Do Creditors Ignore History?
Reputation in International Capital Markets

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In the literature on reputation in international relations, there is a contradiction between two conventional wisdoms, one theoretical and the other empirical. The theoretical wisdom holds that concerns about reputation should play an important role in international relations. For centuries scholars and practitioners of international relations have cited reputation as a motive for keeping one’s word. A government that honors its commitments can acquire a reputation for reliability, which should help it attract partners for cooperative endeavors, whereas a government that breaks its commitments may signal that it cannot be trusted, prompting others to exclude it from beneficial international agreements. This argument, which appears in classical works of international relations as well as modern analyses of political economy, has achieved the status of conventional theoretical wisdom.

The empirical wisdom, in contrast, holds that concerns about reputation exert virtually no effect on world affairs. This wisdom is particularly prevalent among students of international debt. In research on government borrowing in international markets over the past two centuries, scholars such as Rudiger Dornbusch (1989), Barry Eichengreen (1992), Peter Lindert (1989), and Jeffrey Sachs (1989) have found surprisingly little evidence of reputational effects. Apparently, countries with a history of defaults do not face lower credit ceilings or higher interest rates than borrowers with unblemished records, implying that markets do not punish governments for breaking financial commitments. The lesson of history, it seems, is that international creditors ignore history!

In this paper, I propose a theory that reconciles these two conventional wisdoms and could unlock other puzzles in the social sciences. Specifically, I contend that a government alters its reputation by surprising creditors – by doing the opposite of what creditors expect, given circumstances beyond its control. For instance, a government that pays despite war and adverse economic shocks, such as rising world interest rates or deteriorating commodity prices, will improve its standing in the eyes of creditors. By the same logic, a government that defaults under favorable economic conditions will see its reputation sink. But creditors will not deprecate a borrower that defaults under duress, nor will they esteem a government for paying when the yoke is light. Credit history does affect reputation, but only under certain conditions.

As a first step toward testing this theory, I consider the behavior of capital markets during the 1930s and immediately after World War II. Using both statistical and qualitative evidence, I identify several governments that surprised creditors by paying despite economic hardship, and I show that those governments acquired favorable reputations that helped them borrow when others could not. My analysis also demonstrates that creditors reacted harshly toward surprising defaulters, who paid less than external circumstances seemed to warrant, but treated “expected” payers and “expected” defaulters roughly the same. Thus, creditors did discriminate between defaulters and payers, but only after taking mitigating circumstances into account.
The paper is organized into four parts. First, I expose the gap between intuition, which suggests that reputations play an important role in capital markets, and existing studies, which conclude that bondholders and banks ignore history. Next, I attempt to bridge the gap by specifying conditions under which history should affect reputation and, therefore, access to credit. In the third section I test my theory against evidence from capital markets during the interwar and postwar periods. Finally, I suggest how my approach might improve our understanding of reputation in other areas of international relations, such as military crises and alliance politics.

1. The Apparent Absence of Reputational Effects

Debt contracts between public borrowers and foreign lenders represent some of the oldest and most pervasive forms of cross-border commitments in international relations. As early as the 13th century, Italian bankers began extending credit to the English monarchy to finance its wars with France. Notwithstanding occasional defaults, the practice of cross-border lending soon grew to become a prominent feature of the international financial landscape. Today few would question the importance of sovereign borrowing for the global political economy: during 1996 alone, private bondholders and commercial banks lent more than $80 billion to the developing world; virtually the entire sum was borrowed or guaranteed by sovereign governments.

A sovereign debt contract is a voluntary exchange of goods in time, so it is vulnerable to problems of dynamic inconsistency. When a government borrows funds from bondholders or banks on international markets, it promises to repay with interest during subsequent periods as specified by the loan contract. Having received the loan, however, the government may feel tempted or even compelled to violate the contract by refusing to service and amortize as agreed. In my terminology, any contractual violation counts as default. The most extreme form of default occurs when a government repudiates both interest and principal, thereby asserting that the entire debt is illegitimate and will not be recognized at any point in the future. Less severe forms of default include temporary suspensions of payments, permanent reductions in outstanding principal or interest rates, and extensions of the maturity date.
If governments could default with impunity, no international lending would ever take place. To illustrate this point I introduce the debtor’s dilemma, a two-stage game between a private creditor and a foreign government. First, the creditor decides whether to lend $1 at a positive interest rate $r$. A government that borrows will make an investment that yields $x > r$ and then decide whether to repay the principal plus interest. The game tree and payoffs appear in Figure 1. Assuming that each player has complete information about the structure and payoffs the game, we can find the subgame-perfect equilibrium via backward induction. An income-maximizing government would default at the terminal node, because $x+1$ is larger than $x-r$. Knowing this, the creditor would never lend in the first place, because a payoff of 0 is better than -1.

