ONE

Historical Context

The Export of Capital and Sovereign Debt Crises, 1815–1914

Starting about 1815, when the Napoleonic Wars ended and the Concert of Europe, or Pax Britannica, was established, the newly industrialized European states began exporting capital to the periphery.[1] Great Britain, the most advanced industrialized country, led the way but was soon joined by France, Germany, Switzerland, and the Low Countries.[2] By the end of the nineteenth century the United States, until then the largest borrowing country, also began to export capital, primarily to the Far East and Latin America.[3] The process continued throughout the nineteenth century and the beginning of the twentieth century up to World War I, despite numerous intervening debt defaults by borrowing states, the failure of important financial institutions, and periodic financial crises. Capital was exported through the capital markets of the advanced economies largely to sovereign states in the periphery (at present known as developing or emerging market countries, depending on their economic status).

Loans also went to great powers, empires, and former empires—Russia, the Ottoman Empire, the Austro-Hungarian Empire, China, Spain, and Portugal, as examples—who were often in financial distress. As the century progressed, Great

TABLE 1-1. British Overseas Investments in Publicly Issued Securities, 1913

Region or area	*Millions of British pounds*	*Percent*
Total British Empire	1,780.0	47.3
Total Latin America	756.6	20.1
Total Europe	218.6	5.8
All foreign countries	1,983.3	52.7
Total	3,763.3	100.00

Source: Herbert Feis, *Europe: The World's Banker, 1870–1914* (London: Frank Cass, 1936), p. 27.

TABLE 1-2. British Overseas Investments in Publicly Issued Securities, December 1913, by Category

Class of security	*Millions of £*	*Percent*
Government and municipal	1,125.0	29.9
Railways	1,531.0	40.6
Other public utilities	185.1	5.0
Commerce and industry	208.5	5.5
Raw materials	388.5	10.3
Bank and finance	317.1	8.4
Total	3,763.3	100.0

Source: Feis, *Europe: The World's Banker*, p. 27.

Britain began to concentrate its loans in the areas of recent settlement—Canada, New Zealand, Australia, and the United States—where the human capital was able to productively absorb the financial capital. Finally, Britain exported capital to its colonies, above all India (see tables 1-1 and 1-2). Most of these loans were private, raised in the London capital market or the European bourses in the form of long-term debt, usually fifty-year bonds. At times, when countries were in deep distress and the bond markets unavailable to them, they borrowed via floating debt or short-term loans arranged by the issue houses, later known as merchant banks.[4]

During the nineteenth century, defaults on sovereign loans were frequent, particularly to newly independent republics in Latin America or to Greece and the older empires. Some sovereign debtors defaulted for an extended time period. Many of these same debtors were at the heart of sovereign debt crises in the interwar years and the Great Depression (discussed in Part I of this book). Also, several of these debtors featured prominently in the debt crises of the early 1980s or the emerging market crises of the 1990s and early 2000s (Parts II and III of this book), and some featured prominently

in the rescue packages or "bailouts" during the crisis of the early 2000s in the eurozone (Part IV of the book). Some countries were serial defaulters who lacked either the capacity or the will, or both, to service their sovereign debts. Greece, Mexico, Argentina, and Turkey (the Ottoman Republic) are prominent examples, but they are no means alone among frequent defaulters.

The approach to negotiating debt service disruption soon was well established—creditor committees in the various countries representing the bondholders negotiated restructuring of their loans on a case-by-case basis, with the creditors often consolidating all loans, reducing interest or principal due, or extending the amortization period. The fundamental principle was that a debtor in default could not return to the capital market for fresh capital until its debts were recomposed (today we would say resolved or restructured) and the debtor was servicing its debts. The approach to resolving debt service disruption set a precedent for the sovereign crises discussed in subsequent parts of this book. This chapter provides background for the chapters that follow.

