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In *A Christmas Carol*, Ebenezer Scrooge awakes from a deep sleep fearing that his secure British investments have been transformed into default-prone U.S. securities. Had the bank loan officers of the 1970s remembered their Dickens, one conjectures, the problem loans of the 1980s might have been avoided. More seriously, this reference to foreign defaults in the mid-19th century reminds us that problems in international capital markets are no new phenomena.

The parallels between debt crises past and present, far from going unnoticed, have attracted a large number of social scientists to the history of foreign lending and default. In this article I describe the findings of the recent literature on the subject. The questions posed have obvious relevance to the current policy debate over LDC debt.[1] What features of international capital markets have long rendered them vulnerable to generalized crisis? What events tend to spawn debt-servicing difficulties and to provoke default? What have been the consequences of default for lenders and borrowers? What approaches historically have proven most effective at clearing away the residue of debt crises?

[1]That debate was reviewed in the symposium on "New Institutions for Developing Country Debt" published in the Winter 1990 issue of this journal.

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Large-scale international lending can be traced back at least to the Medici banks of the 15th century. A brief survey of this history clearly must impose some limitations on coverage. In this article I focus exclusively on recent contributions to the literature.[2] I concentrate on 20th century experience: on the lending of the 1920s, on the debt crisis of the 1930s, and on the recovery of capital markets after World War II.[3] The interwar debt crisis has received disproportionate attention in the recent literature. Its global nature and the identity of the countries most immediately affected render the interwar episode the one that most closely resembles the debt crisis of the 1980s.

Still, to understand what is distinctive about international lending in the 20th century, it is important to place that episode in the context of previous historical experience. When one contrasts international lending in the 1920s or the 1970s with lending in the half-century preceding World War I, one finds that there is nothing unprecedented about the magnitude of international capital flows in recent decades. On the contrary, scaled by the size of the world economy, international capital flows between 1880 and 1914 were perhaps three times as large as in the 1980s (Bayoumi, 1990; Eichengreen, forthcoming). Regular bursts of overseas lending occurred at 20-year intervals, giving rise to Kuznets cycles (alternating decades of rapid and slow growth).[4]

Defaults were integral to this cyclical process. In the 1820s, all but one of the newly-independent Latin American states defaulted on their foreign debts.[5] The U.S. states that gave Scrooge nightmares defaulted in 1830s and 1840s, and foreign lending ground to a halt. Lending to Latin America picked up again in the 1860s but was interrupted by default in the 1870s. This time not merely Bolivia, Peru, Uruguay, Paraguay and the Central American republics but also Egypt and Turkey suspended interest payments. Most of these defaults were settled by the early 1880s, and another lending boom got underway.[6] It was interrupted by Argentine and Greek defaults in the early 1890s. Large-scale overseas lending did not resume until after the turn of the century.

From a global perspective, many of these defaults were a sideshow. The United States, Canada, Australia and Russia were the leading borrowers of the period. None defaulted on its principal overseas debts in the second half of the

[2]For an excellent analytical survey of the literature that appeared prior to the 1980s, see Fishlow (1986).

[3]In addition, I impose some limitations on aspects of the interwar debt crisis that I consider here. For instance, I limit my attention in this article to commercial debts. In the 1920s and 1930s, commercial debts were in fact interlinked with war debts and reparations, as described in Eichengreen (1989a). Recent contributions which analyze war debts and reparations at length are Fraga (1986), McNeil (1986) and Webb (1988).

[4]The importance—indeed the existence—of Kuznets cycles remains an active subject of debate. As every graduate student knows courtesy of Sargent (1976), the filter applied by Kuznets tended to introduce a spurious cycle. But economic historians continue to find evidence of Kuznets cycles in the experience of a variety of countries, and to link them to the behavior of foreign lending. The recent analysis of Italian experience by Fenoaltea (1988) points to disturbances to the capital market as the autonomous force behind long swings.

[5]A fascinating account of this episode is Dawson (1990).

[6]The settlement mechanism and typical settlement terms are described later in this paper.

19th century. European lending to these nations nonetheless fluctuated sympathetically with lending to Latin America and the Near East, as if disturbances that disrupted the flow of European capital to Latin America and the Near East also affected Europe's willingness to lend to other parts of the world.[7]

Beneath this apparently static surface a sea change was taking place. Though London remained the leading international financial center, followed by Paris and Berlin, the transformation of the United States from debtor to creditor and the rise of New York as a financial center were already underway. Starting in the 1890s, U.S. foreign assets grew more quickly than U.S. foreign liabilities.[8] America's rise to prominence was accelerated by World War I. Another wave of lending, in which the U.S. played a leading role, was unleashed in 1924 following economic stabilization in Central Europe. Default ensued, starting in 1931. The debt crisis of the 1930s differed from its 19th century predecessors by its universality. The majority of sovereign debtors suspended interest payments and initiated protracted negotiations.

Many of these defaults were settled in the 1940s, though some were quickly cleared up in the 1930s and a few lingered into the 1950s. International portfolio lending picked up again only in the 1970s after the lending mechanism was transformed. In the 19th century and the interwar years, capital transfer was accomplished through bond finance. Issue houses negotiated the bond covenant, circulated the prospectus, advanced funds to the borrower, and sold the bonds to individual investors. The underwriter might be embarassed if bad news reached the market before it had disposed of the bonds, as Baring Brothers, one of London's leading issue houses, learned in 1890. But sovereign default rarely threatened creditor-country banking systems, whose investments in foreign bonds amounted to only a fraction of their capital. In the 1970s, money center banks took to extending foreign loans directly, reverting to the practice of the Medici banks some 500 years before.

Operation of the Capital Market

Qualitative histories characterize the lending process in terms that are difficult to reconcile with market efficiency (Kindleberger, 1978). Lending occurred in bursts during which, according to these accounts, virtually any overseas issue was uncritically subscribed.[9] Eventually doubts arose, and the failure of a prominent issue led investors to withdraw to the sidelines. Declining

[7]The same pattern is evident in the 1930s, when default by some countries resulted in an interruption of lending even to others which maintained service on their external debts. For discussion, see the next section of this paper.

