

**Do Creditors Ignore History?
Reputation in International Capital Markets**

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Why do governments uphold their international commitments? For centuries scholars and practitioners of international relations have cited reputation as a motive for compliance. A government that honors its commitments can acquire a reputation for reliability, which should help it attract partners for cooperative endeavors, whereas a government that breaks its commitments may signal that it cannot be trusted, prompting others to exclude it from beneficial international agreements. This argument, which appears in classical works of international relations as well as modern analyses of political economy, has achieved the status of conventional wisdom.

Recent studies of sovereign debt have thrown this wisdom into question, however. In research on government borrowing in international markets over the past two centuries, scholars have found surprisingly little evidence of reputational effects. Apparently, countries with a history of defaults do not face lower credit ceilings or higher interest rates than borrowers with unblemished records, implying that markets do not punish governments for breaking financial commitments. The lesson of history, it seems, is that international creditors ignore the past.

Against these studies, I argue that concerns about reputation exert a powerful influence on international capital markets, but scholars have not detected reputational effects because they have failed to account for mitigating conditions. In particular, existing theories pay insufficient attention to external circumstances that drive governments to honor or break their commitments, and they ignore domestic political institutions that determine the longevity of a government's image. Weak theories, when tested, produce weak results.

In this paper, I propose a new theory to explain how reputations form in international capital markets. According to my theory, *a government alters its reputation by surprising creditors – by doing the opposite of what creditors expect, given circumstances beyond its control*. For instance, a government that pays despite adverse exogenous economic shocks, such as rising world interest rates or deteriorating commodity prices, will improve its standing in the eyes of creditors. By the same logic, a government that defaults under favorable economic conditions will see its reputation sink. But creditors will not deprecate a borrower that defaults under duress, nor will they esteem a government for paying when the yoke is light. Credit history does affect reputation, but only under certain conditions.

I also argue that *the longevity of a reputation depends on domestic political institutions*. When considering the lessons of history, creditors must decide what past events teach them about the disposition of a government in office today or the preferences of its successors. In short, creditors must estimate the correlation of government type over time. If this correlation is high, creditors will consider distant history as well as recent behavior when forming beliefs about the borrower, but if the correlation is low, they will pay more attention to recent signals than dated ones and reputation will have a short half-life. The correlation of type is difficult to measure, so creditors must rely on observable indicators, such as political institutions. A major change in institutions would lead creditors

to discount the past. Thus, credit history shapes reputation, but the effects last longer for some countries than others.

As a first step toward testing this theory, I consider the behavior of capital markets during the 1930s, a decade when – according to all historical accounts – creditors failed to discriminate between defaulters and payers. Using both statistical and qualitative evidence, I identify several governments that surprised creditors by paying despite economic hardship, and I show that those governments acquired favorable reputations that helped them borrow when others could not. In the Argentine case, reputational gains were short-lived. Institutional changes associated with the rise of Perón led to doubts about the correlation of type over time, thereby diminishing the effect of the perfect credit record that Argentina had achieved during the Great Depression.

The paper is organized into four parts. First, I expose the gap between intuition, which suggests that reputations play an important role in capital markets, and existing studies, which conclude that bondholders and banks ignore history. Next, I attempt to bridge the gap by specifying conditions under which history should affect reputation and, therefore, access to credit. In the third section I test my theory against quantitative and qualitative evidence from capital markets during the interwar period. Finally, I suggest how my approach might improve our understanding of reputation in other areas of international relations, such as military crises and alliance politics.

1. The Apparent Absence of Reputational Effects

Debt contracts between public borrowers and foreign lenders represent some of the oldest and most pervasive forms of cross-border commitments in international relations. As early as the 13th century, Italian bankers began extending credit to the English monarchy to finance its wars with France. Notwithstanding occasional defaults, the practice of cross-border lending soon grew to become a prominent feature of the international financial landscape. Today few would question the importance of sovereign lending for the global political economy: during 1996 alone, private bondholders and commercial banks lent more than \$80 billion to the developing world; virtually the entire sum was borrowed or guaranteed by sovereign governments.

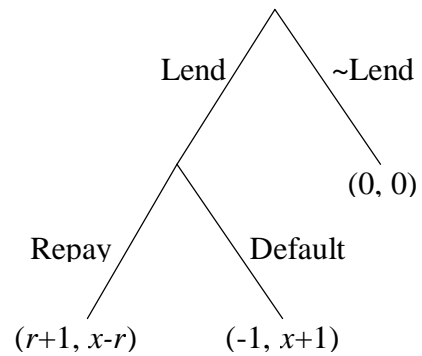
A sovereign debt contract is a voluntary exchange of goods in time, so it is vulnerable to problems of dynamic inconsistency. When a government borrows funds from bondholders or banks on international markets, it promises to repay with interest during subsequent periods as specified by the loan contract. Having received the loan, however, the government may feel tempted or even compelled to violate the contract by refusing to service and amortize as agreed. In my terminology, any contractual violation counts as a default. The most extreme form of default occurs when a government repudiates both interest and principal, thereby asserting that the entire debt is illegitimate and will not be recognized at any point in the future. Less severe forms of default include temporary

suspensions of payments, permanent reductions in outstanding principal or interest rates, and extensions of the maturity date.

If governments could default with impunity, no international lending would ever take place. To illustrate this point I introduce the debtor's dilemma, a two-stage game between a private creditor and a foreign government. First, the creditor decides whether to lend \$1 at a positive interest rate r . A government that borrows will make an investment that yields $x > r$ and then decide whether to repay the principal plus interest. The game tree and payoffs appear in Figure 1. Assuming that each player has complete information about the structure and payoffs the game, we can find the subgame-perfect equilibrium via backward induction. An income-maximizing government would default at the terminal node, because $x+1$ is larger than $x-r$. Knowing this, the creditor would never lend in the first place, because a payoff of 0 is better than -1.

