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Bond Vigilantes and Inflation

Andrew K. Rose and Mark M. Spiegel*

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Abstract

We explore the relationship between inflation and the existence of a local domestic-currency bond market. Domestic bond markets allow governments to inflate away their debt obligations, but also create a potential anti-inflationary force of bond holders. We develop a simple model where bond issuance may lead to political pressure on the government to choose a lower inflation rate. We then check this prediction empirically, finding that inflation-targeting countries with bond markets experience inflation approximately three to four percentage points lower than those without. This effect is insensitive to a variety of estimation strategies and methods to account for potential endogeneity.

Keywords: empirical, panel, long, maturity, domestic, currency, risk, fixed, effect, nominal, debt.

JEL Classification Codes: E52, E58

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“I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody.”

- James Carville, *Wall Street Journal* (February 25, 1993, p. A1)

1. Introduction

Countries issue debt in many varieties: public and private, long- and short-maturity, nominal and real, and so forth. Since most countries do not have a complete set of bond markets, new ones are sometimes added. For instance, Poland introduced 10-year fixed rate government bonds in 1999; Korea followed in 2000.¹ In this paper, we ask the question: does the very existence of such bond markets help keep inflation low and stable?

The answer is not obvious. On one hand, the existence of local currency bond markets gives issuing governments the incentive to raise inflation to lower the real value of outstanding nominal debt obligations. However, at the same time it creates a potentially formidable political force that benefits from low stable inflation, namely the holders of those same nominal bonds.

We have two objectives. First, we present a political-economy median voter model in which the issuance of domestic-currency bonds encourages the government to pursue a lower inflation rate. Our objective is to present a model to formalize our intuition, rather than to estimate the model structurally. As entry into securities markets is costly and the distribution of wealth is skewed, only the rich hold securities; the poor hold only money and are thus always exposed to inflation risk. When exposed to inflation risk through nominal bonds, the rich lobby to induce the government to pursue a lower inflation outcome than it would have chosen on its own. Under certain parameter conditions inflation drops, since the lobbying effect dominates the government incentive to inflate away its debt obligations. In this manner, rich households holding nominal assets and acting solely in their self-interest, can actually work to equalize the distribution of pre-tax wealth across households, since the poor benefit from lower inflation. That is, the anti-inflation lobbying efforts of the rich inadvertently and disproportionately benefit the poor.

This findings seem intuitive. Financing government spending through seigniorage is usually regressive. Money creation causes an inflation tax which is paid more by the poor, since they disproportionately tend to hold money instead of assets that earn interest or are otherwise protected from inflation. If a government begins to finance its deficit by issuing bonds to the rich that are not protected from inflation, it can create a powerful constituency for low inflation.² The consequences of inflation become more concentrated when they are borne by the rich rather than the poor. The logic of collective action then implies that the political free-rider problem is reduced, and anti-inflation measures are more likely to be pursued. Hence the public good of low inflation is likely to be more prevalent when domestic-currency bonds are held, as they are owned by a relatively small powerful interest group necessarily opposed to the redistributive consequences of inflation. That is, inflation is likely to be lower when the consequences of the inflation tax are borne more by bond-holders and less by money-holders. This effect can also operate without any growth in the bond market relative to the money market, if the composition of government debt is transformed. Debt which is short-maturity, indexed, and/or foreign-currency denominated does not provide the anti-inflation bulwark of long, nominal, local-currency bonds; we formalize this intuition in our theory, and test it empirically.

Our study is related to earlier literature in which *ex ante* actions taken by the public or private sector can affect the severity of government moral hazard problems, and therefore *ex post* outcomes. A closely-related paper is Tirole (2003), in which the prevalence of domestic-currency denomination by private firms can discipline government behaviour. Similarly, Chang and Velasco (2006) demonstrate that private wage and debt contracts optimal for a given *ex post* exchange rate policy can change the payoffs to a benevolent government, inducing it to validate these contracts by pursuing a particular policy. An alternative strand of literature argues that low shares of domestic bond issuance may reflect “original sin,” (e.g. Eichengreen and Hausmann, 1999); firms in emerging markets experience difficulties issuing debt in their domestic currencies along with greater macroeconomic instability *ex post*.

Our second objective is to test the implications of local currency nominal bond markets for inflation with an empirical investigation. We demonstrate that the presence of a long, nominal, local-currency bond market is indeed associated with inflation that is approximately three-four percentage points lower, for inflation-targeting countries.

Endogeneity issues arise here, as a number of papers [e.g. Calvo (1996), Jeanne (2000) and Claessens, et al (2007)] argue that the currency composition of debt is endogenously related to perceived borrowing risk, implying causality in the opposite direction. Partial default on nominal debt achieved through inflation may prove less costly and disruptive than formal renegotiation of debt. As such, this form of default may be attractive to a country facing financing difficulties, making it challenging for agents from such countries to issue domestic currency debt *ex ante*. Stable monetary conditions have been shown to be associated with greater shares of public and private domestic currency issuance [e.g. Claessens, et al (2007) and Burger and Warnock (2007)], as have expectations of more stable future monetary conditions [Hale and Spiegel (2012)].

We respond to these concerns in a number of ways. First and foremost, we limit our sample to inflation-targeting countries, who have formally committed to avoiding inflation. We also control for other characteristics that may influence inflation or bond market creation. We also show that our results are robust to treatment effect estimation. Finally, we look to institutional characteristics as instrumental variables, primarily relying on the size of government spending as a share of GDP and the time that has passed since national independence or the adoption of a democratic political system. In practice, we find that least squares, treatment effect, and instrumental variable estimates are similar; the introduction of a bond market seems to cause inflation to fall by around three percentage points.

2. Theory

In this section, we introduce a simple one-period model of an endowment economy with domestic currency and inflation. There are three types of “agents”: households, who are endowed with wealth at the beginning of the period, and invest in either cash or securities; the government, which finances its expenditures through debt issuance and services its debt through a combination of taxes and inflation; and an “inflation lobby” which lobbies the government for lower inflation on behalf of domestic-currency debt holders after the creation of a domestic currency bond market.

There are N atomistic households. Each household i is endowed with nominal assets w_i at the beginning of the period. Households are numbered from the household with the smallest endowment, 0 , to those with the largest endowment, N .

Wealth can be held as cash, which yields no interest, or invested in securities. The government, discussed below, has issued a total of G securities, denominated in either domestic or foreign currency.³

Markets are assumed to be segmented, in the sense that there is a real fixed cost $\phi > 0$ of entering the securities market. After paying the fixed fee, households can choose to purchase domestic or foreign bonds. Since international capital markets are open, interest parity requires that all bonds earn an expected return equal to one plus the real international rate of return on foreign securities, represented as r^* . We set the foreign inflation rate to 0 for simplicity. Domestic bonds pay an endogenous fixed nominal return, R , representing 1 plus the nominal interest rate in domestic currency.

The fixed cost of entering the securities markets implies scale economies to the expected returns in these markets. These scale economies imply that there is a marginal household, i^* , that is indifferent between entering the securities market and holding cash. Wealthier households, $i > i^*$, all pay the fee and enter the bond market, while poorer households, $i < i^*$, hold cash. Without loss of generality, we assume that the set of households entering the bond market is

relatively small, so that the median household ($i = N / 2$) is poorer than the marginal household, i.e. $w_m < w_{i^*}$. This implies a parameter restriction, which we determine in the appendix.

We assume that all households that purchase domestic securities also participate in lobbying. For simplicity, we assume that lobbying contributions are proportional to domestic bond holdings, with each bond holder contributing an amount λ times his bond holdings. λ is endogenous and determined below.

After paying the fixed fee to enter the securities market, households are free to choose between domestic and foreign securities. Interest rate parity ensures that ex ante

$$r = E(\pi r^* + \lambda) \quad (1)$$

where $E(\cdot)$ represents beginning of period expectations, and $\pi \geq 1$ represents 1 plus the rate of domestic inflation. In order to clear the market, the equilibrium nominal rate paid on domestic securities compensates asset holders for both expected inflation and the expected costs of political activity. It is therefore cheaper to issue domestic debt in environments with less expected lobbying activity, holding realized inflation constant.

Let W_i reflect the end-of-period pre-tax household wealth. At the end of the period, if the household does not enter the bond market its expected pre-tax real wealth satisfies $E(\pi)^{-1} w_i$. Alternatively, if household i does enter the bond market (since returns in both domestic and foreign securities are equal *ex ante*), its expected pre-tax real wealth satisfies $r^*(w_i - \phi)$.

By (1), the initial wealth of the marginal household i^* , the household that is indifferent between entering the securities market and holding cash, satisfies

$$w_{i^*} = \frac{\phi}{E(\pi)r^* - 1}. \quad (2)$$

The identity of the marginal household is a function of three arguments: First, i^* is increasing in ϕ ; the more costly it is to enter the securities market, the larger a household's wealth needs to be. It is decreasing in the return on holding foreign securities, r^* , as increases in the returns on bonds reduce the initial wealth needed to make entering the bond market profitable. Finally, i^* is decreasing in the expected inflation rate, $E(\pi)$, as higher expected inflation raises the expected returns from converting into inflation-protected (foreign) bonds.

The government issues debt with exogenous face value G . It earns seigniorage on inflation. To allow for an interior solution, we specify real seigniorage revenues, R_π as increasing in inflation according to the function

$$R_\pi = \bar{\varphi} - \varphi\pi^{-2} \quad (3)$$

We assume that $\varphi'(\pi^{-1}) \geq 0$ and $\varphi''(\pi^{-1}) < 0$.

At the end of the period, the government is assumed to pay its debt obligations.⁴ To balance its budget, its real tax revenues, T , must match the real value of its debt obligations minus its seigniorage revenue. To focus on the distributional impact of inflation, we assume for simplicity that taxes are shared equally across all households, with each household's real tax burden being equal to T/N .⁵ We also ensure that no household is insolvent regardless of the inflation outcome, we assume that $T/N \leq \pi^{-1}w_0$. The parameter constraint needed to satisfy this condition is derived in the appendix.

We follow the political economy literature in assuming that the government is interested in maximizing the real end-of-period wealth utility of the median voter [e.g. Bowen (1943)]. In addition, the government agent values the real value of transfers from the anti-inflation lobby,

$(\pi^{-1})\lambda G$ at par value. We assume that the utility of the median voter is linear in the log of end-of-period wealth. Since the median household holds cash, its end-of-period real wealth satisfies

$$W_m = (\pi^{-1})w_m - \frac{T}{N}.$$

The government loss function then satisfies:

$$U_g = \left[(\pi^{-1})w_m - \frac{T}{N} \right] + (\pi^{-1})\nu\lambda G \quad (4)$$

where ν is an exogenous constant term representing the weight the government agent puts on transfers from the anti-inflation lobby relative to its valuation of the wealth of the median voter.

