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Part I

Sovereign defaults across time

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1 Sovereign debt crises and defaults

In the 1840s, Pennsylvania, seven Southern US states and the Territory of Florida defaulted on their debts.[1] Pennsylvania failed to pay following a deep economic crisis and the insolvency of the United States Bank of Pennsylvania in 1837, then the largest bank in the United States.[2] American creditworthiness abroad 'sustained a heavy blow'.[3] A proposed loan in Europe to the federal government came to naught, because of widespread distrust among European investors.[4]

Two further default waves in 1857 and 1870 cemented the European view that US states were untrustworthy debtors. Between 1840 and 1870 fifteen US states defaulted on their debt, including Virginia, New York and Maryland.[5] Half of all US state debt was in default, and 10 per cent was repudiated outright.[6] In many cases, states challenged the validity and constitutionality of their debts when sued by creditors, but with only limited success. Courts generally upheld these state debts, though creditors found it difficult to enforce their judgments.[7]

[1] D. W. Howe, *What Hath God Wrought: The Transformation of America, 1815–1848* (Oxford University Press, 2007), 508; R. Sylla and J. J. Wallis, 'The anatomy of sovereign debt crises: lessons from the American state defaults of the 1840s', *Japan and the World Economy*, 10 (1998), 267–98.
[2] D. Weber, 'The Spanish-Mexican Rim', in C. Milner et al. (eds.), *Oxford History of the American West* (Oxford University Press, 1944), 73.
[3] *Ibid.*
[4] B. C. Randolph, 'Foreign bondholders and the repudiated debts of the Southern States', AJIL, 25 (1931), 63–82, 75; CFB Rep (1931), 14.
[5] *Ibid.*, 64.
[6] R. C. McGrane, *Foreign Bondholders and American State Debts* (New York: Macmillan, 1935), 21; W. B. English, 'When America defaulted: American state debt in the 1840s', unpublished manuscript, University of Pennsylvania (1991).
[7] E.g. *Mississippi v Johnson*; *Citizens Bank of Louisiana v Funding Board*.

The Southern repudiations were a major obstacle for the Confederacy's fund-raising efforts in Europe, especially in London. Belmont, the Union's financial emissary in London, attempted to dissuade the Rothschilds from advancing any funds to the South. He drew the attention of London bankers to the Southern repudiations in the 1840s: 'Who will take a dollar of a Confederacy of States of which four have already repudiated their debt . . . unless it be that the name of Jefferson Davis, notwithstanding his advocacy of repudiation in his own State of Mississippi, should have a sweeter sound to European capitalists than I think.'[8]

The federal government refused any bailout or assumption of state debt. William Wordsworth, whose family suffered heavy losses on Pennsylvania and Mississippi bonds,[9] gave timeless expression to the feelings of many European holders of US state debt: 'high repute, with bounteous Nature's aid,/Won confidence, now ruthlessly betrayed'.[10]

These defaults, which are comparable to those of independent states, left a bad aftertaste among many European purchasers of US state bonds. As one commentator noted: 'The repudiation of state debts in the early 1840s had a totally shattering effect on European markets for US state and municipal securities.'[11] When economic conditions improved, most states that had defaulted resumed the payment of interest. Michigan, Florida, Mississippi and Arkansas, however, repudiated parts of their debt. One of America's great cultural institutions, the endowment for the Smithsonian Institution, suffered large losses on Arkansas bonds.[12] It took decades for the repudiating states' reputation to recover.

[8] J. Sexton, *Debtor Diplomacy: Finance and American Foreign Relations in the Civil War Era, 1837–1873* (Clarendon: Oxford, 2005).

[9] B. C. Randolph, 'Foreign bondholders', 63; McGrane, *Foreign Bondholders and American State Debts*, 194–203; B. Rowland, 'William Wordsworth and Mississippi Bonds', *Journal of Southern History*, 1 (1935), 501–07.

[10] W. Wordsworth, 'To the Pennsylvanians' (1845), in *Poetical Works* (Oxford University Press, 1947), vol. 4, 132; Letter from Wordsworth to a Mississippi legislator, 23 March 1843, quoted from CFB, Annual Report 1930 (referring to Mississipi's repudation for 'shameless dishonesty' and how it led even 'the most sanguine . . . to fits of despondency').

[11] D. C. S. M. Platt, *Foreign Finance in Continental Europe and the United States, 1815–1870: Quantities, Origins, Functions and Distribution* (Allen & Unwin: London, 1984), 162; C. Kobrak, *Banking on Global Markets: Deutsche Bank and the United States, 1870 to the Present* (Cambridge University Press, 2008), 30 (US financial relations with the rest of the world after the Civil War reached a 'low ebb').

