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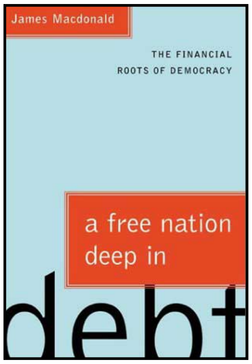

A Free Nation Deep in Debt

The Financial Roots of Democracy

by James A. Macdonald
Farrar, Strauss and Giroux © 2003
564 pages

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Take-Aways

- The history of finance and the history of democracy are closely linked.
- Representative assemblies lowered government credit risk.
- Governments needed to borrow heavily to finance wars and empires.
- Bond markets take a dim view of despots — democracies can borrow cheaper.
- Historically, the strongest countries combine taxes and public credit.
- The roots of finance and politics twined together in Biblical times.
- Deficits incurred to finance wars get more public support than peacetime deficits.
- Peacetime borrowing is more impersonal than wartime borrowing.
- The citizen-creditor is no longer a significant force.
- Institutional investors are not patriotic.

Rating (10 is best)

Overall	Applicability	Innovation	Style
7	**4**	**8**	**8**

Relevance

What You Will Learn

In this Abstract, you will learn a fascinating amount of historical detail about the relationship between finance and political structures from Biblical times to the present.

Recommendation

This impressively researched opus reflects an obsession with One Big Idea that never comes quite clearly into focus, but revolves around the critical historical role played by national credit. Behold an author who not only quotes the Biblical book of Numbers, but also interprets it as a document of financial history, ignoring the contentious issues of authorship and anachronism that make scriptural exegesis such challenging work for specialists. He traces the way government and conflict are funded from Herodotus to the Hanoverian Court to Woodrow Wilson. Like the River Platte, this work is a mile wide and an inch deep; but the river has a definite direction, and this meanders. If you fancy an intriguing browse through major and minor points of political and fiscal history, *getAbstract.com* has found just the book for you. Some scenes are indelible, like the Germans celebrating WWI bond purchases by driving iron nails into a big wooden statue of a Field Marshall, and may jolt you if you think Allied and Axis powers were funded differently. The U.K. and the U.S. sponsored similar popular financial mobilizations, complete with bombastic slogans (no statues, though).

Abstract

Public Credit in Ancient Times

Public credit began in ancient Greece, following the Peloponnesian War, about 404 BC, with loans from Sparta to those who would lose Athens to the democrats. Borrowing and lending in Greece, sometimes voluntary and sometimes not quite completely voluntary, continued for several hundred years, but never quite developed into a financial system. Rome seldom borrowed but, in some cases, the upper classes agreed to give money for a particular campaign with the understanding that they could expect a share of the plunder.

"In medieval Italy, it was the privileged citizens who were entitled to have their taxes repaid with interest, while the less privileged were forced to pay a forfait. In the topsy-turvy world of mass democracy, the formula was reversed."

The relationship between public credit and democratic power in various forms began, for practical purposes, in Italy during the Renaissance. Especially in the north, merchants dominated the Italian states. The city-states established their autonomy, appointed consuls and more or less representative assemblies, stopped paying imperial levies and started borrowing. Most of these city-states wound up dominated by strong men but Venice managed to remain a republic. Free citizens could not be taxed, so Venice relied on loans, sometimes compulsory, to fund its wars. Venice also developed a market in which debt could be traded.

Public borrowing by Italian city-states was understood to be something like refundable taxes. Lending was not voluntary. One advanced money for the needs of the state, the amount depending on one's wealth. In theory, the state paid it back. But city-states had a habit of running up deficits, cutting interest rates, debasing the currency and doing other things that made repayment less than the lender might wish.

Monetary Matters in Medieval Europe

Monarchical Europe also faced a difficult financial dilemma. Generally, people believed that a king ought not to tax his subjects, but should provide for himself. During the

Middle Ages, kings could not levy taxes without their subjects' consent. The subjects spoke through parliaments and similar European assemblies. Parliaments tended to grant kings less than the kings requested. Their operating principle was that the king should "live upon his own."

