CHAPTER 4 History of Sovereign Debt in Latin America

THE LATIN AMERICAN BOND MARKET IN HISTORY: 1820–1913

More than any other region, Latin America provides an expansive historical experience on the contribution to economic development of foreign capital in general and sovereign debt in particular.[1] Latin America is the only part of the formerly colonial periphery with two centuries of post-independence historical experience. Once free from Iberian rule, Latin American countries rapidly embraced the use of global capital markets to finance their public debt (and, increasingly, their private sector debt as well). Perhaps surprisingly, their former colonial status per se does not explain why they had not previously enjoyed this option; debt in British colonies would come to be held by a variety of creditors in the nineteenth century, particularly in the semiautonomous dominions. In Latin America, however, tight Iberian control and immature international financial markets had foreclosed the option of external financing from sources other than Spain and Portugal.

Independence opened the door to external finance starting in the 1820s. Over the next one hundred years, foreign capital flows arrived in four great waves—punctuated by defaults, crises, and periods of near autarky. With the outbreak of World War I, global bond issuances came to an abrupt halt, and they would not restart for Latin American countries until the 1990s. This chapter reviews the historical record of Latin American sovereign debt from 1820 to 1913 and highlights some important parallels between the course of events in the nineteenth century and today.

First Wave

In the 1820s, the newly independent governments of Latin America approached the burgeoning international capital markets of London and Amsterdam. Funding was sought to establish security and infrastructure, and on a smaller scale the private sector went in search of development finance. British investment dominated the first wave.

In 1822, government bond issues with a face value of £3.65 million were floated by Colombia, Chile, Peru, and the fictitious "Poyais" (see Box 4.1); in 1824, there were new issues by Colombia and Peru, plus Buenos Aires, Brazil, and Mexico, to the tune of £10.4 million; and in 1825, Peru (yet again), along with Brazil, Mexico, Guadalajara, and Central America, issued bonds for a further £7.1 million. Sold at an average discount of almost 25 percent, these £21

[1] This section draws heavily on della Paolera and Taylor (2006).

Box 4.1 The State of Poyais

Although all Latin American bonds were risky investments in the 1820s, European investors' interest was so high and information so sketchy that even a fictitious country, Poyais, managed to place bonds. In 1823, a Scottish swindler, Gregor MacGregor, claiming to be the "Cazique" of Poyais, described a thriving European colony in Central America endowed with rich gold mines. He managed to issue bonds, exchange Poyaisian dollars for pounds sterling, and even encourage immigration to the alleged settlement.

Of course, the attempted colonists did not find the capital city of "Saint Joseph" or the rich gold mines while trekking through a plague-infested, isolated tract of jungle. MacGregor sold similar certificates and other Poyaisian material in both Britain and France during the 1820s and 1830s. Despite the evident fraud, he was never convicted of any crime and eventually retired to Venezuela.

Source: Scottish Executive News (2004).

million in government bonds realized on net only £16 million for the borrowers. As investors soon discovered, these issues were at best risky, and at worst (in the case of Poyais) a fraud. When fiscal burdens escalated with the wars of independence and subsequent civil wars, the unseasoned sovereign borrowers soon found themselves with no means to service their debts, and a wave of defaults ensued. As a result, all Latin American bond issues were in default by 1827 (Rippy, 1959; Marichal, 1989; Stone, 1977).

New loans were not extended to the region until the defaults were resolved and political and economic stability seemed more assured, a process that took years and, in some cases, decades (Table 4.1). Of the various 1820s sovereign issues that quickly failed, only the Brazilian default was quickly resolved, in 1829, and most remained in default for decades, with restructuring attempts frequently subject to failure as well. Here was a seemingly clear case in which reputation mattered: the bad debtors paid for their defaults by being excluded for a long period from the financial markets (Lindert and Morton, 1989; Tomz, 2001).

Second Wave

Starting in the 1850s, there was a marked renewal of interest in Latin America in the London capital markets, directed both at government bonds and at new private (especially railroad) investment. By 1880, these new investments had grown into a sizable stock that dwarfed the previous boom in the 1820s, and by then a total of £179 million was outstanding to Britain, £123 million in government bonds (69 percent) and £56 million in private enterprise debts (Table 4.2). The new surge in investment was driven in large part by a global trade boom from the 1850s until the onset of the Great Depression of the 1870s. More exports and imports meant more revenues (principally from customs duties) that governments could use to amortize loans. These new debts constituted a major increase in leverage for the public sector

