Pawned States

State Building in the Era of International Finance

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CONTENTS

1

Introduction

Societies thrive when people can depend upon a functional or "capable" state, one that monopolizes the use of force, protects property rights, and delivers extensive public goods and services from roads to public education to health care; but functional states cannot be taken for granted. State capacity, "the institutional capability of the state to carry out various policies that deliver benefits and services to households and firms,"[1] varies widely from state to state as well as within and across regions. Why do such differences exist, and why are they so persistent?

In this book, I trace differences in state capacity back to the nineteenth century. I will show that countries that then relied on domestic resource mobilization as opposed to foreign debt to fund government hold higher levels of state capacity today. Whereas tax collection compelled incumbents to invest in state strengthening institutions (from a tax agency to a universal census), external finance distorted incentives to initiate state apparatus modernization, pushing highly indebted nations into state weakening trajectories.

In the nineteenth century, recently created and traditionally isolated states floated sovereign loans in Europe to pay for war, balance the budget, and fund infrastructure projects. Rapid indebtedness of these weakly institutionalized economies often ended in external default—the suspension of debt service. In return for fresh capital, borrowers agreed to increasingly

1. Besley and Persson (2011, p. 6).

onerous conditions, including infrastructure concessions, the exchange of old debt for public monopolies, and leasing control over branches of the tax administration. After handing over key sources of government income to foreign bondholders, more loans were soon required to balance the budget. In anticipation of a likely default, foreign investors requested newer hypothecation of public assets, further slicing the effective tax base of the local government. By 1914, when the lending euphoria came to an end, many nations had already fallen into a debt trap, causing persistent fiscal imbalance.

Unlike one-sided theories of financial imperialism,[2] my argument also emphasizes the domestic angle to the surge of external indebtedness at early stages of state building. Foreign loans secure government funds to revenue-thirsty rulers while helping them dodge administrative reform and constraints on their power. That is, building an efficient tax bureaucracy consumes funds that incumbents cannot use for self-indulgence or nurturing patronage networks. Moreover, rulers may be obliged to share fiscal power with taxpayers to overcome hesitancy to increased taxation.[3] By relying on external debt, rulers in the global periphery can avoid the administrative and political costs of fiscal innovation, precluding advances in state capacity.

I quantify the consequences of foreign loans for state building by focusing on war finance in the nineteenth century. This decision is based on two grounds: First, war is the largest shock to any treasury[4] and the thriving force of state building throughout history.[5] Second, the euphoria in sovereign lending and the high frequency of interstate conflict concentrated between the end of the Napoleonic Wars (1815) and the onset of World War I (1914), declining dramatically thereafter. By studying the means of war finance in the so-called Bond Era, I can examine the commitment of rulers to mobilizing internal resources and whether early fiscal policy decisions pushed countries into different state building trajectories.

Addressing the usual suspects in causal inference analysis, I demonstrate that countries that relied disproportionally on foreign capital to finance war before 1914 show a lower capacity to raise taxes all the way to the present day. By contrast, countries that mobilized domestic resources to finance

2. Hobson (1902).
3. Levi (1988).
4. Barro (1979).
5. Boix (2015); Dal Bó, Hernández-Lagos, and Mazzuca (2015).

war show higher tax ratios and stronger tax bureaucracies today, and in some particular cases, stronger democratic institutions. The econometric evidence is accompanied by a collection of case studies that speak to different geographic areas and institutional contexts: Argentina, Chile, late-Qing China, Ethiopia, Japan, the Ottoman Empire, Peru, Siam, and South Africa. These cases illustrate the political game between foreign financiers, local incumbents, and taxpayers, and how early fiscal decisions shaped state building in the long run. In combination, the econometric analysis and qualitative accounts offer complementary evidence of the key assumptions, implications, and mechanisms of the theoretical argument.

On paper, foreign capital in the Bond Era offered an unmatched opportunity to overcome barriers to economic growth and invest in infrastructure with high social returns; however, it also weakened incentives to build capable states, pushing poor and weakly institutionalized nations into debt traps. Counterintuitively, developing nations might have benefited from tighter access to external capital at early stages of state building, which would have strengthened rulers' incentives to expand state capacity on a permanent basis. My conclusions have implications for the study of international finance, state building, and political reform, as I outline below.

The Globalization of Finance

The argument of the book builds on the assumption that countries in the Global South or periphery had access to relatively cheap external credit during the Bond Era;[6] however, sovereign borrowers outside Europe had weak fundamentals and little or poor reputation in capital markets, and they experienced regular episodes of default.[7] I shed light on this apparent contradiction by introducing the concept of *extreme conditionality*: the hypothecation of local assets (e.g., state monopolies, railroads, and customs houses) for fresh foreign loans.

The ability of foreign bondholders to gain new concessions and take control over collateralized assets in the case of default heightened as the interests of financiers and creditor governments grew closer, a phenomenon accelerating in the last decades of the nineteenth century. In Britain—the leader of capital exports—the gradual alignment between financial and government interests resulted from three interrelated factors: elite replacement, bondholders' coordination, and imperial competition. The

6. I use the terms *Global South* and *periphery* interchangeably to refer to countries in Asia, Africa, Central and South America, and Southern and Eastern Europe.

7. Reinhart and Rogoff (2009).

new "gentlemanly class"[8]—the marriage of banking families and landed elites—assumed leading positions in the Foreign Office, the Bank of England, and consular service. Meanwhile, foreign bondholders inaugurated the Corporation of Foreign Bondholders (CFB), an encompassing organization representing big and small investors that perfected the art of requesting diplomatic assistance in sovereign debt crises. Initially hesitant, the British government grew receptive to such demands, incorporating finance into the set of imperialist policies, a practice that France and Germany had been open about since the 1870s.

Mitchener and Weidenmier have shown that "supersanctions" involving foreign financial control and gunboat diplomacy were regularly imposed on *embarrassed governments*—as countries that suspended debt service were referred to. Forty-eight percent of the countries that had defaulted between 1870 and 1914 were supersanctioned. Borrowers that defaulted more than once were supersanctioned 70 percent of the time.[9] Mitchener and Weidenmier argue that supersanctions were imposed on a case-by-case basis and upon manifest bad behavior, namely, *ex post*. I argue instead that severe sanctions gradually became part of the lending business model, a generally recognized practice of debt collection. The possibility of imposing supersanctions following debt service interruption was increasingly agreed upon at time of issue, or *ex ante*, thus my preference for the term *extreme conditionality*. Seizure prioritized pledged assets—state monopolies and tax sources that had been hypothecated in the original loan contracts.[10] Coding the presence of pledges out of 700+ sovereign bond prospectuses in 1858–1914, I show that the expectation of taking control of local public assets decreased the premium paid by countries with poor or no reputation in international markets. For one, extreme conditionality offers an original explanation of the secular decrease of the spread (the interest rate difference between wealthy and poor nations) in the Bond Era despite the high frequency of sovereign default.

My treatment of international lending resonates with the *Hobson-Lenin hypothesis*, according to which European powers used international finance as an instrument of imperial domination.[11] Extreme conditionality can be

8. Cain and Hopkins (2016).

9. Mitchener and Weidenmier (2010, p. 27). As I discuss in chapter 4, this is only a lower-bound estimate of the frequency of supersanctions.

10. Until the mid-twentieth century, the terms *loan* and *bond* were used interchangeably. I follow that convention throughout the book.

11. Hobson (1902) and Lenin (1934), and Frieden (1994) for a concise review.

interpreted as a microfoundation of financial imperialism, a nonviolent policy to gain control over foreign assets. However, unlike the Hobson-Lenin hypothesis, I emphasize the domestic angle to the surge of external finance in the Bond Era: foreign loans secured government funds while helping rulers postpone administrative reform and constraints on their power.

War and State Making

The argument in this book revisits the connection between war and state making in the era of international finance. Contrary to the unconditional characterization of the so-called bellicist hypothesis, that is, *more war, more state*, I argue—very much alongside Tilly's original work—that the effect of war on state building ultimately depends on how warfare is paid for: financing war with taxes (or domestic credit) is conducive to state making, whereas financing wars with external loans may not be similarly conducive because rulers may dodge the long-term equivalence between loans and taxes if war debt is repaid in specie.[12] When this equivalence holds—when rulers repay war debt with tax money—positive institutional transformations associated with the bellicist hypothesis can be expected. That is, war makes states because rulers are compelled to expand tax capacity to repay war debt. If rulers find ways to minimize the war bill or manage to service war debt in specie rather than tax money, war will not make stronger states, unraveling the equivalence of debt and tax for the purpose of state building.

The importance of external finance of war for state making has been emphasized by the institutional sociologist Miguel Angel Centeno.[13] I advance our understanding of external finance on state building in two ways: First, I put forward a political explanation for the preference of external finance over taxation. I argue that the possibility of bypassing administrative costs and tax bargaining with domestic constituency can preempt investment in tax modernization and political reform, impeding the growth of state capacity over time. The new theoretical predictions shed light on which countries are likely to be negatively affected by external finance and why those effects are long-lasting. Second, by introducing the

12. In the economic literature, this equivalence is referred to as *Ricardian equivalence*. My argument suggests that the Ricardian equivalence was largely met for lenders because they recovered their investment one way or another, hence their willingness to lend; but the equivalence does not necessarily apply for the purpose of state building if rulers repay foreign debt with equity instead of tax money, avoiding gains in tax capacity.

13. Centeno (1997, 2002).

concept of extreme conditionality into sovereign borrowing, I elucidate the reasons that weakly institutionalized countries were allowed to float loans even after recent default, growing foreign indebtedness, and an eroding tax base.

Public Finance and Limited Government

The argument and evidence advanced in this book speak to the relationship between state finance and political reform. Public credit in Europe gave rise to a key political institution: limited government, the constitutional right of a parliament to control the national budget on an annual basis.[14] To prevent monarchs from reneging on war debt, the Crown's lenders demanded veto power over spending decisions.[15] This compromise secured war funds for the Crown and enabled taxpayers and creditors—often the same individuals—to hold the monarch accountable. Mutual gain transformed taxation into a nonzero-sum game—the ruler secured funds for war and the taxpayers protection from foreign aggression—enabling sustained investment in state capacity.[16] State building in Europe, in sum, brought together public credit and political development.

In this book, I reexamine contractual theories of public finance and representation in light of the first globalization of credit markets. Cheap external capital may strengthen incentives to finance externally while preempting tax bargaining with domestic constituents and the development of *domestic* credit markets, thus the formation of a mass of domestic lenders with whom to strike bargains conducive to limited government. In other words, the internationalization of credit may work against the spread of democracy, a key driver of strong, capable states.[17]

1.1 External Public Finance and State Building

Before I delve into historical evidence, let me anticipate the main logic of the argument in chapter 2, where I advance a political economy of public finance and delineate fiscal consequences of early policy decisions. Although I focus on war financing—a paramount fiscal shock often related to state building—I envision the argument to apply to other policy realms that require substantial revenue mobilization in a relatively short period of

14. Dincecco (2009, p. 95).
15. Bates and Lien (1985); North and Weingast (1989).
16. Levi (1988); Besley and Persson (2009).
17. Acemoglu and Robinson (2019); Stasavage (2020).

time: for example, combating a pandemic, building critical infrastructure, and recovering from a natural disaster.

Suppose there is an incumbent or ruler who must finance a given exogenous war. To simplify the analysis, I assume two funding options, taxes or loans, ruling out intermediate combinations. Likewise, I consider only *external* loans because domestic credit markets outside Europe were largely tight or nonexistent before the twentieth century.[18] The ruler, motivated only by individual gain, seeks to maximize private income by keeping a cut of total government funds (i.e., rents). Taxpayers, by contrast, prefer all their tax money to be spent on public goods, whereas government lenders—private individuals based overseas—want to recover their investment (the principal and interest) within a stipulated time (or maturity).

To discipline the ruler, taxpayers demand some institutionalized say in how public moneys are spent, that is, power-sharing institutions. If these are granted, the ruler secures war funds at the cost of limiting his discretion over fiscal policy, hence rents from office. Once power-sharing institutions are in place, they are likely to stay for two reasons: First, taxation can become a win-win for the ruler and taxpayers: the former secures a stable stream of funds, and the latter hold the ruler accountable while benefiting from public goods. Second, power-sharing institutions help taxpayers overcome collective action problems in disciplining the ruler, hence their bargaining power.[19] Foreign private investors have market-based means to discipline the ruler: they compensate the risk of default ex ante by charging a higher interest rate (or premium) and ex post by imposing a default sanction: for instance, denying new loans if debt service is interrupted (also known as *capital exclusion*).

The ruler decides which principal to serve: taxpayers or foreign financiers. On the one hand, taxes strengthen power-sharing institutions, thus reducing the share of public funds the ruler can retain for self-consumption. But the capacity of the state to tax improves by exercising it, expanding future tax revenue and the size of the pie the ruler can partially appropriate. On the other hand, external finance secures funds for war today while saving the costs of administering taxes and postponing constraints on the ruler's power. In the future—once the war is over—the ruler will decide whether to assume the cost of taxation to repay war debt with tax money (i.e., funneling resources to enhance tax capacity and sharing

18. Japan is an outlier and because of that it is one of the few successful cases of state building.
19. Stasavage (2011).

fiscal power with taxpayers)—or to suspend debt service and deal with the consequences of default.

The incentives of a ruler to finance war with external loans instead of taxes depend on three domestic factors—the initial strength of power-sharing institutions, the initial strength of the tax administration (or fiscal capacity), and the ruler's time horizons—plus two external factors—the liquidity of international capital markets and the size of the default sanction.

If the war bill is to be paid tomorrow, rulers with short time horizons—for instance, in polities with political instability—might find external war finance preferable even at the cost of future default sanctions. Arguably, those costs are the problem of some future leader. Initial fiscal capacity and political conditions matter, too: If the state has high tax capacity and strong limited government to begin with, preference for financing the war with taxation will strengthen, all else constant. By contrast, rulers in countries with weak executive constraints and low fiscal capacity will find taxation disproportionally burdensome because they need to relinquish political power for relatively small increases in tax capacity.

International factors interact with domestic institutions—a leitmotif in the book. As the liquidity of international finance grows, interest rates decrease for both unseasoned and seasoned borrowers, diminishing the future tax cost of war. This effect is particularly relevant to the Bond Era, when capital surplus from the Industrial Revolution was poured into global financial markets, fueling a culture of cheap credit.

The ruler honors debt in the future only if the cost of interrupting service, namely, the external default sanction, is higher than the cost of building up tax administration and sharing power with domestic taxpayers. The ability of external default sanctions to discipline borrowers depends on its severity and credibility.[20] Foreign bondholders devised in the Bond Era a mechanism that met both properties: extreme conditionality. This involved the hypothecation of public assets (e.g., state monopolies, customs houses, land) as a precondition of new loan issues. In case of default, pledges would be seized or managed by foreign bondholders until debt was liquidated.

Confiscation of national assets, or *debt-equity swaps*, and foreign control of local tax administration, known as *receiverships*, were perceived unpopular enough to preempt the temptation to default. The key for extreme conditionality to work was the enforcement mechanism. Seizure of national

20. Bulow and Rogoff (1989); Schultz and Weingast (1998).

assets, which was impossible if borrowers did not agree to it, occurred only under the veil of coercion. Although bondholders lacked military capacity, they sought diplomatic help from their government.

Officially, the British government resisted involvement in private disputes between bondholders and embarrassed governments. Unofficially, British ambassadors would exert good offices on behalf of home creditors if only to counterbalance the growing and open interventionism of the French and German governments in private credit markets. At other times, the Foreign Office would be as blatantly interventionist as its continental counterparts. Elite replacement within the British government greased the alignment between financial and national interest. In nineteenth-century Britain, landed elites and big merchant families merged into a gentlemanly class that assumed key positions in government and the Bank of England, the pillar of British public credit. Public and private interest became intertwined. International lenders took advantage of this and geostrategic competition between the Great Powers to request of emerging economies the hypothecation of national assets and sources of revenue as a precondition of fresh loans. This had two substantive effects—one of interest for public finance historians and the other for students of state building.

First, extreme conditionality sheds light on the causes of the secular reduction of the spread in the Bond Era. By raising the credibility of default sanctions—the confiscation of national assets—the risk and premium levied on developing nations declined over time despite repeated episodes of default. Second, extreme conditionality was a double-edged sword for state building. By pawning national assets, rulers secured cheap cash without having to assume administrative costs of taxation or sharing power with taxpayers—the hook—but they opened the door to financial control by foreign private investors—the catch. By "agreeing" to debt-equity swaps and installment of receiverships, emerging economies regained access to international markets after default without having strengthened their capacity to tax. If anything, default sanctions shrank the tax base in the hands of the government, leaving the local treasury in a precarious position.

1.2 The Rise of External Public Credit

A key assumption in the argument of this book is that the Global South had access to cheap credit overseas. International capital markets were not invented in the nineteenth century; however, they acquired an entirely

new dimension at that time.[21] Following the Napoleonic Wars, first Britain and later France and Germany pushed surplus capital emanating from the Industrial Revolution into the developing world in the form of sovereign loans. Recipients were a combination of previously closed economies (e.g., China, Japan, Siam), newly independent states (mostly in Latin America, Southern and Eastern Europe, and Northern Africa), and colonial dominions. Borrowers used foreign capital to wage war, balance the budget, and invest in large infrastructure.

The nineteenth century was exceptional for many reasons: First, the magnitude of international lending was unprecedented, and unseen until the turn of the twentieth century. Relative to world GDP, international capital flows in 1980 were still three times smaller than a hundred years earlier.[22] Second, sovereign loans were private contracts between European financiers and foreign governments. Official lending (bilateral or multilateral) played a residual role, the opposite of the modern day.[23] Third, and perhaps most surprisingly, capital was cheap.

Figure 1.1 plots interest rates of an original dataset of 900+ sovereign loans floated in the London Stock Exchange (LSE) between 1816 and 1913. The vertical distance between the two superimposed curves shows the time-varying average spread between emerging economies and European countries, that is, the premium levied on developing nations. The spread remained around 100 basis points until 1860 and gradually vanished thereafter.

