3.1 Allgemeine Angaben zum Teilprojekt D4

3.1.1 Titel:

Providing Macro-Economic Stability: The Politics of Private Sector Involvement in Sovereign Debt Crises

3.1.2 Fachgebiete und Arbeitsrichtung:

Political Science and Economics

3.1.3 Leiter/in:

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3.2 Zusammenfassung

3.2.1 Kurzfassung

Das Teilprojekt untersucht institutionelle und politische Determinanten der Einbindung des Privatsektors in das Management von Finanzkrisen in Schwellenländern sowie ihre Folgen mit dem Ziel, Funktion und Art der Mitregierung von privaten Geldgebern in Schwellenländern zu erfassen. Dazu werden zunächst verschiedene Interaktionsmodi zwischen Regierungen von Schuldnerländern und privaten Geldgebern analysiert (Schritt 1). Darauf aufbauend werden die Auswirkungen dieser Interaktionsmodi auf die Herstellung makroökonomischer Stabilität in den Schuldnerländern untersucht (Schritt 2).

3.2.2 Langfassung

Das Teilprojekt untersucht die unterschiedlichen institutionalisierten Formen der Einbeziehung privater Akteure in die Lösung von Schuldenkrisen, ihre politischen Determinanten sowie ihre Auswirkungen auf die makroökonomische Stabilität in den Schuldnerländern. Es fragt *erstens*, welche institutionellen und politischen Faktoren das Ausmaß des Einflusses privater Geldgeber auf Schuldnerregierungen im Kontext staatlicher Finanzkrisen beeinflussen und *zweitens*, welche Auswirkungen die resultierenden unterschiedlichen Formen des Einflusses privater Geldgeber auf die effektive Bewältigung staatlicher Finanzkrisen haben.

In den meisten Schwellenländern ist die Finanzierung von Staatsschulden durch private Geldgeber (vorwiegend aus OECD-Ländern) in den vergangenen Jahrzehnten deutlich angestiegen. Im Kontext einer Finanzkrise fällt der strategischen Interaktion von privaten Geldgebern und Regierungen von Schuldnerländern folglich große Bedeutung zu. Aus der Perspektive der Schuldnerregierung ist das Ziel dieser Interaktion die Herstellung von makroökonomischer Stabilität unter dem Druck des erwarteten Schuldendienstes. Aus der Perspektive der privaten Geldgeber geht es hauptsächlich um die Begrenzung finanzieller Verluste und daher um die Vermeidung eines Staatsbankrotts.

Vor dem Hintergrund relativ schwacher Regierungsstrukturen in vielen Schuldnerländern, die auch als Schwellenländer häufig Charakteristika „begrenzter Staatlichkeit“ (siehe Dachpapier) aufweisen, stützt sich das Teilprojekt auf die Ausgangsvermutung, dass private Geldgeber politische Einflussmöglichkeiten auf die Schuldnerregierungen aufzubauen versuchen, um die wirtschaftspolitischen Entscheidungen zu beeinflussen. Es ist jedoch wahrscheinlich, dass das Ausmaß dieses Einflusses in Abhängigkeit von verschiedenen institutionellen Faktoren im nationalen Raum variiert. Diesen Unterschied im Grad der Einbeziehung des Privatsektors in die Bewältigung von Finanzkrisen in Entwicklungsländern will das Teilprojekt erklären. Die abhängige Variable variiert dabei zwischen zwei Extremfällen: Einerseits kann der Privatsektor durch einen *bail-out* über staatliche Geldgeber (vor allem durch den IWF) komplett vor Verlusten bewahrt werden, während andererseits eine unilaterale Bankrotterklärung des Schuldnerstaats die privaten Geldgeber als *residual claimants* (Restforderer) in Umschuldungsverhandlungen und damit praktisch in die Akzeptanz von Verlusten zwingt. Zwischen diesen Extremfällen gibt es eine Reihe intermediärer Lösungen wie z.B. die zeitweilige Schuldenaussetzung, sog. *semi-coercive debt exchange offers* oder Vergleichsabkommen (*rollover agreements*).

Das Teilprojekt kombiniert Ansätze aus den Politik- und Wirtschaftswissenschaften, um einerseits diese Varianz zu erklären und andererseits die Auswirkungen unterschiedlicher Ausmaße des Einflusses von privaten Geldgebern auf die Schuldnerländer zu untersuchen.

3.3 Ausgangssituation des Teilprojekts

3.3.1 Stand der Forschung

While there is now a rich literature on economic determinants of sovereign debt crises[1], much less systematic research is available on political and institutional determinants, especially with regard to the involvement of private creditors. This is surprising, given that the provision of credits to sovereign countries takes place within a particular institutional and legal setting, characterized by a rather weak legal framework, limited sanction or enforcement possibilities, multilevel bargains involving domestic and international actors from both the private and the public sectors. Moreover, sovereign debt crises mainly (but not only) occur in countries with a relatively low degree of ‘state capacity’, thus making the joint management of internal and external pressures a particular challenge.

Given that particular setting, the project builds on the working assumptions that informal modes of interaction largely contribute to the management of sovereign debt crises and that private actors (i.e. mainly financial institutions from OECD countries) play a significant role therein. It thus looks at a specific type of public private interaction – private sector involvement (PSI) – and investigates under what form and with which effect private creditors are involved in the *Economic Governance* of debtor countries in a situation of financial distress.

Though there is a very large body of literature on sovereign debt issues, systematic knowledge on institutional and political determinants of PSI still appears underdeveloped. The project seeks to contribute to filling this gap by bringing together variables and approaches from the *Governance* literature in political science with hypotheses and approaches from economics. As such, it aims at producing an innovative research design that seeks to explain economic outcomes (different degrees of PSI and their effects) on the basis of underlying institutional and political determinants. Building on the emerging literature in economics on political determinants of debt crises (see Rijckeghem/Weder 2004 for an overview), it seeks to enrich existing approaches through the use of theories and hypotheses from political science (that mainly emerged in the context of the 1980s debt crises) and to extend the scope of the dependent variable to a variety of degrees of PSI.

