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CRYING ON LOMBARD STREET: FIXING SOVEREIGN DEFAULTS IN THE 1890s

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Abstract

The wave of sovereign defaults in the 1890s was one of the worst ever experienced in the history of finance. From Argentina in 1890 to Brazil in 1898, countries in Latin America and Southern Europe defaulted on their external debt, resulting in huge losses for investors. However, this was the last series of defaults in the gold standard era. At the beginning of the 20th century and until the outbreak of World War I, defaults were less frequent despite the continuous increase in foreign government borrowing. The literature has provided several explanations for this apparent success, all of which point to improvements introduced in the market. This paper argues that the fall in the number of defaults is actually related to a more favourable world macroeconomic environment and to the increased liquidity available in international financial markets rather than to an abrupt shift in the manner in which defaults were handled. I show that settlements were more correlated with the relative ease in reaccessing foreign capital markets than to changes in the financial architecture.

Keywords: capital markets, financial intermediaries, sovereign defaults.

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Introduction

On the 20th June 1898, *The London Times* published a letter addressed to Brazil's President-elect that was written by the country's main creditor at the time, N. M. Rothschild and Sons. Brazil had recently found itself unable to service its debts. The letter was the last in a series of correspondence between Brazil's incoming government and the bank.² Rothschild published the letter to publicly demonstrate how serious the bank was when dealing with problematic borrowers. The missive described the general fiscal and monetary policy conditions required from the new government if it was to obtain further support. Among these, the bank demanded a contraction of the monetary base and the revaluation of the *milreis*. It was implicitly understood that previously lax monetary policies had provoked the depreciation of the currency and had endangered Brazil's capacity to service its public debt.³

In June 1898, Rothschild issued a funding loan to Brazil, imposing a three-year moratorium on Brazil's debt service upon investors, who were then paid with new funding loan bonds. This marked the end of a long episode of sovereign defaults in several countries in Latin America and Eastern and South Europe that had begun with the famous Baring Crisis in 1890. At the turn of the century, a new credit boom developed and capital exports continuously increased until the outbreak of WWI. At the same time, many defaults that had not been previously solved were finally settled. Investors ignored history, though they temporarily imposed higher borrowing costs on previous sinners.⁴ Besides this, there were no major impediments to borrowing governments seeking access to London—then the major financial centre of the world—and probably fewer impediments still to accessing the competing financial centres of continental Europe and the US.⁵

A main feature of Brazil's funding loan was the high level of realized rates of return obtained by bondholders.⁶ This was possible despite the fact that the sole negotiator representing the interests of bondholders, and mainly its own interests, was

² Rothschild Archives, 000/401 F.

³ A summary of this position can be found in *The Economist*, June 18, 1898.

⁴ Flandreau and Zumer, *The Making of Global Finance*, p. 39 calculates this penalty at 90 basis points for the first year (after settlement). It decreased in time and lasted to 45 basis points than years after.

⁵ On the rivalry and cooperation between financial centers in the late 19th century, see Cassis, *Capitals of Capital*.

⁶ Calculations on this can be found in Abreu, "Os funding Loans Brasileiros", Abreu, "Brazil as a Debtor" and Flandreau and Flores, "Bondholders vs Bond-sellers".

Rothschild.⁷ This was not the first time that a financial intermediary was the only negotiator, but it was probably the only case where one succeeded *without* the government having the immediate incentive of a new loan, while even agreeing to pursue specific economic policy conditions. The official body representing the interests of the bondholders, the Corporation of Foreign Bondholders (CFB), was informed of but did not participate in the negotiations between Rothschild and Brazil's government.⁸ By 1898, London's investors already had ample experience dealing with defaulting governments, and that experience provided various examples of the ways in which British investors had achieved a positive balance.⁹

Beginning in the 1820s, investors celebrated various victories and suffered many defeats. Prominent among the victories was investors' abilities to organise various bodies to defend their interests, including the Corporation of Foreign Bondholders. The CFB became officially recognised by British authorities and was able to negotiate directly with governments, although this yielded mixed results. The bondholders association was able to use regulation and cooperate with the London Stock Exchange in order to obtain bargaining power and close access to governments that were unwilling to cooperate. Overall therefore, the history of the CFB is considered a successful story, one of innovative institutionalism and efficient organization.

But Brazil's bailout was a successful case (from an investor's perspective) and the CFB was practically excluded from the negotiating table. Brazil's case remains exceptional in terms of recovery rates, negotiating times and market consequences, as contagion in other countries' bond prices was absent. Argentina's consecutive arrangements in 1891 and 1893 did not enjoy the same success, and negotiations were difficult and full of obstacles. These experiences introduced high volatility and uncertainty into the market despite a joint effort by banks in Germany, France and Britain, and from the Bank of England itself.¹⁰ Other Central and South American defaults, whether inherited or the result of policies concocted in the 1890s, could not agree on final and permanent settlements. Portugal's default in 1893 lasted more than

⁷ Weller, "The Funding Loan" analyses the importance of Brazil to Rothschild underwriting business.

⁸ See for instance the letter sent to bondholders on the 6th June 1898, in Rothschild Archives Box 000/401 F.

⁹ Kindleberger, *Economic growth in France and Britain*.

¹⁰ It has obviously a different nature given the systemic risk that accompanied Argentina's debt problems and Baring's exposure to that country. The Bank of England estimated it at about 33% of Baring's portfolio. Bank of England Archives, file 2484/1.

nine years before reaching a final settlement. Greece's default in 1894 was also settled with the participation of creditor countries' governments (mainly from France and Britain) but with a lapse of only three years. Other settlements reached during these years were short-lived, and allowed some countries to reaccess the market only to default again. In short, *plus ça changeait, plus c'était la même chose*.

Still, 1898 marked winter's end and announced the spring in financial markets, a season that would last until 1914. No major default occurred during that period and foreign government lending reached unprecedented levels. In this paper, I aim to look for abrupt changes in the way sovereign defaults were managed in London during the 1890s that could have fostered the credit boom of the *belle époque*. I aim to demonstrate that most defaults in this transition period did not end happily, not unlike the defaults of the previous period. The success to which the literature refers is more related to the comparative benchmark used, the 1930s, which was the biggest failure in the history of finance. Moreover, the image of great success has been reinforced because the amounts of debt in default between 1900 and 1913 were lower than those of the preceeding century.¹¹ But no major changes in default management occurred, and the innovative elements, those stemming from collusion between financial intermediaries, mostly failed. The important feature of this period was the favourable macroeconomic environment among creditor countries. With the rapid increase in international trade and industrialization in creditor countries, both liquidity and incentives to integrate into the world economy prevented countries from defaulting. I conclude, therefore, that the absence of sovereign defaults after the 1890s was less related to a specific and resounding *know-how* than to a robust and globalized world economy.

