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SETTLING DEFAULTS IN THE ERA OF BOND FINANCE

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"Imagine a counterfactual where banks and countries had been left alone to work out their differences, with the central banks of industrialized countries and the IMF limiting themselves to a strict lender-of-last-resort function...A sharp restructuring period would have cleared up much of the excess debt burden, with both lenders and borrowers suffering from their bad forecasts."

Diaz-Alejandro (1987, p.25)

## 1. Introduction

The parallels between the current LDC debt crisis and its predecessors have been widely remarked upon. The surge of foreign lending in the 1970s, the sudden appearance of debt-servicing difficulties in the 1980s, and the proposals that have been offered to put the crisis behind us by the 1990s all bear an eerie resemblance to previous episodes in which transfer crises disrupted the smooth functioning of the international capital market. According to the received wisdom, however, the current debt crisis differs from those of the 1870s, 1890s and 1930s in one fundamental respect. In these prior instances, debt-servicing difficulties could culminate in an abrupt, unilateral and complete suspension of interest and amortization payments. A sharp restructuring period then followed and cleared up much of the excess debt burden, as in Diaz-Alejandro's counterfactual. The 1930s, when unilateral default was the rule rather than the exception, are invoked as the most dramatic illustration of the general point. In the 1980s, in contrast, debtors and creditors have continued to muddle through. Aided by a variety of expedients, including serial reschedulings, forced lending by the banks and supplementary funds from the international institutions, and at considerable expense to themselves, the debtors so far have succeeded in warding off default. Aside from a number of temporary suspensions, to date

only Peru has unilaterally reduced debt payments for an extended period of time.

The reason for this unprecedented avoidance of default, again according to the received wisdom, is the increased involvement of creditor-country governments. In the 19th century, governments had at best an ambivalent attitude toward intervention on behalf of their investors. Canning's remark that the British government was not a debt collector is widely cited. Admittedly, the exertion of influence by British officials on behalf of bondholders was not unknown. The French and German governments were more willing still to intervene on behalf of investors (Fishlow, 1985). The entanglements to which the interplay of economic and strategic interests could lead are epitomized by the establishment of a British protectorate in Egypt. Neither did the United States hesitate to send in the Marines when politics or policies in the Caribbean or Central America threatened American foreign investments. But in nearly all of these instances, economics was merely an excuse for intervention desired on other, usually military or strategic, grounds. Most observers conclude that there was little systematic use of government influence on behalf of investors.

By the 1930s, government resistance to pressures for intervention had hardened. The Roosevelt Administration, under Cordell Hull's leadership, attached priority to the removal of trade restrictions, a goal incompatible with the calls of bondholders for sanctions against defaulting debtors. It adopted a policy of official noninterposition in negotiations between American bondholders and foreign governments. With a few notable exceptions, the British government too continued to regard default as a private matter (Royal Institute, 1937). The use of military force for debt collection was

basically a thing of the past. By 1937 the U.S. Securities and Exchange Commission advised bondholders to eliminate this possibility from their consideration.

In the 1980s, the argument continues, the government of the leading creditor country, the United States, has been more intimately involved. In contrast to earlier policies of benign neglect, the U.S. has "aggressively managed the debt crisis with a view towards maintaining continued debt servicing" (Sachs, 1986). Its objective has been to buttress the U.S. banking system, which is much more vulnerable to destabilization by nonperforming foreign loans than at any time in the past. The U.S. government has made clear the importance it attaches to the maintenance of debt service, through individual discussions with debtor countries, by enlisting the support of other governments in Paris Club negotiations, and by floating proposals such as the Baker Plan. Given the prominent role of the American government, foreign policymakers have reason to fear that default might trigger trade sanctions and curtail official development assistance and official export credits. By not leaving the banks and borrowers "alone to work out their difficulties," to echo Diaz-Alejandro, the U.S. authorities may have prevented the debtors from forcing the sharp restructuring that would have quickly put the debt crisis behind them.

The influence of governments has been reinforced, it is alleged, by the coordinating role of the International Monetary Fund. In the 19th century there existed no comparable institutions. In the 1930s, the Bank for International Settlements played a limited part in organizing international loans to European countries experiencing balance of payments crises. But the financial role of the BIS was tightly circumscribed, and it was preoccupied

not with debt problems per se but with threats to the stability of the exchange rate system. In the 1980s, in contrast, the IMF has been intimately, if indirectly, involved in debt negotiations. The banks normally require that countries reach an agreement with the Fund as a precondition for rescheduling. In turn, the Fund has required that countries come to terms with the banks to prevent the IMF loan from simply going to debt service. The World Bank has required de facto that an IMF program be in place before extending a structural adjustment loan. And creditor-country governments have normally required that an IMF program be in place before concluding a Paris Club agreement to reschedule bilateral intergovernmental obligations.1/ Knowing that a Fund loan hangs in the balance, the banks have added leverage in their efforts to obtain favorable terms, while the debtor has added incentive to avoid default. The implication is that, absent creditor country and IMF involvement, the dramatic alternatives to muddling through alluded to by Diaz-Alejandro would have been more likely, and these would have helped all parties to put the debt crisis behind them, thereby setting the stage for renewed growth in the borrowing regions.

Official involvement is not the only explanation that has been offered for differences in the extent of default in the 1930s and 1980s. Yet the leading alternatives are less satisfactory. The explanation which focuses on the relative magnitude of shocks must be heavily discounted. If from a global perspective the macroeconomic shock of the 1930s remains unmatched, from the perspective of Latin America's debt-servicing difficulties, the disturbances of the early 1980s were of comparable magnitude (Diaz-Alejandro, 1983; Maddison, 1985; Eichengreen and Portes, 1987). The obvious difference -- the behavior of export volumes, which fell dramatically after 1929 but

have continued to rise in the present crisis -- is attributable as much to the response of Latin America itself, which has made great efforts to expand exports precisely in order to service its debt, as to differences in the global economic environment.

Similar objections can be registered to the argument that emphasizes the greater scope for new money in the era of bond finance. Lending through the bond market, it is argued, created an insurmountable free-rider problem for the provision of new money. Even if it been in the interest of foreign bondholders collectively to provide additional liquidity to the borrowing country, there was no way to mobilize a multitude of bondholders or to compel them to contribute.2/ Although bank lending creates free-rider problems of its own,3/ the presence of a few large creditors provides opportunities to buy out the smaller participants or to compel their cooperation. New money is the result. This new money, it is argued, has provided the cushion the debtors have required to avoid outright default and has served as the carrot inducing them to put adjustment programs in place. The problem with this argument is that new money has been forthcoming in quantities insufficient to relieve the need for net resource transfers to the creditors (by Latin America, $130 billion worth between 1982 and 1986, according to World Bank data). While there is no doubt that this transfer and the domestic difficulties it posed would have been greater still in the absence of forced lending, such a small carrot cannot explain why the indebted countries have resisted default. Thus, to explain the difference between periods investigators ultimately return to the extent of government involvement.

Our purpose in this paper is to scrutinize both strands of the received wisdom: that which draws a strong contrast between the 1930s and 1980s in

expanded to embrace representatives of the British Bankers' Association and of the London Chamber of Commerce, along with some miscellaneous members, at least six of whom were substantial bondholders. By the 1930s these miscellaneous members had come to include representatives of the Association of Investment Trusts, the British Insurance Association, the Bank of England and the Stock Exchange.5/

Initially, much of the influence of the Council derived from its intimate relations with this last-named institution. One of the rules of the Stock Exchange, established in 1825, was to refuse quotation to new loans of governments which had defaulted on their obligations and failed to settle with their creditors, and in extreme instances to strike from the list all loans of the offending government.6/ Although some trading in London took place outside the Stock Exchange and although new loans conceivably could be floated in other markets, lack of access to the London market was a serious sanction.

