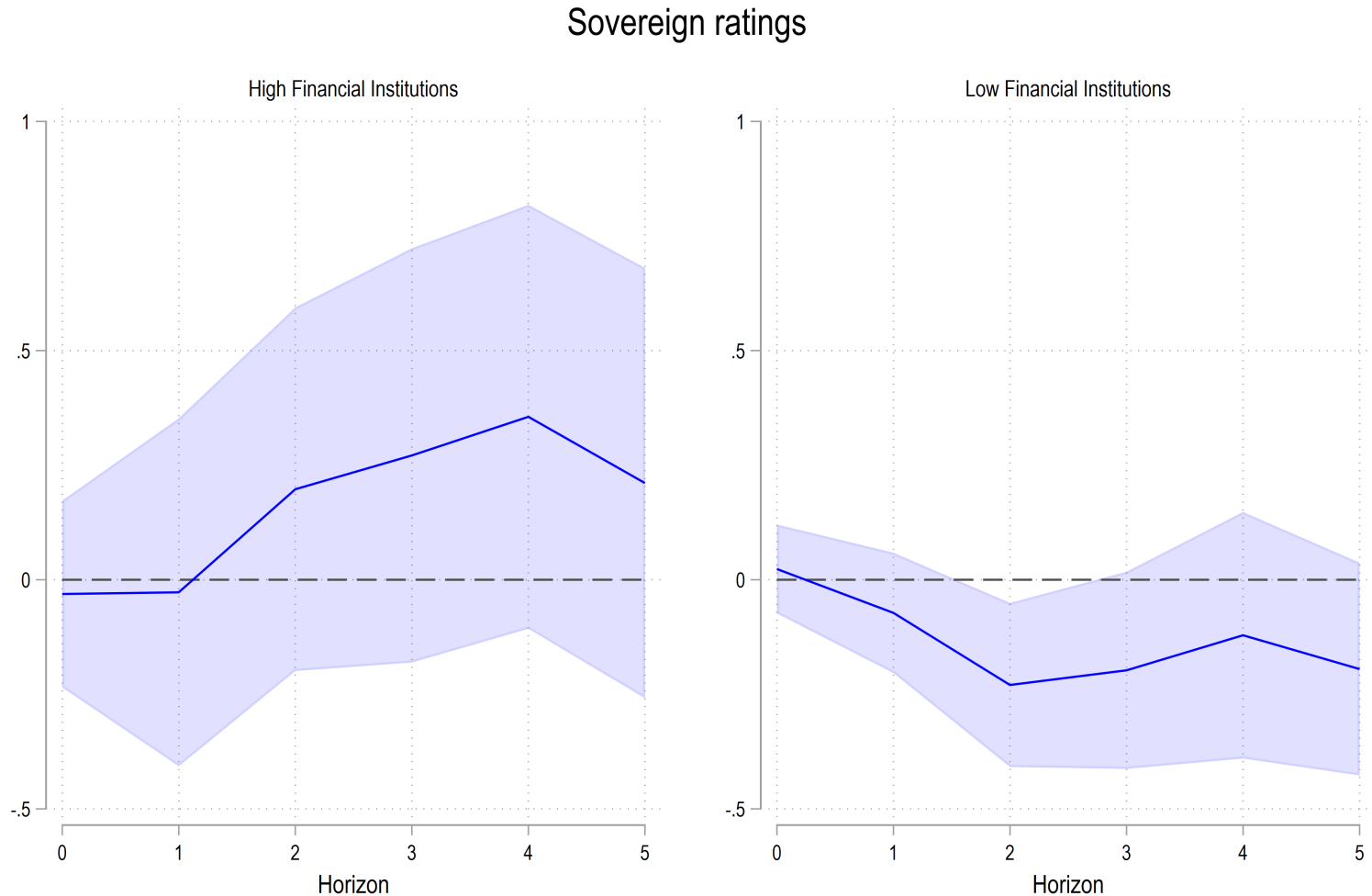
Results

Figure 11. Panel LP for the bond yields (Financial Institutions - Threshold Q3)

Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results

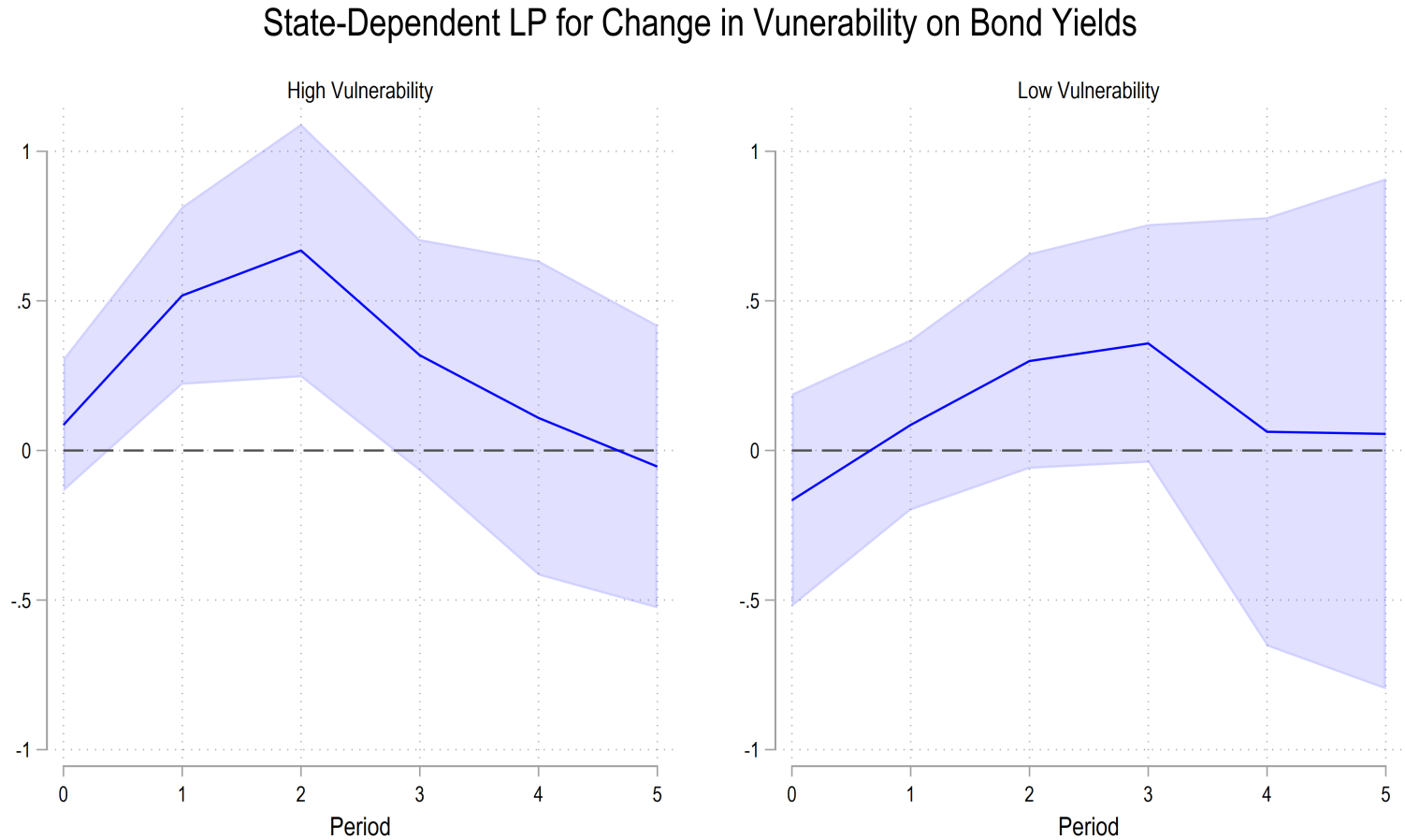
Figure 12. Panel LP for the sovereign ratings (Financial Institutions - Threshold Q3)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results - State Dependence

