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Abstract:

This paper revisits important aspects of the interwar debt debacle. Using insights from recent research in financial economics, new data on foreign government debt underwriting and archival evidence from Thomas W. Lamont's papers, I provide a novel perspective on the failure of the foreign debt underwriting industry. Specifically, I put the collapse of foreign government bonds that occurred in New York in the early 1930s in the perspective of London's earlier experience. I show that the old London set-up for managing foreign government debt was essentially transplanted to New York. 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. I then argue that several critical aspects of New Deal Financial Acts adopted during the 1930s interfered directly with this set-up and prevented the industry from dealing with the crisis in the usual way. I conclude that the global bond market was a casualty of the New Deal, that New Deal Financial Acts opened a new era in international finance and that the foundations of the modern market were laid at that time.

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The 1930s was a decade of transformations in global capital markets described earlier as a "Great Transformation" (Polanyi 1944) or even the "End of Globalization" (James 2000). Central to the process was a violent foreign government debt crisis. Once the domino-like process was completed in 1934, about half of government securities issued during the 1930s in the New York market (where most issues had taken place) were in default.[1] An important legacy of the episode was the scars it left on the international financial system. Following the foreign bond debacle, the global capital market became notoriously narrower, and remained effectively closed to many foreign borrowers, faithful or not, for a long time. Government intervention and capital controls became the norm. Public capital was called in and new institutions, such as the IMF, were created to deal with international financial relations.[2]

Perhaps the most revolutionary impact of the crisis was its impact on microstructures. The interwar debt crisis was a turning point in the ways and means of globalization. Financial globalization did resume in the 1980s with a scope that has inspired reflections of the *plus çà change* variety (Reinhart and Rogoff 2010). But the microeconomics of globalization had been profoundly altered making comparison misleading. Flandreau et al. (2010) argue that the modern international bond market differs markedly from predecessors. They find that when sovereign defaults used to concentrate on securities originated by less prestigious intermediaries, they are now evenly distributed among super-competitive international banks. The prestigious, careful, and conservative international bank of the Rothschild or Morgan variety is no more and trouble-shooting is today the turf of International Financial Institutions.

This paper analyzes economic, political and business aspects of this major transition in the global financial system. I do it in a novel way, arguing that a revolutionary aspect of the transformation was a complete change in the way foreign government debt was certified and managed. In other words, I articulate a business history perspective on the transformation that occurred, focusing on how the industry at large operated until the early 1930s and how New Deal financial regulation dissolved the existing regime – a regime that had operated for decades and served as the backbone of the first regime of "globalization". This regime rested on certification by prestigious intermediaries. The cornerstone of this arrangement was provided by a few enormously prestigious banks wielding considerable symbolic power and acting as certifiers, sellers, and trouble-shooters for borrowing governments. This economic and political order had grew and aged in London but, when the interwar debt crisis struck, it was undergoing a process of transplant to New World. Prestigious banks in New York had followed their London elders' traditions and lessons. They busied themselves with picking the right stuff and supporting their picks on the market while less serious houses took care of lesser quality products. When the crisis struck, the New York investment bank community would have had, to continue with the London way, to put to work bondholders' protection mechanisms, the embryo of which they had created in 1918 with the Investment Bankers' Association's "Foreign Securities Committee". However, owing to provisions introduced in New Deal financial Acts, it became impossible for the industry to keep operating as it had in the past, and the result was the collapse of the existing order, the liquidation of former loyalties and the forceps delivery of a new regime. The transition, which implied massive redefinition of property rights, was dislocating.

Emphasis on "supply side" transformations of the global capital market is usually not strong in the literature on the 1930s. The violence of the shocks occurring on the "demand side" (the deflation, the collapse in export commodities and the adverse effect this had on public finance and finally the ensuing government defaults) magnetized earlier narratives. As a result, existing accounts tend to follow the conventional Bretton Woods account of the crisis as a mix of bad luck and failure of self-regulating markets. This matches the suggestion that the "Great Transformation" that occurred at this point made the emergence of Bretton Woods as a politically administered regime not only inescapable

[1] . At that date, it was estimated that 40 percent of Europe's and 82 percent of Latin America's external debt was in arrears.

[2] . Foreign Bondholders Protective Council (1934); Mintz (1951), Eichengreen and Portes (1989a) and (1989b), Adamson 2002, Flandreau, Gaillard and Panizza (2010), Flandreau, Gaillard and Packer (2011).

but also somehow "desirable".[3] Rhetorical justifications of Bretton Woods have repeated this statement ever since.

For scholars familiar with the earlier experience of London, this conventional narrative is not entirely satisfying. It is true that the graphic events of the 1930s were likely to turn down investors. On the other hand, government debt crises had occurred in the 19th century, when London presided over the global export of capital. Default rates had been high after 1825, 1873, 1890 and in fact comparable to numbers observed during the 1930s.[4] Yet these crises had not been followed by such radical transformations as occurred in the 1930s. Instead, crises had generally been followed by a "lull" as investors licked their wounds. There had always been uproars in the press, as well as bondholders activism. In some cases, there had also been investigations by the British parliament and proposals for reform (such as greater transparency, in the early 1870s) had been made and occasionally followed. But they had not given rise to anything like the revolutionary transformations of the 1930s. This is then, and not earlier, that the largely hands-off context in which capital had been exported so far was brutally replaced by heavy government intervention. This is then that the Bretton Woods Treaty was eventually signed, replacing the patient efforts by the markets to gather information on countries' health by the Article IV which permitted monitoring and supervision through multilateral agencies.

The why and how for this regime change are still not fully understood. This paper is devoted to dealing with these two issues. First, it articulates an understanding of how the regime operated before the interwar crisis, using as analytical framework insights from financial economics. Next I show how such a regime could be subverted, and suggest that this gives interesting insights on why the regime change happened: a careful account of how the transformation occurred enables to identify individual actors' contributions and thus leads to a natural hypothesis regarding why the transformation occurred. As I will conclude, Roosevelt and the New Dealers were at the heart of the regime change. The crisis only provided them with a political opportunity. At the end of the day, power had been transferred from international bankers to policy makers, explaining why a number of earlier institutions were dismissed, while new ones were created.

I use two ingredients to organize the narrative of the revolution. First, building on previous research, I show how, until 1931, "certification" of foreign government debt was delegated to underwriting banks ("International Bankers" as they were known in the US context), whose behavior was constrained by their need to secure and protect prestige (a source of rents). Second, I show how adoption in the US of New Deal financial regulations (in particular, the Banking Act – known as "Glass-Steagall Act" – the Amended Securities Act, and the Securities Exchange Act) had a devastating effect on this very set-up. They interfered directly with an organization of the banking industry that had been a pre-condition for system to operate as it had in the past. First, the acts caused a massive reduction of the amount of reputable capital that underwriting banks could pledge as collateral for sovereign debt issues. Second, by increasing liability, it made reputable capital more cautious. Because the availability of high prestige capital was the cornerstone of the international financial order that had prevailed since the early 19th century, its crowding out by regulation caused the previous order to crumble. Last, the very passing of New Deal Financial Acts was in itself a statement. The Acts implied that there had been a failure of markets and as such they debased the prestige of international bankers.

In sum, New Deal regulatory changes destroyed "old style" foreign debt certification and left the foreign debt market in rack. An important implication of my analysis, therefore, is to reverse the causality that is often found in existing accounts. Rather than seeing New Deal regulations as part of a "response" to the crisis, I argue that they were part of the crisis itself. Causality, I argue went from New Deal regulations to the closure of the foreign debt market, as much as the other way round as generally argued. This perspective is new. Despite an awareness in the literature that New Deal regulations hampered the business of underwriting (most prominently by Carosso 1970a and 1970b[5])

[3] . See Van Dormael (1978), Bordo and Eichengreen (1993), James (1996).

[4] . See Suter (1992) and Flandreau, Flores, Gaillard and Nieto-Parra (2010) for data and sources comparison.

[5] . Carosso (1970a) argues that Glass-Steagall along with the other financial acts of the 1930s were part of a crusade waged against investment banks by the Roosevelt administration. However he argues that this crusade was to a large extent a "failure" because it did not prevent investment banks from remaining at the helm of intermediation between investors and corporate borrowers. This claim is not untrue (after all, the leading underwriters today, are JP Morgan Chase and Citigroup when in the interwar they were JP Morgan and The

or were associated with the coming of a new age (James 2000), I do not know of any work that has discussed systematically, along the same lines as here, the link between New Deal financial regulation, financial globalization and the emergence of the post-WWII international financial institutions.

Primarily, this paper provides insights on the literature on the certification role of intermediaries. Previous researchers have focused on corporate securities. DeLong (1991) study the impact of directorates ("JP's men") on firm's performance and suggests that Morgan directors raise the value of firms. Hannah (2007) disputes this result. DeLong and Ramirez (1995) find that this impact disappeared in the late 1930s. More recently, Frydman and Hilt (2010) reconsider the matter and ask whether bankers on corporate board created or extracted value. The issue of prestige and certification in foreign government debt is the object of a separate literature that has been pioneered by business historians (see Flandreau and Flores 2009 for references). An early economic history reference that is relevant to this paper is Mintz (1951). Flandreau and Flores (2009) study the role of British merchant banks prestige and capital in the rise of the London market for foreign government debt. Flandreau and Flores (2011) study foreign government debt relationship banking during the 19th century and show how prestigious bankers were able to exact structural adjustment. They also provide evidence that underwriting banks rather than bondholders committees were the central character in dealing with default during the 19th century. Flandreau and Flores (2010) provide a theory of 19th century conditionality lending that suggests underwriter's prestige was more important than countries' reputation. Flandreau, Gaillard, and Panizza, 2010 study the role of prestige in disciplining underwriters' foreign government debt quality choices in New York, during the 1920s. Finally, Flandreau, Gaillard and Packer (2011) analyze the performance of rating agencies in predicting interwar default.

Of special relevance to the findings in this paper is an earlier work by Flandreau, Flores, Gaillard and Nieto-Parra (2010). They identify stylized facts on the long run evolution of foreign government debt (1815 till now). They uncover a profound transformation in the underwriting of foreign government securities and identify what they call the "default puzzle", a change in the characteristics of defaulted securities between "then" (until the interwar) and "now" (since the 1990s revival of foreign government securities): default today is randomly distributed across underwriters when it was not until the interwar. Until the interwar, default was negatively correlated with market share (see also Flandreau, Gaillard and Panizza 2010 for more evidence on this). They resolve this puzzle by arguing that underwriters used to act as gatekeepers, lenders of last resort and trouble shooters in this market, while they have given up this role in the modern period (post 1989). They show that today's foreign government debt market is more competitive and riskier than historical counterparts such as the interwar (measured by rating at issue, for post-1993 data). They suggest that that it has to do with the rise of rating agencies, who crowded out investment banks from the sovereign debt certification business and by relieving the from the liability, of having underwritten a bad deal, enable much more risk taking in the modern regime. A similar claim (not focused on foreign debt, though) has been made by Sylla (2002) who suggests that the rise of rating agencies provided an impersonal substitute for personalized, underwriting bank reputation based assessments. Why and when this changeover occurred remains an open matter.[6] In what follows, I will suggest that New Deal financial regulations, by their attempt at limiting the power of investment banks and their concern with raising legal liability, paved the way for this transformation.

