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Foreign capital and Finland: central government's first period of reliance on international financial markets 1862-1938

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Mika Arola

Foreign capital and Finland

Central government's first
period of reliance on
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Valtiokonttori
Statskontoret
State Treasury



EUROJÄRJESTELMÄ
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Abstract

The main objective of the study is to evaluate the Finnish central government's foreign borrowing between the years 1862 and 1938. Most of this period was characterised by deep capital market integration that bears resemblance to the liberal world financial order at the turn of the millennium. The main aim is to analyse the credit risk associated with the state and its determination by evaluating the world financial market centres' perception of Finland. By doing this, the study is also expected to provide an additional dimension to Finland's political and economic history by incorporating into the research the assessments of international capital markets regarding Finland during a period that witnessed profound political and economic changes in Finnish society.

The evaluation of the credit risk mainly relies on exchange-rate risk free time series of the state's foreign bonds. They have been collected from quotations in the stock exchanges in Helsinki, Hamburg, Paris and London. In addition, it investigates Finland's exposure to short-term debt and Moody's credit ratings assigned to Finland. The study emphasises the importance of the political risk. It suggests that the hey-day of the state's reliance on foreign capital markets took place during last few decades of the 19th century when Finland enjoyed a wide autonomy in the Russian Empire and prudently managed its economy, highlighted in Finland's adherence to the international gold standard. Political confrontations in Finland and, in particular, in Russia and the turbulence of the world financial system prevented the return of this beneficial position again.

Through its issuance of foreign bonds the state was able to import substantial amounts of foreign capital, which was sorely needed to foster economic development in Finland. Moreover, the study argues that the state's presence in the western capital markets not only had economic benefits, but it also increased the international awareness of Finland's distinct and separate status in the Russian Empire and later underlined its position as an independent republic.

Key words: credit risk, government borrowing, financial market, government bonds, state finances

JEL classification: E65, G15, H63, N13

Tiivistelmä

Tutkimuksen aiheena on Suomen valtion ulkomainen lainanotto vuosina 1862–1938. Ajanjaksoa leimasi kansainvälisten rahoitusmarkkinoiden suhteellisen syvä integraatio; kuten nykyisinkin, pääomaliikkeitä yli kansallisten rajojen ei juurikaan rajoitettu. Tutkimuksen päätaavoite on arvioida Suomen valtioon kohdistunutta luottoriskiä ja sen määräytymistä kansainvälisissä finanssikeskuksissa. Suomen luottoriskin tutkiminen avaa myös uuden näkökulman suomalaiseen historiantutkimukseen. Lähestymistapa tarjoaa kansainvälisten rahoitusmarkkinoiden arvion Suomen poliittisesta ja taloudellisesta kehityksestä ajanjaksona, jona suomalainen yhteiskunta kävi läpi merkittävän poliittisen ja taloudellisen rakennemuutoksen.

Luottoriskin arvioiminen perustuu valtion ulkomaisten obligaatioiden valuuttakurssiriskistä vapaaseen tuottosarjaan, joka on kerätty Helsingin, Hampurin, Pariisin ja Lontoon arvopaperipörssien hintanoteerauksista. Obligaatioiden tuottosarjojen ohella tutkimus arvioi Suomen valtion luottoriskiä tutkimalla lyhytaikaisen velan osuutta koko valtionvelasta. Se hyödyntää myös Moody'sin luokituslaitoksen luottoluokituksia. Tutkimus painottaa poliittisen riskin merkitystä luottoriskin määräytymisessä. Tulosten mukaan Suomen valtioon kohdistuva luottoriski oli alhaisimmillaan 1800-luvun viimeisinä vuosikymmeninä, jolloin Suomella oli huomattavan autonominen asema Venäjän keisarikunnassa ja se hoiti talouttaan esimerkillisesti. Hyvä taloudenpito huipentui Suomen mukanaoloon kansainvälisessä kultakantajärjestelmässä. 1800-luvun lopun suotuisa luottoriskiasema rahoitusmarkkinoilla ei enää toistunut 1900-luvun puolella; poliittinen epävarmuus Suomessa ja erityisesti Venäjällä, sekä kansainvälisten rahoitusmarkkinoiden epävakaus, estivät edullisten vuosien paluun.

Laskemalla liikkeeseen ulkomaisia obligaatioita valtio toi maahan huomattavan määrän ulkomaista pääomaa, jolla se ratkaisevasti edesauttoi Suomen taloudellista kehitystä. Tutkimuksen mukaan ulkomaisella lainanotolla ei ollut ainoastaan taloudellista merkitystä, vaan se myös lisäsi Suomen kansainvälistä tunnettuutta. Suomen läsnäolo ulkomaisissa rahoituskeskuksissa korosti Suomen erityistä asemaa Venäjän keisarikunnassa ja myöhemmin sen statusta itsenäisenä tasavaltana.

Avainsanat: luottoriski, valtion lainanotto, rahoitusmarkkinat, valtion obligaatiot, valtiontalous

JEL-luokittelu: E65, G15, H63, N13

Acknowledgements

I became acquainted with Finnish central government finances when I was recruited by Director of Finance Kari Nars in 1996 to the unit of foreign borrowing at the Ministry of Finance. It was an interesting phase, as the birth of the euro area capital markets was drawing nearer and the hurdles between national financial markets were pulled down. The state's domestic and foreign borrowing activities were combined and our operations were in 1998 moved to the State Treasury, which had earlier been responsible for domestic issuance. During our first years at the State Treasury we adjusted our issuance according to the requirements of the euro markets through concentration of our borrowing in the form of large benchmark bonds and by widening our investor base internationally. We arranged investor road-shows all over Europe as well as in the great financial centres in Asia and in the United States; we explained our economy, political situation and funding practises to a great number of portfolio managers.

It was probably this experience combined with my long-lasting interest in history that a few years ago aroused my interest in this study: how were the central government finances arranged in Finland earlier and what was the market assessment during an earlier era that was characterised by a financial market environment very similar in nature to that of today's world. Very importantly, Director of Finance Satu Huber at the State Treasury was from the very beginning very encouraging regarding my work. I owe a great debt to her. I also want to thank Director General Jukka Wuolijoki for supporting my project all the way from the beginning.

From the University of Helsinki, Docent Antti Kuusterä's guidance with his profound knowledge on the history of state finances greatly advanced my work. I owe a great deal to him. Professor Riitta Hjerppe very much contributed to the final shaping of this study and arranged me working facilities at the University of Helsinki during my study leave from the State Treasury. Docent Sakari Heikkinen's excellent comments and advice were also absolutely essential. All three read my manuscript and their comments greatly improved its quality. Heikki Kauppi and Arto Kokkinen from the University provided me with useful comments on the econometrics section whereas Professor Jan Tore Klovland from Norges Handelshoyskole offered me important advice on the principles of calculating bond yields. Together with Professor Jari Ojala from the University of Jyväskylä he also pre-examined my manuscript. None of the

commentators, of course, bears responsibility for the errors left in this final version of my study.

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I dedicate this study to Tiina, Elsa, Lotta and Juho.

Helsinki, December 2006

Mika Arola

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Prologue

Finland joined the euro area at the outset of 1999. The benefits and disadvantages of the membership for Finland's economy have been the subject of intense debate. However, one aspect of the common currency has been rather unanimously accepted; the state's borrowing has benefited from the membership. Since 1999 the government has been able to carry out all its funding without any exposure to exchange rate risk, either directly through euro denominated issuance or indirectly, by eliminating foreign exchange risk through currency-swaps in the liquid pan-European derivatives markets.

In the euro zone fixed-income markets a far-reaching yield convergence between sovereign bonds has taken place.¹ Euro area investors have been able buy euro zone sovereign bonds without any exposure to the exchange rate risk, implying that the credit risk has become the central determinant of the sovereign bond yield spreads; this has pushed the sovereign yields closer together. Given Finland's prudent economic management, yields of the republic's bonds have reached those of the euro area benchmarks; the credit risk associated with Finland's central government has become negligible. Moreover, in the context of globalised world financial markets, of which free movement of international cross-border capital is a central phenomenon, the state has been able to reach a wide investor base from all corners of the world. Recent advances in information technology, including the creation of electronic trading platforms, have promoted the world financial market integration and efficiency even further. The state has not hesitated to adopt the latest innovations in its borrowing procedures and reaped the benefits of the modern technology.²

The present situation is in sharp contrast to the situation as recently as in the early 1990s. During the deep economic recession the state urgently required foreign debt to cover government expenses and maintain the central bank's foreign exchange reserves. However, the recession and soaring public budget deficits impinged greatly on the central government's borrowing prospects. Investors' trust in Finland's solvency was hampered and the costs of new borrowing

¹ Yield is the income that bondholder receives from a bond he or she has purchased – in effect; it constitutes the long-term interest rate – whereas yield spread or yield premium is the difference in yield of two (comparable) bonds.

² Debt Management Annual Reviews: 2003–2005.

turned high, while depreciation of the Finnish mark increased the costs of serving outstanding foreign currency debt.³

The present world financial order, ie the government's financial environment, is young. The free movement of global cross-border capital has existed for only a few decades. The euro area has not yet even had its tenth anniversary. However, the present financial landscape and government's borrowing developments of the past 15 years have historical parallels.

Technological innovation and political devotion to a liberal world economic order provided the breeding ground for the astonishing capital market integration in the latter part of the 19th century. International devotion to the gold standard during the pre-World War I era and also temporarily during the interwar period were the essential components of the financial integration that lasted until the Great Depression in the early 1930s, although it was severely interrupted by World War I. Both crises affected the state finances in Finland in a manner very similar to the recession of the early 1990s.

The central government of Finland's was a frequent issuer on the international capital centres during this 'first phase of globalisation', which provides striking similarities with the present world financial order. This study is devoted to examining that experience.

³ Kiander and Vartia, 1998: 146–154; Koivisto, 1994: 381–407.

1 Introduction

1.1 Subject and aim of the study

This study examines the foreign borrowing of the central government of Finland during the first phase of globalisation and thereafter until the outbreak of World War II. This means that it concentrates on one small peripheral issuer in the international bond markets. The aim is not to try to make generalisations on the functioning of the world fixed-income markets during the research period, but rather to use this Finnish case study to provide some useful information on bond market mechanisms, prevailing during the gold standard eras.

The central aim is to examine the determination of the government's ability to access international financial markets and its relative funding costs. In a similar manner with today's international euro area bond markets, especially during the first gold standard period the credit risk premium was the main component of the yield spreads between different government bonds because foreign exchange rate risk did not principally exist. I will analyse the credit risk associated to the central government of Finland by international capital markets and its determinants. I believe that due to the similarities of the periods this historical research will provide some useful insights to markets' assessment mechanisms and behaviour also during the present 'second period of globalisation'. As Jan Tore Klovland points out, there are lessons to be learnt from the history of the nineteenth century that never could be entangled from the quagmire of highly regulated financial markets of the more recent past.⁴

I believe that a study on credit risk should not provide information only on the financial markets and guidelines for proper debt management. By their very nature the financial markets utilise all available information to assess the securities they are trading. They turn this information through bids and offers into quantitative data. A yield premium between two sovereign bonds contains information on various political and economic aspects affecting the creditworthiness of each issuer. This provides the useful link to historical research by offering the views of the contemporary people to various historical events.

⁴ Klovland, 2004: 133.

The period from the 1860s to the end of the 1930s coexisted in Finland with a great variety of profound economic and political developments. Finland went through an exhaustive transformation from a poor, almost fully agrarian society to a much more industrialised country comparable to many relatively wealthy European nations. From the 1860s onwards Finland was able to greatly widen the sphere of its economic and political autonomy in the Russian Empire, finally gaining independence in 1917 due to the political turmoil in Russia. An integral part of the economic autonomy was Finland's independent and separate state finances, later accompanied by monetary sovereignty; Finland received in the 1860s its own currency, the Finnish mark, which was pegged to gold for a period of almost 50 years (1878–1914 and 1926–1931). Through this study I hope to provide a new perspective to this crucial period in Finland's history.

In addition to the evaluation of the credit premium and its determination, this study examines the degree of the government's integration to the world financial system. It analyses the government's ability to adopt the common funding procedures of the contemporary core sovereign issuers, providing simultaneously information on the accessibility and openness of the gold standard bond markets. It will also shed some light on the impacts of the collapses of the world financial markets on state borrowing, for example, by sorting out the foreign exchange losses, from which the state suffered throughout the interwar decades.

1.2 Methodology

This work is based on traditional empirical methodology of economic history studies, principally relying on assorted material from archives. The subject of this study, that is, the state's foreign borrowing, is not examined as such; the endeavour is not to describe each bond issue in a detailed manner. Instead, the aim is to form an overview of the main characteristics and developments of central government's foreign issuance and put the findings into a wider perspective. In this study it means that foreign borrowing is evaluated against the background of the degree of world capital market integration and Finland's economic and political developments.

Moreover, the state's foreign borrowing and the credit risk associated with it has been put into an international perspective; Finland has been compared to Sweden, Norway and Russia. Sweden

and Norway were chosen due to their similar economic situations, Norway even was partially politically analogous until its full independency in 1905. For Russia's part, Finland was subordinated to Russia's political supremacy until 1917 and very much affected by its developments even thereafter; comparison of Finland's and Russia's perception of the international capital market centres brings an additional flavour to the turbulent Russo-Finnish relations of the time.

The theoretical framework is adopted from the finance theory. It defines the risks associated with investing in bonds. This definition provides me the eyeglasses through which I will approach the evolvement of the state's credit risk. I construct a time series of Finnish long-term interest rates free of exchange rate risk covering the period from 1863 to 1938 and make use of it to quantify the credit risk associated with the state. In explaining its determination I exploit a relatively wide spectrum of archives material. In order to complement the historical archives research, I will employ econometric time series analysis. I use a model, which explains credit risk by a number of economic and political variables and also by a variable describing the condition of the world financial markets. A vital methodological choice is that only information that could have been available to the contemporary market participants has been utilised whenever possible, including the econometric regression model, in order to be able to correctly reconstruct the thoughts and beliefs of the people responsible for the market behaviour during that important era.

During my work I noticed that I had to pay some attention on the appropriate name of the actor. Although the issuer was on foreign bourses often referred as 'Finland', I thought this name might be somewhat misleading; after all, there were many other Finnish issuers of foreign bonds, such as Finnish towns and mortgage societies. Even the most obvious alternative notation, the state, was partly questionable; Finland's 'statehood' during the time of autonomy (1809–1917) was not self-evident. However, on foreign market places, bonds issued by the Grand Duchy's Senate were always introduced as 'state bonds'. Also Finnish administration was eager to underline its nature as a state; even the public entity responsible for interest and redemption payments was named the State Treasury in 1876. For these reasons I decided to mainly use the notation 'the state' for the issuer, along with terms 'the central government' – to avoid confusion with the local government, ie towns and municipalities – and 'the Senate', in order to draw attention to the administrative body responsible for borrowing. Naturally, after Finland's independency in 1917 the problem became partly irrelevant.

1.3 Earlier studies and sources

Earlier studies on state's borrowing in Finland are rather scarce. A major part of research on central government's borrowing is incorporated in wider studies on Finland's public finances and monetary policies. The first comprehensive study on handling of the Finnish state finances in the 19th century was prepared by Ernst Nevanlinna after the turn of the century. Antti Kuusterä has later examined the state's lending and investment policies during the time of autonomy. Both studies also touch upon government's borrowing. In the same category could be added studies of A.E. Tudeer on state's finances and Finnish bond markets during the 1920s; they also lay a hand on government's borrowing. In addition, Emil Schybergson, A.E. Tudeer and Hugo Pipping have prepared extensive studies on the history of the Bank of Finland up until 1936. They all handle also the state's borrowing due to the pivotal role of the Bank of Finland in state's foreign currency financial transactions. Histories of Finnish commercial banks also touch upon Finland's international financial contacts and even the central government's borrowing although they principally describe the development of domestic financial markets.⁵

There are only a few studies or surveys concentrating solely on the government's borrowing. During the time of autonomy, Leo Mechelin, Emil Schybergson and Juho Kusti Paasikivi discussed the state's borrowing policies. Thorvald Becker's doctoral dissertation in 1913 concentrated on Finnish state debt from a juridical point of view. In the interwar period, for instance, Kyösti Järvinen and Bruno Suviranta showed interest in the state's funding affairs. Later Hugo Pipping studied the government's connections to the House of Rothschild during the second half of the 19th century. Riitta Hjerppe and Vappu Ikonen have recently examined Finland's response to the famous debt moratorium announced by the US President Herbert Hoover in 1931.⁶

Internationally, the interest in the sovereign borrowing and bond markets during the 19th and early 20th century has greatly risen. For example, Niall Ferguson has prepared several studies, which, among other things, touch upon government bond markets and their information value in historical research. There has also emerged an

⁵ Blomstedt, 1989; Kuusterä, 1989, 2002; Nevanlinna, 1907; Pipping, 1961, 1962; 1969; Schybergson, 1914; Tudeer, 1931; 1932; 1939; 1940.

⁶ Becker, 1913; Hjerppe and Ikonen, 1995; Järvinen, 1931; Mechelin, 1895; Paasikivi, 1910; 1911; Pipping, 1967; Schybergson, 1909; Suviranta, 1931; 1931b.

abundant literature on the sovereign borrowing during the two gold standards and the linkage between the gold adherence and the credit premiums between government bonds. A path-breaking study in this field was *The Gold Standard as a 'Good Housekeeping Seal of Approval'* by Michael Bordo and Hugh Rockoff in 1996. Since then, to mention a few, Michael Bordo, Michael Edelstein and Hugh Rockoff, as well as Marc Flandreau and Frédéric Zumer and also Maurice Obstfeld and Alan Taylor have examined the credibility effect of the gold adherence. I will briefly touch upon this issue from Finland's perspective in this study.⁷

A seminal study on the international lending and sovereign borrowing during the classical gold standard is still the one published for the first time in 1930 by Herbert Feis: *'Europe, the world's banker 1870–1914'*. As a comprehensive and in-depth introduction to monetary mechanisms of both gold standards serves *'A Retrospective on the Classical Gold Standard 1821–1931'*, this was edited by Michael D. Bordo and Anna J. Schwartz. For the interwar period's financial relations Barry Eichengreen's *'Golden Fetters, The Gold Standard and the Great Depression, 1919–1939'* is probably the most extensive presentation. The memoir of the former Russian Minister of Finance Count Sergei Witte, edited by Sidney Harcave, provides an insider's view to the borrowing affairs of one of the great European Empires at the turn of the century and its geopolitical dimensions. The 200th year jubilee book of the Swedish National Debt Office, Riksgäldskontoret, contains a number of articles by different authors on the borrowing of the Swedish state and its relationship to Sweden's economic development since the late 18th century. As regards Norway, a recent research by Jan Tore Klovland offers insights to the methods and costs of the central government of Norway's foreign funding during the classical gold standard and even briefly thereafter.⁸

In addition, some studies on banking history are of great relevance for this research. Niall Ferguson has prepared an extensive overview on the 19th century sovereign bond markets through the history of the leading pan-European contemporary banking dynasty, the House of Rothschild. Studies by Olle Gasslander provide a similar type of inside look at the functioning of the Nordic bond markets at the turn

⁷ Bordo and Rockoff, 1996; 1999; Ferguson, 1999b; 2001; 2006; Flandreau and Zumer, 2004; Obstfeld and Taylor, 2003, 2003, 2004.

⁸ Eichengreen, 1995; Feis, 1930 (new editions in 1964 and 1974); Harcave, 1990; Klovland, 2004; Riksgäldskontoret's history (1989) is edited by Erik Dahmén.

of the century through the history of the Wallenberg's family bank, Stockholms Enskilda Bank.⁹

In my work, I have rather widely utilised both domestic and foreign archives. Parliamentary documents offer the essential information on government borrowing, as each loan individually required parliament approval. This material is supplemented by original bond books and other loan documents stored on the premises of Finland's State Treasury. The Finnish National archives and the Senate archives in particular, have provided other essential material for this study. Moreover, due to its central role in state's borrowing, the Bank of Finland's archives contain a great deal of material on the government's foreign bond issuance, including the vast correspondence between the Board of the central bank and the Frankfurter Rothschilds.

In approaching the credit risk associated with the central government, the Library of the University of Helsinki with its extensive collection of Finnish and foreign newspapers enabled me to collect the price data on Finnish state bonds on the foreign bourses. In addition, I have been able to acquire some bond quotations from the Hamburgische Börsen-Halle newspaper stored in the Staats- und Universitätsbibliothek in Hamburg and from the French financial magazine *Le Rentier* at the Institut d'Etudes Politiques de Paris. British government bond yields I have collected from B.R. Mitchell's and Jan Tore Klovland's studies. Other foreign government bond yields are gathered from Sidney Homer's and Richard Sylla's research and from the Statistical Year-book of the League of Nations. Some data is also abstracted from an American data warehouse Global Financial Data Inc.¹⁰

When assessing the evolution of the credibility of the state in the eyes of the foreign capital market participants, my access to foreign bank archives was absolutely crucial. I have been able to utilise a large variety of historical documents from Archives Historiques du Crédit Lyonnais in Paris and from Stiftelsen för Ekonomisk Historisk Forskning inom Bank och Företagande in Stockholm. In particular, investment bank analyses on Finland were of great interest. I also received some documents from the archives of Citigroup Corporation, including material in the Helsinki office. Extremely valuable was my opportunity to receive Moody's interwar Rating Manuals on Finland from the Moody's Investment Service in the United States. In this

⁹ Ferguson, 1999; Gasslander, 1956; 1959.

¹⁰ Global Financial Data; Homer and Sylla, 1996; League of Nations International Statistical Year-books; Klovland, 1994; Mitchell, 1962.

respect, also the Archives of the Ministry of Foreign Affairs in Helsinki have been most useful due to the extensive interaction between the republic's foreign representatives and foreign financial institutions during the interwar period.

1.4 Structure of the study

The next chapter 2 touches upon the fundamental theoretical framework of this study by defining the meaning of credit risk in finance theory and evaluating its usability in historical research. Moreover, it discusses the determinants of credit risk in a historical context. Chapter 3 studies the historical setting for the state's participation in international financial markets. It first discusses the evolution and nature of the international fixed-income markets during Finland's adherence to the precious metals, concentrating on the aspects affecting the availability of foreign capital to the Finnish central government. This is followed by an outlook on the demand side; it examines the reasons for domestic demand for foreign capital by providing a brief overview of the economic and political developments and economic thought in Finland between the 1860s and the 1930s.

In chapter 4, I adjust my perspective from the macro level to the level of an individual actor in the international financial markets; I study the experience of a *small peripheral borrower*¹¹ in the gold standard capital markets. I examine the degree of the state's reliance on foreign capital and the sources of its funding. I study the characteristics of the issuing mechanisms, the intermediaries and the investors and compare the state's funding procedures to the core market practises and also to those of the states of Sweden and Norway. I will also show the results of the government's foreign borrowing by presenting some new calculations on the amount of state debt, emphasizing the costs of the currency devaluations. In the end of the chapter, I will briefly present a stylised model provided by Maurice Obstfeld and Alan M. Taylor on the degree of capital mobility in modern history and examine how well Finland's

¹¹ Recent study by Marc Flandreau and Clemens Jobst (2005) provides rigorous evidence on Finland's 'peripheral' position in the late 19th and early 20th century monetary system. Their network analysis on the international foreign exchange system put Finland on the extreme periphery of the gold standard financial markets.

experience fits to their evaluation.¹² Although this chapter does not directly touch upon the question of credit risk, I feel it is an integral part of this study; a necessary precondition for Finland's market access was its ability to absorb the mainstream financial practises of the late 19th century and early 20th century international bond markets.

Chapter 5 will study the magnitude and development of credit risk associated with the central government of Finland; it will utilise historical data series, which have been collected from quotations on foreign bourses. It also contains two complementary aspects to quantify credit risk: the portion of short-term debt in the borrower's total debt stock and Moody's credit agency's sovereign bond ratings. The next chapter will examine the determination of the credit risk by going through the evidence supported by historical archives material and, as a complementary method only, by utilising econometric time series analysis.

In both approaches, the credit premiums can be seen as the left-hand variable of an equation through which investors priced sovereign risk as a function of a number of variables, located on the right side of the equation. The econometric approach relies on causal statistical relationships between the credit risk and the explanatory variables, while the main 'qualitative' method examines the causal relationships through traditional empirical historical research that mainly relies on archive documents. Investment bank analyses, documents from loan negotiations, correspondence between government officials and bankers etc. will replace the utilisation of causal statistical relationships. They will provide the essential results of this study: the determinants of Finland's creditworthiness on the global financial exchanges.

Chapter 7 turns to a slightly different approach. It evaluates the economic and political significances of the government's foreign borrowing; what did Finland gain from the state's sufficient credibility in the eyes of the international financiers, enabling it to tap the international bond markets relatively frequently and import substantial amounts of foreign capital to accelerate the 'catching up' – process of its peripheral economy. I will also discuss whether the government's adherence to the international capital markets had also a political element, strengthening Finland's distinct status in the Russian Empire during the time of autonomy and enforcing its sovereign status during the first decades of its independency. The last chapter will draw some

¹² Obstfeld and Taylor 2004: 24–29.

conclusions. The appendixes contain new time series for Finnish long-term exchange-rate risk free interest rates and central government debt.

2 Credit risk in historical research

2.1 Meaning of credit risk

The concept of credit risk, or default risk, is quite clear-cut: it refers to the risk that the debtor repudiates its debt obligations. In case of sovereign debtors the probability of the risk is related to various economic and political factors, either affecting debtors *willingness or ability* to keep up its commitments. The higher the risk associated with the borrower, the weaker are its borrowing prospects in terms of the price or, in the extreme, in its ability to access the market.¹³

The standard procedure to examine the development and magnitude of credit risk associated with a sovereign borrower is to analyse the interest rate spreads between two similar bonds issued by different governments; regarding their characteristics, most importantly, they have to be denominated in same currency, or in different currencies fixed ‘for good’ through a credible currency system, thus removing the currency risk from bond prices. In addition, if the portion of short-term debt is high in relation to total outstanding debt, it may also be a sign of inadequate market access and weakened credibility; risk averse investors are not willing to allocate capital to the borrower’s long-term securities, particularly if they are not assured of the secondary market liquidity enabling smooth liquidation of the assets they are holding.

Use of financial data may provide interesting insights into historical events, as the credit risk associated with a sovereign issuer is affected by a number of economic and political events reflecting various historical developments. This relationship provides a useful link between market behaviour and historical research; it incorporates a price tag to historical events.

Interest rates’ importance as evidence of various economic and political developments is reinforced by the characteristics of the financial markets, where fast and adequate information offers substantial advantages to the market participants. A great number of the counterparts trading in the financial markets therefore utilize all available information to analyse the performance potential of the assets they are trading in. As a result, the market prices of different

¹³ See for example Alesina, De Broeck, Prati, and Tabellini 1992: 430–434; Gelos, Sahay, and Sandleris 2003: 3–5.

securities reflect very efficiently the past, current and future development of the traded assets.¹⁴

This phenomenon was very well understood by the people of the gold standard era, especially in case of bonds issued by sovereign states. At the turn of the century, an Austrian economist, Eugen von Böhm Bawerk, declared that the cultural level of a nation is mirrored by its rate of interest.¹⁵ James de Rothschild wrote in 1868 in a letter to the Austrian Finance Minister, ‘The price of public securities is, with good reason, considered as the exact measure of the degree of trust which national credit deserves’.¹⁶ Performance of government bonds on foreign bourses was followed also in Russia. Johan Gripenberg from the Finnish state-secretary office in St. Petersburg in his letter to a Finnish politician Yrjö Sakari Yrjö-Koskinen in 1889 mentioned Finland’s excellent credit in the international financial markets as one example of Finland’s modernity and distinct autonomous status in the Empire, which had surprised many Russians.¹⁷ Later a British historian Niall Ferguson has described the 19th and early 20th century financial markets as an extremely sensitive thermometer for economic and political events of the time.¹⁸

The precondition for the assessment power of the financial markets was the liberal world order. In general, the governments prior to the 1930s did not restrict trading in financial instruments over the national borders. The only exceptions were possible minor taxes on foreign exchange transactions and some often politically motivated controls on public offerings, or, similarly, requirements to acquire a listing permission on the stock exchanges from local public authorities. The First World War caused the only major break to this liberal international financial order. As an indication of far-reaching financial market integration, market prices of similar government securities between different bourses were almost fully arbitrated prior to the First World War; this enables even comparison of bond prices collected from different stock exchanges in studies on credit risk.¹⁹

¹⁴ Frey and Kucher, 1999: 2–9.

¹⁵ Schumpeter, 1952: 182.

¹⁶ Flandreau and Zumer, 2004: 27.

¹⁷ National archives, Yrjö-Koskinen archives, Packet 18, No: 36, letter from Johan Gripenberg to Yrjö Sakari Yrjö-Koskinen 15.4.1889.

¹⁸ Ferguson, 1999b.

¹⁹ Flandreau and Zumer, 2004: 17.

2.2 Determinants of credit risk

There exists an abundant literature on the determinants of credit risk. The present day economists often examine credit risk in the historical context by utilising the methodology and statistics available in today's economics, especially when selecting the proper determinants of credit risk. This route may have some difficulties, as it does not necessarily reflect the thoughts and beliefs of the contemporary market participants.²⁰ In other words, as the size of the credit risk at each point of time was a result of choices made by numerous contemporary markets participants, it can be argued, that it should be explained only by factors and concepts which could have been in the minds of and available to the contemporary people. Otherwise there is the danger of anachronism; one analyses historical events using concepts and tools which were not known at a time.²¹

Although there is a clear methodological difference between the two approaches, in practise they may not, after all, differ so much. The understanding on the evolution of credit risk has not altered dramatically since the days of the classical gold standard era. The more profound change is, however, the availability of statistical information. The growth of the amount and accuracy of economic statistics and the development of statistical analysing tools enable the current financial market participants to measure the factors affecting credit risk more precisely. This means, that one can principally explain credit risk with factors very similar to those of 100 years ago. However, one has to be careful with the choice of the data; if the idea is to imitate the thoughts of the gold standard market participants, one must be satisfied to use data that was available in the end of the 19th century.

One approach to study the progress of credit risk analyses is to look at the evolution of the rating agencies' sovereign rating methodologies. For example, one of the leading rating agencies, Standard & Poor's nowadays disintegrates its sovereign rating analyses into a number of categories, all of which are evaluated when deciding on sovereign ratings. The categories used are political stability, economic structure, economic growth, fiscal revenue and expenditure, state debt and interest burden, public off-budget and contingent liabilities, monetary stability, external liquidity (mainly

²⁰ Flandreau and Zumer, 2004: 30.

²¹ Jussila, 2004: 15.

consisting of the official foreign exchange reserves), public sector net external debt and bank and private sector net external debt.²²

Norbert Gaillard has examined another rating agency's, Moody's, sovereign rating methodologies during the interwar period by utilising econometric analysis; Moody's itself did not publicly announce its actual credit rating methodologies. According to Gaillard's regression results, Moody's credit ratings were determined by five factors: wealth per capita, external debt, default history of an issuer, external monetary stability and political stability.²³

Prior to the birth of credit rating agencies – the sovereign credit ratings were on a larger scale produced only after the First World War – there were several other financial agencies offering investors and other financial actors information on the solvency of different bond issuers. During the 19th century in Britain, *Fenn's Compendium of the English and Foreign Funds* constituted maybe the most comprehensive handbook on different government securities. Its some 700 pages covered all government debts, including even a brief section for Finland. As *Fenn's Compendium of the Funds* from 1889 stated, its main purpose was to supply 'a faithful record of national indebtedness: setting forth the growth of that indebtedness: the multitude of objects upon which it has been incurred: and the burdens thus entailed upon the civilised world etc.'

Fenn's Compendium of the Funds presented statistics on each debtor's public revenues and expenditures, gross public debt, debt per inhabitant and each country's foreign trade. It also went through sovereign issuers' debt history, often by describing each government loan individually. Debt statistics were usually supplemented by information of the country (ie area and population) and its economy, including monetary conditions. In particular, it presented calculations on national wealth.²⁴ The respective French handbook, Alphonse Courtois' *Manuel des fonds publics et des sociétés par actions*, mainly limited its assessment to listing the development of state expenditure and revenues (budget balance) and state debt. As regards Finland, in 1883 it presented only a list of central government's recent bond issues and their characteristics.²⁵

²² Bhatia, 2002: 13–24.

²³ Gaillard, 2005: 14–17.

²⁴ *Fenn's Compendium*, 1889.

²⁵ *Manuel des Fonds Publics*, 1883. The French handbook also included descriptions of three Finnish banks, ie the Bank of Finland, Förenings-Banken and Nordiska Aktiebank för Handel och Industrie.

Another route to study the determination of credit risk is to examine the analysing methodologies of the contemporary banks; it can well be assumed that the factors that were in the minds of the bank analysts very concretely affected the credit premiums. Marc Flandreau and Frédéric Zumer have provided remarkable insights to the sovereign credit analyses of the late 19th century and early 20th century market participants by examining, for example, the archives of the Crédit Lyonnais economic research department. By relying on the archives material, they divide the explanatory factors of credit risk into four broad categories: structural factors (fiscal sustainability, monetary stability, export performance, public deficits and exchange-rate stability), reputation factors reflecting earlier defaults, political variables and gold adherence.²⁶

The approaches have a lot of similarities. Fiscal position and some sort of an indicator for debt sustainability were usually assumed to be of vital importance, although a pure indicator of the fiscal sustainability was absent in the analysis of Norbert Gaillard on Moody's interwar rating methodologies. Moreover, monetary stability, the structure of the national economy and wealth and external monetary stability were more or less assumed to affect credit risk by all observers. Political risk stood out as an essential determinant of credit risk, except in cases where the observing entity only concentrated on analysing economic matters.

As regards the practical assessment at different time points, the availability of exact statistics on domestic production provides a major discrepancy: it was generally not calculated prior the First World War. In Finland, construction of official statistics on national income was initiated only in 1948.²⁷ This means that if one aims to imitate the analysing methods of the gold standard financial markets one should not use gross national product as one of the determinants of credit risk.

In this study I try to capture the thinking of the market participants of the late 19th and early 20th centuries, ie what had been on their minds when assessing the central government of Finland. In order to trace the beliefs and attitudes of the contemporary people about Finland I have gathered information from various sources, including investment bank analyses on the central government of Finland, newspaper articles, correspondence between Finnish government officials and foreign bankers, reports by Finnish civil servants, the

²⁶ Flandreau and Zumer, 2004: 30–39.

²⁷ Hjerpe, 1989: 35.

government's issue prospectuses and sovereign rating analyses prepared by the Moody's rating agency on Finland during the 1920s and 1930s. In addition, an interesting insight to understanding of credit risk before the First World War in Finland is offered by Thorvald Becker's study from 1913.²⁸

In the following, I briefly illuminate the central content of some of the factors that have usually been assumed to belong to the group of the most important determinants of credit risk: political risk, fiscal sustainability, monetary stability, economic performance, default history and international financial stability.

Political risk

Political event risk is usually understood to refer to the probability of war, revolution, civil unrest, or extra constitutional regime change. All of them may lead to sovereign debt default. Frank Fabozzi looks at the political risk from a somewhat different angle; according to him political risk is an assessment on the willingness of a sovereign borrower to meet its obligations. In comparison, economic risk refers to the government's ability to serve its commitments. For example, a government may have the ability to meet its obligations but may be unwilling to do so, thus exposing lenders to political risk.²⁹

Political risk was clearly something that mattered in the eyes of the gold standard investors. They discounted political confrontations, such as wars and uprisings, which hampered debt sustainability and even led to outright defaults. As Flandreau and Zumer point out, political crises created uncertainty, and uncertainty drove financial markets down.³⁰ The 19th century Rothschilds made this ambiguity clear: 'In general when troops begin to move bondholders are frightened...'³¹ Niall Ferguson has found that the largest short-run jumps in government bond yields in 1843–1880 occurred on dates that were connected to political upheavals, not to economic developments.³²

Interestingly, the existence of a parliament and a constitution were argued to improve creditworthiness. In 1863, Adolf Wagner stated that a constitution was a precondition for issuing long-term debt, while Leroy-Beaulieu noted in 1899: 'A parliamentary regime

²⁸ Becker, 1913.

²⁹ Bhatia, 2002: 14–15; Fabozzi, 2000: 205–206.

³⁰ Flandreau and Zumer, 2004: 34.

³¹ Ferguson, 2001: 275–278.

³² Ferguson, 2006: 81.

functioning in certain conditions of discipline and a firm commitment to established institutions are of course guarantees against financial prodigality'.³³ In Finland a famous parliamentarian and later Senator Yrjö Koskinen in 1872 – probably wanting to underline the revival of Finland's Diet sessions after a long break – emphasised the positive impact that parliament's approval for new loans induced regarding the credit risk associated with the state. According to him, this was because in constitutional countries parliament's approval is required for new taxes and new loans have to be serviced by future taxes, ie parliament approval for loans was regarded by Koskinen to be an adequate and necessary commitment to service them in the future.³⁴

Probably the most famous realisation of the political risk took place in Russia in February 1918; the new Bolshevik regime repudiated all bonds issued by the Imperial Russian government. The performance of the Tsarist Russian bonds on the western bourses after the repudiation is an extreme example of the consequences of the realisation of political risk. The economic considerations had become irrelevant, the Russian government's bond prices on western bourses reflected only political events: possible bailouts by the western governments, negotiations with the Soviet administration over the Imperial government foreign debt and the fate of the white armies in the Russian civil war.³⁵

In similar fashion, the gold standard financial market participants were interested in Finnish politics, particularly concerning Finland's political position as a part of the Russian Empire. As turns out from his letters to the Board of the Bank of Finland, Mayer Carl von Rothschild, Head of the Frankfurt House of the Rothschilds' multinational bank, showed extensive interest in political developments in the Grand Duchy. Later the research department of the Crédit Lyonnais incorporated extensive studies on Finnish politics into its analyses of Finland, which it prepared over a period of 40 years. They typically focused on the form and stability of the government, including the extent of franchise, possibility of internal political upheaval and foreign relations. During periods of political calm, economic matters gained plenty of attention, but as soon as political disorder emerged, the focus in the analyses shifted from the economy to politics. In particular, the destiny of Finland's autonomous position at the turn of the century and relations between Finland and Russia over a long period of time seems to have been of

³³ Flandreau and Zumer, 2004: 35.

³⁴ Koskinen, 1872.

³⁵ Landon-Lane and Oosterlinck, 2005.

extraordinary interest to the Crédit Lyonnais economic research department.³⁶

After the First World War Moody's rating agency began its surveillance of Finland. Its rating manuals contained sections on Finland's constitution and administrative history during the time of the autonomy, focusing on the continuity of the Finnish state institutions. Otherwise Moody's seems to have paid relatively little attention to the political risk in the interwar Finland. In this respect its interest resembled those of Stockholms Enskilda Bank, which never in its credit analyses emphasised Finland's political position to any greater extent. However, documents from loan negotiations between the state and foreign banks during the interwar period underline that political factors were, undoubtedly, something the financial markets were interested in, also between the world wars; during certain periods they even overran all economic considerations.³⁷

Fiscal sustainability

In the end, fiscal solvency is along with political risk often assumed to be the outmost determinant of the creditworthiness of a borrower; a government is said to be solvent if it is expected to be able to generate sufficient future primary budget surpluses (budget balance excluding interest payments) to be able to repay its outstanding debt. Inability to meet this condition inevitably leads to default. Not surprisingly, all current rating agencies actively utilise debt sustainability simulations in their rating decisions. According to studies by Flandreau and Zumer debt sustainability was also the most important determinant of credit risk during the classical gold standard era, although analysed in a somewhat different manner. For the contemporary market participants it served as a proximate for default probability and reflected a number of aspects of the national economy.³⁸

In addition to general notes on Finland and political analyses, the Crédit Lyonnais research department used to devote most of its attention to the condition of public finances in Finland. The public

³⁶ Bank of Finland archives, the archives of the Board, letters from Mayer Carl von Rothschild; Crédit Lyonnais archives, reports on Finland.

³⁷ Ministry of Foreign Affairs archives, 32 O, documents on loan negotiations; Moody's Governments and Municipals Ratings Manual, Finland: 1920–1933; SEB archives, reports on Finland.

³⁸ Bhatia, 2002: 24–27; Flandreau and Zumer, 2004: 30; World Economic Outlook 2003: 113–122.

finance sections of the reports included detailed studies on the development of the central government debt and budget balance. The composition of the outstanding debt was carefully presented and estimates on the future path of debt were evaluated by showing the redemption and interest payments schedules for the upcoming years. The research department even compared the condition of Finland's state finances to other sovereign issuers in precise rank-order analysis. Stockholms Enskilda Bank continued this tradition during the 1920s and 1930s; it monitored state expenditure and income by categories and followed the development of state debt. Interestingly, both the Crédit Lyonnais and Stockholms Enskilda Bank analyses put state debt and debt-related expenditure into perspective; they also monitored state assets with a great accuracy.³⁹

Another aspect to debt sustainability was the use of the borrowing outcomes. If loans were invested in economically useful and desirable fields, the likelihood of default was diminished. The market participants positively assessed investments that would stimulate economic growth; such investments increased public revenues in the future and did not hamper sustainability of government debt. In similar fashion, investments that tended to increase exports were looked at favourably, as they would provide means to pay income to foreign lenders. Spending on uneconomic pursuits, such as wars or maintenance of corrupted governments, might have in turn negatively affected the government's credibility.⁴⁰

Fenn's Compendium gives support to this view. It noted that in earlier times great masses of debt in most countries had been raised for wars and for covering budget deficits, implying that each sovereign borrower had to serve its commitments by new taxes or fresh borrowing. However, as Fenn's noted, recently a great deal of borrowing had been executed for 'reproductive purposes'. This meant that such debt burdens which earlier would have been simply devastating could now be sustained easily through new income from the productive state investments, such as railways.⁴¹

The rather vast attention put on uses of the borrowing outcomes was reflected also in the analyses of the Crédit Lyonnais and Stockholms Enskilda Bank. Both noticed the uses of Finnish state debt on productive purposes in their reports on Finland. In similar fashion,

³⁹ For example, Crédit Lyonnais archives, DEEF 73309, BE 1154, Finlande, Janvier 1895; SEB archives, Direktionens dossier serie II, kreditförsträckningar till Finland, volym 1 and Finland, volymerna 1, 2 and 6.

⁴⁰ Kenwood and Loughheed, 1992: 38–39; World Economic Outlook 2003: 113–115.

⁴¹ Fenn's Compendium, 1889: introduction part.

the National City Bank of New York in the 1920s emphasised the productive uses of the outcomes of the state's bond issues by underlining the economic benefits of the public infrastructure investments, which were to a great extent financed by the government's foreign borrowing.⁴²

The fairly high concern put on the use of borrowing outcomes also reflects upon the borrowers' own actions. The Finnish government was eager to underline in its interaction with the financial markets, eg in the foreign language (English) outlooks of the economy, that the purpose of the debt was limited to productive investments, not to cover current expenditures of the state, which might have resulted in a permanent deterioration of public finances.⁴³ This was rather expected, as the economic doctrine emphasised the use of borrowing for productive investments, for instance, for improving physical infrastructure, which would bring broad positive externalities to the national economy.⁴⁴

Monetary stability

The modern rating analyses assume that there exists a correlation between credit risk and monetary stability. High inflation can adversely affect government finances, either through its direct, but asymmetric impact on state expenditure and revenues or through the performance of the national economy. Interestingly, monetary stability is understood to be enforced by exchange rate arrangements that tie the hands of the domestic policy makers; in Standard and Poor's current rating analyses each sovereign borrower that joins a currency union, currency board or some other pegged exchange rate arrangement is assigned a monetary stability score.⁴⁵

The relationship between the adherence to gold and the credit risk associated with a sovereign borrower during the classical gold standard and the gold exchange standard has recently been rather intensively discussed. The diverse views agree that gold adherence

⁴² Citigroup archives, prospectus of 1925 USD bond; Ministry of Foreign Affairs archives, Group 32 O, United States, prospectus of 1928 USD bond; Crédit Lyonnais archives, assorted reports on Finland; SEB archives, Direktionens dossier serie II, kreditförsträckningar till Finland, volym 1.

⁴³ Bank of Finland Bulletin 1923; Ministry of Foreign Affairs archives, Group 32 O, United States, Prospectus of 1928 USD bond, attached letter by the Minister of Finance.

⁴⁴ Heikkinen, Heinonen, Kuusterä, and Pekkarinen, 2000: 186–195; Järvinen, 1930: 25–30.

⁴⁵ Bhatia, 2002: 21.

affected the sovereign creditworthiness. However, they disagree on the mechanism and magnitude of this relation. According to Flandreau and Zumer, exchange rate stability affected credit risk through fiscal effects: high exchange volatility might have resulted in large increases in foreign currency denominated interest and principal payments relative to government income. The alternative view regards gold adherence as a signal of good housekeeping, an overall record of sound economic performance and prudent fiscal and monetary policies; a country could not have adhered to the gold standard without the ‘right’ sort of economic policies. In other words, the latter view understands the benefits of gold adherence much more widely. These two contrasting views and their relevance in the Finnish context will be briefly discussed later in this study.⁴⁶

During the classical gold standard years monetary analyses on Finland exclusively concentrated on Finland’s adherence to gold. Only following the collapse of the classical gold standard and a period of rapid inflation in Finland, were other monetary factors given more room in the analyses. Even then the main emphasis was put on the exchange rate developments and external economic relations, such as Finland’s balance of foreign trade, which was assumed to affect the value of the Finnish currency – and Finland’s ability to restore its adherence to gold during the financial turmoil in the early 1920s. Following Finland’s second adherence to gold since 1926, the development of the central bank’s reserves, ie the note coverage, gained rather extensive attention in bank analyses. Stockholms Enskilda Bank also attached its subjective evaluations on Finland’s ability to continue commitment to the gold standard to its reports on Finland.⁴⁷

The relatively little attention paid to Finland’s internal monetary conditions, which however, without a doubt were one of the factors causing high inflation, would suggest that the gold standard market psychology was straightforward; in the minds of the contemporary people monetary stability and gold standard were firmly tied together.⁴⁸

⁴⁶ Bordo and Rockoff, 1996 ; Flandreau and Zumer, 2004.

⁴⁷ Crédit Lyonnais archives, reports on Finland; SEB archives, reports in Finland.

⁴⁸ Wood, 2005: 15.

