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Abstract

This paper is about the economics of financial power and regime change. It revisits important aspects of the “end of globalization” – as the shutting down of global capital markets after 1931 is generally referred to. It articulates a novel perspective on the fundamental regime change that occurred at that point by putting the collapse of foreign government bonds that occurred in New York in the early 1930s in the perspective of London’s earlier experience as a centre of global capital exports. It argues that the London industrial set-up for managing foreign government debts had been essentially transplanted from London to New York in the 1920s. This set-up rested on the role of prestigious intermediaries who were involved in originating, distributing and monitoring high quality securities, as well as dealing with crises. It then argues that several critical aspects of the New Deal financial reforms adopted during the 1930s interfered directly with this set-up and prevented the industry from dealing with the crisis in the usual way. It concludes that the global bond market was a casualty of domestic policies associated with the New Deal, and that the New Deal opened a new era in international finance.

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Reputation, Regulation and the Collapse of International Capital Markets, 1920-1935

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January 2017

Abstract: This chapter is about the economics of financial power and how it shifts. It revisits important aspects of the "end of globalization" – as the shutting down of global capital markets after 1931 is generally referred to. It articulates a novel perspective on the fundamental regime change that occurred at that point by putting the collapse of foreign government bonds that occurred in New York in the early 1930s in the perspective of London's earlier experience as a centre of global capital exports. It argues that the London industrial set-up for managing foreign government debts had been essentially transplanted from London to New York in the 1920s. This set-up rested on the role of prestigious intermediaries who were involved in originating, distributing and monitoring high quality securities, as well as dealing with crises. It then argues that several critical aspects of the New Deal financial reforms adopted during the 1930s interfered directly with this set-up and prevented the industry from dealing with the crisis in the usual way. It concludes that the global bond market was a casualty of domestic policies associated with the New Deal, and that the New Deal opened a new era in international finance.

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This chapter discusses one aspect of the interwar crisis, the collapse of the international capital market. In 1931, this market was hit by a wave of foreign government debt defaults and, by the middle of the 1930s, 40 percent of Europe's and 82 percent of Latin America's external debt was in arrears. The center of the cyclone was New York, where most issues now in default had taken place during the 1920s (Foreign Bondholders Protective Council, 1934; Madden, Nadler and Sauvain, 1937; Lewis, 1938; Mintz, 1951). The episode left deep scars in the international financial system. The global capital market became notoriously narrower and remained effectively durably closed to foreign borrowers (Eichengreen, 1989). Public capital (the Marshall Plan) replaced private lending after WWII and new institutions such as the IMF were created in order to deal with downsized international financial relations (Van Dormael 1978). Reflecting this, statistical measures of the evolution of current account openness – an indicator of the accessibility of capital markets – nosedived during the 1930s and did not recover until the 1970s (Obstfeld and Taylor, 1998; Flandreau and Rivière, 1999; Bordo and Flandreau, 2003): "Globalization" had ended in the interwar, and would only "resume" in the 1970s.

Previous economic historians, most prominently perhaps Barry J. Eichengreen, have generally discussed the interwar debt crisis using the language of macroeconomics, prescribing in retrospect those remedies with which intelligent policy makers might have mitigated the dislocation of the international financial system. In those accounts, the crisis was initiated by adverse shocks made worse by the failure of self-regulating markets, and morphed into a full-scale disaster owing to misguided policies, such as adherence to the gold standard. In these accounts, the actions of contemporary policy makers are read as the negative of the collapse: Had policy makers made the right policy choices, the crisis would never have been so bad. This view is widely shared among scholars of different political hues (Eichengreen 1992, 1995a; Temin 1991, 2010; James, 1996; 2002; 2009).

As a result of the existing consensus among economic and financial historians, this reading of the interwar has played a crucial role in legitimizing the response to the subprime crisis among economists, policy makers and the public opinion. By contrast to this narrative, the following chapter does articulate a supply side or structural story of the interwar foreign debt crisis. This perspective is new. The evolution of the international financial architecture of national and international capital markets is usually seen as endogenous to the demand shocks. The same applies to changes in the regulatory set-up. Financial regulation, it is said, resulted from macroeconomic failures. For instance, Harold James portrays New Deal's Glass-Steagall Act as a necessary response to the US banking crisis of 1931-3 (James 2009, p. 41, DeLong and Ramirez, 2001).

The main contribution of this chapter is to discuss an alternative perspective, one that would reverse the causality. Rather than seeing the New Deal financial acts as part of the policies motivated by the financial turmoil of the early 1930s – a "response" to a "shock" – it argues that they were part of the crisis itself. Specifically, it will be argued that causality did run from New Deal regulations to

the closure of the foreign debt market. New quantitative and qualitative evidence is marshaled to support this argument. This novel perspective on the 1930s, while at odds with the axioms of macroeconomic history, shares connections with business history, most prominently with the work of Vincent P. Carosso who argued that New Deal regulations hampered the business of underwriting, and suggested that the financial acts of the 1930s were part of a crusade waged against investment banks by the Roosevelt administration (Carosso 1970a, 1970b).[1] This work also has kinship with analyses that have focused on the political economy of the New Deal financial acts, their links with ongoing disputes within the financial system and regulatory capture (Stigler 1971; Tabarrok 1998; Mahoney 2001). However Carosso only focused on corporate securities. Moreover, he did not elaborate on the relevance of the microeconomic disruptions caused by the New Deal financial acts for macroeconomic outcomes. This is also the case with Stigler (1964, 1971), Tabarrok (1998) and Mahoney (2001). By contrast, the following discussion focuses on the foreign debt markets and is explicitly concerned with articulating the microeconomics of those markets with aggregate trends.

The microeconomic history offered here rests, first, on a methodological innovation. It is argued that the logic of the interwar debt crisis, instead of being captured through such concepts as debt, GDP, and the current account is best observed from the vantage point of the industrial organization of capital markets in the 1920s. In particular, building on previous research by myself and collaborators, the chapter shows how until the crisis, certification of foreign government debt was delegated to a handful of prestigious underwriting banks. In practice there was a tight correspondence between the prestige of any underwriter and the probability that the debts it underwrote would deliver their promise. This is what made the system legible by outsiders. Keeping it this way provided substantial rents to the more prestigious houses. Therefore, they had incentives to go to almost any length to protect what was effectively a grading system. This emphasis, backed with data, enables me to debunk the widespread myth that bankers had failed. At the time, all underwriters were vilified under the name of "International Bankers" and this amorphous category has been used in subsequent research (Lewis 1938, Mintz 1951, Eichengreen 1989). However, as will be shown, what really mattered were the hierarchies of prestige within this group – a group that was anything but amorphous.

Second, this vantage point enables me to introduce a new element into the history of the interwar debt crisis. It suggests that the ownership of the grading or prestige system was a prize worth fighting for as the efforts the New Dealers made to take it away from the prestigious banks suggest. For so doing, reformers had to question the performance of the existing arrangement and thus argued, opportunistically but incorrectly, that international bankers had failed. As we shall see, conflating all kinds of bankers and behaviors enabled critics of the existing order to introduce reforms whose ultimate effect was precisely to annihilate the bankers' ability to deliver according to previous expectations. In other words, at the heart of the New Deal financial acts and of the international

[1] See also Chernow (1990); DeLong and Ramirez (1995); Stratton (2015)

financial dislocations of the 1930s was a ferocious and destructive political fight over control and ownership of existing procedures of certification. The author is not aware of any previous history that has made of foreign government debt quality certification and its ownership a relevant historical concept – and yet it was.

Third, this paper ties into broader evidence on the evolution of the international financial system. While it is generally accepted that the interwar debt crisis was a turning point in the history of global capitalism, it is also emphasized that financial globalization eventually resumed, so that once again, *plus ça change plus c'est la même chose* (Reinhart and Rogoff, 2009). However, as argued by Flandreau, Flores, Gaillard, and Nieto-Para (2010), while macroeconomic measures of financial globalization rose again after 1970, the microeconomics of financial globalization -- the way the business of originating and distributing foreign government debt is organized -- were profoundly transformed and no longer the same. The modern international bond market differs from predecessors in several fundamental respects. When sovereign defaults used to concentrate on securities originated by less prestigious intermediaries, they are now evenly distributed among super-competitive international banks. When until the interwar, careful and conservative prestigious banks exhibited a degree of care for their customers, they do not pay attention today. In the modern world, the certifying and gatekeeping has been markedly relaxed. Flandreau, Flores, Gaillard, and Nieto-Para (2010), argue that rating agencies now play the role of assessing foreign debt while International Financial Institutions take care of the trouble-shooting when problems arise. This paper suggests that the foundations of this modern set-up were laid out during the interwar.

Fourth, in my narrative, the New Deal Financial Acts can be seen as having brought about, in the international finance arena, a transition from personal to impersonal exchange akin to processes already documented by historians of national financial systems. For instance, there is an obvious analogy between Naomi Lamoreaux' analysis of the role of kinship in New England banking (Lamoreaux 1986) and the private bankers-based system of personalized screening of government credit discussed here. In both cases, personalized links substituted for incomplete information and acted as crutches for the market mechanism. By underscoring the disruptions this system experienced in the 1930s, this chapter underscores that such transitions from personal to impersonal exchange need not be smooth. In other words, there may be significant adjustment costs of moving from a regime with tightly held information to an arms-length and competitive one. The interwar foreign debt crisis provides illustration.

Last, the analytical elements in this chapters explain why histories of geopolitics and histories of global finance have had so much in common, as has been often remarked (Kindleberger 1988). This is because, this chapter argues, the ownership of the scale against which the reputations of governments are weighed is a tremendous international prize, resulting in the entanglement of finance and geopolitics. By bringing in new and so far unacknowledged actors of international finance – prestige, certification and their ownership and benefits – this chapter makes this clear.

The result may provide new ways to think of international financial crises, present and past. The importance of the certification system and the value of its ownership have been once again at the heart of the current European debt crisis. The concern shown by authorities – the ECB, Germany – to make sure that Greek debt would eventually deliver after several restructurings, may be interpreted within the framework of this chapter. On the one hand, a Greek default would mean that the reassurances given during the 2000s by the ECB and Germany that the euro was a serious thing and default not really an option were void. This would cast doubt on the credibility of European policy makers. On the other hand, forcing the Greeks to repay enables to rescue earlier pledges and covers the back of the same policy makers. It may be that Greece is really "bailing out" Germany. Observers fixated on the disruptions the policy might create, just like observers obsessed with the "errors" of the interwar blame the politicians and talk of political stupidity or incompetence.[2] But as this chapter will show, for the stupid, stupidity has its perks.

