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Observing bailout expectations during a total eclipse of the sun

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A B S T R A C T

The literature has not reached a consensus yet regarding the existence of sovereign creditor moral hazard. Exploiting an exceptional historical example, this paper proposes an original method to address this issue. As the corona which is observable only during a total eclipse of the sun, market-specific prices of repudiated bonds are observable only when extreme conditions segment the markets. Such very rare events allow for isolating pure country-specific bailout expectations. The paper shows that bailouts do create creditor moral hazard. Based on an impulse response analysis, the econometric results further emphasize the influence of bailout expectations in sovereign bonds valuation.

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1. Introduction

Bailouts have been accused to foster a double-sided moral hazard.¹ On the one hand, by bailing out a country, International Financial Institutions provide incentives to sovereign debtors to default instead of initiating politically costly macroeconomic reforms. On the other hand, creditor moral hazard arises when bondholders lend too favorably to risky borrowers because they expect a third party to bail them

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¹ This accusation can be traced back at least to the beginning of the 1980's. For a recent review of the literature regarding bailouts and moral hazard see [International Monetary Fund \(2007\)](#).

out. Even though a large literature has discussed the theoretical impacts of bailouts, empirical evidence is hard to assess (Rogoff, 2002).

Dreher (2004) reviews the stylized facts which could relate IMF interventions and moral hazard. Testable consequences of such link proposed in the literature include bond spreads decrease in level (Eichengreen and Mody, 2000; Lane and Philipps, 2000; Kamin, 2004; Noy, 2006; Dell'Ariccia et al., 2006) or in variability (Dell'Ariccia et al., 2006), longer term and/or cheaper funds flow to emerging markets (Mina and Martinez-Vasquez, 2002; Kamin, 2004), slower bond reaction to changes in fundamentals (Kamin, 2004; Dell'Ariccia et al., 2006; Lee and Shin, 2008).

Unfortunately, empirical results heavily rest upon the econometric approach adopted and no consensus has been reached so far by the profession on the existence of a moral hazard effect. Lane and Philipps (2000) analyze bond spread reactions to events which should drive bailout expectations and find very little signs of creditor moral hazard. Only in one case do they detect a significant effect: the 1998 Russian default. According to Kamin (2004), prior to 1995 the nature of the IMF interventions could not lead to creditor moral hazard, and afterwards evidence is scarce.

Other authors, however, argue in favor of a strong creditor moral hazard effect. Dell'Ariccia et al. (2006) analyze bond spreads across emerging countries. According to their view, the non-intervention in Russia in 1998 represented a notable change in the IMF policy which influenced significantly bailout expectations. Empirical evidence is provided through a larger dispersion in the spread series to be attributed to a reduction in bailout expectations associated to the fundamentals becoming more relevant in bond valuation. Dell'Ariccia et al. (2006) conclude in favor of the existence of creditor moral hazard prior to 1998. In the same spirit, Lee and Shin (2008) show that when bailout probabilities differ across countries, expectations of the IMF lending lowers the relationship between fundamentals and bond spreads. This effect, attributed to moral hazard, is observed even after the 1998 Russian non bailout.

As a matter of fact, the empirical studies face a serious identification problem. Indeed, in bond prices series, bailout expectations interact with several other influences and no satisfactory method has been put forward yet for disentangling them. In other words, researchers lack clear-cut counterfactual situations. Eichengreen and Mody (2000) point out methodological problems: A decrease in bond spreads following an IMF intervention could either signal creditor moral hazard or reflect expectations that the defaulting country would commit itself to follow IMF-suggested reforms.

Ideally, one would compare simultaneous reactions of a given bond with and without bailout expectations in a context excluding the imposition of macroeconomic reforms. This could happen only if an explicit discriminatory policy were in place making the bailout possible in a given country and impossible in another one. In such case, any difference between the bond prices could be attributed with no doubt to bailout expectations, up to measurement errors. This ideal setting is as rare as a total eclipse of the sun. However, history provides a unique opportunity to observe such a remarkable episode.²

Russian bonds had been traded in Paris and London during the end of the 19th century. In 1918, the Bolsheviks repudiated the Russian debt. The bonds continued nonetheless to be traded in both cities but capital controls due to WWI segmented the markets by preventing international arbitrage. Soon, the French government signaled that it would consider bailing out the Russian bonds, whereas the British only briefly considered such a move. Prices of Russian bonds in Paris and London started to diverge, reflecting the different bailout expectations on each market.

This very special episode resulted from the conjunction of two events: the impossibility of international arbitrage due to war restrictions and the repudiation of a sovereign bond by its issuer. Our empirical analysis based on impulse response functions provides two main insights on bond price reactions in presence of a bailout. First, bailout expectations have a significant impact on bond prices. Second, they alter the whole dynamic of price formation: bonds subject to bailout expectations show

² Actually this historical exception is virtually impossible nowadays. Indeed, it is unlikely that an International financial institution would bail out say, an Argentinean bond traded in London, and not the same bond traded in Paris. Furthermore, even if it did happen, international arbitrage would quickly reduce any difference attributable to the bailout. Waldenström (2010) also uses the segmentation caused by a war (the Second World War) to assess the risk difference between domestic and external sovereign debts.

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