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SOVEREIGN BORROWING, DEBT AND DEFAULT: THE LESSONS OF HISTORY FOR CURRENT POLICIES

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This paper was prepared for the O'Brien Lecture delivered at University College Dublin on 15 May 1986.

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SOVEREIGN BORROWING, DEBT AND DEFAULT:
THE LESSONS OF HISTORY FOR CURRENT POLICIES

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I start from the premise that historical experience can be instructive. There are never precise parallels, never unambiguous lessons from that experience for current policy. The problems posed now by heavily indebted countries are long-run problems, however, and analysis should therefore focus on long-run phenomena. A historical perspective is surely appropriate.

The strategy adopted in 1982 for dealing with the problem of sovereign debt seemed to be working successfully for a few years, but it has proved to be a short-run strategy, and it is now looking decidedly fragile. This concern gave rise to the 'Baker Plan' proposed last autumn by the United States Secretary of the Treasury and endorsed since by the major creditor countries and banks. I shall suggest today that starting from historical experience, we should be looking at alternative approaches.

*The O'Brien Lecture, delivered at University College Dublin on 15 May 1986.
A sketch of the present problem is necessary first. The less developed countries and the East European countries borrowed heavily on the world capital market during the 1970s. Most of this borrowing took the form of bank loans, mainly at variable interest rates and for relatively short maturities (five to seven years). At the end of the decade, world economic conditions changed radically. First, we had the 'second oil shock', when the price of oil doubled. Almost simultaneously, monetary policies tightened in the major industrial countries. Nominal interest rates were already rising because of higher inflation, and recession set in. The burden of debt interest and amortization payments rose sharply, while demand fell for the exports which finance debt service. As tight money brought inflation down, the real interest rates paid by the debtor countries rose to historically high levels.

The strain became intolerable. Poland was the first major debtor to tell the banks and government creditors that it could not continue debt service as scheduled. After it declared a moratorium on payments in March 1981, however, over a year passed before the increasing difficulties of the large LDC debtors brought them to seek assistance. In August 1982, the crisis was confirmed when Mexico declared it could not meet its obligations without help. A significant factor for Mexico as well as for many other problem debtors was the progressive loss of bank confidence, which led to the withdrawal of short-term funds and consequent illiquidity. Domestic loss of confidence and overvalued exchange rates also led to capital flight. Even
debtors whose long-run solvency appeared secure found the short-run burden of debt service unsustainable without help.

The strategy developed then, with leadership from the United States, relied heavily on the International Monetary Fund. Debtor countries were required to work out macroeconomic adjustment programmes with the IMF, which would agree targets with the debtor and monitor their fulfilment. Assistance from the IMF was conditional on such programmes, and rescheduling with the commercial banks was in turn conditional on IMF approval. The adjustment programmes typically imposed severe domestic austerity in order to create substantial trade surpluses.

This strategy was not meant just to buy time. It was expected to lead in the medium run to renewed growth and in the longer run to renewed lender confidence. LDC borrowers would then be able to return to the capital markets without IMF help.

At first, there appeared to be considerable progress. With great efforts, the debtor countries succeeded in generating large trade surpluses. The commercial banks cooperated - they had little choice. 'Muddling through' seemed to be feasible. But the 1982 strategy was not sustainable over the longer run, and by 1985 the mood of crisis had returned. Some major debtors simply could not continue to fulfill IMF conditions, even if this remained their official policy. Others openly broke ranks: Peru announced it was not willing to pay more than 10% of its export earnings in debt service; Nigeria then took a similar line. There were
discussions among LDCs of forming a debtors' cartel.

The 1982 strategy could not be sustained either internally, within the debtor countries, or externally, through international trade. The extent of sacrifice required from the populations of the LDCs, in terms of unemployment and real wage cuts, was not tolerable indefinitely. There has been resistance from the populations of industrial countries, too, since the transfer of resources from debtors to creditors requires large LDC trade surpluses. These translate into higher OECD imports and lost jobs. The resistance is manifest in protectionism. The fall in oil prices has not eased the crisis overall: it has been helpful to some major debtors like Brazil, harmful to others like Mexico, Venezuela, Nigeria and Indonesia.

