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Kim Oosterlinck

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*Université libre de Bruxelles - Solvay Brussels School of Economics and Management
Centre Emile Bernheim - ULB CP114/03 50, avenue F.D. Roosevelt
1050 Brussels - Belgium - e-mail: ceb@admin.ulb.ac.be Tel.: +32 (0)2/650.48.64*

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KIM OOSTERLINCK[#]

Sovereign Debt Defaults: Insights from History

ABSTRACT

History provides many insights to address the issue of sovereign debt defaults. This article first presents a detailed account of defaults in historical perspective. It then discusses the solution devised in the past to address sovereign debt crises and sets these into perspective with today's answers when crises occur. Finally, the paper stresses the role of history when events under study don't occur frequently and when archival data may add a new light to understand the process of crises resolution. The impact of odious debts declarations, of state succession, and of international relations on sovereign defaults and on their settlement is thus also addressed.

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[#] Université Libre de Bruxelles (ULB), SBS-EM, 50 av. Roosevelt, CP 114/03, 1050 Brussels, Belgium, koosterl@ulb.ac.be.

Sovereign Debt Defaults: Insights from History

I. Introduction

Sovereign debts, the debts incurred by governments, have a dual nature: an obligation on one hand and the sovereign status of the issuer on the other hand. In view of the clear opposition existing between sovereignty and obligation one may even wonder if the term “sovereign debt” should not be viewed as an oxymoron. Paradoxically, depending on the premises, sovereign debts may either be presented as risk free or as extremely risky assets!

Sovereign debts are often viewed as safe assets and are used as the risk free asset of most textbooks in finance. This vision makes sense since in most cases sovereigns repay their debts. It relies on the assumption that sovereigns can always increase taxes or print money to repay their dues. This vision may hold for domestic sovereign debts but not for foreign sovereign, the focus of this paper. Before the Eurozone debt crisis, sovereign debts were viewed as safe for developed country. The focus was then laid on developing countries¹.

¹ The definition from Eaton and Fernandez (1995, p. 1) is explicit in this respect : “The focus of this chapter is on specific problems posed by sovereign debts, that is, debt incurred by governments, typically those of developing countries, to foreign investors seeking a competitive return”.

History has however shown that defaults, far from being exceptional, were in fact rather common (Reinhart and Rogoff, 2009). Macroeconomic imbalances, extreme political changes or wars have led to many defaults. The varied nature of the sources of default stems from the very nature of sovereign debts. In the absence of a clear bankruptcy procedure, or a well-defined and internationally agreed-upon “sovereign balance sheet”, sovereigns may abuse the system. Furthermore, ordinary investors are powerless when it comes to forcing sovereigns to repay if they cannot or do not want to. On top of this, states regularly discriminate between bondholders on basis of their residency (Erce and Diaz-Cassou, 2011). Without means to force repayment, and in view of the fact that repayment is politically dependant, it would appear that the risk is so high that nobody should be willing to lend (Eaton and Fernandez, 1995).

The organization of the paper and the points on which it will focus are driven by considerations on what history can bring to the literature on sovereign defaults. The paper first presents a long-term perspective on sovereign defaults. Reputation is often considered as the main motivation countries repay. A historical perspective provides the opportunity to test whether bad (good) behaviours are punished (rewarded). History also allows viewing if some form of institutions prevent defaults. Uncovering bribes, diplomatic negotiations or behind-the-scenes arrangements, is often easier when all stakeholders are dead. The role of international relations is discussed in this context. Eventually some events happen with such a low frequency that using historical records is the only way to get some meaningful sample. The declaration of debts as odious or state successions are exceptional and an historical approach is therefore particularly interesting.

II. Sovereign Debts and Defaults: a Long Term Perspective

Defaults occur whenever the issuer is unable (or unwilling) to honor the legal terms of a debt contract. According to Winkler (1933, p. 8), “a borrower’s failure to pay interest, or failure to meet sinking fund payments or maturing obligations on a stipulated date, constitutes a violation of agreements and is regarded in financial language as default”. The violation of the contract may thus take many forms and be more or less severe (Eichengreen and Portes, 1986). The least serious one is a default on sinking fund payment, followed by a partial or full default on interest payment, on principal and worst of all repudiation. Even though the terms default and repudiation are often used interchangeably, jurists distinguish both. According to Borchard (1951, p. 129) “repudiation constitutes a refusal to admit the binding character of an obligation”. Repudiations are thus much more extreme than simple defaults. Indeed defaults are based on (valid or not) economic justifications. In the case of repudiations, economic elements are simply ignored since the sovereign questions the legality of the loan itself.

