

With a little help from their friends: the maintenance of Brazilian credit, 1889–1898

As part of his research on sovereign bond issuance in the London capital market, 1870–1914, Anders L. Mikkelsen examines the influence of Rothschilds on Brazilian credit between 1889 and 1898.

Despite the crucial position of the City of London at the heart of global financial interaction between 1870 and 1914, we have little idea how key capital market intermediaries operated or how bond market practices evolved in the period of my study. I plan to fill this gap by analysing the development of primary and secondary market techniques and practices, adding a new technical dimension to studies of capital flows during the period. By providing a better understanding of the mechanisms that facilitated the transfer of capital from developed to developing nations between 1870 and 1914 – the first era of globalisation – my thesis will also complement a recent macro-economic study by IMF economists which focuses on debt finance for emerging market economies by the London capital market in the era prior to World War I compared with the present day.¹

Between 1870 and 1914 a main source of capital for emerging markets was the issuing of bonds in the world's main capital centres, the most important of which was London. Throughout this period one of the main houses that helped facilitate such issues in the London market was N M Rothschild & Sons, while Brazil, an important Rothschild client, was a frequent borrower. The relationship between Rothschild and Brazil goes back to the early years of the Brazilian Empire. In 1824 the firm issued the first of what would be a long series of loans for the young nation and the connection grew ever stronger after 1855 when the Rothschilds were made the country's sole financial agents in London.² Compared with other Latin American borrowers Brazil maintained an excellent record. Indeed in 1883 *The Economist* argued that the reason why every application made by Brazil upon the London market met 'with an immediate response' was that 'the letter of the foreign debt [had] been scrupulously kept during some trying years'.³ The country's unblemished credit history thus carried with it clear financial benefits in that it helped facilitate easier access to the London capital market. This naturally meant that Brazil had a strong interest in maintaining its record, an interest it shared with the Rothschild bank. Owing to its long history of issuing loans for the government, the firm was intimately associated with Brazilian finances in the minds of investors and any default would therefore have had a distinctly negative influence on the reputation and standing of the London house.⁴ Thus it is not surprising that the Rothschilds were prepared to go to great lengths to protect Brazilian credit and, as we shall see in the following case study, a powerful issuing house could play an important role in helping a sovereign client maintain its credit in the market. The correspondence in the Brazilian Letter Copy Books at The Rothschild Archive allows us to see exactly what steps the firm took to aid the republic's finances during the period of political and financial turmoil, 1889–1898. Comparing this source with the market commentary in the contemporary financial press we can judge to what extent the Rothschilds were successful in their efforts.⁵

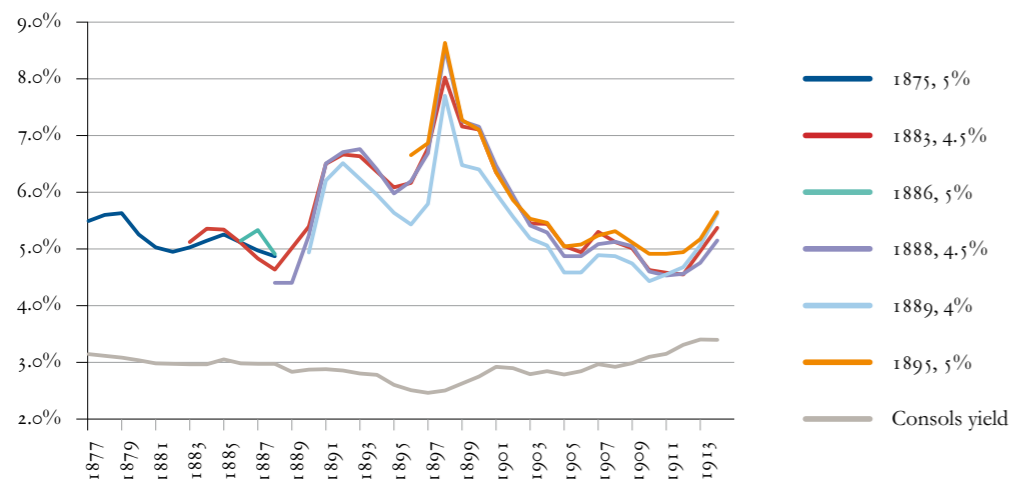
In November 1889 the Brazilian Emperor Dom Pedro II was overthrown in a revolution which inaugurated a decade of political instability.⁶ The revolution led to the beginning of a drastic rise in the yields of Brazilian bonds, as can be seen in Table 1, p.22. This was due to