Economic performance

From the perspective of borrower's credibility, growth prospects are, above all, a measure of the economy's capacity to generate government revenue and keep its expenditures under control, ie economic conditions are closely linked to various aspects of the state's fiscal solvency. In addition to economic growth, wealth and the structure of the economy may have an impact on credit risk; they can be seen as proxies for the level of economic development and economy's resilience to economic and political disturbances.⁴⁹

A Finnish jurist Thorvald Becker's study of the public debt from 1913 offers insight regarding the contemporary thinking over the determination of the state's financial credibility. He wrote that national wealth constitutes the most important determinant of the state's fiscal solvency and its credit risk in the eyes of foreign financial circles. This is because national wealth determines the government's ability to generate taxes, which can be used to service its outstanding debts. However, Becker notified that there exist great difficulties in the valuation of national wealth; according to him, this would inevitably be somewhat arbitrary. As a more clear-cut method he suggested comparison of state debt to government's budget revenues.⁵⁰

An important indicator during the gold standard years for economic prosperity and growth was the development and magnitude of foreign trade. Use of trade statistics was in harmony with the prevailing economic thinking, seeing free trade as the most powerful engine of economic growth and prosperity. The repeal of the Corn Laws in England in 1846 was followed by a far-reaching movement towards free trade in the European continent. Later, during the age of imperialism, the free-trade doctrine reached a global scope through the creation of European overseas Empires. The most powerful nations were the ones with the greatest trade openness; devotion to free trade was strongly associated with economic wealth.⁵¹

As an example, *Fenn's Compendium* had a very straightforward view. According to *Fenn's*, there is no better available test of a nation's wealth than its foreign trade. This was because, as a rule, 'countries which are rich have those things which other nations covet, and countries which are poor have not.'⁵²

⁴⁹ Bhatia, 2002: 15–17; Gelos, Sahay, and Sandleris 2003: 7–8.

⁵⁰ Becker, 1913: 18–22.

⁵¹ Flandreau and Zumer, 2004: 48–49.

⁵² *Fenn's Compendium*, 1889: introduction part.

Moreover, exports provided the means to pay redemptions and interest denominated in foreign currencies and to preserve the central bank's foreign reserves at an adequate level in order to maintain note coverage and adherence to the gold standard. Trade statistics were also usually available without too much delay; customs duties were an important revenue source for the governments, which also guaranteed an accurate and a relatively swift book keeping on foreign trade. In Finland before World War II economic growth was not systematically measured, but foreign trade statistics were published annually already since 1856.⁵³

Reports by *Crédit Lyonnais*, *Stockholms Enskilda Bank* and *Moody's* all contained detailed outlooks of Finland's external commercial relations. They monitored exports and imports both by products and by countries. The balance of trade was equally carefully monitored; a positive trade balance provided the means for currency stabilisation. For the foreign banks, the trade balance probably also served as an indicator of the requirement to obtain foreign currency denominated loans, ie it indicated business opportunities for them.⁵⁴

Default record

There is nowadays no clear consensus on how much earlier defaults actually affect a borrower's creditworthiness. It may be that a clear cut with the past may correct earlier defaults. However, without a definite commitment to new debt management policies after repudiation, the borrower's reputation and credibility on bourses is likely to be seriously damaged. It might substantially raise the borrowing costs of the defaulted issuer or even prevent its access to the financial markets totally. Furthermore, borrowers with no default record probably are capable of running budget deficits considerably longer without investors becoming concerned about the sustainability of the public debt.⁵⁵

During the gold standard years, government defaults came into the limelight after the Argentinean default and the Baring crisis of the early 1890s; the substantial losses suffered by European banks and

⁵³ Hjerpe, 1989: 35; Kenwood and Lougheed, 1992: 38–39; Statistical yearbooks of Finland.

⁵⁴ *Crédit Lyonnais* archives, prospectuses and reports on Finland; *Moody's Governments and Municipals Ratings Manual*, Finland: 1920–1933; *SEB* archives, credit reports on Finland.

⁵⁵ *World Economic Outlook* 2003: 129.

investors forced them to monitor conditions of public finances more prudently than before. As a consequence, the *Crédit Lyonnais* research department expanded its economic surveillance and, for example, ranked countries into different categories in terms of their creditworthiness; defaulted sovereign borrowers were mechanically downgraded to the third group of countries, that is, to the lowest category.⁵⁶

This does not mean that defaults were not of concern already earlier. The interests of bondholders were sometimes strongly protected by Western governments, even by force. A revealing example is provided by the incidents caused by the financial upheaval of the Ottoman Empire during the Balkan crisis of 1875–1878. Following a declaration of Turkish bankruptcy in 1876, including a default of all foreign bonds, the British government in 1880–1881 threatened to occupy Smyrna, an important Turkish seaport city. To prevent foreign military intervention the Turkish Sultan had to give in; he agreed with foreign bondholders on the payment schedule of Turkish bonds and established a foreign administration to control the Ottoman public debt.⁵⁷

The central government of Finland has never implemented an outright default. Quite contrary, the purity of the default record has been carefully maintained and Finland's foreign reputation has traditionally been given a high priority, following the ideas and principles put forward by the Finnish statesman Yrjö Koskinen already in 1872: 'Credibility of a state is founded on honesty in all actions, precision in fulfilment of commitments and prudent management of raised funds'.⁵⁸ However, as discussed later in this study, during the 1920s financial intermediaries and investors showed great concern regarding Finland's willingness to service promptly some of its pre-war gold bonds during the financial turmoil that characterised post-war Europe. In contrast, ten years later Finland's respect for its war debts to the United States government put Finland positively into the limelight. In other words, the interwar experiences show that without a doubt, any suspicion of default always gained a high priority among the financial community.⁵⁹

⁵⁶ Flandreau and Zumer, 2004: 32, 52–53.

⁵⁷ Feis, 1974: 330–335; Ferguson, 1999: 308–309.

⁵⁸ Koskinen, 1872.

⁵⁹ For example, Moody's Governments and Municipals Ratings Manual, Finland: 1920–1933.

International financial stability

Unlike the other factors, discussed above, increased market volatility does not originate from the borrower itself. However, market-wide fluctuations have usually been understood to affect credit premiums as well, although quite asymmetrically. Typically countries that have been located outside the core capital markets might have felt the adverse effects of increased international volatility to a disproportional extent, even if their own fiscal and monetary situation has remained more or less unchanged. In other words, as a result of international turbulence, interest spreads between bonds issued by the core countries and peripheral countries have been amplified; the ‘flight to quality’ effect has enlarged sovereign credit premiums. Later, the well-known CAPM (Capital Asset Pricing Model)⁶⁰ model paid attention to general market volatility; a very important rationale of the model was its ability to take into account market-wide fluctuations in asset pricing.⁶¹

The unfavourable effects of uncertainty were felt in the prices of the peripheral bonds on several occasions. The wars of German unification, the Argentinean default and the consequent Baring crisis and, in particular, the First World War and the Great Depression were revealing examples of adverse market situations; interest rate spreads between different bonds on the financial centres accelerated due to investors’ greater risk aversion. These ups and downs of the international financial markets will be addressed more closely in the following chapter.⁶²

⁶⁰ For the model, see also chapter 6.

⁶¹ Bordo and Rockoff, 1996: 404–407; Gelos, Sahay, and Sandleris, 2003: 3–8; Wood, 2005: 25.

⁶² Homer and Sylla, 1996: 254–273, 520–541.

3 Supply and demand for foreign capital

The adherence of the Central Government of Finland on the western financial markets was concurrent with the ever deepening integration of the world capital markets until the First World War, and the rapid development of the domestic economy. The birth of the global financial markets enabled smooth supply of foreign capital (section 3.1) and the domestic modernisation process created the demand for it (section 3.2). In the 1930s the prerequisites did not exist anymore; the world financial system collapsed as a consequence of the Great Depression. Simultaneously, the improved external balance of the Finnish economy enabled the state to frequently tap the domestic financial market.

3.1 International financial order

Prior to the 19th century, the international capital markets remained limited in size and geographies, London and Amsterdam acting as the key financial centres of the world. In the 19th century, the world capital markets witnessed a remarkable expansion, stemming from the co-existence of various favourable developments. The long peace in Europe after the Napoleonic wars, interrupted in Europe by only constrained military conflicts, gave room for the growing economic prosperity. Free trade escalated under the British leadership. The great European nations widened their economic, political and cultural influence to all continents.

Industrialisation reached new regions and increased the need for investment capital in the economic periphery. Simultaneously, capital accumulation gathered pace in the industrialised core Europe. This provoked the European capitalists to search for a higher rate of return across the national borders. The movement of capital from European regions where it was relatively abundant to the economic periphery, where capital was relatively scarce, was a necessary condition for the expansion of the global financial markets.⁶³

The greatest expansion of foreign lending took place after 1870; the Italian and German unification wars ended and the age of

⁶³ Kenwood and Lougheed, 1992: 25–26; Obstfeld and Taylor, 2003: 121.

imperialism brought all corners of the world under the European sphere of influence. This growth of European lending continued more or less uninterrupted until the outbreak of the First World War. The demand for foreign capital was worldwide; European colonies, the United States, Latin America and European peripheral nations all benefited from the core European investment capital. The key financing instruments and currencies were widely known; bills of exchange, government and private bonds and equities were issued globally and traded on the key European financial exchanges in London, Paris and German cities. Railway bonds flooded to the European financial markets.⁶⁴

British investors turned out to be the major suppliers of foreign capital, followed by investors from France, Germany, Netherlands, Belgium and the Switzerland. Reasons for the massive outflow of capital have been intensively and lengthily debated. One explanation is that in Britain the extensive and constant outward flow of capital was associated with a relatively low rate of domestic investment. This differed somewhat from France, where the domestic investment ratio was high, but domestic savings were even greater. The British investments were overwhelmingly extended to its Empire and Latin America, while the French and the German investors became the major financiers of continental Europe. During the 19th century Hamburg-Altona developed into the major financial center for Northern Europe, including the Nordic governments, before losing its position to Paris and London at the end of the 19th century.⁶⁵

The bourse quotations offered a great deal of information on the trust associated with each issuer by the global capital markets. New economic publications and catalogues, such as the Economist's publication the *Investor's Monthly Manual* and *Fenn's Compendium* issued in London and *Manuel des fonds publics et des fonds publics et des sociétés par action* in Paris offered investors comprehensive information on various issuers of bonds, enabling them to assess more precisely the credit risk associated with different borrowers. Trading intensity was reinforced by innovations in communications technology; in particular, the telegraph and the trans-oceanic cable promoted integration of world financial markets. More effective trading and growing accuracy and speed of information diminished the arbitrage opportunities between the international financial

⁶⁴ Kenwood and Lougheed, 1992: 27–32.

⁶⁵ Foreman-Peck, 1995: 120–126; Jonung, 1984: 380; Klovland, 2004: 102–105.

centres.⁶⁶ The growth of international statistical co-operation and new statistical publications offered the financial markets new and accurate information over a great number of countries.⁶⁷

The movement of capital over national borders was mainly free; the governments rarely openly imposed official controls. However, geopolitical considerations of the great European powers also played a role. According to Herbert Feis, the foreign politics of European nations had a decisive influence on the allocation of private capital. Especially, the pre-World War I rivalry between the great European nations cast a shadow on international finance, often through informal and secret negotiations between governments and domestic banks.⁶⁸ One far-reaching involvement took place in 1887: German Chancellor Otto von Bismarck forbade the Reichsbank to accept Russian securities as collateral. It halted Russian government issues in the German bond market and drove the Russian government to the French financial market.⁶⁹ Lately it has been emphasised that also pure private economic research was an important determinant of capital allocation; investment bank analyses affected private investors' portfolio management decisions.⁷⁰

The world financial market order prior to World War I culminated in the international gold standard, which integrated the world capital markets to an unparalleled extent; it stimulated cross-border capital movements due to the assumed disappearance of currency risk. The monetary unit in each country had a fixed gold content. This meant that the value of each country's currency was fixed in terms of all other gold currencies at the par value. By 1870, only Britain operated on a legal gold standard. The silver standard was operational in several countries, including the German states, the Netherlands and the Nordic countries, while, for example, Russia and Austro-Hungary issued inconvertible paper money. In 1872 Germany adopted the gold standard; the French war indemnities provided the means for the change. Only a year later the Scandinavian countries followed suit and by the end of the decade all industrialised European countries participated in the gold standard. Russia joined the gold standard in 1897, the United States abandoned bimetallism three years later. No

⁶⁶ Fenn's Compendium, 1889; Investor's Monthly Manual, 1909; Manuel des Fonds Publics, 1883. See also: Ferguson, 2001: 285–286; Flandreau, 2003: 20–21; Obstfeld and Taylor, 2003: 122–124.

⁶⁷ Luther, 1993: 65–67.

⁶⁸ Feis, 1974: 83–188.

⁶⁹ Kindleberger, 1984: 227.

⁷⁰ Flandreau, 2003: 17–20.

major economic power abandoned the gold standard before the outbreak of the First World War in 1914.⁷¹

The classical economists' 'price-specie-flow mechanism' was an essential part of the gold standard ideology: price changes induced by international gold flows were argued to adjust each country's external balances automatically. For example, balance of payments deficits were supposed to invoke an outflow of gold that decreased the money supply and price level. As a result, exports should have picked up and remove balance of payments deficit; gold flows should have turned inwards. At later stage, the adjustment mechanism was argued to operate more regularly through movement of cross border capital that grew in importance due to the growth of the international capital markets; gold outflow and a decline in money supply led to a rise in short-term interest rates and attracted (short-term) capital from abroad, thus restoring the external balances. However, long-term capital movements were acknowledged to constitute a source of disturbance; a continuous inflow of long-term capital to the economic periphery enabled some countries to run a persistent balance of payment deficit on current accounts.⁷²

Because the commitment to gold prevented the governments to destabilise price levels through discretionary changes in money supply, the credibility of the system was greatly enhanced. Moreover, central bank co-operation bolstered the credibility of the exchange parities even further. Inflation remained subdued and short-term interest rates across countries converged. Even international bond markets witnessed a great convergence of government bond yields during the first few years of the 20th century, before the outbreak of the First World War. In the centre of the global gold standard was the financial market in London City, which acted as the clearinghouse of the world. Importantly, the British capital stabilised the world economy. In case the British economy and imports slowed, lower domestic interest rates increased capital outflow from Britain; this protected foreign countries from the depressing effects of lower British imports on their economies.⁷³

The First World War altered the international financial landscape. Belligerent states came out of the war greatly in debt. Inflation soared and it was soon realised that the return to pre-war financial order was difficult or even impossible; the pre-war international monetary mechanism had required a special kind of environment which no

⁷¹ Jonung, 1984: 361–362; Kenwood and Lougheed, 1992: 106–117.

⁷² Bordo, 1984: 23–31; Kenwood and Lougheed, 1992: 110–117.

⁷³ Eichengreen and Sussman, 2000: 25, Eichengreen, 1995: 41–65; Flandreau, 2004: 19.

longer existed. Although the international gold standard was reconstructed between 1925 and 1928, it never gained the sort of credibility and functionality that had been the cornerstones of the pre-war classical gold standard.

According to Barry Eichengreen, the key to the success of the pre-war system had laid in two areas: in the undisputed, market-oriented stance of economic policies across countries and, secondly, in the international co-operation between central banks. During the interwar years, the internal political confrontations reflecting, for example, the stronger post-war political positions of labour unions and the international struggles on the German war indemnities and inter-allied war debts made the hopes of the return to pre-war order illusory. International conferences to find a feasible solution to the German indemnities and halt disputes over war debts provided only limited success. Gold standard countries no longer tried to follow the 'rules of the game' in their monetary policies. Instead, a central object of the economic policy in many countries was to maintain plentiful central bank gold reserves, often at the other countries' expense.⁷⁴

The second gold standard was referred to as the Gold Exchange Standard; foreign exchange now accounted for a substantial share of the central bank reserves in the non-core member countries of the system. Some nations, most markedly Britain, the Netherlands and Sweden returned to gold at pre-war parity. Many others re-joined at a depreciated parity; in particular, the French franc lost some 80 per cent of its pre-war value. Germany's return to gold standard was preceded by a currency reform after a period of hyperinflation that destroyed the value of old German currency.

In the wake of World War I the United States replaced the European war ridden and indebted countries as the leading lending nation. New York gained a dominant position as a world's financial hub, but did not gain London's pre-war unquestionable dominance as a world financial center. The hey-day of the US foreign lending, mainly directed to Europe and Latin America, did not last for long. It began in 1924 after the successful placement of the Dawes loan, dedicated to assist Germany in its war reparations, in New York, and was almost halted already in 1928.⁷⁵

Increasingly restrictive US monetary policy since the summer of 1928 – aimed to curtail overheating of the American economy and financial market – raised yields of domestic securities and decreased

⁷⁴ Eichengreen, 1995: 65–66; Kenwood and Lougheed, 1992: 182–186.

⁷⁵ Foreman-Peck, 1995: 217; Kenwood and Lougheed, 1992: 184–185; Kindleberger, 1984: 302–304, 364–366.

American investors' appetite for foreign bonds. At the same time, the booming New York stock exchange attracted American investors' capital: US foreign lending was curtailed even further. Suddenly, due to the lack of American financing, borrowing countries were forced to shift their current accounts from deficits to surpluses. In order to meet this target, they had to curtail domestic spending by raising interest rates and cutting public expenditures: economic activity began to slow down.

In 1929 also the US economy halted and New York stock exchange collapsed; a worldwide depression began. Despite of the sluggishness of its economy, during much of the Great Depression the US monetary policy remained rather restrictive, deepening the global recession even further. In order to protect their gold parities other central banks had to follow the American example and maintain interest rates high, thus redoubling their restrictive policy stances. As a result, the availability of credit was squeezed further.

The worldwide recession – and the consequent sovereign debt defaults that exceed any experienced levels after 1870 – dried up American foreign lending permanently in the early 1930s. This caused a world payment crisis due to the decisive role of previous American foreign lending in the world's financial relations; as mentioned above, the European trade deficit with the United States had been financed by issuance of European securities in the United States during the 1920s.⁷⁶

An outbreak of international financial panic in 1931, after the collapse of the Austrian Credit Anstalt, led to a serious strain on gold reserves in several countries. Most importantly, in September 1931 Britain suspended gold payments and the pound sterling depreciated strongly. Other countries were forced to follow suit in order to maintain their competitiveness in the important British export markets. By the end of 1932, already 32 countries had left the gold standard. The world polarised around a few currency blocks, consisting of the sterling area, the gold block around France, the German-led eastern European area and the Americas. By the end of 1936 also the European gold block countries had abandoned gold convertibility. The United States kept its adherence to gold but at devalued gold rate.

The international financial system collapsed. Several countries imposed strict exchange and trade controls in order to isolate themselves from international instability. As capital markets closed

⁷⁶ Ferguson, 2001: 288–290; Eichengreen, 1995: 222–230; Foreman-Peck, 1995: 217.

down and international trade declined due to the economic slowdown and wave of protectionism, several countries ran into deep crises with their external debts. New lending decreased dramatically and new issues were usually executed inside regional blocks. For instance, new loans in London were confined to members of the Commonwealth, while in the Nordic countries the Swedish bond market offered capital to borrowers from the neighbouring regions. The global capital markets had ceased to exist and did not recover for many decades to come.⁷⁷

3.2 Finland's economic and political awakening

The central government's borrowing in Finland became feasible in 1809. In the peace treaty of Hamina, Finland was incorporated into the Russian Empire as an autonomous Grand Duchy. In contrast, prior to 1809 Finland had been part of Sweden for some 700 years with no special economic or administrative status of a similar scale. During the course of the 19th century Finland was able to widen its political and economic autonomy within the Empire; Finland became a separate entity, belonging to the regions that were administratively very different from the Empire proper. The separate and unique position was laid on a few cornerstones, formed little by little during the 19th century: Finnish nationality, separate administration, own parliament, army, currency and tariffs and tax policies.

After a prolonged expansion of the spectre of its autonomy, the winds changed in the end of the century. Starting in the late 19th century measures were instigated to integrate Finland closer to the Russian Empire. This process was interrupted by the outbreak of World War I and the Russian revolutions in 1917; in December 1917 Finland declared independency and became a parliamentary democracy. In November 1939 the Soviet invasion dragged Finland into World War II.⁷⁸

Throughout the period under investigation Finland remained an agrarian society, although undergoing a rapid modernisation. The pace of economic growth in Finland accelerated from the late 1860s onwards. The average annual growth of gross domestic product during

⁷⁷ Eichengreen, 1995: 246–286, 374–377; Kenwood and Lougheed, 1992: 182–198.

⁷⁸ For example, Jussila, Hentilä, and Nevakivi, 1999.

the period 1860–1890 was 2.2 per cent, while between the years 1890–1913 it was 3.0 per cent and during the years 1920–1938 as high as 4.7 per cent. During World War I economic growth halted, the pre-war level of production was achieved again in 1922.⁷⁹ In addition, growth stagnated during several economic downturns. The recession and the crop failures in the 1860s and the Great Depression of the late 1920s and the early 1930s were the ones affecting the economy and state finances the most.

The roots of the economic upsurge in Finland date back to the economic reform programme drafted under the leadership of L.G. von Haartman, a powerful Vice-Chairman of the Economic Department of the Finnish Senate.⁸⁰ Officially, the reform programme was launched during the visit of the new liberal minded Tsar Alexander II to the Senate in 1856, marking the beginning of a new phase in the Finnish economy. The period from the late 1850s to the 1870s has been referred to ‘the period of liberalist break-through’ in Finland; the mercantilist phase in the management of the economy was left once and for all. During the new era, the state implemented various economic reforms to create proper conditions for the development of the market economy. To mention a few, trade guilds were abolished in 1859 and 1868 and a law on freedom of trade was enacted in 1879.⁸¹

Economic liberalisation was accompanied by institutional developments enhancing Finland’s autonomy inside the Empire. Very importantly, the Swedish laws still remained in force in the Grand Duchy, but otherwise the Finnish autonomy was until the 1860s almost solely grounded on its separate and independent state economy and tariff policy. Osmo Jussila even describes Finland’s position after 1809 as solely a ‘finance state’.⁸² Between the 1850s and 1870s new monetary dimensions were incorporated into the autonomous status through implementation of three reforms: a new paper currency named the Finnish mark (1860), the silver standard (1865), and the

⁷⁹ Hjerpe, 1989: 46–49.

⁸⁰ The general administrative body of the Grand Duchy, the Senate, contained an Economic and a Juridical Department. The Vice-chairman of the Economic Department effectively acted as the prime minister (Governor-General, usually Russian, was de jure chairman of the Senate). The Economic Department was divided into administrative Offices, of which the Office of Financial Matters looked at state finances. In practise, its chairman was the Minister of Finance.

⁸¹ Heikkinen, Heinonen, Kuusterä, and Pekkarinen, 2000: 140–142; Kekkonen, 1987: for example, 79–80, 201, 262–270.

⁸² Jussila, 1987: 5–60.

gold standard (1878). Finally, Finland even gained its own army in 1878, although it was later disbanded.⁸³

Although Finland's monetary separation later became one of the cornerstones of Finland's economic and political autonomy, Finland abandoned the Russian monetary system and created its own currency somewhat unintentionally in 1865. Originally, Russia planned to adopt a hard currency system also herself, but could not carry out the monetary reform due to the financial turmoil and loss of public confidence over Imperial state finances that mainly stemmed from the Polish uprising in 1863.⁸⁴

The currency reform never led to an independent monetary policy. Finland adopted the international silver standard, based on a fixed value of silver for each currency. The fixed exchange rate regime was accompanied by free movement of cross-border capital. This meant that –given the small size of the Finnish economy– Finland did not carry out independent monetary policy.⁸⁵ However, any of this does not decrease the value of the final outcome; the adoption of the international silver standard brought monetary stability through the separation from the inflationary Russian monetary system, and also enforced Finland's unique autonomous status in the Russian Empire.

Dedication to metallic convertibility was enforced one step further in July, 1878; Finland began its adherence to the international gold standard that lasted until the outbreak of World War I. Following a period of rapid inflation, Finland in 1926 returned to the gold standard. The second adherence to the gold standard was preceded by a protracted discussion; the eligibility of the gold standard was not challenged, but after a period of high inflation the return to the pre-war peg was called into question. Finally, Finland decided to peg its currency at a devalued parity, the mark lost 87 per cent of its pre-war value. Already in October 1931 Finland abandoned the interwar gold exchange standard – it followed similar moves implemented by its most important trading partners – and, slightly later, became a member of the international sterling club by pegging its currency to sterling.⁸⁶

The mainly liberal stance of the economic policy set in place between the 1850s and 1870s remained almost intact until the 1930s. The state fostered the development of the free market economy

⁸³ Jussila, Hentilä, and Nevakivi, 1999: 56–60; Kuusterä, 1997: 285–296.

⁸⁴ Hayward, 1973: 171–176.

⁸⁵ The so-called 'open-economy macroeconomic dilemma' draws, for example, on Obstfeld and Taylor (2003), 135.

⁸⁶ García-Iglesias and Kilponen, 2006: 190–200; Kuusterä, 1997: 285–296.

relying on private entrepreneurship. As regards the domestic financial markets, the gradual birth and growth of private commercial banks since the 1860s and Finnish mortgage societies offer an example of the rapid development of the private financial sector. Finnish banks became in the end of the century also active in organising bond issues for several domestic entities, such as the mortgage societies and towns.⁸⁷

The same classical principles were reflected also in both fiscal and monetary policies. The state followed careful fiscal prudence; budget deficits were avoided and a low level of state debt was preferred. The fiscal conservatism was highlighted during the years of Clas Herman Molander as the Head of the Office of Financial Matters in the Senate (in office 1871–1897); the state accumulated a sizeable amount of funds and invested them in both foreign and domestic securities. Monetary policy was, above all, based on stable external and internal value of the currency, anchored by the adherence to international gold standards.⁸⁸

Given the relative backwardness of the country, the state took an active role in removing obstacles to economic growth and promoting modernisation of the society. This active government involvement was possible due to the relatively well-developed administration in Finland. In this respect, the Finnish modernisation experience can be evaluated under the context of thoughts of economic historian Alexander Gerschenkron. Such a strong state both fostered liberal economic reforms in order to promote private markets, as well as overcame obstacles to economic development by building necessary economic infrastructure.⁸⁹

Under these circumstances it is not surprising that also economic thought in Finland turned to the German historical school in the latter part of the 19th century. The German historical school denied the existence of universal economic laws and emphasised the regularities that had roots in historical and geographical conditions of each country. Among German economic thinkers, Georg Friedrich List was associated with this thought. He inspired many Finnish academics and civil servants, not least the influential Finnish intellectual Johan Vilhelm Snellman (1806–1881), who during the 1860s even played an

⁸⁷ Blomstedt, 1989: 195; Pipping, 1962: 27–62, 263–267.

⁸⁸ Kuusterä, 1989: 87–107.

⁸⁹ Heikkinen, Heinonen, Kuusterä, and Pekkarinen, 2000: 208–210; Kuusterä, 1989: 15–24; Pekkarinen and Vartiainen, 1993: 28–41.

important role in government's foreign borrowing in his position as a Senator.⁹⁰

Consequently, the state took in the latter part of the 19th century an active stance in fostering development of the domestic infrastructure: already earlier in the form of the building of the Saimaa Canal (1845–1856), which connected the large interior lake area to the Baltic Sea, and later through the construction of national railway network. There was an urgent need to construct a communications network; the geographically large country was divided into economically isolated regions. In order to foster economic development it was necessary to draw on the interior of the country to take part in the commercial production process. The state's participation was rationalised by the positive externalities benefiting the society as a whole and by the magnitude of the process, it could not have been handled by private enterprises, as the failed private railway lines soon showed.⁹¹

The first railway line was opened in 1862 between Helsinki, Riihimäki and Hämeenlinna. The main national railway line between Riihimäki and St. Petersburg was opened eight years later and was followed by construction of several other railway connections to the main Finnish towns. The construction continued until the First World War and was almost solely financed by the state.⁹² And very importantly, the state acquired the funds mainly from the foreign capital markets. Although debt-financed state spending was generally regarded as something to be avoided, railway financing constituted an exception.

The same line of thinking continued in the interwar period. Borrowing was allowed, but strictly limited for 'productive investments'. As an example from the interwar period, when the government proposed new borrowing authorization to the parliament for the year 1930, it underlined that the interest of the new loans must be fully covered by the income from the investments made possible through new loans.⁹³ Such acceptable uses of debt, in addition to railways, included financing of the acquisition of foreign owned forest industries by the state (for example, Norwegian owned forest company W. Gutzeit was bought in 1918), construction of

⁹⁰ Heikkinen, Heinonen, Kuusterä, and Pekkarinen, 2000: 69–81; Kuusterä, 1989: 87–107; Screpanti and Zamagni, 2005: 109–111.

⁹¹ Heikkinen, Heinonen, Kuusterä, and Pekkarinen, 2000: 186–195.

⁹² Regarding railway construction see, for example, Rasila, 1982: 114–131.

⁹³ Bank of Finland Bulletin 1923; Järvinen, 1930: 3–8; 1–2; Nevanlinna, 1907: 206–234; Parliament documents, Book II, Government proposal No. 28, 31.1.1930.

hydroelectric power at the Imatra Rapids (1921–1929) and improvement of the economic and financial conditions of Finnish farmers.⁹⁴

Following these lines, the Governor of the Bank of Finland, Risto Ryti in 1930 very precisely ranked Finland's foreign borrowing. According to him, foreign borrowing should always be economically profitable. The proceeds of the loans should be placed in a sound fashion; the return on investments must always provide redemption and interest payments for the loans. Therefore, private foreign issuance should be preferred to public issuance because private borrowers are themselves responsible for the loans, whereas public borrowers may depend on taxpayers' money – and according to Ryti, taxes in Finland were already too high. Among private borrowers, such borrowers should be preferred who will either increase Finland's export revenues or substitute for imports.

If, however, foreign borrowing is executed by public sector entities, the proceeds of the loans should mainly be re-directed for the use of private enterprises, such as sea transport and agriculture, against full interest to the lender. As another acceptable investment target Ryti mentioned the power station at the Imatra rapids, in case 'it really was a profitable enterprise.' Moreover, according to him, to a certain degree, railway constructions might also be a suitable use for the proceeds from foreign borrowing, although only after profound consideration over their real economic value for the national economy.⁹⁵

As Ryti's considerations already indicated, fostering monetary stability was the other widely acceptable use of the proceeds of the central government's foreign loans, along with the productive investments. The foreign loans played an important role in Finland's monetary reforms. The adoptions of the silver standard in 1865, the gold standard in 1878 and the gold exchange standard in 1926 were all made possible through issuance of loans that were denominated in hard currencies. This was due to the fact that note circulation during the gold standards was covered by the central bank's reserves, which consisted mainly of gold, silver and foreign assets, depending on the specific rules regulating the relationship between the note issuance and central bank reserves.⁹⁶ In practice, central bank reserves could be raised to higher levels through foreign currency bond issues quickly

⁹⁴ Kuisma, 1993; Parliament documents, Book I, Government proposal No. 44, 24.3.1925.

⁹⁵ Ryti, 1930: 75–81.

⁹⁶ Ikonen, 1998: 7–15.

and efficiently, whereas the foreign bonds had to be redeemed slowly over a period of several years and financed, for example, through steadily growing export revenues.

As regards the monetary reforms, the issuing entity was not necessarily the state. The Bank of Finland promoted issuance of foreign bonds of other Finnish borrowers for the sake of its foreign reserves. For example, the monetary reform in 1865 became feasible due to a foreign bond issue by the Mortgage Association of Finland – the issue was guaranteed by the Grand Duchy's Estates. During the preparation for the monetary reform of 1877–1878 the Bank of Finland raised a foreign loan itself to increase its gold reserves to the appropriate level that was required by the note coverage rules.⁹⁷

Three periods contradict with the harmonious picture of handling of the state finances during the period from the 1860s to the 1930s. The numerous and severe crop failures in the 1860s – in 1867 Finland suffered from the last devastating famine in the history of Western Europe – the consequences of World War I and the Civil War in 1918 and the Great Depression of the early 1930s offer the exceptions. During the crises years the state was forced abandon 'business-as-usual' funding procedures and utilise all available borrowing potential to maintain the basic functions of the society, or in the extreme, to try to keep Finnish people alive.

The years of the First World War and the Great Depression not only led the state to increase its issuance frequency and to look for alternative funding possibilities, but also the drastic depreciation of the Finnish mark affected the domestic currency value of the state's foreign currency debt. The currency miss-match, ie the state had its revenues mainly in domestic currency but debt expenditure in foreign currencies, greatly amplified its debt-related expenditures, as the next chapter will show.

⁹⁷ Nevanlinna, 1907: 106–111; Pihkala, 1961: 63–72; Schybergson, 1914: 243.

4 Implementation of funding

From the viewpoint of the central government's reliance on the great western financial centres, the year 1862 constitutes a beginning of a new era, as that was the year the Senate issued its first bond outside the Russian Empire in the German financial market.⁹⁸ Following frequent issuance of international bonds for a period of over 60 years, this chapter of history was more or less closed in 1928 when the state tapped the bond market in New York for the last time with a new transaction.⁹⁹ During the 1930s the state's new foreign borrowing contained only a couple of relatively small loans issued in Stockholm.

During the 1930s the state's concentrated on redeeming outstanding foreign loans and issuing domestic loans. Indeed, by the end of the decade the foreign debt was negligible. The last remaining bonds from the time of autonomy had been amortised during the year 1938, which also constitutes the end year of this study. The interwar US dollar denominated bonds had been redeemed already a few years earlier.

However, neither the year 1862 nor the year 1938 stand for absolute start nor end points. Instead, they do present important turning points from the viewpoint of borrowing sources, issuance technicalities, and their frequency. Due to the solid condition of the national economy and state finances, borrowing requirements in the 1930s had been relatively limited. The outbreak of the Second World War and the Soviet attack in November 1939 changed the financial situation dramatically and the need for new loans was amplified under the abnormal and critical circumstances. The nature of foreign borrowing differed very much from older practises; borrowing consisted of loan arrangements between the Finnish state and foreign public entities, instead of privately placed bonds.¹⁰⁰ Domestically, the state actively aimed to tap all available domestic savings during the war.

As mentioned above, the year 1862 does not mark the absolute beginning of the state's borrowing. The Senate raised several loans during the first decades of its autonomy under the Russian rule, but

⁹⁸ This first bond issue was executed at the turn of the year. In Finnish statistics it was referred as the 'loan of 1862', but the actual settlement date was 2 January, 1863.

⁹⁹ The state issued one conversion loan in 1934 in the United States. It did not bring any new capital.

¹⁰⁰ As opposed to direct loans, bonds are debt instruments that are traded on the secondary markets.

they were executed in different format and regularity, and all of them had been raised inside the Russian Empire. In particular, the frequency of borrowing was relatively modest when compared to the period from the mid-19th century onwards, ie the period of rapid economic and political development of the Grand Duchy. This meant that the amount of outstanding debt remained modest although not only due to limited borrowing activities; in addition, the government did not inherit any debt from the Swedish era. In Sweden the state debt had greatly increased during the Gustavian wars. Indeed, Sweden actually wrote off a large portion of its government debts during the 1810s.¹⁰¹

In 1810 and again in 1840 the central government raised loans to increase the funds of the Bank of Finland. The first loan was raised for the central bank in conjunction with its founding, either to build up its base fund or, alternatively, as Hugo Pipping claims, to replace Swedish money with Russian roubles, although the change over did not proceed as originally expected. In 1840 a loan was again required to finance the (final and successful) change over from the Swedish money to Russian roubles. In 1830 the state borrowed funds for the construction of the Nikolai church in Helsinki and the Bomarsund fortifications in the Åland islands. In 1855 and 1856 the Senate was forced to borrow to cover the damages of the Crimean war in Finland, ie the bombings of the Finnish coastal regions and the merchant fleet by the French and British naval units during the war.¹⁰²

The following three loans were the first ones related to the state-led transportation infrastructure investments, but unlike the ones raised for the same purpose after 1862, they were still raised inside the Russian Empire. The construction of the Saimaa canal in 1845–1856 was partly financed through domestic ‘Saimaa-notes’, bearer bonds issued by the state during the canal building works. In 1858 a new tranche of the Saimaa-notes was issued to finance the construction of the first railway line in Finland from Helsinki to Hämeenlinna.

The first bond outside the Grand Duchy, but still in the Empire – direct loans had been raised from Russia already earlier – was issued in the following year for the same purpose, to finance the new railway line. The government and the Bank of Finland utilised their contacts with the Stieglitz banking house in St. Petersburg. The Head of the Office of Financial Matters in the Senate, Fabian Langenskiöld, travelled to St. Petersburg to negotiate the bond issue. The first actual railway loan amounted to 4 million roubles, of which 2.5 million was

¹⁰¹ Ahlström, 1989: 91–105; Schön, 1989: 16–17.

¹⁰² Parliament documents, supplements to parliament documents in 1863–64 and 1867, printed in 1879; Pipping, 1961: 54.

directed to the state for the railway construction and the remaining part to the Bank of Finland to build up its reserves. The Senate's next loan in 1862 was already the one, which constitutes the beginning of this study, ie it was issued outside the Russian Empire and denominated in a foreign currency.¹⁰³

4.1 Funding sources

Between 1862 and 1938 the government's funding sources showed significant variation. Both the mixture between domestic and foreign borrowing and the allocation of bond issuance between different national financial markets were altered due to various economic and sometimes also political considerations. Graph 4.1 shows the division between foreign and domestic issuance during five phases. They correspond to Finland's five different exchange rate regimes: the period preceding adherence to the gold standard (1862–1878), the classical gold standard (1878–1914), the free floating period between the two gold standards (1914–1925), the interwar gold exchange standard (1926–1931) and the sterling club of the 1930s (1931–1938).

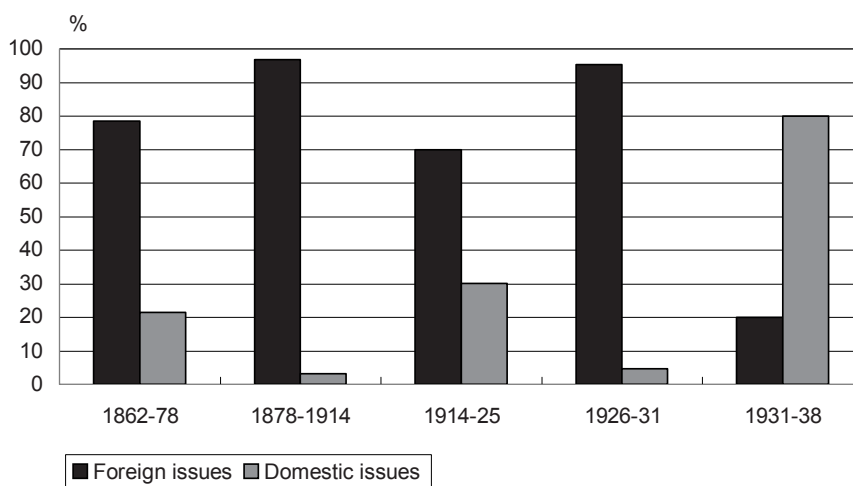
Finland's different exchange rate regimes have been selected to provide the timeframes for each period because the government's willingness to access the foreign financial markets can be assumed to have been dependent on the exchange rate regimes. Credible fixed exchange rate regimes have probably increased the state's readiness to tap foreign capital markets and vice versa, free floating and great exchange rate volatility have underlined the foreign exchange rate risks associated with foreign currency funding.

In addition, the state's ability to gain access to the international bond markets has probably correlated with the exchange rate system. International free floating was typically a sign of severe financial distress; both international gold standards were ruined by financial crises spawned by the First World War and the Great Depression. The crises underlined investors' exposure to market risks, such as currency and price risks, and depressed the appetite for new issues. In a similar manner, capital controls, which were typically imposed during

¹⁰³ National archives, Ha3, Senate, Protocols of the Economic Department of the Senate, 20.7.1859 and 12.10.1859; Parliament documents, supplements to parliament documents in 1863–64 and 1867, printed 1879; Schybergson, 1909: 153–155.

financial crises, might have frightened investors; repatriation of foreign investments at full value became uncertain.¹⁰⁴

Graph 4.1 **Proportion of foreign and domestic borrowing, as percentage of total borrowing, 1862–1938**



Sources: Autio, 1992; Parliament documents, reports on government debt; Statistical yearbooks of Finland.

Graph 4.1 indicates relatively large variation in the significance of foreign issuance between 1862 and 1938. During both classical and gold exchange standards, over 90 per cent of all debt issuance of the central government was executed in the financial markets outside Finland. In 1862–1878 and again in 1914–1925 the foreign share was clearly lower. However, after the Great Depression the distribution of financing sources was entirely reversed; only 20 per cent of all debt issuance in the 1930s was carried out in the foreign financial centres. As indicated, the exchange rate regime as such was probably not the only or even most important factor that dictated the division between foreign and domestic issuance. However, evaluating the funding sources through exchange rate regimes provides one alternative to divide the long timeframe into shorter intervals and evaluate changes over time. And indeed, the variation between domestic and foreign borrowing was quite clear.

¹⁰⁴ Obstfeld and Taylor, 2004: 130–140.

However, the definition of ‘foreign’ is not straightforward. The official Finnish statistics, which were published by the Central Statistical Office, categorized debt as foreign if it had been issued on foreign bourses. However, if defined by currency of denomination, ie from the point of a view of foreign exchange risk, or by the nationality of investors, ie from the viewpoint of the funding source, the analysis is not as clear-cut. A major part of the debt classified as foreign was actually denominated in several currencies prior to World War I, including the Finnish mark. In a similar fashion, also Finnish investors bought government’s bonds that were officially categorized as foreign. Both of these aspects will be discussed later in this study. However, if not otherwise mentioned, the term foreign refers to the official classification throughout this study.

Between 1862 and 1938 the central government of Finland tapped bond markets in five foreign countries¹⁰⁵: in Germany (1862–1889), in France (1895–1903), in the United Kingdom (1909 and 1923), in the United States (1923–1934) and in Sweden (1921–1923 and 1934). A striking feature is that at one point of time the Finnish central government utilized only one national financial market, ie the national capital markets accessed by the state did not overlap. This is in sharp contrast to the period from 1961 onwards, when the government’s second reliance on international bond markets got under way; the state issued bonds regularly and simultaneously in several countries.¹⁰⁶

4.1.1 German engagement

In 1862 the Finnish Senate issued its first foreign loan in the German capital market and abandoned Russian and Finnish capital. In fact, the state never accessed the Russian capital market again. Among other reasons, Russian’s own accelerating needs for new loans made the Russian market a somewhat unsuitable source for the Finnish government’s borrowing. Russia was a later-comer in economic development, requiring huge amounts of foreign capital to finance its catch-up process, and also to strengthen its military capacity. Indeed, Russia turned out to be Europe’s largest borrowing country of pre-war

¹⁰⁵ Defined by all three criteria: the juridical geographical location of the issue, the main official currency of the issue (as defined by the contemporary official Finnish statistics) and the assumed nationality of the majority of investors.

¹⁰⁶ Statistical yearbooks of Finland; valtiovarainministeriön yleinen osasto, 1981.

Europe; foreign investment in Russia rose steadily from 1870 to 1914.¹⁰⁷

Shortly before Finland's bond issue amounting to 16 million Finnish marks, which was executed in December 1862, the Russian government had floated in April 1862 through Rothschilds a 15 million loan denominated in pound sterling.¹⁰⁸ In Finnish marks this loan amounted to some 800 million. In other words, it was 50 times greater than the first foreign bond issue of the Grand Duchy, underlining the dissimilarity in funding needs of the two borrowers.

However, the more cogent reason for abandoning the Russian market may lay elsewhere. Finnish authorities, led by Fabian Langenskiöld, were eagerly speeding up the monetary reform in order to foster monetary stability; the state urgently needed a loan denominated in a silver standard currency in order to build central bank reserves and realize Finland's changeover to the silver standard. Later it turned out that the reform also induced monetary separation from the other parts of the Empire as Russia was not financially strong enough to be able to carry out similar measures; Russia continued to use paper roubles. The loan negotiations took place in Frankfurt am Main, where Fabian Langenskiöld himself represented the Grand Duchy.¹⁰⁹

That the government turned to the German financial market was a natural step. The German markets were the main funding source for Eastern European countries, including Russia, at that time. Finland had traditionally had a lot of economic and cultural connections to Germany; there was also an abundance of German speaking personnel in the state administration, ie in the Bank of Finland. Moreover, Langenskiöld probably would have had some difficulties in starting the loan negotiations in London and Paris, as has been assumed by Hugo Pipping.¹¹⁰

The Finnish government issued altogether seven bonds in the German (Prussian) capital market between 1862 and 1889, in addition to a few short-term credits during the crop failures in the 1860s and a loan issued by the Bank of Finland, of which the latter was never included in the state debt. The bonds amounted to 138 million in terms of Finnish gold marks. The German market represented the sole source of foreign funding during the 27-year period. In addition, a few smaller bonds were issued domestically between 1865 and 1890 to

¹⁰⁷ Feis, 1974: 210.

¹⁰⁸ Fenn's Compendium, 1889: 59.

¹⁰⁹ Pipping, 1967: 50; Schybergson, 1914: 131–136.

¹¹⁰ Pipping, 1967: 48–49; Feis, 1930: 73–74, 210–213.

collect funds for the purchase of the so-called donation lands in eastern Finland. The state issued also two domestic bonds to finance railway construction, but their size was small in comparison to state's foreign railway bonds.¹¹¹

The international bond markets were characterized by an astonishing bull market; interest rates decreased continuously from 1870s to 1890s.¹¹² Indeed, a major part of the bonds that were issued by the Finnish central government were used to redeem older more expensive loans, as the government reaped the benefits from the lower interest rates.¹¹³ For the Finnish government, it was easy to stick to the German market; it was able to benefit from steadily improving cost-efficiency during the decades that were not yet shadowed by the geopolitical rivalry between Russia and Germany.

4.1.2 Entente countries

It has been discussed whether pure economic reasoning or changing geopolitical settings were in the heart of the capital allocation during the classical gold standard.¹¹⁴ This dilemma was first evident for Finland at the end of the century. The government's engagement with the German capital market ended during the 1880s, simultaneously with changes in Europe's political scene; Russia and Germany had begun to fall out. The three Emperors' League, an alliance between Russia, Germany and Austria, announced officially in 1872, broke off in 1887. Three years later the Russo-German reinsurance treaty was not renewed, opening the gateway for the Franco-Russian rapprochement and the creation of the Triple Entente, an alliance formed between Russia, France and Britain in 1907. The German government partly curtailed Russian access to its domestic financial market; as already mentioned, one of the landmarks in Germany's economic warfare against Russia was Lombardverbot in 1887, an order to forbid German banks to lend on Russian securities. As a result, Russian financing activities were mainly transferred from Germany to France, although the German banks continued to take part in Russia's issuance syndicates of foreign bonds.¹¹⁵

¹¹¹ Statistical yearbook of Finland: 1879–1891.