Case 1: No Domestic Bond Market

We first consider the case where no domestic bond market exists and the government issues all its debt in foreign currency. To distinguish this case from that below where the government issues debt in domestic currency, we designate endogenous values with a superscript f . The government's real debt obligation at the of the period in domestic currency will be equal to r^*G . Its budget constraint then satisfies

$$T^f \geq r^*G - \left(\bar{\varphi} - \varphi(\pi^f)^{-2} \right) \quad (5)$$

As there is no inflation lobbying activity in this case, substituting the budget constraint into the government's utility function, the solution of the government satisfies

$$\underset{(\pi^f)^{-1}}{\text{Max}} U_g = \left[(\pi^f)^{-1} w_m - \frac{r^*G - \left(\bar{\varphi} - \varphi(\pi^f)^{-2} \right)}{N} \right] \quad (6)$$

The first order condition for the government satisfies

$$\pi^f = \frac{2\varphi}{Nw_m}. \quad (7)$$

The government chooses a higher level of inflation the greater is N , as an increase in the number of households reduces the impact of increased total taxes on the median household. It chooses a lower level of inflation the larger is w_m , as higher inflation affects the marginal household more dramatically the wealthier is that household. Inflation is unaffected by the government's debt burden, r^*G , as the inflation choice has no effect on the real value of the government's debt obligations when they are denominated in the foreign currency.

Case 2: Domestic Currency Bond Market with Anti-Inflation Lobbying

One might imagine that a domestic currency bond market is likely to increase inflation since it provides the government the opportunity to reduce its fiscal burden ex post. However, since ownership of domestic bonds is relatively concentrated, it is important to consider the logic of collective action and the possibility that a lobby emerges to petition the government on behalf of the domestic bondholders.⁶

We follow Acemoglu et. al. (2008) in assuming that the inflation lobby makes a take-it-or-leave-it offer of a contract pair (λ, π^d) , which promises to pay the government a nominal transfer of λG in return for a promised inflation realization of π^d . The transfer is assumed to be financed by proportional contributions from all bondholders. As in Acemoglu, et al, we assume that the government can credibly commit to a lobbying contract, and that the domestic currency bondholders service the transfer to the government.⁷

The lobby's problem is to choose a pair (λ, π^d) that maximizes the returns of domestic currency debt holdings, subject to: a) the government's budget constraint; and b) the constraint that the government is left at least as well off as it would be in the absence of an agreement with the

lobby. Given an interior solution, the equilibrium outcome will be one with positive lobbying efforts ($\lambda > 0$) and the alternative outcome in the absence of an agreement represents off-equilibrium path activity, where the equilibrium contract derived below is anticipated, but not signed. This alternative outcome provides the threat point that ensures that the offer made by the lobby to the government is incentive compatible.

We first solve for the alternative outcome in the absence of an agreement. Let \bar{U} represent government utility and $\bar{\pi}$ inflation in the absence of an agreement. As nominal debt obligations rG are already determined, the maximization problem in the absence of lobbying activity satisfies

$$\text{Max}_{\bar{\pi}^{-1}} U = \left[\left(\bar{\pi}^{-1} \right) w_m - \frac{\left(\bar{\pi}^{-1} \right) rG - \left(\bar{\varphi} - \varphi \left(\bar{\pi}^{-1} \right)^2 \right)}{N} \right]. \quad (8)$$

The government's solution satisfies

$$\bar{\pi} = \frac{2\varphi}{Nw_m - rG}. \quad (9)$$

and its utility in the absence of an agreement can be obtained directly from (8).

Comparing equations (7) and (9), it can be seen that the government chooses a larger level of π in the presence of a domestic bond market in the absence of an agreement with the anti-inflation lobby. The government capitalizes in this case on its ability to decrease the real value of its liabilities through inflation.

Substituting (9) into (8)

$$\bar{U} = \frac{(Nw_m - rG)^2}{4\varphi N} + \frac{\bar{\varphi}}{N} \quad (10)$$

We next turn to the problem faced by the anti-inflation lobby, which takes both \bar{U} and r as given. We assume that the transfer from the anti-inflation lobby goes directly to the government official, and does not enter into the government budget constraint.

The inflation lobby maximizes net returns to domestic currency bondholders, subject to the constraint of leaving the government at least as well off as it would be in the absence of an agreement ($U \geq \bar{U}$). The Lagrangian representing the maximization problem for the inflation lobby satisfies

$$\text{Max}_{\pi^d, \lambda} L = (\pi^d)^{-1} (r - \lambda)G + \theta \left(\left[(\pi^d)^{-1} w_m - \frac{(\pi^d)^{-1} rG - (\bar{\varphi} - \varphi(\pi^d)^{-2})}{N} \right] + \nu (\pi^d)^{-1} \lambda G - \bar{U} \right) \quad (11)$$

The first-order conditions for $(\pi^d)^{-1}$, λ , and θ satisfy

$$(r - \lambda)G + \theta \left(w_m - \frac{rG + 2\varphi(\pi^d)^{-1}}{N} + \nu \lambda G \right) = 0 \quad (12)$$

$$\theta = \frac{1}{\nu} \quad (13)$$

$$(\pi^d)^{-1} w_m - \frac{(\pi^d)^{-1} rG - (\bar{\varphi} - \varphi(\pi^d)^{-2})}{N} + \nu (\pi^d)^{-1} \lambda G = \bar{U} \quad (14)$$

By (13), we can eliminate θ from (12)

$$\pi^d = \frac{2\varphi}{Nw_m + (N\nu - 1)rG} \quad (15)$$

Comparing equations (9) and (15), it can be seen that the lobbying activity reduces inflation relative to the outcome with no agreement between the government and the lobby. Comparing equations (7) and (15), it can be seen that the net impact of the introduction of the domestic currency bond market on inflation is ambiguous. This ambiguity is formalized in our first

proposition, which specifies the conditions under which the addition of a domestic bond market lowers inflation:

PROPOSITION 1: *Realized inflation is lower with a domestic currency bond market relative to a foreign currency bond market if and only if $N\nu \geq 1$.*

The proof follows directly from equations (7) and (15).

The intuition behind this result is straightforward. When ν is larger, lobbying is more effective, so the introduction of domestic bonds results in lower inflation, since it also launches lobbying. When N is larger, the median household suffers less from increased taxation, so raising taxes and receiving lobbying transfers are more desirable.⁸

We next move towards solving the model. Invoking rational expectations

$[E(\pi^d r^* + \lambda) = \pi^d r^* + \lambda]$, and substituting (1) and (10) into (14) and simplifying yields

$$\left(\pi^d\right)^{-1} 4\varphi\left[\left(Nw_m - rG\right) + N\nu rG\right] - 4\varphi^2\left(\pi^d\right)^{-2} - 4\varphi N\nu r^* G - \left(Nw_m - rG\right)^2 = 0 \quad (16)$$

Combining (15) and (16), r^* will be the positive root of

$$\left(N\nu - 2\right)Gr^2 + 2Nw_m r - 4\varphi r^* = 0 \quad (17)$$

Given r^* , π^d can be obtained directly from (15), and then λ can be obtained from (14), solving the model.

Implications for the distribution of wealth

We next consider the implications of a switch from foreign to domestic currency debt for the distribution of wealth. As taxes are distributed equally across households, it is sufficient to examine the implications for pre-tax end-of-period wealth.⁹ Assuming that we are in the parameter space $N\nu \geq 1$, inflation falls. It follows by equation (4) that the creation of a domestic bond market will

raise the initial wealth of the marginal household, as the gains from entering the bond market are reduced with lower inflation. Let i_f^* represent the marginal household under foreign currency issuance and i_d^* the marginal household under domestic currency issuance.

We therefore have three ranges of households: The poorest, from 0 through i_f^* who hold only cash under both foreign and domestic currency issuance; a middle group from i_f^* through i_d^* , which switches from entering the bond market under foreign currency issuance to holding cash under domestic issuance; and the rich, i_d^* through N , who always enter the bond market.

As the poorest group holds cash, its end-of-period pre-tax wealth is raised by the reduced erosion of the value of their cash holdings through inflation. In contrast, the richest group i_d^* through N , enter the bond market under both regimes and therefore are unexposed to domestic inflation. Their pre-tax end-of-period wealth remains unchanged.

Finally, the middle group i_f^* through i_d^* entered the bond market to protect their assets from inflation under foreign currency issuance. However, with the reduction in inflation under domestic currency issuance, they no longer find effective the inflation protection gained from entering the bond market cost, and thus switch to cash. Their wealth must be higher as a result, since they could have continued to enter the bond market (which would have left their wealth unchanged).

The impact of the introduction of the domestic bond market is illustrated in Figure 1. Under foreign currency issuance, households 0 through i_f^* hold cash and have pre-tax wealth equal to $(\pi^f)^{-1} w_i$. Wealthier households enter the bond market and have pre-tax wealth equal to $r^*(w_i - \phi)$. With the introduction of the domestic currency bond market, households 0 through

i_d^* hold cash and have pre-tax wealth equal to $(\pi^d)^{-1} w_i$, while households wealthier than this higher threshold continue to enter the bond market, and their pre-tax wealth is unchanged at $r^*(w_i - \phi)$. The introduction of the domestic bond market therefore raises pre-tax wealth. We observe an increase in pre-tax wealth in the lower two ranges after the switch from foreign to domestic currency issuance, but no change in the pre-tax wealth of the richest range.

This leads to our second proposition:

PROPOSITION 2: *When the introduction of a domestic currency bond market reduces inflation, it leaves the distribution of end-of-period pre-tax wealth more equal if i_f^* is sufficiently close to i_d^* . In particular, a sufficient, but not necessary condition for wealth to equalize is $i_f^* = i_d^*$.*

The proof of Proposition 2 is in the appendix. First, we demonstrate that the share of wealth for the poorest group increases, while that of the richest group falls as a share of income (absolute wealth levels of this group remain unchanged). A priori, that would suggest a more equal distribution of wealth. However, the middle-income group, whose wealth rises, but not necessarily as much as that of the poorest group, leaves the change in the entire distribution uncertain. We demonstrate that for the special case, where the middle group is of measure zero, that the distribution of wealth unambiguously becomes more equal. Given this condition, our results suggest that the wealthy bondholders, acting only in their self-interest by lobbying for lower inflation, unintentionally become a force for equality.¹⁰

We now turn to the empirics, focusing our energy on the link between domestic bonds and inflation captured in the first proposition.