fears that the revolution would lead to the breakup of Brazil and that the states thus formed would simply repudiate the existing Brazilian debt.⁷ For the Rothschilds the timing was very inconvenient as only in the previous month the firm had unveiled a massive conversion scheme on behalf of the Brazilian government.⁸ This operation had not yet been completed and now the revolution threatened to send Brazilian bonds plummeting, destroying investor confidence and with it the conversion operation.⁹ To avoid failure the Rothschilds actively entered the market to support the price of Brazilian bonds and also persuaded the government to purchase a total of £260,000 of Brazilian bonds.¹⁰ The intervention had the desired effect of boosting investor confidence: in late November *The Economist* described how Brazilian bondholders were reassured by the knowledge that the bonds were supported by powerful financial interests and therefore had only experienced a relatively slight drop.¹¹ Rothschild continued to provide support at least until late December, although intervention could not prevent slippage in the price over the next months.¹² Still, the intervention secured the success of the funding scheme since, despite the revolution, almost the entire issue was placed successfully.¹³

The drop in price was problematic for the Brazilian government as for years it had relied on both internal and external loans to finance an almost chronic budget deficit.¹⁴ Since the state of the market ruled out any further foreign loans the government instead turned to vast issues of paper currency to finance its deficit. The inflationary consequences of this strategy worsened the situation as it resulted in a severe depreciation of the exchange rate, which in turn increased the cost of servicing the sterling denominated overseas debt, escalating the budget deficit and overall debt burden.¹⁵ This was viewed most unfavourably by investors in London and prompted the Rothschilds to warn that 'history [...] shows how dangerous as well as futile such a policy of inflation is for improving the credit and benefitting the finances of a country in any way'.¹⁶ These words proved prophetic as the increasing cost of servicing the debt together with the expenses associated with the suppression of rebellions made it

One of many tin trunks used to store objects and documents in the vaults of the bank in New Court.





impossible for the government to overcome the budget deficit, which further added to the total debt and perpetuated a vicious circle.¹⁷ The government desperately needed foreign currency to allow the country to regain its financial footing but the state of the market ruled out any new issues over the next couple of years.¹⁸ In the summer of 1892 Rothschild was however able to provide the government with some much needed foreign capital by placing £1 million of treasury bills privately.¹⁹ The objective was to improve the exchange rate and Brazilian credit generally – an objective that seems to have been achieved as the yield on Brazilian debt started falling in the months following the issue.²⁰ Indeed in April the following year the Rothschilds were able to issue a Brazilian loan of £3.7 million to the public, though the loan was nominally issued by the Western of Minas Railroad and not the national government.²¹ The loan was, however, effectively taken over by the government providing it with more hard currency and a further improvement in Brazilian credit.²²

Nevertheless, the finances of the Brazilian government remained very precarious as the deficit continued to climb and in July 1895 the Rothschilds issued another loan, this time directly for the government.²³ The bank had already started preparing the market for the issue in January when it arranged for the placement of a further £2 million in treasury bills, which led to a rise of 1% in Brazilian bonds.²⁴ Nevertheless the July loan was issued in a market that had little confidence in Brazilian finances, with the financial position of the country being described by *The Economist* as ‘utterly unsound’.²⁵ Indeed despite the generous terms offered, evidence suggests that the market would not have been able to support the issue had it not been for the Rothschilds’ wider market intervention. As the firm later noted, the successful completion of the issue had required it to ‘[strain] every nerve...’.²⁶ The uncertainty surrounding the success of this issue is also highlighted by the fact that the London house took the unusual step to form a syndicate to underwrite part of the issue.²⁷