I elaborate on the conditions of external public credit in chapters 3 and 4. Here it suffices to say that the modest spread between advanced and developing economies remained for effective interest rates, and that risk was not compensated with shorter maturities. I argue that extreme conditionality—the hypothecation of public assets—helps explain the secular reduction of the spread in the Bond Era. I examine this hypothesis by analyzing the effect of bond securities (also known as pledges, collateral, and hypothecation) on effective interest rates of 700+ newly digitized sovereign loans floated in London. The evidence indicates that the credibility of pledges, hence their capacity to reduce risk, increased as private financial interests and British national interests grew closer in the later decades of

21. Eichengreen, El-Ganainy, Esteves, and Mitchener (2019).

22. Eichengreen (1991, p. 150).

23. Stallings (1972, pp. 13–26) for evidence of this switch following World War II, and Bunte (2019) for continuation of that pattern until the present day.

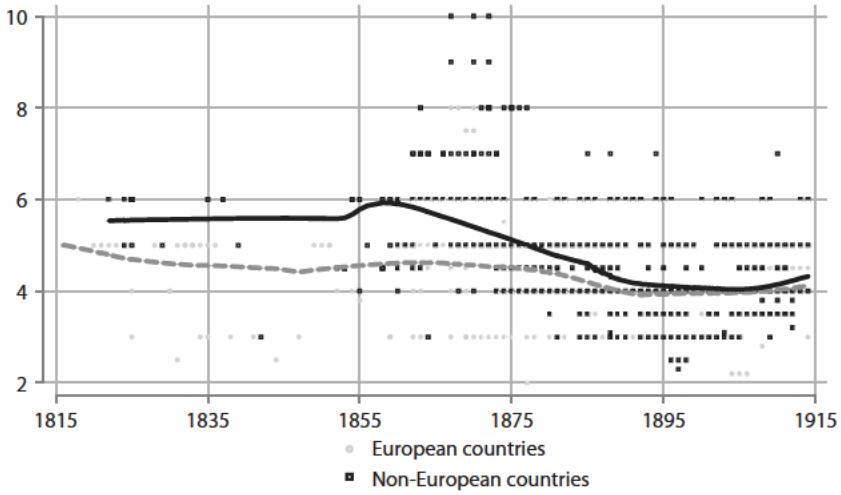

FIGURE 1.1. Nominal interest rates in the Bond Era: European vs. non-European countries. A dashed lowess line is superimposed for the European sample and a solid line for the non-European sample. Compiled by author from multiple sources (see chapter 3).

the nineteenth century. This result contributes to the theories of the spread while revisiting the principle of absolute sovereign immunity in the era of high imperialism.[24]

1.3 State Building and Fiscal Capacity

To quantify the consequences of cheap capital on state building, I focus on the capacity of the state to tax, also known as *fiscal capacity*. This involves the state's ability to assess wealth, monitor compliance, and secure a stable stream of government funds. Taxes are one of the three pillars of the modern state, the others being the monopoly of coercion and the enforcement of property rights or *legal capacity*.[25] Because neither of the other two key functions of the state can be implemented without funds, "the history of the state revenue production is the history of the evolution of the state."[26] For the sake of illustration, figure 1.2 shows the modern-day relationship between tax capacity, measured by income tax ratios, and a general proxy of state capacity produced by the Fund for Peace, the *Fragile States Index*.

24. Verdier and Voeten (2015) for the standard interpretation.
25. Besley and Persson (2011).
26. Levi (1988, p. 1).

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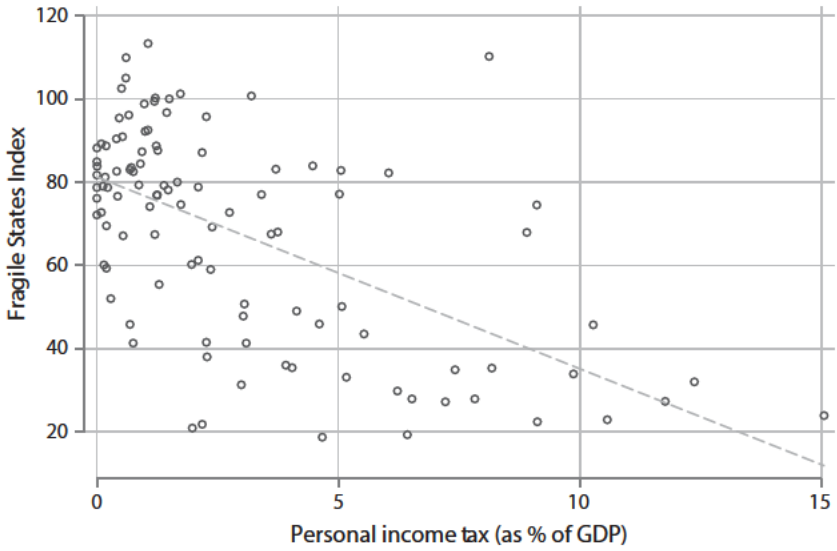


FIGURE 1.2. State fragility and fiscal capacity. This figure plots the Fragile States Index for 2010 on average income tax ratios from 1995 to 2005, drawn from the IMF's government financial statistics and augmented by the author with information from national treasuries (N = 102). The Fragile States Index (Fund for Peace, 2020) triangulates news content analysis with economic, political, and institutional indicators plus qualitative review.

One thing remains clear: a state that underperforms in tax capacity is not a strong state.

Building fiscal capacity requires tax harmonization across the territory and the establishment of a professionalized tax apparatus endowed with extensive powers to assess wealth, collect taxes, and sanction noncompliers. In recent decades, a burgeoning group of scholars has addressed different aspects of fiscal capacity building. A consensus exists about the key role of war in growing the state capacity to tax. Raising an army; buying firearms, cannons, and equipment; transporting troops; feeding soldiers at the front; treating the wounded—all consume vast resources. The fiscal effort required by war is expected to strengthen the capacity of the state to penetrate all layers of society and extract resources in the form of taxes.[27] To implement this in an expedited, orderly, and systematized fashion, rulers may apply a series of "self-strengthening reforms,"[28] including fiscal centralization and the introduction of budgets,[29] the pro-

27. Mann (1984).
28. Hui (2004).
29. Dincecco (2011) and Cox and Dincecco (2021), respectively.

fessionalization of the tax administration,[30] and the adoption of modern forms of taxation—from excises[31] to progressive income taxes.[32] Far from disappearing, the financial innovations that fund the means of war are expected to exert lasting effects on the extractive capacity of the state;[33] or, as Charles Tilly famously put it, "war made the state, and the state made war."[34]

The foregoing argument, known as the *bellicist theory of state formation*, draws heavily from the history of state building in Western Europe.[35] Evidence of the bellicist hypothesis outside Western Europe is mixed. Some point to dissimilar initial conditions: non-European societies were too fragmented and ethnically heterogeneous to capitalize war efforts.[36] Others to the type of war waged in the Global South: short and small.[37] I deviate from this interpretation by showing in chapter 6 that war in the nineteenth century in the global periphery was bigger, longer, and more frequent than usually understood. A key reason it did not translate into stronger states is because it was disproportionally financed with external capital. Rulers in the Global South waged war without having to put forward the institutional transformation and agree to political innovations that European monarchs were compelled to before 1815, simply because the international credit market was too small and expensive at that time.

The reexamination of the bellicist hypothesis in the era of international finance reveals ways in which the joint consideration of debt and taxes can expand the study of fiscal capacity. To date, major contributions focus on one of these two instruments, keeping the other constant.[38] The results in this book indicate that our understanding of the political dilemmas of public finance can benefit from examining the opportunities and trade-offs between taxation and credit, internal and external revenue mobilization.

30. Ardant (1975).

31. Brewer (1988).

32. Scheve and Stasavage (2010, 2016).

33. Besley and Persson (2011); Brewer (1988); Dincecco and Prado (2012).

34. Tilly (1990, p. 42).

35. Seminal contributions can be found in Downing (1993), Ertman (1997), Hintze (1975), Mann (1984), and Tilly (1990).

36. See, for instance, Centeno (2002) and López-Alves (2000) for Latin America and Taylor and Botea (2008) for Asia and Africa.

37. See Centeno (2002, ch. 2) and Soifer (2015, ch. 6) for war and state building in Latin America.

38. See Besley and Persson (2011), Dincecco (2011), and Stasavage (2011).

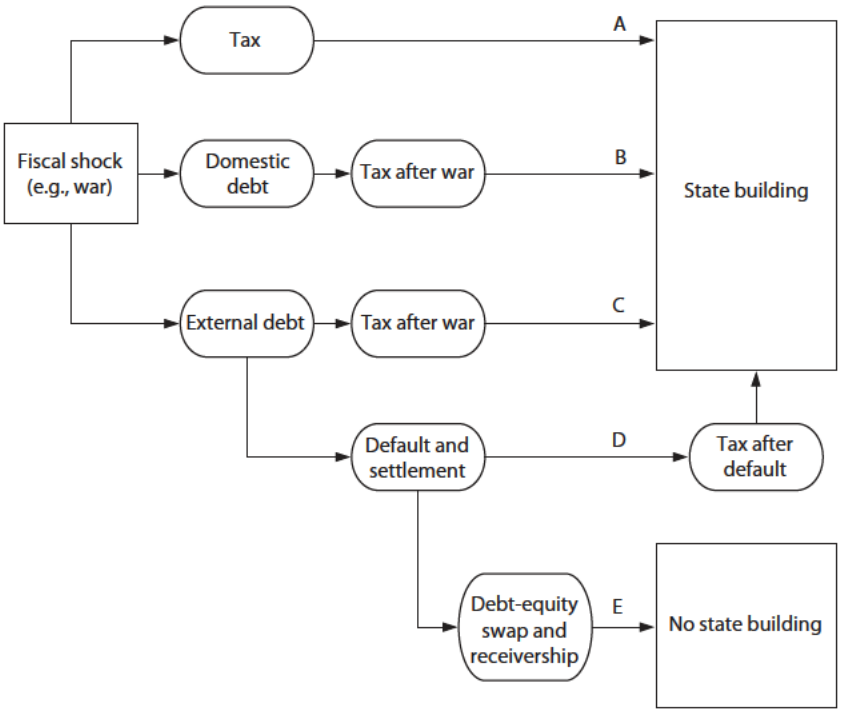


FIGURE 1.3. Fiscal shocks and state building trajectories.

1.3.1 STATE BUILDING TRAJECTORIES

The means to fund government in the Bond Era had lasting consequences because they compromised future policy options. To explain why, I need to expand the time frame to early-modern times as well as the set of revenue-generating policies by considering domestic credit. In this stylized setup, a ruler decides how to secure funds to address a major fiscal shock—and I stick with war. I consider five possible responses, A through E, in figure 1.3.

Paths A and B imply domestic resource mobilization in the form of taxes and domestic debt. Following paths A and B, monarchs in early-modern Europe secured funds for war by relinquishing fiscal power over national elites in return for taxation, domestic credit, or both. Power-sharing institutions materialized into constitutional monarchies (e.g., Britain) or oligarchic regimes in which tax farmers and regional parliaments kept the Crown in check (e.g., France).[39] Because monarchs depended on domestic resources, they were compelled to build large tax bureaucracies to honor

39. For France, see Johnson and Koyama (2014) and Mousnier (1974).

debt after war. Repudiation was political suicide because it implied the loss of political and financial support of big taxpayers and Crown lenders.[40] By making debt repayment self-enforcing, military expenses grew fiscal capacity over time.

European monarchs were compelled to mobilize domestic resources because international markets were tight before the Bond Era.[41] The few who managed to finance war externally (e.g., Spanish monarchs relied on Genoese bankers) were not compelled to invest in state institutions, leading their countries into decay.[42]

After 1815, external loans emerged as a widespread option to fund public spending. Emerging economies could follow path A (taxation) or C–E (external finance in its different trajectories). B was off the table because of the low levels of capital accumulation outside Western Europe, a requirement for domestic credit markets.

Resorting to taxation to finance the means of war (path A) could be a matter of luck—for instance, having skilled politicians in office capable of seeing down the path as Ethiopia and Siam once had—or imposition by circumstances—for example, having to wage war while being excluded from international markets as had once occurred in Spain and Chile.

Statistically, most countries in the periphery during the Bond Era took paths C–E, consistent with the theoretical argument: when the initial stock of fiscal capacity was low and power-sharing institutions were weak—conditions common in the Global South—the administrative and political costs of taxation trumped those of external finance even if it opened the door to foreign control in the (distant) future.

Japan exemplifies path C to state building. This country raised numerous external loans yet never defaulted.[43] Compared to Siam (a relatively similar case[44]), Japan built a stronger bureaucratic state because it assumed the political cost of taxation—power-sharing institutions—as part of the Meiji Restoration. Compared to Argentina, the poster child of international economic integration in the Bond Era, Meiji Japan borrowed less overseas because it inherited a stronger domestic credit market, a rarity (and a blessing) in the Global South. Joint external and domestic resource mobilization

40. Saylor and Wheeler (2017).

41. Homer and Sylla (2005).

42. Drelichman and Voth (2014).

43. Suzuki (1994).

44. See Paik and Vechbanyongratana (2019) for a comparison of state building in Japan and Siam.

pushed Japan down the same path of state building that Western European powers jumped into before 1800.

Japan was unique. The vast majority of countries lacked a domestic credit market to work with and financed externally, taking paths D and E freely or by force. Path D is not necessarily bad for state building, but it can retard it. Arguably, it describes the cycle followed today by countries in financial hardship; for example, Greece after 2010. In the modern day, external default is a relatively ordered process led by multilateral organizations that condition financial support on austerity programs that combine spending cuts and tax reform intended to improve local capacity. For instance, the "first memorandum" between Greece and the troika (the EC, IMF, and ECB) conditioned bailout on an increase in the value added tax (VAT); taxes on corporate profits, real estate, luxury goods, and imported cars; and excises on alcohol, cigarettes, and fuel.

The absence of multilateral organizations in the Bond Era, combined with geostrategic competition of the Great Powers, allowed bondholders to push emerging economies onto path E. Hypothecation of national assets gradually became required to access external capital—extreme conditionality. When default happened—and it often did—foreign control followed. Debt-equity swaps were not intended to produce improvements in tax capacity, nor were receiverships. These parastate organizations took control of entire branches of the local tax administration and were installed for one purpose only: the repatriation of private capital. Receiverships were managed by foreign bondholders or their representatives and operated under European (and American) standards. They might have brought in new tax technologies and created positive externalities in the local administration, but evidence in chapter 5 suggests otherwise. In the Bond Era, receiverships were installed to make profit, not to build capacity.

In sum, unlike paths A–D, E does not satisfy the long-term equivalence between debt and taxes. Quite the opposite, debt-equity swaps and receiverships erode the local tax base and require fresh securitized loans to balance the budget, creating endemic fiscal deficits.

1.3.2 CHANGE AND CONTINUITY

The political dilemmas of public finance shed light on the reasons that fiscal policy in the nineteenth century could affect long-term state capacity. External finance, which allowed rulers to dodge political compromise with taxpayers and investment in tax capacity, was not always available. Countries could be excluded from fresh loans but nevertheless need funds,

for instance, to wage international warfare. Warring states could also be in good standing with foreign creditors but happen to wage a war in the midst of an international financial crisis, when credit was tight.

As speculative as it was, the Bond Era was characterized by ups and downs, lending euphoria followed by "sudden stops"[45] of credit, freezing capital flows around the world on a temporary basis—usually four years. I take advantage of these exogenous episodes to examine whether incentives to enhance taxation strengthened when rulers needed funds for war but could not count on foreign credit. Pursuing this path, rulers would be putting in motion two mechanisms that connected fiscal efforts in the past to state capacity in the future. First, to foster compliance with higher taxes, rulers would be compelled to articulate power-sharing institutions over fiscal policy to overcome taxpayers' hesitancy to further taxation. Once in place, taxation would become a self-sustaining compromise: the rulers would secure funds while taxpayers would hold them accountable for their fiscal decisions, expanding the capacity to tax in the long run. I refer to this as the *political mechanism* of transmission.

Students of democracy agree that power-sharing institutions are actionable when taxpayers face low coordination costs and easy ways to escape taxation—conditions harder to meet in large-scale and poor economies.[46] Negotiating power-sharing institutions in return for tax increases was also off the table for most countries under colonial rule. In response, I consider a second mechanism of transmission that is independent of political status, geographic scale, and capital mobility. I call it the *bureaucratic mechanism*, which refers to the efforts against fiscal capacity disinvestment that tax bureaucracies exert to safeguard organizational survival.[47]

In chapters 8 and 9, I evaluate the effect of external finance on fiscal capacity and the plausibility of the two mechanisms of transmission. A battery of statistical analyses involving advanced and developing nations suggests that access to external finance distorted incentives to invest in fiscal capacity, preventing state building. By contrast, waging war excluded from capital markets expanded the capacity of the state to tax in the short and long run. Resorting to taxation contributed to the expansion of power-sharing institutions, particularly in smaller and wealthier countries, and the growth of the state bureaucracy in sovereign states and colonial dependencies.

45. Catão (2006).
46. Bates and Lien (1985); Boix (2003); Stasavage (2011).
47. Schumpeter (1991).

1.4 Why Europe and Not the Global South?

Ultimately, the theoretical argument and empirical evidence in this book seek to shed light on the broader question that gives this section its name. It is common knowledge among economic historians that states in Europe were made by war *and public credit*. Then why did war make states in Europe but not elsewhere? In short, European monarchs borrowed from domestic sources, guaranteeing efforts in fiscal capacity building to repay debt after war.

Before 1800, international capital markets were limited at best.[48] Lacking access to cheap foreign capital, European monarchs were compelled to mobilize domestic resources to pay for war. Following the military revolution in the mid-sixteenth century, military outlays grew at a faster pace than tax revenue, requiring new forms of government funding. Monarchs then borrowed heavily from merchants and landed elites, but loans came at a price. To convince elites that debt would be repaid, monarchs shared power over fiscal policy with the Crown lenders. Organized into parliaments or lending cartels, the Crown lenders would deny the monarch new funds if debt service was interrupted and withdraw political support if necessary. To avoid the consequences of domestic default, monarchs invested in modernizing the tax administration and secured proceeds to meet domestic debt obligations. By 1815, most European powers had already achieved relatively high levels of fiscal capacity.[49] Securing high tax yields, they could benefit from international liquidity in the Bond Era without having to compromise national sovereignty.

