Bilateral Financial Rescues

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Abstract. Why do governments provide bilateral bailouts to countries that experience financial crises above and beyond what the IMF provides? We argue that governments face a trade off. On one hand, they have incentives to rescue a crisis country because they want to prevent the spread of the crisis to their own country. On the other hand, governments experience pressures from domestic constituents who are oftentimes opposed to financial rescues. Politicians aim to balance these countervailing pressures. Whereas they are more likely to provide financial support when their country's economy is closely integrated with the crisis country's economy, elections may have a detrimental effect on the likelihood of a financial rescue, particularly if the home country's economy is not doing well itself. We test our hypotheses using a new data set on international financial rescues by OECD countries between 1990 and 2010. Our statistical analysis finds robust support for the importance of domestic economic and political factors in international cooperation during financial crises.

1 Introduction

Over the last two decades, financial crises have become more frequent, virulent, and global.[1] The 1990s and 2000s have witnessed an array of financial crises in emerging and developed market economies such as Mexico (1994), East Asia (1997-1998), Russia (1998), Brazil (1999), Turkey (2001), and Argentina (2001), culminating in the global financial crisis of 2007-2008. Those who want to come to the rescue of the crisis countries face a trade off between the benefits of providing sufficient liquidity in order to reassure investors, and to prevent a deterioration of the situation in the crisis country as well as contagion to other countries, and the costs of moral hazard – liquidity provision will provide incentives to recipient countries not to implement economic and financial reforms that prevent the reoccurrence of financial crises in the long term.[2]

To minimize moral hazard, financial rescues have traditionally been delegated to the International Monetary Fund (IMF). The IMF lends money to countries that experience a financial crisis and lack access to the international capital market to solve their balance of payments difficulties. Organizing international financial rescues through the IMF allows donor countries to pool their resources and to coordinate their rescue efforts. It can also reduce moral hazard in recipient countries, because the IMF's provision of liquidity depends on the crisis country's implementation of a package of economic and financial reforms.

Despite these multilateral financial rescues that are organized through the IMF, crisis countries oftentimes receive additional rescue packages from individual countries. For example, during the Asian financial crisis Thailand received an IMF rescue package as well as bilateral bailouts from various countries, notably Japan and other Asian economies (Lipscy, 2003). Participation in such bilateral financial rescues varies considerably. Whereas Thailand received large bilateral rescue packages from a number of Asian economies, it did not receive a rescue package from the United States.

Why do some states provide financial rescue packages to crisis countries even though they could rely on the IMF? And why do other countries abstain from such bilateral financial rescues? In this paper, we provide a political economy theory of bilateral financial rescues. We argue that governments face different, sometimes countervailing pressures when deciding whether to provide financial rescue packages that supplement IMF rescues.[3] On one hand, home country politicians have

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[1]A financial crisis is defined as a sovereign debt crisis, which is "the failure of a government to meet a principal or interest payment on the due date . . . [including] instances in which rescheduled debt is ultimately extinguished in terms less favorable than the original obligation" (Reinhart and Rogoff, 2009, 11).

[2]An alternative solution, not discussed in this paper, is a bail-in, or the restructuring of a crisis country's debt (Roubini and Setser, 2004).

[3]To distinguish potential donor governments from the crisis government, we call them 'home

incentives to provide a financial rescue in order to prevent negative externalities, such as a decline in profits due to falling exports to the crisis country. Such incentives increase the closer the crisis country's economy is integrated with the home country's economy, thus the greater the exposure of the home country to the risk of negative externalities. On the other hand, governments have to take into account the preferences of domestic constituents who are frequently opposed to financial rescues, particularly if the economy is not doing well and the bailout would divert resources that could potentially be used to foster economic growth domestically. Consequently, whereas governments have strong incentives to provide bilateral financial rescue packages, particularly when the home country's economy and the crisis country's economy are highly interdependent, such rescues may be less likely if elections are close, and the country's economy is not doing well.

To test our theoretical hypotheses, we collect a new data set on bilateral financial rescues provided by OECD countries between 1990 and 2010. Using logistic regressions, we find support for our theoretical argument. The more exposed a home country is to a crisis country either economically or financially, the more likely is a financial rescue. However, close elections reduce the likelihood of a financial rescue, *ceteris paribus*, particularly if a country's economy is not doing well itself. These findings provide some interesting insights to the question of international financial rescues. First, much of the literature has focused on explanations of international financial rescues that highlight economic interdependencies and their effects on policy making (Frankel and Roubini, 2001; Broz, 2005, 2012; Lipscy, 2003). Our paper subsumes these arguments and highlights the importance of voter preferences and domestic elections for such an explanation. Second, to our knowledge we provide the first quantitative analysis that analyzes these political economy explanations of bilateral bailouts across a number of donor countries, supporting some of the qualitative evidence for economic explanations, and our domestic politics explanation.

2 Motivation

Over the past few decades, the economic and financial openness of countries has grown rapidly. As Figure 1 illustrates, the world's economy was almost ten times as open (measured in terms of the sum of exports and imports as ratio of a country's GDP, aggregated over all countries) as in the 1950s. Likewise, the world is almost eight times as financially open (measured in terms of the sum of foreign assets and liabilities as ratio of GDP, aggregated over all countries) as it was in the 1970s.

This increasing interdependence has led to a significant increase in the likelihood of financial crises and regional as well as global contagion. The increasing frequency and the globalization of financial crises is therefore not very surprising.

government.'

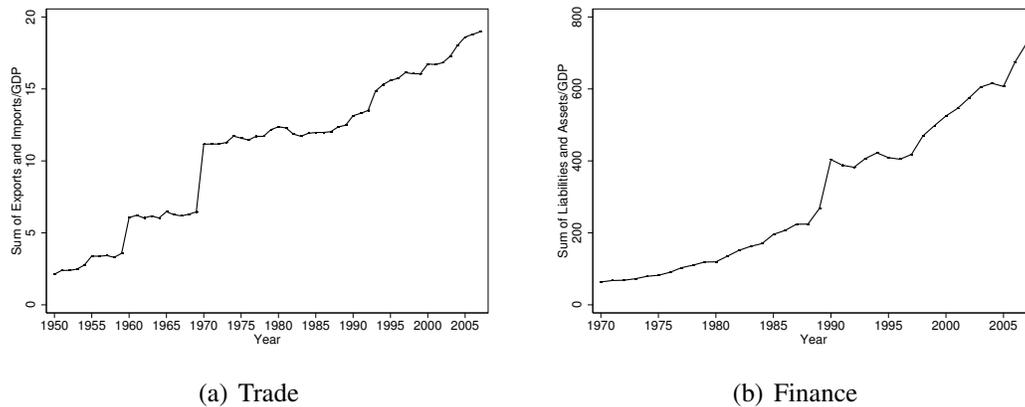|	
(a) Trade	(b) Finance

Figure 1: Trade and Financial Openness in the World (Source: IMF)

