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## Capital Markets and Sovereign Defaults: A Historical Perspective

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# Capital Markets and Sovereign Defaults: A Historical Perspective

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## Abstract

This paper provides a historical perspective on the relationship between capital markets and sovereign defaults. While the main body of the sovereign debt literature has rarely incorporated supply side factors, such as market distortions or conflicts of interest, we argue that the history of sovereign defaults cannot be understood without including the evolutionary structure of capital markets. The Southern European debt crises and the recent controversy surrounding the role of holdouts demonstrate that certain proposals raised in previous default episodes deserve further discussion, in particular, those aiming to deal with problems of collective action, liquidity provision, and information flaws.

**Keywords:** sovereign defaults, capital markets, financial crises

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## Introduction

History, it is said, is written by the victors. This may also be the case in economic theory. Sovereign debt theory is one such illustrative research field, on which this paper provides a historical discussion. Since the 1980s, the literature has mainly analyzed borrower incentives to default. Much less has been written on creditors' incentives to overlend; if anything, this is analyzed by other bodies of literature that are not necessarily connected. True, this fact may be unrelated with the unpleasant possibility that scholars would position themselves with the “victors” or, even less, whether creditors could be even regarded as such. Still, we can only wonder whether this imbalance has hindered our knowledge on the economics of default. After all, a market transaction consists of (at least) two parts.<sup>3</sup> Perhaps unsurprisingly, this literature has stuck to basic issues, related with the macroeconomic causes of defaults or whether new mechanisms could be introduced to reduce the pain they produce — particularly to creditors. The crisis in Southern Europe or the legal controversy between Argentina and NML capital limited have revived previously shelved debates that are now in urgent need of conclusive responses.

This is not to say that the literature has suffered from sclerosis. On the contrary, economists have a much better idea on how sovereign debt markets work and how to manage the risks stemming from a sovereign default to stabilize of financial markets. Moreover, two key facts, directly related to a certain type of interaction with other disciplines, have widened the field and enriched this literature.<sup>4</sup> First, though it was long ignored, the literature on the law of sovereign debt markets has been increasingly incorporated into the mainstream body of economic literature. This is direct a consequence of the gradual erosion of sovereign immunity and other changes introduced into the legal framework of financial markets in the last decades (Panizza et al., 2009). Furthermore, given the escalation in the number of legal conflicts in recent years, the significance of the jurisdiction under which a dispute is settled has been pushed to the forefront.

Second, the time span utilized to test theoretical models has been enlarged as new data has become available. At the turn of the century, the series of defaults that took place in the 1990s could hardly be studied with the necessary distance to analyze their long-term effects. Moreover, the immediate comparative benchmark was the 1980s, a period that strongly contrasted the more liberal context of the 1990s, in terms of international economic and financial links, capital volume and actors involved. The experience offered by the 1930s, on the other hand, was considered rather unsuccessful, and comparable datasets were still lacking for the nineteenth century. In recent years, it is not uncommon for empirical analysis to widen the time spam and look as far back as the early nineteenth century or even before, as Reinhart and Rogoff's “This time is different” demonstrates. This has opened the door to further interaction with the economic history literature, where the clear-cut relationship between lenders and borrowers is less pronounced and case studies of their long-term relationships can be investigated. Finally, this enlargement of the time spam allows us to comprehend the long-term evolution of sovereign debt markets and defaults.

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<sup>2</sup> “The world wants to be deceived, let it therefore be deceived”.

<sup>3</sup> Or, to quote Charles Kindleberger, “The propensities to swindle and be swindled run parallel to the propensity to speculate during a boom” (Kindleberger, 2000:73).

<sup>4</sup> For a literature review on the law and economics of sovereign defaults, see Panizza et al. (2009), Das et al. (2012). For historical insights on sovereign defaults, see Oosterlink (2013).

This paper shows that the possibility for further interaction across disciplines is substantial. It summarizes the main results from the recent literature in economic history and emphasizes the existence of certain fragilities within the supply side factors that have been linked to the problem of sovereign defaults during different historical periods. Section I revisits the controversies raised in the sovereign debt literature from the 1980s, and shows that the relevance of supply side factors was certainly undervalued as a key element that led to the crisis. Section II relates the institutional settings of financial markets to the long-term decline in the exclusion periods faced by countries in default. Section III reviews the boom and bust cycles in sovereign lending over the last two hundred years, and argues that the only reason certain countries could unexpectedly averted default was their exclusion from sovereign debt markets during lending booms. Section IV revisits the reasons why distortions in the financial markets could have led to defaults, and Section V discusses the efficiency of political and market sanctions in history. Section VI concludes.

## **I. A Cyclops perspective on sovereign defaults**

The recent Southern European debt crisis has reopened the Pandora's Box of who is responsible for the crisis. While Greece is accused of running macroeconomic imbalances for several years and incurring excessive debt, several voices have brought up the fact that creditors may be held responsible as well, as they voluntarily entered into the path of debt contracting.<sup>5</sup> Therefore, we would expect "both sides of that misjudgment to pay a price", as Paul Krugman recently argued.<sup>6</sup> To scholars working on sovereign defaults, these questions should sound astonishing. Recall the basics from sovereign debt theory: Why do countries repay their debts? The implicit assumption behind this innocent question is that a "sovereign", would have a perverse incentive to default because no judicial authority could impose a penalty and there is no possibility of seizing its assets. The natural consequence would be that sovereign defaults would be a persistent problem for creditors and therefore, a market with a low probability of developing. Greece should not have been able to borrow in the first place. And yet, it did.

Albeit specific disruptions, the history of sovereign debt markets is one of permanent expansion, in which the number and kind of participants have grown in diversity and complexity, reflecting the parallel evolution of finance and Stock Exchanges.<sup>7</sup> Nevertheless, the essence of these debates persists even today. It would thus be useful to provide a brief summary on the kinds of discussions that first emerged in the 1980s. Back then, it was acknowledged that defaults were less frequent and justified under the reasoning of 'perverse borrowers' and that certain countries had a positive record of "good-behavior" (Sachs and Williamson, 1985; Lindert and Morton, 1989). On the other hand, creditors, which at the time primarily consisted of commercial banks from developed countries, were struggling with a wave of defaults from governments in developing countries. In academic and policy-making circles, the debate then turned to the possibility of public intervention, mainly from creditor governments and international financial institutions. From a theoretical perspective, the central issue concerned the reasons why countries would be willing to avoid default. While the initial argument defended the intuitive reasoning that a government would want to preserve its reputation (Eaton and

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<sup>5</sup> Stiglitz, Joseph E., A Greek Morality Tale. Project Syndicate webpage (<http://www.project-syndicate.org/commentary/greece-eurozone-austerity-reform-by-joseph-e--stiglitz-2015-02>). Accessed on the 3 April 2015.

<sup>6</sup> Krugman, Paul. Europe's Greek Test, *The New York Times*, 30 January 2015.

<sup>7</sup> See, for instance, the case of the long-term history of the London Stock Exchange and the role of public debt instruments in Michie (2001)

Gersovitz, 1981), certain authors maintained that under certain assumptions this will would not suffice , and therefore, other mechanisms had to be considered (Bulow and Rogoff, 1989a, b).