A purely legal vision would thus lead one to consider the smallest breach of the original contract as a case of default. In practice most academics do not view the omission of a payment to the sinking fund as important enough to consider a country in default. This is probably due to the scarcity of defaults limited to amortization payments. From 1820 to 1975, out of 120 cases of debt settlement, Suter and Stamm (1992) mention only five such cases. In general partial defaults on interest payments are viewed as severe enough to include a country in the group of states in default. To be sure, the legal vision doesn’t necessary coincide with investors’ perception of a fair treatment. The ability to print money has led many debtors to reimburse their debts

with a debased currency. Even though this would not technically constitute a default, the end result for the bondholder may be very similar.

Large scale international borrowing can be traced back to at least the 15th century (Eichengreen, 1991). As for defaults they are mentioned already during the Antiquity (Winkler, 1933, p. 17). This long history should not hide the fact that the market for sovereign debts has changed. For a long time, foreign loans were extended by more or less famous bankers. In the beginning of the 19th century a large market for sovereign bonds emerged. Whereas in 1853, foreign bonds represented 6% of listed securities on the London Stock Exchange, at the eve of World War I, the figure had risen to 21% (Tomz and Wright, 2013). Up till World War I loans were mostly held by private investors and during the 19th century a large number of investors were holding sovereign debts.

The costs of World War I resulted in a huge interallied debt, largely developing the practice of loans from one government to the other. The system devised after World War II paved the way for more government lending and radically changed the sovereign debt market. Indeed, for the three decades following World War II, most lending to developing country came from either governments or international institutions such as the World Bank or the IMF (Eichengreen and Lindert, 1989). As a result, defaults were rare and settlements usually occurred without drawing much attention. The Paris Club was created in the 1950s to deal with debts owed to government agencies or wealthy sovereigns (Rieffel, 2003). It was followed 20 years later by the London club which focused on sovereign debts owed to commercial banks.

At the beginning of the 1970s banks began to lend massively to developing countries (Jorgensen and Sachs, 1989). Polish and Mexican defaults in 1981 and 1982

reversed the lending trend, leading to defaults by other countries. The change in investors' nature from a large and diversified pool of bondholders to a few commercial banks had altered the nature of the risk. The risk, formerly spread across many holders, had become concentrated in banks' hands. Sovereign defaults were risking triggering a systemic crisis. To avoid this, the US Treasury Secretary, Nicholas Brady, announced in 1989 a plan to overcome the crisis. Bank debts were exchanged for marketable sovereign bonds with a lower present value but with 30 year US Treasury Bonds as collateral (Rieffel, 2003). This action revived the market for international bonds issued by developing countries. The 1990s saw a series of default by developing countries but the supposedly safety of sovereign bonds issued by developed countries was hardly questioned. Most actors were suffering from the "This-Time-Is-Different Syndrome" defined by Reinhart and Rogoff (2009, p. 15) as "the firmly held belief that financial crises are things that happen to other people in other countries at other times". With the onset of the European sovereign debt crisis in 2009, the world realized that sovereign bonds from developed countries could also end up in trouble.

Surprisingly as it may seem, defaults are not only recurrent but defaulting countries tend to default on a regular basis (Winkler, 1933; Eichengreen and Lindert, 1989, p. 4). Reinhart, Rogoff and Savastano (2003) have defined the concepts of serial defaulter and debt intolerance. Their analysis starts with a puzzle: some countries with low level of debt to GDP default whereas other countries with much larger amounts of debts seem to be immune from default². Some countries seem thus to be "debt intolerant" that is unable to meet the debt obligations even for very low levels of debt. Reinhart, Rogoff and Savastano (2003) argue that history of default allows predicting future defaults. Countries with a history of serial default would become debt intolerant.

² Once domestic debts are included this puzzle seems however to disappear (Reinhart and Rogoff, 2011)

Debt intolerant countries enter a vicious circle: their weak financial system renders them more likely to default, with each new default further weakening their ability to respond to an exogenous shock and thus rendering them more likely to default in the future. For some countries default has become a way of life. Mexico for instance spent more than 45% of the time in a state of default or restructuring between 1824 and 2001.

Defaults almost never lead to a complete loss for bondholders. The size of the loss (the “haircut”) and the time to settle varies from one case to the other. Duration of defaults were on average equal to 9.2 years for the period ranging from 1821 to 1975 (Suter and Stamm, 1992). Determining the exact losses incurred by bondholders is not straightforward³. Suter and Stamm (1992) compare three elements: the reduction of interests in arrears, the reduction of interest rates and the reduction in face value. Interest in arrears often represented a substantial amount because of the protracted nature of negotiations following a default. Over the period 1821-1975, the conversion of interest in arrears averaged 66%, the interest rates were reduced by 22% and the face value of outstanding bonds declined by almost 18%. For the interwar period, Eichengreen and Portes (1989) estimate the averages losses for US investors to 75% of interest due. By contrast British investors’ losses reached a figure between 30 and 50%. Even though these figures offer some point of comparison it is difficult to compare defaults without a synthetic measure of haircuts. Sturzenegger and Zettelmeyer (2007) propose such a measure. Their approach is based on the observation that in many cases bonds are exchanged for new ones with different characteristics. Their measure of haircuts is defined as the percentage difference between the present values of old and new instruments, discounted at the yield prevailing just after the exchange. Their

³ Actually, even computing the exact amounts of sovereign debts is tricky (see Dias, Richmond and Wright, 2011).

analysis shows a huge variety in terms of outcome with investors suffering haircuts ranging from a low of 13% to a high of 73%!