The prediction that no lending occurs in equilibrium is inconsistent with the empirical record. Lending occurs rather frequently, and governments often repay their debts. Thus, markets must have some means of deterring defaults and affording creditors the confidence to lend. In the 19th century gunboats provided some assurance of repayment, but military intervention to collect foreign debts has been unthinkable since the early 20th century.1 Perhaps lending and repayment are sustained not by fear of military force, but by concerns about reputation. For centuries investors and analysts have argued that governments pay their foreign debts in an attempt to protect their good name. John Moody, the founder of Moody’s Investment Service, summarized this argument in his classic textbook on the science of investing: “no nation of importance can maintain its standing and credit … until it takes care of its foreign debts. Consequently, meeting foreign obligations is always the first thought of statesmen in every land.”2

The logic behind such passages is straightforward: international creditors do not have full information about a government’s resolve to honor its financial obligations. For instance, creditors may not know how much leaders would be willing to sacrifice to remain current on principal and interest payments. Absent complete information, creditors must base their lending decisions on beliefs about the government’s political resolve. Those beliefs constitute the government’s reputation in the eyes of international creditors.

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Creditors draw conclusions about the resolve of a government after observing its record of debt payments. A government that defaults will acquire a bad reputation, and creditors will react by charging that government higher interest rates and limiting its access to new loans. Conversely, a government that pays its debts will acquire a good reputation, which it should be able to parlay into large loans at low rates. Thus, if the government and its foreign creditors play the two-stage game repeatedly under conditions of imperfect information, and political leaders care enough about future borrowing, the government will have a strong incentive to protect its reputation by repaying the foreign debt.

The reputational theory is intuitively appealing, but scholarly research does not seem to support it. In their massive study of sovereign debt since the 1850s, Lindert and Morton (1989) conclude that “investors seem to pay little attention to the past repayment record of borrowing governments. [T]hey do not punish governments with a prior default history, undercutting the belief in a penalty that compels faithful repayment.” Other studies, focusing on more limited time periods, concur. Cardoso and Dornbusch (1989), Jorgensen and Sachs (1989), and Eichengreen (1989) all note that governments that defaulted on foreign bonds during the Great Depression did not receive significantly worse terms of credit when they resumed borrowing after the Second World War.

These findings seem particularly puzzling, since investment bankers and private investors have always asserted that reputation plays a central role in lending decisions. This was as true in Roaring Twenties as it is today. Dwight Morrow, a partner at J.P. Morgan, explained that investors rely primarily on reputation when calibrating loans to foreign governments, and Ray Morris of Brown Brothers singled-out the government’s past record of debt service as “much more important” than standard economic variables, including the trade and budget balances and overall level of national indebtedness. Manuals for private investors echoed these sentiments. Kirshman wrote that “bankers

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5 Quoted in David F. Jordan, Jordan on Investments (New York: Prentice Hall, 1934), 231-32.
almost universally recognize an unimpeachable record for financial uprightness as one of the most important considerations in granting lines of credit,”\textsuperscript{7} and Patterson identified the payment history of the borrower as the “first test” of a foreign government bond.\textsuperscript{8}

If investors attach such importance to reputation, why do existing studies find no evidence of reputational effects? The answer, I argue, is that existing studies rest on a weak understanding of how reputations form in international capital markets. In the next section I propose a new theory of reputation that promises to bridge the gap between intuition and evidence. Creditors do mind history, I argue, but only under certain conditions.

2. An Expectation-Based Theory of Reputation

Creditors learn about government resolve through a process of inference: they observe a government’s record of compliance with debt contracts, and use those observations to make inferences about the government’s resolve to pay foreign debts. But the process of inference is tricky, because compliance with a debt contract depends not only on political resolve but also on economic conditions that the debtor faces. When creditors observe a default or payment, they must decide how much responsibility rests with external circumstances beyond the debtor’s reach, and how much is due to the government’s resolve. Put another way, creditors must decide whether to make a situational or a dispositional attribution.

The magnitude of reputational change depends critically on the weight creditors attach to situational versus dispositional factors. If creditors attribute government policy entirely to external circumstances, they have no reason to revise their views about resolve, so reputation will remain the same. In this extreme case, government policy sheds no light on the debtor’s hidden characteristics. But if situational factors do not predominate, creditors can attribute at least part of the default or payment to idiosyncratic dispositions of the government, causing beliefs about resolve (and therefore reputation) to change. Thus, a theory of reputation must clearly specify when creditors are most likely to make dispositional, as opposed to situational, attributions.