Table 4.1 Default History of Latin American Government Bonds Issued in the 1820s

Borrower	Principal owed (pounds)	Resolution (if any)
Brazil	21,129,000	Arrears on interest paid and service resumed in 1829.
Mexico	6,400,000	Refinancing in 1831 to cover principal and arrears on interest. Quickly defaulted on. New refinancing in 1837. More defaults and re-funding. Resolved 1864.
Costa Rica	13,608	Inherited share of Central American confederation debt. Principal paid off in 1840, but not arrears on interest.
Chile	1,000,000	Arrears on interest paid and service resumed in 1842.
Peru	1,816,000	Arrears on interest paid and service resumed in 1849. Default in 1876.
Colombia (New Granada)	3,375,000	Inherited 50% share of Gran Colombia debt. Principal and arrears paid off by new loan in 1845. Default in 1850. Principal and arrears paid off by new loan in 1861.
Venezuela	1,923,750	Inherited 28.5% share of Gran Colombia debt. Principal and arrears paid off by new loan in 1841. Default in 1847. New arrangements and further defaults then followed.
Ecuador	1,451,259	Inherited 21.5% share of Gran Colombia debt. Principal paid off by new loan in 1855. Arrears cancelled in exchange for land warrants and Peruvian bonds. Default in 1868.
Guatemala	68,741	Inherited share of Central American confederation debt. Principal and arrears paid off by new loan in 1856.
Buenos Aires	1,000,000	Resumed service in 1857.
El Salvador	27,217	Inherited share of Central American confederation debt. Paid off 90% of debt in 1860, but balance not until 1877.
Honduras	27,217	Inherited share of Central American confederation debt. Principal and arrears paid off by new loan in 1867.
Nicaragua	27,717	Inherited share of Central American confederation debt. Paid off 85% of debt face value in 1874.

Source: Rippy (1959, 26–28).
Note: Poyais is omitted.

Table 4.2 British Investments in Latin America at the End of 1880

(*pounds sterling*)

Country	Total	Private enterprise	Government bonds	Government bonds in default (year)
Argentina	20,338,709	9,105,009	11,233,700	n.d.
Bolivia	1,654,000	n.d.	1,654,000	1,654,000 (1875)
Brazil	38,869,007	15,808,905	23,060,102	n.d.
Chile	8,466,521	701,417	7,765,104	n.d.
Colombia	3,073,373	973,373	2,100,000	2,100,000 (1874)
Costa Rica	3,304,000	n.d.	3,304,000	3,304,000 (1874)
Cuba	1,231,600	1,231,600	n.d.	n.d.
Dominican Republic	714,300	n.d.	714,300	714,300 (1872)
Ecuador	1,959,380	135,380	1,824,000	1,824,000 (1868)
Guatemala	544,200	n.d.	544,200	544,200 (1876)
Honduras	3,222,000	n.d.	3,222,000	3,222,000 (1872)
Mexico	32,740,916	9,200,116	23,540,800	23,540,800 (1866)
Nicaragua	206,570	206,570	n.d.	n.d.
Paraguay	1,505,400	n.d.	1,505,400	1,505,400 (1874)
Peru	36,177,070	3,488,750	32,688,320	32,688,320 (1876)
Uruguay	7,644,105	4,124,885	3,519,220	n.d.
Venezuela	7,564,390	1,161,590	6,402,800	n.d.
Other	10,274,660	10,274,660	n.d.	n.d.
Total	179,490,261	56,412,255	122,978,006	71,097,020

Source: Rippy (1959, 25, 32), with corrections.
Note: n.d. = no data.

and a test of governments' creditworthiness after three decades of "financial hibernation." A total of 50 major foreign loans were negotiated from 1850 to 1873, most of them in London, and a few in Paris and other European markets (Marichal, 1989).

But the extension of credit to sovereigns was more selective in the second wave as compared to the first—investors avoided riskier locations and started to follow the signals given by the few countries that had shown some dedication to debt service. With respect to sovereign loans, Brazil had worked harder than other countries to honor debts and was duly rewarded with the largest share of the new flows. Other countries took longer to re-establish their creditworthiness. Argentina did not fully resolve internal disputes and old debts until the 1860s, and only then were new loans negotiated. Paraguay borrowed in London in 1871, and Uruguay and Bolivia could do likewise in 1872 (the first Bolivian issue in 1864 had failed). Chile floated issues in 1858, 1865, 1866, 1867, 1870, and 1873 totaling £8.5 million. Costa Rica, Guatemala, and Honduras all issued nonrefinancing debt (new net inflows) at the peak of the investment boom from 1867 to 1872 (Rippy, 1959; Marichal, 1989).

