

CHAPTER FOUR

MARKET RULES: SOCIAL CONVENTIONS, LEGAL FICTIONS, AND THE ORGANIZATION OF SOVEREIGN DEBT MARKETS IN THE LONG TWENTIETH CENTURY

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It is puzzling that in the voluminous International Relations (IR) literatures on governance and order in world politics one finds relatively few references to social conventions.¹ After all, “it would scarcely be an exaggeration to say that almost all economic and social institutions are governed to some extent by convention” (Young 1996: 105). Some examples from a range of pricing activities illustrate the point. In the United States’ property market home prices fluctuate over time; the standard deviation of Robert Shiller’s real home price index in the years between 1960 and 2012 is 21.87. The commission that real estate agents take from a home sale, on the other hand, did not budge from the conventional six percent for many decades.² Prices of visual art in Amsterdam and New York are not determined by the intersection of demand and supply schedules; rather, artists and gallery owners follow a set of conventions, from unwillingness to lower the prices of unsold artworks to setting prices of works in an artist’s oeuvre by size or type rather than anticipated demand for each piece (Velthuis 2003).

Scholars of economic sociology, by contrast, have paid considerable attention to the social and cultural embeddedness of markets. For instance, Viviana Zelizer (2011) explains how societies choose to set

¹ Andrews (1975); Young (1983); Kratochwil (1989, 1993); Koslowski and Kratochwil (1994); Hall (1997), and Daase (1999) are notable exceptions.

² Even in 2009, in the midst of a massive crisis in the market and after the proliferation of websites meant to reduce the power of brokers, the average commission in the United States was 5.36 percent. Susan Stellin, “You Don’t Have to Pay It,” *New York Times* (Online ed.), 28 January 2011. Available here: www.nytimes.com/2011/01/30/realestate/30cov.html.

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limits on the things which can be priced and exchanged; despite the growing tendency to put a price on almost anything, some things (like children) remain excluded from the realm of commensurability and exchangeability (Sandel 2012; Wherry 2012). Some economic sociologists focus on the embeddedness of social relations within various forms of market coordination (Callon 1998; Beckert 2011). Philosophers and economists have also explored how communities evolve different social conventions when they face recurrent coordination dilemmas (Lewis 1969; Sugden 1989). In sum, the coordinating and stabilizing roles of social conventions shared by market actors are amply demonstrated in economic sociology (Biggart and Beamish 2003; Dobbin 2004; Beckert 2009) and in the French *économie des conventions* approach (Storper and Salais 1997; Lazega and Favreau 2002; Jagd 2007).

Markets – whether local, national, or transnational – are social institutions that are governed, at least partially, by non-codified norms and conventions. International markets are also (increasingly) spaces that are governed by law. The intertwining of law and politics at the international level has not escaped the attention of IR scholars; in 2000 the field's premier journal, *International Organization*, devoted a special issue to observing and theorizing what Finnemore and Toope (2005) call the “legal bureaucratization” of world politics. The “legalization” perspective focused on three dimensions of legal institutions: obligation, precision, and delegation (Abbott et al. 2000). Issue areas are subject to “hard law” when the legal institution governing that area feature high values on all three dimensions (exemplified by the WTO's Dispute Settlement System). From the legalization perspective the most important issue is whether law in a given issue area is soft/weak or hard/strong. The actors that produce legal instruments, in this perspective, can (at least in principle) adjust the three dimensions to “produce an institution exactly suited to their specific needs” (Abbott et al. 2000: 404). Law was conceptualized as a problem-solving device, the terms of which are negotiated by instrumental, rational actors. Variation in the strength/firmness of law in different issue areas in world politics is usually explained as an outcome of the struggle between states, whose interests and material capabilities vary, to extend or restrain the force of law, and the competing demands of domestic interest groups whose interests are affected by legalization (Kahler 2000).

A very different view of law emerges from the work on derivatives markets by the economic anthropologist Annelise Riles (2010, 2011). In her ethnographic study of the writing of collateral contracts

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in Japan's financial derivatives market, Riles directs our attention to the way in which seemingly arcane, technical, and apolitical contractual clauses serve as "legal fictions" that enable the transacting parties to act "as if" the ambiguity about what will happen in the (unknowable) future has been mapped out so that the deal can be completed. Legal fictions do not resolve the fundamental uncertainties that parties to a financial market transaction actually face. Rather, the contractual clauses sweep uncertainty – at least for the moment – under the rug (Penet and Mallard 2014). Market participants may not believe in or even fully understand the meaning of a "placeholder" that appears in financial market contracts (Riles 2011). The contractual clause is instead a tool, a means to produce the end (which, in Riles' case, is the swap transaction between market players backed by collateral).

The common feature of the work on social conventions and legal fictions is that both concepts are explained as responses to uncertainty. The conceptual distinction between risky and uncertain settings comes from Knight (1921) and Keynes (1921, 1937). A risky environment is one in which we have a sizeable sample of comparable past events *and* we know enough about the process by which those events were generated to be able to generate a probability distribution. With the distribution in hand we can forecast the results of our decisions with reasonable accuracy. Uncertainty, by contrast, means that we cannot forecast the future with much accuracy. We face uncertainty when, for example, a market is subject to dramatic transformations in the underlying economic structure that permanently shift the mean of the distribution of events (Meltzer 1982: 17).

Conventions allow pragmatic, intentional agents seeking steadier footing to face epistemic uncertainty. In the world of risk the assumption that agents follow consistent, rational, instrumental decision rules is plausible. But that assumption becomes untenable when parameters are too unstable to quantify the prospects for events that may or may not happen in the future (Keynes 1937; Lawson 1985: 915–16; Nelson and Katzenstein 2014). Conventions simplify uncertain situations by enabling agents to impose classification schemas on the world, thereby "delineating the set of circumstances in which it [the convention] is applicable and can serve as a guide." (Kratochwil 1984: 688; see also Kratochwil 1989: 69–72) Thus, central to my argument is the opposition between conventional judgment and rational expectations, which corresponds to the distinction between uncertain and risky environments.

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For Riles, legal fictions are also responses to uncertainty that inheres in financial markets. Keynes long ago distinguished goods in product markets that are consumed “within a short interval of their being produced” from financial assets, the future market price of which cannot be forecasted with much accuracy due to the “the fact that our knowledge of the future is fluctuating, vague, and uncertain” (Keynes 1937: 213). Riles argues along similar lines: “information about past market transactions can never fully predict future market problems or opportunities. Assets have value (positive or negative) that is by definition only discoverable over time and can never be fully predicted in advance . . . Relationships between market participants with respect to those assets unfold in time in ways that can never be fully anticipated or ensured” (Riles 2011: 159). Legal fictions, like social conventions, serve as substitutes for axiomatically rational calculations that are only possible in markets characterized by pure risk. Legal fictions and social conventions enable pragmatic agents operating in the presence of uncertainty to overcome the paralyzing effects of “having to act in unpredictable environments” – not because social conventions and legal fictions actually transform the decision setting from uncertain to risky but because they allow agents to overlook “the profound uncertainty entailed in decisions by increasing commitment to what remain fictional expectations” (Riles 2011: 169; Beckert 2013a; Beckert 2013b).