Most students of reputation in capital markets implicitly assume that observers attribute all behavior to disposition. For instance, studies test for a correlation between the raw credit history of a government and its ability to borrow on international markets. This research strategy presupposes that creditors view every default as a failure of resolve and every payment as proof of intestinal fortitude. Perhaps unwittingly, researchers are committing what psychologists call the “fundamental attribution error,” the tendency to infer directly from behavior to disposition without considering external circumstances that might have compelled the default or repayment.

\textsuperscript{8} Patterson, \textit{Tests of a Foreign Government Bond}, 24.
A recent book by Jonathan Mercer greatly advances the existing literature, because it avoids the fundamental attribution error.\(^9\) Mercer focuses on reputation in military crises, but some of his arguments are applicable to international debt. Most importantly, Mercer notes that observers sometimes make situational attributions, which cannot generate a reputation. This is an important insight, but Mercer carries it in the wrong direction. In deciding whether to make a situational attribution, the actors in Mercer’s theory ironically ignore all information about the situation itself, focusing instead on whether the actor behaved in a desirable way.

According to Mercer, “… people interpret behavior in either situational or dispositional terms depending on the desirability of that behavior. More specifically, observers use dispositional attributions to explain an out-group’s undesirable behavior, and situational attributions to explain an out-group’s desirable behavior.” In a military crisis, people would like to see their allies stand firm and their adversaries surrender. Mercer relegates both allies and adversaries to the out-group, thereby making the following prediction: “while adversaries can get reputations for having resolve, they rarely get reputations for lacking resolve; and while allies can get reputations for lacking resolve, they rarely get reputations for having” it.\(^10\)

There are several powerful objections to this line of reasoning. Above all, Mercer’s framework makes it impossible for a government to acquire a good reputation, and it implies that reputations deteriorate monotonically over time. To see this, consider the case of allies. A government can never gain reputational standing in the eyes of its ally, because honest or reliable behavior is always attributed to circumstance, but the government can suffer reputational losses by failing to meet its ally’s needs. Thus, an ally can never gain a reputation for reliability and its standing before allies cannot improve. The same applies to adversaries. As Mercer himself puts it, neither allies nor adversaries can win, because “only undesirable behavior can generate a reputation”.\(^11\) Yet intuition, experience and the cognitive psychology literature all suggest that some actors do have favorable reputations and that reputations can improve over time. On these grounds, Mercer’s theory is difficult to defend.

I offer an alternative view, which might be called an “expectational” theory of attribution: creditors make dispositional attributions only when behavior is surprising, given the circumstances. Creditors expect defaults in response to severe external shocks, such as wars or falling commodity prices. If a government defaults under these conditions, creditors will attribute the default to situation rather than disposition, and the reputation of the defaulter will not suffer much. Conversely, creditors expect payment when external conditions are favorable, so a government that meets its obligations under auspicious conditions will not see its reputation improve. Only surprising behavior, such as paying despite adversity or defaulting under favorable circumstances, will lead creditors to make

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dispositional attributions that affect the debtor’s reputation. Figure 2 summarizes these predictions.

**Figure 2: The Conditional Effect of Credit History on Reputation**

<table>
<thead>
<tr>
<th>Credit History</th>
<th>Pay</th>
<th>Default</th>
</tr>
</thead>
<tbody>
<tr>
<td>Favorable</td>
<td>No change in reputation</td>
<td>Reputation improves</td>
</tr>
<tr>
<td>Adverse</td>
<td>Reputation deteriorates</td>
<td>No change in reputation</td>
</tr>
</tbody>
</table>

3. Tests

My theory generates several observable implications. For instance, governments will not get punished for defaulting under adversity. Moreover, creditors will reward governments that pay under austere conditions but punish countries that default when external conditions do not warrant a lapse of payments. In the next section I test these predictions using quantitative and qualitative data.

I tested these predictions against evidence from international capital markets during the 1930s and immediately after World War II. These historical periods are ideal for two reasons. First, they are a key source of data for the conventional wisdom that international creditors ignore history. According to virtually all accounts, creditors failed to discriminate between defaulters and payers during the 1930s and after the Second World War. Second, these periods are particularly useful, because many countries were subjected to common shocks of the depression and World War II, yet a few countries surprised creditors by remaining current on their foreign debts. Thus, these periods provide an excellent basis for testing the proposition that creditors will reward governments for paying under adverse conditions.

