The squeaky wheel gets the grease:

Gains and Losses in the aftermath of the Baring crisis

***************Very preliminary and incomplete***************

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Abstract

This paper analyzes some unexplored implications from the Baring crisis in terms of bilateral trade, output losses, bailout conditions and investors' returns. We depart from Baring's balance sheet position in November 1890, when it requested the support from the Bank of England. We demonstrate how the necessity to avoid Baring's fall conditioned the strategy to deal with Argentina's government, obligating London's bankers to avoid a default. The success of this strategy had broader implications on London's activity in trade finance and on the business for sovereign debt underwriting. It also shaped Argentina's economic policies and the structure of Baring's own activities. The Baring crisis offers a case study where the mechanisms in which finance affects the real economy are magnified due to an agent's too big-to-fail position.

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Introduction

The present crisis has opened the door to a set of abandoned questions on the links between banks, governments, and economic growth. The fall of Lehman Brothers in September 2008 had severe implications in terms of interbank credit, overall credit, and a general feeling of mistrust on many banks' solvability. The necessity by governments to step in to support their financial systems, along with countercyclical fiscal policies and the fall in public revenues brought a new height to the crisis. The fragile position by the banks in many developed economies has since then been accompanied by a weakened position of their governments themselves, worsening thereby the possibilities to a prompt economic recovery.

The basic needs of every country to develop a well-performing financial sector has been satisfied only after assuming the costs caused by more or less frequent banking crises. With the continuous deepening of finance into every day's economic activity, the risks of an economic collapse steaming from difficulties in the financial sector have also increased. Moreover, as the fall of Lehman Brother shows, some banks have become too big to fail. Bad risk management in any of these entities can thereby rapidly affect the totality of the financial system and trigger a contraction in credit and in economic activity.

Understanding the interactions between financial crises and the rest of the economy is a complex task. The more so if we take into account the role of governments, central banks, regulators and multilateral organizations, all of which have evolved in the last decades. Still, some mechanisms have remained for more than a century, as demonstrated for instance from the continuous referencing by central bankers to Bagehot's Lombard Street (1873) or the continuous analogies done by economists and policymakers to the Great Depression. This paper assesses some of these interactions during the Baring crisis, which occurred at the height of the so called first globalization period, and analyses the implications of Baring's near bankruptcy. This episode offers interesting insights on how a single bank could jeopardize a whole financial system both within and beyond its national borders.

The too big to fail argument, whereby a central bank is obliged to intervene to save a bank is probably no more justified in history than in November 1890. The Bank of England acted promptly on a number of fronts to support Baring and avoid a financial and probably an economic meltdown. In order to get an idea on the magnitude of "the" problem, I may give some figures. Baring's balance sheet was, one year before the crisis, al most £30 million worth, at a moment where British total exports were about £249 million, or about 11% of them. Baring's capital in 1890 was worth almost £3.0 million, at the moment where a foreign government's average loan at the London Stock Exchange was £6.3 million.[2] Before 1890, the bank had held and kept about 20% of the underwriting debt markets since several decades, despite fierce competition, and was responsible for 15% of the total number of acceptances in Britain, which was the main vehicle to finance trade. Comparative figures on today's investment banks would only pale with those for Baring's.

The rescue package by the Bank of England offers additional, exciting parallels to our financial architecture. In a period of strong financial integration, Baring's toxic assets were those involved with investments in South America, particularly in Uruguay and Argentina. The Bank of England was therefore obliged to find an engagement with the governments of those countries to hinder a default and preserve Baring's portfolio value. This could only succeed with the intervention of the banks participating in the underwriting of foreign securities, in particular Rothschild. The Bank of England also guaranteed Baring's liabilities, with the support of other central banks and mainly, with the support from London's financial community, through the constitution of a guarantee fund.

These measures had short and medium term implications. A bailout fund for Argentina was only possible with that country's government accepting to adopt a fiscal austerity plan and a restrictive monetary policy in order to strengthen the value of the peso. A renegotiation of the initial agreement was necessary three years later given the persistent difficulties by the government to meet its debt service. Investors of Argentinean securities suffered a short term loss, but made important gains after the adjustment period. Baring, on the other hand, was split in two branches. The first branch kept the "toxic assets" from its underwriting business, whereas the sound branch concentrated in the profitable activities, concentrated mainly in the acceptances market. It was precisely Baring's market power in both, trade finance and underwriting, the key element behind the urgency of the Bank of England to act and also on the consequences on London's central role in financing international trade and investment worldwide.

We proceed as follows, Section I presents the reasons advanced in the literature that may explain why Baring was rescued. Section II shows the state of affairs in November 1890, when Baring asked for support by the Bank of England to avoid bankruptcy. Section III describes Baring's path to 1890 in terms of its trade finance activities, while section IV provides a general description on its underwriting activities. Section V looks at the consequences of the Baring crisis in terms of investors' losses, on the one hand, and on the bilateral trade between Britain and Argentina and in the later countries' GDP growth.

[2] This figure corresponds to long-term loans (at least 10 years maturity) for the period 1877-1895. Details on this and related figures can be found in Flandreau et al. (2010). The data on Baring's balance sheet are from Ziegler (1992).

I. A hair in the soup: The Bank of England and Baring's problems

Probably one of the most tense moments ever remembered in the Bank of England was humoristically captured by its governor, Mr Lidderdale, when he described his activities in November 1890: "John Daniell came in about noon and said 'Can't you do something or say something to relieve people's minds –they have made up their minds that something awful is up, and they are talking of the very highest names – the very highest' (I remember both the words and the way he lifted up his arms when speaking)".[3]

Mr Lidderdale, had certainly reasons to be concerned, and still more to find a rapid solution. A first reason concerned the immediate impact of the fall of Baring which, given its size, would very certainly trigger a panic in the City and beyond. A second reason was the potential to affect international trade. London was the financial centre where an important part of international trade was financed, reflecting Britain's largest market for the world's exports and because sterling pound was the world's currency of reference. The bills of exchange on London were therefore in high demand in the most distant places, and those endorsed by Baring were considered among the most reliable. To give but a few examples, Crump (1891, p. 389) stated one year after the crisis that: "it is no exaggeration to say that until the middle of November 1890 the name of Baring Brothers was as good as a bank-note in every port in the civilized world". Rothschild himself recognized that "if the catastrophe came, […] it would put an end to the commercial habit of transacting all the business of the world by bills on London".[4]