Sovereign debt markets, like all markets for financial assets, are marked by uncertainty. Buyers of sovereign debt are making bets about the prices of financial assets that will be realized in the (sometimes distant) future. During crises the uncertainty facing market participants is pervasive; in more settled times the market functions with less uncertainty and more risk. But even in “normal” times the issuer and the buyer are engaged in an exchange that takes place in the shadow of a future state of the world that cannot be forecasted. In response to this “temporal problem of finance” market participants develop conventions and legal fictions to inform their expectations (Riles 2011).

Sovereign debt is among the largest classes of international financial assets, and it is growing in importance.³ The chapter is organized around two puzzling, politically salient features of the market for sovereign

³ The face value of outstanding sovereign debt rose from 11 percent of the total global value of financial assets in 1978 to 17 percent in 1990 to 19 percent in 2010 (Tomz and Wright 2013: 251).

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debt. The first puzzle is the inability of governments of low- and middle-income countries to denominate the sovereign debt instruments that they place internationally in their own currencies. Eichengreen and Hausmann (1999, 2005) were the first to note the difference between the sovereign debt contracts written by the historically rich countries of North America, Western Europe, Oceania, and Japan (who can borrow in their own currencies) and everyone else; they called the condition “original sin,” because “it is as if emerging markets suffer from an inherited burden, almost irrespective of the policies of their governments” (Eichengreen and Hausmann 2005: 6). I present data on the extent of original sin in so-called “developing” and “emerging” countries, examine the covariates of an indicator of original sin to see if it can be rationalized as a consequence of bad policies or weak political institutions, and ask whether it instead makes more sense to think about original sin as the product of an enduring convention followed by participants in the international sovereign debt market.

The second feature is the inclusion of the *pari passu* clause in sovereign debt contracts. In English “*pari passu*” means “in equal step.” The clause is typically a single sentence occupying several lines of text, and it appears “in most cross-border credit instruments” (Buchheit and Pam 2004: 871). The conventional understanding of *pari passu* was that it proscribed borrowers from ranking debts, such that in a debt rescheduling event one outstanding obligation could not be paid before the others (Buchheit and Pam 2004; Gulati and Scott 2013). Unlike the practice of denominating developing and emerging countries’ international debt issuances in a foreign currency, which is not a formal rule that has been written down, *pari passu* is a legal covenant. Even though *pari passu* is codified in a contract, it has a fictional quality: the precise meaning of the clause is obscure and contested, and the lawyers that include the provision in the contracts that they draft for their clients (borrowing governments) have difficulty explaining why they insert the clause in the contract and where the clause came from (Varottil 2011; Gulati and Scott 2013). The fictional element of the *pari passu* is that a bondholder’s rights and obligations are clearly defined and enforceable. Rather than resolving uncertainty the clause introduces other ambiguities: if the sovereign borrower’s legislature passes a law preventing the government from paying “holdouts” that do not participate in a debt rescheduling but the debt was issued in a different jurisdiction (in New York, for example), which legal system applies? What happens if the

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sovereign borrower violates the clause? What constitutes a violation of the covenant?

My chapter, like the others in the volume, foregrounds the important role in international market-based transactions played by contractual knowledge, but I approach the theme of the volume from a different angle. The two features of debt contracts I discuss in the chapter – currency denomination and the *pari passu* clause – are widely followed practices that have little resemblance to rational adaptation by market players. The observed inability of nearly all countries outside the subset of historically rich democracies to borrow internationally in their own currencies cannot be easily explained as a form of insurance against risks (deriving from institutional weakness or macro-economic instability) that are specific to the set of developing and emerging sovereign borrowers. The practice is more consistent with an evaluative process by which the conventional categories (rich/developed versus developing/emerging) employed by key market players (namely, the underwriters that bring the debt issuances to market and international investors who purchase sovereign debt) to sort and classify borrowers produce differences in their terms of access to the market. Likewise, the insertion of the *pari passu* clause in sovereign debt contracts appears to be driven by mimetic behavior among the members of the community of contract writers, most of whom did not have a clear grasp on the meaning or importance of the covenant.

Why does it matter that the decisions of members of communities – in this case, the actors involved in writing, buying, and selling sovereign debt instruments – are based in part on social conventions and legal fictions? It matters because convention-following behavior can generate outcomes that, in the words of Oran Young, “are hard to justify in terms of any reasonable standard of equity” (Young 1983: 105). Conventions are useful for coordinating agents’ actions and stabilizing their expectations, and they are often reasonable ways of organizing action and making decisions. But these qualities do not imply that the conventions in use are optimal – and suboptimal rules can be widely followed and persist for a long time (Sugden 1989: 93–4; Young 1983: 96).

Conventions and contractual “placeholders” that function as rules in international financial markets are politically consequential. The inability to sell home currency-denominated debt on the international market, for example, is the wellspring from which a number of economic syndromes that trouble developing countries emerge.

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Eichengreen et al. (2005b: 266) show that “the volatility of debt-servicing capacity of developing countries with original sin is nearly five times that of industrial countries that borrow abroad in their own currencies.” The inability of developing countries to borrow abroad in their own currencies is a “structural defect” (Gourinchas and Obstfeld 2012) that harms their growth prospects. Original sin is related to currency mismatches on governments’, firms’, and individuals’ balance sheets in developing countries: the different currency denomination of assets and liabilities can create a wave of bankruptcy, from the individual mortgager to the government, when the price of currency of the liability side shoots up relative to the currency on the asset side (Jeanne and Zettelmeyer 2005). Such exchange rate moves multiply the real value of external debt. The result is sometimes a triple crisis: depositors flee the banking system, the monetary authorities struggle to stabilize a sinking national currency, and, ultimately, the government has difficulty rolling over the external debt.

There is no single international organization or consistent set of formal rules to organize debt rescheduling when a government is unable to meet its obligations; rather, sovereign debt rescheduling has been handled in an ad hoc manner by a *mélange* of organizations and forums, including (but not limited to) commercial bankers and money managers, government officials, lawyers and judges, national and international courts, the IMF and the World Bank, the Institute for International Finance, credit rating agencies, and the Paris and London Clubs. There is wide variation in the terms of debt restructuring arrangements: creditors suffered a 75 percent loss in the Argentine restructuring concluded in 2005; when Greece reached an agreement in 2012 to reduce its external debt burden, bondholders took a 65 percent “haircut”; holders of Uruguayan bonds, by contrast, fared far better in the 2003 restructuring, taking just a 13 percent loss (Panizza et al. 2009: 673; Tomz and Wright 2013: 260). The evidence that debt restructuring after a sovereign default brings relief to the average distressed government is meager (Easterly 2002; Depetris and Kraay 2005).

The popularity of the *pari passu* clause was not hampered by the fact that “no one seems quite sure what the clause really means, at least in the context of a loan to a sovereign borrower” (Buchheit and Pam 2004: 875). The political consequence of the increasing usage of the clause in sovereign debt contracts over the past thirty years has been a growing shift in the balance of power away from governments toward private bondholders. Whereas prior to 1981 no sovereign bonds

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contained “versions of the clause that are especially favorable to hold-out creditors,” the toughest version of the clause now appears in 74 percent of bonds issued by developing countries (Tomz and Wright 2013: 256). The biggest beneficiaries of the conventional insertion of the *pari passu* clause in sovereign bonds have been the holdout creditors that refuse to participate in debt rescheduling negotiations.