¹¹² Homer and Sylla, 1996: 260–261.

¹¹³ For example, Parliament documents, Book I, Government proposal No: 15, 18.1.1885; Book IV, report on state debt, 1891.

¹¹⁴ Feis, 1974; 116–117, 156–159; Flandreau, 2003: 19–20.

¹¹⁵ Ferguson, 1999: 378–384; Kindleberger, 1984: 226–227.

Simultaneously with the Russian switch the Finnish government turned to the French financial market. Finland's switchover to the French bond market was concurrent with the international political events, but at the Senate the move was justified only by the cost-efficiency of the French market, including the more advantageous tax treatment and the smaller commission – it was reduced by half – charged by the syndicate banks.¹¹⁶ Moreover, the German capital was becoming scarcer; Germany's own rapid industrial expansion prior to the war accelerated, demanding huge amounts of capital. Unlike in Britain and France, which clearly remained capital surplus countries, in Germany the public sector had to borrow overseas prior to World War I.¹¹⁷

The Finnish mortgage institutions and towns, however, continued their reliance on German capital market: both the Mortgage Society of Finland and the Mortgage Fund of the Finnish Cities as well as several Finnish towns continued to tap the German bond market in the 1890s and 1900s.¹¹⁸ The stamp duty in France made the French capital market unattractive for non-sovereign issuers; only states were exempted from some rather heavy government taxes.¹¹⁹ Even for the state itself the switch to the new bond market was not total; similar as they did with the new loans of the Russian Imperial Government, the German banks continued to take part in the issuing syndicates of the Grand Duchy's French market loans, although with smaller allotments.¹²⁰ The Finnish state also continued to invest its surplus funds in German securities; still in 1905 over 80 per cent of all foreign bonds in the state portfolios were of German origin.¹²¹

Altogether the state's bond issuance in the French capital market between 1895 and 1908 amounted to 108 million Finnish gold marks and consisted of four long-term transactions, in addition to one short-term loan issued in 1908. In comparison, the French investors bought Russian government securities worth of 18.5 billion gold francs (Finnish mark and franc were at parity) between 1889 and 1914. Out of this sum 12.4 billion was issued in France.¹²² No other securities,

¹¹⁶ National archives, Senate archives, Ha5, Senate proposal to the Emperor 8.2.1895; State Secretary Office archives, Fa 1114, act no: 15, Imperial Senate's proposal to the Emperor 8.2.1895.

¹¹⁷ Ferguson, 1999b; Feis, 1974: 60–62.

¹¹⁸ Schybergson, 1909: 159–163.

¹¹⁹ Gasslander, 1956: 199, 215, 265.

¹²⁰ State Treasury archives, original bond books from 1895, 1898, 1901 and 1903.

¹²¹ Kuusterä, 1989: 308–309.

¹²² Kindleberger, 1984: 228.

except the French government bonds, were more widely held by the local investor community.¹²³

The last foreign bond issue during the time of autonomy was executed in 1909 in London. It remained the state's only bond issue in Britain prior to Finland's independence. The French markets no longer seemed willing to provide capital to the Finnish government. One plausible reason was that the French investors had reached their saturation point regarding Russian loans, although Finland's own fragile political situation probably also played a role. The Russian securities were pouring into the pockets of the French investors, particularly after the Russo-Japanese war in 1904–1905 and the consequent revolutionary movement in Russia. The upheaval seriously threatened Russia's political and economic stability, including Russia's adherence to the gold standard, as described by Russian Minister Sergei Witte in his memoirs, and forced Russia to borrow extensively overseas to save its financial order.¹²⁴

In a similar fashion with the switchovers to the German bond market in 1862 and the French capital market in 1895, Finland's entry into the financial market in London in 1909 was preceded by a similar move by the Russian government. In 1906 the Russian government issued its first loan in the British financial market for three decades. According to Herbert Feis, the loan was connected to the political rapprochement between the British and the Russian governments, embodied in the Anglo-Russian Agreement of 1907 and in the evolution of the Triple Entente.¹²⁵

4.1.3 Interwar years

The outbreak of the World War I in 1914 closed the foreign financial markets for Finland. Even interest payments and redemptions to the central powers halted during the war. After the war, following the shift in balance of financial power from Europe to the United States and its economic and financial supremacy, the gravity of the state's foreign borrowing moved to the new continent. The US capital was free to take a leading role as the United States government barely put any obstacles to foreign lending.¹²⁶

¹²³ Feis, 1974: 217–218.

¹²⁴ Harcave, 1990: 561–572.

¹²⁵ Feis, 1974: 232–233.

¹²⁶ Feis, 1974: introduction pages x-xi.

The Finnish government raised five loans from the financial market of the United States prior to the Great Depression. In pre-war Finnish gold marks they would have amounted to 311 million. The engagement with the US private capital was short-lived: the state launched its first bond on New York bourse in 1923, whereas the last new bond, excluding the conversion loan of 1934, was issued already in 1928.¹²⁷ The onset of the Great Depression in the following year and its consequences closed down the dollar market; American lending to Europe almost totally halted after 1930. The government's only source for new foreign capital prior to the Winter War was the Swedish bond market, which had been a source for new capital for the state also during the immediate post-war years in the early 1920s.

The mechanisms to acquire new loans partially changed. During the pre-war years new issues were overwhelmingly placed to the private capital markets for free investor subscription. In the interwar years, a relatively large portion of the new loans consisted of direct loans, which were linked to other economic and financial arrangements. To mention few, the government paid its acquisition of the Norwegian owned forest company Gutzeit in 1919 through a bond issue, which was exclusively directed to the company's shareholders. Some of the most well-known loans were two loans granted by the US Grain Corporation for Finland's food imports from the United States in 1919 and 1920, converted into one 'Hoover loan' in 1923. In 1934, Stockholms Enskilda Bank arranged a loan for the state in order to enable it to finance acquisition of a telephone network from Swedish Ericsson.¹²⁸

A second dissimilarity with pre-war years was the magnitude of domestic issuance and short-term borrowing. The state tapped domestic savings extensively during two periods, in 1918–1920 and again after 1932. Domestic bonds were issued to finance eg acquisitions of some enterprises for state ownership (Tornator Forest Company in 1919 and Hyvinkää alcohol factory in 1920), war finances (both for the costs and damages of the Civil War and armament prior to the Second World War), the planned – and cancelled – Olympic Games in Helsinki in 1940 and early redemptions of outstanding foreign bonds. Short-term borrowing was widely executed during economic crises, first during and in the aftermath of the First World War and later during the Great

¹²⁷ Statistical yearbook of Finland: 1923–1935.

¹²⁸ Olsson, 2001: 114; Parliament documents, Book II, Government proposal no: 18, 22.11.1918; Book I, Government proposal no: 18, 20.3.1923.

Depression.¹²⁹ Table 4.1 summarizes some of the main features of the foreign loans which the central government raised from 1862 to 1938.

Table 4.1 **Foreign primary market loan issues of the Finnish central government, 1862–1938**

Issue date	Coup	Price	Yield	Amount	Use	Lead-manager bank (or lender)	Mat.	Red.
2.1.1863	4.5%	88	5.3%	4.4 m thaler	Monetary reform	M.A. von Rothschild und Söhne	1905	1886
5 / 1866*	–	–	–	0.5 m thaler	Crop failure	M.A. von Rothschild und Söhne	1866	1866
10 / 1867*	6%	97.75	8.4%	1.5 m thaler	Crop failure	M.A. von Rothschild und Söhne	1868	1868
1.2.1868	6%	98	6.5%	4.67 m thaler	St. Petersburg railway	Erlanger & Söhne	1911	1881 and 1911
1.9.1874	4.5%	94	4.9%	16.2 m RM	Tampere and Turku railways	M.A. von Rothschild und Söhne, Bank of Finland	1916	1889
1.2.1881	4.5%	100.25	4.5%	7.374 m RM	Redemption of 1868 loan	M.A. von Rothschild und Söhne, Bank of Finland	1911	1889
1.12.1882	4%	95.6	4.3%	8.1 m RM	Russia's share of St. Petersburg line	M.A. von Rothschild und Söhne, Bank of Finland	1924	1898
1.7.1886	4%	100.3	4.0%	14.256 m RM	Redemption of 1862 loan, Oulu and Savo railways	M.A. von Rothschild und Söhne, Bank of Finland	1928	1898
1.6.1889	3.5%	97.5	3.7%	32.889 m RM	Redemption of 1874 and 1881 loans, Carelia railway	Bleichröder, Bank of Finland, M.A. von Rothschild und Söhne, Disconto-Gesellschaft,	1949	1938
1.3.1895	3.5%	99.75	3.6%	18 m FRG	Turku and Jyväskylä railways	Crédit Lyonnais consortium	1951	1938

¹²⁹ Statistical yearbooks of Finland: 1919–40; Tudeer, 1939: 57–182.

Issue date	Coup	Price	Yield	Amount	Use	Lead-manager bank (or lender)	Mat.	Red.
1.5.1898	3%	97.75	3.2%	55 m FRG	Redemption of 1882 and 1886 loans, railways	Crédit Lyonnais consortium	1958	1938
15.6.1901	3.5%	95.5	3.9%	25 m FRG	Railways	Crédit Lyonnais consortium	1957	1938
15.6.1903	3.5%	97.5	3.8%	10 m FRG	Railways	Crédit Lyonnais consortium	1959	1938
23.9.1908*	6%	–	6.0%	16 m FRG	Railways	Banque de l'union Parisienne	1909	1909
1.1.1909	4.5%	92.5	5.0%	1.6 m GBP	Railways	Hambro & Son	1965	1937
1918–1922*	–	–	–	SEK, NOK	State expenditure	Short-term loans from different entities	1919 – 1923	1919–1923
1919*	5%	–	5%	3.9 m USD	Food imports	US Grain corporation	1921	1923
31.10.1919*	6%	–	–	68.2 m NOK	Buying W. Gutzzeit	Den Norske Kreditbank	1928	1927
1920*	5%	–	5%	4.99 m USD	Food imports	US Grain corporation	1921	1923
15.2.1920*	6.5%	–	–	4 m DKK	Acquiring foreign currencies	Det Store Nordiske Telegrafskab	1930	1932
15.2.1921	6.5%	95	–	250 m FIM or SEK (100=30)	Converting foreign receivables	Scandinavian banks	1931	1928
1.10.1922	7%	98.5	7.1%	150 m FIM	Credit losses from Russian securities	SEB, Skandinaviska Kreditaktiebolaget	1972	1934
10.4.1923*	3.5%	–	–	9 m USD	Re-structuring grain loans	US government ('Hoover loan')	1984	1976
1.9.1923	6%	90	6.9%	10 m USD	Support of mark	National City Company	1963 new	1973
1.10.1923	6%	85	8.3%	2.28 m USD	Support of mark	Svenska Obligationskredit-aktiebolaget	1973	1963
1.11.1923	6%	90	6.7%	1 m GBP	Support of mark	Hambro's	1963	1963
2.3.1925	7%	94	8.0%	10 m USD	Imatra falls power plant	National City Company	1950	1935
1.9.1926	6.5%	94	7.3%	15 m USD	Imatra falls power plant	National City Company	1956	1936
1.2.1928	5.5%	92.5	6.2%	15 m USD	Redemption of old loans	National City Company	1958	1935

Issue date	Coup	Price	Yield	Amount	Use	Lead-manager bank (or lender)	Mat.	Red.
1929–1935*	–	–	–	USD	State expenditure	Short-term loans from different entities	1930–1935	1930–1935
18.5. 1934*	3.5%/4.5%	–	–	7 m SEK	Telephone network	L.M. Ericsson/SEB	1937/1940	1937
1.10.1934	4.5%	99	4.6%	15 m SEK	Redemption of 1925 and 1928 loans	SEB	1944 altered	1973
26.11. 1934	4%	–	–	10 m USD	Conversion of old loans	Brown Brothers Harriman	1940	1940

Note 1: The columns from left to right contain the following information: the date of issuance, the coupon (nominal) interest rate, the price of the bond at launch (price to the market), the yield-to-maturity of the issue, the nominal issue amount, the main use of the proceeds of the loan, the name of the financial entity acting as the book runner of the issue (or lender if not issued through intermediaries), the original maturity year and the year of the actual redemption as many of the loans were called prior to the maturity date by the state.

Note 2: Yields are based on the author's own calculations and Suviranta (1931). All bond issues are those of marketable bonds except those marked by (*). Official sanction for the first foreign bond issue was released in December 23, 1862, but the official settlement date was January 2, 1863. The 1919 loan for food imports was registered in the state's grain office's accounts and the 1920 loan in the state's short-term debt until their conversion in 1923 into one loan. A full list of syndicate banks is presented in the appendix.

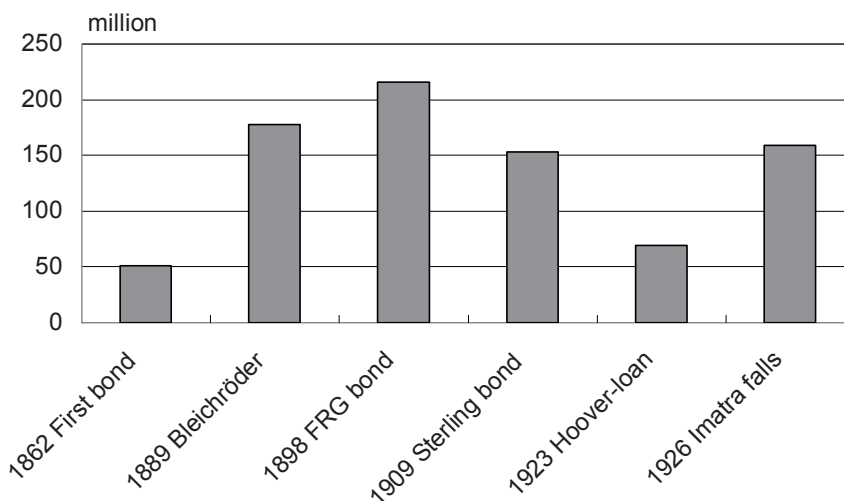
Sources: Nevanlinna, 1907: 63, 121, 157–158, 162, 171, 228–229, 296–297; Parliament documents: 1863–1938; State Treasury archives, original bond books; Statistical yearbooks: 1879–1939.

In order to properly compare the sizes of different transactions, graph 4.2 shows some of them at present euros. The largest bond issued by the state was the franc loan of 1898, which was over four times larger than the first foreign loan that had been issued 36 year earlier. Indeed, the outstanding amounts of the largest bonds exceeded in size many of the state's Eurobond issues between the 1960s and 1990s. Among other things, the relatively large outstanding amounts of bonds can be regarded as a proxy of the relatively high liquidity of the gold standard bond markets and of the placing power (ie capability to find investors for the underwritten bonds) of the contemporary financial intermediaries, even in case of small and relatively unknown sovereign issuers.¹³⁰

¹³⁰ For liquidity, Klovland, 2004: 101.

Graph 4.2

Sizes of some foreign bond issues, at present (2004) euros



Note: The conversion of Finnish marks to present euros is based on Statistics Finland's money converter, available at www.tilastokeskus.fi. The same source has been used also in other parts of this study for the same purpose.

Source: The sizes of loans are gathered from the previous table and have been turned into marks using the exchange rates provided by Auto (1992).

4.2 Administrative borrowing arrangements

The administration of the Grand Duchy was in hands of three entities, The Emperor, The Senate and the Diet, consisting of four estates until 1906, when a parliamentary reform of universal suffrage was carried out. In practice, the powers of the Diet remained very limited, reflecting the spirit of the old Swedish laws still in force in Finland. The main administrative body, the Senate, was responsible to the Emperor in St. Petersburg, not to the Diet. The influence of the Diet was limited even further due to the fact that it did not assemble between 1809 and 1863, when regular sessions began. Later, the relatively large powers of the republic's president continued the principles of the old Swedish laws, although the legislative power was in the hands of the parliament after independence.¹³¹

¹³¹ Kuusterä, 1989: 64–68; Vesanen, 1970: 7–13.

A central aspect of the Finnish autonomy was the separate state economy. Tax revenues and other income collected by the state in Finland were used for domestic expenditure. This fiscal autonomy enabled also government's own borrowing in the foreign capital markets. Administratively, the Swedish Constitution of 1772 was considered to stipulate that decisions on the state's new borrowing belonged to the parliament. However, the King in Sweden received a general authorization from the parliament to raise loans, which left the role of the parliament somewhat open. A similar situation continued after 1809; in the Grand Duchy the government's borrowing was solely in hands of the Senate and the Emperor until 1863 due to the absence of the Diet sessions. In 1863 Emperor Alexander II declared that in the future state borrowing required permission from the Diet, in addition to the consent by the Emperor. A report on state borrowing between 1809 and 1862 was later attached to the Diet documents.¹³²

In practise, the Finance Committee of the Economic Department at the Senate made a proposition on a new loan, which was approved by the Diet. Finally, the Finnish Minister State Secretary in St. Petersburg presented the new loan to the Emperor, who gave his final consent. The funding practises were not greatly altered after independency. The Constitution Act of 1919 continued the existing principles. In the beginning, parliament approval was required for each loan individually. Later the government presented maximum limits for annual borrowing for parliament's approval. The Economic Department of the Senate became the Government of the republic and its Office of Financial Matters was renamed, becoming the Ministry of Finance in 1919. Thereafter, instead of a Senator, the Minister of Finance headed the Ministry.¹³³

Until 1876 the Bank of Finland, founded in 1811, was responsible for all functionalities of state's borrowing at the operational level. The situation begun to change once the Bank of Finland was subordinated to the Diet in 1868. As a response to the alteration, the State Treasury, a central agency subordinated to the Senate, was founded in 1876 to handle the payments of the Senate and take care of the state funds; the state finances consisted of a number of state funds, which have been discussed comprehensively by Antti Kuusterä. As regards state's borrowing, it was mainly a responsibility of the communications fund, which was founded in 1872 – and abolished in 1919. Under the new institutional arrangements, the State Treasury managed the back-office

¹³² Parliament documents, supplement to 1863–64 and 1867 parliament documents, printed in 1879; Vesanen, 1970: 13–14.

¹³³ Valtiovarainministeriön yleinen osasto 1931–1981: 1–2; Vesanen, 1970: 15–24.

operations of state borrowing; it was responsible for payments of interests and redemptions to investors.¹³⁴

Although the functions of the Bank of Finland regarding state borrowing were diminished due to the transfer of responsibilities to the State Treasury, it still had a central role to play. It had a relatively wide network of foreign representatives who from time to time handled the state's payments to foreign investors. It also participated many times in the state's issuing syndicates in similar roles with commercial banks. And above all, due to its management of the foreign currency and gold and silver reserves it had important interests to look after. For instance, it continued to handle foreign exchange transactions and control domestic financial markets. Many central governments' loans were also negotiated by either the Governor of the bank or some other board members. This means that also after 1876 it greatly influenced government's borrowing activities, not least due to its abundance of skilled staff and international contacts.¹³⁵

As acknowledged by Antti Kuusterä, the central entity in all state's financial affairs was the Finance Office of the Economic Department at the Senate. During the 19th century it was even the only state organ able to maintain a comprehensive idea of state finances due to the incoherent system of management of the central government finances. This complex system was modernised only in 1901 when a unified book-keeping system was founded. The Finance Office managed loan negotiations together with the Bank of Finland on behalf of the Grand Duchy, later the Republic. The chief of the loan negotiations was usually the Head of the Office of Financial Matters, named the Minister of Finance since independence, but often the actual negotiations were handled by some other civil servants of high rank, either from the Bank of Finland or from the Diet's Supervisory Committee. Following Finland's independence, also foreign legacies had an important role to play in the negotiations with the foreign banks.¹³⁶

From the narrow viewpoint of government foreign borrowing, particularly some of the heads of the Office of Financial Matters greatly influenced government's borrowing. Fabian Langenskiöld (in office 1858–1863) negotiated the first foreign loan in 1862 whereas J.V. Snellman (1863–1868) implemented the monetary reform in 1865 and acquired 'crises loans' in the 1860s from the Rothschild banking house to limit the consequences of the harsh crop failures. Clas

¹³⁴ Blomstedt, 1976: 7–41; Kuusterä, 1989: 53–68, 349–373.

¹³⁵ Blomstedt, 1976: 37–41.

¹³⁶ Kuusterä, 1989: 66–67, 87.

Herman Molander (1871–1897) headed the office for a total of 27 years. During his term several large railway bonds were issued. The state also carried out large debt management operations; the market conditions enabled higher cost-efficiency through early redemptions of more expensive bonds and issuance of new ones with lower coupon rates. During Molander's term the Grand Duchy also abandoned the German financial market and began its engagement with the French bond market.

However, Molander himself did not take part in the actual loan negotiations. For example, Reinhold Frenckell from the Board of the Bank of Finland negotiated many loans personally in the 1860s and 1870s. In 1874 also Robert Montgomery from the parliament's Supervisory Committee traveled to Germany to arrange a new transaction. In the 1880s Alfred Charpentier negotiated new state loans with Mayer Carl von Rothschild and Gerson von Bleichröder and later acquainted Stockholms Enskilda Bank with the state's foreign borrowing, first as a Governor of the Bank of Finland and later as the Head of the Office of Financial Matters (in office 1897–1900). E.R. Neovius (1900–1905) managed the issuance of the last French market loans in 1901 and 1903 and J.K. Paasikivi (1908–1909) handled the loan negotiations in 1909, when Finland accessed the British financial market under a challenging market situation. He showed considerable interest on government's borrowing also later.

Risto Ryti (minister in 1921–1922 and 1922–1924) was a central figure in all of the republic's financial matters during the interwar period, first as a Minister of Finance and later as a long standing Governor of the Bank of Finland. During his term the state issued tradable bonds on the western bourses for the first time after the First World War. He also actively participated in the dispute over the state's pre-war bonds with the English and French authorities and bondholders. During the terms of H.M.J. Relander (1924, 1925, 1928–1929 and 1932–1936) and Väinö Tanner (1937–1939) the state redeemed almost all of its outstanding foreign debts and utilized domestic savings to an unprecedented extent.¹³⁷

¹³⁷ List of the Heads of the Office of Financial Matters: Kuusterä, 1989: 88. The Ministers of Finance: Hallintohistorian tilastoja 2, 1995. The course of the loan negotiations will be discussed later.

4.3 Funding tools and methods

The history of public debt is much younger than that of private debt. One of the earliest systems of public debt date back to the Venetian public borrowing in the twelfth century. During the following centuries public borrowing was executed in different corners of Europe to varying success. The first issues of British government bonds in the mid-18th century, the consols, marked the birth of modern public debt; they had similar characteristics with today's government bonds. Indeed, consols were the key instrument of British government's borrowing until after the Second World War. As Niall Ferguson points out, consols became a byword for financial security, the benchmark against which all other securities were measured. In the pre-World War I financial markets only the French government bonds, *rentes*, had even a partially similar status.

The long-term fixed-rate debt was called funded debt in contrast to floating rate debt, or the unfunded debt, as it was called in the terminology of the contemporary markets. Government's funded debts in the core European countries usually did not mature in the modern sense: they were callable after a future date, but this was usually at the option of the issuer. The investors bought permanent income: the invested capital could be received back by selling the claim to another investor on the liquid core European market platforms. However, the governments sometimes utilized the possibility to redeem the bonds early, especially in order to benefit from the great bull market of the late 19th century. British Chancellor Goschen undertook probably the most famous redemption of the perpetual debt in 1888; most of the British national debt was converted from 3 per cent consols to 2.5 per cent consols and met with spectacular success. During the World War I the governments' mounting financing needs forced them to introduce new debt instruments with shorter maturities. The importance of the long annuities shrunk and gradually the old concept of perpetual government bonds in the core Europe was replaced by bonds with defined maturity dates.¹³⁸

Traditionally, government debt in most countries had mainly consisted of war debts. However, as the spread of industrialization and construction of national railways accelerated the need for investment capital, railway and other bonds poured into the financial markets towards the end of the 19th century. Prior to the outbreak of the First

¹³⁸ Fenn's Compendium, 1889: 1–35; Ferguson, 2001: 107–119; Homer and Sylla, 1996: 159–228.

World War, securities listed on the London Stock Exchange were comprised of British government bonds, colonial government bonds, foreign government bonds, railway bonds and bonds issued by domestic and foreign private corporations.¹³⁹ When comparing to today's financial markets, government bonds were still at the turn of the century of much greater importance and they constituted a large part of all securities trading on the London Stock Exchange.¹⁴⁰

In contrast to core-European issuers, peripheral sovereign borrowers quite often issued bonds, which were furnished with fixed maturity dates even before the First World War; they were usually sinking fund bonds with semi-annual redemptions, long annuities, as they were usually called. The government bonds were usually issued through multinational bank syndicates, which typically consisted of several banks from different countries, although the British government also issued bonds through competitive auctions.¹⁴¹ Regarding the syndicated method, each bank underwrote a fixed allotment of the issue; against a commission they were obliged to sell the securities to investors. In case they were not able to sell the bonds they normally had to retain them in their own portfolios, although the Finnish Senate sometimes even had to give up this right and agree to receive unsold securities back. Typically, during the classical gold standard the bonds issued by foreign governments were denominated in several currencies. The collapse of the classical gold standard and the exchange rate volatility in the aftermath of World War I induced changes; the system of multi-currency denomination was commonly abandoned.¹⁴²

The central government of Finland never followed suit in issuing perpetual bonds, although the Diet discussed the matter. It assumed that the state would have been able to issue perpetual bonds in a similar manner with core-European countries, but the idea was abandoned for other reasons; the redemption of state debt would be more regular and predictable if executed through annual redemptions. Perpetual bonds could be redeemed only by executing call options or by offering investors voluntary early selling possibilities. Moreover, the Diet assumed that on the German bourses amortization loans

¹³⁹ Investor's Monthly Manual, 1909.

¹⁴⁰ Ferguson, 2001: 281.

¹⁴¹ Becker, 1913: 89.

¹⁴² Hildebrand, 1939: 19–24; Pipping, 1967: 57–87; Riksgäldskontoret årsbok 1921: 42–51.

would also provide better cost-efficiency for the Grand Duchy's central government.¹⁴³

However, from today's perspective, also the Finnish government bonds had very long maturities, both prior to the World War I and in the interwar period, mainly ranging between 25 and 60 years. The bonds were typically accumulative sinking fund bonds bearing annual or semi-annual coupons. The redemptions were drawn by lots by the Finnish civil servants in Helsinki, usually in the premises of the State Treasury. This meant that redemptions were only paid to those investors bearing the bonds with the drawn number; the bondholder could not know the time of the redemption of his or her security. The drawn numbers were published in newspapers in Finland and in the newspapers of those foreign countries, which were mentioned in the terms of the bonds. The banks that had participated in issuing syndicates normally handled coupon payments. Taking into account the technical infrastructure of the time, lottery was probably the most feasible option to manage annual redemptions of the securities with a great number of individual capital and interest payments. The redemptions and the interest were always exempt from all Finnish taxes, in line with the common market practice.¹⁴⁴

The outstanding amount of the state's foreign bonds was reduced also by other means, in addition to originally scheduled redemptions through lotteries. The state bought back bonds from the secondary markets for redemptions during the 1920s, ie the normal redemptions were replaced by open market operations. This was feasible because the terms of the sterling loan of 1909 allowed the state to handle amortizations by two means: it could either draw lots or to buy back the redeemable amount from the financial markets. The interwar dollar loans had similar characteristics enabling the state to redeem the bonds through buy-backs. This meant that if the price of the bond was below par, the latter option was naturally a more cost-efficient way to amortize debt. Moreover, an interwar agreement between the state and the French bondholders association included an offer by the state to buy back the French market bonds from the investors at an agreed fixed price, prior to the official redemption date. This agreement meant that the real outstanding amount of the bonds was in the

¹⁴³ Parliament documents, book II, response of the Finnish estates to the Government proposal no: 22, 5.6.1882.

¹⁴⁴ Blomstedt, 1976: 37–41; State Treasury archives, original bond books.

interwar period often significantly lower than the original redemption schedule would have implied.¹⁴⁵

In addition to reducing the outstanding debt through secondary market operations, as described above, the state called bonds prior to the maturity date. The Finnish government foreign bonds typically carried a call feature; the government reserved for itself the right to redeem the whole loan or part of it prior to the maturity date. Usually this call-option was executable for the state after a certain period, usually 5 to 12 years after the launch, depending on the bond. This option offered the issuer additional value if the market interest rates were decreasing; it could redeem old bonds with higher nominal coupons and refinance them by issuing new ones bearing a lower coupon rate. It meant that the secondary market prices of Finnish government bonds could not raise much above par value; the investor carried a risk that the state would redeem the bonds at par value at any time after the call-option had become executable.¹⁴⁶

Finland's issuing mechanism followed the common market practices of most other sovereign borrowers. Issuance of new bonds was carried out through bank syndicates, where banks acted as underwriters. Investors usually participated in the issue by a written application, accompanied by the requisite deposit on the applied amount. Should no allotment be made the deposit was returned to the investor.

The banks' allotment in the issues varied; every bank gained a certain, different status. The allotment was dependent on the number of banks taking part in the syndicate and the placing power and overall role of each bank in organizing the issue. In the German market issues the number of banks in the syndicates was relatively small: they consisted of only 2–4 banks. In contrast, the French market issues were characterized by much larger bank syndicates. The number of banks amounted even to some 20 banks, each possessing an allotment of different size in the syndicate. The state's British market loan of 1909 contained only 4 syndicate members, whereas the issuing syndications of the US market bonds in the 1920s typically consisted of some 2–5 American banks.¹⁴⁷

The lead manager, ie the main arranger of the bond issue, sometimes could have had access to even some 50 per cent of the

¹⁴⁵ State Treasury archives, original bond books; Statistical yearbooks of Finland; *Obligationsitilasto vuosilta 1905–1914*: appendices. For the agreement with the French bondholders, see chapter 6.

¹⁴⁶ State Treasury archives, original bond books.

¹⁴⁷ A full list of syndicate banks is in the appendix 5.

issue. In contrast, concerning the bond issues on the Paris bourse, the banks with the smallest allotment had to be satisfied with only some 0.5 per cent of the total issue amount. The banks' commission was dependent on the allotment. It was a lucrative business, for instance, in the issue of the 1898 loan the banks' commission was 1 per cent of the nominal issue amount.¹⁴⁸

As regards currency denomination, the central government's foreign bonds were denominated in several currencies between 1886 and 1909. During the interwar years the Finnish central government did not issue multi-currency bonds. Altogether seven bonds were denominated in more than one currency. They are listed in table 4.2.

Table 4.2 **Currency denominations of the state's multicurrency bonds**

Bond	Currency of denomination
Loan of 1886	German and Finnish mark
Loan of 1889	German and Finnish mark, Dutch guilder
Loan of 1895	French franc, Finnish mark
Loan of 1898	French franc, German and Finnish mark, Swedish crown
Loan of 1901	French franc, German and Finnish mark, Swedish crown
Loan of 1903	French franc, German and Finnish mark, Swedish crown
Loan of 1909	Pound sterling, French franc, German and Finnish mark, Dutch guilder

Source: State Treasury archives, original bond books.

Secondary market trading took place on several market places. The first German issues were first listed on the Hamburg and Berlin bourses in Germany, in addition to Helsinki. The liquidity on the Helsinki market platform dried up since the 1870s and trading was concentrated to the German cities. During the 1890s trading expanded to stock exchanges in Paris and Amsterdam. Trading on the London stock exchange began as late as 1909 when the central government's first sterling denominated bond was issued. In the interwar period, new issues were traded on New York, London and Stockholm bourses. However, trading on each stock exchange was usually limited to the bonds, which had been launched on the same platform. An exception was the government's loan issued in 1889, which was quoted also in Paris, although originally issued on the German bourses

¹⁴⁸ Crédit Lyonnais archives, DAF 00255-2, BE 1732, syndicate agreement of 1898 loan; DAF 00277-2, BE 1729, syndicate agreement of 1903 loan; State Treasury archives, original bond books.

and in Amsterdam.¹⁴⁹ Table 4.3 summarizes the main features of the Finnish government marketable bonds.

Table 4.3 **Main features of government foreign bonds in 1862–1938**

Feature	
Maturity	Up to 60 years
Amortization	Sinking funds, amortization through lotteries.
Listing	Helsinki, Hamburg, Berlin, Amsterdam, Paris, London, New York, Stockholm
Type	Marketable bearer bonds
Interest	Fixed coupon, 3% – 7%
Currency	German and Finnish marks, Dutch guilder, French franc, crown, sterling, US dollar
Issuance	Through bank syndicates

Source: State Treasury archives, original bond books.

4.4 Intermediaries

A large number of foreign banks, and a few domestic ones, took part in the government's primary market activities during the period of almost 80 years. Their involvement with the state's foreign borrowing began, above all, through the Bank of Finland. It acquired several foreign correspondents along the 19th century, mostly for handling of its foreign exchange operations. The Bank of Finland created its first formal foreign contacts after the switchover to Russian roubles from the Swedish money in 1840 as it made contacts with banks in St. Petersburg, Stockholm, Riga and Hamburg. In the 1860s, among others, the Rothschilds in London and Paris and Stockholms Enskilda Bank were added to the group of the Bank of Finland's foreign correspondents. M.A. von Rothschild und Söhne from Frankfurt am Main and S. Bleichröder from Berlin were to follow suit in 1871 and the National City Bank of New York in 1904.¹⁵⁰

Most of the central bank's correspondents did not participate in the state's borrowing or they had a very limited role with small allotments in the bank syndicates. Two banks stand out; the Frankfurt House of

¹⁴⁹ Foreign bourse listings: Helsingfors Dagbladet, Huvudstadsbladet, Mercator, Le Rentier, The Times and The New York Times.

¹⁵⁰ Pipping, 1969: 169–175, 435–436.

the Rothschild banking dynasty and the Stockholms Enskilda Bank (SEB), which was managed and to a great extent also owned by the Swedish Wallenberg family. Despite their pivotal role, they could not rest on their laurels. Competition for the lead manager positions in the issuing syndicates was often harsh.

In the German financial market the Rothschild bank competed fiercely with the Erlanger bank in particular, and although it experienced some setbacks it managed to play a crucial role in the state's foreign borrowing for over 20 years from the first foreign bond issue in 1862 until the end of the 1880s. During the 1890s the Stockholms Enskilda Bank became involved with the state finances in Finland. It gained a pivotal position in the state's foreign funding for decades to come, first as an essential member of the *Crédit Lyonnais* group and later during the interwar period as an independent intermediary. In the beginning Enskilda Banken competed keenly for deals in the Nordic government bond market with Stockholms Handelsbank, led by Louis Frænckel, a former representative of the German Erlanger bank.¹⁵¹

In addition to the Rothschilds and Stockholms Enskilda Bank (first with the *Crédit Lyonnais*), only the National City Company, ie National City Bank of New York, organized more than one bond issue for the Finnish state; it arranged four transactions for the state in the American financial market. However, the duration of the National City's central role was short. It arranged new bond issues for the state only over a six-year period between 1923 and 1928. The National City Bank of New York was the largest bank in the United States with a wide overseas branch network; in 1929 it became the largest commercial bank in the world¹⁵².

In the following, I will take a closer look at the two most essential players in the state's foreign funding, the House of Rothschild and Stockholms Enskilda Bank. Together their involvement covers the whole timeframe of this study; the Rothschilds arranged the first foreign bond issue in 1862, whereas the Stockholms Enskilda Bank was responsible for the placement of the government's last foreign loans before the outbreak of World War II.

¹⁵¹ Gasslander, 1956: 96–107, 207–217.

¹⁵² Citigroup, 2005.

4.4.1 House of Rothschild

On the course of the 19th century the Frankfurter Rothschild family created a pan-European bank network operating in the major European financial capitals, that is, in London, Paris, Frankfurt, Vienna and Naples. Close family relations enabled the branches to offer clients financial services over the national borderlines and for the family itself a possibility to exploit the arbitrage opportunities between different markets due to their superior communications network between the local offices. In this respect, the Rothschilds paved way for the creation of integrated European bond markets. Their superior market position was the strongest in the government bond segment, supported by their close contacts to the political elite of 19th century Europe. The Rothschilds organized the first government bonds that were simultaneously issued in multiple national capital markets.¹⁵³

The Rothschilds' strong market position more or less continued throughout the Belle époque, but rapidly vanished thereafter. Their failure to establish a foothold in the financial market of the United States proved to be the main reason for their decline after the First World War, as the gravity of the world financial markets moved to the new continent. The new generations of the family probably also lacked some of the enthusiasm of the older generations to compete and win new business. Even before the Great War, the Rothschild houses in Naples and Frankfurt were wound up.¹⁵⁴

The borrowing activities of the Finnish government were concentrated in Frankfurt am Main. The Frankfurt branch of the family, the M.A. von Rothschild und Söhne banking firm, participated in the state's every foreign, German market issue from 1862 to 1889, bar one in 1868. The Bank of Finland began its co-operation with the Rothschilds in 1861; the Paris and London houses were accepted to manage the central bank's balances in the two cities. However, the Rothschilds in Paris and London were reluctant to arrange Grand Duchy's first foreign bond issue, but the Rothschild house in Frankfurt am Main accepted Finland's offer.

This was the prelude to the long-lasting co-operation between the Finnish government and the Frankfurt Rothschilds, which was personalized in the deep participation of Head of the House, Mayer Carl von Rothschild, in the Grand Duchy's foreign borrowing. Like all

¹⁵³ Ferguson, 1999: preface xxi–xxx.

¹⁵⁴ Ferguson, 1999: 234–244; Pipping, 1967: 45–48.

Rothschilds, also Mayer Carl von Rothschild possessed close contacts to high political circles. He knew Russian financial authorities in St. Petersburg and had also tied personal contacts to the Finnish Minister State Secretary in St. Petersburg, Count Alexander Armfelt (in office 1842–1875), who presented the Finnish state's foreign loans to the Emperor for his final consent.¹⁵⁵

The first years of the co-operation were shadowed by several crop failures and economic malaise in Finland; Mayer Carl von Rothschild arranged short-term loans to the Finnish Senate for the management of the crop failures, in 1866 and 1867. The bank also played an essential role in Finland's monetary reform. The state's first foreign bond issue in 1862, executed through the Frankfurter Rothschilds, had originally been intended to be used for railway construction and to strengthen the silver reserves of the Bank of Finland in preparation for the silver standard. However, it was partly used for imports to cover the effects of the crop failures. The required silver reserves were finally procured from a thaler denominated bond issue of the Finnish Mortgage Society in 1864, enabling Finland to carry out the monetary reform in the following year. The state guaranteed the bond issue, which was again lead-managed by M.A. von Rothschild und Söhne.¹⁵⁶

During the critical years of the 1860s the Head of the Office of Financial Matters in the Senate, J.V. Snellman became acquainted with the Rothschild bank. Snellman's co-operation was not limited to the state affairs; he had also been appointed to the preparatory loan committee of the Finnish Mortgage Society in 1863.¹⁵⁷ Snellman seemed to have truly appreciated Mayer Carl von Rothschild's services. He even wrote to Alexander Armfelt that 'our excellent credit by Baron Rothschild was a miracle, which I cannot understand'. Snellman's admiration this time resulted from his experiences with raising a new loan for the Senate. He had tried in 1866 to acquire a credit from St. Petersburg to provide temporary financial assistance to Finnish exporters. Snellman had first received from St. Petersburg a credit offer at 12 per cent interest, which was later reduced to 9 per cent. In comparison, Mayer Carl von Rothschild had offered to Snellman immediately 1.5 million thalers at 6 per cent interest.¹⁵⁸

For Mayer Carl von Rothschild, his close acquaintance to J.V. Snellman might have been one reason for the setback in January 1868.

¹⁵⁵ Pipping, 1967: 45–48.

¹⁵⁶ Nevanlinna, 1907: 62–67; Pihkala, 1961: 63–72.

¹⁵⁷ Pihkala, 1961: 63.

¹⁵⁸ J.V. Snellman *Samlade Arbeten* XI.2, 1998: 1075–1076, letter from J.V. Snellman to Alexander Armfelt, 20.2.1866.

Snellman's position in the Imperial Senate had come under scrutiny for various reasons, not least due to his different opinions on the construction and completion of the St. Petersburg railway line with General-Governor Adlerberg, and he actually had to resign from his position slightly later in 1868. Partly due to these reasons, Mayer Carl von Rothschild was labeled as 'Snellman's man', the Senate refused to execute the state's second foreign bond issue with Snellman's favorite. Instead, Raphael von Erlanger, von Rothschild's former employee and a great rival, was nominated to execute the transaction in 1868, although the official reason was the greater cost-efficiency of Erlanger's offer. Snellman's close attachment to Mayer Carl von Rothschild once again turns out from his emotional letter to him, deeply regretting the Senate's decision to co-operate with another institution.¹⁵⁹ Without a doubt, Erlanger's victory was an embarrassment for Snellman, who still only a couple of months earlier had praised von Rothschild for his trust and commitment to Finnish affairs during the great famine by granting an 'emergency' loan to the Senate in autumn 1867.¹⁶⁰

Although the Finnish Senate rejected Mayer Carl von Rothschild's services in 1868, his important financial involvement in the 1860s was noticed in Finland. Already J.V. Snellman had suggested that Mayer Carl von Rothschild should be decorated by Russian officials due to his various financial services to Finland and, ultimately, the Russian authorities decorated the German banker after the involvement of Emil Stjernvall-Walleen, deputy of the Finnish Minister State Secretary in St. Petersburg.¹⁶¹ Mayer Carl von Rothschild was said to have greatly appreciated this sort of acknowledgments – earlier he had been decorated by the Prussian government. The bank also quickly returned to the state's financial affairs; it was nominated to organize the state's next foreign bond issue in 1874.¹⁶²

In the coming years the Senate granted M.A. von Rothschild und Söhne more leading positions in the issuing syndications, although competition with the German rivals remained fierce. M.A. von Rothschild und Söhne benefited from downbeat name of Erlanger; the issue of 1868 was commonly in Finland regarded as a failure, not least

¹⁵⁹ National archives, Senate archives, Ha3, protocol of the Economic Department of the Senate 25.1.1868; Telegram Snellman-Rothschild, January 1868; Pipping, 1967: 57–63.

¹⁶⁰ J.V. Snellman Samlade Arbeten XI.2, 1998: 1363, letter from J.V. Snellman to Mayer Carl von Rothschild, October 1867, draft.

¹⁶¹ J.V. Snellman Samlade Arbeten XI.2, 1998: 1213–1214, letter from J.V. Snellman to Nicholas Adlerberg, 1866, draft.

¹⁶² Ferguson, 1999: 79; Pipping, 1967: 64–65.

because it was partially re-constructed into a lottery bond with weaker terms for the issuer.¹⁶³ It was severely criticized by the Finance Committee of the Diet in 1872: ‘Whenever in the future the Finnish state has to borrow abroad, this sort of cheap issuance method must be avoided’. Still in 1911 J.K. Paasikivi in a long article criticized the terms of the loan of 1868, which had been according to his view very unfavorable for the state.¹⁶⁴ The Rothschild bank also arranged a short-term loan for the Bank of Finland in conjunction with Finland’s entry to the gold standard in 1878, meaning that both of Finland’s monetary reforms in the latter part of the 19th century were facilitated by the financial involvement of the M.A. von Rothschild und Söhne banking firm.

Mayer Carl von Rothschild co-operated closely with the Bank of Finland, underlining the strong influence of the central bank on the state’s foreign borrowing and its role in the issuing syndicates: the Bank of Finland took part in them. In some respect, the Bank of Finland sat in two chairs, it represented the government in the borrowing affairs but it also competed for syndicate positions in government loans in alliance with the House of Rothschild. Erlanger had also allies in Finland: it was one of the shareholders of the Northern Joint Stock Bank for Commerce and Industry located in Viipuri, one of the leading Finnish commercial banks. However, during the 1870s and 1880s Erlanger was constantly on the losing side in the competition for government deals.¹⁶⁵

Mayer Carl von Rothschild’s belief that ‘every little thing helps’ becomes evident from his profound commitment to the rather limited financial affairs of the Grand Duchy. It was not unusual for von Rothschild, one of the leading European bankers of the time and a member of the German Reichstag since 1868, to write letters to the Board of the Bank of Finland some 20–30 pages long, typically highlighting the long-lasting relationship between his institution and the Finnish government together with spacious analyses on the market conditions.¹⁶⁶ He did not hesitate to colorfully describe his dedication to Finnish affairs; the Finnish state finances were ‘close to his heart’

¹⁶³ The lottery bond did not have any interest bearing coupons. Instead, each year a lottery was arranged with lottery prizes of different size.

¹⁶⁴ Paasikivi, 1911; Parliament documents, Book II, report no: 7 of the Finance Committee of the Diet, 15.5.1872.

¹⁶⁵ Pipping, 1962: 62; Pipping, 1967: 64–76.

¹⁶⁶ Bank of Finland archives, the archives of the Board, various letters from M.A. von Rothschild und Söhne; Ferguson, 1999: 183.

and he had for two decades done ‘everything possible for the sake of Finnish finances’.¹⁶⁷

His deep dislike of his rival Erlanger becomes evident from his continuous remarks regarding the 1868 Erlanger loan; according to Mayer Carl von Rothschild it had been a fiasco and the state should take a lesson from it.¹⁶⁸ This sort of hostility towards upstarts like Erlanger was common to all Rothschilds; they continuously not only refused to co-operate with them but even sometimes adversely interfered with their businesses.¹⁶⁹

After the death of Mayer Carl von Rothschild in 1886, the bank’s influence started to diminish, although it still participated in the state’s last German market bond issue in 1889 as a co-lead manager, ie in a smaller role; a Berlin-based Bleichröder bank was now the main arranger of the loan. Bleichröder had been an old ally of the Rothschilds for decades, often representing the Frankfurter house in Berlin. Later Bleichröder grew in importance and became a more equal partner to the Rothschilds, not least due to its position as Bismarck’s trusted financier and its location in the new financial centre of the united Germany, in the capital city of Berlin.

The Rothschild bank was not anymore as attractive a business partner as before, the Frankfurt fraction actually fell into disarray in the 1890s and finally halted its business in 1901; the old contacts did not exist anymore. This downturn of the German Rothschilds was concurrent with the waning German influence on the Northern European state finances, which concentrated on France at the turn of the century. The House of Rothschild in Paris continued to handle the payments of the only remaining Finnish state loan organized by M.A. von Rothschild und Söhne, the one issued in 1889.¹⁷⁰

4.4.2 Stockholms Enskilda Bank

The dominance of the Rothschilds was inevitably diminishing as the winds of change arrived in European banking in the late 19th century: new commercial banks partly displaced the old somewhat secretive

¹⁶⁷ Bank of Finland archives, the archives of the Board, letter from M.A. von Rothschild und Söhne 28.8. 1882.