In the United States, where foreign flotations were a new development, there existed no comparable organization until 1933. Instead, ad hoc committees were established to negotiate with each foreign government. These temporary committees had high administrative expenses, lacked the authority to speak credibly for the bondholders, and rarely possessed good relations with the U.S. government. Often ties with the stock exchange were nonexistent. In response to these shortcomings and because correspondence with bondholders was absorbing so much staff time, in 1932-33 the State Department sponsored the formation of a committee to draw up plans for a standing organization. That new organization, the Foreign Bondholders Protective Committee (FBPC), was founded in 1933 and financed by

contributions from charitable foundations and the Stock Exchange until commissions rendered it self-sustaining.

Comparable associations existed in France, Germany and other countries. The CFBH saw clearly the advantage of a creditors' cartel in the face of widespread default; as the Council put it in 1937, there was "no question that in theory cooperation between all the Bondholders' organizations is most desirable and that such cooperation is more than ever necessary in view of the present attitude of the debtors."7/ The European associations had the benefit of long experience in negotiating with both foreign governments and one another; hence cooperation was relatively well developed. But relations between the European and U.S. committees were strained. Sterling and dollar bond covenants differed significantly in their interest rates and in the security offered by the borrower. Hence the British and American committees disagreed on the appropriate treatment for different types of bonds (see Section 5 below). The CFBH was critical of its U.S. counterpart for settling unilaterally, leaving the British no choice but to accept the same terms. It complained that communication by telephone was expensive and unsatisfactory and that the President of the FBPC often failed to respond to letters in timely fashion.

The objective of the committees naturally was to maximize the value of the assets of the bondholders. To this end they opposed writing down principal, forgiving interest arrears, and yielding concessions on future interest payments. The first two points were presented as matters of principle. It was fine to reduce future interest payments if bondholders accepted such offers voluntarily, but inappropriate to write off capital or interest arrears, since these obligations had been incurred prior to

renegotiation of the bond covenants. But in practice the CFBH was willing to trade principal and interest arrears incurred in the past for more favorable treatment in the future. In 1940, for example, the Council agreed to inform the Ecuadorean negotiator that "the Council might be prepared to abandon the arrears if he would put forward a reasonable offer for the future service of the debt ..." In 1943 the Council negotiated an agreement with Brazil under which bondholders could opt for writing off principal in return for a cash payment and a higher interest rate.8/

The objective of the debtors was to minimize damage to their credit owing to protracted default. As the U.S. Securities and Exchange Commission put it in 1937, "The willingness of the issuer to negotiate with representatives of the bondholders and eventually to agree to readjust its default generally has two motivations: a desire to restore the prestige and reputation of the nation, and a desire to borrow more money."9/ It was in the bondholders' interest to emphasize the implications of settlement for market access. In its 1939 negotiations with Brazil, the CFBH "explained how impossible it would be for Brazil to recover and prosper without the goodwill of foreign capitalists." But debtors' willingness to enter into negotiations depended both on the state of the international capital market — since damage to one's credit mattered little in periods when creditors were unwilling to lend -- and on the value attached to ability to borrow relative to other objectives. As Sir Henry Lynch, Rothschild & Sons' representative in Brazil, explained this succinctly to the CFBH in 1936, "the Brazilians knew that they had no credit and ... they thought therefore that they might as well cease payments on their External Debt. There were many people who wished to devote sums now used to pay interest to the internal needs of the

Country and they were exerting strong pressure on the President and the Finance Minister to cease payments."10/

Similar sentiments were again conveyed to the Council by their Brazilian negotiator in 1942. There was a strong bias in Brazil, especially within the Army, against

> "wasting money on the foreign debt. The importance to Brazil of maintaining her credit did not greatly impress many Brazilians, since Brazil seemed able in any case to obtain as much money as she required from the U.S.A. The Finance Minister and Senhor Oswaldo Aranha were more orthodox but their main concern was to reduce the debt as much as possible and meanwhile to pay interest only enough to prevent the debt being too dark a stain on Brazil's escutcheon."11/

3. The Role of Governments

The role of governments in these negotiations was more complex than formal statements of their hands-off attitude would suggest. Even when otherwise uninvolved, governments played an informational role. The FBPC regularly obtained information on the local situation from the State and Commerce Departments. The CFBH obtained information on local economic conditions from local embassy staff and from the Foreign Office in London. The information could be quite specific. In 1938, for example, an official of the South American Department of the British Foreign Office suggested to the CFBH "that it would be helpful if somebody from the Council went out to Brazil. He was naturally discreet, but it seemed clear that his view was that both Sir Hugh Gurney [Ambassador to Brazil] and Sir Henry Lynch [the CFBH's negotiator] had become unduly influenced by Brazilian opinion and needed stiffening by personal contact with a representative of the Bondholders."12/

Embassy officials also might be enlisted in actual negotiations. In the case of the CFBH, Embassy staff or even the Ambassador himself might act as

go-between. Moreover, when initiating other transactions involving the debtor, the relevant government office might be prompted to hint that the bondholders would be receptive to a reopening of negotiations.

Finally, governments could link debt service to the provision of official credits, although the interests of bondholders usually took a back seat to other government objectives. As Sir John Simon of the British Foreign Office wrote in 1934, "my predecessor Lord Palmerston, who is not generally regarded as having been backward in the defence of British interests, laid down the doctrine that if investors choose to buy the bonds of a foreign country carrying a high rate of interest in preference to British Government Bonds carrying a low rate of interest, they cannot claim that the British government is bound to intervene in the event of default."13/ Nonetheless, in 1938, the British Treasury wrote the CFBH for a current list of countries in default. Waley of the Treasury expressed his desire

> "to make it a rule that the Treasury does not consent to issues of loans or to guarantees by His Majesty's Government to Medium Term Credits for countries which are in default to British bondholders. He made it clear that he did not imply that the Treasury could make this an absolute rule and that, as at present, each case must continue to be considered on its own merits. He was, however, anxious to ensure that the Treasury should not give their consent without being fully aware of the defaults which exist."14/

While lending moral support to most readjustment negotiations, direct intervention by the U.S. State Department was generally limited to instances where foreign governments discriminated against American bondholders. When Germany suspended debt service, European governments retaliated with threats of clearing arrangements, and Germany restarted service on its European but not its American debts (see Section 4 below), the State Department went forward at the request of the FBPC "and made the appropriate representations."15/

State similarly protested discrimination against holders of dollar bonds to the Hungarian and Polish governments. It pressed for modifications of Brazil's 1934 readjustment on these same grounds (as described in Section 7 below). It was not the practice of U.S. authorities to make the extension of Export-Import Bank loans conditional on the resumption of debt service. But Ex-Im Bank loans were highly politicized, and officials made clear that their progress could be accelerated by a gesture of good faith in the direction of the bondholders.

Pressure also could operate in reverse. The FBPC had been created on the impetus of the State Department, and the extent of its independence was never entirely clear. On a number of occasions, such as the Brazilian negotiations of 1943, the U.S. Embassy rather than the FBPC played the leading role. As Abreu (1978, p. 131) puts it, the "semi-official character of the FBPC led the institution to much more readily adapt its claims to American foreign policy." The CFBH had more autonomy. The British government's attempts to enlist the Council in its alliance-building efforts intensified with the approach of World War II. In 1938, for example, the Council was engaged in negotiations with Egypt. For a time a settlement seemed imminent, but Egyptian officials added fresh conditions which caused the Council to retreat. The Foreign Office then pressed the CFBH to compromise on the grounds that "friendship with Egypt is of vital importance to the country." In July 1939, with the British Government anxious to conclude a treaty with Greece, the Chancellor of the Exchequer and the Foreign Secretary impressed upon the President of the CFBH the "political importance of a settlement of the Greek default." The President's

interpretation was that the Chancellor "in so many words...advised us to take whatever was available."16/

In contrast to the standard characterization, then, creditor-country governments were intimately involved in interwar debt readjustments. The difference between the 1930s and 1980s lies not in the extent of government involvement but in the direction. Whereas creditor-government intervention in the 1980s has not accelerated the process of readjustment, in this earlier episode official intervention had more ambiguous effects, on some occasions having a positive and on others a negative effect on ease of settlement.