The globalization of public credit in the nineteenth century changed all that. Recently independent states and semiautonomous countries that came to exist outside Europe only in the nineteenth century faced starkly different initial conditions to build states. While European monarchs lacked external options but counted on domestic creditors, rulers in the global periphery lacked home lenders but had access to foreign capital. Emperors, presidents, and sultans outside Europe contracted loans to finance war, budget deficits, and infrastructural investment while postponing key administrative and political reform. External debt soon piled up, consuming vast foreign reserves. When debt service was interrupted, severe conditions were imposed for fresh funds, including receiverships and debt-equity swaps, further eroding the tax base. Many emerging

48. Homer and Sylla (2005).
49. Dincecco (2011).

economies fell into debt traps, causing detrimental long-term consequences for state building and political reform.

Why Europe and not the Global South? One thing is clear: European monarchs before 1800 were hardly more public spirited than leaders of emerging states after 1800—they simply faced a different international context, and state building benefited from it.

1.5 Competing Arguments

States are weak when government cannot accomplish the tasks it intends to do: economic, social, or political. Next, I discuss three widely accepted causes of state weakness: access to natural resources, ethnic division, and colonialism. The argument I advance in this book is not meant to substitute or falsify any of these three hypotheses. I interpret external finance as an additional cause of state weakness, which nevertheless has connections to existing accounts; for instance, natural resources were used as collateral in international loans, and colonial rule was partially articulated via financial control. After briefly addressing these debates, I comment on productive uses of foreign capital, also known as *developmental finance*,[50] and ways to fund government other than tax and debt.

1.5.1 FACTOR ENDOWMENT AND RESOURCE CURSE

Engerman and Sokoloff emphasize the role of factor endowment in explaining the divergence in economic growth, inequality, and political institutions within the American continent. Climate and soil conditions supporting slave-plantation economies and an abundance of natural resources highly valued on world markets led to political institutions that exacerbated long-term inequality and state weakness in Latin America.[51]

In the modern day, institutional quality is eroded by rents from oil and gas. The availability of nontax revenue weakens incentives to initiate tax bargaining with taxpayers[52] and to invest in the bureaucratic apparatus of the state.[53] In rentier states, patronage becomes the means to rule.[54] Corruption trickles down from the political to the bureaucratic

50. Fishlow (1985).
51. Engerman and Sokoloff (2002). See Coatsworth (2005) for a competing argument.
52. Brautigam, Fjeldstad, and Moore (2008); Morrison (2009); Prichard (2015); Ross (2004).
53. Besley and Persson (2011).
54. Beblawi (1987).

arena, reducing professionalism, neutrality, and independence of public administration.[55] The voracity to seize rents from natural resources can destabilize resource-rich states and make civil war endemic.[56] Building capable states under such conditions is extraordinarily difficult.

Foreign aid also allows autocrats to cultivate patronage,[57] dilute accountability mechanisms, and abandon the search for legitimacy,[58] leading to perverse effects not different from those of oil.[59] Instead of a competing hypothesis, external finance can be understood as an alternative form of "easy money," carrying dilemmas similar to foreign aid. Once aid or loans are disbursed, donors and lenders experience similar difficulty disciplining recipient governments.[60] In addition, in the case of loans, rulers may decide to interrupt debt service in anticipation of debt relief or some form of foreign financial intervention or both, relaxing present-day efforts to expand tax capacity and pushing the cost of default onto future generations.

1.5.2 SOCIAL DIVISIONS

Ethnic heterogeneity is a common deterrent to the provision of public goods,[61] chief among them state bureaucracies.[62] Countries outside Europe are said to be highly diverse or ethnically fractionalized, hence their weaker state capacity, a point often made to explain state fragility in Latin America[63] and Asia.[64] This argument might raise issues of reverse causality: states become strong by substituting preexisting social divisions—ethnic, religious, linguistic—for one national identity. Social homogenization is achieved in multiple ways, from indoctrination to mass expulsion to ethnic cleansing.[65] Take France, for instance: exploiting within-country variation, Johnson shows that at the turn of the eighteenth century those parts of France with higher state capacity (measured via

55. Ross (2001); Vandewalle (1998).

56. Collier and Sambanis (2005); Tornell and Lane (1999).

57. Ahmed (2012); Bueno de Mesquita and Smith (2009); Smith (2008).

58. de la Cuesta et al. (2021); Moss, Pettersson Gelander, and van de Walle (2006).

59. Easterly (2006).

60. Collier (2006).

61. Alesina, Baqir, and Easterly (1999); Baldwin and Huber (2010); Easterly and Levine (1997); Habyarimana, Humphreys, Posner, and Weinstein (2007).

62. Besley and Persson (2011); Lieberman (2003).

63. Centeno (2002); López-Alves (2000).

64. Taylor and Botea (2008).

65. Alesina, Reich, and Riboni (2017); Sambanis, Skaperdas, and Wohlforth (2015); Wimmer (2013).

tax receipts) showed higher identification with the French nation.[66] The French state manufactured the French nation, not the other way around. This process continued after the Revolution with state-led cultural assimilation.[67] Contemporary examples outside Western Europe can be found in China, where the state uses the public education system to build national identity,[68] and Africa, where state capacity leads to lower levels of ethnic-based contestation.[69]

Social divisions may also be exacerbated by having access to international capital. To fund the central government, rulers in the capital may be compelled to negotiate institutional design and grant policy concessions to territorially concentrated minorities, building robust federal states.[70] Access to external capital can discourage the central government from reaching out to regional elites, abandoning nation building projects and intensifying territorial divisions.[71]

1.5.3 COLONIALISM

Colonialism is a key cause of state weakness. "Extractive institutions" imposed by Western powers in nonsettler colonies deprived the periphery of its main sources of wealth.[72] The lack of self-determination, the continuation of slavery in the form of forced labor,[73] and arbitrary border design[74] raised tremendous obstacles to state building.[75] This is a compelling explanation with little to add.

I interpret external finance as a complementary hypothesis that amplifies the negative effects of colonial subjugation. In chapter 3, I show that colonies were allowed to borrow from international markets—a widely known result in economic history—and in chapter 6, I show that colonies participated in war, regional and colonial, and were expected to be financially self-sufficient, hence to build fiscal capacity. If colonies met all

66. Johnson (2015).
67. Weber (1978); Zhang and Lee (2020).
68. Cantoni, Chen, Yang, Yuchtman, and Zhang (2017).
69. Müller-Crepon, Hunziker, and Cederman (2021).
70. Alesina and Spolaore (1997); Sambanis and Milanovic (2014).
71. Bormann et al. (2019); Hierro and Queralt (2021).
72. Acemoglu and Robinson (2012).
73. Mamdani (1996).
74. Herbst (2000).
75. See Michalopoulos and Papaioannou (2018) for a detailed and fascinating review of mechanisms linking colonial rule and long-term state weakness.

criteria for war to make states, why did they not build stronger states? Although colonies financed virtually all domestic expenses, including policing and public administration,[76] the lion's share of interstate war was assumed—reluctantly—by the metropole, in the form of either grants-in-aid or heavily discounted loans; hence, the weak connection between colonial war and state making.

1.5.4 DEVELOPMENTAL FINANCE

Developmental finance refers to investment in projects with high social returns. Railroads, accounting for a third of all international capital flows in the Bond Era, were the paramount example of developmental finance at the time.[77] Railroad investment, for instance, grew the US economy[78] and helped irradiate state power in Sweden.[79] The success stories of developmental finance, however, tend to concentrate on a handful of relatively wealthy economies with robust institutions. In large parts of the Global South, railroads reduced dramatically the cost of internal transportation, hence the price of export staples, but did little to stimulate local industry. Or, as Coatsworth put it, railroads brought growth *and* underdevelopment.[80]

The mixed record of developmental finance reflects the international and domestic politics at the time, and it transpires the theoretical argument. The search for yield and strong bargaining power of foreign investors combined with corrupt and opportunist politicians often led to irrational network planning, external dependence for capital and inputs, and budget deficits caused by profit guarantees. The book offers various examples of aggressive foreign lending (e.g., the imperial railroad guaranteed bonds in China) and the conditions under which investors competed for new concessions and seized existing lines. But embezzlement,[81] delusional greatness,[82]

76. Frankema (2011).

77. Suter (1992).

78. But see Fogel (1963) for a restrained assessment.

79. Cermeño, Enflo, and Lindvall (2018).

80. Coatsworth (1981).

81. Claudio Bruzual Serra, the Venezuelan delegate who negotiated the largest and most ruinous foreign loan in the nineteenth century, pocketed Bs.114,000. Venezuela's president, Joaquin Crespo, kept a larger cut, Bs.2 million (4% of loan total). Back to Venezuela, Bruzual Serra was appointed Minister of Finance. The person who brought the scandal to light, Federico Bauder, was put in jail (Harwich Vallenilla, 1976, p. 225). Not surprisingly, the economic record of railroad investment in Venezuela is poor.

82. In 1910, the Cuban president, José Miguel Gómez, negotiated a new foreign loan in Britain to build a new presidential palace and other buildings. President Gómez was willing to

and short-sighted policy[83] on the side of local governments also played a part. My reading of international lending is that more often than not, both developmental and nondevelopmental finance in the Global South during the Bond Era exacerbated external dependence and eroded the effective tax base, causing persistent fiscal disequilibria—the opposite of state building.

My focus on war finance—a form of nondevelopmental investment—is based on two factors: First, increased demand of foreign capital caused by war is easier to date thanks to existing war datasets. Second, the analysis of the effect of war allows me to pin down the scope conditions under which the bellicist hypothesis holds, clarifying the important relationship between military competition and state building from the military revolution in the late sixteenth century to the present.

1.5.5 OTHER FORMS OF PUBLIC FINANCE

Debt and taxes constituted two prominent ways to fund governments in the Bond Era, but there were others, including monetary expansion. This policy often led to price instability, a decline in real tax receipts, and currency depreciation, contravening the mandate of the gold standard. While money printing addressed the liquidity shortage, it created problems larger than those it was intended to solve. In general, this policy was to be avoided to finance fiscal shocks.[84]

Rulers could also exert financial repression,[85] expropriate the Church,[86] sell offices,[87] trade slaves,[88] or rely on intraempire transfers[89] to secure public funds. Choosing taxation instead of any of these measures is, again, a matter of capacity and political calculus. Notably, in terms of state building, any alternative path to taxation would be expected to exert effects

surrender to British investors a public railroad with its connection to the waterfront of the port of Havana, granting de facto control over Cuban exports. President Gómez accepted the conditions despite the outcry from the opposition and local press. The loan did not move forward only because the US Department of State stepped in to protect American interests in the island (Zanetti and García, 1998, pp. 245–251).

83. The search for short-term popularity gains derived from inaugurating major infrastructure played a key role in the poor performance of road investment in the second half of the nineteenth century in Spain (Curto-Grau, Herranz-Loncán, and Solé-Ollé, 2012).

84. Cappella Zielinski (2016); Fujihira (2000); Sprague (1917).

85. Calomiris and Haber (2014); Menaldo (2016).

86. Comín (2012).

87. Hoffman (1994).

88. Herbst (2000).

89. Grafe and Irigoin (2012); Davis and Huttenback (1986).

similar to those of external finance because it would not require building a tax apparatus capable of assessing wealth and securing a steady stream of revenue—namely, enhancing fiscal capacity—nor would it activate key mechanisms of transmission of the ratchet effect of war—that is, strengthening power-sharing institutions and bureaucratic capacity. The scope conditions for state building are somewhat narrow. Easy access to foreign credit following the globalization of capital in the nineteenth century narrowed them further.

1.6 Plan of the Book

In the next chapter, I advance the theory of the book by articulating a political economy of public finance. Although the discussion can be generalized to other major fiscal shocks, I focus attention on military expenses because war was a major and clearly identifiable reason to tax and issue debt before 1914. I pin down a series of domestic and external factors shaping the ruler's preferences for loans vs. taxes, including initial levels of tax capacity and power-sharing institutions, default sanctions, and liquidity in international markets. The discussion leads to the notion of extreme conditionality because it helps us understand why countries with weak fundamentals accessed capital at favorable terms. The case of Peru is examined in brief to illustrate the logic of conditionality. I conclude chapter 2 by formulating the reasons that war finance exerted long-term effects on state building, or mechanisms of transmission.

The remainder of the book is organized into two parts: "The Rise of Global Finance" (chapters 3–5) and "The Consequences of Global Finance for State Building" (chapters 6–9). Chapters 3–5 may be of particular interest to economic historians and international relations scholars inasmuch as I focus on the rise of global finance, test for extreme conditionality, and elaborate on the causes of the low spread between advanced economies and the periphery. Chapters 6–9 may be of interest to students of state capacity building from the Industrial Revolution onward as well as to students interested in historical origins of democratic politics.

In chapter 3, I articulate the main characteristics of the Bond Era—who lent, who borrowed, and how capital was invested—and elaborate on my skepticism about the difference between "developmental" and "revenue" finance for the purpose of state building at that particular time.[90] I then

90. Fishlow (1985).

review standard *push* or supply explanations for the lending euphoria in the long nineteenth century. To this end, I document the rise of public finance by introducing an original dataset of interest rates for 92 countries from 1816 to 1913. The data show clear evidence of the favorable terms of access to capital offered to emerging economies compared to those offered in early-modern Europe and to those offered today.

Chapter 4 sheds light on the *pull* or demand determinants of the lending euphoria, namely, which country-specific characteristics predict low interest rates. Along with standard theories—the gold standard, reputation, and empire membership—I test the notion of extreme conditionality, that is, the hypothecation of public assets for the purpose of external finance. Law scholars have found that asset seizure was grounded in previously pledged assets. To assess the effect of hypothecation, I coded pledges among 700+ original loan prospectuses issued in London between 1858 and 1913 and examined whether pledging decreased effective interest rates. The statistical analysis, which exploits within-country longitudinal variation, shows that pledging reduced the spread when both bondholder coordination and geostrategic competition intensified—in other words, when the capacity to confiscate foreign assets gained credibility.

Default sanctions derived from extreme conditionality included asset seizure and receiverships. The latter were debt collection agencies that took over the local tax administration for the purpose of debt liquidation. In principle, receiverships could be advantageous for local tax capacity if they incorporated know-how and new tax technologies. I review secondary evidence of the performance of receiverships in chapter 5 and complement it with an in-depth analysis of the Ottoman Public Debt Administration (1881–1914), the most ambitious receivership ever run based on the outstanding debt it was meant to liquidate. Results are pessimistic throughout, in line with modern experiences of foreign-led state building.[91] Receiverships were profitable for bondholders because debt was liquidated; however, local tax ratios and administrative performance did not improve relative to preintervention years. The last part of chapter 5 brings us to late-Qing China, where foreign financial control was installed in 1911 after two decades of trying. This case illustrates, first, that the Qing's reluctance to share power with provincial leaders paved the road to foreign intervention; and second, that bondholders took control of an institution, the Maritime Customs Service, which was *already* proficient in tax collection.

91. Lake (2016).

The findings in chapter 5 illuminate the reasons that external finance rarely translated into state building in the Bond Era. Cheap capital often led to high indebtedness and default. Debt restructuring included a mix of new concessions and receiverships, softened with some debt relief. By agreeing to those conditions, countries were readmitted to capital markets without having improved their capacity to tax. If anything, their fiscal position was weakened because foreign control shrank the tax base left for local authorities. New loans and debt suspension loomed on the horizon. In the second part of the book, "The Consequences of Global Finance for State Building," I show that states that relied heavily on external finance to secure government funds did not build state capacity. Because military expenses were a key reason to float loans, I examine the consequences of war finance for short- and long-run state building, with a focus on taxation.

In chapter 6, I elaborate on the nature of war outside Europe and how it was financed in the nineteenth century. First, I revisit historical statistics of war. Based on duration, intensity, and frequency, war in the periphery in the nineteenth century was not different from the average war in the formative period of state building in Europe in the fifteenth to seventeenth centuries. Along with statistical evidence, I rely on war historiographies to shed light on the characteristics of interstate warfare outside Western Europe. Second, I show statistical evidence to document the use of external finance for war purposes, a result that allows me to revisit Polanyi's haute finance hypothesis.[92] Last, I reflect on colonial war finance by studying the effect of war, access to foreign funds, and fiscal performance with a paired comparison between the Cape of Good Hope and the Transvaal in South Africa.

Having shown that war was pervasive around the globe and that it was commonly funded with external capital, I examine the consequences for state building in chapter 7. Some tests focus on short-term effects of war on taxation, others on its long-term repercussions. The study of war finance on state capacity raises questions of reverse causality and selection. I gain leverage on endogeneity issues by exploiting exogenous shocks in international credit markets and focusing on ongoing wars, namely, those initiated while capital flowed but that were eventually hit by a global credit crunch. The chapter also addresses issues of what historians refer to as *history compression*[93] in the study of legacy effects. Overall, the evidence in chapter 7

92. Polanyi (2001).
93. Austin (2008).

suggests that war funded primarily with external debt did not make states in the short or long run; by contrast, war funded by taxation did.

Whereas chapter 7 shows that war finance is consequential for state building, chapter 8 examines why. To that end, I elaborate on the political and bureaucratic mechanisms of transmission introduced in chapter 2. The discussion identifies key differences in war finance before and after 1815, shedding light on the reasons that Europe built strong states and constitutional monarchies while most emerging economies did not. The historical comparison motivates an empirical test of the political channel of transmission from 1815 to date. I show evidence that war finance in the Bond Era shaped the strength of power-sharing institutions by 1914, particularly in small and densely populated polities, and that those effects, although attenuated, persist until the present day. The bureaucratic mechanism of transmission, namely, the idea that tax bureaucracies made by and for war seek organizational survival, also receives support once tested against historical data. Results in chapter 8 emphasize the importance of the study of history to understand political, economic, and bureaucratic characteristics of modern-day states.

In chapter 9, I illustrate the book's argument by studying state building trajectories in five sovereign countries of varied geographic and institutional extraction: Argentina, Chile, Ethiopia, Japan, and Thailand. To assess the different paths in figure 1.3, I divide the exercise into two paired comparisons, Japan–Argentina and Siam–Ethiopia, and a longitudinal analysis for Chile. The comparison between Japan and Argentina sheds light on the importance of domestic credit markets (strong in Japan, weak in Argentina) to keep foreign dependence under control and prevent falling into a debt trap. The Siam-Ethiopia comparison exemplifies the perils and limits of bureaucratic strengthening in the absence of political reform and how access to external funds can undo state strengthening efforts, causing stagnation (Siam) and decline (Ethiopia). Finally, Chile illustrates opposite incentives to mobilize domestic resources depending on access to foreign capital. The War of the Pacific (1879–1883), waged under capital exclusion, activated both the bureaucratic and political mechanisms of transmission. Advances in fiscal capacity were followed by stronger parliamentary power to hold the executive accountable for the growing funds it was to manage.