Figure 1: Debtor's Dilemma

(payoffs to lender given first)



The prediction that no lending occurs in equilibrium is inconsistent with the empirical record. Lending occurs rather frequently, and governments often repay their debts. Thus, markets must have some means of deterring defaults and affording creditors the confidence to lend. In the 19th century gunboats provided some assurance of repayment, but military intervention to collect foreign debts has been unthinkable since the early 20th century.¹ Perhaps lending and repayment are sustained not by fear of military force, but by concerns about reputation. For centuries investors and analysts have argued that governments pay their foreign debts in an attempt to protect their good name. John Moody summarized this argument in his classic textbook on the science of investing: “no nation of importance can maintain its standing and credit ... until it takes care of its foreign debts. Consequently, meeting foreign obligations is always the first thought of statesmen in every land.”²

The logic behind such passages is straightforward: international creditors do not have full information about a government's resolve to honor its financial obligations. For instance, creditors may not know how much leaders would be willing to sacrifice to remain current on principal and interest payments. Absent complete information, creditors must

¹ Martha Finnemore, “Sovereign Default and Military Intervention,” mimeo (Washington, DC: Department of Political Science, George Washington University, 16 June 1996).

² John Moody, *Profitable Investing: Fundamentals of the Science of Investing* (New York: B.C. Forbes, 1925), 131. See also Ernest Minor Patterson, *Tests of a Foreign Government Bond* (New York: Payson and Clarke, 1928) 17; Albert W. Kimber, *Foreign Government Securities: A Text-Book for Banker and Statistician* (New York: A.W. Kimber, 1919), 207 and William L. Raymond, *National Government Loans* (Boston: Barrons, 1925), 6-7.

base their lending decisions on beliefs about the government's political resolve. Those beliefs constitute the government's *reputation* in the eyes of international creditors. Now, creditors draw conclusions about the resolve of a government after observing its record of debt payments. A government that defaults will acquire a bad reputation, and creditors will react by charging that government higher interest rates and limiting its access to new loans. Conversely, a government that pays its debts will acquire a good reputation, which it should be able to parlay into large loans at low rates. Thus, if the government and its foreign creditors play the two-stage game repeatedly under conditions of imperfect information, and political leaders care enough about future borrowing, the government will have a strong incentive to protect its reputation by repaying the foreign debt.

The reputational theory is intuitively appealing, but scholarly research does not seem to support it. In their massive study of sovereign debt since the 1850s, Lindert and Morton (1989) conclude that "investors seem to pay little attention to the past repayment record of borrowing governments. [T]hey do not punish governments with a prior default history, undercutting the belief in a penalty that compels faithful repayment."³ Other studies, focusing on more limited time periods, concur. Cardoso and Dornbusch (1989), Jorgensen and Sachs (1989), and Eichengreen (1989) all note that governments that defaulted on foreign bonds during the Great Depression did not receive significantly worse terms of credit when they resumed borrowing after the Second World War.⁴

These findings seem particularly puzzling, since investment bankers and private investors have always asserted that reputation plays a central role in lending decisions. This was as true in Roaring Twenties as it is today. Dwight Morrow, a partner at J.P. Morgan, explained that investors rely primarily on reputation when calibrating loans to foreign governments⁵, and Ray Morris of Brown Brothers singled-out the government's past record of debt service as "much more important" than standard economic variables, including the

³ Peter H. Lindert and Peter J. Morton, "How Sovereign Debt has Worked," in *Developing Country Debt and Economic Performance, Vol. 1, The International Financial System*, ed. Jeffrey Sachs, 39-106 (Chicago: University of Chicago Press, 1989), 40.

⁴ Eliana A. Cardoso and Rudiger Dornbusch, "Brazilian Debt Crises: Past and Present," in *The International Debt Crisis in Historical Perspective*, eds. Barry Eichengreen and Peter H. Lindert, 106-39 (Cambridge, MA: MIT Press, 1989); Erika Jorgensen and Jeffrey Sachs, "Default and Renegotiation of Latin American Foreign Bonds in the Interwar Period," in *The International Debt Crisis in Historical Perspective*, eds. Barry Eichengreen and Peter H. Lindert, 48-85 (Cambridge, MA: MIT Press, 1989); and Barry Eichengreen, "The U.S. Capital Market and Foreign Lending, 1920-1955," in *Developing Country Debt and Economic Performance, Vol. 1, The International Financial System*, ed. Jeffrey Sachs, 107-55 (Chicago: University of Chicago Press, 1989). A more recent study by Sule Ozler ("Have Commercial Banks Ignored History?" *American Economic Review* 83, no. 3 (June 1993)) argues that countries with histories of repayment difficulties were charged slightly higher interest rates during the 1968-81 period, but the penalties were extremely small and confined to a buoyant phase of international lending that occurred more than 40 years after the original defaults.

⁵ Quoted in David F. Jordan, *Jordan on Investments* (New York: Prentice Hall, 1934), 231-32.

trade and budget balances and overall level of national indebtedness.⁶ Manuals for private investors echoed these sentiments. Kirshman wrote that "bankers almost universally recognize an unimpeachable record for financial uprightness as one of the most important considerations in granting lines of credit,"⁷ and Patterson identified the payment history of the borrower as the "first test" of a foreign government bond.⁸

If investors attach such importance to reputation, why do existing studies find no evidence of reputational effects? The answer, I argue, is that existing studies rest on a weak understanding of how reputations form in international capital markets. In the next section I propose a new theory of reputation that promises to bridge the gap between intuition and evidence. Creditors do mind history, I argue, but only under certain conditions.

2. A Theory of Reputation

Creditors learn about government resolve through a process of inference: they observe a government's record of compliance with debt contracts, and use those observations to make inferences about the government's resolve to pay foreign debts. But the process of inference is tricky, because compliance with a debt contract depends not only on political resolve but also on economic conditions that the debtor faces. When creditors observe a default or payment, they must decide how much responsibility rests with external circumstances beyond the debtor's reach, and how much is due to the government's resolve. Put another way, creditors must decide whether to make a situational or a dispositional attribution.