3. Empirical Strategy and Methodology

Our objective is to investigate whether the presence of a domestic currency bond market is negatively correlated with inflation empirically. There are obviously other determinants of inflation,

especially in the short run. As a consequence, our methodology is relatively low-frequency, relying on annual data for a broad panel of countries. We begin with a conventional least-squares panel estimator:

$$\pi_{it} = \beta Bond_{it} + \gamma X_{it} + \{\delta_i\} + \{\varepsilon_t\} + \eta_{it} \quad (18)$$

where π_{it} is the inflation rate for country i at time t , $Bond_{it}$ is a binary variable (1 if country i has a nominal, long-term, domestic-currency bond market at time t , and 0 otherwise), X_{it} is a vector of controls linked to inflation via a set of nuisance parameters γ , $\{\delta_i\}$ and $\{\varepsilon_t\}$ are respectively country- and time-specific fixed effects, and η is a residual to represent all other influences on inflation. The coefficient of interest is β , the partial-correlation between a bond market and inflation. We use five covariates X_{it} to control for other inflation determinants unlikely to be affected by bond market existence: a) polity (a measure of autocracy/democracy); b) income (the natural logarithm of real GDP per capita); c) size (log population); d) openness (trade as a percentage of GDP); and e) demeaned real GDP growth.¹¹ Since we include comprehensive sets of both time- and country-specific fixed effects, this can be interpreted as a difference-in-differences estimator.¹²

Why and when do local bond markets get created? It is natural to think that low and stable inflation is a necessary prerequisite for the existence of a long, nominal, local-currency bond market.¹³ Perhaps then the presence of a bond market cannot be treated as exogenous for inflation; perhaps some common cause creates the conditions for both a fall in inflation and the creation of a bond market?

We try to handle this potential simultaneity problem in a few ways. First, we estimate (18) only for inflation-targeting regimes (hereafter “IT”). IT regimes have proven remarkably durable and consistently deliver inflation that is low and stable compared with alternate regimes. Thus we begin by restricting our attention to a set of countries that would already seem to have the necessary

conditions to establish a domestic currency bond market. As a robustness check, we also consider other monetary regimes such as hard fixed exchange rate regimes. Only IT regimes have made a policy commitment to low inflation, thereby legitimizing anti-inflation forces such as the bond market. It is thus reasonable to expect the effect (if any) of the bond market to suffer less from endogeneity among IT regimes. In the case of peggers, bond markets may be more likely to arise among lower nominal inflation regimes, leading to more severe endogeneity concerns.¹⁴

We also try two econometric strategies to deal with potential simultaneity. We use a variety of different treatment estimators to estimate β . These may be useful to handle any selection issue, since countries may choose in principle to create a bond market when the conditions are ripe, because of an actual or expected fall in inflation. We also estimate (18) with instrumental variables, relying on fiscal and political variables to construct instruments for bond market existence. We use the size of government spending in the economy and the age of the country as our instrumental variables, and show that our results are insensitive to their exact nature. Our IV results indicate an economically and statistically significant effect of a bond market on inflation for the inflation targeting countries, just like those estimated with least squares.

4. The Data Set

We are interested in estimating β in equation (18), the effect of a bond market on inflation during inflation targeting regimes, *ceteris paribus*. Besides data on inflation and controls, we need information on whether or not a country maintains an IT regime, and a domestic currency bond market. The most difficult information to obtain is whether a suitable bond market exists.

We begin with the GFDdatabase from *Global Financial Data* (hereafter “GFD”). GFDdatabase is advertised as providing data “spanning more than 200 global markets and extending coverage back to 1265.”¹⁵ We employ GFD’s Fixed Income Database which is self-described as:

“recorded electronically for current and historical markets covering 200 countries. GFD provides complete yield curve coverage with data on Interbank Rates, Swap Rates, Treasury-Bill Yields and Long-term Government Bond Yields. The Fixed Income Database enables you to follow changes in yields over different maturities going back several decades using yields at 3 months and 10 years, as well as maturities between and beyond these benchmarks. GFD provides data from both the public sector and the private sector.”¹⁶

In practice, bond data from GFD appear to be available for those bonds traded with sufficient liquidity to have prices quoted, typically over the counter, and often after an initial auction. We rely on series for government bonds, since the corporate analogues from GFD tend to follow government bonds in time. We are interested in long, nominal, local-currency bonds, since these are the most vulnerable to inflation. We begin with bonds which have a maturity of at least a decade. Ten years is an international benchmark, a maturity largely outside the horizon of current monetary policy, and a horizon sufficiently long that bond prices are responsive to inflation. We also use GFD to construct series on shorter maturity, indexed, and foreign-denominated bonds, as robustness checks.

We have checked GFD against other data sources, which typically seem less complete than GFD. For instance GFD provides data for 819 bonds in its “Government Bond Yields” database from some 105 countries; 70 of these countries have bonds with a maturity of at least a decade. By way of contrast, Bloomberg and *The Financial Times* each provide data for twenty 10-year government bond yields (all covered by GFD). In Table 17b of its *Quarterly Review*, the BIS provides data (disaggregated by government, non-financial and financial corporations) for 28 countries with “long-term” domestic bonds and notes; long-term is defined as a maturity of more than one year. Investing.com provides a wide range of data; it covers 59 countries with 10-year (or greater) government bonds. The most comprehensive alternative to GFD we have found is Dealogic, which covers 73 countries (and territories, such as Jersey and Puerto Rico). We have checked the GFD data for errors against all these sources (and others), and corrected some omissions.¹⁷

Other data series are more straightforward. We extract series on inflation (both CPI and GDP) from the World Bank’s *World Development Indicators*. The *WDI* also supplies series for real (PPP-adjusted) GDP per capita, population, and trade as a proportion of GDP.¹⁸ Dates for the start of

inflation targeting regimes are taken from Rose (2013). We use *polity2*, which ranges from -10 (autocracy) to +10 (democracy), taken from the *Polity IV* project.¹⁹ For hard fixed exchange rate regimes, we use the Reinhart-Rogoff (2004) data set, updated through 2010 by the Ilzetzki, Reinhart and Rogoff.²⁰

In all, we have annual data for over 200 countries between 1970 and 2012 (with gaps). However, most of our focus is on a subset of this data set, namely IT countries. These are tabulated in Appendix Table A1, along with two dates: the start of inflation targeting, and the start of domestic-currency, long, nominal, bond markets. Four IT countries do not have bond markets during the sample (Albania, Ghana, Guatemala, and Serbia). The bond markets of a number of countries began long before IT (including Australia, Canada, New Zealand, Norway, South Africa, Sweden, Switzerland, and the UK). Finally, a number of bond markets came into being after IT, including those for: Armenia, Brazil, Chile, Colombia, Czech Republic, Iceland, Indonesia, Israel, Korea, Mexico, Peru, Romania, and Turkey. This variation provides the identification required for our empirical approach.

Table 1 provides some descriptive statistics on inflation across bond markets and monetary regimes. Panel A shows that countries with domestic currency bond markets experience lower and more stable inflation than do countries without bond markets; both the mean and standard deviation of (either measure of) inflation are lower by statistically significant amounts, as shown by the t/F tests to the right of the table. Panel B examines only countries with bond markets, and shows that within this class, inflation targeters experience inflation that is lower and more stable than hard fixers or other countries. Panel C is an analogue for countries without bond markets; here average inflation is similar for inflation targeters and hard fixers, though inflation is more stable with IT. Countries without bond markets in the “sloppy center” of monetary regimes (which are neither inflation targeters nor hard fixers) experience high and unstable inflation. The number of observations is also recorded in Panels A-C; it is interesting to note that there are more IT countries

with bond markets than without, but countries using hard fixes or other monetary regimes usually do not have bond markets. Finally, Panel D compares inflation moments within a given monetary regime, for countries with and without bond markets. The top left t-test is significantly different from zero at all conventional confidence levels, indicating that the average CPI inflation rate is higher for inflation targeters *without* bond markets than for inflation targeters *with* bond markets. The F-test immediately to the right is also large, indicating that inflation volatility is also higher for IT countries without bond markets than IT countries with bond markets. Analogues for GDP inflation, hard fixers, and the sloppy center are tabulated in the remainder of the panel.

Together, the panels of Table 1 paint a suggestive picture. IT countries with domestic currency bond markets seem to have lower and more stable inflation than those without bonds, while results for other monetary regimes are less clear. This impression is bolstered by the evidence in Figure 2, which provides graphical evidence for inflation targeters with and without bond markets. In the pair of histograms at the left of the figure, we plot CPI inflation for IT countries with (below) and without (above) bond markets.²¹ The histograms give the impression that inflation is typically lower for inflation targeters with bond markets. The same view emerges from the analogous histograms for GDP inflation in the middle column. The top-right chart graphs the quantiles of CPI inflation for inflation targeters with bond markets (on the y-axis) against inflation quantiles for those without bond markets (on the x-axis).²² A diagonal line is provided for reference; if inflation were similarly distributed across inflation targeters with and without bond markets, the data would be plotted along the diagonal. In fact, the data are below the diagonal; IT countries without bond markets have systematically higher CPI inflation than those with bonds. The quantile plot for GDP inflation in the lower-right delivers the same message.

Figure 3 provides a different take. This provides a pair of event studies (one for each measure of inflation) that characterize inflation around the creation of bond markets, again restricting attention to IT countries. We show average inflation starting three years before bond

market creation (at the extreme left) and continuing until three years afterward (at the extreme right); a confidence interval is provided by the empirical (5%, 95%) quantiles. The introduction of a long bond market in an inflation-targeting country seems to be associated with lower inflation. Inflation begins at approximately the inflation rate for IT countries without bond markets (marked with horizontal lines) and seems to converge towards that of IT countries with bond markets (also marked). But the event-study should not be over-interpreted. There are only 14 cases where inflation targeters introduced a bond market during the sample. Further, the event is the creation of the bond market; there appears to be a one-year anticipation of these events, which is perhaps unsurprising, given the issues involved with setting up such a market. Accordingly, it is appropriate to add more rigor to the empirics.

5. Results

Our benchmark results for (18) are recorded in Panel A of Table 2. This presents estimates of β from (18), along with robust standard errors (clustered by country). IT countries with a domestic currency bond market experience CPI inflation that is 2.9% lower than those without bond markets, holding a variety of other features constant. The robust t-ratio is -2.9, significantly different from zero at the 1% significance level. The estimate for GDP inflation is over four percentage points, again economically and statistically large. That is, the null hypothesis that the bond market is *not* associated with lower inflation, is grossly inconsistent with the data. Rather, inflation targeting countries have inflation that is three to four percentage points lower when a (long, nominal, local-currency) bond market exists. The same is not true of different monetary regimes, as can be seen in Panel B; while countries with bond markets seem to have *higher* inflation, the coefficients are imprecisely estimated for both hard fixers and countries in the sloppy center.²³

Sensitivity Analysis

Most of Table 2 is sensitivity analysis intended to show that the default estimate in Panel A is not a fluke that can be easily dismissed. Panel C shows that the key (β) coefficients are robust to changes in the precise data sample. We successively drop: a) early/late observations; b) observations for poor/rich countries (annual real GDP per capita less than \$10k/greater than \$40k); c) observations for small/large countries (population <10 million/> 100 million); and d) outlier observations (those with residuals greater than 2.5 standard deviations from zero). While standard errors typically rise as observations are dropped from the sample, the point estimates of β remain reasonably stable and significant in both economic and statistical senses.

