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What Explains Changing Spreads on Emerging-Market Debt: Fundamentals or Market Sentiment?

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In this paper we analyze data on nearly 1,000 developing-country bonds issued in the years 1991-96 the recent episode of heavy reliance on bonded debt. We analyze both the issue decision of debtors and the pricing decision of investors, minimizing selectivity bias by treating the two issues jointly. Overall, the results confirm that higher credit quality translates into a higher probability of issue and a lower spread. Importantly, however, we find that observed changes in fundamentals explain only a fraction of the spread compression in the period leading up to the recent crisis in emerging markets.

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