As might be expected, risk premiums paid by countries varied over a wide range. Good risks like Brazil or Chile could float loans with 5 percent coupons at a price of 80 or 90, for a yield of under 6 percent, and Peru could offer approximately the same yields. Argentine coupons ran to 6 or 7 percent, and the issues sold at around 90, while Costa Rica floated 6s and 7s and sold them for about 70. But war-torn Paraguay had to offer 8s and Honduras 10s, and these bonds still could not be sold for more than 80 (Marichal, 1989).

But a global macroeconomic and financial crisis was stirring yet again, and a second wave of defaults spread over the region in the 1870s. By the end of 1880, of the £123 million in British capital invested in Latin American government bonds, more than £71 million (58 percent) was in default (see Table 4.2). Some of these loans had been ill-conceived in the first place, and some were again tainted by fraud. But even legitimate loans in the larger republics ran into servicing problems as the global depression spread.

Credit conditions suffered. A much wider global debt crisis was under way of which Latin America was only a small part: by 1876 fifteen non-European nations had defaulted to the tune of £300 million. Global capital flows again ground to a halt, and irate bondholders chased down the insolvent republics long into the 1880s. Settlements were again drawn out, and defaulting governments were shut out of new borrowing during negotiations and often for many years beyond.

Third Wave, Crash, and Fourth Wave

An even bigger borrowing boom began in the 1880s as global economic activity, and especially trade, recovered. Defaulting governments gradually straightened out their fiscal problems and sought access to credit again. The overall flows were massive, and by the end of 1890 total British investments in the region were about £425 million, more than double the 1880 total. Of this, £194 million was held in government bonds, now for the first time surpassed by a slightly higher amount, £231 million, in securities issued by private enterprises (Rippy, 1959).

The regional distribution of the new wave of investment favored those countries that prospered the most in the new trade boom. In the 1880s, capital inflows were concentrated in just five countries: 37 percent in Argentina, 17 percent in Mexico, 14 percent in Brazil, 7 percent in Chile, and 5 percent in Uruguay. Government loans were even more skewed, with 60 percent of all new loans going to Argentina and Uruguay. Economic divergence was starting to be seen: foreign capital—which sought out the most profitable investment, the most dynamic economies, and the most creditworthy countries—played a part in furthering economic divergence in the region (Marichal, 1989).

Foreign capital could have helped some countries accelerate their development, a clear gain. But open capital markets required greater fiscal discipline, could quickly punish the guilty for their inconsistent policies, and could even hurt innocent bystanders through volatility over the business cycle and contagion during periodic crises. As financial development and monetization in Latin American economies grew in the late nineteenth century, the consequences of government-induced macroeconomic crises became deeper and more far reaching. With any increase in the probability of default, sovereign spreads widened and the capital market tightened. Domestic banks found themselves in distress, and a credit crunch followed that squeezed local borrowers. Whereas government defaults in the 1820s and 1870s could bypass premodern economic modes of production that relied more on retained profits and less on financial intermediation, by the 1890s the region's more modern economies risked more-resounding economic crises after a default. The major crises in the 1890s for two large capital recipients, Argentina and Brazil, illustrate these new financial risks.

The first crisis occurred in Argentina—arguably the world's first example of a modern "emerging market" crisis, combining debt crisis, bank collapses, maturity and currency mismatches, and contagion. Argentina's bold development strategy of the 1880s rested on a highly leveraged parastatal banking sector, which borrowed in gold and lent in pesos. When the economy faltered and the fiscal gap widened, it was covered by means of printing money, which broke the exchange rate peg and unleashed inflation. A generalized financial and banking crisis ensued, and stabilization and debt restructuring took the better part of a decade. Foreign capital flows dried up, and a global recession contributed to a delayed recovery (della Paolera and Taylor, 2001).

A second crisis followed in Brazil. Political and economic instability was high in the 1890s following the proclamation of the republic: the country was adjusting to the abolition of slavery, the gold standard had been abandoned, and inconsistent monetary and fiscal policies had the presses printing money at full speed. The currency steadily devalued, by a factor of 3.5 from 1890 to 1898, adding to the domestic costs of debt service. Default was put off for a time but was unavoidable in 1898–1900, and again in 1902–1909. By then, the real economy was in deep recession, having never really recovered from the financial instability of the early 1890s (Cardoso and Dornbusch, 1989; Fishlow, 1989; Triner, 2001).