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[1] It should be noted that in accordance with the relevant literature from both political science and economics on this topic, this project does not use the abbreviation ‘PPP’ (as most other projects in this SFB) but rather uses the widely used abbreviation ‘PSI’ for ‘private sector involvement’, referring to renegotiations of private creditors and debtor governments on sovereign debt. In accordance with recent research, this project adopts a rather large definition of sovereign debt crises by not only restricting it to a ‘technical default’ (defined as ‘a breach of any-one of the bond or loan covenants (…), which triggers a renegotiation process’, Pescatori/Sy 2004: 5). Indeed, in practice it can be assumed that debt crises generally involve all kinds of negotiations on the payments of interest and on debt restructuring events. Following Pescatori and Sy, this paper thus defines sovereign debt crises as events occurring when either a country defaults or its bond spreads are above a critical threshold (generally 1000 basis points above US Treasuries) which are assumed to trigger renegotiation procedures (see Pescatori/Sy 2004 for an excellent overview of the literature and the justification of this definition).

The project is embedded in, and seeks to contribute to, research on (1) theories of privately financed sovereign lending, (2) political determinants of sovereign defaults, and (3) concrete policy discussions on the international financial architecture.

(ad 1) Theories of privately financed sovereign lending

In its foundations, the project relates to the economic literature on *theories of privately financed sovereign lending*. The fundamental puzzle addressed in this literature is why private lenders provide financing to sovereign countries given the lack of general rules on sovereign bankruptcy procedures and thus lenders' lack of formal assurance to get back their capital lent to sovereign borrowers (for an overview see Eaton/Fernandez 1995). Several theoretical explanations have argued that the driving force behind private lending to sovereign borrowers is the lender's assurance to be repaid which derives from the sovereign borrower's knowledge that default will hamper access to capital markets in the future (cf. Atkeson 1991; Bulow/Rogoff 1988; Eaton and Gersovitz 1981). Thus, sovereign borrowers and private lenders are in a relationship of strategic interaction, which, in the event of financial distress in the borrowing country, yields different short- and long-term payoffs (see Sachs 1989 for an overview).

In the short-run, there are basically two corner solutions with several intermediate options (cf. Cline 2003; Roubini 2002; Roubini/Setser 2004). At the one extreme, there can be full recourse to public bail-out (e.g. through the IMF and thus indirectly by tax-payers in IMF member countries) without any direct implications for private lenders. At the other extreme, there can be a unilateral declaration of sovereign default, which pushes private lenders as the 'residual claimants' into a position of forced bail-in to recoup at least a share of their capital. In between these two extremes, a more applied body of literature has identified various forms of negotiated intermediate solutions such as temporary debt suspensions and standstills, semi-coercive debt exchange offers, semi-coercive rollover agreements, London Club agreements etc. (see Cline 1995 for an overview of cases the in the 1980s; Roubini/Setser 2004 provide an overview of cases in the 1990s).

These different short-run solutions have important long-run consequences. Repeated public bailouts create incentives for the private sector to engage in overly risky lending ('moral hazard'). Sovereign defaults come with high reputation costs for the sovereign borrower, making its future access to capital markets more difficult. Intermediate solutions, thus, combine aspects of moral hazard with reputation costs, striking some balance between the two.

Three basic conclusions can be derived from this literature. First, there are considerable differences in modes of PSI in the management of sovereign debt crises. Second, these modes are determined by some underlying strategic interaction. Third, this strategic interaction is heavily dependent upon the institutional context, in which it is embedded. There is now a growing literature in political economy that seeks to take these underlying institutional factors into account.

(ad 2) Political determinants of sovereign defaults

The literature on the comparative political economy of debt benefits from contributions by political scientists and economists, yet multidisciplinary studies combining methods, approaches and hypotheses from both disciplines are still rare (see also the recent article by Gould 2003; an exception is the volume by Haggard/Kaufman 1992 on a neighboring issue).

The literature from political science emphasizes that governments of debtor countries generally face two crucial constraints in their approach to situations of financial distress. On the one hand, they are under pressure from their constituencies due to actual and/or anticipated restrictive economic policies (tax increases, interest rate increases, spending cuts) and are thus confronted with their own political survival (see the literature on domestic 'audience costs', e.g. Fearon 1994; Schultz 2001). On the other hand, governments are aware that defaulting on debt and negotiations on debt rescheduling generate consequences for future borrowing in markets ('reputation costs' cf. Tomz 2001, forthcoming). The modalities underlying sovereign borrowing and defaults are thus largely structured within a set of bargains involving debtor governments, private creditors and international financial institutions. Most of the research from political science emerged in the context of the Latin American debt crisis of the 1980s and mainly sought to provide theoretically grounded explanations of the following aspects: domestic and international conditions under which governments suspend payments of their external debts (Frieden 1988; Snider 1990), different strategies of external bargaining used by governments under financial distress (Cohen 1985; Lehman 1993), different strategies of bargaining used by international organizations (Mosley u. a. 1991a, b), and institutional variables in domestic politics (see below, a good example is provided by Haggard/Kaufman 1992).

This literature faces three main drawbacks. First, it has not yet taken into account the role played by private creditors and thus lacks a crucial element in understanding debt bargains (an exception on the early stages of the Latin American Debt crisis is Gould 2003; Lipson also looks at private creditors but focuses on their negotiations with the IMF, Lipson 1985). Second, it is mainly based on isolated case-studies or comparisons of regionally similar cases, but basically does not test its claims in a broader sample (an exception is Tomz forthcoming). Third, it does not control for economic conditions affecting the bargains (which play a considerable role as shown by Detragiache/Spilimbergo 2000). The project seeks to overcome these drawbacks.

In recent years, literature in economics has put more and more emphasis on political and institutional variables in the analysis and prediction of external sovereign financing (for an excellent overview and summary analysis see Rijckeghem/Weder 2004). While not only focusing on sovereign defaults, but also looking at country creditworthiness as a dependent variable (see Keefer/Knack 2002 for an overview), this literature has developed hypotheses based on political and institutional variables: they include the sovereign's willingness to repay (e.g. Bulow/Rogoff 1988), polarization among decision-makers (e.g. Keefer/Knack 2002), veto-players (Alesina/

Drazen 1991), regime-type (Kohlscheen 2003), democratic vs. non-democratic countries (e.g. Rijckeghem/Weder 2004), the electoral calendar (Manasse u. a. 2003), and the quality of policies and institutions (Kraay/Nehru 2004).[2]

This literature provides some first and clear indications that political and institutional factors are important determinants of sovereign debt crises. There are, however, three main drawbacks in this literature, which this project wishes to address.

