The Revenge of Defaulters. Sovereign Defaults and Interstate Negotiations in the Post-War Financial Order, 1940–65

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7.1 Introduction

The post-war era holds a special and important place in the long history of sovereign debt disputes. The majority of states suspended interest payments on their foreign obligations after 1931. In 1945, nearly half of all countries representing 40 per cent of the world income were in default (Reinhart & Rogoff, 2009, p. 73; Suter, 1992). Never before had creditors faced a wave of defaults of this magnitude. Previous scholarship has demonstrated that the economic consequences of the Great Depression were the main causes of debt defaults, and the Second World War further delayed the negotiations between borrowers and bondholders in certain cases (Eichengreen, 1991; Eichengreen & Portes, 1989). Less well known, however, are the important changes affecting the actors, tools, and forums governing the settlement of debt disputes. For debtors and creditors, the post-war settlement of debt disputes represented an enormous task not only because of the sheer amount of debt in default but also because old methods of debt settlement no longer applied.

The methods that debtors and creditors use to settle debt disputes have greatly varied over time. Since the mid-nineteenth century, bondholder committees had furnished creditors with their most efficient method to protect their rights against recalcitrant states. Bondholder committees derived their authority from the capacity to sponsor market access to preferred customers and to refuse to list new bonds from a creditor in default through stock exchange regulations (Hautcoeur & Riva, 2012; Flandreau, 2013). Yet, when the question of debt repayment resurfaced in 1945, capital markets were virtually shut down. Having abandoned bond markets, states borrowed domestically or through public lending schemes from Export Promotion Agencies and multilateral organizations. Syndicate bank lending emerged as the main source of private external finance, while sovereign bond issuances would not return to pre-war levels until the post Brady-plan era of financial globalization. This major shift in the structure of debt financing critically

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weakened bondholders' bargaining power. After the war, creditors began to seek diplomatic support from their government (i.e. creditor states) to remedy broken agreements.

This chapter examines how bondholders and their governments adapted to this new context. How did states act as the agent of private creditors? To what extent did they accept to turn themselves into protectors of private capital? How did bondholders react when creditor states refused to grant diplomatic recognition to private contracts? How did this new context affect investors' gains and losses as compared to previous periods? The post-war context raises many issues for the economic, sociological, and legal history of sovereign debt disputes, their actors and forums, and, more broadly, the capacity of foreign creditors to protect their rights in times of radical uncertainty.

This chapter offers three insights. First, the norm of debt repayment is politically and historically variable (Lienau, 2014). Using the post-war context as empirical illustration, we argue that the sanctity of debt contracts varies according to the identity of the agent charged with conducting debt talks. So long as private creditors were the main negotiator agents, debt talks were strictly restricted to one background expectation: repayment. But as states began to assume a more explicit role as enforcer of debt contracts, negotiating on behalf of their domestic bondholders, debt acquired a broader public and diplomatic meaning. Creditor states did not give consideration to debt repayment without considering as well other concerns such as peace, trade, reparation and the building of a new international order. As a result, the sanctity of debt contracts was durably undermined. No longer universal, the value of debt claims became contingent upon creditor states' recognition.

Second, we suggest that the perceived advantages of legal forums grew in relation to the weaknesses of the diplomatic channel as method of debt settlement. For the great majority of creditors, there was no need to elevate the dispute to international legal forums because creditor state mediation operated according to expectations. But in a few cases, creditors grew dissatisfied with the diplomatic channel and began pursuing alternative legal remedies. Although such attempts failed for the most part, they are significant because they foreshadow many aspects and problems in the current debate on legal tools of debt dispute settlements.

Third, we reflect on the posterity of post-war repudiations in current debt talks. The post-war context was remarkable because it challenged the repayment norm. But the forms of diplomatic involvements that prevailed during these years did not translate into new institutions. As a result, the departure from the repayment rule should be characterized as merely a transitional rather than a permanent one. Negotiations were conducted on a case-by-case basis, outside comprehensive schemes. The post-war experience of settling debt defaults was not codified into principles providing a legal basis for non-repayment. This all but guaranteed that the norm of repayment would once again prevail once creditors recovered their bargaining power. The revenge of defaulters would be short-lived.

The chapter proceeds as follows. Section 7.1 analyses the main causes explaining the shift from a bondholder to a creditor state mediation. Section 7.2 builds on several cases of debt disputes to examine how states fulfilled their task to represent creditors' interests. Section 7.3 explains the complicated post-war development of international law. Section 7.4 assesses the efficiency of different methods of debt settlements against selected metrics of performance. Section 7.5 concludes.

7.2 The Political Economy of Debt Dispute Settlement: A Long-Term Perspective

The history of sovereign debt dispute settlements is one of remarkable resilience and adaptation to a changing political and economic landscape. During the first era of bond finance, foreign creditors began to organize themselves into bondholder committees to conduct debt negotiations with recalcitrant states and maximize the repayment of principal and interests. In 1868, the British Corporation of Foreign Bondholders (CFB) was established to represent British bondholders' interests (Mauro, Sussman & Yafeh, 2006). The British CFB was a particularly efficient forum for the resolution of defaults. Thanks to the close ties it maintained with the banking sector and the London capital market,[1] the British CFB had the ability to sponsor market access to preferred customers and to refuse to list new bonds from a defaulter. Its efficiency of the CFB was also enhanced through its collaboration with underwriting banks (Esteves, 2005, 2013; Flandreau & Flores, 2012). Other CFB-type organizations were established elsewhere (cf. Figure 7.1). Eichengreen and Portes (1989) found that the lack of a CFB-type organization in the US during that period resulted in US bondholders obtaining lower returns on their foreign bonds than their British counterparts, though their results were more recently questioned by Kamlani (2008) and Flandreau (2013).[2]

In the pre-1914 period, the concentration of financial exchanges in London and a few other stock exchanges made it unlikely for a defaulter to obtain capital access elsewhere. Cross-national coordination between European bondholder associations allowed creditors to present a united front against defaulters.[3] Mauro and

[1] For instance, the governing council of the CFB included representatives of the British Bankers' Association and the London Chamber of Commerce.

