

Political Determinants of Sovereign Spread: The Great East-West Divide

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Abstract : We empirically explore whether and how taxation affects bilateral real exchange rates in the euro area - relative unit labor costs and relative consumer price indices. We find that employers' social security contributions and the value added tax changes have the expected effects put forward in the fiscal devaluation literature and simulations. Increases in employers' contributions appreciate the relative unit labor costs in the short- and the long-run, while value added tax hike appreciates the relative consumer prices. Somewhat surprisingly, for personal income tax increases, we find a short-run depreciating impact on the relative unit labor costs, while increases in employees' contributions depreciate both measures of real exchange rates in the short-run.

Keywords : sovereign bonds, European Union, developing countries, political determinants

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