Do good sovereigns default? Lessons of history

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Thank you Stephen, for the invitation. It is a great pleasure to be here, and since I am competing against all these nice desserts, I'm going to try and treat you, hopefully, with some sweets of mine. Let me begin with the straight question, which is: do good sovereigns default? and give you the straight answer, so that the suspense doesn't choke you, and it is: yes. Now the point is, what is the light that history is shining on that question? The political value of history can be difficult to recognize, as the following little anecdote, which I am going to tell you as a caveat on what you can do or can't do with history, reveals.

About 15 years ago, before there was something called the euro, there was a special issue of the journal Economic Policy, which you probably all know, in which I made a contribution on lessons from history. I thought that one thing that could be interesting to look at – since as you will remember, we had all these discussions of market discipline versus statutory rules, such as the stability pact – was the actual historical record of a system of fixed exchange rates, when there was no stability pact, and only market discipline. I thus set out to gather data for the late 19th century, focusing on European countries (this is the very data that Reinhart and Rogoff have used more recently in their acclaimed book), and I explored a number of features of debts and government borrowing rates, and one thing that was flying in the face was that during booms, discrimination by the market was not strong enough: basically the risk premia were there but really tiny and too discreet to encourage countries to make efforts. And when there was a bust, suddenly the markets were becoming really sensitive and were discriminating violently – but it was too late. And so that was the point I was making, and I was therefore concluding that you may not want to rely too much on the market and the market mechanism as a way of monitoring fiscal positions in the eurozone, because if you did that you might run into trouble. At that time, however, I did run into trouble, because the editors and the referees, who included the late Rudi Dornbusch, complained that part of my results were driven by but four countries, viz.: Greece, Portugal, Spain, Italy. Who cares about Greece, Portugal, Spain and Italy, I was asked? How could one draw meaningful inferences from these admittedly isolated cases? As you can see, the art of drawing historical inferences is a difficult one.

Seen historically, the question whether good sovereigns default is an intriguing one indeed, because if you go sufficiently far back in time – I have in mind here the late Middle Ages, the Renaissance and the early modern period – you generally come across sovereigns who face very high interest rates, and going by this yardstick it is very difficult to find a "good sovereign". In fact, back in those years the sovereign was the dangerous guy to lend to, and the safe loans were the loans to private corporations, private companies, merchants, cities possibly, and that was the norm, back then, a norm everybody knew about and understood.

Then came a number of changes that occurred gradually over time and which economic historians call better institutions: a broadening of the tax base,

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improvement in fiscal governance, efforts to match new expenditures with new appropriations etc. Thus started a kind of revolution (a financial revolution) which was begun in Genoa and Italian cities and spread from there to Holland and eventually Great Britain and the rest of Europe in the 18th and 19th centuries, when gradually – at least in a number of countries, because you still need Greece for the fun and the excitement – the sovereign became the safest person or safest institution to which you would be lending.

Yet as this occurred the determination of what is a good sovereign remained a difficult problem. In fact, recasting the question a little bit, I am tempted to argue that the really important question isn't so much whether good sovereigns default, but who said they were good in the first place? That is the key question. Some examples will help and since I'm French, I can't resist talking about Russian bonds, a story which you probably all have in mind, and I hear that in your laughter. The way we have been used to telling that story is that there were political reasons why French leaders wanted to trust Russian loans, and as a result there were these large, misled investments by the French people, and it all ended very badly after 1917.

But actually when you look at the record more carefully, it's even more exciting, because the way that Russia was constructed as a safe risk in the late 19th century was way more "scientific" and less political than you would think. In particular there was the work of one French leading bank – Crédit Lyonnais, the largest continental bank by assets or capital. Crédit Lyonnais, a universal bank, had this amazing research department and they had developed a whole technology for rating countries. They didn't give A's or B's but marks, like 1, 2, 3, and Russia came up with their computation in the top group. And the reason it came in the top group was because in terms of the sustainability indices which the dedicated economists at Lyonnais computed, Russia was doing very well.

And it was doing very well because Russian loans had been exclusively, exclusively – unlike the historical British debt, which was a military debt – issued for industrial purposes: railways, mines, infrastructures. And these debts were, as result "re-productive" (as people called them): they yielded a revenue that accrued to the government-proprietor. Russian railways did not only feature on the liability side: they were on the asset side too. And in the 1890s the Russian economy was expanding and using its infrastructures for that, and revenues were expanding when the cost of servicing the bonded debt was fixed, so you were looking at a situation where eventually the net public debt ratio of Russia would be zero. At the end of the day, Russia was somewhere between the US and Japan in the grading system of Crédit Lyonnais. This was, by any measure, a good sovereign.