Capital export took place through the intermediation of capital market issues on the stock exchange in London and various European bourses, which became the centers for issues of international shares and debentures. These investments were held largely by private investors, as were the two earliest forms of debt securities issued to the public via the market, consols and *rentes*.[5] As the nineteenth century progressed, merchant banks, sometimes referred to as issue houses, which arranged the initial stock exchange listings for debentures or share issues, took on an underwriting role. They were followed by joint-stock banks (which made direct loans or directly assumed investments), by trusts, and by other investment institutions, all of which achieved a more prominent position in international investing as the century progressed.[6] While the capital markets in each of the primary creditor countries—Great Britain, France, Germany, and the United States—developed in different ways, the main actors throughout this period were in the private sector.[7] Government loans and government guarantees were rare.[8]

Two types of conclusions may be drawn from the history of capital export during the period 1815–1914 with respect to the primary focus of this book, sovereign debt crises and their resolution from the Great Depression to the Great Recession. The first set of conclusions is economic in nature. The second set concerns capital export and the political economy and international relations during sovereign crises.

Economic Conclusions

Loans were initially provided by the London capital market and as the century progressed by France and Germany and a number of the traditional European creditors through their bourses in Amsterdam, Frankfurt, and Zurich (see tables 1-3, 1-4, and 1-5).

Hard-Core Creditors and Their Capital Markets

During this era, 1815 to 1914, a small, "hard-core" group of creditor countries and capital markets emerged as the primary sources of capital export. Financial instruments were primarily long-term bonds floated on the London market and various European bourses and subscribed to by private investors. Export capital was intermediated in London, Paris, Frankfurt, Zurich, and Amsterdam primarily by the merchant banks, which were also deeply involved in trade finance. Later in the century the German "great banks" played a strong role in international finance as Germany increasingly emerged as a great power and competed with Great Britain and France in trade, in railway development, and for colonies (see tables 1-4 and 1-6). Capital export went to countries without their own or with weak capital markets.[9]

Toward the end of the century up to World War I, New York emerged as a source of credit to the periphery, particularly Latin America,[10] and the New York investment banks rivaled their competitors in London. In the interwar years New York assumed the mantle as the leading world capital market. Thereafter the bond markets in New York and London, to a lesser extent the other European bourses, and eventually Toronto, Tokyo, Hong Kong, and offshore convenience centers such as the Cayman Islands constituted the major source of capital export to the rest of the world in the post–World War II era and the emerging markets crises of the 1990s.[11]

The issue houses of this period, the private banking concerns that evolved into merchant and investment banks during the nineteenth century, are the key players in the current eurobond market. Moreover, the money center banks, the successors to the Credit Mobilier movement in France, the German great banks, and the concentration of banking in Europe after 1870 resulted in the formation of the large joint-stock banks,[12] which are now, with the addition of the major U.S. money center banks, the market makers in the eurocurrency market. These banks were responsible for most of the syndicated lending to the developing and emerging market countries during the 1970s and 1980s in the leadup to the 1980s debt crisis.

The recent crisis, known as the Great Recession (from 2007 to 2010 in the United States and from 2009 to 2015 in the eurozone), is anomalous in the post–World War II

TABLE 1-3. French Foreign Investment, as of 1914

Country or region	*Thousands of millions of francs*	*Percent*
Russia	11.3	25.1
Turkey	3.3	7.3
Spain and Portugal	3.9	3.7
Austria-Hungary	2.2	4.3
Balkan states	2.5	5.5
Rest of Europe	1.5	3.4
Europe total	27.5	61.1
French colonies	4.0	8.9
Egypt, Suez, and South Africa	3.3	7.3
United States and Canada	2.0	4.4
Latin America	6.0	13.3
Asia	2.2	5.0
World total	45.0	100.0

Source: Feis, *Europe: The World's Banker*, p. 51.

TABLE 1-4. German Foreign Investment, as of 1914

Country or region	*Billions of marks*	*Percent*
Austria-Hungary	8.0	29.3
Russia	1.8	6.6
Balkan countries	1.7	6.2
Turkey (including Asiatic Turkey)	1.8	6.6
France and Great Britain	1.3	4.8
Spain and Portugal	1.7	6.2
Europe total	16.3	59.7
Africa (including German colonies)	2.0	7.3
Asia (including German colonies)	1.0	3.7
United States and Canada	3.7	13.6
Latin America	3.8	13.9
Other areas	0.5	1.8
Outside of Europe total	11.0	40.3
Total	27.3	100.0

Source: Feis, *Europe: The World's Banker*, p. 74.