The root cause of these crises looks familiar. Both Argentina and Brazil had increased their government debt levels at a fast pace as a result of persistent and large deficits, a reflection of the inability of the governments to balance the books and set out a sustainable fiscal path. Eventually a debt ceiling was reached, and markets were unwilling to roll the debt over one more time. Both countries paid a high price during the messy cleanups that followed. Argentina's national debt service was backstopped by rollovers agreed to by the 1891 Rothschild Committee, but at such a punitive interest rate that the deal had to be renegotiated almost immediately that same year. Brazil's 1898 funding loan, another Rothschild product, had harsh adjustment conditions attached to it.

The global capital market quickly recovered from the crisis of the 1890s, although countries badly affected, most notably Argentina, took longer to recover. However, compared to the 1870s boom and bust, this one was not associated with widespread default in the region, but rather a more general and global increase in country risk that slowed foreign capital flows for the better part of a decade. Inflows to Argentina and Uruguay were sluggish in the 1890s, but in other countries in the region, the tap was still open.

WHY WAS LATIN AMERICA THE FAVORITE OF THE MARKETS?

Latin America played a prominent role as recipient of capital flows in the nineteenth century. Between 1880 and 1913 the region received about one-quarter of total British foreign capital flows (Table 4.3). Yet many countries in the region were involved in military and political conflicts, had weak institutions, and showed serious inconsistencies in applying sound fiscal and monetary policies. What accounts for this market preference?

Investment Needs and Savings Scarcity

In the nineteenth century, global capital followed closely a textbook pattern of flowing from advanced, capital-rich countries to less-developed, capital-scarce economies (see Figure

Table 4.3 Cumulative Gross Capital Flows from Britain to Latin America, 1880-1913

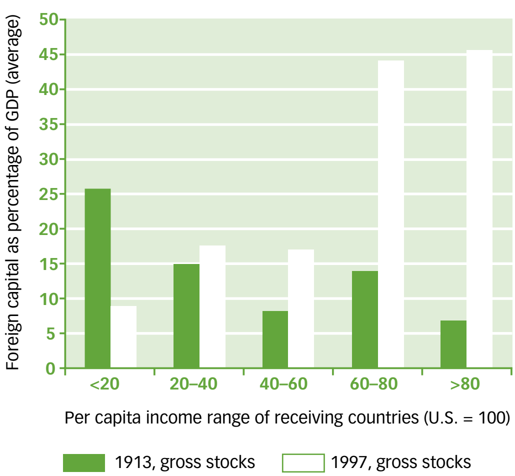
(*millions of pounds*)

										Growth rates (%)		
Type	Country	1880	Share (%)	To 1890	Share (%)	To 1900	Share (%)	To 1913	Share (%)	1880–1891	1890–1901	1900–1914
Private	Argentina	9	3	78	10	102	10	257	12	24	3	7
	Brazil	10	3	29	4	40	4	90	4	11	3	6
	Chile	1	0	12	2	18	2	32	2	28	4	4
	Cuba	1	0	3	0	6	1	20	1	8	7	10
	Mexico	4	1	19	2	27	2	64	3	17	4	7
	Peru	2	1	5	1	6	1	11	1	10	1	5
	Uruguay	5	2	12	2	14	1	20	1	9	2	3
	These seven	32	11	157	20	212	20	494	24	17	3	7
	All countries	296	100	770	100	1,064	100	2,065	100	10	3	5
All	Argentina	21	3	132	10	160	9	332	10	20	2	6
	Brazil	22	4	56	4	74	4	166	5	10	3	6
	Chile	8	1	22	2	33	2	60	2	11	4	5
	Cuba	1	0	3	0	6	0	26	1	8	7	13
	Mexico	5	1	26	2	39	2	80	3	18	4	6
	Peru	27	4	30	2	30	2	37	1	1	0	2
	Uruguay	7	1	20	1	23	1	30	1	11	2	2
	These seven	90	15	289	22	365	20	732	23	12	2	6
	All countries	599	100	1,334	100	1,812	100	3,203	100	8	3	4

Source: Stone (1999).

4.1). In Latin America, government financing accounted for a large fraction of overall capital inflows, because public sector needs were closely correlated with the level of investment demand in the country as a whole. The case of transport infrastructure is a typical example of the strong complementarity between private and public sector investment. When the railroads were publicly operated, lending was directed via government borrowing. But even when they were privately owned, construction of railroads was often accompanied by significant public expenditure: related infrastructure, guarantees and subsidies, and so on. The same was true of ports, canals, and other large transportation-related projects. Latin American countries had very different investment needs in the nineteenth century, and this certainly affected their *overall* need to draw on foreign capital inflows, and infrastructure-led public borrowing in particular. As noted above, foreign financing of railways was a dominant category of foreign capital flows in this period (Twomey, 2000).