The balance of the paper is organized as follows. The first section covers the political economy of prestige. The second section describes the fight between New Dealers and the prestigious houses, in particular Morgans. The third articulates the likely effects of the New Deal financial acts for the political economy of prestige and the fourth section observes the results. Section V, finally, discusses implications for borrowers and for policy makers. It shows that key features of the modern system were introduced by the New Deal Financial Acts. The paper ends with a conclusion emphasizing the importance of brands, the ownership of quality signals and more generally the "immaterial" foundations of the material economy. This approach can be conceived as an economic alternative to ill-defined references to "mentalities" of which cultural historians are found and which some economic historians have espoused (Eichengreen and Temin 2000, Temin 2010).

Section I. The Political Economy of Prestige

a- The Argument: Reliable Bankers

The foreign debt market played a special role in the rhetoric of the 1930s according to which Wall Street had failed Main Street. In language of the time, people spoke of how the "international bankers" had failed "Tom, Dick and Harry." Although the foreign debt market represented only a fraction of the asset classes that experienced considerable stress at the time, it was a significant one, both directly, because it controlled the export of capital and indirectly, because it was used as a lesson for the capital market at large. Several reasons explain this focus on the foreign debt market. It was in this market that the first wave of bond defaults took place at a fairly early stage of the great Depression, as early as January 1931 and accelerating in the fall of that year. The first congressional hearings – the U.S. Senate Committee on Finance Hearings on the Sale of Foreign Bonds hearings organized by the end of 1931 – focused on foreign government debt. When newspapers and politicians took an example in

[2] See Eichengreen (2015b) for a recent illustration.

order to denounce what came to be known as "banksterism" they turned to issues by Bolivia or the Dominican Republic. And when they looked for an example to motivate the Glass-Steagall Act, which contemplated the separation of commercial and investment banking, they turned to the failures of Charles E. Mitchell, chairman of the National City Bank, a leading commercial bank whose security affiliate the National City Company had been responsible for bringing to the market s number of sovereign and sub-sovereign deals which went bad. Some subsequent business historians having examined the matter more closely came to doubt the charges, however. Benston (1990) reviews allegations of bankers' misconduct that attracted public scrutiny during either the Senate Committee on Finance Hearings on the Sale of Foreign Bonds (1931-32) or the subsequent hearings of the U.S. Senate Committee on Banking and Currency (started January 1933) and finds the evidence for widespread accusations limited and unpersuasive. Huertas and Silverman (1986) take a look at the quality of the portfolio underwritten by the National City Company and finds no compelling evidence of wrongdoing.[3]

A natural starting point therefore is to provide more systematic empirical evidence on the performance of banking houses in the foreign debt market. To that end, Figure 1 plots the actual (realized) returns of a given bond (measured by tracking later coupon payments, conversions or reimbursement) against its promised return (measured as the initial yield to maturity, an indicator of the initial payment promise). If, for a given security, the realization matched the promise, the bond is be located on the diagonal 45° line. If all or most of the deals originated by a given underwriter are found along the diagonal 45° line, then all or most of that underwriter's deals may be said to have performed and the said underwriter is reliable. By contrast, less reliable bankers have realized returns, which fall short of promised yields and show up below the 45° line. For data, the chart relies on a selection of 39 sovereign bonds issued in New York during the 1920, which for simplicity can be treated as being a "sample." It comes from Eichengreen and Werley (1988) who compute realized performance for a bunch a New York issues.[4] This selection was matched against the population of foreign issues in New York in Flandreau, Gaillard and Panizza (2009) enabling to identify the yield at

[3] Early attempts to debunk some of the financial myths on which the reforms of the New Deal fed include Moore (1934), Edwards (1942); See Kroszner and Rajan (1998) for a modern treatment. These authors however focus on the classic argument that the security affiliates of commercial banks under-performed. This perspective is different fron the one adopted here.

[4] . Eichengreen and Werley (1988) provide returns on 43 "sovereign" bonds (as well as 73 sub-sovereigns, not considered here). Matching this against the list in Flandreau, Gaillard, Panizza (2009) gives 39 deals. The four missing deals are three Canadian deals (which underwriters did not consider as "foreign" and were excluded from the landreau, Gaillard, Panizza dataset) and one French deal "French National Mail Steamship", which we were unable to ascribe to an underwriter. The sample in Eichengreen and Werley (1988) is different from the one mentioned in Eichengreen and Portes (1989b, p. 14), which had "over 200 dollar bonds." Data for this larger sample is no longer available. The author thanks Barry Eichengreen for discussing this with him.

issue and the underwriter. In the figure, each underwriter is identify by a shape (triangle, circle). To ensure legibility and drive the point home, the Figure simply distinguishes the four main sovereign debt underwriters by market share (JP Morgan, National City Company, Kuhn and Loeb, Guaranty Trust), from the collection of smaller underwriters, called "others".[5]

The novel result is the marked difference that existed between the reliability of leading underwriters and the rest. All but 3 of the 22 deals made by the four more important houses are found at or near the reliability line. Not a single Morgan or Morgan-controlled Guaranty Trust deal is found away from it. Perhaps consistently with contemporary criticism, two out of three of the problem deals were with the National City Company. However, for this sample at least, this represented a fraction only of the securities the National City Company had underwritten. By contrast, 9 out of the 17 deals (about half) from the other houses are found in the disappointment area. This indicates that behavioural hazard was not uniformly spread, but tended to concentrate on smaller underwriters. This result appears to have been known to insiders. On March 27, 1933 Morgan's partner Thomas W. Lamont sent to FDR a Memorandum where he stated that "because of the natural publicity given to witness-stand disclosures, particularly in the case of National City Bank officials, the country seems to have gained the impression that questionable practices prevail in the New York banks and that these banks are largely responsible for the country's banking difficulties. This is clearly not the case".[6]

<<Figure 1 about here>>

The logic whereby banks might have behaved responsibly can be interpreted in the language of modern theories of signaling and of the role of reputation in disciplining intermediaries. These arguments suggest that an intermediary with a large market share will worry to loose market power and will consistently be led to adopt a prudent behavior. Spence (1973) provides the foundations of signaling theory. Shapiro (1983) explains investments in quality by showing that reputation is a source of rents. Diamond (1989) emphasizes the role of repeat play in brining about a kind of weeding of less serious intermediaries. A relevant application of this insight to economic history is Gorton (1996) who suggests that intermediaries' reputation formation deters wrongful behavior. All these arguments converge to emphasize the importance of prestige as an immaterial yet valuable asset. A large literature concerned with underwriters' reputation has explored the theoretical and empirical association between prestige (which is tied to either market share or capital) and the performance of public offerings. Chemmanur and Fulghieri (1994) are credited with the first relevant model in which financial intermediaries' reputation for veracity mitigates the moral hazard problem in information production. Carter, Dark, and Singh (1998) show that, over the long run, issues managed by prestigious houses outperform those managed by ordinary ones.

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[5] Flandreau, Gaillard and Panizza (2010) identify 44 different names. Only a fraction of them shows up in Eichengreen and Werley (1988).

[6] . TWL 127-31. Memorandum to FDR, March 27, 1933.

Table 1 provides a test of these arguments in the context of the interwar foreign debt crisis. Unlike in Figure 1, which documents a sample, Table 1 compares the performance of sovereign debt deals per underwriter for the entire population. Performance is proxied by the average default rate. In line with theories of signaling we identify the underwriter's market share and capital as relevant variables influencing the banks behavior. Specifically, these theories predict in order a negative connection between performance and market share or capital. The benchmark default rate used to compute each firm's "performance" is the average rate for all underwriters except the four leading ones. The JP Morgan line in Table 1 reads as follows: Morgans originated the largest share (31%) of the amount of capital raised in New York for foreign loans, its capital stock before the crisis was the largest (94 millions USD) and the incidence of default among its securities was the lowest (a quarter, or 0.26 of the population's average). As seen from the other cells, the Table supports the idea of a negative association between market share and capital on the one hand and the incidence of sovereign default on the other (note again the somewhat "too" high default rate for of the National City Company). At broad brush, the evidence lends supports to the views of Jacob H. Schiff, former principal of Kuhn and Loeb that "our only attractiveness is our good name and our reputation for sound advice and integrity. If that is gone, our business is gone, however attractive our show window might be" (Birmingham 1967, p. 181).

<<Table 1 about here>>

This striking result has been either ignored or downplayed in the literature. This is especially true for the economic literature. Ilse Mintz (1951) is the only author to have discussed whether reputational concerns could have mattered, reporting some data consistent with this, but she remained sceptical of the possibility. Barry Eichengreen (1989, p.122-23) has energetically criticized the reputation argument, suggesting that in the context of New York in the 1920s, when the market for sovereign debt was new, the forces of reputation would have been counterbalanced by a "lemons" problem: "While [the logic of the reputation argument] is impeccable, it may apply imperfectly to the 1920s by virtue of the fact that many institutional participants in the international bond market were recent entrants […] If, in the long run, track record in comparison with incumbents will drive unsuccessful entrants out of the market, there is no reason to suppose that these forces had much effects between 1921 and 1929." But the evidence in Figure 1 and Table 1 does suggest otherwise.

b- The London Precedent

One way to understand better how the forces of reputation operated in the New York market for foreign debt in the 1920s is to put them in perspective. New York followed on the steps of the experience of London whose techniques it acclimatized. Flandreau and Flores (2009; 2012a) discuss the set of techniques on which the operation of the London sovereign debt market in the 19th century rested. They construct foreign debt "league tables" and find that 19th century had two leaders: By decreasing order of prestige, Rothschilds and Barings. These two had the largest market share in

London during all sub-periods and had the lowest market share in defaulted securities. Rothschilds in particular was famous for "specializing" in reliable securities. As early as in the 1820s in the midst of a fierce foreign debt crisis the entire portfolio of Rothschild originated loans, which included countries as diverse as Prussia, Brazil, Russia or the Kingdom of Naples, thoroughly held its ground. The habit persisted during the entire 19th century (Flandreau, Flores, Gaillard and Nieto-Para, 2010). When, Nathaniel de Rothschild was examined by the *Select Committee on Loans to Foreign States* of 1875 in the aftermath of yet another foreign debt boom and bust cycle, one member asked him to confirm that foreign government securities were a risky proposition. This was heartily granted by the banker. But when the interviewer pressed on and asked ironically: "You have had experience, however, only with good loans?" Nathaniel de Rothschild shot back: "Only in good loans, I am happy to say."[7]

When booms took place, the London market witnessed the entry of new underwriters – "wildcats" – who came in for a quick buck and then walked away after the crash. As a result, reliability charts similar to Figure 1 can be drawn for 19th century London. Flandreau and Flores (2012a, p. 364) provide such a picture for deals originated between 1845 and 1875. The graph shows Rothschilds' deals on the reliability line, a few Baring deals off it, while other underwriters' deals failed to deliver (which made sense, since the high yields at issue precisely reflected the rational expectation that many of them would fail). Thus, since the underlying economics were understood by the market, deals originated by less prestigious banks initially sold at significantly lower prices than those originated by prestigious banks creating incentives for borrowers to try and persuade the prestigious banks to take care of their loans (Suzuki 1994). Flandreau and Flores (2010) estimate the spread to have been as large as 150-300 basis points. Foreign debt booms may have weakened discipline owing to investors' exuberance but they did not topple it altogether. This was observed even in the early stages of the market (Flandreau and Flores, 2009).