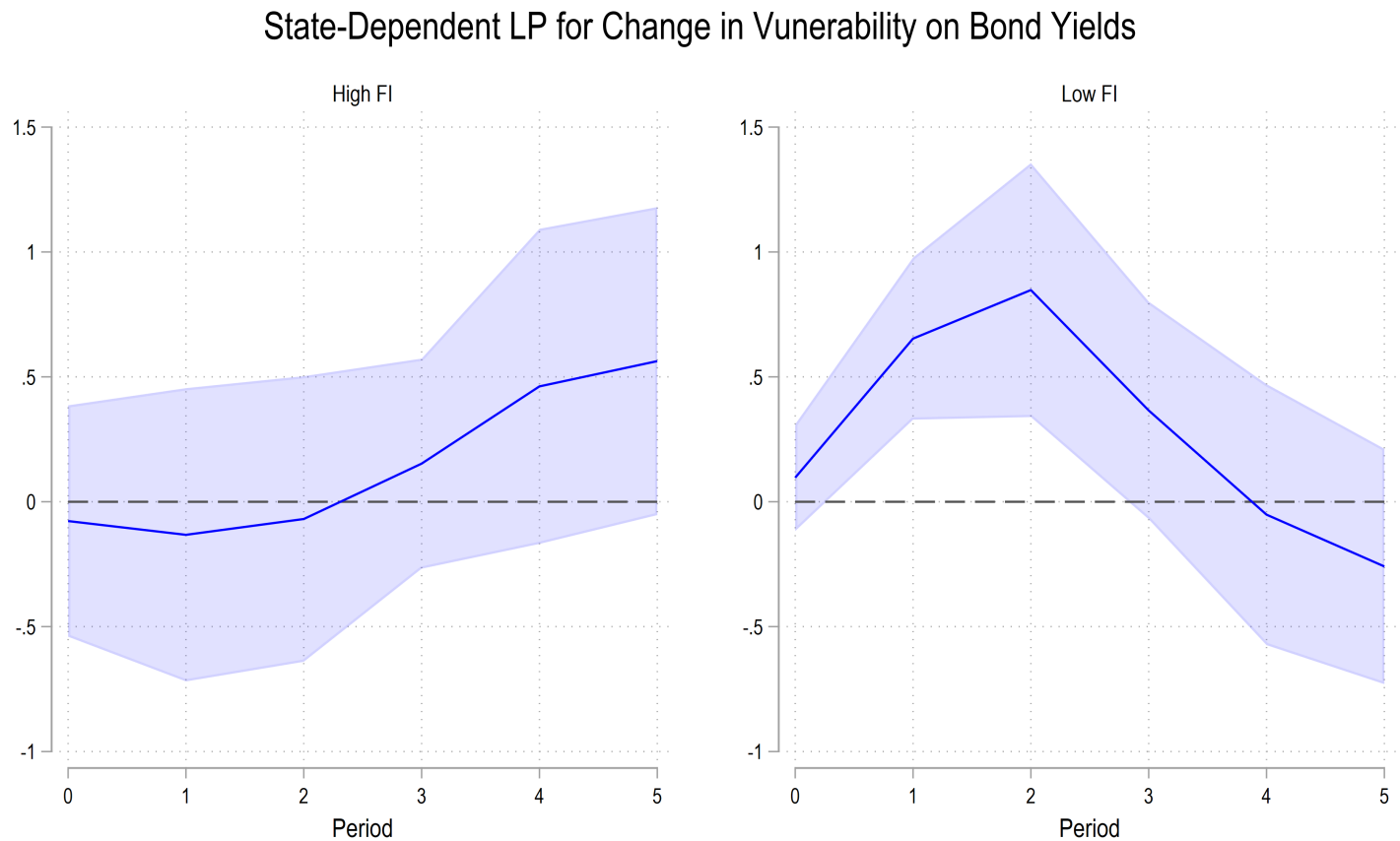
Figure 13. State-dependent Panel LP for the bond yields (Vulnerability - Threshold Q1)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results - State Dependence

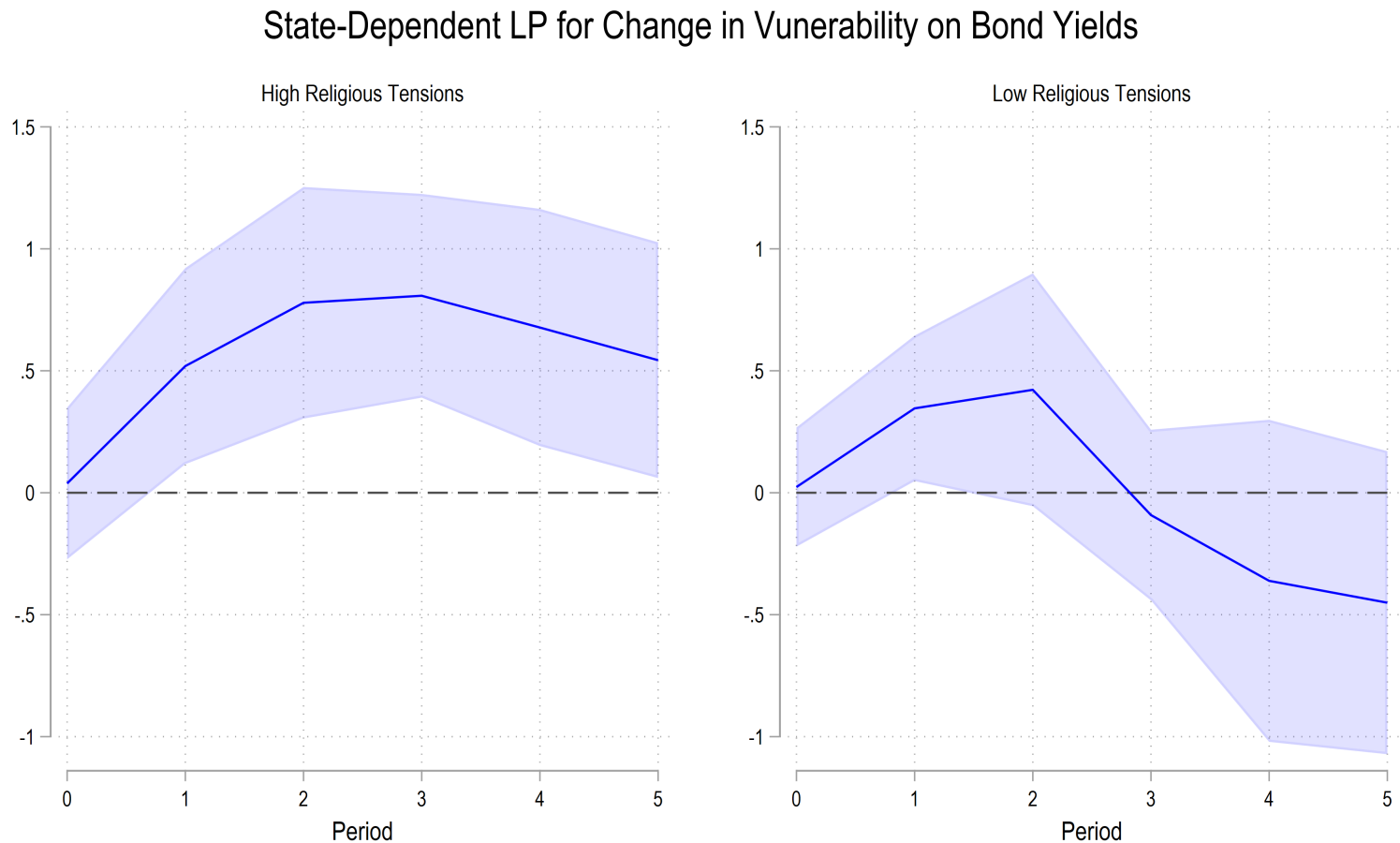
Figure 14. State-dependent Panel LP for the bond yields (Financial Institution - Threshold Q3)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results - State Dependence