How Creditors Make Dispositional Attributions

The magnitude of reputational change depends critically on the weight creditors attach to situational versus dispositional factors. If creditors attribute government policy entirely to external circumstances, they have no reason to revise their views about resolve, so reputation will remain the same. In this extreme case, government policy sheds no light on the debtor's hidden characteristics. But if situational factors do not predominate, creditors can attribute at least part of the default or payment to idiosyncratic dispositions of the government, causing beliefs about resolve (and therefore reputation) to change. Thus, a theory of reputation must clearly specify when creditors are most likely to make dispositional attributions about debtors.

Most students of reputation in capital markets implicitly assume that observers attribute all behavior to disposition. For instance, studies test for a correlation between the raw credit history of a government and its ability to borrow on international markets. This research strategy presupposes that creditors view every default as a failure of resolve and

⁶ Ray Morris, "American Investments in South America," Proceedings of the Academy of Political Science in the City of New York 7, no. 4 (January 1928), 35.

⁷ John Emmett Kirshman, *Principles of Investment* (Chicago: A.W. Shaw, 1924), 287.

⁸ Patterson, *Tests of a Foreign Government Bond*, 24.

every payment as proof of intestinal fortitude. Perhaps unwittingly, researchers are committing what psychologists call the "fundamental attribution error," the tendency to infer directly from behavior to disposition without considering external circumstances that might have compelled the default or repayment.

A recent book by Jonathan Mercer greatly advances the existing literature, because it avoids the fundamental attribution error.⁹ Mercer focuses on reputation in military crises, but some of his arguments are applicable to international debt. Most importantly, Mercer notes that observers sometimes make situational attributions, which cannot generate a reputation. This is an important insight, but Mercer carries it in the wrong direction. In deciding whether to make a situational attribution, the actors in Mercer's theory ironically ignore *all* information about the situation itself, focusing instead on whether the actor behaved in a desirable way.

According to Mercer, "... people interpret behavior in either situational or dispositional terms depending on the desirability of that behavior. More specifically, observers use dispositional attributions to explain an out-group's undesirable behavior, and situational attributions to explain an out-group's desirable behavior." In a military crisis, people would like to see their allies stand firm and their adversaries surrender. Mercer relegates *both* allies and adversaries to the out-group, thereby making the following prediction: "while adversaries can get reputations for having resolve, they rarely get reputations for lacking resolve; and while allies can get reputations for lacking resolve, they rarely get reputations for having" it.¹⁰

There are several powerful objections to this line of reasoning. Above all, Mercer's framework makes it impossible for a government to acquire a good reputation, and it implies that reputations deteriorate monotonically over time. To see this, consider the case of allies. A government can never gain reputational standing in the eyes of its ally, because honest or reliable behavior is always attributed to circumstance, but the government can suffer reputational losses by failing to meet its ally's needs. Thus, an ally can never gain a reputation for reliability, and its standing before allies cannot improve. The same applies to adversaries. As Mercer himself puts it, neither allies nor adversaries can win, because "only undesirable behavior can generate a reputation".¹¹ Yet intuition, experience and the cognitive psychology literature all suggest that some actors do have favorable reputations and that reputations can improve over time. On these grounds alone, Mercer's theory is difficult to defend.

I offer an alternative view: observers make attributions based on expectations, not desires. Creditors make dispositional attributions only when behavior is surprising, given the circumstances. Creditors expect defaults in response to severe external shocks, such as rising world interest rates and falling commodity prices. If a government defaults under

⁹ Jonathan Mercer, *Reputation and International Politics* (New York: Cornell University Press, 1996).

¹⁰ Mercer, *Reputation and International Politics*, 9-10.

¹¹ Mercer, *Reputation and International Politics*, 46.

these conditions, creditors will attribute the default to situation rather than disposition, and the reputation of the defaulter will not suffer much. Conversely, creditors expect payment when external conditions are favorable, so a government that meets its obligations under auspicious conditions will not see its reputation improve. Only surprising behavior, such as paying despite adversity or defaulting under favorable circumstances, will lead creditors to make dispositional attributions that affect the debtor's reputation. Figure 2 summarizes these predictions.

Figure 2: The Conditional Effect of Credit History on Reputation

		<i>External Conditions</i>	
		Favorable	Adverse
<i>Credit History</i>	Pay	No change in reputation	Reputation improves
	Default	Reputation deteriorates	No change in reputation

Military conflict and foreign domination also shape the expectations of creditors, thereby creating conditions under which government behavior can influence reputation. For instance, leaders expect governments to interrupt payments during war, so a belligerent can default without significant loss of face¹², whereas a wartime payer should experience a reputational boon. Foreign domination also influences the beliefs about the probability of default: lenders expect payment from a debtor whose political or financial affairs are under the direct control of a creditor-state. Under these conditions, full compliance cannot affect the reputation of the indigenous government, because coerced payments do not reveal anything about the resolve of local officials.

To summarize, credit history does affect reputation, but only under certain circumstances. A government can alter its reputation by going against the grain: doing the opposite of what creditors expect, given circumstances beyond its control, but if the government behaves as creditors anticipate, its reputation will remain the same. Creditor expectations depend upon clearly observable international variables, such as world interest rates, commodity prices, natural disasters, wars and foreign domination. Before testing this theory against evidence from the interwar period, I briefly consider how long the debtor's reputation will last.

¹² Alberto Alesina, "The End of Large Public Debts," in *High Public Debt: The Italian Experience*, eds. Giavazzi, Francesco and Luigi Spaventa, (Cambridge: Cambridge University Press, 1988), 72. Similarly, Michael D. Bordo and Hugh Rockoff ("The Gold Standard as a Good Housekeeping Seal of Approval," *Journal of Economic History* 56, no. 2 (June 1996), 389-428) argue that governments could break the pre-war Gold Standard included an implicit escape clause for war. Governments could change the parity and suspend convertibility during wartime without significant loss of reputation in credit markets.

