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SOVEREIGN DEBT FOLLIES

"IT HAS TAUGHT US NOTHING"

Financial manias and their consequent collapses have been around for a long time. Such extravagance has been called a *folly* for a long time as well. The first great financial bubble completed in June 1720. As led by the South Sea Company, the impetuous action was described as a bubble in real time. A pamphlet *"The Bubbler's Mirrour or England's Folly"* was published in 1725.

In 1933 a bond dealer in New York published a study of government bond defaults. It included the quote used in our title: ***"It has taught us nothing."*** Also included was the cause: ***"A borrowing orgy"***.

It is worth emphasizing that on all of the previous bond bubbles governments, of virtually any quality, were issuers of bonds. This mania is truly remarkable, as governments or their agencies have buying bonds as well as issuing them. Clearly a fit of bureaucratic busy-ness.

As history tells us, there is a fairly methodical path through a bond mania to the *consequent* bust. Credit spreads narrow on supreme confidence and the yield curve flattens during the boom and the reversal in both signals the beginning of the contraction.

In the US, spreads reversed to widening in June, which has been concerning. Generally, the Treasury curve has been steepening since December 2013, which is still on trend. The reversal will be an alert to speculative abilities becoming exhausted.

However, speculation in European bonds has been without precedent and the focus is again turning on Greece. Specific charts and comments are provided towards the end of this article.

The rest of this piece is based upon an historical review that we have been using for a couple of decades.

During the New Era that culminated so extravagantly in 1825, London was the financial centre and the City floated issues by Russia, Prussia, Spain, and a number of Latin American countries as well as cities.

For example, Peruvian 6 percents were done at 88 in 1822 for a yield to maturity of 6.95%; then again at 82 for a 7.50% yield in 1824, and at 78 (7.85%) in 1825. Then the market became illiquid and eventually collapsed with the usual post-bubble deflation. Some 70 U.K. banks stopped payment and Rothschild assisted in preventing the Bank of England's default.

With the usual swings in the business cycle, the contraction continued until the mid-1840s.

The next long expansion ended with a mania of asset speculation in 1873. At the height of that mania and as credit markets were becoming stressed an important New York newspaper editorialized that nothing could go wrong. The main point was that the US did not have a central bank that would be constrained by the gold standard in accommodating the needs of Wall Street.

Instead there was confidence that the Treasury System and its admired secretary could issue massive amounts of credit by buying bonds out of the market.

While recklessness was rampant, there were rational comments. **The Economist**'s April 27, 1872 edition advised:

> ***"Avoid states which are constantly borrowing, which must therefore be paying off the interest on their old debt with the fresh loans."***

The progress of a disaster in sovereign debt in 1873 was nicely chronicled by headlines in **The Economist**:

June 7:	"The Approaching Spanish Repudiation"
July 5:	"[Spain] Making Arrangements for the Payment of Current Coupon"
August 2:	"Spanish Interest Will Not Be Paid"
August 30:	"Anarchy in Spain"

The Argentine crisis of 2001 was documented by headlines from a number of publications. It is worth noting that as late as that fateful June there was confidence ***"Appetite for Credit Risk has Improved Considerably"*.**

July 18, 2001:	"Markets Laud Argentine Debt Accord – Calms Fears of Default"
August 3, 2001:	"Flurry of International Contacts to Prevent [Argentina] Default"
December 14-20, 2001:	"Angry Argentines Take Their Displeasure to the Streets"
	"State of Siege"
	"Looters Ravage Cities"

There seems to be a common pattern on the transit from confidence to dismay, and it will be interesting to see how it works out this time around. The distinction is that the 1873 example included many countries and as the historian, S.G. Checkland, wrote ***"Many half-barbarous states pressed eagerly for funds, and spent them with no display of wisdom."***

The Argentine problem in 2001 was not accompanied by insolvencies in a number of countries.

However, there is no question that the 1930s disaster in all lower-grade debt was part of a massive post-bubble contraction. It was reviewed in **Foreign Bonds: An Autopsy**, a rather appropriate title, published by Howland Swain Company in 1933:

> ***"The fiscal history of Latin America … is replete with instances of governmental default. Borrowing and default follow each other with almost perfect regularity. When payment is resumed, the past is easily forgotten and a new borrowing orgy ensues. This process started at the beginning of this past century and has continued down to this present day. It has taught nothing."***

How bad can it get? Typically the post-bubble contraction afflicts all aspects of the financial markets – including sovereign debt. The process is devastating and continues until both lenders and borrowers vow to never be reckless again.

