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Recovering from bond market distress: Good luck and good policy[☆]

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ABSTRACT

This paper focuses on the resolution of bond market crises. Episodes of bond market distress are identified using secondary market sovereign bond spreads. Duration models are used to assess the role of the global environment, domestic policy, IMF programs and political events in explaining the length of distress episodes. We find a rich set of interactions between favourable external conditions, sound macroeconomic policies and the presence of an IMF program which contribute to shorter bond market crises.

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1. Introduction

Do emerging market economies recover from financial crises thanks to sound macroeconomic policies or favourable external conditions? Much of the discussion on financial crisis recovery is organized around the following question: “Is it good luck or good policy?”. Yet, the speed of financial crisis recovery could depend on both good policy *and* good luck. And even more interestingly, there could be significant

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interaction effects between various explanatory factors. Suppose that a country experiences a bond market crisis, leading investors to require a very large risk premium. This country responds with a strong macroeconomic policy. The effect of this policy could be perceived differently by investors depending on the international financial context. It could be that even the best macroeconomic policy will not affect the speed of the recovery process when world interest rates are very high (an unfavourable external environment), but will be quite effective when world interest rates are low. This paper focuses on the duration of the crisis recovery process and looks at the effect of various interactions between domestic macroeconomic policy, the external environment and IMF programs in explaining how long these crises last.

We first identify episodes (spells) of bond market distress. [Pescatori and Sy \(2007\)](#) show that distress can be identified on the basis of secondary market sovereign bond spreads. Sovereign spreads typically reflect investor perceptions of sovereign risk and are thus widely used by researchers to provide information on the external financing conditions faced by emerging markets. Next, we study the determinants of these crisis spells in a duration framework. Apart from domestic macroeconomic policy, the external environment and IMF programs, we also control for other standard determinants taken from the vast literature on secondary market spreads and debt crises.

Our econometric analysis shows that the global economic environment, the quality of domestic policy and IMF programs affect the duration of bond market distress. Moreover, we find a rich set of interactions between these determinants. The effect of domestic policy on the duration of bond market distress becomes stronger as the global environment is more favourable, and weaker when an IMF program is in place. Good external conditions affect the risk perceptions of investors more positively when a country pursues sound macroeconomic policies. Finally, the contribution of IMF programs to crisis resolution increases as the state of domestic policy worsens. These significant interaction effects should not be ignored when evaluating the commitment of domestic policymakers to address episodes of bond market distress.

The remainder of this paper is organized as follows. Section 2 provides a short review of the existing literature. Section 3 outlines the strategy used to identify spells of bond market distress and discusses the estimation of duration models. Section 4 focuses on the data and discusses our explanatory variables. Section 5 presents our results and Section 6 concludes.

2. Literature review

The spate of financial crises that shook emerging market economies at the turn of the century has led to a flurry of research activity into the dynamics of financial market turbulence. Much work has been devoted to understanding the causes of currency, banking and bond market crises and key lessons for crisis prevention have been drawn. However, less attention has been given to the process of crisis resolution.

We identify episodes of bond market distress on the basis of secondary market sovereign spreads. There is a vast literature on the determinants of spreads, both in the primary market ([Eichengreen and Mody, 2000](#); [Kamin and von Kleist, 1999](#); [Gelos et al., 2004](#)) and in secondary markets ([Arora and Cerisola, 2001](#); [Min et al., 2003](#); [Ferrucci, 2003](#); [McGuire and Schrijvers, 2003](#); [Rowland, 2004](#); [Jahjah and Yue, 2004](#); [Gonzalez Rozada and Levy-Yeyati, 2006](#)). The extensive body of evidence from this literature provides useful guidance to policymakers for crisis prevention. However, only a few papers have explored the behaviour of spreads during episodes of financial market turbulence, casting light on crisis resolution.

[IMF \(2001, 2005\)](#) focuses on the conditions surrounding the return by countries to international capital markets in the midst of a crisis episode. [Zanforlin \(2007\)](#) uses a probit model to study the determinants of the probability of reaccessing international capital markets after a crisis. These studies make use of primary market spreads which are only observed when bonds are issued. Therefore, they provide information about actual access as opposed to the ability to access international capital markets. To the extent that recovering market access may not coincide with an actual bond issuance, primary market spreads are unlikely to provide accurate information about potential market access. Countries may issue bonds long after recovering market access, and not immediately upon recovery. Hence, studies of reaccess to international capital markets and crisis recoveries should focus on secondary market spreads.

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