I conclude in chapter 10 by reflecting on the effects of external public finance on state building, and why interstate competition helped build strong states in Europe but seldom elsewhere. Then I look at the similarities and differences between external finance in the Bond Era and today.

Much has changed: The weight of private loans has declined dramatically in favor of official lending, switching the priority of conditionality from debt collection to capacity building. Relatedly, extreme conditionality is no longer practiced, perhaps with the exception of China. And yet, some problems persist. First, external finance allows rulers to escape politically costly reform and to postpone state capacity building, feeding all sorts of perverse incentives and attracting vulture investors. And second, when default comes, the foreign enforcers today (e.g., IMF inspectors) face legitimacy barriers similar to those that receiverships did a hundred years ago despite their different mandates. Directed state building, now and then, might just be an impossible enterprise.

4

Extreme Conditionality in International Lending

The previous chapter argued that the price of external capital in the Bond Era responded to supply or "push factors": capital surplus in Europe, fraud, and low domestic returns. In this chapter, I revisit demand or "pull factors," namely, country-specific characteristics that attracted foreign capital. Along with standard explanations—the gold standard, reputation, and empire—I articulate a complementary hypothesis; that is, foreign financial control by bondholders in case of default, or *extreme conditionality*. I elaborate on the conditions under which private bondholders took over local assets and test the hypothesis against an augmented version of the historical interest rate data that includes newly collected information on loan pledges.[1] Results suggest that pledging public assets reduced interest rates of emerging economies but exposed them to foreign financial control. The chapter is organized in three parts: I begin by reviewing leading explanations of the spread in the nineteenth century. Then I articulate the extreme conditionality hypothesis and test some of its empirical implications. Finally, I discuss the risks of pledging national assets for long-term state building.

1. I use interchangeably the expressions *pledge, hypothecation, security*, and *collateral*.

4.1 Bond Yield in the Nineteenth Century

The expansion of European capital exports in the nineteenth century is responsible for the drop in the average cost of external finance, especially for countries with weak fundamentals. Push factors are not unique to the nineteenth century: Frieden and Mosley find similar results in studying external finance of emerging economies from World War II to the present.[2] When capital is abundant, even borrowers with weak and undemocratic institutions access international finance at favorable terms; in other words, in good credit cycles, investors are risk tolerant.[3]

A long tradition of economists and economic historians shows that country-specific characteristics also shape the terms of external finance: that is, demand matters. Existing accounts specific to the Bond Era focus on the borrower's record of default, institution-induced credibility, and empire membership.[4] I review these explanations before introducing the notion of extreme conditionality.

4.1.1 REPUTATION

Why do countries service debt? They might do so because they want to cultivate a good reputation[5] or because they want to avoid credit exclusion.[6] The notion of reputation incorporates the beliefs that bondholders have about the type of government they are dealing with. Governments (countries) with good reputations are expected to do everything in their power to service debt in good or bad times (e.g., implement an austerity policy if needed). Default, although occasionally justified from the investor's point of view, tends to hurt the country's reputation and thus is to be avoided. Good reputation is rewarded by investors with easier access to credit because they perceive the borrower as reliable.[7]

2. Frieden (1991b) and Mosley (2003).

3. Ballard-Rosa, Mosley, and Wellhausen (2021).

4. This list does not exhaust all explanations: some emphasize local economic conditions (Flandreau and Zumer, 2004), issue linkage (Lipson, 1985; Kelly, 1998), and central banks (Poast, 2015). The analysis of these hypotheses requires macroeconomic and institutional data that exist only for a selected group of countries or only for the later decades of the nineteenth century.

5. Tomz (2007).

6. Eaton and Gersovitz (1981).

7. Tomz (2007).

Tomz's cooperative theory of lending through reputation contrasts with Eaton and Gersovitz's noncooperative version.[8] According to this model, lenders compel countries to cultivate their reputations—hence service debt—by threatening them with *credit exclusion*, the practice of refusing quotations of securities to governments that fail to fulfill their obligations or come to terms with their creditors.[9] The principle of exclusion was enshrined in the rules of the London Stock Exchange (LSE) as early as 1826.[10]

Figure 3.3 shows that massive defaults occurred with regularity in the Bond Era, yet effective interest rates decreased over time, bringing some scholars to question the notion of reputation. Lindert and Morton study the conditions of access to capital from 1850 to 1985. Drawing on a sample of 10 emerging economies, they find that countries in default are not systematically punished by international lenders.[11] In some cases, Lindert and Morton claim, the prospect of continued business with large borrowers is enough to regain market access in a short period of time.[12] Eichengreen as well as Jorgensen and Sachs find that countries interrupting debt service during the interwar period were not excluded or penalized in the postwar era because markets attributed default to unforeseen external shocks and rendered the debtor's abrogation of contracts excusable.[13] Instead of initiating an arduous negotiation, investors understood that a quick settlement would ultimately benefit them because it would accelerate the borrower's recovery. Reinhart and Trebesch find support for this conjecture by analyzing forms of debt relief between 1920 and the 2000s.[14]

If countries can default without cost, why would they ever service? Tomz addresses this puzzle by advancing a dynamic model of reputation that relaxes the assumption of complete information about the preferences

8. Eaton and Gersovitz (1981).

9. Jenks (1927, p. 284).

10. Article 62 of the rules of the LSE reads as follows: "The Committee will not recognize new bonds, stock, or other securities, issued by any foreign government that has violated the conditions of any previous public loan raised in this country, unless it shall appear to the Committee that a settlement of existing claims has been assented to by the general body of bondholders. Companies issuing such securities will be liable to be excluded from the official list" (Melsheimer and Gardner, 1891, p. 164).

11. Lindert and Morton (1989).

12. This argument is similar to the one made by Drelichman and Voth (2014) for Spain during the reign of Philip II.

13. Eichengreen (1987); Jorgensen and Sachs (1988).

14. Reinhart and Trebesch (2016).

of foreign governments and that allows preferences to vary over time, resulting from a change in an incumbent or in the populace.[15] In this model, investors continually update their beliefs about the type of government they are confronting. Analyzing bond yields in secondary markets at different points in time as early as 1770, Tomz shows that investors offered worse credit to unproven governments than to better-known or "seasoned" countries, that reputation was built by servicing debt punctually over a number of years, and that regular defaulters struggled to raise new capital in international markets. To date, Tomz offers the strongest evidence for the argument of reputation.

4.1.2 THE GOLD STANDARD

The incentive to cultivate a reputation might conflict with short-term political survival. Opportunistic policy (e.g., printing money to cover a budget deficit) might damage the macroeconomy and put debt service in jeopardy. To credibly commit to honor debt, rulers might peg currency to a precious metal or major currency. In a world of open capital markets, the adoption of a fixed exchange rate puts monetary and fiscal policy at the service of the exchange rate.[16] This policy bundle is expected to preclude political-business cycles and secure debt service.

Bordo and Kydland argue that adherence to the gold standard sent a strong signal of resolve to international markets, serving as a "good housekeeping seal of approval."[17] Drawing on secondary market bond yields from 1870 to 1914, Bordo and Rockoff show that the terms of access to external finance fared better among gold standard adopters.[18] To their surprise, Bordo, Edelstein, and Rockoff find supportive evidence for the gold standard in the interwar period despite the turbulence in international markets.[19] Obstfeld and Taylor size adherence to the gold standard at about 30 basis points before 1914, but they find no effect during the interwar period.[20]

Other scholars are more critical of the gold standard. Ferguson and Schularick argue that gold was insufficient to credibly commit to stable

15. Tomz (2007).
16. This trade-off is known as the Mundell-Fleming trilemma.
17. Bordo and Kydland (1995).
18. Bordo and Rockoff (1996).
19. Bordo, Edelstein, and Rockoff (1999).
20. Obstfeld and Taylor (2004).

macroeconomic policy and debt service.[21] Some countries adopted the gold standard only de jure. Far from blind, international investors looked "behind the thin film of gold," penalizing defectors with higher premiums. Comparing spreads five years into adherence between 1880 and 1914, Mitchener and Weidenmier find that emerging markets in which the gold standard had been adopted still paid a 285-basis-point premium.[22]

4.1.3 THE EMPIRE EFFECT

Grants-in-aid from the metropole were uncommon in the nineteenth century. Instead, British, French, Ottoman, and Spanish colonies floated loans in international capital markets on a regular basis. These loans were marketed in the metropole and occasionally in other financial capitals; for example, Tonkin, a French colony, floated a loan in London in 1896 to finance the construction of a new railway. Private investors did not discriminate in favor of contracting public debt from the empire.[23] Actually, most of the lending went to sovereign nations (refer to chapter 3).

Most research on colonial loans has focused on the British Empire, the largest and best documented and the only one hosting the financial capital of the world.[24] The empire effect—the notion that colonies are treated favorably by investors—was challenged by Obstfeld and Taylor as well as Flandreau and Zumer.[25] By assembling a substantially larger dataset, Ferguson and Schularick revived the empire effect, estimating that membership in the British Empire decreased the spread by 150 basis points between 1880 and 1914.[26] Accominotti, Flandreau, and Rezzik confirm Ferguson and Schularick's results while articulating a novel causal mechanism: British colonies were neither better run nor enjoyed better macroeconomic stability. Simply put, investors anticipated that "strategic default would not be an option because underlying assets could be seized with support of imperial courts."[27]

21. Ferguson and Schularick (2006, 2012).

22. Mitchener and Weidenmier (2009).

23. Davis and Huttenback (1986); Feis (1930); Platt (1968).

24. French (2011) and German (2008) capital flows to colonial dominions have been recently examined by Esteves.

25. Obstfeld and Taylor (2004); Flandreau and Zumer (2004).

26. Ferguson and Schularick (2006).

27. Accominotti, Flandreau, and Rezzik (2011, p. 402).

4.2 Empirical Validation of Existing Explanations

In light of the mixed results from existing hypotheses of the bond spread, I seek to test them anew by exploiting a novel dataset that includes more political units than any previous test—as many as 92 and extending back to 1816.[28] For reference, Ferguson and Schularick, the most comprehensive dataset to date, sample 62 political units from 1880 onward.[29]

The outcome variable in this analysis is the effective interest rate at issue (N = 803), and the unit of observation is the country-year.[30] Some countries issued more than one loan in a given year. For these cases, I compute the average yield per year, reducing the sample size from 803 to 693 country-year observations between 1816 to 1914.

I draw on conventional measures of the three explanations of the spread. For adherence to the gold standard, I include a time-varying indicator variable drawn from Meissner.[31] I completed this variable with data collected by Officer as well as Reinhart, Rogoff, Trebesch, and Reinhart.[32] Note that the gold standard was adopted by both sovereign and nonsovereign states. For reference, 30 percent of loans in the sample were floated while the local currency was pegged to gold.

I account for reputation arguments in two ways: The most common measure is the record of external default, information drawn from Reinhart and Rogoff.[33] The original variable indicates the onset of default and the restructuring years that followed. Chile, for instance, interrupted debt service between 1826 and 1842 and between 1880 and 1884. The default indicator is 1 for every year in both intervals, and 0 otherwise. To test for reputation, I establish whether an external default took place in the last 10 years, a strategy borrowed from Ferguson and Schularick.[34] Tomz shows that countries borrowing from international markets for the first time paid a premium for lacking a reputation. The indicator variable Unseasoned

28. Refer to chapter 3 for further details about this original dataset.

29. Ferguson and Schularick (2006).

30. The effective interest rate at issue is measured as the ratio of the coupon to the price. See chapter 3 for details.

31. Meissner (2005).

32. Officer (2008); Reinhart et al. (2018).

33. Reinhart and Rogoff (2009).

34. Ferguson and Schularick (2006).

Borrower takes the value 1 for the first loan issued by any given country after 1816.[35]

Finally, I produce a time-variant categorical variable, Empire, to indicate the colonial status of any given territory: for instance, Morocco is treated as an independent country until 1912 and as a (French) colony in 1913–1914.[36] To account for the loss of access to Crown agents, self-governing territories in the British Empire are treated as independent borrowers after 1881.[37] With these data at hand, I model the effective interest rate at issue with an ordinary least squares (OLS) model:

$$\begin{aligned}\text{Yield at Issue}_{it} = \alpha + \beta_1 \text{Gold Standard}_{it} + \beta_2 \text{Reputation}_{it} \\ + \beta_3 \text{Colonial Status}_{it} + \epsilon_{it}\end{aligned} \tag{4.1}$$

Results plotted in figure 4.1 confirm the three hypotheses in the existing literature while extending the sample size in both geographic and temporal scope. Data availability for covariates slightly reduces the sample size; nevertheless, with 95 percent confidence, adherence to the gold standard decreases premiums by 155 basis points, twice the effect of membership in the British Empire. Non-British colonies (the dataset includes French, Ottoman, and Spanish colonies) were levied somewhere between 216 and 157 additional points than independent countries. Results suggest also that reputation matters. Countries in default at least one year during the previous ten were charged a 136-basis-point premium when they issued a new loan in London. First-time borrowers were charged an additional 89 basis points, everything else held constant.

The magnitude of the point estimates in figure 4.1 is arguably modest. Take the worst-case scenario: a non-British colony off gold, recently experiencing default. The predicted premium is 501 basis points, a number far from trivial yet significantly below modern-day premiums.[38] Why were embarrassed governments not penalized by private investors at higher rates? To address this question, we should pay attention to the fine print of loan contracts and what was negotiated in default settlements.

35. Tomz (2007).

36. No territory floated a loan in London while a part of the Dutch or German empire, but some did so after gaining independence, for example, Belgium and Tasmania, respectively.

37. The colonial status coefficient is virtually identical if self-governing territories are treated as dependent colonies after 1881.

38. In July 2011, the Greek, Irish, and Portuguese spreads were 1,600, 1,200, and 1,100 basis points, respectively, relative to the German bond (De Santis, 2012, p. 6).

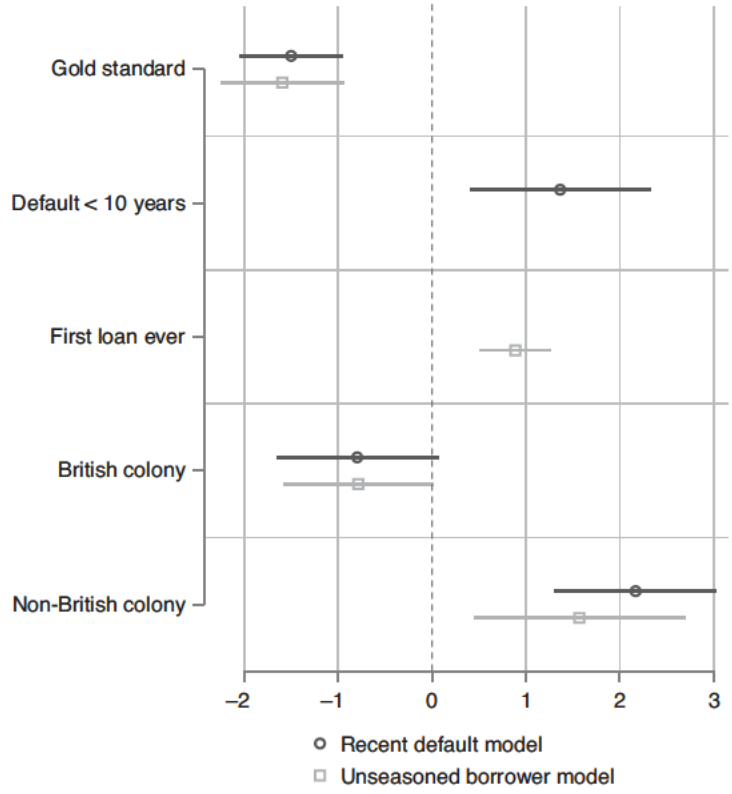


FIGURE 4.1. Test of existing explanations of the bond spread: reputation, the gold standard, and the empire effect. Period covered: 1816–1914. The recent default model samples 69 countries and the unseasoned borrower 82. The reduction in the sample size is attributable to data availability for two controls: default history and the gold standard. Effective interest rate calculated by author. Sources for gold standard: Meissner (2005), Officer (2008), Reinhart et al (2018); for default during the previous 10 years: Reinhart and Rogoff (2009); colonial status: Hensel (2018) and author.

4.3 Loan Contracts and Default Settlements in the Bond Era

International lending in the nineteenth century took place almost exclusively under municipal law, that is, the law of that land where the loan was floated (e.g., London if a bond was quoted at the London Stock Exchange).[39] Until the passage of the Foreign Sovereign Immunity Act in the United States in 1973, countries in default invoked the principle of sovereign immunity to escape municipal jurisdiction. Before the restriction

39. See Waibel (2011) for an illuminating treatment of international private law.

__-1
__0
__+1

imposed by this principle, to sue a sovereign debtor was almost impossible for individual investors.[40] In the absence of a clear legal framework, other mechanisms were necessary to protect bondholders' interests. Overt military coercion, commonly known as gunboat diplomacy, was exceptional.[41] Most often the resolution of default involved ad hoc negotiation and compromise between bondholders and debtors.[42] Default settlements in the Bond Era included debt relief, fresh loans to refinance old debt, and eventually foreign financial control in the form of debt-equity swaps and receiverships.[43] Foreclosure of national assets did not take place in the abstract, but it prioritized state monopolies, land, railroads, and branches of the tax administration hypothecated in previous loan contracts.

4.3.1 DEBT RELIEF

A standard default settlement in the Bond Era was accompanied by a cut in the outstanding debt, a reduction in the interest rate, and the conversion of arrears of interest to new debts.[44] From 1821 to 1871, reduction of standing debt was small, 3 percent of face value on average, but increased to 23 percent in the period from 1870 to 1925. Interest rate cuts were frequent and in the range of 15 percent during both periods.[45] Because settlement could take years to materialize, arrears of interest frequently exceeded the face value of defaulted bonds and often became the lion's share of settlement negotiations. On average, arrears were converted at 75 percent into new bonds issued at low interest rates; the remaining 25 percent was written off by the bondholders. Debt relief, in other words, was substantial in the Bond Era.