With the high risk of contagion comes strong incentives to minimize financial crises in the crisis country as to prevent a spillover to other economies. International financial rescues, or bailouts, can help prevent a deterioration of the crisis economy and contagion to other countries. The rapid provision of abundant liquidity helps crisis countries to signal domestic and foreign investors that they are able to repay their debt, thereby reassuring investors and increasing access to international capital. The short-term solution to the problem may have long-term consequences, however, because it creates moral hazard in the crisis economies. Knowing that they will be bailed out in a crisis situation, investors will have incentives to pursue riskier ventures, and the government will shirk the implementation of financial and economic reforms that are intended to prevent the reoccurrence of a financial crisis in the medium and long term. The risks of moral hazard are particularly high for bilateral financial bailouts provided by countries that have a strong interest in the well-being of the economy (exactly those, as we will show below, that are most likely to come to the financial rescue of a crisis country). Since the donor country needs to provide a bailout to avert negative externalities, it is less credible to implement strict conditionality or to sanction the crisis country if it violates the conditions for receiving a loan.

The IMF has been the most important multilateral body to help balancing the trade off between immediate prevention of a deterioration in the crisis country and the long term occurrence of moral hazard. The IMF provides liquidity to the crisis country to address the immediate problem of a balance of payments crisis, but it also attaches stringent conditionality to the provision of its resources in order to address the long term problem of moral hazard. Countries that experience balance of payment crises receive liquidity from the IMF only if they agree to implement a series of financial and economic reforms that help address structural and other problems that led to the financial crisis. The IMF monitors the implementation of such reforms and sanctions countries that violate these conditions. Since IMF

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decisions are based on the common position of a collective of member states, they are less politically motivated than the decisions made by its individual members. This reduces the moral hazard problem.[4]

Despite this apparent advantage over bilateral financial rescues, the IMF has often been criticized (particularly by crisis countries) not to provide enough liquidity to stop the crisis early on, and therefore to increase the likelihood of negative spillover effects and contagion of the crisis itself. Consequently, many IMF bailouts have been supplemented with additional bilateral or also regional financial rescues. The likelihood of such bilateral financial rescues vary, and not every crisis country receives a bilateral bailout from all potential donor countries. Most explanations for this variation are based on the effect of economic interests on policy making. These arguments generally rest on the argument that the primary rationale for financial rescues is to preserve the openness of the world economy (Kindleberger, 1986; Frankel and Roubini, 2001). Broz (2005), for example, analyzes US congressional voting on financial rescues, and shows that congress members are more likely to vote in favor if they represent districts with high skilled workers (who benefit from globalization according to the Stolper Samuelson theorem), and if they received campaign contributions from banks with assets in developing countries. Consequently, the literature implies that those who gain from globalization should generally be more likely to provide financial bailouts.

This explanation does not explain, however, why home countries also vary in their propensity to provide bilateral financial bailouts over time. For example, whereas the US provided a bilateral bailout to Mexico in 1995, it abstained from providing a bilateral bailout for Thailand in 1998 during the Asian financial crisis (it did offer a bilateral bailout to South Korea during the same period). Lipscy (2003) argues that cross-temporal variation in the incentives to provide bailouts mainly depend on the importance of the crisis country's economy for the home country. That is, whether the financial crisis is likely to have negative externalities for the home country.[5] Similarly, Broz (2012) shows that the US Federal Bank was more likely to provide emergency loans and currency swaps to foreign banks in countries where US money center banks had high loan exposures.

Whereas this work sheds some light on the importance of economic factors on international financial rescues, little is known about the influence of voter preferences and elections on international financial rescues. The importance of domestic electoral politics on international financial bailouts becomes evident in the current European financial crisis (Schneider, 2013). In April 2010 the Greek government had formally requested a rescue package from the IMF and the European Union. The proposal earmarked €45 billion in cash loans of which Germany was to pay

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[4]Note, however, that the IMF is not immune to political influence, which may bias its actions towards recipient countries, thereby creating moral hazard problems as well. See, for example, Thacker (1999); Stone (2002, 2004, 2008, 2012); Copelovitch (2010*a*,*b*).

[5]See also Katada (1998); Bordo and Schwartz (1999).

€8.4 billion by May 19, 2010 (making it the biggest contributor to the bailout package). Even though the IMF and all other EU members agreed to the bailout, Germany was reluctant to approve such a deal officially.[6] The biggest stumbling block to Germany's approval were regional elections in Nordrhein-Westfalen (NRW) on May 9, 2010. The federal government under then Chancellor Angela Merkel from the Christian Democratic Union (CDU) also had the government majority in NRW. The elections were important because they affected the majorities in the *Bundesrat*.[7] An electoral defeat of the CDU-led coalition in NRW would have led to a loss of the majority in the *Bundesrat* (thereby leading to a situation of divided government) with very important implications for the decision-making ability of the federal government. Public polls indicated a close race with a small advantage of the governing CDU, but opinion poll experts predicted that the bailout debate could have a strong impact on voters' choice.[8] A majority of Germans opposed the Greek bailout, particularly in light of domestic austerity measures that were necessary to meet fiscal consolidation targets in Germany.[9] In NRW, which had become one of the most indebted states in Germany, public opposition to the Greek bailout was 90 percent. To avoid negative electoral effects, Germany's then Chancellor, Angela Merkel, wanted to delay an agreement about the Greek bailout until after the regional elections. She was hailed domestically as the "Iron Chancellor," but became the "Madame No" of the EU. Her actions were harshly criticized not only in other EU countries, but in non-EU countries and on the domestic level as well.[10] The uncertainty created by Merkel's tactic led to an almost uncontrolled increase in the price of Greek debt. This worsened the Greek situation and increased the threat of regional crisis contagion thereby endangering the stability of the euro itself.[11] Under this pressure, Merkel agreed to the Greek bailout a few weeks before the NRW elections.[12] The Greek bailout (and the federal government's poor negotiation results) became the most important topic in the election campaigns.[13] Despite early positive predictions, the CDU lost ten percentage points making it the worst electoral defeat of the CDU in NRW ever. The government eventually was replaced by a coalition of Social Democrats and Greens.[14] Whereas the electoral defeat cannot be solely attributed to the federal government's handling of the Greek problem it had played a pivotal role in the week prior to the election.