When defaults in the portfolio of prestigious underwriters nonetheless took place, the bankers worked to make sure investors would nonetheless get compensated. A case in point was the Baring crisis, whereby Argentina's default was followed by the collapse of the House of Barings (through its exposure to a public utility). Investors in Argentine securities (a substantial fraction of which had been originated by Barings) nonetheless got compensated. Another interesting case was the Brazilian Funding Loan of 1898. Years of poor macroeconomic management had led Brazil on the verge of default. This would have reverberated poorly on Rothschilds' track record since they had for years distributed the debts of this country. Instead, Rothschilds managed to implement a debt restructuring that protected the ex post performance for investors. This ensured that their brand would be perceived as reliable. The point is that prestigious bankers had something to give away, enabling them to monitor borrowers. In sum, good borrowers were not so much "discovered" by prestigious banks, as they were "produced" (Flandreau and Flores 2012a) or to use the expression that interwar American

[7] *Select Committee on Loans to Foreign States*, Minutes of evidence, p. 270.

investment bankers would prefer, "constructed." An important consequence was the inherent tendency of the system to persist. Once prestigious brands came to own the ability to signal new loans, they also secured the good will of the borrowers who could share the gains of discipline by showing good behaviour and the trust of investors who did not run away at the first sign of trouble, thus enabling the bankers to do their job.

c-Transition

Emphasis on persistence suggests that shifts in leadership were difficult to obtain. Before WWI, London-based institutions had indeed managed to protect the incumbency of the City. Why was New York able to challenge London successfully? Carosso and Sylla (1991) discuss the beginning of foreign debt underwriting in New York before WWI and show it had been originally contained to issues relevant to the US "backyard" (Asia, Central America). For outsiders willing to dig an inroad in the prestige system, the dilemma can be summarized as follows: One's concern with prestige limits risk taking, but without risk taking, how can one ever topple the incumbent? Conventional accounts explaining the transformation that occurred afterwards point to the rise of the US as a creditor country (Dickens 1933, Lewis 1938, Stallings 1984). However, there again, the availability of resources is not the same as the ownership of an information asymmetries reducing technology: An intermediary is not the same thing as an investor. It is the ownership of the signalling technology, not the ownership of capital, which determines where the market is located.

Given this, what was needed to shift the equilibrium was a shock that would prevent the former system to operate. World War I provided the occasion. As a result of the drain which the war created on Britain's balance of payments, foreign issues were suspended then, once peace was restored, subjected to the tight supervision of the Bank of England (Moggridge 1972). So it is not that Britain had less capital, but more that its intermediation role was hampered. Atkin (1977, p. 28) describes the succession of bans imposed on foreign loans. Until 1925 foreign (and often colonial) loans were banned or subject to clearance by the Bank of England. The ban was resumed in 1929. Foreign borrowers found the London market sealed when they needed it. Rather than fighting the new trends, European banks offered support to their clients by re-directing to New York houses. The situation opened an opportunity for New York bankers.

Previous authors have emphasized the role of Morgans in "Americanizing" London financial techniques (Parrini 1969). Indeed a critical cog in achieving the transition from London to New York certification was the link that existed between J.P. Morgan in New York and J.S Morgan in London. It enabled Morgans (and their allies) to grow inside the existing framework.[8] One reason why Morgans were natural candidates for providing certification services to an expanding New York capital market

[8] This was not unlike what had happened one century earlier when London had succeeded Amsterdam as the main market for foreign government debt. After the introduction of the Continental System by Napoleon in 1806, the House of Hope, a former leader in the Amsterdam market for foreign debt merged with Barings. This paved the road for the rise of Barings as a leader in foreign underwriting (Buist, 1974).

was that they had already pioneered in railway and other corporate underwriting activities the signalling techniques on which the management sovereign debt would rest. According to Brad DeLong (1991) Morgans and the men they put in the boards of railway and other companies served as instruments to resolve the considerable information asymmetries that plagued the operation of the New York capital market in the age of the "Robber Barons."[9] The monopoly power of Morgan's and the Money Trust was a source of valuable signalling. In other words, Morgans and the Money Trust banks provided the elements of a prestige technology, then used to sort out industrial investments, but that was used for other types of investments. Given this, it is not surprising therefore that before WWI, the handful of foreign government debt deals New York managed to win in cooperation with other financial centers, were precisely secured by Morgans and their Money Trust allies (Dickens 1933; Carosso and Sylla 1991).

Notwithstanding the financial economics rationale for the Money Trust suggested by DeLong, it remains that the political acceptability of the arrangement was considerably weaker in the US than it had proved in the UK. Because the arrangement, known to the public as the "Money Trust", conferred Morgans and their allies considerable market power, Morgans came under intense public scrutiny. One result was the Pujo Committee in 1912-13, which enabled lead attorney Samuel Untermeyer to investigate the non-competitive practices of bankers. Influential critics such as Louis Brandeis analyzed and criticized the inherent conflicts of interest of financial intermediaries and found that Morgan's monopoly power was a source of abuse (Brandeis 1913). The Money Trust was, Brandeis argued, servant of two masters, the investors and the borrowers. It could not be honest vis-à-vis both. Thomas W. Lamont's papers in the Baker Library at Harvard hold the minutes of a fascinating debate that took place on the eve of WWI in a New York club between Lamont and Louis Brandeis. They show the extent to which the political positions of the two men were irreconcilable. It was not that Brandeis did not understand the logic that did underpin Lamont's view. But he disputed the political implications. This was something that was to play a critical role in the upheaval of the 1930s.

c- London as Counterfactual

According to Karl Polanyi, in the 1920s, "J.P. Morgan had replaced N. M. Rothschild as the demiurge of a rejuvenated nineteenth century" (Polanyi, 1944). And indeed, the parallel between the arguments heard in the British Select Committee on Loans to Foreign States (1875) and those proffered before the American Senate Committee on Finance Hearings on the Sale of Foreign Government Bonds (1931-32) is striking. Just as Rothschilds had in 1875, representatives of the leading New York houses emphasized their prudence and concerns with the interests of the investor. For instance, asked whether they had engaged in "strong-arm salesmanship" (forcing down securities on ignorant buyers) Otto Kahn from Kuhn and Loeb declared that "such practices as what you might term 'strong-arm methods' of selling, making raids on rather unwilling buyers, exercising undue

[9] For a dissenting view, see Leslie Hannah (2007). For a recent empirical study see Frydman and Hilt (2014).

persuasiveness, tempting buyers by excessive facilities, inducements or exactions, in short, high-powered methods of salesmanship are against the dignity and the ethics of banking. They are not within the permissible functions of a bank or banker" (U.S. Congress, Senate Committee on Finance, p. 394). In fact, Kahn argued, "the banker is called upon to exercise a greater degree of care than pretty nearly anyone else who is dealing with the public, because he is dealing with a commodity as to which he is considered to be an expert adviser and as to which many people rely on his integrity"(U.S. Congress Senate Committee on Finance, p. 353). Refusal to act as intermediary for loans that were considered as dubious was a matter of pride at Morgans just as it had been at Rothschilds and Thomas W. Lamont insisted that they did "never issue a bond unless [they did] believe it to be good" (Adamson, 2006, p. 204).

Another parallel between London merchant bankers in the 19th century and New York investment bankers in the 20th century is the function they fulfilled in their respective geopolitical contexts. Corti (1928) and Polanyi (1944) provide evidence that the House of Rothschilds was "in the employ" of the Holy Alliance and became an instrument to protect peace and the interests of the Alliance. Flandreau and Flores (2012b) explain why this might have been so: The success of Rothschild loans to members of the Alliance (Prussia, Russia, Austria) was dependent on the continuation of peace, creating room for cooperation. Rothschilds used their certification role to design contracts that would favor peace. An illustration was the crisis triggered by Belgium's independence from the Netherlands in 1830 when a clause conditioning the disbursement of funds upon political moderation was included in the contract.[10] In other words high-finance was politically supported by the British government, as an instrument for shaping geopolitics.

A similar logic was observed in the case of the rise of New York bankers as vehicles of global certification when the State Department, at the end of World War I, decided to delegate the monitoring of foreign financial policy to international bankers. In 1921, an agreement was adopted between bankers and President Harding, resulting in a Memorandum whereby bankers would manage the export of capital but would check out with the Administration whether individual loans did not conflict with policy agenda. Foreign lending was being embedded in the broader template of the US Administration.[11] The result was that the banking elites of the time came to identify themselves with subsequent Republican presidencies and their policies. Elite bankers became the advisors and architects of Polanyi's "rejuvenated 19th century." As their British predecessors, they ardently

[10] In a similar spirit, Oosterlinck, Ureche-Langau and Vaslin (2014) describe how the Duke of Wellington used Barings in the early 19th century as an instrument to bring pressure to bear on the French.

[11] Contemporary observers and participants have abundantly discussed the resulting cooperation between international bankers and the US Administration (Lamont 1920; Dulles 1926; Edwards 1928). It is now a standard subject in the academic literature (Lewis 1939, Parrini 1969, Abrahams 1976, Stallings 1984). A recent thorough discussion is Adamson (2002, p. 483-487).

promoted free trade, which would ensure the repayment of loans.[12] And as their British predecessors, they thought of themselves as "peacekeepers."[13]

However, this identification between prestigious bankers and the US policies of the 1920s became the bankers' principal liability after 1929 and even more so after 1931 when the crisis spread and previous attitudes were questioned. It became a bone of contention during the Senate Committee Hearings of 1931-2. It was alleged that the tacit support of the Administration had created a moral hazard problem by persuading the investing public that the US government stood behind foreign loans (bankers insisted before the Senate Committee that this was not the case). Thus were rekindled the embers of the Money Trust investigations, which were everything but extinct. In 1924, an important controversy had been sparked by publication of two articles by Samuel Guy Inman in *The Atlantic Monthly* which denounced US foreign loans and the dollar policy as a imperialism. The matter was then buried in the-called Ladd Senate hearings of 1925 (Rosenberg 2003). But by the time the presidential campaign for the election of November 1932 had begun, the infamous "international bankers" were a natural political prey. Roosevelt was quick to seize the opportunity and in his August 20, 1932 speech in Columbus, Ohio, he announced sweeping financial reforms: Greater disclosure and liability in the underwriting of securities, the separation of commercial and investment banking, the rigid supervision of banks, etc. Regarding the "international bankers" he promised the American public "that it will no longer be possible for international bankers or others to sell foreign securities to the investing public of America on the implied understanding that these securities have been passed on or approved by the State Department or any other agency of the Federal Government."[14]

The link between the earlier teachings of Louis Brandeis and FDR's financial endeavors of the 1930s is both evident and essential. By the time the New Deal was launched Louis Brandeis was a deeply revered figure and an influential judge in the Supreme Court. Through his protégé, Harvard Law School Professor Felix Frankfurter, he had managed to create a generation of young lawyers won to his ideas. As illustration of this legacy, we have FDR's repeated, almost obsessive, use of the phrase "other people's money" in many campaign speeches, a phrase which he took from the title of Brandeis' 1913 book. We have also the wording of the new President's inaugural address on the "money changers" whom FDR wanted swept "out of the temple" again connecting with Brandeis' characteristic rhetoric. We have the fact that Felix Frankfurter's students -- Benjamin V. Cohen, Thomas V. Corcoran -- his Harvard Law School colleague James M. Landis, as well as lawyers who had been directly inspired by Louis Brandeis – such as William O. Douglas – soon got involved in the

[12] As Thomas W. Lamont explained to Charles E. Hughes "it must be obvious that if the country is really to act the part of a creditor nation it must be prepared to handle the situation broadly and without restrictive and crippling measures."TWL, 94-18, "Foreign Credit", letter to Hon. Charles E. Hughes, March 31, 1922.

