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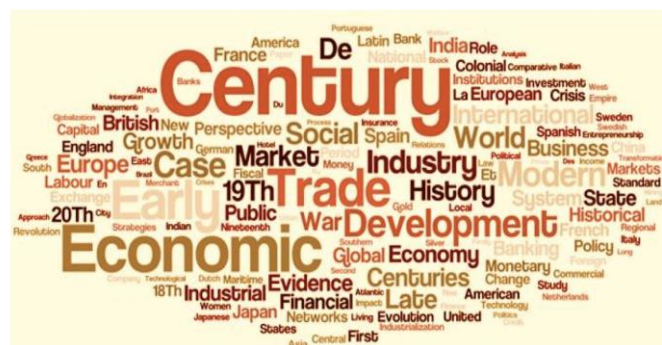
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Averting Defaults in Turbulent Times:

Controversies over the League of Nations Preferred Creditor Status

Juan Flores Zendejas



Averting defaults in turbulent times

Controversies over the League of Nation's Preferred Creditor Status

Juan Flores Zendejas¹

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Abstract

Loans by the IMF are considered to have “preferred creditor status”. However, given the potential distortions for the allocation of resources in IMF lending, the current debt crisis in Greece has raised new questions about the need for such treatment. This paper brings a historical dimension to the debate and analyzes the link between a multilateral's preferred creditor status and its capacity to support countries in financial distress. During the early 1930s, the League of Nations attempted to secure a preferred status for the loans it promoted. At the onset of the Great Depression, while these loans were not legally senior, governments granted the League loans a de facto preferred status under the assumption that averting default would foster renewed support from the League. However, when support did not materialize, the loans' exceptional treatment vanished, further weakening the position of the League to secure emergency lending.

¹ Associate Professor, Paul Bairoch Institute of Economic History, University of Geneva. Contact email: juan.flores@unige.ch. Some preliminary ideas of the paper were presented at a Workshop on “Debt contracts and Economic History” at the Institute of Economics in Montevideo in August 2016, and a very preliminary version of the paper was presented at the Workshop on Sovereign Debt Restructuring at the University of Glasgow in the same month and in Geneva in October. I thank the participants of both meetings for their precious comments. Informal conversations with Ana Gelpern, Mitu Gulati and Pierre Penet were very useful. The usual disclaimer applies. I acknowledge financial support from the Swiss National Science Foundation.

Introduction

The IMF's role as crisis manager has evolved since the 1980s. Progress has depended on the structural and organizational shifts in international finance, but also on the weaknesses and obstacles encountered during each crisis with a continuous learning-by-doing fashion. Its recent intervention in the Greek crisis does not constitute an exception. Instead it has brought an innovative dimension into the debate, which relates to the negative effects stemming from the so-called preferred creditor status (PCS) granted to the IMF. While the seniority of IMF loans are nowhere legally embedded, it has become protocol to safeguard the resources at the IMF's disposal, preserving its capacity to lend. The IMF's PCS has now been deemed incompatible with the possibility of waving the fiscal rules which were set as prerequisites to obtain this body's financial support. Following this argument, the IMF's PCS induces problems of moral hazard and favors discretionary behavior in the lending decisions of the institution.²

This paper takes a step back and analyses the first historical case in which a PCS was claimed by a multilateral organization. During the 1920s, the League of Nations assumed an important role promoting international and private loans on behalf of countries that had been excluded from financial markets. The loans' contracts included clauses that pledged specific public revenues with explicit priorities over previous loans in the cases where the same pledges had been granted. As the Great Depression hit and League-supported governments faced debt service difficulties, investors of these so-called *League loans* claimed seniority based on these clauses and, more importantly based on the involvement of the League of Nations, in the promotion of those loans.

The League was considered a crisis manager, where governments could appeal for technical assistance and financial support. Its role was limited to an intermediary function, given its lack of resources. In the early 1930s, the League attempted to organize new bailout loans on behalf of countries in financial distress which were previously under its tutelage. Those governments perceived the maintenance of debt service as a condition to obtain the League's backing, even in cases in which defaults on other loans could not be averted. Ultimately, the League failed to materialize long-expected financial support. The lack of fresh funds triggered the decision of most governments to extend their moratoria to the League loans.

This paper's contribution is twofold. On the one hand, it sheds new light on the League's experience and limitations it faced to act more efficiently in preventing defaults in Eastern and Southern Europe.

² Schadler (2014). For a previous, theoretical discussion on these types of arguments, see Mussa (2004) and the comments by John Murray in the same volume.

It explores previous claims on the League's failure to obtain a PCS. On the other hand, revisiting the League loans' historical case permits to draw certain parallels regarding present-day role of the IMF and the utility of its PCS. Most importantly, the paper highlights the relevance of the Fund's PCS to allow the entity to act in a countercyclical manner, as compared to financial markets, allowing it to adopt a more risk-taking attitude compared to private investors. Contrary to the IMF, the League of Nations' lack of funds compelled this multilateral body to rely on financial markets. It hindered the League from providing rapid and efficient financial support. One can only speculate a counterfactual situation, if the League had forecasted a PCS, it could have resulted in a different outcome.

Furthermore, the League's basic design prevented problems relating to moral hazard and indiscriminate lending, such as faced by the IMF. In this regard, removing the Fund's PCS can also force this body to be more cautious in its lending policy. Consequently, ambiguity regarding the Fund's willingness to intervene may contribute to prevent problems of moral hazard, but it could also trigger other undesired reactions, as the League's case demonstrates. In fact, the League's experience was similar to what Guttentag and Herring (1983) would later evoke in the aftermath of the 1980s crisis: a situation described as the worst possible case, where a potential lender of last resort, referring to a provider of emergency lending, was unable or unwilling to act. In the aftermath of the Great Depression, when governments ceased to treat the League as having a PCS, the capacity to provide fresh funding definitively vanished, leaving the League with no tools to intervene.

The paper is structured as follows. Section I provides a review of literature on the debate regarding the IMF's PCS. Section II provides the historical context in which the League loans were issued and the controversies over their preferred status. In section III, a Principal Component Analysis is performed on bond prices to test whether the bonds of the League loans behaved differently than other bonds issued by national governments in South Eastern Europe. Section IV revisits the League's reaction to the effects of the Great Depression and the PCS granted by League-supported governments. In section V, two case studies are presented that show that the League's effect on bond prices stemmed from its capacity to provide emergency lending. A conclusion is given in section VI.