TABLE 1-5. German Foreign Investments, as of 1908, by Category

Class of security	*Millions of 1914 marks*	*Percent*
Provincial and municipal	700	2.4
Mortgage bonds	1,087	3.8
Bank shares and debentures	384	1.3
Railway shares	2,681	9.2
Rail debentures	3,929	13.6
Industrial shares and debentures	281	1.0
Total	28,958	100.0

Source: J. Riesser, *The German Great Banks and Their Concentration in Connection with the Economic Development of Germany*, 3rd ed. (Washington: Government Printing Office, 1911), pp. 392–93, citing *Statisches Jahrbuch fur das Deutsche Reich,* Vol. 29 (1908), p. 228. Translated for Hearings of the United States Congress, National Monetary Commission, 61st Congress, 2nd session, Document No. 593. First published as *Die deutschen Grossbanken und ihre Konzentration* (1908).

Note: Included in this nominal amount of approximately 29 billion marks is 8.2 billion marks of conversion issues, of which 6.6 billion represent conversion on state loans.

TABLE 1-6. Main Creditor and Debtor Countries, as of 1913

Gross creditors	*Billions of US$*	*Percent*	*Gross debtors*	*Billions of US$*	*Percent*
United Kingdom	18.0	40.9	Europe	12.0	27.3
France	9.0	20.4	Latin America	8.5	19.3
Germany	5.8	13.2	United States	6.8	15.5
Belgium, Netherlands, and Switzerland	5.5	12.5	Canada	3.7	8.4
			Asia	6.0	13.6
United States	3.5	8.0	Africa	4.7	10.7
Other countries	2.2	5.0	Oceania	2.3	5.2
Total	44.0	100.0		44.0	100.0

Source: United Nations, *International Capital Movements during the Inter-War Period* (Lake Success, N.Y.: United Nations Department of Economic Affairs, 1984), p. 2.

era as a throwback to the Great Depression of the 1930s. The crisis was primarily centered on the large money center banks and the financial markets, the historically traditional sources of capital to the rest of the world. The economic crises that have followed the financial crises were centered largely in the advanced industrial economies starting in Japan in the 1990s, followed by the United States in 2007, then Japan again and the eurozone whose respective economies were characterized by low growth and low to near deflationary conditions. Japan and the United States, two of the major creditor states, are now substantial sovereign debtors, as is China.[13]

Hard-Core Debtors and Their Reliance on External Capital

Joining the hard-core group of creditors was a hard-core group of debtor states in the periphery. Some, particularly those in the areas of recent settlement—the United States, Canada, Australia, and New Zealand—emerged as creditors toward the end of the era or as a result of World War I. These states were generally unencumbered by rigid political and social systems, while benefiting from a transfer of human capital attributable to immigration.[14] However, relatively few states absorbed their external debt well, and, after a series of cycles of default and renegotiation, they emerged as hard-core debtors. This pattern was most pronounced in the Latin American states, the Ottoman Empire (Turkey), Egypt, Greece, Spain, Portugal, Russia, and the Balkan states[15] (see table 1-6 above). At present, several of these or their successor states rank among the major debtor nations, with Mexico, Argentina, Russia, and Turkey needing to be bailed out during the emerging market crises in the 1990s and early 2000s and Greece and Portugal needing to be bailed out during the eurozone crisis.

During the nineteenth century, the peripheral states, with their weak domestic capital markets and undeveloped banking systems, were reliant on external loans for industrialization, particularly capital-intensive infrastructure investments such as railways and utilities.[16] In addition, states borrowed to cover persistent budget deficits. Often their rulers failed to distinguish between their own purse and that of the state. With their narrow fiscal bases, external capital markets were tapped to provide additional resources for governments. This reliance has not changed markedly today.[17]

Expensive Loans to Peripheral States Reflected Perceived Credit Risks

Bonds floated on the bourses of Europe usually had long amortization periods, which matched the capital intensiveness or "lumpiness" of the investments made in railways and other infrastructure projects. However, these loans were expensive. Real rates of interest were high: the nominal interest rates of 5 percent and 6 percent for the peripheral states were doubled through the deep discounting of bonds, a deduction of one to two years of debt service in advance, and heavy commissions paid to the issue houses. In addition, railway concessions often required state-guaranteed returns or revenue per mile of track laid, as well as land grants, all of which added to the expense of these loans (see table 1-7).[18]

