Economic History

Sovereign Debt Markets and Political Stability – Evidence from 19th Century Europe

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The globalisation of financial markets seem a commonplace feature of the modern world economy, however the story of their development is less well-known. Christopher Swords gives an insightful historical overview of the origins of sovereign debt markets. He draws expertly upon 19th century examples of key turning points and figures at the centre of the genesis of the bond market, concluding with possible directions for future research in this area.

Introduction

"I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody." (Carville, 1993)

Twenty three years and six U.S. presidential elections have passed since Democratic strategist James Carville made his famous quip on the power of the bond market. In remarking on its power to intimidate, Carville was referring to the bond market's capacity to exert an influence over governmental policymakers, via its autonomy in setting the price at which government borrows in the global debt market. As one of the pillars of the financial system that characterizes the capitalist economy, the market for debt – both sovereign and corporate – offers a feedback loop between investors and policymakers. If a government executive signals an intent to implement policy that investors feel is not in that nation's best interests, they have the capacity to drive up that nation's cost of borrowing, communicating their unease and making it more difficult for new policy to be implemented. It is via this mechanism that a relationship between the bond market and political outcomes may emerge. Law and order, representative government, institutional stability and the enforcement of property rights are all desirable political characteristics that the bond market rewards; despotism, war and opacity are punished.

In light of recent political events and trends in public discourse, it has never been more important to understand the nature of the relationship between markets and politics. For the best part of 70 years, from the end of the Second World War, a liberal orthodoxy prevailed in western economics, under which the world economy became characterised by globalization – freer flows of trade, labour and capital around the globe. However, the financial crisis of 2008 proved to be an inflection point; the crash served to accentuate rising inequality and growing pockets of concentrated economic hardship, motivating a proliferation of public and political discourse marked by calls for closed borders, caps on migration and barriers to trade. The rise of populism in many developed Western states is indicative of this trend. In the context of capital, the consensus in favour of free cross-border flows was deeply shaken by the Russian and East Asian crises of 1997-98, during which it became apparent that the free movement of debt capital allowed for financial contagion to spread across borders. Reservations motivated by events such as these have had policy implications, such as the "gates" and "walls" to cross-border capital flows discussed by Klein (2012). It has been suggested that we are at the beginning of a second era of "deglobalisation" (Economist, 2016).

The integration of capital markets – a central feature of our democratic capitalist system – is therefore under threat. The efficiency of capital markets, and their capacity to serve as a signaling device to politicians and governments, is predicated on their integration, and the freedom to trade that integration facilitates. It has become imperative therefore to better understand the potential political consequences of erecting barriers to the free movement of capital.

In order to make inferences about the general effect of increases in the integration of capital markets, it is proposed here that it would be instructive to present an account of the particular period in history during which capital markets integrated most rapidly – in the aftermath of the Battle of Waterloo – alongside an account of the geopolitical trends that characterised the period.

Sovereign Debt Market Integration

The core theory of capital markets tells us that in general, the role of capital markets is to allocate capital such that marginal products of labour and natural resources between economic activities, or economies as a whole, are maximized. Under theoretical perfect capital markets conditions, we expect capital to move between economies until the prices of capital in these economies are in equilibrium. In other words, we should expect that capital move from nations in which it is abundant to nations in which it is scarce, in order to take advantage of differentials in the rate of return. As markets integrate and capital becomes more internationally liquid, interest rates between economies should tend to converge. When this is allowed to happen, capital is priced such that the marginal products of labour, land and resources between economies are maximized – the Pareto optimal outcome. To contextualise this, an increase in the integration of the 19th century European sovereign debt market would allow investors in a capital rich nation such as Great Britain, to invest in business projects in a capital-scarce nation elsewhere on the continent. The investor can expect to take advantage of an arbitrage opportunity in the form of a return above that which his risk warrants, due to the excess demand for capital in that nation. Eventually, these opportunities are bid away, and the two capital markets equilibrate.