4.3.2 FOREIGN FINANCIAL CONTROL

Even if desirable, debt write-offs weakened incentives to enact fiscal reform to service external debt, precluding the equivalence between debt and taxes crucial for state building. But debt condonation was not the main obstacle to state strengthening reform. Debt relief had more important

40. Mauro, Sussman, and Yafeh (2006, p. 132). See Verdier and Voeten (2015) and Weidemaier and Gulati (2018) for competing interpretations of the evolution of sovereign immunity.

41. Three prominent episodes of debt-related gunboat diplomacy happened in Mexico in the 1860s, Venezuela in 1902, and Egypt in 1882.

42. Frieden (1994).

43. See Krasner (1999, ch. 5) for an overview.

44. The content of this paragraph borrows from Suter (1992, pp. 94–95).

45. See Borchard (1951, pp. 326–328) for a detailed list of interest rate cuts.

strings attached: it was often granted as part of a larger debt readjustment that included foreign financial control—that is, the exchange of external debt for equity and receiverships.[46]

Debt-Equity Swaps

In order to regain access to international capital markets without paying back loans with tax money, borrowers may lease state-owned monopolies (e.g., a copper mine), key infrastructure (e.g., a railway), and land to foreign bondholders, who exploit the asset until the debt is liquidated. Exchanges of debt for assets are nowadays known as debt-equity swaps.

A textbook example of a debt-equity swap is Peru in 1886. In a default settlement negotiation with British bondholders, Peru exchanged its extant debt for the creation of the Peruvian Corporation, owned and managed by the foreign bondholders. Under the Grace Contract, Peru ceded its state railways to this private company for a period of 66 years, turned over its guano deposits up to a maximum of two million tons, guaranteed the company a subsidy from customs revenue, and endowed it with a land grant of five million acres. In return, Peru regained access to capital markets without having expanded its capacity to tax. Unsurprisingly, dependence on external finance persisted.[47]

Debt-equity swaps were a fairly common practice in loan negotiations in Latin America as well as in Eastern and Southern Europe: They had occurred earlier in Peru (1865, guano), and also in Brazil (1906, coffee), Bulgaria (1904, tobacco), Colombia (1861, land), Costa Rica (1871 and 1885, railways), the Dominican Republic (1893, railways), Ecuador (1855, land; 1895, railways), El Salvador (1899, railways), Greece (1893, salt, petroleum, and cigarette paper, among others commodities), Paraguay (1855, land; 1877, railways and land), Portugal (1891, tobacco), Serbia (1881, railroads, salt, and tobacco), Spain (1835, mercury), and Venezuela (1886, railways), among others.[48]

Receiverships

Instead of state-owned monopolies, borrowers could lease parts of the tax administration to foreign investors, often customshouses in key ports. Setting up a receivership required the creation of a parallel bureaucracy

46. Suter and Stamm (1992, p. 659). The Ottoman case, elaborated in chapter 5, offers a specific example.

47. Further details about external finance of Peru in chapter 2.

48. Borchard (1951); Gnjatović (2009); Mauro and Yafeh (2003); Nadal (1975); Suter (1992); Wynne (1951).

or debt administration council to monitor or take control of tax collection. Receiverships could be operated by private foreign investors (e.g., the Ottoman Public Debt Administration) or be under the direct supervision of a foreign power (e.g., the US in the Dominican Republic). By creating a receivership, borrowers surrendered power over the portion of revenue that became the property of the bondholders or the collecting agency and distributed it in accordance with the loan agreement.[49] The receivership was terminated when external debt was liquidated.

Receiverships were relatively frequent despite the obvious breach in national sovereignty. They were established in China (1911), Costa Rica (1911), Dominican Republic (1905–1913), Egypt (1881–1913), Greece (1898–1913), Liberia (1912–1913), Morocco (1905–1911), Nicaragua (1912), Serbia (1895–1913), Tunisia (1870–1881), Turkey (1882–1913), Uruguay (1903), and Venezuela (1902–1903), among others.

Mitchener and Weidenmier find that 28% of default episodes ended up in receivership, which they refer to as "fiscal house arrest."[50] As valuable and meaningful as this estimate is, Mitchener and Weidenmier's data do not account for preemptive revenue control clauses like the one imposed in Portugal in 1892,[51] or in the 1902, 1904, and 1907 French loans to Bulgaria,[52] or in China in 1898, when European bondholders gained monitoring power over customs revenue as a precondition to issue three new loans to pay war indemnities to Japan.[53] Mitchener and Weidenmier's estimate does not include debt-equity swaps either. This is meant not as a criticism but as a call to attention to the underestimated ability of bondholders to seize foreign assets upon sovereign default. Next, I offer a framework for the study of foreign financial control and its implications for both the spread and state capacity building in the Bond Era and beyond.

4.4 Extreme Conditionality and Enforcement

In chapter 2, I introduced the notion of extreme conditionality—that is, severe sanctions resulting from interrupting debt service, including

49. Borchard (1951, p. 93).

50. Mitchener and Weidenmier (2010). Properly, Mitchener and Weidenmier's estimate includes receiverships and military intervention, but the latter is anecdotal.

51. Wynne (1951, pp. 371–382).

52. Tooze and Ivanov (2011).

53. Feis (1930) and van de Ven (2014). Foreign direct control of Chinese customs would arrive in 1911.

debt-equity swaps and receiverships. The concept of extreme conditionality resonates with the notion of supersanctions in Mitchener and Weidenmier, under whose framework supersanctions were imposed on borrowing nations manifesting bad behavior ex post, and on a case-by-case basis.[54] I conjecture that the possibility of imposing foreign financial control was gradually enshrined in the norms of international lending. It became a practice of debt collection mutually recognized by investors and borrowers and agreed upon at time of issue, or ex ante. Access to foreign funds was conditional on the hypothecation of public assets, which were the focal point of foreign control in case of default. By pledging key sources of revenue, emerging countries accessed international credit markets at unprecedented low rates.

Handing over domestic assets to foreign bondholders was considered a national humiliation. By raising the domestic cost of default for a given sitting incumbent, extreme conditionality was meant to minimize the likelihood of default. However, it did not always prevent default; and when that happened, a supersanction followed in the form of a debt-equity swap and/or receivership. This sequence of events is far more common than is generally understood: supersanctions were imposed on at least half of countries that defaulted between 1870 and 1913, and on 70 percent of those that suspended debt service more than once.[55] How were private bondholders capable of imposing and executing extreme conditionality on sovereign states?

Far from easy tasks, seizing assets and establishing receiverships required first and foremost the approval of the local government. Receiverships were often unpopular with governments because they were interpreted as an improper delegation of power.[56] The first impulse of an embarrassed government was to oppose seizure and invoke the principle of sovereign immunity to prevent investors from suing them.

In the first half of the nineteenth century, foreign bondholders organized into ad hoc committees to negotiate settlements bilaterally with governments in default.[57] In order to extract favorable concessions, bondholders would deny new bonds to countries in default, a practice known as *credit exclusion*. This practice was officially adopted at the LSE soon after

54. Mitchener and Weidenmier (2010).

55. Mitchener and Weidenmier (2010, p. 27).

56. Hyde (1922, p. 535). In some instances, receiverships were welcomed by local authorities, for instance, in Santo Domingo (Maurer, 2013, ch. 3). One may safely count that as an exception.

57. Flandreau (2013).

the 1820s debt crises.[58] Chabot and Santarosa argue that the hypothecation of national assets and sources of revenue perfected credit exclusion because they simplified the interpretation of a breach of contract.[59] If a borrower secured two loans on the same asset or used pledged revenue streams for purposes other than those stipulated in the loan contract, the LSE would consider that as clear evidence of bad faith and deny fresh capital. In anticipation, borrowers would be cautious about pledging assets and using them for spurious ends. In this way, pledges strengthened the logic of reputation in external finance.

Although credit exclusion allowed bondholders to negotiate favorable terms in default settlements, it was hardly enough to enforce swaps and receiverships. These required coercive power, which bondholders lacked. There is little discussion in the literature about the eagerness of French and German governments to intercede in favor of their investors.[60] The French government exerted tight control on the loans floated at the Paris Bourse and refused a quotation when disapproving the nature or direction of a loan.[61] Often, French and German governments brokered loans on behalf of private investors, particularly in the arms trade,[62] and exerted diplomatic pressure on default settlement negotiations.[63] Diplomatic pressure could end up in economic concessions, financial control, and even occupation, like the French did in Tunisia (1881) and Morocco (1912) to "safeguard the claims of French bondholders."[64]

The United States also grew more interventionist in the negotiations of loans and default settlement.[65] Following the Monroe Doctrine, the US pursued a "debt-enforcement empire" in Central and South America and sponsored "controlled loans," by which the debtor country agreed to allow the US or a US appointee to take over tariff or internal tax collection in the event of default—an example of extreme conditionality.[66] *Dollar diplomacy* reached its zenith under President Taft (1909–1913), when the US administration brokered loan contracts in China, Argentina, and Mexico on behalf

58. Neal and Davis (2006, p. 288).
59. Chabot and Santarosa (2017).
60. Feis (1930); Rich (1992); Stern (1977); Viner (1929).
61. Platt (1968, p. 7).
62. Grant (2007).
63. Feis (1930, chs. 5 and 6).
64. Cohen (1986, p. 107).
65. Maurer (2013); Mitchener and Weidenmier (2005); Perez and Weissman (2006).
66. Ahmed, Alfaro, and Maurer (2010, p. 40).

of major bankers (including the Morgan firms, now JP Morgan), blurring the line between national and private interests.[67]

In the later decades of the nineteenth century, the French, German, and US governments resorted to financial diplomacy to advance their economic and geostrategic interests. Foreign policy involved interfering in otherwise private contracts between domestic merchant banks and foreign governments. Many have argued that Britain did not follow that path, standing for free and open markets. I argue instead that Britain's laissez faire in the Bond Era was gradually abandoned for three reasons: First, a process of elite replacement within the British state apparatus placed financial interests at the vanguard of foreign policy priorities. Second, private bondholders perfected the art of lobbying for diplomatic assistance at the time of contracting new loans and negotiating default settlements with foreign nations. Third, in the "age of empire,"[68] the Foreign Office was compelled to counter competing powers' open interventionism in financial markets. Under these conditions, bondholders grew their ability to insert extreme conditionality clauses in private loan contracts and execute them in case of default. Next, I elaborate on these circumstances.

4.4.1 ELITE REPLACEMENT

The second half of the nineteenth century witnessed the birth of the "gentlemanly class" in Britain, a coalition between landed aristocracy and new banking elites.[69] The British aristocracy found in finance an opportunity to maintain its status and lifestyle in times of land decline. For financial elites, this coalition offered a fast track to high social status and political access. The gentlemanly class specialized in commercial activities (finance, shipping, and insurance) and civil service (government and military).

This new coalition knitted a tight and closed network. They attended the same public schools (e.g., Eton) and universities (Oxford and Cambridge), were members of the same London clubs, and married within one another's families.[70] A famous example is the foreign secretary and later prime minister, the 5th Earl of Rosebery, married to Hannah de Rothschild

67. Carosso (1987, p. 594).
68. Hobsbawm (1987).
69. Cain and Hopkins (2016).
70. Cassis (1994) and Scott (2003) for in-depth anthropologies of the gentlemanly class.

and criticized for "fail[ing] to achieve the complete separation of his private and public interest."[71]

The gentlemanly class assumed a high profile in public office. The Conservative party represented their general interest, and occasionally banking families held parliamentary seats themselves.[72] However, foreign policy was largely decided by the executive branch of government, where patronage appointments remained fairly common. Taking advantage of aristocratic dominance of the state bureaucracy, the new gentlemanly class secured a disproportional presence in the Treasury, the Foreign Office, and the Colonial Office, as well as in the British administration in India, Southeast Asia, Africa, and diplomatic positions in Latin America.[73]

Meanwhile, the big banking families held seats on the board of the Bank of England, a quasi-state apparatus that managed the gold standard mechanism, hence the solvency and prestige of issue houses and, by extension, the health of British and colonial public credit.[74] Almost organically, the fates of the old landed elites, the new financial sector, and the British Empire grew tightly connected. Securing fair treatment to foreign investors overseas became a matter of national interest rather naturally.[75]

"This degree of coherence or like-mindedness [between state officials and international bankers] explains why, at the top of the gentlemanly order, the barriers between business and government were no more than mobile Chinese walls."[76] In other words, the weight that finance gained in foreign policy during the Bond Era resulted from preference alignment, not nefarious practices (e.g., bribing). Alignment should not be confounded either with blind support or capture, a thesis defended by Hobson and popularized by Vladimir Lenin.[77] The British government represented various interests and remained accountable to Parliament, where industrial interests—who opposed imperialism, the gold standard, and foreign investment—were also represented.[78]

71. Ferguson (2004, p. 286).

72. See Cassis (1994, table 8.3) for members of Parliament of high-finance extraction.

73. Cain and Hopkins (2016, p. 125); Ingham (1984, p. 151); Smith (1979, p. 5).

74. Keeping prestige was of outmost importance to issue houses because they lived by their reputation (Flandreau and Flores, 2009).

75. Green (1992, p. 203); Ingham (1984, p. 131).

76. Cain and Hopkins (2016, p. 50).

77. Hobson (1902); Lenin (1934).

78. In contemporary debate, imperialism was associated with higher taxes (to fund military spending) and underinvestment in local productive development (Daunton, 2002, p. 129). Actually, less than 10 percent of British industrial development in 1907 received capital from London

Before granting government support, bondholders were expected to exhaust all legal means in the borrowing country and show that the latter had breached international law, for instance, "in instances where specific revenues that had been pledged as collateral to bondholders were willfully diverted for other purposes. Such behavior, to the Victorian mind, was simply bad faith."[79] The Foreign Office was strict in its reading of the situation because of potential perverse incentives that intervention could create, namely, imprudent lending in expectation of diplomatic assistance.[80] And yet, government intervention grew fairly common in the last decades of the nineteenth century.

4.4.2 FOREIGN BONDHOLDERS' COORDINATION

Small investors were left out of the gentlemanly class, but purchased government securities from them—namely, merchant banks, issue houses, or underwriters (I use the three expressions interchangeably). The underwriters could market sovereign bonds in primary markets or buy all of them outright and sell them in secondary markets.[81] Although underwriters kept a residual share of the bonds they marketed to cultivate confidence in their product, small investors were the ultimate buyers of sovereign bonds.

In case of default, issue houses and small investors did not necessarily share strategy. Issue houses tended to favor faster settlements to

(Ingham, 1984, p. 146). A good example of Liberal opposition to government support to foreign bondholders can be found in Sir Campbell-Bannerman's speech in a parliamentary debate about a famous episode of gunboat diplomacy in Venezuela (1902–1903): "Behind these poor fishermen [the pretext to gunboat Venezuela], who were so convenient for the noble Lord and the [Conservative] Government, there lies the great body of financial claims culminating in the claims of the bondholders. I venture to say that nothing could be more mischievous than that we should even seem to accept the doctrine, if it deserves to be called a doctrine, that when our countrymen invest in risky enterprises in foreign countries and default follows, it is a public duty to rescue them. Every man who invests money in a country like Venezuela knows what he is doing. It would, I suppose, not be quite accurate to say that great risks always mean high dividends, but it is more nearly accurate if you put it the other way about—that high dividends generally involve great risks; but if the whole power of the British Empire is to be put behind the investor, his risk vanishes, and the dividends ought to be reduced accordingly" (Hansard's Parliamentary Debates, Session February 17, 1903, 4th series, vol. 118, p. 71).

79. Cohen (1986, p. 104).

80. Fears of moral hazard are described in Cain and Hopkins (2016, p. 340) and Smith (1979, p. 17) and more generally in Platt (1968) and Lipson (1985).

81. For an extraordinarily clear explanation of how bonds were floated, see Mosley (2003, pp. 256–257).

resume lending and minimize damage to their reputation. Small bondholders tended to be more aggressive in their demands, preferring better to faster settlements—after all, their modest savings were at stake.[82] The creation in 1868 of the Corporation of Foreign Bondholders (CFB) mitigated preference misalignment by putting issue houses and small investors under the same roof.

The CFB was a nongovernmental organization representing private holders of foreign securities quoted in the LSE that specialized in negotiating default settlements.[83] Before its creation, small investors organized in self-constituted ad hoc committees to negotiate bilaterally with delinquent payers. There existed no institutionalized structure to coordinate action and share information with other bondholders or to represent their claims to the British government.[84]

Both small investors and loan contracting houses were represented in the governing body of the CFB—the Council—facilitating compromise and unity of action in default negotiations.[85] The CFB was organized into permanent and country-specific committees, which reported to the Council on a regular basis. The Council disseminated this information[86] and shamed members who defected from credit exclusion.[87] The CFB was involved in the negotiation of every single settlement involving British capital.[88] Advances in bondholders' coordination and specialization help explain why the number and rapidity of default settlements were highest after the inauguration of the CFB.[89]

82. Flandreau and Flores (2012a) show that the misalignment between bondholders and prestigious underwriters was smaller because the latter had strong incentives to demand tougher restructuring conditions to preserve their reputation.

83. Similar associations were formed in other financial capitals: the Vereeniging voor den Effecthandel was founded in Amsterdam in 1876, the Association Nationale des Porteurs Francais de Valeurs Mobilières in Paris in 1898, the Association Belge pour la Défense des Détenteurs de Fonds Publics in Belgium in 1903, and the Spezial-Organisation zur Vertretung der Schweizerischen Finanzinteressen im Ausland in Switzerland in 1913.

84. Wynne and Borchard (1933, p. 285).

85. Disagreements between small and big investors did not vanish after 1868 and were a subject of regular discussion. A CFB reorganization in 1898 gave further leverage to small bondholders.

86. Mauro, Sussman, and Yafeh (2006).

87. Wright (2005).

88. The one exception was the negotiation of the Brazilian default of 1898 (Esteves, 2007, p. 25).

89. Suter (1992, ch. 6). For in-depth analysis of CFB effectiveness, see Eichengreen and Portes (1986, 1989), Kelly (1998), and Mauro, Sussman, and Yafeh (2006).