This article is also relevant to the modern literature on the interwar debt crisis pioneered by Eichengreen (Eichengreen 1989; and Eichengreen and Portes 1989a, 1989b) and more recently enriched by Adamson (Adamson 2002). Among the findings that have emerged is the increased politicization that occurred in the management of public debt during the 1930s. Eichengreen and Portes remark that there were many political pressures on the FBPC and relate that to the fact that the creation of the FBPC in 1933 had been sponsored by policy makers. Likewise, Adamson (2002) writes the biography of the political process that underpinned the operation of the FBPC and repeatedly crosses the path of power diplomacy. By contrast bankers and underwriters are much less often spotted. This post-1933 evidence, however, stands in stark contrast to characterizations of the London

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National City Bank) but it overlooks the fact that, especially in the international system, the way the system operates is quite radically different today.

[6] . See Reinhart (2010) for relevant discussion of this and review of possible explanations.

market in the 19th century, such as Platt (1968, chapter 2) who concluded that “as a general rule, the Foreign Office refused altogether to take any part in negotiating an Agreement, or to sanction provisions in Agreements which, if accepted, would have created international responsibility” and suggested that this was because bondholders had their own devices.[7] In my analysis, the politicization of the process during the 1930s becomes a natural by-product of New Deal financial Acts. By adopting a systemic perspective, I am able to show that the sponsoring of the FBPC by the Roosevelt administration was the inevitable consequence of its choice to destroy of earlier institutional mechanisms to deal with crises.

Consequently, this paper provides a contribution to the literature on New Deal regulation and in particular Glass-Steagall. This literature is today dominated by revisionist works that questioned the wisdom of Glass-Steagall (Benston 1990, Calomiris 2000, Kroszner and Rajan 1994). Another research strand has questioned the Roosevelt administration’s official view that the passage of Glass-Steagall was that the interests of the general public that would be better protected if banks were broken up into commercial and investment flavours. Authors in this vein purport that New Deal financial acts were a case of regulatory capture or influenced by lobbying (Tabarrok 1998, Mahoney 2001, Ramirez and DeLong 2001). On this count, I will show that the regime change that occurred in the 1930s did strip the House of Morgans from its power in international finance, lending support to a political economy perspective.

My findings have also relevance for the political history of the New Deal. Carosso (1970a) describes the tension inside the Roosevelt Administration between older supporters of the “Progressive” agenda and the rising generation of New Dealers who favoured cooperation between state and corporate America. More recently, several contributions associated with the work of Theda Skocpol emphasized the autonomous role of State logic in New Deal dynamics (Skocpol (1981), Evans, Rueschemeyer and Skocpol (1985), Skocpol and Finegold (1995)). A strong emphasis of this and related work is the importance of government bureaucracies and institutions for the implementation of new policies and programs. In this paper’s perspective, it appears that, having disbanded prestigious capital, state officials created a responsibility for themselves and this led to their sponsoring of a number of mechanisms such as the FBPC or later the IMF. Such a perspective is also useful to understand the specific design these institutions received. This will enable me to shed new light on the significance of institutional innovation that occurred on the international front following New Deal’s financial acts.

The balance of the paper is organized in a straightforward manner. The first section covers the role of capital and prestige in certification under the London-based “Old Regime” of certification and discusses the transplant of the London set-up to New York in the interwar years. It also provides new evidence on the performance of bankers during that period. Section II discusses salient features of New Deal financial regulation Acts and discusses in theoretical language the effects they ought to have had on the “Old Regime”. Section III explores outcomes of the Acts for the business of foreign debt underwriting. Section IV, finally, discusses implications for borrowers and for policy authorities. I show that some key features of the modern system were really planted with the adoption of New Deal Financial Acts.

Section I: The Old Regime of Certification

a) The Benchmark Model: Relationship Banking in London (1820-1914)

In this paragraph, I provide a summary discussion of the economics of certification in the 19th century London market for foreign government debt. This market had been created in the early 19th century (Neal and Davis 2006, Flandreau and Flores 2009), and appears to have been a successor to the once striving Amsterdam market for foreign government debt (Riley 1984). The development of such a market in London was everything but natural, given the enormous information asymmetries that have always characterized foreign government debt. The solution London developed to deal with this problem was prestige and capital. The argument builds on banking and finance theory that has emphasized the importance of repeat play in sustaining credibility: Financial intermediaries’ concern

[7] . Platt (1968), p. 49 and 51.

over their name (i.e. the need to acquire a reputation for veracity) mitigates moral hazard and improves information production.[8]

This has implications for underwriting: Prestigious underwriters who might be tempted to overprice securities in order to generate short-term gains do not actually do so because it would damage their reputation. As a result, natural monopoly emerges as a separating equilibrium in which quality, commitment, performance, and market power are related to one another. While market share can become over time a self sustaining commitment mechanism, capital can act as a substitute for reputation over the short run before reputation is acquired. Moreover, capital retains a value over the long run, because it is the ability of bankers to take long position in the securities they have sponsored (in essence providing a banker put on their "own" securities) that provides the mean to enforce their reputation in the presence of a run.[9]

This emphasis on wealth and market power in helping the development of the market for foreign government debt helps understand why the transformation occurred in merchant banking. The French wars provided the merchant banking community with enormous risks and opportunities: this came through military contracts, through price volatility, and through border controls such as the Continental Blockade. While many houses failed, others amassed fortunes. Around 1820, Rothschilds' capital (especially when all brothers are taken together which makes sense (because they cooperated tightly on government debt) was a multiple of Barings' and Barings' was a multiple of the next best's.[10] This wealth could be used, when peace came, as a collateral for successful foreign debt origination. And when peace came with its reconstruction and stabilization needs, Rothschilds and to a lesser extent Barings became market leaders (see Figure 1).

Arguments about the role of prestige in foreign government debt have in the past been with business history.[11] Focus on the financial logic underpinning prestige helps identify testable implications. In my work with colleagues I have worked to strengthen and document the case for the role of prestige in foreign government debt certification with the help of new data covering the universe of London government bond issues during the 19th century as well as some other markets for shorter period of times. Data analysis shows this system was kept into operation until WWI: in other words this system was remarkably resilient. This is natural, because the initial large accumulations of capital helped to provide for origination of debts that did perform very well. When crises hit, prestigious bankers intervened to support their securities thus acting as a kind of international lender of last resort. This then reinforced their prestige and thus increased the influence they had on prices which served to protect their monopoly position. In other words, the analysis predicts that there ought to be a significant degree of persistence in leadership.

Empirical evidence from foreign debt markets "league tables" is consistent with this: Rothschilds, the early 19th century leader, had the largest market share in London during all sub-periods.[12] Moreover, Rothschilds had the lowest market share in defaulted securities. This is evidence that prestigious underwriters were indeed successful at delivering value for investors. Another feature of

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8 . Spence (1973) provides the foundation of signalling theory. Shapiro (1983) explains investments in quality by showing that reputation can be a source of rents. Diamond (1989) provides an early theoretical application of these insights to finance, emphasizing the role of repeat play. An important application of this to economic history is Gorton (1996) who suggests that intermediaries' reputation formation deters wrongful behavior. Another foundation for this group of insights is the work of Sutton (2006) on the role of capital as a sunk cost providing a deterrent to competitors' entry.

9 . A large literature concerned with underwriters reputation and securities issue has explored the theoretical and empirical association between prestige and the performance of public offerings. Not all papers in this vein, however, Chemmanur and Fulghieri (1994) are credited for the first relevant model in which financial intermediaries' reputation for veracity mitigates the moral hazard problem in information production. On the empirical side Carter, Dark, and Singh (1998) show that, over the long run, issues managed by prestigious houses outperform those managed by ordinary ones. Beatty and Ritter (1986) show that underwriters whose offerings under-perform lose market share.

10 . Flandreau and Flores (2009), Table 2, pp. 664.

11 . Monographs dealing with investment bank behavior in the market for foreign government debt always emphasize this aspect. Suzuki (1994) gives a survey.

12 . Flandreau, Flores, Gaillard and Nieto-Parra (2010); Flandreau and Flores (2010). The data for Paris in the late 19th century also shows Rothschilds were the market leader there.

this system was its cyclical behavior. During booms, investors often got excited about new markets. Some were risky and prestigious bankers ignored them. The result was that their market share declined. However, when crisis eventually came as it always did, there was a flight to quality and the position of prestigious bankers was again reinforced.[13]

Prestige also enabled prestigious bankers to monitor borrowers carefully. Because they controlled the price of market access (not borrowing through them sent a bad signal and entailed substantial borrowing costs[14]), they could inflict penalties to disobedient borrowers. As a result, they were in a position not only to signal good borrowers but to control them as well. A suggestive case study in Flandreau and Flores (2011) is that of 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 Rothschild's record. Instead, Rothschilds managed to implement a debt restructuring that increased the ex post performance for investors. In other words, this was the reverse of the modern "haircuts": misbehaving borrowers, not innocent lenders (they had trusted Rothschilds and deserve respect), would get trimmed. This shows that on top of signalling and monitoring, prestigious banks – to protect their good name – also acted as crisis manager. This may suggest a comparison with the IMF except that prestigious bankers' loans, instead of coming at IMF's concession rates, came with a penalty.

These facts help explain why the 19th century regime could operate with minimal political interference, vindicating Platt (1968). This was not that this regime wasn't subservient to political ends. The name of the game was the protection of savings and of the London market – a highly political end. But the way it was done was to place a large burden on "market" mechanisms. The monopoly power of prestige, which incidentally was tightly linked to the wealth and prestige of British gentry, was an able substitute for more messy political intervention and the accompanying complications associated with international responsibility. Likewise, despite repeated claims to the contrary in recent research, British trade policy was not involved in the process of exacting policy actions from defaulters. As far as it was concerned, the London capital market did not try to interfere with the *laissez-faire* stance that prevailed in British policy making, on account of the fact, as The Economist reminded it, that "if your baker owed you £5, would you refuse to buy his bread (the best and cheapest bread in town)?".[15] Non interference with Britain's liberal stance was thus the natural appendix of a market based system of global financial governance.

b) *New York as Transplant (1900-1931)*

These procedures were initially developed in London and remained in operation as long as London dominated the market for international securities. However, following the outbreak of World War I, a number of events took place that led to the displacement to New York of the bulk of foreign government debt underwriting. Figure 2, which presents data on foreign issues in London and New York during the post-war boom period, underlines that there was a genuine revolution: the US market crushed its British counterpart.

This rise of New York deserves an explanation. My emphasis on persistence suggests that a shifts in leadership are not obvious. Before WWI, London-based institutions, with their continental and foreign outfits and correspondents, managed successfully to protect the incumbency of the City. Why should New York have been any more successful than Paris or Berlin had been in the past in causing the relative decline of London as a leading center for foreign government debt?

Conventional accounts point to the rise of the US as a creditor country (Dickens 1933, Lewis 1938, Stallings 1984). Around 1900, the US moved from being a debtor to being a creditor nation. This would have enabled New York based intermediaries to capture the underwriting of securities which formerly belonged to London institutions. Another enabling factor would have been the decision by the US administration, at the end of World War I, to delegate the monitoring of international financial

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[13] . See Flandreau and Flores (2011).

[14] . Flandreau and Flores (2010) estimate this cost to be about 300 basis points at least.