Figure 4.1
Foreign Capital in Rich and Poor Countries: Then versus Now



Source: Obstfeld and Taylor (2003).

Financing needs also came about as a result of the insufficiency of domestic savings and the underdevelopment of domestic financial markets. For example, Davis and Gallman (2001) find that in the "settler economies," the British dominions generally had more advanced financial systems than Argentina, a finding consistent with the account of della Paolera and Taylor (2003). In the Argentine case, penetration by foreign banks, many of them branches of London banks, brought the country to the doorstep of the deep and liquid British financial markets. In this type of setting, foreign financial development can substitute for—and thus crowd out—domestic financial development. This effect was probably at work in many less-developed economies, within and beyond the British Empire, before 1914.

In addition, in many Latin American countries savers were rather scarce for demographic reasons. Taylor (1992) made the argument for Argentina, but it applies to many other countries too. In many developing countries then, as now, fertility and population growth rates were very high. The standard life cycle argument would predict that such countries would tend to save less, as compared to countries with a more mature population with greater numbers in high-saving midlife cohorts. Taylor and Williamson (1994) show how these effects could explain a fair portion of the capital flows from Britain to the settler economies before 1914. The small size of the domestic financial markets was an additional reason pushing governments to borrow from abroad.

Policies, Institutions, and Reputations

Sovereign risk premiums, the spread over the market's benchmark bond yield (in those days the British consol), also varied significantly across countries and over time, as seen in Figure 4.2. In extreme cases, countries suffered complete market exclusion, typically as a result of unresolved past defaults. What drove risk premiums? A considerable body of research in recent years has explored this topic, and the answers have focused on policies (adherence to the gold standard, fiscal balance), political and institutional factors (wars, colonial linkages), and reputations (the history of defaults and their resolution).[2]

There is evidence that sovereign borrowers received a lower risk premium when they adhered to the gold standard, which has been interpreted as the equivalent of a "seal of approval" on policies (Bordo and Rockoff, 1996). Because countries needed to maintain sound policies to operate a credible commitment to the gold standard, this automatically reassured bondholders of a country's creditworthiness. The risk premium fell by an estimated 40 or more basis points upon adoption of the gold standard (Obstfeld and Taylor, 2003).

Gold was a highly relevant policy issue for the Latin American countries because they were generally among the weakest countries maintaining gold standard adherence. What was it about the region's economies that made it so difficult for them to stick to a hard monetary regime? Volatility seems to be the answer. The Latin American economies seem to have been more susceptible than any other group of countries to extreme fluctuations in public debt-to-GDP ratios. The region's governments engaged in big run-ups in debt levels during periods of easy credit, which halted suddenly during tighter times or after a default/repudiation episode. Latin American countries were burdened with considerable fiscal volatility, either because their tax revenues were volatile (owing, for example, to trade volatility and terms-of-trade shocks affecting customs revenue) or because spending was volatile (owing, for example, to wars and military spending caused by internal or external political instability). Moreover, governments' propensity to use external borrowing was sometimes fed by institutional weakness of a different sort: governments pursuing short-run prosperity for political gain. Whatever the origin, it is clear

Figure 4.2
Country Risk, 1870–1914: External Bond Spread over British Consol, Latin America versus 11 Core Countries and British Empire Bonds

Source: Taylor (2003).

[2] The most comprehensive coverage of this topic is in Mauro, Sussman, and Yafeh (2006).

that Latin American governments lived in a more fiscally volatile world and witnessed more dramatic fluctuations in their debt positions than countries elsewhere in either the core or the periphery.

Military conflicts involving the sovereign borrower, both civil wars and inter-state wars, were often behind episodes of insolvency, especially in the turbulent period immediately following national independence. Furthermore, wars often meant going off gold, worsening the deterioration in creditworthiness. In fact, political and institutional determinants were so unfavorable in the region that it is not clear how most parts of Latin America could have been expected to attract large-scale capital inflows. Spain and Portugal did not establish colonies that were characterized by good political and economic institutions. Power was concentrated in privileged elites, democracy never flourished, and property rights and the rule of law were weak (except where needed to protect the elite). Although these flaws persisted after independence, the region did manage to sustain strong economic growth in the nineteenth century and hence became attractive to foreign capital, except where the worst political and institutional failures could not be contained.