TABLE 1-7. Realized Rates of Return on Capital Export, 1870–1913

Percent

Category	*1870–76*	*1877–86*	*1887–96*	*1897–1909*	*1910–13*
Consols	3.59	3.76	4.13	0.93	−0.37
French *rentes*	4.79	5.41	5.55	2.73	2.34
Colonial and provincial governments	6.08	4.72	4.95	2.78	1.77
Indian railways	4.63	4.70	6.01	0.74	2.36
U.S. railways	7.84	7.69	4.63	6.13	2.08
Latin American railways	5.96	7.04	6.77	4.09	1.73
Social overhead investment	0.00	0.00	5.20	3.70	2.55

Source: Michael Edelstein, *Overseas Investment in the Age of High Imperialism: The United Kingdom, 1850–1914 (*London: Methuen, 1982), pp. 153–54, table 6.30.

Excessive Short-Term Borrowing (Floating Debt) Signaled Debt Crisis

When states were unable to float bonds during cyclical downturns in the market or when their creditworthiness had declined, they resorted to short-term borrowing in excess of trade requirements. This floating debt was a sure sign that a debt crisis or default was at hand.[19]

High real rates of interest on variable rate commercial bank loans and a concentrated buildup of short-term loans in excess of reserves was characteristic of the 1980s debt crisis and the emerging market crises of the 1990s. The short-term borrowing and very high leverage of the shadow banks leading to the U.S. crisis (2007–10) also triggered financial economic crises in the United States and Europe, particularly in the eurozone.

Defaults, Recurring and Sustained

The relatively frequent defaults during this period were concentrated among the hard-core debtors—Greece, Mexico, Argentina, the Ottoman Empire (Turkey), and Austria, as examples. During the Bolshevik Revolution, Russia was the primary case of sovereign repudiation, on ideological grounds. During the U.S. Civil War the southern U.S. states, financed by British merchants against cotton exports, also defaulted on their debts and the federal government thereafter refused to recognize those debts. Defaults tended to recur and at times were longlasting. At the heart of defaults, subsequent debt negotiations, and resolution are two primary issues: the ca-

pacity of states to pay versus their will to pay. John Maynard Keynes, in a commentary on capital export and defaults, voiced a general distrust of foreign lending based on the experience of the nineteenth century:

> Indeed, it is probable that loans to foreign governments have turned out badly on balance—especially at the low rates of interest current before the War. The investor has no remedy, none whatever against default. There is, on the part of most foreign countries, a strong tendency to default on the occasion of wars, revolutions and whenever the expectation of further loans no longer exceeds in amount the interest payable on the old ones. Defaults are world-wide and frequent.[20]

At times during the nineteenth century the negotiations extended over many years. In the interwar years many countries defaulted from 1931 to 1933 during the Great Depression and remained in default until after World War II, with debts still being settled twenty or so years after the end of World War II. Similarly, after the 1980s debt crisis the major debtors—Mexico, Argentina, Brazil, and others—renegotiated repeatedly with their bank creditors from 1982 to 1994.

During the emerging markets crisis of the mid-1990s and early 2000s, Argentina was in crisis and defaulted in 2002. Argentina then negotiated its debts with bondholders over an extended period of time; it agreed to a punitive and partial settlement with the bondholders, bordering on repudiation, in 2004 and again in 2010. Argentina's default was finally settled after extensive litigation with minority creditors in the first quarter of 2016. Greece went into default in 2010 and has since experienced three bailouts and a major political crisis. The bailouts have not solved the problem of its overindebtedness or restored Greece to a sustainable growth path.[21]

Renegotiation between a Debtor and Its Creditors

Relatively few defaults ended in repudiation, as it was in the interest of both debtors and creditors to renegotiate. Creditors sought to preserve their principal and eventually see full debt service restored, while debtors sought to regain their creditworthiness and access to the external capital markets of Europe. Renegotiation reflected a delicate balance of power between creditor and debtor: the former denied loans to debtors in default via closure of their capital markets and other forms of pressure, including diplomatic representation, while the latter maintained moratoriums on

their debt service until a satisfactory restructuring was achieved. Renegotiations and restructurings were thus common throughout the period.[22]

