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Impact of IMF-related news on capital markets: Further evidence from bond spreads in Indonesia and Korea

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Abstract

The IMF's effects on private capital markets have attracted increasing attention in the literature. This paper examines whether IMF-related news during the Asian crisis contains information regarding the changes in sovereign bond spreads of Indonesia and Korea. Our results indicate that other countries' IMF-related news increases these countries' bond spreads. Both in Indonesia and Korea, the countries' own news associated with program negotiations and approval decreases bond spreads. With respect to the interpretations of the impact of IMF news on private capital markets, we show that the current interpretations vary and identify this issue as an important future research agenda.

JEL classification: F32; F33; F34

Keywords: The Asian crisis; The IMF; Sovereign bond spreads

1. Introduction

The impact of IMF programs on capital markets has been increasingly investigated since the late 1990s (Kamin and Kleist, 1999; Zhang, 1999; Lane and Phillips, 2000; Tillmann, 2001; Dell'Ariccia et al., 2002; Kamin, 2002; Hayo and Kutan, 2005; Kutan and Sudjana, 2003; Evrensel

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and Kutan, 2006; Eichengreen et al., 2005). Our contribution lies in further examining the changes in sovereign bond spreads of Indonesia and Korea due to IMF-related news, such as announcements of program negotiations and approval, during the Asian crisis. We identify three areas to which our paper can contribute to the literature: estimation of the impact of IMF news on capital markets, definition of the IMF-related dummies, and interpretation of the empirical results. The existing literature on the relation between IMF programs and private capital markets has motivated our focus regarding the selection of the sample countries, the type of capital markets, and the methodology.

With respect to the estimation of the IMF's effects on capital markets, we make use of Table 1 that surveys the existing research on this issue. We want to underline the characteristics of previous studies regarding the type of capital instrument, data, and IMF-related dummies employed. The majority of studies that examine bond markets in emerging countries use some variations of the Emerging Market Bond Index (EMBI) that includes 21 emerging economies' dollar denominated debt. Latin America's debt instruments, especially Brady bonds, have a weight of 91% in the EMBI (IMF, 1996). Even though non-Latin debt increased its share from zero to almost 33% during the period from April 1991 to October 2001, the EMBI was still heavily influenced by the Latin American debt during the mid- and late-1990s, which are the years of interest in most of the previous studies. The problem with employing the EMBI spreads in a study focusing on mainly non-Latin American capital markets is that the changes in EMBI spreads are less likely to contain relevant information regarding the extent of changes in the bond spreads of, for example, the Asian crisis countries. Therefore, unlike the previous studies on bond markets, we use country-specific data in our estimations.

Regarding the use of IMF-related dummy in the previous research, this variable covers the entire IMF program period in Zhang (1999), Kamin and Kleist (1999), Dell'Ariccia et al. (2002), Kamin (2002), and Eichengreen et al. (2005). While the IMF program dummy measures the *ex-post* effects of a program in financial markets, IMF-related news dummies describe the *ex-ante* response of investors to the prospective program. By observing the changes in spreads associated with IMF-related news, we can capture the immediate investor response based on the current and expected future fundamentals. Therefore, with respect to the estimation of the IMF's impact on capital markets, an examination of the changes in country-specific spreads due to IMF-related news is in fact a new approach that is complementary to the existing studies. It allows us to check the sensitivity of existing results to using alternative approaches like ours.

The third area to which this paper contributes to the literature is the identification of different interpretations of the results regarding the IMF's impact on private capital markets. Because these interpretations are still in their infancy, a discussion on alternative interpretations is useful for future research. For example, Eichengreen et al. (2005) propose the possibility that the IMF acts as a monitoring agency, providing private information to capital markets. Additionally, if one believes that IMF-supported programs would help improve the performance of program countries, declining spreads or increasing stock market returns as a respond to the IMF's involvement can be interpreted as investors' expectations of greater transparency and efficiency in program countries' capital markets. Alternatively, the above mentioned changes in bond and stock markets may have moral hazard interpretation. Indeed, the IMF's financial support to the Asian crisis countries has raised the question of whether IMF programs provide opportunities for the governments of prospective program countries to grant implicit guarantees to certain investors. It has been argued that an expected IMF support to a country may provide implicit guarantees to its creditors on their returns, which motivates investors to take excessive risks (Edwards, 1998; Friedman, 1998). We therefore argue that the current interpretations of the impact of IMF programs on