[12] *The Banker's Magazine and Statistical Register*, vol. XII (New York: J. Smith Homans, 1857–58), 671; Arkansas Public Documents: 1854–60, Message of Elias N. Conway, Governor of Arkansas to Both Houses of the General Assembly, 7 November 1854 (Little Rock: True Democrat Office), 10.

Notwithstanding, eight states never settled their debts in full with their creditors.[13] The default of some US states is one of the rare cases where the Corporation of Foreign Bondholders failed to obtain a settlement.[14]

A. US state defaults and arbitration

For decades, concerns that foreign bondholders might submit unpaid state bonds to international arbitration tempered the US enthusiasm for treaties on the peaceful settlement of disputes in the United States, especially among Southern politicians.[15] US Secretary of State Hay attributed the Senate's reluctance to ratify such treaties to fears that arbitration would be sought on the question of Southern repudiated debts.[16] A particular fear was that British bondholders might find a receptive forum to bring their claims.

When the Senate considered ratification of the Olney–Pauncefote general arbitration treaty with Great Britain (1897), it included an amendment at the behest of Senator Bacon of Georgia that explicitly ruled out any claim against any state of the Union: 'but no difference shall be submitted under this Treaty which, in the judgment of either Power, materially affects its honor, . . . nor shall any claim *against any State* of the United States, alleged to be due to the Government of Great Britain, or to any subject thereof, be a subject matter of arbitration under this Treaty.'[17] The US Senate declined to ratify the treaty in 1897.

Similarly, when the Senate debated the Roosevelt treaties in 1904–05, the issue of state debt received much attention, to Roosevelt's chagrin.[18]

[13] W. A. Scott, *The Repudiation of State Debts* (New York, Boston: T. Y. Crowell, 1893); C. P. Howland, 'Our repudiated state debts', *Foreign Affairs*, 6 (1928), 395–407; B. R. Curtis, 'Debts of the states', *North American Review*, 58 (1844), 109–57 provides a nuanced account of the causes.

[14] G. A. Sessions, *Prophesying upon the Bones: J. Reuben Clark and the Foreign Debt Crisis, 1933–39* (Urbana: University of Illinois Press, 1992), 20. And see ch. 6.A below.

[15] Randolph, 'Foreign bondholders', 76.

[16] CFB Rep (1930), 42.

[17] Sen. Doc. 161, 58th Congress. 3d Session, 26–27 (emphasis added). See M. Blake Nelson, 'The Olney–Pauncefote Treaty of 1897', *The American Historical Review*, 50 (1945), 228–43, 237 (discussing additional reasons why the treaty failed to win ratification).

[18] Randolph, 'Foreign bondholders', 76; 'Senate mustn't alter arbitration treaties', *New York Times*, 12 January 1905 (no danger that question of state debts will be arbitrated). In 1904–05, Roosevelt submitted to the Senate twenty-two arbitration treaties providing for arbitration by the Permanent Court of Arbitration.

Bondholders do not seem to have submitted any claims to the Anglo-American Pecuniary Claims Commission of 1910.[19] The agreement to arbitrate excluded all claims that were not specifically referred to arbitration in schedules of claims, unless preserved by either Party for further examination. This approach departed from the usual practice of providing for general arbitration.[20]

The reason for limiting arbitration to scheduled claims may have been the hundreds of claims that had been brought to the attention of the respective foreign offices with 'little or no sufficient merit', including many bonds claims.[21] The Schedule of Claims to be submitted included a fourth class based on claims arising out of contracts, and the terms of submission were considerably more restrictive than for the property classes of claims that were submitted to arbitration.

When the Taft Treaty with Great Britain (1911), the first in a series of ambitious general arbitration treaties, came up for ratification in the Senate, Senator Bacon of Georgia secured another carve-out for state debt. The reservation related to 'questions affecting State indebtedness', and provided that 'the Treaty does not authorize the submission to arbitration of any question concerning the question of the alleged indebtedness or monied obligations of any State of the United States'.[22] Senator Lodge opposed allowing any international adjudication of state debts.[23] President Taft withdrew the treaty in response.