All restructurings in the nineteenth century were handled case by case. Creditors initially negotiated with a sovereign debtor through separate bondholder committees formed to handle a default on a single loan. Over time, country committees were formed and eventually incorporated as the Corporation of Foreign Bondholders in England and its continental equivalents. In England the Council of the Corporation coordinated the efforts of the individual committees and brought the weight of the City of London to bear on a sovereign debtor in default, as well as encouraging diplomatic representation from the foreign office in difficult cases. This practice was emulated in Europe, with the various national bondholder committees cooperating to avoid competitive settlements and to maintain maximum leverage over the debtor.[23]

During the 1980s debt crisis, bank creditor committees, chaired by the major money center banks, negotiated restructurings case by case, a clear parallel with the nineteenth-century experience. This practice of case-by-case restructuring continued during the sovereign crises in the 1990s, such as in Mexico (1994–95), East Asia (1997–2003), Russia (1998), Turkey (2001–02), and Argentina (2001–03). However, restructuring support was provided by the IMF, World Bank, and G-7 acting as international lenders of last resort during the crises in the 1990s and early 2000s. In the eurozone crisis individual country bailouts were handled on a case-by-case basis in Greece (beginning in 2010 through 2015), Ireland (2010–14), Portugal (2010–14), and Cyprus (2013) under the auspices of the troika of the European Investment Bank (ECB), the European Commission (EC) and the IMF, which served as lenders of last resort and also provided oversight over crisis reforms.

In the major financial and economic crises in Japan, the United States, and Europe, where sovereign bailouts were not required, the primary central banks—the Bank of Japan, the U.S. Federal Reserve Bank (the Fed) supported by the Treasury and Federal Deposit Insurance Corporation (FDIC), the Bank of England, and the ECB—served as domestic lenders of last resort but also cooperated with each other, as well as with other central banks throughout the world, to prevent a wider banking and financial markets crisis. The U.S. Fed extended currency swap lines to the major central banks noted above, as well as to the central banks of Switzerland, Mexico, Brazil, South Korea, and Singapore. In total the Fed had swap arrangements with some fourteen central banks around the world.[24]

A Flexible Approach to Restructuring

During the nineteenth century there was flexibility in resolving the debt crises. For example, debt service arrears were frequently capitalized and subject to low escalating rates of interest over time; interest rates on the original principal were reduced if the prevailing market rates were lower than the bond coupon rate; debt was consolidated and unified into relatively few classes; debt service was tied to a percentage of import and/or export duties, to earnings from an important export crop such as coffee or rubber, or to state monopolies over tobacco or spirits; and bonds were converted to stocks or equity in newly formed railway concessions. Creditors recognized that there was a cost to default that would be borne by both debtor and creditor, and solutions had to reflect the debtors' capacity to pay in order to be at all workable. Nevertheless, even with those more pragmatic approaches to restructuring, recurring defaults were not avoided.[25] The large external debt overhang that remained throughout World War I and the interwar period was subject to massive defaults in the Depression beginning in 1931. Most of these defaults were renegotiated and settled following World War II.

In the 1980s crisis, after extensive and difficult negotiations between a sovereign debtor and its banks as creditors, the U.S. government stepped in, initially to ensure that its major money center banks with heavily concentrated exposure to Latin American debt were protected, but also to resolve protracted sovereign debt crises through the Baker and Brady Plans (named for U.S. secretaries of the Treasury James Baker and Nicholas Brady); the latter emphasized partial debt forgiveness for debtors that resolved their defaults. Each of these resolutions was handled on a case-by-case basis. Calls for generalized, rather than case-by-case, solutions for debt forgiveness or market buyback of debt on a discounted basis were usually rejected by the creditors and their governments and went nowhere.[26]

The IMF and the World Bank played important roles as lenders of last resort in the 1990s emerging market crises. The IMF served as the primary lender of last resort supported by the World Bank, regional development banks such as the Asian Development Bank for Korea, and the G-7 countries. The idea was to develop sufficiently large packages on a case-by-case basis so that they were credible in international financial markets.

In the crisis that began in 2007, sovereign debtors in difficulty in the eurozone were supported by the troika—the ECB, the European Commission, and the IMF. For the first time in a crisis in the advanced industrial countries, the IMF was called in to play a major role in crisis resolution. Each of the bailout packages was negotiated and monitored individually. Each one required unanimous approval by the other eurozone countries.