How Creditors Weigh Recent versus Distant Behavior

When considering the lessons of history, creditors must decide what past events teach them about the disposition of a government in office today or the preferences of its successors. Two approaches dominate the literature. The first approach, common in formal models of reputation-formation, assumes that observers peer infinitely far into the past for information about the current government's resolve. Once a government defaults on its debts, creditors never forget the misdeed, which is assumed to signal the preferences of all future governments with a high degree of accuracy.

At the opposite extreme, empirical work typically focuses on the government's last move, thereby ignoring the cumulative buildup of information over time. This approach appears not only in studies of deterrence crises, but also in broader work on learning in foreign policy. For instance, Reiter argues that small states rely upon the lessons of history when deciding whether to enter military alliances with great powers.¹³ The most potent lessons arise from "formative events," especially the *last* world war. For Reiter and other scholars contributing to this literature, actors are retrospectively myopic.

Instead of resolving this debate by assumption, we need a more principled way of thinking about how long creditors pay attention to signals, or how far creditors look into the past. I argue that creditors attempt to estimate the correlation of government type over time. If this correlation is high, creditors consider distant history as well as recent behavior when forming beliefs about the borrower, but if the correlation is low, they pay more attention to recent signals than dated ones and reputation has a short half-life.

To judge the correlation of type over time, creditors must decide *whose* reputation or type matters on issues of international debt. There are at least two possibilities. First, the relevant reputation may belong to the leader or political party in office, in which case creditors could use observable information about turnover to estimate continuity in type. A major change in the governing party, cabinet, or president would cause creditors to discount the debt record of previous parties and leaders.

Alternatively, the relevant reputation may belong to key constituents of political leaders, rather than the leaders themselves. In this case, mere turnover in government need not cast doubt on the correlation of type over time, since the underlying constituency that constrains political leaders could remain the same. How, then, do creditors know when a constituency has shifted? I argue that creditors focus on changes in political institutions. For instance, the clout of particular groups should differ depending on whether the regime is authoritarian or democratic, so creditors can equate a change in regime with a change in constituency. The greater the institutional change, the more creditors will discount the debt record accumulated under previous institutions.

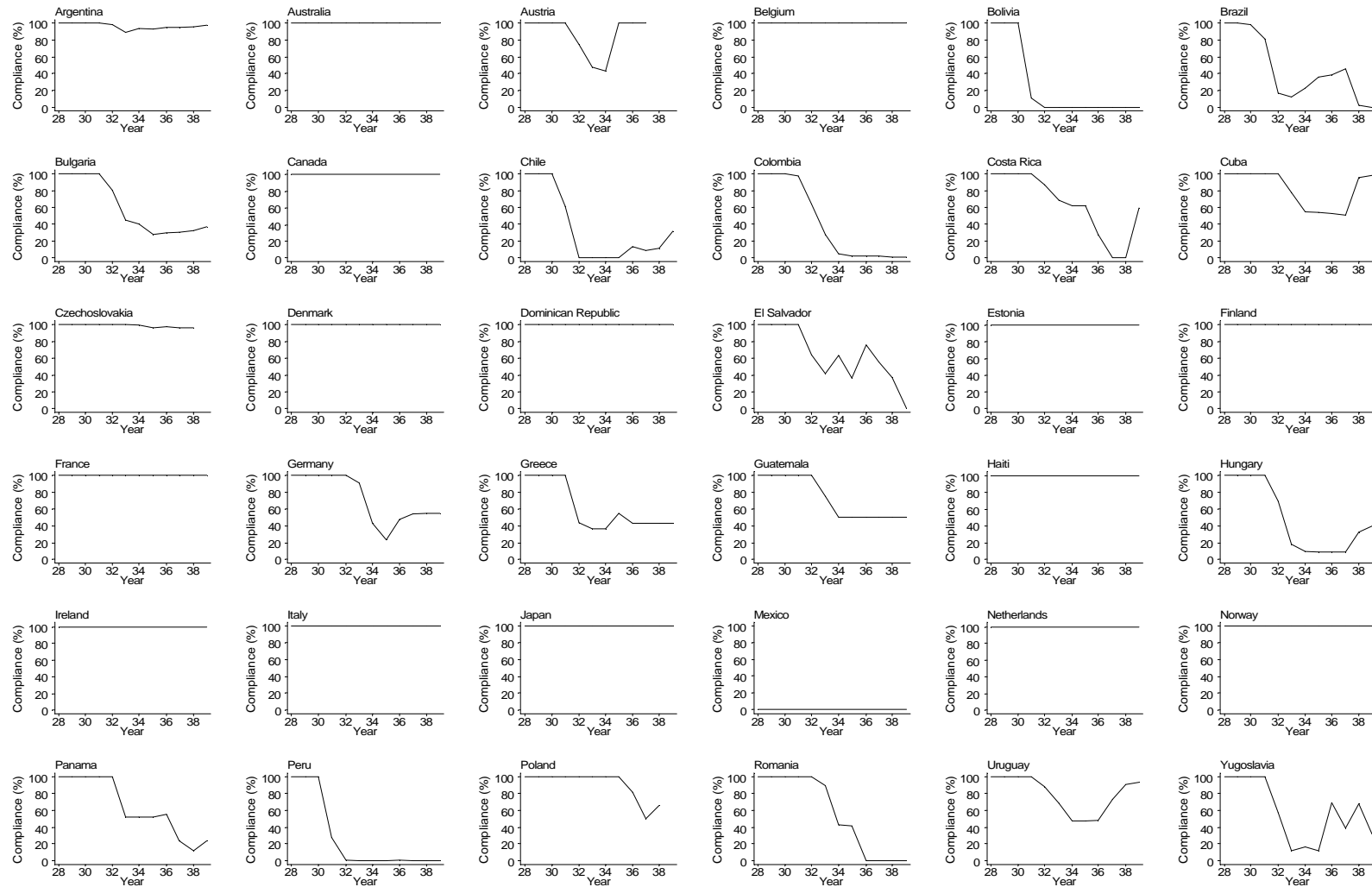
¹³ Dan Reiter, "Learning, Realism, and Alliances: The Weight of the Shadow of the Past," *World Politics* 46, no. 4 (July 1994), 490-526.