The example illustrates not only potential electoral consequences of financial

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[6]Reuters, April 2010, "German elections bring forward a possible stalemate situation for EMU."

[7]The Bundesrat is the second federal legislative chamber. It represents the sixteen German states on the federal level.

[8]RP Online, May 2010, "Griechenland entscheided die Wahl."

[9]Der Spiegel, April 2010, "Mehrheit der Deutschen lehnt Griechen-Hilfe ab."

[10]Der Spiegel, April 2010, "Euro-Angst treibt Merkel zur Griechen-Rettung."

[11]New York Times, April 2010, "As Greek drama plays out, where is Europe?"

[12]Der Spiegel, April 2010,"Merkel's bluff called in poker over Greece."

[13]Der Spiegel, May 2010, "Rüttgers kämpft gegen Griechenland-Effekt."

[14]N-tv, May 2010, "Quittung für die Bundesregierung. Rüttgers brutal zurückgestutzt."

rescues in the home country, but it also indicates that public opinion was very negatively disposed towards bailing out other crisis countries. This observation is supported by various public opinion surveys and recent research on public opinion towards international financial bailouts in the European Union (Katada, 1998; Bechtel, Hainmueller, and Margalit, 2012; Rickard, 2012). For example, Bechtel, Hainmueller, and Margalit (2012) find that only 3% of respondents in Germany strongly favor the European bailouts. 61%, on the other hand, are either somewhat against or strongly against the bailout. Similarly, almost 67% think that Germany should pay somewhat or much less into the European financial rescue fund.[15]

If domestic public opinion toward bilateral financial rescues is negative, then this should have an impact on the home government's decision of whether to provide financial rescues or not. In the next section, we develop a theoretical model of the domestic politics of bilateral financial rescues. In a nutshell, we argue that governments have to balance various domestic interests when deciding on whether or not to provide a bilateral (or participate in a regional) bailout of a crisis country. Specifically, governments have limited budgetary resources and face a trade off. If they bail out the crisis country, then they have to redistribute budgetary resources that could otherwise be spent to stimulate the domestic economy. The larger the expected negative externalities on the domestic economy, the more likely they will decide in favor of a financial rescue. However, if the home economy is not doing well, then governments face greater pressures to decline a bailout, particularly before elections.

3   Theory

Our theory is based on the standard assumptions in the political economy literature (Drazen, 2000). We assume that incumbents are opportunistic actors who want to maximize their time in power. They are influenced by consumers and producers in various sectors of the economy. Domestic constituents can influence the government through two channels. First, they can vote for or against the government during elections. When deciding whether to reelect the incumbent they will try to forecast the incumbent's future policies by observing her past behavior. In their assessment they discount the past, such that events closer to the election will be more important in the voters' decision-making calculus. Second, they can form interest groups and lobby the government directly to pursue policies in their favor.

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[15]Both papers show that bailouts are generally unpopular on the domestic level. However, they differ in the explanations for variation in public opinion. Rickard (2012) finds that public opinion in the United Kingdom towards international financial rescues in the European Union are driven by economic ties to the crisis country. Bechtel, Hainmueller, and Margalit (2012) find that general concerns of the overall financial burden, as well as dispositions such as altruism and cosmopolitanism are stronger predictors of public opinion in Germany than economic ties.

Our theory focuses on the decision of a country (we may call this the *home country*) to bailout a country that currently experiences a financial crisis (we may call this the *crisis country*) and is in need of a financial rescue. We define *bilateral financial rescue* as the provision of liquidity in form of a loan to help solve a balance of payment crisis, whereby the loan may or may not be supplemented by bilateral or multilateral conditionality (many home countries attach existing IMF conditionality to their loans). We assume that the crisis country already experiences the financial crisis, and that it has received an IMF bailout, and accepted IMF conditionality. This allows us to focus on the decision-making calculus of the home government to provide *additional* liquidity for the crisis country.[16] Indeed, most countries that had a financial crisis – as defined by the extant literature – have received IMF loans.

In order to discuss domestic interests toward international financial rescues, we have to analyze the effects of a financial crisis in a crisis country on individuals in the home country. In financially and economically open economies, financial crises usually have negative effects for individuals in other countries even if these countries do not face a financial crisis themselves.

First, financial crises carry the risk of sovereign default of the crisis country. A sovereign default occurs when the crisis government loses the ability to repay its debt to its creditors. A sovereign or bank default in the crisis country will have negative externalities for foreign banks that hold some of the crisis country's government debt. These banks will lose their foreign assets and may slide into economic difficulties themselves. These difficulties may lead, in the worst case scenario, to a default of the foreign bank itself. The exposure of the bank intensifies significantly the more the bank holds of the crisis country's debt.

Second, financial crises are usually accompanied or followed by economic recessions. This will lead to a slow down in the home country's consumer demand. Declining consumer demand will have economic effects on foreign firms that operate in the crisis country as well as on foreign companies that export to the crisis country. Multinational corporations will lose important markets and have to scale down production. This naturally also affects the economic welfare of the company in the home country with consequences for the company's profits as well as employment. National firms in the home country that export have similar concerns. If demand for their products slows down in the crisis country this might have effects on the profitability of production and therefore employment as well. The effect intensifies if the financial crisis leads to a devaluation of the crisis country's currency, thereby lowering the demand in the home country for now costlier imports from the home country.

Accordingly, negative spillover effects are particularly felt in the home country's sectors that are economically and financially exposed. The negative effects become more intense the greater the economic and financial interdependencies be-

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[16]We do not make any assumptions about the strength of the crisis in the crisis country.

tween home country and crisis country. These externalities affect employers and employees alike. On one hand, employers will experience a loss in profits. On the other hand, employees will experience an increasing likelihood of getting laid off.

IMF loans may alleviate some of the concerns, but the size of these multilateral loans may not be large enough to comfort foreign investors and to prevent a deepening of the crisis (or even an improvement of the crisis at least in the short term). Rapid and abundant liquidity provision may be the key to successfully stop the downwards spiral that carries such costly international negative externalities. It increases confidence about the ability to repay debts among investors, and thereby ensure continued access of the home government to the international capital market.