One of the main yardsticks used by the Rothschild bank to assess the terms on which an issue could be made was the yield on existing similar bonds. The issue which the firm considered most relevant as a benchmark for the new loan was the 1893 issue of 5% Western of Minas bonds.²⁸ In Table 2 we can see the price development of these bonds and the 1895 loan. The subscription list for the 1895 loan was opened on 23 July and just one month earlier the price of Western of Minas bonds was well below the price at which the new issue was made.²⁹ Fortunately for the success of the loan as well as Brazilian credit in general the price of Western of Minas bonds rose significantly during the last month before the subscription list opened. This rise seems to have been the result of the Rothschilds buying large quantities of Western of Minas bonds both on their own account and on behalf of the Brazilian government.³⁰ The

TABLE I
Yields on Brazilian government bonds (denoted by year of issue and coupon).
Source: *The Investors Monthly Manual*

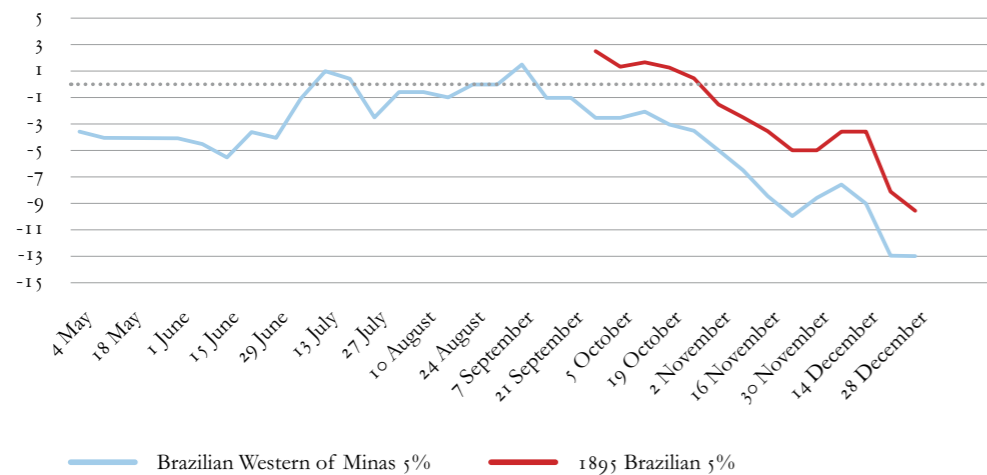
only explanation offered for this rise by *The Economist* is a rise in the exchange rate. But if this had been the cause of the rise, why were other Brazilian bonds not similarly affected?³¹ The fact that it was only the Western of Minas bonds that show this significant rise is a strong indication that it was in fact the Rothschilds’ intervention that caused it. Thus we see that the London house was not just passive, but actively managed the market to allow for an issue on more favourable terms. (See Table 2, p.24).³²

The entire loan was subscribed for, but this did not automatically ensure the success of the loan as investors normally paid for their bonds in instalments spread over a period of up to a year after the issue of the loan. The Rothschilds therefore also had to guard against any major drop in the price of the issue in the immediate after-market that could lead investors to lose confidence and cut their losses by not paying the remaining instalments when due.³³ Indeed the Rothschilds informed the government that they had been ‘obliged to support the markets to a large extent, in order to prevent a really serious fall’.³⁴ This intervention was successful as an initial discount of ½% was turned into a healthy premium when it was first quoted in the press after a few months.³⁵ That this rise was due to the Rothschilds’ intervention is supported by the fact that other Brazilian bonds did not share the rise.³⁶ As it turned out only a relatively small amount of bonds experienced non-payments on instalments, but had the issue experienced a really serious fall from its infancy – as Rothschild suggested would have been the result of an unaided market – this amount would likely have been much larger.³⁷ So just as the purchases of Western of Minas bonds before the launch helped insure that the new loan would be fully subscribed, the stabilisation of the secondary market helped ensure investor confidence and consequently instalments were paid when due. Thus by intervening in the market Rothschild effectively allowed the government access to the London capital market on terms more favourable than those the country could otherwise have obtained.