3. Tests

My theory generates several observable implications. First, governments will not get punished for defaulting under adversity, nor will they get rewarded for paying during prosperous times. This prediction solves the puzzle that I sketched in section 1. Eichengreen, Lindert, Jorgensen, Sachs, and Dornbush all note that governments that defaulted on foreign bonds during the Great Depression did not receive significantly worse terms of credit when they resumed borrowing after the Second World War. This seemingly perplexing finding becomes perfectly understandable within the context of my theory.

By the trough of the Great Depression, more than half of the world's sovereign borrowers had defaulted on their foreign debts. Most of the defaults were fully expected, given the sharp deterioration in commodity prices, rise in real interest rates, and the imposition of protectionist barriers that prevented governments in the developing world from obtaining foreign exchange to meet their external commitments. The set of governments that continued pay was fairly predictable, as well. Most of the countries that evaded default were located in Western Europe, where economic shocks were mild compared to the forces that pummeled Latin America and Eastern Europe (see Figure 3, which shows observed compliance as a percentage of contractual obligations for 36 international borrowers). Since these defaults and payments were expected, they did not affect the reputations of borrowers, so it makes sense that defaulters were not asked to pay a premium after the war.

Figure 3: Observed Compliance with International Debt Contracts during the Depression



Source: Author's calculations, based on FBPC (various issues), Islein (1928-37), and White Weld (various issues).

A second implication of my theory is that creditors will reward governments that pay under austere conditions. I test this prediction against evidence from the 1930s. Although most defaults and payments were expected, a few countries did surprise creditors by paying in the face of adversity. A short list would include Argentina, Australia, Canada, Finland, and Norway. Three complementary procedures helped me identify these countries.

First, I used market prices of foreign government bonds to measure investors' expectations about the degree to which a borrower would honor its contractual obligations. For any time t , the expectation was calculated as

$$E_t(\text{compliance}) = \frac{\text{price of bond}_t}{\text{present value of remaining contractual cash flow}_t}$$

This formula is appropriate because the price of any financial instrument is equal to the present value of its *expected* cash flow.¹⁴ If, at time t , the bond price matches the *contractual* cash flow (discounted at the risk-free rate), investors must think that the borrower will meet the full terms of the indenture, implying that the probability of default is zero. But if the bond is trading at less than its contractual cash flow, investors believe that the borrower will not honor the entire contract. The ratio of the bond price (the flow that investors expect to receive) to the contractual cash flow (the flow they were promised) represents the proportion of the contractual obligation that the borrower is predicted to fulfil. To my knowledge, this ratio has never been used to study compliance with sovereign debt contracts, despite its utility as a measure of market expectations.

Second, I drew upon the leading analysis of payment records in the 1930s. In this study, Barry Eichengreen and Richard Portes found that standard economic circumstances, such as the terms of trade and the magnitude of the debt burden, explained much of the variation in compliance with debt contracts, but a few countries – particularly Argentina, Australia, Canada, Finland, and Norway -- paid more than expected, given the economic conditions they faced.¹⁵ Finally, I verified these findings by examining articles in the popular press, where these countries were consistently identified as surprising payers.

In the remainder of this section I examine the experience of Argentina, perhaps the most surprising payer of the interwar period. The Argentine experience confirms my prediction that governments can acquire favorable reputations by paying under adverse conditions.

¹⁴ This assumes that investors are risk-neutral and markets are competitive.

¹⁵ Barry Eichengreen and Richard Portes, "Debt and Default in the 1930s: Causes and Consequences," *European Economic Review* 30, no. 3 (June 1986): 599-640. For each country-year I simulated residuals from the Tobit model by implementing the procedure described in Christian Gourieroux, et. al., "Simulated Residuals," *Journal of Econometrics* 34, no. 1-2 (January/February 1987): 201-52. The simulated residuals were largest for Argentina, Australia and Canada, implying that the Tobit model under-predicted the degree to which these countries honored their international debt contracts.

Argentina as a Surprising Payer

As a first step, I must establish that markets expected Argentina to default on its foreign debts during the Depression. Figure 4, which plots the expected compliance ratio against time, shows that by the nadir of the depression, investors projected that Argentina would meet only 30% of its contractual obligations. The two curves in the figure represent 95 percent confidence intervals around the expected degree of compliance. The confidence bands are quite narrow, so we can affirm with considerable confidence that, for most of 1931 through 1934, investors believed that Argentina would pay less than half of its foreign debts.

Figure 4: Market Expectations of Argentine Compliance



Source: Author's calculations, based on monthly observations for nine national government bonds. *Commercial and Financial Chronicle* (various issues), Board of Governors (1941), and White Weld (1932).

The leading financial journals of the 1930s reached a similar conclusion concerning the risk of an Argentine default. When Argentine bonds were selling at 40 cents on the dollar in the early 1930s, analysts thought that sooner or later Argentina would succumb to the same pressures of internal unemployment and industrial stagnation that had led other countries to default on their foreign debts.¹⁶ As mentioned in the previous section, even modern econometric models would have predicted a default, given the severe deterioration in Argentina's terms of trade and other economic indicators.