The academic literature engaged in a long debate on the “unwillingness” or “incapacity” of defaulting borrowers to repay (Kohler, 1986), and on the consequences of monetary and fiscal mismanagement (Dornbusch, 1989). Parallel debates appeared on issues that were merely a reflection of the other side of the coin—all related to commercial banks “willingness” to lend— though they remained on the outskirts to the main corpus of sovereign debt literature. One example is Robert Devlin’s “Debt and Crisis in Latin America”, that situates the crisis in a similar instability framework to Minsky’s model of overexpansion and overcontraction and provides a set of reasons behind the commercial banks “misbehavior” both prior to the crisis of 1982 and in its aftermath.<sup>8</sup> Devlin argues that banks underappreciated the risk of default, or dismissed it due to competition. This claim contradicted the findings from scholars working on sovereign risk. In a set of papers that included Edwards (1984, 1986), it was demonstrated that the debt problem would only have become evident in the early 1980s, when world economic conditions suddenly shifted and sharply deteriorated the external position of borrowing governments. These findings implied that the loan pricing granted by commercial banks was adequate, even if results only weakly related risk premiums with certain macroeconomic variables.

An ex post overview of the 1982 crisis demonstrates that the “unexpected” version of the story exhibits some contradictions. One of which, the “unwillingness to be informed,” is related with the infamous myth on “countries don’t go bust”,<sup>9</sup> and could rightly define the general mood in Euromarkets previous to the 1982 crisis. This belief may also explain, for instance, the fact that spreads strongly compressed during the lending boom of the late 1970s (Guttentag and Herring, 1985). Two years before the crisis, while Mexico and other Latin American countries were accumulating fiscal deficits and high levels of inflation, the difference between the risk premiums of new loans to governments in Denmark and Mexico was 0.14 percent.<sup>10</sup> In general, the difference in the spreads between industrial and low income countries (utilizing World Bank classifications) shifted from 95.2 percent to 28.5 percent, and many of the most active borrowers in the early 1980s were those who defaulted afterwards. In fact, national regulators and international organizations, such as the IMF and the BIS, closely followed the banks’ lending behavior, and expressed concern over the limited information with which banks were operating.<sup>11</sup> Archival evidence shows that regulators and central banks worryingly attempted to decelerate the amount of lending to emerging countries.<sup>12</sup>

The apparent optimism was, therefore, difficult to explain. Peru and Pakistan defaulted in the 1970s, as did Poland in 1981. For certain scholars, a third factor could explain the willingness of banks to overlend. Vaubel (1983) and de Vries (1983) raised the issue of moral hazard, caused by the possibility of last resort lender intervention by the IMF. Wellons (1985, 1987) argued that the expansion of commercial bank lending during the 1970s was implicitly supported by the bank’s home governments, who sought to expand their export markets, where the key element would be capital recycled from petrodollars. The implications from Wellons’ analysis join those from other studies

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<sup>8</sup> At the time, Robert Devlin worked at the Economic Commission for Latin America and the Caribbean (ECLAC).

<sup>9</sup> Walter Wriston, chief executive at Citibank.

<sup>10</sup> Figures from the database kindly provided by Rockerbie (1989).

<sup>11</sup> Lamfalussy (2000); Sgard (2012).

<sup>12</sup> In December 1977, The Bank of England prepared a report called “Possible consequences of a default by a major borrowing country (Apocalypse now)” which forecasted the different scenarios and potential impact on the British banking sector (Bank of England Archives, file 3A143).

(Kahler, 1985) or Guttentag and Herring (1985), regarding the banks' reliance on support from their home governments and the IMF in the case of default. As a result, lending levels were kept high and borrowing costs were held to low levels until some months before the August 1982 Mexican moratorium.

Could supply side factors be a key explanation for the crisis? We can only speculate whether the 1982 crisis could have been averted through rationed lending or through indebtedness discouragement though increased borrowing costs. Even if some progress was achieved in terms of information availability and diversity of sources (Flores, 2014), its lack became, once again, the core of a new controversy in the 1990s, and again with a Mexican crisis. John C. Whitehead, Chairman of the Council on Foreign Relations of the U.S., concluded that "full financial information was not forthcoming to all investors. However, enough signals were apparent to at least encourage caution."<sup>13</sup> Nonetheless, Mexico's EMBI spreads had remained stable until a few days before the currency crisis that erupted in December 1994. Whether the tequila crisis could truly be anticipated is still a bone of contention, but one of the issues that could not have been avoided was the potential market distortions caused by moral hazard and rampant information asymmetries (Wyplosz, 1998). As we show in Section IV below, rating agencies were strongly criticized for their failure to downgrade Mexico before the crisis, nor were they more reactive previous to the Asian crisis in 1997.<sup>14</sup> The Group of Thirty (1995) launched a report entitled "Why didn't Wall Street Sound the Alarm" that justified the absence of reaction by foreign investors by the lack of information available. Mussachio (2014) provides, nevertheless, a review on the (known) fragilities of the Mexican economy, and attributes it to the overoptimistic expectations of investors after the economic and financial liberalization of the country.

Analyzing the sovereign bond issues of the 1990s, Nieto-Parra (2009) shows that countries that defaulted had issued debt in the previous years under relative favorable conditions in terms of spreads at issue. This contrasts with the behavior of the corresponding underwriting fees (the commissions charged by investment banks for placing government bonds), which did, in fact, react to increased financial distress in borrowing countries. This striking result suggests that information did not flow freely between agents and that banks were able to price the new issues more adequately than investors. It seems, however, that little progress has been achieved since then in terms of default forecasting. As reported in Gaillard (2014a), Greece was rated A by rating agencies two years before its debt restructuring. Whereas the author acknowledges in a different work a lack of objectivity to explain sovereign rating failure (Gaillard, 2014b), he concludes, nevertheless, that anticipating defaults is a difficult task to do: the risks that would lead to a rapid default include monetary, fiscal and political variables, but also, on natural disasters, and geopolitical risks. Hurricanes and dictators are difficult to predict.

## **II. A useful illustration: solving the Holdout problem with a proper institutional setting**

Let us now turn again to the demand side and assume that certain sovereigns are genetically prone to criminal behavior, financially speaking. The existence of costs—in the form of penalties or sanctions—associated with defaulting becomes necessary to the health of sovereign debt markets, as it prevents sovereigns from defaulting. One cost, stemming from the reputation argument and widely discussed in the literature, is the possibility to exclude defaulters from capital markets. A government

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<sup>13</sup> Kravis et al. (1996), p.16.

<sup>14</sup> Griffith-Jones (1997) and Bonte et al. (1999)

that cannot borrow on international markets loses the possibility to smooth consumption and prevent external shocks against external shocks —the main reason why governments would borrow in the first place. Any procedure that would “ease” default costs would therefore have detrimental effects on sovereign debt markets. Today, this is the main argument against a proposal to establish a recognized international legal procedure —for instance, through an Arbitration Court— that would remove the obstacles that currently prevent the rapid renegotiation of defaults (also called the “statutory approach”).<sup>15</sup> The history of sovereign debt markets, however, circumvents these arguments and demonstrates precisely the contrary. The emergence and the rapid development of this market have been accompanied by a decrease in the exclusion period of defaulters. How has this been possible?

Drelichman and Voth (2011) have argued that the penalty stemming from market exclusion existed already in the sixteenth century, when bankers colluded to avoid lending to default-loving Philip II. This lender capacity to collude could avert defaults and as a last resort, compel a defaulting government to resume repayments, or to at least negotiate an agreement with its creditors. Accordingly, international financial markets set up the necessary framework to maintain and to some extent, reinforce this mechanism, which operated until at least 1914. The overall trend of debt renegotiation periods —the de facto exclusion time from capital markets, see section below— shows that the length of time that these exclusions lasted has shortened since the early nineteenth century. They decreased from fourteen years during the 1821 to 1870 period, 6.3 years from 1871 to 1925, and 10.1 years for the 1926-1975 period (Suter, 1992).