[8]U.S. net indebtedness continued to grow absolutely until 1914 because the foreign assets started from a lower base. A good account of America's transition from external debtor to external creditor is Stallings (1987).

[9]This was the way contemporaries saw things as well. Describing the first wave of lending to Latin America in the 1820s, the banker Alexander Baring remarked, "It seemed as if all Bedlam had broken loose on the Royal Exchange." Cited in Marichal (1989), p. 12.

bond prices left investors unwilling to lend to any foreign borrower at any price. Swings in the volume of lending, according to these histories, far exceeded those warranted by market fundamentals.

The literature points to several factors that exacerbated the volatility of the market. In the 1920s, U.S. banks working on commission, but lacking long-term relations with an established clientele of domestic bondholders, simply sought to maximize the volume of new bond flotations. Kickbacks allegedly induced government officials to contract for loans which their country had no prospect of repaying. Foreign bonds were aggressively marketed in the United States, sometimes with the aid of picture books that introduced investors to countries of which they were totally ignorant. Informational asymmetries and principal-agent problems within issue houses and securities affiliates thus undermined the efficiency of the market.

Quantitative evidence on market efficiency paints a less pessimistic picture. In Eichengreen (1989a), I studied the pricing of new issues on the New York market in the 1920s, while Richard Portes and I (1989a) analyzed data on 250 individual bond flotations in New York and London for the same decade. The premise underlying these analyses, as in comparable exercises using data for the 1970s and 1980s, is that the probability of default and (in an efficient market) the risk premium demanded by lenders should depend on characteristics of the country and its debt. The spread between the expected yield on new issues and the concurrent yield on U.S. Treasury bonds or British consols (infinitely-lived British Treasury securities) was used in regressions as a measure of the risk premium. Explanatory variables included type of foreign borrower (national, state or municipal government, bank or corporation), geographical location of the borrower, and measures of country risk (size of the debt burden, trade and budget balances). We found that the risk premium usually increased with the size of the trade and budget deficits. Latin American countries were charged larger risk premia than Canada and Central American republics with close political ties to the United States. Eastern European borrowers paid larger risk premia than their Western European counterparts. There was little evidence of shifts over time of the sort one would expect to see, if foreign lending had come into or fallen out of fashion. The most striking feature of the results is their resemblance to studies of the bond market and of the secondary market for bank loans in the 1980s (as in Edwards, 1986). There is little evidence in the historical record that investors were less discriminating in the 1920s than in recent decades.

Complementing studies of expected spreads are studies of realized returns.[10] The first such study, by Michael Edelstein (1982) for the United Kingdom in 1870–1913, considered both domestic and overseas issues.

[10]Still another approach is that of Fishlow (1989a), who uses Shiller's variance bounds approach to test for overreaction in the market in Argentine and Brazilian bonds in the 1880s and 1890s. The variance bounds are violated, much as in Shiller's analysis of U.S. financial markets in the 20th century.

Edelstein excluded foreign (as distinct from colonial) government bonds, although foreign railroad and corporate securities were included. Moreover, he limited his sample to first- and second-class securities, omitting the 19th-century equivalent of junk bonds. Edelstein (1982, Table 5.5) found that the returns on his sample of overseas bonds consistently exceeded the returns on a comparable sample of domestic bonds. In other words, Victorians who lent to private foreign borrowers and colonial governments were more than compensated for interruptions to debt service by the risk premia they demanded in advance.

Before concluding that 19th-century foreign lending paid, one must consider the nature of Edelstein's sample. British foreign investors are known to have fared better than their French and German counterparts (Fishlow, 1986). Moreover, default was more prevalent on foreign government securities, which are excluded from Edelstein's sample, than on colonial securities, which are included.

However, subsequent studies by Peter Lindert (1989) and by Lindert and Peter Morton (1989) considered all bonds outstanding in 1850 and floated between 1850 and 1970 on behalf of ten leading debtor governments: Argentina, Australia, Brazil, Canada, Chile, Egypt, Japan, Mexico, Russia and Turkey. According to Lindert and Morton's calculations, investors in foreign government bonds in the period 1850–1914 demanded risk premia of some 2 percent over the yield on British consols. On loans to the four Latin American governments, these premia more than compensated for default: realized returns on Latin American loans exceeded by a third the contemporaneous return on consols. The same was not true for loans to other countries, on which realized returns fell just short of the consol yield. Still, investors would have taken away from this experience the conclusion that sovereign lending paid.

The same need not be true of interwar loans, since default was much more widespread in the 1930s. Once again, however, Lindert and Morton find that foreign lending paid better than contemporaneous investments in British consols and U.S. Treasury bonds. An obvious question is whether this conclusion depends on the heavy weights attached in their sample to faithful repayers like Australia, Canada and Argentina, and on the omission of notorious defaulters like Germany and the smaller South American countries. Other studies provide the answer. Erika Jorgensen and Jeffrey Sachs (1989) studied the repayment of all nationally-guaranteed bonded debt issued in dollars and outstanding in the 1930s for five Latin American countries: Argentina (whose 14 bonds were continually serviced) along with Bolivia, Chile, Colombia and Peru (whose 26 bonds all experienced some degree of default). Their results confirm that the countries' varying treatment of external debt had dramatic implications for investor returns: investors in Argentine issues profited handsomely by choosing them over U.S. Treasury bonds, whereas investors in the others suffered substantial losses.

Richard Portes and I (1988, 1989b) sought to provide a comprehensive analysis of the performance of interwar loans, computing realized returns on

more than 200 dollar bonds and 125 sterling bonds issued on behalf of governments and other foreign borrowers in the 1920s. The bonds considered were a sample of all overseas issues floated in London and New York between 1920 and 1929. For bonds issued in London, we too found that overseas lending paid better than contemporaneous investment in British consols. Overseas issues in London yielded a nominal internal rate of return of about 5 percent per annum; consols yielded just in excess of 4 percent. The same was not quite true for overseas dollar issues, which yielded an average annual nominal return of 4 percent, slightly below Treasury bond yields. The implication is not that losses from default were negligible, since expected yields could be 8 percent or more. Rather, it is that actual yields more than compensated British investors and nearly compensated U.S. investors for interruptions to debt service and write-downs of principal. Horror stories abound, but the investor in a representative foreign bond portfolio holding out to the end could have concluded that foreign lending paid.