This paper is structured as follows. In the first section I will review the main theories advanced in the literature that explain the fall of sovereign defaults in the late 19th century. Next, I argue that most of these theories are severely limited in their ability to account for the post 1890s period. The paper then briefly describes the ways in which sovereign defaults were managed before and during the 1890s. I demonstrate that the management of the 1890s defaults has only one innovative feature, which is the major involvement of financial intermediaries, though their final record is not entirely positive. We conclude in the last section.

¹¹ Suter, *Schuldenzyklen*, p. 94.

Literature review

When the nightmare decade of the 1890s ended, investors on Lombard Street would not experience another string of defaults until the outbreak of the First World War. This is probably the reason why the literature treats the general period between 1870 and 1914 as the victory of finance over the evil practice of defaulting. The successful record of recovery rates and the lower number of sovereign defaults compared to the later period of the 1930s reinforce this apparent consensus.¹² The precise reasons for this are still debated. Many explanations have been advanced, each of which point to changes in the financial structure of the market for sovereign debt, institutional innovations, the participation of creditors' governments in the negotiations or enforcement of the engagements acquired by borrowing governments.¹³

These explanations can be roughly divided into two groups. One group of works has concentrated on *prevention*: they analyze whether an evolutionary process took place in 19th century financial markets that deterred governments from defaulting. This would consist of a continuous improvement in the regulatory framework along with an increase in prudence and information availability among financial intermediaries and investors. In this vein, some authors have looked at the regulations established to impede access to countries that had pending accounts with investors. Others have looked at the role of underwriting banks and have argued that they may have suffered from a position of conflict of interest, which would have vanished in time given the increased pressure from the market itself, from the government and public opinion.¹⁴

On the other hand, a second group of works has analyzed the different manners utilized by investors to deal with defaulting securities (default management). Here again, two lines of argument can be identified. The first line of argument highlights the

¹² See for instance, Eichengreen and Portes, "Debt and Default" and "Settling Defaults"

¹³ There has been a parallel and intriguing evolution on the legal side of sovereign debt that we have left aside but that was to play an important role since the 1930s. See League of Nations, *Report of the Committee*, Borchard, *State Insolvency* and more recently, the Special Issue on the history of sovereign debt edited by Gelpern and Giulati, *A modern legal history*, or the comprehensive literature review on sovereign debt by Panizza et al., "The Economics and Law".

¹⁴ On the conflicts of interest among underwriters, see Eichengreen and Portes, op. cit. for the 19th century, and Crocket et al., *Conflict of Interest* for a theoretical perspective. Flandreau et al., "The end of gatekeeping" show how the market mechanisms of reputation deal with conflicts of interest in the underwriting industry of sovereign debt.

formation of bodies of organised bondholders that took place in London and elsewhere in order to have an official status and gain bargaining power *vis-à-vis* defaulting governments.¹⁵ The second line of argument emphasizes the role of governments from creditor countries, and examines whether gunboat diplomacy played a role in forcing defaulting countries to negotiate with investors, sometimes about issues beyond debt repayment.¹⁶ The former argument has concentrated on the innovative institutional setting with the formation of the CFB in 1868. The CFB was different from other bondholders associations in that it gained official recognition and permanent status. Previous bondholders associations were scattered and had specific and temporary goals. Their limited scope of action was circumscribed to specific defaults, and this weakened their bargaining power. Common wisdom suggests that the establishment of the CFB was rather revolutionary, and that its *raison d'être* was to acquire power and glory.

Admittedly, both groups of theories are strongly related and the distinction between them is not exact. The mere existence of active mechanisms to deal with defaults from within the market (officially recognised bodies of bondholders) or out of it (gunboat diplomacy) were also dissuasive and preventive incentives that deterred borrowing governments from defaulting. Moreover, it may also be true that many of the changes analyzed in the literature were complementary and mutually reinforcing. It seems natural that mainly during bust periods, each actor (regulators, leading banks and investors of defaulting securities) was interested in introducing new rules of the game to prevent present or future losses and in keeping, if possible, the roulette (and the business) going. Still, looking for a main reason behind the relative success of financial markets in dealing with sovereign defaults is a difficult yet important exercise. This is especially true given that many of the arguments advanced can barely coexist, as most of them are mutually exclusive. For instance, if the regulations introduced were strict enough to keep risky securities from accessing the market, defaults would have been sporadic accidents and there would have been no need for bodies of bondholders or the participation of creditor governments in the defaulting events. In fact, one of the clauses used to keep countries from gaining access to London's financial market, and which was

¹⁵ See for instance Esteves, "Qui custodiam quem?" or Mauro and Yafeh, "The Corporation of Foreign Bondholders".

¹⁶ On this argument, see Mitchener and Weidenmier, "Supersanctions".

widely used by unhappy bondholders, appeared very early in the 19th century.¹⁷ No major regulatory change occurred after the defaulting waves of the 1870s and the 1890s. Therefore, something else may have impeded regulation to act as an efficient gatekeeper.¹⁸

Similar objections can be advanced for other theories. Conditions in London and other financial centres in Europe in the early 19th century provided the necessary motivation for bondholders to organise into representative bodies.¹⁹ However, as late as 1898, these bodies could still be relegated to a secondary role in negotiations, as in the case of Brazil's default. Moreover, their final recognition in 1868 as an official instance fully recognised by the British government did not deter countries from dishonouring their commitments in the 1870s. In fact, as Flandreau and Flores (2012) show, bond prices of countries having disputes with bondholders did not react to the formation of the Corporation of Foreign Bondholders in 1868, or to any of the actions that followed. This objectively demonstrates that contemporary investors did not perceive the CFB as a credible body with the capability to oblige countries to negotiate. On the contrary, the CFB had itself been accused of insider trading and conflicts of interest.²⁰ Even if most of the recent literature has argued that its establishment considerably reduced the settlement time of defaults, failure cases were a constant and permanent fact even in the late 19th century.²¹

Underwriting banks have also been perceived as responsible for issuing bonds with high probability of default. Claims that they acted as short-term gain-seekers provoked heated debates in the public opinion, the press and even the British

¹⁷ Flandreau, *The Age of Prestige*.