[2] The US Foreign Bondholders Council Protection was only founded in 1934.

[3] Kelly (1998) and Kamlani (2008) evoke Ecuador as an exceptional case of a defaulting government having succeeded in avoiding this global exclusion. After having defaulted on its foreign debt in 1909, a Railway Company with state guarantee issued new bonds in Paris in 1911 and the government issued a short-term loan in the US in 1910 (Corporation of Foreign Bondholders, Annual Report 1911). Kamlani also mentions the case of Guatemala, whose government reportedly obtained credit from the US and Germany while being in default to British bondholders. The original source (CFB Annual

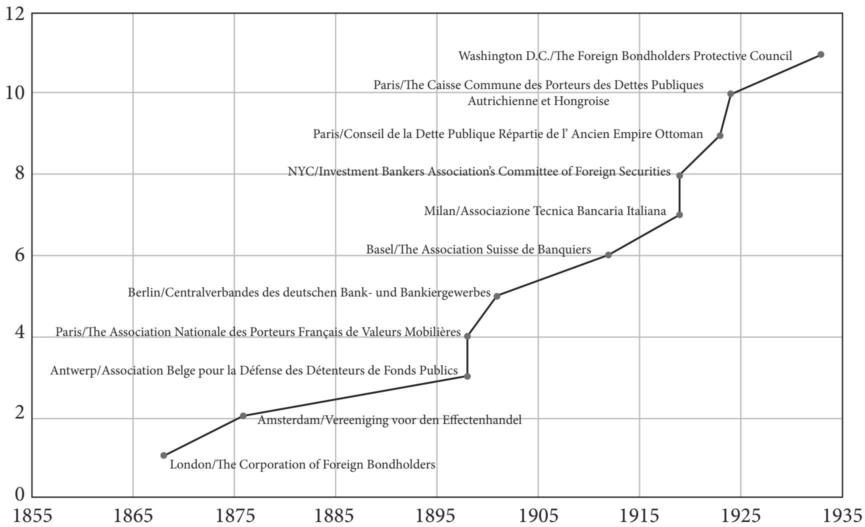

Figure 7.1. Main bondholder committees, 1868–1934 (by year of foundation)
Source: Winkler (1933) and online sources for dates of foundation

Yafeh (2003) report that such coordination efforts convinced the Mexican government to negotiate in 1874 while similar actions were undertaken during default negotiations with the Greek government in the same year. Debtor countries were thus under strong reputational incentives to work out a solution with bondholder committees in order to avoid being cut off from capital markets. In 1873, the CFB in London partnered with Amsterdam to prevent Guatemala from issuing a new bond because of its failure to repay old loans. During the period 1870–1914, bondholder committees reached their gold age, making the cost of defaulting on its foreign obligations a prohibitive one (Mauro & Yafeh, 2003).

The coordination function of CFBs weakened considerably during the 1930s. For instance, the correspondence held by the British Corporation of Foreign Bondholders shows that it actively sought, but ultimately failed, to establish a close collaboration with the US bondholders committee and the US State Department.[4] Without transatlantic coordination, the British CFB privately recognized that its bargaining position was sluggish. During the negotiations with

reports of 1895 and 1908) is unclear regarding the chronology of the arrangement (1895) and the issue of a new loan in Germany, but the dispute referred to in those documents concerned mainly the security for the new loan (Coffee Warrants) and the respective priority over these assets.

[4] See, for instance, London Metropolitan Archives (LMA), Archives of the Corporation of Foreign Bondholders, files Ms34661/3 and Ms 34661/4. Elliot Butler, Director General of the CFB, pushed the idea of an 'Anglo-American approach to all foreign governmental external debts composed of both dollar and sterling loans', an idea supported by the British Treasury (as expressed by Rowe-Dutton) and by the Bank of England (as expressed by Otto Niemeyer).

Chile's government in 1945, Otto Niemeyer from the Bank of England recognized: 'we are unlikely to get anywhere without US support.'[5] Very often therefore, each committee attempted to obtain a favourable bilateral agreement with defaulting governments. One reason for this, as argued by Eichengreen and Portes (1989), were the original terms of the loan contracts issued in London and New York, which were drafted differently and led to occasional disputes between the British and US CFBs. An illustrative example of these disputes were the guarantees granted to each loan. Contrary to dollar bonds, most sterling loans were secured, and bondholders insisted that such loans received a preferential treatment over the US (non-secured) loans. In many instances, the British CFB also blamed the US Foreign Bondholders Protective Council for settling unilaterally with defaulters, as this obliged British bondholders to accept the same terms (Eichengreen & Portes, 1989, p. 216).

Another contrast between the post-1940 period and the pre–First World War years was the role of creditor states. Bondholder committees had always entertained close relationships with government authorities. Before 1914, government diplomats provided bondholder committees with some degree of cooperation with respect to routine tasks. They also served as liaison in the country where they operated. But states seldom intervened in debt disputes, performing only a passive, subsidiary role (Lipson, 1985). This is reflected in US Secretary of State Bryan's dictum: 'When you go abroad you have to take your chances.' The British Foreign Office operated under a similar frame of mind in accordance with the Palmerson doctrine—'When people choose to lend money to a foreign country, they [do] so at their own risk' (Williams, 1924, p. 18)—that forbade British authorities to provide 'authoritative representation' in support of the bondholders.