This trend benefited both creditors and borrowers. From a creditor’s perspective, this was a guarantee that payment interruptions would be minimized, regardless of occasional losses stemming from haircuts (realized reductions on the bonds’ original nominal value). From a borrower’s perspective, this trend constituted a positive externality because penalties from market exclusion could be reduced. In other words, overpenalizing defaulters would be counterproductive — dying patients are just as bad for a doctor’s business as healthy ones are. During the nineteenth century, a reduction in the average period of market exclusion was partly due to the fact that “holdouts” —minorities of creditors that refuse to participate in an agreement with a defaulting government— were not such a problem as they are today. The near absence of holdouts throughout almost 150 years of international finance is remarkable, and could be qualified as one of the biggest successes of sovereign debt markets. Admittedly, even if the context is not directly transposable to the present, the mechanisms under which holdouts could operate were present and some attempts have been recorded. The literature has advanced two main arguments that attempted to resolve the holdout problem, one related to the legal context and the other to the institutional setting.

During the nineteenth and the early twentieth centuries, the main authorities that governed sovereign debt markets were Stock Exchanges, and not courts, as is common today (Waidenmier and Gulati, 2014).<sup>16</sup> Stock exchanges provided a basic, but mostly relevant filter for potential borrowers. To some extent, they had been put into place to oversee operational rules and regulations, but also, to avert misbehavior, encourage information transparency and if necessary, protect the interests of their members. The early evolution of the nineteenth century London Stock Exchange was one such example.<sup>17</sup> Flandreau (2013) explains how the London Committee for General Purposes (the CGP, which was, prior to 1828, the successor of the Foreign Stock Market Committee) could grant or refuse

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<sup>15</sup> See for instance, IIF (2014). The alternative “market based” approach suggests that the market could find its own solutions, such as via the inclusion of Collective Action Clauses. See IIF (2004).

<sup>16</sup> Waibel (2011) provides a historical review of the legal disputes surrounding sovereign defaults, their restructuring, and the roles of diplomacy and military interventions.

<sup>17</sup> Its evolution has been described in works including Michie (2001) and Neal and Davis (2006).



quotations to a foreign loan at the LSE if a government was in default and refused to "negotiate in good faith with its creditors" (Flandreau, 2013:7).

Flandreau (2013) calls this requirement "the non-default rule". It parallels the same need that the majority of bondholders agree to a repayment scheme with a defaulting government, in the sense that resolving the problem is a collective action. No precise level of majority was defined, but it sufficiently mitigated the holdout problem. This author also finds evidence that in some cases, rival groups of bondholders emerged and behaved similarly to what today would be equivalent to "vulture funds", i.e. bought the defaulted bonds at an extremely low price, and then used varying actions against defaulting governments in an attempt to negotiate an agreement where they would receive a higher price for the bonds. The available evidence showed that these attempts failed. The CGP was always in favor of obtaining the majority of investors in support of an agreement with governments, so holdouts had little chance of success. The CFP acted as a de facto arbitration court, and it remained so throughout the century preceding World War I.

For some scholars, there was an additional institutional innovation that was also responsible for reducing the market exclusion time period. This new type of institution emanated directly from the markets, and consisted of different corporations of bondholders that formed and were officially recognized in several European countries. The British Corporation of Foreign Bondholders, perhaps the most widely known of these bodies, intended to resolve problems related to collective action and holdouts. At the end of the nineteenth century, these investors attempted to collude and collaborate to exert pressure on countries that had defaulted. A set of works by Eichengreen and Portes (1989), Mauro and Yafeh (2003), and Esteves (2007), analyzed such institutions and found there were several advantages to their formation. Prior to the CFB's formation, committees of bondholders competed against each other, which weakened their bargaining power and prevented them from obtaining more advantageous deals with governments. This lack of a collaborative framework also had a negative impact on defaulting governments, as they remained excluded from financial markets for a longer period of time.

The utilized empirical evidence has, nevertheless, presented mixed evidence in regards to the success of the CFB experience. Three types of benefits for creditors and borrowers could be emphasized. First, because the CFB facilitated debt restructurings, it was responsible for a decline in the time period that defaulters were excluded from the market. Second, compared to other periods and experiences, the CFB helped investors reduce haircuts. Finally, the increased bargaining power obtained by the bondholders meant that there should have been a decline in the yields of countries that were the most prone to default.

A critical perspective of the CFB has highlighted several facts. One is related with the more favorable world economic context in the last decades of the nineteenth century, in which international trade strongly increased, along with international capital flows: repayment was facilitated through higher rates of economic growth.<sup>18</sup> Moreover, Flandreau and Flores (2012a) study the reaction of the bonds' yields of defaulting governments during the time period surrounding the establishment of the CFB to test investor acceptance of the CFB's ability to broker favorable agreements. They did not observe any decline in yields, except for the case of Colombia, where the CFB's announcement of its intervention was supported by the Baring bank. Furthermore, Flandreau (2013) makes a direct analogy between the existence of the CFB and today's argued advantages of CACs, as in principle they have the same aim, which is to facilitate agreements by majorities of bondholders, prevent holdouts, and encourage

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<sup>18</sup> Flandreau and Zumer (2004) argue that the decline in the debt to GDP ratio during this period can be traced to higher increases in GDP growth than in nominal debt, which was also on the rise.

collective action. This view of the historical experience contrasts the perspective found in Eichengreen and Portes (1989), who demonstrate that the superior organizational power of the CFB in comparison with its U.S. counterparts during the 1930s allowed British investors to obtain higher internal rates of return. Flandreau (2013) casts doubts on these results, due to sample biases and heterogeneity during each period, and suggests that no major differences exist between the IRR of dollar and sterling bonds. Finally, Esteves (2013) recognizes that the most favorable results from an investor's perspective — measured by the importance of rescheduling haircuts— were those in which the big banks participated (for reasons explained below). He contends, though, that the CFB did obtain better results in the dealings that it participated in than those obtained solely by bondholders or other issuing banks. While the relevance of the CFB in securing better terms from debt restructures is unclear, a proper institutional setting appears to be a necessary condition for the decline in exclusion periods faced by defaulting governments.

### **III. Surfing the wave: debtors' survival in lending boom and bust cycles**

Why have some countries historically chosen to keep paying back their debts? One way to respond to this question is to consider which types of penalties have averted governments from default. A long-term perspective could be illustrative. Here we summarize historical trends in defaulting behavior identified in previous works. In the last 200 years, several lending cycles can be observed: the 1820s, the 1860s, the 1880s, the 1920s, the late 1970s and the early 1990s.<sup>19</sup> Each of these ended in more or less severe busts, once the world business cycle moved downwards and defaulting became either attractive or unavoidable. Several scholars have frequently remarked that defaults are concentrated in time and geography. There are, however, other elements that can be highlighted, among which, the fact that countries that have chosen *not* to default share similar initial conditions with defaulting countries. A common pattern emerges among unexpected non-defaulters: they chose not to participate, or were involuntarily excluded from the lending boom. In other words, penalties generally have not averted governments from defaulting. Rather, the countries that did not default were those that did not borrow in the first place.