Panel D shows that the precise econometric technique does not seem to matter much. We successively: a) replace robust with conventional standard errors; b) replace fixed with random country effects; c) drop country effects; d) drop time effects; and e) drop the control covariates (X in equation (18)). Again, none of the perturbations in Panel D undermine confidence in the default estimate.

We check the robustness of the precise measure of the bond market in Panel E. First, we substitute a five-year lag of the bond market in place of its contemporaneous variable. Next, we substitute shorter maturity bonds (technically “notes”), those between five and nine years, instead of requiring that bonds be trading for maturities of at least ten years. The effect of the bond market on inflation remains statistically and economically significant through both of these checks.²⁴

The final pair of checks, recorded at the bottom of Table 2, is expected to fail. Our hypothesis is that only bond-holders significantly affected by domestic inflation can be expected to provide support for anti-inflationary policies. We test this by successively replacing our long, nominal, domestic-currency bond market dummy variable with analogous dummies for bonds that are a) indexed or adjusted for inflation; and b) denominated in foreign exchange rather than domestic currency.²⁵ In the former case, the point estimates shrink but remains negative, measured with sufficient imprecision as to be insignificantly different from zero; in the latter case, the point

estimates are actually positive, though again insignificantly different from zero. Thus, the drop in inflation appears to come from a particular type of bonds, not extra fiscal space in itself.

A simple placebo test is presented in Figure 4. For each IT country, we replace the actual date a bond market was created (if any, since four of our countries never have bond markets in the sample) with a date bootstrapped from our 32 inflation targeters, replace our bond dummy variable with this artificially created one, and then estimate β from (1). We do this a large number of times, and display histograms for these bootstrapped coefficients in Figure 3. Most cluster around zero; our actual estimates are displayed and are out on the tail. Falsified bond market dates, even for IT countries, do not deliver our results.

All this bolsters confidence in the basic result: the presence of a long, nominal, local-currency bond market within an IT regime is associated with inflation that is about three-four percentage points lower.

Treatment Effect Estimates

In Table 3, we provide estimates for the effect of a bond market on inflation using a variety of different treatment effect estimators, all confined to inflation-targeting countries. For instance, we match bond market observations to those without bond markets using both the propensity score and nearest-neighbour matching techniques in the top pair of rows.²⁶ The estimated treatment effects of the bond market for both CPI and GDP inflation is between 3.6 and 5.1 percentage points. This is both economically and statically significant; it is also reassuringly close to the panel estimates of Table 2. The next row tabulates a similar effect estimated using a regression-adjusted treatment effect estimator, using the five control covariates as the regression model to predict potential outcomes. We also provide inverse-probability treatment effect estimates, and then combine this technique with regression adjustment in two ways. The bottom line for inflation targeters from a

dozen treatment effect estimates is similar; inflation is approximately three to four percentage points lower for countries with bond markets.

Instrumental Variable Estimates

The existence (or absence) of a bond market is a variable that may be measured with error. It may also be simultaneously determined with inflation, even within the class of inflation-targeting countries. For both reasons, we now pursue instrumental variables estimation. We begin with two instrumental variables: the size of government spending (relative to GDP), and (the log of) the length of time since national independence. The motivation for our choice of IVs is simple: more mature governments are likely to have the institutional capacity necessary to create a bond market, and governments that spend more are likely to have a greater need to create one. We also show that IV results do not depend sensitively on the exact choice of instrumental variables by considering six alternatives.

Table 4 presents evidence associated with instrumental variables estimation of (18). The top row contains the default results, instrumenting bond market existence with government spending (measured as a fraction of output) and the log of years of independence. These are not weak instrumental variables; the left-hand column tabulates the p-value for the hypothesis that both coefficients are zero in the first-stage regression of the bond market dummy variable on the two instrumental variables (as well as the other controls in (18)). The p-value is low, indicating that the instrumental variables are significantly correlated with the bond market dummy variable. Two IV estimates of β are then tabulated, one for each measure of inflation, along with their standard errors. These are both economically larger – in the range of 8% – than their least squares analogues tabulated in the bottom row of the table for convenience – which are approximately 3-4%. However, the IV coefficients are estimated with worse precision, so that Hausman tests for equality between the IV and LS estimates of β are insignificantly different from zero; the t-ratios are recorded. We also add the IVs directly into equation (18) and test the hypothesis that both IVs can

be excluded. The tabulated p-values are above .1, indicating that the IVs can reasonably be excluded from (18). Succinctly, it appears that plausible instrumental variables lead to the same conclusion as least squares estimation: the existence of a bond market lowers inflation significantly, even for countries already pursuing an inflation-targeting strategy.

The remainder of Table 4 shows that these results do not depend sensitively on the exact choice of instrumental variables. We consider six variants of our default IVs. First, we drop government spending, since this variable is only weakly correlated with bond market presence. Next, we replace government spending with measures of security effectiveness and legitimacy.²⁷ The third and fourth variants repeat the first rows but replace (the log of) years of independence with (log) years of democracy using the Acemoglu et al (2014) methodology. This series is only available for countries which have democratized recently (51% of the sample), resulting in a halving of the sample size. In the penultimate row we use civil liberties as measured by Freedom House, an IV which varies from 1 through 7.²⁸ For the final perturbation we use a dummy variable for democracy as an IV, again as measured by Freedom House.²⁹

The results indicate that our instrumental variable results are relatively insensitive to the exact choice of instruments. All the IVs we use seem to be strong in the sense that they are correlated with bond market existence; none seem to be directly correlated with inflation with a single exception (log years independence, when one measures inflation via the CPI). All the IV estimates are negative and economically larger than their LS analogues, though they are less precisely estimated. Ten out of fourteen IV estimates of β are also significantly different from zero at conventional significance levels. In no case does a standard Hausman test indicate a significant difference between IV and LS estimates.³⁰

More sophisticated strategies to develop instrumental variables undoubtedly exist. For instance, one could imagine focusing on wars, private-sector financial development, and/or instability associated with previous inflations.³¹ We leave further elaboration for future research.

Still, we conclude that estimation with reasonable instrumental variables does not weaken our results significantly.

Business Cycles and Output

The evidence presented above indicates that inflation is strongly affected by the presence of a domestic bond market. What of other phenomena? Since the major focus here is on monetary policy, it is natural to examine output over the business cycle. Our theory suggests that the existence of a bond market discourages the use of inflation to ease the government budget constraint, but has no implication for the efficacy of counter-cyclical policy in the presence of such a bond market. In particular, while bond markets create a constituency for low inflation, those same bonds may face increased default risk in the presence of business cycle volatility.

Table 5 presents estimates that are analogous to those of (18), substituting a measure of the business cycle in place of inflation as the dependent variable. We estimate:

$$BC_{it} = \beta Bond_{it} + \gamma X'_{it} + \{\delta_i\} + \{\varepsilon_t\} + \eta_{it} \quad (18')$$

where BC_{it} is a measure of country i 's business cycle deviation from trend at time t , and X'_{it} is a set of control covariates. To ensure the robustness of our results, we de-trend real GDP using four techniques: a) Baxter-King filtering; b) Christiano-Fitzgerald filtering; c) Hodrick-Prescott filtering; and d) de-measured annual growth rates.³² We estimate (18') after dropping real GDP growth from the covariate controls (X). Equation (18') links a bond market presence to the average deviation of output from trend; in order to see if there is a linkage between the bond market and the *magnitude* of business cycle deviations, we re-run (18') after taking absolute values of the dependent variable.

The bond market seems to dampen the volatility of business cycles, as shown by the negative coefficients in the right-hand column of Table 5. Still, the estimates of β in Table 5 are all small, and none are statistically significant at conventional levels. In this (limited) sense, the

existence of the bond market does not appear to affect either the average size of business cycle deviations or their magnitude, at least for IT countries.³³

6. Conclusion

It is natural (if sometimes mistaken) to think that low and stable inflation is necessary for a bond market. In this paper, we ask the converse question: does the existence of a long nominal local-currency bond market help to control inflation?

We introduce a model that suggests that the answer may be positive. In our model, the numerous poor hold cash and are thus exposed to inflation, while the few wealthy initially hold foreign bonds. Our model suggests that when a domestic bond market is created, the rich find themselves holding assets exposed to inflation, and respond by lobbying to lower inflation. Our model is stylized and not meant to be taken literally. Still, it formalizes our contention that domestic financial market development can influence macroeconomic outcomes. By issuing debt that is not protected from inflation, the government creates a powerful political group opposed to inflation, and ends up choosing less inflation than it would otherwise.

Our empirical work supports this prediction: the very existence of a market for long maturity, nominal bonds denominated in local currency seems to lower inflation by three to four percentage points; bonds that are either indexed to inflation or denominated in foreign currency do not have a similar effect. This result seems natural, and is consistent with the intuition provided by our theoretical model; countries with bond markets have a powerful interest group opposed to inflation, one that often has considerable influence. This result is more striking because it holds for countries with inflation-targeting regimes, countries which already seem disposed to low and stable inflation. Other monetary regimes, such as those dedicated to maintaining hard fixed exchange

rates, do not have the same reaction. Finally, and reassuringly, no effect of the bond market is apparent on real output.

This work could be improved in several ways. First, a more structural approach to the issue of simultaneity might prove fruitful. Second, it might be possible to improve on our measure of bond market presence. We use a simply dummy variable for the existence of publicly-traded market for long nominal local-currency bonds; a more continuous measure would be preferable.

We conclude that bond markets constitute an effective bulwark in the defence of an inflation-targeting regime.

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Table 1: Descriptive Statistics**A: Inflation with and without the presence of bond markets**

Inflation	With Bond Market			No Bond Market			Test for Equality	
	Mean	Std Dev	Obs	Mean	Std Dev	Obs	Mean (t)	Std Dev (F)
CPI	5.5	32.	1,108	56.	682.	2,967	2.5*	443**
GDP	5.7	30.	1,146	63.	638.	3,650	3.0**	459**

The tests are t/F tests for equality of means/standard deviations across observations without/with bond markets. One (two) asterisk(s) indicate rejection of equality at the .05 (.01) significance level.