The contrast between British and American experiences in the 1930s is typically ascribed to the different destinations of British and American capital (Schuker, 1988). British investors lent to the Empire and Dominions, while American investors purchased riskier Latin American and Central European bonds. Though some two-thirds of dollar bonds lapsed into default in the 1930s, the same was true for only about a third of sterling issues. Portes and I show that the direction of lending is only part of the story. Whereas the average default on a dollar bond reduced the realized internal rate of return from 6.0 percent to 1.4 percent, the average default on a sterling issue reduced the return from 5.5 percent to no less than 2.7 percent.[11] Fully understanding the performance of foreign loans therefore requires analyzing both the incidence of default and the bondholders' ability to recover.

Incidence of Default

In contrast with the 1980s, outright default was common in the era of bond finance. The difference is readily explained. Avoiding default sometimes requires the provision of new money (additional loans to tide the debtor over a period of illiquidity). In the era of bond finance, free rider problems made the provision of new money difficult when tens of thousands of individual investors had to go along, even more so than today when sovereign lending is the province of syndicates of several hundred commercial banks (White, 1986). Moreover, creditor-country governments were less inclined to intervene to insure the continuance of debt service in earlier periods when their banking systems were not at risk (Lipson, 1989; Aggarwal, 1989).

[11] To compute realized returns on sterling issues, an assumption had to be made about the price at which bonds in default were repurchased on the market. Eichengreen and Portes calculate returns under several alternatives. The figure reported in the text is for the assumption that repurchases occurred at prevailing market prices.

Even in the 1930s, when default was widespread, it was far from universal. Argentina, Australia, Canada and most of the Central American republics continued to service their national government debts. States and municipalities did not always follow central governments when the latter opted to maintain service on their external debts. Early analyses (Diaz-Alejandro, 1983; Fishlow, 1986) emphasized the severity of the external shock experienced by indebted nations as the central determinant of default. New lending collapsed abruptly in the second half of 1928; ability to service existing debts consequently hinged on a country's capacity to generate export earnings, which depended on its terms of trade. Latin America's terms of trade declined by 33 percent on average between 1929 and 1931, but the extent of the deterioration varied across countries, as did the treatment of external debts.

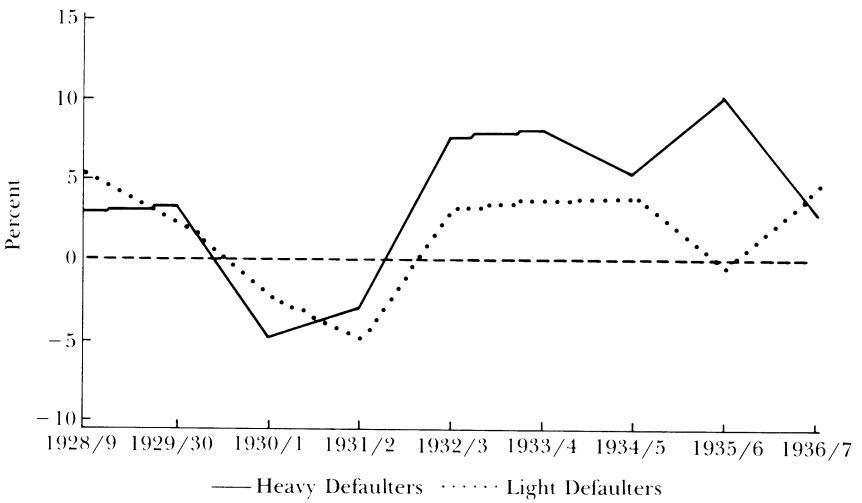
Portes and I (1986) analyzed the incidence and extent of default in the 1930s, finding the explanation to be more complicated than early accounts suggest. We related the percentage of government and government-guaranteed debt in default (for all levels of government) to proxies for both economic and political conditions. The debt-to-export ratio and the magnitude of the terms-of-trade deterioration both were positively associated with the extent of default. But so were measures of the policy response in the indebted nation and of its relationship to its creditors. Countries that responded to the crisis by raising taxes or cutting public spending were less likely to default than others which allowed large budget deficits to persist. Domestic politics therefore seem to have played an important role in choice of debt-management strategy. The same is true of international politics. Even after controlling for observable economic characteristics, regression equations significantly overpredict the extent of default by a country like Australia with close political ties to its principal external creditor, in Australia's case Great Britain. Albert Fishlow's (1986, p. 69) characterization of 19th century lending, that it "occurred within a larger economic and political system," is equally applicable to the lending of the 1920s and the defaults of the 1930s.

Another way to view these findings is in terms of the two categories of explanation for debt-servicing difficulties familiar from the literature on the 1980s: that default was forced on the debtors by circumstances beyond their control, namely the instability of global commodity prices and volatile swings in the availability of external finance (the view of Marichal, 1989, for example); and that debt-servicing difficulties were compounded, if not created, by domestic policies (the view of Schuker, 1988). Historical analysis suggests that the contest is artificial. There is more than enough blame to go around.

Consequences of Default

One of the most controversial issues in the literature on LDC debt is the consequences of default. Unilateral suspension of interest and amortization payments may lead to trade retaliation and loss of capital-market access which

Figure 1
Rate of Growth of Real GNP, 1928–1937



damage the prospects for economic growth. At the same time, countries may, by suspending debt service, be able to redirect resources previously channeled abroad to domestic uses, and to relax restrictive monetary and fiscal policies required to limit commodity imports and to free up domestic goods for export. It is unclear a priori which effect dominates, and it is too early to definitively evaluate post-1982 macroeconomic performance. Moreover, since the 1980s were a decade of serial reschedulings, ambiguities arise when one attempts to distinguish between countries that do and do not service their debts.