Against the pessimism of international investors, Finance Minister Alberto Hueyo resolved to "achieve the impossible": full compliance with international debt contracts. Hueyo understood that Argentina could enhance its reputation by paying foreign debts

¹⁶ John U. Grissinger, "Metamorphosis of Argentine Bonds," *Barron's* (15 July 1935): 17.

during a period of economic crisis, and he was farsighted enough to value Argentina's long-term access to credit. When the Argentine Congress called for a moratorium on debt payments in 1933, Hueyo argued that Argentina would need to borrow again, and a good payment record would enable the country to convert its outstanding debt to lower interest rates. Default, by contrast, would be "short sighted," since it would not convey Argentina's "determination to carry out the weight of contractual obligations."¹⁷ According to insiders, both Hueyo and President Justo thought "it would be madness not to maintain debt service ... at a time when almost every other South American state is defaulting," since payment under those conditions would "consolidate the good name and high credit of Argentina."¹⁸ In short, Hueyo and Justo understood the theory of reputation that I outlined in Section 2.

Argentina did, in fact, distinguish itself from other South American borrowers by maintaining an excellent record of debt service throughout the Great Depression, even though its terms of trade and other external indicators dropped precipitously during the early 1930s. Not one central government bond fell into default, and the few Argentine municipalities that abrogated their contractual agreements imposed relatively little harm to bondholders. As the first panel in Figure 3 demonstrates, compliance rates for the country as a whole never dropped below 89 percent, even though investors had expected Argentina to honor only one-third of its obligations.

How did Argentina achieve such a clean record of debt service when its neighbors were defaulting? The short explanation is that Argentine citizens tightened their belts, thereby leaving enough government revenue and foreign exchange to uphold contractual obligations to foreigners. On the fiscal side, the central government raised import duties and imposed an income tax for the first time in Argentine history; it also slashed public spending, particularly in the previously inviolate civil service and military sectors. These measures transformed the budget deficit of 360 million pesos in 1930 into a surplus of nearly 11 million pesos two years later. In monetary affairs, the government began commandeering foreign exchange and dedicating it to debt service, thereby depriving domestic firms of the ability to import. Through these and other measures, the Government demonstrated that it "would not hesitate to introduce unpopular legislation to maintain Argentina's credit."¹⁹

Investors rewarded this perseverance; Argentina was one of the only countries that that issued new bonds in London and New York during the Depression, and it was able to convert its entire foreign debt into new issues at lower interest rates and slower amortization requirements. Conversions began in May 1934, when the Argentine Government reduced interest rates on its sterling-denominated debt from 5 percent to 4.5 percent (see Table 1) and cut amortization payments from 1 percent to only ½ percent per

¹⁷ Dr. Alberto Hueyo, Speech before Congress, May 30, 1933, in Memorandum dated July 11, 1933, Argentina Files, OV 102/3, Archives of the Bank of England, London. See also Alberto Hueyo, *La Argentina en La Depresión Mundial* (Buenos Aires: Librería y Editorial 'El Ateneo,' 1938).

¹⁸ *Financial News*, September 28, 1932. See also *Financial News*, October 26, 1932.

¹⁹ *Financial News*, January 22, 1932.

year.²⁰ At the same time, the government refunded its local-currency debt at lower rates, due largely to the enthusiasm of foreign investors, who bought many of the domestic securities.²¹ After completing its sterling and peso conversions, the Argentine government refunded its 6 percent dollar bonds at a new rate of 4 percent, and then borrowed \$25 million in fresh capital on the New York market in November 1938. This was "the first time in the history of the republic" that internal and external bonds had been issued at such economical rates.²² Overall, these operations reduced the government's external burden by 30 percent, allowing the government to save £5.1 million per year.²³ Thus, the behavior of creditors in response to Argentine policy seems consistent with my theory of reputation: by doing the seemingly impossible, Argentina bolstered its reputation in the eyes of creditors, who responded by lowering interest rates and raising credit ceilings at a time when most governments were shut-out of capital markets.

Table 1: Conversion of Sterling and Dollar Debt

Conversion Date	Name of Bond	Currency	Original Rate	Reduced Rate
May 1934	City of Buenos Aires (1909)	£	5 %	4.5 %
May 1934	Argentine Irrigation Loan (1913)	£	5	4.5
Sept 1934	Port of Buenos Aires (1892)	£	5	4.5
Sept 1934	Buenos Aires Water Supply (1892)	£	5	4.5
Sept 1934	Internal Loan (1907)	£	5	4.5
Sept 1934	Internal Loan (1909)	£	5	4.5
Sept 1934	Internal Loan (1910)	£	5	4.5
Dec 1934	Port of the Capital (1913)	£	5	4.5
Oct 1935	Argentine Railway (1896-99)	£	4	3.5
Nov 1936	External Series B (1924)	\$	6	4.5
Feb 1937	External series A (1923)	\$	6	4
Feb 1937	State Railway (1927)	\$	6	4
Apr 1937	Public Works (1926)	\$	6	4
Apr 1937	Public Works (1927)	\$	6	4

Sources: "La Conversión de la Deuda en Libras Esterlinas," *Poder Ejecutivo Nacional 1932-38*, vol. 1, ch. 3; *Moody's Governments and Municipals*, various issues; White Weld, *Foreign Dollar Bonds*; and Newspaper Cuttings of the Corporation of Foreign Bondholders, Guildhall Library, London.

Skeptics might grant that Argentina enjoyed special privileges in capital markets during the 1930s, but argue that the privileges did not stem from a favorable reputation. At

²⁰ John U. Grissinger, "Metamorphosis of Argentine Bonds," *Barrons* (July 15, 1935): 17.

²¹ "Argentina: Bond Issues Since the Beginning of 1937," Memorandum, March 22, 1938 in Argentina Files, OV 102/8, Bank of England Archives.

²² J.H. Leche to Anthony Eden, December 22, 1935 in Argentina Files, OV102/6, Bank of England Archives.