In light of the approach taken by the US government in respect of the international adjudication of US states' debts in the nineteenth century, the Soviet government deplored double standards and noted that the political arguments raised in the UK to exercise caution with respect to US state debts applied equally to Tsarist debt.[24] The Corporation of Foreign Bondholders lamented that the US government 'seems to vary its attitude according to whether a dispute lies between its own nationals and a foreign State or between foreign nationals and its own States. It is alone in the world to adhere in theory and practice to the amazing thesis that its own subsidiary . . . "sovereign states" can find sanctuary from just debts behind a national aegis.'[25]

[19] Editorial Comments, 'The American and British pecuniary claims arbitration', AJIL, 7 (1913), 575–80. Text of the arbitration agreement, signed at Washington, 18 August 1910, AJIL, 5 (1911), 257.
[20] *Ibid.*, 1035. [21] *Ibid.*
[22] Sen. Doc. 98, 62d Cong. 2d Sess; CFB Rep (1930), 397.
[23] Sen. Doc. 353, 62d Cong. 2d Sess. [24] CFB Rep (1930), 45, 398. [25] *Ibid.*, 48.

The only defeat for the opponents of state debts ever reaching an international arbitral tribunal or mixed commission came during the debate for the Bryan Treaties (1914), when an amendment reserving state debts failed to pass.[26] The British government showed no strong inclination to press the bondholder claims diplomatically vis-à-vis the United States. In 1930, the debts of seven US states remained in default.[27]

The Eleventh Amendment to the US Constitution (1794) precludes suits by foreign bondholders against US states.[28] State sovereign immunity erected an almost insurmountable barrier for bondholders in national courts. Cuba sought redress on defaulted state bonds before the US Supreme Court, but quickly withdrew the suit.[29] In the interwar period, Monaco was assigned state bonds by private parties, and brought a claim in the US Supreme Court.[30] Yet it failed on the ground that such suit required North Carolina's consent.

For decades, debates raged about whether the federal government should assume defaulted state debts.[31] After winning the revolutionary war against Britain in 1783, the US federal government had assumed about $21 million ($1.6 trillion, $0.5 billion) in debt of the thirteen states.[32] Back then, the assumption of debt, incurred in a common war of independence, was a way to bring the young nation closer together. In the nineteenth century, by contrast, the fiscal independence of the states won the day.

The US experience in the nineteenth and early twentieth centuries points to broader lessons about arbitration and sovereign debt. For one, virtually all states in the world have encountered, at some point in their history, serious payment difficulties and defaults (see Figure 1 below). Secondly, states show a great reluctance to commit to independent adjudication of disputes arising out of sovereign debt, not just for reasons of sovereignty, but also because the volume of borrowing potentially involved is so large. For borrowing countries, the implications of arbitration could be dramatic.

[26] Randolph, 'Foreign bondholders', 76.
[27] H. Feis, *Europe the World's Banker, 1870–1914* (Yale University Press, 1931), 105.
[28] W. L. Raymond, 'Savings bank loans and repudiations of state debt', *Barron's*, 9 February 1931 (the 11th Amendment 'shelters repudiating states of the Union from prosecution by their creditors').
[29] *Cuba v North Carolina*.
[30] *Principality of Monaco v Mississippi*.
[31] Sen. Doc. 153, 26th Congress 1st Sess (1840).
[32] Randolph, 'Foreign bondholders', 78.

B. Sovereign defaults as a perennial feature of sovereign lending

Public credit achieved for the power of the state a revolution similar to the one caused by gunpowder.[33] Wars and the attendant need for large-scale public borrowing catalysed the rise of the modern state, an institution which is unthinkable without the power to borrow and tax. As Charles Tilly writes, 'preparation for war, paying for it, and mending its damage preoccupied rulers' from the 1500s till modern times '… From the late seventeenth century onwards, budgets, debts and taxes arose to the rhythm of war.'[34]

Ever since the birth of the modern fiscal and borrowing state in the seventeenth century,[35] disputes on the non-payment of sovereign debt have been common. States most commonly resolved these disputes through negotiation at the interstate level,[36] and occasionally the use of force to compel repayment.[37] The sovereign debt disputes that appear before international courts and tribunals are just the tip of the iceberg. Much negotiation was out of the public view. Arbitration had been a frequent tool used to settle defaulted sovereign debt, and reached its heyday before World War I.[38] With the advent of restricted sovereign immunity in the 1960s and the widespread use of private loan agreements for sovereign borrowing, the locus of sovereign debt disputes shifted decisively to national courts.

When a country defaults, creditors pursue various strategies – diplomatic, legal and market pressure – to obtain repayment. Historically, a prominent method to enforce a debt claim against a sovereign has

[33] Jean Baptiste Say, *A Treatise on Political Economy*, 6th US edn (Philadelphia: Claxton, Remsen & Haffelfinger, 1834), 480 ('The faculty of borrowing is a more powerful agent than even gunpowder, but probably the gross abuse that is made will soon destroy its efficacity').