¹⁸ However, a regulation emerged in the early 1820s. On the evolution of the regulatory framework and structure of the London Stock Exchange, see Neal and Davis, "The Evolution". Flandreau, *ibid.* provides empirical evidence on the use of this regulation by bondholders. Detailed accounts of the history of different bodies of bondholders in Europe and the US can be found in the League of Nations, *Report of the Committee* and Borchard, *State Insolvency*.

¹⁹ See for instance Costeloe, *Bonds and Bondholders* or Salvucci, *Politics, Markets* on the specific cases of bodies of bondholders for Mexican and Latin American (then the "Spanish American" bondholders).

²⁰ See for instance *The Economist*, November 20th 1897. In fact, the CFB was accused of accepting to generous terms in order to achieve rapid settlements. This pressure came from new bondholders or from CFB members themselves, and from underwriting banks, who pressed for an arrangement in order to place new bonds into the market.

²¹ On the reduction of settlement times and increases in recovery rates, see Esteves, "Qui custodiet". Opposite views include Shay Kamlani "Why Bondholders council don't matter, and Flandreau and Flores, "Bondholders vs Bondsellers".

Parliament.²² Although there were certainly reasons to mistrust some financial intermediaries, if this had been a recurrent behavior, investors would have avoided being swindled simply by investing in other securities besides foreign government bonds—a kind of security where information asymmetries are at their highest.²³ Other authors have therefore differentiated among underwriters. Following this argument, we see that a market mechanism based on reputation developed which encouraged financial intermediaries to truly select the securities they issued (the case of the so called “prestigious” underwriters). Other underwriters would only have sought short-term gains (“wildcat banks”).²⁴ In fact, the market for sovereign debt was dominated by a few banks that cared about their reputation. These banks liked to develop long-term relationships with borrowing governments. They acted as “agents” for these governments in London, which assured that governments would have access to investors’ capital at lower interest rates.²⁵ These bonds defaulted less, and investors could also be confident that the financial intermediary would monitor a government’s behavior regarding the funds it received. An important feature of the 1890s, however, was that three of the most resounding defaults affected bonds issued by the most prestigious banks.²⁶ Therefore, even if the argument on prestigious underwriters holds for the 19th century, it is certainly weakened for the period after 1890.

Mitchener and Weidenmier (2005) have argued that “supersanctions” and “gunboat diplomacy” were “important and common used enforcement mechanisms from 1870-1913” (p. 2). However, it has been generally acknowledged among historians and economic historians that Britain almost never intervened on behalf of its bondholders, and was rather reluctant to do so. Moreover, the empirical evidence presented in Mitchener and Weidenmier is only hardly convincing. From twelve cases of “supersanctions”, four are concentrated in Central America, where military

²² An investigation was appointed by the British Parliament after the defaults taking place after 1873. The enquiries and discussions are published in the Select Committee report of 1875.

²³ Flandreau and Flores (2009) provide a general discussion on the emergence of sovereign debt in the early 19th century.

²⁴ *Idem*, pp. 654-655.

²⁵ On a general discussion on this, see Jenks, *The Migration of British Capital* or Cairncross, *Home and Foreign Investment*.

²⁶ Flores, “Information asymmetries” provides a general comparison on the defaults and identity of underwriters between the periods of 1845-1876 and the period of 1880-1895. He also demonstrates how the Imperial Ottoman Bank lost market shares between after the first period given the high number of bonds in default that this bank had issued. Weller, “The Funding Loan” estimates that Brazil represented 27% of the bonds in the market issued by Rothschild.

interventions were related to the US government's interests beyond debt concerns. Another four cases deal with bonds which were not originally issued in London (and were related to countries having rather a colonial status). Only four cases remain. In the same period, a total of 39 cases of defaults could be computed, which means that this way of default settlement was not common in the long 19th century.²⁷

Looking for the missing element

Taken individually, each of the explanations offered fail to account for the whole story. Sovereign defaults were common in the 19th century, but we do observe a notable and continuous fall in the amount of securities in default, with a last peak in the 1890s and then a renewed fall afterwards. Thus, there may have been some unstudied elements in the international financial architecture or in other spheres that provoked the decline. Situating this shift in the context and time in which it took place can give us a better idea of what other explanations might be considered.

In Figure 1, I have represented the nominal amounts of foreign government bond issues in London between 1865 and 1913.²⁸ Figure 1 also shows the number of defaults per year. Four main features should be noticed. First, note the cyclical nature of British capital exports, where lending booms were followed by periodical busts.²⁹ These cycles can be identified during the 1820s, the 1860s, the 1880s and the 1900s. Second, note that defaults have always been present, with occasional peaks in every bust period. Third, the 1890s should have represented a serious concern for investors. Fourth, there is an exceptional disconnect in the late 1890s and early 1900s, where defaults did not occur at the same levels as before, despite the fact that the boom was higher and lasted at least as long as others before. Looking at relative levels between number of issues and number of defaults further confirms this general trend. In the 1820s, the number of

²⁷ See Platt, *Finance, Trade and Politics*. Recent works arguing against the incidence of supersanctions can be found in Tomz, *Reputation and International Cooperation* or Flandreau, "Home Biases". Details on the sources used on type, amounts, yields at issue and identity of borrowers and underwriters can be found in Flandreau et al., "The End of Gatekeeping". Sources on defaults are from Suter, *Schuldenzyklen* and *Debt cycles*, CFB Annual report of 1915 and *The Economist*, different issues.

²⁸ Original data is from Stone, *The Global Export of Capital*.