[15] . *The Economist*, November 20, 1909, Quoted in Flores (2009) who emphasizes the commitment of financiers to free trade with debtors.

policy to international bankers.[16] In 1921, an agreement was adopted between bankers and President Harding, whereby bankers would manage the export of capital but would check out with the Administration whether individual loans did not conflict with policy agenda.[17]

Yet none of these factors can in itself provide a sufficient reason for the changeover in Figure 2. The availability of large resources willing to be employed abroad and the lifting of political opposition to this (or even the encouragement) cannot explain why New York could displace London. A concise interpretation of the reasons for the transfer can be built upon the model articulated above. The persistence I have emphasized was not a geographical persistence in a strict sense. Because of information asymmetries, prestige earned revenue. And because it earned revenue, some agents had invested it. The result was a persistence in the reputation of certain "global brands" in international finance. These were more or less closely tied to given markets, but because of global impact and reputation, a measure of geographical plasticity was available to them. Prestigious brand names (such as Rothschilds) were recognized all over the world and thus transcended political boundaries. Not only did this permit certain markets to exist, but it also endowed them with a global reach. In other words, certification was proprietary and its international nature was an instrument of global financial integration. With certification being owned by globally recognized prestigious underwriters, what mattered, for the geography of reputation provision was supply factors rather than demand ones. In other words the important element was the identity of the banks providing certification (supply side) not where savings were being located (demand side), explaining why we should be sceptical that the rise of the US as a creditor country or the US Administration's support could ever be a sufficient condition for the core of the market to migrate to New York. These could not by themselves transform the routes of finance.

This way of reasoning urges us to look for two different factors explaining the rise of New York. First, we should expect to observe something happening in London, that would have stumbled in the way of the normal operation of certification and distribution. Only a violent transformation could have created the necessary pressure for designing new ways of doing business. Second, filling the void thus created, we should expect to witness the transfer of London competence to New York or the emergence of New York-based international financial brands that would have found a way to co-opt the existing regime of certification. Similar events had happened in the past, when the storming of Amsterdam by French troops and the introduction of the continental blockade led to the transfer of the Dutch House of Hope foreign debt expertise to London, through its merger in 1806 with London-based House of Barings.

The shock that caused the system to shift was World War I. As a result of the drain created on British resources and balance of payments, London issues were, during the conflict, first suspended, then, once peace was restored, subjected to a tight regime of control where they would be recurrently subjected to Bank of England's approval (Moggridge 1972).[18] This occurred each time there were concerns about sterling or the balance of payments, which turned out to be quite often. Table 1 reproduces information from Atkin's dissertation (Atkin, 1968) describing the succession of regimes for foreign issues during the relevant period (1918 to 1931).[19] An interesting feature of the Table is seasonality: foreign borrowers frequently found the London market closed during the fall, when international money was tight. This defeated the whole purpose of smoothing domestic expenditure

16 . Cooperation between international bankers and the US Administration has been extensively discussed by both contemporary observers (Lamont 1920; Dulles 1926; Edwards 1928) and in later work (Lewis 1939, Parrini 1965, Abraham 1976, Stallings 1984, Adamson 2002). It was also scrutinized during debates in the Senate Committee hearings of 1931-32 and was associated with bankers support to Republican presidents.

17 . This memorandum attracted much discussion. See Dulles (1926), Edwards (1928). During the 1930s it became a bone of contention (see Senate Committee Hearings of 1931-2; Roosevelt's Columbus, Ohio, campaign address which stated that that he would never permit international bankers to sell foreign government loans on the "implied understanding that these securities have been passed on or approved by the State Department". For archival evidence, see TWL papers 94-18, Letter between TWL and the Hon. Charles E. Hughes, March 31, 1922. This agreement is also discussed in numerous secondary sources, most recently by Adamson (2002), p. 483-487.

18 . In the past, similar monitoring had been adopted for colonies, but it remained soft and limited (Sayers 1976).

19 . After 1931, following the sterling crisis and the debate sparked by the Macmillan Committee, controls on capital exports became the norm.

through foreign borrowing and must have dramatically reduced the attractiveness of London.[20] As a result the global market was open for an adjustment in the certification regime to substitute for London's retreating commitment to international finance. In the context of the 1920s, when London's main former competitors (Paris and Berlin) were struggling in the middle of similar or worse problems, this opened an opportunity to the US and the New York bankers, provided they could provide some credible alternative to the existing certification regime.

Fortunately from New York's point of view, it did have the relevant infrastructures. Insulated from Europe by geography and regulations, New York had developed its own brands and home grown certifiers (Carosso 1970b, Chernow 1990). The New York "prestigious bank" par excellence was the House of Morgan, surrounded by a handful of other private houses such as Kuhn and Loeb, or universal banks such as the National City Bank and Guaranty Trust (commercial banks were banned from underwriting securities, but they could enter investment banking through the agency of so-called "Security Affiliates" which they owned and managed; Peach 1941). Before World War I, Morgans and their allies in what came to be vilified as the "Money Trust" accumulated considerable prestige in underwriting of corporate securities and railways. This arose, according to business and financial historians, precisely out of the relative backwardness and enormous asymmetries of information which the New York market had to handle when distributing the new securities (DeLong 1991, Hannah 2007). Obviously, such market imperfections were not unlike the ones that had led to the emergence of global financial certifiers in Europe almost a century earlier.

A natural candidate for providing certification services to an expanding New York market, therefore, was the high prestige structure of the Money Trust: indeed, before World War I, the few prizes (about 10) that New York managed to win (often in cooperation with other centers) in the foreign government debt market, were captured by Morgan and its "Money Trust" allies (logically, this happened where US investors had location or informational advantages: Asia, Central America).[21] But the very fact that Morgans were concerned with prestige placed a Malthusian brake on the expansion of the New York market for foreign debt: actual underwriting had to be limited to the top of the crop, and foreign debt underwriting remained homeopathic way, until WWI.

In any case, the important element is that the House of Morgan emerged as some kind of US styled Rothschilds and was the natural vehicle through which a transplant could occur. The testing of the waters before WWI had provided a lead. This was fostered by the fact that, out of political and other resistance, European brands never managed to develop powerful outfits in the US system.[22] Conversely, Morgans did have a London branch. JS Morgan & Co had been initially an underdog in the London market for foreign government debt, but its association with *the* leading New York investment bank gradually bridged the prestige gap. Investors understood that JS Morgan & Co inherited the prestige of a market leader in New York and this was raising the global certification power of the Morgan brand. Come a time when established London certifiers would be hampered in their market operation, Morgans would offer a ready alternative. And this even more so, because as business and political historians have described it, Morgans were always concerned with avoiding a confrontation with the London establishment and banking apparel, which they instead sought to "Americanize" (Parrini 1969). This meant that overly violent competition was initially avoided and that deals negotiated in New York could lead to redistribution in London, with fees for cooperating institutions, greasing the process.

In summary, an industrial organization perspective on the business of foreign debt certification suggests that it exhibited both a considerable degree of loyalty to incumbent locations, but also an ability to move when circumstances changed. This character permitted prestigious institutions to hedge against government intervention and helped them survive geo-political vicissitudes.[23] It also

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[20] . The result was a focus on the British Empire, which received a more favourable treatment. This policy would be even amplified during the 1930s.

[21] . Carosso and Sylla (1991); Flandreau, Gaillard and Panizza (2009).

[22] . Rothschilds never managed to fully integrate their New York correspondent, Belmont (Gille 1967).

[23] . An early illustration of this is provided by anecdotal evidence about the merger of the House of Hope with the House of Baring in 1806 (Buist 1983). Riley (1984) argues that before the French wars, the Amsterdam market for foreign government debt appears to have developed along lines similar to what happened later in London: it rested on prudent merchant banks with large capital stocks. After the storming of Amsterdam by the entry of French troops and the Continental Blockade jeopardized Amsterdam as a banking center, London

opened the possibility of change. If anything stumbled on the way of London normal operations, global brands would and probably could reinvent themselves. In the case of the transition that occurred between London and New York, the process turned out to be smooth. As a result of new macroeconomic conditions, British underwriters were hampered in their usual ways. The void this created sucked in a new global brand that was already established in the US market – Morgan and the "Money Trust" infrastructure. The process was in practice cooperative explaining why prestige, despite it being proprietary and London based, was eventually transferred to New York: the key aspects of the certification regime that had matured in London would now be observed there.

c) Reputation in the New York market for Foreign Government Debt

I have so far developed the argument that bankers in New York had reasons to follow their London predecessors lead and make the right picks. Given the importance of this statement for this article's general argument, hard evidence is necessary. This is even more so because recent research has disputed DeLong's contention that JP Morgan's pre-1914 screening of corporations was efficient (Hannah 2007).[24] It is therefore necessary to bring in material supporting the view that prestigious bankers involved in foreign government finance cared about what they did.[25]

The first bit of evidence that has been abundantly discussed earlier is declarations to that effect by the bankers themselves. A rich repository is provided by the Senate Committee on Finance Hearings on the sale of foreign government bonds (1931-32). For instance, asked whether they had engaged in strong-arm salesmanship forcing down securities on ignorant investors, 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, exorcizing undue 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"[26]. In another place during the interview, he also declared that accusations of conflicts of interest had more to do with myth than reality: "As to the matter of high powered salesmanship to which you have referred, that is a practice which has been exaggerated and overdone."[27] In fact, Kahn argued, bankers never really faced serious conflicts of interest, because it was the logic : I think that 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."[28] The implication was that it was essential to deserve a reputation for integrity, or face substantial losses. In this declaration, Kahn may have been reminded of the house wisdom as articulated earlier by Jacob H. Schiff, former principal of Kuhn, 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".[29] The practical implication, Kahn asserted was that sound bankers cared to bring to the market only loans which could sustain economic development, for only this would increase the likelihood of future repayments. Accusations of conflicts of interest were missing the point: bankers were concerned with bringing to the market high quality products. As proof, he insisted Kuhn & Loeb declined military loans.[30] He and

became a safe haven. The merger of Hope with a London leader, the House of Barings followed immediately on the steps of Napoleon's Berlin decree introducing the Continental Blockade.

24 . An early statement of this view is Brandeis (1914); See Frydman and Hilt (2010) for a recent discussion.

25 . There is one strong a priori reason to believe that foreign governments debt is an area this is an area where prestige did add value. Sovereign finance lacks the sort of legal protection which is normally available to holders of corporate securities, meaning that enforcement problems and information asymmetries are bigger. As a result, it is reasonable to predict that successful signalling and control must have been even more critical for New York operators of the interwar market for foreign government debt, just as it had been for their pre-War London predecessors.

26 . U.S. Congress, Senate Committee on Finance, p. 394.

27 . U.S. Congress, Senate Committee on Finance, p. 342.

28 . U.S. Congress Senate Committee on Finance, p. 353.

29 . Quoted in Birmingham (1967), p. 181.

30 . U.S. Congress, Senate Committee on Finance, p. 357.

emphasized that rash competition was to be avoided by serious houses: "It is a strict tradition of my house not so to compete either in South America or elsewhere", he claimed.[31]

The argument of course, may have been self-serving, although it is also consistent with assessments by external observers who recognized the value of certification by prestigious houses. For instance, writing about the determinants of ratings in general, Harold (1938, p. 67-8) emphasizes that the identity of the underwriter influenced ratings: Securities underwritten by prestigious banks would receive a higher grade other things being equal.[32] Moreover, existing work concerned with the validity of arguments about bankers' conflicts of interest have generally sided with the bankers. Benston (1990) reviews cases of alleged bankers' misconduct that attracted public scrutiny during either the Senate Committee on Finance Hearings on the Sale of Foreign Bonds or the subsequent "Pecora" hearings and finds the evidence wanting, limited or unpersuasive. Huertas and Silverman (1986) take a look at the quality of the portfolio underwritten by the National City Company (the National City Bank security affiliate, whose behavior attracted much criticism) and find no convincing evidence of wrongdoing.