As a rule, governments acted as the sword arm of private creditors only when the mediation of bondholder clubs had failed. Episodes of gunboat diplomacy in the aftermath of a sovereign default were rather infrequent (Flores, 2012; Tomz, 2006, pp. 114–57).[6] Far from mechanical, creditor state support required a great deal of persuasion from bondholders. And creditor state–lent military support against recalcitrant countries only when they found political and diplomatic interest to do so. Episodes of gunboat diplomacy were few but rather 'loud' events because of the use of military force and the social and human toll exacted on the invaded territories. In Egypt and North Africa, England and France granted diplomatic protection to their bondholders because doing so intersected with their agenda to expand colonial rule. Geopolitical interests were also relevant in Southern Europe and the Middle East, where creditor governments established Commissions of Foreign Control. In cases such as Greece, Serbia, or the Ottoman

[5] Letter by Otto Niemeyer to Mather-Jackson from the Treasury Chambers, 25 June 1945, LMA, Ms 34661/4.

[6] See also Coskun Tunçer and Flores Zendejas & Cole in this volume.

Empire, bondholder representatives directly participated in the decision-making of fiscal policies.[7] To summarize: debt talks were mostly a private matter that concerned the debtor country and his private creditors. Support from the official sector only provided a dissuasive 'plan B'.

The Great Depression durably undermined the structure of capital flows. Sovereign debt market evaporated after 1931, debt issuances came to a halt along with the fall of capital exports from the US, and bondholder committees lost their most precious bargaining power (Jorgensen & Sachs, 1988). The threat to block a country's future debt issuances was persuasive only in a context of continuous sovereign debt borrowing. With the global retreat of external debt markets, this threat had lost its dissuasive authority on defaulters. The post-war financial order relegated CFBs to the background: few countries issued, domestic and official lending dominated bond financing and the reputational system that bondholder clubs had spent decades to build no longer mattered. The structural dependence link between the repayment of past debt and the issuance of future debt that creditors had long exploited to force debtors to repay their debt no longer existed. The great bargaining power that creditors had enjoyed during the first globalization through their bondholder committees was, after all, fragile and reversible.

Nevertheless, this dull horizon does not show the whole picture. Faced with the declining significance of bondholder committees, creditors increasingly sought the mediation of their governments. The first signs of creditor states' expanding role were manifested in the onset of the Second World War. The US government developed a financial strategy based on geopolitical interests.[8] This involved a direct participation in the negotiations with foreign governments willing to secure US aid and public loans (Adamson, 2002). The final outcome, as perceived by the bondholders, was far from satisfactory (Kamlani, 2008). In the case of Mexico, the US government pressed US creditors to secure a financial settlement (Aggarwal, 1996). Roosevelt insisted in 1941 that the US investors (represented by the so-called International Committee of Bankers on Mexico) acknowledged the Mexican government's programme for debt repudiation. During the 20s and 30s, the inflexible behaviour of US creditors toward Mexico had poisoned Mexican–American relations. But this legalistic approach to repayment increasingly ran up against governmental interests. Anxious to enlist Mexico into the war effort, Roosevelt called to normalize the economic relations between the US and Mexico, persuading JP Morgan, the coordinating force behind US bondholders, to forbear a portion of Mexican debt. For the US government, debt had become a secondary concern to the most pressing issue of bolstering diplomatic and trade

[7] See Pamuk (1987) and Tunçer (2015).

[8] For the case of Latin America and the effects of the 'Good Neighbor' policy of the US government on debt negotiations with Latin American governments, see Wallich (1943).

ties with foreign allies. The sovereign interest of the US government prevailed with the signature of the debt settlement of 1942 providing for the drastic reduction of both the principal and interest (see Del Angel and Pérez-Hernández contribution in this volume).

A similar pattern occurred in Egypt. The relationship between British bondholders and the Foreign Office had long been marked by a spirit of cooperation and mutual interests. After the Egyptian default of 1876, England used military force to oblige Egypt to repay foreign bondholders, and episode that ended in full colonization after 1882. A Public Debt Commission ('Caisse de la dette') was organized to maintain regular debt service and give foreign creditors (British and French for the most part) a direct line of communication with Egyptian officials (Saul, 1997; Wynne, 1951). The British support for its bondholders began to vanish since the early 1930s, when disputes over the interpretation of gold clauses emerged and the British government positioned itself on the Egyptian government side.[9] In 1940, the British government sought to bolster its ties with Egypt, which British officials (quite rightfully) predicted would play an important role during the war. In July 1940, in the midst of the Battle of London, British and French authorities reached an agreement with Egyptian authorities concerning the dissolution of the much-hated Caisse. The revenues payable to the Caisse would be assumed by the National Bank of Egypt and by Egypt's government.[10] Most importantly, the agreement gave Treaty recognition to Egyptian authorities' request to redeem its foreign debt in pounds sterling, something that British creditors adamantly opposed, claiming their rights to receive debt repayment in gold, and this in spite of Great Britain's abandonment of the gold standard in 1931. Taking advantage of this provision, Egypt redeemed at par her outstanding foreign loans in 1943.

It is an understatement to say that creditors did not appreciate states meddling into their affairs. But creditors' defiant attitude towards their own governments began to change after the War. In the face of uncooperative behaviour from defaulting and recalcitrant governments, the threat to block market access was no longer dissuasive because markets were shut down. Creditors were left with no other choice than to seek the mediation of their governments to press their rights. Of course, when debtor states were cooperative, creditors could still rely on the mediation provided by bondholder committees to reach a settlement. In Japan, US and British creditors obtained the resumption of debt service at the full contractual rates. But when state debtors had neither the will nor the capacity to repay,

[9] See Bank of England Archives, File C40/270. A letter addressed to Montagu Norman, governor of the Bank of England, by Frederick Leith Ross, chief economic advisor to the British government, dated 26 July 1932, referred to the importance of the support to the Egyptian Government based on 'political grounds'.