In view of the above-mentioned frequency of defaults, one may wonder how bondholders fared on the long run. As long as bondholders manage to properly price default risk, *ex post* returns need not be dramatic. Indeed, in such a case, defaults may on average be compensated by higher coupons. The *ex post* return will thus depend on the required coupon, the probability of default and the recovery value in case of default. Using an historical perspective raises the question of investors' sophistication. Evidence from equity markets tends to indicate that investors then were paying a close attention at elements perceived as important today. Investors were aware of the benefits of diversification even in early periods. Mutual funds for example existed already in the Netherlands during the 18th century (Rouwenhorst, 2004). In the 19th century such mutual funds were extremely popular. Chambers and Esteves (2011) note the existence of 61 mutual funds with a combined market capitalization of £60 million at the eve of World War I. They also attribute the longevity and the success of the Foreign & Colonial Investment Trust (FCIT) to its ability to propose wholesale investment portfolios to the general public. Goetzmann and Ukhov (2006) and Chabot and Kurz (2010) show empirically that British investors gained from international diversification in the 19th century

Drelichman and Voth (2011) highlight the importance to take all the elements related to sovereign defaults into account. In contrast to the common-held belief that lending to Habsburg Spain was irrational, they show that lenders earned on average a positive return. Lenders were willing to sustain losses in time of duress knowing that they would be able to charge higher rates in more tranquil periods. Eichengreen and Portes (1989) compare *ex ante* promised returns on sovereign bonds with the realized

returns for bonds issued in New York and London in the 1920s. Returns on dollar bonds (4.6%) were higher than returns investors would have received had they invested in US T-Bills. For a more recent period (1970-2000), Klungen, Weder and Zettelmeyer (2004) compute realized returns on public and publicly guaranteed debt issued by emerging countries. On average, returns on these securities were about the same or slightly higher than returns on 3 year US Treasury bonds. This long-term observation hides however a marked difference depending on the period analyzed. Indeed, for the period 1970-1989 *ex post* spreads were highly negative with figures of at least -330 basis points. By contrast when we look at returns for the period 1989-1994, *ex post* spreads reached a minimum of 1100 basis points and for the period 1994-2000, it was a minimum of 560 basis points. In view of these historical examples, we can see that defaults affected bondholders but on the long run a diversified portfolio of foreign sovereign bonds would not have fared so badly.

III. Reputation and Reputation Lending?

Since bondholders generally lack the power to coerce a debtor to repay, the literature has for a long time attempted to understand sovereigns' motivations to honour their debts. The only direct action bondholders can undertake is to threaten issuers not to grant them access to the market should they remain in default. Keeping a good reputation would then be the main element driving repayment (Tomz, 2007). The importance of the state's reputation was already mentioned by Demosthenes ([1880], p.12), "My prayer to the Gods is that, if possible, we may have wealth also in abundance, but that at all events, we may maintain our character of being trustworthy". Eaton and Gersovitz (1981) provide a theoretical model stressing the role of intuition and show, among other, that if exclusion is permanent lenders will establish a credit ceiling. History allows determining to which extent governments in default were

penalized, or conversely to which extent good behaviour was rewarded. It also provides indications regarding the nature of the sanction (exclusion from the market, higher interest rate) and the length of the penalty.

Jorgensen and Sachs (1989) analyse the extent to which previous good or bad behaviour was taken into account when countries attempted to borrow again. Their analysis focuses on Latin American government bonds in the 1930s. Argentina, the only country which faithfully honoured its obligations during this period, was not rewarded afterward. Jorgensen and Sachs (1989, p. 79) conclude that “the costs of default in terms of future capital flows were negligible”. This observation is consistent with the theoretical findings of Bulow and Rogoff (1989) who suggested that to forgive debts was to forget them.

Özler (1993) scrutinizes the impact of borrowers’ repayment history on credit-market access. In the 1970s, defaults prior to the 1930s had no impact on credit terms, whereas defaults during the 1930s led to higher borrowing costs. Commercial banks thus distinguished defaults from the distant past from recent ones. Furthermore newly created countries were charged a higher interest than previous defaulters. This suggests that commercial banks required a substantial risk premium to lend to countries which have no record regarding sovereign borrowing. Flandreau and Zumer (2004) focus on 18 countries during the gold standard (1880-1913). Empirically, defaults were taken into account by market participants. The penalty associated to default was however quickly decaying. Indeed markets required a premium of 500 basis points during renegotiations but only 90 basis points the first year following a settlement and a meager 45 basis points ten years later.