These two reasons alone were important enough to justify intervention. However, the Bank of England's incipient functions as lender of last resort could not be pursued straightforward, given the amount of Baring's liabilities, too high compared even with the Bank's own reserves. The Bank expected therefore an essential support from the British government, but also from the most important financial institutions. Previous literature has advanced two main causes for this cooperative mood. On the one hand, some authors have emphasized the importance of the financial sector in shaping British economic policy. The power structure prevailing in the British economy has been described as a kind of unique governing body in which the scope of a joint action by these three actors was to be demonstrated during the Baring episode.[5] As later studies would argue, within the financial world of the 19th century, the position of the Bank of England was regarded as the head and centre of a "banking hierarchy, which dominated not only the banks of the United Kingdom, but has many

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[3] Mr Lidderdale's comments on Mr Greene's statement; Bank of England Archives G15 / 192. The episode is often quoted in the literature on the Baring crisis. For instance, Ziegler (1989, p. 250), Clapham (p.331), Kindleberger (2000 [1978], p.152). describes John Daniell as the leading man at Mullens & co. and a main participant for the Bank of England's open market operations

[4] Quoted in Ziegler (1989, p.246).

[5] See for instance Cain and Hopkins, 1993.

foreign connections" (Powell, 1915; pp.522). In other words, the structure of British merchant banking provided sufficient incentives to collaborate in case of financial distress. The Baring crisis episode provides a perfect example of common interests to avoid catastrophes.

On the other hand, a second group of arguments concern the importance of market incentives. The evolution of London's 19th century financial structure was marked by a high concentration of banks dominating the business of securities underwriting, in particular those from foreign governments. The result was the set up a market mechanism that had successfully operated, whereby banks with a high market share had incentives to be selective bringing to the market only safe securities. The reputation-based rating of financial assets risked failure, and those risking losing the most were those with the highest market shares.[6] *The Economist* summarized the general sentiment towards them: "while the name of a well-known house must and should always be of value, it has never been an index to the permanence of a country's solvency, and we should learn to accept it for what it is worth and no more".7

For those concerned, resignation was the most immediate reaction. John Baring himself put it in plain English, once it appeared clear that his firm would be able to survive:, "the glory of the past and the prestige of the name have I fear disappeared forever". (quoted in Ziegler, 1989, p. 257). For others, however, this required active cooperation and a reactive defence on the very essence of their business. This was certainly the *raison d'être* for Rothschild's involvement in the successive negotiations with defaulting Argentina in 1890 and afterwards, and for the severe conditions that Rothschild imposed to defaulting Brazil in 1898, as shown in Flandreau and Flores (2012).

II. Sir? We have a small problem here…

Both groups of arguments are non-exclusive, and share a common feature on the importance given by that London's financial elites to prevent Baring from failing. The plan designed by the Bank of England involved two steps, conditioned on the verification on Baring being solvent though temporarily illiquid. The first was the provision of support by the Bank of England itself to guarantee Baring's liabilities during the distress period. This was conditioned first by the direct support of the British government and then by the commitment of a syndicate of banks to share losses if trouble arose. The second step foresaw the restructuration of the firm into a limited corporation. The first step was certainly the most problematic. The success of the operation depended on the valuation of Baring's assets, and on the length of the distress period. Both aspects were linked to the faith of their most problematic investments from Argentina and Uruguay. These assets included unplaced

[6] On a description on this mechanism see Flandreau and Flores (2009, 2011).
[7] The Economist, May 23 1891.

government bonds and the shares and debentures from the famous Buenos Aires Water Supply Company, which Baring had underwritten.
The negotiations with Argentina's government were left to a group of bankers, whose head was no less than Rothschild. Their two main aims were to avoid a default and to obtain the engagement of Argentina's government to repurchase the Buenos Aires Water & Supply Co. The Bank also set up a guarantee fund to which most private and joint-stock banks were bound to participate, along with other actors such as the discount houses and the British government itself. Finally, the Bank of England obtained a loan from the Bank of France, task for which the multinational branching nature of the Rothschild banks was crucial,[8] and obtained the agreement of the Russian Government not to withdraw any deposit from Baring during the following months.

Before looking at the broader consequences of the form adopted for the bailout, we aim to emphasize that the will by the Bank of England to sustain Baring was beyond a mere illiquidity or insolvability issue. Table 1 presents Baring's portfolio with the valuation done by B.M. Currie and Benjamin J. Greene, the agents charged by the Bank of England to enquire about Baring's solvability. Liabilities showed a total of £ 19 million, whereas assets amounted £24.7 million. Liabilities were mainly composed by acceptances ("falling due day by day") and deposits, which could be withdrawn at any time. One of the deposits was precisely held by the Russian government, of £2.4 million, and had already given notice to take £0.5 million each month during the following three months. On the asset site, the estimates were generous and mostly optimistic. A more detailed look at the classification used gives a better idea on the need to rate Baring as solvable. Cash at call, bills receivable and real estate were considered safe assets. Strikingly, we can also find some Argentinean securities among the "AAA" rated assets. They were mainly stock from the Bank of the Province of Buenos Aires and from Argentina's National Bank (the latter, "though good it is not so strong as the others"). In fact, the National bank had already suspended dividend payments since March 1890, and after the crisis it was liquidated and replaced by the Banco de la Nacion. The provincial bank was also bankrupt in 1890 and had to be re-established one year later (Della Paolera, 1994, Rapoport, 2005). Telegraphs received by Baring showed also the concerns raised since the early 1890 concerning the poor state of the banking sector in Argentina.

<Table 1 about here>

Speculative graded ("Debtors "B"") stock were those whose value was uncertain and more volatile. It included short-term advances to the governments of Argentina, Portugal and Montreal, and debts from companies and third banks. It included also a stock portfolio, valuated at £4.1 million, of which £2.5 million were related to Argentina and Uruguay, whose government was

[8] Ref. to the Bank of England Archives. Pressnell says also in the Banker's Magazine…

also on the brink to default and shared at the time many common troubles with the government from its bigger neighbour. Moreover, Baring held also supplementary Argentinean' government bonds that the bank had accepted as payment for debts incurred by Samuel Hale, its agent in Buenos Aires. Baring' total assets related with Argentina amounted £8.2 million, or about a third of its total. If we add those assets related with other "B" debtors, we have a total of £9.7 million of "subprime" assets, equivalent to something less than half of total assets.