[34] C. Tilly, *Coercion, Capital, and European States AD 990–1990* (Oxford: Blackwell, 1990), 74–75.

[35] R. Bonney, *The Rise of the Fiscal State in Europe, c. 1200–1815* (Oxford University Press, 1999).

[36] M. Waibel, 'The diplomatic channel', in J. Crawford, A. Pellet and S. Olleson (eds.), *The Law of International Responsibility* (Oxford University Press, 2010).

[37] M. Finnemore, 'The case of sovereign default and military intervention', in *The Purpose of Intervention: Changing Beliefs about the Use of Force* (Ithaca: Cornell University Press, 2003); J. Latané, 'Forcible collection of international debts', *The Atlantic Monthly* (1906), 542–50.

[38] H. A. Moulin, 'La Doctrine de Drago', RDGIP, 14 (1907), 417–72, 458 ('le contentieux des emprunts d'États est essentiellement du domaine de l'arbitrage'); I. Soares Micali, 'Aspects juridiques de l'endettement international: l'expérience du Brésil', Doctoral Thesis (University of Paris I, Panthéon Sorbonne, 1993), 383, assesses the suitability of arbitrating sovereign debt disputes, and cites the favourable experience with arbitration clauses in Brazil's debt restructuring agreements in the 1980s.

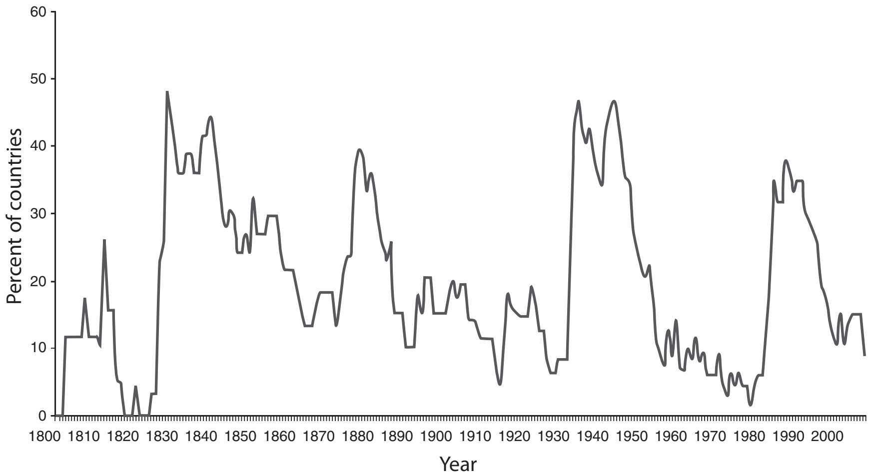

Figure 1 Sovereign external debt: 1800–2006. Percent of countries in default or restructuring.
Source: Reinhardt and Rogoff (2008).

been to bring a claim before an international court and tribunal. The question of how to resolve the tension between a country's limited payment capacity and creditor claims has repeatedly arisen in international adjudication, and is likely to arise in future cases.

Sovereign defaults have been a perennial feature of sovereign lending.[39] Their incidence is high, though the causes vary.[40] The high frequency of sovereign defaults is striking given the small number of states before 1918. Sovereign defaults often cluster in time, due to economic linkages among countries and the dependence on world economic conditions, such as commodity prices and interest rates. Periodic sovereign debt crises not only decrease welfare for countries

[39] A. Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations* (1776) (New York: Knopf, 1991), 563 ('Almost all states, however, ancient, as well as modern, when reduced to this necessity, have, upon some occasion, played this very juggling trick [of an undeclared national bankruptcy]'); E. Borchard, *State Insolvency and Foreign Bondholders: Vol.1, General Principles* (Yale University Press, 1951); M. Winkler, *Foreign Bonds, an Autopsy: A Study of Defaults and Repudiations of Government Obligations* (Philadelphia: Swain, 1933); F. Sturzenegger and J. Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises* (Cambridge, MA: MIT Press, 2007), 3–30, survey the last two decades.

[40] K. Rogoff and C. Reinhart, 'Serial default and the "paradox" of rich to poor capital flows', AER P&P (2004), 53–58, find 125 defaults for a sample of 23 countries over the last five centuries; A. G. Haldane, *Fixing Financial Crises in the Twenty-First Century* (London: Routledge, 2004), documents about 200 defaults since 1830.

and their population. They also threaten political and financial stability, both regionally and globally.