The degree of governmental involvement in loan and default negotiations was the subject of heated debate in the early years of the CFB. Although government intervention could help solve default crises (to the liking of small investors), it could also scare away borrowers and hurt the business model (which merchant banks feared). Both positions were heard as early as the first general meeting in 1873. The low-interventionism position prevailed in that inaugural meeting, but the relationship between the CFB and the government grew stronger shortly thereafter.[90]

Indeed, as early as 1876, the CFB sought government support following Egypt's external default. British bondholders were the main creditors to the Khedive, as the Egyptian government was known at the time, and the CFB requested government support and the use of force if necessary. For that, the CFB hired top negotiators and organized public gatherings to gain the sympathy of the financial press and prominent conservative politicians, including Lord Salisbury, then secretary of state for India, and Sir Stafford Northcote, chancellor of the Exchequer.[91] If there was any doubt, "there has never been a time when our commercial and financial interests have been so eager to embark in costly military operations as they are now," the *Economist* wrote.[92]

Lobbying efforts succeeded. Foreign financial control and gunboat diplomacy followed and Egypt became a British protectorate in 1882. Although multiple economic considerations were at play—the Suez Canal was critical to secure trade flux with India[93]—the CFB shares responsibility for the loss of Egyptian sovereignty.[94] Importantly, foreign financial control of Egypt helped bondholders recover their investment and expand their business in the region.[95]

The CFB also sought support of British officials overseas. "From the earliest [annual] report to the latest it is clear that the diplomatic agents of Great Britain acted on behalf of the bondholders in their respective countries and thereby rendered invaluable service which no organization without quasi-official standing could have commanded."[96] For instance,

90. Ronald (1935, pp. 424–426).

91. Meszaros (1973, p. 429).

92. *Economist*, XL (July 29, 1882), pp. 936–937.

93. Kohli (2019, ch. 2) for the importance of Egypt for trade with India.

94. Meszaros (1973, p. 438). For additional discussion on lobbying by bondholders in Great Britain, see Smith (1979, pp. 16–24).

95. Hansen (1983).

96. Ronald (1935, p. 425). The first annual report dates as of 1873.

in 1884, the CFB requested the assistance of the British representative in Paraguay, Sir Edmund John Monson—of gentlemanly extraction—in the negotiations of a default settlement, upheld since 1874. Although we can only speculate about what was discussed in those meetings, within months Paraguay agreed to the bond conversion suggested by the bondholders. Diplomatic support was duly acknowledged: "The thanks of the Bondholders are due to Mr. Monson for the assistance he has rendered to Dr. Stewart [the CFB agent in Paraguay] in obtaining this result."[97]

In sum, concerted action between big and small bondholders perfected the art of credit exclusion and enhanced the CFB's capacity to reach for government assistance. Combined with preference alignment between high finance and high politics—reproduced also within the original CFB Council, where 9 of the 29 members were members of Parliament[98]—the Corporation elevated qualitatively the bondholder's bargaining power vis-à-vis embarrassed governments. Next, I assess the third and last ingredient for the enforceability of extreme conditionality—the international context under which sovereign loans were contracted.

4.4.3 THE AGE OF EMPIRE

Officially, the British government in the Bond Era interpreted defaults as the consequence of imprudent investment and preferred to stay away from what was considered a private matter.[99] Over time, the principle of non-intervention was relaxed because of the imperialistic ambitions of Great Britain coupled with that of competing powers: France, Russia, and later Germany and the United States.[100]

In the absence of international law that supported government intervention on behalf of private matters, British government action was initially guided by the Palmerston Doctrine of 1849. Responding to bondholders' supplication for assistance, Foreign Secretary Palmerston issued a circular to the House of Commons on March 2, 1849, in which he enshrined the British government policy upon sovereign default of private capital. The spirit of this policy may be summarized in one paragraph:

> It is simply therefore a question of discretion with the British Government whether this matter should or should not be taken up by

97. *Annual Report of Foreign Bondholders*, vol. 12 (1885, p. 95).
98. Ronald (1935, fn. 31).
99. Lipson (1985, p. 187).
100. Cain and Hopkins (2016); Feis (1930).

> diplomatic negotiation and the decision of that question of discretion turns entirely upon British and domestic considerations.[101]

This circular was "sufficiently broad to permit the British Government to justify any course it chose to take."[102] In a now classic text, D.C.M. Platt argues that the British government intervened on behalf of British investors only when preexisting geostrategic considerations were at stake.[103] Cain and Hopkins suspect that Platt's own readings of official intervention "follow the workings of the official mind rather too closely,"[104] an interpretation I generally share.

Platt concedes a change in approach to foreign defaults after 1870, when other Great Powers were pushing for empire: "It proved impossible [for the Foreign Office] to remain entirely inflexible on non-intervention, especially in cases where political interests were likely to be damaged."[105] Under this international context, "the Foreign Office invariably felt obliged at least to make sure that British bondholders received treatment parallel to that obtained by other nationalities."[106] From Platt's point of view, British interventionism in financial markets was reactive, that is, a response to that of other European powers on behalf of their bondholders.

The revised doctrine of British diplomacy by the turn of the nineteenth century was enshrined in 1889 in an interview with Lord Salisbury (three times prime minister):

> The Foreign Office judged each case on its particular circumstance. In cases of simple default due to misfortune or necessity, it would be improper for H. M. Government to exact payment; but where unfair discrimination had been exercised between equal creditors, or where the

101. House of Commons, *State Papers British and Foreign* XLII, March 2, 1849, p. 385.

102. Feis (1930, p. 103).

103. Platt (1968), and Lipson (1985) and Tomz (2007) for concurrent opinion.

104. Cain and Hopkins (2016, p. 265), and Gallagher and Robinson (1953) for concurrent opinion. Notice that Cain and Hopkins and Gallagher and Robinson disagree on the identity of the domestic interest prioritized by the British diplomacy. Cain and Hopkins argue that foreign policy pursued the interest of financial elites, whereas Gallagher and Robinson claim that the Foreign Office chased the interests of manufacturing. My own reading is that those interests often coincided. Take the case of railroad investment overseas: Its expansion was good for steel and locomotive exporters in Britain and that of manufactured goods, which gained new markets to sell their products and import raw materials. At the same time, railroad investment overseas was financed with British capital, benefiting merchant houses in London. Once built, commodity exports were shipped and insured by the same financial circles in London. The empire often advanced both the manufacturing and financial interests at once.

105. Platt (1968, p. 17).

106. Platt (1968, pp. 46–47).

> preferential rights and securities of British subjects [read bondholders] were unjustly denied, ground would exist for special sympathy from the Foreign Office.[107]

The new doctrine broadened the set of scenarios in which government intervention was justified while emphasizing refusal to discriminatory treatment relative to creditors from other Great Powers. In a context of imperial competition, however, allegations of discrimination grew fairly common and motivated government intervention. The "scramble for concessions" in late-Qing China, which I return to in chapter 5, is a good example of that.[108]

In general, the Foreign Office would limit diplomatic intervention to "good offices." These, "when exercised by such men as Consul-General Chatfield in Central America or Consul-General Wilson in Chile, must have been difficult indeed to distinguish from unqualified diplomatic intervention."[109] When major economic or geostrategic considerations were at play, the Foreign Office would manage loan contracts and default settlement negotiations firsthand. British diplomacy played a leading role in negotiating loans, securities, and receiverships in Brazil (1913), China (1898–1911), Egypt (1876), Greece (1898), Persia (1889), and Turkey (1875), among others.[110] These negotiations were carried out by state officials—usually of gentlemanly extraction—or hand-picked representatives, like Ernest Cassell, an independent financier who led loan negotiations with Egypt, China, and the Ottoman Empire outside official channels but under the auspices of the Foreign Office.[111]

Military intervention, or gunboat diplomacy, was used as a last resort and employed surgically because it conflicted with the official laissez faire policy. Famous episodes include military intervention in Egypt (1882), Guatemala (1913), Mexico (1861), Morocco (1910), and Venezuela

107. Quoted in Platt (1968, pp. 39–41).

108. Here it suffices to say that British involvement in loan negotiations is consistent with existing models of Great Power competition (e.g., Gent 2007). Protection of bondholders could not have been externalized to other Great Powers as these would have advanced the interests of their nationals. Whenever other powers were involved, the Foreign Office was compelled to abandon laissez faire politics and prevent discrimination against British bondholders in loan concessions and default settlements.

109. Platt (1968, p. 42).

110. See surveys by Cain and Hopkins (2016), Peterson (2002, pp. 106–111), and Wynne (1951).

111. Thane (1986).

(1902).[112] More importantly, in the age of empire the threat of military intervention shaped expectations about costs of noncompliance with debt obligations.[113] Bear in mind that military intervention was considered an accepted practice of debt collection by the international community until the early part of the twentieth century. In 1902, "at arbitration the Hague Tribunal found not only that Germany and Britain were justified in intervening [militarily in Venezuela for the purpose of debt collection] but also that, because of their willingness to use force to secure justice, they had a right to payment ahead of the powers who had been content with a peaceful solution."[114]

Merchant banks built on those fears to include harsh conditions in loan contracts. For instance, in the late 1890s, the Rothschilds agreed to bail out Brazil at the price of extreme conditionality.[115] The £10 million funding loan floated in London in 1898 required the hypothecation of all federal receipts from customs duties and imposed severe deflationary measures.[116] Why did Brazil accept these terms?

> The Rothschilds simply employed the gentle tools of logical persuasion, conjecturing "that besides the complete loss of the country's credit the measure [i.e., default] could greatly affect Brazil's sovereignty, provoking complaints that could arrive at the extreme of foreign intervention." With contemporary examples of the United States in Cuba, Puerto Rico, and the Philippines, and, even more germane, Great Britain in Egypt, Brazilian politicians took the Rothschilds' threat seriously.[117]

The veiled threat of military intervention, "which was unauthorized but managed to sound authoritative,"[118] speaks to the international context of the time and the expectations that came with external finance and debt

112. Tomz (2007, p. 145) shows evidence that in the first half of the nineteenth century the British government refused to use force on behalf of bondholders as a general rule.

113. Mitchener and Weidenmier (2010, p. 156).

114. Finnemore (2003, p. 28). The Great Powers only renounced military means for debt collection in 1907, when they signed Convention II of the Treaty of the Hague. And even then, it is hard to believe that loan-related concessions in China and elsewhere would have taken place absent the clout of military coercion.

115. At that time, Brazil was experiencing economic hardship, and debt service consumed half of the federal budget. Rothschilds had been the official banker of Brazil since 1855.

116. Cain and Hopkins (2016, p. 283).

117. Topik (1979, p. 331) quoting Manoel Ferraz de Campos Salles, the president of Brazil between 1898 and 1902.

118. Cain and Hopkins (2016, p. 283).

suspension. Atul Kohli summarizes this position as compellingly as English allows:

> It is not surprising that Platt and others searching official records do not find explicit orders, say, from a Palmerston, to the British navy to go secure the Barings loan in Argentina. That is not how power operates. . . . When pressure was needed, the sigh of naval vessels and whispers from proconsuls were often enough to bend the will of rulers on the periphery.[119]

Such whispers carried weight. Take Venezuela: In 1849, Congress passed the *Ley de Espera y Quita*, which extended the maturity of loan contracts up to nine years.[120] Outraged by this unilateral move, British bondholders sought diplomatic assistance from the Chargé d'Affairs, Belford H. Wilson, who petitioned backup from the Royal Navy. Wilson's request received support from Thomas Cochrane, then commander-in-chief of the North America and West Indies Station of the British Navy, who in correspondence with Wilson confirmed that he "was assembling [in Trinidad] a force sufficient to effect whatever is necessary to the accomplishment of Her Majesty's command."[121] When Wilson presented a copy of Mr. Cochrane's note to the Venezuelan government, the foreign minister agreed to discuss the settlement of the claims. Within weeks, the controversial law was abolished and the rights of foreign bondholders were reinstated.[122] No display of military force was necessary. A note sufficed.[123]

Driven by conviction, dragged by other Great Powers' desires for empire, and possibly both, British diplomatic intervention accelerated in the 1870s. The British government openly interfered in loan contracts

119. Kohli (2019, p. 74).

120. Banko (1995).

121. The quoted text was pronounced by Thomas Cochrane—not coincidentally, of gentlemanly extraction—and was referenced by Wilson in his correspondence with Lord Palmerston (Carl, 1980, pp. 109–110).

122. The Venezuelan government accused Wilson of colluding at a profit with the board of investors of the British Colonial Bank, inaugurated in 1839 to manage the liquidation of foreign debt contracted to finance the war of independence from Spain. The allegations were denied by the British creditors and Mr. Wilson (Carl, 1980, p. 111).

123. This example sheds light on the empirical challenge of testing gunboat diplomacy with hard data. The best test to date is offered by Tomz (2007), who concludes that gunboat diplomacy was not regularly used for the purpose of debt collection. That analysis draws from military interstate dispute data (Jones, Bremer, and Singer, 1996), which lists threats, naval display, and overt military action, but does not account for much of the opaque yet key diplomatic back channels like the one employed by Mr. Wilson in 1850.

and default settlements in Latin America, West Africa, Zanzibar, Burma, Malaya, Persia, China, and the Ottoman Empire, among others.[124] By the early 1900s, there was little doubt about the advantages of loan diplomacy, as the British minister to Persia reminded the Foreign Office:

> The more we get [Persia] into our debt, the greater will be our hold and our political influence over her government. Once the day of liquidation comes, the greater Persia's financial obligation to us . . . the stronger will be our moral claim to an authoritative voice in the settlement.[125]

The risks associated with external finance were also felt by sovereign borrowers. The so-called Drago Doctrine, which considers military means for the purpose of debt repayment unlawful, originated in the early twentieth century in Latin America as a response to European gunboat diplomacy in Venezuela. Luis M. Drago, lawyer, journalist, and minister of foreign affairs of Argentina (in office 1902–1903), denounced the "subordination . . . of the local government to the creditor nation so frequently repeated in recent history."[126] Drago's writing eloquently reflects how the Palmerston and Salisbury doctrines were understood in the Global South:

> Many hold to the circular of Lord Palmerston of 1848, confirmed in 1880 by Lord Salisbury, according to which the right of military intervention is indisputable, it to be decided in each case whether it is advisable or not from simple considerations of expediency of purely national and domestic character.[127]

The Drago Doctrine was incorporated into international law only after 1907, and it applied to cases of insolvency, not fraud, leaving room for interpretation.[128] Fears of military coercion in the age of empire were shared beyond Latin America, and I illustrate that in chapter 9 when I examine the relationship between external finance and state building in Thailand, Ethiopia, and Japan.

To recapitulate, the bargaining power of British investors vis-à-vis peripheral economies grew over time as a result of elite replacement within the British government, bondholders' organizational gains, and Great Power

124. McLean (1976, p. 305).

125. A. Hardinge to Lansdowne, July 18, 1903, C.P. [8399] cited in McLean (1976, pp. 297–298).

126. Drago (1907, p. 725).

127. Drago (1907, pp. 697–698).

128. Drago (1907, p. 704).

rivalries for territorial and economic concessions. Under such conditions, investors were able to insert extreme conditionality clauses in loan contracts and have them enforced in case of default thanks to implicit or explicit governmental support.

The language of loan contracts gradually reflected the increased bargaining power of bondholders. Most often, loans required the hypothecation of assets with the understanding that these would be subject to foreign confiscation in case of default. At other times, loan contracts explicitly incorporated debt-equity swaps and receiverships if service was interrupted, solidifying investors' expectations. For instance, Bulgaria secured a new loan in 1892 for a mortgage on the Kaspitshan-Sofia-Kyustendil and Rustchuk-Varna railways plus the revenues and dues of the two harbors. In case of default, foreign bondholders were entitled after six months to take over the railroads and to sell them if necessary after two years. Explicit references to swaps and receiverships in case of debt suspension were introduced in the loan contracts of China (1898, 1911, 1913), Costa Rica (1911), El Salvador (1922), Liberia (1906), Morocco (1904), Poland (1920), Portugal (1891), and Serbia (1902, 1906, 1909, 1913), to name a few examples.

4.5 An Empirical Investigation of Extreme Conditionality

In this section, I assess a key aspect of extreme conditionality: the relationship between pledges and the spread. If pledges are credible—read seizable—collateralized bonds should be rewarded by investors with a lower premium. Asset seizure did not occur in the abstract. The legal basis for debt-equity swaps and receiverships comprised pledges made at the time of contracting a new loan. Law scholars recognize that pledges in the Bond Era had intrinsic legal value: First, collateralized loans received priority in the negotiation of default settlements. Loans with pledges would be repaid first and subject to lower interest reduction and principal haircuts.[129] Second, lenders of loans that were pledged had priority in the control or administration of those resources in case of financial intervention.[130] If investors anticipated the ability to enforce swaps or receiverships in case of default, and collateralized assets served as focal points in default

129. Irmscher (2007).
130. Borchard (1951, pp. 98–100).

settlements, then loans containing pledges would be expected to carry a lower interest rate.

Chabot and Santarosa have shown the impact of pledges on bond prices in secondary markets by comparing the bond price of collateralized and noncollateralized loans in two important cases: Spain (1870–1874) and Argentina (1887–1899).[131] Their research design focuses on loans that were virtually equivalent except for the presence of pledges, showing a cleanly identified negative effect of collateral on bond prices. In the empirical exercise that follows, I take a different and complementary route by examining under a regression framework the effect of pledges on interest rates in primary markets for as many as 88 countries from 1858 to 1914. Unlike Chabot and Santarosa, my analysis emphasizes the importance of imperial competition between Great Powers for the credibility of loan pledges.

4.5.1 CODING PLEDGES

To test the effect of pledging on the price of capital, I digitized the *Stock Exchange Loan and Company Prospectuses* collection held by the Guildhall Library, City of London, where the archives of the LSE are currently stored. This collection includes 707 bond prospectuses for 88 countries floated or marketed in London between 1858 and 1914 (earliest and latest entry).[132] I considered all government and government-guaranteed loans regardless of their official use: war, debt conversion, and infrastructure.[133] In coding pledges out of the prospectuses, I dismissed general statements—for example, loans secured upon the "general revenue of the country," a frequent rhetorical recourse—and focused on specific pledges—for instance, a tobacco monopoly or the customs receipts in a major port.

Specific pledges reduced asymmetric information about the value of the collateral. Prospectuses often included information about the yearly income generated by the specific pledge (see, for instance, figure 4.4a); other times, loans were collateralized against the very same infrastructure to be financed by external capital (for instance, a new railroad; see

131. Chabot and Santarosa (2017).

132. The collection lists company prospectuses before 1858, but the first sovereign loan is dated as of that year.

133. For fungibility of government income, refer to chapter 6.

£600,000, or Fcs. 15,000,000, or 4,000,000 Thalers.