To conduct a test, I needed reliable data on the behavior of international creditors and sovereign debtors, as well as the external conditions they faced. The data were not readily available in electronic format, so I collected the information by hand from primary and archival sources in the United States and the United Kingdom. This effort yielded a nearly comprehensive record of sovereign borrowing in the 20th century, as well as 5000 bond-years of information on compliance (the degree to which debtors honored their commitments) and 12,000 bond prices. My dataset also describes political and economic conditions in borrowing and creditor countries. For this paper, I used the data to see how debtors responded to the external shocks of the Depression and World War II, and how creditors, in turn, reacted to the surprising and unsurprising behavior of debtors. I will consider these two external shocks in chronological order.
Responses to the Depression

By the trough of the Depression, more than half of the world’s sovereign borrowers had defaulted on their foreign debts (see Figure 3, which shows observed compliance as a percentage of contractual obligations for 36 international borrowers). Most of the defaults were fully expected, given the sharp deterioration in commodity prices, rise in real interest rates, and the imposition of protectionist barriers that prevented governments in the developing world from obtaining foreign exchange to meet their external commitments. The set of governments that continued pay was fairly predictable, as well. Most of the countries that evaded default were located in Western Europe, where economic shocks were mild compared to the forces that pummeled Latin America and Eastern Europe.

Figure 4 shows that a single variable – the terms of trade (defined as the price of exports relative to imports) – can explain much of the variation in debtor behavior during the 1930s. The horizontal axis measures deterioration in the terms of trade 1928 until 1932. The larger the number, the harsher the shock; negative numbers mean that the terms of trade actually improved. The vertical axis measures default as a proportion of all contractual obligations for the years 1933-39. Each dot on the scatterplot represents a country that had borrowed on the New York capital market during the 1920s and still had dollar-debt during the 1930s. The figure reveals a very powerful relationship between the terms of trade shock and the degree of default: countries that experienced extremely adverse shocks, such as Peru, Chile and Bolivia (in upper right-hand corner) fell into complete default on their foreign debts. Other countries, like Belgium and France (lower left-hand corner), actually experienced improvements in their terms of trade; these countries paid their debts in full. Finally, countries that suffered intermediate shocks defaulted on part but not all of their foreign debts.
Figure 3: Observed Compliance with International Debt Contracts during the Depression

Source: Author’s calculations, based on FBPC (various issues), Islein (1928-37), and White Weld (various issues).
In short, most countries defaulted at a level commensurate with the external shock they suffered. This fact helps solve the puzzle that I outlined in section 1. Eichengreen, Lindert, Jorgensen, Sachs, and Dornbusch all note that governments that defaulted on foreign bonds during the Great Depression did not receive significantly worse terms of credit when they resumed borrowing after the Second World War. This seemingly perplexing finding becomes perfectly understandable within the context of my theory. Many defaults were expected, so it makes sense that creditors would not punish such countries for misbehavior.

My theory also predicts that creditors will reward surprising payers. As Figure 4 shows, a few countries paid in the face of extreme adversity. These countries, which appear in the lower right-hand corner of the scatterplot, include Australia, Argentina, Canada, Denmark, Haiti, and the Dominican Republic. The behavior of the last two countries on the list – Haiti and the Dominican Republic – did not arise from abnormal resolve and technical competence. Rather, it was due to the power of US Marines and the customs receivers they installed. In both Haiti and the Dominican Republic, the customs receiver collected all foreign exchange earnings from trade and remitted them to bondholders in the United States, surrendering any surplus to the local government after debts had been serviced. Thus, Haiti and the Dominican Republic behaved as expected, despite the terms of trade shocks they faced. This leaves us with Argentina, Australia, Canada and Denmark as the truly surprising payers of the 1930s.

Three other pieces of evidence helped verify that these countries were, in fact, surprising payers. First, I used market prices of foreign government bonds during the years 1931-34 to measure investors’ expectations about the degree to which a borrower would honor its contractual obligations. Second, I drew upon the leading analysis of payment records in the 1930s. In this study, Barry Eichengreen and Richard Portes found that standard economic circumstances, such as the terms of trade and the magnitude of the debt
burden, explained much of the variation in compliance with debt contracts. But a few countries -- particularly Argentina, Australia, and Canada -- paid more than expected, given the economic conditions they faced. Finally, I verified this coding by examining articles in the financial press, where these countries were consistently identified as surprising payers.

If the theory in Section 2 is correct, not only should creditors forgive an excusable default arising from terms-of-trade shocks, but they should also reward countries for paying despite adversity. In fact, this is precisely what happened to Argentina, Australia and Canada during the 1930s. For reasons of space I focus on Argentina, the only major country in South America that avoided default on its foreign debts.