[13] For instance, when he discussed the quality of bonds underwritten by Kuhn and Loeb, Otto Kahn emphasized that they declined military loans (U.S. Congress, Senate Committee on Finance, p. 357).

[14] At American Presidency Project, http://www.presidency.ucsb.edu/index.php

financial reforms brought about by the New Deal and articulated a new catechism of regulation. Or again, the New Deal relied on Guy Inman, the leader of the campaign against American imperialism in the 1920s, as the living "symbol of a change toward a 'good neighbor policy.'" In 1933 Inman would accompany Secretary of State Cordell Hull to the Seventh Pan-American Conference and remained an active advisor to both Hull and Roosevelt.[15]

This turn of event was unlike anything that had taken place in Britain. In fact, the dislocation of the previously near perfect parallel between London in the 19th century and New York in the 1920s provides the methodological inspiration on which this chapter draws. Our knowledge of the London market and of the way it responded to financial turmoil or handled crises provides a way to construct a plausible counterfactual that sheds light on the dynamics and significance of the evolutions experienced by the New York market for foreign debt during the 1930s.

Section II. The Politics of Brands

FDR's Ohio speech lashed at international bankers but craftily avoided alienating the House of Morgan and the banking elite, describing investment banking was a "legitimate business." Morgans may have believed that FDR had to concede reforms in order to attract the median voter. But as they approached the new president with free advice, they soon realized that FDR was in for substantial changes and that reducing their power was part of the plan. The signs of times were abundant. Chernow (1990, p. 355) writes that when Senator Carter Glass was approached about taking the Treasury job in the Roosevelt administration, he suggested he would want to hire two Morgan men (Leffingwell and Parker Gilbert). But Roosevelt "cringed": "We simply can't tie up with 23 [23, Wall Street, home of Morgans]", he said. The Hearst press emphasized this exclusion of Morgans from decision-making centers and interpreted it as a loss of prestige. *New York American*'s financial editor Julius Berens argued that the shift had begun during the compulsory "Bank Holiday" which the new administration had decreed in early March 1933: "Morgan partners have been noticeably absent from the innermost circles of the new Administration. Invariably, during the last Administration, the Morgan firm was called in instantly whenever a financial crisis developed." And to be fully sure he added: "[Morgan]'s decline in prestige was emphasized by the fact that none of the emergency meetings which preceded the Bank Holiday were held in Morgan offices." This underscores the extent to which prestige did not solely rest on the track record, but also on government support, whether tacit or explicit.[16]

Because this was a conflict about the "democracy and finance nexus" as identified by New Dealer and Securities and Exchange Commission chairman William O. Douglas in a famous pamphlet (Douglas 1940), it mobilized the tools of democracy. The press, and press reports of the latest

[15] Rosenberg (2003, p. 137).

[16] *New York American*, March 10, 1933.

developments in the capital markets, played a critical role, in building the case against the "international bankers." In the final run up to the election of FDR, the Hearst press (which until 1934 supported Roosevelt) stepped up pressure and published accusations against international bankers who "as you all know from exposure and experience, are centered on foreign loans and big commissions, rather than on the essential interests of the American people". The claims were then backed by more or less vague and vaguely stated "facts", vaguely amended when Lamont confronted Hearst with threats of legal action.[17] Father Coughlin, whom Lamont assumed to have been "somewhat sponsored" by "Old Henry Morgenthau" (Roosevelt's Treasury Secretary) preached for the benefits of millions of Midwestern radio listeners that "until a few years ago, the banker was as respected as a clergyman…. Today […those in] the international group – the gold group – are not only in disrepute. Their presence amongst respectable Americans is becoming obnoxious. Their bankcraft at New York is more pernicious than was witchcraft at Salem."[18] And then of course there were the Senate Committee on Banking and Currency, which under Ferdinand went on to "expose" Wall Street malpractice. The "Pecora hearings" claimed several symbolic prizes. In addition to the shaming and resignation of Charles E. Mitchell, which *per se* "proved" the wrongdoings, Pecora managed to produce Morgan balance sheets under threat of subpoena, thus violating the privacy of the most secret private bank. This, plus the irruption of a midget who jumped on Jack Morgan's lap during the hearings, were public statements that "prestige" was not above the "American People", a notion captured in the title of Pecora's *Wall Street Under Oath. The Story of Our Modern Money Changers* (Pecora 1936).

These events were significant, because they made a decisive contribution to a process of wilting which ended up undermining the reputation of the elite banker. As suggested, political destruction of prestige came from a number of alleys and Lamont's papers bear witness of the bank's losing efforts to deal with them. One way to fully capture the significance of this process is to contrast it with what had happened in Britain under similar circumstances. As indicated, parliamentary commissions comparable to the Senate Committee Hearings of 1931-2 had taken place in Victorian Britain. The 1875 House of Commons Committee on Loans to Foreign States provides proof. Its concerns had been very similar to the Senate Committee Hearings on the Sale of Foreign Bonds: the high fees, the dishonest promotion of Latin American loans and the manipulation of market prices. The key difference however was that the British debate, virulent as it was, was conducted by the elite, within elite media (such as *The Economist* or *The Times*) and for the benefit of the elite and it accepted the notion that the uninformed outsider who had bought bonds "out of greed" deserved no compassion. In such a context the hearings resulted not in complaints about bankers' malpractice but in the

[17] . TWL papers, 98-2. Statement by Randolph Hearst during a broadcast of the National Broadcast Company Network, December 2, 1933.

[18] . TWL Papers, 84-16, Letter by TWL, December 28, 1933; Rev. Chas. E. Coughlin, Transcript of broadcast, Nov 19, 1933, 4 p.m. Eastern Standard Time.

condemnation of some specific "wildcat" bankers and the admonishment of the middle class investor for the hubris it had displayed in embarking her money in a Paraguay loan at 10% when British government bonds yielded 3%. Not so, perhaps, in a country where democracy was deeply entrenched (Calomiris and Haber 2014).

To summarize, the very fact that banks' floatation and distribution of foreign government securities could be questioned was *per se* a judgment – very much like the production of Morgan's balancesheet. This interpretation is not inconsistent with Carosso (1970a) who argues that one of the goals of the New Deal Acts was "harassing [bankers] out of business".[19] However, the present analysis adds the following: Since the business of underwriting foreign sovereign debt rested on prestige, public harassment itself was a form of undermining. How could bankers bring to the market funding loans and implement stabilization programs in the same successful way as their London predecessors had, at the very same time when they were named and shamed on Main Street? In other words, the irruption of public scrutiny into matters that rested on secrecy heralded the end of the old regime.

Section III: The Rock and the Hard Place

Let us now turn to the consequences that the New Deal had for the underwriting of foreign government debt. The Financial Acts that were adopted after the election of FDR followed a multi-pronged regulatory program that had two main, complementary dimensions. They sought to reorganize security underwriting by increasing "transparency" (the preferred word was "publicity") and they sought to police their distribution (Carosso 1970a, 1970b). In a long list of changes, three Acts, debated from the spring of 1933 onwards should specifically retain our attention. They were the Banking Act more popularly known as the Glass-Steagall Act, which divorced commercial and investment banking; the Amended Securities Act, which increased underwriter's liability; and the Securities Exchange Act; which created high standards of disclosure and forced to reveal information surrounding security issues. This section discusses their effects, focusing on how they interfered with the economic logic of foreign debt certification as it has been described above.[20]

Glass-Steagall and the Crowding Out of Prestige

Glass-Steagall is well-known for having achieved the separation of investment and commercial banking. This is usually understood as meaning the exclusion of security affiliates from the market for securities, a change that did not mean any business difficulty for investment banks such as JP Morgan or Kuhn and Loeb. Commercial banks were those facing the dilemma: A spin-off would of their security affiliate would create a bank operating under the same "name", yet on which the main bank would no longer have control. On the other hand, a change of name would destroy reputational capital.

[19] . Carosso (1970a), p. 439.

[20] . These Acts were followed by a long series of other pieces of meaningful legislation, not discussed here, for the sake of simplicity; For a list of major New Deal security laws see Carosso (1970a, p. 433, n. 22).

The case of National City Bank offers valuable evidence. According to Cleveland and Huertas (1985, p. 197-198) its new chairman James H. Perkins, who had succeeded to Charles E. Mitchell, worried that selling off City Bank's security affiliate, the National City Company, would amount to selling the affiliate's "goodwill", embedded in National City Bank's name, but now borne out by an entity the National City Bank would no longer control. On the other hand Glass-Steagall forbid control of the separated affiliate. Should the spin-off misbehave after the split, this may reverberate on the National City Bank's own reputation. But, if the name was removed – i.e. once stripped from prestige – then the security affiliate was not worth much. Thus, the immediate effect of the divorce of investment and commercial banking was to crowd out the capital of the more reliable security affiliates.