A similar feeling emerges when one focuses on the behavior of the House of Morgan from both archival and secondary sources. The evidence in Chernow (1990) reveals no contradiction between actual behavior and the public statements by partner Thomas W. Lamont. For instance, he declared before the Senate Committee on Finance that "on the whole, American banking houses are very careful to secure complete and adequate information in any instance that you might have in mind"[33] and indeed, worked hard at collecting the proper information for the loans JP Morgan put out. Adamson (2006) also underscores the consistency between archival material and public statements. Refusal to act as intermediary for loans that were considered as dubious was a matter of pride and Lamont insisted that they did "never issue a bond unless [they did] believe it to be good".[34]

Adamson (2006) also report evidence that is consistent with the characterization of prestigious bankers' conditionality lending that prevailed in London under the old regime. Focusing on the experience of Brazil, Flandreau and Flores (2011) argue that prestigious banks tried to use monopoly power in order to exact adjustments that protected the interests of bondholders (increased the likelihood of repayment). Those who misbehaved were punished through the higher costs entailed by borrowing through a less prestigious intermediary. JP Morgan's experience with Mexico is consistent with this. According to Adamson, "as the one government [in Latin America] that had defaulted on its external debt in recent memory, Mexico stood apart as a risk which Lamont was keen to have investors avoid".[35] Risky loans being defined in terms of fiscal position (the extent of the deficit and the quality of borrowing), Morgans, like London predecessors, worked to link fiscal performance (the restoration of credit) and foreign loans. In the case of Mexico, Morgans took the lead of an ad hoc committee (the International Committee of Bankers on Mexico or ICBM) that sought to guide Mexico towards restoration of its credit.

My own foray in Thomas W. Lamont's papers is consistent with this notion of Morgans using their market power to seek a raising of standards. The important point was not that they would always succeed: rather, it is that they had an incentive to try and that they were prepared to walk away if things did not go as planned. A revealing document on this account is a memorandum by Thomas W. Lamont to the Secretary of Commerce Robert P. Lamont where he discusses the experience of the South American Group formed under Morgan auspices between the more prestigious banks. According to the document, Latin American governments consistently eschewed the more painful adjustments: "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 favourable 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

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

[32] . "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". He also states that *Fitch Bond Book*, 1931, "second unnumbered page following Foreword" contains statements to this effect.

[33] . US. Congress , Senate Committee on Finance, p. 48.

[34] . Adamson (2006), p. 204.

[35] . Adamson (2006), p. 205.

became so hopeless that we disbanded the Group".[36] The result, as Adamson (2006) has already noted, was JP Morgan's a strong anti-Latin American loans bias which shows up in its under-representation in this part of the world. This is additional evidence that more prestigious bankers meant what they did.

Flandreau, Gaillard and Panizza (2009) capture this using the techniques of panel econometrics. Studying the record of sovereign and sub-sovereign foreign government issues, they compute market shares for principal foreign government debt underwriters during the 1920s. They find that four leading firms controlled together 56% of the market for foreign government securities issued between 1920 and 1929.[37] They were JP Morgan (31%), the National City Company (security affiliate of National City Bank, for 13%), Kuhn & Loeb and finally the Guaranty Trust Company (each 6%). They also find a large and significant negative correlation between prestige (i.e. market shares) and default rates. They find that a 1 percentage point increase in prestige was associated with almost a 2 percentage-point reduction in the probability of default.[38] This occurs even once they control for "visible" default risk, captured by ratings. Table 2 summarizes the evidence and shows the relation with capital stocks (circa 1929) which are also negatively correlated with default (consistently with the pattern identified by Flores and Flandreau (2009) for the London market in the early 19th century). In Table 2, the House of Morgan stands out as the most capitalized one, the one with by far the largest market share and the one with the lowest number of casualties (a ratio that was about four times less than the average one for non prestigious house). We also see that the three other top houses did outperform the rest of the market in terms of default.[39]

d) Reliable Bankers: New Evidence

There are two directions in which the previous evidence can be refined. First it is possible to improve on the simple dichotomy between defaulting and non-defaulting bonds and consider actual rates of returns. Second, since the issue at stake is whether prestigious bankers were reliable, it is interesting to sort out performance according to underwriters. I am not aware of any previous paper that has considered this important aspect of the interwar record. The method builds on previous work for the 19th century (Flandreau and Flores (2011). It rests on comparing initial yield to maturity (which measures the initial payment promise) with actual (ex post) returns. If, for a given underwriter, the two match one another, then the underwriter may be deemed reliable – her deals perform. Therefore, the deals of reliable bankers are found along the diagonal 45° line where ex ante promises equal ex post returns. By contrast, less reliable bankers have ex post returns that fall short of promised yields.

The data used focuses on sovereign bonds. The performance is taken from Eichengreen and Werley (1988) who report so-called "Internal Rates of Return" (or IRR).[40] The numbers were then matched with yields-at-issue and lead underwriters. These were taken from Moody's and a variety of other sources (see Flandreau, Gaillard and Panizza (2009) for details). To study alternative banks' record, different banks are identified. To ensure legibility a selection was made: The graph identifies the best from the rest, namely "JP Morgan", "City", "Kuhn and Loeb", "Guaranty" (the best) and "others" (the rest). The outcome is shown in Figure 3 where expected (ex ante) returns (YTM) are on the x-axis while realized (ex post) returns (IRR) are on the y-axis. The diagonal line, or "reliability line", plots where expected and realized returns equal each other. Observations close to the reliability line are

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36 . TWL Papers, 102-20.

37 . The results from Flandreau, Gaillard and Panizza (2009) are based on the complete population of sovereign and sub-sovereign securities, excluding Canada. Flandreau, Flores, Gaillard and Nieto-Parra (2010) focus on sovereign debt only. This explains the mild discrepancies between the two sets of findings.

38 . Effect evaluated at the mean of the explanatory variables (Flandreau, Gaillard and Panizza, 2009, Sect. IV).

39 . Computations based on the entire life of the bonds; Results would be strengthened by exclusion of war-time defaults.

40 . The IRR in Eichengreen and Werley is the constant compounded rate of return that equalizes chained actual annual variations in coupons and prices throughout the bond's life. They provide returns on 42 sovereign and 73 sub-sovereign bonds. Our population has sovereign 39 deals. The three missing deals are Canada (which underwriters did not consider as "foreign" and is excluded from the dataset in Flandreau, Gaillard, Panizza (2009) and one French deal "French National Mail Steamship", which we were unable to pin down. Note that Eichengreen and Portes (1989b, p. 14) mention relying on a sample of "over 200 dollar bonds". Data for this larger sample, however, is no longer available. I am grateful to Barry Eichengreen discussing this with me.

"reliable deals".[41] Observations significantly below the reliability line mean that expectations were not met: this is the "disappointment area" (circled).

The chart underscores Eichengreen and Portes (1986, 1989a and 1989b) that returns were not as disastrous as previously believed. The novel result is the marked difference between prestigious and ordinary houses. All but 3 of the 22 deals made by the four more prestigious houses are found near the reliability line. Not a single Morgan or Morgan-controlled Guaranty Trust deal is found away from the reliability line.[42] Two of the problem deals were National City Bank (explaining the focus on this bank) but this represents a fraction only of the securities it had underwritten. By contrast, 9 out of the 17 deals by "ordinary" houses are found in the disappointment area (in rough terms, about half of these deals collapsed). This is indicative that behavioural hazard was limited to ordinary underwriters. Even for these, as Eichengreen and Portes might argue, the results were not so disastrous. We may also point out that they were way less disastrous than observed by Flandreau and Flores (2011) for ordinary deals in the 1870s debt crisis. This is consistent with the finding in Flandreau, Gaillard and Packer (2011) that ratings at issue for bonds defaulted during the interwar debt crisis were fairly decent.

While there are limitations to this exercise the results are strongly suggestive of prestigious banks' watching out rather than succumbing to temptations or conflicts of interest. Significantly, the limited number of problems that occurred and the fact that by and large they did not involve Morgans was also a recurrent theme among Morgan insiders: Errors had been the making of others and there was no point introducing regulation that would punish those with the proper track record. Instead, it was expected that politicians should only provide an environment that would help market participants to work problems out. This is what partner Thomas W. Lamont sought to convey to Franklin D. Roosevelt in a March 27, 1933 *Memorandum*, which emphasized 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".[43]

I conclude that the more reputable New York bankers had done their best to acclimatize business traditions that prevailed to the London market. They had watched out and they had made good picks, and they certainly intended to support their customers. When trouble came, they were naturally led to expect regulation to tackle the malfunctioning part of the system, which they identified with lesser banks who had taken advantage, they felt, of the financial exuberance of the late 1920s. Lamont's Memorandum to the Secretary of Commerce about Latin America precisely raised this question of competition at the bottom. The crisis, as catharsis, was an opportunity to relearn old lessons and shine Morgan's shield. And yet as I proceed to show, the regulatory overhaul that was about to be implemented when Lamont filed his complaint with the new President about the wrong impression of "questionable practices", was about to strike a lethal blow, not the lesser ones, but the New York's financial aristocracy's ability to conduct business as it had.

Section II: The Rock and the Hard Place: New Deal Financial Acts and Underwriting

New Deal Financial Acts followed from a multi-pronged regulatory program that had two main, complementary dimensions. They sought to reorganize security underwriting and they sought to police their distribution (Carosso 1970a, 1970b).[44] In a long list of changes, three Acts (discussed from the spring of 1933 and going into effect in the summer of 1934) were epoch making: the Banking Act (or Glass-Steagall, which divorced commercial and investment banking,) the amended Securities Act (which increased underwriter's liability), and finally the Securities Exchange Act (which created high standards of disclosure and forced to reveal information surrounding security issues). These Acts involved many features. They were followed by a long series of other pieces of meaningful legislation.

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41 . Because YTM is computed from the crude coupon-price formula and for other minor technical reasons too, discrepancies from the 45° line may be observed—but the point is that these must be small when no default.

42 . This may be an effect of how the sample was constructed and would have to be checked with more data. However, given that the sample was constructed by Eichengreen and Werley, there is no moral hazard on my part involved.

43 . TWL 127-31. Memorandum to FDR, March 27, 1933.

44 . For a list of major New Deal security laws see Carosso (1970a, p. 433, n. 22).

Rather than engaging in a hopeless attempt at being exhaustive, I provide in what follows a selective discussion of aspects of the 1933-34 financial Acts focusing on how they interfered with foreign debt certification as I have described it.

a- Glass-Steagall and the Crowding Out of Reputable Capital

Glass-Steagall is conventionally portrayed as 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, although as we shall see, there were other aspects to it. As such, the Act did not sap the basic foundations of the business of underwriting as it had existed so far, and did not mean any business change for investment banks such as JP Morgan or Kuhn and Loeb. The situation was thornier for the security affiliates of commercial banks. They faced the following dilemma: A spin-off would create a bank operating under the same "name", yet on which the bank would no longer have control. On the other hand, a change of name would destroy reputational capital. The case of National City Bank offers valuable qualitative evidence. Cleveland and Huertas (1985) review claims made by chairman Perkins (who succeeded to Charles E. Mitchell after he resigned) that selling off the security affiliate (the National City Company) would be delicate: it amounted to selling the affiliate's "goodwill" (embedded in National City Bank's name) without it having any credibility of its own since this was a name which the National City Bank would no longer control.[45] Should the spin-off misbehave after the split, this may even reverberate on the National City Bank's own reputation. On the other hand, if the name was removed – i.e. once stripped from prestige – then the security affiliate was not worth much. It was eventually decided to shut it down and retain the best employees in the National City Bank.[46] Thus, the immediate effect of the divorce of investment and commercial banking was to crowd out the reputable capital of the more reliable security affiliates.