What looks like a technical bit of mundane legal jargon in a contract that few (if any) bond buyers actually read is in fact a politically potent form of private governance of the market. The clause does not reduce the uncertainty that the bondholder faces; rather, it describes the exchange as a relationship involving rights and obligations of the contracting parties (see Riles 2010). *Pari passu* does nothing to clarify the probability of default or the price of the instrument, nor does it involve making predictions about what will actually happen in the future; rather, it generates the possibility of moving the discussion to the realm of law, and in doing so it empowers some actors and disempowers others. Like other legal fictions, the *pari passu* clause becomes “a kind of reality of its own . . . something that raises real world consequential problems that demand lawyers’, and perhaps judges’, academics’, and bureaucrats’ attention” (Riles 2011). The politics of the practice lie in the way in which the participants in the market struggle over the “political validity and legitimacy” of the legal fictions (Adler and Pouliot 2011: 27; Riles 2011).⁴

The two elements of the contemporary sovereign debt market discussed in this chapter do not appear to be the products of compulsory power exercised by states and private actors to rig the rules in their favor; nor do they look much like “rational, negotiated responses to the problems international actors face” (Koremenos, Lipson, and Snidal 2001: 768). “Original sin” and the *pari passu* clause each pre-date the onset of World War I by over forty years; and in both cases, the origin of the phenomenon is shrouded in mystery and the reason for its persistence is unclear.

⁴ Consider this section from a full page advertisements in the 30 June 2014 print editions of the *Financial Times* and *New York Times* taken out by the government of Argentina after the US Supreme Court chose not to overturn a decision by a judge in New York requiring Argentina to pay all of its bondholders, including those that did not participate in the 2005 and 2010 debt restructuring negotiations: “the fact that the prospectus transfers jurisdiction to the United States does not mean accepting court decisions that are impossible to comply with. All the more if any such decision violates the sovereign immunity principle effective in the United States as a higher-ranking institutional rule and if it interprets in a whimsical and absurd manner the *pari passu* principle.”

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SOCIAL CONVENTIONS AND THE STUDY OF INTERNATIONAL ORDERS

The two branches of the recent IR literature on sovereign debt mirror a more general division in the subfield between broadly material-rationalist and social-constructivist analytical frameworks (Katzenstein, Keohane, and Krasner 1998).

One branch emphasizes material interests, incomplete information, and political institutions. Michael Tomz (2007), for example, develops a theory to explain why sovereign debtors repay bondholders. Tomz argues that governments pay back their debts in order to preserve their reputations. He describes three types of reputations ascribed to governments by prospective investors: stalwarts, who honor the terms of debt contracts in good and bad times; fair-weatherers, who repay in good times but default in bad; and lemons, who are likely to alter the terms of the debt contract in good and bad times. A country's reputation is based on its repayment history. Rational investors lack information about the government's "true" preferences with respect to its external debt load ("preferences, unlike economic statistics, exist in the hearts and minds of foreign leaders," Tomz 2007: 16); what they can observe is a borrower's behavior, which has a signaling function.

Since international bond buyers watch governments closely for signals, and rational governments know that investors use simple decision rules to screen debtors, then governments will realize that their reputations are at stake and if they care about their reputation they will honor the terms of the debt contract. Not all signals are relevant for investors; the only signal that will lead investors to update their priors is when a government acts contrary to its type (e.g., a reputed lemon fully repays during the trough of an international business cycle). The market's incentive structure "facilitates the emergence of a certain form of discipline and permits government debt to emerge" (Flandreau and Flores 2012: 215). Tomz is agnostic about whether governments care about their reputations or not, but the fact that "fair-weatherers" and "lemons" pay more to borrow than reputed "stalwarts" implies that governments will not take decisions that harm their reputations lightly. In Tomz's model of the market for sovereign debt, governments and private lenders⁵ are atomized, rational, and responsive to material

⁵ While Tomz argues that bondholders of all kinds have "overwhelming incentives" to allocate credit based on their (rational) expectations about countries' propensities to repay, he distinguishes investment from commercial bankers, whose decisions may be shaped by other kinds of

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incentives; rule-following (in the sense of honoring contractual obligations) is driven entirely by self-interest calculations; and the key contextual element of the market is incomplete information.

Others turn to the structure of domestic political institutions to explain aspects of the market for sovereign debt. Schultz and Weingast (2003) argue that since the mid 1600s every hegemonic power in the international system has had democratic institutions, and this correlation is not coincidental. In their words, “representative institutions enhance a state’s borrowing power by making it easier for those with a stake in the repayment of debt to punish the sovereign in the event of default” (Schultz and Weingast 2003: 5). Democracies prevail in hegemonic competitions due to the fact that they have access to plentiful credit at comparatively cheap prices. A recent article by Beaulieu et al. (2013) similarly finds that democratic regimes benefit from better access to credit (some autocratic countries cannot even enter the international bond market) and the bonds they issue garner higher ratings from credit rating agencies.

The rationalist understanding of the market for sovereign debt follows the widely held view by IR scholars of order in world politics: forms of governance evolve in response to exogenous shocks in a given issue area that generate the need for negotiated solutions. Institutions and rules are optimal bargained solutions adopted by rational agents, differently endowed with social and material sources of power, seeking to maximize their (often material) interests (most likely to be measured by prices paid for certain goods they can obtain on markets), subject to environmental pressures and constraints. Undoubtedly this “realist” analytical lens captures a lot of what goes on in world politics. But it does not shed light on how policy issues can be the *endogenous* products of actors following social conventions; nor does it capture the “numerous cases in which subjects’ expectations converge to a remarkable degree in the absence of conscious design or even explicit awareness” (Young 1983: 98).

The constructivist approach disputes the material basis of actors’ interests. Martha Finnemore’s (2003) work on the evolution of the norms governing the enforcement of sovereign debt is an exemplar. Finnemore traces the proscription of the practice of “gunboat

incentives (they might lend to a country in arrears as part of a “defensive” bailout package, or they might be more responsive to political incentives to extend credit to a borrower since they may derive income from activities other than lending).

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enforcement” in the early twentieth century to principled arguments against the practice advanced by an emergent global epistemic legal community. Before 1907 military intervention to collect collateral pledged against an outstanding debt was common. Finnemore details how the international legal community and allies in powerful political positions, such as U.S. Secretary of State Elihu Root (a lawyer by training and the first president of the American Society for International Law), reconfigured states’ and bankers’ understanding of the rules of the sovereign debt market. Just a half-decade after British and German forces bombed and blockaded Venezuela after strongman Cipriano Castro repudiated the country’s foreign debts, Root was able to put the end of military intervention for debt collection on the table at the Hague Peace Conference (Finnemore 2003: 33–4).