First, most existing studies look at a binary dependent variable, reduced to default or non-default outcomes. Any kind of rollover agreement or rescheduling is considered a 'default', although the financial implications for private creditors as well as their influence in negotiating the 'default' vary greatly. It would be of considerable interest to explain different types of crisis management on the basis of underlying political and institutional variables. Second, existing studies do not put sufficient emphasis on the room for maneuver of private creditors themselves. However, it would be surprising to assume that private credit provisions to sovereigns would not be followed by creditors' attempts to gain access to governments before the financing takes place (to reduce adverse selection) and to be closely associated to the management of public finances after the financing takes place (to reduce moral hazard). Third, while there generally is some link to the underlying literature in political economy (mainly formal game-theoretic models), no emphasis is put on theoretical arguments related to why and how political and institutional variables might affect the final outcome. This is an easily understandable issue of method: most economic analyses rely upon empirical investigation without undertaking process-tracing on selected case-studies. An exception is the literature by economic historians, which however has not been extended to cases of the 1980s and 1990s (see Eichengreen 1991 for an overview).

Given this state of research and its drawbacks, it appears highly relevant to systematically assess the determinants shaping the institutional setting, in which such bargains take place and to investigate whether there are correlations or patterns with regard to the results in terms of PSI in sovereign debt management. This is what the project will seek to undertake.

(ad 3) Policy discussions on the international financial architecture

In recent years, many *policy proposals on reforms in sovereign debt markets* have been floated. Most of these proposals recommend changes to the institutional or legal framework of international finance to increase the effectiveness of debt rollover or restructuring (for comparative overviews see Eichengreen 1999; Rogoff 1999; Roubini/Setser 2003). It is interesting to note, however, that there is little systematic evidence on how such proposals relate to current or past

[2] In addition, economic historians have demonstrated that specific institutional features affecting the context of sovereign credit agreements can significantly influence the level and risk premium of interest rates on sovereign lending. Using evidence from the late 19th and early 20th century, this work provides evidence that the underlying institutional setting is a key component in private creditors' willingness to lend to sovereign debtors. In particular, credit risks of emerging market economies were significantly lower in the context a concrete threat potential due to direct military threats in the British Empire (Ferguson 2003, Ferguson forthcoming, Mitchener/Weidenmier 2004) and in the 'Roosevelt Corollary' after 1904 (Weidenmier/Mitchener 2004).

practices in sovereign debt crisis management. Although institutional variables are at the core of these proposals, they are not derived from analyses of institutional determinants of sovereign debt crises and management. Many proposals are based on largely anecdotal evidence from recent financial crises of the so-called ‘third generation’ (Desai 2003; Eichengreen 2002, 2003; Kahler 1998; Krugman 2000) and concentrate on “sovereign debt restructuring mechanisms” or the introduction of “collective action clauses” (e.g. G7 2000, 2001; Krueger 2002; Meltzer 2000, 2002). Other proposals build on formal models but do not provide systematic testing of their claims (e.g. Becker u. a. 2001; Elderson/Perassi 2003; Jonas 2002; Kletzer 2003). These policy recommendations would benefit from a better knowledge of the institutional and political determinants of PSI and their ensuing impact on the effective debt crisis management. Ultimately, the project aims at providing a solidly researched foundation for such recommendations.

3.3.2 Eigene Vorarbeiten

The project builds on relevant theoretical and practical background knowledge in the area of sovereign debts. However, given the early stage of the principal investigator’s own research career (he took up my Junior-Professorship in the fall of 2003) it also constitutes an opening towards a new area of expertise. Enderlein’s background knowledge on theoretical issues in international political economy derives from research on European monetary integration and its implications for the Member States (Enderlein 2003, 2004a, b, 2005b). Concerning the substance of the current project, relevant practical background knowledge was assembled during two years of work experience in the Directorate International and European Relations of the European Central Bank. Concerning methods and the interdisciplinary approach, all of Enderlein’s previous research has brought together theory building and methods from both political science and economics (Enderlein 2004a, 2005a).

3.3.3 Liste der publizierten einschlägigen Vorarbeiten

I. Referierte Veröffentlichungen

a) in wissenschaftlichen Zeitschriften

Enderlein, Henrik (2004b). “Break it, Don’t Fix it!”, in: Journal of Common Market Studies, 42: 5, 1039-1046.

--- (2001). „Adapt a Winning Team. Die Auswirkungen der Europäischen Wirtschafts- und Währungsunion auf Konjunkturzyklen und die wirtschaftspolitischen Institutionen, in: Österreichische Zeitschrift für Politikwissenschaft 2001/3, 257-274.

b) auf wesentlichen Fachkongressen

c) in monographischen Reihen

Enderlein, Henrik (2004a). „Nationale Wirtschaftspolitik in der europäischen Währungsunion“. Frankfurt/Main, Campus.

--- mit J. Lindner, O. Calvo-Gonzales, R. Ritter (2005a): “The EU budget - how much scope for institutional reform”, in Helge Berger und Thomas Moutos (Hrsg.): Designing the New EU, Boston.

II. Nicht referierte Veröffentlichungen

d) in wissenschaftlichen Zeitschriften

Enderlein, Henrik (2000). „Wechselnde Ansichten zu Wechselkursen: Über die Bedeutung der Verknüpfung politischer Lernprozesse und ökonomischer Mechanismen in der Geschichte der europäischen Währungskooperation“, in: Politische Vierteljahresschrift 41(4), 771-775.

e) auf wesentlichen Fachkongressen

Enderlein, Henrik (2004c). „Analyzing Patterns of Economic Stabilization: Past Experiences and Present Challenges”. Paper presented at the CES-Conference in Chicago, March 2004.

--- (2003). “Adjusting to EMU: The impact of monetary union on domestic fiscal and wage-setting institutions”. Paper presented at the EUSA Conference in Nashville, March 2003

f) in monographischen Reihen

Enderlein, Henrik (2005b). “Fraternal Twins: Why the Fed and the ECB are more similar than often suggested”, in J. Hölscher and H. Tomann:The Globalization of Capital Markets. London.