B: Inflation across monetary regimes in the presence of bond markets

Inflation	Inflation Targeting			Hard Fix			Neither		
	Mean	Std Dev	Obs	Mean	Std Dev	Obs	Mean	Std Dev	Obs
CPI	3.2	2.2	277	5.9	54.	381	6.6	10.4	412
GDP	3.6	2.9	294	6.1	50.	383	6.6	9.5	421

C: Inflation across monetary regimes without a bond market

Inflation	Inflation Targeting			Hard Fix			Neither		
	Mean	Std Dev	Obs	Mean	Std Dev	Obs	Mean	Std Dev	Obs
CPI	7.2	4.0	69	6.6	22.	999	95.	951.	1,489
GDP	8.9	5.7	71	13.1	169.	1,229	114.	933.	1,596

D: Tests for Equality of Inflation in the absence/presence of bond markets

	Inflation Targeting		Hard Fix		Neither	
	Mean (t)	Std Dev (F)	Mean (t)	Std Dev (F)	Mean (t)	Std Dev (F)
CPI	11.4**	3.4**	.3	.2	1.9	8300**
GDP	11.0**	3.9**	.8	11.**	2.4*	9600**

The tests are t/F tests for equality of means/standard deviations across observations without/with bond markets. One (two) asterisk(s) indicate rejection of equality at the .05 (.01) significance level.

Table 2: Effect of Presence of Long Bond Market on Inflation, for Inflation Targeters**A: Default**

	CPI Inflation	GDP Inflation
Inflation Targeters	-2.9** (1.0)	-4.4** (1.1)

B: Different Monetary Regimes

Analogue for Hard Fixers	7.3 (7.7)	.6 (13.7)
Analogue for Other Monetary Regimes	74. (53.)	136. (83.)

C: Sample Sensitivity

Drop pre-1995	-2.6** (1.0)	-4.1** (1.1)
Drop post-2006	-4.7** (1.2)	-6.4** (1.3)
Drop Poor (real GDP p/c < \$10k)	-5.4** (1.0)	-6.5** (1.2)
Drop Rich (real GDP p/c > \$40k)	-2.9** (1.0)	-4.5** (1.1)
Drop Small (population <10m)	-2.8* (1.0)	-4.5** (1.5)
Drop Large (population > 100m)	-1.8 (1.2)	-4.8** (1.6)
Drop > 2.5 σ outliers	-2.8** (.6)	-4.4** (.6)

D: Estimator Sensitivity

Conventional standard errors	-2.9** (.5)	-4.4** (.7)
Random (not fixed) country effects	-3.2** (1.0)	-4.5** (1.0)
Drop country effects	-3.2** (.9)	-3.8** (1.0)
Drop time effects	-2.6** (.9)	-4.6** (1.2)
Drop covariates	-2.8* (1.1)	-4.5** (1.3)

E: Robustness of Bond Market Measure

5-year lag of bond market, not contemporaneous	-1.9** (.5)	-3.4** (.8)
5-9 year maturity bonds instead of \geq 10 years maturity	-4.7** (1.0)	-4.2* (1.7)
Indexed/Adjusted instead of nominal long bonds	-1.6 (1.3)	-2.7 (1.9)
Bonds denominated in foreign exchange, not LCU	1.1 (.6)	1.4 (.8)

Coefficients for dummy variable (=1 if bond market exists, =0 otherwise). Robust standard errors (clustered by country) recorded parenthetically unless otherwise indicated; coefficients significantly different from zero at .05 (.01) level marked with one (two) asterisk(s). Sample restricted to inflation targeters unless otherwise indicated. Each cell is the result of a single panel regression of inflation on bond market presence with comprehensive time- and country-specific fixed effects unless otherwise indicated. Control covariates included: a) polity; b) log real GDP per capita; c) log population; d) trade, %GDP; and e) demeaned real GDP growth. Default includes annual data for up to 32 IT countries, 1991-2012 (up to 116 hard fixers, 1987-2012; up to 129 others, 1987-2012).

Table 3: Average Treatment Effect of Long Bond Market on Inflation, for Inflation Targeters

	CPI Inflation	GDP Inflation
Propensity Score Matching (three matches)	-3.6** (1.2)	-3.6** (.9)
Nearest-Neighbour Matching (three matches)	-3.9** (.6)	-5.1** (.8)
Regression Adjusted	-3.8** (.8)	-4.2** (1.0)
Inverse-Probability Weighted	-3.8** (.6)	-4.4** (.8)
Inverse-Probability Weighted with Regression Adjustment	-3.3** (.9)	-3.7** (.9)
Augmented Inverse-Probability Weighted	-3.6** (.8)	-4.1** (1.0)

ATE for dummy variable (=1 if long bond market exists, =0 otherwise). Robust standard errors recorded parenthetically; coefficients significantly different from zero at .05 (.01) level marked with one (two) asterisk(s). Sample restricted to inflation targeters. Each cell is the result of a treatment effects estimation; estimator listed in left-hand column. Matching covariates: a) polity; b) log real GDP per capita; c) log population; d) trade, %GDP; and e) demeaned real GDP growth.

Table 4: Instrumental Variables Estimates

Instrumental Variables	Obs.	Weak IV? (p-value)	CPI Inflation			GDP Inflation		
			β_{IV}	Hausman t for β	Excludable? (p-value)	β_{IV}	Hausman t for β	Excludable? (p-value)
Log Years Independence, Gov't Spending (% GDP)	353	.00**	-8.0** (3.0)	1.7	.12	-8.7** (3.7)	1.2	.23
Log Years Independence	353	.00**	-8.0** (3.0)	1.7	.05*	-8.4** (3.7)	1.1	.24
Log Years Independence, Security Effectiveness, Legitimacy	329	.00**	-4.1* (1.8)	.8	.11	-7.1** (2.4)	1.3	.14
Log Years Democracy, Gov't Spending (% GDP)	183	.01**	-4.4 (4.1)	.9	.61	-7.9* (3.8)	1.7	.14
Log Years Democracy	183	.00**	-4.4 (4.1)	.9	.36	-7.7* (3.8)	1.6	.06
Civil Liberties	353	.00**	-6.5* (2.6)	1.4	.12	-8.6* (4.3)	1.0	.30
Democracy	353	.01*	-7.9 (5.2)	1.0	.27	-5.8 (5.2)	.3	.78
Least Squares	353		-2.9** (1.0)			-4.4** (1.1)		

Instrumental variables estimates of (18); IVs recorded in left column. β_{IV} records coefficients for dummy variable (=1 if bond market exists, =0 otherwise); standard errors recorded parenthetically, coefficients significantly different from zero at .05 (.01) level marked with one (two) asterisk(s). Hausman test for equality of IV and least squares β coefficient. Sample restricted to inflation targeters. Comprehensive time- and country-specific fixed effects and five control covariates included but not recorded (a) polity; b) log real GDP per capita; c) log population; d) trade, %GDP; and e) GDP growth). Annual data for up to 32 IT countries, 1991-2012.

Table 5: Effect of Presence of Long Bond Market on Business Cycle, for Inflation Targeters

Real GDP detrender	Business Cycle Deviation from Trend	Absolute Business Cycle Deviation from Trend
Baxter-King	.001 (.005)	-.005 (.004)
Christiano-Fitzgerald	.001 (.005)	-.000 (.007)
Hodrick-Prescott	-.002 (.006)	-.010 (.006)
Growth	.63 (1.57)	-1.92 (.99)

Coefficients for dummy variable (=1 if long bond market exists, =0 otherwise). Robust standard errors (clustered by country) recorded parenthetically; coefficients significantly different from zero at .05 (.01) level marked with one (two) asterisk(s). Sample restricted to inflation targeters. Each cell is the result of a single panel regression of business cycle deviation on bond market presence with comprehensive time- and country-specific fixed effects, and control covariates. Control covariates included: a) polity; b) log real GDP per capita; c) log population; and d) trade, %GDP; GDP growth excluded. Annual data for up to 32 IT countries, 1991-2012.