²³ Peter Alhadeff, "Finance and the Economic Management of the Argentine Government in the 1930s," Ph.D. Thesis (St Antony's College, University of Oxford, 1983): 178-79; "Argentine Conversion Savings," Memorandum of the Overseas and Foreign Department, August 7, 1937, in Argentina Files, OV102/7, Bank of England Archives.

least in the Argentine case, however, evidence does not support the skeptic's position. The standing ovation that Argentina received from foreign creditors reflected the reputation it acquired for paying during difficult times. As Sir Otto Niemeyer wrote to the Argentine finance minister in June 1934, the successful conversion of Argentine debt in London was "made possible by the impression created by the firm adherence of Argentina ... to the payment of her foreign obligations. Had it not been for the reputation so gained, I am sure that the result could not have been achieved. [T]he prevalence of defaults doubly enhances the standing of those who do not default."²⁴

Articles in the London press seemed to echo Niemeyer's view. The *Economist* noted the Argentina had enhanced its "good name" through "the exemplary manner" in which it complied with its financial obligations throughout the Depression. By elevating its reputation, officials in Buenos Aires were able to "penetrate the wall of fire" surrounding the London capital market and convert sterling-denominated debt to lower rates of interest.²⁵ Likewise, the *Times* reported in September 1934 that "Argentina has throughout the severe economic depression maintained in full the service of her external debt. At times this has involved ... considerable strain. But Argentina ... has succeeded where every other South American state has failed. She is now to receive the reward for this exceptional financial record."²⁶

Feelings were similar in New York, where Argentina converted its debt and then issued a new loan for \$25 million in 1938, while other countries were completely barred from private capital markets. *Barron's* magazine explained that investors were willing to extend cheap credit to Argentina, because it had "demonstrated to the world how it values a satisfactory credit rating. ... with every other South American borrower and the majority throughout the world taking the easier course, [Argentina] kept its eyes fixed on the goal of meeting contractual obligations. This during the most severe and comprehensive economic dislocation the world has yet seen when so many countries seemed to feel the matter of debt honor wasn't worth the sacrifice".²⁷ And the *New York Herald Tribune* added, "The numerous Latin-American defaulters have to stand, hat in hand, and beg for advances from the official Export-Import Bank. But Argentina stands as a shining example of probity in

²⁴ Sir Otto Niemeyer to Dr. Alberto Hueyo, June 13, 1934, in Argentina Files, OV 102/4, Archives of the Bank of England, London.

²⁵ "Argentina and the Investor," *The Economist* (April 28, 1934), 933; "Argentina and the Crisis," *The Economist* (February 8, 1936), 6. The *South American Journal*, a leading source of economic data for British bankers, concurred: Argentina "as a primary producer, has been badly hit during the past five years; but the Government has maintained Argentine credit at the highest level, by steadfastly refusing to agree to any schemes of interference with the strict letter of its contractual debt obligations, and is now getting its reward...." (May 25, 1935). See also the *Financial News* (May 29, 1934).

²⁶ "Big Argentine Conversion," *Times*, September 12, 1934, in Argentine National vol. 8, Newspaper Cuttings of the Corporation of Foreign Bondholders, Guildhall Library, London.

²⁷ John U. Grissinger, "Metamorphosis of Argentine Bonds," *Barrons* (July 15, 1935): 17

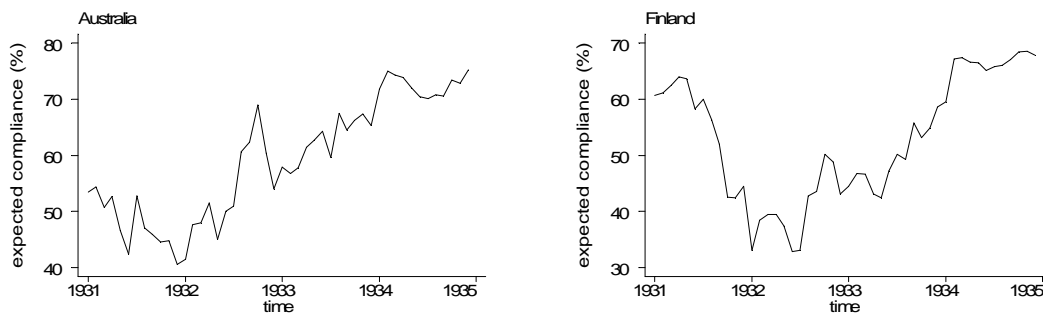
international financial dealings and fully deserves, on her record, the ability to borrow in the United States.”²⁸

Thus, credit markets did discriminate between borrowers and payers during the 1930s in ways consistent with my theory. Governments that honored their debts under adverse conditions climbed the reputational ladder and gained access to foreign capital when other governments could not borrow. In the case of Argentina, reputational gains were short-lived. Institutional changes associated with the rise of Perón led to doubts about the correlation of type over time, thereby diminishing the effect of the perfect credit record that Argentina had achieved during the Great Depression.

Other Surprising Payers of the Interwar Period

Argentina stands as the most surprising payer of the 1930s, but other borrowers showed fortitude by honoring their obligations to international creditors despite severe external shocks. As Figure 5 reveals, investors expected less than 50 percent compliance from Australia and Finland during the lowest point of the depression. Against these expectations, both countries met their financial commitments in full, thereby demonstrating their resolve and earning the respect of the international financial community.

Figure 5: Market Expectations of Australian and Finnish Compliance



Source: Author's calculations, based on monthly observations for Australian 5% bond maturing in 1957 and Finnish 7% bond maturing in 1950. Data from *Commercial and Financial Chronicle* (various issues), Board of Governors (1941), and White Weld (1932).