In this new phase of the debt crisis, what are the prospects for emerging without a wave of debtor defaults, bank failures, cascading breakdowns in the world financial system, and a depression on the scale of the 1930s? It is this short-run danger of systemic failure to which policies have been addressed. The long-run question on which growth of the world economy depends is how to renew the developing countries' access to world capital markets, how to resume the flow of capital to its most productive uses worldwide. The 1982 strategy assumed that successful short-run adjustment would lead to medium-term growth, longer-term rescheduling of debt, and an enhanced ability to service debt which would create the conditions for new lending. It is now understood that new net lending is needed in the short
run, but the emphasis of the Baker Plan is on associating this with long-run structural changes in the debtors' economies. It is claimed that improving the functioning of domestic markets will be sufficient to bring substantial voluntary new lending to the debtors soon, with no need for debt relief in any form.

This would be a new phenomenon in the history of the international lending which began on a large scale in the early nineteenth century. In the past, there has always some sharing between creditors and debtors of the consequences of mistakes, whether of domestic policies or erroneous expectations, internal or external shocks. Debt burdens which for any reason have become unsustainable have been relieved, not perpetuated indefinitely at a cumulative cost in output, employment and welfare.

In the century up to World War I, there were waves of substantial cross-border lending and a repeated pattern of defaults, typically followed sooner or later (sometimes decades later) by partial refundings of debt which allowed the debtor renewed access to the international capital market. A default by one debtor country was normally an isolated event, however, not simultaneous with other defaults or a part of a generalized international financial crisis; nor did default by one impair the flow of capital to others. Some countries defaulted frequently, as many as half a dozen times over the period, and it is interesting to ask why they could - that is, why they were able to borrow again after repeated defaults. The answer, of course,
is that lenders nevertheless found it worth their while, because
the risk premia they charged as part of the interest on the loans
were sufficient to compensate for the expected costs of default.
This was put very clearly by Leon Frazer of the First National
Bank of New York: 'It is better to have loaned and lost than
never to have loaned at all.'

There were some interesting new features of international lending
in the 1920s. Most important, the role of dominant capital
exporter passed from Britain to the United States. And as
Figures 1 and 2 suggest, American lending was much less stable
than British. Note that by this time, the net transfer from
Britain was consistently negative, in that the income from
foreign investments plus amortization exceeded the gross capital
outflow. The net transfer from the US was positive until the
'crossover point' in early 1929 - but note that the sharp cutback
in capital outflow from the US began as early as mid-1928, as
investors shifted their attention to the Wall Street boom. This
was in no way a response to any threat of default from the
borrowing countries.

Indeed, the first signs of financial distress came with
convertibility crises. The cutback of foreign lending was
followed by the US cyclical downturn which began in summer 1929
and quickly hit the exports of debtor countries; the US then
accounted for about 40% of the primary product consumption of
industrial countries. The debtors initially chose to maintain
debt service by sacrificing their exchange rates, that is, by
Figure 2. Income and Amortization Receipts from United Kingdom

Foreign Investments and Gross Capital Outflow, 1920-38
going off the gold peg: Uruguay in April 1929, then Argentina, Paraguay, Brazil, Australia, New Zealand, Venezuela, Bolivia, Mexico. Some introduced exchange controls, others suspended convertibility entirely.

The downturn deepened, and the wave of debt defaults followed. Bolivia was first, on 1 January 1931. Other Latin American countries defaulted during that year: Peru, Chile, Brazil, Colombia, most of Central America; but not Argentina. From the beginning of 1932 until mid-1933, the problem area was Central Europe. By 1933, 25% of foreign bond issues in New York were in default; by 1935, 40% overall, and 77% of Latin American bonds. Debt service requires both a government fiscal surplus to devote to repayment and net foreign exchange earnings to effect it. The depression cut output and thereby government revenues, while raising some elements of expenditure, and it hit drastically both the quantity and price of exports. International lending collapsed, and there were indeed outflows of short-run capital; so there was little incentive for debtors to retain access to the market by avoiding default. The problems of Latin American debtors were exacerbated by government fiscal mismanagement, those of Central Europe by bank failures.

