When the Leader Follows the Crowd

By Rui Pedro Esteves

In common folklore, economists never lose an opportunity to exalt the virtues of competition, labeling any deviation as an abuse, a loss or, indeed, the opening of the "road to serfdom." But look closer: one can actually find economists who use perfectly standard economic theory to show that sometimes more competition may not be in the interest of the common good. Juan Flores's talk at CLAS on the 1890 Argentinean financial crisis and default is a good example of this apparently iconoclastic position.

The Argentinean crisis has often attracted the interest of economists for three main reasons. Although a national crisis, the fact that it severely endangered the stability of the main financial center of the time, London, seems to have affected the way in which the international capital markets operated. Some authors have even called it a watershed event. After 1890, the question of information gathering on a debtor's ability to pay, and of its dissemination, was taken more seriously by the markets. Secondly, in an integrated system, disturbances at the center are likely to spread to all parts. This was the case in 1890, when what started as an Argentinean problem was eventually adversely felt in such disparate places as India and Australia. In other words, the Argentinean crisis is also seen as an early case of "contagion," a problem that more recently loomed menacingly in the financial crisis of Mexico, East Asia and, again, Argentina. And finally, the Argentinean default of 1890 is taken, as are many others during the same period, as a benchmark to evaluate the competing plans for redesigning the international financial architecture, with a view of making crises less common or, when they occur, less disturbing to the global capital markets.

Juan Flores's paper and talk offer an interesting contribution to this debate by inquiring into the causes of the crisis, and by putting them in the context of the international debt market on the late 19th century. Traditional theories on the origins of the crisis have a typical macro-economic bent, i.e., they blame some sort of imbalance in the main economic aggregates of the Argentinean economy, be it the balance of payments, the budget deficit or the money supply. Compelling as they may be, as Juan Flores comments, these earlier analyses leave a number of unanswered questions. In particular, they do not fit with the timing of the crisis, because many of the macroeconomic imbalances were already observable three years before the actual crisis began. Short of dismissing foreign investors as irrational, because they saw the crisis coming and yet did nothing to protect their investments, we need a better story.

A more convincing rendering of the facts, together with an analytical framework to

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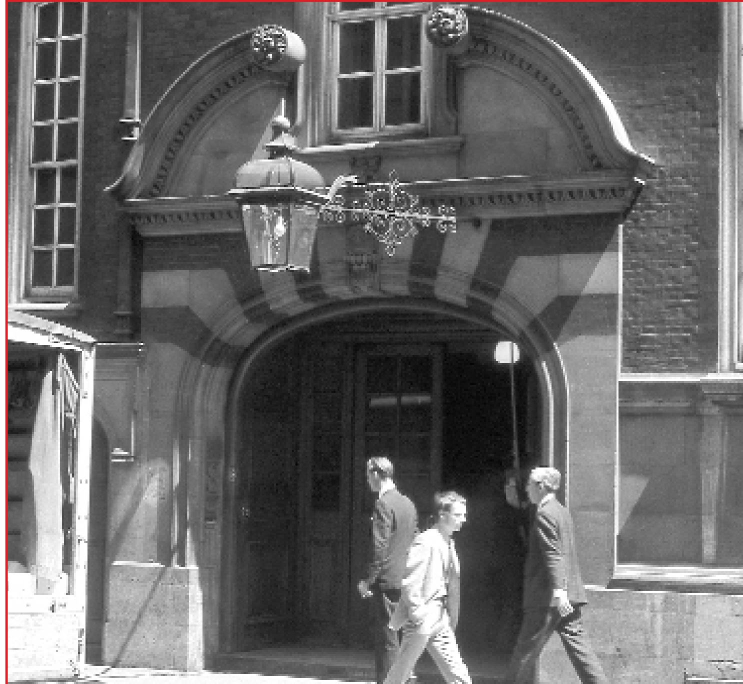

Photo courtesy of David Flint; www.historyinfocus-london.co.uk.

The entrance to the original Barings Bank in a shot taken in the 1960s.

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Photo by Getty Images.

A protestor carries his daughter during a 2002 Buenos Aires demonstration following the most recent collapse of the Argentine economy.

interpret them, is precisely what Juan Flores's provides in his paper. In marked contrast to previous explanations, the author concentrates on the microeconomic dimension of the crisis. In particular, he shows that there was a connection between the timing and sequence of events leading to the crisis and the industrial structure of the market for financial intermediation.

The international market for sovereign debt was fraught — as it still is — by a compound of what economists refer to as market distortions, i.e., objective conditions in the market structure that warn against a competitive solution. In an ideal competitive setting, information should be accurate and effortless to acquire. Such was obviously not the case in the sovereign debt market in the 1880s. The gathering of information on potential debtors and the monitoring of their actions was both costly and protracted, which made information a strategic asset that financial intermediaries could use to their advantage. This naturally created a situation favorable to market concentration along the lines of long-term relationships. That is, instead of having competitive tenders for every debt issue, sovereign governments typically established a privileged relationship with one banker who got a virtual monopoly in the placement of the country's debt. In return, the banker had extra incentives to monitor the debtor, since the rents from superior information would not be diluted through competition.