In the 1820s, for example, sovereign bond issuances by Latin American countries surged.[41] But economic and political instability in the young Latin American nations was the order of the day. Countries also borrowed to maintain internal order and to buy weaponry, rather than for infrastructure investment as stated in bonds' prospectuses.[42] The upper and middle echelons of rapidly industrialising European societies were eager for the high yields promised by the bonds.

Financial fraud has always been the dark underbelly of financial globalisation and sovereign borrowing. In 1822, the newly independent Latin American state of Poyais issued a bond in London, with handsome commissions for the arranging bankers. Poyais, according to the bond prospectus, was a bountiful land with great riches on the Bay of Honduras.[43] But Poyais was a fictitious country, and the bond a scheme to defraud gullible investors of their money.[44]

Borchard noted that the 'English investor, like his American counterpart, was inexperienced, eager for high yields and in a feverishly speculative temper'.[45] Taken together, these factors were a recipe for disaster. After just two years, a wave of sovereign defaults rattled financial markets, and over 90 per cent of Latin American bonds were in default. It took more than four decades to clean up the Latin American defaults in settlements.[46]

A major House of Commons investigation in 1875 revealed that overborrowing by states in the nineteenth century was common. The funds received were often misused, financial intermediaries charged

[41] S. Dawson, *The First Latin American Debt Crisis: The City of London and the 1822–25 Loan Bubble* (Yale University Press, 1990) captures this episode best.
[42] L Bethell, *The Cambridge History of Latin America* (Cambridge University Press, 2009), 153.
[43] Dawson, *Latin American Debt Crisis*, 41.
[44] D. C. M. Platt, 'British bondholders in nineteenth-Century Latin America: injury and remedy', *Inter-American Economic Affairs*, 14 (1960), 3–43 has further examples of fraudulent lending schemes.
[45] Borchard, *State Insolvency and Foreign Bondholders*, xx. Cf also C. Marichal, *A Century of Debt Crises in Latin America: from Independence to the Great Depression, 1820–1930* (Princeton University Press, 1989), 81 (strong demand for bonds with high yield, lax regulation and the fact that financial intermediaries did not share in the risk meant that 'the issue of external bonds was as easy as printing money'); D. S. Landes, *Bankers and Pashas: International Finance and Economic Imperialism in Egypt* (Harvard University Press, 1979), 106 ('for Egypt in the second half of the nineteenth century, the only limit on the issue of such bonds was the confidence of the public').
[46] Bethell, *Cambridge History*, 153 ('a legacy of diplomatic complications').

enormous fees (up to 25 per cent of the borrowing proceeds), sometimes paying commissions to representatives of the issuer and engaging in serious misrepresentations to investors who bought such securities in great numbers, especially on the London market.[47]

Similarly, a Senate committee offered the following diagnosis of the havoc in the sovereign debt market at the height of the Great Depression:

> The records of the activities of investment bankers in the flotation of foreign securities is one of the most scandalous chapters in the history of American investment banking. The sale of these foreign issues was characterized by practices and abuses which were violative of the most elementary principles of business ethics.[48]

The financial intermediaries ought to have paid much greater attention to the creditworthiness, or absence thereof, of individual issuers. Moreover, they 'generally indulged in practices of doubtful propriety in the promotion of foreign loans and in the sale of foreign securities to the American public'. A Bavarian village wanted to borrow $125,000, but ended up borrowing $3 million instead after repeated persuasion by the lender.[49]

C. Sovereign debt

Sovereign bonds are at the heart of public finance and play a central role in the development of capital markets. To developed and developing countries alike, bonds have long been the instrument of choice for raising long-term funds, domestically and internationally. The history of sovereign bonds in the Americas and Europe spans almost 200 years, despite periodic ups-and-downs.[50]

[47] House of Commons, Reports on Loans to Foreign States (1975); J. F. Rippy, 'A bond-selling extravaganza of the 1920s', *Journal of Business of the University of Chicago*, 23 (1950), 238–47.

[48] Senate Committee on Banking and Currency, Report of the Committee on Banking and Currency on Stock Exchange Practices, S. Rept. 1455, 73rd Congress 2d. sess. 1934, 125.

[49] C. Lewis and K. T. Schlotterbeck, *America's Stake in International Investments* (Washington, DC: Brookings Institution, 1938), 377.

[50] Dawson, *Latin American Debt Crisis*; House of Commons, *Report from the Select Committee on Loans to Foreign States; together with the Proceedings of the Committee, Minutes of Evidence, Appendix, and Index* (London: Her Majesty's Stationery Office, 1875); N. Ferguson, *The Cash Nexus: Money and Power in the Modern World, 1700–2000* (New York: Basic Books, 2001).