²⁹ This fact was already noted in Jenks, *The Migration of British Capital*, Ford, "Overseas Lending" or Stone, *ibid*. Esteves, "Between Imperialism and Capitalism" demonstrates that this pattern can also be found in the case of Germany for the period between 1870 and 1914.

defaults compared to the number of issues was 57%. In the mid-century (1845-1876), this ratio decreases to 30.8%. It only smoothly falls between 1877 and 1895 (30.1%), but has a violent fall to 11.4% between 1896 and 1914.³⁰

We would possibly conclude that the 1890s was the final bucket of cold water that triggered a violent reaction among investors. A period of relative peace in London's sovereign debt market followed, thanks to innovative changes in the financial architecture. We should therefore look in detail at the novelties introduced during those years. A first major change was the final consolidation of the Corporation of Foreign Bondholders. From their annual reports, we observe that, once consolidated, the CFB's activities multiplied—their statistics and information gathering work increased and they systemized their communication channels, mainly with the London Stock Exchange.³¹ It may also be that investors in general improved their information level. Flandreau (2004), for instance, looks at the case of Crédit Lyonnais, and demonstrates that the "massive expansion" of its department of economic intelligence was created precisely in the aftermath of the Baring Crisis. It could also be that after the decade of the 1890s, the US government decided to play a more active role, mainly in the defaulting countries of Central America, after the Roosevelt corollary of 1904 (Mitchener and Wiedenmier, 2005). Finally, it may also be that the spread of more democratic regimes favored responsible public spending and adequate debt management, which made governments less prone to default.

All these elements were present and yet they provide only a limited explanation of the post-1890 period of low defaulting. First, access to information greatly improved during the century, and publications with precise information on fiscal and monetary variables—and more generally on economic conditions of distant countries—were already well established by the 1860s. *The Statesman Yearbook*, which provided detailed figures on exchange rates, fiscal and trade statistics, started in 1879. *Fenn's Compendium* was first published in the 1830s. Other weekly journals, such as *The Economist*, saw light in 1843. *Mulhall's Dictionary of Statistics*, which contained some of the first attempts to compare some countries' levels of wealth internationally, dates from 1886. Second, the

³⁰ Sources for these estimates are described in Flandreau et al., "The End of Gatekeeping".

³¹ The Annual reports published by the council of the CFB were much more detailed on defaulting countries, and later also none defaulters. In the 1915 report, there is a general summary of the history of debts and defaults of borrowing countries in London since the 1820s.

London Stock Exchange, through its Committee of General Purposes, had introduced strict requirements for countries willing to have quotations for their bonds as early as the late 1820s.³² Third, the US intervened on behalf of many countries in which other interests were present apart from pure debt issues, but the position of British bondholders in the successive arrangements were unclear and not necessarily favourable, as Mitchener and Weidenmier recognise themselves. Fourth, it seems unclear that the spread of democracy was a main factor behind the fall of sovereign defaults. Political science theorists would strongly disagree with qualifying the late part of the 19th century as democratic, nor would they argue that any form of autocratic government would struggle to access foreign capital markets. Furthermore, democracies did not default less—in fact, quite the opposite is true.³³ Mexico's final debt settlement in 1886, whose process lasted more than 60 years, arrived under the dictatorship of Porfirio Diaz.

A broader perspective could give us additional hints about the nature of the post-1890s period. It is most important to note that the changes that took place during and after the 1890s were accompanied by an improvement in the world macroeconomic situation. As Eichengreen (2003) demonstrates, lending booms have taken place in the last 200 years in presence of the following: an upswing of business cycles, expanding world trade, supportive political conditions and periods of financial innovation. I have already mentioned most of these conditions, but two of them deserve further discussion. In any account of business cycles, the period beginning in 1900 was one where financial integration, trade openness and international migrations were at their highest levels. Historians and contemporary economists have already argued about the consequences of monetary and financial integration. Alec Ford (1960) explains the differences in the functioning of the gold standard between "core" and "periphery" countries. In particular, he argued (argues) that much of the well-functioning of the gold standard regime in the latter countries depended on the constant imports of capital to finance developmental investments. Raul Prebisch notes how Britain exported its business cycles through its financial markets.³⁴ At the turn of the century, financial integration and capital exports

³² These requirements are described in Davis et al., "How it all began". The Guildhall library in London contains the files received by the London Stock Exchange for each issue since the mid-19th century.

³³ General discussion on this can be found in Summerhill "Fiscal Bargains" or in Flandreau and Flores, "Bonds and Brands".

³⁴ Prebisch, "Geografía Económica".

continued to increase, though this general augmentation and synchronization were not necessarily paralleled in the real sector.³⁵ Some recipient countries were diversifying the sources of external funds, given the commercial and financial rise of France, Germany and the US. There may have been a disconnect, then, between British business cycles and absolute levels of foreign investment in periphery economies. The immediate consequence was a fall in the probabilities of sudden stops with an accompanying decline in the number of financial crises and sovereign defaults.³⁶

The improvement of the international macroeconomic environment was accompanied by another element: the continuous increase in international trade despite rising trade barriers (Findlay and O'Rourke, 2003). Britain remained the primary partner of many borrowing countries, and it would only lose market shares to other capital exports countries. Still, its figures remained substantial. Argentina's exports to Britain amounted to about 30% of its total exports in 1890. At the turn of the century, this proportion was about 58% for Chile. More generally, borrowing governments in London were those from countries with which Britain had strong commercial links.³⁷ As economists have long recognised, it is more costly to default on debts to investors from countries that are important trading partners, because it could trigger a fall in international trade.³⁸ This is a defining characteristic of the wave of defaults of the 1930s, where trade tariffs had a direct impact on international trade and thereby affected countries' ability *and* willingness to repay. Moreover, during the 1890s, increased international trade was also sustained by the spread of the gold standard. This general shift was favored by the inflationary nature of this monetary regime—a direct consequence of the relative abundance of gold stemming from the discoveries of the 1890s. The general stabilization in the international monetary regime (Flandreau et al, 1998, p.145) and the fall in transport costs generated conditions that helped to increase international trade and, secondarily, capital flows.

³⁵ On a general review on business cycles during this period see Flandreau et al., "Business cycles".

³⁶ Ford, *The Gold Standard* argues that cycles in foreign lending (he calls this "overseas investment") lasted between 15 and 20 years during the 19th century. The cycle he identifies for British investments in Argentina during the belle époque was a long period, which started at the lowest point in 1889 and reaching a peak in 1911.

³⁷ On these links, see Chapman, *The Rise of Merchant banking* or Flores, "On trade and sovereign defaults". The figures are my own computations from Mitchell's *International Historical Statistics* and Tena's database.

³⁸ This argument can be found in today's debate on existing incentives for repayment. See Rose, "One reason".