Finnemore’s work is about the formulation and adoption of a norm that asserted the primacy of international law to resolve disputes between debtors and creditors (on the rise of arbitration, see Sgard as well as Dezalay and Garth in this volume). In this case states followed the norm even though it was not in their material interest to do so. The argument is consistent with a line of research in IR that explores how social norms can serve as reasons for action (Kratochwil 1984, 1989; Hurd 1999).

As I noted in the first section of the chapter, a rather small number of IR scholars have asked whether some of the patterns of behavior we observe in the international realm are consistent with convention-following. Oran Young was one exception; in his contribution to the *International Regimes* volume he argued, “it is hard to escape the conclusion that spontaneous orders are of critical importance in the international system just as they are in other realms” (Young 1983: 102). As the Bretton Woods monetary system fell apart in the early 1970s the international economist John Williamson reflected on the new “non-system” that was taking its place: “the world is to function on the basis of a set of conventions and practices that have evolved out of a mixture of custom and crisis” (Williamson John 1976: 54).

What are social conventions, and why do agents use them? In philosopher David Lewis’ (1969) account, social conventions are rules adopted in order to solve recurrent coordination problems that almost every member of a community follows. Lewis’ conceptualization of conventions helps us understand how, in “pure” coordination games with multiple equilibria, social conventions provide “a consistent structure of mutual expectations about the preferences, rationality and actions of

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agents” that facilitate stable, recurrent patterns of cooperation (David 1994: 209). But it seems too restrictive to limit the concept of conventions to include only solutions to coordination problems (Gilbert 1989). It does not make much sense to view enduring conventions in, for example, classical music or in children’s bedtime stories as efficient solutions to some kind of cooperation problem (Biggart and Beamish 2003: 452–3; Marmor 2009).

Some social conventions are followed not because they are solutions to coordination dilemmas but rather because they “supply the foundations for stability . . . because they limit the debilitating effects of interactional uncertainty” (Biggart and Beamish 2003: 452). In financial markets social conventions are important because they “provide a means in the present of calculating and feigning control over a necessarily uncertain future” (Langley 2008: 481). They give agents confidence to make judgment calls when resources and prestige are at stake. In legal philosopher Andrei Marmor’s (2009) conceptualization, social conventions are social rules that members of a population (more or less) follow in some circumstance(s) for a reason. For Marmor, conventions have an arbitrary quality; there may be a good reason to follow the convention in use, but there is a counterfactual scenario in which we can conceive of an alternative rule “that could have been followed instead without a significant loss in its function or purpose” (Marmor 2009: 9). Conventions are more than just observed behavioral regularities. I drink coffee every morning but that is not an instance of rule-following. Social conventions have a normative quality even if they are not norms (Young 1983: 94–5; Marmor 2009: 13). The prescriptive element of social conventions provides “a basis for judging the appropriateness of acts by self and others” (Biggart and Beamish 2003: 444).

Conventions exercise themselves at different levels. Consider four elements of the international sovereign debt markets: (1) *Actors* – government officials, staff members from international organizations, commercial bankers and money managers, lawyers, judges, and legal experts, credit rating agencies, among others; (2) *Actions* – decisions by governments to borrow internationally and to repay or not; decisions by financiers whether or not to lend and the terms (price, maturity) on which they will extend credit; decisions by lawyers about what goes into (and what’s left out of) contracts; (3) *Contexts for action* – including, among many others, the density of networks connecting the actors and the degree of “regime complexity” (Alter and Meunier 2009) in which the actors are embedded; (4) *Rules for action* – formal legal

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obligations, requirements of membership in international organizations, causal beliefs, norms and principles, and “shared templates” that agents rely on, sometimes consciously but at other times tacitly, to classify “phenomena in order to make them manageable, and once classified, to select an appropriate program of action” (Biggart and Beamish 2003: 444, 452; see also Nelson and Katzenstein 2014).⁶ Conventions enter in each of the elements; most clearly as rules that market participants follow, but also by constituting the actors that can legitimately participate in the market, shaping the kinds of actions available to participants, and forming part of the contexts in which the markets and the players operate. The arguments and evidence in this chapter suggests that we can miss important facets of the organization of international financial markets if we overlook or dismiss the role of conventions and legal fictions.

CONVENTIONS AND CATEGORIES IN INTERNATIONAL SOVEREIGN DEBT CONTRACTS: THE MYSTERY OF ORIGINAL SIN

Processes of commensuration and categorization, several prominent sociologists argue, constitute an essential part of the bedrock upon which markets rest (cf. Espeland and Stevens 1998; Fourcade and Healy 2013; Lamont 2012). These processes are particularly important when transactions span continents; commensuration, in Espeland and Stevens’ view, “makes possible precise comparisons across vast cultural and geographical distances that allow transactions fundamental to global markets” (Espeland and Stevens 1998: 325).

In the market for sovereign debt (as in all markets) the participants make use of “splitting” and “lumping” devices (in Eviatar Zerubavel’s (1996) evocative terms) to organize and make their environments, rife with uncertainty, more manageable. Underwriters and money managers put countries into different categories (for example, distinguishing between “developing,” “frontier,” “emerging,” and “developed” clusters) (Brooks, Cunha, and Mosley 2014); the lumping process makes decision making in the presence of uncertainty less paralyzing, but it comes at the cost of “abstracting and reducing information” (Espeland

⁶ The four elements come from Carruthers and Kim’s (2011: 240–41) analysis of the organization of financial markets.

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and Stevens 1998). And, as Zerubavel notes, the ways in which we slice the continuous “ocean” of reality into distinct “mental archipelagos” are based almost entirely on social conventions (Zerubavel 1996: 426–27). The conventional categories can (and do) become institutionalized, serving as rules that decision makers follow as a matter of routine (Powell and Colyvas 2008). In this section I present indirect evidence suggesting that the conventional categorization of borrowers – whether they are included with the “developed” group or not – drives the currency denomination of sovereign debt contracts.

In the canonical economic model of the sovereign debt market, all debts are denominated in real consumption (Eaton and Gersovitz 1981; Tomz and Wright 2013: 254). In the world outside the model countries issue debt denominated in national currencies. There is a remarkable concentration in the currencies in which international sovereign bonds are denominated: in the 1999–2001 period, 85 percent of bonds sold by countries that were not Eurozone members, the United States, Japan, the UK, or Switzerland were denominated in either euros, US dollars, yen, pounds sterling, or Swiss francs (Eichengreen et al. 2005a). The historically rich countries can sell debt instruments to non-residents in their own currencies and the other 180-odd countries in the world cannot. Eichengreen and Hausmann (1999, 2005) called this apparently structural feature of the sovereign debt market “original sin.”