Despite the importance given by some authors to reputation, empirical analyses find thus a relatively limited impact of past defaults on borrowing terms. Cruces and Trebesch (2011) have questioned these previous empirical results on the ground that earlier research did not take into account the severity of default. They compute the size of haircuts for debt restructurings which occurred between 1970 and 2010 and show the existence of a close relationship between severity of default and the subsequent borrowing terms. Higher haircuts led to higher post-restructuring spreads and to longer exclusion from financial markets.

Individual lenders have limited power to force a given government to honour its debts or negotiate a settlement. In theory, by joining forces and creating bondholders associations, bondholders could have a bigger say. In the 19th century many bondholders' organizations emerged. The role of the British Corporation of Foreign Bondholders (CFB) in successfully protecting bondholders' interests has often been stressed (Eichengreen and Portes, 1989). When, following a default, bondholders' interest were represented by the issuing banks, results were less favourable for bondholders (Esteves, 2007). Esteves (2007) further stresses the importance of the strategic interaction between bondholders' associations. Eichengreen and Portes (1989) suggest that US investors suffered from the absence of a bondholder association before the creation of the Foreign Bondholder Protective Council (FBPC) in 1933.

Flandreau (2013) has challenged the traditional view that presented bondholders as powerless before the creation of bondholders committees. Well before the formal establishment of the CFB bondholders had devised means to sanction defaulting governments. The London Stock Exchange played a central role and acted as a sort of Court of Arbitration. The role of the London Stock Exchange allows understanding why a close relationship was vital for the CFB when the latter was created

(Eichengreen and Portes, 1989). During the 19th century, in view of the central position of the London Stock Exchange in the sovereign debt market, the threat to exclude countries from this market was serious. As time went by competition for the issue of sovereign debt increased and coordination across markets became more and more important if a sanction was to be effective.

For a long time issuers' reputation received the bulk of academics' attention. During the 19th century however, other actors were risking their reputation when sovereign bonds were issued. Actors with a good reputation could help sovereign overcome a reputation deficit. Underwriters were certainly the most important group to exploit their reputation. In some rare instances the good name of other actors such as merchant houses or foreign government could also serve as guarantee for sovereign bonds.

Flandreau and Flores (2009) have highlighted the role of underwriter in the development of sovereign bond markets. In the beginning of the 19th century swindles were common; one of the most famous example being the sale to the public of sovereign bonds from the fictitious state of Poyais by Gregor MacGregor. In such a setting, investors were willing to pay a premium to be insured against such frauds. Flandreau and Flores (2009) argue that whereas investors faced difficulties to judge the quality of a given security, they could easily form an opinion on underwriters. Sovereign credibility had therefore to transit through intermediaries' reputation. Soon prestigious underwriters managed to get a monopoly on solvent sovereign issuers. By using the services of a major underwriter, sovereigns could benefit from their good reputation. Quite logically, major underwriters protected their good reputation and exploited it when they brought new paper on the market. Flandreau et al. (2009) show that at the beginning of the 19th century, underwriters had a dual role: they were providing liquidity

and gave a signal on the sovereigns' quality. The second role gradually disappeared, taken over by rating agencies. As a result, defaults which were not randomly distributed across underwriters up till the beginning of the 20th century became less and less correlated with underwriters.

Even though underwriters were probably the main provider of good reputation, occasionally other commercial intermediaries ended up lending their good reputation to governments. Vizcarra (2009) analyses the importance of guano, a natural fertilizer, as collateral for the Peruvian sovereign debt during the 19th century. By entitling respected British merchant houses to manage guano's exports, and by relying on these merchant houses for the debt service, Peru indirectly benefited from their good reputation. The fact that guano revenues transited through London and were thus out of reach for the Peruvian government further enhanced guano's credibility as collateral. As a result even the most extreme forms of political instability in Peru had almost no effect on Peru's debts.

IV. Institutions

The role of institutions has received a substantial attention following the seminal paper by North and Weingast (1989). Their analysis suggests that constitutional modifications brought by the Glorious Revolution (1688) changed the balance of power in such a way that property rights enjoyed an increased protection from the sovereign. As a result of this increased protection the long-term borrowing rate of the state declined from 14% in 1693 to just 3% in 1739. North and Weingast (1989) stress however the importance of the conjunction of adequate rules and a credible commitment to honor these rules. Sussman and Yafeh (2006) have suggested that a substantial amount of time elapsed before the impact of good institutions on sovereign

borrowing could be observed. The importance of changes occurring after the Glorious Revolution has been stressed by Stasavage (2007, p.150) who underlines the role of political parties. Cox (2012) argues that the Glorious Revolution was indeed a watershed especially if one focuses on the transactions most affected by the lack of Royal credibility.