Greater liquidity in the main financial centres of the world also contributed to the general decrease in the cost of money.³⁹ In Table 2, I present the probabilities of default calculated from the spreads at issue of foreign government loans during the gold standard era.⁴⁰ A downward trend can be identified. There are two main causes advanced in previous studies that can explain this fact. The first argument points to the stronger economic fundamentals that were present in many countries prior to World War I. Authors such as Obstfeld and Taylor qualify the economic policies of the time as liberal, referring to them as the "London Consensus" (p. 264). As Flandreau and Zumer argue, a second possible explanation is the closer monitoring of economic fundamentals by investors *after* 1895, as this would have increased pressure on borrowing governments. Yet, many borrowing countries actually experienced an increase in their absolute levels of debt. As economic growth increased in these countries, debt service became sustainable, as measured in debt to GDP ratios.⁴¹ With the lowering of debt service compared to public revenues, the probability of default also decreased, and this certainly contributed to the substantial decline in default cases observed after 1900.⁴²

In sum, both the supply and the demand sides played against defaulting. Higher liquidity and more international trade increased the opportunity cost of defaulting. Stronger fundamentals, a more stable monetary regime in many borrowing countries and economic growth increased the capacity of repayment. Finally, in order to exclude this pure macroeconomic explanation, we should also provide some comparative elements from a microeconomic perspective. The main elements advanced in the literature (regulatory framework, institutional changes or actors involved) have to be revised and contrasted in the periods before and during the 1890s. If there were important features that differentiated this period from its earlier counterparts, we should deepen our analysis of one (or more) explanations of the changes in the financial architecture and relativize the role of macroeconomics. Otherwise, we could safely assert that the *belle époque* of capital exports and the relatively low number of defaults

³⁹ This was a general consequence from capital accumulation and international financial integration. See Kindleberger, *Economic Growth*.

⁴⁰ The transformation I used follows the same methodology as in Feder and Just, "Debt crisis".

⁴¹ Flores, "Living with the Big Bad Wolf" looks at fundamentals among a sample of high and low economic growth countries, and concludes that there was a general increase in inflation and debt service to revenue ratios, with a limited impact on sovereign spreads or economic growth.

⁴² Flandreau and Zumer, *Making of Global Finance*, argue that debt increased in the period between 1880 and 1912, but that economic growth allowed this increased indebtedness to be sustainable.

could mainly be attributed to the world's market integration and the improvement of macroeconomic conditions.

Solving sovereign defaults: the experience prior to 1890

The wave of defaults during the 1870s provoked violent reactions and a not-so-silent revolution among British authorities. Faithfully following a general tradition, the Parliament appointed a Select Committee to investigate the practices of lending to foreign countries, bringing active bankers from the market to respond to questions and implicit accusations from parliamentarians and the public opinion.⁴³ Despite allegations and the big coverage given by the press, no major outcome emerged, and regulation was hardly modified even during the development of the new lending boom in the 1880s.

By that time, the Corporation of Foreign Bondholders was already in place and had been involved in the resolution of some defaults. They were active in a number of negotiations with different countries in Europe, Asia, Central and South America, and also with many US states which were in default. Their first annual report, published by its Council in August 1873, provides a general view of how the body had dealt with defaulting countries, the results they obtained and how they defended the interests of bondholders against any injury which the organization considered unfair. Its activities expanded as the number of defaults increased, and by the 1890s it already had a wide number of agents in different parts of the world, and held constant communications with British parliamentarians and members of the London Stock Exchange.

The CFB almost never acted alone. It constantly sought support from the Stock Exchange, the British government and financial intermediaries, although it could directly hold negotiations with defaulting governments. The CFB was also first in line to protest when a default arose, though this did not necessarily mean that it was a main protagonist in the negotiations. Some pragmatism prevailed and the CFB decided to negotiate directly with defaulting governments if no other option was available. Other

⁴³ On these practices see Davis et al. "How it all began".

negotiators included financial intermediaries, diplomats or merchants with strong connections with defaulting countries.⁴⁴

Besides the CFB, financial intermediaries and governments would act on behalf of bondholders mainly if it would have an impact in the immediate or the medium-term. Some financial intermediaries would have an immediate interest in resolving a default if it would allow a borrower to issue a new loan through their own intermediation.⁴⁵ Other financial intermediaries with a longer-term perspective would avoid losing business by defending investors' interests in the defaults of the bonds they issued. The basic idea here would be to have financial intermediaries recognise their own responsibility and restore confidence for the future. Finally, governments from creditor countries may also have been tempted to intervene if their own interests were involved—whether political, commercial or financial.

One useful way to classify the different types of negotiating processes is to identify the main negotiator representing investors. This has been common in the recent literature, as it serves to compare the relative performance of each negotiator. We can enumerate "pure" cases when one sole agent acts as negotiator: a) investors' own representative bodies, which could be ad-hoc bodies of bondholders, or officially recognised organizations;⁴⁶ b) a financial intermediary negotiates and decides on behalf of the bondholders it is supposed to represent; and c) creditors' governments. In practice, most defaults were negotiated with more than one bondholders' representative. The 1820s defaults were treated with so called ad-hoc bodies of bondholders, and in some cases they acted accompanied by one financial intermediary, the most notable of which was Baring. In fact, the first debt rescheduling after this wave of defaults was Mexico's settlement of 1831, where Baring acted as the representative of the Mexican bondholders. This case appeared to be a big success, as all other Latin American bonds remained in default and no prompt solution seemed probable. But this first arrangement lasted three years before Mexico defaulted a second time and Baring

⁴⁴ This was evoked in the reply sent by the Committee for General Purposes concerning the letter sent to him by Isidor Gerstenberg, the first chairman of the CFB, informing that he had asked the support of Baring Brothers. Francis Levien, the Secretary of the Committee, wrote that "... if properly organized and by influential capitalists, [the CFB] is calculated to be of very great advantage to the interests of the holders of foreign bonds. *The Times*, 30 November 1868.

⁴⁵ There is an interesting discussion of this published in *The Times*, 24th September 1872, "Money Market and City Intelligence".

⁴⁶ This classification can be found in Esteves, "Quis custodiet quem?".

abandoned its position as representative of the Mexican bondholders. Other cases seemed equally hopeless. Marichal (1989) calculates the settlement time between a default and a final arrangement to have been between fifteen and thirty years (p.60), whereas Suter (1990) gives an estimate of 14 years for the period between 1821 and 1870.