Figure 4.1 illustrates the gulf between the small group of historically rich countries and everyone else. I use a measure based on Eichengreen et al.’s (2005a) conceptualization of original sin. Their OSIN1 indicator is constructed by taking one minus the ratio of total securities issued by a country in its own currency over the total amount of currencies issued by the country in any currency:

$$\left[1 - \frac{\text{Securities issued by country } i \text{ in currency } i}{\text{Securities issued by country } i} \right]$$

In this construction a country that has no trace of original sin would have a value of zero; for a country that enters international debt markets but is unable to raise any funds using instruments denominated in its own currency, the indicator would equal one. The indicator is imperfect as a measure of a country’s financial vulnerability, but it allows us to observe the degree to which different countries differ in one aspect of their entry into the international sovereign debt market – the currency

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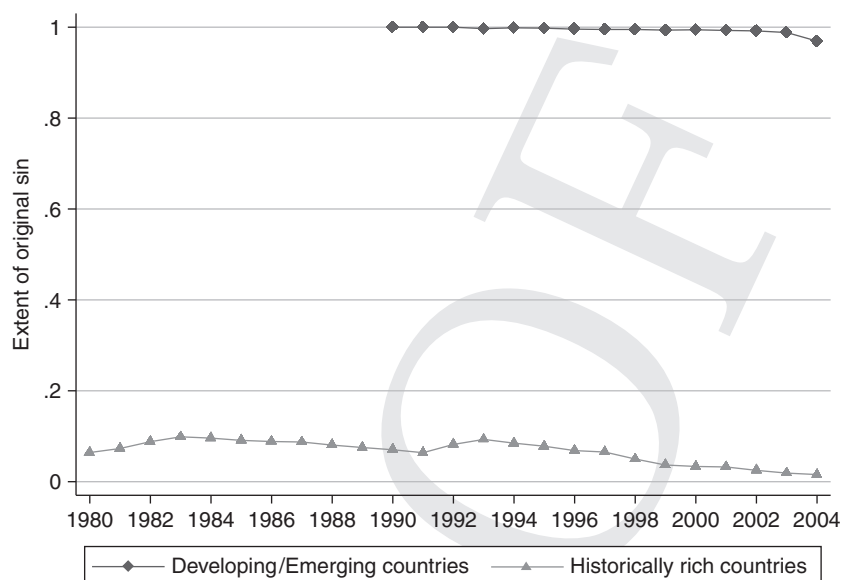


Figure 4.1 The extent of foreign currency–denominated sovereign debt

denomination of the debt contract.⁷ Figure 4.1 tracks the average annual value of OSIN1 for historically rich countries after 1980 and for low- and middle-income countries between 1993 and 2004.⁸

The difference between the historically rich countries and the rest of the world is stark. Within the country groupings, however, Figure 4.1 does not give us much variation to puzzle over. The indicator of original sin barely budes over the observation window (for the low- and middle-income countries in the sample, the average value falls from one at the beginning to 0.97 at the end of the series; for the historically rich

⁷ OSIN1 does not account for the possibility of hedging currency exposure in the derivatives markets. To estimate the share of debt that can be hedged, Eichengreen et al. (2005a) design the following indicator (OSIN3): $\max\left(1 - \frac{\text{Securities issued in currency } i}{\text{Securities issued by country } i}, 0\right)$. Hausmann and Panizza (2010) estimate that the maximum amount of foreign-denominated debt issued by developing countries that could be potentially hedged through the swap market is 18.5 percent. In other words, OSIN1 overstates developing countries' exposure to currency mismatch but the vast majority of these countries' outstanding debt is in a foreign currency and is difficult to hedge.

⁸ The indicator of original sin for the developing and emerging countries comes from Obstfeld et al.'s (2010) dataset. For the historically rich countries, the indicator is drawn from Abbas et al.'s (2014) database. Their database includes thirteen historically rich countries (Australia, Belgium, Canada, France, Germany, Ireland, Italy, Japan, the Netherlands, Spain, Sweden, the UK, and the United States.)

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countries, the indicator of foreign currency-denominated international debt falls from 10 percent to just over 1 percent).

The inability of a large set of the world's governments to sell debt denominated in their domestic currencies to non-residents looks like a patterned regularity, but that does not mean that it is consistent with a rule arising from a social convention. Martin Wolf of the *Financial Times* has asserted: "I don't believe in original sin."⁹ The structural difference between historically rich and non-rich countries may simply be a legacy of historically "strong" institutions and "good" macroeconomic policies in some countries. And not all developing and emerging countries suffer equally from the condition.¹⁰

Bondholders dislike currency depreciation and price inflation. Chinn and Frieden (2011: 188) explain: "one tried-and-true way countries make it easier to pay their debts is to inflate or depreciate some of them away. With just 5 percent inflation, 100bn in debts loses more than a fourth of its real value in just five years... Many countries with foreign debts in their own currency reduce their real debt burden by allowing their currency to drop in value, so that foreigners get repaid in less-valuable currency." If all non-historically rich countries have demonstrated a propensity to follow policies that harm creditors, then there is no mystery to original sin: it is an international-level regularity produced by pathologies of macroeconomic policymaking at the domestic level.¹¹ Indeed, Gourinchas and Obstfeld (2012: 232) assert: "frequent recourse to inflationary finance in the past has created a tendency for financial contracts to be denominated in a stable foreign currency, such as the US dollar or euro."

The problem with this explanation is that there's rather scant evidence to support it. Eichengreen et al (2005b) explored some of the determinants countries' level of original sin in 2001. All of the usual suspects (inflation history, fiscal deficits, the rule of law, foreign economic policy openness) were statistically insignificant in their regressions. I examined the covariates of OSIN1 indicator of the extent of foreign currency borrowing using data covering a sizeable sample of

⁹ Wolf is quoted in Hausmann and Panizza (2010: 4).

¹⁰ The lowest observed value for OSIN1 is 0.82 (Singapore, 2004). Several other developing countries have values below 0.9 (South Africa, Thailand, and Uruguay).

¹¹ This view is similar to structural realists' view of international regimes. In the causal pathway sketched by Krasner (1983) (prior causal factors → regimes → related behavior/outcomes) regimes do not have any independent effect. They are artifacts of deeper causal factors (the absence of a governing authority in world politics, the distribution of material power, etc.).

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countries observed between 1993 and 2004.¹² I regressed the original sin indicator on measures of country size (real GDP and the natural log of population)¹³, age (recorded as a count from the date of independence if after the year 1800, or 1800 if the country's date of birth preceded that year)¹⁴, macroeconomic performance (real GDP growth and the log of consumer price inflation), political institutions (the Polity2 indicator of the level of democracy and the number of "veto players"), foreign economic openness (exports/GDP and a measure of capital account openness), and domestic financial market depth (credit/GDP). I also included an indicator for whether a country is a member of the historically rich grouping or not.¹⁵ I estimated cross-sectional time-series models with annual observations and cross-sectional regressions in which OSIN1 and the explanatory variables are averaged for each country over time periods noted in Table 4.1 below. Table 4.1 displays the results from the regressions.

The statistical results suggest that the level of original sin is not easily explained by differences in countries' economic policies and political institutions. No covariate is statistically significant across all the specifications. Inflation, population size, real GDP, GDP growth, and domestic credit/GDP are each significant in at least one specification, but by far the most powerful covariate is the classification of countries as being either an historically-rich country or not. The results in Table 4.1 (coupled with the evidence presented in Eichengreen et al. 2005b) suggest that the causes of original sin probably do not lie in the quality of developing countries' macroeconomic policies and political institutions.