Note, however, that this was good news for the investment banks, who would see their potential market share increased and whose leaders would not only retain their operations, but who would also need to increase their capital outlays to compensate for security affiliates' withdrawal, or absorb them. Such was the working hypothesis leading investment banks took as a starting point of their lobbying effort during the discussion of Glass-Steagall as evidence by abundant archival and published evidence to this effect (Carosso 1970a): Glass-Steagall was good for them, it could serve to raise their stakes. 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".[47] In a similar spirit, Carosso (1970b) has argued that JP Morgan initially sought to use regulation as a way to get rid of competitors: it appears that such was the initial blueprint of Glass-Steagall, and the main focus of Senator Glass.

But the New Deal had something for investment banks, too. This ran against their hope to emerge reinforced from the crowding out of security affiliates. Following the Bank Holiday, the initial spirit of an amicable divorce was replaced by something much more drastic. Public attention was focused on the problem of bank runs to which the Bank Holiday had been an emergency response. Some commercial banks, represented by Chase's Winthrop W. Aldrich, took advantage of this to argue that just like commercial banks should not underwrite, unregulated investment banks should not get into deposit taking. The press took notice of this and interpreted it as a challenge to Morgans.[48] Aldrich proved successful having this provision drafted into the final Glass-Steagall bill signed into law in June 1933. Evidence from a letter by Carter Glass to Leffingwell suggests that the provision, drafted

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45 . "Goodwill is a nebulous thing. In so far as it is attached to the name of the City Company it cannot be realized on, because the continued use of the name would identify the user with the Bank and cannot be permitted without control by the Bank, which is forbidden by law". Cleveland and Huertas (1985), p. 197-198.

46 . Quoted in Cleveland and Huertas (1985), p. 197-198.

47 . 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".

48 . TWL 80-13.

by Aldrich, was foisted on Senator Glass by Roosevelt.[49] Investment banks were now prevented from taking deposits or else be subjected to regulatory supervision.

Aside from abstract considerations on the theoretical desirability of such a measure, the decision was a direct challenge to certain prestigious investment banks and was understood as such by contemporary observers.[50] Investment banks such as JP Morgan were leading recipients of foreign government and corporate deposits. This business was a natural feature of the relationship banking arrangements that prevailed before. If unsupervised investment banks were authorized to keep receiving deposits, they would benefit from the exclusion of security affiliates: archival evidence from foreign central banks shows that leading commercial banks such as the National City Bank were the other large recipients of foreign deposits (Eichengreen and Flandreau 2009). If banned from security underwriting, the affiliates would likely lose these deposits to the benefit of Morgan and others. This would increase the flow of valuable current account information and would as a result boost the investment banks ability to monitor customers as suggested in traditional models of relationship banking (Black 1975, Fama 1985).

Thus, the addition to Glass-Steagall of provisions preventing investment banks from deposit taking deeply modified the way they were conducting 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 hand, giving away deposits would significantly weaken their balance-sheet. Fundamentally, the shedding of deposits weakened the relation between prestigious banks and their sovereign customers.[51] It raised questions about the viability of older ways and was likely to lead investment banks to reconsider their options. The implication from this must be that, rather than leading to a substitution of investment banks for security affiliates, Glass-Steagall should have led to complementary moves by both parts out of underwriting. This was indeed Morgans' view: In a brief to *New York Times* financial editor Alexander Dana Noyes, Lamont emphasized that the if put into effect, the divorce of investment and commercial banking that was 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 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".[52]

b- Liability and Transparency

The second group of reforms brought about by New Deal Financial Acts were incorporated in 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 bankers' malpractices that had emerged from Congressional hearings and public debates, in particular so-called 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 methods and practices without altering, over the long run, "investment bankers primary role of channelling savings into long-term investment".[53] While this is a correct characterization, it downplays the fact that the changes in practices and methods the new rules encouraged reflected a revolution. Indeed, the New Deal's transformations did not succeed to drive forever investment banking out of its former niches: a

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

[50] . *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".

[51] . 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.

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

[53] . Carosso (1970a).

bank called JP Morgan-Chase is today the leader in foreign government debt underwriting (Flandreau et al. 2010). But in view of the earlier discussion of the old regime of underwriting, the Securities Acts were not innocuous.

First, among the most considerable transformations brought about by the Securities Act were the new disclosure requirements. All issuers were now bound to reveal more. This weakened the advantage of prestigious houses which were no longer in a position to use their market power to acquire private information from issuers. The arrangement was reinforced 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, permitting brokers and investors to study the new issue, there again limiting the information wedge between serious and less serious banks. This weakening of the informational advantage of prestigious underwriters was furthered by a provision of the subsequent Securities Exchange Act that enforced transparency of price support operations. [54] 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 were now more vulnerable to adverse speculation.

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 underwriters. Civil liability had been repeatedly considered in the London market.[55] However, it had been felt that this would weaken market discipline: bad loans had to be costly, so that investors would learn the lesson.[56] The upshot is that, by increasing liability, New Deal Acts not only complicated the art of underwriting but amended a basic feature of the earlier set-up. The limited enforceability of contracts inherent in sovereign debt required that high-quality certification capital be pledged – and rewarded. It also required that a free-hand be given to prestigious banks. This being prevented, the natural outcome was to make prestige "more cautious". Either it would just walk out of the market and lead to a complete collapse of foreign debt or it would still be involved but in a much more reduced capacity (as a simple broker in charge of building the order book and then walking away once the deal completed). The prediction I make, therefore is that the new rules were disruptive over the short run and, over the long run they implied a reconstruction of the business of underwriting along completely different lines, characterized by reduced incentives to screen deals and support those who failed. That is, if and when foreign debt underwriting would to be reinvented, it would have to be on a much less committing and as a result more competitive basis than had existed in the past.

c- Regulation vs. Prestige

The last change brought about by New Deal's Financial Acts is not associated with any specific provision of these Acts, but with their "performative" power, or politics. The very promulgation of the Acts was a political statement that informal, prestige-based management had "failed". Public declarations that reform was needed were equivalent to saying that prestige was part of the problem: the New Deal and New Deal financial acts thus coincided with a transfer of symbolic power. It can be captured in shifts in the geography of decision making and how people interpreted them. Chernow 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[57]. The Hearst press emphasized this exclusion from decision making centers and interpreted it as a loss of prestige. Immediately following the Bank Holiday, *New York American*'s financial editor Julius Berens argued: "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

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[54] . This point is actually recognized by Carosso (1970a, 433) who notes that the Acts had the effect to make "[responsible investment houses] even more cautious". On London merchant banks support schemes see Flandreau and Flores (2009); (2011).

[55] . 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.

[56] . An example is provided by Nathaniel Meyer de Rothschild's testimony in House of Commons (1875).

[57] . Chernow (1990, p. 355).

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".[58] This of course was a form of self-congratulation: Hearst newspapers had long campaigned against "international bankers". Nevertheless, that such statements could be made in papers with an influence reflects that various constituencies were prepared to talk down the prestige of bankers. I think this process goes some way towards explaining why both contemporaries and later economists have repeatedly come under the impression that bankers had "failed" only to keep re-discovering they had not: The first scholarly papers that did endeavour to debunk some contemporary myths about intermediaries' failure came out at very early on (Moore 1934, followed by Edwards 1942). But there is something self-fulfilling about pieces of legislation: if Glass-Steagall did not address bankers' shortcomings, then what?

FDR's "money changers" theme (he wanted to "sweep them out of the temple") during the presidential campaign gave enormous political clout to this business of debasement. Symbolic 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. The Hearst press (which until 1934 supported Roosevelt) published accusations against international bankers who "as you all know from exposure and experience, are centred in 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.[59] 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".[60] And then of course there was Ferdinand Pecora, chief counsel of the U.S. Senate's Committee on Banking and Currency after January 1933, who used subpoena to "expose" Wall Street malpractice, again with the tacit support from the President Elect (Pecora 1936). The "Pecora hearings" claimed several symbolic prizes and can be considered as the climax in this process of wilting. In addition to the shaming and resignation of Charles E. Mitchell (which per se "proved" there had been wrongdoings), Pecora managed to produce Morgan balance sheets, 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 memoirs: *Wall Street Under Oath*.

One way to fully capture the significance of this process is to contrast it with what had happened under the old regime. Parliamentary commissions comparable to the Senate Committee Hearings of 1931-2 were not unheard of in the 19th century. The 1875 House of Commons Commission on Loans to Foreign States provides proof. Its concerns had been very similar to its later US counterpart: the high fees, the dishonest promotion of Latin American loans, the manipulation of market prices. The key difference however, was that the conversation was conducted by the elite, within elite media (such as *The Economist* or *The Times*) and for the benefit of the elite. As a result its bottom line was the re-discovery of sacred principles: It provided an opportunity for the "good" bankers to emphasize that in the surrounding panic their securities were faring decently well. Blame was laid upon the less reputable banks, and upon the investors who had purchased risky securities for the sake of higher returns. The opinion of the "regular Joe" was irrelevant when it came to reforming a system that was fully understood by insiders who happened to be those in charge of running Britain's market-based

58 . *New York American*, March 10, 1933. The semi-formal role Morgans played in various financial panics (such as 1907 or in the immediate aftermath of the 1929 stock market crash) is well-known. Likewise, Stratton (2011) claims that partner Lamont was behind Hoover moratorium in the Summer of 1931, although he insisted upon secrecy.

59 . TWL papers, 98-2. Statement by Randolph Hearst during a broadcast of the National Broadcast Company Network, December 2, 1933. Hearst Newspapers had a long tradition of lashing out against "international bankers". It had begun in the 1920s.

60 . 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.

gentlemanly imperialism. As a result, the reforms and amends suggested were a trifle in comparison to the sweeping changes of the 1930s.

To summarize, the very fact that banks' floatation and distribution of foreign government securities could be questioned was per se a judgment passed over their performance. This is consistent with Carosso (1970a) who argues that one of the goal of the New Deal Acts was "harassing [investment bankers] out of business".[61] I would add that, since the business rested on prestige harassment itself was a part of the crowding out. 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 Crowding Out of Private Capital

a) *The Flight of "High Quality" Capital*

The previous sections have derived a number a predictions regarding the effects of New Deal financial Acts. The first is their impact on high quality (i.e. prestigious) capital. One way to gauge this is to construct a series for the evolution of "reputable capital". The prediction is that one ought to observe a dramatic absolute decline in available prestigious capital.[62] In Figure 4, I have constructed a series for the capital stock of the "top four" foreign government debt certifiers which as seen earlier controlled close to 60% of the market and had a good record. This line is the relevant measure, because while a number of investment banks entered the underwriting game using qualified staff from divested structures such as the National City Corporation, they lacked a name and a record.

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. As a result the contraction in capital available to collateralize foreign loans was drastic: huge quantities of high quality capital evaporated (Figure 4). 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.

b) *The Rise of Modern Underwriting of Foreign Securities*

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 role as market maker and book builder – more like a broker between borrowers and the institutional investors.

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 aftermath. Therefore I use two suggestive ways to establish my proposition. First, I observe what happened in the corporate securities market at the time of the financial acts. 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. 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. Carosso's (1970a) description of the responses investment bankers adopted in this market thus provide insight and it turns out to be consistent with the predictions I made: he claims 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 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 fees, which were

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

[62] . Carosso (1970a), p. 432) makes a similar inference but does not examine it systematically.

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.[63] The efforts New Deal financial Acts made to make the issuing of stocks more transparent resulted in a change of ways, where it was no longer possible to "beat the gun": information on deals was no compulsory, and a mandatory wait period was introduced. The result was the rise of the pre-issue prospectus, known as "red herring", which all investors could study and which contained information that issuers had to surrender. This further deprived prestigious intermediaries of their former ability to crate value through signalling. The result, Carosso says, was increased competition,[64] consistently with what one would expect.

