Governments and the Markets – Then and Now

Layna Mosley, the Robert T. and Thomas J. Rolfs Assistant Professor of Government and International Studies at the University of Notre Dame, explains how close examination of Rothschild business letters from a century ago illuminated her research into present-day relationships between international capital markets and government policy.

My current research project investigates the influence of international capital markets on government policy choices. This project is part of a large stream of contemporary social science research that attempts to delineate the impact of economic globalisation on national government policies. In my book manuscript, I focus on the extent to which international capital mobility limits the policy choices of national governments. I examine, for instance, the degree to which capital market openness renders impossible the public provision of education and health care, income redistribution and active labour market policies – all hallmarks of the modern welfare state.

The bulk of this project focuses on financial market-government relations in the contemporary era. In considering financial market-government interactions in the advanced industrial democracies in the 1980s and 1990s, I rely on interviews with financial market participants, surveys of investment fund managers, and cross-national quantitative analyses. On the basis of this evidence, I contend that the influence of international financial markets on the governments of advanced industrial democracies is "strong but narrow." Capital market openness allows financial market participants to react dramatically to changes in government policy outcomes. Market participants, however, consider only a small set of government policies when making asset allocation decisions. Therefore, governments face pressures to adopt market-pleasing policies in macro-policy areas, but retain room for manoeuvre in many other policy areas. Despite financial internationalisation, we observe a significant amount of cross-national policy divergence among advanced industrial democracies.

At the same time, governments of developing nations are constrained more broadly by financial market pressures. Because financial market participants worry about default by developing country governments, they will consider a wide range of policy areas, including macro-economic outcomes, the partisan nature of governments, the ways in which governments allocate national spending, and the character of supply-side policies. I evaluate this argument in a variety of ways, including simple statistical analysis, an evaluation of sovereign credit ratings, and evidence from a follow-up round of interviews with financial market participants. I conclude that, while there is variance in the extent to which emerging market nations are constrained by financial market pressures, emerging market nations generally face a broader financial market constraint.

Although financial globalisation has reached high levels in the current period, international financial openness is not unprecedented historically. In fact, many contemporary discussions of economic globalisation go to great lengths to point out the

parallels between the early 21st century and the pre-World War One era. These discussions suggest that we can learn something about contemporary financial market-government relations by looking at the past; scholars, however, have yet to make careful comparisons of the characteristics and implications for government policy of different periods of financial globalisation. Although economic historians have employed archival material from the pre-World War I period to examine issues such as the pricing of sovereign debt and the effects of sovereign default, they have not examined systematically the types of government policies that merchant bankers considered when issuing sovereign debt.

As an initial step toward filling this lacuna, and as a way of enriching my research project, I decided to undertake research that compares the constraints on governments generated by the current phase of financial globalisation to the constraints created by financial globalisation in earlier periods. By assessing financial market-government relations in the late 19th and early 20th centuries, I consider the extent to which the influence in the 1990s of financial markets on government policy choices is historically unique.

The historical section of my book manuscript draws on both primary and secondary sources. For background regarding the operation of pre-World War I investment banking, I explore relations among merchant banks, between merchant banks and home governments, and between merchant banks and the investing public. In order to assess the specific issue of financial market-generated constraints on governments, I explore market participants' assessments of sovereign debt issues, in terms of the factors that drive issuance and pricing decisions. Archival sources allow me to assess firsthand the types of considerations made by investment bankers; this provides the equivalent to conducting interviews or surveys of contemporary financial market participants. In some ways, archival materials may be more accurate than contemporary sources, as they are internal documents rather than information provided specifically to researchers.

What brought me to Rothschild?

My archival research focuses on issues made in the London financial market, and I rely on archival materials from N M Rothschild, Baring Brothers (now ING Barings), and Morgan Grenfell (now Deutsche Morgan Grenfell). Each of these banks was a major actor in merchant banking and government finance prior to the first World War. N M Rothschild was responsible for over one-fourth of public issues of foreign securities in London between 1865 and 1914 and their business was weighted heavily toward government issues.

At the Rothschild Archive, I consulted a richly detailed set of correspondence, between the London Rothschilds (primarily Nathaniel, 1st Lord Rothschild) and their Paris cousins. The Archive contains copies of almost daily letters from London to Paris. These letters – many of which have been summarised by previous researchers – contain discussions of potential and actual sovereign issues to a wide range of countries, as well as commentary on economic policy in Britain and France. This information allows the researcher to assess the views of merchant bankers regarding government policy – for instance, the degree of credit risk associated with lending to Russia in 1906, or the economic viability of a plan for price supports for coffee in Brazil in 1906 and 1907, or the fiscal position of Japan in the early 1900s. The Archive also provides many examples of direct contact between merchant bankers and borrowing governments; for instance, Nathaniel's letters provide a detailed account of the visits of and conversations with emissaries from the Russian and Japanese governments.

From the systematic examination of these materials and those in other investment bank archives, I conclude that financial market actors influenced government policy decisions in early periods, much as they influenced those decisions in the 1990s. Where default risk was high, for instance, investors went to great lengths to insure repayment. The impact of financial market influences, however, was mediated by political and security considerations, by competition within the investment banking industry, and by governments' relatively modest policy ambitions. The archival research I conducted at the Rothschild Archive has enhanced greatly the quality of my historical chapters and has improved the overall quality and scope of my book manuscript.