One of the most striking pieces of evidence presented by Eichengreen et al. (2005a: 24–25) is the overlap between the group of countries that had high levels of original sin in the 1990s and the group of countries that included gold clauses in the sovereign bonds that they issued in the 1850s. Flandreau and Sussman's (2005) research on the structure of bond markets in the mid-to late-1800s suggests a possible origin for the inability of most developing countries today to borrow

¹² In starting the analysis in 1993 I follow Flandreau et al.'s (2009) dating of the onset of the "modern era" of sovereign debt markets (before 1993 "emerging" and "transition" countries were not able to place much debt internationally).

¹³ Size is one of the few variables that are consistently significant in Eichengreen et al.'s (2005b) models of the determinants of original sin. The variables come from the World Bank's *World Development Indicators*.

¹⁴ Older countries have more opportunity to build reputations for creditworthiness (Tomz 2007).

¹⁵ The "historically rich" countries in the sample are Australia, Belgium, Canada, France, Germany, Ireland, Italy, Japan, the Netherlands, Spain, Sweden, the UK, and the United States.

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TABLE 4.1 Covariates of original sin

	(1)	(2)	(3)	(4)
Exports/GDP	-0.0001 (0.0004)	-0.0003 (0.0002)	0.002 (0.002)	0.003 (0.002)
Real GDP	-2.06×10^{-6} (1.06×10^{-6})	-5.67×10^{-7} (5.38×10^{-7})	-0.00001^* (4.09×10^{-6})	-0.00001^* (5.15×10^{-6})
GDP growth	0.0006 (0.0005)	0.0001 (0.0003)	0.023* (0.009)	0.023* (0.011)
Polity2 score	-0.001 (0.001)	-0.0002 (0.001)	-0.002 (0.004)	-0.001 (0.005)
Number of veto players	0.003 (0.002)	0.0007 (0.001)	-0.005 (0.016)	-0.009 (0.023)
Population size (log)	-0.010* (0.005)	-0.002 (0.002)	-0.027 (0.019)	-0.022 (0.022)
Inflation (log)	0.002 (0.004)	0.005 (0.003)	0.067* (0.024)	0.069* (0.028)
Credit/GDP	-0.0003* (0.0001)	-0.0002 (0.0001)	0.0004 (0.0009)	0.00002 (0.000)
Cap. account policy index	-0.001 (0.002)	0.001 (0.001)	-0.013 (0.018)	-0.019 (0.024)
Country age	0.00002 (0.00009)	-0.00007 (0.00005)		
Historically rich country	-0.880*** (0.035)		-0.648** (0.079)	
Countries	71	58	52	40
Total observations	624	454	52	40

Notes:

* $p < .1$

** $p < .05$

*** $p < .01$. Standard errors (clustered by country in the time-series cross-section models 1 and 2) are in parentheses. Estimates are from OLS regressions. Columns (1) and (2) presents results from cross-sectional time-series estimates of the covariates of original sin (annual data, 1993–2004). Column (1) includes all countries for which data are available; column (2) excludes historically-rich countries. Columns (3) and (4) report cross-sectional models. Covariates are averages over the years between 1980 and 1993. The dependent variable in (3) and (4) (original sin) is averaged over years between 1993 and 2004. Model (3) includes all countries; historically rich democracies are excluded from the model reported in column (4).

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abroad in domestic currency. Based on analysis of sovereign bond issues from the 1820s to the 1890s, Flandreau and Sussman distinguish three varieties of borrowers: the countries that in their initial public offering of sovereign bonds in London or Paris included an exchange rate clause (requiring repayment in pounds, francs, gold, etc.) in the debt instrument; countries that issued a mix of bonds in domestic currency and with exchange rate clauses; and a small set of borrowers (Belgium, Britain, Germany, Netherlands, and Switzerland) that borrowed exclusively in their own currencies. According to Flandreau and Sussman, the factor that differentiated the varieties was liquidity. Bond buyers wanted to be able “to trade the long-term bond for short term assets in that currency” (Flandreau and Sussman 2005: 181). The countries that were able to borrow in the nineteenth century debt markets in their own currencies had “intense foreign exchange relations with the rest of the world . . . Liquidity was achieved by transforming the national currency into a key currency” (Flandreau and Sussman 2005: 183, 186). While expiation and redemption is possible, it appears to be the case that a market convention developed in the nineteenth century for reasons specific to that historical context was sustained by path dependency into the first decades of the twenty-first century.

If domestic policy and institutional weaknesses in developing countries do not explain why international sovereign bonds remain denominated in just a handful of rich countries’ currencies, what, other than convention-following, might account for the existence and persistence of original sin? Perhaps the concentration of the international sovereign debt portfolio in a handful of currencies is an efficient arrangement, because the transaction costs of denominating bonds in many different national currencies are excessively high.¹⁶ After all, Nobel Laureate Robert Mundell (1968) showed the efficiency gains of coordinating on a single currency as the world’s central money.¹⁷ The efficiency gains of concentrating transactions in one or a few “top currencies” are evident for activities such as invoicing cross-border trade and payments; for financial assets, however, the benefits of extreme

¹⁶ Eichengreen et al. (2005b) raise this possibility.

¹⁷ Here is McKinnon’s (2010: 2) depiction: “To see this efficiency gain, consider a world of 150 countries and 150 currencies but without a central money. To preserve monetary symmetry, you would need 11,175 bilateral foreign exchange markets for trading goods and services. However, if one money – the Nth – is mutually selected to be the common intermediary currency among banks, then only 149 markets need to be actively traded.”

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concentration are less obvious. In fact, the concentration of international bonds in a handful of currencies contravenes the logic of portfolio diversification.¹⁸ The data in Griffith-Jones et al. (2002) show, for example, that the chance of a very large loss in a portfolio that is only spread across advanced industrial countries is 25 percent higher than a portfolio that includes both historically-rich and developing countries.

Until recent years only a handful of international investment firms were willing to invest in so-called “exotic” local currency-denominated sovereign bonds (Panizza 2010: 99). In the 1990s Shari Spiegel, a bond trader with Lazard Frères, pioneered an investment strategy that focused on local currency debt; in her words, “the fund was operated with the goal of capturing high rates of return paid on local currency securities while reducing risk through a diversification strategy” (Dodd and Spiegel 2005: 6). While the strategy was highly successful, Spiegel’s team was nearly alone in pursuing it. Since 2007, however, there has been a wave of new investment funds specializing in local currency sovereign bonds placed internationally. The conventional classification schema that prevented many so-called “emerging” countries from denominating debt in their own currencies appears to be breaking down. The onset of the Global Financial Crisis in 2008, subsequent buildup of sovereign debt burdens as governments bailed out their damaged financial systems, and the eruption of the Eurozone debt crisis in 2010 have each served as powerful shocks forcing investors and underwriters to examine the routines and understandings that were in place in the market. A particularly interesting facet of changing contractual knowledge in the area is its embedding in a new narrative that money managers have developed to explain (in the words of the Director of Emerging Market Strategies at Bank of New York Mellon) “the rise of local currency debt.” Investment fund managers and market analysts are

¹⁸ The case for portfolio diversification is clearest in the Capital Assets Pricing Model (CAPM), which is widely used to price investment risks, based on Harry Markowitz’s (1952) seminal contribution to portfolio theory. In Markowitz’s model, investors start with a portfolio Q , which has an expected return μ_q and a variance of σ_q (which measures how strongly the return deviates, on average, from its mean value). The variance is the key measure of risk. A portfolio that results in the highest level of return for a given level of risk or the lowest level of risk for a given expected return is deemed efficient. The functional form is typically written as $V_q = \gamma\mu_q - \sigma_q$, where V is the value of a portfolio, and γ is a weighting factor that measures how much an investor cares about the expected return. Based on this model, the CAPM was developed to help investors balance risk and reward in a portfolio. In CAPM, all non-systematic sources of risk (political events, strategies pursued by individual firms, etc.) in a market portfolio that might cause the actual return to deviate from the expected return are completely diversified by picking a portfolio that contains securities with variances that are uncorrelated (Bechtel 2009).