It is fair to say that Latin America's post-independence experience remains relatively neglected in the theories currently in vogue that stress the importance of colonial-times institutions. Despite their weak institutions, countries in the region enjoyed respectable economic growth and capital market access. Although defaults were undoubtedly higher than in the British Empire group, the region still managed to attract significant capital flows despite higher default risks. The returns must have outweighed the risks in the eyes of the investors. Colonial origins did not doom the region to failure, at least up to 1914.

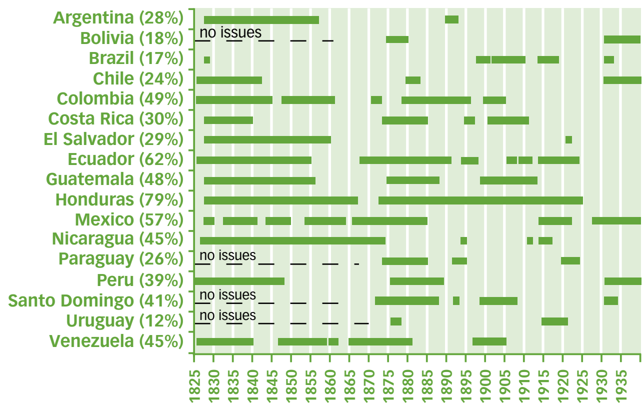
Nonetheless, frequent episodes of default were a major factor influencing the cost and availability of foreign financing for Latin America in this period. The crises of the 1820s and 1870s started to cement in investors' minds the untrustworthiness of Latin American sovereign borrowers, a reputation that was to expand in the years ahead and that persists even to this day.

According to Tomz (2001), of the 77 government defaults from 1820 to 1914, 58 (75 percent) involved Latin American countries. Compared to other periphery countries, the economic potential and sovereign independence of the region obviously encouraged this outcome: the potential for high returns favored more borrowing ex ante, and independence from empire gave more freedom to default ex post. Another factor may have been a relatively modest cost for a soiled reputation, according to some estimates. Studies put the penalty for default at about 100 basis points for a full default and 50 basis points for partial defaults (Obstfeld and Taylor, 2003; Ferguson and Schularick, 2006; see Chapter 12 for a discussion of the cost of default). Figure 4.3 shows the incidence of sovereign default in the region from 1820 to 1940, and the fraction of years that debtors spent in default status is impressive: 38 percent on average.

CHARACTERISTICS OF THE HISTORICAL SOVEREIGN BOND MARKET

In the nineteenth century, sovereign bonds typically had a very long maturity. Their maturities averaged more than 20 years, while in the current globalization period of the 1990s and 2000s, the issue of Eurobonds by emerging market sovereigns was at maximum maturities of 7 to 10 years. Also, in the 1870–1913 period, early redemption clauses were the norm in the structuring of public debt issues. These were the so-called "lottery clauses," allowing partial repayment and conversion on bonds whose numbers were drawn randomly at specified moments.[3] This implies that the international capital markets of the nineteenth century (notably, the London market) offered favorable conditions to debtor countries, allowing them to refinance and swap long-term debt instruments for comparable instruments at lower interest or coupon rates to exploit favorable liquidity conditions, perhaps more easily than in the modern market.

Figure 4.3
Latin America: Periods in Default, 1825–1940



Sources: Taylor (2003); default data from Tomz (2001); issue dates from Marichal (1989).
Note: Percentage of years in default shown in parentheses. Poyais is omitted.

Most of the sovereign bonds floated by Latin American countries in the period were denominated in foreign currency or in terms of gold (or else had "gold clauses," allowing the creditor to choose to be paid in gold). Moreover, Latin American countries, especially Brazil and Argentina, also issued domestic debt with gold clauses. Although this was fairly common practice in emerging markets at the time, the acute credibility problems created by monetary and fiscal policies in Latin American countries left them with little choice in the matter (Bordo and Meissner, 2005).

In terms of seniority, a notable difference between international markets then and those today was that in many debt issues, export revenues and tax revenues were earmarked as collateral to guarantee servicing of the debt. This granted some public bonds an explicit seniority over other bonds of the same type and issued by the same national political entity. Most bond issues in current times include "negative pledge" clauses that prevent the selective use of collateral. In the same vein, "sharing" clauses, which prevent selective default on certain bonds, were not used very often in the nineteenth-century market.

A country's cost of borrowing was closely associated with its track record. "Seasoned" borrowers could expect to pay much lower spreads than debtors with poor reputations. But the difference narrowed or disappeared during good times, times of abundant liquidity and solid performance in the global economy, as emphasized by Tomz (2001). During the first wave of lending (the 1820s), the Latin American economies were new borrowers par excellence, and spreads were around 350 basis points. In the second wave of the 1870s, the market attached reasonable premiums to seasoned borrowers and to countries that had settled past defaults or were new entrants, but the proven "lemons" or junk bonds were trading at an average yield of 27 percent.