Argentina as a Surprising Payer

Figure 5 shows that investors expected Argentina to default on its foreign debts during the depths of the depression. The horizontal axis measures time, and the vertical axis is a measure of expected compliance as a percentage of the total obligation. The measure is equal to the market price of the bond, divided by the present value of the remaining contractual cash flow, discounted at the risk free rate. The two curves in the figure represent 95 percent confidence intervals around the expected degree of compliance. The confidence bands are quite narrow, so we can affirm with considerable confidence that, for most of 1931 through 1934, investors believed that Argentina would pay less than half of its foreign debts. This same conclusion is supported by an analysis of the popular press, as well as the residuals from the Eichengreen-Portes econometric model. Thus, investors expected Argentina to default during the Depression.

12 Barry Eichengreen and Richard Portes, “Debt and Default in the 1930s: Causes and Consequences,” European Economic Review 30, no. 3 (June 1986): 599-640. For each country-year I simulated residuals from the Tobit model that Eichengreen and Portes estimated. The simulated residuals were largest for Argentina, Australia and Canada, implying that the Tobit model under-predicted the degree to which these countries honored their international debt contracts.

13 This formula seems appropriate because the price of any financial instrument is equal to the present value of its expected cash flow. If, at time $t$, the bond price matches the contractual cash flow (discounted at the risk-free rate), investors must think that the borrower will meet the full terms of the indenture, implying that the probability of default is zero. But if the bond is trading at less than its contractual cash flow, investors believe that the borrower will not honor the entire contract. The ratio of the bond price (the flow that investors expect to receive) to the contractual cash flow (the flow they were promised) represents the proportion of the contractual obligation that the borrower is predicted to fulfill. Of course, this measure assumes that investors are risk-neutral and markets are competitive. If investors are risk-averse, the measure will understimate the degree of expected compliance.
Despite the pessimism of international investors, Argentina distinguished itself from other borrowers in South America by maintaining a near-perfect record of debt service throughout the Great Depression, even though its terms of trade and other external indicators dropped precipitously during the early 1930s. Not one central government bond fell into default, and the few Argentine municipalities that abrogated their contractual agreements imposed relatively little harm to bondholders. As the first panel in Figure 3 demonstrates, compliance rates for the country as a whole never dropped below 89 percent, even though investors had expected Argentina to honor only one-third of its obligations.

How did Argentina achieve such a clean record of debt service when its neighbors were defaulting? The short explanation is that Argentine citizens tightened their belts, thereby leaving enough government revenue and foreign exchange to uphold contractual obligations to foreigners. On the fiscal side, the central government raised import duties and imposed an income tax for the first time in Argentine history; it also slashed public spending, particularly in the previously inviolate civil service and military sectors. These measures transformed the budget deficit of 360 million pesos in 1930 into a surplus of nearly 11 million pesos two years later. In monetary affairs, the government began commandeering foreign exchange and dedicating it to debt service, thereby depriving domestic firms of the ability to import.

Why did the government take these seemingly unpopular steps? Finance Minister Alberto Hueyo gave the rationale: “it would be madness not to maintain debt service … at a time when almost every other South American state is defaulting,” since payment under
those conditions would “consolidate the good name and high credit of Argentina.”¹⁴ When the Argentine Congress called for a moratorium on debt payments in 1933, Hueyo argued that Argentina would need to borrow again, and a good payment record would enable the country to convert its outstanding debt to lower interest rates. Default, by contrast, would be “short sighted,” since it would not convey Argentina’s “determination to carry out the weight of contractual obligations.”¹⁵ Clearly, Hueyo and President Justo understood the expectational theory of reputation that was outlined in Section 2.

Creditors rewarded this perseverance; Argentina was one of the only countries that that issued new bonds in London and New York during the Depression, and it was able to convert its entire foreign debt into new issues at lower interest rates and slower amortization requirements. Conversions began in May 1934, when the Argentine Government reduced interest rates on its sterling-denominated debt from 5 percent to 4.5 percent (see Table 1) and cut amortization payments from 1 percent to only ½ percent per year.¹⁶ At the same time, the government refunded its local-currency debt at lower rates, due largely to the enthusiasm of foreign investors, who bought many of the domestic securities.¹⁷ After completing its sterling and peso conversions, the Argentine government refunded its 6 percent dollar bonds at a new rate of 4 percent, and then borrowed $25 million in fresh capital on the New York market in November 1938. This was “the first time in the history of the republic” that internal and external bonds had been issued at such economical rates.¹⁸ Overall, these operations reduced the government’s external burden by 30 percent, allowing the government to save £5.1 million per year.¹⁹

Thus, the behavior of creditors in response to Argentine policy seems consistent with my theory of reputation. By doing the seemingly impossible, Argentina bolstered its reputation in the eyes of creditors, who responded by lowering interest rates and raising credit ceilings at a time when most governments were shut-out of capital markets.