The genesis of the bond market as we know it today can perhaps be ascribed to the period 1818-1822. The first half of the 19th century was a period of rapid development and international integration of European financial markets, during which time London emerged as a global financial centre. Prior to this, Europe was mired in a financial wilderness – revolutionary France defaulted on the monarchy's debts, French subjugation and annexation left the Dutch bankrupt by 1810, and the Russian monarchy narrowly avoided bankruptcy through two renegotiations of external debt, in 1797 and 1815. The respected Dutch system of sovereign debt issuance that prevailed throughout the 18th century was dealt heavy blows by the wars of 1793 to 1815 (Riley, 1980). The Battle of Waterloo in 1815, however, represented a turning point, as it figuratively pitted two financial systems against each other, with the British and their system of balancing the fiscal budget with debt raised in capital markets defeating the French and their alternative system of balancing by conquest and pillage.

Technological and institutional conditions had developed such that by the time of the conclusion of the Battle of Waterloo, they allowed for rapid international financial development. The introduction of the telegraph for instance greatly enhanced the speed with which information could travel across the continent (Standage, 1998), while the adoption of the gold standard as a currency peg throughout the latter half of the century across the continent mitigated currency risk, thereby allowing for freer capital flows (Obstfeld & Taylor, 2003).

One cannot discuss the 19th century globalisation of financial markets without mention of the house of Rothschild. The brothers Rothschild – Nathan, Amschel, Salomon, Carl and James – serve to embody this formative period in the development of the capitalist system with which we are today familiar. Via their internationally integrated network of banks, the Rothschild bankers underwrote a bond in 1818 for the state of Prussia to be issued in London and denominated in Sterling. They underwrote a similar issuance for the Russian state in 1822, the most significant difference in the present context being that interest payments on the Russian bonds could be collected in either London or St. Petersburg, in either Sterling or Russian Roubles. Being issued in a foreign currency and a foreign market, these Prussian and Russian bonds were unprecedented, and were identified by Ferguson (2005) as the first "Eurobonds". An immensely important financial innovation, these bonds set a new precedent for cross-border capital flows, and heralded a new era in financial markets in Europe and globally; one characterised by the integration of international markets and one whose development culminated in the markets that we use today.

Sylla, Wilson and Wright's (2006) investigation into the point at which trans-Atlantic capital markets began to integrate corroborates this conclusion. They analysed the price convergence of three financial assets that were traded on both the London and New York exchanges – shares in the First Bank of the US, shares in the Second Bank of the US, and US three-month bonds – as a gauge of market integration. It was an ideal test of market integration - with perfect arbitrage, prices of the same asset in separate markets should always be the same, and discrepancies eliminated immediately. Their analysis suggested that price convergence began in earnest in 1815, in the aftermath of the Battle of Waterloo and precisely as the Rothschilds were beginning work on their first Eurobonds.

Pax Britannica

From a political perspective, the period spanning from the end of the Napoleonic Wars until the beginning of World War I was a period of relative geopolitical calm, and was characterised by the ascent of the British Empire to global political and economic dominance. Victory over Napoleon at the Battle of Waterloo left the British Empire without a serious international rival and free to establish a period of hegemon referred to in the literature as Pax Britannica – Latin for "British Peace" (Johnson et al., 2008). Thackeray (2002) identified a vested interest in unimpeded international trade on the part of the British, combined with a navy powerful enough to police the oceans, as one of the central causes of the peace and stability associated with Pax Britannica. The emergence of the Great British Empire coincided with the proliferation of new ideas about free markets and trade, particularly those of Adam Smith (1776). Recognising the importance of trade for prosperity, the British invested in the Royal Navy to the point that it developed an unrivalled maritime dominance, allowing them to determine trade policy and coordinate the movement of goods and capital around the globe. With a global hegemon that had developed a commercial interest in peace, political stability prevailed. Although not a period of total geopolitical tranquillity – owing to the Crimean War (1854-1855), the Indian Mutiny (1857), and the Zulu War (1878-1879) – Brown, Burdekin and Weidenmier (2006) point to the marked decrease in reduction in British Consol price volatility as quantified evidence of calm.

It is tentatively hypothesised in this paper therefore, on the basis of their temporal co-occurrence, that the integration of the European bond market throughout the course of the 19th century was amongst the causal factors that induced the political stability that characterised the period.