For the 1930s, analyzing the macroeconomic effects of debt-management strategies is more straightforward. Portes and I (1989a) found for a sample of some two dozen countries that both GNP and industrial production recovered more quickly in countries that defaulted than in countries that continued to service their debts. This is evident in Figure 1, which displays indices of the annual rate of growth of real GNP for the two sets of countries.[12]

[12]Heavy defaulters are countries that suspended more than a small fraction of interest payments between 1931 and 1939. The full list of heavy defaulters is Brazil, Bulgaria, Chile, Colombia, El Salvador, Germany, Greece, Guatemala, Hungary, Poland and Yugoslavia. The full list of light defaulters is Argentina, Australia, Austria, Belgium, Czechoslovakia, Denmark, Finland, France, Italy, Japan, New Zealand, Nicargua, Norway and Spain. The sample of countries was dictated by the availability of data. Data sources are described in Eichengreen and Portes (1986, 1989a). Belgium, Poland, Spain and Yugoslavia are omitted from Figure 1 for lack of comparable data for all years. Figure 1 differs from the first figure in Eichengreen and Portes (1989a), where we took unweighted averages of country data. Here I converted real GNP into U.S. dollars using the 1929 average dollar exchange rate and aggregated within each category. Hence Figure 1 attaches heavier weights to larger countries. The same procedure was used in constructing the other figures that follow.

There is good reason to treat these comparisons cautiously. GNP data for this period are exceptionally fragile. Moreover, the experience of defaulting and nondefaulting countries differed in other ways that could have significantly affected growth. Figure 1 shows that the 1929–31 contraction was more severe in countries that subsequently lapsed into default; those same countries may have had more scope for rapid growth subsequently simply by putting underutilized resources back to work. Other domestic initiatives, such as tariff and exchange rate policy, also affected economic performance, and it is likely that the tendency to pursue particular trade and exchange rate policies was correlated with debt-management strategy.[13] One can raise questions about the direction of causality: even if external debt policies had an impact on growth, variations across countries in macroeconomic performance also affected their treatment of external debts.

Portes and I estimated a number of multivariate regressions designed to assess these possibilities. These revealed that changes in the import share of GNP, in the terms of trade, and in growth performance in 1929–31 all influenced countries' rate of growth between 1931 and 1937. But the share of government and government-guaranteed debt in default remained positive and statistically significant at standard confidence levels. Additional regressions correcting for simultaneity confirmed the presence of feedback from growth to debt-management strategy but suggested that it led, if anything, to understatement of the impact of debt management on growth.[14]

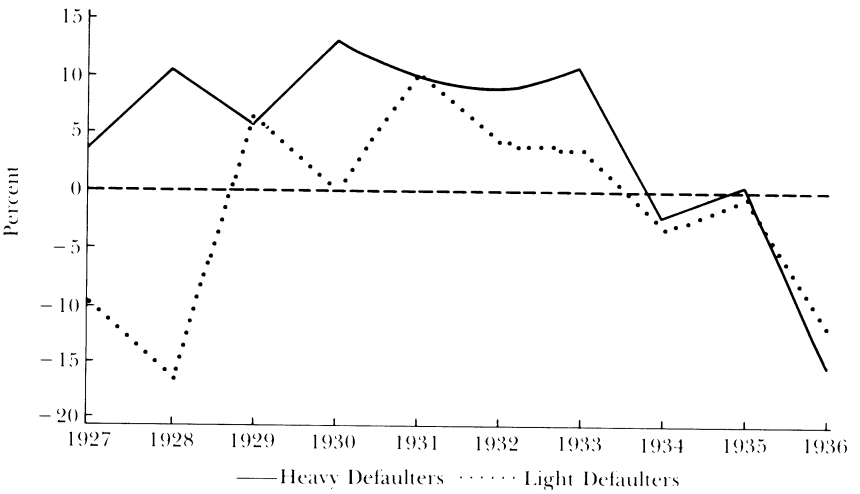
David Felix (1987) has documented the sources of these differences in growth performance for Latin America, suggesting that they were associated primarily with countries' choice of monetary and fiscal policies. To mobilize foreign exchange and transfer it abroad, governments continuing to service their debts were forced to compress domestic spending. Taxes were raised, public spending was cut, and the loss of international reserves was permitted to reduce the money supply. Figures 2 and 3 suggest that the point extends to a broader range of countries.[15] Figure 2 shows that heavy defaulters ran larger government budget deficits after 1931. (They also ran larger deficits in the preceding period, a fact cited by those who ascribed default to profligacy on the part of the borrowers.) Figure 3 shows that their money supplies grew more

[13]In the case of the Latin American debtors, the importance of exchange-rate and trade policies is well documented. See Campa (1990) and Fishlow (1972), respectively.

[14]More rapid growth reduces the likelihood of default; this negative association causes the positive association running from default to growth to be understated in ordinary-least-squares regressions. The cautious reader will have thought of reasons why the conclusions of this analysis may not be applicable to the post-1982 crisis. It may be that export-oriented policies worked less well in the '30s, when global export markets collapsed, than in the '80s when export markets held up relatively well. It may be that the capital market's failure to distinguish defaulters and nondefaulters after World War II reflects the prevalence of debt-servicing difficulties. In the 1950s the market remained entirely demoralized; in the 1970s and 1980s (as in the 1890s), when debt-servicing difficulties were more localized, the market may have been more discriminating.

[15]In Figure 2, Guatamala, France, Italy and Belgium are excluded from the complete list of countries for lack of comparable data for all years.

Figure 2
Government Budget Deficit as a Share of Expenditure, 1927–1936



quickly after 1932, since default attenuated the need to restrict domestic spending in order to mobilize resources for service of external debts.