Losses from Defaults

The losses from defaults during the period under discussion (1815–1914) are difficult to evaluate. However, a conservative estimate based on repudiations, conversion of interest to lower rates on arrears and original principal, and conversion to scrip from hard currency debt on British bond holdings up to 1914 generated losses estimated at one third of the cumulative defaults during the period, but only 7 percent of the foreign bonds issued on the London Stock Exchange during this same period.

French losses were much higher owing to the Russian repudiation in 1917 during the Bolshevik Revolution. Since most bonds issued between 1815 and 1914 were fifty-year bonds (amortized over fifty years), the real losses far exceeded the historical estimates made at the convenient stopping point used by most analysts of the period, World War I. The overhang of nineteenth-century debt to the interwar years through the Great Depression and World War II led to losses far greater than the nineteenth-century estimates. As a result of the two World Wars and the Great Depression, Great Britain and France lost most of their portfolios. Germany of course was saddled with reparations after World War I and became a debtor state; and the United States, now the major creditor country, took losses on commercial loans to Latin America and on inter-Allied war loans. Thomas Piketty notes that British and French portfolio losses after the Great Depression, the two World Wars, and the loss of colonies were very substantial: "In the wake of the cumulative shock of two world wars, the Great Depression and de-colonialization these vast stocks of foreign assets would eventually evaporate. In the 1950s, both France and Great Britain found themselves with net foreign asset holdings close to zero."[27]

In more recent times, the large money center banks reached settlements with their major debtors and took partial writedowns of their loans. Argentine bondholders were forced to live with significantly discounted returns from negotiated settlements in 2004 and 2010. In 1998 and 1999 the major Russian banks defaulted on and even repudiated some of their loans from their Western creditors. Creditors absorbed initial losses from the Greek bailouts, but ultimately it is unknown what the losses will be on Greece's substantial sovereign debt outstanding. It is a reasonable assumption, given the state of the Greek economy and its proven difficulty mobilizing tax receipts and effecting structural reforms such as privatization, that the eventual writedown of Greek debt will be very large. In the bailout of Cyprus even deposit holders (largely Russians who had parked money offshore) were "bailed in" and forced to suffer losses (discussed in greater detail in parts III and IV herein).

Finally, there are Japanese government bonds and U.S. Treasuries with gross sovereign debt at 240 percent and 100 percent of GDP, respectively. Since virtually all of

the Japanese debt is held by individual Japanese investors and individuals, there appears to be no immediate threat of a sovereign default. U.S. debt is mostly held by U.S. investors and institutions, though other governments such as the Chinese and other East Asian exporters holding large reserves in dollars make the United States somewhat more vulnerable, in principle, than Japan. However, the U.S. dollar remains the world's major trade and reserve currency, and it strengthened against the euro and yen during the Great Recession. To date, when there has been a flight to quality from emerging market countries, it has been primarily to the U.S. dollar. However, because both Japan and the United States have elevated sovereign debt, both are vulnerable to a future shock and/or a change in sentiment or loss of confidence in their respective currencies, and their debt trajectories are not sustainable (see Part IV).

International Relations Aspects of Capital Export

Although the economic aspects of capital export during the nineteenth century have received substantial attention, the link between external debt and international relations is for the most part not adequately addressed.

Capital Export and State Power

From the viewpoint of the creditor states, capital export has to be seen as a projection of state power in its broadest sense: "The export of capital has in recent times been a familiar practice of powerful states. The political supremacy of Great Britain throughout the nineteenth century was closely associated with London's position as the financial center of the world."[28]

Not only did Great Britain project its power via capital export to the periphery, so did France in loans to its continental allies, most notably to Russia as a way to counter the growing power of Germany, and in loans to Tunisia and Morocco as a way to extend its sphere of influence in North Africa. Germany backed its primary ally on the continent, Austria-Hungary, and sought to project itself as a major power, following unification in 1870, in a number of peripheral states. The German great banks, guided by the chancellor, were the vehicle for Germany's growing industrial power and increased penetration of overseas trading markets, largely in competition with Great Britain.

Even Russia, a major debtor, sought to extend its influence in Persia and China via loans. In the beginning of the twentieth century, the United States, still a major

debtor, demonstrated its role as a growing power by supporting capital export to several Central American and Caribbean states. All the powers contested with each other for political and economic spheres of influence in China via loans, until the creditors curtailed this competition.