The other evidence that can be exploited is a comparison of the underwriting of foreign government securities as it had existed until the 1920s with its modern reinvention. During a long period that extended between 1931 and the late 1980s, the international market for foreign government bond was a sleeping beauty. It is not that there was nothing, but as several authors have previously noted, nothing of the kind that had prevailed until 1931. It seems therefore an adequate way to go to compare the pre-1931 system with the modern regime. Flandreau, Flores, Gaillard, and Nieto-Parra (2010) argue that there is a stark contrast between older ways of underwriting (up to the 1920s) and modern techniques observed today (1993-2007). They emphasize that, while the latter system 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 (and thus taking a direct exposure), the new system involves a much less comprehensive role of the "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. This is captured by the fact that, while "firm commitment" was the rule in the old system, so-called "best efforts" prevail today instead. Interviews with market participants, uncovered the central role of the "red herring" as the focal point of new issues. This importance of the circulation of information before the issue takes place is also what explains the central role of ratings now (they are provided before the issue) when they were much less important then (they were provided after the issue, and as already mentioned, were said to take a careful look at the identity of the underwriter). This is consistent with the notion that New Deal financial Acts ought to have reduced the role of investment bank to that of mere market makers. Another striking feature of the modern system is much greater competition. As reported in Flandreau, Flores, Gaillard and Nieto-Parra (2009), Herfindhal-Hirschman indicators of market concentration suggest that the market moved from being very concentrated (interwar) to being non concentrated (modern era).[65] This leaves little doubt that a radical market transformation has occurred and it points to the role of New Deal regulation in increasing competitions. Finally, all this fits into "default puzzle": Defaults used to be concentrated on securities issued by houses with smaller market shares while they are totally random nowadays. This is a straightforward consequence of the fact that the old regime when investment banks added value is no more.

The conclusion from this is that New Deal financial Acts (in particular the Securities and Securities Exchange Act) deeply modified ways to conduct business. The change was not merely technical. It is true that over the long run, investment banks remained the chief intermediaries of that market. But their modern contribution is much smaller and uncompromising, reflecting the deep rule changes of New Deal financial acts which forever destroyed the old ways.

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

63 . Carosso Carosso (1970a, p. 437) argues that leading brokerage firms such as Lehman bothers 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. They also sought to compensate the reduction in fees by increasing market activity.

64 . According to Carosso (1970a) it became usual for corporate issuers to be courted by several bankers at once.

65 . They find that the HH index for the modern period is below 1000 (842) when its interwar counterpart was close to 3000 (2869). An index value below 1000 is associated with an non-concentrated market. Values between 1000 and 1800 characterize a moderately concentrated market, and values above 1800 indicate that the market is highly concentrated.

The previous two sections have articulated and tested predictions on the effects of New Deal financial Acts for certification of foreign government debt. In this final section, I resume the historical narrative and show how the insights gleaned previously can shed light on the dynamics of the international financial system after 1933. A new system did not emerge immediately from the destruction of the old regime. Rather, a process of institutional tâtonnement occurred, and it is the general direction this process took which I am interested in explaining.

a) Dismantled Loyalties

As Adamson (2002, p. 487) emphasizes, the market for foreign government debt was quite dead even before New Deal Regulations. Thomas W. Lamont would have agreed who found things "terribly dead down here".[66] However, such lull in foreign lending was quite typical of previous foreign debt crisis. Taking again the London experience as a guide, we can identify the following pattern to have been characteristic of earlier boom bust. First, as the boom expanded, the more prestigious banks were losing market share. Then came the market crash and new loans were radically restricted.[67] However, after the crash, the market (now purged from the "excesses" committed by lesser banks,) had always reconstructed. Moroever, during the post-crash period, prestigious names were regaining relative market share and helping more serious borrowers maintain or restore market access. This was because, as Flandreau and Flores (2011) explain, crises shone the shield of prestigious underwriters, since their deals were found to perform better than those of others.

New York had followed the pattern until the late 1920s. As data suggests, JP Morgan had indeed gradually lost market share as the boom developed.[68] In the early 1930s, their self-restraint was in fact paying in the form of default rates that were lower than competitors. But Morgans were prevented from behaving in the usual "London" pattern by the political attack against bankers and then by New Deal regulations. Rather than being able to exploit the crisis as evidence against the lower banks and converting the crisis into a market signal ("I told you so") or in regulatory capture (regulate commercial banks), Morgans found their ability to act hampered by debasement of their high quality capital and in effect forced out of the foreign debt market.[69]

The destruction of older ways can be identified in many places and is evidenced by an adjustment of discourses and practices. One important implication of this evaporation of prestigious capital must have been a change in the strategic relation between lenders and borrowers. The old regime rested on capital and a long term horizon which created an ownership of prestige that acted as a way to discipline players. Destruction of the ownership ought to have affected outcome. I predict that the exit of collateral capital was bound to dismantle loyalties.

There is anecdotal evidence of contemporaries concern to that effect. For instance, Perkins (new Chairman of National City Bank) worried that the disbanding of the National City Company would create further reputational damage, because its balance sheet had been used to support the price of issues that had not gone well. The new regulation forced him to "get rid of the thing". But in doing so, they may cause further declines in the securities they had sponsored. He thus wanted "to 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 balancing act.[70]

An consequence of this is that adoption of Glass-Steagall signalled 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. There is no need for borrowers to have been very sophisticate to be able to understand this. In some cases they soon realized that there was nobody left to call (as in the case of the National City or JP Morgan). In other

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

[67] . The brutal interruption of lending is also observed in modern markets. It has been described by economist Guillermo Calvo as "sudden stop" (Calvo 1998); See Catao (2006), Flandreau, Flores, Gaillard and Nieto-Parra (2010) for historical counterpart.

[68] . This has been repeatedly emphasized: Mintz (1951); Adamson (2002, p. 483). Prestigious bankers complaints about "rash or excessive lending, as has been mentioned" earlier (Winkler 1933, Adamson, 2005, p. 598). Makes perfect sense in this perspective.

[69] . This stands in contrast to the joint front they had offered before the debt crisis. See "Hoover and Lamont would Limit Loans", New York Times, May 3, 1927.

[70] . Cleveland and Huertas (1985, p. 197).

cases, calls may have been returned, but it is doubtful that bankers could be encouraging (Kuhn and Loeb).

In other words, the New Deal was destroying relationship banking as an encouragement to pay back the debts. As a result, we should expect defaults of high quality debtors to increase after Glass-Steagall. To see whether this was the case, Figure 5, shows the number of monthly defaults, and identifies those on securities underwritten by the four prestigious banks. The chart also reports the Glass-Steagall window 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 Glass-Steagall window was followed by a major wave of defaults. More importantly, the number of post-Glass-Steagall defaults surpassed pre-Glass Steagall defaults for the two most prestigious houses which as we have seen did walk out of the market as a result of the Act.[71] There were 14 National City Company defaults after Glass-Steagall against 7 before. The only two pre-War Morgan defaults that occurred were also post-Glass-Steagall events. This is consistent with the notion that borrowers gave up any hope for sorting out their problems in an orderly way, as a result of the regime change.

There are obvious limitations with what one can infer from this chart, since it does not control for other factors that may have deteriorated borrowers prospects independently from the strategic behaviour considered here.[72] But it remains that Figure 5 is consistent with a disruptive role of Glass-Steagall. Glass-Steagall 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. As a result, some fundamental elements of their earlier policies came under scrutiny. When Lamont had been until Glass-Stegall a strong supporter of unconditional free-trade (which helped borrowers adjust) and as such a critique of Smoot-Hawley, he began later to advocate linking concessions on trade to debt settlements.[73] Of course, a snowballing effect arose with further defaults weakened the bankers' case and fortified their opponent's narrative. At the end of the day, the bankers' failure story was born.

b) Filling the Void: FBPC, Government, and the Making of the Post-War Order

But just like New Deal financial regulations crowded out old ways, they must have sucked in new ones. The reason is that the collapse of the earlier regime created a void that could not be perfectly filled by the bashing of bankers. If the political system denounced bankers as inept, then they had to take charge.[74] Having interfered with the "market mechanism", the Administration had created a responsibility for itself. This certainly helps explaining why, immediately after FDR's inauguration, in March 1933, *at the same time the Banking Act and separation of commercial and investment banking were intensely discussed*, Herbert Feis (who worked with the State Department and whom Adamson describes as the "chief architect of the FBPC") started exploring ways of redressing bondholders' interests.[75] The result would be that the Securities Act of 1933 stated that a corporation would be created "for the purpose of protecting, conserving and advancing the interests of the holders of foreign

[71] . This excludes WWII, when enemies of the US defaulted.

[72] . For one thing, post-Glass-Steagall defaults include many German defaults, which may have been favoured by Hitler's takeover in January 1933. That said, given that as emphasized by Schuker (1988), the extensive lending from which Germany benefited in the 1920s was permitted by the existing set-up, its profound alteration with the arrival of a new administration and policy heralded a new type of conditionality where bankers would be less influential and can, as a result be taken as a sufficient reason to default, which is essentially my claim here.

[73] . See e.g. Lamont's doctrine regarding foreign credit and the request by industrial interests to force debtors to purchase from the same market as the one from which they receive funding: "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", in TWL, 94-18, "Foreign Credit", letter to Hon. Charles E. Hughes, March 31, 1922. On Lamont's conversion, see Adamson (2005).

[74] . 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).

[75] . Adamson 2002, p. 487.

securities in default" and from whose board of directors underwriters and bankers were explicitly excluded.[76]

This meant that the dilemmas that had been with bankers (how to manage the liability created by dealing with foreign securities?) were now with the Administration. In other words, a government body to protect bondholders created government problems. This explains why Roosevelt, (as previous authors have noted), was concerned with incorporating the FBPC as a private body. The institutional solution minimized exposure to public criticism that might result from unsuccessful negotiations. The result was the mixed character of the FBPC, which have been abundantly commented upon by previous writers.[77] Another implication was that the new Adminstration could not be overly committed to make the FBPC a success: good performance of the FBPC would somehow restore the honour of international bankers, whereas the New Deal Securities Acts were all about subverting the existing order. Consistently with this, Adamson (2002, p. 492) 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'".

This may help revisit, clarify and qualify some existing views about the FBPC. Eichengreen and Portes (1992) argue that it emerged because of problems with the former set-up that was characterized by "*ad hoc*" negotiation and "because dealings with bondholders were absorbing so much [State Department] staff time".[78] But why were defaults consuming staff time? The reason must have been that, by attacking bankers, the Administration stated it was in charge and this directed public complaints towards itself. Comparison with the British experience help clarify this. In Britain, Prime Minister Canning had established in the early 19th century the principle that losses on foreign bonds were the investor's funeral. This policy was upheld throughout the entire century with the Foreign Office getting involved only when intervention created political value (Platt 1968). Throughout that period the Foreign Office had been able to direct complains to other bodies. Prestigious bankers took care of redress and bondholders committee such as the Corporation for Foreign Bondholders acted as a last resort lamentation bureau (Flandreau and Flores 2011).

