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IMF-related news and emerging financial markets

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Abstract

We examine the reaction of financial market returns and volatility in a diverse group of six emerging markets to a set of IMF events during the Asian, Russian and Brazilian crises of 1997–1999. Focusing on stock markets first, we find that on average, negative (positive) IMF news reduces (increases) daily stock returns by about one percentage point. The most influential event is the delay of loans from the IMF. For foreign exchange market returns, we only observe significant effects of bad IMF news, and on bond markets neither good nor bad news seems to affect interest rate spreads. IMF news does not have a significant impact on the volatility of the financial markets. Further, both gains and losses resulting from IMF news tend to be neutralized within one day after the announcement. Finally, we find that IMF news does not cause creditor panic.

JEL classification: F300; G100

Keywords: IMF news; Financial market returns; Emerging markets; Bond spread; Creditor panic; Market efficiency

1. Introduction

The role of the International Monetary Fund (IMF) in the international monetary system has been extensively studied. While most of the discussion centers on issues such as effectiveness

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of IMF programs and IMF-induced moral hazard, little is known about the influence of the IMF as a source of news on financial markets. In this paper, we analyze the impact of various categories of IMF actions on emerging financial markets by studying the reaction of investors to announcements of IMF actions during the Asian, Russian and Brazilian crises of 1997–1999.

IMF-related news has two possible roles to play in emerging financial markets. First, this news may convey some information to market participants, for instance, about the economic situation of a country, which was not known before. Second, it may give some indication to market participants of how the IMF is going to act in response to a country's crisis. Unanticipated good IMF news should increase returns on the day of announcement, while bad news should result in lower returns. Whether returns continue to rise or fall subsequently depends on how market participants perceive such news and whether they consider the IMF stabilization program to be effective (Evrensel, 2002).

IMF policies during the Asian financial crisis have been severely criticized by some observers, and the debate over the effectiveness of IMF policies has intensified since the crisis (see, for instance, Katz (1998) and Naim (2000)). Critics have argued that the Asian crisis, resulted from, or was intensified by, a "creditor panic" resulting from the IMF's statements that Asia needed drastic financial reforms. Declining investor confidence in the region was therefore an important factor in initiating and sustaining the crisis. For example, Sachs (1999) has argued, "…provocative IMF actions have probably contributed to the [creditor] panics" (p. 389).

A significant and sustained decline in stock market returns would be an evidence that unanticipated negative IMF actions, such as unfavorable statements regarding a country's economic situation or a delay of IMF loan announcements, have undermined investor confidence in markets if the latter follows the former. In the extreme, this may cause investors to rapidly and massively sell off their assets, creating a self-fulfilling panic. It is well known that volatility linkages among bond, money, and stock markets are strong (see Fleming et al. (1998) and the references cited therein), and therefore IMF actions might affect many different local financial markets. The empirical approach initially utilized to study the effects of news on stock markets is therefore also applied to foreign exchange and bond markets in order to separate general from idiosyncratic effects of IMF actions.[2]

This paper focuses on the response of stock, bond, and foreign exchange markets to a comprehensive set of IMF-related news to investigate whether market participants are able to extract information from IMF-related news and on the question of whether such news has any effect on market returns. The paper also investigates whether IMF-related news is associated with increasing volatility in financial markets because such volatility increases are a sign of panic among market participants. Our findings refute the panic hypothesis, suggesting that financial markets showed no excessive reaction to IMF announcements during the turbulent period of 1997–1999.

[2] Another heavily debated issue is that of the IMF causing moral hazard in financial markets (Lane and Phillips, 2000). According to this view, investors knowingly take very risky positions because they believe that the IMF will bail them out (creditor moral hazard) or governments do not adjust inappropriate economic policies unless bailed out by the IMF (debtor moral hazard). A thorough empirical test of the portfolio moral hazard hypothesis, among others, is provided by Sarno and Taylor (1999). They show that the asset price bubbles observed before the crisis may be due to moral hazard problems in financial intermediation. The empirical approach in this paper is not really suited to contribute to this debate, as moral hazard may not be connected with specific IMF news announcements. Moral hazard may also take place long before IMF announcements due to the expectation of IMF support in a country. In addition, there are many forms of moral hazard, and it is not easy to detect what type of moral hazard is primarily related to IMF news.