Dincecco (2009) and Gelderblom and Jonker (2011) present a nuanced vision: sound institutions and credible commitment are necessary but not sufficient conditions to increase a sovereign's credit rating. For a more recent period (1976-2000), Kohlscheen (2007) shows that presidential democracies are almost 5 times more likely to default than parliamentary ones. Other institutions have been scrutinized to determine to which extent they played a role on a country's rate of borrowing. In this respect, adherence to the gold standard has probably been the most analysed topic.

The impact of adherence to the gold standard on sovereign borrowing has been at the core of a large body of literature. Bordo and Kydland (1995) present the gold standard as a commitment device preventing governments' to implement time-inconsistent policies. As a result adherence to the gold standard would force governments to follow sound macroeconomic policies. If such was the case then adherence should enhance the government's credibility and thus lower its borrowing cost. Adherence would be viewed by markets as a good housekeeping seal of approval. Bordo and Rockoff (1996) test this proposition by comparing the coupon yields of nine countries during the gold standard (1870-1914). They find that countries adhering to the gold standard benefited from reduced yields. Obstfeld and Taylor (2003) compare the gold standard and the interwar periods. During the first period adherence to the gold standard provided a signal of good quality to the market which brought a 30 basis point reduction in borrowing costs. By contrast, the interwar gold standard was not

viewed as credible and as a result adherence brought no direct benefits in terms of borrowing.

Several authors have however challenged the role of gold standard adherence. Flandreau and Zumer (2004) argue that when additional control variables are included in the model, the gold standard effect disappears. Mitchener and Weidenmier (2009) analyse the interest rate differential between a sovereign's paper and gold bonds following the country's decision to adhere to the gold standard. More than five years after joining the gold standard markets still required a substantial premium (400 basis points) to hold paper instead of gold bonds. They conclude that markets did not believe in emerging countries' commitment to follow a hard peg. Eventually, bonds issued by countries off gold earned higher unconditional returns than the ones issued by countries on gold (Alquist and Chabot, 2011). Alquist and Chabot (2011) attribute however this difference to risk factors and not to adherence to the gold standard.

Economic historians have also analysed the impact of colonization on borrowing. Obstfeld and Taylor (2003) find that membership in the British Empire during the gold standard period was "neither a necessary nor a sufficient condition to get a preferential access on the London Stock Exchange". However, membership allowed securing lower borrowing costs during the troubled interwar period. Ferguson and Schularick (2006) find that membership of the British Empire cut risk premia by more than 150 basis points. They suggest that colonies actually benefited from being members of the British Empire. Both papers rely on a similar approach, a dummy variable is included in the regressions to measure the "Empire Effect". Accominotti et al. (2011) have shown this approach to be misspecified since being a colony did not have a marginal impact but a structural one. Therefore pooling all countries (independent ones and colonies) together leads to biased estimates. Colonies benefited

from the guarantee from the colonizing powers and therefore their own economic variables had no effect on their borrowing costs. Accominotti et al. (2011) further argue that such a guarantee created perverse incentives for colonies and encouraged excessive borrowing. When guarantees were absent, bondholders used an approach common for corporate bonds: require collaterals.

During the Middle-Ages creditors sometimes required from kings their crown or their coronation robe as guarantee (Hoeflich, 1982). Specific revenues or collaterals have also regularly been pledged for the service of sovereign bonds (Eichengreen and Portes, 1986). In the 19th century, most countries from the Balkans had to pledge a stream of revenues just to be able to borrow. Such pledges could reach extremely high values. In 1931, they represented more than 45% of total budgeted revenues for Bulgaria (Ivanov and Tooze, 2011). When default occurred these guarantees proved however most of the time useless. Indeed, assets were either beyond the reach of bondholders or required the issuing state to be sued with all the difficulties mentioned previously in this respect. The case of the Peruvian guano during the 19th century is a rare counter-example but as pointed out by Vizcarra (2009), its value rested largely on the good reputation of the British intermediaries in charge of selling the guano, collecting the revenues and guaranteeing the service of Peru's foreign debt.

The economic factors leading to default have been investigated at length. In many instances variables considered as relevant today were also significant in the past. For example, the most heavily indebted countries were the most likely to default in the 1930s (Eichengreen and Portes, 1986). Severe deterioration of the terms of trade also altered the capacity to repay. A special attention has been devoted to the role of foreign currency debts. Eichengreen, Haussman and Panizza (2005) have formalized one of the main issue facing emerging countries by defining the concept of original sin as “the

inability of a country to borrow abroad in its own currency”. Eichengreen, Haussman and Panizza (2007) distinguish original sin, debt intolerance and currency mismatches. They view debt intolerance and original sin as different approaches to analyse a similar phenomenon: the volatility of emerging market economies and their difficulty to service and repay external debts. Currency mismatches, “differences in the values of the foreign currency-denominated assets and liabilities on the balance sheets of households, firms, the government and the economy as a whole”, are presented as a consequence of the two other elements. Original sin has been presented as harmful since it would increase exchange rate and macroeconomic volatility (Eichengreen, Haussman and Panizza, 2005). Bordo and Meissner (2006) find a less clear-cut relationship. Their analysis comparing the period 1880-1913 to the period 1972-1997 shows that an increase in exposure to foreign currency debt did not necessarily lead to more financial crises.