In other words, the reason why policy makers had to get involved was that they had taken the problem from the hands of the bankers. Archival evidence show that, contrary to the view that there existed nothing else than *ad hoc* committees to defend bondholders, there did exist such centralized structure. In 1918, a "Foreign securities committee" was created within the Investment Bankers' Association in response to investors' inquiries about Russia.[79] It included the top brass of foreign debt underwriting and was chaired by people in Morgan's inner circle.[80] The committees that were in charge of the few problems that occurred, such as the International Committee of Bankers on Mexico emanated from it.[81]

From Morgan's vantage point, a key aspect of their willingness to sponsor and chair the creation of the Foreign Securities Committee was the attempt to diffuse the risk of the emergence of a representative body which they feared would weaken market discipline. Discussion with their London partners Morgan Grenfell underscored the risk that a US-styled CFB would really lower standards by competing against prestigious bank's reorganization proposals without having the amount of skin in the game that would encourage successful settlements. Morgan-Grenfell argued that apart from small countries such as Guatemala or Honduras whose securities had not been fathered by anybody reputable and for which the CFB had occasionally played a valuable role, the success of debt reconstruction hinged critically on a "certain amount of money" being put up, thus placing important

76 . As quoted in 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". The formal creation of the FBPC was announced by Roosevelt in October 1933.

77 . Eichengreen and Portes (1989a) and (1989b).

78 . Eichengreen and Portes (1989) p. 16. This is also suggested by primary sources discussed in Adamson, 2002, p. 487.

79 . 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.

80 . First Thomas Lamont and later Charles Sabin, President of the Guaranty Trust, TWL papers, 100-7 and 8.

81 . On the ICBM, see Adamson (2006).

underwriters at the center of the mechanism.[82] This interpretation might have been self-serving, but it is in line with the empirical evidence reported in Flandreau and Flores (2011) who find that CFB participation in restructuring was only significant when it occurred in partnership with prestigious banks.

Of course, given the limited number insolvencies that had affected the New York market until the crisis of the 1930s, this structure could not have much visibility.[83] But the previous analysis underscores the fact that the New York market was equipped with a technology with the implication that the significance of the FBPC must be revisited. Should trouble come, Morgans, the Guaranty, the National City, Kuhn and Loeb could be called to task and, if parallel with London experience is a guide, they would be central for any crisis management. But the mechanism was lodged with prestigious banks and that New Deal Acts were intended at grounding them as opposed to (say) increasing pressure on bankers to clean up the mess. This policy choice is what put the international financial system on an entirely new trajectory: other fixes would have to be invented.

The rest of the story has been aptly told elsewhere and my narrative only adds perspective. Previous writers have suggested that the FBPC encountered difficulties in reaching satisfactory settlements (Eichengreen and Portes 1988). One important aspect of its operation that my account underscores is that this banker-free organization lacked critical tools such as the carrot of market access. The London experience suggests that this may have played a role. It has also been suggested that as the Roosevelt administration and State Department became more powerful, they began replacing the FBPC by more direct, "imperial" policies, using trade policy as an instrument of coercion (Adamson 2002). 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, again for political reasons, these mechanisms would be multi-lateralized trhough their embedded-ness in new international institutions such as the IMF and the International Bank for Reconstruction and Development (World Bank). While this evolution is consistent with New Dealers' eagerness to support to "use public capital to promote overseas stabilization and development", they also constituted a necessary response and solution to the destruction of earlier processes.[84]

The long result of this evolution we already know: after the long sleep of the "first Bretton Woofs" era of capital controls, global finance was reinvented during the late 1980s and 1990s under new rules of the game. In today's regime, investment banks do the selling, rating agencies do the assessing and the IMF does the troubleshooting. This paper has argued that the deep foundations of this system, were laid during the 1930s and are really associated with New Deal financial Acts and their methodical attempt at destroying the old order.

Conclusion: The Transition from Personal to Impersonal Exchange

This paper has traced the effects of New Deal Financial Acts on the old regime of certification that had previously operated in London and was in a process of transplant to New York when the interwar debt crisis broke out. I have argued that the crisis gave an opportunity for regulatory action, and the resulting Acts succeeded in destroying this earlier regime profoundly reducing the power of Wall Street former financial elite. The effect of this changeover was a profound dislocation of the international financial system. The central theme is that Roosevelt through out the baby with the bath

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[82] . Morgan Grenfell to Morgans. TWL papers, 100-7: "The Council of Foreign Bondholders have taken up defence of bondholders of certain small countries, such as Guatemala, Honduras where no issuing house of any prominence had interests, but it has never achieved any particular success since in all reorganizations a certain amount of money must be put up and therefore a firm prominent or issuing house has always in the end had to conduct the operation. By terms of its constitution the Council of Foreign Bondholders should be able to command influence and banking support, but in practice it has never been able to do so and reorganization of any depth of important countries, such as Argentina, Mexico, Uruguay, etc. have always had to be conducted by some issuing house".

[83] . 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".

[84] . Adamson, (2002), p. 487-8.

water – when the water was not even so dirty. This underscores the historical significance of New Deal financial Acts as effecting a power transfer – from bankers to the US Administration.

To show this, I have discussed the industrial organization of international banking that emerged in 19th century London to deal with information asymmetries in foreign government debt and its direct transplant to the New York market in the interwar years. I then discussed some key implications of New Deal financial Acts. I articulated some predictions: First, Glass-Steagall crowded out reputational capital. Second, the Securities and Securities Exchange Act stripped prestige of its former ability to provide stabilizing features at the same time it discouraged it from taking responsibility. This was done by increasing underwriters liability, depriving prestigious banks from informational advantages (thus asymmetries across intermediaries) and generally increasing competition. The short term effect of this increase in competition was (perhaps ironically) a destruction of international lending – the reason being that nobody was in charge any more, and thus nobody was credible.

New and earlier empirical evidence provide support. Data from archive and printed documents shows that Glass-Steagall led to a massive collapse of the upper bound for the amount of prestigious capital available to collateralize foreign government debt between 1927 and 1939. Also, the Securities and Securities Exchange Acts reduced brought about a reduction of their monopoly power over the long run. This helps explain the emergence of the modern regime where foreign debt underwriters are more like competitive brokers who help "make the market" and have a limited amount of skin in the game.

Last, regarding transitional dynamics, I have argued that the massive wave of defaults that took place when it became clear that international bankers were losing their grip is consistent with the notion that the destruction of the older regime dismantled existing loyalties. In other words, my counterfactual story here is that, had the Glass-Steagall Act not been adopted, then financial globalization as it had been known in the past may have survived. By contrast, the adoption of New Deal Financial Acts put the international financial system on a new path. In particular, the Acts forced public authorities to step in to show they were doing something for bondholders, resulting in greater involvement of public capital. One result of this was the creation of US-government sponsored FBPC whose chronology is intimately enmeshed with that of Glass-Stegall's anti-international bankers' provisions.

New Deal and the New Dealers are at the center of this new narrative. The conclusion underscores the role of domestic politics in upsetting international regimes. Nonetheless, I caution readers against interpreting my work as laying the blame on "Roosevelt" or "the US" for the pain they would have "caused" to the global economy. On the other hand, I recognize that there is some kinship between my argument and Kindleberger's claim that one of the problems of the interwar was the US' refusal to act as the "benevolent hegemonic power" Britain had been in the past.[85]

One economic issue is the costs and benefit of the regime change. Empirical evidence in Flandreau et al. (2010) suggests that the crowing out of the international banker led to more, not less, risk taking in foreign government debt, measured by comparing rating at issue in the modern world with the interwar record.[86] This is a logical consequence of Roosevelt's dismissal of the international banker who was more likely (having skin in the game) to take a safety margin. Once the banker out and private informational rents weakened, the system was bound to evolve towards higher levels of risk taking. The conclusion, ironic as it may sound, is that the New Deal's self-professed concern with policing bankers eventually brought up, in the business of foreign debt underwriting a transition from old style Dickensian banker of the Tellson's type -- an old man carrying on business gravely and for an extensive period of time – with his modern ultra-competitive counterpart who comes straight from an Oliver Stone movie.

An interesting business history lesson has to do with transplants and the conditions that make them succeed or fail. The old European regime of certification that rested on hierarchy and scarcity conflicted with the American values of more democratic and open access. Concern about this had emerged in early Brandeisian critiques of the "Money Trust", which bankers had been able to fend off

[85] . Kindleberger (1973). The blaming of one country for the interwar crisis is tempting and popular. France is the usual suspect. See Johnson (1997) and more recently Irwin (2010).

[86] . A related result is Stigler (1964) rejection of the null that the Securities Acts of the 1934 did not raise the quality of new securities sold to the public.

for a time. This perspective suggests that the success of the industry in the 1920s owed a lot to the support it received from the Republican administration. The conventional emphasis on the role of subsequent Republican Administrations in promoting the New York market for foreign government debt is thus correct, to the extent that it is interpreted as a political economy argument about their support for a non-democratic arrangement. But this also shows the vulnerability of the specific transplant under study to political change. This interpretation that was put forward in Walter Lippman's syndicated column in May 1931 under the title "The Morgan Inquiry": "The only check upon [Morgans] has been the conscience of the form and its banking tradition. Now the possession of such a great power by private individuals who are not publicly accountable is in principle irreconciliable with any sound conception of a democratic state."[87] The 1930s failure in New York of a foreign debt business developed in London underscores the relevance of political and social embedded-ness of capital markets.

To conclude, 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 similar processes already documented by historians of national financial systems. For instance, there is an obvious analogy between Naomi Lamoreaux' inspiring analysis of the role of kinship in New England banking (Lamoreaux 1986) and the Rothschild-Morgan system of personalized screening of government credit. In both cases, personalized links substituted for incomplete information and acted as crutches for the market mechanism. The main lesson from this paper it is that there is nothing smooth or natural or easy with the way the transition to impersonal exchange occurs. As Stigler (1971) notes, serious regulatory changes operate a transfer of property rights. They are, as a result, inevitably disruptive. The short term effect of New Deal financial Acts was a dramatic disruption of well-tried international financial roads and a global dislocation that was without precedent.

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Table 1. The Overseas Loan Embargo in London: A Chronology (1918-1931).

Period	Controlling Agent	Extent
1918-Nov 1919	Capital Issues Committee	Most Overseas Issues
1920	Bank of England	Overseas government issues and foreign cy loans
1921-Feb 1924	Bank of England	Short and medium term foreign government and cy loans
Feb 1924-Nov 1924	None	Free
Nov 1924-June 1925	Bank of England	Foreign government loans
June 1925-Nov 1925	Bank of England	Colonial and foreign government loans
Nov 1925-Mid 1929	None	Free
Mid 1929-May 1930	Bank of England	Foreign government and foreign company loans
May 1930-Sep 1930	None	Free
Sep 1930-1931	Bank of England	Foreign loans extending to most issues in 1931

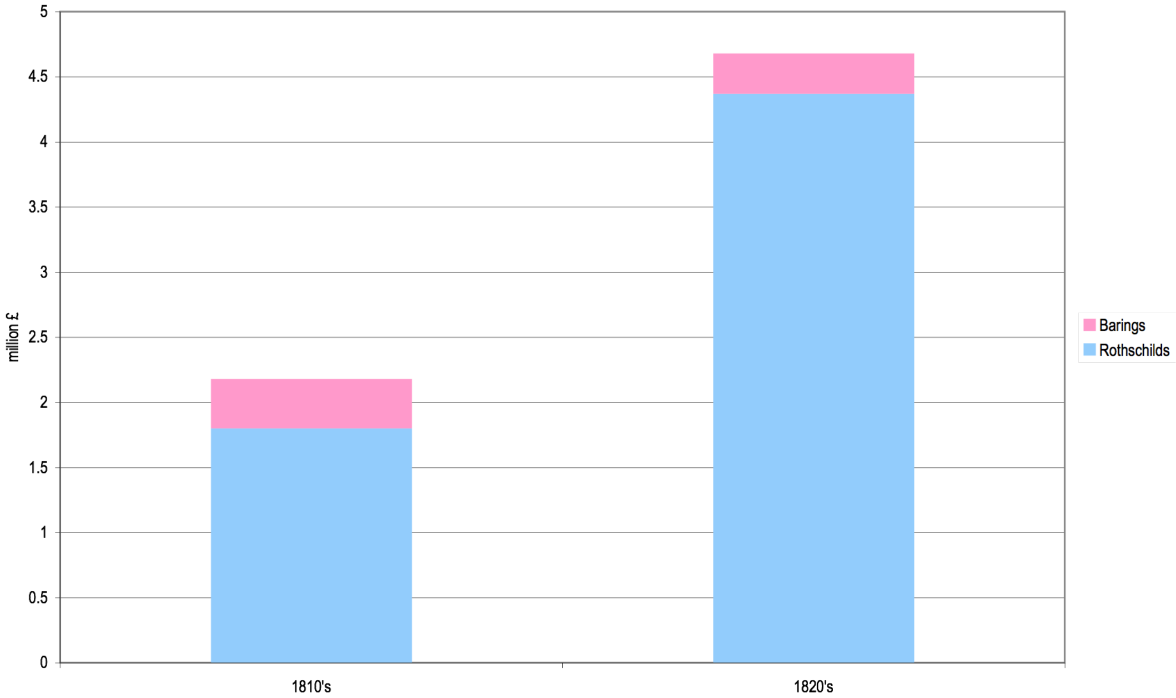
Source: Atkin, 1968, p. 28.

