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Emerging market yield spreads: Domestic, external determinants, and volatility spillovers[☆]

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ABSTRACT

This study examines the determinants of bond yield spreads for 22 emerging markets in the period 1998–2009. Several determinants are considered. In addition, I consider the connection between volatility and bond yield spreads. Volatility and central bank transparency are two factors common to all countries examined whereas clear idiosyncrasies are found according to whether emerging markets are in Latin and South America, Europe, Asia or Africa. Most notably, the global financial crisis raised yield spreads, except in Asia, which suggests that, in a sense, bond markets in that region were decoupled from those in other parts of the world.

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1. Introduction

The issuance of emerging market sovereign bonds surged during the 1990s, triggered by the Brady rescheduling agreement of the late 1980s. Financial crises during the 1990s and early 2000s, most notably the Mexican ‘tequila’ crisis of 1994–95, the Asian crisis of 1997–98, the Russian crisis of 1998, and the Argentine crisis of 2000–2001, led several economists to investigate the determinants of spreads between emerging market bond yields and those of comparable instruments issued by the U.S. government. The global financial crisis of 2008–9 adds yet another milestone that potentially significantly influenced yield spreads.

Opinion is still divided about the role of economic ‘fundamentals’ in explaining movements in these spreads. Nevertheless, if fundamentals do matter and, just as importantly, if a set of common economic factors exists that

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have significant explanatory power in the determination of these spreads, then there are clear policy implications that can be drawn. A related question is the role played by economic shocks that influence spreads more or less simultaneously. This raises the possibility of spillover or contagion type effects. As is well-known, there is no universally accepted definition of contagion, though several metrics have been proposed in the literature.¹ Contagion effects are relevant since, for example, a post-mortem of the Asian crisis (e.g., *BIS, 1999*) suggests that the transmission of financial shocks across countries, in some instances, took place over a period of several months, in part owing to infrequent adjustment of credit ratings (also see *Remolona, Scatigna, & Wu, 2006*).

The aim of this study is to contribute to the literature on the determinants of emerging market bond spreads. A large number of potential determinants, including volatility, are permitted to directly influence yield spreads. The volatility index derived from the S&P 500 group of stocks, also known as the VIX, is the proxy employed here (also see *IMF, 2006*). In view of the rise in volatility of equity prices during the 2008–9 financial crisis, the addition of more recent data may provide new insights into the role of asset price volatility on bond yield spreads.

I also consider a time series indicator of central bank transparency. As far as I am aware this variable has not been used in studies of this kind. The relevant index captures many features present in alternative indicators of institutional performance and may well be a better way of capturing the relationship between the conduct of monetary policy and the behavior of term spreads. *Dincer and Eichengreen (2007)* provide a good survey of the role of central bank transparency in improving the delivery of monetary policy. In addition, the paper also employs yields derived from credit default swaps (CDS), for a subset of countries, to investigate the role of economic fundamentals in explaining emerging market bond yield spreads. Relatively few studies have considered this possibility (*Remolona et al. (2006)*, and *Ammer and Cai (2007)* are exceptions), and none, to my knowledge, in the panel framework. In another departure from most studies in the extant literature, I also rely on forecasts of inflation, economic growth, and the current account, as potential determinants of spreads behavior. It is surprising that such forward-looking variables have not been considered more often in specifications of the kind estimated here. After all, economic theory suggests that sovereign bond spreads ought to contain a forward-looking component and there is, of course, a large literature that considers whether the slope of the yield curve can reasonably predict future inflation, output growth, or even the likelihood of a recession (e.g., see *Hamilton & Kim, 2002*). Moreover, there is scope for asymmetry in the determination of emerging market bond yield spreads which is illustrated by permitting positive and negative inflation forecast errors, to separately influence yield spreads. Finally, explicit account is taken of the global financial crisis of 2008–9.

Briefly, I find that the global financial crisis raised yield spreads in all regions except Asia and Africa, giving some credence to the decoupling view in the case of interest rate developments. It is also found that central bank transparency and changes in risk aversion are also significant determinants. U.S. monetary policy impacts only Latin, South American and Asian economies in the sample. Finally, forward-looking variables, such as inflation and current account balance forecasts, are also significant determinants of emerging market yield spreads.

The rest of the paper proceeds as follows. *Section 2* which provides a literature review, focuses on studies that rely on quarterly or monthly data.² *Section 3* describes the data and provides some stylized facts, as well as outlining the econometric methodology employed in the paper. *Section 4* summarizes the empirical results while *Section 5* concludes.

2. Literature review

In theory, the spread between emerging market bonds over U.S. Treasuries seek to compensate investors in part for assuming a greater default risk.³ The probability of default is exogenously determined and inherently tied to the sustainability of a given level of debt and, hence, to a set of macroeconomic fundamentals (*Ferrucci, 2003*). The drawback with this interpretation is that the impact of any contagion style effects may be unaccounted for. One definition of contagion refers to a significant increase in cross-market asset linkages following a shock to an individual country, or groups of countries (*Forbes & Rigobon, 2002*). Hence, in calmer times, co-movements

¹ A useful recent review of contagion versus interdependence hypotheses (also, see below) is *Dungey, Fry, and Martin (2009)*.

² There is also a burgeoning literature that relies on daily data (e.g., *Benelli & Ganguly, 2007*, and references therein). At the daily frequency the role of conventional macroeconomic fundamentals cannot be as easily investigated.

³ Liquidity risk is also present. However, the data used in the paper only includes bonds with a liquid market rendering the measurement of a liquidity premium less relevant for this type of analysis. Moreover, *Remolona et al. (2006)* report that default risk is the largest risk component in sovereign spreads. *Hartelius, Kashiwase, and Kodres (2008)* also conclude that liquidity effects are modest in the emerging markets bond market.

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