Creditor states such as France and Germany maintained direct control over their capital markets, while the British government maintained close but unofficial ties to the financial community in the City. Moreover, in Great Britain, legislation was used to channel loans to India after 1857.

State Intervention and Debt

When the powers sought to maintain the balance of power or the independence of newly created states, they intervened directly via loan guarantees, as in Turkey, Greece, and Egypt. Some authors on imperialism, such as Hobson, Hilferding, and Lenin, argued that the creditors—that is, capitalist states—were pushed into imperialism by finance or monopoly capital.[29] This view does not appear to be supported by the facts. These states acted in what they perceived as their higher political and strategic interest and often clouded their actions in a veil of financial maneuverings.

Direct intervention by the creditor states over defaults was relatively rare. However, where strategic interests were involved, defaults served as a convenient pretext for intervention, as, for example, by Britain in Egypt, France in Morocco, or the United States in the Dominican Republic or Panama. More frequently, the creditor states tried indirect intervention, such as international control commissions, banking consortiums, or customs authorities. These institutions, which amounted to enclaves of creditor control, were used in Greece, Turkey, Egypt, China, the Dominican Republic, Haiti, and Nicaragua to assist the debtor states in reorganizing their external debt, to maintain control over sources of revenues dedicated to debt service, and to report extensively on the economic and political status of the debtor.

In the case of post–World War II defaults on public credits such as trade credits insured by bilateral export finance institutions, sovereign debtors are required to renegotiate their debts with their creditors through the Paris Club, with the IMF in attendance to report on the debtors' economic prospects. During the 1970s and 1980s, Paris Club negotiations were frequent and recurring, as many of the poorer developing countries found it difficult to service their debts. During the 1980s debt crisis, sovereign debtors frequently renegotiated their Paris Club debts in parallel with their commercial bank loans.

In recent debt crises the creditor states have used the multilateral financial institutions—the Bank for International Settlements (BIS), the International Monetary Fund (IMF, the International Bank for Reconstruction and Development (World Bank), and regional development banks such as the Asian Development Bank, supported by backup facilities from the G-7 countries, to support countries in crisis—for example, during the East Asian crisis. The objective was to keep debt restructurings and negotiations politically "neutral." During the the eurozone crisis as noted, the troika provided most of the support in the so-called bailouts of Greece, Ireland, Portugal, and Cyprus. However, the bailout of Greece took the low politics of debt to high politics as the newly elected government from the socialist party Syriza threatened default and exit from the eurozone, while Greece's creditors, notably Germany and other northern tier countries, took a hard line on the writedown of debt and at some point threatened or seemed to favor a Greek exit from the eurozone.

During the nineteenth century, in cases of default where strategic interests were not involved, creditors often sought the assistance of local consuls in making diplomatic representations to debtor governments. These representations, often made jointly by all the creditor powers, were perceived as direct interventions by the weaker states of the periphery. In addition, governments would intervene when violations of international law occurred, such as default on a loan guaranteed by the creditor government, alienation of the collateral hypothecated to one loan, or servicing of domestic debt in preference to external debt. A default per se was not a violation of international law.

International Law and Debt Intervention

The Calvo Doctrine maintained that the powers discriminated against the weaker states in their interventions and rarely exhausted their remedies under national law before intervening. The Drago Doctrine, pronounced in the wake of the Venezuelan intervention, viewed all interventions over pecuniary claims as immoral and illegal under international law. The Latin American states, often the objects of intervention, sought to define "American international law" on debt interventions, eventually bringing this issue to the second Hague Convention of 1907. The convention expressed a preference for nonintervention and for arbitration over armed intervention. However, the powers refused to rule out intervention in cases of arbitrary and discriminatory treatment of their nationals as creditors. Overall, however, from the turn of the century until World War I, attitudes and customary practices in international law related to defaults evolved away from intervention.