Table 1: Argentina Converted its Debt on Favorable Terms

<table>
<thead>
<tr>
<th>Conversion Date</th>
<th>Name of Bond</th>
<th>Currency</th>
<th>Original Rate</th>
<th>Reduced Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 1934</td>
<td>City of Buenos Aires (1909)</td>
<td>£</td>
<td>5 %</td>
<td>4.5 %</td>
</tr>
<tr>
<td>May 1934</td>
<td>Argentine Irrigation Loan (1913)</td>
<td>£</td>
<td>5</td>
<td>4.5</td>
</tr>
<tr>
<td>Sept 1934</td>
<td>Port of Buenos Aires (1892)</td>
<td>£</td>
<td>5</td>
<td>4.5</td>
</tr>
<tr>
<td>Sept 1934</td>
<td>Buenos Aires Water Supply (1892)</td>
<td>£</td>
<td>5</td>
<td>4.5</td>
</tr>
<tr>
<td>Sept 1934</td>
<td>Internal Loan (1907)</td>
<td>£</td>
<td>5</td>
<td>4.5</td>
</tr>
<tr>
<td>Sept 1934</td>
<td>Internal Loan (1909)</td>
<td>£</td>
<td>5</td>
<td>4.5</td>
</tr>
<tr>
<td>Sept 1934</td>
<td>Internal Loan (1910)</td>
<td>£</td>
<td>5</td>
<td>4.5</td>
</tr>
<tr>
<td>Dec 1934</td>
<td>Port of the Capital (1913)</td>
<td>£</td>
<td>5</td>
<td>4.5</td>
</tr>
<tr>
<td>Oct 1935</td>
<td>Argentine Railway (1896-99)</td>
<td>£</td>
<td>4</td>
<td>3.5</td>
</tr>
<tr>
<td>Nov 1936</td>
<td>External Series B (1924)</td>
<td>$</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Feb 1937</td>
<td>External series A (1923)</td>
<td>$</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Feb 1937</td>
<td>State Railway (1927)</td>
<td>$</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Apr 1937</td>
<td>Public Works (1926)</td>
<td>$</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Apr 1937</td>
<td>Public Works (1927)</td>
<td>$</td>
<td>6</td>
<td>4</td>
</tr>
</tbody>
</table>


Skeptics might grant that Argentina enjoyed special privileges in capital markets during the 1930s, but argue that the privileges did not stem from a favorable reputation. At least in the Argentine case, however, evidence does not support the skeptic’s position. The standing ovation that Argentina received from foreign creditors reflected the reputation it acquired for paying during difficult times. As Sir Otto Niemeyer wrote to the Argentine finance minister in June 1934, the successful conversion of Argentine debt in London was “made possible by the impression created by the firm adherence of Argentina … to the payment of her foreign obligations. Had it not been for the reputation so gained, I am sure that the result could not have been achieved. [T]he prevalence of defaults doubly enhances the standing of those who do not default.”

Articles in the London press seemed to echo Niemeyer’s view. The Economist noted the Argentina had enhanced its “good name” through “the exemplary manner” in which it complied with its financial obligations throughout the Depression. By elevating its reputation, officials in Buenos Aires were able to “penetrate the wall of fire” surrounding the London capital market and convert sterling-denominated debt to lower rates of interest. Likewise, the Times reported in September 1934 that “Argentina has

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21 “Argentina and the Investor,” The Economist (April 28, 1934), 933; “Argentina and the Crisis,” The Economist (February 8, 1936), 6. The South American Journal, a leading source of economic data for British bankers, concurred: Argentina “as a primary producer, has been badly hit during the past five years; but the Government has maintained Argentine credit at the highest level, by steadfastly refusing to agree to any schemes of interference with he strict letter of its contractual debt obligations, and is now getting its reward….” (May 25, 1935). See also the Financial News (May 29, 1934).
throughout the severe economic depression maintained in full the service of her external debt. At times this has involved ... considerable strain. But Argentina ... has succeeded where every other South American state has failed. She is now to receive the reward for this exceptional financial record.”

Feelings were similar in New York, where Argentina converted its debt and then issued a new loan for $25 million in 1938, while other countries were completely barred from private capital markets. Barron’s magazine explained that investors were willing to extend cheap credit to Argentina, because it had “demonstrated to the world how it values a satisfactory credit rating. [W]ith every other South American borrower and the majority throughout the world taking the easier course, [Argentina] kept its eyes fixed on the goal of meeting contractual obligations. This during the most severe and comprehensive economic dislocation the world has yet seen when so many countries seemed to feel the matter of debt honor wasn’t worth the sacrifice”. And the New York Herald Tribune added, “The numerous Latin-American defaulters have to stand, hat in hand, and beg for advances from the official Export-Import Bank. But Argentina stands as a shining example of probity in international financial dealings and fully deserves, on her record, the ability to borrow in the United States.”