## 4. Trade as a Negotiating Tool

To explain why debt repudiation is not commonplace, theoretical models of sovereign default (e.g. Eaton and Gersovitz, 1981) posit the existence of a "default penalty," designed to capture the notion that nations which fail to service their debts provoke retaliation by creditor countries. Examples of retaliation might include loss of access to creditor-country markets and inability to secure trade credits. In the 1930s, members of the CFBH were divided over the advisability of using these levers. On the one hand, they recognized that retaliatory tariffs and trade credit embargoes served as powerful negotiating devices. On the other, they acknowledged that exports were the source of the foreign exchange that made debt service possible, so that hindering exports hindered the resumption of service. While other members of the CFBH generally supported an embargo on trade credits, the bankers argued that facilitating trade through the provision of credits was "the best way of liquidating a frozen position."17/

The divergent interests of the financial and commercial communities undercut sentiment for retaliation. The extension of trade credits was a

profitable business for the banks. Whereas long-term bonds had been underwritten by investment bankers and distributed to the public, short-term credits were retained by the original lender or sold to a select group of clients. Those engaged in a profitable import-export trade were loath to see their business suffer in the interest of foreign investors. On several occasions the representatives of the bankers reaffirmed that they were "unable to associate themselves with any attempt of the Council to oppose export credits to a defaulting country or to put the bondholders in a better position than the traders."18/

For their part, the indebted countries attached considerable importance to trade credits. Even while debt service on foreign bonds was suspended, many debtor nations continued to service their commercial debts.19/ The rationale was clear: while the bond market had dried up, the market for commercial credits was still active, providing an incentive for borrowers to stay current on their commercial debts. The CFBH implicitly endorsed these priorities, as in 1938, for example, when it recommended that "the sums at present being paid by Brazil as a result of agreements with England, France and the USA for commercial arrears, should be allocated to the service of the external debt as and when the commercial arrears are paid off."20/

The creditors' most potent threat was to enlist their government in the imposition of a clearing arrangement. This mechanism was available to any country running a trade deficit with a debtor country and hence with an excess of expenditures on foreign goods which it could sequester. The 1934 Act of Parliament creating a clearing office to regulate British trade with Germany illustrates its operation. The clearing office was authorized to recover, out of the proceeds of German trade with Britain, a sufficient sum

in sterling to pay interest on British tranches of the 1924 Dawes Loan and the 1930 Young Loan.21/ The potency of the threat is revealed by the speed with which a German financial delegation was dispatched to London, where it negotiated an agreement under which Britain would impose no sanctions against Germany, while Germany would continue to service the Dawes and Young Plan bonds held by British citizens. No such clearing was threatened by the United States, and from June 1934 only partial interest was received by American bondholders.22/

Yet the clearing arrangements threatened by German's European trading partners in 1934 were the exception rather than the rule. Germany herself had made provocative use of clearing arrangements (Ellis, 1941, Chapter IV) and could hardly invoke free trade principles in objection. Furthermore, the readiness with which European governments intervened reflected their direct involvement in the flotation of the Dawes and Young Plan Loans. Having urged their citizens to invest in German bonds, it was hard to insist that default was a private matter. In other cases, the position of the British Treasury, stated for example in connection with Greece in 1937, was that it was undesirable "to link together any question of purchase of Greek goods with negotiations for a settlement of the Greek External Debt." In the case of British trade negotiations with Colombia in 1938, the head of the British delegation, Sir Thomas Hohler, informed the CFBH that "he would not discuss the debt problem with Colombia but ... would take any suitable opportunity to impress on the Colombians the importance from the point of view of their own credit of coming to an agreement over their external debts."23/

The U.S. State Department similarly opposed to the linkage of trade and debt. In 1934 the FBPC attempted to convince Colombia that "increasing

pressure is being brought both upon the Council and upon Washington by bondholders who are insisting that some sort of coercive measure shall be adopted against Colombia along the model set up by European countries or by levying a special tariff against Colombian coffee..."24/ Representatives of investors in Colombian bonds appeared before the Tariff Commission when a reciprocal trade treaty with Colombia was under consideration. Yet officials consistently resisted these representations. Sumner Welles, the Assistant Secretary of State, summarized the official position.

> "The position of the Department is that the primary purpose of the trade agreements negotiated under the Act of June 12, 1934 is the revival of international trade, and the agreement with Colombia does not, therefore, contain provisions specifically relating to the resumption of service of Colombian dollar obligations. However, inasmuch as the decline in international trade was one of the principal causes of financial difficulties in many countries, it is to be expected that the revival of international trade which the trade agreement program seeks to foster will aid in remedying conditions which have led to defaults."25/

Promises and threats concerning trade grew more common with the outbreak of World War II. Early in 1940 a Greek mission journeyed to London to meet with British officials and negotiate trade arrangements. Waley of the Treasury conveyed to them that "the Chancellor of the Exchequer was anxious to help the Greek to establish a market for their tobacco, but he could not defend such a course unless a settlement on the debt were reached..." When Peru failed to remit interest for the first half of 1940, the British Treasury informed the Peruvian Minister of Finance that if the June coupon was not met, the British Government would be "obliged to reconsider their purchasing policy towards Peru." In general, the U.S. government remained less interventionist. In 1943 the President of the CFBH complained that although the U.S. was Brazil's principal market and principal source of credit, "the U.S. Government has not shown much regard for even its own

Bondholders. In the interest of trade and of the Good Neighbour policy, it is lending money to Brasil regardless of Brasil's attitude toward its external bonded debt..."26/

Debtors too could link trade and debt. They repeatedly offered commodities in lieu of financial transfers in negotiations with the CFBH, offers which the Council rebuffed. In 1937 the Greek Government proposed "that if Great Britain could take more currants, tobacco and iron ore it would enable them to make a better proposal for a permanent settlement." The 1940 imbroglio over tobacco had been initiated by Greece itself, which in 1939 had proposed British purchases in exchange for debt concessions. The scope for such transactions widened with the approach of World War II and growing involvement of governments in trade. When in September 1939 the British Government purchased sunflower seeds from Bulgaria (in part to deprive Germany of them), Bulgaria agreed to allocate more than a third of the proceeds to the bondholders.27/

5. Discrimination Among Creditors

One of the main sources of tension between the British and American committees centered on the treatment of different types of bonds. On a number of occasions foreign governments, when renegotiating terms of repayment, chose to treat different debts in different ways. Obligations of the central government might receive very different treatment owing to previously obscure provisions of bond covenants assigning particular government revenues to debt service. Obligations of central, state and municipal governments, while all renegotiated by national authorities, might receive very different treatment from one another. Treatment of debts incurred to finance specific investment projects might depend on how those

projects had fared. These practices were highly controversial. The debates they elicited resemble controversies today surrounding proposals for exit bonds (which permit differential treatment for large and small creditors) and debt subordination (differential treatment for new and old creditors).

In many instances, foreign governments and bondholders' committees agreed in principle on the relative treatment different categories of bonds should receive. Foreign governments were more concerned with the creditworthiness of central than of state and local authorities. National governments could take over the service of state and local loans, where the converse was inconceivable; hence changes in the creditworthiness of the national authorities had a much greater impact on that of state and local authorities than vice versa. When unilaterally reducing interest payments, debtors often scaled down interest on national loans by less than interest on state and local loans. Since suspending service on funding loans, which had been used to capitalize earlier interest arrears, was likely to remind creditors of the country's history of debt-servicing difficulties, debtors often extended these loans preferential treatment.