France's Charles IV changed all that in the mid-fifteenth century, taking taxes as he pleased without parliamentary authorization. Still, royal requirements often outstripped revenues, so kings borrowed, initially from the only parties allowed to lend, the monasteries and the Jews. Interest was touchy, given the Church's ban of usury, so financial arrangements were complex. Kings were known to ease their credit burden by arranging the execution of their creditors for usurious profiteering, or by the bloodless expedient of debasing the currency.

"While the bond market in its infancy was simply the financial expression of the political freedom of medieval Italian republics, the mature bond market of the modern world has a life of its own."

The influx of gold and silver after the discovery of the New World radically rearranged European finances, from monetary shortage to surplus. The money supply grew by almost half in just a few decades. The Spanish crown got about a quarter of the nearly 17,000 tons of silver and almost 200 tons of gold brought from the Americas between 1540 and 1660, a sum sufficient to give the monarch almost complete independence from parliament. New World silver flowed through Europe. Inflation ensued. Markets developed, particularly in Antwerp and Lyons, to address the unstable money supply by allowing traders to hedge their risks.

"Every citizen of any means whatsoever had become a public creditor by 1918."

Financial markets emerged as political players in the sixteenth century. A league of financially powerful cities united, more or less, to stem the growing power of imperial monarchies. Financial acumen allowed the Dutch to borrow, on a per capita basis, several times as much as the Spanish empire and to finance a victorious war of independence. An important part of Dutch success was the recognition that a country needed a reliable stream of tax revenue to secure its loans. The Dutch agreed to pay such taxes. One English contemporary wrote, "The Tributes, Taxes and Customes, of all kinds imposed by mutual consent — so great is the love of liberty or freedome — are very burthensome, and they willingly beare them."

"It was agreed that the resources for war had to be found in the pockets of citizens."

The Dutch succeeded because the state and its citizens were one, united body. The leading families owned the debt. In a monarchical system, the interests of the king were usually his interests alone. Hence people came to believe that the king should live out of his own purse. By contrast, the Dutch system brought citizen and state together to support one cause.

"The First World War had shown that, however widely the war debt was distributed, taxpayers and creditors were not wholly identical, and it was therefore impossible to avoid class conflict altogether when the cost of debt service rose above a certain point."

The Eighteenth and Nineteenth Centuries

A similar thread runs through the financial history of France and England in the eighteenth century. Both countries suffered severe economic dislocation in the wake of the bursting Mississippi and South Sea bubbles, respectively. The very word "banque" was tainted in France, as was the term "joint stock company" in England. Yet the two countries took very distinct approaches to mopping up their messes. France attempted simply to turn back the clock with various measures, including:

- Close the curb market and abolish the Banque Royale.
- Establish an official, centralized exchange, license brokers and restrict trading hours.
- Allow people who had sold land for banknotes to buy it back at the original price.
- Return prior office holders to their former positions.
- Confiscate wealth from those adjudged to be "speculators."

- Burn all records and disallow any appeals.
- Devalue the currency by 50% and cut the real interest rate on state debt.

The French approach seriously damaged the creditor class, which had losses near 75%. In England, by contrast, the approach to clearing the South Sea Bubble's rubble was to:

- Cancel unpaid subscriptions and 90% of loans secured by subscriptions.
- Calculate a retroactive price of 300 pounds sterling per share and distribute shares at that price to all who had paid for their subscriptions.
- Distribute un-issued shares pro-rata and confiscate wealth from the directors.
- Forgive the 7.5 million pound sterling debt the company owed to the government.

The British approach respected the market and private contracts. Creditors and investors suffered, but they did not lose confidence in the state or the rule of law. In France, state power reversed, annulled, taxed and otherwise neutered decisions freely made and obligations freely undertaken. It re-established the *status quo ante*, leaving lenders with festering resentments against state power that would eventually seek release in revolution.

"Germans excused the hyperinflation as the inevitable consequence of the need to avoid unemployment that could have handed the country to the communists, combined with the strain of attempting to fulfill impossible reparation demands."