Thus, credit markets did discriminate between borrowers and payers during the 1930s in ways consistent with my theory. Governments that honored their debts under adverse conditions climbed the reputational ladder and gained access to foreign capital when other governments could not borrow. So far, the evidence seems consistent with the two observable implications of my theory.

**Responses to World War II**

Soon after the Depression, debtors faced a second external shock: World War II. During the war, some governments defaulted on their foreign debts, whereas others paid interest and principal in full.

To see how creditors responded to this variation in debtor behavior, I conducted a statistical test. The dependent variable was the number of years that a government had to wait before regaining access to international bond markets after 1945. Some governments, and private corporations with sovereign guarantees, floated new bonds within a year or two of the war, while others had to wait until the 1970s or even longer. I used a Weibull duration model to examine the relationship between a country’s credit history and the timing of its postwar borrowing. The key explanatory variable of interest was the country’s...
record of payment during World War II.\textsuperscript{25} If the conventional wisdom is correct (if creditors ignore history), a country that defaulted on its debts during the war should be able to borrow again just as quickly as a country that paid in full.

A preliminary analysis of the data seems to support the conventional wisdom. I used the results of the Weibull model to predict how long a typical wartime defaulter would have to wait before borrowing again, and I compared this with the expected delay for a typical wartime payer. Figure 6 shows the delay was virtually the same for payers and defaulters. The horizontal axis marks time in years, and the vertical axis gives the density or the relative likelihood of each outcome. The curves are kernel densities, or smoothed histograms. I plotted two densities, one for each type of country. As the figure shows, defaulters were excluded from capital markets a bit longer than payers, but the densities overlap so thoroughly that it is hard to distinguish the two cases with a high degree of confidence. Thus, consistent with the conventional wisdom, it seems that creditors ignore history.

\textbf{Figure 6: Preliminary Analysis Supports the Conventional Wisdom}

We can show that the conventional wisdom is wrong, however, by splitting each density into two parts and demonstrating that surprising payers were treated quite differently from surprising defaulters.

To distinguish surprising from expected behavior, I created a very simple measure of wartime surprise. I asked whether the borrower behaved contrary to expectation during the years 1939 to 1945. Lenders expect governments to interrupt payments during external emergencies such as major wars, so a belligerent can default without significant loss of face\textsuperscript{26}, whereas a wartime payer should experience a reputational boon. Based on this

\textsuperscript{25} The model controls for the long-term payment record of the government, as well as various political and economic features (such as Communism and GDP/capita) that would influence access to credit in the postwar period.

logic, a country that entered World War II and defaulted on its foreign debts could be called an expected defaulter. If, on the other hand, a country defaulted without fighting, it was a surprising defaulter. Finally, a country that paid without fighting was an expected payer, but a country that serviced its debts notwithstanding its active involvement in World War II should be regarded as a surprising payer. Figure 7 summarizes this measure of wartime surprise.

**Figure 7: A Simple Measure of Wartime Surprise**

| Fought in WW II |  
|-----------------|-----------------|
| Defaulted       |                 |
| Paid            | No              | Yes             |
| expected payer  | surprising payer|
| surprising defaulter | expected defaulter |

I incorporated this measure of surprise into the Weibull model and re-examined the results, which appear in Figure 8. The top panel shows that creditors did discriminate between surprising payers and surprising defaulters. The duration model predicted that the average surprising payer could borrow again less than 7 years after the war, but a surprising payer would have to wait nearly 28 years, on average, before issuing another international bond. The two densities are far apart, so we can affirm with a high degree of confidence that the difference did not arise by chance alone.

In contrast, expected payers and expected defaulters were treated quite similarly, consistent with the predictions of the theory in Section 2. Setting other explanatory variables at their median levels, an expected payer was predicted to borrow within about 13 years of the were, while an expected defaulter only had to wait about 1 year longer. Furthermore, the densities in the lower panel of Figure 8 overlap so thoroughly that any difference in duration could easily be random rather than systematic.

72. Similarly, Michael D. Bordo and Hugh Rockoff ("The Gold Standard as a Good Housekeeping Seal of Approval," *Journal of Economic History* 56, no. 2 (June 1996), 389-428) argue that governments could break the pre-war Gold Standard included an implicit escape clause for war. Governments could change the parity and suspend convertibility during wartime without significant loss of reputation in credit markets.
4. Extensions and Applications to Other Issue Areas

The evidence in the previous section demonstrates that creditors do not ignore history, and it provides strong support for an expectational theory of reputation: governments acquire their reputations by doing something unexpected, given external circumstances beyond their control.