This was good news for the investment banks, who would see their potential market share increase and whose leaders would not only retain their operation, but expand and match the increase in required personnel by their capital outlays to compensate for security affiliates' withdrawal. Such was the working hypothesis leading investment banks took as a starting point of their lobbying effort during the discussion of Glass-Steagall (Carosso 1970a). As such, Glass-Steagall was good for them. An illustrative statement is found in the March 1933 Lamont Memorandum to FDR already quoted. There, Thomas W. Lamont argues that "the corollary to the suggestion that commercial banks should dispense with their affiliates and withdraw from the capital issues must be that private bankers, issuing houses and dealers should be encouraged and facilitated to resume their former place in the national economy to the end that the machinery for handling capital issues shall be recreated and so recovery from depression facilitated".[21]

But the New Deal had something in store for investment banks, too. Following the Bank Holiday, the initial spirit of an amicable divorce was replaced by something much more hostile. Public attention was focused on the problem of bank runs to which their closure by FDR had been an emergency response. The press was full of calls to ring-fence the balance-sheet of commercial banks. The industry, represented by Chase's Winthrop W. Aldrich, retaliated by arguing that if commercial banks were to be parked into the dull business of deposit taking, at least they should be rewarded by some kind of monopoly. Just like commercial banks should not underwrite he suggested, unregulated investment banks should not get into deposit taking. Aldrich succeeded in having this provision drafted into the final Glass-Steagall bill signed into law in June 1933. Evidence from a letter by Carter

[21] . TWL 127-31, March 27, 1933, p. 9. Likewise a handwritten note (March 1933, probably by Lamont) in TWL Papers, 80-13, states: "If it is determined to take the banks out of the investment securities business then it must be the policy of the Government to strengthen the investment bankers rather than hamper them since the flow of capital must be resumed". In a similar logic, Carosso (1970b) argues that JP Morgan initially sought to exploit the new regulation as a way to get rid of competitors, that this was reflected the initial blueprint of Glass-Steagall, and had been the main focus of Senator Glass.

Glass to Leffingwell suggests that the provision, drafted by Aldrich, was foisted on Senator Glass by Roosevelt.[22]

In other words, the new turn the Glass-Steagall bill was taking was a direct challenge to the more prestigious investment banks. This was understood as such by contemporary observers: The press took notice of this and immediately interpreted it as a challenge to Morgans.[23] The problem can be understood in the light of standard arguments about the role of deposits in relationship banking, which emphasize that bankers learns about their customer by studying the evolution of deposits (Black 1975, Fama 1985). Now if unsupervised investment banks were authorized to keep those deposits, while the security affiliates were shut down, this would be to the advantage of JP Morgan and Kuhn and Loeb. The transfer would also increase the flow of valuable current account information and would boost the investment banks' ability to monitor customers. Not so if investment banks were prevented from taking deposits. The challenge was had special significance for the foreign debt market. In the past, leading investment banks such as JP Morgan along with leading commercial banks such as the National City Bank had been among the principal New York recipients of foreign government deposits (Eichengreen and Flandreau 2009). The reform thus threatened the ability of Morgans to receive the deposits of the governments it lent to, while National City Bank could take their deposit but would not lend.

Thus, the addition to Glass-Steagall of provisions preventing investment banks from deposit taking deeply modified the way they were conducting sovereign debt business. On the one hand, accepting supervision would force disclosure and would thus deprive prestigious banks from the ability to draw on their own buffer of prestige during crises. On the other, giving away deposits would both weaken their balance-sheet and their ability to stand on the edge of valuable information flows. Fundamentally, the shedding of deposits weakened the relation between prestigious banks and their sovereign customers.[24] It raised questions about the viability of older ways and was likely to lead investment banks to reconsider their options. This was indeed Morgans' view: In a brief to *New York Times* financial editor Alexander Dana Noyes, Lamont emphasized that if put into effect, the divorce of investment and commercial banking as envisaged would "make it impossible for commercial banks to handle securities […] at the same time [it would deprive] the private banks of the means of serving

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[22] . Chernow (1990, p. 375, and footnote 87).

[23] . TWL 80-13. *New York American*, March 10, 1933, "Rockefeller seen challenging supremacy of Morgan – Program interpreted as Rockefeller challenge to Morgans". Article by Julius Berens: "There was no alternative for Wall Street than to interpret the Aldrich declarations as a direct challenge by the John D. Rockefeller faction to the private banking houses headed by J.P. Morgan & C°, and comprising the whole gamut of publicly unregulated creators and vendors of securities who also, under present practices, are recipient of enormous deposits". *New York Times*, March 10, 1933, "Aldrich proposals stir private banks".

[24] . For instance, Berlin and Mester (1999) argue that relationship with depositors provide a co-insurance mechanism: Depositors receive support and this protects the bank's balance-sheet against withdrawals.

the public in this way […]. If put into effect, they would result in tearing down all existing methods of handling securities, without substituting any adequate mechanism in their place."[25]

Liability and Transparency

The second group of significant transformations arising from New Deal financial Acts resulted from the Securities Act of 1933 and the Securities Exchange Act of 1934 which amended the former. The Securities Act was concerned with primary markets while the Securities Exchange Act dealt with secondary trading. Both had in sight so-called bankers' malpractices that had emerged from Congressional hearings and public debates, in particular price rigging and fictitious purchases that were said to happen during new issues. The reforms sought to raise standards of transparency and information dissemination at the same time they created civil liability for the underwriters.

Carosso (1970a) has contrasted the Banking Act, which would have changed the industry's landscape and the Securities' Act, which would have "merely" modified underwriters' practices without altering, over the long run, "investment bankers' primary role of channeling savings into long-term investment" (Carosso 1970a). Indeed, the New Deal's transformations did not succeed to drive forever investment banking out of its former niches, since a bank called JP Morgan-Chase was still recently the leader in foreign government debt underwriting (Flandreau et al. 2010). But this view downplays the fact that the change in practices the new rules encouraged brought about a microeconomic and informational a revolution.

With the new disclosure requirements resulting from the Securities Act, all issuers were bound to reveal more. This weakened the informational advantage of prestigious houses. Moreover, the ney disclosure standards were completed by a number of provisions such as the institution of a mandatory "cooling off" period of twenty days between registration with the Stock Exchange and the time when an offering could be sold to dealers and the public. The goal was to permit brokers and investors to "study" the new issue and form an "independent" opinion, there again limiting the information wedge between prestigious and less prestigious banks. This was furthered by a provision of the subsequent Securities Exchange Act that enforced transparency regarding price support operations. Explicitly intended to prevent fictitious deals that were said to have served deceiving uninformed traders, they also increased the operational risk of prestigious houses whose public offerings, which typically involved such interventions, when needed, were now conducted in the open and thus more vulnerable to adverse speculation. According to Carosso (1970a, 433) the Acts had the end effect to make "[responsible investment houses] even more cautious".

Second, a critical change (brought about by the Securities Act, and partly weakened, under intense lobbying by the industry in the Securities Exchange Act) was the creation of civil liability for the

[25] . Thomas W. Lamont, "Memorandum for A.D.N.", TWL papers 80-13.

underwriters. Civil liability had been repeatedly considered in the London market.[26] However, it had been felt that this would weaken market discipline: bad loans had to be costly for investors, or else they would never learn the lesson. Adopting civil liability as was done in the 1930s thus changed the whole microeconomics of sovereign underwriting. The inherently limited enforceability of sovereign debt contracts required that high-quality certification capital be pledged, rewarded and that a free-hand be given to prestigious banks. Holding them accountable for mishaps was a potent deterrent. This being prevented, the natural outcome was to make prestige "more cautious." In and by itself, the measure encouraged more prestigious investment banks to just walk out of the market, leading to a collapse of foreign debt.

Section IV. The Crowding Out of Prestigious Capital and the Rise of Modern Underwriting

The previous two sections derived a number of predictions regarding the effects of New Deal financial Acts. In broad terms, two types of responses might have been expected. One would have been an outright reduction of on high quality (prestigious) capital. Another would have been the continuation of underwriting but in a much more reduced capacity as a simple "prime broker" in charge of building the order book and then walking away once the deal is completed. What this section suggests is that the two responses were observed over different time horizons. Perhaps because of their association with political hostility, the New Deal Financial Acts were disruptive over the short run. Over the long run they implied a reconstruction of the business of underwriting along new lines of business, characterized by reduced incentives to screen deals and support those who failed.

a) The Flight of High Quality Capital

As predicted above, New Deal regulations put the various firms in a quandary. Certification capital was crowded out by regulation and regulatory risk. JP Morgan eventually decided to give up investment banking and focus on its relationship with its clientele of prime corporate depositors. A consonant avatar (Morgan Stanley and Co) returned in late 1934 but with drastically reduced capital. The National City Bank shut down its security affiliate and so did the Guaranty Trust. Only Kuhn & Loeb remained in the trade. One way to capture this evolution is to construct a series for the "reputable capital". The prediction is that one ought to observe a dramatic absolute decline in available prestigious capital (see Carosso 1970a, p. 432). Figure 2 shows a series for the total capital stock of the top four foreign government debt certifiers, which controlled close to 60% of the market before the New Deal Acts. This line is the relevant measure, because while a number of investment banks

[26] . Following the American States debacle in the early 1840s, the London *Times* had vented investors' anger and talked about the need to replace the "moral liability" of merchant banks with "legal liability" (Hidy 1949, p. 309). Likewise, in the midst of the 1870s foreign bond debacle, the *Report from the Select Committee on Foreign Loans* (House of Commons 1875) discussed the possibility of referring to civil tribunals. The proposals were never implemented however.

entered the underwriting game using skilled staff from divested structures such as the National City Corporation, they lacked a name and a record. On the other hand, the impact of skilled staff being absorbed by leading underwriters should be captured in the chart (Stratton 2015). Note that because the capital of investment banks collateralized both corporate and investment banks, the data shown in Figure 2 must be taken as an upper bound. In fact, since corporate but not sovereign debt was revived after 1935, the inference for sovereign debt is even more powerful than the chart suggests.

Figure 2 delivers a powerful message. The impact of the New Deal financial acts on the supply of certification capital was drastic: huge quantities of high quality capital evaporated. Since at the same time, London was still struggling with controls over foreign debt issues, New York international finance one-way street had come to a dead end. Note that this was happening in the midst of a violent sovereign debt crisis, precisely when supporting capital ought to have been expanded. This is *prima facie* evidence of the pro-cyclical effects of the New Deal on sovereign debt markets.

<<Figure 2 here>>

b) The Rise of Modern Foreign Securities Underwriting

I now argue that the new rules on security underwriting caused a radical change in the way senior investment banks conducted business. It led them to shed their former status as conscience of the market and adopt a more modest present role of a broker matching sovereign borrowers and the institutional investors. However, establishing this proposition is not straightforward. With the retreat of high quality capital from underwriting, the short-run effect of the change in rules was the effective closure of the New York market to foreign government issues, meaning that one cannot "observe" the effects of New Deal changes by in the immediate or even medium-run. One must therefore rely on a heuristic way to establish the conjecture. First, we observe what happened in the corporate securities market at the time of the financial acts. Next we describe the long run transformation that has taken place in sovereign debt. The parallel between the two evolutions provides prima facie evidence that the New Deal financial acts played a critical role in the transformation.

Unlike the foreign debt market, corporate issues were not completely destroyed by New Deal Financial Acts, probably because (as emphasized by theoreticians) the marketing and management of corporate securities does not face as enormous information asymmetries and enforcement problems as sovereign debt, and also because (as stated earlier) the New Dealers' hostility to investment banks was absolute when it came to foreign debt. But since New Deal regulations applied across the board, their effect on corporate debt underwriting is a guide to their potential effect on sovereign debt, thus offering a kind of counterpart experiment.