This figures somewhat confirm Ferns (1992) conclusions. He argued that Baring's difficulties were not really caused by the amounts of Buenos Ayres stock that the bank had underwritten, but rather, by the failure of the company that they had promoted). In fact, even without Baring's involvement in this enterprise, Baring's position was too exposed to any economic or political shock from Argentina. Most economic historians give the issue of Buenos Ayres Water Supply and Drainage company stock a main role in Baring's successive liquidity problems. The IPO for this company had place on the 15th November 1888. Three million sterling pounds were issued in preference shares, and five hundred thousand in ordinary shares, both at par. Apparently, this issue was a complete failure. Though we cannot know precisely the amount of unplaced stock, we can estimate the charge on Baring's portfolio and the constant need for intervention by the bank to support stock prices given the fact that, one year later, the prices of both stocks were quoted between par and small discounts, and during the first part of 1890 no recovery took place.[9] Baring's balance sheet at the end of 1889 shows that Argentina's stock value was about 10% of Baring's total stock value, and about 5% of total assets.[10] The value for the Buenos Ayres Water Supply Company was ca. £200 thousand, which is by no means impressive. The main problem, as we shall see, was the commitment by Baring to underwrite a further £0.9 million in that company's debentures, and that the bank was unable to issue given the poor results it had previously obtained from other issues.

Moreover, examiners did not take into account the liquidity or the pace at which the prices of Argentina's assets were falling. The value of the shares of the National Bank halved between December 1889 and August 1890 (data from the Buenos Aires Stock Exchange Yearbooks of 1889 and 1890). Argentina's 4,5% internal gold bonds, which Baring had underwritten and still held in its portfolio, were priced at 71 at examination's date (end of October), whereas they had been quoting at 91 in February and were to lose a further 20% until year's end (Figure 1). Other assets, such as the underwritten but unissued Buenos Ayres Water Supply company debentures were practically

[9] Dealing with the preference stock was the most active. In August 1890, the price was 8 5/8, or 1 3/8 below issue price (The London Times, 16 august 1890), a considerable discount compared to typical IPOs during that period.

[10] Baring ledger for the year 1889. We found no precisions about valuations or stock prices on these figures.

illiquid.[11] The boundary between insolvency and illiquidity of Baring was thin and required a cold blooded strategy to assume a more than probable Argentina's default could be avoided.

Table 1 sheds light on the reasons why the Rothschild committee, which was the group of bankers in charge of the negotiations with Argentina's government, was mainly concerned with Argentina's national bonds. The initial arrangement negotiated with Argentina's government excluded bonds issued by the provinces, municipalities and the infamous mortgage *cedulas*, issued by the provincial banks to finance the housing boom of the country during those years. Baring's portfolio contained only a minor proportion of these bonds, implying that they could be excluded from the general negotiations. An arrangement for the repayment of those loans was only met in 1896 for the railway guarantees provided by Argentina's government to attract investment to the railway sector, and in 1897 for the municipalities and provincial loans.

III. Baring's trade finance

The balance sheet also gives an accurate idea on the main activities where Baring was the most active. However, we would not have the complete picture on the implications of its failure if we did not know Baring's place in the markets in which it participated. In this section we look at the functioning of both, the acceptance business and the underwriting activities, particularly the one related with foreign government securities.

Merchants, or merchant bankers as they came later to be known, were banks whose original function was as merchants of specific commodities (such as wool, cotton, sugar or dry goods). During the 18th and 19th centuries, as international trade increased along with the integration of capital markets, some of these institutions also assumed functions as "accepting houses" and "issue houses", acquiring a prominent role for both commerce and the development of capital markets. According to Richard Roberts, the main activities of accepting houses referred to "the endorsement of bills of exchange, the means by which trade transactions were often paid, by highly regarded merchants on behalf of lesser known firms" (Roberts, 1993: 23). On the other hand, issuing houses activities included mainly the issuing of long term loans on behalf of foreign countries. By the second half of the 19th century, London had taken the lead as the main financial centre of the world, overshadowing Amsterdam and making the sterling pound the international currency per excellence (Flandreau and Jobst, 2005, 2007). Through the issue of bills of exchange, merchants all over the world could finance

[11] These were 4% debentures, amounting to a total of £5 million that were to be issued at a near date to the declaration of Argentina's government to pay in paper the hard dollar loan in 1889. Apparently this decision deterred Baring from issuing these debentures (Ferns, 1992), probably due to the possible actions of the CFB and the refusal of the LSE to grant a quotation to the new stock.

their transactions through a confident and efficient mean. Chapman (1983) studied the evolution of merchant banking and how their functions combined accepting activities, by which they "earned their bread and butter" (Chapman, 1983: 82), and the issuing activities. Though Amsterdam had already been a major financial centre to provide loans to foreign countries, London appeared in the international scene after the loan on behalf of the Prussian government in 1818, which was issued by Rothschild. After the independence of most Latin American states during the 1820s, they also became major borrowers opening the first major boom of capital exports, which ended in a major bust by 1826 (see Gille, 1965; Marichal, 1989; Dawson, 1990; Flandreau and Flores, 2009a).

During the first half of the 19th century, many of these merchant banks operated internationally through agents. Hidy (1941, 1949) analyses the operation of British merchant banks in the United States, and argues that the main activities of these agents were to "sign contracts, borrow money, receive payments and consignments, and grant credits in the name of their principals" (Hidy, 1941:55). This author identifies by mid-19th century that agents began to be supplanted by the selection of special firms as representatives (Hidy, 1941: 56). In Argentina, Marichal (1984) argues that French banks were following this kind of procedures, so that Paribas, who actively participated in the commerce between France and Argentina operated through the house of Bemberg in Buenos Aires. Baring, who became very active in South America, also operated through direct connections with specific Argentine merchants and bankers: Zimmerman, Frazier & Co (1832-1856), Edward O. Madero (1860-1886), and through S.B. Hale between 1879-1899 (Orwell, 2000: 94). These connections allowed merchant banks to be informed on the state of the world markets, and to directly participate in particular operations. Within these operations issuing activities became important for some of these houses. Although the specific relationship between issues and acceptances remains unclear, several arguments can be advanced. First, merchant banks could propose to issue loans on behalf of Governments of prosperous countries, as they offered a safer business with rapid gains.[12] Second, trade expansion coincided with stronger economic activity and higher funds availability, and thus, the opportunities for new business in both activities were highly correlated. Third, specific links with railway contractors or other merchants (and even without them) often meant that the funds raised from the loans would translate into the exports of specific goods. For instance, Chapman (1983) quotes 1866 James Rothschild ascertaining that "seven-eighths or fifteen-sixteenths of any loan issued are employed in buying goods" (Chapman, 1983:104). Marichal (1984) argues that much of the expansion of trade between France and Argentina was nourished by the loans raised in Paris by Argentina's Government by the 1880s. Finally, issuing a loan also meant the expansion of commercial

[12] Chapman (1983) observes that issuing activities were generally regarded as risky and with low profitability. However, a precise analysis of the evolution of underwriting fees in the 19th century for "safe" Governments indicate that fees were a permanent, albeit low source of profits. Fees for risky countries were high, up to 15% in some cases. To avoid the high risk that this involved, syndicalisation became recurrent use by the end of the century.

business, as official recognition of foreign governments in order to obtain commercial connections (Chapman, 1983: 104).