ROUMANIAN STATE RAILWAY LOAN,

WITH GOVERNMENT GUARANTEE.

Being balance of a Loan of £4,800,000, issued in Berlin, and authorized by the Act of Concession voted by the Legislative Bodies and sanctioned by Decree (No. 1,516) of His Highness Prince Charles I., of Roumania, dated September 21st (October 3rd), 1868.

To be issued in Bonds to Bearer of £15 each, or in multiples of Four, Eight, or Ten Bonds respectively, bearing Interest at 7½ per cent. per Annum.

The Interest to commence from the 1st January, 1870, and to be payable half-yearly on the 1st January and 1st July in each year.

The Bonds to be Redeemed at par, by the operation of an accumulating Sinking Fund, in yearly drawings. The first drawing to take place on the 1st March following the completion of the Line, from Galatz to Roman.

Messrs. GLYN, MILLS, CURRIE & Co. are authorised by the Contractors of the Loan to receive subscriptions for the above Bonds, which are issued by virtue of a Concession granted by His Highness Prince Charles I., of Roumania, and approved by the Roumanian Chambers, on the 3rd of October, 1868, to provide the requisite capital for the construction of Railways in the Principalities. A portion of the contemplated lines has already been opened, and a further section is expected to be opened in the course of two or three weeks, and the remaining lines by the end of August, and before October, 1870, and only for a small portion of the lines, the latest time is stipulated to be in the course of 1871. The present issue of the Bonds is designed for the works and purchases executed, and all particulars will be found in the Report of the Special Commissary of the Roumanian Government, appended to this Prospectus. In the same official document, a literal translation of which is annexed, will be found in detail the various terms and conditions of the issue. The Loan bears the immediate and unconditional guarantee of the Roumanian Government for the due payment of interest, and is moreover secured on the entire property of all the conceded Railways.

FIGURE 4.2. Example 1: pledge in the 1870 Romanian bond. Excerpt of original prospectus. *Source*: *The Stock Exchange Loan and Company Prospectuses*. Adaptation of image digitized at the Guildhall Library, City of London.

figure 4.2). Those prospectuses detailed expected returns of the project, including operational expenses and yearly income.[134] All this information

134. In the Romanian railroad loan just mentioned, the prospectus was followed by a one-page note specifying the route of the railroad, locomotives, passenger carriages, and expected

REPUBLIC OF SAN DOMINGO.

ISSUE OF £1,500,000 DOMINICAN UNIFIED DEBT 4 PER CENT. BONDS.

Being part of a total of £4,236,750 authorized by Law of August 9th, 1897, and created for the purpose of discharging all the Bonded and Floating Debts of the Republic, all of which have separate special securities attached to them, and of unifying and applying all those securities to this new Debt.

The remainder of the creation under the denomination of "Obligations Or de St. Domingue," bearing $2\frac{3}{4}$ per cent. interest and redeemable in 1999, out of surplus revenue, has been applied to the conversion at par of the Gold Bonds of 1893 (chiefly held in Belgium) in accordance with arrangements made between the Government and the **Committees of Bondholders in Belgium** which have been submitted to and approved by the **London Committee of Bondholders**, acting in conjunction with the **Council of Foreign Bondholders** in London.

(a) Title page

of the "Caisse de la Regie" will hereafter be made under the advice and approval of the Council of Foreign Bondholders in London. It is also provided by Law, and will be a term of the contract with the Bondholders, that in case of any default in the payment of Coupon or Sinking Fund, or in case of "other manifest necessity," the Improvement Company under its powers as their Trustee shall call upon the Governments of the United States, Great Britain, Belgium, Holland and France to each name a Commissioner, and the Dominican Government consents that the person or persons so appointed shall constitute a "**Financial Commission**" for the purpose of collecting directly the Revenues of the Republic and exercising the functions of the "Caisse de la Regie."

(b) Pledge clause

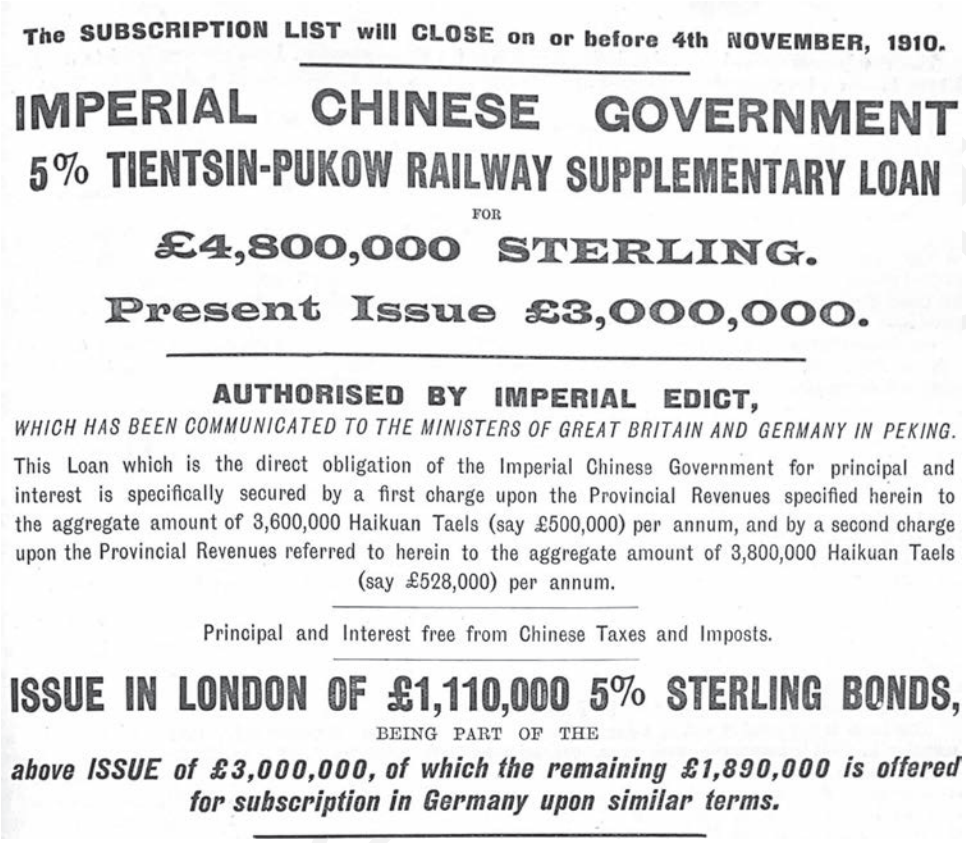
FIGURE 4.3. Example 2: pledges in the 1897 Dominican bond. Excerpts of original prospectus. *Source*: *The Stock Exchange Loan and Company Prospectuses*. Adaptation of image digitized at the Guildhall Library, City of London.

was meant to attract the attention of investors while helping them calibrate the expected return in case of default.

A total of 175 prospectuses, or 29.8 percent of the sample, include one or more specific pledges, with the vast majority of bonds with pledges involving sovereign countries, not colonial dependencies. To minimize coding assumptions, I set Pledge to 1 whenever a country includes one or more specific pledges in a loan contract and 0 otherwise. I offer three examples in figures 4.2–4.4. The first is from 1870, when the Romanian government issued a loan in various financial capitals of Europe to build a state railway (figure 4.2). This particular loan was "secured on the entire property of all the conceded Railways," as stated in the last line of the excerpt in figure 4.2.

income: "Exports c[ould] be effected [by the railroad] in a safe and comparatively cheap way—the above figures [200 million francs of export value yearly] will be doubled."

__-1
__0
__+1



The SUBSCRIPTION LIST will CLOSE on or before 4th NOVEMBER, 1910.

IMPERIAL CHINESE GOVERNMENT

5% TIENTSIN-PUKOW RAILWAY SUPPLEMENTARY LOAN

FOR

£4,800,000 STERLING.

Present Issue £3,000,000.

AUTHORISED BY IMPERIAL EDICT,

WHICH HAS BEEN COMMUNICATED TO THE MINISTERS OF GREAT BRITAIN AND GERMANY IN PEKING.

This Loan which is the direct obligation of the Imperial Chinese Government for principal and interest is specifically secured by a first charge upon the Provincial Revenues specified herein to the aggregate amount of 3,600,000 Haikuan Taels (say £500,000) per annum, and by a second charge upon the Provincial Revenues referred to herein to the aggregate amount of 3,800,000 Haikuan Taels (say £528,000) per annum.

Principal and Interest free from Chinese Taxes and Imposts.

ISSUE IN LONDON OF £1,110,000 5% STERLING BONDS,

BEING PART OF THE

above ISSUE of £3,000,000, of which the remaining £1,890,000 is offered for subscription in Germany upon similar terms.

(a) Title page

So long as principal and interest of the Loan are regularly paid, there is to be no interference with these provincial revenues; but if principal or interest of the Loan be in default at due date, then, after a reasonable period of grace, likin and suitable internal revenues of the four provinces sufficient to provide the amount above stated are to be forthwith transferred to, and administered by, the Imperial Maritime Customs, in the interest of the Bondholders. And so long as this Loan or any part thereof shall remain unredeemed, it is to have priority both as regards principal and interest, subject to the obligations created by Article 9 of the Loan Agreement of 13th January, 1908, over all future Loans, charges and mortgages charged on the above-mentioned revenues of the four Provinces.

(b) Pledge clause

FIGURE 4.4. Example 3: pledges in the 1910 Chinese bond. Excerpts of original prospectus. *Source*: *The Stock Exchange Loan and Company Prospectuses*. Adaptation of image digitized at the Guildhall Library, City of London.

Figure 4.3 shows a second type of security: control over the tax administration in case of default, the so-called receivership. In this example, the government of Santo Domingo (modern-day Dominican Republic) agreed to hand over the tax administration to the Corporation of Foreign Bondholders (CFB) in London in case of default. As reflected in the loan, tax collection had already been externalized to an American firm a few years earlier—a sign of low fiscal capacity.[135] The loan required the agreement of Santo Domingo, the CFB, the American firm, and the American government. The effective rate at issue for this loan was 6.1 percent, 230 basis points above the average rate in 1897—a nontrivial yet modest premium considering the dire fiscal position of the country. Unsurprisingly, Santo Domingo suspended debt service two years later. As part of the default settlement negotiations, an American receivership was installed in Santo Domingo (1905–1941), railways were put in the hands of American bondholders, and a monthly installment by the Treasury to an agent nominated by the European bondholders based in Santo Domingo was to be deposited until the debt was liquidated.[136]

The third example, in figure 4.4, shows that foreign intervention clauses were agreed upon with large countries as well—China in this case. The loan of 1910, for instance, allowed foreign bondholders to seize key sources of revenue in case of default. To float that loan, the Chinese government hypothecated the *likin* (internal toll and most lucrative tax in the empire) plus the internal revenues of four provinces: Zhili, Shantung, Kiangsu, and Anhui. If China defaulted, the collection of these revenues would be transferred to the Imperial Maritime Customs Service, a tax agency that was effectively seized by European investors only one year later.[137]

Assessing the £25 million reorganization loan to China in 1913,[138] van de Ven offers an illuminating description of how pledges were perceived by European investors in the era of high imperialism:

> [John] Jordan [the British envoy to China] believed that the [European] banks . . . rel[ied] on the belief that the powers were prepared to

135. Santo Domingo's government had defaulted on a loan floated in 1869 to purchase munitions and new equipment for a cruiser (Wynne, 1951, p. 207). In 1888, the American firm had replaced a Dutch *régie* created for the purpose of debt collection.

136. Wynne (1951, pp. 224–269).

137. Find details of foreign financial control in China in chapter 5.

138. This loan was secured with further *likin*, all the maritime customs revenue, and the Salt Tax Administration. In the event of default, the salt tax was to be put under the management of the Maritime Customs Administration, as occurred with the 1910 loan (Feis, 1930, p. 450).

use gunboat diplomacy to recover their money. He wrote that "lending money to China is a mild form of gambling. The lenders trust to her great natural resources and to political pressure or intervention," adding, "the recovery of all this money will be an unpleasant task for our successors."[139]

This example sheds light on the investors' calculations at the time and the anticipated diplomatic (when not military) intervention of European governments on their behalf. Pledges were not mere scraps of paper: they shaped expectations, and these were reflected in the price of capital.

4.5.2 ANALYSIS

The ability of investors to seize pledged assets grew over time as a result of gentlemanly representation in key government offices, advances in bondholders' organizational capacity, and Great Powers' imperial ambitions. To account for the the time-varying credibility of pledges, I first run a linear interaction between pledging and time:

$$\begin{aligned}\text{Yield at Issue}_{it} = \alpha + \beta_1 \text{Pledge}_{it} + \beta_2 \text{Year}_t + \beta_3 \text{Pledge}_{it} \times \text{Year}_t \\ + \boldsymbol{X}\beta_4 + \eta_i + \epsilon_{it}\end{aligned} \tag{4.2}$$

where $\boldsymbol{X}$ denotes a vector of time-varying country-level controls. I expect β_1 to be positive and β_3 negative. At the beginning of the nineteenth century, the expectation of asset seizure in case of default was remote. Bondholders were good at denying credit if needed but government interventionism on behalf of private investors was unlikely. In those times, the presence of a pledge in a loan contract could reveal a lemon; that is, only countries that anticipated difficulty paying back their debt would have pledged their assets to overcome creditors' doubts, hence $\beta_1 > 0$.

As time passed, bondholders became better organized. By creating encompassing investors' organizations, lenders improved their ability to negotiate with embarrassed governments and to lobby their home government for diplomatic support. By then, European governments were themselves involved in a colonial-imperial race, making them more receptive to bondholders' requests. In that context, I expect pledges to be deemed credible, that is, seizable in case of default. Accordingly, investors would

139. van de Ven (2014, p. 170).

revise downward their prior beliefs about the risk of lending to an emerging economy. Empirically, I expect interest rates to decrease in the presence of pledges, $\beta_3 < 0$.

Pledges are not randomly assigned. To minimize selection, I include a battery of country fixed effects η_i. These capture unobserved characteristics (e.g., weak economic fundamentals, strong military, or diplomatic relations with Britain) that affect yield and the need to pledge.[140] Substantially, the "within estimator" captures the effect of pledging relative to not pledging for the same country.

The analysis is limited to loans for which I can compute the effective yield at issue. This brings the sample size from 707 to 643 units. As I did for the analysis in figure 3.6, I compute the average yield at issue for any year in which a given country floated more than one loan. Within the same year some loans might come with a pledge, but others do not. I compute the share of the total issue amount for any given year. If 50 percent or more derives from a pledged loan, I assign value 1 to Pledge for that country-year observation. The final sample size comes down from 643 to 567 country-year observations.

Column 1 in table 4.1 reports results for the simplest specification, including country fixed effects and no other covariates. The estimates are consistent with expectations: by the mid-nineteenth century, pledges were hardly seizable. Collateral was read by investors as a signal of poor macroeconomic performance, hence $\hat{\beta}_1 > 0$. As time passed, pledges became credible and interest rate premiums decreased accordingly, $\hat{\beta}_3 < 0$.

Figure 4.5 offers a visual representation of the main result. Two patterns are worth mentioning. First, observe a secular decline in effective interest rates. Despite repeated episodes of default in this period,[141] markets offered credit at increasingly lower rates as years passed. Second, one way lemons' rates converged with those of seasoned borrowers, I argue, was by pledging precious public assets and sources of revenue. At the outset of the period of study, pledges were interpreted as empty promises, hence they led to no premium cut. As time passed and bondholders became more effective in negotiating settlements and seizing collateral, the gap between

140. Arguably, when borrowers have a strong military (e.g., Russia), asset seizure is less likely, decreasing the credibility of pledges. If any, this issue adds a downward bias, that is, it pushes β_3 toward zero.

141. Reinhart and Rogoff (2009).

TABLE 4.1. Bond Yield and Pledging, 1858–1914

	(1)	(2)	(3)	(4)	(5)	(6)
Pledge × Year	−0.039***	−0.030***	−0.025***	−0.033***		
	(0.012)	(0.009)	(0.009)	(0.012)		
Pledge × After CFB					−0.732*	−0.781*
					(0.420)	(0.439)
Pledge	74.056***	56.336***	48.109***	62.293***	0.773**	0.726*
	(22.833)	(17.840)	(16.234)	(22.854)	(0.381)	(0.374)
Year	−0.030***	0.046***	0.048***	−0.013**		
	(0.005)	(0.004)	(0.007)	(0.006)		
After CFB					2.544***	2.649***
					(0.250)	(0.387)
Gold standard			−0.257			−0.269
			(0.266)			(0.290)
Default within the last 10 years			0.356**			0.404**
			(0.163)			(0.197)
Public debt/Revenue				0.027		
				(0.034)		
ln(per capita exports)				0.183		
				(0.153)		
Fiscal deficit/Revenue				0.037		
				(0.049)		
Intercept	62.075***	−82.391***	−86.283***	28.644**	2.180***	2.263***
	(8.828)	(8.304)	(12.223)	(12.005)	(0.149)	(0.157)
Country FE	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	No	Yes	Yes	Yes	Yes	Yes
Colonial status	No	No	Yes	No	No	Yes
Observations	567	567	492	286	567	492
R-squared	0.888	0.938	0.918	0.873	0.934	0.914

Note: Bond yield is measured at issue. Pledges coded by the author. See chapter 3 for sources for the gold standard and external default. Country-clustered standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

these curves narrowed. The spread at issue vanished in approximately 1880, soon after the establishment of the CFB.