Then comes 1904–1906, a war with Japan, and suddenly Russia learns that its fleet has been destroyed by this little country over there in the Pacific. Political trouble ensues, and these gentlemen who call themselves "Bolsheviks" (unlike the nihilists, nobody had heard of them before), they go out on the Prospekt Nevsky in St Petersburg, and they say, "These debts are odious debts. When we take power, we won't pay them". There goes the good sovereign.

All of a sudden people were looking at a very different story. One minute ago, you were considering a reliable sovereign, by any measure, not a serial defaulter, for Russia had not defaulted in the past, a sovereign with a very sound debt by any of the popular economic computations of the time, but there is political change and suddenly you have to re-think the whole thing.

What is quite interesting and suggestive is that this was when the collusion between the French financial system and French politicians took place and you can see why. On the one hand, French politicians wanted to consolidate their alliance with Russia. On the other hand, the banks that had sold the bonds of the formerly good sovereign were really worried. This was when propaganda was begun, with people being told that Russia was very safe, that there was a little problem with the Bolsheviks, but, you know, that would be okay, the situation could be handled, and in the end things would be sorted out.

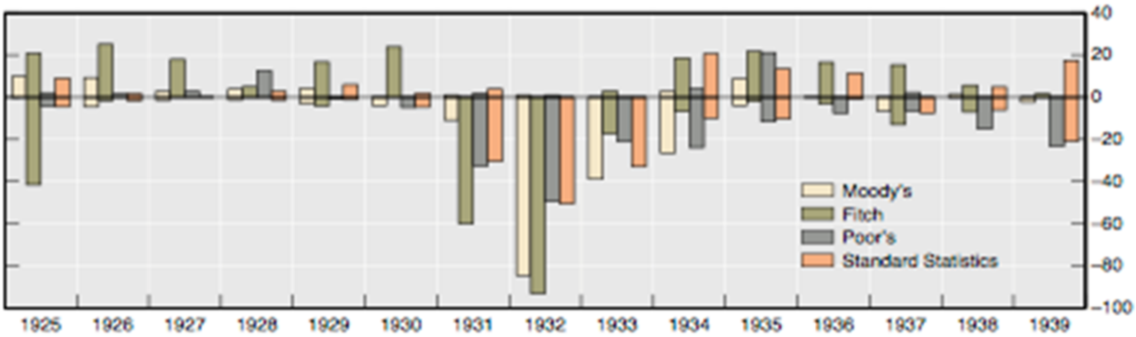
Embarrassingly, such instances are far from unique. Another interesting case, which is useful to combine with the previous one, is what happened in the interwar period, with the foreign debt crisis, when, after 1931, lots of countries in the world started defaulting. Just like was the case for Russia in my previous example, most of the defaults were occurring in the investment grade category, if you use the grades provided by US rating agencies, which had started rating foreign debt after 1918. Most of the defaults taking place at that stage in 1931 were taking place for securities in the four top notches which conventionally define investment as opposed to speculation. Thus these defaulters were really the good borrowers, if you will. Consider Fitch for instance. In 1931 16% of what they have identified as investment grade is experiencing default, against (curiously!) 0% of the speculative grade. Moody's were doing not much better, with 16% of investment grade defaulting, but at least they did not get the ranking totally wrong, since 17% of the speculative grade securities were going bust, and if you look at interest rates and the yield at which these countries had been borrowing before, they seem to suggest that the market was fine with a lot of those borrowers, and considered them as very safe entities.

An interesting difference is between the reaction of credit agencies and Crédit Lyonnais. In the middle of the Russian confidence crisis, Crédit Lyonnais told investors, "Oh, Russia is really safe. What we told you was correct". And they kept lending to Russia, and things were sorted out for a while at least. On the eve of WWI the Russian economy was booming again and it took the First World War and a few other things occurring a number of years later for default to eventually come. But in the case of the interwar crisis, rating agencies just ran away. When trouble started, they began downgrading massively. In the case of Moody's, for instance, in one week, after the sterling crisis in September 1931, 80% of the sovereigns it rated were being downgraded. When you look at the profile of sovereign upgrades and downgrades by Moody's, you have a line that is very similar to what we have seen in the most recent crisis. Suddenly, beliefs are updated and it often means massive downgrades. It's not who you are, it's who makes your reputation.

