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(Update of 2001 Version)

SOVEREIGN DEBT FOLLIES

"IT HAS TAUGHT US NOTHING"

Another episode of sovereign defaults seems to be getting under way, which prompts the question about just how bad can it get? The above quotation is from a 1933 study of that example of government defaults and as the writer notes, it had been preceded by a ***"new borrowing orgy"***. The word "new" is important because the literature often includes the description "new financial era". The first one, the South Sea Bubble, culminated in June 1720 and it has essentially been the model for five subsequent ones, including the example that completed in 2007.

Although the stock market attracts the most attention during a great financial mania, the action has included the equivalent mania with investors reaching for yield and underwriters reaching for fees. There is a typical path that leads to a post-bubble contraction that includes widespread remorse and chagrin. In the credit markets this has included the recent setback to corporate bonds and more recently some sudden liquidity problems that could be soon threatening the sovereign debt market.

Today’s focus has been on the “Troublesome Trio”, headline of March 1st. But if the past is any guide this is the initial phase of another historical problem in sovereign debt.

That dating back some 2,000 years, such problems have started in outlying financial markets and then in accumulating hit the major financial centers.

Quite likely this Fall. One feature could be no bids for lower-grade bonds. This has been signaled since Emerging Market Bonds (EMB) began to distinctively underperform in January.

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 priced 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. With the 1825 Crash, 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.

> ***"True, some great event may prick the commercial bubble, and create convulsions; but while the Secretary of the Treasury [U.S. was at that time between central banks] plays the role of the banker for the entire United States, it is difficult to conceive of any condition of circumstances which he cannot control. Power has been centralized in him to an extent not enjoyed by the Governor of the Bank of England. He can issue the paper representative of gold to the amount of scores of millions."***

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"
Dec. 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 transition 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 contraction *consequent* to a “classic” financial bubble. 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.

In England, chronic weakness following the 1873 Bubble prompted economists to call it the “Great Depression”. Which prevailed until 1895.

Ampersand

Sovereign Debt Follies 2021:

March 1:	"Troublesome Trio in Emerging Markets: Facing Yield Spike Scare: Turkey, Brazil and South Africa”
March 5:	"Hyperinflation Pushes Venezuela to Print 1,000,000 Bolivar Bills"
March 17:	"Dear Market, Don’t Worry, Be Happy. Yours, the Fed"
March 21:	"Bond Rout Hits Safest Company Debt"
March 23:	"All Hell Breaks Loose in Turkey: Turkey’s Lira Plunges”
March 25:	"We Don’t Have the Money: Argentina Warns It Will Default, Again"

> ***“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.

The next few months could record another set of statements boasting that “Nothing can go wrong”.