3.4 Planung des Teilprojekts

3.4.1 Forschungsziele und Leitfragen

The project aims at developing systematic knowledge on institutional and political determinants of private sector involvement (PSI) in the management of sovereign debt problems in developing countries and on their effects. Looking at the issue from a *Governance* perspective, the project first assesses the determinants of different degrees of private creditor involvement in economic policy choices in situations of financial distress (stage 1), before seeking to determine the impact of such different degrees of PSI in solving debt crises in an effective manner (stage 2).

Overcoming sovereign debt crises is a key challenge in developing countries that increasingly rely upon resources from private creditors. When facing periods of financial distress, governments are faced with different (and often divergent) options on how to ensure the provision of macro-economic stability under the constraint of servicing their external debt. Private creditors, as potential victims of a government decision to default on debt can be assumed to seek ways to assist governments in their policy choices and to exert influence as soon as a debt crisis is likely to emerge. Given that sovereign debt crises mainly (but not only) occur in countries with a relatively low degree of ‘state capacity’ (see the framework paper for the relevant definition), questions on the type and the effect of private creditors’ involvement in government economic policy choices emerge. Do situations of financial distress lead to co-government by private creditors (*mitregieren*, as discussed in the framework paper)? Do debtor governments seek to resist influence by private debtors and to play a ‘hard’ game (as recently observed in the case of Argentina)? How do multilateral actors, such as the IMF, influence that bargain between private creditors and governments?

Managing sovereign debt crises in developing countries involves bargains and interactions at the domestic level (e.g. within government, with parties and interest groups) and at the international level (e.g. with International Financial Institutions, rating agencies, private creditors). With regard to the specific role of private creditors, it is surprising how little attention has been paid to their roles and strategic orientations during these bargains. Yet the incentives for private creditors to engage very actively in the conduct of domestic politics are considerable: potential losses from sovereign defaults are high, alternative solutions (mainly an IMF bailout) can safeguard the investment, and even intermediate solutions generally yield much more favorable outcomes than a government default. Taking these incentives into account, it would be surprising to assume that the provision of privately financed credit to countries with a low degree of state capacity could be reduced to a simple matter of providing finances. Rather, creditors with a stake in the finances of a country should be assumed to seek ways to gain access to governments before the financing takes place (to reduce adverse selection) and to be closely associated to the management of public finances after the financing takes place (to reduce moral hazard). In the case of a financial crisis, efforts to assist, influence or threaten governments are likely to get even stronger.

On the foil of different bargaining options and outcomes in private creditors' and governments' strategic interaction under the constraint of a financial crisis, this project asks two main research questions:

(1) Which institutional and political determinants shape the degree of influence of private debtors in sovereign debt crises? The first stage of the project aims at providing systematic knowledge of the underlying institutional and political determinants of different degrees of PSI.

(2) What is the impact of different degrees of PSI on the nature of crisis management and resolution of sovereign debt crises? Building on the index of different degrees of PSI, the second stage of the project will seek to identify how PSI influences the effectiveness of domestic *Economic Governance* in situations of financial distress.

As these two questions indicate, the research-design is based on a two-stage approach, whereby the second stage builds on the results of the first. In stage one the project seeks to explain different levels of the involvement of private creditors in a financial crisis on the basis of institutional variables. In stage two, building on the index of different degrees of PSI, the effectiveness of the management of sovereign debt crises is systematized and explained. This means that the dependent variable of stage one will become the independent variable in stage two.

Fig.1 Independent-Dependent Variables

INDEPENDENT VARIABLES		*DEPENDENT VARIABLES*
Stage 1		
Set of institutional variables	→	Different degrees of PSI
Stage 2		
Different degrees of PSI	→	Nature of domestic *Economic Governance* and effectiveness of crisis management

The project will use both qualitative and quantitative methods. Empirical investigations will be used in stages one and two. Qualitative approaches will be used in stage one only.

(ad 1) Determinants of different degrees of PSI in the management of sovereign debt crises

As sketched out above, PSI is not always based on a voluntary decision by private creditors. It can either be unilaterally initiated by the sovereign borrower through a declaration of default or can be completely prevented in a process of public bailout. In between these two extremes, there are various forms of negotiated intermediate solutions such as temporary debt suspensions and standstills, semi-coercive debt exchange offers, semi-coercive rollover agreements, London Club agreements etc. There is thus a considerable degree of variance in the dependent variable. As noted above, this variance is not taken into account in most existing studies of political determinants of sovereign debt crises. However, by restricting the outcome of the bargain to either 'default' or 'non-default', these studies fall short of the considerable room for maneuver that characterizes private creditors' strategies in debt crises.

A few authors have already presented preliminary attempts to (Cline 2003; Roubini 2002; Roubini/Setser 2004) classify modes of PSI as a function of the degree of private creditors' voluntariness to engage in PSI. Table 1 builds on these classifications to present a first preliminary classification (largely based on Cline 2002). At the top of the table, some form of mutual consent between creditors and debtors can be taken for granted, whereas types at the bottom refer to unilateral actions by debtors that normally imply losses for private creditors and thus generally also some kind of negotiations on rescheduling.[3] I have added examples from Cline (2002) and own preliminary research.

[3] Cline includes two additional types: (1) Bond rescheduling through collective action clauses and (2) Officially approved standstill. Both are ranked directly below Bond exchange and forgiveness. Both types refer to policy proposals which are presently under discussion, but never occurred in practice.

Tab. 1: Types of PSI

Types of PSI	Examples
No PSI (mainly: IMF bailouts)	e.g. Uruguay 2002
Spontaneous lending	Mexico, 1993-1994
Foreign direct investment	
Maintenance of bank credit lines	Brazil 1999, Turkey 2000
Medium-term conversion of bank credit lines	Korea 1998
London club rescheduling	Frequently used in Latin American debt crises of the 1980s
London club concerted lending	Rarely used in Latin American debt crises of the 1980s
Bond exchange maintaining value	Pakistan 1999, Ukraine 2000, (Argentina 2001)
Brady bond debt reduction	Frequently used in Latin American debt crises of the 1980s
Bond exchange and forgiveness	Russia 1998, Ecuador 1999
Outward capital controls	Malaysia 1998
Default	Many Latin American debt crises of the 1980s, Indonesia 1998, Russia 1998, Ecuador 1999, Argentina 2002.