V. International Relations

Historically, international relations played a role in the whole life of sovereign debts. The decision, or the possibility, to float a debt in a given country has for a long time mainly been driven by political considerations. The decision by a government to help another country honour its debts was also motivated by the relationship existing between the two countries. Eventually, the sanction imposed on defaulting countries depended on the relationship between creditor and debtor countries.

International relations played a role in determining to whom lending should be extended. Great-Britain did seldom use loans as a diplomatic tool. On the other hand, France and Germany often directed foreign loans to “European allies such as Russia, or to areas of special diplomatic interest, such as Turkey” (Lipson, 1989, p. 192). In view of the interest shown by foreign government to see their bonds issued on the

Paris Bourse, the French government took measures to exploit its privileged situation. Loans to be issued by companies in competition with the French industry, or by countries which had preferred foreign suppliers were regularly excluded from the French market (Feis, 1930).

In some instances, financial support was granted for geopolitical reasons. In 1833, France, Great-Britain and Russia jointly guaranteed a Greek loan because they had a common interest in securing Greece's existence (Wynne, 1951, p. 285). In other cases, access to the capital market was traded against diplomatic help. For example, Russian support at the Algeciras conference in 1906 gained them the opportunity to issue a new loan on the Paris stock exchange.

In case of trouble, reactions were also influenced by the existing relationship between creditor and debtor. Eichengreen and Portes (1989, p. 13) suggest that before the 1980s, "governments maintained a decidedly ambivalent attitude towards intervention on behalf of investors". According to them, French and German governments were more prone to intervene than their British counterparts. Officially, Great Britain followed the Palmerston doctrine: if investors wanted a British guarantee they should have invested in British bonds (Lipson, 1989). There was thus no reason to intervene in their favour. The United States intervened only in case of a selective default discriminating against US citizens. According to Eichengreen and Portes (1989), interventions were mostly driven by strategic or military motives, the sovereign default being used as an excuse to extend a country's sphere of influence. From this observation, the literature has been quick to conclude that debt defaults were of little relevance. This traditional view has been challenged by Mitchener and Weidenmier (2010). They define, "supersanctions", as military pressure or political control applied following a debt default and show that supersanctions were commonly used during

the gold standard period (1870-1913). During this period, 64% of defaulting countries experienced a form of sanction. For small Central American countries threat of (or actual) military interventions were common following a default (Costa Rica, 1911; Guatemala, 1913; Nicaragua, 1912, Santo Domingo 1905-1913 and Venezuela 1902-1903). The Venezuelan case deserves special attention as it was at the basis of several doctrines related to military interventions in case of sovereign default.

In 1902, Venezuela refused to honour its debts and even to deal with its creditors. The unwillingness on the Venezuelan side to negotiate prompted a military action by British, German and Italian governments. Creditors from intervening countries secured better terms than creditors from passive countries leading many governments to fear an increase in the number of interventions. Luis Mario Drago, then Argentinian Secretary of State, formulated a non-intervention doctrine in December 1902: “The public debt cannot occasion armed intervention nor even the actual occupation of the territory of American nations by a European power” (Drago and Nettles, 1928). The Venezuelan intervention also prompted the formulation of the Roosevelt corollary to the Monroe doctrine in 1904. In flagrant cases of wrongdoing or impotence by countries in the Western Hemisphere, the United States would exercise the role of an international police power. Markets were prompt to react to this announcement. The price of sovereign debts issued by countries directly under the US sphere of influence experienced a dramatic price increase (Mitchener and Weidenmier, 2005). Even if the recourse to military force seldom happened, the possibility that such an intervention might take place helped reassure bondholders at the beginning of the 20th century. Military interventions were however only carried out against weak states (Borchard, 1913). By the middle of the 1930s the US Securities and Exchange Commission warned bondholders that military interventions should not be counted upon to force repayment (Eichengreen and Portes, 1986)

The appropriation of custom revenues was also a common practice at the end of the 19th and beginning of the 20th century (Fishlow, 1989). Taking over public finances could either be done by a single country or by a group of creditor countries (Mitchener and Weidenmier, 2010). In some cases, such a control led to the imposition of a protectorate. In other cases, creditors secured exclusive economic control on land or railways (Suter and Stamm, 1992). Close “collaboration” between central banks was also valued by investors. In the 1930s, when the Banque de France offered its help to Romania, French holders of Romanian bonds reacted positively driving the prices of these bonds upwards (Oosterlinck and Ureche-Rangau, 2012). According to Lipson (1989), the appropriation of the fiscal apparatus of defaulting countries gradually disappeared with the rise of modern nationalism.