[10] The correspondence and text of the agreement can be found in the Bank of England Archives, file C40/270.

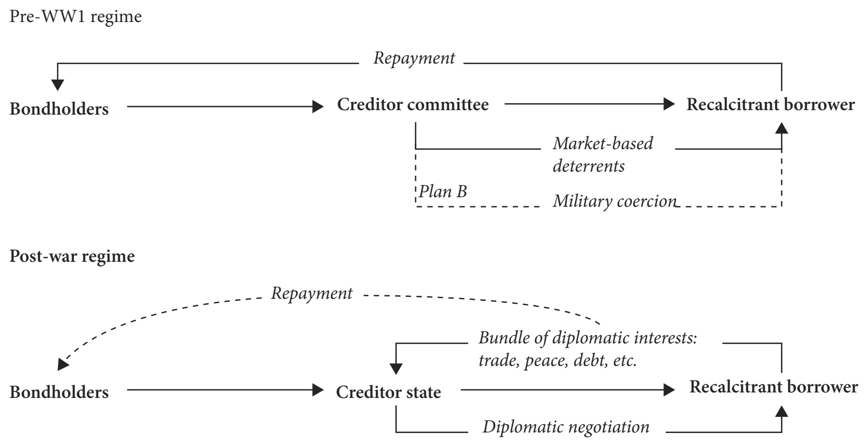

Figure 7.2. The new political economy of debt dispute settlement before and after the Great Depression

foreign creditors depended ultimately on brokerage resources from their representative states.

As a result, the post-war period was marked by the transfer of the functional control over international enforcement of sovereign debt claims from creditor committees to creditor states. In the hands of states as ultimate enforcers, bond contracts lost their universal validity and their value became contingent upon diplomatic recognition. Debt became one layer or tranche of interests in the bundle of interests (peace, commercial interests, etc.) which a state was prepared to defend during interstate negotiations (cf. Figure 7.2).

7.3 When Debt Repayment Takes the 'Backseat'

The much-discussed case of Germany cements the view that political and commercial interests primed over debt repayment. German debts amounted to about 800 billion DM, a sum that no one expected Germany could repay. At the London Agreement on German External Debts of 1953, commercial and trade issues prevailed over the issue of debt repayment (see de la Villa's contribution in this volume). The macroeconomic background mattered considerably when assessing the validity of debt claims. In the next twenty-five years, trade and debt policies became intimately connected.

The emergence of state-sponsored Export-Import banks ('Exim Banks') further affected bondholders' private bargaining power. The first of such banks was created in England in 1919. As shown in Figure 7.3, the development of Exim Banks accelerated during the early 1930s and then after the war until the late

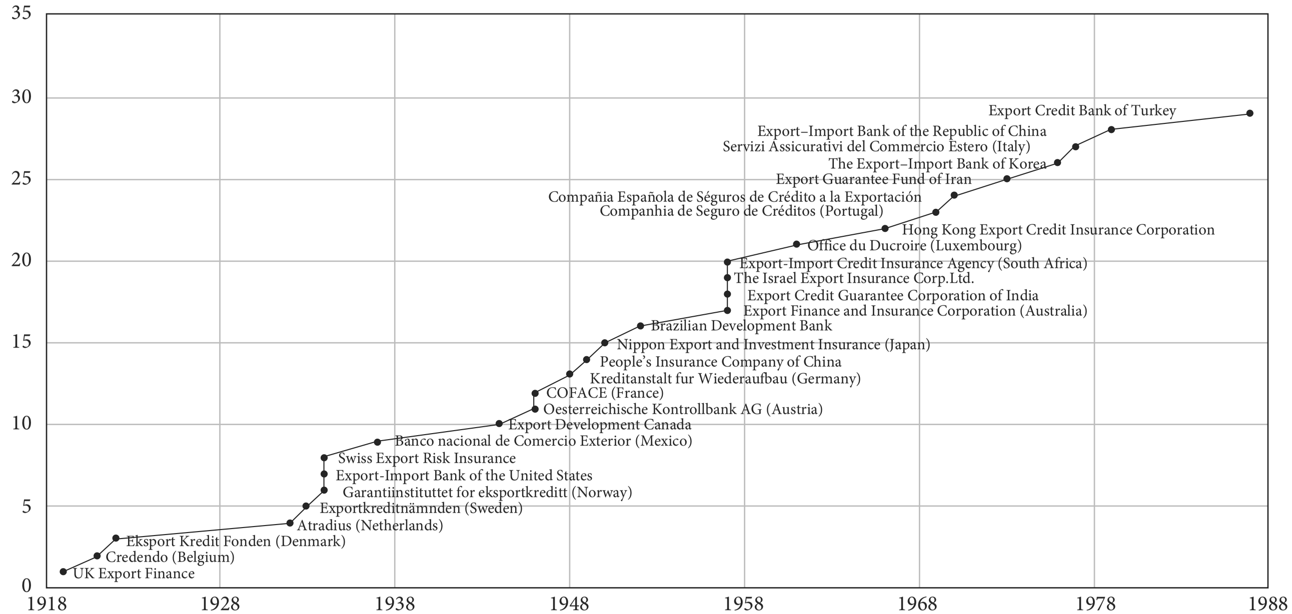

Figure 7.3. Exim banks, 1919–89 (by year of foundation)

Source: OECD (2002)

1950s, precisely when bond financing, which since the nineteenth century had provided states with their main source of external financing, was in disarray. During those years, the market for commercial credit remained open, providing tremendous incentives for countries to stay current on their commercial debts.