The multiple defaults of the 1930s clearly do offer suggestive parallels to reschedulings in the 1980s. Illiquidity was not then confined to any one country or region, and the debts arose from widespread balance-of-payments disequilibria in both the 1920s and the 1970s. In both periods borrowers' problems were
due partly to their domestic policies; partly to disturbances in the world economy, including real interest rate shocks, commodity price fluctuations and exceptionally severe recessions in industrialized regions; and partly to systemic features leading to a collapse of lending to the debtors. Now as in the 1930s, there is a significant political dimension to the creditor-debtor relation which was largely absent from 19th-century debt problems.

Yet the institutional arrangements governing international lending have changed fundamentally. The switch from bond to bank finance, with different loan contracts and fewer creditors party to negotiations, is said to facilitate rescheduling of debt as an alternative to outright default; it is easier to organize a creditor cartel now. The bank lending of the 1970s also introduced a high proportion of debt at variable nominal interest rates, which proved a heavy burden when they rose abruptly; the bond finance of the 1920s was all at fixed rates. Now, the IMF can serve as an external lender of last resort to illiquid borrowers, and it gives the capital market information on domestic adjustment programmes. The domestic lenders of last resort are stronger than they were in the 1930s, and they coordinate their actions much more closely on an international basis; this may not fully counterbalance, however, the tremendous increase in international capital mobility over the past fifty years. Macroeconomic stabilization policies should preclude a business cycle downturn like the Great Depression, which would in turn hit borrowing countries. On the other hand, the financial
institutions were merely intermediaries in selling bonds in the 1920s. Now their capital is at risk, and this has implications for the stability of the entire financial system.

Despite the similarities between the two periods, are not all these differences sufficient to warrant considerable skepticism towards any historical analogies? I think not, but I came to that conclusion only after extensive analysis of the data. The first part of our research* addressed this question — was the behaviour of debtor countries and lenders sufficiently similar across the two periods to establish a firm basis for comparison?

We first constructed a macroeconomic data base for over twenty major borrowers from the mid-1920s to 1938. We then employed regression analysis to characterize these data, using models and relationships identical to those used to describe the LDC borrowers of the 1970s. As you will see from the next two transparencies, we obtained results that exhibit clear patterns which accord not only with economic reasoning but also with the behaviour of borrower countries in the recent period.

*I report here on joint work with Barry Eichengreen, available as CEPR Discussion Paper No. 75, "Debt and Default in the 1930s: Causes and Consequences", and forthcoming in European Economic Review. Professor Eichengreen is not responsible for any of the views expressed here.
Demand for International Reserves, 1930-38

\[ LGOLD = -2.87 + 1.16 \times \log GDP \]
\[ + 0.76 \times LMD + 0.26 \times LCVX \]
\[ (0.52) \quad (0.05) \]
\[ (0.13) \quad (0.12) \]

Pooled time-series and cross-section:

\[ n = 185, \quad R^2 = 0.75 \]

\( LGOLD = \) gold reserves (logarithm)
\( LGDP = \) GDP (log)
\( LMD = \) imports/GDP (log)
\( LCVX = \) export variability
\( \text{(log of coefficient of variation)} \)
Determinants of Stock of Debt, 1930-38

LDEBT = \[ -3.36 + 1.86 \text{ SDX} + 1.78 \text{ MD} \]
\[ (0.70) \quad (1.38) \quad (0.86) \]
\[ +1.01 \text{ LGDP} + 0.24 \text{ LPOP} - 0.001 \text{ GRP} \]
\[ (0.05) \quad (0.10) \quad (0.001) \]

Pooled time-series and cross-section:
\[ n = 184, \quad R^2 = 0.84 \]

LDG = \[ -3.37 + 1.86 \text{ SDX} + 1.74 \text{ MD} \]
\[ (0.69) \quad (1.32) \quad (0.71) \]
\[ +0.24 \text{ LPOP} - 0.001 \text{ GRP} \]
\[ (0.07) \quad (0.0007) \]