I. Origins and controversies of today's IMF PCS

The IMF began assuming the role of crisis manager (Bordo ; Sgard 2016) in the 1980s (Bordo 2010; Sgard 2016). In order to reinforce its capacity to provide financial support, and facing defaults of low-income countries, the IMF claimed a PCS in September 1988 in a Communiqué of the Interim Committee of the Board of Governors of the IMF (Martha 1990). This call was reinforced one year

later, by the Interim Committee of the Board of Governors of the IMF, suggesting a “legal entitlement to preferential treatment” (quoted in Martha, 2015). Since then, the Fund has included this claim as a measure to manage the financial risk of its loans, which complements other mechanisms and devices, such as its lending policies (conditionality, access limits, maturities), safeguards assessments and co-financing strategies.³

Nevertheless, this preferential treatment is nowhere embodied in international law.⁴ The legal regime of privileges and immunities of international organizations already provide safeguards against transfer or payment interruptions at the national level (Martha, 2015). Moreover, a need for such a concept in international law has been questioned by law scholars given the strength of the economic incentives for borrowers to avoid a default to IMF loans (Martha, 1990). From an IMF member’s perspective, not fulfilling the financial obligations to the Fund may lead to direct consequences on future support by that body, as stated in the Fund’s Articles of Agreement. Finally, an important consideration raised by the IMF was its “cooperative nature” and “special role” in supporting adjustment and development, basically providing a public good to the international community.

In the context of the recent European debt crisis, moral hazard issues have questioned the PCS of the Fund. This assumes that the PCS of IMF-loans makes them essentially risk-free, distorting this body’s incentives for selective lending. The origin of this conflicting position emanates from existing political pressures from major IMF-shareholders coupled with a lack of effective checks on IMF decisions. Given the heterogeneity of preferences among shareholders, and given their differences in the size and voting power, the Fund may have incentives (or be even obliged) to act according to the preferences of major shareholders (Mussa 2004; Barro and Lee 2005). A direct consequence of this bias is unequal access to IMF funds. As a result, IMF’s lending is characterized by a major discretionary component.

The Greek bailout was granted despite IMF’s rule to secure a sustainable debt burden before a government could have access to IMF funding.⁵ In this vain, Schadler (2014) refers to the IMF as a provider of a public good, for which its financial resources are made available below market interest rates to support adjustment programs. Such a framework can only be sustainable if it ensures a high probability of success. In the case in which pre-established rules can be waived, as during the Greek crisis, IMF loans should incur the same risks of default and restructuring, dissociating them from its PCS. This conclusion echoes those raised by Murray (2004), who suggested that the IMF should

³ See Dept (2016).

⁴ On possible solutions to modify the legal framework of the IMF PCS, see Boudreau and Gulati (2014).

⁵ The press echoed these types of argument: Bretton Wood Observer, 7 July 2015. A similar criticism can be found in Larosi re (2016).

instead accept *pari passu* treatment and abandon PCS. Such a measure would encourage more discipline in IMF's lending activities, reduce its potential problem of moral hazard and enhance its credibility. However, an opposing argument on the IMF's scope for discretionary behavior would argue that the IMF's PCS permits the Fund to act on a case-by-case basis. This further allows the IMF to react according to specific circumstances, leading to more efficient interventions. But even in this case, the resulting uncertainty could generate opposite effects.

Fischer (1999) has provided some parallels with literature on lending of last resort in the banking sector, in which a lender or crisis manager may intervene only in specific circumstances, leading to a situation in which a "constructive" ambiguity would encourage lenders and borrowers to negotiate a debt restructuring –under the assumption of no official support– bringing back to the market the defaults' disputes and optimizing the need for official intervention.⁶ But unnecessary ambiguity may enhance the risk of disorderly defaults. Such a situation may be caused by very restrictive rules to IMF funds' access, due to asymmetries of information with investors, triggering capital outflows and defaults. Therefore, there may be an optimal level of uncertainty under which incentives for policy reforms are alienated and official support provided only when necessary. From this perspective, the Fund's PCS reduces the unnecessary ambiguity of its interventions, in as much as a government perceives it as a condition to increase the possibility for financial support.

II. The League of Nations' Preferred Creditor Status

i) League's parallels and contrasts with the IMF

The League presents fascinating parallels and contrasts to the IMF and other international financial institutions. Pauly (1996) refers to the League as a precursor of the IMF. In fact, some of the affiliates of the League's Economic and Financial Organization (EFO) would become active members of the IMF –Per Jacobsson for instance, IMF's third managing director, had been member at the EFO–. The EFO was responsible for the design and implementation of the stabilization programs, which established a set of conditions to which governments had to comply. The "conditionality package" included a balanced budget, adherence to the gold standard and the establishment of a central bank when absent. This roadmap was materialized in a set of documents called the *Protocols*, which are not so different from today's letters of intent utilized for IMF programs. The League would then send

⁶ Fischer (1999) evokes in particular the work by Freixas (1999).

permanent missions to monitor the program's implementation and the utilization of the loans' proceeds until the macroeconomic targets were achieved.

Conversely, there are relevant contrasts with the IMF. Today, the EFO of the League of Nations could be considered a hybrid institution combining features of other international organizations, such as today's multilateral banks; for example the Inter-American Development Bank or the World Bank, who act as intermediaries between private investors and borrowers. Without funds at its disposal to lend directly, the League provided this intermediary role. In contrast with those multilateral agencies, the League did not borrow directly, as member governments were not expected to act as guarantors for repayment. Its intermediation functions were limited to facilitating private lending, mostly for macroeconomic purposes. This restriction obliged the League to attract sufficient capital to finance its stabilization projects, for which reputation building and credibility were key. This task, embodied in the long-term private loans issued on different capital markets, could involve a diplomatic role if external guarantees were deemed necessary. However, it was more closely related to the initial public offerings' road shows that intended to convince underwriting banks and investors to the feasibility of their programs and potential for success.

ii) The general historical context

The League's appearance in sovereign debt markets marked a turning point in history. In the aftermath of World War I, the League was expected to support the recovery of the world economy, though the precise means to achieve this aim were undefined. At its origins, it became the forum in which different proposals were discussed. This included a plan for international short-term commercial credits, the setting up of a governments' supported trade-finance program (the Ter-Meulen scheme) and a US government-backed international loan program to European countries. The EFO was initially set up to implement this credit program in 1921, though its execution was ultimately aborted. It was later enabled to monitor and support the efforts by different countries to restore the gold standard regime. The EFO became the permanent forum for international cooperation in issues such as monetary stability, central banking, commercial policy and international credit.