In the 1820s, the wave of defaults started in 1825 and was not completely resolved until very late during the nineteenth century.<sup>20</sup> While all the Latin American and Southern European countries that borrowed during the boom years defaulted, Naples and Brazil emerged as main exceptions. Dawson (1990) argues that there were two main reasons for Brazil's exceptionalism. One is Brazil's particular path to independence, which involved much less political instability and led to the continuity of a monarchy, in contrast to many of the new unstable Latin American republics. However, the state of public finances did provoke a set of discussions among Brazilian parliamentarians, some of which favored default (Barroso, 1937). A second reason was the continuous financial support from Rothschild (the case of Naples was similar; see Gille, 1965 and Flandreau and Flores, 2009). Finally, despite Brazil's difficult macroeconomic position in the early nineteenth century, the country avoided default and remained so until 1898. However, until the 1880s, Brazil hardly participated in sovereign

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<sup>19</sup> Suter (1992) provides a comprehensive list of defaults and their duration that have taken place since the early nineteenth century. Reinhart and Rogoff (2009) estimate that in the boom-bust cycles of the nineteenth century, at least 40 percent of the issues defaulted. Flandreau et al. (2010) look at these different cycles, with the exception of the 1970s, which is different than the typical originate and distribute system that prevailed in other periods.

<sup>20</sup> Mexico defaulted in 1828 and reached a permanent agreement with bondholders only in 1888, under the dictatorship regime of Porfirio Díaz. See Salvucci (2009) on the history of Mexican debt during the nineteenth century.

debt markets;<sup>21</sup> the general lack of foreign capital has further been raised as one of the reasons for Brazil's stunted development in the nineteenth century (Leff, 1997).

A second lending cycle terminated with a worldwide economic crisis (also called the "Great Depression of the Nineteenth Century", see Marichal, 2014), during which Peru, the Ottoman Empire and other Latin America countries defaulted during the 1873-1876 downward slump. The defaults that followed had long-lasting effects, to the extent that fiscal and even political control by creditor governments were involved in the crises resolutions.<sup>22</sup> On the contrary, Argentina unexpectedly avoided default, a fact that has been evoked as a major reason why the country enjoyed high volumes of capital inflows some years later (Flores, 2011). In fact, the country borrowed only modest amounts compared to other, more active governments (Peru and the Ottoman Empire, in particular), while its terms of trade strongly improved, thereby boosting the performance of its exports.<sup>23</sup> Argentina's exclusion from capital markets was one side effect of its delay in reaching a permanent agreement with investors: after its 1824 default, an agreement, promoted by its original underwriter, Baring, was only reached in 1857. A modest loan issued in London had to wait another nine years (Ferns, 1992).

A third cycle that took place during the 1880s, ended with the famous Baring crisis of 1890, in which Argentina and Uruguay defaulted and several other countries in Latin America and Southern Europe followed. Most of the defaults were resolved rapidly, though in some cases, a final resolution was only reached as late as the first years of the twentieth century. By then, international trade had continuously increased and capital flows were at higher levels than any other time in history.<sup>24</sup> This time, a major "outlier" was Mexico, a serial defaulter that had rearranged its external debt position in 1888. Again, Mexico had hardly participated in the lending boom precisely because at the peak of the lending boom, the government was still negotiating a permanent debt agreement with its creditors (Costeloe, 2003). On the other hand, Brazil was obliged to restructure its external debt for the first time, after a decade of sluggish economic growth and unfavorable coffee prices, a crop that constituted the country's main export revenues.

The 1920s saw a brief but intensive period of high levels of foreign government lending, mainly from the New York financial market.<sup>25</sup> This lending boom ended abruptly with the arrival of the Great Depression, the consequent disintegration in international trade and capital markets, and finally the

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<sup>21</sup> A currency crisis at the end of the 1850s and an adverse economic context impeded Brazil from obtaining new external funds at the height of the lending boom of the 1860s (Rothschild remained Brazil's main underwriting bank), and partly explains its modest indebtedness compared to other Latin American countries. See Gille (1965).

<sup>22</sup> This was notably the case of Egypt and the Ottoman Empire. Wynne (1951) provides a detailed description on both default episodes, Hunter (1998) for Egypt and Birdal (2010) for the Ottoman Empire.

<sup>23</sup> Between 1862 and 1873, Argentina borrowed 12.8 million sterling pounds, while Peru borrowed 41.7 million sterling pounds, and Turkey 76.9 million. For comparative purposes, Argentina's exports were double those of Peru. Suzuki (1994) provides a comprehensive list on foreign government loans issued in London during the nineteenth century. On exports and economic growth in nineteenth century Latin America, see Bertola and Ocampo (2012).

<sup>24</sup> Bailouts were mainly organized by underwriting banks, though creditor governments would eventually participate. The imposition of different kinds of external controls was set up in exceptional cases. In Greece, for instance, an International Financial Commission was set up by the governments of Great Britain, France and Russia. See Borchard (1951) for a detailed description, Mitchener and Weidenmier (2010) for cases of external control, Rosenberg and Rosenberg (1987), and Rosenberg (1999) for the case of U.S. intervention in Central American countries.

<sup>25</sup> Klug (1990) argues that the U.S. government promoted a policy of foreign lending as part of its strategy to resolve the problem of war debt and reparations. Eichengreen (2003) argues that the U.S. government encouraged reconstruction and development loans to "strengthen the competitive position of their banks and firms".

wave of defaults from governments worldwide, many of which were resolved once World War II ended. Most Eastern European countries that participated in the lending boom defaulted, with the notable exception of Estonia, the sole country supported by the League of Nations that continued to meet its debt service during the 1930s. However, the government had only issued one small loan that did not represent an important charge for the government's public finances.<sup>26</sup> In Latin America, one of the exceptions to this general trend was Argentina, which kept servicing its debt payments as part of a larger trade and economic agreement it made with Great Britain in 1933, (the pact Roca-Runciman, see Marichal, 1989 and Rapoport, 2006), although Tomz (2007) contends that the payments were only continued because of the Argentine government's desire to maintain its reputation. A notable contrast between the country's behavior during the 1930s and previous non-defaulters was the fact that the government had substantially participated in the 1920s lending boom.

After the deregulation process took place during the last years of the Bretton-Woods monetary regime, a new lending boom emerged in the 1970s. In contrast to previous lending booms, this time it was international bank syndicates who provided variable interest rates loans, mainly to developing countries and to Eastern Europe. This cycle ended with a series of defaults in the early 1980s, first in Eastern Europe and later in Latin America, Africa and the Philippines. One exception to this general trend was Colombia, which, again, borrowed a much smaller amount than other defaulting countries (Kalmanovitz, 2010; Ocampo et al., 2014). Many Southeastern Asian countries, though having borrowed substantial sums, avoided default, given their strong rates of export and economic growth.<sup>27</sup> Finally, the 1990s lending boom ended with a set of debt crises and defaults, starting with Mexico in 1994, but affecting other countries such as Russia in 1998, Brazil in 1999, Turkey in 2000 and Argentina in 2001 (Sturzenegger and Zettelmeyer, 2006). The levels of public debt were not high overall, though the structure (short-term, as in the case of Mexico) and rapid devaluations (Mexico and Russia) affected the fiscal position of the defaulting governments.

#### **IV. Market distortions or why there will always be defaults**

A sovereign default can be foreseen under particular events, such as a continuous deterioration in the macroeconomic position of a country, an adverse external shock, or a political shift that could lead to debt mismanagement or repudiation.<sup>28</sup> Frequently, markets have been unable to avert further borrowing, or to price for the increased default risk. A strand of the literature on financial contagion identifies a mechanism through which investors experience a "wake-up call", once problems in one country triggers a risk reassessment in other countries.<sup>29</sup> The literature has also explored whether market distortions have had any effects on the volumes and prices of sovereign lending and ultimately, whether defaults could have been averted, or at least, whether the consequences of defaults on financial markets could have been mitigated.