Thus far, I have assumed that the ability of foreign bondholders to seize pledged assets grew over time because they gained bargaining power, preferences of high politics and finance aligned, and imperial competition intensified; however, the secular decrease of interest rates could coincide with other unobserved trends (e.g., a sustained expansion of capital supply), making the relationship in column 1 in table 4.1 biased if not spurious. In order to account for any secular trends in international capital markets, I fit a battery of year fixed effects in column 2. As expected, the effect of

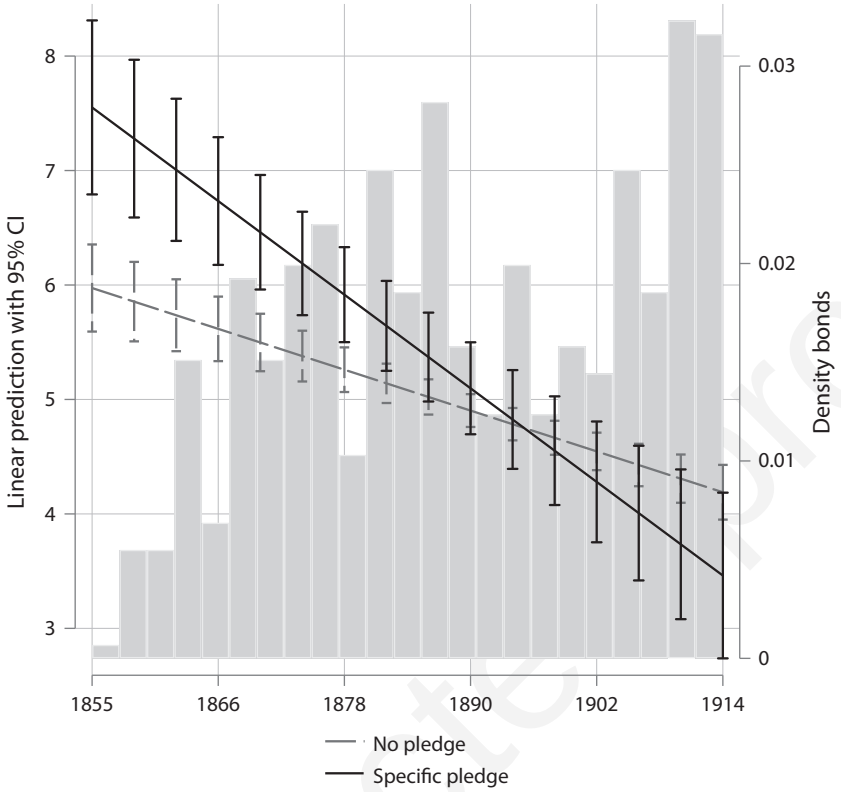


FIGURE 4.5. Effect of pledges on bond yield over time. Bond yield is computed at issue (refer to chapter 3 for details). Dark solid lines and gray long-dash lines show predictions for pledged and nonpledged loans, respectively. 95% CI reported. The density superimposed shows the distribution of bonds issued over time.

pledges over time weakens once we control for the common secular trend; however, it does not vanish.

Column 3 adds controls for standard explanations of the spread examined earlier in this chapter: the gold standard, recent default, and colonial status.[142] Including these covariates decreases the magnitude of the pledging, as expected, but the effect is still negative and is statistically different from zero.

142. I do not include an indicator for "first loan ever" because it is collinear with country fixed effect. For consistency with previous analysis, self-governing territories after 1881 are considered financially independent, but results hold if they are considered colonial dependencies until 1914.

In column 4, I add a series of economic controls that guide investors' decisions in the Bond Era:[143] public debt as a proportion of revenue, fiscal deficit as a proportion of revenue, and trade openness (measured as logged per capita exports).[144] These controls, drawn from Ferguson and Schularick, are available only for 1880 onward.[145] Despite the significant reduction in sample size, results for the interaction terms in column 4 are similar to previous specifications.

Thus far, I have assumed that the ability to seize pledged assets increased linearly over time; however, the creation of the CFB in 1868 was arguably a game changer in debt renegotiation. In column 5, I interact the pledge variable with a time indicator, "after CFB," which equals 0 until 1868 and 1 afterward. This indicator is meant to estimate any significant change in the effect of pledging on the effective interest rate before and after the official creation of the CFB—a difference-in-difference estimator. Because the dataset begins in 1858, little statistical power exists before the 1868 cutoff; and results may be assessed accordingly. The interaction Pledge × After CFB in column 5 is negative and statistically significant at 90 percent. This coefficient means that, everything else constant, a loan including a pledge would have an effective interest rate 0.73 points lower after the CFB was established (a 15 percent decrease relative to the average interest rate in the sample), arguably because of the heightened capacity of bondholders to execute asset seizure in case of default. In column 6, I repeat the exercise by adding institutional controls. Results, if any, strengthen the working hypothesis. Because macroeconomic data are available only after 1880 (after the CFB was created), I cannot include those controls in this specification.

Accominotti, Flandreau, and Rezzik as well as Ferguson and Schularick show abundant evidence of the so-called empire effect, that is, the systematic lower spread for colonies relative to other economies with similar fundamentals.[146] Accominotti et al. argue that investors perceived colonies as an extension of the national territory—namely, provinces. If colonies defaulted, investors could resolve the dispute under imperial jurisdiction; that is, investors could bring the embarrassed colonial government to (British) court. If this is true, we should observe few pledges in colonial

143. Accominotti, Flandreau, and Rezzik (2011, p. 392).

144. Interest services as a proportion of revenue is also an important control (Flandreau and Zumer, 2004); however, this variable has many missing values. Because it correlates strongly with debt as a proportion of revenue, I choose the latter. Results are identical nonetheless.

145. Ferguson and Schularick (2006).

146. Accominotti, Flandreau, and Rezzik (2011); Ferguson and Schularick (2006).

TABLE 4.2. Pledging and the Empire Effect

	(1)	(2)
Pledge × Year × Independent	−0.028***	
	(0.011)	
Pledge × Year × Empire	0.021	
	(0.015)	
Pledge × After CFB × Independent		−0.898*
		(0.477)
Pledge × After CFB × Empire		1.213
		(0.784)
Observations	567	567
R-squared	0.938	0.936

Note: Empire and Independent are mutually exclusive. Empire = 1 if unit is a dependent colony in the British Empire. Independent = 1 if unit is not a dependent colony of the British Empire: i.e., sovereign nations, colonies of other sovereign nations, and self-governing British dependencies after 1881 (see text for discussion). All models include all constituent parts of the three-way interaction, but only selected coefficients are reported. Country-clustered standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

bonds to begin with. By the same token, pledges should help reduce the spread among foreign countries, not colonial dependencies. Imagining that the British government would allow a debt-equity swap in any given colony is difficult because doing so would reduce the empire tax base.

Pledges were uncommon among colonies: only 6 percent of colonial bonds had one compared to 50 percent outside the empire.[147] Indeed, as many as 35 (or 70 percent) of the independent countries in the Bond Era collateralized a specific national asset at some point between 1850 and 1914. The few countries that never did include Great Powers and self-governing British territories. In order to test the differential effect of pledges in and outside the empire and over time, a three-way interaction is required. Table 4.2 reports the results. For ease of interpretation, I report two-paired comparisons, namely, the effect of pledges over time for the British Empire and sovereign countries, separately. In column 1, I report the interaction with Year (following expression 4.2) and in column 2 with the indicator variable After CFB. Results confirm that pledges reduced the price of external finance for sovereign countries, not colonies, but they did so only once

147. Weidemaier, Scott, and Gulati (2013) find similar numbers in pre-WWII bonds (N = 493).

bondholders gained the ability to seize pledged assets in case of default, that is, in the final decades of the nineteenth century.[148]

Before I conclude this section, let me entertain an alternative hypothesis, by which pledges decreased the interest rate because they conveyed information about the financial health of the borrower.[149] As I mentioned earlier, prospectuses with pledges enclosed key data about the yearly income of the collateral and, when the loan was developmental, how it would contribute to commercial activity. The disclosure of this information could have been interpreted as a sign of government transparency, which tends to correlate with "good institutions" and be rewarded by capital markets.[150] Were this the case, the mere presence of pledges (regardless of any gains in bondholders' ability to seize assets) should decrease the yield at issue. I assess this possibility later in table 4.3 by examining the bivariate relationship between pledges and yield (see section 4.9). Results are null, contravening this alternative hypothesis.

4.6 Extreme Conditionality and State Building

In 1951, Borchard argued that pledges had "intrinsic value" and "legal significance," enabling foreign financial control in case of default.[151] The statistical evidence above is consistent with Borchard's diagnosis. In the later decades of the nineteenth century, the presence of specific collateral in loan contracts decreased the interest rates at issue, arguably because anticipated swaps and receiverships reduced the risk of lending to economies with weak economic fundamentals. Lower interest rates poured much needed capital into the Global South, but pledges did not stop default. Supersanctions often followed, and local assets and streams of revenue were put in the hands of foreign investors in at least 28 percent of default episodes

148. To be consistent with previous specifications, self-governing colonies are considered financially independent after 1881. If any, this biases results against finding an effect because self-governing colonies were less likely to pledge assets than sovereign countries or colonies of other powers. Results hold if self-governing territories are considered dependent colonies all the way to 1914.

149. I thank an anonymous reviewer for pointing out this possibility.

150. Hollyer, Rosendorff, and Vreeland (2018) for the relationship between transparency and governance quality, and Schultz and Weingast (2003) for the democratic advantage in capital markets.

151. Borchard (1951, p. 99).

and 48 percent of sovereign defaulters,[152] completing the circle of extreme conditionality.

The prevalence of foreign financial control in the Bond Era is critical to understanding why external finance was unlikely to contribute to state building. By surrendering assets and sections of the tax apparatus to bondholders, the tax base available to the local government shrank, leaving emerging economies in precarious fiscal positions. Revenue shortages would soon require new loans, possibly agreed upon as part of foreign financial control. This stylized sequence of events (i.e., trajectory E in figure 1.3) pushed many emerging economies into a "debt trap,"[153] characterized by high indebtedness and persistence of low state capacity.

Why would incumbents of emerging economies assume such a big risk? Why would they float loans if swaps and receiverships in case of default were anticipated? One reason, elaborated in chapter 2, is that external finance allowed rulers to dodge the immediate costs of alternative sources of revenue, key among them taxation. Higher or new taxes may give rise to demands for power sharing over fiscal policy by taxpayers—namely, having a say about how tax revenue is spent. Alternatively, power-sharing institutions may be required to induce quasi-voluntary compliance from taxpayers. Either way, tax reform was likely to limit the incumbent's discretion over spending decisions. By contrast, foreign loans allowed rulers to accumulate power in the short run while shifting the political costs of servicing external finance (either power-sharing institutions or foreign control) to future leaders.

The search for yield by foreign investors combined with myopic political calculations of unconstrained rulers was responsible for high indebtedness, default, and foreign financial control—the opposite of state building.

4.7 Betting on Default?

Was confiscation of public assets the ultimate goal of international finance? Did investors bet on default? Fishlow admits that

> default could become for [European investors] a source of gain rather than of loss, but only when some implicit guarantee of intervention

152. Mitchener and Weidenmier (2010). Recall these statistics are a lower bound because they do not include debt-equity swaps.

153. Fishlow (1985, p. 400).

> [i.e., financial control] promised to bring order to the financial chaos of mismanaged states and lead to refunding of prior debt.[154]

Flandreau suggests that British investors entertained the idea a "default-colonization nexus," and to that effect, requested the hypothecation of land in expectation of debt interruption.[155] The "scramble for concessions" in loans to China could be interpreted under this lens.[156]

Loan contracts often included pledges as well as *sinking funds*, which forced borrowers to set aside capital periodically to repurchase a portion of the existing bonds and gradually reduce the face value of the loan. Sinking funds were created to dissuade borrowers from reneging on the outstanding principal at the end of the credit term. Before 1914, debtor countries could pay the sinking fund to an agent, usually the underwriter of the bond, instead of the creditors directly.[157] From the investors' point of view, the presence of sinking funds reduced risk and translated into lower interest rates. A sinking fund, however, did not secure a stream of future income, unlike taking control of a state monopoly or a receivership.

Along with pledges, I coded sinking funds from every loan in the Guildhall prospectus series: 52 percent of loans floated in the LSE had a sinking fund. In table 4.4 in the chapter appendix, I report results for expression 4.2 once pledges are replaced by the presence of a sinking fund in a loan contract. The effect of the interaction coefficient is zero no matter the specification. A benevolent interpretation of this result is that sinking funds were not strong enough risk reduction mechanisms compared to pledges. A not-so-benevolent interpretation is that sinking funds were not as profitable for investors as was foreclosing foreign assets; hence their null effect on the price of capital.

More generally, the use of international lending for political and economic advantage resonates with the Hobson-Lenin hypothesis of financial imperialism;[158] however, my reading of extreme conditionality is that the confiscation of assets was a second-best outcome for private investors, not a deliberate goal. Bondholders gained leverage vis-à-vis sovereign borrowers in the second half of the nineteenth century, and they profited from

154. Fishlow (1985, p. 401).
155. Flandreau (2016, pp. 93–101).
156. Cain and Hopkins (2016).
157. Tunçer (2015, p. 20).
158. See Frieden (1994) for a phenomenal treatment.

regular debt service and also default; however, to date I have found insufficient direct evidence to sustain that default and foreign control were the ultimate drivers of international lending, maybe with the exception of late-Qing China. Hopefully, new archival discoveries will shed light on this old but important question.

Departing from the Hobson-Lenin hypothesis, this book brings attention to the domestic causes of foreign financial control and state weakness. My argument attributes shared (although arguably asymmetric) responsibility to foreign investors and local rulers, who often preferred to assume the risks of external finance to the certainty of political and administrative costs associated with tax reform.

4.8 Summary and Implications

This and the previous chapter show evidence of the relatively favorable terms of external finance for economies with weak fundamentals in the Bond Era. Standard explanations of the spread have been tested and confirmed with an original dataset that covers the longest period and largest number of political units to date. Along with standard explanations, I argue that the low spread resulted from foreign bondholders' ability to seize key assets and sources of revenue in case of default. Foreign financial control did not take place in the abstract: it often built on previously pledged assets and sources of revenue. Consistently, I show that pledges decreased the spread conditional on bondholders gaining organizational capacity and creditors' governments becoming more interventionist in lending markets. The role of pledges in shaping investors' beliefs is novel because collateral is often considered "irrelevant."[159]

The conditions under which developing nations accessed (cheap) external finance are crucial to understanding the persistence of limited state capacity in emerging economies. The expectation of foreclosure and preemptive appropriation of foreign assets help explain the historically low spread for emerging economies despite repeated default episodes in the Bond Era. Incumbents in the borrowing countries, far from victims, might have preferred to push war bills (and other major expenses) to future generations while gaining access to cheap credit in the short run and bypassing the political costs of taxation. In the case of default, responsibility fell to

159. Bulow and Rogoff (1989, p. 156). See Weidemaier and Gulati (2017) for a survey of recent work by international law scholars showing that "contract terms mattered" even in the age of "absolute" sovereign immunity.

some future leader to raise new taxes to service debt, negotiate debt relief, or agree upon a debt-equity swap or receivership.

For the purpose of state building, default and foreign control of domestic assets—possibly sweetened with some haircut—contributed to break the connection between fiscal shocks (e.g., war) and state making. Instead of expanding fiscal capacity to service debt after the fiscal shock, emerging economies often canceled public debt by requesting relief and leasing their assets to foreign powers. Under such conditions, even interstate war fiscal efforts eroded or *unmade* state capacity, carrying on long-term consequences for institutional development. I show statistical evidence of that in chapters 7 and 8.

An important caveat accompanies the above interpretation: bondholders' temporary control of local tax administrations may be good for state building. Well-designed foreign financial control could exert positive influence and externalities over the local bureaucratic apparatus. In the next chapter, I evaluate this possibility. The evidence suggests, however, that the tax administrations did not improve under the control of foreign bondholders.

4.9 Appendix

This appendix examines an alternative hypothesis for the effect of pledges and reports a test for sinking funds. First, do pledges signal government transparency and good governance? Were this the case, the mere presence of pledges should *decrease* the interest rate charged at issue *regardless of when loans were floated*. I assess this alternative hypothesis in table 4.3. In column 1, I report the bivariate relationship between pledges and yield at issue. The relationship is positive and statistically different from zero, and resonates with Mosley's bivariate analysis of 70 loans floated by 22 states during the 1880–1914 period.[160] However, the positive sign of the coefficient is inconsistent with the alternative hypothesis.

Pledges are not randomly assigned. There are country-level unobserved characteristics that likely correlate with the presence of pledges and yield at issue. Column 2 shows that once we account for country fixed effects, the effect of Pledge is a third of the original size, and still positive. Now we need to account for any secular trend that could have affected pledging and yield, for instance, imperial competition. Once we include a battery of

160. Mosley (2003, pp. 289–291).

TABLE 4.3. Bivariate Relationship between Pledges and Yield at Issue

	(1)	(2)	(3)	(4)
Pledge	2.117***	0.642*	0.148	0.059
	(0.293)	(0.329)	(0.241)	(0.217)
Country FE	No	Yes	Yes	Yes
Year FE	No	No	Yes	Yes
Controls	No	No	No	Yes
Observations	567	567	567	492
R-squared	0.200	0.818	0.932	0.912

Note: Bond yield is measured at issue. Pledges coded by the author. Controls are gold standard, external default in the last 10 years, and time-varying colonial status. Intercept not reported. Country-clustered standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

TABLE 4.4. Sinking Funds and Yield at Issue

	(1)	(2)	(3)
Sinking Fund	−0.036	−11.131	−0.073
	(0.089)	(12.554)	(0.540)
Sinking Fund × Year		0.006	
		(0.007)	
Sinking Fund × After CFB			0.040
			(0.554)
Year		0.041***	
		(0.007)	
After CFB			2.695***
			(0.597)
Country FE	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Controls	Yes	Yes	Yes
Observations	492	492	492
R-squared	0.912	0.912	0.912

Note: Bond yield is measured at issue. Sinking funds coded by the author. Controls are gold standard, external default in the last 10 years, and time-varying colonial status. Country-clustered standard errors in parentheses. Intercept not reported. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

year fixed effects in column 3, the effect of Pledge vanishes. In column 4, I add other relevant controls and the effect of Pledge remains null. In sum, table 4.3 suggests that the *average* effect of pledges on the spread between 1850 and 1914 is zero. Pledges reduced the interest rate only when imperial competition intensified, as indicated in figure 4.1.

__-1
__0
__+1

Second, I examine the effect of sinking funds. These were meant to reduce risk, but they did not bring to investors the profits associated with seizing foreign assets and tax branches. In table 4.4, I examine whether sinking funds decreased the yield at issue. I report three models: Because sinking funds were easily enforceable—at least relative to asset seizure—I report a model without a time interaction in column 1. Immediately after, I report an interaction with Year and After CFB in columns 2 and 3, respectively. Results are null across specifications. That is, sinking funds did not reduce interest rates.