Business historians' description of the responses investment bankers adopted in the market for corporate securities provides insight consistent with my prediction. Investment bankers reacted to New Deal financial acts by reducing the scope of their underwriting services, now merely working to match supply and demand. Equipped with lawyers who included covenants that limited their legal liability,

they now retreated from firm commitment and started adding clauses that parked losses in subsequent price fluctuations with the issuers. Lawyer expenses became a non-negligible part of the fees they charged, while fees were gradually reduced in proportion of the lesser services provided to borrowers. In turn, investment banks sought to compensate the smaller revenues by increasing the number of deals they participated in and this raised the competitive outlook. Prime brokerage firms such as Lehman bothers, which had previously developed niche markets, availed themselves to this new opportunity, and developed the profitable business of assisting corporations intent on direct sale by helping them plan their offerings to meet market conditions, as well as compiling the necessary data for submissions to institutional buyers (Carosso, 1970a, p. 437).

All these are characteristics also observable in the long run evolution of the market for sovereign debt as described by Flandreau, Flores, Gaillard, and Nieto-Parra (2010). They emphasize that, unlike until the 1920s when sovereign underwriting rested on a formal commitment by the underwriter or underwriting syndicate to purchase part or all of the security issue and then take care of disposing of it through subscriptions and sales in the open market, modern sovereign debt underwriting involves a much less comprehensive role of the so-called underwriter who really acts as a broker, contributing to make the market and assisting in the issue, but without having as much skin in the game as it used to. This is reflected for instance by the fact that, while so-called firm commitment was the rule in the old system, so-called "best efforts" prevail today instead. It is also reflected by the fact that the modern system, which began to emerge in the interwar was characterized by much greater competition. As reported in Flandreau, Flores, Gaillard and Nieto-Parra (2010), Herfindhal-Hirschman indicators of foreign debt market concentration suggest that the market moved from being very concentrated (1920s) to being non-concentrated (modern era).

Some important aspects of the modern informational set-up of foreign debt markets can also be traced to the transformations brought about by the New Deal financial acts. Interviews with modern market participants conducted by Flandreau, Flores, Gaillard, and Nieto-Parra (2010) uncovered today's role of an institution dating back to the Securities Acts, the "red herring" a pre-prospectus circulated in advance and which serves as a focal point for the release of information. This importance of the circulation of information before the issue takes place also contributes to explain the modern reliance on ratings produced before the issue takes place, which is made possible by the creation of a "study time" when investors are supposed to avail themselves of the merit of a given issue. By contrast to this modern arrangement, which slowly evolved out of the New Deal financial acts (as indicated previously, the creation of the "study time" was a product of the securities acts), rating agencies during the 1920s typically released their grades *after* an issue had taken place. Moreover, according to Gilbert Harold (1938) the identity of the underwriter influenced old regime ratings. Quoting *Fitch Bond Book*, Harold claims: "among the non-statistical factors considered by rating agency are the banking relations […]. Several avenues of approach are available […] such as the default record of the particular house's sponsored securities" (Harold, 1938 p. 67-8). This is a

connection that has disappeared today. While sovereign defaults used to be concentrated on securities issued by less prestigious houses that were also houses with smaller market shares, they are randomly distributed across modern underwriters (Flandreau, Flores, Gaillard, and Nieto-Parra (2010)). As a result, modern rating agencies produce their enlightened opinion on the theory that any proposition stands on its own merits, rather than on the merit of those who propose it.

This section is too brief and opens more issues than it closes – in particular, one would want to know more about the subsequent regulatory and market dynamics between the years of the New Deal and the modern era. But while much more research ought to be produced on the subject before we can reach solid conclusion, the most likely conjecture remains that New Deal financial acts deeply modified the ways in which the business of sovereign underwriting had been conducted. The change was not merely the escape of prestigious capital from the sovereign debt market that was observed in the short run. For if over the long run, investment banks remained the chief intermediaries of that market (later joined again by commercial banks as Glass-Steagall was eventually repealed) they did it in completely different manners than they had before – now prudent, limited, non-committal– reflecting the deep changes the New Deal had introduced in the old financial ways.

Section V. Borrowers' Responses and the Crowding in of Public Capital

The previous three sections have articulated and tested predictions on the effects of New Deal financial Acts for certification of foreign government debt. This final section, does resume the historical narrative. Building on the previous insights it organizes the narrative so as to underscore the manner in which the prestige system ought to have responded if unhampered, using the British record as a counterfactual. This enables to underscore in what critical way the system was prevented from delivering its typical response and thus interpret the observed outcome as well as subsequent dynamics. A new system did not emerge immediately from the destruction of the old. Rather, a process of *tâtonnement* occurred, that ultimately involved institutional innovations.

a) Dismantled Loyalties

Early accounts of the interwar debt crisis have emphasized the gradual "deterioration" in the quality of foreign loans originated during the 1920s (Lewis 1938, Mintz 1951). In the logic of this paper, this deterioration may be seen as having mirrored a transformation in the composition of the underwriting institutions. Such a process was also typical of previous experiences. Flandreau and Flores (2012a, p. 368) describe the evolution of the market share of prestige during 19th century sovereign debt boom-and-bust cycles in Britain. They find that as the boom expanded, new intermediaries ("wildcats") entered the market. Logically, incumbent prestigious banks remained cautious avoiding the compromising of their brand in a battle against the ordinary. Taken together, these evolutions resulted in a decline in the market share of prestige. At the peak of the boom, a lull followed, which preceded the market crash. Following the crash, new loans were radically restricted

and defaults began spreading. As this happened, prestigious banks regained relative market share. This was because defaults concentrated on new intermediaries, since their more prudent deals did perform better than those of others. More capitalized prestigious banks could also help their sovereign customers to maintain or regain market access. In the new, difficult, context "old wisdoms" were relearned and the prestigious banks' ability to address information asymmetries was prized again by investors.

Until 1931, the New York sovereign debt interwar boom-and-bust cycle did exhibit these traditional characteristics. Morgans started the market for foreign government loans in the early 1920s and until 1925 their supremacy, along with that of other first order houses, was complete. When the boom spread to central Europe and Latin American countries beyond Argentina Morgans and the other prestigious banks remained circumspect. They tried to organize them in an top-of-the-shelf underwriters' cartel -- the South American Group -- in order to "filter" these countries' loans and embed foreign lending into fiscal workouts that would construct the credit of the borrower. They gave up when they found that, no sooner had governments agreed to something with the group that they tried to secure a better deal with some lower ranked bank and consistently eschewed the more painful adjustments. According to Thomas W. Lamont: "They would say – Yes, Yes – to everything, but the moment that somebody came along and offered them a loan for spending money at a rate that seemed to them 1/8 to 1% more favorable than what they could get from the Group, they would jump overboard and abandon all our carefully laid plans for establishing their credit and building it up step by step over a series of years […] We became so hopeless that we disbanded the Group".[27]

Kuhn and Loeb partner Otto Kahn explained later that in order to avoid succumbing to such competitive pressures "from the bottom", you just had to ignore them altogether: "It is a strict tradition of my house not so to compete either in South America or elsewhere."[28] Forecasting how it would all end, prestigious banks stoically watched the boom stoically and lost market share as the boom developed (Mintz 1951; Adamson 2002, p. 483). At the peak of the boom in 1927, prestigious bankers publicly complaints about "rash or excessive lending" (Winkler 1933, Adamson, 2005, p. 598). They managed to enroll the Secretary of Commerce Herbert Hoover to endorse their concern to limit foreign loans.[29]

The reward was about to come after 1931, when self-restraint began to pay off in the shape of lower default rates than the underlings, something which Morgan and Kuhn and Loeb partners boasted before the Senate Hearings on the Sale of Foreign Bonds or Securities in the United States (US Congress 1932). It was now time for "house-cleaning." If previous London experiences are used as yardstick, there should have been much activity in advising client-countries through the mire or in

[27] TWL Papers, 102-20; On JP Morgan's a strong anti-Latin American loans bias, see Adamson (2006).

[28] U.S. Congress, Senate Committee on Finance, p. 343

[29] "Hoover and Lamont would Limit Loans", *New York Times*, May 3, 1927

inspiring restructurings or debt renegotiations. Although this was not the type of business that brought immediate rewards in terms of fees, it nonetheless provided visibility and the opportunity for an edifying display of the moral authority of the banker.[30] Morgans and their allied already owned a stake in the shape of embryonic organizations created to deal with foreign default, although the "tranquil" 1920s (as far as sovereign debt crises are concerned) ensured that until 1931 the activity of such groups was limited. Nonetheless, in 1918, a "Foreign Securities Committee" (FSC) had been created within the Investment Bankers' Association in response to investors' inquiries about Russia.[31] The Committee was initially chaired by Thomas W. Lamont and subsequently by Charles Sabin, president of the Guaranty Trust.[32] The *ad hoc* country committees that were set up to deal with occasional issues such as the International Committee of Bankers on Mexico, emanated from the FSC (Adamson 2006).

But this imaginary history of the way the House of Morgan and its allies would have "normally" found themselves dealing with the post 1931 debt crises is one that never occurred. Rather than being able to exploit the crisis as their "I told you so" against the lower banks, Morgans found their ability to act hampered by political hostility. The Roosevelt campaign's attacks against "international bankers", which amalgamated under the same criticism bankers of all make – the small and large, the prudent and reckless, the investment bank and the security affiliate of commercial banks – prevented Morgans from behaving in the usual ways of their London predecessors. Instead of being on the front line, negotiating with foreign governments, the House of Morgan's foreign debt desk was put on holiday (Adamson 2002, p. 487) and, one year after the Roosevelt election, Thomas W. Lamont rightly complained that he found things "terribly dead down here."[33]

The destruction of the older ways can be identified in many places. The old regime had rested on prestige being a durable good, or rather asset. Its existence and ownership provided discipline to borrowers who were to be helped and rewarded, if they behaved as instructed. It provided discipline to underwriters who had to be careful lest they lose that prestige. Taking the asset from the hands of their owners ought to have affected the outcome: In other word, the exit of prestigious capital from the foreign debt market was bound to dismantle loyalties. There is anecdotal evidence of serious concenrs about this. For instance, the new Chairman of National City Bank James H. Perkins worried that the liquidation of the National City Company would cause disruption, because its balance sheet had been

[30] According to a Memorandum written in October 29, 1928, TWL 100-8: "We have not now to deal with any great loans in default; what we have now to do is to study developments in those countries to which we have made loans with a view of seeing that the debtor country takes no action impairing the security or rights of holders of its bonds in this country".

[31] See TWL papers, 100-8. This occurred when Hayden, President of the Investment Banking association, inquired with Morgans about the opportunity of setting up a body comparable to the CFB. Hayden's approach of Morgans underscores the perception of their authority as a certification body.

[32] TWL papers, 100-7 and 8.