¹⁶⁸ Bank of Finland archives, the archives of the Board, letter from M.A. von Rothschild und Söhne 8.10.1882 and 8.4.1886.

¹⁶⁹ Ferguson, 1999: 130–131.

¹⁷⁰ Ferguson, 1999: 92–98, 378–379; Kindleberger, 1984: 239; Pipping, 1967: 66–87; Schybergson, 1914: 243–249.

investment houses in foreign funding affairs. Banks like the House of Rothschild had difficulties to compete in selling foreign sovereign bonds to the French public because they lacked the nation-wide network of local branches. A French commercial bank, *Crédit Lyonnais* grew ambitiously; at the end of the 19th century it had become Europe's largest commercial bank. It actively looked for a foothold in the Scandinavian governments' bond markets. The large French investor base was eager to buy foreign securities yielding more than the expensive domestic government bonds. Among the foreign securities, the Nordic government bonds offered a competitive alternative for the French investors; they were usually assessed to be politically and economically safe alternatives combined with higher yields.¹⁷¹

A Swedish banker, Knut Agathon Wallenberg, chairman of the *Stockholms Enskilda Bank* since 1886, used the opportunity, which resulted from the new market situation. *Stockholms Enskilda Bank* had been founded in 1856 by a group of Swedish businessmen led by André Oscar Wallenberg, father of Knut Agathon. Under the leadership of K.A. Wallenberg the bank grew vigorously since the 1880s and expanded its business to government bond emissions. Wallenberg, who had a wide knowledge of languages and a large amount of international contacts, was able to convince the management of *Crédit Lyonnais* that he was the proper contact in Sweden in case the French bank wanted to approach the Swedish government and lend a hand in its borrowing.

Already in 1891 Wallenberg had co-operated with *Crédit Lyonnais* in issuing a Swedish government loan in Paris; the loan had been placed quickly and efficiently. The year 1894 marked the 'official' beginning of the period dominated by the *Crédit Lyonnais* consortium; it lead-managed a long-term bond issue for the Swedish state, following discussions between *Crédit Lyonnais* and K.A. Wallenberg to jointly arrange Nordic government bond issues in the future. The Swedish emission was executed via an alliance between *Crédit Lyonnais*, *Stockholm Enskilda Bank*, *L. Behrens und Söhne*, *Hambro's* and *Den Danske Landmansbank*, the latter of which, headed by Isak Glückstadt, was a long-lasting Nordic partner of *SEB's* during the hey-days of the *Crédit Lyonnais* consortium.¹⁷²

In the coming years *Crédit Lyonnais* expanded its issuing business to other Nordic states, with the assist of the wide contact network of

¹⁷¹ Feis, 1974: 33–59; Flandreau, 2003: 19–23; Kindleberger, 1984: 227.

¹⁷² Gasslander, 1956: 14–18, 92–107, 148–154, 184–197; Olsson, 2006: 102–105, 148–157.

K.A. Wallenberg and his bank in all Nordic countries. In *Crédit Lyonnais* Edmund Moret, responsible for the bank's businesses in the Nordic countries, became Wallenberg's closest contact and a long-lasting friend. During his period of training in *Crédit Lyonnais* in 1877–1878 Wallenberg had also been introduced to Adrien Mazerat, the future chairman of the French bank. *Stockholms Enskilda Bank* never held itself a sole leading position in the government bond syndicates during this era; the placing power of the Scandinavian orientated bank was probably too weak for the sizeable government issues in the capital-poor Scandinavia. After all, Sweden itself was prior to the First World War an importer of foreign capital.¹⁷³ But through its alliance with *Crédit Lyonnais*, possessing substantial placing power among the French investor base, *Stockholms Enskilda Bank* was able to get involved in much larger businesses than its own size, or the size of the Swedish financial market, would have rendered possible.

The engagement of *Crédit Lyonnais* with Finland also began during the 1890s, through *Stockholms Enskilda Bank*. By that time, the Wallenbergs had already created solid contacts with the Finnish administration. The bank became a representative of the Bank of Finland in Stockholm in 1864. Later A.O. Wallenberg was an adviser to the Finnish administration during the preparations to the gold reform, implemented in 1878. He knew some leading Finnish politicians, including influential later senators Robert Montgomery and Leo Mechelin, both of which were members of the Finnish gold committee, responsible for planning the monetary reform of 1878.¹⁷⁴

Later his son showed a similar interest in Finland. K.A. Wallenberg was in continuous correspondence with Mechelin and seems to have given a thought to Finland's political developments as well; for example, in his letter to Mechelin in late 1905, – ie in the end of a year shadowed by a great political upheaval in the Russian Empire, – K.A. Wallenberg admired the acts of the Finnish patriots during the eventful year and hoped that the year 1906 would bring happiness and freedom to the Finnish people.¹⁷⁵

The first contacts in borrowing activities took place in 1892. K.A. Wallenberg introduced the Bank of Finland's Governor Alfred Charpentier to the directors at *Crédit Lyonnais*. Charpentier was visiting Paris to sound out the market sentiment and arrange a short-

¹⁷³ Jonung, 1984: 361–367.

¹⁷⁴ Björkqvist, 1953: 149–151; Pipping, 1961: 486–515.

¹⁷⁵ National archives, Leo Mechelin's archives, 602:37c, correspondence with Wallenbergs, letter from K.A. Wallenberg to Leo Mechelin, 29.12.1905.

term credit for the bank in order to strengthen its foreign exchange reserves.¹⁷⁶

In 1895 the Finnish central government returned to the foreign financial markets, which had recovered from the Baring crisis a few years earlier. The new bond issue marked not only Finland's engagement with the French financial market but also the onset of the *Crédit Lyonnais* group's involvement in Finnish borrowing affairs. *Stockholms Enskilda Bank* was deeply involved; K.A. Wallenberg utilized his old contacts to the Board of the Bank of Finland in competition for the new affair. During the years 1895–1903 the *Crédit Lyonnais* consortium organized four bond issues for the Finnish state, Wallenberg acting as the middleman between the state and *Crédit Lyonnais* in all issues. At the same time, *Stockholms Enskilda Bank*'s capital market businesses in other Nordic countries flourished: it organized loans for the Swedish, Norwegian and Danish governments, usually as a central member of the *Crédit Lyonnais* group.¹⁷⁷

In 1908, despite a request by the Finnish Senate and exploratory contacts by K.A. Wallenberg in Paris, *Crédit Lyonnais* was no longer capable, or willing, to place a new Finnish government bond issue in the French capital market. Soon thereafter the close co-operation between *Crédit Lyonnais* and *Stockholms Enskilda Bank* also deteriorated. The market conditions during the last few years prior to World War I became less satisfactory; investors' appetite for new sovereign loans somewhat declined. The European capital markets became increasingly politicized. The presence of *Crédit Lyonnais*' in the Nordic bond markets slowly dried up. As a final seal to this era characterised by the extensive bond issuance of various Nordic entities through the *Crédit Lyonnais* consortium, K.A. Wallenberg left the bond markets when he was appointed as Sweden's Minister of Foreign Affairs in February 1914.¹⁷⁸

During the interwar period, the role of *Crédit Lyonnais* was limited to the management of the Finnish state's annual cash flows to French investors, although it looked for possibilities for new business deals with the Finnish government in the late 1920s. Its analysis department continued to produce detailed reports on Finland until the early 1930s. The first reports had been prepared already in the early 1890s.

¹⁷⁶ *Crédit Lyonnais* archives, DAF 00145, BE 1728, letters from K.A. Wallenberg to Adrien Mazerat, 16.9.1892, 24.9.1892 and 1.10.1892; Schybergson, 1914: 250.

¹⁷⁷ Gasslander, 1956: 184–217.

¹⁷⁸ Gasslander, 1959: 309–328; National archives, Senate archives, Cc1, Finance Committee of the Economic Department of the Senate, secret minutes, protocol of the Economic Department of the Senate, 28.4.1908; Olsson, 2006: 148–171.

The engagement with Stockholms Enskilda Bank continued although it no longer played a dominating role in government's borrowing as it had at the turn of the century, when it represented *Crédit Lyonnais* in the Northern European government finances. Altogether Stockholms Enskilda Bank lead-managed five bond issues for the Finnish central government during the interwar years: in 1921, 1922, and twice in 1934 and again in 1939. This was more than any other foreign bank, if measured by the number of the transactions.

In the early 1920s Jacob Wallenberg (managing director of the bank in 1927–1946) negotiated with the Bank of Finland over new bond issues to support the exchange rate of the mark. In 1934 it was time for his younger brother Marcus (managing director 1946–1958) to participate to the loan preparations; he negotiated a loan in Helsinki to finance the acquisition and expansion of the Finnish long-distance telephone networks by the state. Another Wallenberg affiliated company was also involved; the state bought Ericsson's stake in the Finnish telephone network and later ordered equipment from it for the network expansion. Another bond was slightly later issued through Stockholms Enskilda Bank to finance early redemptions of the bonds, which the state had issued in the United States in 1925 and 1928. The bank even took part in some of central government's domestic bond issues with small allotments.¹⁷⁹ In the spring of 1939, the bank still arranged one more bond issue for the state; the funds were used for Finland's armament.

On Finland's behalf, Risto Ryti usually played a central role in the loan negotiations. The negotiations over state finances between Ryti and Wallenberg were not limited to bond issues: they covered Finnish economic matters much more broadly. Marcus Wallenberg's connections with Ryti continued for many years, including Wallenberg's involvement with Finnish affairs during the Second World War.¹⁸⁰

¹⁷⁹ SEB archives, *Direktionens dossier serie II, Finland*, vol. 6, P.M. Marcus Wallenberg JR:s samtal med Risto Ryti, 9.1.1935.

¹⁸⁰ Olsson, 2001: 113–114, 209–218; *Parliament documents, Book IV, Government proposal no: 115, 31.10.1935*; SEB archives, *Direktionens dossier serie II, Finland*, vol. 1, frågor framställda av director Freckell i Finlands bank till Marcus Wallenberg, 27.10.1922; vol. 6, anteckningar från samtal med bankdirektör Risto Ryti, 3.12.1933, 8.3.1934 and 9.1.1935.

4.5 Investors

Rapid economic growth during the 19th century and growing prosperity of ever greater amounts of people – although economic wealth was still extremely unevenly distributed – was a necessary precondition for the accumulation of savings to an unprecedented extent. Simultaneously, the great expansion of the international capital markets provided the channels to transfer capital from the rich core to the poor periphery. John Maynard Keynes emphasized after World War I the pivotal role of the saving behavior of the wealthy households in the pre-war Europe:

Europe was so organized socially and economically as to secure the maximum accumulation of capital. While there was some continuous improvement in the daily conditions of life of the mass of the population, Society was so framed as to throw a great part of the increased income into the control of the class least likely to consume it. The new rich of the nineteenth century were not brought up to large expenditures, and preferred the power which their investment gave them to pleasures of immediate consumption. In fact, it was precisely the inequality of the distribution of wealth which made possible those vast accumulations of fixed wealth and of capital improvements which distinguished that age from all others.¹⁸¹

Regarding the Finnish government bonds, exact statistics on the type or geographical distribution of the investors – the new rich of the nineteenth century, as Keynes called them – were never formed. Direct contacts between the issuer and investor were rare; the banks received the coupons from bondholders and handled independently principal and interest payments to them. The unusual exceptions were occasions when investors felt somehow betrayed and complained directly to the issuer or, as sometimes happened, asked for new coupons to substitute for original ones, which they had lost for some reason.

This means that the estimates on geographical distribution or type of investors are unavoidably only rough proximities, collected either from the primary or the secondary market.¹⁸² In this study, at the primary stage evaluation of the investor base is done by studying banks' allotments in different government issues and assuming that geographical distribution of the banks taking part in the issuing

¹⁸¹ Keynes, 1920: 16.

¹⁸² Primary market is the market for new securities; investors buy securities from the issuer. In the secondary market, investors purchase securities from other investors, usually through bourse transactions.

syndicates correlates with the investor allocation, ie each bank's customer base mainly consists of investors of the same nationality as the bank.

Marketing material from the archives of *Crédit Lyonnais*, for instance, indicates that its allocation of the Finnish government bond issues were marketed and sold only in the French cities, in mainland France and in Algeria.¹⁸³ It is not known to whom M.A. von Rothschild und Söhne sold Finnish loans, but given the relatively small size of Finnish government's bonds, one might assume that the whole cross-boundary placement power of the European Rothschilds was not used; more likely, the Finnish bonds were mainly sold to the bank's local client base in Germany. Moreover, it is assumed that the government's domestic bonds were sold only to Finnish investors; government's domestic bonds were overwhelmingly retail-targeted and marketed mainly to Finnish households, although *Stockholms Enskilda Bank* participated with very minor allotments in some of the state's domestic issues in the 1930s.

Secondary market information is somewhat less satisfactory because government bonds were bearer bonds that were traded on bourses throughout their lifetime; their ownership was constantly altered, but not registered. However, there are some estimates on domestic bondholders' asset allocation already during the 19th century and, in particular, Finland's Statistical Office prepared statistics on bond holdings of largest domestic investors after the turn of the century. Given these limitations it is possible to make a rough estimate on the division between domestic and foreign ownership at the secondary stage but the geographical distribution of investors by nationalities only at the primary stage. Despite of the constraints, it is still, however, possible to partly answer the question: who provided the foreign capital to the Finnish central government for its modernization process?

4.5.1 Domestic versus foreign investors

The first official statistics on domestic and foreign ownership of the central government debt were collected in 1915 for the years 1905–1914 by Finland's Statistical Office. The first statistics were followed by a new publication in the 1923, which included domestic bond

¹⁸³ *Crédit Lyonnais* archives, DAF 00255-1, BE 1729, 'Agences régionales, Notices Emprunt Finlandais 1895'.

holdings for the year 1920. This means that due to the lack of exact statistics only estimates on the division between foreign and domestic ownerships can be calculated for the years 1862–1904 and 1921–1938, mainly by going through the structure of the issuing syndicates.

The issuance of the state's first two foreign bonds in 1862 and 1868 was arranged solely by German banks. In addition to these two foreign bond issues the state had issued domestic bonds during the 1860s.¹⁸⁴ By assuming that domestic bonds were exclusively placed in Finland and foreign bonds abroad, it is possible to estimate that the foreign ownership accounted for some 85 per cent of total central government debt in 1870.¹⁸⁵

Between 1874 and 1903 the Bank of Finland participated in all of the state's new bond issues. Its share was as high as 50 per cent in all primary market operations from the issue of 1874 to the one, carried out in 1889. In the French market operations (1895–1903) its share was significantly lower, accounting for only 10 per cent of the total issue amounts. As regards the sterling loan of 1909, it no longer took part in the issuing syndicate, but it had minor allotments again in some of the state's foreign bond issues during the 1920s and 1930s.¹⁸⁶

The Bank of Finland typically first kept its allotment in its own portfolios and sold them later as part of its monetary policy, for instance, to different state funds. The rationale for the state to buy its own bonds was that it offered a technique to transfer cash and assets from one state fund to another one in a highly complex system of state finances during the 19th century. The state economy used to consist of a large number of different funds during the 19th century without central bookkeeping.¹⁸⁷

In the secondary market, the importance of the domestic investors might even have increased during the 1870s and 1880s. As regards the bond issue of 1874, some of the bonds that originally had been dedicated for foreign placement were left to foreign banks' own portfolios due to the weak demand and later returned to Finland. In addition, according to contemporary estimates, quite a few foreign investors sold their Finnish government bonds on bourses to Finnish

¹⁸⁴ The classification between domestic and foreign bonds is the same as that of the Statistical Office.

¹⁸⁵ J.K. Paasikivi calculated in 1911 that foreign ownership of the 1868 lottery bond almost constantly decreased throughout its lifetime (it matured in 1911). However, still in 1880 foreigners had 95 per cent of its outstanding stock. This would confirm the assumption that it was almost totally placed abroad in 1868 at the primary stage and, consequently, held by foreign investors in 1870. Paasikivi, 1911: 300.

¹⁸⁶ See appendix 5 for sources.

¹⁸⁷ Kuusterä, 1989: 307.

investors, undoubtedly at good profit due to the long bull market of the late 19th century.¹⁸⁸ Taking into account the important share of the Bank of Finland in the primary market issues – and assuming its allocation was always placed inside the country – and presuming that a small portion of government foreign bonds were ‘returned’ to Finland by foreign banks, one gets a rough estimate that some 2/3 of government bonds were in foreign hands both in 1880 and 1890.

During the 1890s the share of domestic investors greatly fell. This development took place both in the primary and secondary markets. The change was most remarkable in state funds’ own portfolios that constituted at that time the most important domestic investor group. Still in 1890 the state held a large number of its own securities; their portion was as high as 91 per cent in the ‘domestic’ portfolios of state funds.¹⁸⁹ In the 1890s the Senate halted issuance of domestic debt and exchanged most of its old bonds for new foreign bonds with lower coupon rates. It seems to be that state funds allocated the capital they received from the early redemptions to other securities, not to the newly issued central government bonds.

This declining importance of the domestic investor base towards the turn of the century – as indicated by the diminishing importance of the Bank of Finland in issuing syndicates and state funds’ new investment policies – stands out in the first official statistics on domestic investors’ bond holdings. According to the first official statistics, which described the situation in 1905, foreign investors held 97.7 per cent of Finnish central government bonds. However, the portion probably slightly exaggerates foreign ownership because some smaller domestic investors were not included in the statistics.

In the next few years, the foreign portion somewhat declined, but still in 1914 some 92 per cent of all state’s bonds were in the hands of foreign investors. The largest domestic investors were commercial banks and insurance companies.¹⁹⁰ After the war in 1920 still 90 per cent of state’s foreign debt was in foreign hands.¹⁹¹ However, the state has issued domestically placed bonds in 1918 and 1919 and raised domestic short-term loans since 1915. This means that foreign ownership now only accounted for some 1/3 of total state debt (combined foreign and domestic debt).

¹⁸⁸ Mechelin, 1895: 67; Parliament documents, Book II, letter by the estates to the Emperor, 5.6.1882.

¹⁸⁹ Kuusterä, 1989: 307, 310.

¹⁹⁰ Obligationsitilasto vuosilta 1905–1914: 10 and appendix 8.

¹⁹¹ Obligationsitilasto vuosilta 1915–1920: 27.

During the 1920s the state concentrated its borrowing to foreign markets. However, a relatively large portion of these bonds were placed in Finland at the primary stage or sold to Finland after the issues; according to A.E. Tudeer domestic investors might have acquired even 1/3 of all foreign bonds issued by Finnish entities¹⁹². By the end of 1920s the outstanding central government debt overwhelmingly consisted of foreign bonds, which had been issued during the 1920s. Given Tudeer's assumptions regarding the domestic investors' role, this would imply that almost some 2/3 of total central government debt was held outside Finland before the outbreak of the Great Depression in the late 1920s.

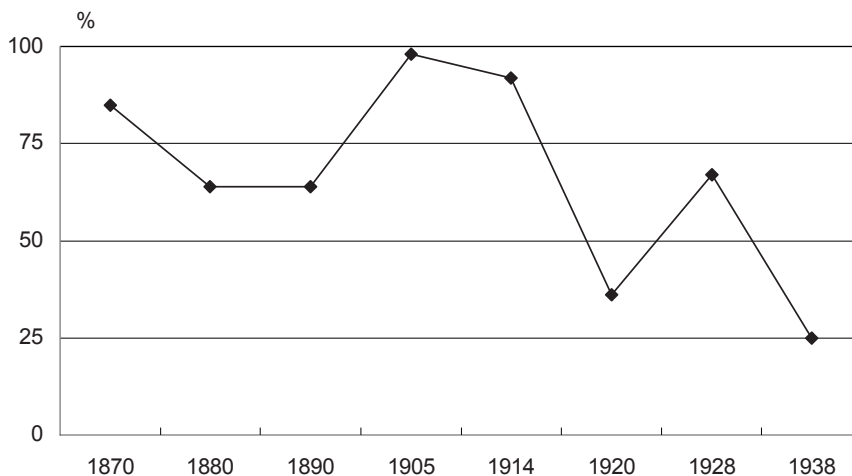
During the 1930s foreign ownership considerably declined because new borrowing was concentrated on Finland and foreign bonds were called early by the government. Assuming that domestic bonds had been fully placed in Finland – given the minimal size of cross-border capital movements in the 1930s and the nature of the state's domestic bond issues, clearly directed to Finnish households, this probably serves as a proper assumption – foreign ownership in 1938 accounted for only 25 per cent of the total state debt.

The stylized view presented in graph 4.3 on foreign ownership of the central government debt draws on the previous argumentation. The estimates are presented in approximately ten-year intervals, although adjusted according to the availability of statistics.

¹⁹² Tudeer, 1931: 90–91.

Graph 4.3

**Estimate on the foreign ownership of the
central government's total debt
(combined foreign and domestic debt),
1870–1938**



Sources: Larjavaara, 1971: 344–345; Mechelin, 1895: 67; Nevanlinna, 1907: 63–241; Obligationslilastoa vuosilta 1905–1914; Obligationslilastoa vuosilta 1915–1920; Pipping, 1967: 48–79; Statistical yearbook of Finland: 1881, 1921, 1929 and 1939; Tudeer, 1931: 90–91.

Although it is not possible to provide any exact figures, the stylized line probably catches quite well the major changes; foreign ownership was highest during the early 20th century and it somewhat bounced back in the late 1920s. Foreign ownership seemed to have declined during the ‘crises decades’ in the 1910s and in the 1930s, and also during the 1870s, when the Bank of Finland began to participate in the placement of new state bonds. The Bank of Finland’s participation probably reflected, among other things, faster accumulation of domestic capital: for example, the state’s own portfolio investments increased manifold between 1870 and 1890.¹⁹³

It is somewhat surprising that foreign ownership grew so vigorously at the turn of the century although capital accumulation in Finland constantly gathered speed. It may reflect investors’ greater willingness to diversify their portfolios abroad as international capital market integration deepened. At least partially, the reason may also stem from the domestic’s investors’ pure difficulty in buying state

¹⁹³ Kuusterä, 1989: 304.

securities. The Bank of Finland's role in the issuing syndicates first declined and then vanished, and Finnish commercial banks had relatively minor allocations only in a few issuing syndications; domestic investors should have left their bids in the primary offerings to foreign banks. This probably affected adversely their interest. Moreover, government bond trading on the Helsinki bourse disappeared in the 1890s.¹⁹⁴ It was not anymore straightforward to buy domestic central government bonds in Helsinki.

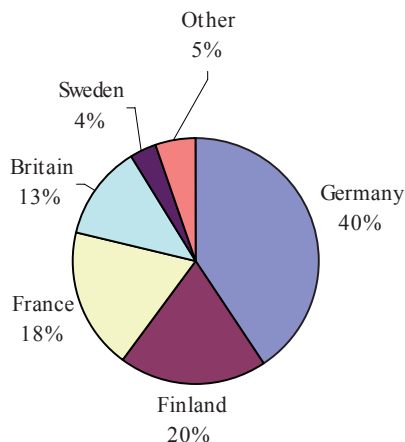
4.5.2 Geographical distribution

Given the knowledge of the structure of the issuing syndications, it is possible to draw some estimates on the geographical distribution of the primary market offerings by countries. Before the First World War German capital was the main financier of the Finnish central government, followed by domestic and French investors. The importance of the German investor base was enforced by the important positions that the German banks held in the government's bond issues aimed at the French financial market (1895–1903), highlighting the fact the switchover to the French bond market was never total. In contrast, the French banks never participated in the government's German capital market issues (1862–1889). Interestingly, the Russian investors seem to have had no role in financing the Grand Duchy's extensive infrastructure investments. Graph 4.4 shows the investor base of the state's foreign bonds during time of autonomy, measured through banks' allotments in the primary market. Because the state's domestic issuance before the First World War was very limited, or even non-existent since 1890, this evaluation serves as a proper proxy also for the whole investor base at the primary stage.

¹⁹⁴ Autio, 1996: 38.

Graph 4.4

**Estimate of the geographical allocation
of the Finnish central government foreign
bond issues until 1917**



Note: Relies solely on the allotment of each bank in issuing syndicates, assuming that each banks' allotment was sold mainly to the residents of the same country.

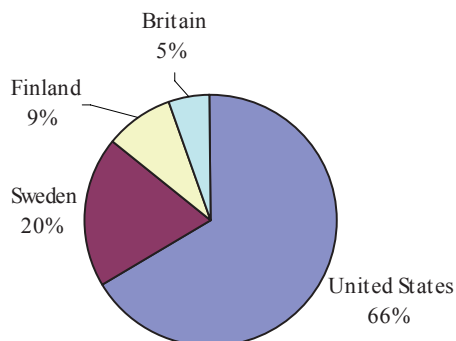
Sources: See appendix 5 for sources.

Following the First World War the investor base dramatically changed, as graph 4.5 indicates. American money dominated the interwar years; some 2/3 of the state's foreign bonds were placed in the United States. Capital from the European continent all but vanished; during the 1920s and 1930s only one bond was issued in core-Europe, it was executed in London in 1923.

Following the collapse of American foreign lending, the state's limited foreign issuance was executed in Stockholm. Moreover, the state had launched two bonds in Sweden already in the early 1920s. Indeed, the Swedish financial market offered the most capital to the Finnish central government, after that of the United States. Domestic investors had an appetite for the state's foreign bonds issues as well; a relatively large portion of dollar-denominated bonds were sold to Finnish investors.

Graph 4.5

**Estimate of the geographical allocation
of the Finnish central government foreign
bond issues, 1918–1938**



Note: Relies solely on the allotment of each bank in issuing syndicates, assuming that each banks' allotment was sold mainly to the residents of the same country.

Sources: See appendix 5 for sources.

Information on investor types is very limited and can be evaluated only through some examples and general information regarding the core-European bondholders. The trading house of Malm in the coastal town of Pietarsaari provides an example of the domestic investors during the period of autonomy. Oscar Nikula has described its investment practices and showed that the trading house followed the financial markets rather intensively and used the Bank of Finland as an intermediary in its transactions. For instance, as the threat of the Russo-English conflict dampened bond prices, the trading house in 1877 bought Finnish government 4.5% bonds of 1874 at a price of 90.25, and sold them four years later at a price of 99. At the time of the death of Otto A. Malm in 1898, owner of the trading house, the value of its property was 10 million marks, of which the major portion had been invested in bonds. In comparison, only one fourth had been invested in shares and five per cent was held in bank deposits.¹⁹⁵

In France, investing in foreign securities became quite common before the First World War. The amount of *rentiers*, small but wealthy households who had invested their savings in French government

¹⁹⁵ Nikula, 1948: 438–455; Pipping, 1969: 165–166.

bonds, was as high as 4.6 million in 1909, in a country of 40 million inhabitants. Moreover, a great deal of their savings was also allocated to foreign securities. In contrast, in Britain the number of individual holders of British consols remained much smaller at around 200,000, ie bondholders still clearly belonged to the upper class groups of the society. However, in both countries the number of small savers with accounts in banks was much higher; depositors amounted to some 10 million both in France and Britain. A large portion of the deposits was channeled to investments in government bonds, sometimes through some sort of official regulation. As regards Germany, the state did not impose the same sort of control over private deposits, but also there the private banks managed substantial funds and constituted a major German investor group. During the First World War, governments' efforts to encourage savers to put their money in government securities were further enforced in all belligerent countries. Following World War I the European investors in the bond markets were replaced by Americans' money, provided by wealthy households, banks and corporations alike.¹⁹⁶

The rare evidence on holders of Finnish securities confirms the views presented above. During the struggle regarding the pre-war government bonds in the 1920s, Finnish embassies received letters from local investors, upset by the intentions of the government not to pay the coupons of the pre-war bonds at full gold value.¹⁹⁷ The complaining investors typically represented large amounts of bondholders that had invested part of their savings in Finnish bonds. In France they operated through the French Bondholders Association (L'Association Nationale des Porteurs Français des Valeurs Mobilières), which represented a large number of French investors, some of them having quite small allocations in Finnish securities. These remarks are supported by the information about the primary market operations. Crédit Lyonnais marketed and distributed the Finnish government bonds through its nation-wide bank network in 28 French towns; the target groups were clearly French households and small businesses.¹⁹⁸

¹⁹⁶ Feis, 1974: 35–39; Ferguson, 2006: 96–98; Ferguson, 2001: 195–200.

¹⁹⁷ For the dispute, see chapter 6.

¹⁹⁸ Crédit Lyonnais archives, DAF 00255-1, BE 1729 'Agences régionales, Notices Emprunt Finlandais'.

4.6 Central government debt 1860–1938

The Finnish central government debt in relation to gross domestic production (GDP) remained modest throughout the period from the 1860s until the outbreak of the Winter War in 1939. Later, during the Second World War and again during the recession in the early 1990s the state's indebtedness accounted for a much larger share in relation to domestic production. The prudent management of state finances – large budget deficits have been traditionally avoided in Finland – maintained the debt at a modest level. Moreover, the importance of the state economy in the national economy was small before the First World War and, although its share grew during the interwar years, it still remained limited, especially when compared to the decades following the Second World War, which witnessed a rapid expansion of the public sector and birth of the welfare state.

As a result, the state debt in relation to GDP never exceeded 30 per cent between 1860 and 1938 (graph 4.6). Even the 20 per cent threshold was exceeded only twice, in the aftermath of the First World War and during the Great Depression in the early 1930s. On both occasions, the deteriorated economic conditions increased the central government's borrowing needs and, at the same time, the depreciation of the Finnish mark increased the domestic currency value of the foreign debt. Following both peaks the central government debt quickly returned back to substantially lower levels. At the outbreak of the Winter War in November 1939 the central government debt accounted for only some 10 per cent in relation to GDP.¹⁹⁹

In absolute terms, the state debt in 1860 amounted to some 23 million marks (7.2%/GDP), that is, 92 million present day (2005) euros. By the outbreak of the First World War in 1914 the state debt had risen to 171 million marks, ie 543 million current euros (10.8%/GDP). Following the collapse of the Gold Exchange Standard in 1931 and depreciation of the Finnish mark, the state debt peaked at 5.84 billion marks, that is, 1.8 billion euros in current value (29.4%/GDP), but declined by the end of 1938 to 3.7 billion marks (9.6%/GDP).²⁰⁰ For comparison, following the economic recession in the early 1990s, the central government debt amounted at the highest point to some 70 billion euros. In relation to GDP it reached 67.1% in 1996, which so far is the highest ratio in relation to production.²⁰¹

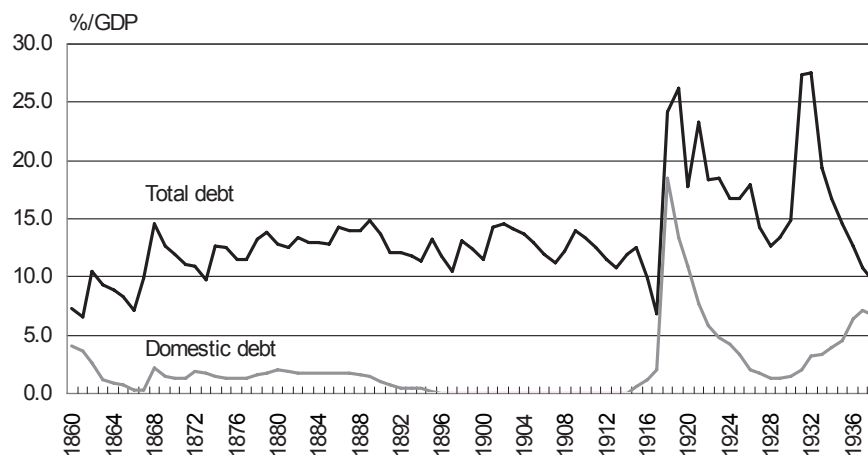
¹⁹⁹ Hjerpe, 1989: 124–127; Pohjola, 1999: 163–167.

²⁰⁰ Sources: See appendix 3.

²⁰¹ Ministry of Finance, 2000: appendix.

Graph 4.6 shows total and domestic central government debt in relation to domestic production, ie difference between the two constitutes the central government's foreign debt. Prior to the First World War the central government debt was overwhelmingly foreign if defined according to the criteria used by Finland's Statistical Office. During the last two decades preceding the war the state had no domestic debt. During and in the aftermath of World War I the state had to borrow extensively short-term domestically, including borrowing from the Bank of Finland. This was a major reason for the increase of domestic debt from 1916 onwards. After the post-war economic crisis the state depended on foreign capital again, and in the end of the 1920s the state debt was again mainly of foreign origin. The reliance on foreign capital was more permanently altered only after the Great Depression; the central government redeemed its foreign debts during the 1930s save a few loans and utilised the domestic savings to an unprecedented extend.

Graph 4.6 **Central government's total debt and domestic debt in relation to GDP, 1860-1938**



Note: Total debt consists of foreign and domestic debt. The value of foreign debt is calculated according the spot exchange rates. Prior to 1927 this time-series differs from Finland's official debt statistics, which have not taken into account currency movements after the issues of new debt. For some years before the first issue of the Statistical yearbook in 1879 there are no statistics on the state debt. For the missing years I have calculated the amount of debt by generating the cash flows of each bond separately with the help of the redemption and interest payment schedules printed in the statute books and summed them up for each year. Complete time-series are presented in appendix 4.

Sources: See appendix 3 for sources.

In international comparison, the central government debt in Finland was at a modest level. Table 4.4 shows the central government's debt in Finland per capita in comparison to some other European countries in 1888, 1913, 1925 and 1937. Indeed, according to this measure the central government of Finland had the lowest debt burden among this peer group. It highlights the constant fiscal rectitude in Finland, but also Finland's ability to remain outside great European wars. Similar peaceful circumstances enabled other Nordic countries to keep their public debt at modest levels.

In contrast, Britain inherited most of its relatively high outstanding debt from the Napoleonic wars. It was able to lower its national debt during the following 100 years but borrowed extensively again during the First World War, like all belligerent countries. In France, the war indemnities to Germany after the peace treaty in 1871 increased the government's issuance but otherwise the decades preceding the Great War witnessed relatively rapid economic growth and solid public finances. In the interwar period, Britain's debt burden was the heaviest, reflecting, among other things, the restoration of the pound's pre-war value, which kept the real value of the national debt high, unlike in Germany and France.²⁰²

Table 4.4 **Central government debt per inhabitant in 1888, 1913, 1925 and 1937, Finnish state debt = 100**

	Finland	Sweden	Norway	Germany	France	Britain
1888	100	211	218	–	2182	1370
1913	100	325	383	758	1564	653
1925	100	435	763	609	1692	4668
1937	100	382	496	396	986	3294

Note: Sweden and Norway in 1913 refer only to bonds. France in 1937 refers to domestic debt.

Sources for years 1913, 1925 and 1937: Ferguson, 1999b; 5–200; Franzén, 1989: 276; Klovland, 2004: 111; League of Nations, 1926 and 1938. Sources for year 1888: Fenn's Compendium, 1889: x–xiii. All exchange rates are from Autio (1992).

Although comparison to the size of the population does not take into account differences in wealth and income, which are crucial factors from the point of view of the ability to service the state debt, it still

²⁰² Eichengreen, 1995: 74–88; Kindleberger, 1984: 165, 294–296.

provides a rough indicator of the burden of the public debt in each country. Moreover, the contemporary people did not have statistics on national production in their hands. Instead, public debt was compared to other statistical variables, of which population was one. The outstanding debt was also compared to the value of state assets, ie value of state railways and canals, forests and land, state industries and buildings. Annual debt servicing costs were put into perspective by evaluating the state's budget revenues and revenues of state funds, providing indicators on the sustainability of the debt. In addition, the magnitude of export revenues was believed to be a suitable indicator on the ability to service foreign currency securities.²⁰³

On these lines, in addition to presenting figures on state debt per head, *Fenn's Compendium* presented adjusted debt calculated on a uniform interest basis. It also calculated annual debt charges and compared them with respect to government earnings. In 1888, Finland had the lowest annual debt charges among the countries listed in table 4.4 and second lowest when adjusted with respect to government income, right after Sweden.²⁰⁴

Prior to 1914 the movements in the foreign exchange markets posed no problem to the state. Quite contrary, the state even slightly benefited from the weakness of the Russian rouble, which after the 1860s depreciated against the Finnish mark and decreased the value of the rouble-denominated government debt that had been raised prior to Finland's engagement with foreign bond markets. The collapse of the gold standard regime and the mark's rapid depreciation in the aftermath of the First World War altered the situation radically; the domestic currency value of the foreign debt rose dramatically after 1918. However, the partial redemptions of old foreign bonds during the 1920s and the drastic depreciation of the French franc, which had been an important currency of denomination of the central government's securities during the last decades of the classical gold standard, limited the negative effects of the mark's depreciation on the outstanding government debt.

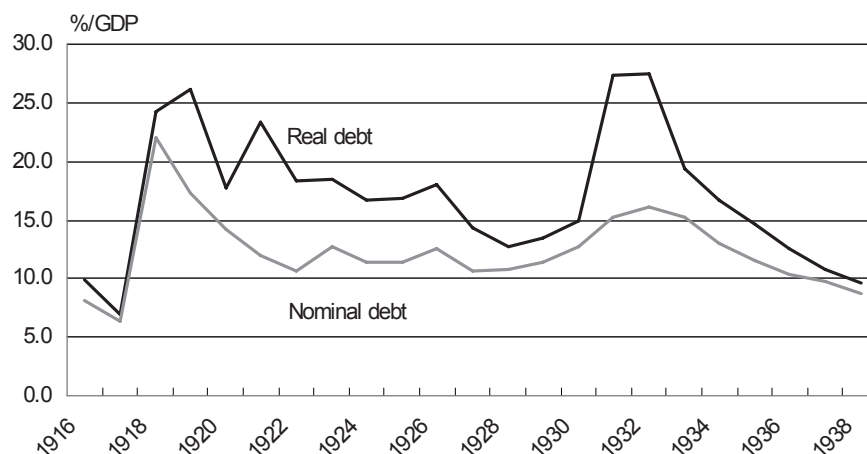
The effects of currency depreciation were repeated in 1931–1932; the mark's fall, in particular against the US dollar, increased the domestic currency value of the sizeable dollar bonds. However, the devaluation of the dollar in the spring of 1933 and the government's

²⁰³ Crédit Lyonnais archives, DAF 00255-1, BE 1729 Finances Finlandaises Note, 8.2.1895; Moody's Governments and Municipals Ratings Manual, Finland: 1925; SEB archives, Direktionens dossier serie II, Finland, kreditförsträckningar till, vol. 1, meddelanden angående Finlands ekonomiska ställning, December 1919.

²⁰⁴ Fenn's Compendium, 1889: x–xvii, 449–465, 572, 596–607.

early redemptions of foreign bonds during the 1930s rapidly decreased the effects of currency movements. Graph 4.7 illustrates the effects of currency movements on the value of the central government debt converted into marks. The nominal debt refers to the value of debt calculated according to the exchange rates at the time of the launch of each foreign bond, ie no exchange rate movements have been taken into account after the issue date. The real debt is the domestic currency value of state debt based on spot exchange rates. Consequently, the difference between the two lines illustrates the effects of currency depreciation on the value of outstanding debt.

Graph 4.7 Domestic currency value of state debt in relation to GDP based either on the exchange rate at launch of each bond (nominal debt) or on the spot exchange rate (real debt), 1916–1938



Note: Full series are presented in appendix 3.

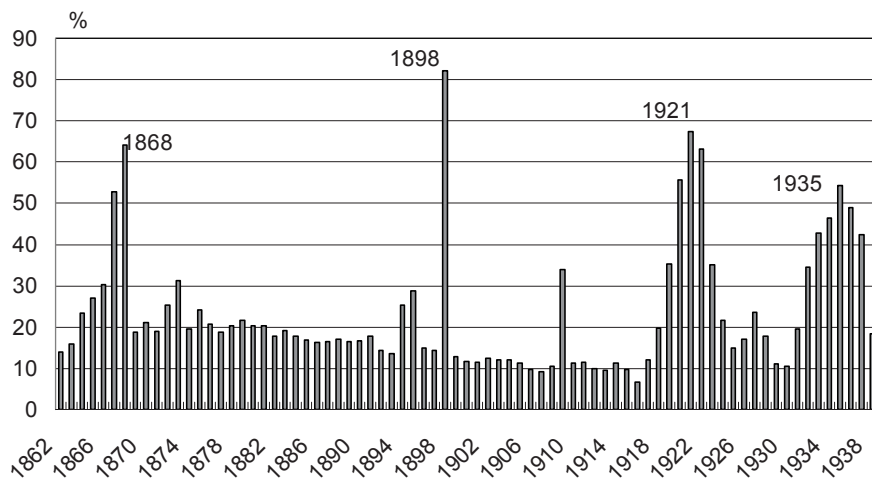
Sources: See appendix 3 for sources

The amount of debt by itself does not yet indicate very much regarding its burden on state finances. Even a relatively large amount of sinking fund debt can induce manageable annual expenditures if, for instance, the debt is of very long maturity. When the amount of debt is measured against national production, the relative size of the central government in the economy further complicates the accuracy of the measurement; in case the size of the public sector is small, debt-

related expenses could cause a great stress on state finances, even if they are modest in relation to the whole national production.

In order to illustrate further, graph 4.8 presents the central government's annual debt service payments, ie redemptions and interests, in relation to the state's tax and customs revenues. For most of the time, debt-related expenditures accounted for some 10 to 20 per cent in relation to the state's tax and customs revenue. However, in the 1860s, in 1898, in the early 1920s and during the 1930s the relation was a great deal higher. During the 1860s, the early 1920s and partly during the early 1930s the state extensively borrowed short-term. The rolling over of short-term debt increased annual redemptions payments, in addition to the negative effects of currency depreciation on debt service expenses.

Graph 4.8 Central government debt expenditures (redemptions and interests) in relation to its tax and customs revenues, 1862–1938



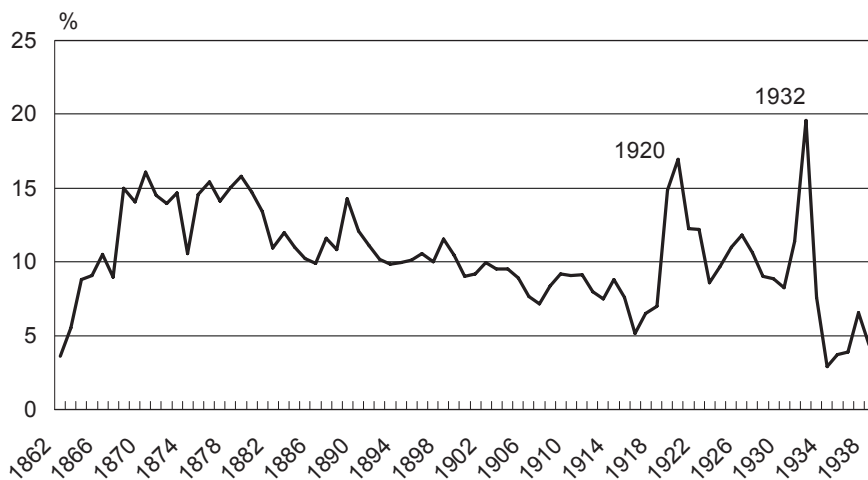
Note: For the years prior to 1901 there are no continuous statistics on state's redemptions and interest payments separately. For the missing years, I have utilized the statute books and generated the cash flows for each bond separately and summed them up. This probably serves as a rather good proxy for the debt expenses.

Sources: Taxes and customs revenue: Suomen taloushistoria 3 for the years 1862–1881 and Statistical yearbooks of Finland for the years 1882–1938; Debt expenses: Parliament documents, closing of state accounts 1901–1938; Pihkala, 1977; State statute-books 1862, 1868, 1874, 1881, 1882, 1886, 1889, 1895, 1898; Statistical yearbooks of Finland.

The peak in 1898 and part of the increase during the 1930s were, however, different in nature; the high amount of redemptions resulted from early redemptions of old bonds, which were simultaneously refinanced through more cost-efficient new borrowing. This sort of debt management policy can hardly be claimed to have brought excessive economic hardship to state finances. It may thus to a certain extent exaggerate the impact of debt expenditures on state finances.

In this respect, the removal of annual amortizations offers a more appropriate insight to the financial burden of the central government debt. Graph 4.9 presents only interest payments on the central government debt in relation to tax and customs revenues. As earlier, the years 1920 and 1932 still stand out. However, after 1932 the interest expenses quickly fell; the devaluation of the US dollar and implementation of substantial early redemptions of foreign bonds greatly reduced interest expenses.

Graph 4.9 **Central government's interest payments in relation to its tax and customs revenues, 1862–1938**



Note: See graph 4.8.

Source: See graph 4.8.

As graph 4.9 indicated, the financial burden of the railway construction posed a relatively hefty burden on state finances in the 1870s; during the 1870s interest expenses, which mainly stemmed from railway loans, amounted to some 15 per cent in relation to tax and customs revenues. On top of that, the state had to pay annual

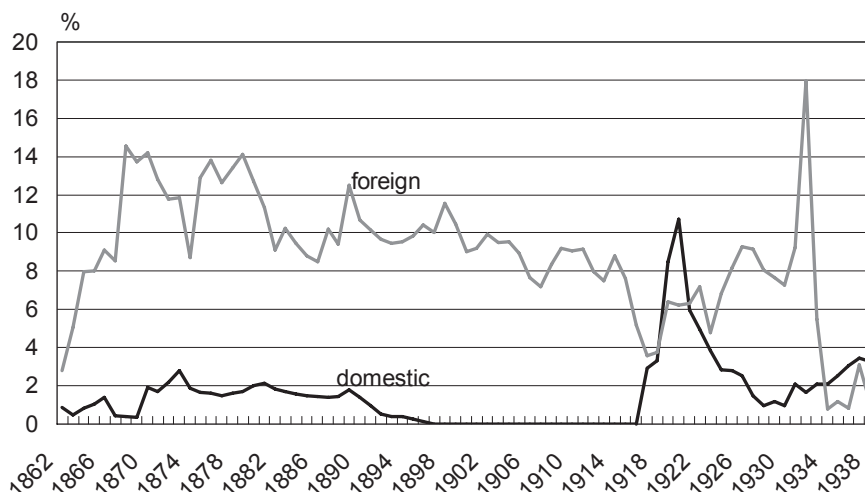
amortizations of the loans. Later, during the time of autonomy, although the state still rather extensively raised new loans to finance railway constructions, tax and customs revenues increased; the relative burden of interest expenses decreased.