Official credits could also be conditioned on reaching an agreement over bonds in default. The limitation of trade credit to defaulting states could however hamper their economic recovery and thus, in the long run, jeopardize the repayment of bonds in default. Therefore, bondholders’ committees usually gave priority to repayment of commercial debts (Eichengreen and Portes, 1989). Despite this priority, trade could be affected by sovereign defaults. Following the imposition of sanctions, trade declined dramatically in Egypt, Greece and the Ottoman Empire (Mitchener and Weidenmier, 2010). The decline could be substantial such as in the Greek case when trade dropped by approximately 20%. On basis of a gravity model and a panel data covering 50 years and more than 150 countries, Rose (2005) estimates that debt renegotiation lead to a yearly decline in bilateral trade of 8%. Martinez and Sandleris (2011) show that bilateral trade decline is of the same order of magnitude for creditor and non-creditor countries suggesting that the decline is not a punishment following the default. Sovereign defaults may also trigger a decline in Foreign Direct Investment

(FDI). Fuentes and Saravia (2010) show that following a default FDI declines. The decline is however mostly concentrated on the flows originating from defaulters' creditor countries suggesting a form of punishment.

In some rare instances, governments in which the bonds had been issued felt the necessity to intervene financially in favour of holders of foreign bonds in default. France in particular showed twice at least, the willingness to bailout part of a debt issued by a foreign country. In 1868, following the repudiation by Juarez of Mexican bonds issued under Maximilian's rule, the French government agreed to reimburse approximately 50% of the bonds value since Napoleon III had, for political reasons, promoted these securities (Wynne, 1951). French holders of Russian bonds were also very partially bailed out 50 years later. On September 19th, 1918 the government passed a law allowing French investors to subscribe up to 50% of the new French Liberation loan by paying with the Russian coupons due from April to December 1918. In view of the Mexican precedent bondholders actually expected a larger bailout (Bernal et al., 2010). The partial bailout decision was motivated by the fact that before the outbreak of World War I, the French government had regularly recommended that banks and businessmen support its Russian Ally. The Russian government had also actively bribed French politicians, the French press and major actors of French finance to promote their bonds (Raffalovitch, 1931).

VI. Odious Debts and State Succession

On top of the elements presented previously, history also allows analysing events which do not occur frequently and for which an historical perspective is therefore required. The declarations of debts as odious and state successions (country break-ups as well as country formation and annexation) warrant such an approach.

Even though such events occur on a very infrequent basis, each has a contemporary echo. Independence movements in Catalonia, Flanders, Quebec or Scotland may someday succeed, raising then the question of state succession. The reverse is certainly also worth considering. The creation of Eurozone bonds raises the question of managing public finances from several countries which used to be completely separated. The odious debt doctrine received renewed attention following the fall of Saddam Hussein. Many writers indeed questioned the legitimacy of the debts issued by his regime and found that asking the Iraqi people to pay for its own oppression abhorrent. Kremer and Jayachandran (2002) mention a series of other potential “candidates” such as debts incurred under the regimes of Mobutu Sese Seko (Zaire, no Congo), of Ferdinand Marcos (The Philippines), of Anastasio Somoza (Nicaragua), or of Franjo Tudjman (Croatia).

The fate of sovereign debts in instances of state succession has preoccupied scholars since at least the late 16th century. Before the 19th century there was a consensus: successor states had to take over the public debts of their predecessors. During the 19th century the position of major countries such as Great Britain or the United States shifted. Hoefflich (1982) attributes this change to imperialism: both countries were conquering new territories and had little inclination to take over debts. During the 20th century however, both countries’ position experienced a reversal as imperialism had ground to a halt.

The historical record regarding country break-up is mixed. In most instances bondholders managed to get part of the former bond reimbursed but in almost all cases the settlement was a protracted process. Belgium seceded from The Netherlands in 1830 but the final agreement regarding the debt repartition was only agreed upon in 1844. When more than two countries were involved bondholders had usually to show

even more patience. The Ottoman Empire started to break-up at the end of the 1870s but investors had to wait for the Lausanne Treaty in 1923 to know which proportion of the Ottoman debt each country would take over. The process was, and is, complicated by the fact that there is no unique mechanism to apportion the debts. Debts have indeed been divided according to population (Great Colombia in 1831; the Federal Republic of Central America in 1841), to fiscal revenues (Austro-Hungarian and Ottoman Empires after World War I), to GDP (Central African Federation in 1963), population and GDP (Czechoslovakia in 1993). In the case of Yugoslavia the repartition was done on basis of a procedure provided by the IMF guaranteeing an equitable burden sharing (Stavridi and Kolliopoulos, 2002). In some instances one country agreed to assume the whole debt burden (Pakistan following the secession of Bangladesh in 1971)