In other cases, bondholders would act also in collusion with financial intermediaries and/or their own governments. These kinds of events were not as frequent as the others outlined, but are worth mentioning as we look at the 1870s. Two illustrative cases can be found in this decade: the defaults of the Ottoman Empire in 1875, and that of Egypt in 1876. The case of the Ottoman Empire was complicated for several reasons: rivalries between bodies of bondholders from different countries emerged, which increased the probability of having a veto to an arrangement considered more favourable to one body of bondholders than to another. Additionally, governments of creditor countries were directly affected by a loan they had guaranteed in 1855 in order to support Turkey during the Crimean war. Lastly, Turkey entered into war against Russia in 1877 while negotiations were still open, and, after being defeated, was obliged to repay an important war indemnity. The final settlement was negotiated in 1881, with the participation of bondholders, banks and the direct involvement of creditors' governments, mainly from Britain and France.⁴⁷ In the case of Egypt, similar difficulties arose, including rivalries between groups of bondholders and conflicting interests between creditor governments. This led to the instauration of an international commission of financial control, and the final settlement was reached in 1880.⁴⁸

In both cases, Egyptian and Turkish bondholders were given an abnormally strong voice through the intermediary of banks and creditor governments, as each were interested in rapid and favourable arrangements of the debts due. However, these cases were exceptional compared to the number of defaults that took place in the late 1860s and during the 1873-1876 world crisis. Peru's government, the biggest borrower of the period, did not reach a final settlement until 1889 (13 years after default).⁴⁹ Smaller countries such as Costa Rica or the Dominican Republic were in default for 9 and 16

⁴⁷ Wynne, *State Insolvency*, pp. 413-435.

⁴⁸ Ibid, pp. 587-608.

⁴⁹ Suter, *Debt cycles*, makes a general description of Peru's negotiations with bondholders in Britain and France.

years respectively. Probably the sole country to have directly suffered the consequences of the crisis, Uruguay, defaulted and then rapidly renegotiated its debt (spending just two years in default). Most other countries reached agreements with their bondholders which resulted in perennial engagements that merely led to occasional and irregular payments, further disappointing investors. Such was the crude record of the CFB.

After 1876, capital flows did not take off again until the 1880s. This fact can be explained by factors at both the supply and the demand sides. Among the supply factors, low interest rates in Britain were the main incentives for investors to look for securities promising higher returns. Among the demand side factors, there were countries with promissory prospects of high growth potential where fresh capital was strongly needed.⁵⁰ This was certainly the case with Argentina (the biggest borrower of the period), then considered the “United States of South America”, and also with many colonial borrowers in Australia, Canada and South Africa. The new lending boom of the 1880s was short-lived, and few events were worth mentioning besides the nature and willingness of financial intermediaries to keep the money flowing.

The history of the Baring crisis of 1890, which marked a sudden halt to the lending boom, has been well-studied and most historians and contemporary observers agree that the high amounts of debt contracted by Argentina's national, provincial and municipal governments were only possible because of the complacency of underwriters. A particular novelty in the way Argentina's default was managed that has not been mentioned before in the literature is the (forced) market-based nature of the 1890 resolution. I will explore the reasons for this in the next section. Financial intermediaries colluded and jointly negotiated a debt rescheduling with Argentina. This kind of arrangement, though not unique, was exceptional for the time, and had an immediate precedent in the 1885 crisis, which also took place in Argentina. Both experiences failed for different reasons, but the funding loan arranged in 1890 allowed for the rescue of Baring even if it did not necessarily help Argentina's bondholders.

The peak of the lending boom of the 1880s occurred after 1885. The chronology of this inflection point is worth mentioning given the fact that Argentina's national government experienced a liquidity crisis in the same year, triggering it to abandon the

⁵⁰ Flores, “Information asymmetries” provides a general summary on the beginnings of the 1880s lending boom.

gold standard. Argentina's historiography has long described the process through which the national government and its underwriters solved the default problem, and also illuminates how this arrangement affected the borrowing pattern adopted in the years prior to 1890. In short, Argentina's government was in a delicate fiscal position in 1885 that jeopardized its ability to service its foreign debt in a timely manner.⁵¹ Argentina had counted on expected revenues from two foreign loans that were to be issued in 1884, but the failure of those loans resulted in the proceeds being retained in London. Each loan had been negotiated with a different syndicate, and competition and antagonism reciprocally impeded any action leading to the placement of the bonds.⁵² Negotiations between the government, both syndicates and Baring, as the main underwriter of Argentina's securities, resulted in the cancellation of the previous loans and in an agreement to issue a new loan, which was to be conditioned with the inclusion of two special guarantees. First, the loan was to be secured through the revenues from customs duties. Second, Argentina's national government would be prohibited from borrowing fresh funds without first acquiring permission from the banks.

Historians have debated what pushed Argentina's government into this delicate situation, but the discussion has mainly focused on the consequences of this agreement. Arguments related to the risk perception of investors are particularly important. Authors such as Jones (1972) or Regalsky (1987) analyze Argentina's bargaining position in its negotiations with the banks. Jones (1972) explains that the agreement was just an attempt by the bankers to impose their interests. In fact, in spite of the critics in the London press, Jones writes that the banks were able to achieve their objectives and could place Argentina's bonds—which they had not been able to issue previously and which were still in their possession—into the market. At the same time, the banks assumed a kind of control on the Argentinean finances by guaranteeing that customs duties would be engaged for the repayment of the loan. However, Jones argues that this control failed because the bankers did not have the means to enforce it.

Unlike Regalsky, Jones believes that the Argentinean government was in a more advantageous position than the bankers. Even if the syndicate who signed the

⁵¹ On the government's debt policy of the period see Regalsky, "Exportaciones de Capital" and *Mercado, Inversiones y Elites*.

⁵² This situation is described in a Report to the Deputies Chamber, published in *La Prensa*, an Argentinean newspaper, on the 21st October 1885.

agreement of 1885 was composed of seven banks, the Argentinean government went beyond and underwrote new loans with other banks. Jones considers the syndicalization of the banks as an inefficient measure of defence, at first against the market and later against the Argentinean government, which did not respect the clauses of temporary suspensions of loan negotiations and continued to search for new syndicates. This harmed Argentinean credit, resulting in the country having to negotiate on worse terms than countries like Brazil or Chile.