Home country politicians will thus have incentives to provide a bilateral financial rescue in addition to an IMF resource in order to mitigate these negative effects. The greater the negative externalities from the crisis country, the more individuals in the home country will experience adverse negative effects such as a loss in income or loss of employment which will result in an overall decline of economic welfare. During elections, individuals will attribute this loss in welfare at least partially to the economic incompetence of the government. The greater the number of negatively affected individuals, the greater therefore the incentive of the government to avert the negative consequences of a crisis in the crisis country. This leads to our first two testable hypotheses:

Hypothesis 1 *The greater trade interdependence between the home country and the crisis country, the more likely is a bilateral financial rescue in addition to an IMF rescue package, ceteris paribus.*

Hypothesis 2 *The greater financial interdependence between the home country and the crisis country, the more likely is a bilateral financial rescue in addition to an IMF rescue package, ceteris paribus.*

At the same time, bilateral financial rescues divert money away from the government budget (particularly if the crisis country cannot repay its debts). For example, in the course of the Greek debt crisis, members of the Eurozone have transferred €127 billion Euro to Greece – mounting to about 1.3% of the Eurozone's GDP in 2011.[17] If one takes into account overall debt held by sovereign governments as well as bank and private lending, the short term costs increase. For example, Greece owes $38 billion to French banks and $1.91 billion to the French government (BIS, July 2012). Overall, $407 billion was provided by domestic and international investors, and sovereign countries. Eventually, most of these loans will be repaid. However, in the short term the home government has to transfer these resources to the crisis country. If the crisis country defaults, or is granted a debt relief (as is currently discussed for Greece), then the home government also loses these resources in the long term.

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[17]The IMF provided billion €22 billion. Another €30-38 billion might be necessary as of 2014.

The home country government could finance a financial rescue twofold. First, it could redistribute budgetary resources or decrease spending on domestic public goods in order to have resources for the bilateral financial rescue. Second, it could increase the budget deficit in order to achieve the same goal. Both strategies reduce the economic welfare of the home country's population.[18]

These negative effects of a bilateral bailout to taxpayers becomes more severe when the home economy itself has already been affected. In such a situation, employees become increasingly concerned with the government's ability to stimulate the domestic economy and to provide domestic public goods. If the domestic economy is already affected, companies are scaling down by reducing wages, cutting benefits, or releasing their employees. Individuals that face significant pay or benefit cuts are now more reliant on the government to provide some compensation through, for example, tax cuts or increase in publicly provided social benefits and services. Individuals that already were laid off now rely on the government's ability to provide unemployment benefits and to stimulate the economy in order to increase employment in the medium run. In other words, in a home economy that is not doing very well, individuals that are unemployed or will likely be unemployed in the future are more likely to oppose a bilateral bailout. This is particularly true if one assumes that individuals cannot fully comprehend the potential beneficial economic effects of preventing a crisis spillover through an international financial rescue (Bechtel, Hainmueller, and Margalit, 2012; Rickard, 2012). Interestingly, individuals who will be most concerned about the distributional effects of bilateral bailouts during times of economic downturn are exactly those in the sectors which are most exposed to the crisis country.

Home country governments will thus face increasing pressure from domestic constituents who oppose a bilateral financial rescue the worse the home country's economy is doing. The ability of the government to signal economic competence to its voters before elections depends on its ability to increase the voters' domestic welfare, by for example reducing the domestic unemployment rate, before elections. Providing a bilateral financial rescue may achieve this goal. However, the effect is not felt immediately and whether the financial rescue has positive externalities for the home country depends on the likelihood that the crisis country's government uses a mix of liquidity and economic reforms to lead its country out of the recession. Pursuing expansionary fiscal policies, on the other hand, underlies full control of the home government and provides economic benefits for voters immediately.

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[18]Of course, if the home country experiences a crisis itself as a consequence of the financial crisis abroad, then the economic decline in the home country will have a negative effect on these individuals as well. This, however, would assume that voters can calculate these future benefits and costs, and value them more than current benefits and costs. Rickard (2012) for example shows that most individuals do not know whether their country is economically dependent on the well being of particular other countries. It would be hard for those individuals to expect costs in the long term.

The home country government therefore faces a trade off between providing a bilateral financial bailout in order to mitigate the negative economic effects on its economy, and providing more resources to stimulate the domestic economy in order to signal economic competence to its voters. The incentives to provide a bilateral bailout should be greater if the government does not face an upcoming election. The further away elections, the less likely employees will use their votes to punish the government for its pro-bailout policies at the ballot. However, if government's face elections during the time of crisis, they will have to take into account the pressure exerted by the large, yet unorganized, group of constituents.

Hypothesis 3 *Upcoming elections in the home country will decrease the likelihood of a bilateral financial rescue, particularly if the home country's economy is not doing well, ceteris paribus.*

In a way of summarizing, financial and economic exposure create strong pressures on home governments to provide international bailout to a country experiencing a financial crisis. The worse the economy is doing, however, the more pressure the government experiences to oppose international financial rescues in favor of extended domestic stimulus measures. These voters are most likely to assert themselves shortly before elections. In other words, governments may face situations in which they decide against an international financial rescue even though their country's economy is closely related to the crisis country's economy.

4 Quantitative Analysis

To test our hypotheses, we analyze a home government's decisions to provide an international financial rescue to a given crisis country between 1990 and 2010.[19] By home country, we refer to states that consider offering bilateral loans to a country experiencing a financial crisis. Usually these states are large countries with resources sufficient to mitigate economic hardship via relatively large rescue packages (almost all bilateral rescue packages are greater than \$1 billion). For this reason, the home states that we consider were members of the Organization for Economic Cooperation and Development (OECD) prior to 1990.[20] The 23 home countries included in our sample are displayed in Table 1.

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[19]We focus our analysis on crisis since the 1990s since most loans made in the period after the collapse of the Bretton Woods system in the early 1970s and the 1990s attempted to prevent devaluation of a currency or the abandonment of a pegged exchange rate (Bordo and Schwartz, 1999). By focusing on the period from 1990, we can compare loans that were granted after the peg had failed. In addition, by the end of the 1980s the IMF started to provide its packages first (it used to provide its packages after the bilateral packages were in place before that) (Meltzer, 1991).

[20]Restricting the sample of home countries to the G-8 (Canada, France, Germany, Italy, Japan, Russia, United Kingdom, USA) or to the OECD countries that de facto provided financial rescue packages does not change the results substantively.