Figure 15. State-dependent Panel LP for the bond yields (Religious Tensions - Threshold Q3)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results - Robustness

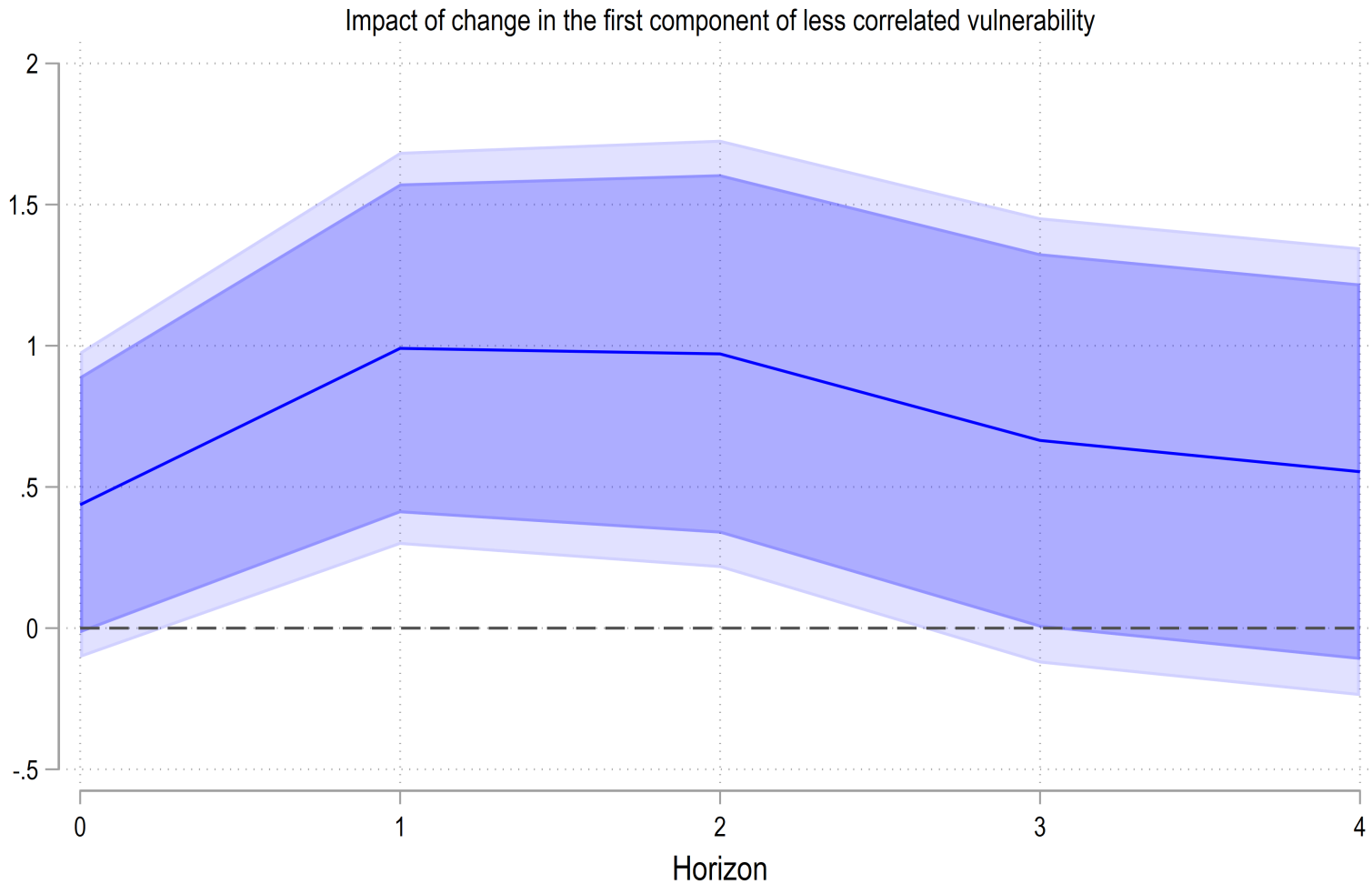
- We provide, in the appendixes C to L, several robustness checks showing the relevance of our results under various conditions. In particular, we introduce (i) a boarder set for controls, (ii) test different threshold variables for political stability and financial development, (iii) extend the lag specification from 1 to 4 years for the impulse variable, the shock variable, and the controls of the boarder set for controls' specification, (iv) the Local Projections (LP) specification without any controls, and (v) for different income country groupings.