Finally, the participation in both activities also involved risks. Chapman (1983) evocates the paradox that though merchant banks were obliged to act upon high prudence when granting credit and advances for trade purposes, in many cases they became gamblers when acting as issuing houses. So, the 1820s saw the bankruptcy of implanted houses such as B.A. Goldschmidt or Barclay, Herring, Richardson. This is a main reason why many of these houses preferred to avoid participating in these activities. Much had to do with the activities involved in issuing a loan. Sometimes the banks assumed the risk of the issuance by taking the bonds "firm", and then try to place them in the market a bet that often involved heavy losses if investors refused to buy.[13] In other cases, they had to sustain the prices by intervening in the market, so as to keep the illusion of a successful placement. Finally, an extreme case was of course, when a country defaulted. Flandreau and Flores (2009) and Flandreau et al. (2009) show that some merchant banks, particularly those with the major market share and reputation cared about the countries whose bonds they issued and to avoid by all means losses to investors, as this would entail the loss of market share. This could be costly in the short term: Baring, for instance, as it undertook Mexican agency after Barclay's bankruptcy in 1828 did finance coupon payments during six months hoping the Mexican Government to arrange its finance. This was not the case, Mexico defaulted and Baring abandoned the agency for more than four decades.

The bills of exchange were also issued by merchant banks—who operated through agents or merchant houses in the countries with which they dealt. Some of these merchant banks became highly specialized and competitive in the commodities and geographical regions where they operated, and thus, the acceptance business was a relatively highly concentrated market. Unfortunately, we lack precise and continuous series of the total acceptances issued by British merchant banks. One of the few datasets available is Chapman's (1983) database on total acceptances issued for the period 1900-1913 by British merchant banks or accepting houses. That database also includes figure for individual cases, those which Chapman considers the most important and representative merchant banks and accepting houses. These were: Barings, Rothschilds, Kleinworts, Schröders, Hambros, Gibbs, Brandts. They represented about one third of the total market.

Historians have described how their functioning evolved during the 18th and 19th century, and how these activities became complementary with the activity of underwriting sovereign bonds for foreign Governments. These agents, whose functions moved from pure merchant activities, to merchant finance and finally to the underwriting of securities and public bonds in London, were also

[13] On the description of the different issue systems in the 19th century see Flores (2007) and Flandreau et al. (2009).

present in other markets such as Paris or Amsterdam. Both underwriting and trade finance became very soon highly concentrated markets with some few merchant banks dominating the market for sovereign debt and looking for new international trade opportunities (Chapman, 1983). The participation in both markets of the same agents –big houses and big names who dominated in both markets--provide a link which has not been explored so far in the recent literature of trade and sovereign trade. Nevertheless, from my perspective, this is precisely the link that explains why trade fell in response of sovereign default and excludes the possibility of a direct penalty in the form of a "sanction". In any case, if we were to write about sanctions, we should analyse whether merchant banks imposed sanctions on defaulting governments as they were the agents who had the power to do so; and in fact, as frequently the merchant banks possessed quantities of securities from Governments or countries whose bonds they underwrite, deterring them from defaulting yielded in a particular gain for them. This economic rationality, which to our perspective seems essential to the understanding of 19th century sovereign defaults, has been completely ignored so far.

As these activities became soon highly concentrated markets, some banks underwrote the major part of the bonds issued in the main financial centres of Europe. This fact provides the connection between trade and capital exports booms. The market of sovereign debt and of trade finance were both highly concentrated market, with some main participans, for instance, the Rothschilds, the Barings or the Hambros being very active in both markets. These intermediaries could exclude countries to participate in the London capital markets, and could even "restrict" the credit necessary for trade.

IV. Baring's underwriting activities

In an article published in June 1876, at the peak of a World economic crisis that followed the major trade boom of the 19th century, the Banker's Magazine argued that defaults from a number of foreign governments would strongly affect the international trade (in particular the exports) of Great Britain—the more so as arrangements to resume payments seemed very difficult—though it recognized that the effects would be temporal and that it would be a matter of time to have a new take off. The logic of a typical sudden-stop situation was well described by the fact that many countries who recurred to the London market did so to procure goods which would otherwise be not affordable to them, at least at their present state of development. But some loans were also used to pay the interest of previous loans, and thus, many of these countries, who fostered the exports from the U.K., were obliged to default.

Economists in Great Britain were well aware of the risks of foreign governments' defaults. The U.K. being an export economy and the main creditor, defaults not only inflicted losses to its investors; it also shrunk its trade with defaulting countries as demand fell. Besides, as we mentioned, the British financial system was international in nature, and underwriting banks also lost from defaults, as it was the case in the 1820s but mainly in 1890, as Baring Brothers required a bailout from the Bank of England to continue operations and avoid a banking panic in the city.

To deter such events to happen was not an easy task. Since the 1820s, Colombia was the first country, before the loan boom had actually taken place, to default on its 10% debentures issued to pay for new armaments. The affected merchants decided to stop exporting new armament until the Colombian Government resume payments. In fact, the first Colombian loan of 1822, the first of the loans that were to come, had as a first objective to repay former debts. Besides, once the storm of foreign government loans passed by 1825, and defaults spread one after the other, negotiations almost immediately followed for two countries: Argentina (Buenos Aires) and Mexico. Others had to wait until the new countries stabilized and even separate, as in the case of Central America of New Granada; or had to wait for the will of every new government, or the end of civil war, until they succeeded to reach an agreement.