Home Country	Recipients
USA	Argentina, Brazil I, Indonesia, Mexico, South Korea, Uruguay
Australia	Indonesia, South Korea, Thailand
Japan	Indonesia, South Korea, Thailand
Sweden	Iceland, Ireland, South Korea
UK	Iceland, Ireland, South Korea
Canada	Mexico, South Korea
Denmark	Iceland, Ireland
Germany	Iceland, South Korea
Belgium	South Korea
Finland	Iceland
France	South Korea
Italy	South Korea
Netherlands	Iceland
New Zealand	Indonesia
Norway	Iceland
Switzerland	South Korea
Austria	–
Iceland	–
Ireland	–
Luxembourg	–
Portugal	–
Spain	–
Turkey	–

Table 1: Home Countries and the Recipients of Financial Rescue Packages

Recipients of multilateral and bilateral rescue packages are called crisis countries. Although any country could conceivably receive a rescue package at any time, empirically we observe that all states that received a bilateral financial rescue since at least 1990 also received a substantial IMF loan. For this reason, we define the universe of crisis countries to consist of all states that received an IMF loan at least five times their IMF quota in a given year. The advantage of restricting the sample of financial rescues to those supplementing existing IMF rescues is that the cases are more comparable. A home country's calculus is more complex in the absence of an IMF rescue package because the government has to decide whether to provide additional conditionality. Table 2 displays the 13 crisis countries that meet the selection criteria in addition to the size of their IMF loan and the total number of bilateral loans they received.

Crisis Country	Year	IMF Loan	Bilateral Bailouts
South Korea	1997	20.9	11
Iceland	2008	2.1	7
Indonesia	1997	11.3	4
Ireland	2010	22.5	3
Mexico	1995	18.9	2
Thailand	1997	4.0	2
Argentina	2000	22.1	1
Brazil I	1998	18.4	1
Uruguay	2002	2.7	1
Brazil II	2002	35.1	0
Greece	2010	30.0	0
Turkey	1999	33.8	0
Ukraine	2008	16.5	0

Table 2: Crisis Countries and IMF Loans (IMF loan amounts reported in billions of dollars).

The unit of analysis is the home country-crisis country dyad. For example, Germany as the home country and Thailand as the crisis country constitute one such dyad. Our data set includes a total of 299 dyads. Iceland, Ireland and Turkey are OECD members and each experienced a crisis. Since they cannot offer bilateral bailouts to themselves, we dropped them from the sample as home countries for the corresponding crises, thereby reducing the total number of dyads to 296.

4.1 Variables

Our theory allows predictions about the likelihood that a home country provides a financial rescue package to a crisis country. The outcome of interest is a dichotomous variable indicating whether the home country decided to provide a financial

rescue package to the crisis country, or not. Data on bilateral financial rescues are not readily available from the IMF or other international organizations. We compiled an original dataset containing the dollar amounts that each OECD country contributed to crisis states. Data sources include newspapers such as the New York Times and Financial Times, governmental reports, and the data provided by Bordo and Schwartz (1999); Roubini and Setser (2004). Every positive data entry on a bilateral financial bailout is supported by at least two different sources of information. Generally, whereas the dollar amounts may not be as reliable, the occurrence of a bilateral financial rescue has been very consistent across different sources. The dependent variable is coded 1 if a given home country provided an bilateral financial rescue package to a given crisis country, and 0 otherwise.

According to Hypothesis 1, a home country should be more likely to provide a bilateral financial rescue package to a given crisis country, the greater its trade exposure to the crisis country. We measure the degree of trade dependence between the home and crisis country by calculating the home country's total trade with the crisis country (the sum of exports and imports) as a share of the home country's total GDP for the year when the IMF rescue package was initiated (*Trade Dependence*.) Data are from the OECD.

Hypothesis 2 states that a home country should be more likely to provide an international financial rescue package to a given crisis country, the greater its financial exposure to the crisis country. We measure the degree of financial exposure as the logged amount of crisis country's debt held by the home country in millions of US$ for the year when the IMF rescue package was initiated (*Financial Dependence*). Data are from the Bank of International Settlements (BIS).

Finally, Hypothesis 3 indicates that home countries are significantly less likely to provide bilateral financial rescues if the home economy is not doing well, and elections are close. To test this hypothesis, we use a measure for the home country's economic well-being as well as for the proximity of elections in the home country. First, we measure economic well-being of the home country as the home country's economic growth in the year when the IMF rescue package was initiated (*GDP Growth (Home)*). Second, to test for the effect of close elections we use the proximity (in months) of elections for those elections that occurred within one year of the date of the IMF rescue. Following Franzese (2000) we scale the election indicator so that it takes values between 0 and 1. A score of 1 means that the home country will hold an election within one month of the beginning of the crisis, and a score of 0 means that the next election will not occur for at least 12 months after the crisis began. Data on elections are from the Database of Political Institutions (Beck, Keefer, and Clarke, 2010).

In addition to our main independent variables, we control for a variety of factors that may influence the likelihood of an international financial rescue. First, we use the home country's unemployment rate as an additional measure of the home country's economic well being (*Unemployment*). Data are from the World Bank.

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Second, we control for the effect of a home and crisis country's wealth on the likelihood of an international bailout. *Per Capita GDP (Home)*) is measured as the per capita GDP of the home country in thousands of US$. *Per Capita GDP (Crisis)* is measured as the per capita GDP of the crisis country in thousands of US$. Lastly, cultural and geographic proximity between the home and crisis states might also affect financial rescues, so we include the logged distance (in miles) between the home and crisis state. Data are from (Gleditsch and Ward, 2001).

Table 3 provides the descriptive statistics for all variables described above.