Results - Endogeneity

- Following Kling et al (2021), we collected the data for the least correlated dimensions of the ND-GAINS score with macroeconomic variables;
- 7 dimensions out 36 that displayed moderate correlation with macroeconomic variables **and** that are not time-invariant:
  - FOOD_03: food import dependency;
  - WATE_03: fresh water withdrawal rate;
  - ECOS_04: ecological footprint;
  - ECOS_05: protected biome;
  - ECOS_06: engagement in international environmental conventions;
  - INFR_04: population living under 5m above sea level.
- Principal component analysis with 3 components.
- We use, as the shock, the change in the first component (VUL_N).
- VUL_N is correlated at 82 percent with the vulnerability score and less correlated with economic outcomes.

Results - Endogeneity

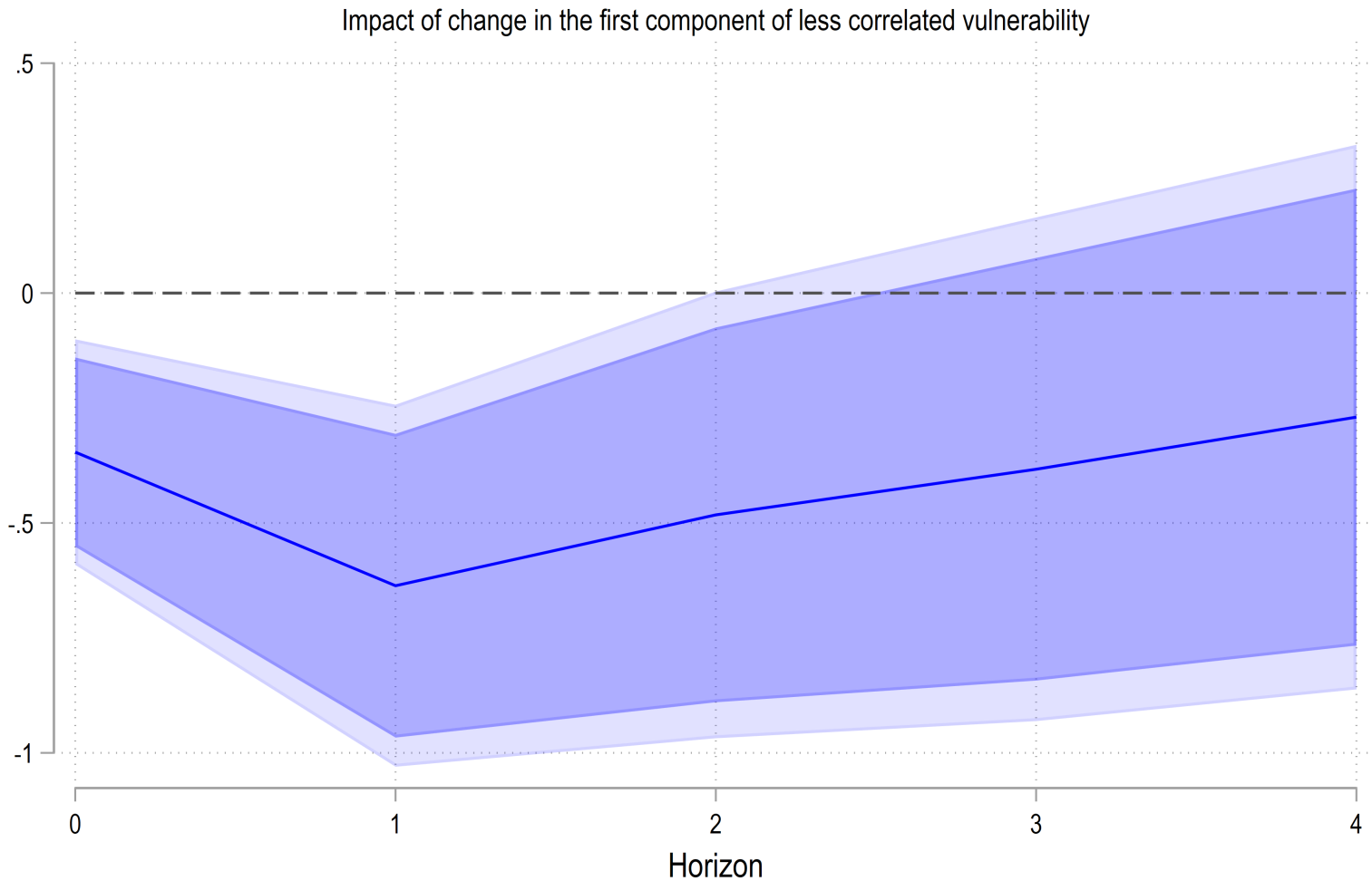
Figure 16. Panel LP for the bond yields (change in VUL_N)