Table 2. Market shares, Default Rates, and Capital Stock of New York Underwriters

	Market Share (a)	Performance: (Own Default Rate)/(Others' Default Rate) (b)	Average Capital Stock Mo USD (c)
JP Morgan	31%	0.26	94
City Company	13%	0.74	22.5
Kuhn, Loeb	6%	0.57	21.5
Guaranty Company	6%	0.54	[10] (d)
Others (average)	1%	1	n.a.

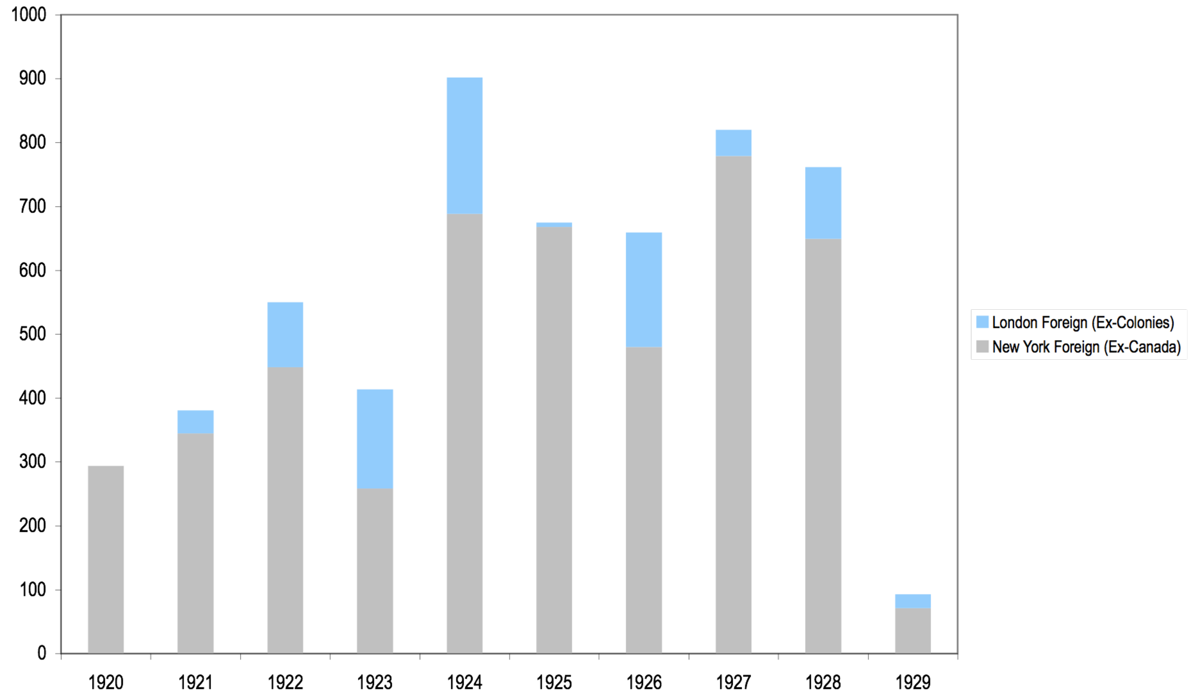
Source: Author's computation from database in Flandreau, Gaillard and Panizza (2009). Capital Data as in Figure 4.
Notes: (a) Number of bonds, period 1920-1929; (b): Based on number of defaults occurring before the end of WWII. Excluding post 1934 defaults substantially increases performance for top four. (c): Based on data for 1927-1929. (d) Estimate based on data for 1933.

Figure 1. Capital in Two Leading Merchant Banks



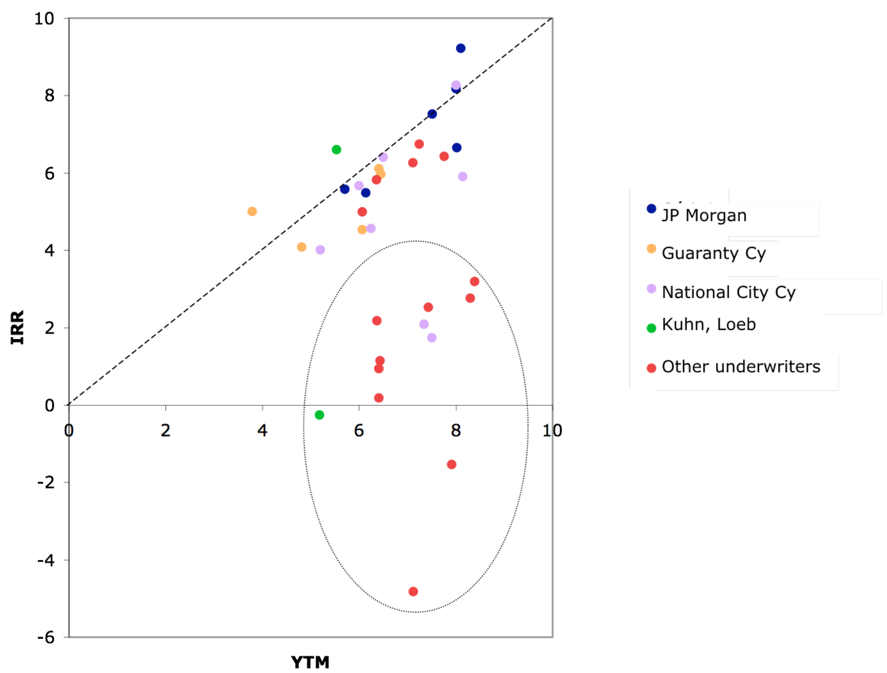
Source: Flandreau and Flores (2009, p. 664).

Figure 2. Foreign Issues in London and New York.



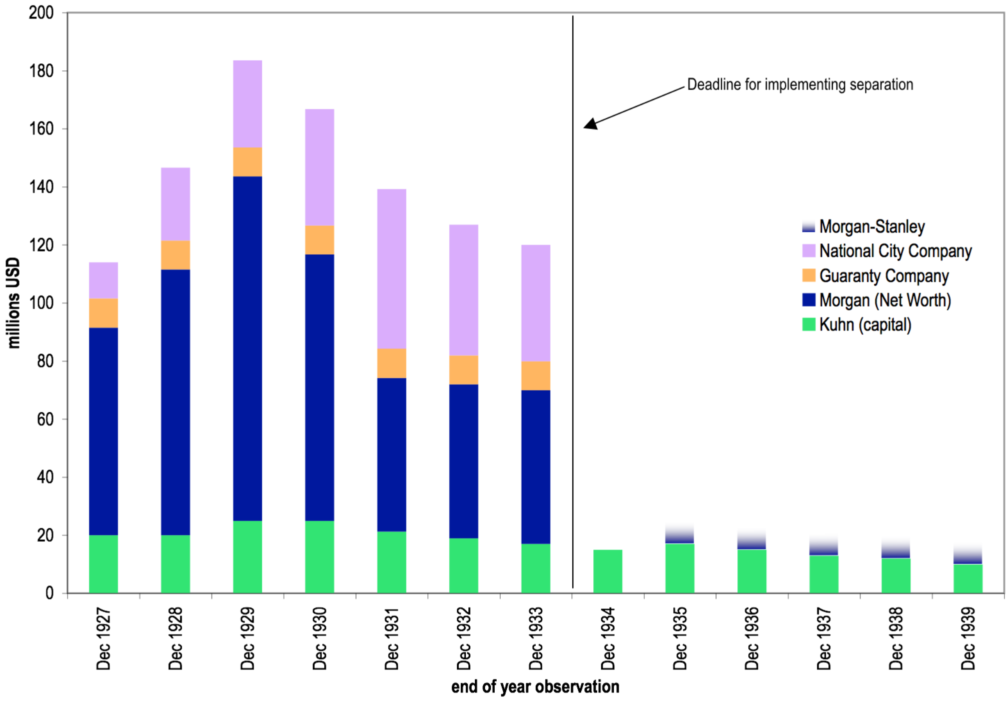
Source: Author, from computations in Young (1930) (for multiple issues, I record amounts issued in the US and amounts issued in the UK).

Figure 3. Delivering Value: Deals, Underwriters and Performance in the New York Market



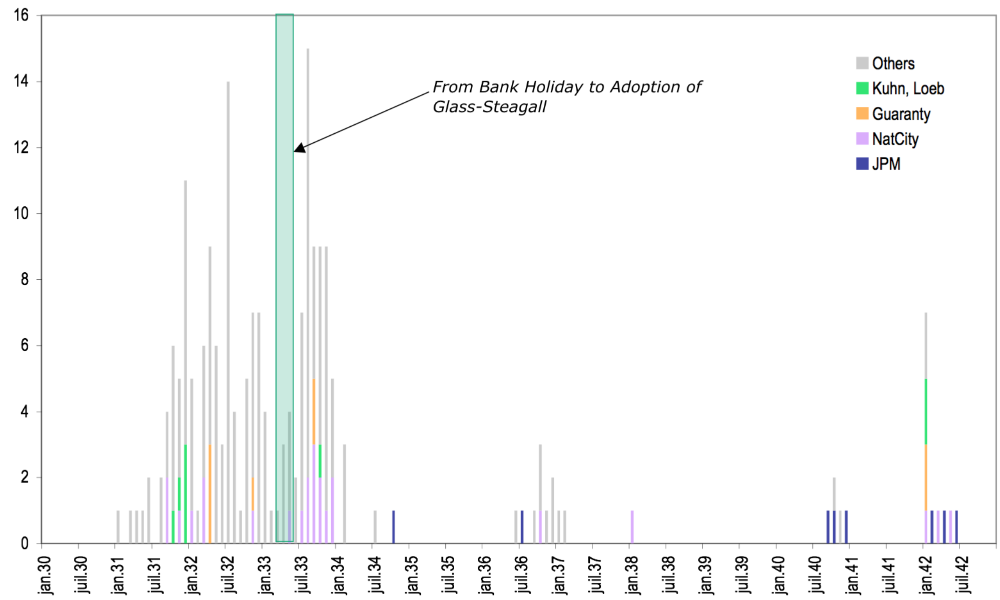
Source: Author, from Data in Eichengreen and Werley (1988) and own database.

Figure 4. 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 5. Monthly Defaults on US Debts 1930-1942



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