Given its close ties with the United Kingdom, Australia chose to cash its reputational chips in London instead of New York during the second half of the 1930s. Consequently, the number of Australian bonds quoted on the London Stock Exchange more than doubled between January 1933 and December 1938, a period when only a handful of countries could tap the British financial markets. The interest rate on new Australian issues hovered around 3.25 percent, though at one point the nominal rate dipped as low as 2.75 percent, quite near the “risk-free” rates of the major creditor countries. Immediately after

²⁸ *NY Herald Tribune*, March 24, 1940, in Argentine National vol. 8, Newspaper Cuttings of the Corporation of Foreign Bondholders, Guildhall Library, London.

the Second World War, Australia joined Norway and the Netherlands as the only three countries who borrowed in New York. Australia was, by far, the heaviest borrower, obtaining \$130 million in 1946-47 while pledging only 3.4 percent interest.²⁹

Like Australia, Finland proved its mettle during the 1930s and earned the status of a "blue chip" investment. In November 1934, the Finnish central government floated a new bond at only 4% interest, due mainly to the positive reputation it had obtained. As the Institute of International Finance reported in 1937, certain "... countries which regard their credit standing as a sacred heritage have done everything within their power to meet their external obligations ... in spite of the economic depression." The Institute singled-out Finland, in particular, for paying despite severe economic strain.³⁰ Other commentators noted that Finland distinguished itself by maintaining full payment on its war debts. Victor Schoepperle, Vice President of National City Bank, put this exemplary performance in perspective: "Some of us put willingness or determination to pay ahead of capacity to pay in our estimate of the credit standing of a borrower. The man in the street is familiar with the case of Finland, which alone of all the debtors to the United States has continued to meet her obligations arising out of the First World War," and maintained full payment on other debts at a time when other countries had the capacity to pay but chose not to do so.³¹

Beyond Australia and Finland, only two countries – Canada and Norway – managed to float new bonds during the 1930s; both qualify as surprising payers, given the adverse shocks they faced and considering market forecasts of their performance. Table 2 summarizes the new bond issues of Canada and Norway during the second half of the decade. The table reveals that both countries were able to borrow at low rates, which seems consistent with the prediction that countries can improve their reputations and gain privileged access to international capital markets by paying when investors would typically expect a default.

²⁹ John Henry Huber, "United States Investment in Foreign Bonds: A Study in International Capital Transfers," Ph.D. Dissertation (Syracuse: Department of Economics, Syracuse University, 1957), 201.

³⁰ John T. Madden, Marcus Nadler, and Harry C. Sauvain, *America's Experience as a Creditor Nation* (New York: Prentice Hall, 1937), 121.

³¹ Victor Schoepperle, "Foreign Bonds and Direct Foreign Investment," in *Fundamentals of Investment Banking* (Chicago: Investment Banker's Association of America, 1947), 486, 490.

Table 2: New Bond Issues by Canada and Norway

Canada			Norway		
Date	Amount	Interest	Date	Amount	Interest
Aug 1935	\$ 76	2.5 %	Mar 1936	\$ 17	4.5 %
Jan 1936	30	3.25	Mar 1936	7	4.5
Jan 1937	30	2.25	Apr 1936	32	4
Jan 1937	55	3	Feb 1937	29	4
Nov 1938	40	3	Mar 1938	7	4

Source: White Weld, *Foreign Dollar Bonds*, various issues.

When Do Defaults Occur?

A final implication of my theory is that defaults should coincide with external economic shocks. If, as the conventional wisdom suggests, concerns about reputation really do motivate governments to honor their debts, then a government will default only when defaulting would not compromise its image. This prediction, too, seems consistent with the facts. Over the past two centuries, defaults have occurred in waves coinciding with international economic contractions (1870s, 1890s, 1930s, and 1980s), but between these crises, defaults were relatively rare.³² Thus, concerns about reputation probably do motivate compliance, and creditors do not ignore history.

4. Applications to Other Issue Areas

The theory that I develop in this paper could shed light on reputation in other areas of international relations. In their qualitative analysis of deterrence cases, Snyder and Diesing find only one instance in which a decision-maker gave another state a reputation.³³ Quantitative research by Paul Huth and colleagues corroborates this result: they find no evidence that potential attackers made choices based on the defender's prior behavior in disputes with other states across various geographical regions. At most, reputations formed between states that were engaged in enduring rivalries within a single geographic region³⁴. Mercer's book casts even these findings into doubt. After examining the behavior of European powers between 1905 and 1914, Mercer concludes that reputations do not play

³² Christian Suter, *Debt Cycles in the World Economy* (Boulder: Westview, 1992); Vinod K. Aggarwal, *Debt Games: Strategic Interaction in International Debt Rescheduling* (New York: Cambridge University Press, 1996).

³³ Glenn H. Snyder and Paul Diesing, *Conflict among Nations: Bargaining, Decision Making, and System Structure in International Crises* (Princeton, NJ: Princeton University Press, 1977).

³⁴ Paul K. Huth, "Extended Deterrence and the Outbreak of War," *American Political Science Review* 82, no. 2 (June 1988): 423-43; Paul Huth, Christopher Gelpi, and D. Scott Bennett, "The Escalation of Great Power Militarized Disputes: Testing Rational Deterrence Theory and Structural Realism," *American Political Science Review* 87, no. 3 (September 1993): 609-23.

important an important role in explaining the outcomes of international crises.³⁵ Thus, "there is a substantial gap between the intuitive belief that reputations are an important cause of international conflict and the development of a compelling logical argument and empirical evidence to support such a conclusion"³⁶.

This paper provides a theory that could bridge the gap between intuition and evidence. The existing literature on military crises, like the work on sovereign debt, has failed to detect the influence of reputation, because the empirical research rests on a flawed theory of how reputations form in international relations. My theory of reputation explicitly accounts for external circumstances that shape government behavior, as well as domestic political institutions that determine the longevity of a government's image.

Government behavior in military crises probably does affect reputation, but only under certain conditions. In particular, a government that capitulates in the face of overwhelming military force will not suffer a loss of reputation, and a government that uses superior firepower to escalate crises against weaker enemies will not be regarded as unusually gutsy. But a government that persists against awesome force should gain a reputation for resolve by behaving contrary to what circumstances dictate. These hypotheses, which flow from my theory of reputation, could help resolve some of the most vexing puzzles in studies of military affairs.

³⁵ Mercer, *Reputation and International Politics*.

³⁶ Paul K. Huth, "Reputations and Deterrence: A Theoretical and Empirical Assessment," *Security Studies* 7, no. 1 (Autumn 1997): 72-99.