A major part of the central government's interest expenses originated from foreign debts (graph 4.10). This implies that they put continuous stress on the current account, although naturally depending on the nationality of the investors, which was presented earlier. As graph 4.10 shows, the years following World War I and the 1930s are in these respect exceptions: foreign interest expenditures fell.

In 1916–1917 the relative importance of foreign interest radically sank due to the fact that the state revenues were greatly inflated. However, at the same time the foreign value of the Finnish mark was still relatively close to the old pre-war gold value, ie state income was inflated, but high inflation was not yet reflected in the exchange rates. Simultaneously, the central government heavily leaned on internal sources, including loans from the Bank of Finland, causing a dramatic rise in domestic interest expenditure. This situation was later reversed, but as noted already earlier, the 1930s brought a more permanent revision. During that decade, domestic borrowing replaced foreign issuance and, furthermore, outstanding foreign currency bonds were actively redeemed.

Graph 4.10

Central government's foreign and domestic interest payments in relation to its tax and customs revenues, 1862–1938



Note: Part of the state debt classified as foreign was held in Finland. This means that part of foreign interest payments actually stayed inside the country.

Source: See graph 4.8.

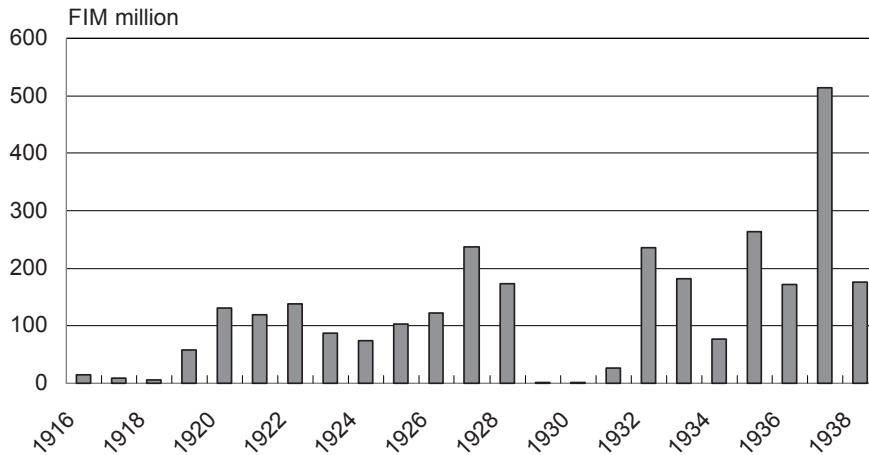
As the previous examples illustrated, the collapses of the classical gold standard and the gold exchange standard had serious implications on the central government debt. The Finnish mark depreciated, which raised the burden of foreign currency debt on the state budgets. The rise in the domestic currency value of the debt did not as such harm state finances; the effects were felt year by year in the form of accelerated redemptions and interest payments. The total amount of realized exchange rate losses between 1916 and 1938 was 2.92 billion marks at 1926 prices.²⁰⁵ For comparison, the state's total tax and customs revenues in 1926 were considerably less, they amounted to 1.8 billion.²⁰⁶ Graph 4.11 illustrates the timing of the exchange losses; they were naturally felt most severely during the years when the state carried out large redemptions of foreign debt.

²⁰⁵ Parliament documents, closing of state accounts 1916–1938; Hjerppe (1989) for price indices.

²⁰⁶ Statistical yearbook: 1927.

Graph 4.11

**Annual exchange rate losses of the central government 1916–1938,
million Finnish marks at 1926 prices.**



Sources: Parliament documents, closing of state accounts: 1916–1938; Hjerppe (1989) for price indices.

4.7 Comparison with Sweden and Norway

Comparison to borrowing practises of two other Nordic sovereign borrowers, the states of Sweden and Norway, can offer some interesting insights due to the similarities between the three countries. In addition to geographical closeness and comparable size, their economic development was fairly parallel, although living standards in Finland were clearly lower. In other words, despite of the fact that the degree of economic development greatly varied between the three nations, they were all late-comers in economic development, catching-up with the core-Europe. Every government relied on core-European capital in financing their modernisation processes; they became frequent bond issuers in the international capital markets during the 19th century. In the case of Finland and Norway, even the political status was partially analogous until 1905; both nations lacked full independency.

Norway was ceded to Sweden in 1814 and granted an autonomous status. The new sovereign state issued its first foreign loan in 1820 with the banking firm Bennecke in Berlin after some difficulties in loan negotiations. Thereafter, the central government of Norway became a frequent issuer on the international stock exchanges. Most

of the loans were issued for railway construction and conversions of older loans, although the state depended on foreign capital also, for example, during the economic crises in 1857–1858. Until 1863, its foreign bonds were denominated in Hamburg banco and usually issued through Hambro bank. The first sterling issue was launched in 1876. Until the 1890s Hamburg, Berlin, London and Copenhagen bourses offered most of the foreign capital to the Norwegian government.²⁰⁷

In 1894 the Norwegian state issued its first securities on the Paris bourse; the French capital market was its major source of capital until 1905. The issues were lead-managed by the *Crédit Lyonnais* group, including *Crédit Lyonnais*, *Banque de Paris et des Pays-Bas* and *Stockholms Enskilda Bank*. In 1911 the Norwegian government returned to the British financial market through an issue organised by *Hambro* and *Swiss Bank Verein*. During the 1920s the Norway's government's foreign bond issuance was concentrated in the financial market of the United States; it issued several dollar denominated bonds between 1920 and 1928. In addition, the state issued one bond in Britain in 1921. In the 1930s the Norwegian government carried out some foreign bond issuance in Sweden.²⁰⁸

In Sweden the state had inherited a considerable amount of debt from the Gustavian wars in 1789–1790. After the turn of the century, the state reduced its debt through massive redemptions; by the year 1809 the state debt had been already reduced by 50 per cent. During the following years, Sweden took advantage of the developments of the Napoleonic wars and wrote off debts, which had been raised from countries that were in a state of war with Sweden. The rest of the government debt was paid off by the sale of *Guadeloupe Island*. This meant that by 1815 the state had practically no foreign debt left, and in a few years time even the domestic debt was redeemed. Remarkably, during a period from the 1820s to the 1840s the Swedish state was basically free from debt.²⁰⁹

The Swedish state returned to the foreign capital markets in the 1850s due to similar reasoning as Finland did only slightly later; it began to acquire foreign capital to bolster industrialisation of the country and modernise the national infrastructure. It tried to acquire funding domestically but with very weak results. As a result, the Swedish parliament came to the conclusion that foreign markets were

²⁰⁷ Klovland, 2004: 102–107; Rygg, 1918: 165–166; Rygg, 1954:17–22, 158, 236, 322–324.

²⁰⁸ Klovland, 2004: 103–108; Rygg, 1950: 187, 409, 609.

²⁰⁹ Ahlström, 1989: 93–112.

the only source of funds on a larger scale. The Swedish National Debt Office, Riksgäldskontoret, issued the government's first foreign bond in 1858 in the German financial market, amounting to 7.6 million Prussian Thaler, with a 40-year maturity. France replaced the dominance of the German financial market before the turn of the century; the first bond in France was issued in 1878. Like in Finland and Norway, the Crédit Lyonnais group played a central role as regards the new issues but also Rothschild Frères and Banque de Paris et des Pays Bas, among others, arranged funding for the Swedish state. By 1913 a major part of the state's foreign debt was of French origin.²¹⁰

Sweden's external financial position changed dramatically during World War I. It began to run a trade surplus while the belligerent countries started running deficits. Suddenly, Sweden became a capital exporter vis-à-vis the core Europe. Stabilisation of the balance of payments occurred through a massive change of ownership of pre-war government's foreign securities; Swedish entities bought back the major bulk of the government's foreign loans during the war. The government's reliance on foreign capital declined drastically during the First World War: in 1913 some 90 per cent of state debt was in foreign hands, while ten years later the portion was only 17 per cent. Immediately after the war the government of Sweden tapped the financial market of the United States, but even these securities were bought back prior to the maturity dates.²¹¹

The comparison between the three nations shows that the pattern of borrowing was strikingly similar. Each benefited first from the expansion of Germany's export of capital and towards the end of the century turned to the rapidly growing French capital market. One important difference was that Finland entered the London market at a somewhat later stage than its Scandinavian neighbours. During the 1920s American investors became the main financiers of the Nordic states. However, Sweden's engagement with the American markets was short-lived. Indeed, it turned into a financier of its neighbouring countries during the interwar years.

The issuing syndicates in each country consisted of a large number of banks, which represented several nationalities. The Crédit Lyonnais group dominated the turn of the century. In the preceding decades, the House of Rothschild had arranged several bond issues for the Finnish and Swedish governments, whereas in Norway Hambro had held a

²¹⁰ Riksgäldskontoret årsbok 1921: 41–51; Schön, 1989: 227–253; Sundbom: 228–237.

²¹¹ Franzén, 1989: 272–292; Franzén, 1998: 270–292.

comparable position, in addition to the participation of some Danish banks. The characteristics of the government bonds resembled each other to a great extent. Typical Nordic government bonds were of long maturities, they were denominated in several gold currencies and the borrowing outcomes were used for infrastructure investments. However, Sweden was the only one that issued perpetual bonds, of which the first one was launched in 1887.²¹²

Between the 1860s and 1914 all three governments relatively frequently tapped foreign bond markets, but, in contrast, their borrowing greatly differed before and thereafter. Only the Norwegian government had regularly issued foreign bonds before the mid-century, whereas after the First World War Sweden principally abandoned foreign bond markets. Table 4.5 summarises and compares some features of the Nordic sovereigns' funding practises between 1862 and 1914, a period of pan-Nordic dependence on international bond markets, and characteristics of their debt at the end of that era.

Table 4.5 **Central governments' foreign bond issues in 1862–1914 and outstanding amount of government bonds in 1914**

Country	Year of 1 st issue	Amount, foreign issues	Average issue size (FIM million)	Central government debt in 1914		
				Outstanding (FIM million)	%/GDP 1914	Held abroad
Finland	1862	12	23.2	172	10.9 %	92 %
Norway	1820	19	38.4	499	18.7 %	94 %
Sweden	1858	23	67	969	17.6 %	88 %

Note 1: Table contains from left the year of first foreign issue since the Napoleonic wars, number of foreign bond issues in 1862–1914, the average size of foreign bond issues in 1862–1914, the outstanding amount of all central government bonds in 1914 (for instance, in Finland the central government debt consisted only of foreign bonds in 1914), the share of all central government bonds in relation to GDP and the portion of foreign ownership of all outstanding central government bonds in 1914.

Note 2: FIM million refers to millions of Finnish pre-World War I gold marks.

Sources: Franzén, 1989: 276; Klovland, 2004: 99–120; Grytten, 2004: 274; Obligationslaster og utgifter 1905–1914: 2–15; Parliament documents, reports on state debt; Riksgäldskontoret årsbok 1921: 11; Statistical yearbooks of Finland.

²¹² Klovland, 2004: 102–119; Schön, 1989: 250.

As is evident from table 4.5, the Nordic states were characterized by relatively low debt; the outstanding amount of government bonds remained under 20 per cent in relation to GDP. This would indicate that the credit risk, when examined from the perspective of fiscal sustainability, was quite similar and modest in all three countries. In terms of liquidity, Sweden issued the largest bonds, which might give reason to believe that the Swedish government securities were the most liquid ones among the three Nordic borrowers. In all countries domestic investors were not the ones providing capital for the state; some 90 per cent of the state debt was held abroad prior to the First World War.

4.8 Adherence to gold and financial integration

Maurice Obstfeld and Alan Taylor have sketched ‘a stylized view of capital mobility in modern history’. According to their view the globalization of the world capital markets accelerated from the 1860s until the outbreak of the First World War, but dramatically collapsed thereafter. The temporal bounce back of world financial integration in the 1920s was succeeded by a long-lasting disintegration of the world financial markets during and after the Great Depression. Only by the turn of the millennium had the financial market integration reached the same degree that was experienced almost a hundred years earlier during the classical gold standard.²¹³

They employ two complementary approaches to analyze the validity of their view on the historical development of capital market integration. Firstly, they discuss the size of cross-border investment stocks and flows. Secondly, they assess international price relationships by evaluating covered nominal interest rate parity (= exchange rate risk-free interest parity), real interest-rate convergence and purchasing power parity, that is, international convergence of prices. Their results confirm the stylized view of capital mobility; the hey-day of the financial market integration was reached at the end of the classical gold standard era and a moderate recovery of market integration occurred during the interwar gold exchange standard.²¹⁴

The micro level experience, narrative of the foreign borrowing of the central government of Finland, seems to confirm the views of

²¹³ Obstfeld and Taylor, 2003: 124–127; Obstfeld and Taylor, 2004: 24–29.

²¹⁴ Obstfeld and Taylor, 2004: 43–122.

Obstfeld and Taylor, although utilizing a somewhat different methodology. During the gold standard and gold exchange standard the state's reliance on foreign capital was almost full-blooded. The state had no domestic debt during the hey-days of the classical gold standard, and even by 1928 its portion had once again greatly fallen. The collapse of the gold exchange standard in the early 1930s was a clear watershed; the state turned inwards in its financing operations. The permanent nature of this change was highlighted in the calls to urgently develop the domestic bond markets; foreign financial markets were no longer expected to be able to meet the capital demand of Finland's public sector and Finnish enterprises.²¹⁵

Consequently, the government's investor base became highly international after the turn of the century and to a lesser extent in the 1920s. Finland's early industrialization and world financial integration became deeply interlinked. Finland was able to reap one of the great benefits of the integration of the world financial markets; it attracted foreign capital seeking higher returns, which enabled the state to finance its massive communications network investments.

The deep integration of the pre-World War I bond markets was also reflected in the structure of the issuing syndicates and currency denominations of the sovereign bonds. The issuing syndicates were highly international: they could consist of banks from almost ten different nationalities – typically even both the French and German banks took part in the same issuing syndicates. The profound trust on the continuation of the world financial order was highlighted in the custom of denominating sovereign bonds in a number of gold standard currencies; on the issuer's behalf it posed a huge exposure to the exchange rate risk, realized when the gold standard broke apart. International studies, including Obstfeld's and Taylor's results, claiming that the interwar gold exchange standard did not induce the same level of integration as the classical gold standard, are partially confirmed; the genuinely multinational issuing syndicates and multi-currency denominated bonds did not return during the interwar era.

The Finnish central government, as well as other Nordic sovereign borrowers, adopted the common market procedures; the state co-operated with the most prominent contemporary investment banks, its bonds were listed among core-European sovereign borrowers on the European bourses and the technical characteristics of its bonds for the most part followed the common market standards. As Flandreau, Le

²¹⁵ Ajan Sana, 1932; Helsingin Sanomat, 1931; Karjala, 1931; Tudeer, 1932. Articles are written by newspaper journalists citing, for example, presentations held by Finnish civil servants and academics.

Cacheux and Zumer point out, large and well-organized international financial markets provided borrowers a huge amount of funds they could tap. Public bond issuance took place in co-ordination with banking syndicates that channeled individual savings to borrowers. This meant that national savings in the economic periphery was not limited by domestic capital accumulation, thus giving rise to a disconnection between saving and investment.²¹⁶

Some of the market mechanisms were also highly similar to today's market practices. Issuing syndicates were constructed in a similar way and even many of the banks were the same. *Crédit Lyonnais*, *Deutsche Bank*, *Dresdner Bank*, *Stockholms Enskilda Bank* and *National City Bank of New York* still as of today belong to the Finnish government's primary dealer group, although some names have changed due to the mergers and acquisitions on the way.²¹⁷

The state's relations with some banks were very long-lasting; the German House of the Rothschilds maintained a dominant position in the central government's foreign borrowing for some three decades. However, the Grand Duchy did not continue its co-operation with the Paris Rothschilds in the French bond market, which overtook the German capital market in terms of liquidity at the turn of the century. This differed from the action of the Russian Imperial government; it used the Rothschilds' services also in the French capital market, although *Crédit Lyonnais* arranged many loans as well.²¹⁸ Finland followed a different path partly due to the strong presence of K.A. Wallenberg and *Stockholms Enskilda Bank* in the Northern European financial market; the state was exclusively involved with the financial services of the *Crédit Lyonnais* group. *Crédit Lyonnais* withdrew relatively early from the Nordic bond markets, but the Wallenbergs' engagement in the state's borrowing has continued ever since.

The Finnish government's choice of the national financial markets also closely resembled choices of other Nordic sovereigns. On the other hand, the Grand Duchy followed the Russian Imperial government from the German capital market to France and finally to the financial market in London. This has led Antti Kuusterä to assume that Finland's engagement with the French capital market was affected by the new geopolitical alliances, ie Finland probably had to follow the moves implemented by the Russian Imperial

²¹⁶ Flandreau, Le Cacheux, and Zumer, 1998: 120–121.

²¹⁷ Primary dealers are state's main banking partners in the bond markets. They organise central government's new bond issues and maintain the liquidity of the secondary market bond trading (State Treasury, 2005).

²¹⁸ Feis, 1974: 216; Ferguson, 1999: 381–384.

government.²¹⁹ This connection to the world politics is probably not without grounds, although it may slightly simplify the matter; for example, K.A. Wallenberg acknowledged in 1908 that for the Finnish state ‘the German financial markets as a funding source is self evidently out of the question’.²²⁰ This political interpretation favours the ideas of Herbert Feis. He emphasized the importance of power politics in lending decisions of the European banks. The same interaction between world politics and finance also greatly affected the operations of the European Rothschilds at the turn of the century.²²¹

Marc Flandreau has partly challenged the argumentation that world politics was the overriding factor in allocation of foreign investments. He has underlined that also risk analyses prepared by private financial institutions played a central role in investors’ capital allocation to different sovereign borrowers.²²² On the borrower’s part, the historical evidence from Finnish state archives mainly favours the view based on economic argumentation; at the Grand Duchy’s Imperial Senate it was mainly economic reasoning that dictated the funding sources. This does not mean that the preceding Russian loans would not have had any impact; in any case, Russian access to new national financial markets assured to Finland’s Senate that the Imperial government had no geopolitical obstacles on the Grand Duchy’s borrowing decisions.

Probably both views, economic and political, are correct. The French bond markets exceeded the German markets in placing power and cost-efficiency at the end of the 19th century, which enabled Stockholms Enskilda Bank to take a leading role in the Scandinavian finances. Later the French investors were overwhelmed by the flow of foreign loans, especially from Russia. At this point, the involvement of the French trade policies and the political rivalry between the great powers also reached its peak and, without a doubt, also affected foreigners’ ability to access the French capital markets.

However, although the public authorities in the lender countries were able to deny the access of certain issuers to their bond markets, formally or informally, once the access was allowed, the price was in the hands of the financial markets; pricing of foreign securities is an area where private risk analyses certainly played a role. In other

²¹⁹ Kuusterä, 1989: 312.

²²⁰ SEB archives, brevkopieböcker 1907–1908, letter from K.A. Wallenberg to Clas von Collan, 9.3.1908.

²²¹ Ferguson, 1999: 369–437.

²²² Flandreau, 2003: 17–20, 48–49.

words, it was all the time a mixture of economic reasoning and politics. And after all, the notion of a straightforward Russian changeover, or similar Finnish switch, from the German financial market to France is an exaggeration; the German banks continued to play an important role in the issuing syndicates even after the famous Lombardverbot in 1887; historical studies have sometimes exaggerated the big financial shifts in the pre-war Europe.²²³

It is important to notice the great difference between Finland and Russia. Unlike Finland, Russia was a great European power; its economic stability was of geopolitical interest. A great deal of the French capital was used to strengthen Russia's military capability, ie to support the military interests of France. This brought inevitably the political dimension to the Russian bond issues, as described by Herbert Feis and Count Witte in his memoirs.²²⁴

Public interest regarding Finland was smaller, which meant that the French government also had fewer interests over Finland. News from tiny Finland hardly raised too many eyebrows among the French *rentiers* for the simple reason that there were much fewer owners of Finnish bonds than Russian bonds and those who had bought them, had probably relatively limited exposure to Finnish securities. J.K. Paasikivi wondered in his memoirs about the huge bribes the Russian government had to pay to the French press to guarantee positive publicity for its loans. Similarly, according to Herbert Feis, the Russian government fought French criticism over its extensive borrowing in France by bribing virtually all the press in Paris.²²⁵ For Finland, this was never an issue; small Finnish bond issues could be sold to the public without bribery.²²⁶

During the interwar years, exchange rate movements after the collapses of the fixed exchange rate regimes had considerable repercussions on the Finnish state economy because it suffered throughout the interwar period from exchange rate losses in the form of higher interest payments and redemptions. In other words, the government's and the Bank of Finland's firm trust on the stability of the international financial order had a price. The effects on state budgets remained manageable due to the strict fiscal austerity carried out in Finland; in international comparison, the Finnish central government was still all the time only mildly indebted.

²²³ Ferguson, 1999: 378–380.

²²⁴ Feis, 1974: 33–59; Harcave, 1990: 318–319, 561–572.

²²⁵ Feis, 1974: 218.

²²⁶ Paasikivi, 1957: 28–29.

After all, the state's trust in the continuity of the period of the classical gold standard was not exceptional. John Maynard Keynes wrote in his book *The Economic Consequences of the Peace* immediately after the Versailles Peace Treaty in November 1919:

‘What an extraordinary episode in the economic progress of man that age which came to an end in August 1914...The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend...But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable.’²²⁷

However, even during the hey-day of the classical gold standard, which Keynes elegantly described, all countries were not in a similar position. Some had to pay more for borrowing, while others might have, at least occasionally, been cut off from the capital markets completely, not only due to the lender country's government's political hostility but due to a lack of the investor's appetite for its bonds. Continuity and cost-efficiency of funding also depended on the issuer's credibility in the eyes of international investors and banks.

²²⁷ Keynes, 1920: 9–10.

5 Credit risk associated with the state

The credit risk associated with any bond issuer is generally derived from the price quotations collected from the secondary markets or, less satisfactorily due to randomness of observations, from the prices of its primary market bond issues. The understanding of the importance of this indicator in pricing of bonds has remained intact; it was understood already by the people of the classical gold standard and it is, still today, widely used by academics and market analysts as well. The yield offered on a bond is a result of considerations by a great number of financial market participants, depending on a myriad of factors. Theoretically, the yield offered on a bond traded on bourses can be expressed simply as

Risk-free interest rate + spread against benchmark

Or, equivalently,

Risk-free interest rate + risk premiums

In the financial markets the risk-free interest rate is usually regarded to be the safest security of the bond markets. As of today, faith and credit associated with the securities issued by the United States government, or the German government in case of the euro area financial market, are viewed as the benchmark bonds representing the theoretical risk-free interest rate. During the years of the international gold standards the securities issued by the British government had a very similar status due to the economic and political supremacy of Great Britain.²²⁸

The magnitude of the risk premiums can be measured by comparing two different bonds. Although the standard market practise is to measure the risk premiums against the benchmark bonds, the comparisons can equally well be made between any pair of bonds that qualify for the comparison. The risk premiums may stem from several risk factors, ie perceived creditworthiness of bond issuer, inclusion of options in the terms of the bond, taxability of the interest income of the bond, liquidity of the bond, term to maturity of bond and exchange

²²⁸ Fabozzi 2000: 1–8, 88–117; 197–206; Homer and Sylla 1996: 181–185; 436–455.

rate risk. In order to assess the credit risk other risk factors have to be excluded from the analysis, ie the bonds must be identical in all respects except for quality. Probably the most important aspect to ensure is that the compared bonds are denominated in a same currency; often exchange rate risk is the largest risk factor, in addition to the credit risk.²²⁹

5.1 Construction of time series

I have constructed exchange rate risk time series for the Finnish central government long-term bonds for a period of 75 years, from 1863 to 1938. In the formation of the time-series my aim was twofold: the time-series should correctly represent the development of the long-term Finnish bond yields and, above all, they should be formed in such a manner that allows their comparability with foreign government bond yields.

Because I wanted to evaluate the credit risk associated with the state, I had to collect such bond yields that would reflect vis-à-vis other sovereign bonds only the credit premium, ie other factors affecting the risk premiums had to be eliminated. Fortunately, Finland's government had all the time long-term foreign currency bonds outstanding and they were always exempted from all Finnish taxes. That more or less left three important pitfalls: liquidity aspects, embedded call options and redemption of bonds by drawings versus purchase.

Poor liquidity of a bond might put a downward pressure on its price as investors might be reluctant to buy a security which could not readily be liquidated later. This might not have had the same importance earlier as it has in today's hectic financial markets, but it probably mattered to a degree also during the Gold Standard years.²³⁰ If measured by the outstanding stock of the bonds, the Finnish bonds were never nearly as liquid as, for instance, the benchmark bonds of the core European sovereign issuers, Britain, France or Germany, or as already noted above, the foreign bonds issued by the government of Russia. I have tried to use the price quotations of the Finnish government bond with the largest outstanding amount in order to reduce the liquidity premium versus more liquid government bonds and to avoid adverse price effects of extremely thin markets. By doing

²²⁹ For instance, Fabozzi, 2000: 88–117.

²³⁰ Kindleberger, 1984: 265.

this, I have also aimed to keep the liquidity premium constant over time, so that changes in yield spreads would not stem from changes in liquidity.

Another important aspect is the embedded call options of the Finnish central government bonds. Like most other contemporary borrowers, Finland also included a call option to its bonds. They allowed the issuer to redeem the bonds early at par value, ie well prior to the maturity date. In Finnish bonds, the first possible call date was usually 5 to 12 years after the issue date.

During periods of falling nominal interest rates this posed a major advantage to the issuer as it could redeem old issues with higher coupon rates and issue new ones with more cost-efficient terms. From the viewpoint of forming correct time series this was distressing. The phenomenon prevented the bond prices to rise above the par value, as there was a possibility that issuer calls the bonds at par. To avoid this dilemma, the conventional market practise is to compute the yield to the first call date if the bond trades above the par. The existence of the call option is disregarded if it is quoted at par or lower, as the issuer has no incentive to call the bond. However, as stated by Jan Tore Klovland, the likelihood of the call option being executed depends on the circumstances and has to be evaluated case by case every time. For instance, if the financial markets expect the existing low interest rates to be only a very temporary phenomenon, they tend to assume the issuer will not execute the call option at a later stage.²³¹

In order to avoid the problem caused by the call option, I have used government bonds that were furnished with a coupon rate closest to the secondary market interest rates and, if necessary, picked up bonds that were most recently issued, implying that the call option was not yet executable.²³² Unfortunately, during three periods all the state's foreign bonds traded over the par due to the falling interest rates, that is, during some months in 1880–1881 and 1896–1898 and for a longer period in 1933–1938. All of them were equipped with call options that were executable. However, I have taken into account the call option in yield calculations only in the 1930s. It is not very likely that the financial markets expected the execution of the call option during the two earlier periods. The state had other bonds outstanding

²³¹ Klovland, 2004: 101; Klovland, 1994: 164–174.

²³² The following bonds are used in construction of the exchange rate risk free long-term Finnish central government interest rates: 4.5% of 1862 until 1874, 4.5% of 1874 until 1881, 4.5% of 1881 until 1883, 4% of 1882 until 1886, 4% of 1886 until 1888, 3.5% of 1889 until 1900, 3% of 1898 until 1914, 4.5% of 1909 until 1924 and 6% (converted to 5% in 1934) of 1923 until 1938.

with higher coupon rates than the ones that I have used in this study; a plausible hypothesis is that the financial markets assessed the possibility of an early redemption to be more likely with regard to Finnish government bonds furnished with higher coupon rates.

The third pitfall concerns the effects of the repurchase of bonds by the government for redemption purposes. This option was sometimes embedded into the terms of bonds. If the bond price was below par, and the bond carried this option, the government would have benefited from purchasing bonds from the secondary markets to meet its redemption obligations. This could have caused an upward bias on the bond price, in particular if its liquidity was weak. The government's loan of 1909 was furnished with this option; taking into account the rather thin trading intensity in the early 1920s it might have had an effect, but due to the lack of alternatives this distortion has been accepted in this study.²³³

The data is collected from secondary market price quotations for Finnish central government bonds on different European bourses. As the prices of similar bonds quoted in several markets were quite well arbitrated prior to the First World War,²³⁴ this should not pose a major problem in the perspective of continuity and comparability of the time-series during the pre-war years.²³⁵ The quotations are collected from the following bourses: Helsinki (for the years 1863–1875), Hamburg (1875–1895), Paris (1896–1914) and London (1914–1938). The currencies of denominations of the respective bonds were Prussian Thaler or German mark (1863–1886), several gold standard currencies (1886–1923) and pound sterling (1923–1938). The Paris and London prices were gross prices, ie they included accrued interest.

The rationale for the choices regarding bourses is straightforward. For the years 1863–1895 the collected time series represent the only available source, because all outstanding bonds were denominated in German currencies and traded in German cities. During the years 1896–1914 the Finnish government issuance was concentrated in Paris, which had turned out to be one of the most liquid market places for the continental European bonds.²³⁶ After the outbreak of the First World War in 1914 and the consequent collapse of the gold standard

²³³ Klovland, 2004: 100–101; Klovland, 1994: 174.

²³⁴ Flandreau and Zumer, 2004: 17.

²³⁵ For example, yields on the 3.5 per cent loan of 1889 in 1896, when quotations in Paris began, were 3.46% in Paris and 3.58% in Hamburg. Respectively, in 1909, when quotations in London began, Finnish bonds yielded in Hamburg 4.98% (3.5 per cent loan of 1889), 4.94% in Paris (3 per cent loan of 1898) and 4.88% in London (4.5 per cent loan of 1909).

²³⁶ Kindleberger, 1984: 265–268.

the interest arbitrage between different European stock exchanges did not hold anymore. Consequently, from 1914 onwards the quotations for the Finnish central government bonds are gathered from the London stock exchange. Similarly, all other sovereign bonds which are used in this chapter for the creation of the yield spread series after 1914 were also denominated in pound sterling and payable in London in order to eliminate exchange rate risk premiums.

Yields to maturity have been calculated from the price quotations for the Finnish foreign currency bonds. The calculation of yields has been assumed to be based on the 30/360 days convention. As conventional bond pricing theory states, the yield represents the discounting factor that would make the sum of the present value of all assumed cash flows, ie interest and redemptions, equal to the prevailing market price of the bond. The credit risk associated with the central government of Finland has been calculated by comparing the yields of its bonds to four other sovereign issuers: the United Kingdom, Norway, Sweden and Russia. The sources for the Finnish government bond quotations are the contemporary Finnish and foreign newspapers and economic magazines that published bourse quotations. The foreign yield series are obtained either from the Global Financial Data or from academic studies.²³⁷

The data is based on quarterly observations, meaning that the first observation for the Finnish central government bonds is from 1863 (Q1) and the last price observation from 1938 (Q4). There are no quotations for the Finnish central government bonds during the second half of 1914, as trading in major European stock exchanges almost halted due to the outbreak of World War I. The observations for all other bonds begin at the same time with the Finnish government bonds bar Sweden. For the Swedish bonds the data begins in 1868 (Q2) due to the unavailability of earlier data. The consol yields are available up to 1938 (Q4), but the Swedish yield series end in 1919 (Q2), the Norwegian time series in 1920 (Q4) and the Russian time

²³⁷ Finnish data: Helsingfors Dagblad 1863–1886, Hamburgische Börsen-Halle 1886–1888, Huvudstadsbladet 1889–1894, Le Rentier 1895–1907, Mercator 1908–1914 and The Times 1914–1938. Foreign data: Global Financial Data for Russian and Swedish data, Klovland (2004) for Norwegian data and Klovland (1994) and Global Financial Data for British data.

series in 1928 (Q2).²³⁸ All bonds in the comparison had very long maturities; they were either perpetual bonds or had original maturities in excess of 50 years.

The rationale for using these countries for comparison is fairly straightforward. I have used the yields of the British Consols (British government bonds) for the yield spread evaluation due to their market benchmark status. The other three sovereign issuers incorporated into the analyses were the neighbouring governments of Finland that either were rather similar to Finland (Sweden and Norway) or due to the course of historical events had a strong impact on Finland's economy and politics (Russia).

5.2 Credit risk associated with the central government of Finland

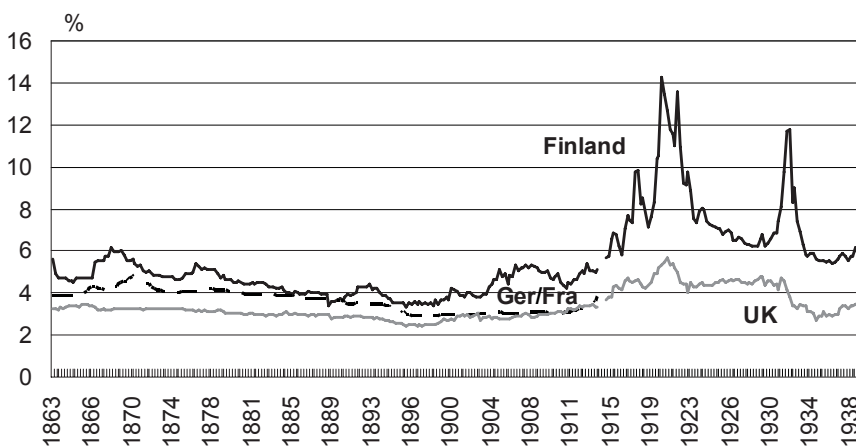
The nominal yields of foreign bonds issued by the central government of Finland declined almost constantly from the 1860s until the turn of the century (graph 5.1). This period was characterised by the long-lasting international deflation. Since the turn of the century Finnish government bond yields rose until a slight bounce back: this was experienced before the outbreak of the First World War. In the interwar time, nominal yields peaked twice to unprecedented levels. The first time this happened in the aftermath of the First World War, the highest yield was recorded in the summer of 1920. For the second time Finnish bond yields skyrocketed in the summer of 1932. In between, during the latter half of the 1920s government bond yields had steadily fallen. After 1932 the computed yields of Finnish government bonds are no longer directly comparable; the Finnish 5% sterling issue of 1923 traded clearly above par and the yield has been

²³⁸ The foreign bonds are listed in the following. The United Kingdom: 3% consol until 1888, 2 3/4% until 1906 and 2 1/2% beginning in 1907. All quotations are from London. Sweden: The 5s from June 1868 through September 1878, the 4s from October 1878 through October 1894, and the 3s from November 1894 through July 1914. No data available from February through October 1915. The 4% bond is used through 1917 and 3.5% is used thereafter until June 1919. All quotations are from London. Russia: Russia 5s of 1822 until 1907 and 5% Tsarist Bond of 1907 thereafter. All quotations are from London. Norway: Long-term government bonds quoted in Hamburg (1863–1895), in Paris (1896–1914) and London (1915–1920), as collected by Klovland (2004). In this respect, they most closely follow the Finnish bonds by being quoted exactly in the same market places with the Finnish government bonds until the last quotation in 1920.

calculated with respect to the first call date in 1943, meaning that they do not stand for long-term bond yields anymore.

The stability of the British long-term yields, representing the benchmark yield, offered a dramatic contrast to Finnish bond yields, as presented in graph 5.1. However, in order to catch possible ‘market specific’ events, the following graph also includes a dotted line presenting a combination of the yields of Prussian/German (1863–1894) and French (1895–1914) government bonds. Because the Finnish quotations are collected from German bourses until 1894 and thereafter from Paris until 1914, it can be interesting to see also the yields of the ‘local benchmarks’.

Graph 5.1 Long-term exchange-rate risk free Finnish yields and consol yields, 1863–1938. Dotted line: yields of Prussian/German (1863–1894) and French (1895–1914) government bond yields



Note: After 1932 Finnish observations represent medium-term yields, which are not directly comparable to British long-term yields. German and French yields are yearly observations. Finnish yields are quarterly and UK yields are monthly observations.

Sources: For methodology and sources see section 5.1. German and French yields are from Homer and Sylla (1996).

The difference between the Finnish bond yields and those of the British consols in graph 5.1 presents the credit risk associated with the central government of Finland. Investors’ faith in Finland’s economy and political stability was highest during a 25-year period from 1879

to 1904. During that phase the credit risk was continuously less than two percentage points (graph 5.2). In the end of the 1880s, and again, ten years later the credit premium shrunk even further. After the turn of the century the credit premium suddenly rose although it still slightly dropped back down before the First World War. The state's creditworthiness seems to have hit rock bottom in 1919–1921 and again in 1931–1932.

Graph 5.2 **Credit risk associated with the central government of Finland, 1863–1932**



Sources: For methodology and sources see section 5.1.

Graph 5.3 provides an alternative angle to evaluate the credit risk associated with the Finnish central government. Instead of the usual measure of absolute difference in bond yields expressed in terms of basis points (one hundredth of a percentage point), it plots the relative yield difference: yield spread is measured in relation to British consol yields.²³⁹ The rationale for this alternative evaluation is that it takes into account consol yields, which were affected, among other things, by price developments.

For example, during the long deflation in the end of the 19th century nominal long-term interest rates declined, which narrowed absolute yield differentials, while the opposite took place during and immediately after the First World War. As graph 5.3 shows, the

²³⁹ More concretely: $(R_{\text{FIN}} - R_{\text{UK}}) / R_{\text{UK}} = R_{\text{FIN}} / R_{\text{UK}} - 1$

relative measure 'increases' the Finnish credit premiums before the Great War and 'diminishes' them in 1919–1922. According to the standard measure yield premiums were roughly nine times higher in 1919–1922 than in the mid-1890, but according to the second approach 'only' three times more. Moreover, according to the relative measure the yield premiums associated with the Finnish central government were record high during the Great Depression, not in 1919–1921, as the conventional evaluation indicated.

Graph 5.3 **Relative credit risk associated to the central government of Finland, 1863–1932**

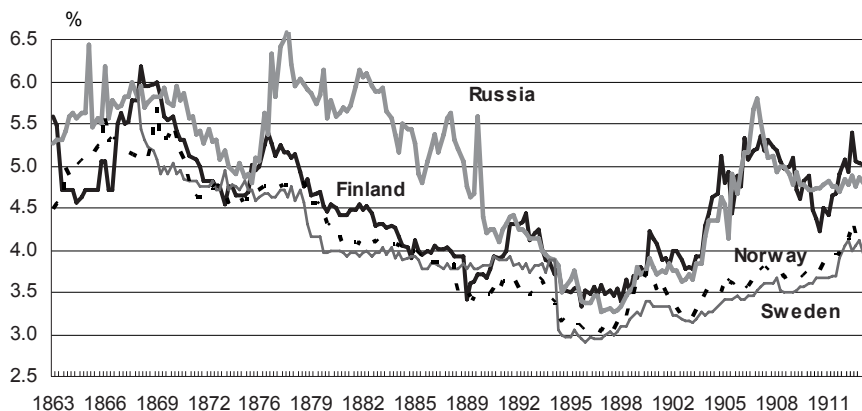


Sources: For methodology and sources see section 5.1.

The First World War clearly divided the timeframe into two distinct periods; the pre-war period was characterised by relatively stable yield spreads, whereas during the interwar years fluctuations in yield differentials were much greater. In order to capture the market developments during the first period more precisely, graph 5.4 plots the bond yields of governments of Finland, Sweden, Norway and Russia only for the years ranging from 1863 to 1914.

Graph 5.4

Bond yields of the central governments of Finland, Sweden, Norway and Russia, 1863–1914



Sources: For methodology and sources see section 5.1.

Graph 5.4 shows that the early 1890s and the turn of the century offered interesting watersheds in the market assessment. Before the 1890s all Nordic bonds showed rather clear correlation with each other, ie they were deemed to carry quite similar credit risk. The yields of the Russian Imperial government securities were clearly higher – in this respect, a clear shift had taken place in 1877–1878, the time of the Balkan war. However, during the 1890s the yields on Russian government bonds sharply fell to similar levels with the Nordic government bonds, maybe due to the reason that its monetary conditions stabilised and Russia's adherence to the gold standard became closer. This outperformance of the Russian securities was reversed after the turn of the century. In particular, during the Russo-Japanese conflict and following Russia's internal political upheaval credit premiums between Russian and Nordic government bonds widened, bar Finland.

Suddenly, the yields of the Finnish government bonds correlated with those of the Imperial government securities. After being regarded by the international capital markets as being similar to the Scandinavian states Sweden and Norway – especially during the 1880s and latter half of the 1890s – in the early 20th century Finland was deemed to be similar to the Russian Imperial government in terms of credibility as a borrower.

To illustrate Finland's performance against other Nordic states further, graph 5.5 shows the Finnish government's credit premium

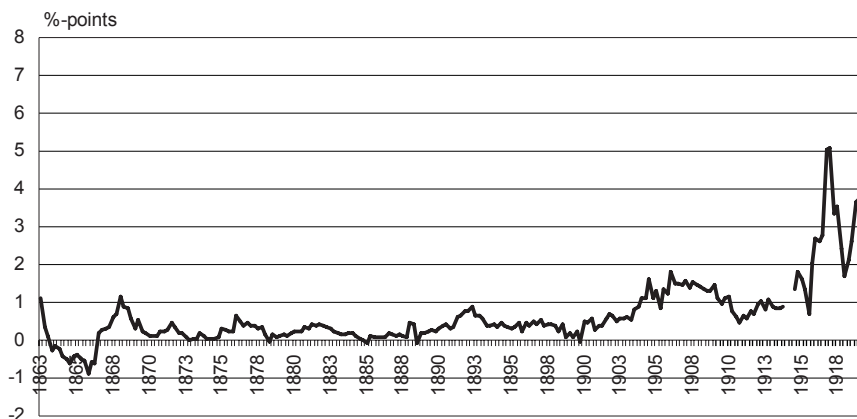
against Norway, but this time until 1920. With respect to Swedish government bonds the development of the credit premium would have been very similar due to the yield correlation between the two countries. Graph 5.5 clearly shows that following the volatile 1860s, marked by eg international financial crises and economic malaise in Finland, the credit premium vis-à-vis Norwegian government bonds remained relatively stable until the beginning of the 20th century – the largest jump in the credit premiums was felt in the early 1890s during the international Baring crisis and Russia’s first efforts to suppress Finland’s autonomy. As already indicated a much greater widening of the yield differentials took place after the turn of the century when political conflict between Russia’s central administration and Finland escalated and the revolutionary movement shook Russia – although even Norway experienced a political crisis as the personal union with Sweden broke apart.²⁴⁰

However, the period between the last quarter of 1917 and end of 1920 constitutes a whole new era. Between September 1917 and December 1917 the credit premium between Finnish and Norwegian government bonds enlarged from 2.78 percentage points to 5 percentage points. This last quarter of 1917, naturally, witnessed the Bolshevik coup in Russia. Although the yield spread fell in the early part of the year 1919, it again widened to over 5 percentage points by the end of 1920.

²⁴⁰ The political events will be discussed in chapter 6.

Graph 5.5

Yield difference between Finnish and Norwegian government bonds (Finland–Norway), 1863–1920



Sources: For methodology and sources see section 5.1.

In fact, despite Finland's independence in 1917, the yields of the Republic's bonds never reached the levels of the other Nordic government's bonds on foreign bourses during the interwar years.²⁴¹ For example, still in the end of 1929 the yield differential between Finnish and Norwegian government bonds on the New York Stock Exchange was almost one percentage point and between Finnish and Swedish bonds 1.5 percentage points. During the autumn of 1931, when the international gold standard collapsed, intra-Nordic yield differentials widened even much further both in New York and London.²⁴²

Interestingly, the correlation between the Finnish government and the Russian Imperial government bond yields ended finally only during the year 1920 (graph 5.6). Still in September 1918 the bonds were quoted almost at par despite of the fact that the Bolshevik government had announced a total default of all Imperial government debts in February 1918. Indeed, interest and redemptions of the Finnish loan of 1909 had not been paid as due in London in July 1918 because the British government had frozen Finnish deposits with banks in England due to Finland's alliance with Germany. This meant

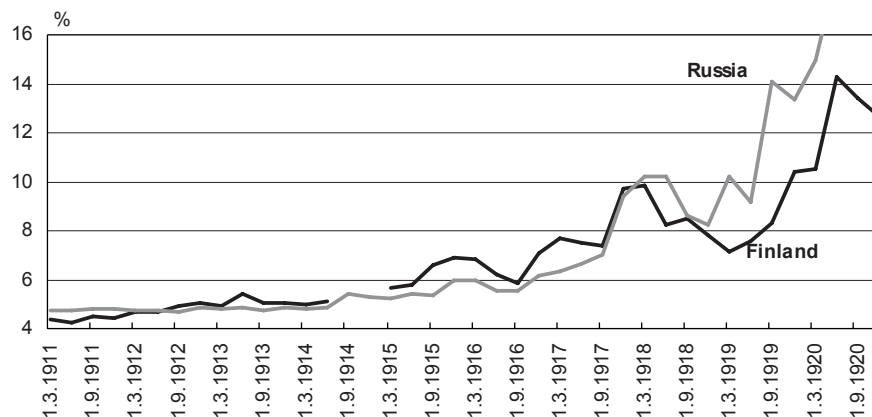
²⁴¹ Due to the lack of Swedish and Norwegian data there are no fully comparable continuous time series after 1920.

²⁴² Source: Gebhard, 1930; The New York Times and The Times, bond quotations in various interwar years.

that both Finnish and Russian government securities were in a state of default in the latter part of 1918.²⁴³

A clear convergence between Finnish and Russian securities in London took place again in the summer of 1919, although Finland had in January 1919 delivered all unpaid interests and redemptions to bondholders. This would imply that the western financial markets still in the summer of 1919 put the faith of the White Russians, who would probably have showed more respect for old Imperial government debts, and the White Finnish government into the same basket, ie the credit risk associated with the government in Helsinki was similar to that of the white armies. This is somewhat surprising because during the summer all main regions of Russia were in the hands of the reds, although three white Russian armies, headed by generals Kolchak, Denikin and Yudenich prepared extensive counter-offensives. In Finland, the white armies had won the civil war against the reds over a year earlier. As a curiosity, also the white government in Helsinki was in the early summer of 1919 headed by a Finnish ex-Russian army General Gustaf Mannerheim, who even planned to support the Russian white armies in their attack on St. Petersburg.²⁴⁴

Graph 5.6 **Long-term Finnish and Russian government foreign bond yields, 1911–1920**



Sources: For methodology and sources see section 5.1.

²⁴³ Moody's Governments and Municipals Ratings Manual, Finland: 1929.

²⁴⁴ Ahti, 1987; Zetterberg, 2004: 361.

In order to complement the previous evaluation on the credit risk associated with the central government of Finland, the following sections will examine the topic from two additional angles; they investigate the portion of short-term debt in the government's debt portfolio and Moody's credit ratings given to the central government of Finland.