The attitude of the majority of creditors was embodied in a resolution adopted by the representatives of the national committees assembled at the Conference of Bondholders Associations in Paris in June of 1938. Loans to national governments had a claim to better treatment than loans to provinces or municipalities. Within each category, secured debt (debt for which specific revenue or security was earmarked) had priority over debt to be serviced out of general revenues. The resolution adopted at the Paris Conference embodied the preferences of the CFBH which, as the most prestigious committee, heavily influenced the proceedings. The CFBH favored

preferential treatment for secured debt by virtue of the fact that a disproportionate share of British bonds were specifically secured. Its U.S. counterpart opposed differential treatment for the equally pragmatic reason that few dollar bonds were specifically secured.28/

The difficulties that could result are illustrated by the 1939 Colombian negotiations. The majority of Colombian debt was dollar denominated, and officials were particularly concerned to satisfy American bondholders and officials, since the U.S. was their largest export market. The CFBH noted the opinion of Lazards that "the Americans were the only people who were likely to be able to make the Colombian government pay anything to its bondholders." Rather than initiating separate negotiations, the CFBH chose to let the Americans negotiate and then to attempt to secure the same treatment for sterling bonds. But when in early 1939 it appeared that settlement was imminent, in a letter to the FBPC the CFBH reported some "very strong feeling among the interests we represent that in any debt settlement some measure of practical recognition should be given to the preferential claims of the specifically secured loans." It was "not so much the amount of preference" to which they attached importance "as to some practical recognition of the principle..."29/

The practical effect of extending preferential treatment to specifically secured loans would have been to elevate sterling bonds above dollar bonds. Neither of the two dollar bonds in default had specific security. Of the five sterling bonds, four had specific security: the receipts of the Bogota-Sabana Railway were earmarked for service of the 1906 loan, 3 per cent of customs revenues were assigned to the 1911 loan, another 7 per cent of

customs receipts were earmarked for the 1913 loan, and a first charge on five per cent of Atlantic customs revenues were assigned to the 1920 loan.

Not surprisingly, the British claim to priority was rejected by the FBPC, which dismissed the difference between "so-called 'secured' and so-called 'unsecured' loans." In reply, the CFBH cited the resolution adopted in Paris in 1938. The CFBH regarded Colombia as a test case; as one of its officials wrote, "It seems to me important that we should if possible come to an understanding on the principle, since it is one which affects so many debt situations..."30/ The Council offered two justifications for preferential treatment of secured debt. First, bondholders had demanded lower interest rates in light of the special security offered. "Throughout the history of foreign lending," the CFBH noted, the market prices of secured loans had exceeded the prices of unsecured loans of the same debtor in reflection of this fact. It was inequitable that "a bondholder who has taken the precaution to choose, in preference to an unsecured loan which would have given him a somewhat higher yield, a secured loan of the same debtor, should be treated no better than the man who has deliberately preferred to take the greater risk of default for the sake of the higher yield." Second, if this principle was not respected, future investors would attach little weight to specific security. For many countries, this would increase the difficulty of borrowing, "since it is precisely those countries which are temporarily passing through a difficult period, which are...in most need of loans, and [for which]...the offer of special security has in the past often enabled their difficulties to be overcome." "To treat these differences as nonexistent," Otto Niemeyer wrote the President of the Council, "cuts at the root of much past foreign lending and would, I believe, prove very nearly fatal to whatever chances there may be of foreign lending in the future."31/

The Americans, in response, questioned the meaningfulness of specific security, concluding that "these so-called 'securities' are not in fact securities, and...because they have not been effective against the funds designated the idea apparently is to give the bonds an actual preferential position on the general revenues and exchange of the country." What the British were seeking was to transform their claim to preferential access to specific revenues into a claim for preferential access to general revenues precisely when their claim to specific revenues had proven worthless. "To state this position is to answer it," the FBPC wrote. "No rule of equity or law could justify such a course."

The CFBH took legal advice before replying. Its central argument was that specific security implied "a contractual priority of payment to the specifically secured loans." It implied preferential access to general revenues rather than simply to earmarked revenues, since "it is common knowledge that it is no more possible by legal proceedings to sequester particular revenues than it is to sequester general revenues."32/ Ultimately, disagreement over the issue proved so profound as to undermine cooperation among the two bondholders' committees, leading them to conduct separate negotiations with Colombia.33/

Did discrimination help to normalize relations in the international capital market? No doubt preferential treatment of national loans permitted the resumption of meaningful levels of service where only token payments would have been possible otherwise. If creditworthiness depended more heavily on the status of national than of state and local loans, this could have been helpful for restarting international capital flows. But at the same time discrimination deepened divisions between British and American

bondholders and reinforced the impression on the part of some creditors that the debtors were engaged in arbitrary and unjust actions. Discrimination was a two-edged sword.

6. Repurchases of Defaulted Bonds

Another technique for resolving disputes over defaulted bonds was for countries to buy out their creditors through purchases at market prices. The practice was controversial. Bondholders complained that creditors violated not just the letter but the spirit of the bond covenants by diverting foreign exchange from debt service to capital repurchase.34/ Repurchases indicated that foreign exchange was available; bondholders argued that it was properly devoted to debt service until interest was up to date and only then to debt retirement. Permitting countries to repurchase defaulted bonds at market prices strengthened the incentive to default, they alleged, for suspending debt service both depressed bond prices, making repurchase more attractive, and relaxed the foreign exchange constraint that limited the scope for bond market operations. Most important of all, from the investor's standpoint the low prices at which repurchases were attractive to the debtor implied disappointing rates of return compared to those offered ex ante. As the FBPC summarized the position in its annual report for 1935:

> "If the bonds have service, according to their contracts, the debtor governments of course are well within their rights in availing themselves of the opportunity of purchasing the bonds on the market even if they are selling substantially below par but to do so when the bonds are depreciated abnormally on account of default...is a practice which the Council most strongly condemns; against which it has repeatedly protested..."35/

If small bondholders objected heatedly to the practice of repurchasing defaulted bonds, financial specialists noted that by entering the market and bidding for bonds, the foreign government put upward pressure on bond prices,

ceteris paribus.36/ Repurchases of defaulted debts were a way to eliminate costly lending mistakes. By removing the residue of nonperforming loans from the market, it would be possible to list new issues on the Stock Exchange and to get the lending process restarted. Repurchases were also resales -- that is, voluntary transactions on the part of the bondholders -- and as such represented the market solution to the problem of how to share the losses associated with an unsatisfactory loan.

Officially the CFBH opposed repurchases of defaulted bonds. When in 1938, with its defaulted debt trading at £29 (down from a par of £100), the Guatemalan Government broached this issue with the Council, the latter advised that "if the Government now have funds available for the repurchase of bonds, the proper course would be that they should offer to resume the Sinking Funds, in whole if possible, or if not, in part... haphazard purchases of Bonds by the Government, at the time when the Sinking Fund is suspended on the ground of lack of funds would naturally be considered irregular and would do damage to their credit." The CFBH also noted the practical difficulties of completing large purchases in an extremely thin market. Yet the CFBH may have revealed its true attitude when it went on to suggest that "if a firm order were given at a price not exceeding, say 33, for the purchase of up to say -- £5000 Bonds...it might be possible to complete the order in the course of a few weeks." Indeed, the CFBH accepted repurchase provisions as components of interim settlements. For example, in the four-year settlement with Brazil recommended by the Council in 1940, in addition to restarting partial interest payments the Brazilian authorities undertook to "devote at least $400,000 in each of four years ... in the English market."37/

In Section 8 below we present some evidence on how much difference buybacks of defaulted bonds made for the returns realized by foreign investors.