The differences between the two groups of countries, though visible, are relatively small. One reason is that countries could relax the external constraint on the adoption of reflationary policies not just by suspending interest transfers but also by suspending gold convertibility. Several of the light defaulters (Argentina and Australia, for example) left the gold standard early in the

Figure 3
Percentage Change in M1, 1927–1937

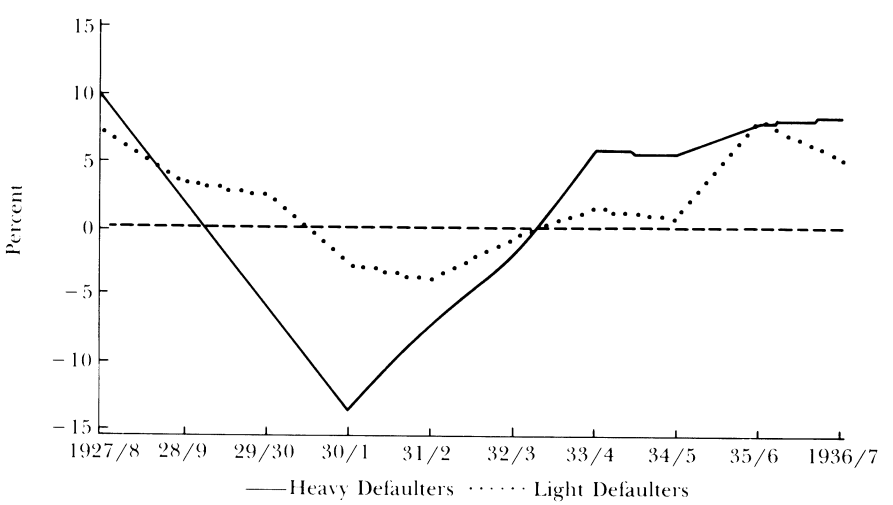
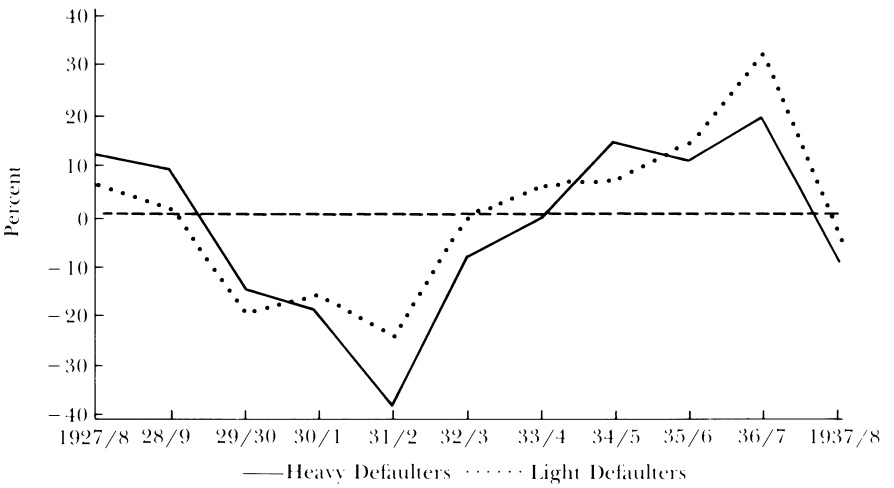


Figure 4
Percentage Change in Exports, 1927–1938



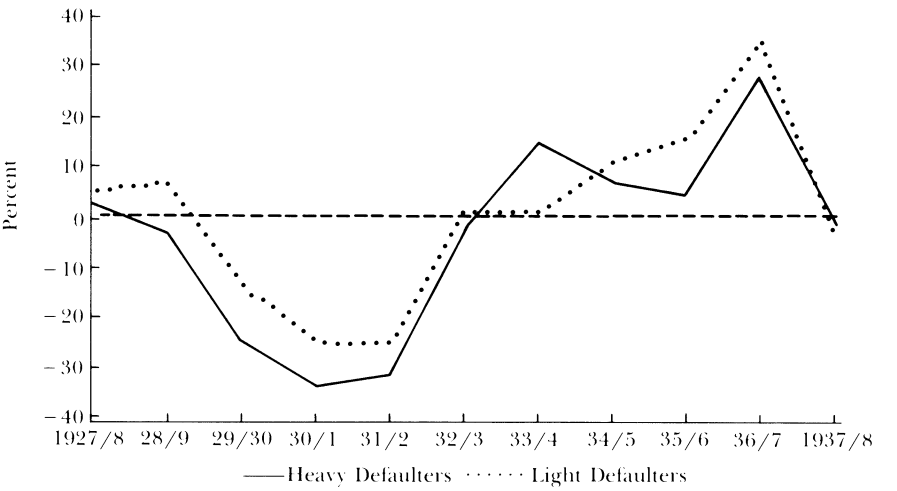
period, which could have facilitated the pursuit of more expansionary policies. But even there the maintenance of debt service continued to constrain the pursuit of reflationary policies, as Diaz-Alejandro (1983, 1984) has shown. M2 recovered to 1929 levels by 1930 in Uruguay, by 1932 in Brazil and by 1933 in Colombia, but only by 1937 in Argentina, even though Argentina, like its neighbors, had left the gold standard at the beginning of the 1930s. Diaz-Alejandro's explanation highlights external debt policy as a constraint on the adoption of reflationary policies.

Figure 4 confirms that the light defaulters boosted their exports more quickly after 1931, presumably to generate the foreign exchange required for debt service. Currency depreciation, in combination with domestic policies to limit spending, was used to achieve this end. In contrast, there is little evidence in Figure 5 of a difference between the average rate of import growth of heavy and light defaulters.[16] The light defaulters may have exported more, but the extra revenues financed debt service rather than commodity imports. Felix reaches the same conclusion for Argentina and five major Latin American defaulters (Brazil, Chile, Colombia, Mexico and Peru).

The contrast is attributable, in the main, to differences in domestic policies rather than to differences in export-market access. The principal creditor, the United States, was loath to employ trade policy as a lever to obtain concessions from the debtors. The Roosevelt administration blamed trade warfare for the severity of the Great Depression and was unwilling to risk another outbreak in the service of American bondholders. By 1934, with the adoption of the

[16]In Figures 4 and 5, Austria and Spain are excluded from the complete list of countries for lack of comparable data for all years.

Figure 5
Percentage Change in Imports, 1927–1938



Reciprocal Trade Agreements Act, the U.S. was leading the way toward freer trade. The U.S. State Department attempted to reassure the bondholders by observing that the recovery of trade would enhance the debtors' capacity to raise foreign exchange.