Future research should proceed along two lines, one theoretical and the other empirical. The theory in Section 2 implies that a government acquires a reputation through surprising behavior, but the theory does not yet predict how long that reputation will last. How many years or political administrations pass before the stain of an unexpected default or the boon of a surprising payment wear-off? Thus, scholars could make a theoretical contribution by indicating why some reputational effects are likely to last longer than others. On the empirical front, the logic of Section 2 could be tested in other areas of international relations and comparative politics. I will comment briefly on these two possibilities.
Theoretical Extension: How Long does a Particular Reputation Last?

When considering the lessons of history, creditors must decide what past events teach them about the disposition of a government in office today or the preferences of its successors. In short, creditors must estimate the correlation of government type over time. If this correlation is high, creditors will consider distant history as well as recent behavior when forming beliefs about the borrower, but if the correlation is low, they will pay more attention to recent signals than dated ones and reputation will have a short half-life.

Two approaches to the correlation issue currently dominate the literature. The first approach, common in formal models of reputation-formation, assumes that observers peer infinitely far into the past for information about the current government’s resolve. Once a government defaults on its debts, creditors never forget the misdeed, which is assumed to signal the preferences of all future governments with a high degree of accuracy. At the opposite extreme, empirical work typically focuses on the government’s last move, thereby ignoring the cumulative buildup of information over time. For Reiter and other scholars contributing to this literature, actors are retrospectively myopic.

Instead of resolving this debate by assumption, we need a more principled way of thinking about how long creditors pay attention to signals, or how far creditors look into the past. I argue that creditors attempt to estimate the correlation of government type over time. The correlation of type is difficult to measure, so creditors must rely on observable indicators, such as political institutions and events. A major change in institutions would lead creditors to discount the past.

There are at least two possible estimation strategies, depending on whose reputation or type matters on issues of international debt. First, the relevant reputation may belong to the leader or political party in office, in which case creditors could use observable information about turnover to estimate continuity in type. By this logic, a major change in the governing party, cabinet, or president would cause creditors to discount the debt record of previous parties and leaders.

Alternatively, the relevant reputation may belong to key constituents of political leaders, rather than the leaders themselves. In this case, mere turnover in government need not cast doubt on the correlation of type over time, since the underlying constituency that constrains political leaders could remain the same. How, then, do creditors know when a constituency has shifted? I argue that creditors focus on changes in political institutions. For instance, the clout of particular groups should differ depending on whether the regime is authoritarian or democratic, so creditors can equate a change in regime with a change in constituency. The greater the institutional change, the more creditors will discount the debt record accumulated under previous institutions.

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The hypotheses outlined in this section are preliminary, and they have not been
tested empirically, but they may help us understand why reputational effects last longer for
some countries than others.

**Empirical Extension: Reputation in Other Issue Areas**

The theory that I develop in this paper could shed light on reputation in other areas
of international relations, such as military crises. In their qualitative analysis of deterrence
cases, Snyder and Diesing find only one instance in which a decision-maker gave another
state a reputation. Jon Mercer reaches a similar conclusion in his book, *Reputation in
International Politics*. After examining the behavior of European powers between 1905
and 1914, Mercer concludes that reputations do not play an important role in
explaining the outcomes of international military crises. In light of these and other
studies, Paul Huth recently summarized the state of the literature. “There is a substantial
gap,” Huth wrote, “between the intuitive belief that reputations are an important cause of
international conflict and the development of a compelling logical argument and empirical
evidence to support such a conclusion.”

This paper provides a theory that could bridge the gap between intuition and
evidence. Government behavior in military crises probably does affect reputation, but only
under certain conditions. In particular, a government that capitulates in the face of
overwhelming military force will not suffer a loss of reputation, and a government that uses
superior firepower to escalate crises against weaker enemies will not be regarded as
unusually gutsy. But a government that persists against awesome force should gain a
reputation for resolve by behaving contrary to what circumstances dictate.

In the same way, my argument could help us understand the role of reputation in
alliance politics and foreign direct investment. If the decision to abandon an ally or
expropriate a foreign asset is expected, given external circumstances, then commitment-
breaking probably will not cause reputations to deteriorate. The same logic might apply to
theories of economic voting. If the economy performs poorly due to circumstances beyond
the president’s control, such as an international economic downturn, a divided legislature,
or the behavior of an independent central bank, voters may be less likely to hold the
president and his party responsible for the slump. Put another way, the reputation of the
president as an effective economic manager would not suffer much. These hypotheses,
which flow from my theory of reputation, could help resolve some of the more vexing
puzzles in economics and political science.

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28 Glenn H. Snyder and Paul Diesing, *Conflict among Nations: Bargaining, Decision Making, and
29 Jon Mercer, *Reputation and International Politics*.