Brazilian credit continued to improve after the issue of the 1895 loan, but it was to prove only a temporary respite as the government was unable to gain control of the country’s deteriorating finances.³⁸ Throughout the decade Rothschild had continuously urged the government to implement economies.³⁹ Indeed a promise of economies had been exacted by the firm as a condition for the issue of the 1895 loan, but the government proved unable to deliver what it had promised.⁴⁰ The continued deficit led the government to continue its reliance on an inflationary monetary policy, which inevitably led to a further depreciation of the exchange rate.⁴¹ Despite Rothschild placing a further £2 million in treasury bills in December 1897, the precarious condition of Brazil’s finances became increasingly clear.⁴² In March 1898 *The Economist* argued that, ‘it is now a question of whether national bankruptcy can be avoided’.⁴³

By this time the Brazilian government had already contacted the Rothschilds to enquire into the feasibility of suspending the sinking funds on the loans, effectively signalling the end of Brazil’s almost decade-long battle against compromising its record as a borrower in the London market.⁴⁴ In the end not even the mighty house of Rothschild could save the country and its government from its own financial recklessness. Yet even in defeat the firm still had a role to play – to insure that this defeat was honourable and reversible. When the Rothschild bank was first approached on this topic they stressed the importance of demonstrating to the country’s creditors that Brazil had strained every nerve and made every sacrifice to honour its obligations.⁴⁵ Only in such a case could it be hoped that the bondholders would consent to a funding scheme that would allow the country to regain its financial footing while not irreparably damaging its standing in the market and injuring the reputation of its financial agents.

When the funding scheme was published in June 1898 yields on Brazilian bonds soared to new heights, but in spite of this it was a success.⁴⁶ To help ensure the success of the funding scheme the Rothschilds put together an international syndicate to create a market in the new bonds and guarantee that the price did not fall below 80, an objective which was seemingly achieved simply by public awareness of the syndicate’s existence.⁴⁷ Furthermore, according



to the financial press, it seems that it was generally recognised that the government had done all it could in order to meet its obligations and that it offered the best possible terms to the bondholders.⁴⁸ This, together with the fact that Brazil took advantage of the moratorium to get its house in order and was able to resume its obligations in 1901, was what facilitated Brazil's rapid financial rehabilitation.⁴⁹ Already in 1903 the country was able to borrow again and on better terms than in 1895, while by 1910 the yield at issue on new Brazilian loans was down to the level achieved right before the revolution in 1889.⁵⁰

This case study thus clearly shows the important role that an issuing house such as N M Rothschild & Sons could play in helping maintain the credit of its sovereign clients in the London market. Without this help, the Brazilian government would not have been able to gain access to the London market on as favourable terms as they did, clearly shown by the case of the 1895 loan. Similarly the ability to place treasury bills privately when market conditions were to unfavourable for a loan was also of great significance, not to mention the aid the firm rendered to support the market in both 1889 and 1898. However, this case study also shows the limitations of the abilities of an issuing house. In the end even the unwavering support of the mighty house of Rothschild could not save Brazil from its own financial imprudence, as is evidenced by the collapse in 1898. Still, the support rendered by the Rothschilds played an important role both in aiding Brazilian credit during the troublesome decade and in helping the country ensure that its reputation was not irreparably damaged by the suspension of payments in 1898, thus allowing for a relatively quick financial rehabilitation.

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TABLE 2

Premium on bonds (in £) May to December 1895.

Source: *The Economist*

NOTES

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