This was the case of Argentina who had maintained a long-term relationship with Baring Brothers, one of the main merchant bankers in London. Because investors knew of this relationship, they bought Argentinean bonds, which were placed in the European markets through Baring. They trusted in the incentives of Baring to collect accurate financial information on Argentina, and so considered Argentinean bonds as a safe application of their funds.

This market structure was, however, shattered by the penetration of new competitors that tried to displace Baring from its dominant position in the Argentinean business. In the early 1880s French and German banks started to compete with Baring for the placement of Argentinean

bonds. Nevertheless, and this is the main point of Flores's argument, "this fact did not change the market's perception that Baring was Argentina's monitoring institution." The new competitors left it to Baring to continue providing the implicit "certificate of quality" of Argentinean debt, while driving Baring away from the market by offering the Argentine government increasingly better conditions for the placement of the debt. In a world without international financial institutions such as the International Monetary Fund (IMF) or sophisticated rating agencies, this combination of events eroded Baring's incentives to monitor Argentina. An increase in competition, although benefiting the debtor country over the short run, led to a worsening of the informational basis of the market because it allowed new competitors to free ride on Baring's reputation.

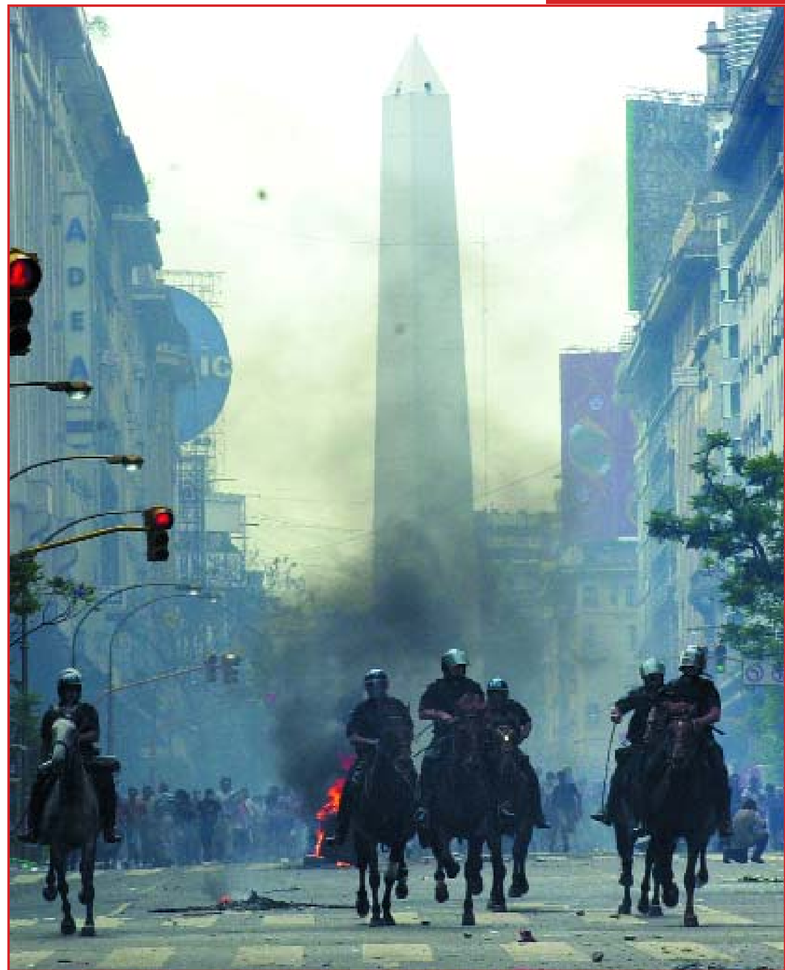
It is this combination of unaltered market perceptions and increased competition that allows Juan Flores to explain the simultaneous deterioration of Argentina's macroeconomic fundamentals throughout the 1880s and the improvement in the conditions under which the government could place its debt in the international markets of London, Paris and Berlin. This approach overcomes the timing conundrum of traditional macroeconomic theories of the crisis.

In order to test his hypothesis, the author compiled a detailed database of debt contracts signed by Argentina during the 1880s. The evidence conclusively supports the author's interpretation and shows that debt contracts disputed by more banks yielded better results (in terms of price paid and risk shared) to the Argentinean government even in the last three years of the decade when Argentina's financial position became more ominous. As a benchmark, the author also compares the Argentinean debt contracts to the contracts concluded by Chile and Brazil — two countries that did not break the privileged relationships with their bankers — during the same period. Despite having worse fundamentals than these two countries, Argentina ended up getting similar deals in the debt market.

In conclusion, Juan Flores's research commends itself both by the compelling reinterpretation of the 1890 Argentinean episode and by the policy implications for the regulation of financial markets. In the market for sovereign debt, competition may be too much of a good thing, although today the existence of international agencies that monitor borrowing governments, both in the public (IMF) and the private sectors (rating agencies), compensate for the informational disadvantages of competition.

Juan Flores is Assistant Professor of Economic History at the Universidad Carlos III of Madrid. He spoke at CLAS on October 10, 2005.

Rui Pedro Esteves is a graduate student in the Economics Department at UC Berkeley.



Mounted police charge anti-government demonstrators in Buenos Aires.

Photo by AP Wide World.