The first candidates to seek for the League's support were countries that had been the most affected by the war in Central and Eastern Europe and were unable to access private capital markets. While the League's first task was diplomatic, often acting as intermediary in the concession of intergovernmental bilateral short-term loans, they became increasingly involved in securing a long-

term loan on behalf of the Austrian government. This capacity to procure emergency lending, even as an intermediary, was the origin of the League loans experience in the early 1920s.

One of the conditions to obtain such support concerned the relations by the government with its bondholders. A government in default was expected to negotiate an agreement with its creditors *before* a loan could be prospected. Once the macroeconomic objectives and monitoring devices were settled in the protocols, the League would deploy its diplomatic and technical staff to secure the support from central banks and governments in creditor countries and negotiate the terms of the loan with potential underwriters. For the first and most urgent case, Austria, the League went as far as arranging a guarantee from other European governments and convincing the Bank of England to act as underwriter.⁷ While external guarantees ceased to be requested for other League loans, the flotation of bonds always succeeded.

The League's activity required a confidence vote from investors, for which the legal and economic frameworks of the loans were designed. The stabilization programs were only established after a set of enquiries and reports pursued by the EFO and approved by the League's council. Their monitoring was secured through a set of agents that were placed in the monetary and fiscal institutions of the country. Regarding the legal framework, each of the contracts and general bonds governing the loans included provision of collateral (securities such as specific revenues' first charge) and the inclusion of agencies to enforce the execution of the contract. This was mainly pursued by the trustees in charge of managing the loan's proceeds and acting as bondholders' representatives.

iii) The League's Preferred Creditor Status

Before 1945, the sole experience of a PCS granted *de facto* by governments to an international organization was the League of Nations (Borchard 1951; Wood 1982; Martha 1990). More precisely, PCS was claimed for the bondholders of the League loans. However, this claim was raised once the defaults were declared.⁸ League-loans seniority had been first considered once the possibility of default was imminent. When the negotiations for loans' restructuring started, arguments advanced

⁷ This guarantee was agreed upon in one of the Protocols signed before the issue of the bonds (Protocol II signed the 4th October 1922. The signing countries being France, Great Britain, Czechoslovakia and Italy, later joined by Belgium, Sweden, Denmark and the Netherlands). Each of the participating governments was engaged to a specific portion of the loan, which was unrelated with the amount of each of the tranches of the loan. See League of Nations (1922) and Jèze (1925).

⁸ The Council of the League recognized that it was not the appropriate entity to create a legal status "for the League loans *ex post facto* which they did not enjoy". (LoNA, Box R3010, 10E/39271/34170, Minute of the Sixty-Ninth Session of the Council, 5 October 1932).

by the League loans committee (an informal body that was formed to defend the interest of League loans' bondholders) were not different from those raised by today's international organizations. To quote the most important, in its first annual report the League loans committee justified a preferred treatment given "the special circumstances in which the loans were issued, and the approval extended to them by the Council of the League, give the League loans a particular consideration" (League Loans Committee 1933). In its second annual report, the committee referred to the League as "a powerful and useful reconstruction machine". Most importantly, the League loans committee raised the most important argument in favor of the particular status of the League loans: the prestige of the League of Nations and the disastrous effect on the prospects of borrowers in the future.⁹

While previous literature occasionally mentions the League's failure to obtain a PCS, an accurate narrative on this historical period has not been provided. The League's experience demonstrates how a PCS was strongly attached to the closest function of "international lender of last resort", herein understood as an emergency lender, to which contemporaries could aspire. This multilateral organization focused on governments which had been unable to access private capital markets, providing monitoring functions (enhancing adjustment programs' credibility) and securing better borrowing conditions (Flores Zendejas and Decorzant 2016). Nevertheless, despite the League's efforts, the number of governments in default during the 1930s reached an all-time record (Suter, 1992; Reinhart and Rogoff, 2009). While this fact is consistent with the magnitude of the economic shock (Table 1 shows some basic macroeconomic indicators for the countries analyzed in this paper), it may also merely constitute a side effect of the lack of international cooperation, as scholars of the Great Depression frequently evoke.¹⁰ Moreover, the immediate recourse to defaulting by certain governments begs the natural question on the impediments faced by the League to assume a more proactive role, at least in the countries in which it was involved.

III. Bonds' pricing of the League loans

The League loans issued during the 1920s are shown in Table 2. They are nine loans issued on behalf of six countries on different financial markets. A main feature that distinguished these loans was their international profile, typically issued in tranches in distinct places and denominated in different currencies but ranking *pari passu* among them. They were all secured through specific revenues, which were supervised by a trustee designated by the League. This monitoring device was only

⁹ LoNA, Box R3010, 10E/37470/34170, "A Memorial from the League Loans Committee (London) to the Council of the League of Nations, 18 July 1932.

¹⁰ See for instance, (Bernanke 2000; Wolf 2010)

absent in the case of Greece, for which the International Financial Commission had assumed this role since the late 19th century. This agency had been set up by creditor governments to manage Greece's public finances in the aftermath of the sovereign default of 1893.

A main issue, present in the case of the Dawes and Young German loans, was the priority granted to these new private loans as compared to previous commitments (Ritschl 2012).¹¹ This concern affected not only pre-war loans, but also war reparations' debts, as most countries seeking the League's support were those having lost the war. The foreseen provision of pledges required that the Reparations Commission release liens on the assets of governments willing to issue a loan (League of Nations, 1945; Marcus 2011). Once this was negotiated, the League compelled governments that were in default to negotiate an agreement with their bondholders, including rearrangements on the pledges that had been provided. As a result, most League loans enjoyed a priority on the main revenues as compared to other external debt commitments. In the case of Austria, the existence of the guarantee by third governments necessarily implied that the loan was senior to other state loans. This was a condition requested by the guaranteeing governments and supported by the loan's underwriters.

How did the markets' price these loans? In principle, these pledges should have had a positive impact on bonds' prices given the implicit seniority over other loans (a *de facto* preferred status). This expected effect should have been reinforced by the monitoring function of the League over each country's economic policies. Flores Zendejas and Decorzant (2016) show that borrowing conditions of League-supported countries experienced a net improvement during the decade even if they remained above the average borrower on the New York Stock market in terms of underwriting fees and interest rates. This should not be surprising as, by definition, governments that sought the assistance from the League were those that had been unable to access financial markets even at very high interest rates.

