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Banks should learn from Habsburg Spain

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Risk transfers worked in the 16th century, write Hans-Joachim Voth and Mauricio Drelichman

Investors in the volatile debt of Ireland, Portugal, Spain and Italy can be forgiven a sense of déjà vu. The history of sovereign debt is strewn with promises broken, creditors losing their shirts (and sometimes literally their heads) and, during defaults, economic malaise. So does the long, melancholy history of government borrowing offer any lessons for policy makers today?

Carmen Reinhart and Kenneth Rogoff, in their classic study of eight centuries of financial crises, argue that the repeated folly of investors is the cause of sovereign debt problems. After a few good years, creditors forget the risks, lend recklessly, then end up snared in a default. The cycle soon restarts as new investors convince themselves “this time is different”.

At the dawn of sovereign lending, King Philip II of Spain – ruler between 1556 and 1598 of the only superpower of his age – signed hundreds of loan contracts. He also became the first serial defaulter, halting payments four times. The story of a powerful monarch able to convince creditors to lend as much as 60 per cent of gross domestic product while defaulting again and again offers useful insights into how the bargain can be improved.

Sovereign debt crises today “hurt” in three ways. First, when bond markets panic and yields rise in a downturn, taxes are raised and spending is cut. Austerity aggravates the slump. Second, a country’s banking system typically implodes. Third, the return to debt markets is often long delayed; state employees are sacked, contractors go unpaid, and the economic slump deepens.

By contrast, Genoese lenders to Philip II created a safe and stable sovereign borrowing system. It survived shocks such as the failed 1588 invasion of England with the Armada. Most bankers lent to the king for decades; no lender lost money in the long term. Financiers simply charged higher rates in normal times to compensate for the risks during crises.

When shocks hit – such as a combination of low silver revenues and a costly war against the Ottomans – debt contracts were not expected to be honoured to the letter. Renegotiations were concluded fast – in 12 to 18 months, compared with today's average of six to seven years. "Haircuts" for investors, from 20 to 40 per cent, were moderate. Lending resumed promptly.

Even in normal times, lenders and borrowers shared risk effectively. A large fraction of Philip II's short-term debt was "state contingent" – repayment terms and interest rates were automatically adjusted in line with fiscal conditions. In bad times – when the silver fleet from the Americas was small, say – the king either repaid less or extended the maturity of a loan. This avoided the need to let soldiers go unpaid.

Automatic loan modification enabled Spain to avoid negative feedback loops such as those seen in southern Europe today, with falling tax revenue leading to austerity and hence an even more severe slump. The ability to write state-contingent debt using an easily observed indicator of fiscal health, such as the arrival of a fleet, was crucial. In modern debt markets, verifiable indicators such as value added tax receipts, certified economic growth figures or world oil prices could be used as measures of fiscal strength.

The practices of the bankers, too, offer lessons for today. Loans were expensive and profits high. The Genoese absorbed losses easily because of their low leverage. Instead of borrowing themselves or taking deposits (as earlier competitors had done), they mostly financed themselves with equity. In addition, they sold the lion's share of each loan on to other investors. Profits and losses were then distributed proportionately. During crises, everyone suffered, but no toxic concentration of risk threatened the bankers' survival. In other words, risk transfers that failed during the recent subprime crisis worked well in the 16th century.

Repeated cycles of lending and default, contrary to common belief, are not a sign of bankers' stupidity. Often, creditors have realised that "next time will be the same", and prepared themselves accordingly. They have provided effective insurance to the sovereign, and absorbed losses with thick equity cushions. The age of the galleon produced effective risk-sharing and a stable banking system; the age of the internet and jet travel is failing to do the same.

The writers, who teach economic history in Barcelona and Vancouver, are the authors of the forthcoming 'Lending to the Borrower from Hell'