Note: authors' calculations. The shock is a change in VUL_N. Country, time FE, and controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results - Endogeneity

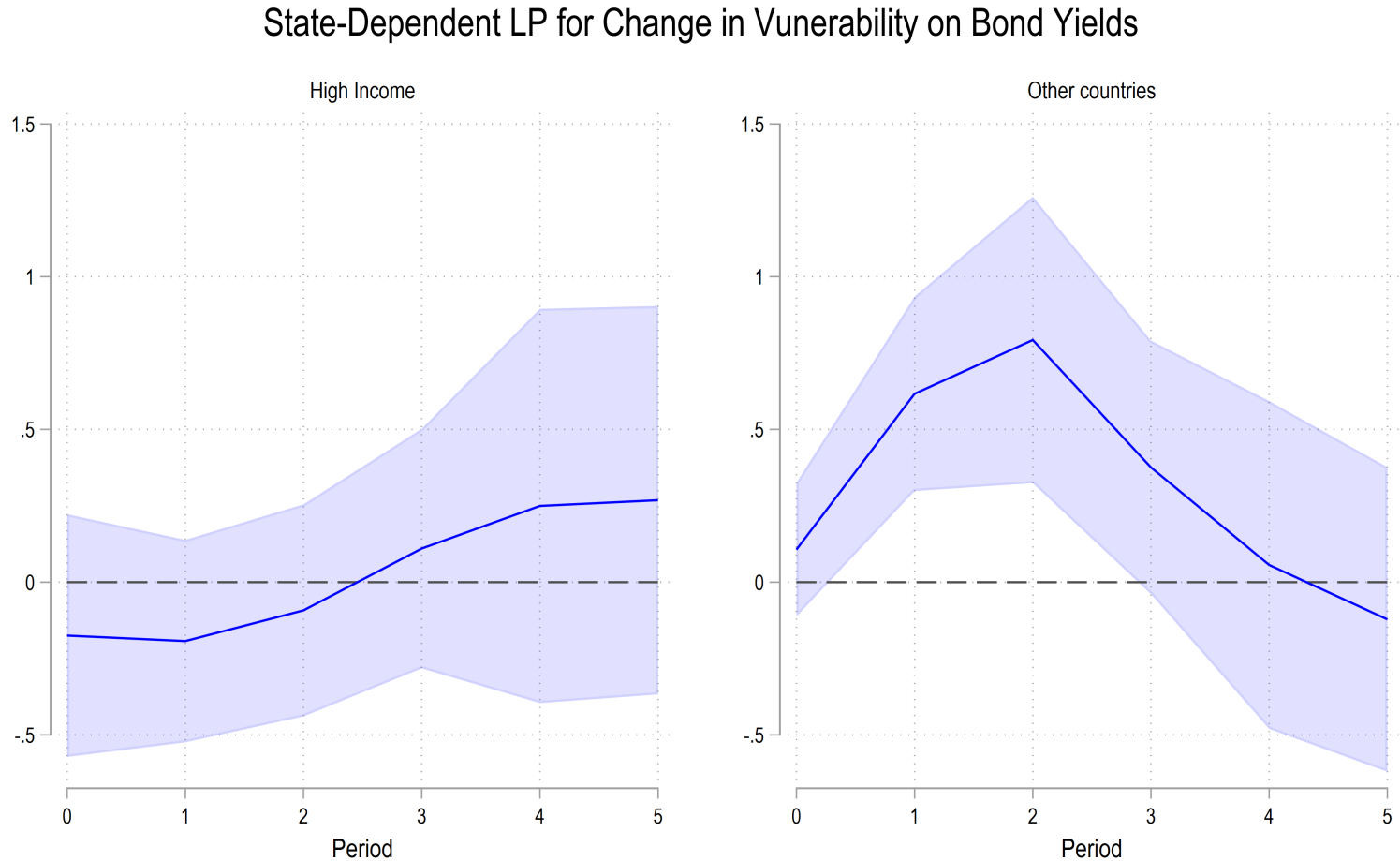
Figure 17. Panel LP for the sovereign ratings (change in VUL_N)