Nevertheless, before the Great crash (i.e., until 1929) yields and spreads above U.S. Treasury bonds remained remarkably stable and even decreased (Figure 1). This was not necessarily the case for other countries having also succumbed to foreign money doctoring.¹² Figure 1 shows the evolution of spreads of other countries in Eastern Europe that issued bonds on the NYSE. Czechoslovakia, the first country to issue a loan in 1922, whose macroeconomic fundamentals were by large better than other

¹¹ These priorities were defined as "first charges" over the specific revenues such as the Customs Duties, Tobacco Monopolies, etc. which was specified in the prospectuses of the loans (reported in Table 2).

¹² External agents were present in other Eastern European countries. Poland resorted to Kemmerer as a foreign advisor; Romania's government had a set of French advisors while Serbia had an international commission. The only exception in the region was Czechoslovakia.

Eastern European country, has the lowest spreads of the sample. Serbia's bonds' spreads are also stable, while those of Poland's governments were highly volatile during the whole period.

The empirical evidence presented here aims to test whether the League loans had a preferred status and whether this was correlated with its capacity to provide financial support. To be demonstrated is the League loans' sole added value (in terms of pricing) stemming from its perceived capacity to provide financial support. Governments granted the League loans this privileged status at a time in which the League negotiated bail out loans with creditor governments and underwriting banks. In this section Principal Component Analysis is utilized on the monthly bonds' spreads of the loans from national governments in South Eastern European countries.¹³ The aim is to capture the particularity of the League loans as compared to other loans from the region, and focus on the bonds quoted in the NYSE. The spreads are computed as the difference between the bonds' yields and the yields of long-term U.S. treasury bonds. The yields utilized are measured by the coupon/price ratio.¹⁴

The use of Principal Component Analysis allows us to identify common factors in the pricing of the "League-bonds". This methodology groups the most relevant information of the data by computing eigenvectors from the data variance-covariance matrix. It identifies the main patterns of co-movements between the bonds' series. The League's added value can be measured through the uniqueness of the first factor loadings for the League loans. The inclusion of bonds from all countries in our sample serves to disentangle the potential coincidence between the regional and the League component. For Hungary, we use two loans (one League loan, and one issued without the support of the League).¹⁵ We then test whether this common factor changed at the onset of the crisis. For this, an analysis was performed for two periods. A "pre-crisis" period excludes the months with high volatility, while the second period includes them. We have defined the beginning of the crisis-period in September of 1931, where we register a structural break for all the series analyzed.¹⁶ Overall, the period analyzed starts in March 1929 and ends in June 1932, before the first default takes place. The comparison of the component scores when the crisis-months are excluded provides relevant information regarding the role of the League during the crisis. A significant change in the component

¹³ The bonds utilized are the following: Bulgaria Settlement loan 1926; Czechoslovakia 8% Secured Sinking Fund Gold Bonds; Estonia 7% Loan 1927; Greece government loan 7% 1924; Kingdom of Hungary, 1924, 7,5%; Hungarian Consolidated Municipalities loan 7,5%; Republic of Poland 6% External Loan 1920; Yugoslavia External 1922 8%.

¹⁴ I acknowledge that this type of measure could be problematic as it does not take into account the maturity and callable options of the bond. However, most of the loans analyzed in the New York market had very long maturities (20 years), and I analyze the immediate period after they were issued (the first 10-12 years).

¹⁵ Further details on these loans in Section V.

¹⁶ I utilize the breakpoints' identification methodology developed by Bai and Perron (1998, 2003). I test the existence of I globally optimized break against the null of no structural breaks. The results are available upon request.

scores of League loans would point to an important role, while the opposite holds if there are no differences.

A summary of the results is reported in Table 3. Panel A shows that for the pre-crisis period the first principal component explains 75% of the variation in the data, whereas the second explains 10% (a cumulative total of 86%). The factor loadings in Table 3 can be interpreted as correlations between individual spreads and the principal components. Their behavior is positive and uniform, which means that all countries moved together with the first principal component. Correlations with the second principal component change sign for Estonia, both Hungary loans, and Yugoslavia. No pattern seems to emerge.

These results can be compared with those for the whole period in panel B. The cumulative variance of the first two principal component increases to 89%, which reflects the importance of the external factor (sterling crisis of September 1931) affecting all the countries in South Eastern Europe. The component scores also show certain changes. The first principal component is now even more uniform, while this uniformity strongly declines for the rest. In the case of the second principal component, all the League loans show a negative sign, though this difference is not consistent for the remaining principal components. Interestingly, the component scores of both Hungarian loans differ considerably, suggesting that their price behavior did not follow a common pattern. We may tentatively conclude from this section that once the first common factor is taken into account, investors may have granted the League loans a particular treatment since the onset of the crisis. Hence, we focus on the reasons for this shift and analyze the League's influence on price co-movements.

IV. Emergency lending and PCS

Before turning to the analysis of factors that drove results of the previous section, we need to provide an additional account on the dynamics of the crisis. The fall of economic growth, accompanied by the decline in international trade and exacerbated by worldwide protectionist policies, impeded a rapid resumption of debt payments. The dynamics and typology of defaults differed according to the region and severity of the default (B. J. Eichengreen and Portes 1990). The defaults from Latin American countries were the first to take place in the 1930s, starting with Bolivia in January and Peru in March of 1931 (other South American countries followed in the same year except for Argentina). This was a consequence of a fall in commodity prices and export revenues (Madden 1937). European defaults followed a year later, starting with countries in central Europe

which had been hit by a severe banking crisis. The most violent began with Austria's Credit Anstalt failure in the spring of 1931. The first countries to suffer payment interruptions were Austria and Hungary, followed by other Southern and Eastern European countries including Bulgaria, Germany and Greece.¹⁷ While Austria could avoid a default owing to a bailout loan set up by the League in 1932, no arrangement materialized for Hungary.

It is worth noting that not all defaults were alike. The governments' decisions to default could affect each loan differently. The most straightforward contrast was between partial and total defaults, depending on whether repayment was suspended only on amortization (sinking fund) or whether it also involved interest payments. Accordingly, Eichengreen and Portes (1990) differentiate between "heavy" and "light" defaulters, while in another article they introduced other elements that determined investors' losses, including national discrimination and the relevance of securities ((B. Eichengreen and Portes 1989). For several reasons, governments chose to default selectively. Some countries defaulted on certain loans but not on others, even among loans issued in the same financial center (i.e., no national discrimination). This was the case for Costa Rica, Cuba, Panama, and Yugoslavia (Foreign Bondholders Protective Council, 1935).