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<sup>26</sup> Estonia's government issued £1.5 million, which was an even lower level lower than Danzig. Its debt service to public revenue ratio was equivalent to about 12% (own estimates from the League of Nations annual reports).

<sup>27</sup> A useful comparison of debt to GDP ratios and GDP to export ratios between Latin American and Southeastern Asia countries can be found in Sachs and Williamson (1985).

<sup>28</sup> This may be the case, for instance, during an episode of macroeconomic populism (see for instance, Dornbusch and Edwards, 1991) or those behind the concept of "odious debt" (See Howse, 2007).

<sup>29</sup> Goldstein (1998), Masson (1999) or Goldstein et al. (2000). The case of Russia in 1998 has been reviewed in Chiodo and Owyand (2002).

Historically, financial market public authorities have attempted to provide the most adequate regulatory framework to avert sovereign defaults when markets fail to do so. This involves the introduction of laws and rules to encourage proper risk management and portfolio diversification by investors and financial intermediaries, and also to avoid conflicts of interest and other measures that intend to avert excessive high risk lending.<sup>30</sup> The famous 1933 U.S. regulation leading to the Glass-Steagall Act is perhaps the most famous example. However, several reasons, which we enumerate below, have impeded these mechanisms from responding to the necessities of the markets, and have triggered contractionary episodes.

The first mechanism to prevent defaults is to avoid high risk lending in the first place. The history of financial crises provides cases of regulators and enquiry commissions set up by parliaments in creditor countries to look for the "suspects" and the market flaws that led to the crisis.<sup>31</sup> In certain cases, however, those reasons seemed anodyne. A proper price attributed to the risk involved when the loan was issued should have been sufficient to attract investment to more risky issues. In fact, despite considerable criticisms directed towards banks in different crises episodes, the estimates of investors' historical returns from foreign government lending are positive and higher than comparable potential investments in domestic assets. Lindert and Morton (1989), who analyze and compare the realized return rates of the ten major borrowers from 1850 to 1983, estimate that in six cases, these rates were higher than in domestic assets (an equivalent home government long-term treasury bond).

Accordingly, regulatory attempts seemed destined to fail. Furthermore, contemporary testimonies demonstrate why sovereign debt markets have remained attractive. In the 1876 Commission set up by the British Parliament, Nathaniel Meyer de Rothschild blamed investors' "disease" whose essence was "the desire of people to get a high rate of interest for their money".<sup>32</sup> In the hearings before the Committee on Finance of the U.S. Senate in 1931, Thomas Lamont from J.P. Morgan is quoted in a speech in 1926 —at the apogee of the lending boom—in which he dismissed other banks' attitude "competing on almost a violent scale for the purpose of obtaining loans in various foreign money markets overseas" (U.S. Senate, 1931: 25). In fact, Eichengreen (1989) identifies a considerable difference between the yields offered by medium-grade domestic bonds in the US (5.5%) and foreign bonds (yielding 7-8%) for those years. A similar debate was again brought up once again in 1983, in the Hearings before the Subcommittee on Financial Institution Supervision, Regulation and Insurance, where the Chairman, St. German diagnosed the lack of prudence by commercial banks on the fact that "those profits looked so big to a lot of prudent people who were charged with the responsibility of making prudent decisions" (U.S. Government, 1983: 169).

Apart from promised ex ante high yields, preventing high-risk lending is further complicated because the essential meaning of "high-risk" is loose and may have been distorted by a set of factors related to macroeconomic conditions in creditor countries (push factors), financial displacements — borrowing the terms from Kindlebergers' classic *Manias, Panics and Crashes* — and by information asymmetries. These different aspects could have affected the risk eagerness of investors during the boom phases (see next subsection), but also the investment prospects of borrowing governments. So

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<sup>30</sup> Prudential lending by commercial banks has been a main issue for governors of central banks at the BIS since 1962, as an implicit recognition of the risks stemming from the recently created Eurocurrency markets (Toniolo, 2005).

<sup>31</sup> Marichal (2014) offers a comprehensive review of these episodes.

<sup>32</sup> Report from the Select Committee on Loans to Foreign States, House of Commons Parliamentary Papers, Question 5767, 13 May 1875.

for instance, the lending boom to the newly independent Latin American countries in the 1820s can be explained by the promising expectation of high returns, given the new opportunities stemming from international trade, mainly through the exploitation of mineral resources, but also due to the fact that interest rates in Britain were low.<sup>33</sup> While these promises may have been the result of exaggerated marketing by brokers and financial intermediates, it was obvious that the necessary information for an international investment decision was still unavailable: figures on the fiscal position of Latin American governments, for instance, were extremely difficult to obtain.<sup>34</sup> In an extreme case, even the now-famous case of the fictitious country of Poyais, whose *cacique* could place 2 million pounds sterling worth of bonds on the market. An overview of the contemporary publications at investors' disposal confirms that information was incomplete at best, and inexistent at worst. The production of economic information and the availability of public sources have constantly expanded since then.<sup>35</sup> Nonetheless, the need for proper information processing has reemerged in the recent crisis, as demonstrated by the proposals that aim to circumscribe the potential conflicts of interest in the financial sector, as investors are still “being encouraged to make their own credit assessments” (Gaillard and Harrington, 2014).

### *Distortions stemming from high liquidity episodes*

Periods of high liquidity often coincide with favorable world economic conditions. Eichengreen (2004) characterized lending booms by an increase in both international trade and capital flows. During these periods, risk premiums may lose any relation to macroeconomic fundamentals,<sup>36</sup> which may subsequently deteriorate. Absolute public debt levels may increase because easy access to credit can have positive effects on economic growth, and this could have a short-term positive externality on public finances. Implementing countercyclical fiscal policies may appear less appetizing: even more so if a government expects a lack of access to international credit during a recession (Gavin and Perotti, 1997; Riascos and Végh, 2003; Caballero and Krishnamurthy, 2003) or if there are political pressures to avoid reductions in spending (Tornell and Lane, 1999). However, the effects stemming from global financial factors may disguise the importance of macroeconomic imbalances. The most recent evidence is related to the measurement of risk aversion around the Southern European debt crisis, where credit default swaps seem to have been driven not only by macroeconomic fundamentals, but during certain subperiods, CDS were also largely driven by changes in risk aversion and liquidity conditions (Ferdinand Heinz and Sun, 2014).<sup>37</sup>

Global financial factors were highly relevant in certain historical episodes of overlending and severe busts. During the 1860s, the liberal commercial policies in several European countries and the reduced transport costs encouraged the growth of international trade. The corresponding increase in capital flows and foreign government lending did not strongly discriminate amongst the set of new borrowing governments that entered the market. In the case of Peru, guano exports boomed during the upward

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<sup>33</sup> See Dawson, 1991 or Fodor, 2002.

<sup>34</sup> On the sources available to investors in London, see Flandreau and Flores (2009). The deteriorated position of public finances in Latin American countries, see Vizcarra and Sicotte, 2009.

<sup>35</sup> The state of information sources of London investors on South American countries is described in Flores (2011). Flandreau (2003) shows the case of Crédit Lyonnais' creation of its Department of Economic Studies, a nineteenth century case that foreshadowed the present credit risk analysis. Gaillard (2012) describes the need and emergence of rating agencies.