Household pre-tax wealth under foreign and domestic currency bond issuance

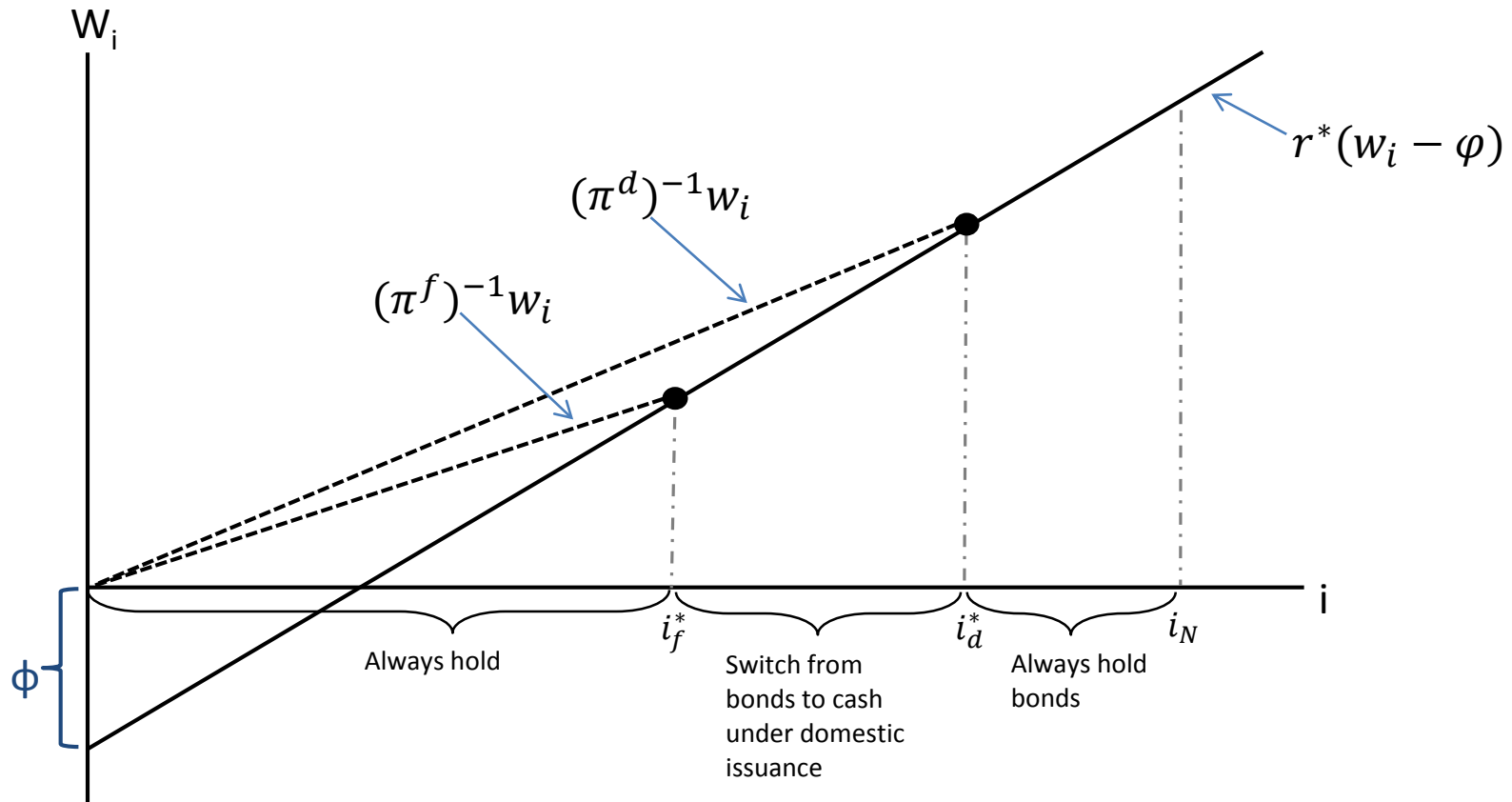


Figure 1

Inflation with and without Bond Markets

Inflation Targeters: Histograms and Quantile Plots

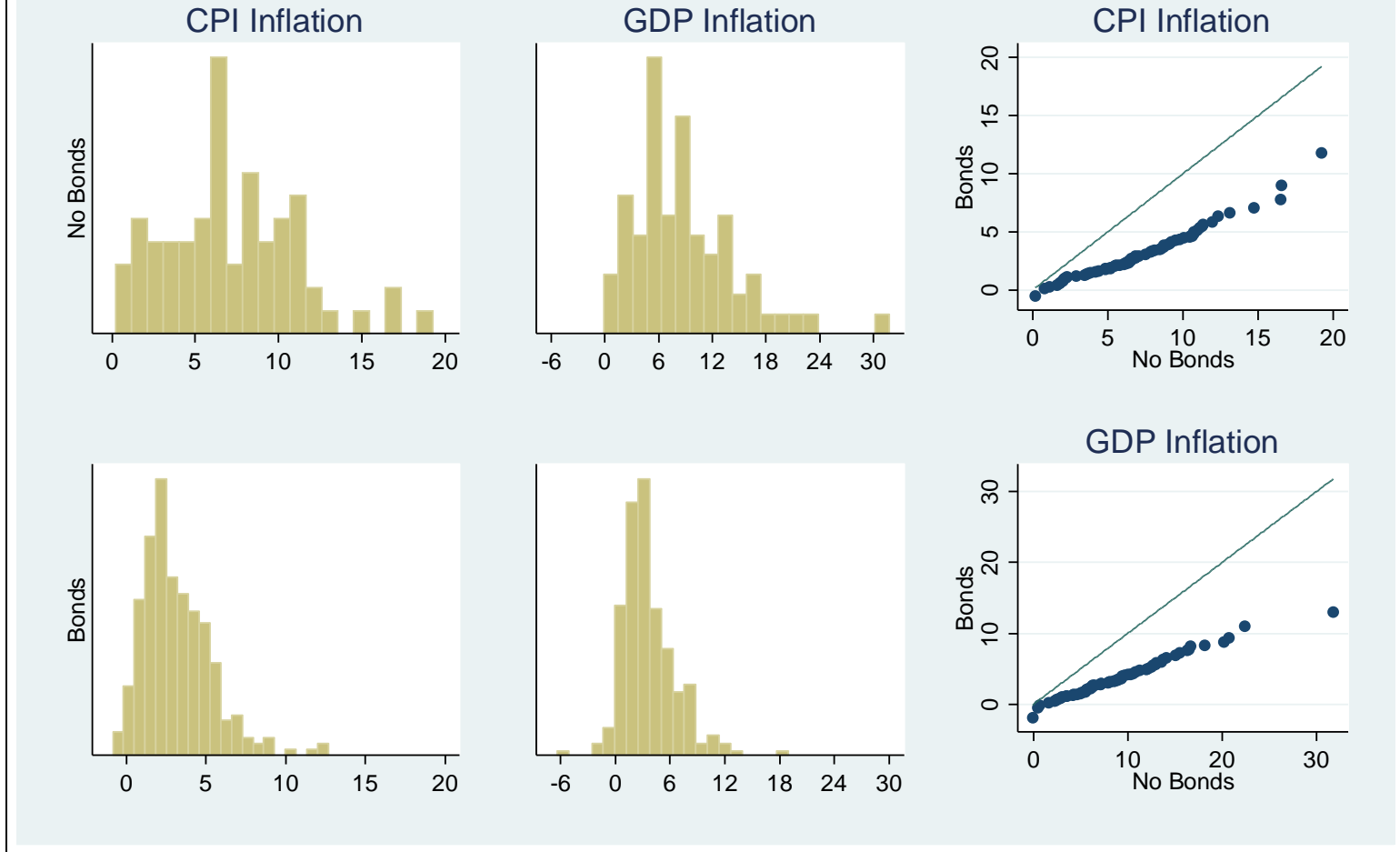


Figure 2: Descriptive Statistics

Inflation around Year of Bond Market Introductions

14 Inflation Targeters: mean, (5%, 95%) band

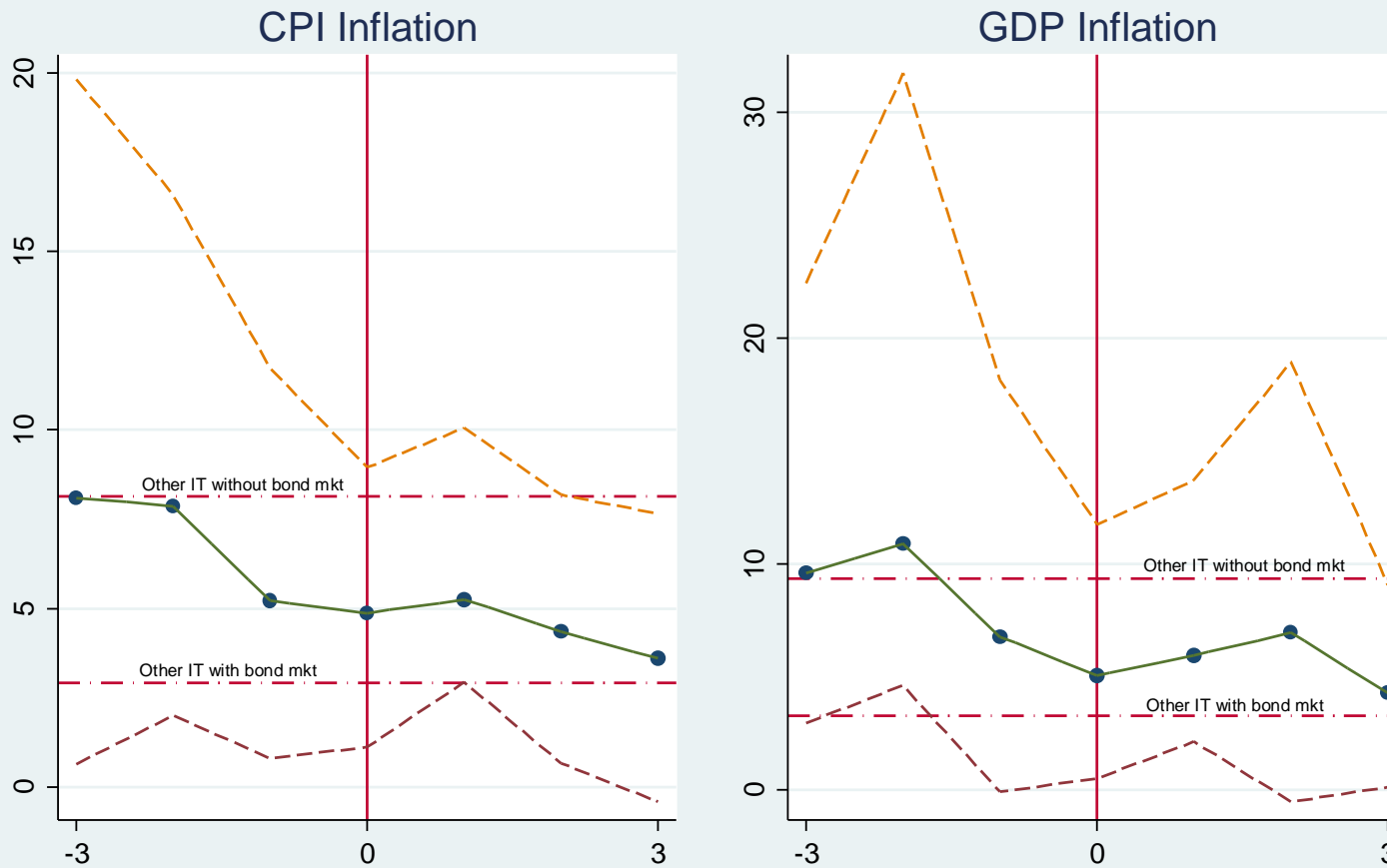


Figure 3: Event Studies

Histograms of Bootstrapped Betas

Bootstrap Samples of Bond Market Dates, IT observations

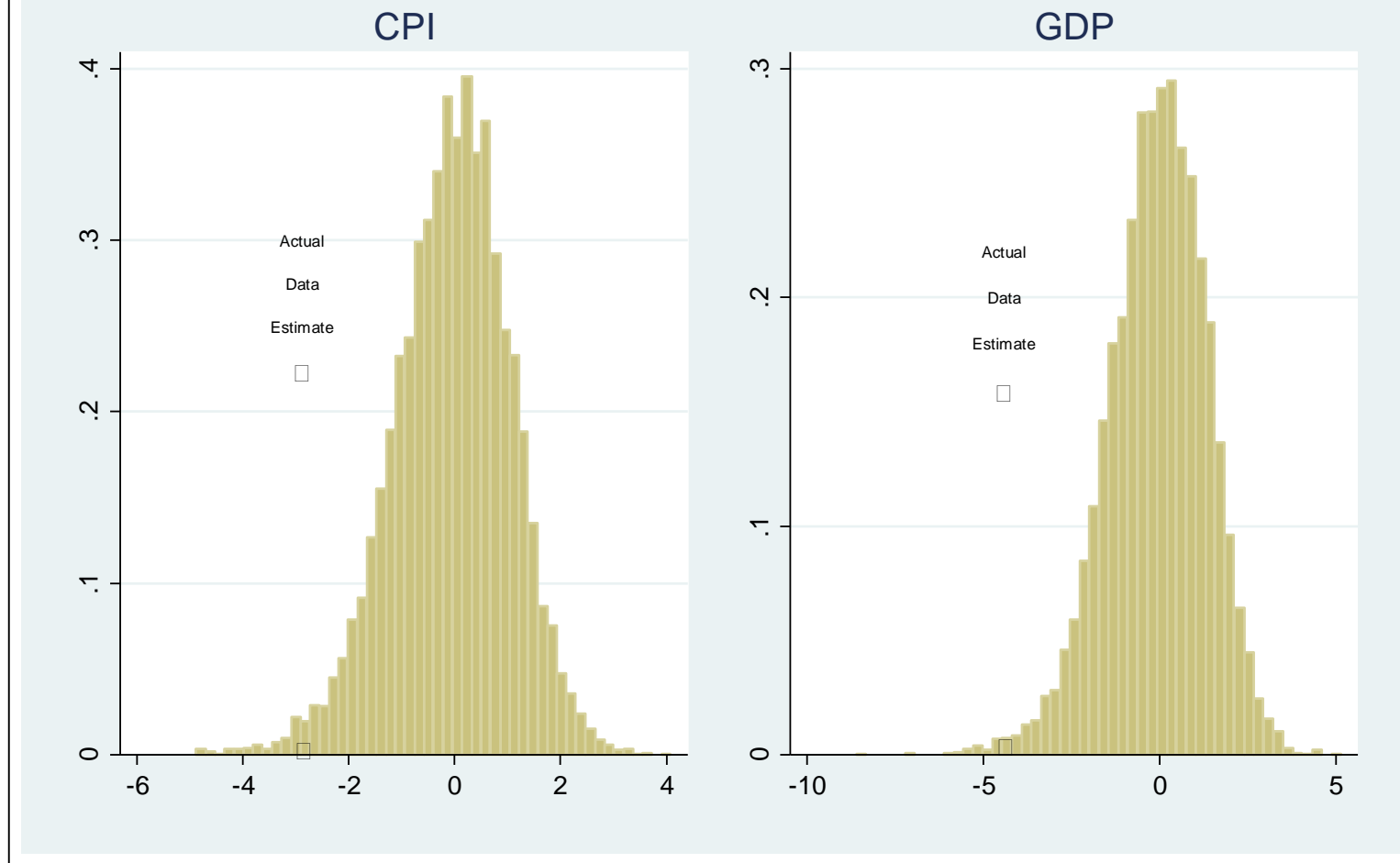


Figure 4: Placebo Tests

Theoretical Appendix

1. Parameter restrictions

1.1 Restriction on w_m

We require w_m sufficiently small that the median household holds cash in all cases we consider. By equation (1), the initial wealth of the marginal household is decreasing in expected inflation. It therefore follows that a sufficient parameter restriction would be based on the highest inflation case, which is that obtained under foreign bond issuance. By (1) and (7), our parameter restriction satisfies

$$w_m \leq \frac{N}{2\phi r^*} - \phi \quad (\text{A.1})$$

which we adopt.

1.2 Minimum initial wealth of poorest household

As discussed in the text we require the restriction $T/N \leq \pi^{-1}w_0$ to ensure that the minimum wealth household has adequate funds to meet its tax obligations. As taxes will be highest under the domestic currency issuance, our restriction needs to pertain to that regime. By (18), (15), and (17), a sufficient, but not necessary restriction is

$$w_0 \geq \frac{(N\nu+1) \left(\left[(Nw_m)^2 + 4\phi r^*(N\nu-2)G \right]^{\frac{1}{2}} - Nw_m \right) - 6Nw_m}{2N(N\nu-2)} \quad (\text{A.2})$$

which we also adopt.

2. Proof of Proposition 2

To prove Proposition 2, we consider the Lorenz curves of the economy for pre-tax wealth under foreign and domestic currency bond issuance. This curve is calculated for each household i as the ratio of the cumulative wealth of all households $j \leq i$ to total pre-tax wealth.

Recall that there are three segments, corresponding to the three ranges articulated in the text. First, the poorest segment, households 0 through i_f^* , hold cash under both foreign and domestic currency issuance. The height of the Lorenz curve for a household i within this range under either form of issuance satisfies

$$\left(L_i^k \mid 0 \leq i < i_f^* \right) = \frac{\sum_{j=0}^i (\pi^k)^{-1} w_j}{\sum_{j=0}^{i_f^*} (\pi^k)^{-1} w_j + \sum_{j=i_f^*}^N r^*(w_j - \phi)}; k = f, d \quad (\text{A.3})$$

Given $Nv \geq 1$, inflation falls with the introduction of the domestic currency bond market by Proposition 1. We can therefore conclude that $\left(L_i^d \mid 0 \leq i < i_f^* \right) \geq \left(L_i^f \mid 0 \leq i < i_f^* \right)$ if the height of the Lorenz curve is decreasing in inflation within this range. Differentiating with respect to π^k , ($k = f, d$) yields

$$\left(\frac{\partial L_i^k}{\partial \pi^k} \mid 0 \leq i < i_f^* \right) = - \frac{\sum_{j=0}^i w_j \sum_{j=i_f^*}^N r^*(w_j - \phi)}{\left[\sum_{j=0}^{i_f^*} w_j + \pi^k \sum_{j=i_f^*}^N r^*(w_j - \phi) \right]^2} < 0; k = f, d \quad (\text{A.4})$$

It follows that $\left(L_i^d \mid 0 \leq i < i_f^* \right) \geq \left(L_i^f \mid 0 \leq i < i_f^* \right)$ in this range, i.e. the relative income share of the poorest households is increased by the switch to domestic currency issuance.

We next turn to the wealthiest households, i.e. those in the range i_d^* through N who enter the bond market under both regimes. Households in this range experience no change in their pre-

tax wealth, as they earn $r^*(w_j - \phi)$ regardless of the inflation level. As such, their share of total wealth declines with the introduction of the domestic bond market, as total pre-tax wealth rises.

It would therefore appear to be unambiguous that the introduction of the domestic currency bond market would lead to equalization of the distribution of pre-tax wealth, as it raises the share of the poorest segment and lowers that of the richest segment. However, ambiguity is introduced through the middle group, i.e. households i_f^* through i_d^* , that switch back to holding cash when the inflation rate is reduced due to the introduction of the local currency bond market. This “middle” group may be either relatively wealthy or poor, depending on parameters, and therefore a restriction is required to demonstrate that the introduction of the domestic currency bond market equalizes the pre-tax distribution of wealth.