Ferns (1960) emphasizes the objectives of the agreement and its results. If the final objective was the rational control of the investment process, the agreement caused exactly the opposite. He agrees with Jones that the banks were incapable of exercising any kind of control, not only over the activities of the federal, provincial, or municipal Argentinean governments, but also over their own activities. There were seven banks that participated in the syndicate that signed the agreement, but after 1885 nine additional banks entered the Argentinean loan market upon being invited by provincial and municipal governments. Moreover, the author argues that the agreement gave the public the false impression that the investment process was under the supervision of institutions that understood both the process and its requirements. However, Ferns emphasizes that the agreement was not actually a control scheme at all, but rather a medium to ensure that a smaller group of bankers and their clients would enjoy a first claim on Argentina's revenues.

Forcing collusion: from Argentina's default of 1890 to Brazil's 1898 funding loan

Despite the failed attempt to let the market manage a country's foreign government public finances, the Baring crisis of 1890 was to be resolved in a similar manner: another market solution. However, that the bonds issued by Argentina's state and municipal governments were not included in the arrangement and were not resolved until 1897 proves that the principal aim was not to resolve Argentina's very certain default, but rather to assure the value of Baring's portfolio. The funding loan, too, can be considered a complete failure, given that Argentina's bond prices continued to fall, Argentina's economy and the fiscal position of the government did not improve, and the arrangement reached in 1891 had to be renegotiated in 1893.

In both 1885 and 1890 there was, however, a market rationality that did not emanate from the bondholders but from financial intermediaries. This was a direct consequence of the nature and identity of the countries that defaulted and the underwriters that issued the bonds. As Flores (2011) demonstrates, a main feature of the 1890s is the fact that defaulting bonds were issued by the biggest and most prestigious financial intermediaries, which comprised more than 65.5% of the market: Baring, Hambro and Rothschild. The sole manner for them to maintain both their market dominance and credibility was to force a rapid and favourable solution for bondholders. Baring and Hambro achieved this through the direct or indirect intervention of the British government, while Rothschild achieved it through the power of monopoly. Even these arrangements failed, however, for a number of reasons which I explain below. But this serves to explain the comparatively high recovery rates of this period that are calculated in recent works. The high internal rates of return do have their *raison d'être*, but seem to respond to a market necessity rather than to an institutional innovation.

Argentina's funding loan was negotiated in November 1890 with the Rothschild committee (headed, of course, by Rothschild). At the outset, the Bank of England pressed for the collusion of Argentina's main underwriters and Rothschild. The agreement stipulated that funding bonds to be issued were to be exchanged for coupon payments of the old bonds for a period of three years. According to Fishlow, the terms conceded to Argentina were too generous, provoking the French and the German banks that had also been present initially to abandon the negotiations.⁵³ Still, because of the Argentine government's difficulties in meeting the debt service, it was obliged to renegotiate three years later.⁵⁴ The new agreement, called the "Romero Arrangement", was negotiated in 1893 with Baring back on its feet, representing the CFB and the Rothschild committee (Rothschild had in fact refused to renegotiate).⁵⁵ Under the new agreement, the sinking fund was suspended for a decade. Interests on most external debt were reduced for a period of five years. For most loans, this reduction amounted to 60% of the face value of the coupons.

⁵³ Fishlow, "Conditionality and Willingness to pay"

⁵⁴ On Argentina's economic situation see Rapoport et al., *Historia económica*.

⁵⁵ The 1893 annual report of the CFB maintains however that negotiations were held only by the issue houses, as an implicit complaint of exclusion.

The terms were less favourable to investors, but the Romero Arrangement allowed Argentina to recover, to reinstitute monetary stability and to attract foreign capital back to the country in the late 1890s. However, with Argentina's default not definitively settled and amidst Baring's own problems, Portugal defaulted on its external obligations in January 1892.⁵⁶ Portugal's government also held a special relationship with Baring, and the absence of Baring's support, due to the bank's financial difficulties, may have induced the government to promulgate a law whereby coupon payments were reduced to 50% on external debt and 30% on internal bonds. Negotiations with English, French, German and Dutch bondholders began in February (no financial intermediary was involved). Investors suffered greater losses than June, as payments on external bonds were reduced to 33 1/3%. In 1901, the French government entered into direct negotiations with Portugal. The final settlement was reached in May 1902, by which bondholders accepted "a permanent reduction of interest to half the amount originally payable on the old bonds" (Wynne, 1951, p.378). Moreover, as Wynne concluded: "This was at least better than the treatment the bondholders had".

Greece, too, experienced a failed attempt of having a financial intermediary negotiate directly with the borrower. The country had neared default already in 1892. After long negotiations with French and British bankers, Hambro, Greece's main underwriter, issued a funding loan in June 1893, under conditions previously accepted by the Greeks (which were to revalue the drachma and to put some order in the public finances of the state, and to pay half of customs duties in gold). The bonds from the funding loan were supposed to be exchanged for the coupon payments for a period of two and a half years. However, after the initial issue of the bonds for payments of the July and October coupons, the new Greek government refused the funding agreement and stopped issuing funding loans in November. Partial default followed on all obligations in December 1893. Greece lost access to international financial markets even during its war with Turkey in 1897. After the country was defeated and urgently needed a foreign loan to face indemnity payments, the governments from France, England, Russia and Germany intervened and, in cooperation with the bondholders, reached an agreement in January 1898. The initial interests to be paid by Greece on its defaulted debts varied from 43% of the original interest to 32% depending on the loans (some

⁵⁶ On Portugal's decision to default, see Lains, "The Power".

bonds had higher priority than others). Part of the original interest had to be collected to pay amortization, but the sinking fund was to be reduced to half this amount over a period of five years. An increase in interest payments depended on the behavior of the exchange rate, which was expected to appreciate, and the income of some public monopolies and stamp dues, until there was enough to repay interest in full. Wynne (1951 p.336) shows that full interest payments on loans began only in 1920.

In 1898, as the fiscal position of Brazil grew dire, the government realised that no exit option was available with Rothschild as its major external creditor. The funding loan was a success in terms of profitability and conditionality, contrary to the rest of the defaults managed by other financial intermediaries. But Rothschild's absolute monopoly position was fairly unique in the 19th century. In London, only a few Scandinavian countries and Japan retained the same underwriter, though each of them could rely on their domestic financial markets; the same was not true for Brazil. The relationship between Rothschild and Brazil was also unique in terms of the financial intermediary's own financial position. In other instances, it could be a major drawback to have the bank experiencing its own difficulties or suffering from a government's default. This conditioned Argentina's bailout, for instance, but also affected Portugal, as it shared the same financial intermediary as Argentina..