Variable	Mean	Std. Dev.	Min.	Max.	N
Financial Rescue (Dummy)	0.1100	0.3134	0.0000	1.0000	291
Trade Dependence	0.0023	0.0027	0.0000	0.0205	266
Bank Holdings	7,158	15,830	0	141,612	199
Election Indicator	0.1675	0.3027	0.0000	1.0000	296
GDP Growth (Home)	2.837	2.387	-3.548	11.488	296
Unemployment (Home)	6.9	3.2	2.2	20.1	278
Distance (Miles)	4,849	2,715	309	11,639	296
Per Capita GDP (Crisis)	11.2083	12.9640	1.2705	42.6937	296
Per Capita GDP (Home)	30.4212	13.2327	3.4276	95.6361	296

Table 3: Descriptive Statistics

4.2 Model Specification

Since the home country's choice to initiate a bilateral financial rescue is a dichotomous dependent variable, we estimate the following equation using logistic regression in order to test Hypotheses 1 and 2:

$$Pr(\text{Financial Rescue}_{ij} = 1 | X_{ij}) = P(\beta_1(\text{Trade Dependence}_{ij})$$
$$+ \beta_2(\text{Financial Dependence}_{ij}) + \beta_3(\text{Election Indicator}_j) \quad (1)$$
$$+ \beta_4(\text{Controls}_{ij}) + \gamma_k + \epsilon_{ij})$$

where *Financial Rescue*$_{ij}$ indicates the international financial rescue of of crisis country i by home country j. *Trade Dependence*$_{ij}$, *Financial Dependence*$_{ij}$, and *Election Indicator*$_j$ are the main variables that test Hypotheses 1-3 variable. *Controls*$_{ij}$ represents a vector of control variables that are expected to affect international financial rescues, namely the home and crisis country's wealth, unemployment rates in the home country, the distance between home and crisis country, as well as economic growth in the home country. Regional fixed effects are represented by γ_j. They capture regional-level characteristics that are shared across

home countries in the same region and may affect the likelihood of bilateral financial rescues. Finally, ϵ_{ij} is the error term.[21] In addition, we use robust standard errors to control for heteroscedasticity.[22]

To examine the effect of close elections on the likelihood of a bilateral financial rescue when the home country's economy is not doing well (Hypothesis 3), we include an interaction effect into the logistic regression:[23]

$$
\begin{aligned}
Pr(\text{Financial Rescue}_{ij} = 1 | X_{ij}) = P(\beta_1(\text{Trade Dependence}_{ij}) \\
+ \beta_2(\text{Financial Dependence}_{ij}) + \beta_3(\text{Election Indicator}_j) \\
+ \beta_3(\text{Election Indicator}_j * \text{GDP Growth (Home)}_j) \\
+ \beta_4(\text{Controls}_{ij}) + \gamma_k + \epsilon_{ij})
\end{aligned}
\tag{2}
$$

4.3   Empirical Results

Table 4 presents the main findings of the logistic regression. The table displays average marginal effects as they are easier to interpret than the coefficient estimates in a logit model.[24] Model 1 includes the main independent variables and several controls (including regional fixed effects), but omits the interaction term used to test the conditional election-proximity effect. Model 2 is identical to Model 1 except it adds an interaction between GDP growth and the election indicator in order to test Hypothesis 3.

The models fit the data very well. The Wald χ^2 is statistically significant indicating that we can reject the null hypothesis that together the independent variables have no effect on the likelihood of an international financial rescue. Turning to the substantive effects, the models provide substantial support for our three hypotheses. In general, we find that greater financial or trade exposure corresponds with an increased likelihood that a home country will offer a bilateral rescue package to a crisis country. Additionally, proximate elections in the home country are associated with a lower probability of bilateral rescue packages when home country's economy is doing poorly.

Providing support Hypothesis 1, we find that trade dependency has a positive and significant impact on the likelihood of a bilateral financial rescue. A one standard deviation increase in trade dependence between the home and the crisis country leads to a 10.8% (Model 1) /11.4% (Model 2) increase in the likelihood that a given home country decides to bailout a particular crisis country, *ceteris paribus*. We find similar effects (although substantively smaller) for financial interdependence. Supporting Hypothesis 2 we find that a one standard deviation increase in the logged

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[21]The results are substantively the same if regional fixed effects are excluded.

[22]Clustering standard errors by crisis or home country does not affect the results.

[23]Note, the individual term for *GDP Growth (Home)* is incorporated into $Controls_{ij}$.

[24]Coefficient estimates are presented in Appendix A.

	Model 1	Model 2
Trade Dependence	39.426***	41.649***
	(10.539)	(10.804)
Financial Dependence	0.027*	0.024*
	(0.014)	(0.014)
Election Indicator	-0.162**	-0.150**
	(0.077)	(0.06)
GDP Growth (Home)	0.005	0.006
	(0.011)	(0.012)
Unemployment (Home)	0.007	0.008
	(0.008)	(0.009)
Distance (log)	0.047	0.052
	(0.048)	(0.054)
Per Capita GDP (Crisis)	0.008***	0.008***
	(0.002)	(0.002)
Per Capita GDP (Home)	0.008**	0.007**
	(0.003)	(0.004)
Regional Fixed Effects	Yes	Yes
Observations	167	169
Wald χ^2	240.99**	246.03**
Pseudo R-squared	0.454	0.488

Robust standard errors in parentheses
Average marginal effects are displayed
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 4: The Domestic Politics of International Bailouts

amount of bank holdings increases the likelihood of a bilateral bailout by 5.9% (Model 1) / 5.3% (Model 2). These findings strongly suggest that governments are more attracted to bilateral financial rescues when the home country's economy is closely related to the crisis country's economy, and when negative spillover effects are likely. The findings support our theoretical argument and are in line with similar arguments made by Lipscy (2003).

Whether a government grants a bilateral financial rescue does not solely depend on economic factors, however. Table 4 provides clear support for the importance of domestic politics. If the home country's incumbent faces an election within one year, then the closer this election, the less likely is a bilateral bailout. The effect of the election indicator is statistically significant, and also substantively interesting. A one standard deviation increase in the closeness of elections in the home country leads to a 4.9% decrease in the likelihood of an international financial rescue, even though the model does not take into account regional elections or a delay in the provision of rescue packages.

Model 1 indicates that elections have an independent negative effect. Above, we argued that elections should only impact the government if the economy in the home country is already not doing well. To test Hypothesis 3 we analyze the effect of the election indicator on the likelihood of a bilateral financial rescue for different values of *GDP Growth (Home)*. Model 2 presents the main results when the interaction effect is included (we exclude the coefficient on the interaction effect, because we are presenting average marginal effects; the models with the coefficient estimates including the interaction coefficient can be found in Appendix A). Since interaction effects are difficult to assess, we graphed the marginal effect of the election indicator for various sample values of *GDP Growth (Home)* in Figure 3. The x-axis shows the values for *GDP Growth (Home)*, and the y-axis shows the average marginal effects of the election indicator (indicated by the solid line). We also graphed the 90%-confidence intervals as indicated by the two dashed lines.