We therefore prove Proposition 2 for no change in the marginal household. Recall that for monotonically increasing in income households, the Gini formula for inequality satisfies

$$G^k = \frac{1}{N} \left\{ N + 1 - 2 \left[\frac{\sum_{j=0}^{i_k^*} (\pi^k)^{-1} w_j (N+1-i) + \sum_{j=i_k^*}^N r^*(w_j - \phi)(N+1-i)}{\sum_{j=0}^{i_k^*} (\pi^k)^{-1} w_j + \sum_{j=i_k^*}^N r^*(w_j - \phi)} \right] \right\}; k = f, d \quad (\text{A.5})$$

Letting i^* represent the marginal household, the introduction of the domestic currency bond market leads to more equality, $G^f > G^d$, if and only if

$$\left[\sum_{j=0}^{i^*} (\pi^d)^{-1} w_j (N+1-i) + \sum_{j=i^*}^N r^*(w_j - \phi)(N+1-i) \right] \left[\sum_{j=0}^{i^*} (\pi^f)^{-1} w_j + \sum_{j=i^*}^N r^*(w_j - \phi) \right] > \left[\sum_{j=0}^{i^*} (\pi^f)^{-1} w_j (N+1-i) + \sum_{j=i^*}^N r^*(w_j - \phi)(N+1-i) \right] \left[\sum_{j=0}^{i^*} (\pi^d)^{-1} w_j + \sum_{j=i^*}^N r^*(w_j - \phi) \right] \quad (\text{A.6})$$

Expanding and simplifying

$$\left[(\pi^d)^{-1} - (\pi^f)^{-1} \right] \left[\sum_{j=0}^{i^*} w_j (N+1-i) \sum_{j=i^*}^N r^*(w_j - \phi) - \sum_{j=0}^{i^*} w_j \sum_{j=i^*}^N r^*(w_j - \phi)(N+1-i) \right] > 0$$

(A.7)

As inflation declines, the first term is positive. This implies that the entire term will be positive if the bracketed term is positive. This term will be unambiguously positive according to our assumption that $i^* > i_m$, i.e. that the median wealth household does not enter the bond market.

This completes the proof of Proposition 2.

Appendix Table A1: Inflation Targeting Countries

	Inflation Targeting Begins	Bond Market Begins
Albania	2009	
Armenia	2006	2008
Australia	1993	1857
Brazil	1999	2007
Canada	1991	1853
Chile	1991	1993
Colombia	2000	2002
Czech Republic	1998	2000
Finland*	1993	1896
Ghana	2007	
Guatemala	2005	
Hungary	2001	1999
Iceland	2001	2004
Indonesia	2006	2009
Israel	1992	2001
Korea, Rep.	1998	2000
Mexico	1999	2001
New Zealand	1990	1861
Norway	2001	1822
Peru	2002	2008
Philippines	2002	1996
Poland	1999	1999
Romania	2006	2012
Serbia	2009	
Slovak Republic*	2005	1994
South Africa	2000	1860
Spain*	1995	1788
Sweden	1993	1788
Switzerland	2000	1899
Thailand	2000	1979
Turkey	2006	2012
United Kingdom	1993	1729

*Finland and Spain joined EMU in 1999; Slovakia joined in 2009.

Appendix Table A2: Effect of Presence of Inflation Targeting on Inflation, for Bond Marketers

	CPI Inflation	GDP Inflation
Default	-1.4 (1.7)	-1.2 (1.6)
Analogue for Hard Fixers	2.3 (3.4)	2.4 (3.4)

Coefficients for dummy variables (=1 if relevant monetary regime exists, =0 otherwise). Robust standard errors (clustered by country) recorded parenthetically; coefficients significantly different from zero at .05 (.01) level marked with one (two) asterisk(s). Sample restricted to country x year observations with bond market. Each cell is the result of a single panel regression of inflation on monetary regime dummy variable with comprehensive time- and country-specific fixed effects unless otherwise indicated. Control covariates included: a) polity; b) log real GDP per capita; c) log population; d) trade, %GDP; and e) demeaned real GDP growth. Annual data for up to 62 countries with long nominal LCU bond markets, 1987-2012.

Appendix Table A3: Bond Markets and the Choice of Monetary Regime

	Default	Drop Large Economies	3-year lag of Bond market
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Hard Fixed Exchange Rate

Bond Market	1.01** (.35)	.71* (.36)	1.16** (.37)
Log Population	-.37** (.10)	-.43** (.10)	-.36** (.11)
Log Real GDP p/c	.05 (.14)	-.04 (.14)	.07 (.14)
Polity	-.05* (.02)	-.05* (.02)	-.05* (.02)

Inflation Target

Bond Market	1.42** (.53)	1.03* (.44)	.70 (.51)
Log Population	.15 (.16)	.51** (.17)	.23 (.17)
Log Real GDP p/c	.29 (.25)	.89** (.28)	.51* (.26)
Polity	.21** (.06)	.24** (.08)	.24** (.06)

Statistics

Observations	3402	3138	3081
Pseudo R ²	.14	.19	.15

Each column is the result of a multinomial logit estimation: default (omitted) cell is "sloppy centre". Coefficients for variables recorded in left-hand column. Robust standard errors (clustered by country) recorded parenthetically; coefficients significantly different from zero at .05 (.01) level marked with one (two) asterisk(s). Constants included in each column but not recorded.