In the United States, Exim Banks were a lever that state authorities used to pressure debtor states to service their external debt. But at least in their early years, Exim Banks refused to link trade policies to debt repayment. From the US Export-Import Bank semi-annual reports, we have computed a total of forty loans from the bank granted to countries whose governments were in default regarding their dollar debts between 1945 and 1962. In its report for July–December 1945, the US Exim Bank announced that following a request from Congress, it would remove any prohibition on loans to countries in default. It further insisted that 'the bank has not ordinarily made payment of service on outstanding dollar obligations a condition of its loans to foreign countries' (Export-Import Bank, 1945, p. 29). Disgruntled bondholders criticized the extension of commercial credits to defaulters, and pressed their governments for a change in this policy. That countries in default could access external capital sent strong signals that the reputational cost of default was in fact negligible. This undermined the bargaining power of creditors. Placing defaulters under trade embargoes would have bolstered bondholders' bargaining power. But, in general, state authorities refused to accede to creditors' calls for commercial sanctions against defaulters. This is particularly true to the US government and to a lesser extent Britain. France and Germany, on the other hand, were more prompt to intervene in support of bondholders (Wynne & Borchard, 1933).

The claim that bondholder interests took the backseat seem particularly relevant in the US where the common practice was to not make Exim Bank loans conditional upon the resumption of debt service, though the US government could encourage borrowing governments to show a tangible will to settle its disputes with its creditors. Most often, nevertheless, decisions to extend such loans were premised on politics (Eichengreen, 1991, pp. 163–4). The Mexican debt agreement of 1942 was followed the same year by a trade agreement involving the extension of credits through the US Exim bank to finance highway construction in Mexico (Wynne, 1951, pp. 95–6). In the 1940s and 1950s, the US Exim Bank also granted different loans to Chile, Bolivia (both defaulters), and Argentina to finance infrastructure projects. Official flows also served to finance commercial arrears on imports from the US (Jorgensen & Sachs, 1988).

US-Latin America trade relations experienced a boom under the Roosevelt administration. In a 1939 speech, Roosevelt warned Congress that defaulted Latin American bonds were 'ancient history' (Eichengreen, 1991, p. 164). The President urged creditors to put the national interest above their own. On some occasions, the US administration invoked diplomatic interests to pressure bondholders into accepting important reductions in interest payment. Roosevelt even presented a formal apology to the President of Bolivia, blaming the greed of US bankers as chief causes for the default on a loan contracted in 1927 and claiming that 'the era of financial exploitation in Latin America was over.'[11] It should be noted that the situation was somewhat different in the UK, where debt repayment was construed by state authorities as standing within the public interest.

Switzerland is another illuminating case of our argument of debt repayment taking the 'back seat'. In the 1970s, Swiss banks continuously granted a set of loans to the government of and companies from Rhodesia despite a default in 1965.[12] The Swiss financial market became an attractive alternative to borrowing states that used to obtain their external funds from London or New York. After 1952, South Africa became a recurrent borrower in the Swiss market.[13] Swiss authorities were also pursuing an aggressive policy of exports promotion, and many of these loans were accompanied by promises for purchases of Swiss products. This example also exposed the lack of coordination between investors in the post-war era, as trade raised to a prominent level.[14] As a result, the attitude of the British authorities was to refrain South Africa's government from seeking loans from other countries or from the IBRD and IMF, as this could also prejudice UK exports.[15]

Creditors struggled to adapt to this new context of contingent validity of debt claims. But there was not much that creditors could do if they failed to obtain diplomatic representation of their private debt claims. Additionally, creditor states' reluctance to use military force to help creditors recover their claims also weakened the bargaining power of creditors. Disappointed by the trade-off between commercial interests and debt repayment, creditors began to contemplate alternative tactics to force repayment. Although creditors relied primarily on the extrajudicial enforcement of creditor states, they were also keen on exploring the possibility of having their debt claims adjudicated in international courts when the mediation of their home state proved unsatisfactory or inefficient.

The IBRD assumed a friendlier stance to bondholders' committees. The need by this new body to borrow from private capital markets imposed a policy in which the bank would avoid lending to governments in default (Lienau, 2014). Very often therefore, governments would negotiate with bondholders when the possibility for securing a IBRD loan was imminent. This was the case of the default settlements of Chile (1948), Ecuador (1955) or Peru (1952), which were

[11] 'President Says Old Bolivian Loan Was Exploitation', *The New York Times*, 8 May 1943.

[12] Swiss National Bank Archives, Box 264.252.

[13] Swiss National Bank Archives, Box 2.6/2144, 'Die Schweizerische Kapitalanlagetätigkeit in Ausland seit Kriegsende, 1950–1983'.

[14] The practice known as stock exchange 'shopping' has always been a tactic pursued by defaulters. Recall that, in the nineteenth century, the British CFB was never able to reach a settlement about US states' defaulted debt precisely because the US developed a rival debt market.

[15] Bank of England Archives, file C40/1216, correspondence between the Foreign Office and the Bank of England, 1966.

immediately followed by a loan from the IBRD. But even then, governments in creditor countries would press its bondholder committees to accept the offers from defaulting governments to allow them to benefit from these public loans. This also included unilateral offers from the governments with which the Foreign Bondholder Protective Council (hereafter FBPC) did not necessarily agree.[16] Furthermore, the IBRD granted several loans to Yugoslavia despite the country being in default (FBPC Annual Report, 1953–54). There was the competition with the Exim bank, which was finally settled in 1953 with the announcement of a State of Principles, in which the IBRD would concentrate in loans for development purposes and the Exim bank would confine itself to short- and medium-term commodity loans, though certain exceptions were foreseen and it managed to continue to provide an important tool for export promotion and to achieve foreign policy goals.