I think that one important factor explaining the difference is that in one case one is dealing with a financial institution, which had its reputation at stake somehow, but more fundamentally, which had the means of acting on the market. In other words, because Crédit Lyonnais was able to lend to Russia, it was fabricating its credit in not exactly the same way as a rating agency is. At the same time they were telling customers "Don't panic, Russia is fine", the bankers were trying to do something about it. But in the case of the rating panic of 1931, what could a rating agency do except cover its back and run with the herd? The massive downgrades by Moody's and others in the autumn of 1931 were essentially telling people: "We can't do anything about the stampede, so let us just give you the temperature. People are panicking, and we register that". This is what they said because they could not act on the situation. And this illustrates what I mean when I say that the question is not who are the good borrowers, but who says so?

Upgrades and downgrades as fraction of outstanding ratings[1]

In per cent



Positive bars indicate upgrades, negative indicate downgrades.

Source: Authors' computations.

Note: an upgrade (resp. downgrade) measures any upward (resp. downward) revision occurring between previous year's manual and current year's manual. Publications dates are: January (Moody's), March: Poor's; August (Fitch) and December (Standard Statistics).

Source: Flandreau et al (2010).

Now let me elaborate a little bit on this. I think one illuminating episode where you can see these mechanics at work is during the controversies that took place in Britain during the French wars and that are known through the works of Ricardo and Thornton. During those years, Britain is adding on to its debt, and the debt-to-GDP ratio of Britain is something like 250%. So this is obviously very big, the country is probably the mostly heavily indebted in the world during those years, and yet a number of people are thinking that this is comparatively a safer type of debt, because unlike what is happening on the Continent, where armies are roaming and governments defaulting, at least in Britain the political system is supposed to hold, and people are dumping continental securities, such as Dutch securities, and going to British securities as a safe haven.

But the war continues and Britain keeps borrowing, and it needs a mechanism to address that. The mechanism is the Bank of England. What the Bank of England is doing is providing the British Government with a put, a put option that if the market is not mopping up new issues, then the Bank of England is going to take them up. Ricardo, as you may remember, was very upset with this, perhaps because that was shocking his theories and perhaps because he was shorting the British debt and did not like the Bank of England put. This is the context in which Ricardo produced this story that the bailout of the British Government by the Bank of England was a very bad thing, especially because in return for the help the Bank of England was receiving privileges. The arrangement as it was taking place was one where on the one hand the government was benefitting from the put, but on the other hand the Bank of England was benefitting too. For instance, it was not bound to convert its notes into gold, and as a result, this gave the Bank of England more room for printing money, buying more British debt etc. Of course, to keep everybody happy, the Bank of England was also generously extending credit to support the economy, and calling this the "real bill doctrine" (according to which no good bill goes undiscounted). The yield on British government bonds was going down, the dividend of the Bank of England was going up and the result looked like a "win-win" game.

This was bound to start a controversy that would only be gradually resolved (it is disputable that it is resolved as of the day of this writing!). One thing that soon came to be understood however was that for this arrangement to work, one needed to make sure that some institutional fixes be considered: for instance, the Bank of England could not be playing this game forever, because there must be a stage where the central bank put would conflict with the mandate of monetary stability – a stage where some unpleasant arithmetic would set in and the next minute one would be looking at a hyperinflation. And indeed several countries on the Continent did experience hyperinflation in the subsequent years as a result of not cutting a proper deal between the central bank and the government. In other words, who is telling you what is a good sovereign, in this case, is the central bank. But the important element is not the central bank as such, or the central bank's put. Rather it is the nexus of contracts that make the pledge of the central bank credible and successful – or not.

This focus on the central bank as a producer of safe assets can be elaborated upon. Someone mentioned this morning that there is a demand for safe assets. How this demand is met is obviously an important issue. Britain and its Empire are interesting to look at from this vantage point. If you remember what Bagehot argued in Lombard Street, when he discusses how, during a crisis, the Bank should lend on the good collateral, he emphasized two types of such collateral: first, the Consols (British Government debt) and, he adds, the securities of the "strange Empire of India". And one reason he writes about the securities of the strange Empire of India is that, as you might remember, a few years before he wrote, in 1857 in India, there was an uprising called the Sepoy Mutiny which led British authorities to intervene directly in India, whose management was taken over from the East India Company. One wouldn't think of India as the most obvious example of the good sovereign: not really a sovereign and probably not so good.

But a mix of institutional factors made the securities of the strange Empire of India legitimate instruments for LLR operations. The British State was providing a backing and thus fabricated safe securities. I suggest that in effect, a process developed in the later part of the 19th century, where on the one hand there was a demand for safe securities, and on the other hand, the expansion of the British Empire and the expansion of borrowing by British colonies was meeting that demand by supplying, by fabricating, if you will (structuring would be the technical word) safe sovereign securities that could be used as collateral.