[33] TWL papers, 105-7, Letter to W. Lippmann, January 30, 1934.

used to support the price of issues that had not gone well. Glass-Steagall forced him to "get rid of the thing." But doing so would trigger further declines in the securities the National City Bank had sponsored. He wished he could "keep the organization together because it will be necessary for the men to handle a number of bond issues which have gone bad [,] to service those issues and give the best results possible to the owners of the bonds" – an impossible thing under the New Deal (Cleveland and Huertas 1985, p. 197).

Thus Glass-Steagall signaled to borrowers that any current efforts to adjust would not be paid back since any relationship with prestigious banks was about to come to an abrupt end by the disappearance of the investment bank itself. In other words, the New Deal changed the time horizon of bilateral bargaining between banks and sovereigns. Borrowers needed not being very sophisticate for understanding this. They soon realized it when there was nobody left to call, as in the case of the National City Company or JP Morgan. In other cases, calls may have been returned, but it is doubtful that bankers could be encouraging (Kuhn and Loeb). But if the New Deal was destroying relationship banking as an encouragement to pay back the debts, we should expect defaults of high quality debtors to have increased after Glass-Steagall. Figure 3 shows the number of monthly defaults, and identifies those on securities underwritten by the four prestigious banks. The chart also displays a Glass-Steagall time frame that ranges between the Bank Holiday in March 1933 when the main provisions of the Glass-Steagall "Revolution" emerged and were widely discussed, and June 1933 when the Act was formally ratified by FDR. As can be seen the opening Glass-Steagall window was followed by a major wave of defaults. In particular, for those two prestigious houses that did walk out of the market as a result of the Act, the number of post-Glass-Steagall defaults (excluding those after the outbreak of WWII, when enemies of the US defaulted) surpassed pre-Glass Steagall defaults. There were fourteen National City Company defaults *after* Glass-Steagall against seven before. The only two pre-War Morgan defaults that occurred were post-Glass-Steagall events. This is consistent with the notion that borrowers gave up hope.

<<Figure 3 here>>

Of course, Figure 3 does not control for other factors that may have lowered borrowers' incentives to repay independently from the strategic behavior considered here.[34] But it remains that, given the evidence, Figure 3 is consistent with the notion that the Act stifled the ability of prestigious underwriters to provide borrowers with the types of rewards, support and punishment that had been a critical aspect of the operation of foreign bond markets under the old regime. Granted this, the foundations of a snowballing mechanism were laid out. Further defaults weakened the bankers' case and fortified their opponent's narrative. This encouraged leaving them less leeway and providing them with less political support. At the end of the day, the bankers' failure story was born.

[34] . Post-Glass-Steagall defaults include German defaults, which may have been favored by Hitler's takeover in January 1933.

b) Filling the Void

New Deal financial regulations crowded out old ways, but crowded in new ones, too. The bashing of bankers, the refusal to let them act, and the choice to refrain from at least compelling them to "take their responsibilities" created a political void. At the same time, the very process through which this was happening did point to where authority now lay. If the political system denounced bankers as inept, then the political system had to take charge.[35] The bondholding public understood it and naturally re-directed inquiries towards the State Department, where staff was reported to be crumbling under the volume of mail.[36] In March 1933, immediately after FDR's inauguration, Herbert Feis began working on the blueprint for a foreign bondholders' protection organization, which would thus substitute for such as institutions as the Foreign Securities Committee that were backed by the bankers. Feis was an economist with the State Department and the author of a celebrated book published in 1931 under the auspices of the Council for Foreign Affairs. It reviewed and criticized British and Continental lending practices in the 19th century, characterizing them as the product of European imperialism (Feis, 1931). Adamson (2002, p. 487) describes Feis as the "chief architect" of the resulting Foreign Bondholders Protective Council. Its creation was included in the Securities Act of 1933, which stated that a corporation would be created "for the purpose of protecting, conserving and advancing the interests of the holders of foreign securities in default" and from whose board of directors underwriters and bankers were explicitly banned. The formal creation of the FBPC was announced by Roosevelt in October 1933. As emphasized by Winkler (1933: 174) was excluded from the board of directors anyone "who within the five years preceding has had any interest, direct or indirect, in any corporation, company, partnership, bank or association which has sold, or offered for sale any foreign securities." Next, the Johnson Act of 1934 did forbid the selling of any new loan or financial product from a government in arrears with US investors. Conditionality was being nationalized.

This differential diagnosis of the emergence of the FBPC may help clarify existing debates. Previous authors have speculated on the reasons for the mixed public-private nature of the newly created foreign bondholders organization (Eichengreen and Portes 1989a, 1989b). In fact, those reputational problems that previously confronted bankers now confronted the Administration. Roosevelt, while relishing the opportunity to praise some countries for their credit-worthiness (as he famously did for Finland, which he dubbed "a country that pays its debts"[37]), he understood the dangers of reputational liability. This may explain his preference for chartering a semi-independent,

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[35] An aggravating factor was the recurrent accusation that foreign loans had received the blessing of the State Department (see Adamson 2002 for a discussion). However, a similar claim had been made against British policy makers in the 1820s who were accused to have tacitly encouraged Latin American loans because they reduced the Spanish hold in the region (Jenks, 1927).

[36] Eichengreen and Portes (1989a) p. 216; Adamson (2002, p. 487), from primary sources.

[37] Arola 2006, p. 189.

private body, in charge of representing the bondholders -- but distinct from the government so as to deflect public criticism. Likewise, previous writers have suggested that the FBPC encountered difficulties in reaching satisfactory settlements (1986, 1989a, 1989b). The evidence in this chapter may give some clues as to why this was the case. The new administration could not be overly committed to make the FBPC a success. After all good performance of the FBPC would have restored the honor of international bankers, showing the deals to have been successful, whereas showing failure was essential to reach the goal that the New Deal financial acts were aiming at. Consistently with this interpretation, Adamson emphasizes that "Roosevelt administration's support for the FBPC was half-hearted at best" and that Roosevelt considered "the billions of dollars [of foreign government loans] 'gone for good'" (Adamson 2002, p. 492).

What the narrative in this chapter underscores is that, while the resulting "banker-free" FBPC lacked conflicts of interest, it also lacked (for the same reason) critical incentivizing tools such as the "carrot" of market access. But such had never been its role. It had been created instead to serve as a P.O. Box for letters lamenting the losses of foreign debt. After this had been played out long enough, the Roosevelt administration and especially the State Department started to take a more assertive role. They began replacing the FBPC by more direct, "imperial" policies, using such things as trade policy as an instrument of coercion and thus matching the demands of policy credibility with adequate policy weapons (Adamson 2002).[38] The result was a greater use of political conditionality when it could be successfully implemented, a process, which effectively transformed the US administration into a powerful financial agent. Later on, and again for political reasons, these mechanisms would be multi-lateralized with the help the Bretton Woods Treaty, whose Article IV permitted monitoring and supervision through multilateral agencies. This led to the creation of the International Monetary Fund and the International Bank for Reconstruction and Development (later World Bank), which came to embed the new system of reputation production. While this evolution is consistent with the New Dealers' eagerness to support the "use public capital to promote overseas stabilization and development" (Adamson, 2002, p. 487-8), this chapter suggests that it also constituted an inescapable response and solution to the destruction of the earlier order.

The end result of this history is familiar to the reader. After the long sleep of the "first Bretton Woods" era of capital controls, global finance was reinvented during the late 1980s and 1990s under new rules of the game. As Flandreau, Flores, Gaillard and Nieto-Parra (2010) argue, in today's regime, investment banks do the selling, rating agencies do the assessing and the IMF does the troubleshooting. This chapter has suggested that the deep foundations of this system were laid out during the 1930s. They were really associated with the political efforts of the Roosevelt administration to reclaim foreign financial policies from the hands of the investment bankers -- a process which, the article has been suggested, had the not unintended effect to deepen the interwar debt crisis.

[38] See also Securities Exchange Commission's Historical Society's material at http://www.sechistorical.org/museum/galleries/imp/imp02a.php, which provides relevant material.

Conclusion

The interwar collapse of the international capital market is usually considered to have been a major disruption in the history of global capitalism, a period, to paraphrase Charles Dickens' famous opening words in *A Tale of Two Cities*, that was so far like the present period, that the best authorities (Dickens writes "nosiest") insist on "its being received, for good or for evil, in the superlative degree of comparison only": the "Great Transformation" according to Polanyi (1944), the "End of Globalization" according to James (2000) or the "Great Reversal" according to Rajan and Zingales (2003). The present narrative, though not necessarily inconsistent with the conventional one, which suggested to read the event as having resulted from the deadly mix of an unprecedentedly violent shock, a financially fragile system and very "incompetent" policies, differs from it as well in that it seeks to integrate new elements. The story this chapter has told is a story of brands and reputations as significant factors in the history of global capitalism. From there may perhaps result the elements of a new way of writing global economic history, one detached from the physical markets in a way and yet tied to them in another. Narrating the history of the global system of rating as this chapter has tried here in a limited way may provide a novel perspective on the evolution of the material economy, one that would give its full role to its immaterial underpinnings – a material story of the immaterial, so to speak.

At its bottom, the story of the interwar foreign debt collapse is the story of a failed transplant. And the failure, as the chapter argued, occurred not for economic reasons but for political ones. Perhaps it had been ill-advised from the beginning to seek to adapt or "Americanize" business manners that had grown up and developed in Britain. As Walter Lippman's syndicated column of May 31, 1933 declared under the title "The Morgan Inquiry": "The only check upon [Morgans] has been the conscience of the firm and its banking tradition. Now the possession of such a great power by private individuals who are not publicly accountable is in principle irreconcilable with any sound conception of a democratic state."[39] The democratic state required at least the appearance of free-entry and an organization whose main system rested on a rent given to a financial oligarchy of prestigious banks for them to use it well was perhaps unavoidably bound to succumb to the blows of its critics. But if this is true, then the conclusion is that the political origins of the interwar debt crisis cannot be overemphasized. These were not incompetent policy makers, but extremely shrewd ones. They had understood the logic of functioning of the system, which they set to destroy, successfully. Granted this, we can measure the enormous effects that the domestic politics of the country responsible for providing international reputations has on the global financial system. Polanyi's Great Transformation would bear witness to this, and the tale narrated here would point to a quite different direction than the

[39] "Material and Drafts about Two Articles by Lippman about activities of JP Morgan", TWL, 105-7.

conventional lamentations on the gold standard "mentality" and the stupidity of policy makers (Eichengreen and Temin, 2000; Temin 2010).