## 7. Brazil as a Case Study

Despite a long history of debt-servicing difficulties, Brazil had no trouble borrowing after World War I. Although she turned increasingly to New York in the 1920s, as late as 1929 nearly two-thirds of Brazil's external public debt was sterling denominated. Service on her external loans was interrupted in 1931 as part of the spread of default in Latin America. Of the fact that Brazil was forced into default by the Depression there can be little doubt; continuing to service the public debt in 1932 would have required 45 per cent of *gross* export receipts and nearly the same percentage of *gross* federal revenue. In August 1931 the Government announced that it was unable to obtain sufficient foreign exchange to maintain service in full, choosing to suspend Sinking Fund payments on most loans while continuing to transfer interest. In October it unilaterally suspended interest as well on all except the 1898 and 1914 Funding Loans and the 7 1/2% Coffee Security Loan. These last assets were held mainly by British investors, who owed their good fortune to the influence of Sir Otto Niemeyer, banker, former British official and himself soon to become a member of the CFBH, then serving the Brazilian government in an advisory capacity.

The orthodox approach to dispose of interest arrears was to issue a funding loan, and in March 1932 a plan was announced to issue 20 and 40 year funding bonds denominated in sterling, U.S. dollars and French francs. Coupons of the various central government bonds were to be exchanged as they

matured for an equal amount of Funding Bonds. The plan was for normal interest payments to resume no later than 1934.38/

This dealt at least temporarily with the Federal Government debt but not with the obligations of states and municipalities. Not only did servicing these debts strain the budgets of the local authorities, but exchange controls imposed by the Federal Government in 1931 impeded transfers even by those with relatively strong budgets. The Federal authorities effectively could veto transfers by local authorities through foreign exchange allocations. This reality was acknowledged in 1934. Export volume remained depressed and there was little prospect for obtaining another funding loan. As a director of the Banco do Brasil described the options to a British embassy official, Brazil had enough exchange to satisfy either bondholders or commercial debtors, but not both.39/ Rather than suspend debt service, the orthodox Finance Minister Osvaldo Aranha, with the advice of Niemeyer, crafted a plan to reduce it to levels consistent with Brazil's ability to pay.40/ The Aranha Plan was designed to run through 1937. The most important precedents it established concerned discrimination and ability to pay. Service was limited to roughly 50 per cent of Brazil's balance of trade. Bonds were divided into seven grades. Funding loans and the 7% Coffee Loan were to receive full interest, other Federal, state and local loans partial interest, and certain state and municipal loans no interest. Brazil was entitled to devote any remaining foreign exchange to market purchases of bonds in default.

Dissatisfied by the treatment of dollar bonds in Grade VI, the American bondholders enlisted the State Department to request a delay in the implementation of the decree. The U.S. Ambassador was instructed to warn Aranha that

discrimination against U.S. bondholders might provoke trade retaliation.41/ Negotiators for the Americans secured an improvement in the relative treatment of dollar bonds in Grade VI, which became Grade VII as the number of categories was expanded from seven to eight (see Table 1). Neither was the CFBH satisfied with the outcome. It complained that by failing to consult systematically with the bondholders or to articulate the principles upon which the grading had been based, Brazil had created an "impression of arbitrariness." Much of the trouble, it was later alleged, resulted from the fact that Brazil had discussed the settlement with the issue houses but not with other interested parties.42/ The CFBH objected the placing of the loans of the State of Bahia in Grade VIII, where they received no interest, on the grounds that Bahia was one of the three leading exporting states of the Federation and had the budgetary resources available in 1932-34 to provide a quarter or more of the service specified under the bond covenants.43/

By the end of 1937 the external situation was little improved. Exports had risen only slightly and were now adversely affected by the U.S. recession. Foreign exchange derived from trade with Germany remained blocked. Even if the foreign exchange constraint could be relaxed, resistance to devoting resources to debt service continued to mount, especially within the Army which took on an increasing political role in the Estado Novo established in 1937.44/ Efforts to maintain creditworthiness through continued interest transfers had not conferred an ability to borrow. Rather than renewing the Aranha Plan, Brazilian debt payments were suspended. British reaction was especially harsh, since it was felt that Brazil had defaulted for political rather than economic reasons. Although the U.S.

Table 1

Schedule of Brazilian Debt Service Payments Under the Aranha Plan

| Name of Loan | 31st March 1935 | | 31st March 1936 | | 31st March 1937 | | 31st March 1938 | |
|---|---|---|---|---|---|---|---|---|
| | Int. | S.F. | Int. | S.F. | Int. | S.F. | Int. | S.F. |
| **Grade I** | | | | | | | | |
| United States of Brazil 5% Funding Loan, 1898<br>Do., 1914<br>Do., 1931 (20-Year Bonds)<br>Do. (40-Year Bonds)<br>Repayment of Arrears under the Hague Award | 100% | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| **Grade II** | | | | | | | | |
| State of San Paulo 7% Coffee Realisation Loan, 1930 | 100% | 5% of initial issue. | 100% | 5% of initial issue. | 100% | 5% of initial issue. | 100% | 5% of initial issue. |
| **Grade III** | | | | | | | | |
| Brazilian Federal Government Secured Loans | After expiry of 1931 Funding Plan.<br>35% | nil | 35% | nil | 40% | nil | 50% | nil |
| **Grade IV** | | | | | | | | |
| Brazilian Federal Government Unsecured Loans | After expiry of 1931 Funding Plan.<br>27.5% | nil | 27.5% | nil | 30% | nil | 40% | nil |

Table 1 (Cont.)

| Name of Loan | 31st March 1935 | | 31st March 1936 | | 31st March 1937 | | 31st March 1938 | |
|---|---|---|---|---|---|---|---|---|
| | Int. | S.F. | Int. | S.F. | Int. | S.F. | Int. | S.F. |
| **Grade V** | | | | | | | | |
| State of San Paulo Coffee Institute 7.5%, 1926 | 22.5% | nil | 25% | nil | 27.5% | nil | 37.5% | nil |
| **Grade VI** | | | | | | | | |
| Miscellaneous State Loans | 20% | nil | 22 % | nil | 25% | nil | 35% | nil |
| **Grade VII** | | | | | | | | |
| Miscellaneous State and Municipal Loans | 17.5% | nil | 20% | nil | 22.5% | nil | 32.5% | nil |
| **Grade VIII** | | | | | | | | |
| Miscellaneous State and Municipal Loans | nil | nil | nil | nil | nil | nil | nil | nil |

Note: S.F. denotes sinking fund.

Source: Council of Foreign Bondholders (1933), pp. 114-115.

Ambassador lodged a protest, American reaction was restrained for political reasons, namely the desire to advance Roosevelt's Good Neighbor Policy.

Moreover, Brazil could play off the U.S. against Germany, the two countries which between them accounted for a majority of Brazil's export trade. In an effort to keep Brazil out of the German orbit, Roosevelt invited Finance Minister Aranha and a team of financial experts to Washington, D.C. In March 1939 the U.S. extended a $70 million credit from the Export-Import Bank, $19 million of which was to be used to liquidate frozen commercial claims and the rest of which was to finance U.S. exports to Brazil.45/ As a gesture of goodwill, Aranha promised that Brazil would resume service on the external debt, to the tune of at least $9 million. But this was more than the Brazilian Government and the Army in particular were willing to accept.46/ Vargas instructed the Finance Minister to deposit only $1 million in New York, a sum which did little to encourage negotiations. Still, the Ex-Im loan went through. The CFBH was concerned nonetheless that the Americans might negotiate a separate settlement and took advantage of the opening to secure an assurance that Brazil would extend equal treatment to bonds of different currencies. In July the Brazilian Government informed the bondholders' committees of its desire to initiate negotiations. Representatives of the American, British and French committees met jointly with a special Brazilian commission.