7.4 Bumpy Legal Roads Towards Repayment

State mediation posed important problems for creditors, one being the concern over inequality of treatment. Unequal treatment was a manifestation of the way talks were structured: since state mediation was organized along territorial borders, debt talks were fragmented along national borders. In certain cases, a group of bondholders was given preference as compared to others. For instance, in 1954 the government of Ecuador reached an agreement with the US FBPC and British CFB, but it excluded a Railway loan originally issued in Paris (Foreign Bondholder Protective Council Annual Report, 1954). That Ecuador's government was a defaulter (at least in the view of French bondholders) did not prevent the World Bank from granting a loan in 1954. In the case of Costa Rica, the government first reached a deal with the FBPC before having one with the British CFB one year thereafter. A similar case concerned Peru, for which the initial debt agreement of 1951 included only Peruvian's dollar bonds, while British bondholders could only reach an agreement two years thereafter. These cases show debtor countries actively exploiting the competitive dynamics building up between different bondholder clubs. In the face of the costs implied by bilateral debt disputes, national rivalries grew within bondholders. In some cases—as in the cases of Japan and Norway which we present below—creditors sought alternative means to remedy broken contracts.

The Japanese government first reached an agreement with US bondholders in July 1952. Negotiations with the British and French bondholders had to be prolonged because of rival interpretations of currency clauses in the debt

[16] Kamlani (2008) mentions the offers by Colombia, Peru, and Brazil in the 1940s.

contracts. The British succeeded in achieving an agreement in the same year, one that was to have the approval of the US government and the FBPC.[17] After the French government's failed mission to convince the Japanese government to honour the gold clause included in bonds, French bondholders appointed a Conciliator (Mr Black, President of the IBRD) to settle the dispute. The settlement involved a revalorization of bond value to take equitable account of the severe depreciation of the yen but the settlement fell short on recognizing French bondholders' contention that bonds included a gold clause (Waibel, 2011, pp. 80–1).

The dispute between French bondholders and Norway is also interesting along those lines. French bondholders bought Norwegian bonds from 1925 to 1955. The key question was whether debt payment was due in gold or in kroner currency. Norway refused to recognize the gold clause inserted into bond contracts. French creditors attempted to elevate debt claims against Norway to the International Court of Justice. But the court was not receptive to French bondholders' claims (in the meantime, Norway obtained new loans from the Swiss financial market). The Court denied jurisdiction because it deemed the dispute an interstate issue. The lack of reciprocity was another argument cited by the court: since the state of France did not acknowledge the jurisdiction of the court, the Court refused to seize upon the case. This case is not an isolated one: international forums frequently declined jurisdiction (Borchard, 1915, p. 302; Schoo, 1940, pp. 410, 437; Weidemaier, 2010, p. 340).

These examples suggest that law provided a weak remedy against non-repayment. Legal instruments provided little protection for bondholders and did not effectively contribute to hold debtor countries to their contractual obligations. As a rule, debt was negotiated not litigated (Borchard, 1951). The post-war context is instructive of an important change affecting bondholders' expectations regarding international law. The early development of arbitration in late nineteenth century was construed by investors as a method to enlist creditor state support of private claims (Weidemaier, 2010). The reluctance of creditor states to provide diplomatic protection of bondholders' rights led them to reconsider. They developed the idea—and this was a novel idea—that they could themselves elevate their claims to legal forums without the mediation of the creditor state. What creditors could not obtain through the diplomatic channel, they began to pursue through legal methods. As we have suggested this new representation was not immediately consequential. In Japan and Norway, international forums refused to accede to French creditors' claims. Courts extended jurisdiction only to interstates disputes, meaning that states had to have accepted to submit to arbitration, which France hadn't. Sovereign immunity is another cause for the complicated

[17] London Metropolitan Archives—CFB, Ms 34727/4.

development of international law. This is shown in the court's fear of over-extending its jurisdiction. The chance of successful legal action was limited under the principle of sovereign immunity, a principle well institutionalized until the mid-1950s which made it virtually impossible for bondholders to sue sovereign debtors.

7.5 Inter-Period Performance Assessment

As economists and historians have noted, the post-war context did often not generate favourable settlements for creditors and was often quite harmful to their interests. But we still lack precision as to how post-war debt settlements compare to settlements reached during previous periods. This section provides a comparative assessment of the outcome performance of debt dispute resolutions across three periods. Our analysis uses two metrics of performance, namely 1) the duration of debt disputes (measured by the time span between the outbreak of debt-servicing incapacities and the final conclusion of the debt settlement arrangement), and 2) bondholder losses (estimated from three indicators: a) the capitalization rate of arrears in interest, b) reductions in outstanding debts, and c) reductions in interest rates).[18] We applied these metrics to debt settlements from three periods: the pre–First World War period (1868–1914), the interwar (1919–33), and the Second World War and post war years (1940–73). As suggested above, the starting years for each period (1868, 1919, 1940) correspond to a major turning point (the creation of the British CFB, the signature of the Versailles Treaty, and the beginning of the Second World War, respectively) in the history of sovereign debt.[19]

Based on our reasoning developed in the previous sections, our presumption is that these periods are characterized by different degrees of bargaining power (i.e. the capacity of private creditors to act strategically to force the repayment of debt) and conceptions of state responsibility (i.e. broad conceptions that govern states' decisions to intervene into debt disputes). We expect that changes in creditors' bargaining power and conception of state responsibility will translate into more or less favourable terms for creditors. Additionally, we expect to witness substantial variations in debt settlement outcomes within each period, most particularly during the post-1945 period.

During the nineteenth century, bondholder committees had enough bargaining power to coerce recalcitrant borrowers to repay their debt in time and in full. Defaulting countries were blacklisted from Europe's capital markets. Those who

[18] To compute bondholder losses, we updated the database originally compiled by Suter (1990, 1992).