At one level therefore, the story narrated here is that of a crucial moment in the evolution (progress?) of international finance from a regime with tightly held information (Rothschilds, Morgans) to an arms-length and competitive one (the agencies called in by the new market rules ushered in by the New Deal). Considering it that way brings a last question, which was raised by the editors and with which this paper does conclude. Did the adjustment costs brought about by the transition described here necessarily entail the destructions that occurred? The obvious answer is: In theory, no. It is of course possible to draw, from an armchair, the path of a smoother transition to the new regime from the old and indeed, economic journals are full of such speculations in other contexts. However, things may have been slightly more complicated to secure in practice. As we indicated, the New Dealers needed the default of many foreign debt securities in order to bolster their claim that reform was needed. Policy-making has to reckon with the performative. As the ever unfolding crisis in Europe reminds us again, the problem may be, not that there are good or bad policies, but that for better or worse, politicians are elected and macroeconomic policies are only a portion of what the world is about. Is it cynical to observe that catastrophes have their beneficiaries?

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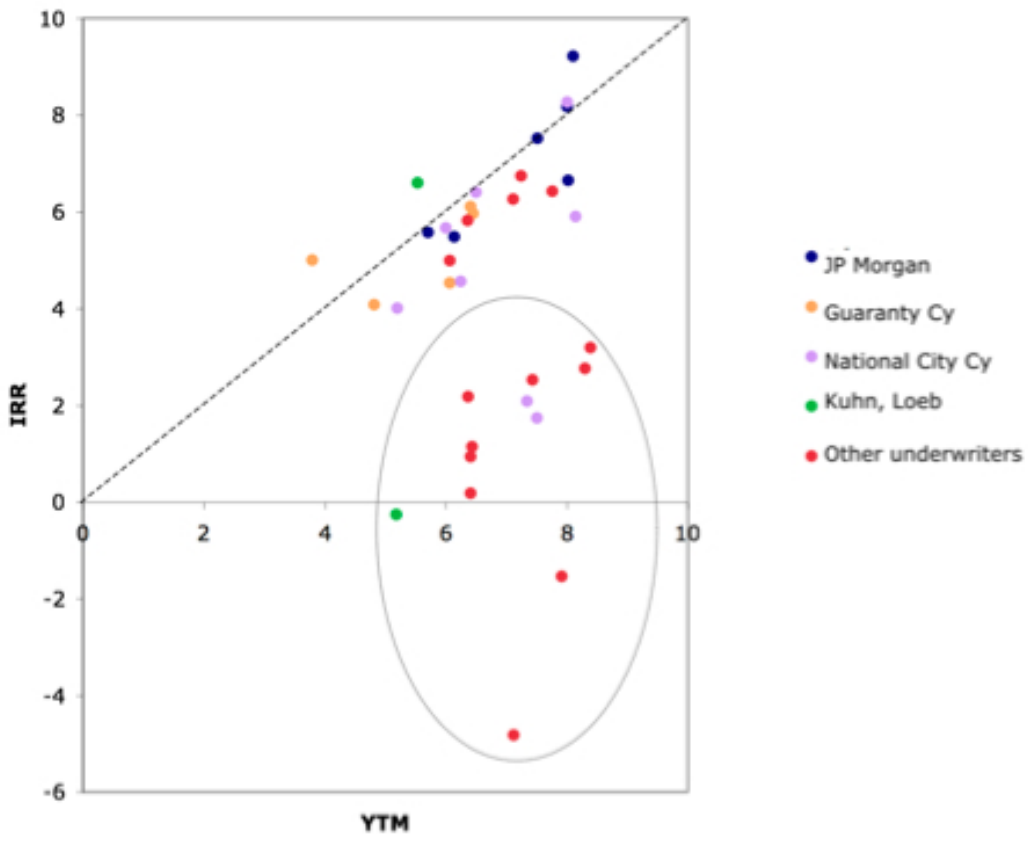
Table 1. Market shares, Default Rates, and the Capital of New York Underwriters

	Market Share (a)	Performance: (Own Default Rate)/(Others' Default Rate) (b)	Capital Stock 1927-9 Mo USD
JP Morgan	31%	0.26	94.0
City Company	13%	0.74	22.5
Kuhn, Loeb	6%	0.57	21.5
Guaranty Company	6%	0.54	10.0 (c)
Others (average)	1%	1	n.a.

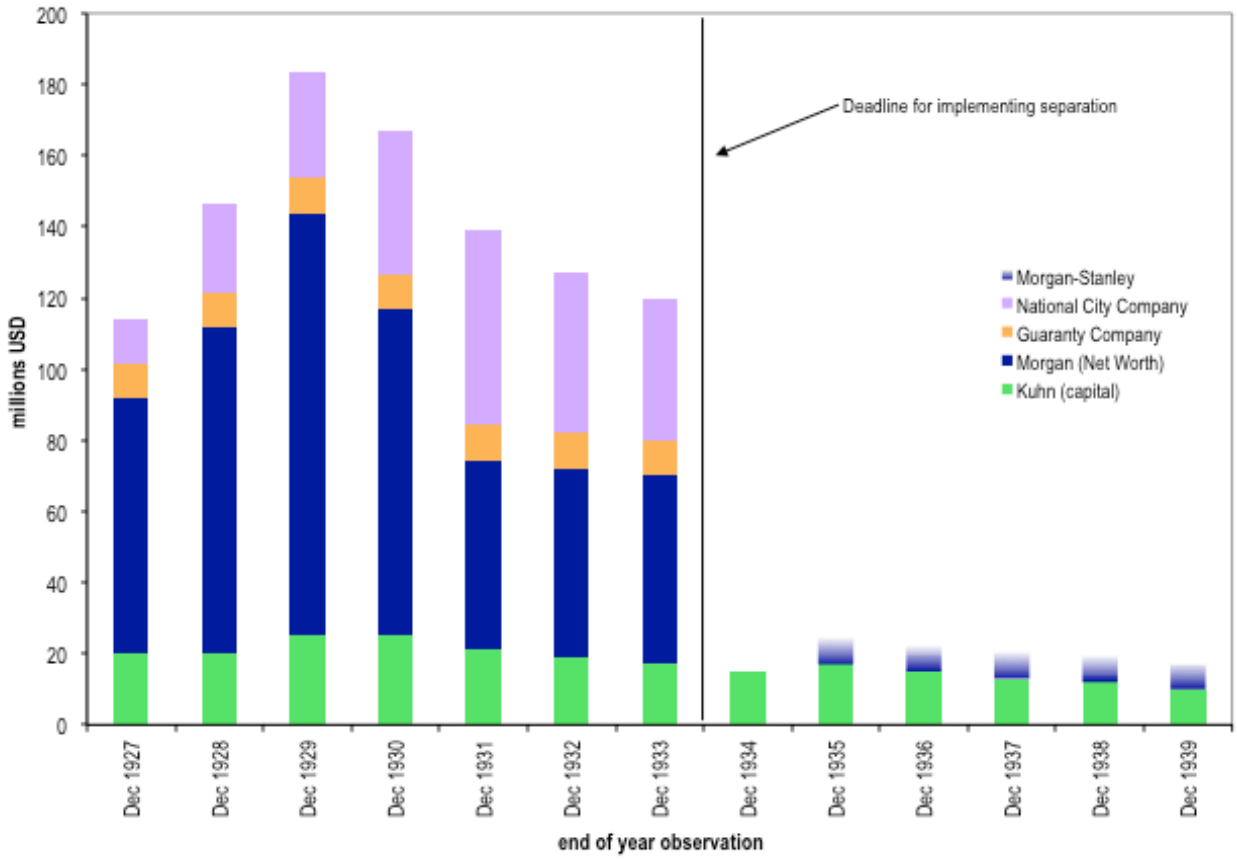
Source: Author's computation from database in Flandreau, Gaillard and Panizza (2010). Capital Data: Figure 2.
Notes: (a) As a percentage of the amount of capital raised, period 1920-1929; (b): Based on number of defaults occurring before the end of WWII. Excluding post 1934 defaults substantially increases performance for the top four; excluding the WWII further improves the performance of JP Morgan. (c) Estimate based on data for 1933.

Figure 1. Delivering Value: Deals, Underwriters and Performance in the New York Market



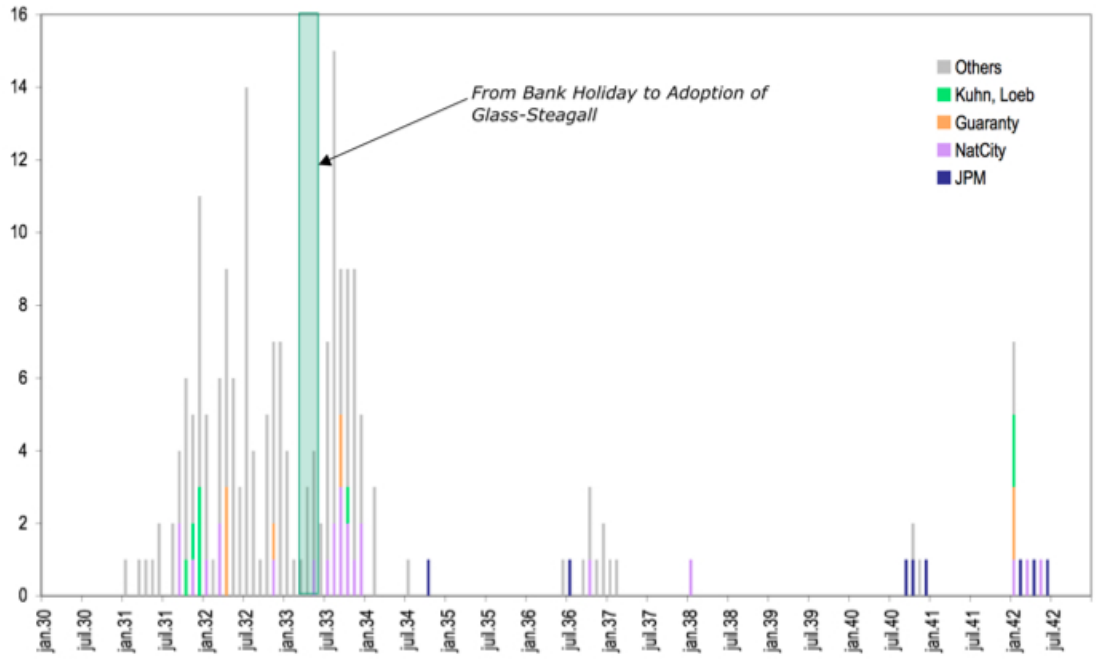
Source: Author, from Flandreau, Gaillard and Panizza (2010) and Eichengreen and Werley (1988).

Figure 2. Available Certification Capital from Four Most Prestigious Underwriters (Millions USD)



Source: Author, with interpolations. Bankers' Almanac, various issues (National City Company), Lehman Brothers Archive Baker Library, (Kuhn and Loeb), Committee on Banking and Currency (1934) (Morgan), ProQuest's online balance sheets of the Guaranty Trust Company (Guaranty Company); Chernow (1990) (Morgan-Stanley, Created 1935)

Figure 3. Monthly Defaults on Foreign Debts 1930-1942



Source: Author, from data in Flandreau, Gaillard and Panizza.