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TABLE 4.2 Pari passu in unsecured cross-border bonds

Decade	Number of issuances	% with <i>pari passu</i> clause
1940s	20	5.0
1950s	38	63.2
1960s	64	84.4
1970s	77	87.0
1980s	121	84.3
1990s	343	95.3
2000s	691	98.7

normalizing this new contractual feature of international bonds issued by emerging countries by reconstructing their conventional categories. Emerging markets have “improved” or “graduated” from the institutional and macroeconomic syndromes that hobbled them until a sea change arrived a half-decade ago; money managers refer to “improved EM sovereign fundamentals,” the “much firmer financial footing” onto which governments have put their economies, and “victories” over “political instability, social unrest, and economic turmoil . . . [that were] *status quo*” in these countries until recent years.¹⁹ The symbolic reconstruction of local currency debt as safe now that a subset of countries have “emerged” from their sinful practices is, following Marion Fourcade’s dissection of the BRICs categorization, “a narrative strategy that seeks to alter investment patterns in the emerging markets fund industry” (Fourcade 2013: 263–64).

LEGAL FICTIONS IN SOVEREIGN DEBT CONTRACTS: THE PARI PASSU CLAUSE

The *pari passu* clause first appeared in debt contracts in the 1870s and in recent decades has appeared in nearly every international sovereign debt instrument. Table 4.2 from Gulati and Scott’s (2013: 122) book on

¹⁹ The quotes in this section are drawn from reports by the financial market research firm Research Affiliates (“An Emerging Asset Class: The Case for Emerging Markets Local Currency Debt,” July 2013) and Alexander Kozhemiakin, the Director of Emerging Markets Strategies at Standard Mellon (“Emerging Markets Local Currency Debt: Capitalizing on Improved Sovereign Fundamentals,” August 2011).

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pari passu, tracks the proportion of unsecured bond issuances containing the covenant in each decade after 1940.

The clause has the character of a legal fiction, since “almost no one knows what it means” (Gulati and Scott 2013: 3; see also Buchheit and Pam 2004; Varotttil 2011). Why would a legal covenant that is difficult to interpret and in any case does not match the reality of how sovereign debt restructuring works become ubiquitous in prospectuses that detail the terms of the transaction? The suspension of market players’ disbelief resembles the way in which readers readily accept elements in works of literary fiction that are clearly untrue or impossible. Searle suggests that the suspension of disbelief is made possible by a “set of extralinguistic, nonsemantic conventions . . . [that] enable the speaker to use words with their literal meanings without undertaking the commitments that are normally required by those meanings” (Searle 1975: 326; quoted also in Beckert 2013a). Beckert (2013a) suggests that market players’ “fictional expectations” in the presence of Knightian uncertainty are rooted in conventions just as fiction in literature is made possible by the conventions shared by authors and readers. The legal fiction of pari passu allows bondholders to pretend “as if” the problem of discriminatory action by the sovereign issuer down the road has been resolved, so that they can pass over it in order to move onto other business. As Beckert writes, “only by being overlooked does uncertainty not lead to paralysis or randomness” (2013a).

The ostensible purpose of the contractual clause is to protect bondholders when the borrower needs to restructure its debts. In a corporate bankruptcy, pari passu prevents the debtor from ranking its creditors by giving some privileged claims on liquidated assets and subordinating other bondholders (Buchheit and Pam 2004: 873–74). The significance of this kind of protective clause in a sovereign debt instrument is less obvious: to paraphrase legendary banker Walter Wriston, countries don’t go into bankruptcy proceedings. Wright (2011) argues that the general aim of the pari passu clause in sovereign debt instruments has been to reduce the risk of discriminatory action by the government involved in a restructuring against some subset of the country’s nonresident creditors.

Law practitioners and scholars Buchheit and Pam (2004: 912–15) identify several specific risks that might justify the use of clause in unsecured international sovereign bonds. One is the risk that the government will set aside some assets or revenue stream (such as foreign reserves) to ensure that some bondholders, with whom the government

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may have informally negotiated, receive full payment, while others are subordinated. Gulati and Scott's interviews with transactional lawyers indicate that this is a commonly told origin story in the profession (Gulati and Scott 2013: 112–13).

From the mid 1970s to the present, however, a different legal covenant in sovereign debt instruments – the negative pledge clause – has been interpreted as the way to address the risk of earmarking; thus Buchheit and Pam argue that “the risk of sovereign earmarking was not the only motivation for inclusion of a *pari passu* clause in sovereign credit instruments” (Buchheit and Pam 2004: 913). Gulati and Scott argue similarly: “the historic function of the clause was unrelated to concerns about earmarking, which concerns were primarily, if incompletely, addressed by a version of the negative pledge clause” (Gulati and Scott 2013: 125).

Perhaps *pari passu*'s enduring popularity has to do with the risk of governments issuing decrees that lead to subordination of some group of creditors in favor of a different group. Before the 1970s the principle of sovereign immunity made it very difficult for creditors to pursue litigation when a government unilaterally altered or failed to observe the terms of the debt contract. Sovereigns' insulation from legal means of enforcement eroded over time “through statutory changes and through case law” (Panizza et al. 2009: 653). Yet private litigation against governments was infrequent until a sizeable secondary market for sovereign debt emerged in the late 1980s. In this environment new, more litigious specialized firms (“distressed debt funds,” colloquially known as “vulture funds”) set out “to buy defaulted debt at large discounts with the aim of extracting the best possible settlement” (Panizza et al. 2009: 656). *Pari passu* was a useful legal covenant for these firms. But it is difficult to explain the large increase in the usage of *pari passu* in sovereign debt instruments from the 1940s to the 1970s as a consequence of demand by litigious creditors, given that legal means for debt enforcement only became common in the 1990s.

Buchheit and Pam offer a third rationale for the use of *pari passu* in debt instruments: it can be a tool for protecting international investors from the risk of discriminatory treatment emanating from quirks in national legal codes. They provide evidence from the Philippines' legal system to demonstrate “the risk that sovereign debt might be involuntarily subordinated as the result of local law procedures” (Buchheit and Pam 2004: 917). For Buchheit and Pam the risk of

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involuntary subordination due to provisions in national legal codes is the most powerful reason for the ubiquity of *pari passu*.