Committees were formed in order to defend the interests of the bondholders. A constant research was initially the support from the Government in the form of military pressure, although these demands were constantly rejected (On the beginnings of these initiatives, see Flandreau and Flores, 2009b). In one of the first speeches, Isidor Gerstenberg, considered the founder of the British Corporation for Foreign Bondholders, also recalled the idea that British interests ought to be defended by their Government. The CFB should consider military intervention as a legitimate way to defend British interests; however, they understood that this would be a real mean only in extreme cases. In fact, in the first annual reports on the activities of the CFB, it was explicitly understood that the realistic means to enforce payments were actually the exclusion from the quotation on the Stock Exchange, the cooperation with investors from other countries, and to press upon the Committee for General Purposes to prevent any new issues from defaulting states (something that was to become a law in the later functioning of financial markets both in Europe and in the US).

During the 19th century, financial integration reached standards which have not been reached even today; capital could flow among international borders, and investors were free to decide on the best destiny for their money, seeking the highest rentability. These investments were not without risk. Bankruptcies, wars, and sovereign defaults inflicted occasionally heavy losses to adventurous investors; and thus, the effects on investment, trade, and economic activity had to be evaluated. In fact, it was no mystery to 19th century economists that booms in capital exports were accompanied by booms in international trade. Much of the capital issued in London market was later used to finance railway equipment for the development of contemporary emerging countries. More generally, many of the exports from Great Britain were financed precisely by the means of the financial market of London. Business cycles were thus self-inforcing: a stop in capital exports also put a halt in the exports from Great Britain, which had negative consequences in the country thereby exporting the negative cycle to the world. In fact, British and international historiographies have a long tradition analysing the relationship between Great Britain's business cycles with the rest of the World. Great Britain was the main trade partner for the majority of European countries and to many other countries in all continents. Besides, it was the major capital export country, only challenged by the end of the century by France and Germany.[14] The economic cycles in Great Britain were exported to other countries. Ford (1971) has analysed these cycles for the period 1870-1914 and linked them with the operation of the gold standard. This author has also analysed how Argentina also suffered from the sudden stop of British capitals and how it negatively affected the economic conditions in Argentina that gave way to the 1890 crisis.[15]

The fact that capital flows and exports were accompanied is nothing new. In Figure 2 I show the evolution of total trade between Britain and Argentina (from Ferns, 1963) and the evolution of capital flows from Britain to that country (from Stone, 1999). The evolution of both variables follows the same path, with a strong boom during the 1880s and then a bust in 1890 with the crisis. It is clear that we are not looking at a case of supersanctions: British marines did not invade Buenos Aires nor was there any embargo at the ports. However, British Banks (the Rothschild committee) and Argentina's Government did negotiate the bailout by the end of 1890 to end the default and restructure Argentina's debt. It was in the interest of the London capital market, of Baring, and of Argentina to deal with the problem.

To understand thus the link between trade and capital exports we have to look at the industrial organization of both markets. Figure 3 shows the evolution of the Herfindahl index of the market for sovereign bonds underwriting for the 19th century. A main feature is that, overall, the market was highly concentrated, with two main leaders, the Rothschilds and the Barings, as already noted by Chapman (1983). However, this is not stable, and a second feature is the occasional peaks of concentration that follow capital booms. In fact, after the 1820s, the 1860s, and the 1880s, where the markets become highly competitive, there is a return to concentration as during bust times, only some countries (and some underwriters) are able to issue new bonds. This is explained by the fact that boom periods are followed by a number of defaults (represented as the dots for every year) which trigger the bust and sudden stop in capital exports. Default times provoke thus the closing in the capital markets, and the Herfindahl index increase as a result.

[14] For a recent review on business cycles for the period 1870-1913 see Flandreau et al. (2009).
[15] On sudden stops in the 19th century see Catao (2006). Prebisch (1919) makes an exhaustive analysis on trade specialization and the effect of cycles in the "core" countries on the "periphery".

Figure 4 shows how these two markets were linked. The same agents who were leading the markets for acceptances issues were the same leading agents who dominated the markets for sovereign issues. The Figure takes into account the market share of the six banks (Barings, Rothschilds, Kleinworts, Schröders, Hambros, Gibbs, Brandts) included in Chapman's dataset. Of course, not all banks issued new bonds every year, meaning that Figure 3 only include observations when banks were active in the underwriting market. Though the acceptance business was less concentrated; it remained in the hand of some merchant houses. I now proceed to explore the link between these two markets for a specific case: Baring and Argentina in the 1880s.

V. Explaining the survival: restructuring the Bank and getting investors' happy

Ex-post returns to investors

Market shares by prestigious banks were persistently high during most of the 19th century, with a peak in the early decades of the 19th century with more than 70% of market share in the period of 1818 to 1825 to a total of about 52% by the beginning of the 20th century (1895 to 1913). In the later period, Baring was back in third position only after Rothschild and the Hong Kong bank, with 11.5% market share. It was certainly below its own record, but considerable higher than expected from a bank having failed, having sold junk bonds during a whole decade and having just emerged from its own ashes. A main question that would naturally arise concerns the nature of its recovery, and the general perception of affected bondholders towards the bank.

Since November 1890 and until March of the next year Argentina's government and the Rothschild committee negotiated a funding loan to provide for the payments for the external debt of the country and the national railway guarantees. Provincial and municipalities loans were left out of the negotiations, and the reasons for this seem obvious, as these loans were mainly issued in other financial centres and more importantly, contrary to the railway bonds, they were absent from Baring's portfolio (refs.). In fact, the only provincial loans included in the negotiations, were the Buenos Aires loans of 1824 and 1857, both of which had Baring as underwriter and some of which were still held by the bank. The conditions imposed were basically three. First, the commitment from Argentina's government to stop borrowing abroad, to retire a specific amount of paper money from circulation in order to revaluate the peso and third, to buy the Buenos Ayres Water Supply and Drainage company, for which a second loan was to be issued in 1892.

The funding bonds were to be exchanged during three years for the coupons due and redemption payments during three years, after which Argentina had to resume its total debt service. The interest of the funding loan was the only to be paid in cash, reducing thereby the total amount of interest to be paid by the government, expecting that in three years the government would have the necessary time to reorder its financial position. In practice, this schema had to be renegotiated since November 1892, with Baring as a main intermediary, given the continuous difficulties by Argentina's government to continue its debt payments. This new arrangement, known as "arreglo Romero" (Juan José Romero was Argentina's new finance minister in that year), contemplated a permanent yearly amount of cash to be used to face debt service. It implied a temporary reduction from July 1893 to July 1898 of interest service, amounting to 60% of interest rates for most loans, and punctual reductions of others, such as the 6% funding loan, which was reduced to 5% during this period. The surpluses were to be used, during 1898, to the repayment of the differences in the interest rates of the 1886 loan and of the Funding Loan. Argentina's government was to assume the payment of the reduction for these two loans afterwards.