Britain was more inclined to use trade policy to extract concessions. Marcelo de Paiva Abreu (1984) cites Britain's use of the 1932 General Tariff and the Ottawa Agreements as bargaining chips in accounting for Argentina's decision to maintain service on its external debt.[17] Britain also threatened sanctions against Germany when Hitler moved to suspend payments on Germany's Dawes and Young Plan bonds.[18] But these were exceptions to the rule. British officials generally rejected bondholders' calls for commercial retaliation.

Defaulting countries could have paid a price through loss of capital-market access. Theoretical models of international lending in the presence of default risk (like Cohen and Sachs, 1986) are built on the assumption that default blemishes the borrower's reputation and destroys its ability to borrow, while countries that maintain debt service enjoy continued access to international capital markets. This assumption can be reconciled with the historical evidence only with difficulty. Countries that faithfully serviced their debts in the 1930s did not enjoy superior credit market access subsequently. In fact, virtually no one was able to obtain significant amounts of new portfolio capital abroad in the 1930s or in the decades following World War II.

[17]Another factor is that an unusually large share of Argentina's sterling-denominated debt was owned by Argentine citizens themselves (Diaz-Alejandro, 1984, p. 27).

[18]The Dawes and Young Plan loans were issued in 1924 and 1930, respectively, in conjunction with two reschedulings of Germany's reparations obligation. For details, see Schuker (1988).

The argument is not that default was without implications for the operation of the market, but rather that the effects were largely external to the defaulting countries. Defaulters and nondefaulters suffered alike as the international capital market shut down. Even when lending picked up after World War II, there remained little discernible difference in the capital-market access of countries that had pursued different policies toward their external debts. Eliana Cardoso and Rudiger Dornbusch (1989), comparing patterns of borrowing from the 1930s to the 1960s, conclude that the faithful repayer, Argentina, enjoyed no better capital market access than less accommodating Brazil. Jorgensen and Sachs (1989), comparing Argentina with Bolivia, Chile, Colombia and Peru, find little systematic difference in flows of external finance to governments or private borrowers between 1950 and 1964. External finance as a share of exports was actually smallest for Argentina. This is true whether or not direct foreign investment is included.

One worries that the two classes of countries differed in other ways that affected their demands for and access to external finance. In Eichengreen (1989a), I therefore estimated multivariate models of foreign borrowing for a cross-section of countries for the period 1945–55. The volume of foreign borrowing was related to standard determinants—GNP, openness, export variability and the initial stock of debt, as in Eaton and Gersovitz (1981)—but also to the share of debt in default in 1935. Regressions analyzing net foreign lending to public authorities of 32 countries and private portfolio lending to 18 Latin American countries produced no evidence that the volume of external capital a borrower could obtain was negatively affected by its prior default.

There are two obvious objections to these results. First, the legacy of default might show up in the interest rates charged problem debtors rather than in the volume of loans.[19] Second, a difference in capital market access might only surface once private lending was again in full swing in the 1970s and 1980s. Lindert (1989) therefore analyzed determinants of the 1985 stock of public and publicly guaranteed long-term debt of 51 countries and the interest rates charged on new official loans in that year. His regressions included dummy variables for countries that defaulted before 1919, in the 1930s, and between 1940 and 1981. In no case did they indicate that the prior debt-servicing record had a discernible impact on the terms or volume of borrowing.

In contrast, Sule Ozler's (1988) analysis of new loans in the 1970s, using Lindert's own measures of default, did find evidence that countries with a prior record of debt-servicing difficulties paid higher interest rates. The contrast may reflect the different periods on which the authors focus. In 1985, new lending was dominated by involuntary rollovers; the interest rates charged were one

[19]Of course, in simple market-clearing models (in which countries face a positively-sloped supply curve of external funds), the interest rate and the volume of lending will be closely correlated. In models where credit rationing occurs—for example, because the probability of default increases with the interest rate (Eaton, Gersovitz and Stiglitz, 1986)—it is necessary to look at both the volume of loans and the interest rate.

element of an implicit contract specifying not only the rate of return on that loan but also the treatment of existing debts. In the 1970s, in contrast, banks were voluntarily dispensing loans, the yields on which did not reflect these additional complications. If this interpretation is correct, then there is evidence for a short period in the 1970s that countries with prior records of default were charged larger spreads on new loans. But there is no evidence that they were rationed out of the market.

How are we to understand the willingness of creditors to lend repeatedly to problem debtors? It may be that investors simply have short memories—that they have forgotten their Dickens. Few of the bank loan officers of the 1970s had experienced the debt crisis of the 1930s firsthand. But had they recalled that experience, they would not have concluded in any case that foreign lending was bad business. After all, in both the 19th century and the first half of the 20th, risk premia had more than compensated British investors for losses from default. They nearly compensated Americans who had purchased foreign bonds in the 1920s. Still, this does not explain the apparent failure of the creditors to discriminate against debtors with a record of defaulting.

The most plausible explanation is that damage to creditworthiness due to default could be repaired by a credible change in regime. As emphasized by Fishlow (1989b), a systematic change in policy could overwhelm the reputational effects of prior default. Once debtors adopted policies consistent with sustained income and export growth, creditors regained willingness to lend. In the 19th century, returning to the gold standard was a way of signalling that a regime change had taken place. The restoration of convertibility indicated that monetary and fiscal policies were again consistent with external balance. Given the sunk costs incurred in returning to gold, it was thought unlikely that governments would allow aggregate financial policy to run out of control and threaten their investment in convertibility. Today, concluding an agreement with the IMF can play a similar role.

The Resolution of Debt Crises

The readjustment of defaulted debts involved protracted negotiations requiring up to a quarter-century to complete. They were complicated by the multiplicity of bondholders and by uncertainty about their representation. Committees of financial experts negotiated with foreign governments on behalf of the bondholders. In Britain, the Corporation of Foreign Bondholders, or CFBH, in existence since 1868, was universally recognized as their spokesman.[20] The CFBH's influence derived from its connections to the Stock Exchange. A

[20]More information on the bondholders committees may be found in Eichengreen and Portes (1989c). The CFBH finally went out of business in 1989, demanding until the end compensation for the creditors of US states that had defaulted in the 1840s. Many of its records are now held by the Guildhall Library (London). The paragraphs that follow are based on these records and on annual reports of the CFBH and FBPC.

representative of the Exchange sat on the Corporation's governing council. The Exchange refused quotation to new loans of governments in default, especially those that had failed to negotiate in good faith with their creditors. For information on good faith, the Exchange relied on the CFBH.