Figure 3 provides support for the conditional effect of elections as described in Hypothesis 3. Whereas close elections have a detrimental effect on bilateral bailouts when economic growth in the home country is very low, this negative effect does not persist for higher levels of growth. Specifically, if GDP growth in the home country falls below 3%, the average marginal effect of the election indicator is negative and statistically significant. The size of the effect varies between about 1% and 5.3%. Elections have no effect on bilateral financial rescues whatsoever for growth levels between 3.5% and 5.5%. Finally, when the home country's economy is growing by at least 6% then elections actually have a positive an significant effect on the likelihood of a bilateral financial rescue.

The positive effect of the election indicator is interesting and was not anticipated by the theoretical model. One could interpret these findings as showing that, given the home economy is doing well, a majority of voters generally prefers a bilateral financial rescue.
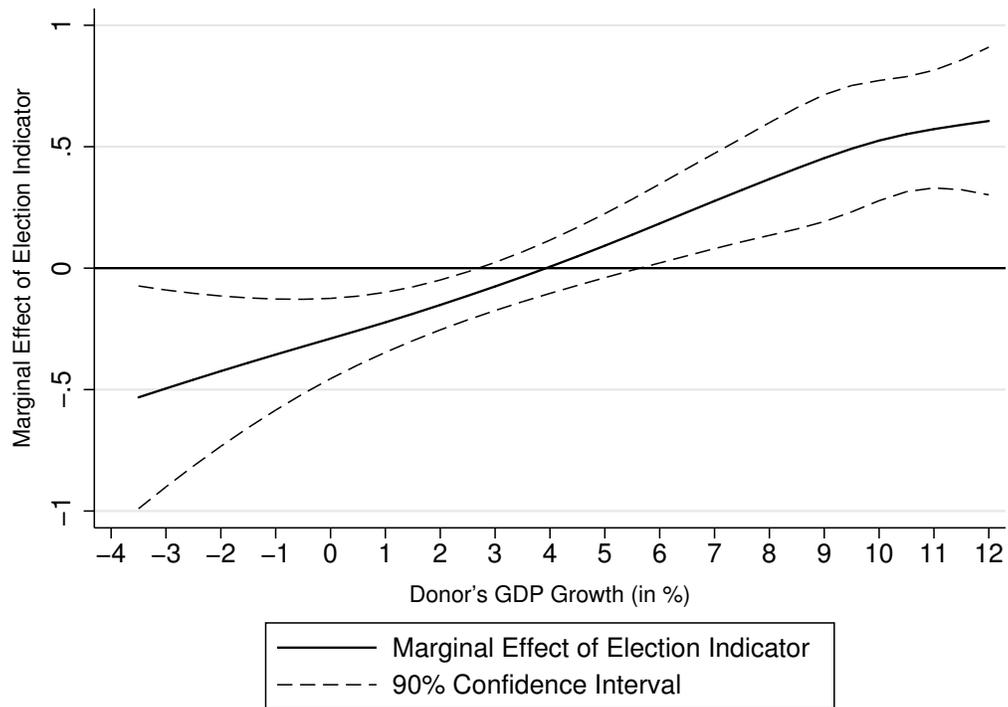
17

Figure 2: Effect of Elections on Bilateral Financial Rescues for Different Levels of the Home Country's GDP Growth

The findings for the control variables provide additional insights into the causes of bilateral financial rescues. First, from Table 4 it appears that economic growth in the home economy does not have a significant positive effect on bilateral financial rescues, but just acts as conditioning variable as demonstrated in Figure 3. Similarly, unemployment rates in the home country are not related to the likelihood of bilateral financial bailouts. As expected, we find that a home country's economic wealth contributes positively to the likelihood that a bilateral rescue package is offered. The greater the home country's GDP per capita, the more likely is a financial rescue. In addition, financial rescues seem to be more likely for crisis countries that are generally more wealthy as the positive and significant coefficient on *Per Capita GDP (Crisis)* suggests.

In sum analysis provides support for our theory that governments balance various, often contradicting domestic interests when deciding whether to provide a bilateral rescue packages to a country in financial trouble. Whereas economic and financial interdependencies create strong pressures to rescue the crisis country through a bilateral bailout that provides additional liquidity, close elections may reduce the likelihood of such a financial rescue particularly when the home economy is not doing very well.

4.4   Robustness

Empirical results are oftentimes fragile to different model specifications. To analyze the robustness of our results we estimated a number of models with additional independent variables and model specifications.[25]

Table 5 presents the estimation of Equation (1) with additional independent variables that could have an effect on the relationship between our main independent variables and the dependent variable. We include a measure for the total amount of bilateral loans provided by OECD countries (Model R1), the logged amount of the IMF loan provided to the crisis country (Model R2), a simple dummy for whether an election took place in the next twelve months (Model R3), and a measure for the population size of the crisis country (Model R4). First, the inclusion of none of these measures affects the relationship between our main independent variables and the dependent variable. Second, besides the population measure, none of the variables is significantly related to the likelihood of a financial crisis. The non-significant effect of the election variable is interesting, because it indicates that elections only matter if they are relatively close (as captured by the election indicator in the main models). In addition, note the insignificant effect of the IMF variable. One could have argued that bilateral bailouts are more likely when IMF

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[25]We do not present all findings of our robustness checks due to space constraints. For example, our main results are not affected by controlling for the home government's ideology, the amount of FDI from to the crisis country, or the political affinity between the home and the crisis country. Results are available from the authors.

	(R1)	(R2)	(R3)	(R4)
Trade Dependence	427.9*	596.6***	530.0***	764.5***
	(237.5)	(166.9)	(138.6)	(210.1)
Financial Dependence	0.593*	0.403*	0.414**	0.483**
	(0.336)	(0.233)	(0.209)	(0.225)
Election Indicator	-2.766*	-2.450*		-3.030**
	(1.578)	(1.385)		(1.350)
GDP Growth (Home)	-0.0244	0.0745	0.116	-0.0493
	(0.178)	(0.167)	(0.160)	(0.187)
Unemployment	-0.145	0.101	0.0799	0.0524
	(0.186)	(0.117)	(0.123)	(0.115)
Distance (log)	-0.0650	0.703	0.585	1.141
	(0.642)	(0.734)	(0.666)	(0.774)
GDP Per Capita (Crisis)	0.100**	0.114**	0.102***	0.0889***
	(0.0441)	(0.0522)	(0.0293)	(0.0338)
GDP Per Capita (Home)	0.0465	0.116**	0.117**	0.103**
	(0.0599)	(0.0526)	(0.0505)	(0.0518)
Total Bilateral Loans	0.0962			
	(0.0613)			
IMF Loan (log)		-0.00283		
		(0.571)		
Election (Dummy)			-0.970	
			(1.378)	
Population (Crisis)				-0.0173**
				(0.00805)
Regional Fixed Effects	Yes	Yes	Yes	Yes
Observations	161	167	167	167
Wald χ^2	.	217.6	218.0	264.7
Pseudo R-Squared	0.528	0.454	0.429	0.492