Many developing country debtors, however, view the IMF or the combination of the IMF and World Bank as anything but politically neutral, since loans from these institutions are often conditional on economic reforms to be undertaken by the borrowers. In the late 1980s and 1990s the view was that globalization, including financial sector liberalization, was based on the Washington Consensus promoted by the United States, Great Britain, and other European countries, the major shareholders of the IMF and World Bank, and strongly endorsed by the management and staff of the IMF and World Bank. Joseph Stiglitz, among others, sees the push toward rapid globalization, especially the support of financial sector liberalization by the IMF and World Bank, as an important contributor to the emerging market crises of the 1990s and early 2000s (as discussed in Part III of this book).[30]

Trade and Capital Export

Another important component of capital export was trade and commercial relations. Trade, an important element of economic policy, was intimately tied to the export of capital, as the powers competed via loans to gain concessions in the peripheral states seeking to industrialize, and to supply them with capital equipment and other finished goods and services. Britain's initial recognition of the Latin American republics was embodied in a series of commercial treaties. Competition over the Baghdad Railway project and other concessions in Turkey opened that country to loans and probably accelerated the demise of the Ottoman Empire. All the powers vied for concessions and trade with China, using loans as a means of securing trading enclaves and spheres of influence.[31]

External Loans as a Basis for State Sovereignty

Viewed from the perspective of the borrowing states, external loans provided the resources for action. Initially, many smaller countries such as Greece, the Balkan states, and the Latin American republics sought loans to secure and maintain their independence. Newly established states then needed to pay off the external debt they inherited, as was the clearly established practice in the international law of state succession. The successor states to the Ottoman Empire, the Austro-Hungarian Empire, the Central American Republic, and Colombia all acquired external debt in this way.[32] In recent times, Russia and the other states of the former Soviet Union negotiated over debts of succession and the retention of assets by these countries, such as Aeroflot's fleet and factories of large Russian enterprises located in the former states of the Soviet Union.[33]

Debts Arising from Wars, Indemnities, and Pecuniary Claims

States borrowed to finance wars. The Balkan states, Turkey, Russia, and China all borrowed extensively to prepare for, engage in, or pay indemnities resulting from war. If, as Raymond Aron writes, peace is the other side of war, or if the dictum "in peace prepare for war" is accepted, then it follows that a substantial amount of debt was acquired to prepare for or engage in war.[34] At present, a hidden component of the external indebtedness of many states is expenditures for armaments.

In the current era the United States fought two wars—Afghanistan and Iraq—that were not formally in the budget approved by Congress; and the country spends more on defense annually than the next eight countries collectively. The wars and continuously heavy spending on defense have added significantly to the United States' sovereign debt problem.

Civil wars and internal strife in the peripheral states also created a demand for loans, as well as pecuniary claims resulting from damage to the property and lives of citizens of the major powers. The Southern states of the United States, individually and collectively the Confederate states, repudiated their debt acquired before and during the American Civil War. The Mexican intervention was occasioned in part by the pecuniary claims of the powers and resulted in Mexico's repudiation of the Maximilian Debt following the French occupation. The Venezuelan intervention was largely over pecuniary claims arising from civil strife and revolution. China was forced to borrow to pay indemnities arising from the Boxer Rebellion. Perhaps the classic case of borrowing to pay indemnities claimed by citizens of the European powers under extraterritorial privilege was Egypt.[35]

Developmental versus Revenue Borrowing

Although states in the periphery were potentially able to absorb external loans for major investments, such as railways, their borrowing for nonproductive purposes such as wars or to cover budget deficits inevitably led to defaults. The states in the periphery, with weak capital markets and narrow fiscal bases, often saw their economies buffeted by political events. The Ottoman Empire, the Austro-Hungarian Empire, Spain, Portugal, China, and most of those in the Caribbean were untouched by meaningful social and political change and were unable to absorb capital productively. It could be argued that borrowing forced a certain amount of opening up in these empires that accelerated their disintegration. Japan, in contrast, a non-Western society, was able, following the Meiji Reformation, to utilize external capital effectively and industrialize rapidly. Japan later borrowed extensively through the intermediation of

the New York investment banks and the New York bond market to support imperial expansion in Manchuria.

The Vital Interests of States versus the Sanctity of Contracts

In the nineteenth century, governments of the peripheral states faced a difficult balance between the sanctity of contracts, *pacta sunt servanda*, the basis of all contract law, and the vital interests of their states under changing conditions, or *clausula rebus sic stantibus*. In extreme crisis, states chose to default. Many hard-core debtor states during this period found themselves locked into a vicious cycle of default, renegotiation and restructuring, and subsequent default that elevated finance from low to high politics. External debt was inevitably linked to other international issues. Argentina, Mexico, and Greece are examples of such states in the current era.