In seeking to explain different degrees of PSI, the project will seek to make Cline's rather anecdotal classification of modes of PSI more operational and to construct an index of objectively derivable *degrees* of PSI, which can than serve as the *dependent variable* to be explained by political and institutional variables.

The *explanatory variables* will be derived from three main features that characterize sovereign debt bargains:

- their *multilevel* nature: bargains involve sovereign borrowers (mostly emerging market economies with a low degree of state capacity), private lenders (mostly international financial intermediaries such as banks and investment funds), international organizations (mainly the IMF and to some extent the World Bank);
- their *heterogeneous incentive structures*: bargains are shaped by various incentives, including domestic political incentives (e.g. re-election considerations by governments in borrowing countries), domestic economic incentives on development (e.g. growth and financing strategies), international (or systemic) political incentives on overall financial stability (e.g. considerations on moral hazard issues by the IMF), international (or systemic) economic incentives on profits (e.g. by banks and funds);
- their *varying degree of organizational embeddedness*: bargains take place in different organizational environments (ranging from institutionalized fora such as the London Club and the Paris Club to more improvised ad-hoc meetings of a bi- or multi-lateral nature) and are generally not based on a solid legal framework but on a multitude of weakly formalized or completely informal relationships.

These three characteristics are constitutive elements of the institutional setting in which players, bargaining over the outcome of debt management crises, interact. Consequently, the project relates its hypotheses to actor preferences and will seek to incorporate the following main variables in its empirical investigations and case studies.

Hypotheses can be formulated with regard to the preferences of three types of actors involved in a stylized debt bargain: (i) national governments of the borrowing country, (ii) private creditors, (iii) the IMF as the primary candidate for public bailout.[4]

National governments' preferences and strategic orientations are likely to be influenced by the following constraints:

(1) The *constitutional regime-type:* On the basis of the seminal paper by North and Weingast (1989), several recent papers have tried to find causal links between constitutional regime types and sovereign debt risk or likelihood to default and come to the conclusion that democracies are generally less likely to default than authoritarian regimes (Rijckeghem/Weder 2004) and there might even be indications that parliamentary democracies could be less crisis prone than presidential democracies (Kohlscheen 2003). The key argument in this hypothesis is that representative political systems are more likely to service their debt given the stronger commitment mechanisms on which they are built (e.g. Schultz/Weingast 2003).

(2) The *length of the remaining electoral cycle:* Governments with shorter remaining electoral cycles might have stronger incentives to take decisions in favor of voters' considerations and refrain from adopting adjustment programs – and thus default more easily. By contrast, governments in the beginning of their electoral cycle might decide to aggressively reduce their deficit spending and/or give in more easily to austerity requests by the IMF. While there are some initial tests of such arguments in Manasse u.a. (2003), Buissère u.a. (2000), and Rijckeghem and Weder (2004), more solid tests based on the theoretical framework developed in Alesina, Roubini, and Cohen (1997) are still missing.

(3) The *polarization of government:* Based on an influential argument by Alesina and Drazen (1991), one can argue that sharing the burden of domestic adjustment policies to service external debt may raise challenges within coalition-governments on the burden sharing of reform costs. The higher the number of parties in a political system, the lower is the systems' reliability to pay back debts (a similar argument on industrialized countries can be found in Roubini/Sachs 1989).

(4) The role of *veto-players* in the economy: While the general argument on veto-players is straightforward and closely linked to regime-types (Tsebelis 2002), additional arguments on interest representation are more subtle and require knowledge on the veto-power of players repre-

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[4] The project does not include the twenty-seven so-called Heavily Indebted Poor Countries (HIPC) which are covered under the IMF's and the World Bank's joint HIPC initiative of 1996, it restricts itself to emerging market economies that generally bargain directly with the IMF.

senting certain interests. A default on external debt might be favored by certain groups within society and opposed by others. Following Frieden (1988), one might argue that class and sector interests matter in player's preferences and thus influence in what way they can use an eventual veto-power. Simplifying Frieden's arguments, one could assume that wage-earners would prefer default over austerity programs whereas capital intensive producers and bankers would prefer the opposite.

Private creditors can be assumed to know about debtor governments' constraints and strategies. Their own orientation is likely to be influenced by:

(5) The *degree of difficulty to aggregate their own interests:* A large and disaggregated group of private creditors will face more difficulties in building up pressure on governments, since every single creditor constitutes only a minority. Creditors' capacity to obtain concessions from debtor governments (e.g. the acceptance of IMF austerity programs to ensure bailout) thus decreases with a larger number of debt-holders due to interest aggregation costs (also Eichengreen/Mody 2003; cf. Lipson 1985).

(6) The *presence of collective action clauses in the debt instrument*: A collective action clause allows a predefined share of creditors to strike a deal with debtor governments that would be binding for all debtors (cf. Eichengreen/Mody 2004). Although collective action clauses are mainly limited to bonds issued in London and have basically never been applied, their presence or absence is likely to affect the strategic orientation of private creditors.

(7) The *degree of previous access to, and influence on, debtor governments* is likely to increase private debtors' capacity to pressure for their most preferred policy outcome (IMF bailout). There are obvious problems related to the operationalization of this variable. Proxies could be the previous degree of credit exposure as suggested by Gould (2003).

The IMF can be assumed to know about debtor governments' and private creditors' constraints and strategies. Its own orientation is likely to be influenced by:

(8) *Considerations on moral hazard*, deriving from previous public bailouts in the country under financial distress (c.f. Powell/Arozamena 2003). Previous bailouts are likely to reduce the IMFs willingness to re-engage in bailouts thus increasing the likelihood of direct negotiations between debtor governments and private creditors.

(9) *Considerations on its own finances*, based on previous financial exposure to the country. Higher IMF exposure to the country could result in higher willingness to provide additional resources (c.f. Mussa 2002). One might argue, however, that this hypothesis is in some contradiction with the previous hypothesis.

(10) *Considerations on its own credibility*, based on previous statements on conditionality and non-bailout (cf. Eichengreen/Ruhl 2001). Previous public statements by the IMF on ending fi-

nancial support to countries in financial distress are likely to increase pressure on debtor governments to negotiate directly with private creditors.

Obivously, these variables will be analyzed in conjunction with the main control variables on economic conditions (as in Kraay/Nehru 2004).

