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Sovereign debt guarantees and default: Lessons from the UK and Ireland, 1920–1938 ☆

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ABSTRACT

We study the daily yields on Irish land bonds listed on the Dublin Stock Exchange during the years 1920–1938. We exploit Irish events during the period and structural differences in land bonds to tease out a measure of investors' credibility in a UK sovereign guarantee. Using Ireland's default on intergovernmental payments in 1932, we find a premium of about 43 basis points associated with uncertainty about the UK government guarantee. We discuss the economic and political forces behind the Irish and UK governments' decisions pertaining to the default. Our finding has implications for modern-day proposals to issue jointly-guaranteed sovereign debt.

'Further, in view of all the historical circumstances, it is not equitable that the Irish people should be obliged to pay away these moneys' – Eamon De Valera, 12 October 1932

1. Introduction

In the wake of the European sovereign debt crisis, there have been several proposals to issue jointly guaranteed European bonds.[1] Under these proposals, guarantors would each take responsibility for the obligations issued under the joint guarantee, with the intention of allowing some countries to take advantage of the creditworthiness of other countries. These proposals typically assume that jointly guaranteed sovereign debt would have near-zero spreads relative to the largest and most creditworthy participating sovereign, usually Germany. The assumption that jointly guaranteed debt would be risk-free has made its way into a budding literature assessing the potential effects of issuing such debt, for example, Hatchondo et al. (2014).

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[1] For example, Delpla and Weizsacker (2011) propose that states issue jointly guaranteed ('blue') bonds up to a limit of 60 percent of their GDP, with any issuance above the limit in sole-guaranteed ('red') bonds. Bofinger et al. (2011) suggest that joint-guarantees be given to debt issued by states in excess of 60 percent of their GDP, while Hellwig and Philippon (2011) propose that the jointly guaranteed debt should be in the form of short-term bills, rather than bonds. See also Jones (2010), Favero and Missale (2012) and Stiglitz and Basu (2013). Claessens et al. (2012) provide a helpful review of the proposals.

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Crucially, as noted by Gros (2011), the assumption that jointly guaranteed debt is risk-free takes as given that investors have faith in the guarantee. But what evidence do we have that such guarantees are generally perceived as credible? One first-order test would be to measure accurately the market premia associated with investors' perception of the credibility in government guarantees. This is challenging because there are few examples of guaranteed sovereign debt, in a setting similar to Europe, in which it is possible to estimate such a premium. Some progress may be made by carefully studying historical cases.[2]

In this paper, we study *land bonds* introduced at the end of the nineteenth century specifically to address problems associated with the structure of land ownership in Ireland.[3] Beginning in 1891, a sequence of parliamentary acts authorized the Treasury to issue government guaranteed bonds on international capital markets. The proceeds from the issuance were passed to the Irish Land Commission, which had been authorized under the same parliamentary acts to administer state-funded mortgages. Tenant-farmers used these long-term state loans to purchase land from the incumbent land-owners, and promised to repay annuities twice a year for terms of up to 70 years into Irish government-administered funds. The holdings in these funds were transferred through the National Debt Commission to the Treasury, which held ultimate responsibility for upholding the government's guarantee to repay the interest and principal on the land bonds.[4]

In many ways, the historical setting we study is reminiscent of modern-day Europe. For example, Ireland and the UK had a de-facto single currency throughout the period of our study. In addition, the two countries were close trading partners and had integrated financial markets (Ó Gráda, 1994). And, although Ireland was less-developed compared with the UK, both had relatively strong and advanced institutions and markets in comparison with the rest of the world. Undoubtedly, there are differences between the two economic environments but, as we will discuss, this is often to our advantage.