In England an effective *modus vivendi* evolved: London merchants conducted the nation's financial business while the landholders dealt with politics. But the classes slowly merged, and eventually the system resembled the one born in Holland during the war against Spain. That is, the holders of government debt tended to be involved one way or another in the administration of government, so the state and its creditors shared a united interest. This led in turn to greater transparency in government accounting. Budgets were published, and this built trust. Of course, trust means lower risk and lower costs of borrowing. From 1740 to 1784, Britain was almost continually at war. It financed the lion's share of the costs by borrowing. Capital flowed into Britain from abroad.

"The unavoidable conclusion is that by the late 1970's a patriotic appeal to the public to buy bonds at negative real interest rates would merely have provided suitable material for Saturday night television satire."

In many respects, France had a sounder economic base. Although its debt levels were much lower, France paid much higher debt service costs. One important reason was that France had suppressed the markets that could have provided liquidity, transparency, risk management vehicles and other valuable advantages for which creditors are willing to "pay" by demanding lower interest rates.

The defeat of Napoleon in the nineteenth century established the supremacy of British financial principles. Napoleon did not pay for his wars by borrowing. He did not share power with parliaments and financiers. Britain's victory made it clear that public borrowing and representative government were an unbeatable combination, and the wars of the twentieth century reinforced that partnership.

"Credit markets still generally rank democracies more favorably than other forms of government."

The Twentieth Century

Patriotic appeals leading up to WWI allowed all combatants to tap the citizenry for credit. Buying bonds became a surrogate for going to battle — a connection made explicit in exhortations to "Enlist or Invest." To some extent, the financing harked back to the spirit of Athens and Rome, where "voluntary" donations made under significant moral pressure provided the military's money. An Italian professor dramatized this historic connection by organizing a march to the Forum in 1917, calling on Romans to make public contributions in the style of the ancients who donated gold, silver and gems to support the Second Punic War.

"For all practical purposes, however, the venerable marriage between public credit and democratic government, so vital a factor in the history of the world, has been dissolved."

Both the Allies and the Axis nations depended on citizen creditors in the First World War. In every combatant country, millions subscribed to war bonds. Debt climbed to almost unprecedented levels, leaving the question of how to repay it when the war ended. The obvious but deceptively simple answer was to collect from the loser. Almost from the outset Germany planned to extract indemnities from the enemies it expected to defeat, Britain and France. Woodrow Wilson, on the other hand, opposed indemnities (though not reparations). Britain did not begin to think seriously about collecting them until near the Armistice.

"The German government was quite explicit that the war debt would be paid by indemnities received from its defeated enemies."

But the conference in Versailles turned on the issue of how much could be squeezed out of beaten Germany and who should receive it. Another issue lurked: how much inter-Allied debt would be honored. The U.S. demanded no reparations from the vanquished, but stood by the principle that Britain, having borrowed the money, ought to pay it back. Eventually, by rearranging repayment terms, the U.S. substantially reduced the amount it would collect.

After the war, Germany, which was burdened with an impossible combination of debt and reparations, resorted to hyperinflation to zero-out (in real terms) the claims against it. Citizen creditors were among the losers. In France, the citizen creditors also suffered from devaluation. If German citizen-creditors received 10% repayment, the French got a little better than three times that. Britain held the line against inflation as a solution to war debt. Even the socialists advocated hard-money and, in 1925, the U.K. re-instated the Gold Standard. In Russia, Lenin repudiated debt and inflated the currency.

"The new economic theories of Keynes and others emphasized the role of the state as economic engineer."

Lessons learned in the First World War bore fruit in the second. Neither Germany nor Russia (now the U.S.S.R.) attempted to mobilize citizen creditors with anything like a good faith intention to repay. Stalin's bonds were well understood to be permanent "loans" to the state. Hitler planned, like Napoleon, to fund his conquests with tribute from the conquered. The Nazis held no mass bond drives, but they covertly mobilized public credit by exhorting the population to "save." The United States and Great Britain relied heavily on bonds and taxes. Again, the link between public finance and representative government prevailed. Whether that could ever happen again is debatable. The bond market is now a force more powerful than governments and dominated by institutions.

About The Author

James Macdonald was an investment banker for many years, and this is his first book.

Buzz-Words

Citizen creditor / **P**ublic credit / **P**ublic finance