The extensive data on sovereign bond issues collected by Gulati and Scott, however, does not fit neatly with the Buchheit and Pam story. Their data show that modifications to the *pari passu* boilerplate began to appear around 1980; these new variants “were an attempt to address . . . sources of local law risk” (Gulati and Scott 2013: 132). The additional language added to the clause suggests that *pari passu* alone wasn’t regarded by contract drafters as sufficiently strong to protect against the risk of involuntary subordination due to local laws. More puzzling still is the sharp decline in the modified variants of the clause over the past two decades. Gulati and Scott ask why, if lawyers’ primary reason for including the *pari passu* clause was to protect bond buyers from local law risk, “would they have subsequently removed language that explicitly addressed those risks?” (Gulati and Scott 2013: 132–33).

Gulati and Scott do not use the term “legal fiction” or “placeholder” in their study of *pari passu*’s enduring presence in sovereign debt contracts. Their preferred explanation – “in the great majority of firms, lawyers rely on the herd and their myths” (Gulati and Scott 2013: 6) – is, however, consistent with the claim that rule-following behavior by economic agents is a common and, indeed, necessary element of the structure of stable markets (Biggart and Beamish 2003: 455–57). Gulati and Scott briefly suggest that the herd-like behavior of debt contract drafters is rooted in uncertainty: “when subjects are asked to make decisions under conditions of uncertainty, they often look to what others are doing (social proof and conformity) or look to well-established practices (deference to authority and anchoring) before deciding on a course of action” (Gulati and Scott 2013: 42).

The endurance of the *pari passu* covenant is particularly surprising given the big problems that it causes. In the late 1990s a fund specializing in distressed debt, Elliott Associates L.P., sued a Peruvian bank (Banco de la Nación, the issuer) and the government of Peru (the guarantor of the debt) for repayment of bonds the fund had purchased at steep discount just before Peru wrapped up restructuring its external debt under the auspices of the Brady Bond plan spearheaded by the US Treasury department. Elliott Associates won its case in a New York court and was awarded a \$57 million judgment – but winning a case against a government and collecting on the judgment are two different problems, and the former is easier to solve than the latter (Panizza

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et al. 2009: 657; Varottil 2011: 227–28). To ensure that it would be paid, Elliott’s lawyers constructed a legal argument, built on NYU law professor Andreas Lowenfeld’s interpretation of the *pari passu* clause in the Peruvian debt contracts as requiring *ratability* of payments, to prevent any other bondholder (including the vast majority of bondholders that participated in the Brady negotiations) from being paid if Elliott was not also paid in full (Buchheit and Pam 2004: 877–78). Instead of the conventional interpretation of the clause as meaning that a borrower could not accumulate *new* debt that would be paid before the previously-issued debt in a restructuring event, Elliott’s lawyers argued that “a debtor not yet in bankruptcy that has accepted a *pari passu* covenant must *pay* all its equally-ranking debts equally” (Buchheit and Pam 2004: 879). In September 2000 a Belgian court ruled in favor of Elliott over Peru, and it ordered the Euroclear system through which the first Brady payments were to flow to European bondholders to freeze Peruvian payments. Caught between two horns – give up its case against the “vulture fund” or miss the Brady bond payment and fall into technical default – the Peruvian government chose to settle with Elliott for over \$56 million (Panizza et al. 2009: 658). Other distressed debt funds noted the extraordinary interpretation of *pari passu* in Brussels and a flurry of similar lawsuits were launched.²⁰

Buchheit and Pam (2004: 883–90) lay out a series of criticisms of the Belgian interpretation of the *pari passu* clause. The decision strengthened the position of holdout creditors and worsened coordination problems involved in organizing debt restructuring among far-flung bondholders with different preferences. The decision also conflicted with a long-standing convention in the sovereign debt market: the debt owned by “official” creditors (the IMF, World Bank, and other international financial organizations) is, by custom, senior to privately held debt. The “ratable” interpretation of the clause threw this practice into question. Legal scholar Umakanth Varottil distills the critical view of the decision: “The overwhelming number of arguments against the judgment in *Elliott* confirms that the court’s interpretation cannot stand. The market should therefore be expected to react by clarifying the language in sovereign debt documentation to avoid similar results in the future” (Varottil 2011: 229).

²⁰ The follow-on suits are briefly described by Buchheit and Pam (2004: 880–82) and Panizza et al. (2009: 658–59).

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That's not what happened. Instead, the *pari passu* clause was retained in post-September 2000 sovereign debt contracts without any significant alterations (Gulati and Scott 2013). The clause is at the center of the case brought by NML Capital (a subsidiary of Elliott Associates) against Argentina. The Argentine government refused to redeem NML Capital's holdings of bonds, purchased on the secondary market at bargain-basement prices, because doing so would contravene the 2005 "padlock" law that prevents the government from paying bondholders that were not party to the country's debt restructurings (Gulati and Scott 2013: 170–71). In 2011 a judge in New York ruled that the 2005 law was a violation of the *pari passu* clause and moved in 2012 to freeze the country's payments to its creditors, raising the specter, as Peru experienced in September 2000, of another (this time involuntary) default on its international debt. And indeed Argentina did fall into a "technical default" in July 2014 after the Supreme Court of the United States rejected the Argentine government's challenge to the New York court's decision. Argentina has been unable to make payments to any of its creditors; as a consequence, it has been locked out of the international debt market, and as the central bank's reserves dwindle the threat of a serious balance of payments crisis looms.

CONCLUSION

Agents rely on social conventions to resolve recurrent coordination dilemmas and to stabilize their expectations in the presence of epistemic uncertainty. Conventions are an element of the organization of social institutions, including international markets. Contracts in financial markets include "legal fictions" – covenants which are not strictly true but are useful "placeholders" that allow parties to a transaction to overlook the uncertainty that characterizes the market. In this chapter I asked whether two puzzling aspects of the international sovereign debt markets – the inability of governments of low- and middle-income countries to denominate the sovereign debt instruments that they sell to nonresident investors in their own currencies and the use of the *pari passu* clause in sovereign debt contracts – can be viewed as conventional rather than simply behavioral regularities driven by underlying causal factors such as poor economic policies and weak institutions in developing countries, transaction costs, and constrained optimization by rational actors trying to contract around various risks. The evidence in the chapter is drawn from economists' and legal scholars' research on

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“original sin” and the terms of sovereign debt contracts. My interpretation of the research might be incomplete or incorrect, but there seems to be sufficient evidence to swing the burden back to IR scholars that argue that explanations rooted in the material-rationalist approach can tell us everything we want to know about sovereign debt. If we do not look for social conventions and legal fictions we are apt to miss some potentially important facets of international financial orders.

Conventions are not the only important explanatory factor in the two cases discussed in the chapter. In many, if not most, domains of world politics the regularities we observe are the output of some combination of instrumental decision making by materially oriented, risk-calculating agents and rule-following by agents following logics of appropriateness (March and Olsen 1998; Fearon and Wendt 2002; Hurd 2008: 310–11). In some contexts instrumentalism dominates; in others, behavior is driven mainly or wholly by social norms and conventions. The way to figure out if explanations built from material-rationalist, social-constructivist, or eclectic elements are right is to look at the consistency of each explanation with the data. This chapter suggests that social conventions and legal fictions ought to be an important part of the analytical toolkit employed by scholars of international organization.

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