[19] Our analysis does not cover settlements reached between 1933 and 1940 because they were too few. Debt liquidations that included the assignment of state railways to bondholders have also been excluded (El Salvador and Peru). For these two cases, we were not able to compute creditors' losses.

accepted creditors' terms could regain access through a process known as 'white-listing'. Not only creditors possessed bargaining power, but they could also count on the diplomatic mediation of their home state to remedy broken contracts. As explained above, the diplomatic channel was not always available. But when states accepted to intervene, their diplomatic mediation generally worked in favour—not against—creditors. Overall, due to high bargaining power and occasional support granted to them by their home states, we expect that debt settlements from 1868 to 1914 generated favourable terms for creditors, both in terms of duration and bondholder losses.

The interwar period witnessed the emergence of the Reparations Commission and the League of Nations, whose active implication in the settling of debt disputes compromised the uncompromising stance adopted by creditors before 1914. During the Great Depression sovereign debt market evaporated after 1931 and debt issuances came to a halt. As a result, bondholder committees lost their most precious bargaining power.[20] From the 1940s onward, the rising influence of the US State Department and Exim banks further eroded creditors' claims. These new political actors conveyed a radically different conception of state responsibility in which debt was relegated to a secondary concern to the most pressing issue of rebuilding diplomatic and trade ties with foreign allies. This resulted in states adopting a stance of forbearance towards defaulters. Given this combination of lower bargaining power and forbearance, we expect that debt settlements after 1918 began generating less favourable terms for creditors, both in terms of duration of negotiation and creditors' losses as compared to the pre-1914 period. Our assumptions are broadly verified (see Table 7.1). Table 7.1 shows that the duration of negotiations and bondholders' losses were at their lowest during the first period which corresponds to the 'pure' CFB-based regime (1868–1914). The first column of Table 7.1 shows that the CFB participated as main mediators in 86 per cent of the cases reported.[21] Governments' remained at a secondary stage as they directly intervened in 24 per cent of all cases.[22] The duration of debt disputes increased from 6.1 to 9.5 years from the first to the second, interwar period (while losses remaining stable at 18.9 per cent), which suggests a more hostile context in which bondholders had to negotiate harder and longer to obtain comparable settlements. The post-1940 context is markedly different with considerably longer negotiations (18.8 years) and massive private losses (just over 50 per cent), while governments increased their assistance (more than 52 per cent

[20] A good illustration for the loss of this power source and the consequent weakness of the CFB in the post-Great Depression period are the settlements of defaulted pre-war bonds concluded in the 1980s with the Soviet Union and China, where the CFB had to accept quite unfavourable arrangements negotiated by the British government which was interested in opening up the London bond market to these countries.

[21] The prominence of CFB representation in debt settlements is reported in Esteves (2013).

[22] These interventions are broadly defined: military, customs' control, diplomatic participation, and financial support. These interventions also include those from international organizations.

Table 7.1. Yearly duration of debt dispute settlements and degree of bondholders losses

	Bondholder committees as main mediators (in percentages)	Direct government intervention (in percentages)	Average duration of debt dispute settlement (in years)	Average bondholders' losses (in percentages)
1868–1914	86.0(45)	24.4(45)	6.1(47)	18.9(42)
1919–1933	92.9(14)	58.3(12)	9.5(14)	18.9(11)
1940–1973	73.9(23)	52.2(23)	18.8(23)	50.1(23)

Number of agreements in brackets.

Note: The boundary between the periods is, of course, more fluid than suggested by our periodization. Yet we chose this characterization in three periods because it broadly aligns with the conventional representation adopted by financial historians. Our data suggests—although we are unable to present these results within the scope of this chapter—that the content and conditions of settlements also varied within the three financial periods.

Source: Updated data originally from Suter (1990, 1992).

of all cases), albeit assuming a different approach. These findings suggest that CFBs no longer had the upper hand in debt dispute negotiations. The creation of the US Foreign Bondholder Protective Council in 1934 did not contribute to reverse creditors' gradual loss of bargaining power. Several cases in our data show that the US FBPC, unlike the British CFB during its heydays, did not succeed in blacklisting defaulting sovereign borrowers on the New York stock exchange and blocking new lending.

A telling example are the exchange bonds unilaterally offered by Peru in 1949 to buy back bonds that have been defaulted in 1931. This offer came after several years of unsuccessful negotiations between Peru and the FBPC and CFB. FBPC representatives complained bitterly about the offer to the British CFB but acknowledged that they were 'powerless to stop it' (Kamlani, 2008, p. 146). Interestingly, the terms of the final agreement concluded between Peru and the FBPC (which was reached only two years later) have been rather similar to the 1949 unilateral bond offer which creditors had refused.[23] These rather favourable conditions for Peru represented a loss of about 60 per cent for US bondholders (thus slightly above the period's average). The British CFB, finally, concluded a settlement with Peru on the Sterling bonds in 1953. The fact that the terms of this agreement were identical to the FBPC settlement conditions powerfully suggests the erosion of bondholder committees' bargaining power.

[23] The offer included a reduction in interest rates from 6–7 per cent to 2.5 per cent and a full debt release of all arrears of interest, whereas in the final agreement of 1951 interest rates were reduced from 6–7 per cent to 3 per cent and arrears of interest were capitalized at 10 per cent.