5.3 Short-term debt and incomplete market access

The evaluation of the state's dependence on short-term debt can provide some complementary benefits to analyses of yield premiums between bonds. This alternative approach enables us to assess the primary market behaviour by tracking periods when the financial markets have had no appetite for the long-term securities of a certain issuer. Recently, a slightly related topic has received a lot of attention among scholars. Many emerging countries during the 19th and early 20th century faced a problem that is common also today among the developing countries; they had difficulties to borrow domestically long-term and they were unable to borrow abroad in their own currencies. This phenomenon has been referred to in the literature as 'Original Sin'.²⁴⁵

The intention here is not to examine the issue of 'Original Sin' in the Finnish context, but to sort out periods characterised by the inability of the state to access the long-term financial markets abroad, not even through loans denominated in a foreign currency. The 19th century and early 20th century debt managers usually wanted to avoid accumulation of short-term debt, or unfunded debt, as it used to be called in contrast to funded, that is, long-term debt. The short average maturity of debt left the borrower exposed to sizeable refunding risk; lenders could abstain from renewing the short-term loans and instead liquidate their securities. A high portion of short-term debt could therefore be viewed as a signal of inadequate market access of the borrower and, if raised extensively, a source of instability, something the borrowers were eager to avoid.²⁴⁶ The use of short-term loans typically increased during economic distress. The First World War forced governments to issue short-term debt as it became difficult to

²⁴⁵ Bordo, Meissner and Redish, 2003: 2–5.

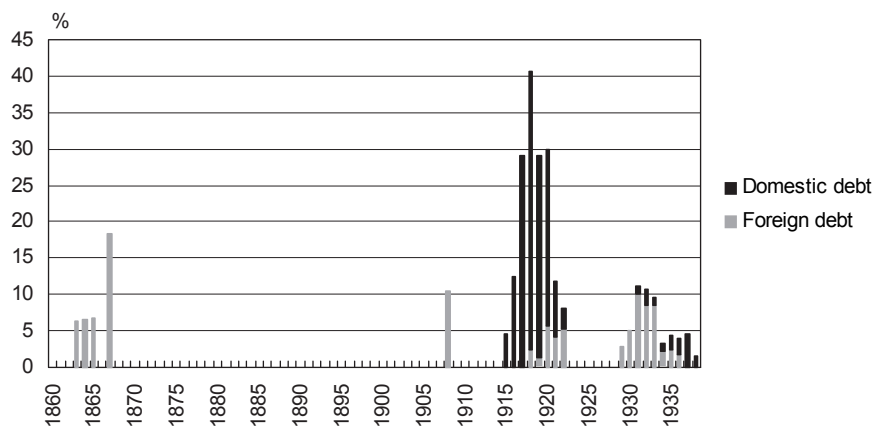
²⁴⁶ Bhatia, 2002: 22; Eichengreen, 1995: 175; Gelos, Sahay and Sandleris, 2003: 6.

persuade their residents to buy war bonds with long maturities.²⁴⁷ Later, the cut-off of the American long-term overseas lending in 1928 partly resulted to its replacement by short-term loans in Europe.²⁴⁸ On both occasions, the increased exposure to short-term funding did not by-pass the central government of Finland, which also was forced to borrow extensively short-term.

Some caution must still be exercised. Short-term debt is not necessarily an indication of the borrower's deteriorated credibility; it can also be a cost-efficient and flexible funding tool for the borrower.²⁴⁹ Therefore, the portion of short-term debt as an indicator of difficulties in market access or such must always be examined in the historical context; is it a result of well-planned borrowing policies or unwanted phenomena stemming from the weak credibility of an issuer.

Graph 5.7 relates the short-term debt of the Finnish central government to its total debt. Following the common practise, the short-term debt is defined to comprise debt with a maximum maturity of one year.

Graph 5.7 Short-term debts in relation to the total central government debt in Finland, 1860–1938



Sources: For sources see appendix 4.

²⁴⁷ Ferguson, 2001: 118–119.

²⁴⁸ Eichengreen, 1985: 222–232; Kindleberger, 1984: 364–371.

²⁴⁹ State Treasury, 2005: 21.

The central government of Finland resorted to issuing short-term debt in four phases: in 1862–1867, 1908, 1915–1922 and from 1929 onwards, ie short-term debt seemed to be raised during periods that were characterised with economic and/or political disorder. Most of the time short-term debt consisted of foreign credits, only during the years of the World War I was a major part of short-term debt domestically issued. Indeed, it was to a great extent raised from the Bank of Finland; this was the only occasion the state was forced to print money with severe inflationary consequences.²⁵⁰

5.4 Moody's sovereign ratings

An additional angle to evaluate the state's credibility is to look at the credit ratings assigned to the state for the reason that they reflect a great number of economic and political factors that have been considered important by one market authority, the sovereign credit rating agency. The expansion of the sovereign ratings took place in the aftermath of World War I concurrently with the appearance of the United States as the leading lending nation in the world. American investors' growing exposure to foreign securities increased their need for information on the solvency of foreign bond issuers. They used the ratings in their decisions to buy, sell or hold securities; ratings offered compact and easily comparable analysis on large number of foreign issuers. Issuers, on the other hand, were ready to pay for the rating services in order to attract American investors to their bonds.²⁵¹ A contemporary American author, Gilbert Harold appraised the importance of the bond ratings:

'Bond ratings have become an institution in the American field of investment. Nearly every commercial bank, investment bank, insurance company, investment trust and investment trustee from the Atlantic to the Pacific, from Canada to Mexico, consults them. Constant users of ratings are found among countless individual investors, traders, and bond brokers. It is, indeed, no exaggeration to say that bond ratings are as much an institution in the investment field as commercial credit ratings in the field of mercantile credit. Bond ratings constitute the most important single phase of bond selection to most of their innumerable followers.'²⁵²

²⁵⁰ Korpisaari, 1926: 24–159.

²⁵¹ Gaillard, 2005: 2–4.

²⁵² Harold, 1938: 3.

However, the number of the credit ratings assigned to European sovereign borrowers fell in the late 1930s due to political instability in Europe and the collapse of international borrowing. In the end, all European sovereign ratings were suspended during the Second World War. Regarding Finland, only Moody's rating agency prepared thorough rating analyses on it during the 1920s and 1930s.²⁵³

Moody's rating agency was founded in 1900. It is still as of today one of the world's three leading sovereign rating agencies along with Standard & Poor's and Fitch Ratings. In March 1918 Moody's released its first sovereign ratings manual, becoming the first company to offer systematic analyses of sovereigns' creditworthiness. The first rating manual in 1918 contained 89 foreign government bonds. The Republic of Finland was rated by the Moody's for first time in 1920. The last rating to the Finnish central government was assigned in 1933, prior to the 1970s.²⁵⁴

Moody's foreign government bond rating scale consisted of nine categories during the interwar period: Aaa, Aa, A, Baa, Ba, B, Caa, Ca, C. The ratings were granted for each bond separately, ie the same bond issuer could receive many ratings. The ratings were published annually and each publication included an explanation of the rating hierarchy. Table 5.1 presents some highlights of each category as they were defined since 1921.

²⁵³ Bhatia, 2002: 3–5; Gaillard, 2005: 5–6.

²⁵⁴ Bhatia, 2002: 3–6; Moody's Governments and Municipals Ratings Manual, Finland: 1921–1933.

Table 5.1

Moody's rating hierarchy from 1921

Aaa	'intrinsic strength and security', 'assurance of the prompt payment of principal and interest'
Aa	'strong investment and generally fundamentally secure', 'subject to some qualification in security or stability'
A	'well established but have not yet acquired the full development necessary for higher ratings'
Baa	'bonds of this rating require close discrimination', 'liable to become largely speculative'
Ba	'a security of this type is purchased for its speculative possibilities rather than its investment quality'
B	'Imminent danger of defaulting'
Caa	'obligations of dangerous weakened communities'
Ca	'little or no hope of any substantial improvement short of partial repudiation'
C	'practically worthless'

Source: Gaillard, 2005: 6–7.

For example, in 1925 Moody's had assigned the central government of Finland three separate credit ratings, depending on the bond (Table 5.2). The sterling issue of 1909 and every interwar foreign bond – all of which had been issued either in London or New York – were rated as 'A', belonging safely to the investment grade. Their ratings differed from the securities which had been issued in the mainland Europe during the time of autonomy, either in Germany or France. They belonged to categories defined as 'speculative possibilities rather than investment quality'. One of the franc securities, the one launched in 1895, was even assessed to be under 'imminent danger of default'.

Table 5.2

Credit ratings of the Finnish government foreign bonds in 1925

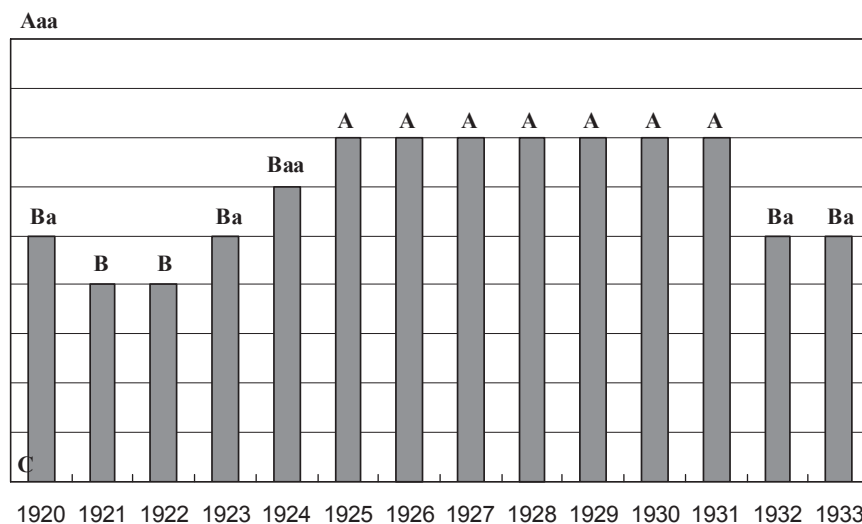
Bond	1889 3.5%, 1898 3%, 1901/03 3.5%	1895 3.5% franc issue	1909 4.5% sterling bond	Bonds issued since 1923
Rating	Ba	B	A	A

Source: Moody's Government and Municipals Ratings Manual, Finland: 1925.

Moody's ratings, assigned to the bonds issued by the Finnish central government, showed important variation. The rating development of each bond was somewhat different, but the general pattern is quite clear. The ratings hit rock bottom in 1921–1922 whereas the highest

credit ratings were assigned between 1925 and 1931. In 1932 Moody's downgraded the government's bonds by two notches back to roughly the same levels which it had assigned ten years earlier. As an example, graph 5.8 plots the rating history of the state's sterling bond of 1909. Its ratings were upgraded by three notches in 1923–1925; still in 1922 it had been close to default according to Moody's. In 1932 Moody's downgraded it by two notches back to speculative grade.

Graph 5.8 **Moody's credit rating for 4.5% sterling bond of 1909**



Sources: Moody's Governments and Municipals Ratings Manual, Finland: 1920–1933.

As regards Moody's credit ratings, in international comparison Finland did not belong to the same group of countries with other Nordic countries. All other Nordic states had been assigned the highest 'Aaa' rating, but Finland was rated two notches below them. Finland had a higher rating than the government of Estonia, but lower than France. For example, Moody's had assigned similar 'A' credit ratings to Hungary and several Latin American countries. Some of the credit ratings assigned by Moody's in 1931 to government securities, all of which had been issued during the 1920s, are listed in the following.²⁵⁵

²⁵⁵ Moody's Governments and Municipals Ratings Manual, Finland: 1931; Gaillard, 2005: 32–33.

Britain	Aaa
Norway	Aaa
Sweden	Aaa
France	Aa
Finland	A
Estonia	Ba

In the same way as in the mid-1920s, Moody's still in the 1930s had a preference for securities issued in the Anglo-Saxon markets. All franc bonds dating back to the time of autonomy had been assigned lower credit ratings than the ones launched either in London or New York.²⁵⁶ Unfortunately, Moody's does not explicitly explain the rating rationale for each Finnish government bond separately. The differences might have reflected the currency denominations of the securities. The state serviced its foreign liabilities somewhat asymmetrically during the financial turmoil characterising the post-First World War years, depending on their currency of denomination, as will later be discussed.

5.5 Great variation of creditworthiness

The three alternative approaches, the secondary market performance, the primary market's assessment, ie ability to tap long-term capital markets, and the rating agency's analyses, to assess the credibility associated with the central government of Finland, provide similar results. A high portion of short-term debt coincides with rising yield differentials. Moreover, during the interwar period, the evolution of Moody's credit ratings assigned to the state quite closely bears a resemblance to the two other approaches that were applied to evaluate the development of the state's credibility on foreign bourses.

The three last decades of the 19th century present the hey-day of the central government of Finland on the international financial centres. The yield differentials with respect to its peer group, ie other Nordic sovereign borrowers, remained almost constantly low and the state had no exposure to short-term debt. This contrasts with the periods before and thereafter during the time of autonomy. In the 1860s credit premiums rose and the state depended heavily on short-term money. At the turn of the century the favourable phase was over.

²⁵⁶ Moody's Governments and Municipals Ratings Manual, Finland: 1931.

Suddenly, the Finnish government bond yields showed an increasing correlation with those of the Russian Imperial government. The underperformance of the Russian government bonds in the early 20th century meant that Finland's credit premiums against other Scandinavian states considerably widened. Quite remarkably, Finland was left out of the great world capital market integration that took place during the first years of the 20th century, in the form of remarkable yield convergence in the bond markets.

Somewhat surprisingly, the correlation of the Finnish government foreign bonds with the Russian Imperial government securities ended permanently only in the second half of the year 1919. This meant – due to the amplified credit risk associated with the Russian government bonds – that during the immediate post-war years the yield differentials against western European sovereign bonds stood, so far, at their all time highs. In fact, the Finnish bonds on the London Stock Exchange bounced back only in 1922. Great widening of yield differentials was accompanied by heavy reliance on short-term debt: the state's exposure to short-term funding grew from nothing in 1915 to over 40 per cent in 1918 in relation to total central government debt. Only by 1923 was the state financially strong enough to redeem its short-term loans.

Towards the mid-1920 all applied credibility indicators showed positive development. The credit premium against consols fell on the London Stock Exchange and Moody's credit agency upgraded Finnish government securities. The state had no exposure to short-term debt in 1923–1928. However, this phase did not last for long. Already in 1929 the central government borrowed short-term. The yield differentials against British consols, and versus many other sovereign bonds, greatly widened on foreign bourses and somewhat later, in 1932 Moody's downgraded Finnish state securities: the new ratings were similar to the ones that had been assigned to the central government during the financial turbulence that characterised the early 1920s. Interestingly, credit indicators in the late 1920s and early 1930s clearly pointed out that Finland in the eyes of the international financial markets was still far behind its Scandinavian neighbours. The next chapter will turn to one of the innermost questions of this study: what were the determinants of these developments?

6 Determination of credit risk

In order to trace the factors that affected the credit premium associated with the central government of Finland, I have divided the timeframe of this study into six sub-periods: 1862–1878, 1879–1903, 1904–1914, 1914–1922, 1923–1928 and 1929–1938. The timeframes for each sub-period are based on the evaluations presented in the previous chapter. Each phase had some distinct features when evaluated from the perspective of the government's credibility in the international financial markets; the end years of each sub-period principally denote a turning point in credit premiums and/or end or beginning of the state's dependence on short-term capital.

Naturally, to divide the timeframe into shorter periods by some precise years is somewhat arbitrary. History is continuous; the government's credibility was not altered over one night. However, I feel that using this sort of categorisation enables us to bring some clarity to the examination and draw attention to the development of the state's creditworthiness, to evaluate both the differences between different phases and also discover determinants common to all periods.

Credit premiums between different phases showed relatively large variation. They ranged from an average of over 4 percentage points (400 basis points) in 1914–1922 to slightly over one percentage point in 1879–1903. At its high point almost one third of the state debt was short-term, while during two periods, in the late 19th century and during the mid-1920s, the state was not exposed to short-term debt at all. Table 6.1 shows the central government's average credit premium against the market benchmark, that is, the British consols for each period. In addition, it presents the amount of short-term debt in relation to the total central government debt.

Table 6.1

Credit risk indicators associated with the state during six periods

	1862– 1878	1879– 1903	1904– 1914	1914– 1922	1923– 1928	1929– 1938
Average yield spread	1.9% – points	1.1% – points	1.8% – points	4.1% – points	2.4% – points	3.3% – points (up to 1932)
Portion of short-term debt	5–18% (during 1862–1868)	None	11% (during 1908–1909)	5–30% (during 1915–1922)	None	3–11% (during 1929–1938)

Note: 1 percentage point = 100 basis points.

Source: See previous chapter 5.

The following sections will study the reasons for the developments of the credit risk indicators. The starting point in the evaluation is the beliefs and actions of the contemporary market participants. Relying on the communication between the state and banks during loan negotiations, investment bank analyses and reports of contemporary Finnish authorities responsible for state's borrowing, the following will contain an interpretation of the market behaviour. In addition, an econometric analysis of the determination of the credit risk will supplement the evaluation.

6.1 An unknown issuer (1862–1878)

The government's entry to the international capital markets along the 1860s coincided with profound changes in the Finnish society. The reform programme of 1856 was followed by several economic and political reforms, enhancing Finland's autonomous status in the Russian Empire and bolstering economic development. The Diet assembled regularly since 1863. Its position was ratified in the new Parliament Act of 1869, which, in fact, remained the only part of the political reforms proposed by the earlier reform committee. The Finnish mark was created in 1860 and pegged to silver in 1865, separating Finland's monetary system from that of Russia's.

The monetary reforms were accompanied by economic malaise. In order to implement the monetary reform of 1865 the government had to carry out severe deflation. The silver value of the mark had been decided in St. Petersburg earlier, prior to a period of rapid inflation.

The Head of the Office of Financial Matters, Senator J.V. Snellman was reluctant to reopen the negotiations; new discussions with Russian authorities over the mark's value could have hampered the monetary reform as a whole. Furthermore, during the 1860s Finland was also ravaged by bad harvests casting a shadow over Snellman's term in the Senate. Economic activity slowed down – Finland's national production declined by 3.4 per cent from 1861 to 1867 – and government finances met great difficulties. It turned out that proceeds from the loans issues had to be used for unintended (and unproductive) purposes that did not later increase state revenues and provide the means for amortisation and interest payments of the loans – something the contemporary financial markets did not assess in a positive light.²⁵⁷

The Senate issued during the 1860s two bonds outside the Russian Empire, in 1862 and 1868, constituting the beginning of its engagement with the western capital markets. The loans were directed abroad as the government aimed to increase the silver reserves of the Bank of Finland and implement the changeover to the silver standard. Moreover, through the latter foreign bond the Senate wanted to complete the construction of the St. Petersburg railway line. Under the unfavourable economic circumstances, neither of the objects was fully met. A great part of the proceeds had to be used to relieve the effects of the crop failures as the government had to increase the imports of flour and grain and pay back temporary loans it had been forced to raise constantly during the 1860s.

Indeed, due to the adverse economic conditions in the middle of the 1860s the government negotiated several short-term loans to meet its acute financial requirements, in addition to the two foreign bond issues that were executed during the decade. In 1862–1863 the Senate raised short-term 'emergency loans' from St. Petersburg. Again, in 1866 two short-term loans amounting to 1.5 and 1.85 million Finnish marks were raised, this time from the Finnish Mortgage Society and from M.A. von Rothschild und Söhne in Frankfurt. In addition, the Senate launched two domestic railway bonds – they were clearly smaller than the foreign ones and of much shorter maturity – in order to complete railway constructions as the proceeds of the foreign loans were used for other purposes.²⁵⁸

The severest crop failure of the decade in Finland took place in 1867; the country desperately required, again, a new foreign credit as

²⁵⁷ Hjerpe, 1989: 192; Jussila, Hentilä, and Nevakivi, 1999: 48–55; Kuusterä, 1997: 288–291.

²⁵⁸ Nevanlinna, 1907: 63–187.

the condition of the state finances was under enormous distress. J.V. Snellman wrote to general Alftan, governor of the northern province of Oulu, in early autumn 1867: ‘The state has no money to give, neither as a gift nor as a loan... Every penny which from now on is used for emergency help must be borrowed.’²⁵⁹ Loan negotiations turned out to be extremely intense. Indeed, the course of the discussions highlights the difficult situation that faced the Grand Duchy’s Senate in its attempts to acquire money under auspicious conditions.

In September 1867 J.V. Snellman contacted Mayer Carl von Rothschild and asked for a new emergency loan from the bank’s own balance sheet to acquire flour and grain. Snellman underlined the severity of the situation in his letter by writing that ‘we have to make a choice now, either to leave the population to die in hunger or to acquire money at any price’ and continued that the loan had nothing to do with the state budget; it was exclusively dedicated ‘to save the inhabitants of this country’.²⁶⁰ Baron von Rothschild was amenable to arrange a new loan according to the normal procedure, ie to place the loan in the financial market for investor subscription, claiming that ‘Snellman had gone haywire due to the distress’, when he requested such an unusual arrangement. Snellman answered to the baron that the Finnish people would have died in hunger before the loan was placed according to standard market procedures.²⁶¹

Finally, later in autumn Mayer Carl von Rothschild responded to Snellman’s desperate cries and lent Finland 5.4 million Finnish marks for one year. Although less than originally demanded the loan presented a considerable amount, the annual state income in the 1860s (excluding state borrowing and cash transactions) was in the range of 15–20 million Finnish marks.²⁶² The final transaction was negotiated in Germany by Reinhold Frenckell, member of the board of directors of the Bank of Finland. Frenckell later described the loan negotiations ‘that he does not have such an arch enemy that he would hope him to go through the same as he had during the eight days in Berlin’.²⁶³ Mayer Carl von Rothschild seemed to have appreciated the commitment that Reinhold Frenckell showed in the negotiations. von Rothschild wrote to Snellman that without Frenckell’s devotion and

²⁵⁹ Nevanlinna, 1907: 156.

²⁶⁰ J.V. Snellman samlade arbeten XI2, 1998: 1309–1310, letter from J.V. Snellman to Mayer Carl von Rothschild, September 1867, draft; Nevanlinna, 1907: 157–158.

²⁶¹ Nevanlinna, 1907: 157–158.

²⁶² Pihkala, 1977: 23; Nevanlinna, 1907: 116.

²⁶³ Pipping, 1967: 55.

patriotism the loan would not have been rendered possible and proposed him a high Russian decoration.²⁶⁴ Due to von Rothschild's involvement Frenckell actually was decorated slightly later.²⁶⁵

Placement of the 1867 loan through the normal procedure would probably have been sluggish and painful, as anticipated by Snellman. In the following year, the Senate wanted to acquire a loan to finance the construction of the Riihimäki-St. Petersburg railway line. Issuance of the new railway loan proved to be difficult, as Deputy Minister State Secretary Emil Stjernvall-Walleen had already anticipated in late 1867. He wrote to Snellman that if 'the Frankfurter Jew' rejects Finland's loan proposal, the Senate should turn to the financial market in England. However, according to Stjernvall-Walleen, Russian credit was not appreciated in England for the time being and, continued that, unfortunately, 'our credit will be compared to that of Russia's and we have to pay a similarly high price'. Stjernvall-Walleen proposed to search for a well-known and credible intermediary who could explain to Englishmen Finland's distinct financial administration – differentiating Finland from Russia – and maybe even guarantee the new issue. He suggested that possibly the Hackman Merchant House from Eastern Finland's commercial centre Viipuri could fulfil such a role.²⁶⁶

Following a fierce competition between banks, Erlanger & Söhne organised the loan, but underwrote only 3/5 of the total loan amount of 17.3 million Finnish marks. In the end, the resulting 2/5 could not be placed to the markets because there was not sufficient investor demand. Instead, the residual was restructured into a lottery bond with weaker terms for the state. In particular, it was not possible for the Senate to redeem it prior to the maturity date. This proved to be a serious set-back for the central government because it could not utilise the declining interest-rates in the following decades in accordance with the lottery bond. The Senate carried out early calls of all other foreign bonds, which it had issued during the 1860s and 1870s, and financed the buy-backs by issuance of new bonds at lower costs. As an exception, the lottery bond remained part of the outstanding central government debt until the original maturity date in 1911: the state had

²⁶⁴ J.V. Snellman samlade arbeten XI, 1998: 1339, letter from Mayer Carl von Rothschild to J.V. Snellman, 14.10.1867.

²⁶⁵ J.V. Snellman samlade arbeten XI, 1998: 1363, letter from J.V. Snellman to Mayer Carl von Rothschild, October 1867, draft.

²⁶⁶ J.V. Snellman samlade arbeten XI, 1998: 1387, letter from Emil Stjernvall-Walleen to J.V. Snellman, 10.12.1867.

to pay the 6% coupon until the very end.²⁶⁷ Part of the failure to place the bond adequately could possibly be traced to the state's rush in the negotiations; Governor-General Adlerberg hastened the procedure due to the strategic importance of the railway construction connecting the Grand Duchy to the Imperial capital. However, there was also serious mistrust of Finland. For example, the German newspapers had described the earlier economic emergency situation in Finland, frightening investor away.²⁶⁸

Comparison of the primary market prices between Finland and Sweden and Norway confirm the difficulties the Grand Duchy faced in the end of the 1860s. The first foreign bond was still issued close to the levels achieved by the Swedish and Norwegian governments: The Finnish 4.5% of 1862 yielded 5.3 per cent, whereas the Swedish 4.5% of 1861 gave a yield of 5.2 per cent and the Norwegian 4.5% of 1863 5.0 per cent. In comparison, the Finnish one-year loan in 1867 yielded 8.4 per cent and 6% long-term bond of 1868 gave a yield of 6.5 per cent, whereas Swedish bond issues in 1867–1868 yielded under 6 per cent.²⁶⁹

The next foreign bond issue since the somewhat failed 1868 issue was executed in 1874 to acquire funding for the Hämeenlinna – Tampere and Toijala – Turku railway lines, ie to extend the railway network to the remaining two major Finnish towns not yet reachable by train. M.A. Rothschild und Söhne announced to have easily placed the issue in Germany; the baron himself telegraphed it to be a stunning success with considerable oversubscription. However, part of the issue was later returned to Finland for domestic placement, indicating that Mayer Carl von Rothschild had probably somewhat exaggerated the success of his bank's return to the execution of foreign borrowing on behalf of the Grand Duchy's Senate.²⁷⁰

On top of Finland's internal difficulties, international monetary conditions were not favourable. The Polish uprising of 1863 and, especially, the wars of German unification were shattering the financial markets of Northern Europe; real yields of Prussian state bonds rose by one fifth in the end of the 1860s.²⁷¹ In this respect, Finland also had some good luck with the timing of the first foreign

²⁶⁷ Paasikivi, 1911.

²⁶⁸ Nevanlinna, 1907: 162–164; 171–172; Pipping, 1967: 57–63.

²⁶⁹ Klovland, 2004: 106; Riksgäldskontoret årsbok 1921: table 3. Probably both Swedish and Norwegian yields include commissions, which means that the comparable primary market yields would be somewhat lower.

²⁷⁰ Mechelin, 1895: 67; Parliament documents, Book II, letter by the estates to the Emperor, 5.6.1882; Pipping, 1967: 64–65.

²⁷¹ Homer and Sylla, 1996: 260.

bond issue because the Polish revolt against Russian rule begun in January 1863, that is, immediately after the Finnish transaction. It distressed the western European financial markets, not least due to the possible participation of Napoleon III's France in the Polish conflict.²⁷²

This financial distress, mainly stemming from the Polish revolt, finally prevented Russia's own monetary reform. In September 1863 the Rothschilds, for the reason that international monetary conditions had deteriorated, refused to underwrite a second loan to the Imperial Government to strengthen its metallic reserves. Prices of Russian government bonds on the Paris bourse dropped sharply. By November 1863 Russian hopes of successful implementation of its monetary reform were buried.²⁷³ Given Finland's own difficulties in the loan negotiations, it probably hanged by a thread that Finland did not share Russia's fate; inability to tap the international bond markets postponed or even prevented monetary reform.

After the end of the Franco-Prussian war and the creation of the German Empire the international financial conditions rapidly improved. The end of international financial distress and Finland's enhanced economic situation probably already affected its 4.5% bond issue in 1874, of which the market yield was 4.9 per cent. It was priced relatively close to the levels achieved by the governments of Sweden and Norway: Sweden's 4.5% issue of 1875 yielded 4.76 per cent whereas Norway's similar issue had given a yield of 4.79 per cent a year earlier.²⁷⁴ The relative successful Finnish government issue turned out to be a prelude for the next decades.

6.2 Heydays of foreign borrowing (1879–1903)

The final part of the 19th century witnessed relatively solid economic development in Finland; the economy expanded albeit recessions were felt in 1877–1881 and 1891–1892, government finances were balanced and inflation remained subdued, sliding even into deflation.²⁷⁵ Extensive railway construction integrated different regions of the Grand Duchy into one entity, Finland's industrialisation

²⁷² Ferguson, 1999: 126–128.

²⁷³ Hayward, 1973: 169–174.

²⁷⁴ Klovland, 2004: 106; Riksgäldskontoret årsbok 1921: table 3. Probably both Swedish and Norwegian yields include kommissions, which means that the comparable figures would be somewhat lower.

²⁷⁵ Hjerpe, 1989: 192, 277; Nevanlinna, 1907: 209–243.

gathered momentum, agricultural production became increasingly commercialised and foreign trade grew. There was an increasing separation between the Grand Duchy and the Empire. The regularly assembling Finnish Diet actively enacted new legislation for Finland and, in practise, steered Finland in its own distinct direction. Finland's monetary independency was further enhanced by the adaptation of the gold standard in 1878. Russia was to follow suit only in 1897.²⁷⁶

Internationally, the amount of cross-border lending grew vigorously in the decades from 1870s to the outbreak of the First World War. There were no military conflicts in Western Europe after the wars of German unification. In the 1870s the French indemnities fed the German capital markets, also enabling Germany to go over to the Gold Standard. Soon the Scandinavian states followed suit. The nominal interest rates declined steadily until 1897; the long international deflation continued from the 1870s to the middle of the 1890s. During the years 1894–1897 long-term British nominal interest rates reached their lowest point ever. The decreasing bond yields in the core Europe were one reason for the rising investor appetite for the other securities, not issued by the core governments.²⁷⁷

The world financial markets had in their reach an ever growing amount of information, and at a much faster pace. This held also with respect to Finland. The Diet assemblies and newly founded newspapers increased discussion and information on the Finnish politics and economy. The telegraph had been adopted in Finland already in 1855; the first telegraph message from St. Petersburg to Viipuri was expected to contain peace news from the Crimean war, but, instead, it contained bourse quotations from the St. Petersburg stock exchange.²⁷⁸

The Grand Duchy's temporal Statistical Office had been founded in 1865; five years later it was granted a permanent status. It published several multi-lingual publications on Finland; most important of them was the annual Finnish statistical yearbook founded in 1879, containing French translations. Finnish statistical authorities also participated in international statistical meetings; the first time this took place in the statistical congress in Florence in 1867. The gatherings offered a chance to present information on Finland to an international audience and participate in international publications.²⁷⁹ In 1886

²⁷⁶ For example, Jussila, Hentilä, and Nevakivi, 1999: 48–60; Kaukiainen, 2006: 138–148; Krantz, 2001: 44–48; Ojala and Nummela, 2006: 73.

²⁷⁷ Homer and Sylla, 1997: 183–184; Kindleberger, 1984: 239–250.

²⁷⁸ Kallioinen, 2002: 61–62.

²⁷⁹ Luther, 1993: 69–78, 133–138.

senator Leo Mechelin published a book in French on the administration of Finland, 'Précis du droit public de la Grand-duché de Finlande', presenting the idea of a separate Finnish state. Due to his wide international network he was able to disseminate his political views to a relatively large audience.²⁸⁰

Between 1879 and the turn of the century the Finnish state issued altogether six international bonds, each issue giving a lower yield than the previous one. The latest issue of the century in 1898 yielded a mere 3.2%. It was in line with Norway's issue of 1896 with a similar maturity and even slightly less than Sweden's bond issues from the same time.²⁸¹

Moreover, the state took advantage of the declining nominal interest rates by actively converting older high-coupon bonds to new ones with market-level coupon rates. In March 1886 the Grand Duchy's Senate described the international market situation in its proposal to the Emperor to exchange older securities for new ones – the proposal provides an illuminating insight into the market situation from the Finnish perspective. According to the Senate, at the time the government bonds listed on the foreign bourses were under such strong demand that this had also affected their superior price performance. However, the Senate saw it necessary to warn – maybe to contribute to the proposal's acceptance in high Russian circles – that political upheavals, threat of possible excess supply of corporate bonds or Finland's internal economic difficulties, such as crop failures, might rapidly alter the encouraging market situation.²⁸²

Due to the favourable developments the loan negotiations no longer entailed the same sort of excitement and complications as in the 1860s, as is evident from the letters of Mayer Carl von Rothschild. Although one should approach them with some care – they also reflect the banker's desire to emphasise his skills and devotion to acquire new businesses – their tone still probably also mirrors changes in market sentiment. For example, after the 1882 bond issue Mayer Carl von Rothschild was able to congratulate the Bank of Finland for the 'great victory' that was achieved. According to him, the coupon rate of the new government bond was historically low and its price had exceeded all expectations. The total amount of subscriptions had been

²⁸⁰ Jussila, 2004: 541–550; Klinge, 1997: 300–322.

²⁸¹ Klovland, 2004: 107; Riksgäldskontoret årsbok 1921: table 3. Probably both Swedish and Norwegian yields include commissions, which means that the comparable figures would be somewhat lower.

²⁸² National archives, State Secretary Office archives, act no: 41, 41/18, proposal of the Imperial Senate to the Emperor 3.3.1886.

large and consisted of many small tickets. This was proof of the great investor demand on the Finnish securities, ‘the Finnish state of affairs had greatly attracted wider audiences’ (‘Dass die Sache in breiten Publicum grossen Anklang gefunden hat’), as he wrote in 1883.²⁸³ Prior to the loan of 1886 Baron von Rothschild was already able to expect great public interest in Finnish ‘state credit’ although he warned that there will always be also some ‘professional critics’ underlining any negative aspects, of which he mentioned the Russian government efforts to introduce stamp duty on their bonds.²⁸⁴

Later, an important step was also the arrival of *Crédit Lyonnais* in the 1890s as the main banking partner for the state; *Crédit Lyonnais* represented a new type of commercial banking with more transparent business operations compared to the House of Rothschild. As Marc Flandreau notes, the new type of banks brought along with them more formal and precise credit analyses replacing the traditions of the *Haute banque*, where bankers kept the customer’s account in the back of their minds. The research department of *Crédit Lyonnais*, *Service des Etudes Financières* (SEF), was founded in 1871. It constantly expanded the coverage of its research until the outbreak of the First World War, preparing profound reports on a large number of borrowers. Its public debt unit was set up in the late 1890s. The bank never disclosed more than some specific parts of its surveillance to the public, but even the awareness of the *Lyonnais*’ superb expertise and knowledge fostered its position as a market mood setter in Paris.²⁸⁵

Crédit Lyonnais began its surveillance on Finland in 1892 in conjunction with the negotiations over a short-term loan with the Bank of Finland, initially organised by the Stockholms *Enskilda Bank*.²⁸⁶ In the coming decades the *Crédit Lyonnais* analysis department produced several analyses on the economic and political situation in Finland, spreading the knowledge on Finland to its own personnel and customers. The reports were typically prepared with greatest accuracy; they contained lots of detailed information on the Finnish economy and state finances in particular. The reports touched upon the Grand Duchy’s politics as well. The political analyses were strikingly

²⁸³ Bank of Finland archives, the archives of the Board, letter from M.A. von Rothschild und Söhne 20.2.1883.

²⁸⁴ Bank of Finland archives, the archives of the Board, letter from M.A. von Rothschild und Söhne 11.4.1886.

²⁸⁵ Flandreau, 2003: 20–35.

²⁸⁶ *Crédit Lyonnais* archives, DAF 00145, BE 1728 ‘Bilans au 31 Décembre de chaque année 1887–1891 et le système monétaire’, 1892 ; DAF 00255-1, BE 1729 ‘Les Finances Finlandaises’, 1895.

profound, presenting both the history and current stance of Finland's unique administration in the Russian Empire.

The first more thorough analysis on Finland was prepared in 1895, containing two main sections, one about the political situation and another one on the economy. The report contained information on the state budget, state funds, agriculture, industries, transportation, postal system, monetary system, financial markets and finances of the municipalities. The main emphasis was put on the state's financial situation. Both state expenditure and revenues were studied thoroughly by components, as well as the value of state property. The amount of state debt and its annual service costs were evaluated. The composition of state debt was monitored extremely prudently, including a detailed amortisation schedule.²⁸⁷

A similar analysis was prepared three years later, in 1898. The tone of both analyses was extremely positive. The bank noted that the state revenues exceeded six times its debt service expenditure and furthermore, even the revenues from the state railways solely exceeded the debt service costs. As a conclusion, *Crédit Lyonnais* stated that the state finances were managed with great wisdom and foresight ('Depuis de longues années, la gestion financière du Grand-Duché de Finlande a fait preuve de sagesse et de prévoyance').

Finland's political situation was seen in a positive light, even exaggerating its autonomous position. In the 1895 report Finland was claimed to form its absolutely distinct political entity ('sa constitution politique est absolument distincte de celle de la Russie'). According to *Crédit Lyonnais*, Finland had formed a personal union with Russia since 1809. The governance was based on a constitutional monarchy ('Le gouvernement, dont la forme est celle d'une monarchie constitutionnelle'). In its reports, the bank also noted that Finland has close contacts with Russia and it has succeeded to defend its independence, especially its monetary autonomy.²⁸⁸

In 1898 *Crédit Lyonnais* produced internal analysis ranking sovereign borrowers into three categories according to their management of state finances. The ranking provides insightful information on the creditworthiness of each issuer. The exact construct of the ranking is not available, but according to recent estimates prepared by Marc Flandreau, it was based on the borrower's default history and one sort of sustainability index of the debt,

²⁸⁷ *Crédit Lyonnais* archives, DEEF 73309, BE 1154 'Grand Duché de Finlande', 1895.

²⁸⁸ *Crédit Lyonnais* archives, DAF 00255-1, BE 1729 'Les Finances Finlandaises', 1895; DEEF 73309, BE 1154, 'Note sommaire', 1895; DAF 00255-1, BE 1729, 'Emprunt 3% Or 1898 du Grand-Duché de Finlande', 1898.

dividing the annual flow of interest payments net of dividends from government assets, by government revenues.²⁸⁹ The content of the Crédit Lyonnais risk table is presented in table 6.1.

Table 6.1 **Crédit Lyonnais risk table from year 1898**

Group 1: Fiscally the most prudently managed countries (Pays dont les finances sont de premier ordre)
Germany (imperial government), United Kingdom, United States (federal government), Russia, Sweden, <i>Finland</i> , Denmark, Belgium, Norway, Transvaal, Switzerland (federal government)
Group 2: The second tier (Pays dont les finances sont de second ordre)
Holland, Egypt, Japan, Austria, Hungary, Romania, Italy, Chile, Dutch Indies, British India
Group 3: The third tier (Pays dont les finances sont de troisième ordre)
Brazil, Argentina, Spain, Portugal, Greece, Serbia, Bulgaria, Romania

Source: Crédit Lyonnais archives, DEEF, 72879/1, ‘Généralités, 6, Classification des Etats d’après les résultats de leur gestion financière’, 1898.

According to Marc Flandreau’s estimates, Finland actually belonged to the top five countries inside the first group (together with Denmark, Sweden, Switzerland and Transvaal). Unfortunately, a similar type of rank-order analysis was never repeated.²⁹⁰ As an attachment to the table the research department of Crédit Lyonnais had prepared brief evaluations on each issuer. The notes on each Nordic country were overwhelmingly positive, underlining stable monetary conditions and sound state finances. In Finland, the bank particularly mentioned the improved competitiveness of the economy. The risks were seen on the political side; in Sweden and Norway the bank foresaw potential problems stemming from the disputes concerning the future of the union. As regards Finland, short remarks had already been incorporated that reminded about the measures taken in Russia in the early part of the decade to integrate Finland closer to the Empire, ie to cancel some of the reforms that had strengthened Finland’s autonomy earlier.²⁹¹

The positive observations on the condition of the Finnish state finances reflected the contemporary economic policy doctrine in

²⁸⁹ Flandreau, 2003: 41–49.

²⁹⁰ Flandreau, 2003: 38–49.

²⁹¹ Crédit Lyonnais archives, DEEF, 72879/1, ‘Généralités, 6, Classification des Etats d’après les résultats de leur gestion financière’, 1898.

Finland, aiming at a financially strong state. Head of the Office of Financial Matters in 1871–1897, Clas Herman Molander, followed prudent fiscal policies, emphasising the need of surplus funds to prepare for a recession, having the consequences of the crisis of the 1860s in mind.²⁹² Moreover, the long-term foreign debt was solely used for two purposes: railway construction and conversions of older issues; borrowing proceeds were used in an economically sound fashion, in sharp contrast to the 1860s. This sound management of state finances stands out also from *Fenn's Compendium*; as regards the fiscal position, the Grand Duchy's government belonged to the top tier of countries.²⁹³

However, even during the politically harmonious and economically sound decades of the late 19th century there were signs of fragility of Finland's position that became more evident after the turn of the century. The international financial crises, which had their origins in the Argentinean default and the Baring crisis of the early 1890s, were accompanied by internal difficulties. The Russian government threatened Finland's monetary and customs autonomy and implemented a post manifesto, integrating Finland's postal system to that of Russia. Moreover, there was a crop failure in Finland in 1892, although its effects were far less severe than the effects of the catastrophe experienced 25 years earlier. Bad harvest forced increased imports of corn and stressed the central bank's reserves.

At this point, the Bank of Finland experienced great difficulties in acquiring a short-term credit to strengthen its metallic reserves. In 1893 it finally succeeded to raise a loan from the Rothschilds and Bleichröder, although the banks referred to the political nervousness in Finland and hesitated to hand over any funds.²⁹⁴ The mistrust was probably the underlying reason for the underperformance of the state's foreign bonds on foreign bourses in 1892–94, along with the international financial market volatility: yield differentials against other sovereign bonds considerably widened. However, the development was still soon reversed, before a permanent deterioration of Finland's position at the turn of the century.

²⁹² Kuusterä, 98–104.

²⁹³ *Fenn's Compendium*, 1889. Debt comparison was presented in chapter 4.

²⁹⁴ Pipping, 1967: 82–84; Schybergson, 1914: 249–251.

6.3 Credibility under pressure (1904–1914)

The new century brought an end to the economic and political calm in Finland. Turbulence hit Finland at two stages. The political turmoil emerged already at the turn of the century and continued almost continuously for the next two decades. Economic difficulties began only during the First World War; Finland's economic performance during the years preceding the Great War was solid. Economic growth continued at a rapid pace, the average growth during the period 1902–1913 was 3.7 per cent, after a minor recession.²⁹⁵ The currency was anchored by Finland's adherence to the international gold standard, inflation remained subdued and government finances were balanced.

One example of the contrast between the political situation and the economy is provided by Thorvald Becker, who in 1913 described the solid condition of the Finnish state economy. The value of state assets, consisting of state funds, state's land property, canals and state forests was three times greater than the amount of the outstanding state debt. Moreover, government debt had been raised overwhelmingly for financing of national railway lines, ie for productive purposes. He also compared the relation of the state debt to state revenues in Finland and in other countries and found out that this ratio was clearly lower in Finland than, for example, in Russia, France or Britain. Only political uncertainties shadowed the low credit risk associated with Finland. This led Becker to conclude that if Russia were not a threat to Finland's autonomous position, the 'credit' of the Grand Duchy would belong to the first class.²⁹⁶

Indeed, the political instability, above all, stemmed from the Russo-Finnish conflict and the turmoil of the Russian Empire. There was a growing Russo-Finnish dispute on the degree of Finland's autonomy; towards the turn of the century there emerged a growing desire in Russia to harmonise legislation within the Empire and to define the relationship between local (Finnish) and pan-imperial legislation. From the point of view of the financial markets, the pressure on Finland's autonomy was important, because in the extreme, it might have even endangered the independency of the Grand Duchy as a financial actor, thus posing a serious credit risk. In similar fashion, the revolutionary movement in Russia in 1905

²⁹⁵ Hjerpe, 1989: 47.

²⁹⁶ Becker, 1913: 18–22.

questioned the solvency of the whole Russian government, as explained by Count Witte.²⁹⁷

The beginning of the ‘Russian oppression’ was culminated in the manifesto of February 1899, which stipulated that affairs concerning the whole Empire would be regulated according to the imperial legislative procedures and the Finnish Diet would only have a consultative role, lacking the possibility to veto a law coming into force in the Grand Duchy. The Finnish reaction was twofold. The conciliation line favoured tactical collaboration to guarantee the basic interest of the nation while the constitutionalist camp urged for passive resistance – in the extreme circles, even use of violence was accepted.

The miserable outcome of the Russo-Japanese war in 1904–1905 and the subsequent revolutionary movement in Russia underlined the credit risk of the seemingly vulnerable Russian government. The unrest spread also to the Grand Duchy in autumn of 1905 and a general strike broke out. The Russo-Japanese war and its consequences in Russia and Finland led to the temporary suspension of the February manifesto in 1905. In Russia the unrest led to political reforms in 1905–1906. Russia obtained a parliament, the Duma, and a prime ministerial government, the Council of Ministers, while in Finland a new unicameral parliamentary system based on universal suffrage was founded in 1906.

In Russia, the reforms brought a more systematic handling of affairs in the Russian administration. Before the reforms proposals were presented directly to the Emperor by the Finnish Minister State Secretary. In 1908 it was decided that also the Russian Prime Minister and government would monitor Finnish affairs, prior to the presentation to the Tsar. In practise, it reduced Finland’s special status in the Empire. In 1910 the Finnish parliament was obliged to send representatives to the Russian Duma and a new statute applying the pan-imperial legislation was enacted.