(ad 2) Assessing the effectiveness of PSI in sovereign debt crisis prevention and management

Building on the typology of PSI as explained in stage one, the second stage of the project will seek to establish explanations of the effectiveness of crisis management. The aim of this second stage is to gain insight on whether different modes of involvement of private debtors' in debt negotiations will affect a debtor state's capacity to overcome the debt crisis. As mentioned above, the method used in stage two will be quantitative only.

The effectiveness of sovereign debt crisis management can obviously be assessed from many perspectives. Taking up the three groups of actors of stage one, the following considerations on crisis management effectiveness can be looked at.

From the *perspective of the debtor country,* two key dimensions of effectiveness are of most interest for this specific project.

First, one can assume crisis management to be effective if the situation of public finances in the debtor country improves. This is mainly the case if one crisis event does not trigger another crisis event. One could label this aspect the necessary condition of crisis effectiveness.

Second, from the perspective of the debtor country itself, crisis management can be assumed to be effective if domestic economic conditions improve, i.e. if growth rates rise, unemployment falls, and inflation rates do not get out of control. In short, a decrease in Okun's 'misery index' (combining unemployment and inflation) or a similar index can show that the domestic economy has not been significantly punished by efforts to overcome the crisis. Obvious questions on this point relate to the time-horizon of economic improvements in the domestic economy after the crisis. One might assume that economic conditions should not have deteriorated for 3 years after the crisis, though other time-horizons might be chosen. One could label this aspect the sufficient condition of crisis effectiveness.

From the *perspective of private creditors*, there is probably only one relevant indicator of crisis management: the ratio of losses compared to the initial investment (cf. Klingen u. a. 2004). More effective management is likely to result in lower losses – and the opposite.

From the *perspective of the IMF*, assessing views on the effectiveness of crisis management is a difficult exercise. While the IMF might fully subscribe to the two conditions spelled-out above from the perspective of the debtor country (crisis and in combination with a decrease in the Okun index), one should also look at financial implications for the IMF resulting from crisis management (e.g. Vaubel 1996; Vaubel/Willett 1991).

Given these different readings of 'effectiveness', different quantitative regressions will have to be undertaken to measure the effect of different types of PSI on management effectiveness.

The working hypotheses will have to be re-specified on the basis of full knowledge on the independent variable, the full scope and range of which will only be known at the end of stage one of the project. However, even at the present stage, the following preliminary and rather broad expectations on causal relationships can be formulated:

1. An earlier or stronger involvement of private creditors in negotiations with countries in financial distress is likely to result in a more favorable outcome for the debtor country and for private creditors (cf. Gould 2003 for a related argument).
2. An earlier or stronger involvement of the IMF in negotiations with countries in financial distress is likely to result in a more favorable outcome for the debtor country and for the IMF (see however the highly mitigated results by Przeworski/Vreeland 2000, as well as Vreeland 2002 on the impact of IMF programs on growth and employment).

3.4.2 Methode und Operationalisierung

Design and operationalization of the variables

In its *first stage*, the project will use statistical analysis and qualitative process-tracing to explain the degree of PSI as the dependent variable (rather than *default* or *non-default* as most existing approaches) on the basis of a set of institutional variables. In *stage two*, the degree of PSI will be used as the independent variable to empirically test its relationship with the effectiveness of crisis management. Qualitative process-tracing on four selected case-studies will be applied in stage one only, since case studies on both steps of research do not appear feasible within a time-horizon of four years. The project thus aims at providing a double perspective on the issue: on the one hand a broad macro-approach (based on roughly 200 crises events between 1975 and 2002); on the other hand a more narrow but in-depth micro-approach (based on four case-studies from the 1990s).

In stage one, we will seek to explain a newly constructed indicator of the degree of private sector involvement in situations of financial distress on the basis of institutional and political indicators. The methods will be both quantitative and qualitative. While both project assistants will start their work with the construction of the datasets for the dependent and the independent variables, one of them will then overtake the empirical work to estimate the effect of the selected institutional and political variables on types of involvement of PSI (controlling for various economic indicators), whereas the other one will select four cases of PSI on the basis of a more restrictive set of hypotheses and undertake process-tracing in the selected countries.

Concerning the independent variables of the first stage, the project will build on a wide array of existing datasets on institutions (mainly the Database of Political Institutions) and undertake its own data collection to refine this set and add new elements in accordance with the working hypotheses.

Concerning the dependent variable, variance is based on the degree of PSI. As already referred to above (see Table 1), there are some preliminary attempts to classify types of PSI on a scale ranging from full public bailout (meaning a complete absence of PSI) to unilateral default (meaning a completely forced involvement of the private sector). However, the different existing distinctions of types of PSI that have been suggested by Cline or Roubini (Cline 2003; Roubini 2002; Roubini/Setser 2004), and that are underlying Table 1, are for the time being rather anecdotal: they do not provide a rigorous formal approach to classifying different degrees of PSI. In a first step of the analysis, available datasets will thus have to be examined with the purpose to determine their usefulness for the classification of different degrees of PSI. The data most widely used are (i) the S&P dataset on external debt, (ii) the World Bank dataset on external debt as provided in the Global Development Finance, (iii) data on IMF financing or agreement, (iv) data on debt restructuring from the London Club or the Paris Club. To build a reliable and formalized indicator of different degree of PSI, the project might have to combine existing datasets and possibly conduct its own data collection. Systematic coding of qualitative accounts of episodes of PSI as provided by the IMF and the World Bank could be part of own data collection.

The *second stage* of the project will be restricted to empirical investigations by one of the two project assistants: the second project assistant working on the case-studies will need time to complete and evaluate field-work. The empirical investigation of the project will build on the typology of different types of PSI to estimate its impact on the effectiveness of debt crisis management.

The dependent variable used in this second stage can take different forms and will be determined at a later stage of the project. Obvious possible proxies for the effectiveness of PSI – that could possibly be aggregated within a composite indicator of PSI effectiveness – are the following:

- crisis duration since the beginning of PSI,
- crisis frequency since the beginning of PSI,
- amount of losses for the private sector in negotiations,
- amount of co-financing by the IMF.