Once again, this fact raises the question on the reasons behind these preferences and about the potential relevance of each loan's securities. This was a pertinent issue for contemporaries, and was subsequently debated in the meetings of the Committee for the Study of International Loan Contracts, which intended to reframe the legal context to facilitate debt renegotiations. Regarding pledges included in certain loan contracts, Eichengreen and Portes (1989) described how British bondholders claimed priority for secured loans, given that most sterling bonds had such a status while most dollar bonds did not. While the US position prevailed, preference was clearly defined since the beginning of the negotiations: this included preference of central governments' debts over those issued by state and local authorities, and funding loans (i.e., bail out loans) over other loans.

This criteria points to pragmatic reasons, and a major reason why defaults were selective was the potential for securing fresh funding. From a historical perspective, arguments in favor of a PCS have parallels not only with the League loans but also previous periods regardless on the type of liquidity-crisis lender. To name the most relevant, Argentina's restructuring in the 1890s omitted the 1885 loan, which had been granted by a syndicate of banks in the midst of a currency crisis, when Argentina's government was unable to place new bonds in the market. Borchard (1951) quotes the funding loans of Greece and Brazil as those for which defaults were either avoided or restructured in

¹⁷ Though this country defaulted on the sinking fund of several external loans in 1930.

a priority position. In these cases, the funding loans had been arranged by agents that had acted as crisis managers (and lenders), such as Rothschild with Brazil during the 19th century.

In the League's case, its potential role as emergency-lender was ambiguous given its lack of resources. This constraint sheds doubts on whether the League loans' committee realistically expected governments to concede to investors of the League loans a PCS, as it did during the 1930s. In fact, the League's first reaction to the deterioration in the fiscal position of the countries it had supported was to find the means to provide liquidity financing. The discussions that followed within the League largely focused on the need to find new procedures to provide prompt and effective assistance when necessary.¹⁸

Table 4 reports the de facto PCS granted by League-supported countries. Austria's government consistently granted PCS to its 1923 loan, and it repaid it in full until the German Anschluss in 1938. Hungary's government defaulted on July 1st, 1932 on all non-League loans, while the coupon payments of the League loan ceased to be paid almost two years later. Bulgaria and Greece were the governments that defaulted equally on the League loans and on other loans. However, Greece had suspended the sinking fund of non-League loans since 1930. On the other hand, Danzig did not default until its unification with Poland, while Estonia interrupted payments when the country was occupied by the Soviet Union in 1940.

As argued above, Table 4 disputes the claim that the League loans failed. Moreover, it shows that governments devoted considerable efforts to avoid defaulting particularly towards the League loans. Austria had been the first League country to temporarily suspend its debt service. Nevertheless, this default passed almost unnoticed in the spreads' series. The trustee for the loan was warned as soon as the funds deposited by Austria's government were insufficient to meet the corresponding debt service. As foreseen in the protocol, this activated the clause under which the guarantee would be called in. The trustee continued remitting coupon payments and sinking funds from the reserves that had been constituted since the bonds' issue. Austria's government rapidly resumed payments once the outlook for a new loan became concrete in 1932, when the League again interceded with those countries that had acted as guarantors to obtain a second loan.

V. The League of Nations and the Southern European crisis

¹⁸ LoNA, Box R3008, 10E/31582/31322, "Minutes of the Meeting of the 65th Session of the Council, September 26th 1931".

After Austria, other countries addressed their claims for financial support to the League, including those that had not been under the League's tutelage. The League participated in a set of multilateral meetings to ease the governments' increasingly delicate situation. Given the nature of the shock in South Eastern Europe, related with the fall in the prices of agricultural products, the support sought by the League was embedded in a global effort to avert the global slump. The recently created Bank for International Settlements began providing short-term loans to central banks, although the collaboration with the League remained unclear (Toniolo 2005).

A different set of proposals were discussed in successive meetings between 1931 and 1933, including the creation of a free-trade area, the establishment of an international institution that would borrow in capital markets and make loans to the agricultural sector, and the guarantee of an international government loan of 10 million sterling pounds during a meeting in April 1932 (London conference). The provision of this loan failed as the amount was judged insufficient (Schirmann 2011). Finally, the League experienced a transition to a more pragmatic stance to the crisis, and began voicing recommendations to abandon the gold standard. Regarding the debt service of the loans, the EFO's inquiries regarding the economic situation in Europe favored a temporary suspension of debt service (for Bulgaria and Greece), a fact that relieved the debt's fiscal burden but marked the immediate future of the League.

The attempts to provide solutions to the economic problems in the South Eastern Europe did not differentiate countries with or without the League's previous presence. This fact may explain why the common factor previously identified in this paper was even more relevant during the crisis. Nonetheless, the governments that remained collaborating with the League were also those with the highest expectation to obtain the same support, as obtained by Austria. In this section, two case studies (Greece and Hungary) are provided to show that investors attributed a lower probability of default to the League loans than other loans (of the same governments) precisely during the period in which these governments sought assistance from the League. These cases studies were chosen given the comparability of the loans. In the case of Greece, its government issued one loan in the London Stock Exchange in 1928 which was unrelated with the League.¹⁹ At the same time, Hungary's government was also the only case that issued more than one loan at the NYSE. Their experience confirm that the League's added value in terms of bond pricing solely stemmed from the markets' perception that it would be capable to provide its support.

a) Greece

¹⁹ The series utilized were those reported in the Stock Exchange Daily Official List (London).

In Greece, the government had set of pre-war bonds quoted in London whose repayment was secured by the International Financial Commission. This entity managed the revenues that were assigned as pledges. This arrangement was extended to the League loans issued in 1924 and 1926. The Greek government undertook a set of public works in 1928 for which new loans were issued, without the involvement of the Commission or the League, while the pledges attached were subordinated to those of the League loans. A direct comparison between the League's stabilization loan of 1928 and the Public Works loan of the same year show that issuing conditions were almost similar, as both were 6% loans (issue prices were 91 and 89, respectively) and had a Baa Moody's rating. Figure 2 shows that the yields of the League loans (Greek 1924 and Stabilization loan of 1928) were about the same as the non-League loan (Public Works 1928) before the onset of the crisis in September 1931. This confirms that investors did not account for differences in the pledges assigned in the pricing of the loans. Interestingly, the yield of the Public Works loan then diverged from the League loans as the Greek government sought the assistance of the League and before default was declared. This divergence gradually dissipated by the end of 1933, after all efforts for external support failed.

b) Hungary

Hungary presents an interesting case study because it was the only country whose government issued other loans on the US capital market in the 1920s.²⁰ The League loan issued between July and September 1924 was followed a year later by two municipal loans which were managed by Hungary's central government for infrastructure purposes. These loans were secured by the revenues of local governments (Foreign Bondholders Protective Council 1935). The maturity of the loans was 20 years and the issuing conditions were not so different from the League loan, including the identity of the underwriter (Speyer). While Moody's rating favored the national loan (Baa vs A), the market priced this loan only slightly more favorably (spreads at issue for the League loan were 4.32 and 4.39, and the municipalities loans were 4.89 and 3.95).