Note: authors' calculations. The shock is a change in VUL_N. Country and time FE, and controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results - Income groups

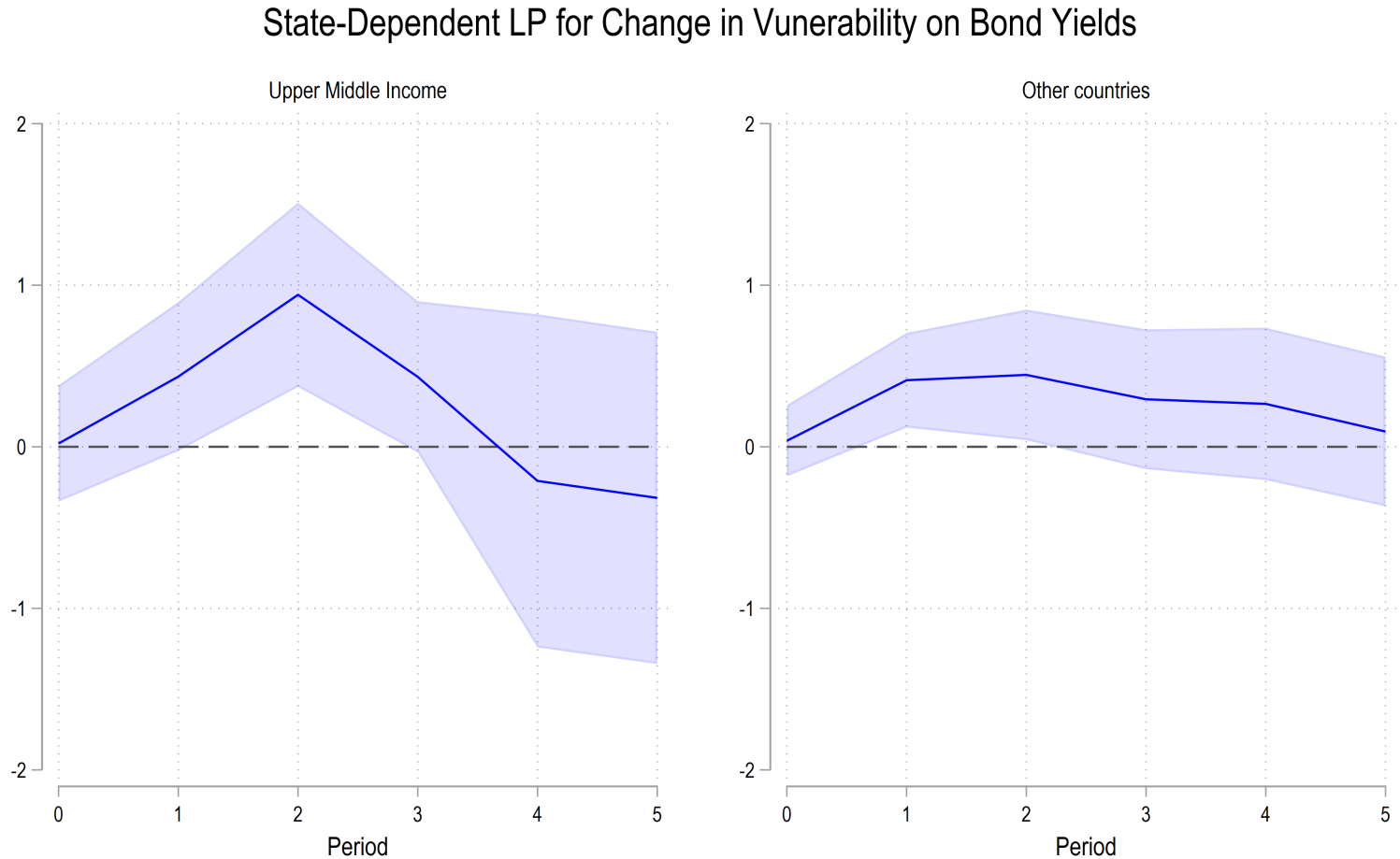
Figure 18. State-dependent Panel LP for the bond yields (High Income)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results - Income groups

Figure 19. State-dependent Panel LP for the bond yields (Upper Middle Income)