To tease out a measure of the investors' perception of the credibility of the guarantee, we exploit structural differences between land bonds. Prior to Ireland's independence in 1922, land bonds were guaranteed by the UK government. Following independence, the Irish government continued to implement land reform by issuing land bonds through the Irish Treasury.[5] In all major respects, the pre- and post-independence land bonds were identical except that the pre-independence land bonds carried UK government guarantees.[6] Part of the difference between the yield on benchmark government securities and the yields on land bonds reflects the market's perception of the value of government guarantees. Irish events during our period help to assess the credibility of government guarantees, using variation in the response of the yield spreads on different land bonds to the events.

We study the daily yields to maturity on land bonds traded on the Dublin Stock Exchange during the years 1920–1938. We use the same analytical framework that is frequently applied to financial time-series to find historical events that were perceived as important at the time they occurred.[7] We compute a weighted average of the individual yields to maturity, where the weights are the nominal amounts outstanding, shown in Fig. 1 for UK government bonds (the thick black line), UK-guaranteed land bonds (the medium red line) and Irish-guaranteed land bonds (the thin blue line) from 1910 to 1938.

Our main finding is a significant break coinciding with the Irish government's decision to no longer make annuity transfers to the UK government. The reneging of a sovereign financial obligation to another state constitutes a sovereign default.[8] The default event allows us to quantify the premium associated with investors' credibility about the UK government guarantee. We compare the effect of the default on the long-term spreads of both UK and Irish guaranteed land bonds. This analysis is akin to a difference-in-difference estimation, where the first difference is between land bond yields and government bond yields, and the second difference is between the periods before and after the default. The UK government's decision to uphold the guarantee on the land bonds suggests a premium of about 45 basis points was attributable to uncertainty about the UK government guarantee.

Our findings suggest that there was a significant risk premium associated with uncertainty about the commitment of the UK to the guarantee. In our concluding remarks, we discuss the implications for recent policy proposals to issue jointly

[2] In related work, Esteves and Tunçer (2016) study the moral hazard associated with debt guaranteed by Britain, France and Russia that were issued by Greece, Turkey, Egypt and China during the eighteenth and early part of the nineteenth centuries. And Collet (2014) studies the mutualization of debt as part of Italian unification. In addition, an historical analogy to debt guaranteed by another sovereign is drawn by Winkler (2011) and passing mention of some examples is made by Phillips (2012).

[3] The United Kingdom of Great Britain & Ireland was formed by the union of Britain (England, Wales & Scotland) and Ireland in 1801. From 1922, when Southern Ireland became independent with Dominion status, the United Kingdom was composed of Great Britain and Northern Ireland. We use the term UK throughout and refer to southern Ireland as the Irish Free State or Ireland.

[4] For more details on institutional background, see Appendix A and Foley-Fisher and McLaughlin (2016).

[5] Fiscal responsibility was determined before independence and negotiations surrounding the debt were relatively transparent. For example, prior to the 1913 and 1920 *Government of Ireland* bills, there were several parliamentary publications regarding Irish contribution to UK national debt published which laid the foundation for the subsequent independence (B.P.P., 1912–1913b, 1912–1913a, 1912–1913c, 1913, 1920d, 1920a, 1920c, 1920b).

[6] The presence of the gold standard and the de facto single currency between the UK and Ireland obviated the risks of inflation and exchange rate movements (e.g. see Daly, 2011). We discuss volatility and liquidity risks in Section 5. Moral hazard associated with the guarantee was limited by the strict connection between bond issuance and land reform.

[7] Some examples in European settings include Frey and Kucher (2000, 2001), Frey and Waldenström (2004), Waldenström and Frey (2008), and Brown and Burdekin (2002). Additional examples in U.S. settings include Davis and Pecquet (1990), Willard et al. (1996), Brown and Burdekin (2000), and Weidenmier (2002).

[8] Default is the term used by the UK government 'Irish Situation Committee' and the Chancellor of the Exchequer, e.g. 21 June 1932: 'Irish Situation Committee', National Archives of Scotland, CAB27/523. However, largely because there was no actual loss for bondholders, this default is not recorded in established lists of sovereign defaults (Reinhart and Rogoff, 2009, 2014).