Endnotes

¹ P39 of *Financial Market in Poland 1998-2001*, http://www.nbp.pl/en/systemfinansowy/financial_market.pdf, and p 74 of *Government Bond Market Development: The Korean Experience*, <http://ksp.go.kr/common/attdown.jsp?fidx=220&pag=0000700003&pid=88>.

² It is interesting to note that bonds have long been issued disproportionately to the rich. Pezzolo (2005, p147) writes:

“Along with voluntary loans, some communes began to require forced loans from well to-do citizens. As far as we know, the first Italian government to do so was that of Venice, which in 1171, in order to prepare a fleet against the Byzantine emperor, decreed a loan from every citizen in relation to his patrimony, at an interest rate of 5 percent until the money was paid back (*donec pecunia imprestata restituatur*).”

³ We assume that the law of one price holds, so that inflation is reflected perfectly in the nominal exchange rate.

⁴ Note that by assuming that the government services its debt obligations we are limiting its discretion.

⁵ We consider more progressive tax systems below; these do not change results.

⁶ There is certainly anecdotal evidence of this mechanism. For instance Deacon et al (2004, pp 67-68) write “Certainly, by providing [indexation] protection for bondholders a government is reducing the political lobby against inflation. It is interesting to note that for some years now the Israeli authorities have preferred to issue nominal bonds for precisely this reason: the belief that by expanding the group of agents with a vested interest in the maintenance of low and stable inflation, pressure will be brought to bear on the authorities to this end ...”

⁷ Acemoglu, et al (2008) motivate these assumptions by allowing for the possibility that the interaction between the government and the lobby and its constituents might be a repeated game.

⁸ As N represents the number of households in the economy, we would expect it to tend to be large. The parameter condition in Proposition 1 would therefore hold if ν is not de minimus. We would expect that to be the case, but ν is likely to be opaque in practice, reflecting, among other things, the level of corruption. Still, it seems unlikely that the weight the government puts on a dollar of personal revenues from the anti-inflation lobby would be minuscule, i.e. lower than $1/N$.

⁹ The conditions that support decreased skewness in the end-of-period wealth would be robust to the introduction of a progressive tax system, as the increase in taxation required under decreased inflation would be predominantly borne by the rich. However, under a regressive tax system, further parameter restrictions would be required to conclude that the distribution of wealth became less skewed with domestic currency bonds.

¹⁰ Our interest is in the distribution of income, and we do not evaluate welfare. In general, the distributional implications of the introduction of the domestic currency bond market leave overall welfare conclusions challenging. Nevertheless, as lobbying activity represents a deadweight loss for the economy as a whole, it is clear that overall wealth must decline. The implications of this decline for welfare depend on preferences concerning the distribution of wealth, as well as the technologies for lobbying and seigniorage, which are likely to vary across countries. On the other hand, our model also contains no explicit gains from the reduction in inflation, leaving scope for more favorable implications of lobbying activity in a richer model.

¹¹ Romer (1993) has provided a compelling link between openness and inflation; accordingly, we include the ratio of trade to GDP.

¹² With a twist, since some countries are “treated” all the way through the sample, as they enter inflation targeting with a bond market.

¹³ Natural, but perhaps mistaken. Even restricting attention to the OECD, a number of countries have experienced high inflation in the presence of a bond market; indeed, that is the norm. In the mid-1970s, Australia, Canada, and Denmark all experienced bouts of inflation of 15% or more while maintaining long bond markets; such inflationary episodes were more extended for Greece, Ireland, Italy, New Zealand, Spain, and the UK.

¹⁴ As hard fixed exchange rate regimes have made no explicit low inflation commitment, they may differ in other dimensions that leave it difficult in our parsimonious specification to identify the impact of bond markets on inflation. For example, rapidly-growing pegged regimes may experience real exchange rate appreciation that manifests itself in the form of increased inflation, even as hard nominal pegs remain intact.

¹⁵ <https://www.globalfinancialdata.com/Databases/GFDatabase.html>.

¹⁶ <https://www.globalfinancialdata.com/Databases/FixedIncomeDatabase.html>.

¹⁷ In particular, GFD seems to omit bonds of relevance from Armenia, Brazil, Chile, Israel, Kazakhstan, Nigeria, Peru, Trinidad and Tobago, Ukraine, and UAE.

¹⁸ We fill in some observations missing from *WDI* with comparable series from the *Penn World Table 7.1*.

¹⁹ <http://www.systemicpeace.org/polity/polity4.htm>.

²⁰ Available at <http://personal.lse.ac.uk/ilzetzki/data/ERA-Annual%20coarse%20class.xls>; we use the first group of the coarse classification which includes: a) no separate legal tender; b) pre-announced peg or currency board arrangement; c) pre-announced horizontal band that is narrower than or equal to +/- 2%; and d) de facto peg. There is one exception: while we allow both Spain and Finland to be members of both hard fix and inflation target regimes during the run-up to EMU, we do not allow the Czech Republic to be classified as a hard fix after it begins inflation targeting.

²¹ It is interesting to note that our sample includes deflationary observations.

²² Quantiles are points taken at regular intervals from the cumulative distribution function of a random variable. Dividing ordered data into q essentially equal-sized data subsets is the motivation for q -quantiles; the quantiles are the data values marking the boundaries between consecutive subsets (<http://en.wikipedia.org/wiki/Quantile>).

²³ The anti-inflationary bias of rich bond-holders may also be detectable in other historical episodes. Randall Morck has suggested to us that this bias may explain attempts by WWI victors to return to the gold standard in the interwar period, while Steve Haber has suggested that the behavior may also be detectable in the conduct of fiscal policy in nineteenth-century Brazil as documented in part by Summerhill in his forthcoming *Inglorious Revolution*.

²⁴ We have also done a number of sensitivity checks that are not tabulated. For instance, adding the debt/GDP ratio (either net or gross government debt) has little effect on our key estimates of β , as does adding either maximal inflation from the preceding twenty years, interactions with democracy, the point inflation target (if it exists), and the upper and/or lower bounds on inflation (if they exist) to condition for any changes in the inflation target of a country over the course of our sample.

²⁵ One cannot perform the same exercise on stock markets, since all IT countries had stock markets throughout the sample.

²⁶ We use three matches; results remain strong if the exact number of matches is varied. We match on the basis of the five control covariates used in (11).

²⁷ Measures of security effectiveness, and legitimacy are available from 1995 through 2013 at <http://www.systemicpeace.org/inscrdata.html>. Both are annual quantitative measures available for 167 countries: "Security effectiveness [is] a measure of general security and vulnerability to political violence ...

based on two assumptions: (1) the residual effects of low level and/or short wars diminish relatively quickly; and (2) the residual effects of serious or protracted wars diminish gradually over a 25-year period. Three indicators are used to calculate each country's "residual war" score ... "Security legitimacy [is] a measure of state repression ... [using data from] Political Terror Scale ... [which] provides separate annual indicators drawn from U.S. State Department and Amnesty International Reports ... coded on a five-point scale, from 1: "no repression" to 5: "systemic, collective repression."

(<http://www.systemicpeace.org/vlibrary/GlobalReport2014.pdf>)

²⁸ "A country or territory is awarded 0 to 4 points for each of ... 15 civil liberties indicators, which take the form of questions; a score of 0 represents the smallest degree of freedom and 4 the greatest degree of freedom... The civil liberties questions are grouped into four subcategories: Freedom of Expression and Belief (4 questions), Associational and Organizational Rights (3), Rule of Law (4), and Personal Autonomy and Individual Rights (4). A country or territory is assigned ... ratings (7 to 1) ... for civil liberties—based on its total scores for the ... civil liberties questions. Each rating of 1 through 7, with 1 representing the greatest degree of freedom and 7 the smallest degree of freedom, corresponds to a specific range of total scores ..."

(<https://www.freedomhouse.org/report/freedom-world-2014/methodology#.VFq48vnF8WJ>)

²⁹ "[Freedom House] ... assigns the designation "electoral democracy" to countries that have met certain minimum standards. In determining whether a country is an electoral democracy, Freedom House examines several key factors concerning the last major national election or elections. To qualify as an electoral democracy, a state must have satisfied the following criteria: 1. A competitive, multiparty political system; 2. Universal adult suffrage for all citizens (with exceptions for restrictions that states may legitimately place on citizens as sanctions for criminal offenses); 3. Regularly contested elections conducted in conditions of ballot secrecy, reasonable ballot security, and in the absence of massive voter fraud, and that yield results that are representative of the public will; 4. Significant public access of major political parties to the electorate through the media and through generally open political campaigning." (<https://freedomhouse.org/report/freedom-world-2012/methodology#.VFq81fnF8WI>)

³⁰ Estimates for the equivalent of a reverse regression to (11) are presented in Appendix Table A2. Where (11) estimates the inflation effect of the existence of a bond market for inflation targeters, the results in Table A2 show that IT has no effect on inflation for countries with bond markets.

One could also argue that the IT regime itself is endogenous with respect to the existence of the bond market. A small amount of evidence consistent with this is tabulated in Appendix Table A3. The determination of monetary regimes is notoriously difficult to model empirically; this multinomial logit model uses the default model of size, income, and polity developed in Table 8 of Rose (2013).

³¹ A number of government bond markets, especially older ones, were created to provide a way for the government to finance fiscal deficits, especially those associated with war. The Bank of England was founded in order to issue and manage debt for the government during a war with France (<http://www.bankofengland.co.uk/education/Documents/resources/postcards/history2.pdf>), and the United States began to issue Treasury bonds in 1917 shortly after entering WWI (<http://www.treasury.gov/about/history/Pages/1900-Present.aspx>). The martial origins of Italian and Dutch debt are discussed by Pezzolo (2005) and de Vries and van der Woude (1997) respectively. Alternatively, a long government bond market may be a necessary ingredient for a benchmark yield curve. Finally, modern aversion to inflation may reflect historical experience (Germany is often cited); bond markets may also be developed as a response to crises (East Asia after the crisis is a case in point). Such issues are worth considering in future research.

³² We use standard parameter values for our filtering techniques: a smoothing parameter of 6.25 for Hodrick-Prescott (as suggested by e.g., Ravn and Uhlig); and for Christiano-Fitzgerald and Baxter-King bandpass filtering, minimal/maximal periodicities of two/eight years respectively, with a lead-lag length of three years (as suggested by e.g., Baxter and King).

³³ Similarly negative results appear if one replaces the regressand with standard measures of fiscal policy, such as either the budget surplus/deficit or stock of central government debt (both expressed as percentages of GDP).