[3] Because bonds sometimes traded above par, investors who "won" lotteries in those cases actually lost money.

The high cost of capital in the first wave might have been associated with the building up of reputation for the early borrowers, but in addition, genuine asymmetric-information problems were surely quite acute during the 1820–1870 period. Paucity of information, in fact, was a major issue, especially until the second wave in the 1870s. In the 1820s there were in London several important newspapers which compiled quite sophisticated data on bond pricing and volumes traded and also reported on the political and economic news of different countries. *The Colonist*, *Common Sense*, *The Times,* and *Course of Exchange* followed Latin American debt closely during the first wave on a daily basis until the generalized defaults of 1826–1827. Della Paolera and Taylor (2006) collected data on a substantial portion of the sovereign bonds outstanding for the six years 1822–28 and constructed a Latin American bond composite index that is quite comparable to the current Emerging Markets Bond Index (EMBI) (Figure 4.4).

During the second wave, by contrast, news was much more widely available. Information on macro variables such as outstanding debt per nation, trade flows, fiscal positions, population, railway construction as a proxy for investment, and prices and quotations of sovereign bonds was readily available from additional sources such as *Investor's Monthly Manual*, *The Economist*, *Palmer's Index*, and the *Annual Reports of the Corporation of Foreign Bondholders*, which was created in the mid-1860s as an association of British investors holding bonds issued by the emerging economies.

Defaults and Their Resolution

The major Latin American nations in the wave of the 1820s—Brazil, Chile, Mexico, Peru, Gran Colombia, the Federation of Central America, and the Province of Buenos Aires (which seceded in the 1820s from the Argentine Confederation)—all defaulted between 1826 and 1828. All of these borrowers had issued their sovereign bonds in the early 1820s, but by the mid-1830s, they had started renegotiating and settling their debt situations. Their situations were completely regularized no later than the 1870s, with arrangements that capitalized interest and amortization arrears. Although repayment was often very delayed, in this first wave there were no cases of outright repudiation.

In between the two waves, for the period 1850–1873, the approximate total of outstanding foreign loans to Latin America was £140 million—but 45 percent of this stock was simply devoted to refinancing the defaults of the 1820s. Later, after the crisis of 1873, which saw a massive fall in the price of commodities, eight Latin American countries defaulted, but most of them restructured in the 1880s, with the exception of Honduras, which was in a perennial situation of default and was one of the few cases in which gunboat diplomacy was applied (in 1905–1907). Hence, most countries were in some sense willing to restructure their debts and resume service when they could take advantage of renewed liquidity in global capital markets. Interestingly enough, in the cases of both Chile (a span of 18 years of outright default) and Argentina (a period of 16 years of outright default and 13 years of a unilateral partial-repayment scheme), debt restructuring did not include *any* debt relief or principal reduction schemes. In the case of Brazil, the most significant principal owed, about £21 million, went into default by the mid-1820s, but default was short lived, and already as early as 1829, arrears on interest were paid and service resumed normally (again, see Table 4.1).

In the period of the 1880s and 1890s Argentina alone was the recipient of 30 percent of all foreign loans to Latin America, followed distantly by Brazil, with 14 percent of total foreign loans inflows to Latin America. It is no surprise, then, that when Argentina started to reveal by the end of 1890 that it would have problems servicing its foreign debt, a panic arose in London, and means were sought to avoid a contagion in the event of an Argentine default. This event became famously known as the Baring Crash of 1890–1891. To avoid an across-the-board default by Argentina, the Bank of England coordinated a rescue operation in January 1891 that involved a syndicate of merchant banks providing a "standby" loan of £15 million, a "6 percent funding loan," to cover the full service of the external debt over three years for the Argentine bonds. This arrangement, known as the "de la Plaza–Bank of England agreement," also included very harsh conditionality measures. Yet, in spite of the stabilization reform efforts, it became clear in 1892 that the package had failed to put debt service onto a sustainable path. The *real* yield at which the funding loan was floated was 16 percent at a time of recession, when the debt-to-GDP ratio rose from 72 percent to 91 percent. A debt forgiveness package was proposed by J. J. Romero in 1893 to a committee of creditors headed by the House of Rothschild, leading to a successful resolution (della Paolera and Taylor, 2001, 106–117). Argentina's "Romero Agreement" of 1893 stated that, between 1893 and 1898, the Argentine government would pay half the level of original debt service envisaged in the de la Plaza–Bank of England agreement, then from 1898 onwards, it would pay the full level of debt service, and finally from 1901, the government would begin to amortize principal on the national sovereign bonds. Therefore, the Argentine bonds were never technically in default, but they avoided default only through two sequential restructuring operations. It is important to note here that some provincial and municipal Argentine bonds had been in default since 1891 and that the federal government would assume those obligations, some as late as 1898. Argentina could float new bonds again only in 1901, so the country was effectively without access to international financing for almost a decade.