This later arrangement allowed Argentina for more scope to meet other necessary expenses, and the necessary time for the balance of payments to recover (Williams, 1920), allowing for general surpluses and an improved position of its public finances. On the other hand, at a first sight, investors faced apparently important losses given these successive debt arrangements. We have therefore estimated these contradictory result, as ex-post losses not corresponding with ex-ante yields may have had considerably affected Baring's market share in later period, which, as we just mentioned, was far from being the case.

We have computed both short- and medium-term estimates of a hypothetical investor buying two different kind of bonds. In both short-term and medium term cases, we have analysed two scenarios, one for an investor buying (and holding) a given number 5% 1886 bonds (to simplify our calculations, we have set this number to 16), and a second scenario where this investor acquired 5% 1884 bonds in April 1890, some months before the big collapse in Argentina's bonds prices. The 5% 1886 loan was the only loan that was excluded from the funding loan, as it had the customs revenues pledged to meet the coupon payments. Baring was part of the syndicate of eight banks that issued these bonds, but it did not held any in its portfolio in 1890. Still, as no default occurred to this loan and only a temporary 1% reduction was undertook in 1893, the ex-post internal rate of return was positive in the medium-term.

The results for the investor buying the defaulting bonds was positive in the medium-term, though he would have not escaped short-term losses. Whether this investor had acquired the 1884 bonds (defaulting) or the 1886 bonds (not defaulting), the losses would have been roughly equivalent (10.7% and 9.8% respectively). This loss is still limited given the magnitude of Argentina's financial distress and the consequent fall in bond prices. If, however, this hypothetical investor would have kept its bonds until December 1896, three years after the Arreglo Romero and one year before full resumption of payments, the investor of defaulting bonds would have still made a gain of 14.3%, and the investor of the 1886% bonds a gain of 8.8%. At a time were British consols were offering a 2.2% yield per year, these gains appear attractive and more than compensate for the initial losses of the last months of 1890.

Obviously, the initial losses were strongly related to the incertitude regarding Argentina's economy and the latent possibility of plain default. The inflection point would be the renegotiation of the initial terms which were contained in the Arreglo Romero which was negotiated three years later. As Argentina's economy recovered and the public finances were reordered, the substantial promised returns from the initial agreement were finally converted into gains.

Argentina's recovery was therefore subject to the recovery of its exports. This could only be possible if the British market for Argentina's product remain open and that imports of capital goods continued. This condition could only be possible through the extent of trade finance availability, and this was initially unclear given Baring's fragile situation.

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TABLES AND FIGURES

Baring's Portfolio				
Liabilities				
	Acceptances			£13'841'200.00
	Deposits			£5'208'000.00
	Total:			£19'049'200.00
Assets				
	Cash at call with the brokers			£1'000'000.00
	Bills receivable			£7'000'000.00
	Remmittances to come forward			£5'000'000.00
		Bank of the Province of BsAs	£350'000.00	
		National Bank of BsAs	£245'000.00	
		Others	£4'405'000.00	
	Remmittances from debtors B			£10'790'328.00
		Argentina's related assets		£7'609'746.00
		Others		£3'180'582.00
	Partners' Landed Estates, Houses and valuable contents			£1'000'000.00
	Total:			£24'790'328.00

Sources: The Bank of England Archives.

Table 1. Baring's balance sheet in November 1890.