<sup>36</sup> This is particularly relevant for the literature on banking crises. See Gavin and Hausman (1996).

<sup>37</sup> These results confirm the findings in previous works linking global risk aversion and sovereign risk, such as Pan and Singleton (2008).

cycle (this sole product represented about a third of total exports, see Bertola and Ocampo, 2012), and the country could borrow at very low interest rates despite the fragile state of its economy (Marichal, 1989; Vizcarra, 2009). Egypt's Viceroy Said Pasha also appealed to foreign finance to cover the costs related to the construction of the Suez Canal (Hunter, 1998). Egyptian public finances had been in poor conditions for at least ten years before the default, and there had even been a failed commitment by the government to freeze any new foreign lending (Wynne, 1951).

The 1860s were further characterized by the large number of new borrowers present on the London financial market, surpassing the boom periods of the 1820s and the 1880s. Nevertheless, we could only hardly confirm whether some prior screening existed before these high risk loans were placed on financial markets. From the total number of loans on behalf of these unseasoned borrowers during the 1860s, 58% eventually defaulted (estimated from the dataset from Flandreau and Flores, 2012, Table 2). For comparative purposes, this figure was about the same in the 1920s, when 53% of the loans on behalf of new issuers also defaulted.

On the contrary, during global downturn cycles, countries may be more easily tempted to default. The consequential decrease in economic activity and decline in public revenues constitute one source of financial strain. The consequences of global crises involve a general drop in international trade and capital flows, which means that the costs of defaulting are considerably lower. In the 1930s, defaulting was considered an attractive option, given the higher levels of protectionism and the lack of credit caused by the 1929 Stock Market crash (Bacha and Diaz-Alejandro, 1982). Even in less extreme cases, the costs of new borrowing increases, which may rapidly lead to liquidity problems. Downturns in the international business cycles mean that economic growth perspectives deteriorate as exports and foreign investment decline. Moreover, as in the most recent crisis, flight to quality means that investors cease investing in more risky issues and instead show a preference for safe assets, triggering the feared "sudden-stops" of capital flows.<sup>38</sup>

Ford (1956) observed that in as early as the nineteenth century, even if foreign borrowing was invested in profitable long-term projects, a fall in capital inflows might have led to a liquidity crisis. He termed these events "development crises", because short-term loans were invested in long-term projects, such as railway construction. Debt servicing was difficult, given the long period necessary for the projects to become profitable. This dependency on the business cycles of capital exporting countries also lies at the analysis of capital flows dynamics by dependentist economists (Prebisch, 1919). Today, a parallel argument is raised by scholars who support the need for an international lender of last resort. During a financial crisis, countries that may be temporary under liquidity pressure — due to the external shocks from international financial markets — would still be able to remain solvent if additional resources were temporarily made available. The adverse reaction of individual investors to a country's liquidity problems may be rational, though it appears as irrational from the perspective of the market. As demonstrated by Radelet et al. (1998) during the 1997 Asian crisis, the lack of possibility for collective action among investors, and the fact that there was no lender of last resort, resulted in an exaggerated market response.

Finally, the importance of global factors has been used to explain the apparent paradox behind the relatively weak correlation between individual countries' business cycles and defaults. Whereas certain authors observe that countries do tend to default in "bad times", in many other cases, they opt to default even during "good times". The definition of good and bad times depends upon whether output is above or below trend, and, as observed by Panizza et al. (2009), does not consider global

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<sup>38</sup> A historical perspective of sudden-stops can be found in Catao (2007).

credit factors. These authors also note a somewhat striking fact: “the connection between capital market conditions and defaults has not been emphasized very much in the classic literature on sovereign debt” (Panizza et al., 2009:668). One message from their surveyed literature on investment behavior and expectations is similar to that which can be extracted from history: taking the existence and structure of sovereign debt as a constant, tightening external financial conditions may lead to waves of sovereign defaults.

### *The conflict of interest problem*

Different actors have suffered problems related to conflicts of interest, which have been present in the financial sector in varying forms.<sup>39</sup> Conflict of interest cases in the 1990s and 2000s have been identified by several authors, in different contexts. Its relevance, on the contrary, has been much disputed in the past. Today, potential conflicts of interest have been considered to explain pricing failures or the unexpectedness of sovereign defaults. In the case of investment banking, Nieto-Parra and Santiso (2007) argue that recommendations by investment banks had an impact on the allocation of portfolio flows in emerging-market assets during the 1997 to 2006 period, and that these recommendations were more important than macroeconomic variables. The recommendations were strongly affected by the underwriting activities of the investment banks at issue. Furthermore, underwriting activities could be particularly problematic during high liquidity periods, because banks would be willing to maximize earnings from fees and promote new loans without engaging in information production. While this potential flaw can be discounted by investors, it is unclear whether this pricing suffices to avert defaults.

Have conflicts of interest affected the frequency of defaults in the past? How have these conflicts of interest been resolved? The nineteenth century provides an interesting context in which information asymmetries constituted a huge obstacle for international investors, and, in fact, was a main impediment against further financial integration (Bordo et al., 2000). Merchant banks emerged as key actors to surmount these adversities, as many of them generated a considerable amount of “soft” information from their contacts with local governments and merchants (Chapman, 1984). The increased demand for external funds by governments worldwide was met through the intermediation of merchant banks, which were well positioned to match the demand with the capital supplied from international financial centers. The corresponding conflict of interest appeared as these banks possessed a double role as information providers (to investors and, occasionally, to the financial press) and underwriting agents. The 1890 crisis illustrates this concern. The Baring bank was accused of placing bonds on behalf of Argentina's government, despite the bank's awareness of the high risk of default. However, Flores (2011) demonstrates from archival evidence that this did not seem to be the case, and that during the 1880s investors did not expect Baring to play a certification role.

Other cases of possible conflicts of interest have generated mixed evidence. In the 1920s, the debate over whether commercial banks had a conflict of interest provoked a series of inquiries from the U.S. Senate, whose results lead to the Glass Steagall Act in 1933. However, subsequent research has demonstrated that the conflict of interest did not have an impact on the relative performance of the bonds issued between commercial and investment banks (Kroszner and Rajan, 1994). Looking at the pricing of securities underwritten by banks and investment houses, Puri (1996) tests whether investors priced the securities according to a potential conflict of interest. In fact, commercial banks were found

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<sup>39</sup> On the problems and solutions of conflicts of interest in the financial sector, see Crocket et al. (2003).



to have provided a "certification effect", given their close relationship with firms and commercial banks. In the case of foreign government securities, no major differences were reported, as banks were expected to provide distribution, rather than certification services.