Countries may also annex territories. Burdekin (2006) and Burdekin and Laney (2010) analyse bond prices reaction respectively when Texas (1845) and Hawaii (1898) were annexed by the United States. In both cases bonds from the annexed territories experienced a large price increase probably because bondholders assumed that the United States would stand behind these new states should a problem occur. Collet (2012) analyses the much more complex case of Italian unification when seven separate entities (the Kingdoms of Piedmont-Sardinia, of Lombardy-Venetia, and of the Two-Sicilies, the Papal States, and the Duchies of Parma, Modena and Tuscany) merged to become the Kingdom of Italy. Following the proclamation of the Kingdom of Italy in 1861, sovereign debts from the different entities could be converted into Italian bonds. Some bondholders refused the conversion and the Antwerp stock exchange distinguished Italian bonds on basis of their origin. This distinction allows tracking the perceived risk of all bonds. First, investors discriminated bonds on basis of their origin. It was only once fiscal union was fully completed that all bond prices fully

converged. Second the entity which had benefited from the lowest borrowing costs before the unification saw a dramatic increase in its yields.

The concept of odious debt was born following a case of state succession. As a result of the Spanish-American war, the United States took over Cuba but refused to assume the burden of the Cuban debts. The refusal to take over the Cuban debts was justified in several ways. First, the United States argued that Cuban debts were in fact Spanish ones (Ludington, Gulati and Brophy 2010). Second, the United States stressed that the proceeds of these debts had served to repress the Cuban insurrection and that therefore had been used against the interests of the Cuban people. Building on this example Sack (1927) defined the concept of odious debts. In his definition to be odious debts have to: have been issued without the consent of the population, to have brought no benefits to the population and to have been bought by investors knowing that funds would be misused. With such a strict definition proving that a debt is odious represents a daunting task. Indeed since debts are fungible and their end destination is hardly ever mentioned one would have to prove that all debts are odious to be convincing. Paradoxically this condition was easier to prove during the 19th century. Investors were aware that the proceeds of some (but not all) Cuban debts were used to repress the Cuban insurrection (Collet, 2013). On basis of this information Collet (2013) shows that bondholders were requiring a specific risk premium to hold debts which were at risk of being declared odious. History provides other examples of odious debts. When Russia issued a bond in 1906 huge protests were staged against a loan viewed by many as having helped the Tsarist regime crush the 1905 Revolution. Many Russian parties vowed to repudiate this debt if they came to power. Investors required a substantial premium to hold this bond which faced an idiosyncratic risk of repudiation (Collet and Oosterlinck, 2012).

VII. Conclusion

Even though sovereign debts are often presented as risk free assets, history shows that defaults are common and that it would be erroneous to consider any country totally safe from default. On the long run several countries have shown a tendency to default on a regular basis. Despite the existence of these serial defaulters, long term returns on diversified portfolios of sovereign debts have been close to the ones observed for sovereign debts issued by major economic powers (Great Britain or the United States).

Theory has suggested that reputation plays a key role in the motivation to repay. Empirical evidence in this respect is mixed. Some studies find limited reputational effects, other find an effect which is quickly decaying and eventually others indicate that good behavior does not seem to be rewarded. Historical analyses have also shown that in the past underwriters played an important gatekeeping and monitoring role. These underwriters were in a sense selling their reputation to a select group of sovereigns. As a result their reputation proved to be one of their major assets and the signaling provided by the underwriters was crucial for investors.

The role of institutions has also been investigated. Good institutions and a credible commitment to honor property rights led to reduced borrowing costs. Constitutions also play an important role; parliamentary democracies being less likely to default than presidential ones. Adherence to the gold standard seems to have been less valued by investors whereas colonial status actually removed a territory from the sovereign world placing it under the guarantee of the colonial power.

History also shows the crucial role played by international relations. The ability to float a bond in a given country and the sanctions or the help obtained when problems arose, were largely conditioned by these relations. Military interventions to force repayment as well as supersanctions were common up till World War I after which they disappeared with the rise of modern nationalism. There is less evidence of commercial retaliations even if bilateral trade usually declines following defaults.

Eventually history allows analyzing the impact of events which rarely occur such as the denunciation of debts as odious or the partition of debts following secessions. Historical analyses show that bondholders actually penalize debts which might be repudiated because of their odious character. Regarding state succession, repartitions of the existing debts have been made on basis of many different rules. In some instances successor states refused to assume past debts. The actual reimbursement of such debts following a country break-up occurs many years after the country's partition. History provides also an example of union which offers interesting insights for the Eurobond debate. When Italy gradually became a unified country during the 19th century, sovereign bonds of the sovereign entities which would compose Italy were traded on international markets. When the Kingdom of Italy was established these debts were unified under the heading of Italian debts. Some foreign markets on which these bonds were traded listed the bonds in function of their former origin. Investors did not assign the same risk of default to these bonds showing their skepticism regarding Italy's future. Eventually yields converged towards the yields of the former sovereign with the lowest credit, a sign not very encouraging in the event Eurobonds were to become reality.

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