We interpret higher levels of creditors' losses after 1940 as the effect of the new forbearing stance adopted by creditor states during and after the Second World War. This is especially true for the US State Department, which intervened in several debt disputes in order to protect the political, economic and strategic interests of the US, with detrimental effects on bondholders' financial interests, which were then subordinated to national US interests. As stated above, such diplomatic interference ran high in several high-profile cases. As already explained (see also Del Angel & Pérez-Hernández in this volume), the extremely favourable settlement obtained by Mexico in 1942 was due in large part to the Roosevelt administration's quest to bolster diplomatic and trade ties with a country it hoped to turn into an ally during the Second World War. Another telling example is the lending into arrears policies of the US government in, for instance, Bolivia (in the 1940s) and Yugoslavia (in the 1950s). Bolivia received loans for infrastructure construction from the US Export-Import Bank, as part of a general effort by the US government to boost its exports to Latin American countries. In additional to US capital, Yugoslavia received loans from the World Bank and IMF at the time when pre-war bonds were still in default. Granting such loans carried strategic meaning in the then particularly tense political context in Eastern Europe (Lampe et al., 1990).

In a great many cases, debt agreements were reached within inter-governmental frameworks, which often involved political or economic aspects such as investment or trade. Switzerland held bilateral trade agreements with Bulgaria, Poland, or Czechoslovakia. In later decades, these agreements would also encompass access to private capital markets. China settled its debt disputes under an inter-governmental agreement with the UK signed in June 1987. This agreement allowed (only) British bondholders to recover about 5 per cent of the value assigned to the bonds that had been in default since 1939 (CFB Annual Report, 1988). China's government regained access to London's capital market, after being barred during several decades (*New York Times*, 8 June 1987). On the contrary, US bondholders did not succeed in excluding China from US capital markets and, as a result, never obtained any compensation for their unpaid bonds.

7.6 Conclusion

Sovereign debt disputes are as old as bond financing itself. During the post-war context, the locus of debt disputes shifted to the interstate level. Dispute resolution became firmly anchored within the ambit of state authority. Government pursued peaceful modes of negotiation and abandoned gunboat diplomacy. But the attitude of creditor states towards bondholders was selective since creditor states' lending of diplomatic support was contingent upon states' interests. In some cases, governments granted diplomatic protection to bondholders and help them recover their debt claims. But in other cases, states emancipated themselves from their domestic creditors and pushed debtor states to forgive a large portion of their external debt in the name of political, diplomatic, and commercial interests. This spirit of forbearance was a defining trait of post-1945 settlements. After the Second World War, states were a far cry from serving as 'protectors of private capital', a role which they began to assume after the 1980s (Abdelal, 2007).

The legacy of the post-war years is hard to assess with precision. As a rule, post-war interstate negotiations unfolded in a disorganized fashion outside any institutional pattern. After the First World War, the World War Foreign Debt Commission successfully restructured the debts of European countries during a single negotiation event (Waibel, 2011, pp. 119–20). The only post–Second World War international event that compares to the WWFDC is the London conference on German debt. The conference was a resounding success: for the first time in history the entire debt of a major industrialized country had been renegotiated in one comprehensive plan (see de la Villa in this volume). But, unfortunately, this ad hoc experience was not codified into hard, legal principles of international debt restructuration. As a result, the forms of diplomatic involvements that prevailed during these years—and the spirit of forbearance often adopted towards defaulters—did not translate into new institutions. This all but guaranteed that the norm of repayment would once again prevail once creditors recovered their bargaining power. The revenge of defaulters would be short-lived after all.

Yet, this chapter suggests that the post-war era fathered new habits and modes of legal reasoning. In particular, this period reflects an important change in creditors' preference towards legal remedies beyond creditor state representation. Until 1914, legal methods of enforcement like arbitration clauses were not meant to open to litigation but served merely to enlist the participation of creditor states in sovereign debt disputes (Weidemaier, 2010). After 1945, creditors developed new modes of legal reasoning which would durably alter future episodes of debt restructuring. In the event states refused to lend creditors their diplomatic support, creditors turned to international courts, expecting that these courts could serve as the prime enforcers of broken contracts. We showed that, in many instances, international courts refused jurisdiction. For instance, the International Court of Justice refused to recognize the claims of French bondholders against Norway because it deemed the dispute an interstate issue. 1950s courts were cognizant that international debt contracts stood outside their competence.

This interpretation of sovereign debt as an interstate matter began to erode following the US legislative decisions to weaken the doctrine of sovereign immunity in the 1950s. The US repeal of sovereign debt immunity provided impetus for debtor litigation and arbitration as means to sanction recalcitrant borrowers (Buchheit, 1995). The post-1970s context has seen an increasing 'legalization' of debt markets. Over the last three decades, international creditors have increasingly resorted to litigation in national courts, though without much success. Studies in law and society have noted that international law is not nearly as triumphant as it is usually felt. Not only litigation delays the resolution process (Trebesch, 2008), it also weakens the prospect of effective resolution (Bi, Chamon & Zettelmeyer, 2011; Krueger, 2002). Another development is arbitration, in particular the initiative to take a defaulting country before the International Centre for Settlement of Investment Disputes (ICSID). This legal option has yet to produce the desired results (Waibel, 2007). The role of international law in the stabilization of creditor–debtor interactions is more wish than reality.

The premise of this chapter—and of this volume as a whole—is that the meaning of debt, the sanctity of contracts, and the extent to which debt can and should be repaid have been controversial subjects and will remain so in the years to come. Debt conflicts are inherent to sovereign indebtedness, rather than anomalies that could be cured. This observation finds substance in the post-1980s context. According to Cruces and Trebesch (2013), the recent decades have been marked by a dual pattern of financial uncertainties. On the one hand, despite the availability of legal recourses, bondholders' losses—as measured by haircuts—have increased, though this increase has been variable across cases. On the other, governments have faced tougher sanctions, being often excluded from debt markets after a default. In the light of the above, reducing the cost of sovereign defaults is a critically important task that should concern both creditors and debtors.

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