The new regulatory framework that emerged in the U.S. after the 1929 crisis placed rating agencies at the heart of banks' portfolio evaluation in 1931, implicitly assuming that these actors were, contrary to underwriting banks, free from *any* conflict of interest. This initiative was justified based on the fact that compared to banks and investors, rating agencies possessed superior prediction capabilities.. Nevertheless, Flandreau, Gaillard and Packer (2011) demonstrate that the rating agencies' performance in terms of defaults forecasting was as deceiving as that of the banks. These authors observe that "high-grade" ratings were no guarantee against default (more than half of all defaulted bonds during the interwar period had a high-grade rating at the time of default). Notwithstanding this poor performance, the rating composition of foreign government bonds did deteriorate in the later part of the 1920s, though apparently, the shock of the sterling crisis in 1931 was too rapid and too violent to predict. Comparatively speaking, certain common criticisms with today's rating agencies could be found in the 1920s, such as the problem of ratings' procyclicality and their poor ability to avert default. There are, nevertheless, important differences. The evolution of rating agencies in the post-1945 period, rating agencies have become concentrated, leading to an oligopolistic structure, and has placed rating agencies in a new potential position of conflict of interest. The passage from the investor-pays to issuer-pays model in the 1970s implied that ratings could suffer from upper biases, mainly as a consequence of competition and the desire to retain market share.<sup>40</sup>

Another relevant contrast between the 1920s and today is the difference in ratings given by the individual credit rating agencies, which showed more variations in the interwar period, as reported in Flandreau, Gillard and Packer (2011). While today's reliance on ratings in the regulatory rules has provoked rating inflation stemming from competition, in the 1920s, reputation was at the core of rating agencies behavior, which meant that better forecasting could lead to increased market shares. Moreover, this kind of market mechanism —in which reputation led to an increase in market share— is illustrated in the history of underwriting banks. In a set of studies on nineteenth century underwriting markets (Flandreau and Flores, 2009, 2012a and 2012b), we show that major financial intermediaries —those with dominant market shares— were responsible for selecting the loans that were issued on the market as safe loans: a bad choice would have a negative impact on their reputation. These banks engaged in information production and long-term relationships with borrowing governments (thereby also generating soft information), and thus would be very careful when placing new loans, acting as lenders of last resort in periods of financial distress. This reasoning allowed them to dominate the sovereign debt market during the nineteenth century (Rothschild and Baring) in London, and later in New York in the 1920s (JP Morgan).

One implication of these developments was the appearance of a segmented market, both during nineteenth century (London) and the 1920s (New York), in which high-risk securities were issued by "non-prestigious banks", while securities with low risk of default were issued by major underwriters. In contrast with today, the certification task that should have been pursued by these financial intermediaries has been, instead, taken over by rating agencies (Flandreau et al. 2010). Moreover, today's financial intermediaries have lost the incentive (or the capacity) to engage in lender of last resort activities —a practice that became rational and profitable given the long-term relationships between underwriting banks and borrowing governments during the nineteenth century— a task that has been partly left to international organizations. A side effect of this oligopolistic structure was a

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<sup>40</sup> On the passage of investor pays to issuer pays model, see White (2010).

much more restrictive market than today. The proportion of high-quality, low-risk securities, however, was higher than in the 1990s.

### *Costs and benefits of International Financial Institutions*

One additional bone of contention concerns the effects of international financial institutions in supporting sovereign debt markets. The IMF has had an active role as a crisis mediator, monitor, provider of hard information, and lender of last resort (Sgard, 2012; Flores, 2015). On the other hand, this institution has been held responsible for causing debtor and creditor moral hazard, which has led investors to misprice the risk of the bonds and lend to countries with a high probability of default.

While a counterfactual analysis of the development of sovereign debt markets in the absence of the IMF is complicated, we can briefly provide what is the historical experience with international organizations. While they were absent until the 19<sup>th</sup> century, the League of Nations' Economic and Financial Organization (EFO) assumed certain functions that would be later adopted by the IMF (Flores, 2015 and Flores and Decorzant, 2015). The EFO emerged as a main actor in the economic reconstruction efforts of Central and Eastern Europe after World War I. The idea of the League was to attract private investment to countries that remained excluded from financial markets. The League was active, to the extent that it coordinated efforts by governments in Europe to participate in the financing of these countries and assisted them in their set up of national economic institutions—in particular, the establishment or reforms of a central bank—and acted as a monitor and information provider in the countries in which the League intervened.

Several studies have demonstrated that the League played a catalytic role, to the extent that the loans issued under the auspices of the League were major successes (Eichengreen, 1989; Flores and Decorzant 2015).<sup>41</sup> One of the main shortcomings, however, was that the League lacked its own capital, which impeded its potential capability to act as a lender of last resort, a main contrast with today's IMF. The procedure followed by the League had several advantages that were adapted to the situation of the 1920s—including the impossibility of suffering from moral hazard—when financial markets were in a position to invest if they were provided with trustworthy and profitable investment projects. The situation in the 1930s was different, with the internal shocks of borrowing countries being accompanied by shocks in the main financial centers of Europe and the U.S. When the Great Depression hit Europe, borrowing countries needed rapid assistance that the League was unable to provide.

## **V. Market and political sanctions: too much or too little?**

The proposals to reform the legal framework under which sovereign debt restructures could be negotiated have run against the general argument on the need to keep the costs of defaulting high. Sanctions and penalties are implicitly assumed to be relevant for the proper functioning of sovereign debt markets. In section II we raised the issue of market exclusion, but other types of sanctions could be considered. Political penalties may involve an active role by the home countries of international creditors. They include trade embargoes, diplomatic pressure and even external intervention. Market sanctions are responses from market actors (creditors, financial intermediaries or stock market authorities) that have the capacity to retaliate against a defaulting government. Such measures may

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<sup>41</sup> The catalytic role of the IMF is a bone of contention in the academic literature. See Bird and Rowlands (2004).

involve, other than exclusion from financial markets and increased borrowing costs, a lack of trade finance and a fall in bilateral trade.

The importance of political penalties has been evoked as one major coercive method that leads countries to repay their debts. For Mitchener and Weidenmier (2010), these extreme sanctions improved the fiscal discipline of the countries intervened, experienced a decline in their ex ante default probabilities and spent no additional time in default, concluding that “some type of external fiscal and monetary control may be effective in imposing discipline on serial debt defaulters” (Mitchener and Weidenmier, 2010). These results contradict, to a large extent, the reasons why political penalties have weakened in the more recent periods. The basic premise would suggest that these types of penalties may trigger problems of free riding: investors may be willing to invest in high risk countries — and pocket high interest rates— while, on the other hand, avoid the potential losses from a default. In a sense, it parallels the moral hazard argument that is evoked in the case of the IMF.

Historical periods have shown less evidence in favor of political penalties. Waibel (2011) demonstrates that political responses to defaults included, amongst other options, military interventions, though he describes the use of force as a complex decision in which different political variables were considered. The Drago doctrine in 1902 marked the decline of this means to resolve defaults. For a previous experience of nineteenth century Britain, Platt (1968) describes how the British government was reluctant to intervene in defaulting countries, though a certain kind of diplomatic pressure may have existed. In exceptional cases, when interventions took place, other motivations accompanied the active role of the British government. Even so, episodes of gunboat diplomacy were never been really a common practice in international finance (Flores, 2011), and were strongly concentrated in the case of several Central American countries in the early twentieth century—in the case of the US— and only occasionally practiced by Great Britain, and even less after the 1930s. On the other hand, external fiscal control has been utilized in different contexts, as mentioned above. Examples of this type of control include Greece, Turkey, Egypt in the nineteenth century, and Central America and the Caribbean in the early twentieth century. During the 1920s, the League of Nations exerted a control on the countries where it had intervened. Nevertheless, this type of control proved to be inefficient and it did not impede the defaults that followed in the 1930s.