Hopes for rapid progress were dashed by the outbreak of war. Germany had been Brazil's second most important customer, and the disruption of this trade clouded the prospects for Brazilian exports. In any case, Brazil and her creditors were miles apart on the terms of permanent settlement. Brazil proposed a fixed sum for interest, in the range of one third that provided

under the Aranha Plan, sufficient to finance only a relatively low interest rate initially but one that would rise as the operation of the sinking fund retired outstanding debt, and for a rate of amortization (and hence rate of increase of interest) that would be linked to the level of Brazilian exports. The CFBH objected to turning "a first debenture into a deferred equity" and countered with plans for a permanent settlement along the lines of the Aranha Plan.47/ Yet the outcome once again was a temporary settlement whose acceptance was encouraged by U.S. authorities still anxious to keep Brazil from turning toward Germany. For its part Brazil received a $20 million Ex-Im Bank loan (increased eventually to $45 million). In return it offered a plan to run for four years (and to be reviewed no later than October 1943). The seven categories of bonds distinguished in 1934 were maintained, with somewhat modified interest rates. To avoid any implication that the bondholders had written off interest arrears, the CFBH insisted that payments made in the period 1940-44 were to apply to unpaid coupons from the period 1937-41, and to mollify holders of sterling bonds on which interest had been reduced, the Council obtained a clause committing Brazil to repurchase some of these bonds on the market. The plan received the Council's standard endorsement on March 11, 1940.48/

Interest on the loans of the Federal Government and, with sporadic interruptions, of the states and municipalities was maintained through the life of the plan. In September 1943 negotiations recommenced in Rio between the Brazilian Government and the CFBH, who were subsequently joined by the Americans. Brazilian officials felt the time was ripe for a settlement, given the country's large accumulated foreign balances and the growing competitive pressures Brazil was likely to face after the war.49/ From the

beginning the Brazilians made clear that they were interested only in a permanent settlement and one "which would permit of a drastic writing down of the capital of the Debt."50/ The bondholders' representatives naturally opposed any compulsory writedown of principal, and as a counteroffer proposed that bondholders be presented the option of either retaining their existing securities and receiving somewhat reduced interest rates, or of selling back some share of the principal. Presumably the interest rate could be lowered just to the point where the share of bondholders whose securities the Brazilian government wished to liquidate would come forward. In addition, the CFBH, anticipating that Brazil would have accumulated more foreign exchange to devote to debt service by the end of the war, preferred a temporary readjustment to a permanent settlement.

Ultimately the CFBH proved unable to counter American willingness to accept a permanent settlement or American pressure to increase the interest paid on intermediate grade dollar bonds at the expense of high-grade sterling securities. Again, the Aranha Plan provided the basic structure for the settlement, with modifications favoring dollar bonds at the expense of sterling loans, reflecting the impact of U.S. economic ascendancy on the Americans' bargaining position. The offer announced in November 1943 is summarized in Table 2. Under Plan A, which involved no liquidation of principal, interest rates were reduced to about 70 per cent of contractual levels for Grade I loans and to around 30 per cent of contractual levels for Grade VII. Under Plan B, investors were to surrender 20 to 50 per cent of capital, in exchange for which they would receive a cash payment (amounting to anywhere from 6 to 60 per cent of the par value of the capital surrendered) and a somewhat higher interest rate on the remainder. Plan B

Table 2
Schedule of Payments Under the 1940 and 1943 Brazilian Settlements

| Loans as graded in 1934 and 1940 Debt Plans | Con-tractual Interest | Interest payable in fourth year of 1940 Plan | Sinking Fund payable in fourth year of 1940 Plan | 1943 PLAN A: Interest payable under Plan A | 1943 PLAN A: Sinking Fund payable under Plan A on Sterling Loans | 1943 PLAN B: Capital surrender under Plan B | 1943 PLAN B: Per cent of Capital to carry Interest at 3 3/4% | 1943 PLAN B: Sinking Fund payable under Plan B on Sterling Loans* | 1943 PLAN B: Cash payments payable under Plan B |
|---|---|---|---|---|---|---|---|---|---|
| Grade I | Per cent 5 | Per cent 2.5 | Per cent of Con-tractual 40 | Per cent 3 3/8 | Per cent of Con-tractual 70 | Per cent 20 | 80 | 20 % more than under Plan A | Per cent Ł12 10s. |
| II | 7 | 3.5 | 20 | 3 1/2 | 40 | 20 | 80 | 20% more than under Plan A | Ł15 |
| III | 5<br>6 1/2<br>7<br>8 | 1.25<br>1.625<br>1.75<br>2 | Nil | 2 3/4<br>3 3/8<br>3 1/2<br>3 1/2 | 25 | 20 | 80 | 30% more than under Plan A | Ł5<br>Ł12 10s.<br>Ł14<br>Ł14 |
| IV | 4<br>4 1/2<br>5 | .8<br>.9<br>1 | Nil | 1 1/2<br>1 5/8<br>1 3/4 | 20 | 50 | 50 | 62% more than under Plan A | Ł7 10s.<br>Ł9<br>Ł10 10s. |
| V | 7 1/2 | 1.40625 | Nil | 2 1/2 | 20 | 50 | 50 | 61% more than under Plan A | Ł17 10s. |

Table 2 (Cont.)

| Loans as graded in 1934 and 1940 Debt Plans | Con-tractual Interest | Interest payable in fourth year of 1940 Plan | Sinking Fund payable in fourth year of 1940 Plan | PLAN A | | PLAN B | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Interest payable under Plan A | Sinking Fund payable under Plan A on Sterling Loans | Capital surrender under Plan B | Per cent of Capital to carry Interest at 3 3/4% | Sinking Fund payable under Plan B on Sterling Loans* | Cash payments payable under Plan B |
| VI | 5 | .875 | | 1 3/4 | | | | 40% | £6 |
| | 6 | 1.05 | | 2 | | | | more than | £9 |
| | 6 1/2 | 1.1375 | Nil | 2 1/8 | 10 1/2 | 50 | 50 | under | £11 |
| | 7 | 1.225 | | 2 1/4 | | | | Plan A | £12 10s. |
| | 8 | 1.4 | | 2 1/2 | | | | | £17 10s. |
| VII | 4 1/2 | .73125 | | 1 1/2 | | | | | £3 |
| | 5 | .8125 | | 1 5/8 | | | | 50% | £4 10s. |
| | 5 1/2 | .89375 | | 1 3/4 | | | | more than | £6 |
| | 6 | .975 | Nil | 1 7/8 | 10 1/2 | 50 | 50 | under | £7 10s. |
| | 6 1/2 | 1.05625 | | 2 | | | | Plan A | £9 10s. |
| | 7 | 1.1375 | | 2 1/8 | | | | | £11 |
| | 7 1/2 | 1.21875 | | 2 1/4 | | | | | £13 |
| | 8 | 1.3 | | 2 3/8 | | | | | £14 10s. |

* The effective rates of these Sinking Funds, when applied to the capital as reduced under Plan B, compare approximately as follows with the rates applicable under Plan A: Grades I and II half as much again; Grade III about 60 per cent higher; Grades IV and V more than three times higher; Grades VI and VII nearly three times higher.

Source: Council of Foreign Bondholders (1943), pp. 15-16.

was suggested by the CFBH to provide an option for holders of bonds in Grades IV-VII likely to be disappointed by low interest rates and to satisfy Brazilian demands for capital reductions. In addition, arrear coupons not included in the 1934 or 1940 Plans were to be serviced at 10 or 25 per cent of the payments due under the final year of the 1940 Plan. Finally, a number of the more disastrous state and municipal loans were redeemed for 12 per cent of their nominal value, with all arrear coupons cancelled. Bondholders were initially given 12 months to choose a plan, those failing to specify being automatically included in Plan A. Again, as additional foreign exchange became available, the Brazilian Government was permitted to repurchase bonds in the market.