Figure 3 shows the evolution of the "national spread" that existed between the yields of the League loan and the first municipal loan. The national spread remained close to zero during the pre-crisis period. This trend suggests that even if the security of both loans were very different, it was not a major determinant of each loan's yield. The national spread began to increase in early 1929, suggesting either that investors' started to reevaluate the value of the pledges attached to each loan,

²⁰ Hungary had first access with the support of the League. The municipalities' loans were signed by the central government with bankers, though a previous arrangement was signed among all the counties of the country regarding their respective responsibility for repayment (Stock Exchange, 1930).

or that they expected the government to favor the League loan. This second possibility was more likely, as the government pre-announced that the League-loan had a particular status. Figure 3 also shows the transition period, in which the municipal loan defaults but not the League loan (represented through the shaded area). Once the League loans joined the rest of the loans, the spread between both loans almost disappeared but reached around 20% by the mid-1930s, suggesting a slight but remarkable hope for optimism as compared to the municipal loan.

VI. Conclusions

In 1946, the League of Nations was dissolved, a time when the United Nations was still at its second year of life, and the newly created International Bank for Reconstruction and Development was commencing operations. One of the last activities pursued by the League loans committee was to communicate with the new bank about the need for preserving the “prior claim the Loans had over other external debts”. The main justification was the “important contribution towards creating the public confidence required for the success of any future issues under international auspices”(League Loans Committee 1950:8).

The League loans experience was unique and can only be understood once placed into its historical context. It is nevertheless striking that the discussions on debt restructuring arrangements in the 1930s led to proposals such as those related with the improvement of legal framework, the need for the establishment of an international court and even others that were not very different from those recently discussed.²¹ It can be observed that the claim on the League’s supposed failure, which focuses on the League loans’ defaults, excludes many elements that affected the loans’ destiny but were exogenous to the League’s structural design. As shown in this paper, this failure assertion needs to be qualified, at the very least, since most of the League loans were the last to default in a steadily difficult macroeconomic context. The Great Depression constituted a supply-side shock against which the League had no means to react. In contrast to the IMF, the League’s lack of funds, while avoiding problems related with moral hazard, meant that it could not intervene in a countercyclical manner unless official support could be provided. The diplomatic defeat, and the creditor’s countries own financial weaknesses, prevented such a solution.

Admittedly, the historical comparison with the IMF is far from straightforward. While a major reason that justifies the PCS to the IMF is the need to safeguard its funds stemming from the public sector,

²¹ The main results of the Committee are summarized in (League Of Nations. Committee For The Study Of International Loan Contracts, 1939).

in the case of the League the conferment of a PCS was intended to attract funds from the private sector. In both cases, the PCS has served to reduce the extent of unnecessary ambiguity regarding the capacity (the League) or willingness (the IMF) to intervene in periods of financial distress. Furthermore, governments have agreed to confer PCS to the emergency-lender as a reaction to secure official support, at least as it was envisioned. In the League's case, the onset of the crisis was accompanied by a constructive ambiguity, which provided the right incentives for governments to adapt their policies to the macroeconomic context. Nevertheless, this situation led to one with unnecessary ambiguity because of the League's incapacity to secure additional funds. The Fund's financial advantage over the League averts this risk to some extent, a capacity that is further reinforced by its PCS.

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Table 1. Public debt and economic growth in the 1931 crisis in South Eastern Europe

Country	Debt to GDP	Debt service / exports	Debt service / public revenue	Real GDP growth	First defaulted in
Austria	21.8	15.58	10.29	-8.04	1932 (bailed out)
Bulgaria	155.9	20.55	8.38	NA	1932
Czechoslovakia	NA	19.28	27.76	-3.41	1938
Estonia	NA	0.13	11.29	NA	1938
Greece	138.8	70.60	32.54	-4.15	1932
Hungary	NA	16.79	8.30	-4.83	1932
Poland	NA	12.81	10.65	-7.23	1936
Serbia	96.41	19.14	8.38	-11.79	1932

Sources: (Broadberry and Klein 2012; Reinhart and Rogoff 2009; League of Nations. Economic and Financial Section 1927).

Table 2. League of Nations' Loans.

Country	Year	Total face value (in mill. £)	Places of Issue	Amount issued in NYSE (in mill. \$)	Nominal interest rate	Yield to maturity	Spread at issue (NY)	Secured by	Maturity (years)
Austria	1923	33.78	Vienna, Paris, NY, Prague, Brussels, Geneva, Stockholm, Milan, Madrid, London, Amsterdam	25	7	8.02	3.44	First charge: customs and the tobacco monopoly	20
Hungary	1924	14.38	NY, London, Geneva, Prague, Stockholm, Amsterdam, Hungary, Italy	9	7	8.3	4.63	First charge: general revenues and customs the sugar tax, tobacco monopoly, salt monopoly	20
Greece	1924	21.0	NY, London, Athens	11	7	8.01	3.99	First charge: specific revenues, including monopolies salt matches, etc. only the alcohol duty the loan is ranked second to the Greek 5% 1920	40
Danzig	1925	1.5	London	-	7	7.7	3.39 ^(a)	First and exclusive charge on: (a) the receipts from the tobacco monopoly and (b) the excise on spirits (including vinegar)	20
Bulgaria	1926	3.3	London, Milan, Zurich, Amsterdam, NY,	4.5	7	7.645	4.05	First charge on the customs duties; if necessary those assigned to the Inter-Allied commission	40
Estonia	1927	1.5	London Amsterdam, NY	4	7	7.43	4.07	No specific security but such a security could be introduced if any other loan would be granted one such that it ranks <i>pari passu</i> with it	40
Danzig	1927	1.9	London, Amsterdam	-	7	7.14	2.54 ^(a)	Tobacco Monopoly revenues	20
Greece	1928	7.56	London, New York	17	6	6.65	3.41	First charge: revenues under the control of the International Financial Commission in so far as the yield of these revenues is not required for the service of the loans having a prior charge, but ranking in priority to any future loan	40
Bulgaria	1928	5.53	London, (Amsterdam, Prague), New York, (Brussels, Milan, Zurich), Paris	13	7.5	7.745	2.99	First charge on the customs duties; if necessary those assigned to the Inter-Allied commission	40

Source: Flores and Decorzant (2016) and League of Nations (1945). (a): London.