In the United States, where foreign bond flotations were a recent innovation, no comparable institution existed. In the event of default, ad hoc committees sprang up to conduct negotiations. These committees suffered from high administrative expenses, poor relations with the U.S. government and the stock exchange, and an inability to speak credibly for the bondholders. In response to these problems, the U.S. State Department sponsored the formation of a working party to draw up plans for a permanent organization. As a result of its efforts, the Foreign Bondholders Protective Council was founded in 1933.

The settlement process typically worked as follows. The bondholders' committee dispatched a representative to negotiate with foreign government officials. Upon the satisfactory conclusion of negotiations, it issued a press release advising bondholders to accept the offer by cashing a coupon or submitting their bond certificates for stamping or exchange. Bondholders dissatisfied by the terms could hold out for better ones, as some do to this day. Interest arrears were generally written off in these settlements. Future interest obligations were reduced substantially, the amortization period was lengthened, and occasionally principal was forgiven. In evaluating a readjustment offer, both economic and political conditions were considered.[21]

The fact that export credits and long-term loans were extended by different lenders limited the sanctions that could be applied. Disaffected bondholders frequently demanded that trade credits be interdicted. But the commercial bankers and merchants who were the source of trade credits held little bonded debt. Repeatedly their spokesmen stated their unwillingness "to associate themselves with any attempt . . . to oppose export credits to a defaulting country or to put the bondholders in a better position than the traders," as cited in Eichengreen and Portes (1989b, p. 21).

The role of creditor-country governments in these negotiations was more complex than official statements of their hands-off policy would suggest. The American State and Commerce Departments generally limited their involvement to providing the FBPC with information, although they sometimes intervened when American bondholders received less favorable treatment than their foreign counterparts. While U.S. officials did not as a rule make Export-Import

[21]Sir Otto Niemeyer, British financial expert and member of the CFBH's governing Council, wrote its Brazilian negotiator in 1940, for example, "There are two entirely different kinds of facts which we have to consider. The first one is the political facts and the second one is the economic facts or . . . [rather] the economic probabilities . . . On the first set of facts [it is] not possible at the present moment to extract from the Brazilian Government an offer . . . different from that which you have . . . [obtained], and for this reason I am in favour of accepting that offer." Cited in Eichengreen and Portes (1989b, p. 17).

Bank loans conditional upon the resumption of debt service, on a number of occasions they made clear the extension of such loans was a political matter, and that the Congress might well consider existing debts when reviewing Eximbank loans.

The British Foreign Office was more intimately involved. It provided the CFBH with advice and even allowed Embassy officials to conduct negotiations. The British Treasury let it be known that the status of commercial debts influenced its decision of whether to extend official credits to foreign countries. Following the outbreak of World War II, policies toward trade and debt became more closely linked. On more than one occasion British officials made clear that government purchasing policy toward foreign countries was influenced by their treatment of existing debts.

But since sovereign default did not pose a threat to the stability of creditor-country banking systems, creditor-country government pressure remained moderate. Franklin Roosevelt, in a 1939 speech to Congress, dismissed defaulted Latin American bonds as "ancient history" and urged the bondholders to settle in order to cement U.S. economic relations with its neighbors to the south. Creditor-country governments might even pressure the bondholders to settle if the latter's inflexibility impeded the attainment of diplomatic goals. That pressure was applied to creditors as well as debtors is one of the features that distinguishes the 1930s from the 1980s.

The combination of effective representation by the CFBH and active involvement by the British government helps to explain that, compared to investors in dollar bonds, sterling bondholders recovered a larger share of contractual interest and principal on bonds that lapsed into default. German bonds provide an illustration. As mentioned above, the British government threatened trade retaliation against Germany; Roosevelt, in contrast, instructed his ambassador to Berlin to "lend what personal, unofficial aid you can, but no more" (cited in Schuker, 1988, p. 77). The ambassador did not find time to meet with the bondholders' representatives. Reflecting this difference in creditor-country policies, Germany treated British bondholders more favorably than their U.S. counterparts. The nominal rate of return realized on German issues purchased in the 1920s was 3.6 percent annually for sterling bondholders but only 1.1 percent for dollar bondholders (Eichengreen and Portes, 1989a, p. 79).

Another option for the debtors was to buy up bonds in default. Jorgensen and Sachs (1989) estimate that Bolivia repurchased 5 percent of its defaulted debt at 16 cents on the dollar, Chile retired 18 percent at 59 cents, Columbia 22 percent at 22 cents, and Peru 31 percent at 21 cents. Then as now, buybacks were controversial. Bondholders objected that if sovereign debtors possessed foreign exchange, it should be devoted to debt service rather than buybacks. They accused the debtors of manipulating bond prices—of taking steps to depress their level immediately before entering the market. The attitude of representative committees was more ambivalent. They noted that purchases by

the debtor put upward pressure on market prices and removed the residue of nonperforming loans from the market. They were willing to overlook a history of buybacks and to permit additional purchases at market prices as part of a general settlement.

A recent literature (Bulow and Rogoff, 1988) identifies circumstances in which buybacks do not benefit the debtor. If there is a large volume of debt trading below par, openly repurchasing that debt using international reserves without altering the country's debt-servicing capacity will simply drive up the secondary market price of remaining debt, leaving the market value of the debt unchanged. Reserves will be squandered without effectively reducing the debt burden.

Interwar data for countries like Chile that engaged in this practice confirm that buybacks exerted some upward pressure on secondary market prices. They do not suggest, however, that prices rose sufficiently to leave the overall debt burden unchanged. The explanation may lie in the fact that countries like Chile attempted to enter the market secretly when repurchasing outstanding debt. As Cohen and Verdier (1990) point out, secret buybacks of debt may benefit the defaulting country even when Bulow and Rogoff's other conditions are met. Historical evidence from the 1930s is consonant with this view.