Now of course this arrangement ran into all kinds of difficulties, including problems of illiquidity. For instance, as it was, in the early 1890s, there was an Australian crisis originating in Australia's banking system, and Australian banks dumped their government securities as an attempt to shore up their liquidity, in turn causing doubts about colonial bonds. Some money funds operating on the colonial market went bust, even though they were holding in their portfolios these safe securities. This brought again the Bank of England into the middle of the field and the Bank of England handled the matter by helping with the liquidation or funding of the collapsing investment trusts. This is how the Bank of England became an imperial institution, by providing back stop facilities and deeming "safe and sound and good government" colonial governments to which it was now tied. Of course, it could only do that if it had a number of institutions to handle the resulting moral hazard problem. To make a long story short, the arrangements depended on the political status of the colony and gave the Bank of England authority in terms of supervising, managing, and influencing local financial policies.

Again, as we can see, the critical point appears to be the institutions set up to handle potential problems, and these institutions are really part of the question of distinguishing between what is a good sovereign and what is not. Of course when you start thinking along those lines the way you design new innovative, effective institutions is going to be very delicate, and the politics of it are going to be very difficult – the Ricardo controversy over the role of the Bank of England is a good illustration.

So let me give you one example that I think captures a lot of the underlying tension. During the 1890s, following this Australian crisis, there was a growing concern among colonial leaders that they were sound, but that their securities were not liquid so that as a result, they could run into a number of troubles. They wanted some security from the British authorities – essentially a mechanism that would foster the liquidity of their bonds. The scheme that was invented by the Colonial Secretary Chamberlain was the so-called "colonial bond". Essentially the colonial bond was an anticipation of the euro bond. The idea was that you would have the Colonial Office going on the market and issuing bonds to fund a pool, and then single colonies would be able to draw from that pool. Instead of having an Australian and a New Zealand and a Canadian debt, you would have a colonial debt: de facto federalization of colonial debts. And Chamberlain was very excited about this scheme, and he pushed it in various places, and obviously a number of colonies were very excited too, so they pushed it as well.

Now of course you can readily feel where this story is heading. The Colonial Secretary – Chamberlain – met his nemesis the British Exchequer. The Exchequer, if you want to stick with the metaphor of the euro bond, was playing the role of the German Government. And the Exchequer was saying "Nay!". First, because it feared that if the colonial bond was really successful and became really liquid and all, it might drive out Consols as an instrument of choice, and this the Exchequer could not let be. Another risk was colonial moral hazard if suddenly the colonial bonds were "too" liquid and all. And thus the status quo prevailed and colonial bonds never came into being. The solution had the advantage of keeping with the previous policy of producing safe assets that could be used as collateral, but on the other hand, making sure that those safe assets wouldn't be so liquid that those issuing those assets would escape Treasury control, so that the tail would eventually wag the dog.

It is time for a conclusion. One is that you can see why historians can't believe that good sovereigns never default. There is no such thing as a perfectly safe sovereign. Nothing is perfectly safe and sound, trouble comes, and opportunity knocks. If that were all, however, history would be a dismal science. But there is more: we perceive in the historical process of financial evolution conspicuous efforts, not at spotting eternally safe assets, but rather at producing such assets. In fact, one thing I take from my story is that the whole development of modern capitalist institutions can be seen as a succession of attempts at addressing the problem of the production of safe assets. As I mentioned, the development of the central bank, the fact that the central bank is providing a "put", or the political arrangements between an imperial country and its colonies can be seen as being as many aspects of the attempted production of safe(r?) securities.

This narrative puts the political process and political or institutional incentives at the centre of the stage. One feature that emerges clearly from the French, US and British examples is the role of financial power. In the case of the US rating agencies in the interwar period we have seen the effects of lacking a real power to act. The implication of this is that politics should not be seen as an exogenous problem to the financial system – something that should be circumnavigated, circumscribed, circumvented. Because the Bank of England, unlike a rating agency, when trouble was coming knew it could rely on the strength of the British State, it was better equipped to deal with liquidity problems in Indian or Australian bonds. Mandates were given and made contractual. Expectations were formed on those mandates. It is inconceivable that faced with a problem, British authorities would have said: “I cannot do anything about that. I’m just giving you an opinion”. An opinion that is not backed by some kind of power has little value. And a power that is not rooted in some form of responsibility is of little use. If we proceed that way, the really important question to focus on is the institutional transformations that will be up to the challenges that the current crisis has revealed.

Thank you very much.

References

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