Pooled time-series and cross-section:
\[ n = 184, \quad R^2 = 0.10 \]

LDEBT = central government external debt (logarithm)
SDX = export variability (standard deviation)
MD = imports/GDP
LGDP = GDP (log)
LPOP = population (log)
GRP = growth rate of GDP
LDG = debt/GDP (log)
Incidence of Default, 1934-38

\[
\begin{align*}
\text{DEF} &= 0.52 & +0.35 \text{ DG} & +0.27 \text{ TT} & +0.06 \text{ XG} \\
&(0.05) & (0.18) & (0.09) & (0.04) \\
+0.005 \text{ BDF} & +0.19 \text{ RES} & -0.006 \text{ LA} & -1.29 \text{ AUS} \\
&(0.003) & (0.05) & (0.05) & (0.22)
\end{align*}
\]

Pooled time-series and cross-section:

\[
\begin{align*}
n &= 95 \\
\text{DEF} &= \text{ percentage of debt in default} \\
\text{DG} &= \text{ debt/GDP} \\
\text{TT} &= \text{ percentage fall of terms of trade, 1929-current year} \\
\text{XG} &= \text{ exports/GDP (lagged)} \\
\text{BDF} &= \text{ percentage rise of budget deficit, 1929-31} \\
\text{RES} &= \text{ percentage rise of ratio of gold reserves to money supply}
\end{align*}
\]
### Rates of Return On Foreign Loans

**Floated in the 1920s**

<table>
<thead>
<tr>
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<th>Full Sample</th>
<th>All Govt.-backed Bonds</th>
<th>Default-free Bonds</th>
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<tbody>
<tr>
<td><strong>Dollar Bonds</strong></td>
<td>0.72%</td>
<td>3.25%</td>
<td>6.74%</td>
</tr>
<tr>
<td><strong>Sterling Bonds</strong></td>
<td>5.40%</td>
<td>5.40%</td>
<td>5.82%</td>
</tr>
</tbody>
</table>

For government-backed bonds:

- \( \text{IRR (\$)} = 6.74 - 11.02 \text{ DEFAULT} \)
  \( (2.08) \) \( (2.87) \) \[ n = 33 \]

- \( \text{IRR (\£)} = 5.82 - 1.68 \text{ DEFAULT} \)
  \( (0.06) \) \( (0.48) \) \[ n = 31 \]
First, we find that a country's demand for international reserves was positively related to the size and openness of its economy and the variability of its exports. Second, we show that across countries and over time, levels of debt during 1930-38 were closely related to GDP and positively associated with the degree of 'openness' of the economy and the variability of exports. The results are remarkably similar to those obtained with similar methods for the 1970s; and they also give us some confidence in the quality of our data themselves.

Existing accounts of countries' decisions to default in the 1930s cannot explain why and how the incidence and extent of default varied so greatly among debtors. Some accounts cite idiosyncratic national circumstances. Others, in contrast, stress irresistible generalized 'bandwagon effects'. Some simply maintain that default was the only feasible alternative for debtor developing countries facing so great an external shock. The next transparency is a representative sample of our new results showing that the proportion of a country's debt in default during 1934-38 was positively related to its debt/GDP ratio, the extent of deterioration of its terms of trade from 1929 onwards, and the percentage increase in its government budget deficit during 1929-31. These results, I argue, are inconsistent with the view that there was no alternative to default for developing countries during the Great Depression, and also with the view that non-economic factors were decisive. On the contrary, simple economic variables go a long way towards explaining the incidence and extent of default in the 1930s and
might similarly indicate appropriate candidates for partial debt relief today.

There are at least three key features of international debtor-creditor relations in the 1930s which are relevant today. First, debt servicing problems and eventual defaults did not come immediately when economic conditions deteriorated and the debtors’ positions appeared worst, but rather it was after they had achieved a significant measure of improvement in their trade balances that debtors stopped paying; they had less need to borrow from the international capital markets. Second, default was not an accidental or random choice made by governments; it appears to have been related clearly to economic circumstances. Third, in the event, defaults themselves were not uniformly disastrous for the creditors.