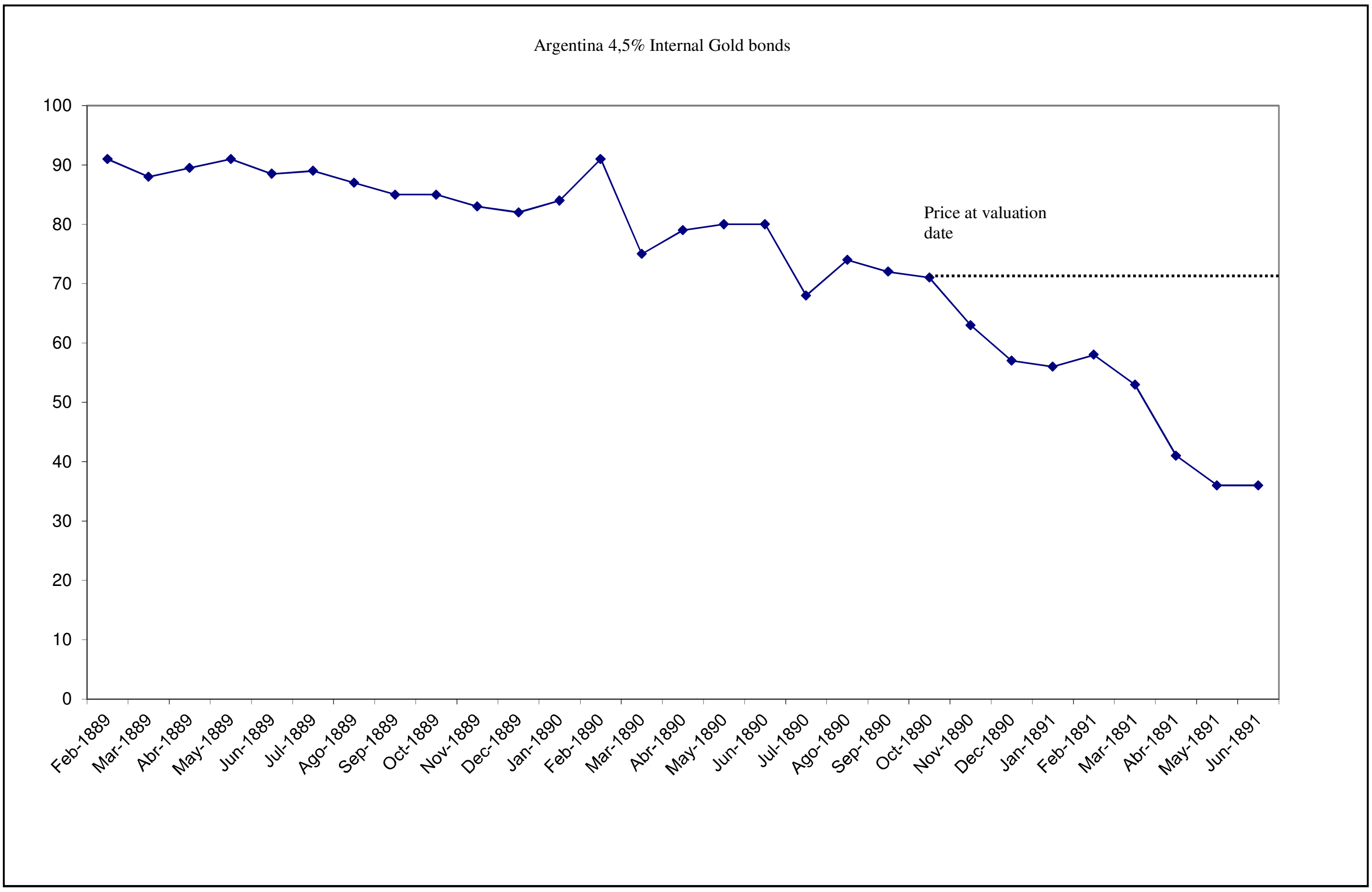

Figure 1. Valuation of an Argentina's government bond in November 1890. *Source*: Investors' Monthly Manual.

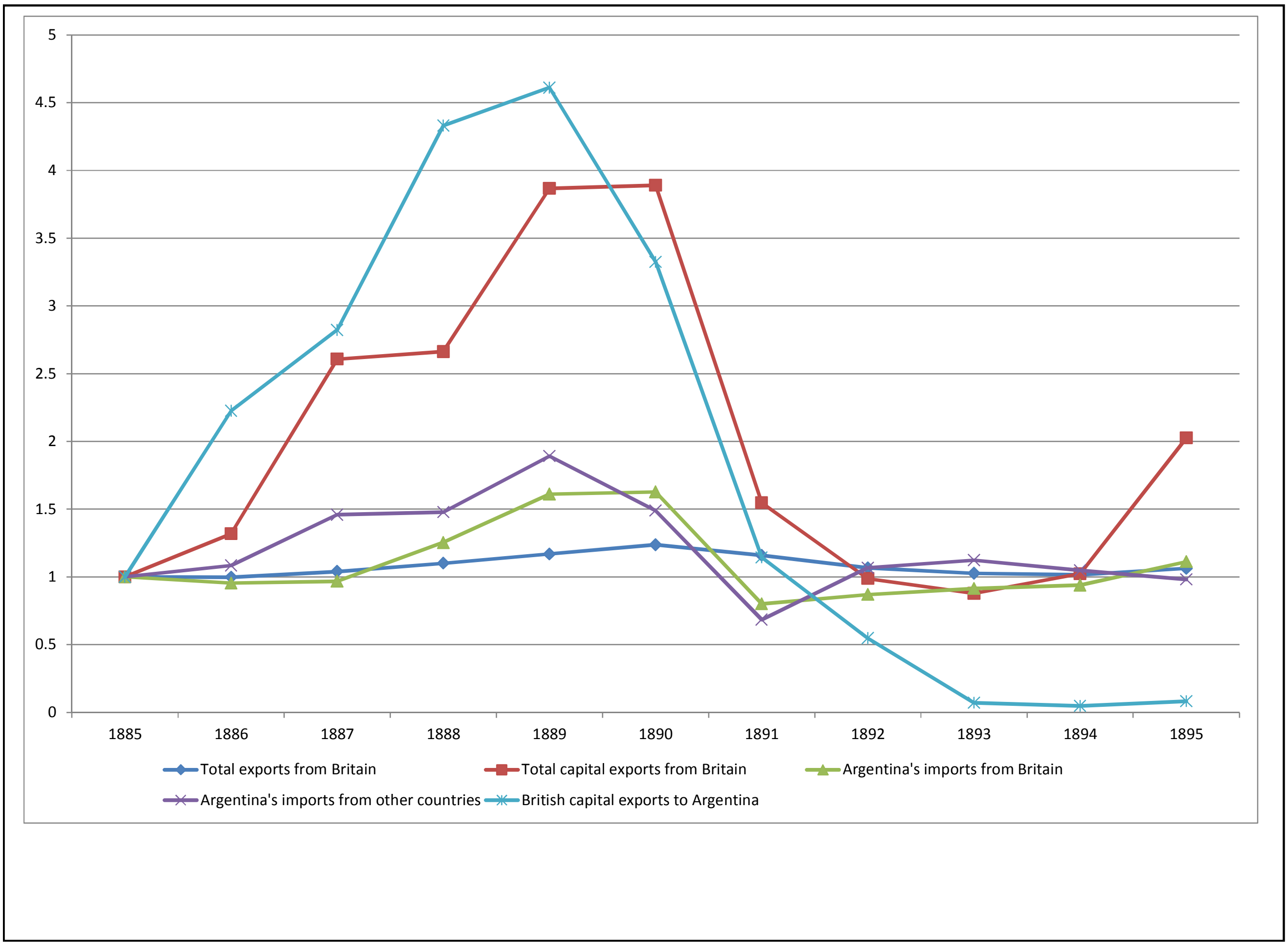

Figure 2. Capital exports and Argentina's bilateral and total imports.