Sovereign Follies 2010:

Jan. 14:	"Greece Unveils Stability Program"
Jan. 21:	"Investors are concerned that Greece won't be able to finance its budget deficit."
Feb. 14:	"Years of unrestrained spending, cheap lending and failure to implement reform."
Feb. 17:	"Greek Tragedy Averted, For Now"
Feb. 24:	"Greek Police, Protesters Clash"
April 11:	"Emergency Aid Approved"
Aug. 10:	"Greek Debt Crisis Finally Over"
Aug. 10:	"Greece is one part of the crisis and it has faded from the headlines."

2011:

May 29:	"Thousands of protestors denounce Greece's entire ruling class."
June 28:	"Greek Debt Crisis Leads to Mass Strike"
June 28:	"Greece Faces 'Suicide' Vote on Austerity"

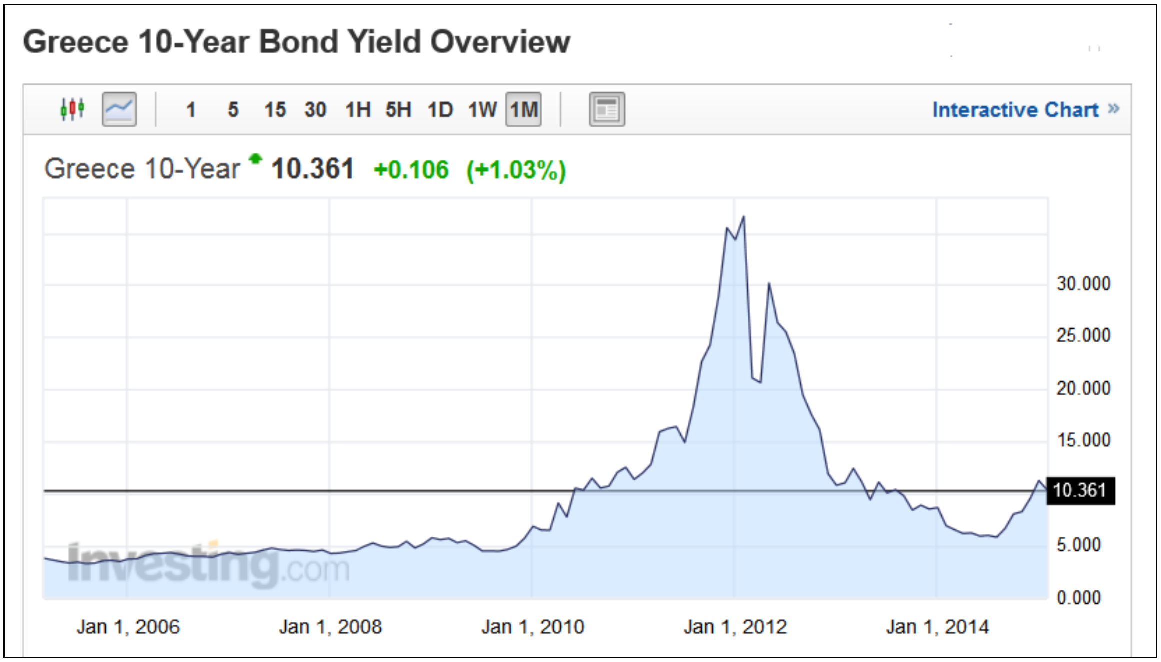
Two-Year Greek Government Notes

2010 - 2011

- August 10, 2010: ***"Greek Debt Crisis Finally Over"***: Yield 9%.
- June 28, 2011: ***"Greece Faces 'Suicide' Vote on Austerity"***: Yield 30%.

Greece: Ten-Year Yield

2015



- The rise from 15% in June 2011 signalled the beginning of drama.
- It led the European Bond Panic by a number of months.
- The general panic ended in July 2012.
- Greece is again a threat and at 10.25% now, the pattern looks similar to the breakout at 10.55% in June 2010.

"Bankruptcies of governments have, on the whole, done less harm to mankind than their ability to raise loans."

– Prof. R.H. Tawney, **Religion And The Rise Of Capitalism**, 1926