In regards to market penalties, several scholars have been skeptical about the consequences stemming from the loss of reputation in capital markets. Özler’s (1993) “How Banks Ignored History” insisted that banks expectedly “punished” previous defaulting countries with (slightly) higher interest rates, while Lindert and Morton (1989) had previously shown that investors do ignore the past. Other authors also find weak evidence on the costs of defaulting, reputation loss and increases in borrowing costs and exclusion from capital markets (Bulow and Rogoff, 1989; Gelos et al., 2011; Panizza et al. 2011). More recently, however, Cruces and Trebesch (2013) have argued that market penalties have been present in the 1970 to 2010 period, but that their relevance depended upon the level of haircuts that were agreed upon in restructuring agreements. Hence, higher haircuts are associated with higher subsequent bond yield spreads and longer periods of capital market exclusion. For a longer historical perspective, the effects of defaults on long-term borrowing costs have been analyzed in Tomz (2007). Non-defaulting countries have been able to borrow at lower rates, while defaulting governments have been obliged to pay premium rates to access capital markets. Further historical evidence comes from the experience in the late nineteenth century. Flandreau and Zumer (2004) estimated that a default may increase the risk premium by 500 basis points during the next ten years. Moreover, Catao, Fostel, and Mano (2015) do find a historical consistency for a “default premium” beginning in 1870.

Other market penalties provide mixed evidence. In the case of a potential drop in international trade, Rose (2002) observed that bilateral trade between creditor and borrowing countries fall after a sovereign default. The precise link between defaults and bilateral trade is still unresolved. One possible explanation is a potential sanction. However, in principle this would be counterintuitive, as reducing international trade would negatively affect both countries. In fact, this evidence has been explored during past episodes of international finance. Both the markets and public entities have been responsible for enforcing this condition. Mitchener and Weidenmier (2005) did not find any evidence of an impact on nineteenth century bilateral trade.

Contemporary literature has looked for other links to explain the decline in international trade. One of the links is trade finance, which may be strongly affected by a sovereign default, mainly if the country experiences a currency or banking crisis (Borensztein and Panizza, 2010). Auboin and Engemann (2012) estimate how the recent financial crisis affected the real economy through the lack of credit for export-import firms and through mistrust of counterpart banks from crisis-hit countries. A sovereign default may trigger similar effects: first, through an increase in interest rates for firms from countries in default, as can be seen in historical crises as well as in the recent episode in Argentina, but also in more historical crises, and second from the lowered country exposure that international banks may be willing to tolerate.

Trade finance has been explored in historical periods. Flores (2008) explores the link between sovereign defaults and financing international trade, as both activities relied, to a large extent, on merchant banks. He demonstrates that during the 1890 crisis, Argentina's default triggered Baring's withdrawal from financing trade with that country. Given that both underwriting and trade finance were both concentrated markets, it is almost certain that other defaults have generated similar effects. In the case of the post-1982 crisis, the IMF (2003) has argued that trade finance was not an important issue during those years. However, Alvarez and Flores (2014) show that this was not the case. International banks engaged in trade finance, as well as several official credit export agencies, withdrew their support to defaulting countries. Nevertheless, public intervention smoothed over the immediate effects of these policies. Governments in creditor countries encouraged defaulting countries to enter into an IMF loan program, after which the respective export credit agencies were engaged to maintain their credit levels. The drop in the levels of imports that followed the debt crisis was more related to the drop in income and changes in relative prices than to the drop in trade finance.

A final market sanction is the behavior of foreign investments in the aftermath of a sovereign default. This link is often a byproduct of the consequent increase in sovereign risk after a default. An increase in borrowing costs also diminishes the demand for capital by firms to an extent, because governments' borrowing costs also influence private borrowing costs. Kaminsky and Schmukler (2002) argued that sovereign rating changes affect not only the bonds being rated but also the stocks. This introduces greater volatility into a country's stock market and increases the costs of corporate finance, which is also partly due to the so-called "sovereign ceiling doctrine". These authors also argue that even international trade can suffer because of the higher costs faced by commercial banks in issuing internationally recognized letters of credit, which thereby affect economic growth. Recent works by Grandes and Peter (2005), Cavallo and Valenzuela (2010) and Borensztein et al. (2013) also confirm that sovereign risk affects corporate bond spreads in emerging markets. They find that this effect is asymmetric, having a stronger positive effect when sovereign risk increases. Borrowing costs for both private and public agents will therefore determine levels of private and public investment and economic growth.

Overall, it seems unlikely that sanctions are too weak to be ignored. On the contrary, it may be even argued that a “fear of default” has emerged and governments only very reluctantly cede to debt restructuring (let alone debt repudiation). In a highly integrated economy, where a default may impact trade and investment, this is the logical outcome. Whether we have reached an optimal level of default sanctioning, or whether it has gone too far is a different issue. Two facts may point to this somber possibility. The first is the observed timing of default, considered to be “too late and too little”. This implies that countries may be caught in situations of prolonged pre-default crisis, boosting thereby the side-effects of a default (Panizza, 2013).

Second, the “fear of default” causes additional inefficiencies because governments incur considerable costs in legal fees for every new bond issuance. In a recent paper on the evolution of sovereign debt markets, Bradley et al. (2014) observe that the identity of certain law firms began to gain recognition in the post- World War II period. Outside prestigious law firms that participated in the issuance of new loans could be engaged to participate in the process with the issuer and with the underwriter. The decision regarding the identity of the law firm in both cases relied solely on the issuer choice, and in fact, the observed relationship between law firms and borrowers was a long-term relationship, contrary to the short-term nature of the relationship between underwriters and issuers. Bradley et al. (2014) conclude that the more risky a country is (measured by their rating status), the more prestigious a law firm it retains. The authors interpret this to mean that as these countries consider default a real possibility, they prepare for future lawsuits by hiring these firms. As a result, these countries are faced with additional borrowing costs.

## **VI. Conclusions**

Diaz-Alejandro wrote in 1984 that “blaming victims is an appealing evasion of responsibility, especially when the victims are far from virtuous. But when sins are as heterogeneous as those of the Latin American regimes of the 1980s, one wonders how well the exemplary mass punishment fits the alleged individual crime.” Several messages can be extracted from the history of two centuries of sovereign defaults. First, the history of the international financial architecture has a poor record of avoiding sovereign defaults. Looking at general trends, defaults have been a frequent event during international economic crises. Countries that avoided defaults were generally those participated less in the lending booms than defaulting borrowers.

Second, market penalties (rather than political penalties) have played an important role in the history of sovereign debt markets. Due in increased economic and financial integration, these seem to have increased in recent decades. Third, financial markets have been considerably affected by market distortions, which stem from conflicts of interest, information asymmetries and, to some extent, lack of liquidity provisions. Moral hazard seems to have been less of an issue historically, and the problem that this paper has identified is rather related to information flaws and the provision of the adequate incentives for more information processing. These features emerge as particularly relevant to the more recent period of international finance. Fourth, certain agents, referred to as gatekeepers, have occasionally emerged to prevent defaults. In particular, the historical periods of the nineteenth century and the 1920s provide successful examples of where underwriting banks enacted screening processes for new loans that were placed on the markets. However, specialization in the financial industry that has accompanied the recent globalization of financial markets has mitigated the importance of underwriting. Rating agencies, which are designed to diminish information asymmetries, have failed to perform expected gatekeeping functions.

Finally, assuming the role of the London Stock Exchange General Purpose Committee as Arbitration Court, its experience seems to have been effective in dealing with defaults and permitting the expansion of sovereign debt markets. More generally, public intervention has also been positive in providing monitoring and services as a lender of last resort, though regulatory innovations (or its occasional immobility) have not always been positive. It seems, therefore, that there are still a number of potential gains for the literature on sovereign defaults from the understanding of the long-term evolution of the structure of capital markets.

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