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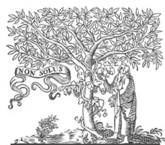

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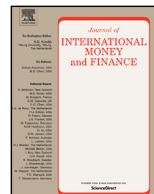

Feeling the blues Moral hazard and debt dilution in Eurobonds before 1914

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ABSTRACT

Debt mutualisation through Eurobonds has been proposed as a solution to the Euro crisis. Although this proposal found some support, it also attracted strong criticisms as it risks raising the spreads for strong countries, diluting legacy debt and promoting moral hazard by weak countries. Because Eurobonds are a new addition to the policy toolkit, there are many untested hypotheses in the literature about the counterfactual behaviour of markets and sovereigns. This paper offers some tests of the issues by drawing from the closest historical parallel – five guaranteed bonds issued in Europe between 1833 and 1913. The empirical evidence suggests that contemporary concerns about fiscal transfers and debt dilution may be overblown, and creditors' moral hazard may be as much of a problem as debtors'.

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1. Introduction

The European sovereign debt crisis, which has been affecting some of the heavily indebted member states of the European Union since 2008, has casted doubts on the long-term sustainability of the

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European Monetary Union (EMU). Different proposals to tackle the crisis include introducing structural reforms in programme countries, higher inflation targets for the ECB and restructuring EU institutions along the lines of stronger federalism. An important line of this debate focuses on the debt mutualisation through the issue of "Eurobonds." Having appeared under different labels and guises, the Eurobonds proposal, in essence, recommends that EMU countries pool all or a fraction of their debts. This would presumably reduce borrowing costs for member states and stabilise the European debt market. Although this proposal found some support, it also attracted strong criticisms for its possible caveats, particularly for its potential for generating moral hazard and diluting the outstanding debt stock.

Compared to other tried solutions for fiscal crises, such as debt restructuring or default, inflation and devaluation, and stabilisation plans from multilaterals, there is precious little evidence on the potential effectiveness of the Eurobonds proposal. The bailout and recapitalisation programmes organised since 2010 offer some suggestions of how Eurobonds could fare in the market, particularly after the reduction in mid-2011 of the interest paid by programme countries to close to the effective cost of funding of multilaterals. However, it is questionable whether the relatively short experience with these loans is a good estimate of the consequences of debt mutualisation for the future of European financial stability. The debate has therefore been mainly informed by untested hypotheses about the behaviour of financial markets and sovereigns after the issue of Eurobonds (Claessens et al., 2012).

This paper aims to contribute to this debate by drawing on the history of five guaranteed bonds issued before 1914. Somewhat ironically, these operations started with a Greek loan in 1833, which can arguably be considered the first Eurobond in history. The bonds we study were issued with the guaranty of other sovereigns, usually a combination of the great powers of the time (Britain, France, Germany and Russia) and were perceived by the market as instances of debt mutualisation, unlike the current European programme bonds (EFSF, EFSM and ESM). Perhaps because of the risks involved for the guarantors, these loans were seldom raised and often only after overcoming considerable political opposition within the guarantor countries themselves. After the first Greek loan, there were only four other guaranteed loans issued in our period of study – for Turkey in 1855, Egypt in 1885, China in 1895, and Greece again in 1898. Despite the significant differences between current and pre-1914 international financial architecture, we argue that the guaranteed bonds constitute the most relevant historical examples of debt mutualisation. Consequently, we borrow the current terminology in distinguishing between 'blue bonds' (mutualised debt) and 'red bonds', the exclusive responsibility of each sovereign (Delpla and von Weizsäcker, 2010).

We use the long historical record of these five loans to address three main questions – how the introduction of guaranteed bonds impacted existing creditors, how they were initially received by the markets, and how markets priced guaranteed debt relative to the other bonds of the assisted countries. The first two questions focus on the short-time horizon around the announcement and flotation of guaranteed bonds. By using an original dataset of daily market prices, we investigate the direct dilution of previous claims on the sovereign, which depended on the relative shares of 'blue' (guaranteed) and 'red' (non-guaranteed) bonds, seniority dispositions, possible write-downs of existing debts, liquidity of the new issues, and, when included, the benefits from foreign-imposed conditionality. We also compare the yields of guaranteed bonds to the marginal costs of funding of the guarantors. The third question has to be addressed over longer time horizons. In this part of the paper, we quantify the evolution of the spreads of guaranteed bonds relative to other non-guaranteed domestic bonds, and investigate the relation between the yields of guaranteed bonds, their non-guaranteed cousins, and their avuncular guarantors. These spreads are informative of the structural impact of these debt relief operations on the fiscal positions of the recipient nations and should help with addressing the contemporary criticisms about debtors' moral hazard from the issue of Eurobonds.

Our paper also relates to the literature on non-sovereign borrowing and foreign financial intervention in the pre-1914 period. Two of the countries under study here (China and Egypt) were under a status of informal colonial dependency from outside powers. Nevertheless, we show that guaranteed bonds of these countries were perceived differently in the market from other colonial issues, in that they were not priced entirely on the fiat of the colonial power. Colonial issues were more than guaranteed by the coloniser, as the latter reserved complete control over colonial finances (Accominotti et al., 2010; Chavaz and Flandreau, 2015). A different category of bonds was those issued under the

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