Robust standard errors in parentheses

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 5: Robustness: Additional Independent Variables

loans are too small to prevent contagion. The effect here indicates that this is not the case.[26]

	(R5)	(R6)	(R7)
	Logit	Logit	Tobit
Trade Dependence	829.1***	554.0***	161.9***
	(234.8)	(168.6)	(36.82)
Financial Independence	0.607*	0.417*	0.228***
	(0.354)	(0.239)	(0.0873)
Election Indicator	-2.787*	-2.339*	-1.033*
	(1.633)	(1.270)	(0.602)
GDP Growth (Home)	0.146	0.129	0.0325
	(0.212)	(0.174)	(0.0913)
Unemployment (Home)	0.236*	0.0945	0.0728
	(0.139)	(0.137)	(0.0571)
Distance (log)	0.871	0.635	0.287
	(0.936)	(0.712)	(0.249)
GDP Per Capita (Crisis)	0.144***	0.120***	0.0488***
	(0.0457)	(0.0384)	(0.0103)
GDP Per Capita (Home)	0.179**	0.0949*	0.0607***
	(0.0708)	(0.0569)	(0.0231)
Donor Fixed Effects	Yes	No	No
Regional Fixed Effects	No	Yes*	Yes
Observations	167	136	167
Wald χ^2	39.07	206.1	
Pseudo R-Squared	0.523	0.430	0.319

Robust standard errors in parentheses
*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 6: Robustness: Fixed Effects

Table 6 presents the results of different model specifications. In particular, we use donor fixed effects instead of regional fixed effects (Model R5), an estimation that excludes all donors that have never provided a bilateral financial bailout (Model R6), and a tobit estimation to account for the truncation of the dependent variable (Model R7). None of these specification changes affect the main independent variables.

Finally, Table 7 provides the results of estimations in which we controlled for different types of clustered error terms. We controlled for clustering by year (Model

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[26]Another interesting question for future rescues is whether bilateral rescues are more likely when the IMF rescue process is taking too long.

	(R8)	(R9)	(R10)
Clustering:	Year	Home Country	Crisis Country
Trade Dependence	596.5***	596.5***	596.5***
	(135.1)	(157.2)	(132.7)
Financial Dependence	0.403*	0.403*	0.403**
	(0.213)	(0.221)	(0.167)
Election Indicator	-2.452**	-2.452***	-2.452**
	(0.978)	(0.747)	(0.980)
GDP Growth (Home)	0.0744	0.0744	0.0744
	(0.0790)	(0.157)	(0.157)
Unemployment	0.101	0.101	0.101
	(0.148)	(0.104)	(0.150)
Distance (log)	0.704*	0.704	0.704
	(0.427)	(0.940)	(0.524)
GDP Per Capita (Crisis)	0.114***	0.114***	0.114***
	(0.0198)	(0.0315)	(0.0312)
GDP Per Capita (Home)	0.116***	0.116***	0.116***
	(0.0406)	(0.0438)	(0.0435)
Regional Fixed Effects	Yes	Yes	Yes
Observations	167	167	167
Pseudo R-Squared	0.454	0.454	0.454

Clustered standard errors in parentheses

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 7: Robustness Test: Clustered Standard Errors

R8), home country (Model R9), and crisis country (Model R10). Again, none of these changes affect the main findings.

5   Conclusion

In this paper, we analyze the domestic politics of bilateral financial rescues. We argue that governments have to balance different domestic pressures. On one hand, the greater the economic or financial integration of the home and the crisis economy, the greater are pressures to provide a bilateral rescue package that supplements an existing IMF rescue package with additional liquidity. On the other hand, if the home economy is not doing well, then such pressures are countered by greater demands for a redistribution of such resources towards the domestic economy. The closer elections in the home country, the more important are these demands to the incumbent government, and the less likely is a bilateral financial rescue, holding everything else constant. The findings of logistic regression models robustly support the theoretical argument.

Whereas our paper provides a first step towards a theory of the domestic politics of bilateral financial rescues, there are many questions that we could not address due to space constraints. For example, we used a measure of national legislative elections as a conservative strategy to test the effect of domestic politics on bilateral bailouts. We would expect that the effect of domestic politics to be much larger if one would also control for (important) regional elections, or if one would also analyze possible delay strategies as were used in Germany in 2010. As another example, the analysis has not included some factors that the public opinion research highlight to be important. Future research could analyze factors such as a country's overall attitude toward globalization, etc, in order to provide a more fine grained analysis of the relationship between public opinion and the provision of bilateral bailouts. Finally, whereas our paper focuses on the likelihood that a rescue package is provided, these financial rescues often look very different in terms of amounts provided, or conditionality imposed. In addition, as the German case demonstrated, the timing of bilateral rescue packages should be affected by domestic electoral politics. Our findings provide a basis on which theories about these questions can be developed.

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Appendix A

	Model 1	Model 2
Trade Dependence	596.5***	654.5***
	(169.9)	(196.0)
Financial Dependence	0.403*	0.380
	(0.229)	(0.235)
Election Indicator	-2.452**	-4.842***
	(1.249)	(1.604)
GDP Growth (Home)	0.0744	-0.0731
	(0.172)	(0.210)
Election * GDP Growth (Home)		1.232***
		(0.419)
Unemployment	0.101	0.120
	(0.120)	(0.142)
Distance (log)	0.704	0.810
	(0.714)	(0.849)
Per Capita GDP (Crisis)	0.114***	0.127***
	(0.0348)	(0.0409)
Per Capita GDP (Home)	0.116**	0.112**
	(0.0517)	(0.0553)
Regional Fixed Effects	Yes	Yes
Observations	167	167
Wald χ^2	225.6	238.1
Pseudo R-Squared	0.454	0.475

Robust standard errors in parentheses

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 8: Coefficient estimates for main models reported in Table 4