Figure 4.4
London Latin American Bond Market in the 1820s: Composite Yield Index Using Coupon-Price Ratio

Source: della Paolera and Taylor (2006).
Note: Index comprises Argentina (Buenos Aires), Brazil, Colombia, Chile, Mexico, and Peru.

AFTER THE COLLAPSE

In the space of the next few decades, the integrated global markets for goods, capital, and labor that had been built over the course of the long nineteenth century were effectively destroyed. The outbreak of World War I led to capital controls and the collapse of the gold standard under inflationary war-financing policies. The core European countries, and Britain in particular, were no longer in any position to export capital to the developing world. The center of the world capital market gradually shifted from London to New York, but the American capacity to supply funds to the rest of the world did not fill the void left by the British. There was considerable distress in the region in the wartime years: Brazil defaulted again, for example, as did Uruguay and revolutionary Mexico, but Argentina did not, despite a brutal recession. The 1920s were a period of marked improvement for Latin American borrowers, notwithstanding the still-uncertain outlook in the world economy. By late in the decade, capital flows to the region seemed to be on their way to recovering their previous shine, but this was soon to change.

In the 1930s, the situation grew gloomier. The Great Depression reached its lowest point from 1929 to 1933. Capital controls and competitive devaluations became widespread. Nearly all Latin American countries also adopted capital controls in this decade, most fell in default of their external debts, and several attempted to maintain multiple exchange rates, which gave rise to active parallel markets in foreign currency. Despite these unfavorable conditions, some countries remained engaged with capital markets as best they could in the 1930s. A small few, notably Argentina, did not default, and they were rewarded with favorable access to new trickles of capital in the late 1930s. Others continued engaging with creditors to renegotiate debts, perhaps hoping for a resumption of global flows. Many governments managed to shrink their debt burden through secret buybacks of their own debt at the deep discount that was offered by the secondary market. Through buybacks, unilateral offers to creditors, or renegotiation, several countries achieved substantial debt concessions. In this decade, at least, default had little stigma attached to it—almost every bank, enterprise, or country was afflicted by it. Reputations could be rebuilt, then, but as it would turn out, another war and a new backlash against global finance would soon render efforts in this direction moot, and no significant capital flows would be seen again in the region for three or four decades.

From the 1940s to the 1980s, the constraints on global capital markets were to fluctuate, but not until the 1990s did financial globalization appear to regain prominence again, and even then, on a more modest scale than in the nineteenth century. Virtually no foreign capital flowed from rich to poor countries for most of the period after World War II. And when capital flows resumed in the 1970s and 1980s, they tended to favor areas other than Latin America. Foreign direct investment provides a sharp example. In 1914, and similarly in 1938, Latin America accounted for about 55 percent of world stock of inward foreign investment in developing countries, but by the year 1990, the region accounted for only 37 percent (Twomey, 2000). Asia has gained significant market share, but the major destination of gross flows from advanced economies is now to other advanced economies.[4] With the resumption of capital flows, major debt crises have again swept over the region in a manner eerily reminiscent of the experiences from the 1820s to the 1930s. Sovereign debt exploded in the 1970s in the form of bank loans, in the context of the global growth slowdown and the recycling of the so-called petrodollars of newly rich creditors in the Organization of the

[4] The decline in importance of foreign direct investment (FDI) for the Latin American economies is dramatic. In 1914, the stock of FDI was estimated to be the equivalent of 270 percent of GDP, while by 1990, after a modest recovery, it amounted to only 47 percent (Twomey, 2000).

Petroleum Exporting Countries (OPEC). International bank lending to Argentina, Brazil, and Mexico doubled from 1979 to 1981. In 1982 a default crisis engulfed these countries and many others in the region and elsewhere on the periphery. A recession in the global economy, high interest rates, weak commodity prices, and overborrowing led to another familiar scenario. Renegotiations and an orderly working out of this debacle took almost a decade, during which the door to financial markets was temporarily shut once again and the region endured more political and economic turmoil.