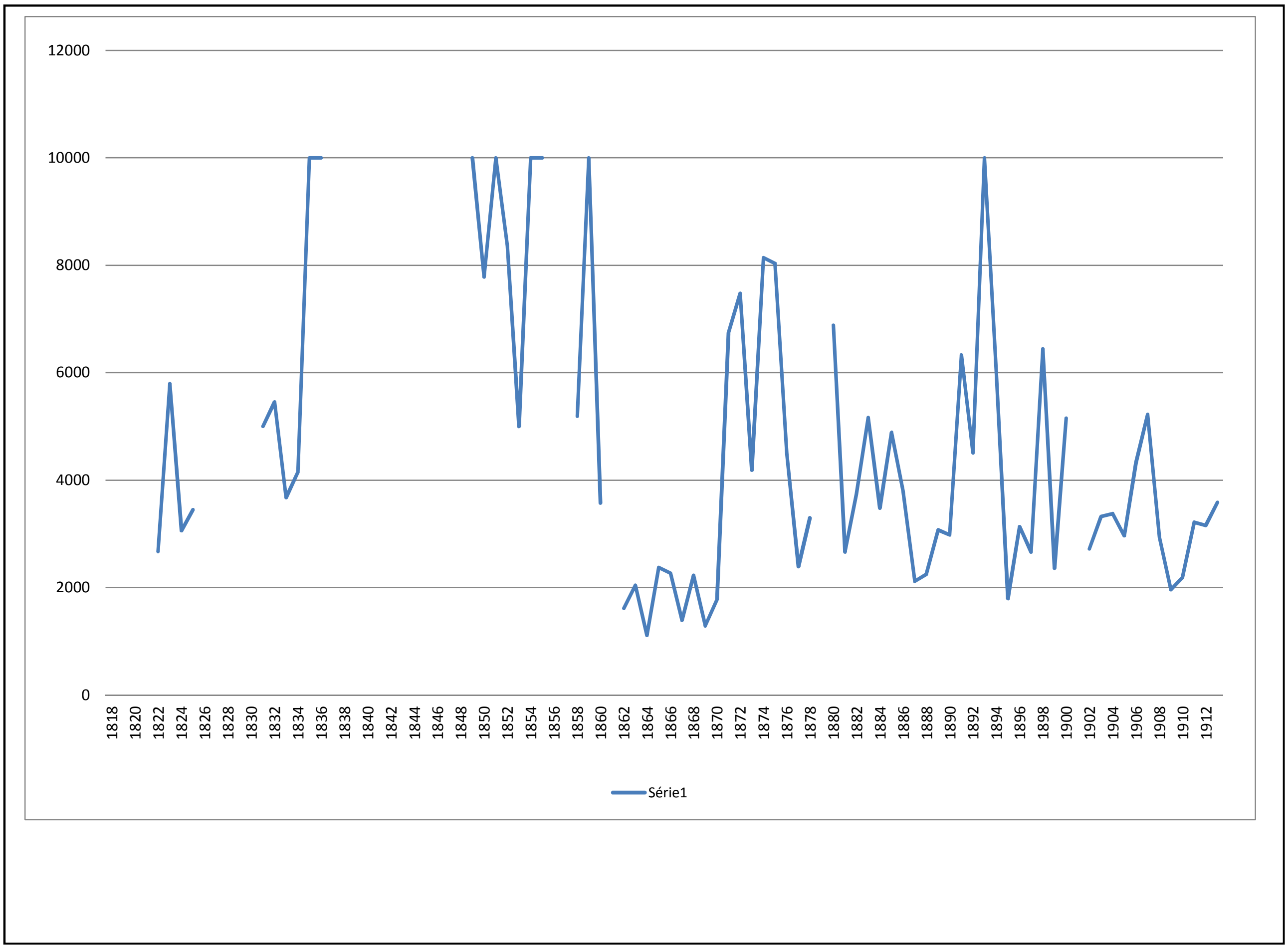

Figure 3. Herfindahl index for London's sovereign debt market.

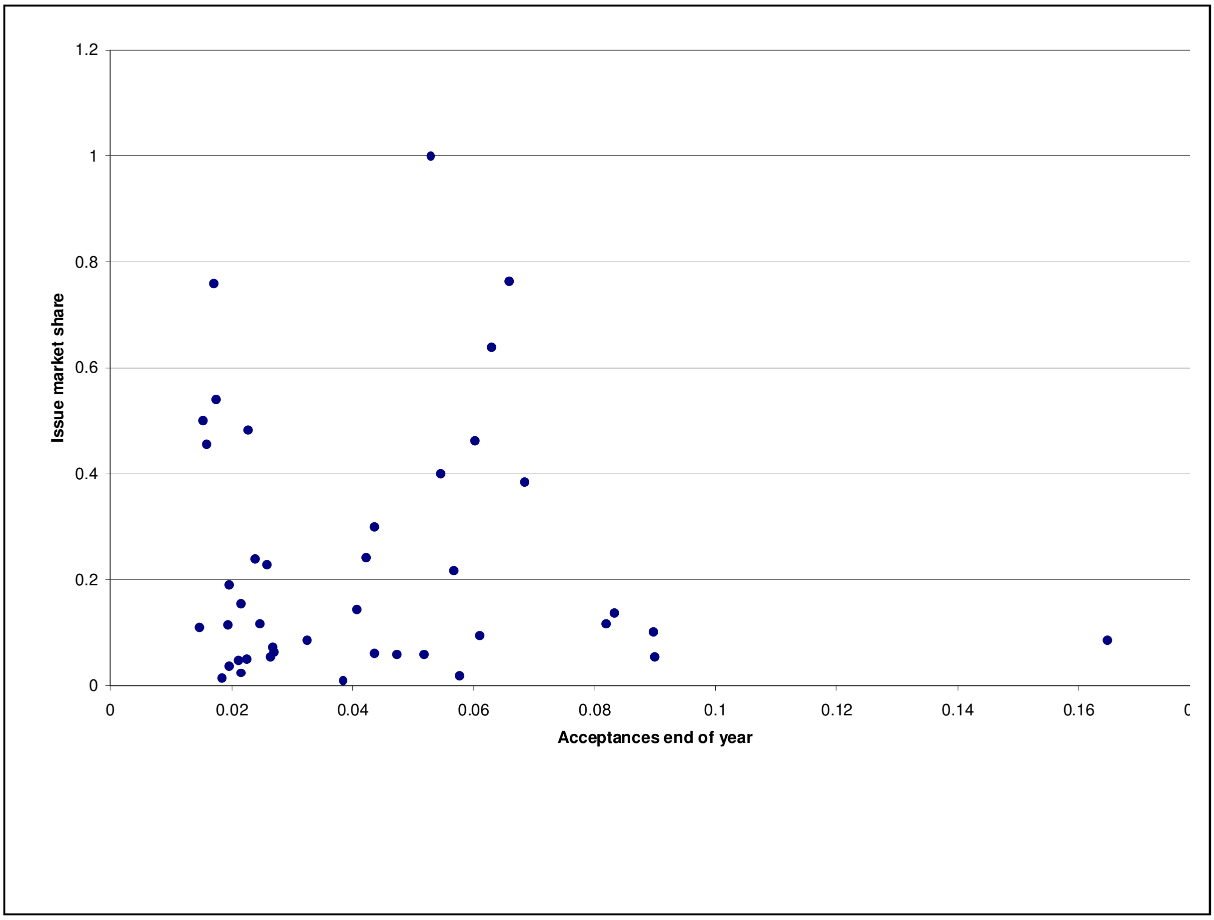

Figure 4. Market shares of top six merchant banks in Acceptances and Underwriting. Source: See text.