8. How It All Worked Out

It is difficult to summarize concisely the outcome of a large number of debtor-creditor negotiations as complex as Brazil's. The only obvious way of doing so is by calculating rates of return realized by foreign investors and comparing those realizations with the returns offered ex ante and with the yields on otherwise comparable domestic investments. In particular, the comparison of ex ante and ex post returns on foreign bonds provides an indication of how the losses on poorly performing loans were shared between debtors and creditors. We have recently completed a study which estimates the internal rates of return realized on 250 dollar and 125 sterling issues floated in the 1920s (Eichengreen and Portes, 1988). We summarize our findings here.

An important element of these calculations was incorporation of repurchases at market prices of defaulted foreign bonds as well as normal interest and amortization.51/ For dollar loans we were generally able to

distinguish bonds retired at market prices and at par. For sterling loans this information was not readily available, so we constructed two rate-of-return estimates under the alternative assumptions that capital repayments took place at market price and at par.

The nominal internal rate of return (weighted by the value of the loan) averaged almost exactly 4 per cent for dollar bonds, five per cent for sterling bonds (4.98 per cent when repurchases are assumed to have taken place at market price, 5.18 per cent when they are assumed to occur at par). These results are striking for several reasons. First, the positive internal rates of return indicate that, on average, both British and American bondholders succeeded in recovering their principal. Second, the realized returns were significantly lower than those offered ex ante, which were generally in the range of 7-8 per cent range.52/ On average, these bondholders settled for slightly less than half of contractual interest. Third, British bondholders did better than their American counterparts.53/

A number of factors are likely to have contributed to the international difference. Most important was the incidence of default. Nearly half the dollar bonds in the sample lapsed into default, but this was true for less than 20 per cent of the sterling bonds. (These figures are shares of the value of sterling and dollar issues.) More British lending went to Dominions and colonies that were unlikely to interrupt service in the 1930s. In addition, once default occurred British bondholders more successfully recovered. The typical default reduced the internal rate of return by 4.3 per cent on dollar loans, but by 1.4-2.3 per cent on sterling loans.

What was the impact on realized rates of return of the controversial practice of buying back defaulted bonds at depressed market prices? To shed

light on this question, we recalculated the internal rates of return on dollar bonds under the counterfactual assumption that all repurchases took place at par. While in a small number of cases the difference was dramatic, the overall impact on the internal rate of return was slight. The estimated return on dollar bonds rises from 4.00 to 4.96 per cent (recall from above that the comparable figures for sterling bonds are 4.99 and 5.18 per cent), with the internal rate of return on those bonds which lapsed into default rising from 1.64 to 3.58 per cent.

## 9. Conclusion

Our review of the history of negotiations over the sovereign defaults of the 1930s suggests a number of conclusions relevant to the debate over today's LDC debt crisis. First, even prior to the era of interlocking official export credits, Paris Club reschedulings, IMF stabilization loans and World Bank development assistance, the process of settlement tended to be protracted. Negotiations could suffer serious setbacks owing to changes in political and economic conditions both at home and abroad, and decades could be required to conclude a negotiated settlement successfully. Debtors may have found it easier to suspend debt service unilaterally in the era of bond finance, but they still found it difficult to achieve the kind of permanent settlement needed to put behind them the uncertainty created by default. This is not to dispute that by choosing unilateral suspension debtors were able to redirect resources toward investment and to stimulate growth, but rather to point out that this strategy created residual uncertainty that continued to complicate foreign investment, trade and diplomatic relations for a considerable number of years.

Second, the contrast often drawn between the degree of creditor government involvement today and in the past is all too easily exaggerated. It is probably true that in the era of bond finance governments were less inclined to press for favorable settlements on behalf of private creditors because their banking systems were not at risk. But it would be misleading to infer from this that governments were uninvolved. If governments were disinclined to intervene systematically on behalf of bondholders or to subordinate trade policy and political objectives to the interests of the bondholders, their presence was nonetheless continually felt in readjustment negotiations. The suggestion that defaults were easier to settle in the past because creditor-country governments were not involved must be carefully tempered.

But did this creditor-country government contribute positively or negatively to the ease of settlement? Where a strong case can be made that creditor-government involvement in the 1980s has contributed to the protracted nature of the crisis, for the 1930s the evidence does not point in any one direction. On a significant number of occasions, U.S. or U.K. officials made clear that export credits and market access were tied, however obliquely, to the resumption of reasonable levels of debt service. On others they applied pressure not to the debtors but to the creditors. Since default did not pose the same risk to creditor-country banking systems as in the 1980s, the interests of private creditors and their governments did not possess the same natural complementarity. And with the approach of World War II, creditor governments were more inclined to press for concessions from investors to keep the debtors out of enemy camp. The strong contrast between

the 1930s and 1980s lies not in the extent of government involvement, but in the extent to which all government involvement worked in a single direction.

A number of the institutional features of the market for foreign debt also had an ambiguous impact on ease of settlement. Discrimination between different classes of creditors, notably the holders of secured and unsecured debt, permitted reasonable levels of service to be restarted on some obligations but fueled the objections of other bondholders. Buybacks of defaulted bonds were widely utilized and helped to remove the debt overhang, but at the expense of ill will on the part of small bondholders who objected to the practice.

The other factors considered all tended to increase ease of settlement. In the 1930s, the provision of long-term finance and of trade credits was basically in the hands of two different sets of creditors who had divergent interests. Not so today. Moreover, the links between those arms of government concerned with debt and trade were even more remote than in the 1980s. Finally, squabbling between different sets of national creditors and competition among their governments weakened the negotiating position of the creditors in the 1930s and 1940s, unlike the 1980s when the U.S. has been permitted to take the lead in Latin America as has Western Europe vis-a-vis the Eastern Bloc. All these factors have tended to make the crisis more protracted in the current period.

With all these factors increasing the ease of settlement, why could debt adjustments still require 25 years or more to conclude? The answer is that macroeconomic conditions exercised a powerful influence over settlement. If we had to single out one factor that facilitated the movement toward settlement in the 1940s and 1950s, it would not be the structure of the

bargaining process or the form of government intervention but rather improvements in the international economic environment. As developing-country export markets recovered with the outbreak of World War II and with the continued strength of commodity prices thereafter, the costs of settlement declined. As it once again appeared that the United States would be willing to lend, the benefits of settlement rose. This suggests that an important contribution by the creditor countries to the resolution of the current debt crisis lies in the adoption of macroeconomic policies conducive to the maintenance of steady growth, open markets and financial stability.

## FOOTNOTES

1. There have been exceptions, notably Mozambique, Poland and Cuba (not an IMF member).

2. Extrapolating from estimates of Dwight Morrow, in 1937 the Securities and Exchange Commission (1937, p.6) conjectured that up to 700,000 investors held foreign bonds in default.

3. Again, part of the problem is large numbers. Fischer (1987) notes that 500 banks were involved in the September 1986 Mexican agreement, and nearly six months were required for all of them to sign on.

4. In some cases, their unassented bonds are still traded in London or New York. Often the market for unassented bonds would shrink as the deadline for acceptance (usually five years) approached and the bonds' option value depreciated. But these deadlines were not a universal feature of the terms of offer. Peru's 6% sterling bonds of 1928 illustrate the point. As of August 1987, the amounts outstanding included £51,600 in assented and £11,000 in assented bonds. The unassented bonds were last traded on the London market on 12 June 1987, the unassented bonds in 1976.

5. Securities and Exchange Commission (1937), pp.39-53.

6. See Jenks (1927) and Feis (1930), pp.114-115.

7. Minutes of the Council of the Corporation of Foreign Bondholders (hereinafter "Minutes"), Cooperation, 25/11/37. The Council's document went on, "the debtor not infrequently managed to pay in all, less than he would have been willing to do had there been no difference of opinion among the Bondholders' Organizations."