Historical Perspectives on Global Debt Reduction Plans

The alternative in the 1980s to case-by-case negotiation has been global schemes such as the Baker and Brady Plans.[22] A number of remarkably similar plans were mooted in the 1930s (Eichengreen, 1989b). None came to fruition.

The first such scheme proposed to delegate responsibility for solving the debt crisis to the Bank for International Settlements. The BIS had been established in 1930, in conjunction with the Young Plan rescheduling of German reparations, to act as a "central bank for central banks." In 1931 Hubert Henderson, an advisor to the British government, proposed that the BIS issue international certificates, much like the Special Drawing Rights first issued by the IMF in the 1960s. These certificates would have to be accepted by all BIS member countries in settlement of international transactions. Insofar as governments could use these certificates to make interest payments abroad, they might be able to resume service on their external debts.

But the BIS, as a matter of statute, was prohibited from extending loans directly to governments. Having extended loans to the Austrian, German and Hungarian central banks during the financial crisis of 1931, it had few remaining resources of its own. The board of the BIS was dominated by creditor-country central banks, which attached a higher priority to exchange rate

[22]Again, the interested reader should consult the symposium in the Winter 1990 issue of this journal for details and analysis of these plans.

stabilization than to debt problems. For all these reasons, the Henderson Plan made no headway.

The 1931 Kindersley-Norman Plan, named after Montagu Norman, Governor of the Bank of England, and Robert Kindersley, Chairman of Lazard Brothers and a Bank of England director, proposed establishing an international corporation to extend loans to countries and enterprises otherwise unable to obtain them. Their plan resembled ideas offered previously by Hjalmar Schacht, long-time President of the German Reichsbank (Luke, 1985). The governments of the creditor countries would contribute the capital of the new facility, which would be authorized to raise additional finance by floating bonds on the international market. It would extend loans to countries otherwise unable to obtain them, "reestablishing the credit of foreign Governments, corporations, etc., to whom the money is lent... improving the price of their securities... and the purchasing power of their nationals" (cited in Eichengreen, 1989b). The new facility would repackage these claims and sell them to investors on the open market. An attempt was made to interest central bankers in the plan at a 1931 meeting of the BIS. But, as J. P. Morgan and Co. partner Thomas Lamont's Paris correspondent described the reaction, "No comments were made and no special interest was shown..."

The Beyen and Crena de Jongh Plans, offered by two Dutch bankers in the winter of 1931–2, were more specialized in intent. The short-term debts of Austria and Germany had been frozen in the course of the 1931 financial crisis, to prevent withdrawals of foreign deposits from threatening their banking systems, destabilizing their exchange rates, and dissipating the resources lent them by the BIS. As long as short-term credits remained frozen, observers feared, foreign banks would hesitate to extend trade credits. Beyen's proposal was to convert the credits into loans repayable in installments over 20 years. In the event of a foreign exchange shortfall, debtors would have been permitted to extend preferential treatment to creditor countries that purchased their exports. The Crena de Jongh Plan made no attempt to lengthen the maturity structure of the debt but would have permitted countries with inadequate foreign-exchange earnings to repay their debts in domestic currency. But once again, neither plan was enthusiastically received by the bankers.

More ambitious proposals were considered at meetings that preceded the 1933 World Economic Conference. In discussions with U.S. officials, Britain proposed a "normalization fund" to channel capital to countries requiring funds for purposes including the resumption of debt service. In return, the recipients would lift trade barriers and exchange controls. One by one, the debtors endorsed variants of the plan. The Roumanians argued that it was essential for economic recovery. The Turks proposed official establishment of an "international credit bank." The Czechs, though not heavily indebted themselves, argued that the plan was essential to the prosperity of their neighbors and hence to the recovery of their foreign trade. But the British

proposal was barely discussed at the London Conference, held in the aftermath of the dollar's devaluation and consequently preoccupied by exchange rate problems. U.S. officials admitted that, in any case, an international fund could not have been pushed through Congress. "American experience with respect to international loans has not been sufficiently happy to encourage it to enter into additional obligations," as they put it to the Polish Ambassador (cited in Eichengreen, 1989b, p. 82).

The failure of these proposals points to three fundamental obstacles to the implementation of global plans. First, there must be sustained political commitment. In the 1930s, domestic problems and international entanglements repeatedly diverted policymakers' attention from the international debt crisis. In 1931 Britain was attempting to cope with the increasingly intense balance-of-payments difficulties that ultimately drove her from the gold standard. In 1933 the Roosevelt Administration turned to devaluation and away from international collaboration precisely when the World Economic Conference provided an opportunity to address the debt crisis.

Second, even if governments and banks are willing to entertain an international debt facility, there remain serious problems of finance and control. Under the Kindersley-Norman Plan, for instance, the finance was supposed to come largely from the private sector. Large investors, such as J. P. Morgan and Co., expressed their unwillingness to cooperate unless control of the new organization rested in private hands. Central bankers and Treasury officials demanded that control be allocated according to the nationality of finance. The Bank of France, for instance, insisted that it be granted a controlling interest because the largest share of the funds would come from Paris.

Finally, there can be debilitating disputes over what countries and obligations to include. At the 1933 World Economic Conference, the United States declared intergovernmental debts off limits. The realization that forgiveness of inter-allied obligations was unlikely weakened the resolve of the Europeans to push for the adoption of a global plan.

These obstacles to the implementation of global solutions will sound depressingly familiar to observers of the current policy debate. The failure of such schemes in the 1930s does not leave one optimistic about their prospects in the 1990s. Much has changed, of course, over the intervening 60 years. The IMF plays a much more active role in the current crisis than did the BIS in the 1930s. The Paris Club has institutionalized the renegotiation of intergovernmental debts. Creditor-country governments are also much more actively involved in other debt negotiations. The shift from bond to bank finance provides greater scope for new money and opens the way for the adoption of a richer menu of debt reduction and refinancing schemes. Still, the historical precedents all point away from a speedy resolution to the current crisis. They suggest that today's debt crisis will not be the last one experienced in our lifetimes.

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