This led to new resistance in Finland and also representatives of the conciliation line refused to co-operate. The Finnish Senate was depoliticised and former officers from the Russian army were appointed senators. The co-operation between the Senate and the Finnish Parliament run into great difficulties; the legislative work almost halted. The outbreak of World War I brought the efforts to suppress Finland’s autonomy to a standstill. Finland was able to maintain the main building blocks of the Finnish autonomy, the

²⁹⁷ Harcave, 1990: 318–319, 561–572.

distinct administrative institutions and local legislation. It also kept its economic autonomy, the separate monetary system and customs area, although, for instance, the Russian authorities had questioned the monetary and customs autonomy several times.²⁹⁸

In the international capital markets, the years preceding World War I manifested the zenith of the global financial market integration; a massive interest rate convergence took place. Yields of peripheral government bonds, including the Scandinavian governments of Sweden, Denmark and Norway, converged closer to the yields of the British government consols. It meant that the risks of lending abroad from the Core-Europe had been perceived to become smaller. Although the British nominal long-term interest rates rose during the period, the rise was not felt to a similar extent in most of the peripheral countries due to this international yield convergence.²⁹⁹

A striking development is that the Finnish central government bonds were left out of the international yield convergence. This implied that yield differentials against other peripheral borrowers widened. For example, during a five-year period from 1893 to 1898 the Finnish government bonds traded in the financial markets only a mere 0.02 percentage points above the Swedish government bonds on average. During the next five years the average spread was already 0.53 percentage points while in 1904–1908 the spread was 1.63 percentage points, after which the yield differential slightly contracted during the next five year period. Against the Norwegian state bonds the performance was very similar. This meant that although the widening of the credit spread against the British consols commenced only in 1904, against the Scandinavian government bonds it appeared already during the last few years of the 19th century.

Finland's international creditworthiness during the early years of the 20th century had become under serious scrutiny. The underperformance of the Finnish central government bonds on the international financial centres would indicate that the markets were well aware of the political developments in Finland. The analyses of *Crédit Lyonnais* confirm this assumption. Finland's Senate and the Bank of Finland contacted the *Crédit Lyonnais* group twice to sort out

²⁹⁸ For instance, Jussila, Hentilä, and Nevakivi, 1999: 66–91; Pipping, 1969: 220–248; Polvinen, 1989: 205–264.

²⁹⁹ Flandreau and Zumer, 2004: 17–20; Homer and Sylla, 1996: 436–455.

prospects for new bond issues, in 1905 and 1908.³⁰⁰ To prepare the upcoming transactions, which in reality were never carried out, Crédit Lyonnais drafted profound reports on Finland.

Unlike in the analyses prepared in the 1890s, the main emphasis was now on political matters; the economic aspects were given less space as there had taken place no major changes. Although the state finances were again noted to be in a superior condition, the threats to economic autonomy were now highlighted. The Russian efforts to integrate the Russian and Finnish monetary systems were carefully evaluated; a special report was dedicated to the Russian decree to integrate Finland's separate monetary system to that of Russia's, which also had switched over to the gold standard.

The analysis department of Crédit Lyonnais explained Finland's administrative and political history since 1809 and the present form of government. The reports carefully monitored the Russian efforts to integrate Finland closer into Russia since the post manifesto of 1890 and February manifesto of 1899, as well as the revision of 1908 to promote collegiate handling of the Finnish affairs in the Russian administration and the replacement of the civilian General Governor by an army officer. The report of March 1908 was finished by the news that certain areas in the eastern province of Viipuri might be ceded to Russia from the Grand Duchy. In other words, the political risk was reflected in the analyses.³⁰¹

The new political climate was felt in the loan negotiations. The state issued three marketable bonds on the international financial centres between the years 1900 and 1914: in 1901, 1903 and 1909. The first two issues were still launched at roughly similar levels with other Nordic states, but in 1909 there appeared already a clear difference. The primary market yield of the loan of 1909 was 5.0%. In comparison, the new bond issued by the central government of Sweden yielded 3.9% in 1908, whereas the Kingdom of Norway issued securities at 4.15% in 1911.³⁰²

³⁰⁰ Crédit Lyonnais archives, DAF, MO/2, BE 1727, letter from K.A. Wallenberg to Edmond Moret at the Banque de Paris et des Pays-Bas, 22.2.1905; National archives, Senate archives, Cc1, Finance Committee, secret minutes, protocol of the Economic Department of the Senate, 28.4.1908; Letter from the Parliamentary Supervisory Council to the Finance Committee of the Senate, 24.4.1908.

³⁰¹ Crédit Lyonnais archives, DEEF 73251, BE 1372: Decret Imperial du 27 mai (9 juin) 1904, 'Finlande', 1905; 'Finlande' Mars 1908; 'Note Sommaire sur la situation Politique', Septembre 1908; 'Note sommaire', Septembre 1908.

³⁰² Klovland, 2004: 108; Riksgäldskontoret årsbok 1921: appendix 12. The issuance fees may have been taken into account differently. This may cause slight inaccuracy in the comparability of the yields.

As the relatively tight pricing indicates, the issues of 1901 and 1903 were still placed without serious distortions. However, the Finns were anxious about a possible reaction of the financial markets or Russian authorities under the new circumstances. They wanted to hasten the issue of 1901 and carry it out without any delay for fear of Russian interference, regardless of the exact pricing, resembling J.V. Snellman's requests over 30 years earlier during the great famines. The rush is evidenced by a letter from a Finnish politician and banker Emil Schybergson to K.A. Wallenberg: 'We have to strike while the iron is hot, even if it becomes expensive. The country requires money to be able to breath and, above all, if the loan is postponed, it can meet difficulties of a political nature'.³⁰³ The final approval of the Emperor remained uncertain until the last minute. Finally, the approval arrived, but for an amount that was reduced from the original proposal of 35 million to 25 million marks.³⁰⁴

Both the issues of 1901 and 1903 brought extraordinary high commissions to the syndicate banks;³⁰⁵ under the uncertain circumstances emphasis in Finland was not directed to the price negotiations with the banks, but to the successful execution of the bond issues. On the other hand, the banks probably charged higher commissions if they felt that underwriting of the loans would carry substantial risks due to Finland's weakened credibility, which might distort smooth placement of the loans.

During the preparation for the central government's bond issue of 1908 the new adverse circumstances were felt more concretely, resulting in the end to the cancellation of the whole issue; the Senate was for the first time facing a situation where it lacked access to the financial markets despite its serious attempts. The central government's inability to tap the western financial markets did not reflect only its weakened credibility, but also more profound changes in the international market mood. The European financial markets were seriously politicised prior to the First World War, turning to one of the embodiments of foreign and trade politics of the great European nations. The link between trade and foreign policies was the strongest in France; for instance, the Swedish government turned to the British capital market in 1907–1908 due to similar considerations, having earlier regularly tapped the French bond market. In Finland the trade

³⁰³ SEB archives, Ankomna brev 1901, letter from Emil Schybergson to K.A. Wallenberg, 5.2.1901.

³⁰⁴ SEB archives, Svenska sekretariatets dossier, Akt 27(korrespondens), letter from O. Nykopp to K.A. Wallenberg, 3.4.1901.

³⁰⁵ Gasslander, 1959: 59–60.

policy connection was worsened by the planned prohibition of alcohol, on which the Finnish Parliament decided in 1907, although it was never ratified by the Emperor.³⁰⁶

During the course of the first half of 1908 the Senate and the Bank of Finland were trying to issue a new long-term foreign bond to finance new railway construction. K.A. Wallenberg, who had been authorised to manage the negotiations by the Bank of Finland, made during the winter preparations for the new bond issue in several countries, including England, Belgium, the Netherlands and Switzerland, but with no success. Only in England had the market response been positive in the first place, but even there the rising political tensions stemming from the political disputes concerning the Åland islands and the North Sea-Baltic Sea canal prevented any further progress.³⁰⁷

Once again, the French capital seemed to provide the only suitable source for a new bond issue. However, the market mood in the French bond market had also turned unsympathetic. Bank director Edmond Moret from Banque de Paris & des Pays-Bas informed Wallenberg in March 1908 that although a new Finnish bond issue might be executable, many factors worked against its efficient pricing. According to him, a new bond issue by the Grand Duchy would now correlate with the prices of Russian bonds, which, however, had a much larger investor base than the Finnish ones; as a result, they should be priced under the Russian government securities. Moreover, Moret wrote that ‘the Russian persecution, although undeserved and rude, would lay uncertainty over the Finnish bond issue’. Moret concluded that although a state loan might still work out, a proposed new city loan by Helsinki was absolutely ruled out.³⁰⁸

In March and April 1908 Wallenberg reported disappointing news to the Senate. He wrote that in order to receive permission for the new issue from the French government, the Finnish plans for the alcohol prohibition should be denied ‘at a higher level’. Moreover, the French markets could not easily digest a long-term Finnish issue in any case. He stated that the unfavourable situation resulted from the weak performance of the Finnish bonds and excess supply of other government and municipal bonds in the French bond market, including a recent bond issue by the City of St. Petersburg. Although

³⁰⁶ Gasslander, 1959: 306–328; Paasikivi, 1957: 23–26.

³⁰⁷ SEB archives, Svenska sekretariatets dossier, Akt 29(korrespondens), letter from K.A. Wallenberg to Clas von Collan, 9.3.1908.

³⁰⁸ SEB archives, Svenska sekretariatets dossier, Akt 29(korrespondens), letter from Edmond Moret to K.A. Wallenberg, 13.3.1908.

he personally considered it unreasonable, Wallenberg emphasised that the French nowadays too much mix Finnish and Russian affairs. This means that the Finnish bonds had become dependent on Russian securities, which had recently underperformed on the Paris stock exchange. However, according to Wallenberg, a new loan might have been possible to launch on the Paris bourse at 90 per cent with a 5 per cent coupon, in three months time.³⁰⁹

The Parliament's Supervisory Council for the central bank considered the terms too expensive; after all, the Parliament's authorization was granted in 1906 for a new loan with a coupon of 4 per cent at most.³¹⁰ It was decided to look at other solutions; a short-term loan or smaller issue size that might improve the price from the Finnish perspective. The Senate still continued its efforts to issue a new bond in Paris, but during the summer it became clear that long-term funding from the French market was not a feasible option. The state was forced to depend on a short-term loan in August, as long-term financing was not available due to the weak conditions in the financial markets and 'other unfavourable conditions'.³¹¹ The short-term loan was also a practical way to get around the politically motivated restrictions by the French government; the short-term notes did not require the state's permission. For Finland, it also gave some short-term relief in its financing needs and time to seek for alternative borrowing possibilities.³¹²

Later in autumn 1908 the adverse effects of the Finnish prohibition plans still showed up. A French banker from *Crédit Lyonnais*, Count F. de Chevilly arrived in Helsinki and negotiated with J.K. Paasikivi, Head of the Office of the Financial Matters of the Senate on the prospects for a new Finnish bond issue. The market sentiment had now somewhat improved in France and a new long-term bond issue might, after all, be executable. According to Chevilly, however, an absolutely necessary precondition for the issue was a government guarantee that no prohibition was to be implemented in the near future. As Paasikivi refused to give such a reassurance, the

³⁰⁹ SEB archives, *Brevkopieböcker 1907–1908*, letter from K.A. Wallenberg to Clas von Collan 9.3.1908, 25.4.1908 and 1.5.1908.

³¹⁰ Parliament documents, Book I, Government proposal no: 7, 9.2.1906.

³¹¹ National archives, Cc1, Senate archives, Finance Committee of the Economic Department of the Senate, secret minutes, letter from the Parliamentary Supervisory Council to the Finance Committee of the Senate, 24.4.1908; Protocols of the Economic Department of the Senate, 28.4.1908 and 24.8.1908.

³¹² Gasslander, 1959: 316–317; Paasikivi, 1957: 24.

negotiations ended without any results. The state left the French financial market and did not return for over half a century.³¹³

The state was finally able to issue a new long-term bond. Through the intermediation of Louis Frænckel, managing director of the Swedish Handelsbanken, the state entered the capital market in London. Hambro & Son, an old bank counterpart to other Scandinavian states, lead managed the issue. Even here some political questions troubled the issue preparations in the last minute in December 1908. Rumours had spread in England that Finland mistreated its small Jewish minority. Sir Everard Hambro, who was himself of Jewish origin, was worried about the news and its impact on the success of the bond issue. The preparations proceeded only after the Senate issued a statement at the request of Paasikivi that Finland did not implement any anti-Semitic policies. The state succeeded to issue a new bond immediately at the outset of 1909, right at the last minute before a large Russian government bond was floated and saturated the British government bond market. Through this relatively minor incidence also Finland became involved in the Jewish question, which had affected sovereign finances in Europe for a long time, not least due to the heavy involvement of Jews in European banking.³¹⁴

The issue price was criticised in Finland; the press and politicians alike claimed it to have been offered at too low a price. The criticism probably upset Paasikivi, who came back to the loan affair still in 1910. He touched upon the loan negotiations in a long article published in a Finnish newspaper *Uusi Suometar*. Paasikivi drew together the performance of state's bonds since the mid-1880. According to him during the 1880s Finnish government bonds were still clearly more expensive than the Russian bonds, but since the early 1890s Finnish and Russian bond prices had greatly correlated. Paasikivi concluded that this correlation was a result of 'the new direction of Russia's policy towards Finland', as 'they have explained our autonomy to be of only provincial nature'.

Paasikivi continued that during the 1890s this correlation did not pose a serious problem because the prices of Russian bonds appreciably rose to levels on par with Swedish and Norwegian bonds. Unfortunately, the Russo-Japanese war later dampened the prices of the Russian bonds, and drew Finnish bonds along, whereas Swedish and other Nordic securities still performed well. Moreover, Finland's

³¹³ Paasikivi, 1957: 23–26.

³¹⁴ Ferguson, 1999: 257–283; Polvinen, 1989: 182–187.

foreign credit had further deteriorated due to Finland's own internal insecurity. Paasikivi, however, defended the issuance of the loan in 1909 because under the adverse circumstances better terms were not achievable; the timing of the issue was anyway satisfactory and the price was better than that received by Russia slightly later. He also reminded that the English bond market was new to Finland, which might have affected adversely pricing of the new issue.³¹⁵

Similar conclusions were drawn in the Finnish Parliament. Finnish parliamentarians admitted that the market situation was difficult, particularly when taking into account that it was central government's first bond issue in Britain. However, a major part of the complications was laid on the Russian authorities; the Russian oppression was claimed to have negatively affected the demand for Finnish government bonds on the western bourses.³¹⁶

After the smooth and painless execution of state borrowing during the last decades of the 19th century, the state's bond issuance after the turn of the century had met a new sort of political difficulties. However, in the end, the state was able to carry out new borrowing to finance new railway lines and train stations. During the years following the outbreak of the world war political difficulties escalated and the parts of the financial environment that had been in excellent condition prior to the war, also ran into great trouble; the Finnish economy experienced a sharp downturn and the world financial system collapsed.

6.4 Political and economic disorder (1914–1922)

Finland managed by and large to remain outside the actual war efforts during the First World War; the Finns were exempt from military service in the Russian army and the eastern front of the Great War never stretched to Finland. Finland's participation was mainly limited to Finland's financing of the Russian military budget in 1902–1916 amounting to 195 million marks, so called 'military millions', although Finnish volunteers fought both in the Russian and the German armies.³¹⁷ The Finnish economy partly even benefited from the considerable Russian war orders during the three first years of the

³¹⁵ Paasikivi, 1910.

³¹⁶ Parliament documents, Book IV, report on state debt in 1909, 1911.

³¹⁷ Luntinen, 1984: 172.

fighting. Nevertheless, the Russian revolutions of 1917, the internal political confrontation and the economic crises of 1917, mainly resulting from the collapse of the Russian war orders, were the beginning of an extremely unstable era in Finland. Production stagnated, and the main export markets closed down as even the eastern trade halted. The current account began to run a large deficit, putting pressure on the foreign reserves of the Bank of Finland. National production dropped by some 15 per cent both in 1917 and in 1918.³¹⁸

Monetary conditions were also extremely difficult. During the war, note circulation increased manifold. The government budget deficits soared and it was forced to borrow from the central bank. Simultaneously, the Russian officials forced the Bank of Finland to change Russian roubles to marks at an artificially high exchange rate, which caused an inflow of roubles to the Grand Duchy. As a result, inflation, an almost unknown phenomenon prior to the war, surged. The convertibility to gold had been relinquished in 1914; after the war the inflated marks lost some 90 per cent of their pre-war value.³¹⁹

The Russian provisional government in March 1917 cancelled the Tsarist government's efforts to suppress Finland's autonomy. Following the Bolshevik coup in October, the Finnish Parliament declared Finland independent in December 1917. However, Finland's both internal and international position remained fragile during the first years of independency. Internally, the society had gradually broken apart, which had led to political turmoil in 1917. A general strike broke out in the autumn of 1917. In January 1918 a civil war began between the reds and whites. The war was brief, but bloody. It ended in the victory of the white Finland in the spring of 1918, but the society remained fragmented for years to come.

The outcome of the civil war allied Finland with imperial Germany, and isolated Finland from the Western allies. The German orientation was abandoned after the armistice, which ended the war efforts in Europe. Finally, during the spring of 1919 the Western powers recognised Finland's independence. The Russian Bolshevik government had recognised Finland's independence already in the end of 1917, but there was reason to believe that the Soviet government did not regard the recognition as the seal of final separation. The Russian civil war continued and Finland's destiny after the war remained unclear. The Bolsheviks had supported the reds in Finland's

³¹⁸ Hjerpe, 1989: 47–48, 193.

³¹⁹ Korpisaari 1926: 22–51; Kuusterä, 1997: 294–295; Tudeer, 1939: 26–86.

civil war and the Russian whites were not ready to recognise Finland's full separation. In the west, the question of the Åland islands burdened the relations with Sweden.

Finland's political position and economy stabilised in 1919–1922. The new republican constitution was ratified in July 1919. The results of the Parliamentary elections in March 1919 and the choice on the republic's first president in July 1919 moved the country to the political centre. The peace treaty with the Soviet Union was signed in October 1920. The disputes over the Åland islands and East Carelia were settled with Sweden and Russia in early 1922. During the same years the economy found a new balance. Economic growth had bounced back already in 1919 and remained robust until the end of the 1920s. During the year 1922 the current account stabilised, inflation halted and the state returned to balanced budgets. The depreciation of the external value of mark was also over by the end of the year 1922.³²⁰

The outbreak of the First World War had dramatically altered the global financial landscape. Restrictions on international capital movements put an end to the existence of integrated global financial markets. Europe lost its position as the world's foremost lender to the United States. During the war the European belligerent countries encouraged their nationals to liquidate their foreign securities: the money was used to enable the countries to run ever larger trade deficits. International lending concentrated to the United States, where Entente governments floated loans during the course of the war, including also the Russian state.³²¹ In Finland the possibility to acquire loans from the United States during the war was not even discussed. The foreign borrowing of the Russian Empire was concentrated on the war finances of the Imperial government.

The First World War also interrupted Finnish state's faultless servicing of its foreign obligations. Until the Russo-German peace treaty in 1918 the coupon payments of the government loans to German investors were halted due to the state of war between Russia and Germany. In 1918 Finland's alliance with Germany halted the coupon payments of the loans to Britain. However, already by 1919 the payments functioned normally.³²²

Inflation and public budget deficits soared all over the world. The end of World War I did not bring back financial order. Still in 1919 a

³²⁰ For example, Jussila, Hentilä, and Nevakivi 1999: 100–142; Korpisaari, 1926: 198–205; Tudeer, 1939: 178–202.

³²¹ Eichengreen, 1995: 81–88.

³²² Moody's Governments and Municipals Ratings Manual, Finland: 1929.

return to pre-war financial stability was widely anticipated. Economic reality was nevertheless very different. Inflation and public deficits stayed high and exchange and interest rates remained volatile. Failure to find international understanding on stabilisation of international monetary relations was highlighted in the inability to decide on German war reparations, which was a precondition for the stabilisation of Germany's monetary conditions. Inter-governmental conferences in Brussels in 1920 and Genoa in 1922 favoured a return to the gold standard, but produced little results in stabilising the world financial markets.³²³ Contemporary correspondence between government officials shows that the international economic and political nervousness did not bypass the Finnish state; its plans to issue new bonds were several times rejected by foreign banks due to the market volatility stemming from international disorder, including the dispute over Germany's war indemnities and political conflicts in various quarters of Europe.³²⁴

The state's credit premium (against the consols) on the London stock exchange skyrocketed. Prior to the First World War it had been much below two percentage points; in 1920 it exceeded eight percentage points. Against Swedish and Norwegian government bonds the credit premium had been less than one percentage point in 1913; in 1919 it was 3.5 percentage points against Sweden and 2 percentage points against Norway.³²⁵ The fact that the state's creditworthiness hit rock bottom in 1920 was probably a result of both Finland's internal difficulties and international disorder. During the year of 1920 the monetary policies in several countries, including the United States, turned restrictive, American lending to Europe fell off and the world economy lost its steam after the brief post-war boom.³²⁶ In the Russian civil war, the reds were heading to an unavoidable victory. This probably affected to a disproportional extent Finland because its relations to the neighbouring Soviet-Russia remained unclear: the peace treaty between the two countries was signed only in October 1920 in the Estonian town Tartu.

Under the adverse circumstances the state could not access the foreign bond markets, although the state desperately needed to borrow funds to cover its budget deficits. From the outbreak of the First

³²³ Eichengreen, 1995: 100–124; Kenwood and Lougheed, 1994: 179–182.

³²⁴ National archives, Risto Ryti 12, letter from L. Ehrnrooth from Helsingfors Aktiebank to Risto Ryti, 22.12.1921, letter from G.K. Weeks from National City Bank to Risto Ryti, 20.9.1923; G.K. Weeks to Ossian Donner, 14.9.1923.

³²⁵ See chapter 5.

³²⁶ Eichengreen, 1995: 100–186.

World War until 1922 the state borrowed internationally only either short-term or through long-term loans that were not issued through the standard market practises in the private capital markets. This led the state to utilise domestic savings to an inexperienced extent.

Between 1915 and 1922 the state borrowed domestically short-term for the first time since the 1860s, including several credits from the Bank of Finland. It also issued a number of domestic bonds in 1918–1920. The domestic credits and loans were not enough; the need for a foreign currency loan was urgent because the foreign exchange reserves of the Bank of Finland were alarmingly low and, above all, the country required foreign currency to finance imports of grain and food.³²⁷ Already in February 1919 the chairman of the supervisors of the central bank, Emil Schybergson, proposed to begin preparations for an issue of a foreign currency bond, in order to strengthen the bank's foreign reserves. The negotiations with foreign banks soon showed that acquiring a new loan through standard market channels was not yet possible.³²⁸

Even the government's access to foreign short-term credit was uncertain. During the civil war, the evacuated white government in Vaasa acquired a short-term loan from Skandinaviska Kreditaktiebolaget in Sweden. The loan was guaranteed by Finnish nationals living abroad, many of whom had escaped during the civil war from southern Finland, which was controlled by the reds, to Sweden. Later in autumn 1918, after the end of the Finnish civil war, part of the gold reserves of the Bank of Finland was transferred to Stockholm as collateral for the credit, indicating the deep mistrust of Finland even in the neighbouring Sweden. The current political upheaval affected even the practical implementation of the transaction; the gold was transferred to Stockholm by a boat during the night-time in order to avoid Russian war-ships on the sea. The gold was returned to Finland in early 1921 when the credit was paid back.³²⁹

All foreign long-term loans prior to the first marketable bond issue in late 1923 were loans that were not placed according to the standard market procedures to the foreign financial markets, ie investors could not subscribe them freely. In 1919 the state acquired the ownership of the Norwegian forest company, W. Gutzeit; the take-over was paid through a Norwegian crown denominated bond issue to the company's

³²⁷ Parliament documents, Book II, report of the Finance Committee no: 2, 11.6.1919.

³²⁸ Korpisaari, 1926: 88–118.; Statistical yearbook of Finland: 1915–1925; Stenroth, 1927: 142–143.

³²⁹ Donner, 1927: 13–15; Korpisaari, 1926: 87; Tudeer, 1939: 103.

shareholders.³³⁰ In 1920 the state borrowed directly from a Danish telephone corporation.³³¹

The republic's first foreign bond after the First World War was issued in 1921 in the Scandinavian countries. Even this bond was directed to a limited audience and was denominated also in Finnish marks; the aim was to replace foreigners' short-term mark claims by a long-term loan and promote stabilisation of the foreign value of mark. The loan became expensive in the end; the debtor was obliged to pay interest and redemptions either in marks or crowns, depending on the choice of the bondholder. The mark depreciated strongly against the crown after the launch of the bond, meaning that the state's exposure to exchange rate risk was soon realised. Nevertheless, according to the former Governor of the Bank of Finland Otto Stenroth, – who was probably somewhat upset by the criticism over the issue – the successful entry to the foreign financial markets was said to have spread a positive image in the United States about Finland's financial solvency. In 1922 the state issued a similar type of a bond, it was partly sold in Sweden, partly in Finland, but was now denominated solely in Finnish marks.³³²

The most well known of the direct, non-marketable loans that Finland was able to raise were two short-term loans from the United States Grain Corporation. The Food Administration, headed by the later United States President Herbert Hoover, had established the Grain Corporation in 1919 to act as a purchasing agent for foreign food relief. Finland received the first loan from the corporation in 1919 and used the proceeds of the loans for food purchases from the American Relief Administration, which provided shipments of food mainly for Central and Eastern European countries.³³³

According to an interview by the New York Times in early 1920 Hoover considered that most of the European countries overestimated their borrowing needs from the United States, the exceptions being Finland, Poland and couple of other countries, which still suffered from a lack of foodstuffs.³³⁴ Indeed, Finland was granted a second food loan in June 1920 by the US Grain Corporation, for imports of

³³⁰ Parliament documents, Book II, Government proposal no: 18, 22.11.1918.

³³¹ Statistical yearbook of Finland: 1924.

³³² Parliament documents, Book II, Government proposal no: 56, 2.2.1921; Stenroth, 1927: 129–137; Suviranta, 1931: 123–124; Tudeer, 1939: 154–155.

³³³ Larjavaara, 1967: 73–74; Parliamentary documents, Book I, Government proposal no: 18, 20.3.1923.

³³⁴ Ministry of Foreign Affairs archives, Group 32 O, United States, A.H. Saastamoinen from the United States to the Ministry of Foreign Affairs, 7.1.1920.

food as well. A couple of years later the two food loans were combined and converted into a long-term commitment.³³⁵

It soon became clear that the two grain loans were exceptions. Already the American Victory Liberty Bond Act, enacted in March 1919 prohibited new war loans to Europe by the United States government, with the exception of food relief.³³⁶ Newly appointed Secretary of Commerce Herbert Hoover warned in public that the American government could not grant new loans abroad. During a discussion with Finland's ambassador, Minister A.H. Saastamoinen, Hoover explained that the Finnish government had to gain access to the private financial markets by increasing its production capacity and exports.³³⁷

In a similar manner, Secretary of State Charles Hughes gave a statement in 1923 that the policy of the United States government is not to supply loans to other governments; this statement set the American policy guidelines for the coming years.³³⁸ In practise the policy stance of the administration of the United States meant that in order to be able to utilise the American excess capital – the only available source of funding on a significant scale – Finland had to continue its efforts to attract private investors, ie to attain adequate credibility in the eyes of the American financial market participants. Before the year 1923 this did not turn out to be possible due to the international financial market turmoil and, especially, due to the country-specific risks associated with Finland.

In comparison, the governments of both Sweden and Norway entered the post-war Western financial markets before Finland. Sweden issued a dollar denominated bond in the United States in 1919 to finance shipments of raw materials, although it otherwise mainly concentrated on domestic issuance. Norway issued several foreign bonds for similar reasons to Finland: to support the depreciated currency. Its first bond in the United States was issued in September 1920 and was furnished with an 8% coupon. In the following year Norway issued its sole interwar bond in the British capital market.³³⁹

The greatest attention of the international market participants did not lie in Finland's economy. The risk associated with the Finnish government stemmed in particular from two sources. The first threat

³³⁵ Parliamentary documents, Book I, Government proposal no: 18, 20.3.1923.

³³⁶ Hjerpe and Ikonen, 1995: 16, Järvinen, 1933: 40.

³³⁷ Ministry of Foreign Affairs archives, Group 32 O, United States, A.H. Saastamoinen from the United States to the Ministry of Foreign Affairs, 7.1.1920 and 6.1. 1921.

³³⁸ Feis, 1974: introduction.

³³⁹ Hildebrand, 1939: 32; Klovland, 2004: 119; Rygg, 1950: 187.

to the state's creditworthiness rose from fear of the Bolshevism and its potential threat to Finland. The Bolsheviks had in February 1918 defaulted on all Imperial government debts and, highly likely, in the case of a Bolshevik coup d'état in Finland the same would have taken place. The second major risk stemmed from the government's own actions. Its reluctance to service the pre-war gold bonds in a manner demanded by foreign bondholders – culminating in the Bond Act enacted by the Finnish Parliament in May 1921 – provoked great indignation among foreign investors. From their point of view, Finland had, at least partially, repudiated its pre-war international commitments.

6.4.1 Fear of Bolsheviks

Capitalists' fear of the new Bolshevik state became evident in the loan negotiations between the Finnish civil servants and international bankers. Finland's attempts to issue new marketable bonds on the western market places met with great suspicion, both in Europe and in the United States. Prior to the recognition of Finland's independence by the western allies' new foreign loans seemed to be ruled out.³⁴⁰ Even after the recognition, however, the attempts to acquire funding in London failed; in the eyes of the British capital the Bolshevik threat to Finland was too great and hampered Finland's credibility, as Ambassador Ossian Donner wrote from London in autumn 1919.³⁴¹ During the following year the state planned to finance purchases of food supplies by borrowing 100 million guilders from the Dutch financial market, which had not been directly hit by the war; the negative response was motivated by the fear of Soviet-Russian occupation and, later in the same year, by the Soviet-Russian offensive in the Soviet-Polish war. On the same grounds also Germany failed to access the financial markets in Amsterdam during the same year. Once again, in 1920, the Finnish state carried out a new attempt in Holland, but again with no success.³⁴²

J.K. Paasikivi, who as a chairman of Kansallis-Osake-Pankki, a big Finnish commercial bank, visited several European banks in 1921,

³⁴⁰ Ministry of Foreign Affairs archives, Group 32 O, General, Ossian Donner from London to the Ministry of Foreign Affairs, 27.3.1919.

³⁴¹ Ministry of Foreign Affairs archives, Group 32 O, General, Ossian Donner from London to the Ministry of Foreign Affairs, 4.9.1919.

³⁴² Ministry of Foreign Affairs archives, Group 32 O, General, letters from the embassy in Amsterdam to the Ministry of Foreign Affairs, 29.1.1920 and 10.7.1920.

has described similar experiences in a number of European capitals. In London, Sir Eric Hambro did not hesitate to proclaim to Paasikivi that the handling of Finnish affairs in London is greatly troubled by the closeness of the Bolshevik Russia. According to Sir Hambro, price of the loan of 1909, the only Finnish government security quoted in England, on the stock exchange was so miserable that Finland would have to wait with a new bond issue in London.³⁴³

Finland faced similar obstacles in the United States. Finland's ambassador to the United States, A.H. Saastamoinen negotiated with several American banks, including the Liberty National Bank, the National City Bank and Lee, Higginson & Co, during the years 1919–1921. In January 1920, he informed the Ministry of Foreign Affairs in Helsinki, 'for the time being we have no hope of acquiring loans from the United States'. Saastamoinen referred to an article about America's lending to Europe prepared by Vice-President Francis Sisson from the Guaranty Trust Company for the New York Tribune.

'As a policy of self protection American investors should, and undoubtedly will, be discriminating in the matter of foreign investments. Political stability, social order, respect for the rights of property and a sound financial program should, of course underline any request for credit.'³⁴⁴

Saastamoinen continued that unfortunately we have to draw a conclusion, that Finland is not included in the group of countries with established and firm political and other conditions. Later, as a concrete example he mentioned rumours in the American press about concentration of the Bolshevik troops on the borders of Estonia, Latvia and Poland. He even asked further information from the Finnish general staff about the military situation on the Finnish borders.³⁴⁵

In March 1921, Saastamoinen concluded his remarks on Finland's prospects to tap the financial market of the United States, following discussions with several local bankers. His observations probably reflect quite well the turbulence of the financial markets and the international anxiety over Finland's political position in the post-war Europe. According to Saastamoinen, the Finnish government lacked access to the government bond market for six reasons:

³⁴³ Paasikivi, 2000: 17–43.

³⁴⁴ Ministry of Foreign Affairs archives, Group 32 O, United States, A.H. Saastamoinen from the United States to the Ministry of Foreign Affairs, 7.1.1920.

³⁴⁵ Ministry of Foreign Affairs archives, Group 32 O, United States, A.H. Saastamoinen from the United States to the Ministry of Foreign Affairs, 7.1.1920 and 6.1. 1921.

- 1) Finland is too little known in the United States
- 2) Finland is included in the group of the ‘new European countries’
- 3) Financial markets are anxious about Finland’s internal and external ‘Bolshevik threat’
- 4) Russia may resume its former status and absorb Finland back
- 5) General pessimism over Europe
- 6) General market situation in the financial market of the United States³⁴⁶

On the other hand, the economic situation in Finland was seen in a positive light. According to the estimates by the Liberty National Bank and the Lee, Higginson & Co, in economic matters Finland was comparable to the governments that had recently issued securities in the United States. Moreover, it was noted positively that Finland had gained administrative experience during the time of its autonomy. However, once again, both banks were afraid of the Bolshevik threat to Finland and saw no possibilities for loan transactions in America.³⁴⁷

The fear of Bolshevism cast a shadow over the Finnish state’s foreign borrowing for years to come, but probably the ‘worst’ phase was over after the Tartu peace treaty and the end of the Russian civil war as the disorganised political situation began to stabilise. The Soviets, for the time being, no longer tried to absorb by force the former border states of the Empire back into Soviet-Russia – as they had successfully done, for example, in the Caucasus in the early 1920s. The main attention of Soviet politics was directed towards the strengthening of the economy and anchoring the new political order.³⁴⁸

6.4.2 Bond Act raises acquisitions of default

The Finnish debtors were facing a painful situation after the war. During the days of the classical gold standard the state and other borrowers had issued multicurrency bonds, ie bonds that were denominated in several currencies. This exposure to foreign exchange rate risk had not been deemed to entail risks as the exchange rates were ‘fixed for good’. The post-war turbulence in the foreign

³⁴⁶ Ministry of Foreign Affairs archives, Group 32 O, United States, A.H. Saastamoinen from the United States to the Ministry of Foreign Affairs, 7.3.1921.

³⁴⁷ Ministry of Foreign Affairs archives, Group 32 O, United States, A.H. Saastamoinen from the United States to the Ministry of Foreign Affairs, 7.3.1921.

³⁴⁸ Jussila, 1985: 85–136.

exchange markets had radically altered the situation; the cross parities between different currencies had suddenly changed and, for instance, the Finnish mark had greatly depreciated.

Holders of the pre-1914 multicurrency bonds naturally wanted to present the coupons for principal and interest payments in the countries with the least depreciated currencies. For instance, Finnish bondholders were sending their coupons abroad to redeem them in the currencies that had appreciated the most against the Finnish mark. Especially hard hit were the Finnish mortgage societies suffering from great exchange rate losses. The original rationale for the issuer had been to access several financial markets with the same debt instrument and simultaneously serve the bondholders of each nationality in their own currencies, relieving them from the need to exchange currencies and thus increasing their appetite for the securities. Instead, this practise now enabled bondholders' far-reaching currency speculation. The Finnish debtors were in a painful currency mismatch situation; their revenues were in depreciated Finnish marks, while they faced a risk that their commitments should be served totally in currencies that stood close to or at their pre-war gold prices.³⁴⁹

In order to prevent currency speculation and to save Finnish debtors from huge exchange losses, – the Mortgage Society of the Cities in Finland was actually at a brink of bankruptcy due to the amplified costs of servicing its pre-war foreign currency loans³⁵⁰ – the state on many occasions limited the freedom of the bondholders to decide on the currency of their cash flows after the war. This practise was confirmed by the Finnish Parliament, which enacted the Bond Act on 27 May 1921 that was designed to forestall possibilities for currency speculation. The law regulated the currency of the coupon payments of the pre-war bonds: the investor could no longer decide the currency on which he or she would like to receive the redemption or interest. Instead, the nationality of the bondholder at the end of 1914 defined the currency, or alternatively he could always receive the payments in Finnish marks. The content of the Bond Act was the following, presented to the Parliament by the Minister of Finance, Risto Ryti:

‘Bonds and their interest coupons issued before January 1st, 1915 when they have been made payable both in Finnish and foreign currency, are, if the owner is a foreigner, to be redeemed according to the choice of the owner

³⁴⁹ Ministry of Foreign Affairs archives, Group 320, France, letter from L. Åström at the Ministry of Foreign Affairs to the embassy in Paris, 20.1.1921.

³⁵⁰ Mercator, 1921: 1212.

either in Finnish currency or in the currency of that country mentioned on the Bond in which the Bonds were held at the end of 1914.

If the owner of the Bond is or has been after the year 1914 a Finnish citizen, the presenter of the Bond or interest coupon is obliged to receive the payment in Finnish currency.³⁵¹

The Bond Act affected six central government bonds that had been issued by the Grand Duchy: the loan of 1889, denominated in Finnish marks, German marks and Dutch guilder; the loan of 1895, denominated in Finnish marks and French francs; the loans of 1898, 1901 and 1903, all denominated in Finnish marks, German marks, French francs, and Swedish crowns; and the loan of 1909, denominated in Finnish marks, German marks, British pounds, French francs and Dutch guilders.

The difficulty was that the currencies of denominations performed very differently after the First World War. The Dutch guilder, sterling and Swedish crown returned by the mid-1920 to the pre-war gold parity, whereas the Finnish mark and French franc depreciated strongly. As an extreme case, the German mark lost practically all of its value during the hyperinflation and was later replaced by the new German mark.³⁵²

The limits on the choice of the currency and the later enactment of the Bond Act were followed by a wave of protests, especially in Britain and France. In Britain the British Council of Foreign Bondholders represented the local investors, while in France they were organised through the National Association of French Holders of Securities.³⁵³ Both insisted acquiring the cash flows at any currency printed on face of the bonds without any requirement to show evidence on the past ownership, or, alternatively, at the pre-war gold value of the depreciated currency.

The protests were justified mainly by two reasons. Foreign investors who had bought the bonds after 1914 from Finnish investors or from investors who were nationals of a country with a depreciated currency felt betrayed; they would now be repaid either in Finnish

³⁵¹ Parliament documents, Book I, Government proposal No: 20, 27.5.1921. Translation is from the prospectus of the 1934 US dollar loan.

³⁵² Autio, 1992.

³⁵³ The Finnish bonds were only one example of the conflicts stemming from the monetary disorder after World War I. For instance, the bondholders accused the Norwegian Hypobank for similar reasons, Klovland (2004). In Germany, pre-war debts were changed for new ones at 15 per cent of the old gold value and government bonds were altered at an artificial rate at 1000 old marks = 25 new marks for new securities, Korpisaari (1926), 238.

mark or in some other less valuable currency, although they had paid for the bonds in hard currency. As a more general argument, many bondholders claimed that the money lent prior to war was in gold currencies and should be served at full gold value, not in depreciated paper currencies.³⁵⁴

Several Finnish embassies reported nervously to the Ministry of Foreign Affairs in Helsinki about the markets' and, in particular, bondholders' reactions. The French bondholders' association warned the Finnish government in its letter to the Finnish embassy in Paris already before the enactment of the Bond Act that its implementation will cause severe damage to Finnish creditworthiness. According to the association, the disputed loans were relatively small, especially in comparison to the value of permanently lost credibility. In other words, it would be wise for the government to give in. Concerning the private Finnish debtors the association even showed readiness for compromise solutions, given the hard burden caused by the currency movements for the entities which had their revenues in marks.³⁵⁵

Later in 1921 Finland's Ambassador to Britain, Ossian Donner, warned the Ministry of Foreign Affairs in Helsinki that due to the unsympathetic market reactions Finland's creditworthiness will drop to the level of the South American states if the Bond Act is not altered. He was troubled that Britain's Foreign Office may interfere if the conflict is not settled; according to Donner the Finnish bondholders have sold their securities prior the enactment of the law while many Britons have bought Finnish bonds after 1914 and now feel betrayed.³⁵⁶ A complaint by an English retail investor, Mr. E.S. Gunn from late 1921 provides an example of the reactions against the new Bond Act:

I purchased the bonds on June 13th 1921 through my brokers, paying them £ 805:2:0.... Failure to pay me is a breach of the contract between us as sustained by the bond. A similar default in a business transaction would sustain an act of bankruptcy. Formerly I had business dealings with Finnish people and I got a good impression of their honesty and faith keeping. I feel sure they cannot on reflection persevere with acts of default, which will be destructive to Finnish commercial credit. As I am retired from business, I

³⁵⁴ Ministry of Foreign Affairs archives, Group 32O, letters from bondholders to the Finnish embassies.

³⁵⁵ Ministry of Foreign Affairs archives, Group 32O, France, letter from President G. de Vellefrey at Association Nationale des Porteurs Francais des Valeurs Mobilières to the Finnish embassy in Paris, 10.5.1921.

³⁵⁶ Ministry of Foreign Affairs archives, Group 32O, United Kingdom, Ossian Donner from the embassy in London to the Ministry of Foreign Affairs, 21.11.1921 and 2.12.1921.

regard my Finnish investment as a means for providing for my old age. Laws made for Finnish people cannot apply to me as a British subject.³⁵⁷

Later Donner reported that Sir Eric Hambro, chairman of Hambro's influential investment bank, had warned that for the time being the Bank of England prevents any Finnish issuance in London until the implementation of the Bond Act is altered and the coupons of the pre-war loans by the central government and city of Helsinki are paid at full gold value of pound sterling. The French public authorities were drawn in as well. In Paris the French Foreign Ministry, – following complaints by the French Bondholder's associations – sent during the course of 1920 and 1921 three inquiries to the Finnish legation in Paris and insisted that investors should have the right to receive the coupon payments in any of the cities mentioned on the face of the securities. On the Amsterdam bourse list the Finnish bonds were marked by an asterisk for not paying the coupons.³⁵⁸

Donner's warnings from London were not without grounds. The law seriously hampered the government's access to the foreign financial markets. Otto Stenroth from the Bank of Finland carried out painful and stressing negotiations in London during the winter of 1922 on behalf of the Republic. Following discussions with several bankers he had to report to Ryti that it was impossible to sign a contract due to the Bond Act. Stenroth later wrote that the British officials had also been involved and prevented government's first after-war bond issue in London due to the Bond Act.³⁵⁹ Market participants claimed that under these circumstances only short-term issuance might be possible to carry out. For example, bankers from the Samuel Montagu & Co. informed Finns that due to the Finland's Bond Act only possibility to borrow was through Treasury Bills, long-term issuance was absolutely ruled out.³⁶⁰

The market's reaction in the United States was very similar, although Finland had not yet tapped the American financial market. Director Strauss from the investment bank Kuhn, Loeb & Co indicated to the Finland's new ambassador L. Åström in April 1922

³⁵⁷ Ministry of Foreign Affairs archives, Group 320, United Kingdom, letter from E.S. Gunn to Messrs. Schroder and Co. 5.12.1921.

³⁵⁸ Ministry of Foreign Affairs archives, Group 320, France, Ministry's memorandum concerning the French inquiries, 1921; National archives, Risto Ryti 12, Donner's report no: 208, 4.4.1922; Åström's report no: 12, 10.4.1922.

³⁵⁹ Otto Stenroth, 1927: 143; National archives, Risto Ryti 12, letter from Otto Stenroth from Paris to Risto Ryti, 26.3.1922; Otto Stenroth from Baden-Baden to Risto Ryti 1.4.1922.

³⁶⁰ National archives, Risto Ryti 12, Donner's report no: 182, 2.2.1922.

that he renounced his earlier comparison to Denmark as an equivalent sovereign borrower due to the Bond Act. The law ‘cannot be explained to investors’; one cannot overturn agreements afterwards by laws. Finland’s credibility had deteriorated to the extent that Finland’s customs revenues should be used as collateral for a new issue.³⁶¹ In the light of the Bond Act, Finland’s issue price would be closer to that of the government of Brazil. According to Strauss it was absolutely impossible to issue bonds in the United States and neglect miserable market quotations in Europe. He stated that Kuhn, Loeb & Co would not underwrite any bond issue for the Republic if the issuer has outstanding coupons. Brazil had actually tried; when it was found out that Brazil had unpaid coupons, public totally lost confidence and the bank organising the issue was forced to leave the bourse.³⁶²

Under the market pressure Finland finally gave in, although only in Britain. Ryti informed Donner in London on 28 April 1922, that the state would honour the state’s single pre-war sterling loan of 1909 at sterling’s full gold value in London, or in other currencies mentioned on the face of the security, without requiring evidence on the past ownership. On the following day, the city of Helsinki made a similar decision concerning its old sterling loan. However, Ryti demanded that this must imply that no further demands are made and negotiations on new loan arrangements can proceed. Immediately following the declarations, the prices of the central government’s loan of 1909 rose by 2% and the loan of Helsinki by 10% on the bourse. The announcement allowed Hambro to provide an offer for a new loan of four million pounds to the Republic, although the issue was later postponed due to general financial market volatility.³⁶³

Finland’s announcement of the sterling loan aroused anger in France; local investors required to be given the same sort of treatment as in Britain, ie the possibility to choose the currency.³⁶⁴ Ryti strongly rejected the French demands. According to him the underlining principle of the multicurrency bonds was that investors in every country can receive annual payments in their own currencies. The investor base of the French market loans had been and still was overwhelmingly French; the coupon payments had always been paid only in French francs and Finnish marks. The investor base of the sterling loan of 1909 was overwhelmingly British. Now they had been

³⁶¹ National archives, Risto Ryti 12, Åström’s report no: 12, 10.4.1922.

³⁶² National archives, Risto Ryti 12, Åström’s report no: 13, 24.4.1922

³⁶³ National archives, Risto Ryti 12, Donner’s report no: 212, 3.5.1922.

³⁶⁴ Ministry of Foreign Affairs archives, Group 320, France, letter from J. du Chaffault at the French embassy in Helsinki to the Ministry of Foreign Affairs, 19.5.1923.

granted the right to receive coupon payments in sterling, without any proof. That the British investors could choose any other currency as an alternative to sterling had no practical implications; the exchange rate volatility between the 'strong' currencies of denomination of the 1909 loan was minimal and sterling belonged to this group of strong currencies.

