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How do IMF announcements affect financial markets in crises? Evidence from forward exchange markets

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Abstract

We employ a theoretical model to interpret the liquidity and moral hazard effects of IMF support during a financial crisis. We then estimate the response of forward exchange markets to IMF-related announcements, using data on the 3-, 9-, and 12-month forward exchange rates. Our results indicate that the announcement of IMF negotiations is associated with a premium on the baht and the rupiah, where the premium is much larger on the latter. This result is largely consistent with the responses of stock and bond markets, especially when country-specific data are employed.
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1. Introduction

This paper extends the literature on the impact of IMF-related events on financial markets during financial crises in two directions. First, previous studies tend to rush to conclusions regarding the liquidity/credibility or moral hazard interpretation of the IMF support. While the debate still continues, our goal is to use a sound theoretical framework to demonstrate the difficulty of providing unambiguous interpretations on the impact of IMF events on private financial markets. To this end, we employ a theoretical model developed by Corsetti et al. (2006) in which liquidity and moral hazard effects of IMF support are developed, and interpret our empirical results accordingly.[2] Second, we investigate the response of forward exchange markets to IMF-related news. Previous studies have focused on the response of either bond or stock markets to either IMF program duration or IMF-related news. However, the behavior of forward exchange rate has not yet been investigated in this context. This is the first study focusing on forward exchange rates.

There are several reasons why investigating forward exchange rate is important. First, it allows us the opportunity to examine whether the responses of bond and stock markets are consistent with those of forward exchange markets. A second main reason for investigating forward exchange rates lies in the fact that the interest rate parity (IRP) may not hold during crisis periods due to time-varying risk premium. One can argue that interest rate spreads may be affected by factors such as expected or existing capital controls during crisis periods, which implies some degree of segmentation in domestic and foreign bond markets. Therefore, the absence of fully materialized interest rate arbitrage may not allow bond spreads to fully reflect market reactions. On the other hand, because foreign exchange markets are global and large enough to be affected by any one country, forward exchange rate movements may be better able to capture the dynamics of the risk premium, especially during crisis periods. Therefore, the addition of forward exchange rates can improve our understanding regarding the effects of prospective IMF programs on financial markets. Third, investigating the term structure of the forward premium at different maturities (3-, 9-, and 12-month) may provide evidence how investors react differently to IMF events at different horizons. For example, our results show that IMF program approval news results in a forward discount in the shorter maturities, but such news brings about a premium over time at the relatively long-run maturities (i.e., 12-month).

In the following section, we introduce the theoretical framework to analyze and interpret the liquidity and moral hazard effects of IMF support. Section 3 provides a summary of previous research regarding the effects of IMF programs or IMF-related news on bond and stock markets to motivate our focus on forward exchange rates. In Section 4, we summarize the methodology and the results of the estimations using forward exchange rates of various maturities. Section 5 provides concluding remarks.

2. Interpretation of financial markets' response to IMF-related news: catalytic or moral hazard effects?

While it is easier to estimate financial markets' responses to IMF-related news, it is much harder to interpret the empirical results. If, for example, such news increases stock returns, decreases sovereign bond spreads, or leads to a premium in the prospective program country's currency,

[2] Zwart (2007) is another recent theoretical study that examines the circumstances in which the IMF support can create positive liquidity but negative credibility or signaling effects.

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