Table 3. Principal component analysis (PCA) results. Factor loadings of the principal components.

Panel A. Pre-crisis period — Bonds' spreads 3/1929 -8/1931

	Principal Component 1	Principal Component 2	Principal Component 3	Principal Component 4	Principal Component 5
<i>League-loans</i>					
Bulgaria	0.40	0.02	-0.04	-0.23	-0.46
Estonia	0.39	-0.06	0.01	-0.37	-0.51
Greece	0.25	0.52	0.76	0.07	0.04
Hungary	0.37	-0.31	-0.11	0.42	0.06
<i>Other loans</i>					
Czechoslovakia	0.33	0.46	-0.31	0.60	-0.05
Hungary	0.38	-0.32	-0.07	0.12	0.05
Poland	0.34	0.36	-0.41	-0.49	0.56
Yugoslavia	0.34	-0.42	0.39	-0.04	0.45
Variance explained	76%	86%	95%	98%	99%

Panel B. Whole period – Bonds' spreads 3/1929 – 6/1932

	Principal Component 1	Principal Component 2	Principal Component 3	Principal Component 4	Principal Component 5
<i>League-loans</i>					
Bulgaria	0.37	-0.24	-0.22	-0.02	-0.44
Estonia	0.36	-0.25	-0.26	-0.04	-0.46
Greece	0.34	-0.56	-0.01	0.51	0.34
Hungary	0.36	-0.06	0.45	-0.54	-0.04
<i>Other loans</i>					
Czechoslovakia	0.35	0.14	0.69	0.32	0.05
Hungary	0.36	0.17	-0.06	-0.40	0.14
Poland	0.33	0.71	-0.18	0.40	-0.21
Yugoslavia	0.36	0.13	-0.41	-0.16	0.63
Variance explained	89%	94%	97%	98%	99%

Source: Own computations.

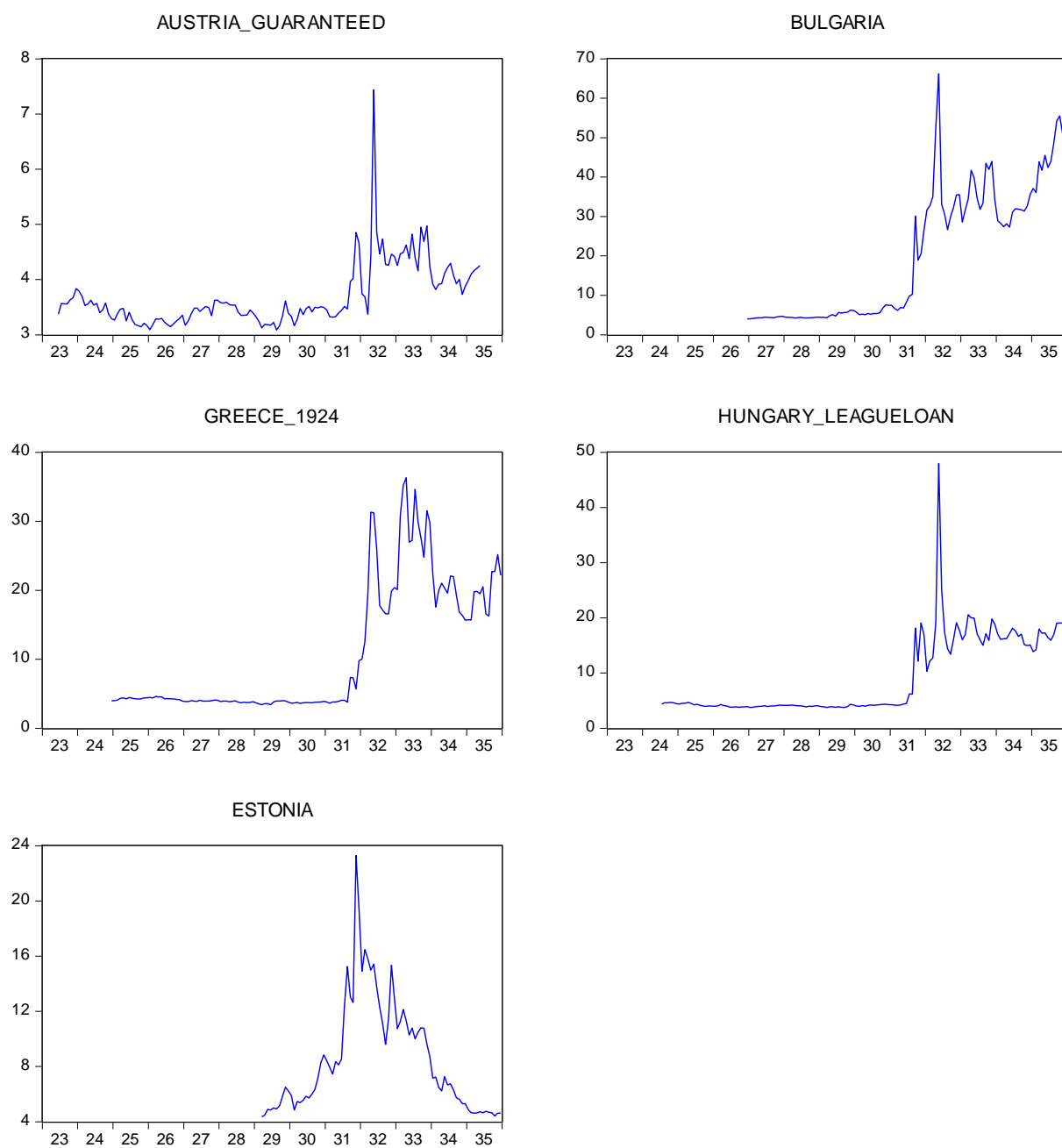
Table 4. League of Nations' Loans.

Country	Year	Default on the League loan	Default on other dollar loans
Austria	1923	Temporary in July 1932 (trustee did not receive monthly instalment, but reserve funds utilized)	Full interest payments had been made until the German occupation of Austria in 1938.
Hungary	1924	Interest defaulted February 1 1934; sinking fund defaulted 1 February 1933	Interest defaulted on 1st July 1932, sinking fund Jan 1 1932
Greece	1924	Interest and sinking fund on 1st August 1932	Interest defaulted Oct 1 1932; sinking fund suspended since 1930
Danzig	1925	1939	26 July 1939
Bulgaria	1926	Interest defaulted July 1st 1933, sinking fund Jan 1 1933	Same treatment as the League loans
Estonia	1927	Sinking fund: November 1940; interest: January 1 1941	1940
Danzig	1927	1939	26 July 1939
Greece	1928	Interest and sinking fund on 1st August 1932	Interest defaulted Oct 1 1932; sinking fund suspended since 1930
Bulgaria	1928	Interest defaulted July 1st 1933, sinking fund Jan 1 1933	Same treatment as the League loans

Source: *The Economist* and Annual Reports of Foreign Bondholders Protective Council, 1935, 1955.