Case selection

In its empirical investigation the project will consider all cases of financial distress in emerging market economies since 1975, but will exclude cases of countries that would today be classified as ‘Heavily Indebted Poor Countries’ (HIPC), i.e. countries that face an unsustainable debt situation[5] after the full application of the traditional debt relief mechanism and that are classified as

[5] According to the HIPC initiative’s definition, a country's debt level is considered unsustainable if ‘debt-to-export levels are above a fixed ratio of 150 percent; or, where countries have very open economies where the exclusive reliance on external indicators may not adequately reflect the fiscal burden of external debt the debt-

the poorest countries.[6] The reason for the exclusion of the poorest and most heavily indebted countries directly stems from the relatively little degree of private sector involvement in these cases and the large number of 'failing' states in that category. For the remaining group of countries, situations of financial distress will be defined in accordance with Pescatori and Sy (2004) as either any type of technical default, defined as a breach of the bond or loan covenants, which triggers a renegotiation process, or as bond spreads above a critical threshold – generally 1000 basis points above US Treasuries.[7] For each of these cases of financial distress, the degree of PSI will be determined.

In its country analyses, the project will process-trace for four individual cases. These cases will be selected on the basis of methodologically sound research criteria (most similar or most different) in the first steps of stage one (see King u. a. 1994 on case selection). In all likelihood, cases will be chosen from the 1990s and will vary on the dependent variable, i.e. they will differ in the resulting degrees of PSI. For illustrative purposes, the calculation of the project costs is based on a sample of Argentina, Brazil, Indonesia, and Korea. Such a sample would bring together cases where the interaction between governments, private creditors, and the IMF resulted either in defaults (Argentina and Indonesia) or non-default (Brazil and Korea) and where the degree of PSI seemed to vary significantly (for the purpose of this table, the classification 'Degree of PSI' is based on an ad hoc classification on the basis of IMF publications on the four cases).

Tab. 2: Possible case selection

Case	**Degree of PSI**	**Outcome**
Argentina (2001-2002)	Strong PSI	Default
Korea (1998-1999)	Strong PSI	No Default
Indonesia (1998-1999)	Weak PSI	Default
Brazil (2001-2002)	Weak PSI	No Default

Such sample could be justified on the basis of a rather narrow time-period (1998-2002 - thus reducing the impact of exogenous macroeconomic circumstances), the concentration on two different regions (with cases of default/non default and strong/weak PSI in both regions). Final case selection will however only be possible once the index "Degrees of PSI" will be established.

to-government revenues are above of 250 percent.' (cf. the information on the HIPC initiative on www.worldbank.org/debt).

6 According to the HIPC definition, they are 'only eligible for highly concessional assistance from the International Development Association (the part of the World Bank that lends on highly concessional terms), and from the IMF's Poverty Reduction and Growth Facility' (idem).

7 Pescatori and Sy determine 275 cases of situations of financial distress between 1975 and 2000. However, as their list includes HIPC cases which will have to be filtered out, the final number of cases will be lower and can be estimated at around 200 cases.

3.4.3 Arbeitsprogramm und Zeitplan

During the first four years, the project will proceed in four steps. As the project explicitly aims at proceeding in a multidisciplinary way, the first three of these steps will have an “economic component” (E) and a “political science component” (PS).

(1) (E) Building an index “Degrees of PSI”: Building on existing research in economics, the first step will be an assessment of available data on the magnitude, modes, and types of PSI, possibly also involving data collection or combination. The aim of this step is to formalize the anecdotal classifications suggested by Cline and Roubini (Cline 2003; Roubini 2002; Roubini/Setser 2004) and to establish an indicator that could be used in empirical investigations. The indicator to be constructed will serve as the dependent variable of stage 1 in the project.
(PS) Building a dataset “Institutional and Political determinants of PSI”: Based on an in-depth assessment of existing theories from economics and political science, a dataset of independent variables of an institutional and political nature will be constructed. While this dataset could possibly build on existing datasets (such as the Database of Political Institutions), the aim is to include additional variables and to bring the data closer in line with standards in comparative politics. This dataset will provide independent variables for stage 1 of the project.

Moreover, on the basis of this dataset and on the working assumptions, four case-studies will be selected for process-tracing in step three.

(2) (E) Estimating the effect of political and institutional variables on degrees of PSI: Based on the results of step one, empirical analyses will be undertaken to come to a comprehensive assessment of the institutional determinants of different degrees of PSI. The aim is to produce a publishable paper on political determinants of PSI, which would have more variance in the dependent variable than existing approaches.
(PS) Process-tracing of particular case-studies: Four individual cases will be covered in detail. The aim of these case studies will be to gain in-depth knowledge about the explanatory factors underlying different degrees of PSI in emerging market economies. In this step, interviews in the four selected countries will be undertaken (mainly with Ministries, the Central Banks, private bankers etc.)

(3) (E) Building an index “Effectiveness of Sovereign Debt Management” and estimating its underlying determinants: Taking into account existing approaches on the effectiveness of sovereign debt management, an index on the effectiveness of debt crisis management will be constructed and analyzed on the basis of different modes of PSI. Once the indicator constructed, empirical assessments will be undertaken. The aim is to produce a publishable paper on the effectiveness of PSI
(PS) Assessing the case-study results: Analyzing the knowledge gained from fieldwork in step 2, a theoretically grounded evaluation of patterns of interaction in sovereign debt bargains will be

developed. The aim is to prepare a publishable study in comparative political economy, based on four cases that would explain patterns of PSI in sovereign debt crises.

(4) Assessment and agenda for further research: In step four, summary analyses and articles would be prepared to present the results of the project. The aim would be to address the publications to audiences in both political science and economics. Moreover, building on the results achieved in the analysis of the large data set, the project expects to be able to develop new hypotheses, and to determine test cases that would be looked at in the second phase of the project.

Arbeitsschritte	**2006**		**2007**		**2008**		**2009**	
(E) Building an index "Degrees of PSI"								
(PS) Building a dataset "Institutional and political determinants of PSI" and selecting cases								
(E) Estimating the effect of political and institutional variables on types of PSI								
(PS) Process-tracing on particular case studies (field work)								
(E) Building an index "Effectiveness of Sovereign Debt Management" and its underlying determinants								
(PS) Evaluating case-studies on PSI in sovereign debt crises								
Assessment and agenda for further research; project report								

As the project-director is employed on a fixed-term position, the long-term perspective of the project is obviously dependent on future employment perspectives. Should a continuation be possible, the following perspectives could be developed:

In the second phase of the project, the results obtained in phase one could be put into a wider context and solidified through the introduction of further hypotheses. Further field work could be undertaken to ground the empirical results of stage two in phase one in comparative case-studies. Possibly, the scope of the relationships between the variables in part 1 of the project could extended to broader systemic variables, such as participation of the borrowing country in a regional agreement, the presence of a 'shadow of hierarchy' (as theorized by economic historians for cases of the late 19th and early 20th century), the role of negotiations in the London Club or the

Paris Club, the involvement of private creditors' association (such as the Institute of International Finance). It could also be extended to HIPC cases. The project would also certainly benefit from insights gained by other projects on PPPs within this SFB, so as to adjust its hypotheses and extend them further, e.g. with regard to the impact of the effectiveness of PSI on crisis management.