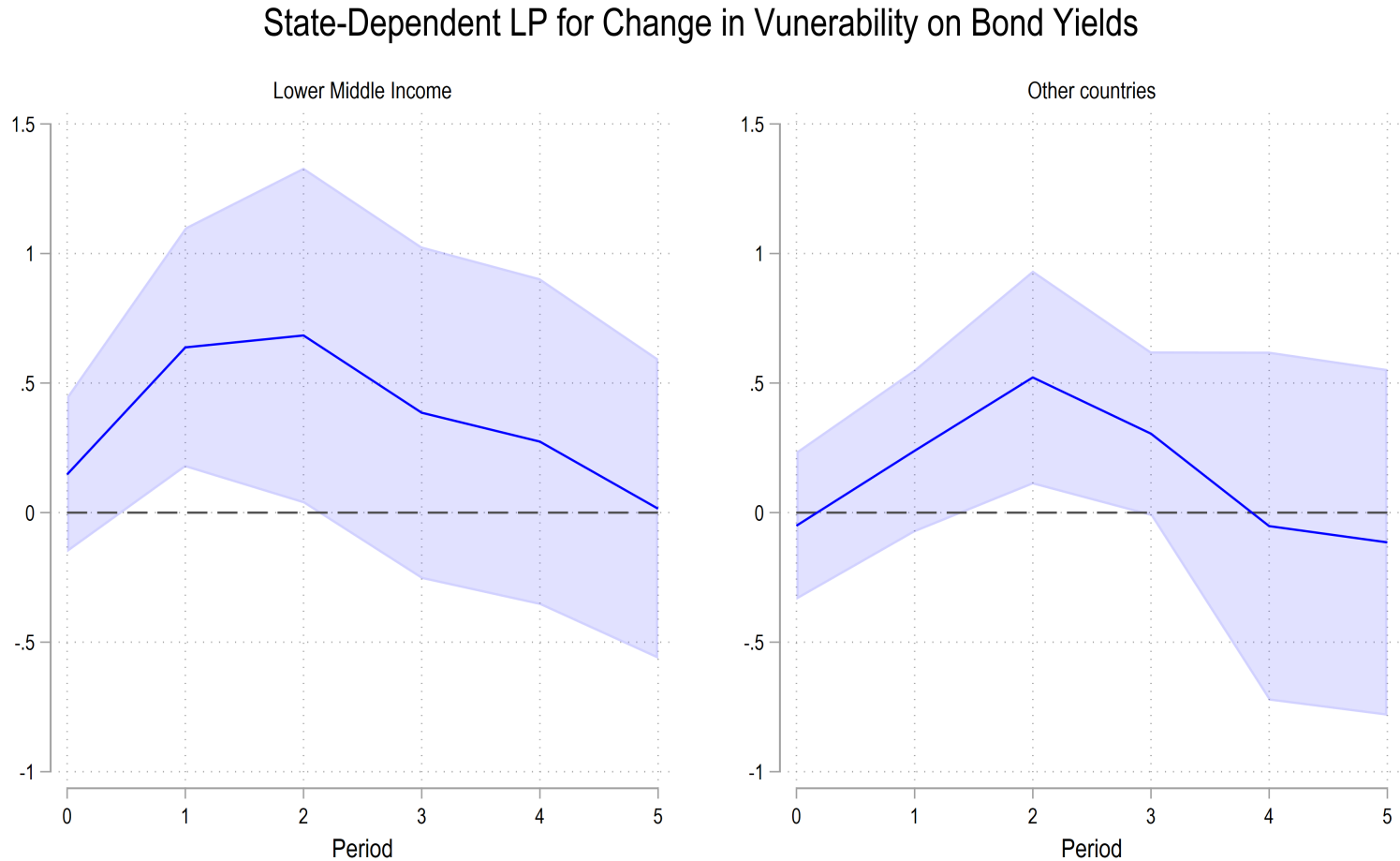


Note: State dependence is measured with a dummy for income country groups.
The shock is on D.vul100. Time FE included.

Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Results - Income groups

Figure 20. State-dependent Panel LP for the bond yields (Lower Middle Income)



Note: authors' calculations. The shock is a change in vulnerability. Country and time FE, controls are included, and standard errors are obtained through bootstrapping. Light blue confidence intervals are 95% level confidence intervals.

Final thoughts

Key takeaways

- Negative spillovers of exposure to climate change on fiscal space are most pronounced for economies most vulnerable to climate change
- Effects are mitigated in countries with more stable political environments and better developed financial markets
- A unit increase in vulnerability causes an increase in bond yields between 0.5 and 1 percent and a maximum decrease of 1 for the sovereign ratings (S&P: 21 AAA, 20 AA+, ..., 5 CCC+,...) at the horizon of 1 and 2 years;
- While fiscal consolidation is the key to mitigating the adverse effect of climate risks on fiscal space, our results suggest that both political stability and financial development can contribute as well