The intuitive rationale for this hypothesis lies in the detail of the Prussian and Russian 19th century bond issuances. In addition to a mortgage on Prussian royal estates, Nathan Rothschild demanded what is referred to as a sinking fund as part of the collateral on the loan – a pool of capital in the form of English government bonds, supplemented annually with compound interest and more such bond purchases until the extinction of the Prussian debt (Ferguson, 2005). In a remarkable clause, Nathan

Rothschild decreed that the sinking fund should be administered by a committee of seven, four of whom should be outside of government. In explaining his thinking behind this clause, Rothschild explained that for British investors to invest in foreign debt, such debt should be structured as closely as possible to British debt, in that it should have some form of security beyond the "mere good faith of the government". He cites the case of more recent British investment in French debt, which was undertaken upon the general belief in the representative system now in place there. Apparently, the 'sanction of the Chamber', or parliament, to debt incurred by the state affords a guarantee that is not to be found in debt issued by a state 'uncontrolled in the exercise of executive powers' (Ferguson, 2005: 318). It would appear here that Rothschild was effectively declaring that he would underwrite foreign loans in London but only for certain types of states – constitutional monarchies similar to that in Britain but not some neo-absolutist regime. Ferguson (2005) hypothesises that this financial liberalism may be seen as a subtle form of political pressure, in support of Prussian reformers who had been pressuring Frederick William III some form of popular representation. If so, we may have witnessed an instance in which the globalisation of financial markets exerted a definite influence over important political outcomes.

Subsequently, included in the Russian bond issue in 1822 was a war clause, which stated that 'The payment of the perpetual annuity, as well as the payment of the outstanding debts, will be effected in time of peace, as well as time of war, without distinction, whether the creditor belongs to a friendly or hostile nation' (Ferguson, 2005: 320). Rothschild and his bankers recognised that war greatly increased the possibility of a sovereign default, and included the clause in order to reassure investors that their dues would be paid irrespective of political situations. Simultaneously, the clause presented nation states with a considerable incentive not to engage in warfare or incite conflict – they would no longer be in a position to relieve war-induced financial pressure by a debt default.

Directions for Future Research

Two hundred years on, the potential for a second era of deglobalisation necessitates a greater understanding of the broader consequences of the disintegration of capital markets. In this essay, a brief account of the first period of European capital market integration and the political trends with which it co-occurred has been presented, in the hope that it may help to instruct hypotheses surrounding the role of capital markets in political outcomes. In particular, on the basis of the clauses included in the first Russian and Prussian foreign-issue bonds, it has been hypothesised here that the integration of European sovereign debt markets was among the factors that played a causal role in motivating geopolitical stability throughout the 19th century.

In order to test this hypothesis, researchers may make use of the fact that interest rate convergence is related to capital market integration, and that major financial asset (such as the British consol) price volatility is related to uncertainty in the broader political landscape. An investigation of the relationship between interest rate convergence in 19th century Europe, and consol price volatility over the same period, may help to determine whether or not a causal mechanism between capital market integration and political outcomes exists. It has never been more important to understand the nature of this relationship.

Conclusion

The 19th century marked a major turning point in the world economy. Ikenberry (2000) describes how the onset of the industrial revolution triggered a massive expansion of trade, capital and technology flows, alongside an explosion of migration and communications, and characterised the 'first age of globalisation'. The Rothschild Bank and the flotation of the first foreign-issue "Eurobonds" heralded an era of unprecedented capital mobility. Up until that point, capital had been tied up in the form of land, and the wealthy subsided off of the rents of the estates to which they were tied. This new system of paper security, such as that issued by Prussia in 1818 and Russia in 1822, endowed the elite with a portable property. No longer tied to their land, this newfound mobility allowed wealthy individuals to gather in cities, setting in motion the establishment of a new social order. Essayist Heinrich Heine (1838) went so far as to mention Nathan Rothschild in the same breath as Richelieu and Robespierre, as one of the three names that 'spell the gradual annihilation of the old aristocracy'. He rose the system of government bonds to supreme power, replacing land with money as the most important manifestation of capital.

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