8. Minutes, Ecuador, 14/3/40. The Brazilian negotiations are discussed in greater detail below.

9. Securities and Exchange Commission (1937), p.31.

10. Minutes, Brazil, 27/10/36; Minutes, Brazil, 9/12/37.

11. Minutes, Brazil, 18/9/42.

12. Minutes, Brazil, 23/6/38.

13. Cited in Abreu (1978), p. 118.

14. Minutes, Foreign Loans, 24/2/38.

15. Securities and Exchange Commission (1937), p.390.

16. Minutes, Egypt, 17/2/39; Minutes, Greece, 17/1/40. It is important to note that in both instances the Council successfully resisted the Government's attempt to pressure it into immediate settlements which it considered unsatisfactory. Still, government pressure in 1938-39 may have had something to do with the fact that both cases were settled in 1940.

17. Minutes, Egypt, 16/3/37.

18. Ibid.

19. For example, between 1931 and 1934, when Chile remained in total default on its long-term external debt, it negotiated with its principal short-term foreign creditor, National City Bank, a considerable reduction of the outstanding short-term debt. Securities and Exchange Commission (1937), p.542.

20. Emphasis added. Minutes, Brazil, 7/11/38.

21. In practice, the mechanism would work as follows. British purchasers would be required to pay for German goods by depositing the relevant amount of sterling in the clearing office. Exporters of goods to Germany would then be paid in sterling from the funds which accumulated in the clearing office. Any surplus that accumulated would be devoted to debt service. See Einzig (1935).

22. In 1934 partial interest was paid out of the accumulated funds in the hands of the trustees. Thereafter bondholders were paid in blocked Reichsmarks, and from October 1935 they were given the option of selling their coupons for up to 70 per cent of their face value in cash. All the while, European investors in these loans received full service. See Foreign Bondholders Protective Council (1935), pp.217-218 and subsequent volumes.

23. Minutes, Greece, 18/3/37; Minutes, Columbia, 14/7/38. Similarly, in response to CFBH efforts to link the discussions of a British trade mission to Colombia to negotiations over the debt, the Board of Trade responded that "if we now pressed the Colombians to settle their foreign debt, they would insist on linking this question with the trade discussions and...neither we nor the Trade Mission make any headway." The Board urged the Council to wait for trade discussions to end before pursuing the debt question. Minutes, Colombia, 17/11/38.

24. Foreign Bondholders Protective Council (1934), p.95.

25. Securities and Exchange Commission (1937), pp.445-446.

26. Minutes, Greece, 17/1/40; Minutes, Peru, 13/6/40; Minutes, Brazil, 24/8/43.

27. Minutes, Greece, 18/3/37; Minutes, Bulgaria, 7/11/39.

28. The FBPC later claimed that its representative to the Paris Conference had made clear his unwillingness to endorse any resolution which encouraged discrimination in favor of one category of bonds over another. The CFBH noted that there was nothing in the minutes of the Conference to substantiate the American claim. Correspondence Files of the Council of Foreign Bondholders (hereinafter "Correspondence"), Letter from FBPC to CFBH, 17/5/39, 311/314.

29. Letter from CFBH to FBPC, 25/4/39, 311/308.

30. Correspondence, Letter, 17/5/39, 311/314; Letter, 5/6/39, 311/314A.

31. Ibid and Correspondence, Letter from Otto Niemeyer to Lord Bessborough, 7/11/39.

32. Correspondence, Letter from the FBPC to the CFBH, 19/10/39, 311/328; letter from the CFBH to the FBPC, 29/11/39, 311/328A.

33. In 1940 the U.S. government superseded the FBPC and entered into direct negotiations with Colombia. The result was a settlement on the dollar debt, "distinctly generous" in the words of the CFBH, but nonetheless "strongly criticized" by the FBPC. Minutes, Colombia, 4/12/41.

34. The State Department protested German purchases of defaulted bonds in 1934 on these grounds. Securities and Exchange Commission (1937), pp.312-313, 496.

35. Foreign Bondholders Protective Council (1935), p.12.

36. This relationship was not always appreciated by the creditors. Witness the following exchange between William Rosenblatt of the Coyle Committee for Cuban Public Works and the questioner for the Securities and Exchange Commission (1937, p.311):

"Q. ...you are putting into a bondholders' plan of rearrangement a provision whereby the debtor country moves into the market and picks up as many of these bonds as its purchasing power will permit at as low a price as possible...Could you state in what way the repatriation provision would protect bondholders?
A. In the first place, the bonds would go up in price, wouldn't they?
Q. I beg your pardon?
A. They would go up in price, wouldn't they?
Q. That would be your judgment as a person experienced in the securities business?
A. It would.
Q. That would be your prediction, that they would go up?
A. Certainly.
Q. And go up as a result of the buying?
A. Those people who have bonds up as collateral for loans--
Q. Just a minute, please. Go up as a result of buying?
A. Buying on the part of the Cuban Government."

37. Minutes, Guatemala, 22/9/38; Correspondence, Letter from Aranha to CFBH, 9/30/40, 241/1299; Minutes, Brazil, 14/3/40.

38. The text of the official announcement of the funding plan is in Corporation of Foreign Bondholders (1934), pp.116-123.

39. Hilton (1975), p. 65.

40. In British circles the Aranha Plan was sometimes referred to as the Niemeyer Plan. Niemeyer and a staff of assistants made a complete study of Brazilian financial conditions in 1931 and left behind recommendations for institutional reform. He returned in the spring of 1933 and worked with Brazilian officials to develop their plan for readjusting the debt.

41. Abreu (1978), p. 116.

42. Minutes, Brazil, 14/12/39.

43. Corporation of Foreign Bondholders (1934), pp.25-27. The Brazilian authorities subsequently agreed to upgrade the debts of Bahia to Grade VII, where they would receive 17 1/2 per cent of scheduled interest.

44. Aranha later asserted that a price Vargas paid for Army support in 1937 was to "stop payment on the debt and to let them [the Army] have the money." Hilton (1975), p. 186.

45. The imports in question were needed mainly for the construction of a steel plant. Aranha explicitly suggested that Brazil would be forced to turn to Germany if Ex-Im Bank financing was not forthcoming. Wirth (1970), p. 107.

46. Dulles (1967), p. 204.

47. Minutes, Brazil, 11/1/40.

48. Initially Brazil had proposed that interest should cover coupons for a four-year period commencing 1 April 1940, but the Council insisted that the interest apply to bonds due between November 1937 and April 1940 because, were those coupons "left in abeyance, [this] would probably entail ultimately the total cancellation of those arrears." Minutes, Brazil, 22/1/40. The text of the Brazilian decree and the Council's announcement appear in Corporation of Foreign Bondholders (1940), pp.15-19. On the second loan from the Ex-Im Bank, see Wirth (1970), pp. 116-117.

49. Abreu (1978), p. 126.

50. Corporation of Foreign Bondholders (1943), p.13.

51. This study is an expansion of the pilot study of realized rates of return reported in Eichengreen and Portes (1986). There we estimated rates of return on 51 dollar and 31 sterling bonds issued in the years 1923-30 (1924-30 in the case of dollar bonds). The pilot study did not incorporate market-price repurchases of defaulted bonds. Thus, the current study differs from its predecessor by virtue of the larger sample size, longer time period, and incorporation of buybacks.

52. Information on ex ante returns on dollar loans, for example, appears in Eichengreen (1988b).

53. The contrast between sterling and dollar returns is relatively small compared to that in our pilot study. The difference is due largely to our having extended the sample period back from 1924 to the beginning of the decade (when loans bore higher interest rates) and our greater success in tracking the returns on loans to foreign corporations through World War II and into the postwar period. Note that converting sterling investments and returns into dollars makes relatively little difference for the results.

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