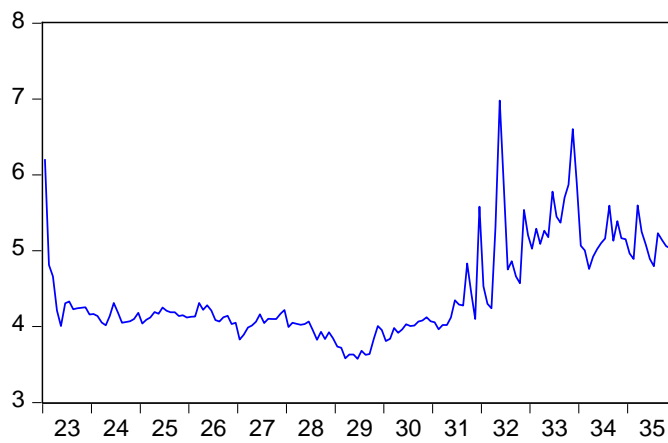
Figure 1. Eastern and Central European Government bonds' spreads.

a) *League loans*

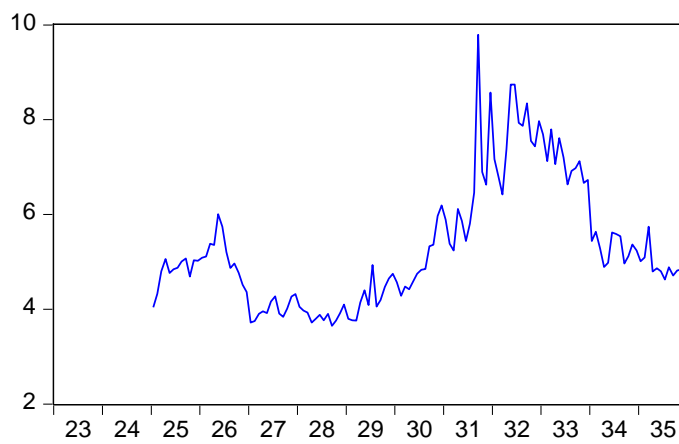


b) Other loans

CZECHOSLOVAKIA



POLAND



SERBIA

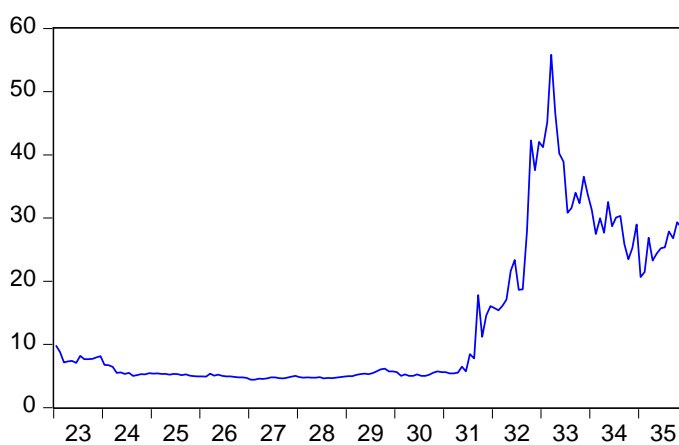


Figure 2. Greek loans quoted on the London Stock Exchange

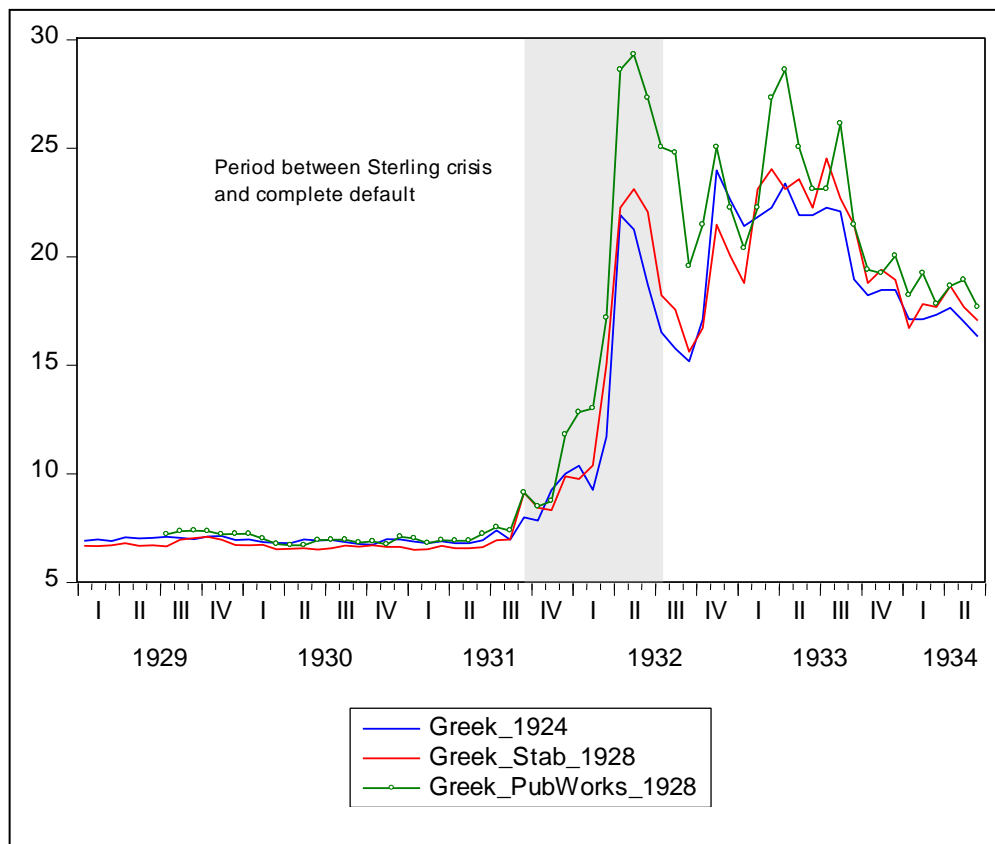


Figure 3. Hungary – Yields' differences between Municipal and League loan