The third phase of the project could then be used to combine elements from phases one and two with the goal to come to highly systematized conclusions on how to enhance the involvement of private actors in sovereign debt crises and to foster systemic stability in international financial relations.

3.5 Stellung innerhalb des Sonderforschungsbereichs

Innerhalb des SFB untersucht das Teilprojekt mit dem Bereich Finanzierungsfragen einen spezifischen Teilaspekt der Politik in Räumen begrenzter Staatlichkeit. Da die im SFB untersuchten Räume fast notwendigerweise niedrigere Entwicklungsstandards aufweisen als OECD-Länder, fällt der Frage nach der Umsetzung von wirtschaftspolitischen Zielen unter der Berücksichtigung externer Einflussmöglichkeiten erhebliche Bedeutung zu. Die Finanzierung von Wirtschaftspolitik in Entwicklungsländern stellt eine wichtige Schnittstelle zwischen nach innen und nach außen gerichteten Politikzielen dar, die gerade in Krisensituationen und die damit verbundene direkte Verbindung zu privaten Akteuren (hier Kreditgeber) Aufschluss über die Möglichkeiten und Grenzen effektiven Regierens in den betroffenen Ländern geben kann.

Das Teilprojekt bettet sich also direkt in den Projektbereich D „Wohlfahrt und Umwelt" ein, der der Frage nach der Bereitstellung materielle Gemeinschaftsgüter im nationalen Raum und den damit in vielen Bereichen verbundenen transnationalen Verbindungen zu privaten Akteuren untersucht (Projektbereich D). Die Fragestellung ist parallel zu D1 Risse/Beisheim zu sehen, insofern es zunächst um unterschiedlich institutionalisierte Formen der Einbeziehung privater Akteure in die Herstellung von Gemeinschaftsgütern und anschließend um deren Effektivität geht. Im Unterschied zu D1 Risse/Beisheim, aber auch zu D2 Börzel/Héritier und D3 Fuhr, wird allerdings inhaltlich auf eine andere Literatur aus dem Bereich der internationalen politischen Ökonomie zurückgegriffen. Darüber hinaus untersucht das Teilprojekt mit der als *Private Sector Involvement* bezeichneten Form von PPP eine spezifische Unterkategorie, die sich im Gegensatz zu den anderen beteiligten Teilprojekten durch die weitgehend unfreiwillige Einbindung des Privatsektors in politische Problemlösungsversuche kennzeichnet. In der Tat können Regierungen durch die einseitige Bekanntgabe eines Staatsbankrotts private Geldgeber förmlich an den Verhandlungstisch zwingen. Alternativ kann durch frühzeitigen Dialog zwischen Regierung, privaten Geldgebern und den betroffenen internationalen Organisationen auch eine tatsächlich kooperative Lösung gefunden werden. Das Teilprojekt versucht, die Bestimmungsmerkmale und Effekte dieser unterschiedlichen Muster zu erklären und ergänzt damit die anderen Forschungsprojekte zu öffentlich-privaten Kooperationspartnerschaften. Auch inhaltlich setzt sich das Teilprojekt durch die Schwerpunktsetzung auf wirtschaftspolitische Fragen von diesen projekt durch die Schwerpunktsetzung auf wirtschaftspolitische Fragen von diesen Teilprojekten ab.

Im Rahmen der geplanten dialogischen Querschnittsgruppe „Theoretische Reflexion von ‚neuen' Formen des Regierens" wird das Teilprojekt einen wichtigen Beitrag zu Fragen nicht-staatlicher Akteure und *Governance* leisten. Als einziges Teilprojekt mit dem Schwerpunkt auf wirtschaftspolitische Fragen und mit seiner doppelten disziplinären Ausrichtung auf Politik- und Wirtschaftswissenschaften wird es spezifische inhaltliche Impulse geben können, die zur Theoriebildung im Arbeitsbereich der Querschnittsgruppe zentral erscheinen.

Aufgabenbeschreibung von Mitarbeitern der Grundausstattung für die beantragte Förderperiode

Wissenschaftliche Mitarbeiter/innen (einschließlich Hilfskräfte)

1. Prof. Dr. Enderlein (W1) ist mit 8 Wochenstunden am Teilprojekt beteiligt. Seine Aufgaben umfassen die allgemeine Leitung und Koordination des Teilprojektes.

Nichtwissenschaftliche Mitarbeiter/innen

1. Frau Spannagel (BAT Vb) wird im Rahmen von 3 Wochenstunden verschiedene Verwaltungs- und Schreibarbeiten erledigen. Ab 10/2005 wird diese Aufgabe von einer Sekretariatskraft aus dem Pool der Hertie School of Governance, Berlin, übernommen.

Aufgabenbeschreibung von Mitarbeitern der Ergänzungsausstattung für die beantragte Förderperiode

Wissenschaftliche Mitarbeiter/innen (einschließlich Hilfskräfte)

1. N.N. (VWL) ist mit 19,25 Wochenstunden am Teilprojekt beteiligt. Seine/Ihre Aufgaben umfassen die im Arbeitsprogramm mit (E) gekennzeichneten Arbeiten.
2. N.N. (Politikwiss.) ist mit 19,25 Wochenstunden am Teilprojekt beteiligt. Seine/Ihre Aufgaben umfassen die im Arbeitsprogramm mit (PS) gekennzeichneten Arbeiten.
3. Stud. pol./VWL N.N. (5. oder höheres Fachsemester) ist als studentische Hilfskraft mit 10 Wochenstunden für die Unterstützung der aufwändigen qualitativen Fallstudienarbeit vorgesehen.

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