The other side of the coin is also worth mentioning. Brazil's funding loan was strongly criticized in Brazil, and its effects have long been discussed in that country's historiography. Barroso (1936:66-67) refers to this agreement as a national humiliation, and recalls the consequences of retiring the "*papel moneda da circulação*" on the economy. Fritsch agrees with Barroso regarding the repercussions of the deflationary monetary policy in Brazil, which included the Banking Crisis of 1900. Topik (1987) quotes a contemporary Rio newspaper which complained that the economic policy that followed the funding loan led to three years of complete stagnation and the unquestionable decline of industrial policy (p. 38). Brazil needed a second Funding Loan in 1914 and did not return to a sustainable path of economic growth, contrary to other defaulting countries such as Mexico or Argentina. This devastating overview constitutes the final evidence of the relative weight of the macroeconomic environment on the decision to default or to settle previous debts. In bad times, no financial architecture could oblige governments to repay their debts.

Other countries defaulted in the 1890s and could only reach temporary settlements in the 1900s (Colombia, Dominican Republic, Ecuador, Guatemala, Liberia and Nicaragua). Those reaching permanent settlements (besides Argentina, Brazil, Greece and Portugal, Paraguay, Peru, and Venezuela) could access London's financial markets once more. But my claim about the lack of innovative features in the management or prevention of sovereign defaults seems to have strong historical support.

Conclusions

This paper demonstrates that in the first years of the 20th century, a major shift took place in which the macroeconomic environment favored capital flows and debt service. Rather than innovative elements in London's financial architecture, default management in the 1890s was different to the extent that prominence in negotiations with defaulting governments shifted from bondholders' bodies and creditor's governments to financial intermediaries, though this was not necessarily more successful. This kind of default resolution dominated the financial records of the decade, which was different from the experiences of previous periods. The financial intermediaries that issued the defaulted bonds, Baring, Hambro or Rothschild, held high market shares and this added pressure for reform if the losses had become too important to be ignored. This fact obliged the banks to prevent investors from losing money. Moreover, for different reasons, these defaults also involved the interests from governments and central banks in creditor countries. Therefore, settlement periods were shorter than before, but the resulting default arrangements were not necessarily permanent, nor did they guarantee the best terms for investors, though they imposed severe conditions on governments.

These results therefore relativize the importance of other explanations that rely on the formation of permanent bodies of bondholders, the spread of democracy or the increased use of gunboat diplomacy. Defaults in the early 20th century were not managed differently than they had been before, and no new dissuasive power emerged to prevent governments from defaulting. This does not mean that other factors, such as improvements in technology, information gathering, and the systematic enforcement of regulation did not play a role. But it should be clear that they only marginally affected the overall result, and that liquidity, market integration and luck were the main elements responsible for the bright results of the *belle époque* of capital flows.

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Figures and Tables

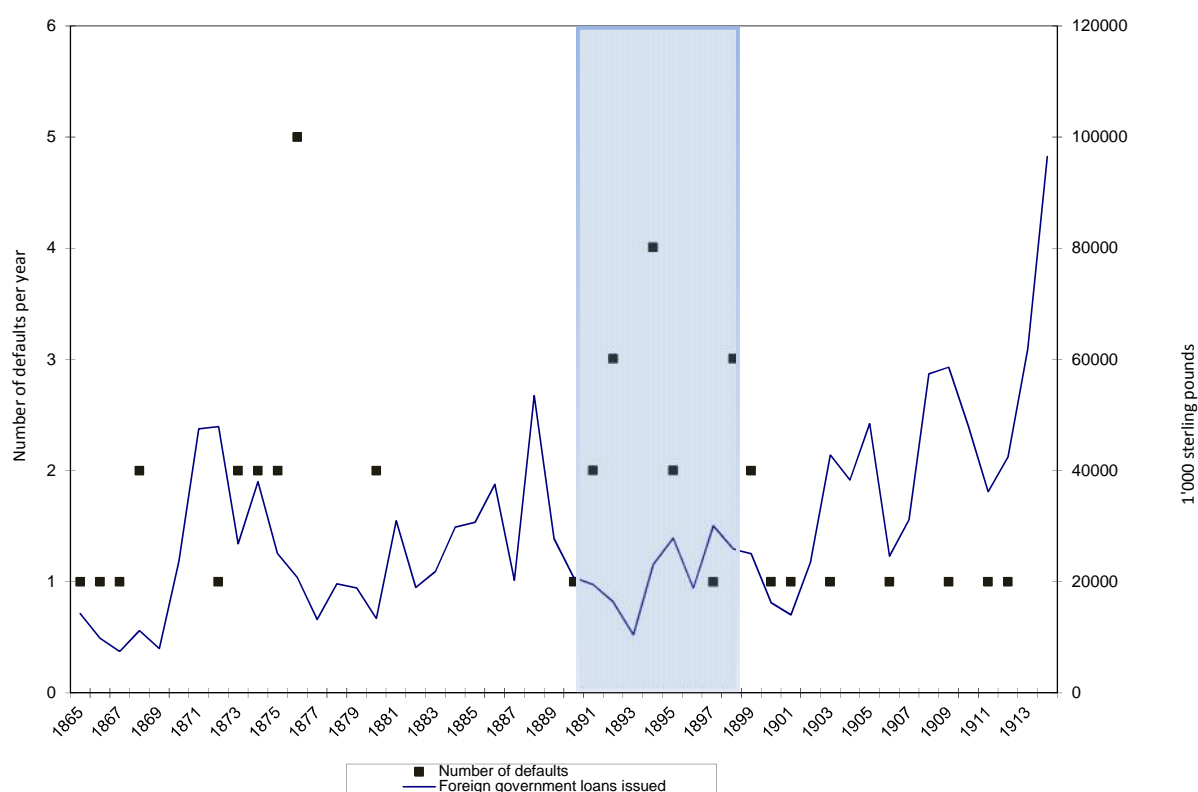


Figure 1. Number of defaults and foreign government bond issues in Britain. Sources: See text.

Period	Average Probabiliy	Standard deviation
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1870-1874	54.2	11.9
1875-1879	44.2	18.4
1880-1884	46.3	10.4
1885-1889	48.4	12.9
1890-1894	45.1	15.4
1895-1899	45.8	16.6
1900-1904	45.5	7.1
1905-1909	40.5	8.0
1910-1913	32.5	9.5

Table 1. Probabilities of partial default in London, 1870-1913. Sources: Author's own computations (see text).