What did happen after the defaults? The final transparency presents new estimates of the rate of return on foreign loans floated in the 1920s. We took a sample of individual bond issues floated on the New York and London markets in the 1920s and followed the history of each to final redemption or settlement or to the present day, where necessary (as, for example, with the Greek Refugee Loan of 1924, which is still being serviced after two lengthy periods of default). The internal rate of return on default-free loans was close to 6% for both dollar and sterling issues, but default hit dollar bondholders much harder than those holding sterling bonds. For example, the average realized internal rates of return (weighted by issue value) on the full
samples of government-backed loans are 3.25% for dollar issues and 5.4% for sterling issues; not only are both positive, but the latter compares favourably with the average yield on consols during the period. Despite the preoccupation with sovereign default, investors who lent directly to national governments ultimately received respectable rates of return; settlements appear to have been relatively favourable.

How did this come about, if it was impossible to put together a cartel of major creditors with power in the capital market which could be exerted to bring debtors into line? In fact, although bondholdings were widely dispersed among private individuals rather than concentrated in the hands of financial institutions, there were extensive negotiations between debtors and the representatives of the bondholders. The difference with the present day is that these negotiations typically did not start until there was already some form of default. The banks and issuing houses were involved, even if only as intermediaries; they had little incentive to take any lending risk by attempting to tide over illiquid debtors before default, but they took some role in acting on behalf of bondholders. Still, the American issuing houses of the 1920s-30s were less experienced, more competitive and fragmented, and had weaker relations with their clients than their British counterparts in the nineteenth century and indeed in the interwar period. The 1930s defaults were more disruptive than those before the War, partly because the American issuing houses were unable to manage defaults as well as the British had (and did in the 1930s, as the comparative data
suggest). Nevertheless, I stress that there were ex post negotiations, and they did produce results.

Would such rates of return be unacceptable for the 1980s-1990s? I would suggest that creditors may be unable to continue to insist on payment in full. Bank profitability, even solvency, are not obviously more important to systemic stability than debtor country ability to maintain a regular pattern of (possibly reduced) payments without their debt continuing to increase faster than exports. Both considerations are important for stability, and the appropriate policy involves sharing of the burden created by internal and external economic and political shocks.

Although interest rates are still high relative to export growth rates, the adjustment programmes implemented under IMF conditionality were typically more than adequate to guarantee solvency, on reasonable projections - if they were sustainable. The export surpluses generated in 1983-84 by these programmes were actually large enough to ensure that the present value of future debt would fall to zero. But these programmes are unlikely to prove sustainable. Even if they were - even if the debtors could accept continued sacrifices and the creditors the corresponding import surpluses - is this what we want? Is it efficient, in the sense of stimulating capital to flow where it will be most productive and maximizing world output growth? Is it equitable, as between rich and poor countries, and as between the rich and poor in both debtor and creditor countries?
Both in the nineteenth century and in the 1930s defaults were managed in such a way as to shift some of the debt burden to the creditors. Now the creditors are holding out for payment in full, with only some degree of postponement. Debtors face the prospect of continued net resource transfers to creditors for many years, with only the most remote possibility of renewed net capital inflow for development. Financial intermediaries used to assist in allocating the burden of mistakes and consequently excessive debt between debtor and creditor; now we argue that their stake requires putting the full burden on the debtors.

I suggest that this cannot and should not continue. Our analysis of the 1930s experience of defaults suggests where the strains will appear. Our account of negotiated settlements provides the background for considering how to manage them. Partial debt relief, under appropriate conditions, must come back on the policy agenda— not in the form of any of the comprehensive debt restructuring plans, but as a principle to guide a selective approach, finding solutions individually tailored to debtor countries according to carefully judged criteria. Otherwise we continue to risk ad hoc defaults, systemic instability, and poor long-run growth prospects not only for the debtor countries but for the world economy as a whole.
Determinants of Stock of Debt, 1930-38

\[
\text{LDEBT} = -3.36 + 1.86 \text{ SDX} + 1.78 \text{ MD} \\
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