In addition, the terms of the French market bonds clearly stated that coupon payments are paid only in marks or francs, although the principal value was stated in other currencies as well. The French bondholders' claim that they should be paid in stronger currencies, such as Swedish crowns, was therefore without any grounds. Ryti concluded that a claim that the French investors are treated worse than the English ones or some others were not true. Finally, he finished his letter to the Ministry of Foreign Affairs, who was in contact with foreign bondholders through Finland's foreign embassies, by a strong statement: 'Finland has and will always honour its commitments. It is a mean revilement against the Finnish government to claim something else.'³⁶⁵

Ryti's decision on the sterling loan was finally relatively easy, because sterling gradually returned to its pre-war parity; the British investors had no reason to complain, and Finland could service the loan at the full gold-value of sterling with a good reason. In contrast, the French investors did not digest paper francs, which had lost most of their value since 1914; in France the conflict was more severe and lasted much longer. The bondholders organised a campaign against the Finnish state in the press arguing that Finland mistreated the French bondholders when compared to the English ones.³⁶⁶

After serious pressure by the French bondholders Finland partly gave in. In 1925 the Finnish government and the National Association of French Holders of Securities found an agreement; the state opened a buy-back programme in American dollars for the loans of 1898, 1901 and 1903 or, alternatively, offered to exchange the loans for the new Finnish 6 % loan issued in New York in 1923. According to the agreement the Finnish government bought back the loan of 1898 at the rate of 26 dollars for each bond of 500 francs and the loans of 1901 and 1903 at the rate of 30 dollars for each bond of 500 francs, that is, either 19 or 17 francs to the dollar. The pre-war parity implied 5 francs to the dollar while in 1928 the franc was re-pegged to gold at

³⁶⁵ National archives, Ministry of Finance, Group Jb3, letter from Risto Ryti to the Ministry of Foreign Affairs, 8.3.1923 and 8.11.1923.

³⁶⁶ National archives, Ministry of Finance, Group Jb3, Ministry of Finance Memorandum, 1925.

25.5 francs to the dollar. The loan of 1895 was in the first place left out of the agreement, as even its face value was only denominated in francs and marks.³⁶⁷

The 'hard line' represented by Risto Ryti seemed to have been successful for Finland. The compromise was much closer to the franc's new gold rate than to the pre-war parity. However, at the time of the agreement with the French bondholders the external value of the franc hit rock bottom. It bounced back against the dollar by the time of the re-peg in 1928. To avoid further complications, the state somewhat improved the terms of the buy-back facility and included the loan of 1895 in the agreement.³⁶⁸

Nevertheless, there still emerged new bondholders who demanded better terms and were ready to take the Finnish state to court. They were usually individuals representing a pool of bondholders who were not satisfied with the agreement between the Finnish state and the bondholders' association. The state tried to find an agreement prior to the court hearings and sometimes offered even slightly better terms than the ones agreed with the bondholders association. However, in 1936 the government finally took one complainant to court and won.³⁶⁹ This manifested the end to the long struggle between the Finnish state and the French bondholders. Two years later, in 1938 the state redeemed all its bonds issued in the French capital market during the time of autonomy. The early redemptions were spurred by the possibility to replace the capital by domestic borrowing and the high foreign exchange losses caused by the franc denominated bonds – franc had stayed in gold longer than most other currencies during the 1930s.³⁷⁰

Finland tailored the implementation of the Bond Act still once more. The only other remaining central government bond from the pre-war period, the 'Bleichröder' loan of 1889 was in the end serviced in Dutch guilders, although originally denominated also in German and Finnish marks. The wording on the face of the bond did not leave much choice to the state: 'the interest and capital is paid, *according to*

³⁶⁷ Bank of Finland archives, chairman archives, prospectus of 1934 bond.

³⁶⁸ Bank of Finland archives, chairman archives, prospectus of 1934 bond; Eichengreen, 1995: 183.

³⁶⁹ Ministry of Foreign Affairs archives, Group 32 O, France, Asko Ivalo from the embassy in Paris to the Ministry of Foreign Affairs, 21.10.1936.

³⁷⁰ Parliament documents, Book I, Government proposal No: 26, 1.4.1938; Book IV, state debt in 1938, 1939.

the choice of the bond holder, in Finnish marks in Finland, in German marks in Germany and in guilders in Amsterdam'.³⁷¹

In Finland, opinions over the Bond Act varied. The Ministry of Finance and the Ministry of Foreign Affairs saw the outrage in a slightly different light. Finnish embassies in the western capitals feared the damages the conflict caused to Finland's foreign reputation while the standpoint of the Ministry of Finance was sterner. The Minister of Finance, Risto Ryti, required the taking into account of the changed economic conditions and also resisted the claims on the basis of the wordings on the loan documents. Finnish businessmen were – in similar fashion with the Foreign Ministry – concerned about the consequences of the law on Finland's foreign reputation and the damage caused with respect to the foreign economic and financial affairs. For example, already in December 1921 Finnish Mercator magazine stringently demanded the abolition of the Bond Act, which 'hampered all prospects for new foreign bond issues'.³⁷²

For Risto Ryti, the most influential person in Finnish monetary affairs in the 1920s and 1930s, it was also a moral question. For him, gold standard was the best monetary regime in the world, presenting the normal state of affairs. World War I broke apart this financial order. Under the abnormal circumstances one had to find a second-best solution which treated all parties involved rightfully. Ryti favoured Finland's return to gold adherence, but at the spot exchange rate, instead of running a deflation or inflation orientated policy prior to the fixing of mark's gold value. Both actions would have too much benefited either lenders or debtors, while a return at the spot exchange rate presented a morally justifiable solution by splitting the damages between both parties.³⁷³ One can interpret that the agreement with the French bondholders was based on very similar argumentation, to find the second-best alternative, which could be justified from the moral point of a view. Ryti's way of thinking is illustrated in his letter from 1924 to Vice-President G.K. Weeks in the National City Bank of New York:

You are acquainted with the fact that the Finnish state has various loans in France, raised in pre-war times. Interest and amortisation for there loans has been paid in French francs also after the war, and considering the text of the bonds the lenders have no juridical right to insist on payment of any other

³⁷¹ State Treasury archives: original bond book of 1889 loan; Bank of Finland archives, chairman archives, prospectus of 1934 bond.

³⁷² Mercator, 1921: 1212–1213.

³⁷³ Ryti, 1925.

kind. However, in order to avoid trouble, I considered it desirable, when I had the portefeuille of the Finances, to try to exclude from the market these bonds, against which we in any case had received gold francs the value of which had been considerably higher than the present paper franc. Subsequently certain measures were taken for the carrying out this idea. Now it has been preliminarily agreed upon that all the franc bonds that are still out will be exchanged for dollar bonds. The difference caused by the fall of the French franc will be divided in an appropriate manner between the holders of the bonds and the Finnish state. It was intended that the Finnish government would lay next autumn before the Diet the necessary motion for the realisation of this plan.³⁷⁴

For Ryti, the wave of protests evoked by the Bond Act provided an insight to the power of the market forces. If the capital markets felt that a certain borrower had repudiated, its prospects for new transactions were fatally hampered, regardless of how carefully argued the action had been on the borrower's side. Moreover, the confrontation showed that the foreign governments, in this case those of Britain and France, were quite willing to defend the interests of their own investors. Ten years later, Ryti did not anymore take the risk of being accused of default; this becomes clear from his action with reference to Finland's response to the end of the one-year Hoover moratorium on war debts that is touched upon later in this study.

Compared to the fear of the communist takeover and irritation caused by the Bond Act, Finland's other internal disputes and economic developments seem to have provoked only little suspicion abroad. However, the first post-war reports of Moody's and Stockholms Enskilda Bank on Finland in 1919–1922 mostly touched upon economic aspects. Their analyses monitored relatively carefully the condition of state finances; the content of both state and local government debt were evaluated and compared to state revenues and expenditures, as well as to national wealth. Moody's noted that the state finances had been 'in a very flourishing condition' before the war. Both institutions stated that the post-war depreciation of the currency and the establishment of the army and foreign representation had placed a burden on state finances after the civil war. Moreover, tax reforms had been delayed and the state had acquired ownership in important industries.

In addition to analysis on public finances, Moody's monitored the composition of foreign trade and monetary conditions. The depreciation of the mark was explained by three factors: high

³⁷⁴ Bank of Finland archives, chairman archives, Risto Ryti no: 4 1565, letter from Risto Ryti to G.K. Weeks, 27.6.1924.

inflation, unfavourable trade balance and the political uncertainty in Eastern Europe. It seems that Moody's leaned toward classifying Finland into the group of the new peril countries of the collapsed Central and Eastern European Empires, characterised by the volatility of their economies.³⁷⁵

Moody's bond ratings probably also reflected the dispute over the Bond Act, although it did not announce the rationale for its rating decisions. It assigned the lowest ratings to the bonds which had been issued on the Paris stock exchange between 1895 and 1903, although it upgraded most of them in 1925. However, the government's loan of 1895 received a higher credit rating only in 1926; it was included to the agreement between the state and the French bondholders later than other franc denominated securities. Similarly, Moody's upgraded the sterling bond of 1909 in 1923, following Finland's decision in the spring of 1922 to service it at the full pre-war value of pound sterling.³⁷⁶

6.5 Revival of international lending (1923–1928)

Stabilisation of Finland's international position and its economic revival combined with the restoration of the international financial markets paved the way for the government's return to the international bond markets. Internationally, the recession of 1920–1921 was followed by an international economic upturn. The successful placement of the Dawes loan in the United States in 1924, intended to stabilise the German monetary conditions, unleashed a burst of US private foreign lending to Europe. The German economy was stabilised in the mid-1920 and a currency reform was carried out. Several countries joined the international gold exchange standard. By early 1926 some 39 countries had returned to gold adherence, either at the pre-war parity or at a devalued rate. For Finland, the re-peg entailed substantial depreciation of its currency; the return to the gold

³⁷⁵ Moody's Governments and Municipals Ratings Manual, Finland: 1920–1923; SEB archives, Direktionens dossier, serie II, Finland, kreditförsträckningar till, vol. 1 and Finland, volymerna 1, 2 och 6.

³⁷⁶ Moody's Governments and Municipals Ratings Manual, Finland: 1922–1928.

peg took place at the outset of 1926 on average at 1/8 of the pre-war value.³⁷⁷

Financial markets shifted their interest in Finland from politics to the economy. *Crédit Lyonnais'* report on Finland in 1921 still concentrated on political events; it went through the orientation of Finland's foreign policy from December 1917 until the peace treaty of Tartu in October 1920.³⁷⁸ Four years later, the bank's focus was already overwhelmingly on the economic matters. The structure of the Finnish economy was carefully examined; not very surprisingly, Finland was assessed to be 'a paper country and an agrarian country'. However, improved monetary conditions and management of state finances were again appreciated.³⁷⁹

Moody's report from 1925 stated that there is unanimous opinion in Finland that the mark should be stabilised at its present level to gold. The agency concluded that devaluation is not expected to give rise to difficulties since the balance of payments for the whole country is satisfactory, the state finances are in particularly promising condition and the creditworthiness of the country abroad is first-class.³⁸⁰ In many ways, by the mid-1920's Finland had been able to restore its status of over a quarter of a century earlier; its political situation was fairly stable and the prudent management of its economy had once again gained the acceptance of the financial markets.

The Finnish government eagerly wanted to take advantage of the improved state of affairs through issuance in the foreign bond markets for very similar reasons as many times before; the Bank of Finland desperately needed to strengthen its foreign currency reserves in preparation for a monetary reform, this time for the second adherence to gold standard.³⁸¹ This was probably the most important single factor behind Finland's readiness to quickly finish the disputes with foreign bondholders, especially in Britain.

The unsettled disputes in Europe affected the market sentiment also in the new continent. The American capital market was of crucial importance for Finland in its attempt to acquire new capital in foreign currencies. This underlined the importance of the fast ending to the disputes with European investors. However, Finland had some open

³⁷⁷ Kuusterä, 1997: 294–295; Eichengreen, 1995: 150–152; Kenwood and Lougheed, 1994: 179–182.

³⁷⁸ *Crédit Lyonnais* archives, DEEF 73251, BE 1372, Finlandé principaux événements politiques, 1921.

³⁷⁹ *Crédit Lyonnais* archives, DEEF 31740, BE 1638, Finlande, étude économique détaillée avec tableaux et note résumée, 1925.

³⁸⁰ Moody's *Governments and Municipals Ratings Manual*, Finland : 1925.

³⁸¹ Korpisaari, 1926: 200–211; Tudeer, 1939: 188–229.

financial matters with the United States as well. The United States government was eager to arrange its war loans with European nations – it had become a big lender to the European countries during the war –, usually through re-structuring of the short-term war loans into long-term obligations, providing simultaneously also some relief in their terms.³⁸² As regards Finland, the government and the Finance Minister Risto Ryti were eager to meet the demands of the US government: similarly with the settlements of the disputes in Europe, a rapid solution to the war loan matter would improve the possibilities for quick access to the American capital market.

Indeed, Finland re-structured its two short-term loans, granted by the Grain Corporation in 1919 and 1920, in April 1923 – although the grain loans were granted to Finland after World War I, they were still classified by the American administration as war loans. Finland was the second nation in Europe to restructure its war loans from the United States, after Britain. Reflecting parallel timing of the settlements, the alterations in the terms were similar to those arranged for Britain. According to the arrangement, the two short-term loans were converted into one long-term loan, which was payable in 62 years. The nominal interest was reduced from 5 per cent to 3 per cent during the first ten years and 3.5 per cent thereafter.³⁸³

Later the new war loan of 1923 became Finland's most famous loan ever, mainly due to Finland's decision to continue servicing the loan after the Hoover moratorium in 1933. Nevertheless, already the earlier events raised discussion. It was even claimed that the American government had confiscated part of the grain shipments and the grain had been of bad quality, but Finland's ambassador to the United States, L. Åström, did not believe the accusations and did not raise them in the negotiations with the US government in 1923. However, the main criticism, which took place inside the Finnish administration, was pointed at the quick rearrangement; other European countries, which rearranged their war debts later, had their commitments furnished with better terms.³⁸⁴ The complaints were later confirmed by Kyösti Järvinen. According to him, on average the European countries received a 40 per cent reduction to the nominal capital of their war

³⁸² Järvinen, 1933: 37–47; Kindlebrger, 1984: 306–308.

³⁸³ Parliamentary documents, Book I, Government proposal No: 18, 12.12.1922; Eichengreen, 1995: 153–172, 276–278, 318–222; State Treasury archives, prospectus of 1928 5 1/2% loan.

³⁸⁴ Ministry of Foreign Affairs archives, 32 O, United States, L. Åström's report no. 46 from the United States to the Ministry of Foreign Affairs, 19.12.1922; National archives, Ministry of Finance, Jb 8, Ministry of Finance 1924–1933, Rudolf Holsti's memorandum 12.8.1932: 'Suomen elintarvikelaina Yhdysvalloista 1923'.

debts whereas Finland (and Britain) consolidated their war debt at 82 per cent of the original nominal value.³⁸⁵

Finland suffered from weaker terms than many others, but on the other hand the hastening of the negotiations induced also some advantages. The state issued its first interwar foreign bond on the western financial capitals half a year later in autumn 1923. The security was partly denominated in American dollars and partly in pound sterling.³⁸⁶ Risto Ryti was personally involved in the launch of the first American market bond: he sent instructions to the embassy in Washington D.C. during the negotiations. According to the Finnish legacy, Ryti's contribution in the loan negotiations was appreciated in the United States. It was said that his skills and professionalism had raised positive attention among American bankers.³⁸⁷

However, the first marketable post-war transaction was not an outright success: 2/3 of the sterling leg was left in the underwriters' hands. In other words, although public authorities no more put obstacles on Finland's right of market entry and banks were ready to underwrite Finnish bonds, investors still remained sceptical, at least in Britain.³⁸⁸

For Finland it was important that, despite of the difficulties, access to foreign financial markets was reopened. The year 1923 symbolized a turning point also in the sense that the state during the same year redeemed all of its domestic and foreign short-term debts. This included short-term credits, which had been raised from the Bank of Finland since 1915; they had been continuously rolled over ever since. In this respect, it can probably be argued with a good reason that by the end of 1923 the period characterised by great uncertainty in state's borrowing was, for the time being, over.³⁸⁹

As a remainder of the past, however, still in 1925–1926 Finland had to undergo negotiations in London over Finland's responsibility for the pre-war Russian Imperial government debts. In Western Europe, holders of defaulted Russian bonds were eager to seize all opportunities to receive even some part of the lost money back and tried to make the newly independent borderland countries of the former Empire responsible for their share of the Imperial government

³⁸⁵ Järvinen 1933, 44–45.

³⁸⁶ Tudeer, 1939: 207.

³⁸⁷ Ministry of Foreign Affairs archives, Group 320, United States, L. Åström's reports from the United States to the Ministry of Foreign Affairs, no. 46, 19.12.1922 and no. 13, 16.6.1924.

³⁸⁸ National archives, Risto Ryti 12, letter from Anders Norrgren from the legacy to the Ministry of Finance, 2.11.1923.

³⁸⁹ Statistical yearbook of Finland: 1923–1924; Tudeer, 1939: 182.

debt. These claims and discussions ended in London to Finland's victory. Secretary of State for Foreign Affairs, Austen Chamberlain answered in August 1926 in the British Parliament to a question concerning the responsibility of Finland, the Baltic States and Poland over the defaulted Russian government debts. He explained that Finland had never received any part of the loans, which had been raised by the Russian government before the First World War and, in fact, Finland had even during its Russian time acted as an independent borrower abroad and raised itself the loans it had required in order to foster its economic development.³⁹⁰

The government's access in 1923 to the international capital markets paved way for other bond issues; in 1924 the Industrial Mortgage Bank of Finland, Finland's Associated Municipalities and City of Helsinki all issued dollar denominated bonds in New York. In the coming years, between 1925 and 1928 the state issued three additional foreign bonds. They were all issued in New York and were denominated in American dollars.³⁹¹

Table 6.2 shows the primary market yields of all Finnish central government bonds on the New York stock exchange and yields of American corporate and municipal long-term bonds during the same months, providing benchmark yields in the American financial markets. Due to different tax treatments direct yield comparisons are somewhat inaccurate, but the yield differential provides information on the changes of the premiums. The US corporate yields were relatively stable in the mid-1920s, while the offered yields of the Finnish government bonds decreased by almost two percentage points during the same period; there was a clear improvement in the markets' assessment on the central government of Finland.

Table 6.2 **Yields of the central government bond issues in New York and secondary market American bond yields**

	7% loan of 1925	6.5% loan of 1926	5.5% loan of 1928
Offered yield	8.03%	7.33%	6.24%
US prime corporate yield	4.48%	4.37%	4.05%
Yield premium	3.55%-points	2.96%-points	2.19%-points

Sources: American yields: Homer and Sylla, 1996: 350. Finnish yields: Moody's Governments and Municipals Ratings Manuals, Finland: 1929.

³⁹⁰ Donner, 1927: 214–228.

³⁹¹ Moody's Governments and Municipals Ratings Manual, Finland: 1925.

The same phenomenon of improved market assessment was observable in reports of the Finnish embassy to the United States. In 1927 the ambassador was able to inform the Ministry in Helsinki that large institutional investors had finally begun to show considerable interest on Finnish bonds. According to investment banks, the only remaining obstacle for American investors in buying Finnish bonds was Finland's close geographical proximity to the Soviet Union.³⁹²

Finland's strengthened economic and political status and, above all, the resurgence of the international financial markets re-opened the global capital markets for the state. However, this period remained a short-lived phenomenon. The government's dollar issue of 1928 was its last new marketable bond issue in the foreign private capital markets before 1961 save a couple of transactions executed in Stockholm in the 1930s. The state launched still one more dollar transaction in 1934, but it was a conversion loan, which did not bring in net terms new capital to the state. The state's next new dollar denominated bond was issued as late as in 1963.³⁹³

Although the capital markets' assessment of Finland greatly improved after the mid-1920s, it is important to notice that the central government was not able to reach the level of the other Nordic states at any stage. In 1929 – before the actual panic hit Wall Street, as next chapter will describe – the yield difference was clear. The yield on Swedish government long-term bonds in New York was 5.08 per cent, for Norwegian government bonds 5.73 per cent and for the Danish ones 5.11 per cent. The tightest Finnish government bond in yield terms, the 5.5% loan of 1928, yielded 6.64 per cent, implying, for example, that the yield difference to Sweden was over 1.5 percentage points.

The managing director of a Finnish co-operative bank, Central Bank for Credit Co-operatives, Hannes Gebhard presented in 1930 his view on the unsatisfactory pricing of Finnish state securities on the international financial centres. He divided the reasons into three classes, reflecting his discussions with foreign bankers: political, economic and loan technical. According to Gebhard, Finland's close geographical proximity to Russia constantly raised state's borrowing costs abroad. This view had been presented to Gebhard in a nutshell by one foreign banker: 'Your geographical position is not beautiful'.

³⁹² Ministry of Foreign Affairs archives, Group 320, United States, L. Åström's report no. 2 from the United States to the Ministry of Foreign Affairs, 31.3.1927.

³⁹³ Bank of Finland archives, chairman archives, prospectus of 1934 loan; valtiovarainministeriön yleinen osasto 1931–1981: 40–42.

In addition, Gebhard even claimed that the radical Ultra-Finnish movement, which had its base of support among Finnish-speaking Finns and was aimed against the strong position of the Swedish language in Finland, would harm Finland's foreign borrowing due to Stockholm's pivotal position in Nordic finances, along with other internal confrontations and prohibition, which had been in force in Finland since 1919. Finland's economic weakness culminated in Finland's inability to restore the value of its currency after the war, along with constantly high domestic interest rates. Finally, Gebhard mentioned the miserable effects of the Bond Act on Finland's foreign credibility and remarked that too many Finnish entities were seeking foreign loans simultaneously, causing over-demand for funds that would principally be available to borrowers from Finland.³⁹⁴

Foreign bankers' assessment was in this case probably influenced also by Hannes Gebhard's own views, but surely, the outbreak of the international financial crises showed even more plainly that foreigners constantly assessed Finland to be a relatively risky investment – and moreover, its credibility on foreign bourses was still very clearly below other Nordic governments.

6.6 Collapse of the international financial system (1929–1938)

The restored international gold standard proved to contain structural weaknesses that did not enable it to gain the sort of credibility that constituted an essential part of the pre-war gold standard. The second gold standard, or the gold exchange standard, as it was named, proved to be short-lived. It collapsed as a consequence of the Great Depression, partly originated in the American industrial downturn and the collapse of the Wall Street stock markets in October 1929.

US foreign lending, a key to the operation of the gold exchange standard, declined already during 1928 and 1929, due to the rise of US interest rates and the stock market boom that attracted capital to the American Stock Exchanges at the expense of Americans' overseas investments. After the stock market crash on Wall Street American lending almost halted and Americans investors began to repatriate their foreign investments. The bounce back of overseas lending in 1930 turned out to be temporary. Several debtors had difficulties in

³⁹⁴ Gebhard, 1930.

honouring their commitments, which from 1931 onwards led to a series of bond defaults; Americans' appetite for foreign portfolio investments collapsed permanently.

The final collapse of the fragile gold exchange standard took place after the financial panic that stemmed from the insolvency of the Austrian Credit-Anstalt. The panic led to massive withdrawal of funds from the central European banks. During the spring and summer 1931 Austria, Hungary and Germany suspended gold convertibility and restricted foreign exchange transactions. In September sterling was withdrawn from the gold standard, followed by the Scandinavian currencies. In April 1933 the newly elected president Roosevelt withdrew the United States from the gold standard. The United States returned in 1934 to a gold peg, but at a devalued rate. The remaining gold bloc countries, led by France, left the gold standard in 1936. By 1937 all major economies had implemented exchange controls. The disintegration of the world financial markets was sealed.³⁹⁵

The Finnish economy lost its steam in 1928. Prices of agricultural products and sawn timber turned down and construction works almost halted. Finnish gross domestic product dropped in three consecutive years from 1930 to 1932, although the downfall was rather moderate as a whole. The Bank of Finland carried out strict monetary policy since autumn 1928 in order to protect its foreign exchange reserves and maintain the gold peg; the trade account had showed deficits in three consecutive years in 1927, 1928 and 1929, before beginning to run a surplus in 1930. As a result, real interest rates remained high. Those who suffered among the worst were farmers who had taken out loans, which they could not pay back. The recession years witnessed also the birth of the radical anti-communist Lapua movement, which after the Mäntsälä revolt was disbanded in March 1932 by the government.³⁹⁶

Finland had to leave the gold standard in November 1931. During the following year, the mark depreciated against the American dollar by 45 per cent, but later bounced back, partly due to the dollar's depreciation after April 1933. From 1933 onwards the mark's value followed sterling; Finland had in practise become a member of the sterling bloc together with other countries that had intensive trading relations with Britain. The economy turned to the better already in 1932. The mainly export-led growth continued the rest of the 1930s

³⁹⁵ Eichengreen, 1995: 258–389; Kenwood and Lougheed, 1992: 191–198; Suviranta, 1931b: 338–345.

³⁹⁶ Hjerppe, 1989: 193; Jussila, Hentilä, and Nevakivi, 1999: 156–160; Kalela, 1987: 20–24.

and Finland was able to benefit from substantial current account surpluses for many years.³⁹⁷

Although the economic recession in Finland was milder and shorter than in many other European countries and in the United States,³⁹⁸ it still imposed a great strain on the state budget. Financially the most difficult year for the state was 1931: the state's revenues dropped by almost 10 per cent in 1931.³⁹⁹ The state was forced to borrow short-term abroad already in 1929 to meet its acute cash needs. In the coming years, it raised more short-term loans mainly from American banks and Finnish Postal Savings Bank. The New York Trust Company and the National City Bank of New York arranged the largest American loans. The short-term loans were probably also the only constantly feasible option to acquire foreign currencies to maintain the foreign exchange reserves of the Bank of Finland due to the collapse of international lending.⁴⁰⁰

Later the state's fiscal and monetary policies have raised a lot of criticism due to their 'restrictiveness' during the recession years.⁴⁰¹ Concerning the state's borrowing, this view can be partly confirmed: the level of state debt did not change much between 1928 and 1933 if one excludes the effects of currency depreciation.⁴⁰² However, the relative limited new borrowing – a great deal of the new loans substituted only for annual amortizations of outstanding loans – does not only reflect domestic policy decisions but also the difficulty to raise new foreign loans.

Due to the depression and financial disintegration, American investors lost their appetite for bonds in general, and foreign bonds in particular. Negotiations with the American bankers showed already in 1929 that a new bond issue was probably not doable. Prior to the stock market crash, in September 1929 L. Åström reported that the appetite of the American investors was solely directed to speculation in shares and the outlook of the bond markets was depressed. After exploratory contacts by American bankers on market sentiment Åström concluded that it was not possible to arrange long-term funding for the Finnish government at any acceptable terms.⁴⁰³

³⁹⁷ Hjerpe, 1989: 48; Kuusterä, 1997: 295–296.

³⁹⁸ Hjerpe, 2004: 14–18.

³⁹⁹ Pihkala, 1974: 271.

⁴⁰⁰ Hjerpe, 1997: 14; Parliament documents, Book II, Government proposal No. 28, 31.1.1930; Rossi, 1951: 250.

⁴⁰¹ For a comprehensive overview, see, for example, Kalela (1987), 1–79.

⁴⁰² Statistical yearbook of Finland: 1929–1934.

⁴⁰³ Ministry of Foreign Affairs archives, Group 32O, United States, L. Åström's report from the United States to the Ministry of Foreign Affairs, 27.8.1929.

In the following year, Åström reported that Finland's creditworthiness was greatly hampered. The financial markets were hit by a panic affecting all securities. Moreover, the recent news from Finland had very negatively affected Finland's credibility; the abduction of the former President Ståhlberg by Finnish officers sympathetic to the right-wing Lapua movement had been noticed on the Wall Street. Åström continued that fortunately the bankers did not yet put Finland in the same category with the South and Central American states. However, 'the aim to move Finland's credibility to the same level with Scandinavian states was removed further away'.

According to Åström, a temporary remedy might be to increase the interest of Finnish institutional investors in the government's foreign bonds. Even relatively minor investments might increase the prices of the Finnish bonds, as had taken place with bonds issued by the Scandinavian states. In the long run, however, the prices of the Finnish bonds were dependent on the overall performance of the European bonds. The recent advances of Adolf Hitler in the German elections had frightened many investors. This turbulence might settle down but the stock market nervousness hindered any considerable rise of the bond market for the time being; many investors were selling their bonds in order to finance their huge losses in equities.⁴⁰⁴

In 1931 the market sentiment was even worse and speculation on Finland continued. During the spring the credit rating agency Standard Statistics refused to issue a credit rating to Finland due to the 'Russian effect', which was not limited to the political threat but also referred to the dumping of forest products by the Soviet Union, thus posing an economic threat to Finnish exporters. In October Åström reported about a panic that ravaged the American financial market. The mania was a result of the withdrawal of sterling and the Swedish crown from the gold standard. The prices of the Scandinavian bonds had been stabilised due to the action of Scandinavian investors, who had bought securities that were issued by their own governments, but the Finnish government bonds 'had been cast adrift'. He noted again that, according to his recent remarks, Finland's creditworthiness seemed to be comparable to Yugoslavia, Romania, Poland and Argentina, not to the Scandinavian countries.⁴⁰⁵

⁴⁰⁴ Ministry of Foreign Affairs archives, Group 320, United States, L. Åström's report no: 14 from the United States to the Ministry of Foreign Affairs, 15.11.1930.

⁴⁰⁵ Ministry of Foreign Affairs archives, Group 320, United States, L. Åström's reports no: 2 and no: 8 from the United States to the Ministry of Foreign Affairs, 16.4.1931 and 21.10.1931.

On the New York stock exchange the prices of the Finnish bonds dropped sharply. The Finnish central government's bonds, which still in 1930 had traded close to par, lost some 2/3 of their value by October 1931. In September-October 1931 their price was close to 30, giving a yield of almost 20 per cent. Interestingly, bonds of other Scandinavian governments at the same time lost only some 10–15 per cent of their value.⁴⁰⁶ In London, yields of the Finnish government bonds increased from 6.7% at the outset of the year to 11.4% at their peak⁴⁰⁷.

Finnish investors maybe not have heard ambassador Åström's requests for greater Finnish demand for the state's bonds on the New York stock exchange, but they recognised an opportunity for windfall profits. Some 200 million of the state's dollar bonds were bought back to Finland in August and September 1931.⁴⁰⁸ Only a few years later the state called the bonds back at par value, implying that domestic investors' pure capital gains were 200 per cent, and on top of that they benefited from depreciation of the mark against the dollar. Asymmetric information probably played an important role: domestic investors could be relatively certain that the Finnish state was not on the brink of bankruptcy, unlike the American investors, who were making decisions in the middle of a panic and under great financial strain. Moody's downgraded Finnish bonds in 1932: this probably dampened American investors' appetite for Finnish bonds even further, at least temporarily.⁴⁰⁹

The state had relied exclusively on American capital in the 1920s. However, the revival of the French financial market raised the interests of the French commercial banks on Finland in the late 1920s. French capital constituted a serious alternative to American foreign lending especially in the early 1930s; unlike in the United States, in France the capital market remained rather liquid, ie the French financial market did not suffer from same sort of liquidation of portfolios as the financial market in the United States. France remained temporarily immune to the international recession and the gold reserves of the Bank of France grew. The situation was reversed only following the decision of the Roosevelt administration to abandon the gold standard in April 1933; the move deteriorated the

⁴⁰⁶ Ministry of Foreign Affairs archives, Group 320, United States, L. Åström's report no: 8 from the United States to the Ministry of Foreign Affairs, 21.10.1931; New York Times, 1.10.1931 and 1.11.1931.

⁴⁰⁷ See chapter 5.

⁴⁰⁸ Tudeer, 1932: 15.

⁴⁰⁹ Moody's Governments and Municipals Ratings Manual, Finland: 1932.

competitiveness of French industries and put pressure on France's gold reserves.⁴¹⁰

French bankers visited Helsinki in the late 1920s and marketed the potential of the French bond markets. According to the bankers, the French markets had reached a situation similar to the one that had existed prior the First World War; liquid investors were looking after higher returns abroad.⁴¹¹ Baron Watteville, director at *Crédit Lyonnais*, met several leading Finnish civil servants in May 1929. After the journey, his remarks on Finland were positive. The financial situation was sound, the debt burden per inhabitant was the lowest in Europe, and the industry was rapidly developing, although there was scarcity of capital.⁴¹²

However, at that stage, the Finns were not yet eager to widen their financial presence in France. During their meeting, Ryti informed Watteville that for the time being the Bank of Finland was conducting very little business in Paris. According to Ryti the Finnish financial affairs were currently being handled in the Anglo-Saxon financial capitals, New York and London. Ryti even claimed that cities like Madrid are more interesting to Finland due to the growing commercial ties between the countries. Moreover, Finland required no long-term loans because the financial needs of the state were only temporary. According to Ryti, the country was experiencing only a temporary growth crisis, partly reflecting the fact that the Bank of Finland had carried out restrictive monetary policies, especially in order to cool down the construction boom in Helsinki.

Ryti's response was bitter; maybe his lack of enthusiasm to carry out business with *Crédit Lyonnais* was also affected by the state's lengthy struggle with the French bondholders association during the 1920s, in which he had personally been involved. This might well be the case because Watteville reported to Paris that he had expressed his regret to Ryti regarding the past difficulties in France. An interesting nuance was that in his internal memorandum Watteville noted that it was believed in Finland that in the future Ryti might be the president of the republic.⁴¹³

During another discussion in 1929, the Minister of Finance H.M.J. Relander showed more interest in the French capital markets, but even

⁴¹⁰ Eichengreen, 1995: 253–377.

⁴¹¹ *Huvudstadsbladet*, 1928.

⁴¹² *Crédit Lyonnais* archives, BE 1638, DEEF 31740, Mission de M. de Watteville, Note Resumée sur la Finlande, May 1929.

⁴¹³ *Crédit Lyonnais* archives, BE 1638, DEEF 31740, Banque Centrale de la Finlande, visite chez M. Ryti, May 1929. Ryti was the President of Finland from 1940 to 1944.

he saw the prospects for new transactions limited. According to Relander, Finland wanted guarantees that up to a certain ceiling a short-term credit could be converted into a long-term loan. This was not acceptable to *Crédit Lyonnais*. Moreover, Relander continued that the state's budget situation in Finland was favourable and the American banks were competing for Finnish business; the Guaranty Trust, the National City Bank and the Bank Blair are 'always willing to finance Finland'.⁴¹⁴

A Finnish co-operative bank, Central bank for Credit Co-operatives, was still in autumn 1930 – through the intermediation of the Bank of Finland – able to launch a new bond in Paris. The loan had been negotiated between Risto Ryti and Marcus Wallenberg Junior from Stockholms Enskilda Bank, representing once again the old *Crédit Lyonnais* consortium built by his uncle K.A. Wallenberg.⁴¹⁵ In Britain, Finland's Industrial Mortgage Bank's bond issue in the same year turned out to be a failure; it was left to the underwriter banks' own portfolios. To close an episode, the City of Helsinki still tapped the financial market of the United States through a new bond. It turned out to be the last new interwar Finnish bond issue in the new continent by any Finnish entity.⁴¹⁶

As the recession turned out to be much more prolonged than anticipated in the spring of 1929, and the American financial market closed down, the government's willingness to access the French financial market increased. In December 1932 also Ryti was ready to approach the French financial market on the state's behalf in order to strengthen the central bank's foreign exchange reserves. He admitted that the access to the private capital markets was limited. Ryti considered it, however, possible to arrange a new loan with the assistance of the French government; he initiated an idea to interlink the ending of the alcohol prohibition in Finland with the loan negotiations – prohibition had been discontinued in April 1932. The negotiations nevertheless ended without any success. The market situation in France was not anymore favourable; the French private investors had stopped buying foreign securities.⁴¹⁷ Ryti's initiative might have had its roots in the confrontation of 1908; the Senate was unsuccessful in issuing a new bond in Paris then because the French

⁴¹⁴ *Crédit Lyonnais* archives, BE 1638, DEEF 31740, Finlande, visite chez M. Relander, *Ministre des Finances*, Mai 1929.

⁴¹⁵ Kuusterä, 2002: 24–25.

⁴¹⁶ Larjavaara, 1969: 42–43.

⁴¹⁷ Ministry of Foreign Affairs archives, Group 32 O, France, memorandum by Hjalmar Procopé from Paris, 9.11.1931 and memorandum by Risto Ryti, 1.12.1932.

government did not accept the intentions of the Finnish Parliament to implement prohibition in Finland. Now Ryti tried to benefit from the ending of it, although with no success.

The government's creditworthiness had also suffered in the eyes of the French investors. The French financial markets still had in mind the dispute on the Bond Act of 1921, but in addition, the right-wing radicalism in Finland had frightened also the French investors. According to Finnish Consul Mauno Nordberg in Paris, the conservative circles in the French capital markets generally assessed positively the fight against communism in Finland, but the recent violence, especially president Ståhlberg's abduction in October 1930, 'had gone over the limits'.⁴¹⁸ Already in June 1930 the *Crédit Lyonnais* analysts had warned that due to the recent internal instability the establishment of a conservative dictatorship in Finland was possible.⁴¹⁹

Once again, also Finland's relations with the Soviet Union raised doubts in Europe. In 1931 German newspapers wrote about the political confrontation between Finland and the Soviet Union, which stemmed from the deportation of 8 000 Ingrian peasants (Finns living close to Leningrad) to Siberia. *Crédit Lyonnais* followed the conflict as well and cited German newspapers, which had followed the deportations. *Crédit Lyonnais* noted also the dispute in East Carelia; it stated that Finnish nationalists keep the question about the province open, 'a province, which had never been a part of Finland, but has an important Finnish minority population'.⁴²⁰

In the end, the Finnish central government did not return to the French financial markets during the interwar years. In the late 1920s, when French banks offered their services, the real face of the recession was not yet known in Finland, and the trust on the continuity of American investments was firm. A few years later, when attitudes in Finland had turned more positive, the political risks associated with Finland had risen, meaning that the French's willingness to finance the Finnish state had diminished. On the background, the struggle between the state and the French bondholders still negatively affected the funding prospects; whether the French would even have been able to arrange a long-term loan for the state at any stage can be doubted.

⁴¹⁸ Ministry of Foreign Affairs archives, Group 32 O, France, Mauno Nordberg from Paris to Ministry of Foreign Affairs, 2.4.1931.

⁴¹⁹ *Crédit Lyonnais* archives, BE 1638, DEEF 31740, Finlande, situation politique interieure, 24.6.1930.

⁴²⁰ *Crédit Lyonnais* archives, BE 1638, DEEF 31740, Les rapports Russo-Finlandais situation politique interieure, 29.5.1931.

A Finnish bank, Central bank for Credit Co-operatives, had still at a relatively late stage succeeded in issuing a foreign bond on the Paris bourse, but it did not have the same background as the state, which had struggled with the French bondholders for years during the 1920s and even its loan was placed only after serious difficulties. Following the franc's devaluation in 1937, however, a new dispute between the French bondholders and the Finns arose concerning the proper value of the franc that should be used in serving the Credit Co-operative loan. In a similar fashion with the earlier dispute, the French government was involved and the result was a compromise between the issuer and the bondholders.⁴²¹

Like ten years earlier, the state's acute cash requirements were fulfilled throughout the recession by short-term loans. The international financial distress and the increased credit risk of the central government prevented long-term issuance. After the recession, which in Finland ended for most part already during 1932, the situation was already different. Instead of even trying to issue new foreign bonds to any greater extent – it would probably have been very difficult or even impossible – the state for the rest of the decade focused on redeeming its outstanding foreign debts. This debt management policy has later raised a lot of attention in Finland, including the somewhat traumatic assertion of being a country that entered the Winter War with no debt, but with bad weaponry and the positive assertion of a country that always paid back its debt, referring to Finland's respect to service its war loans to the United States.

For some reason, the assertions have contained some misinterpretations and have partly been unable to perceive the wider context. Firstly, the total amount of central government debt did not much change during the 1930s. Only the mixture between domestic and foreign debt changed, which reflected both the improved external balance of the economy and the collapse of the international financial system, both of which stimulated domestic borrowing. Secondly, Finland's clean default record holds in reference to the American capital market, but surely many French bondholders frustrated by Finland's reluctance to fully serve its pre-war loans would probably disagree. Anyhow, Finland's respect for American war loans should be evaluated in the context of its earlier experiences with the upset European investors.

⁴²¹ Kuusterä, 2002: 26–27.

6.6.1 Foreign debt becomes domestic

As mentioned above, the level of Finnish central government debt did not greatly change. In the end of 1938 the total state debt amounted to 4.05 billion marks, while in the end of 1933 the state debt had been 4.75 billion marks. The issuance of new loans in the early part of 1939 meant that at the outbreak of the Winter War in the end of November 1939 the absolute amount of state debt already exceeded the 1933 level, even when adjusted for inflation. In relation to GDP the state debt had nevertheless been higher in 1933. In the year-ends of 1931 and 1932 the absolute amount of state debt had been even higher, but the end of 1933 provided a more accurate comparison; the devaluation of the US dollar in April 1933 removed the ‘overshooting’ effect from the mark/dollar exchange rate. This overshooting had temporarily between November 1931 and April 1933, that is, during the interval between the devaluations of the two currencies, boosted the domestic currency value of the central government’s substantial dollar denominated loans.

The real difference was the amount of foreign currency debt. At the end of 1933 foreign currency debt amounted to 3.95 billion marks, while at the end of 1938 it was only 1.2 billion, less than one third of the amount five years earlier. In fact, at the end of 1938 the state had only three foreign currency bonds left, in addition to the Hoover-loan from 1923.⁴²²

Due to the international financial disorder the state’s only foreign source of fresh capital was the Swedish market. Indeed, the central government tapped it in 1934 and again in 1939. Fortunately, at the same time, the Finnish economy gathered momentum and borrowing needs diminished; also from the cyclical point of a view it probably became wise to limit the growth of state expenditure and borrowing. Also the economy’s external balances witnessed a radical alteration. Abandonment of the gold standard and mark’s devaluation led to a surge of exports that removed the current account constraint; central bank’s foreign exchange reserves jumped by 200 per cent between 1933–1938.⁴²³

Under these circumstances, the state concentrated on redeeming outstanding foreign loans. It paid back the short-term loans it has issued during the recession and, finally, during the years 1934–1938

⁴²² Hjerpe, Ikonen, and Valkama, 1993: 12–13; Statistical yearbook of Finland: 1929–1940; Tudeer, 1940: 6–8.

⁴²³ Rossi, 1951: 243.

most of the foreign bonds were redeemed long before the maturity dates set in the terms of the bonds. First the state redeemed in 1934–1936 the foreign bonds issued during the 1920s, which were equipped with coupon rates between 5.5% and 7%. An early redemption of the sterling 4.5% bond of 1909 took place in 1937. Finally, the early redemptions of the four French market bonds and the ‘Bleichröder’ loan of 1889 in 1938 closed an era characterised by intensive engagement with global financial markets.⁴²⁴

The reason for the early redemptions was straightforward. The foreign bonds were furnished with high coupon rates and the state continuously suffered from exchange-rate losses due to the mark’s devaluation against other currencies. For example, according to the government’s own calculations, without the collapse of the gold exchange standard, serving of the three dollar-denominated bonds dating back to the 1920s (loans of 1925, 1926 and 1928) would have cost 330 million marks less for the state. In comparison, the loans had amounted altogether to only 1.4 billion marks meaning that the state suffered from very concrete and substantial exchange losses.⁴²⁵ Through the early redemptions the state was able to avoid further losses stemming from the interest payments.

In addition to improved external balances and the solid condition of state finances, the early redemptions were made possible through the astonishing growth of domestic bond markets. Already in 1934 the Finance Committee of the parliament had noticed that secondary market performance of recent domestic government bonds had been excellent, reflecting the liquidity of the domestic market and high domestic investor demand for government bonds.⁴²⁶ Indeed, a great amount of domestic bonds were issued after the recession by domestic industry, Finnish towns and the state. The state had 4 domestic bonds outstanding in the end of 1928; five years later its domestic loans amounted to 8 bonds and ten years later, in the end of 1938, the number was already 12 bonds. In many domestic bond issues the Bank of Finland was a member of the bank syndicates and took part of the bonds to its own portfolio at the launch, and gradually sold them to domestic investors.⁴²⁷

⁴²⁴ Parliament documents, Book II, Government proposal No. 48, 27.10.1933; Book III, Government proposal No. 98, 1.9.1934; Book III, Government proposal No. 115, 31.10.1934; Book III, Government proposal No. 77, 25.10.1935; Book I, Government proposal No: 5, 22.1.1937; Book I, Government proposal No. 26, 1.4.1938.

⁴²⁵ Parliament documents, Book I, Government proposal No: 5, 22.1.1937.

⁴²⁶ Parliament documents, Book II, report no: 58 of the Finance Committee of the Parliament, 23.10.1934.

⁴²⁷ Statistical yearbook of Finland: 1929–1939; Tudeer, 1939: 329–330.

6.6.2 A country that paid its debt

The legend of Finland as ‘a country that paid its debt’ has its origins in the international war reparations and intergovernmental war debts that had disturbed the international financial relations for the whole post-war period. In June 1931 in response to the international financial panic American president Herbert Hoover proposed a one-year moratorium on principal and interest payments on intergovernmental debt and reparations to ease the financial burden of countries struggling with fiscal and financial problems. After negotiations between the United States, Britain and France the moratorium went into force a few weeks later. In the same year the international conference held in Lausanne finally abolished almost all German war reparations but did not resolve the dispute over intergovernmental war debts.

In the summer of 1932 President Hoover proposed to renew the war debt moratorium for another year, but the proposition was rejected in the United States. European countries still tried to reopen the negotiations on war debts with the United States with little success. In December 1932 several European countries, including France, defaulted on their semi-annual war debt instalments. Other countries that paid in 1932 defaulted in the following year. The default damaged international financial co-cooperation and, among other factors, pushed the United States to unilateral financial and commercial action, which harmed the international economic relations for the rest of the decade. According to Barry Eichengreen, defaults by the European governments inflamed American public opinion and weakened the hand of the internationalists in Congress. It was no surprise that the World Economic Conference in London in June 1933 was an almost complete failure; the aim to stabilise the international foreign exchange markets was not met.⁴²⁸

The central government of Finland provided a striking exception. It decided to continue the payments both in 1932 and again in 1933, when the rest of other the countries defaulted on their war debts to the United States. As later described by Finnish economic historians, Finland’s decision was widely praised in the United States, although Finland’s share of the total amount of war debts given by the United States was only a mere 0.08 per cent.⁴²⁹ Ambassador Järnefelt from Washington D.C. reported to Helsinki in 1938 even over-

⁴²⁸ Eichengreen, 1995: 270–278, 318–332.

⁴²⁹ Larjavaara, 1971: 70–84; Hjerpe and Ikonen, 1995: 15–16, 22–27.

enthusiastically about the great publicity the decision to honour the war debts had gained in the United States:

Americans think that Finland is the only country, which, under the present international circumstances characterised by unruliness and unlawfulness, respects all its international commitments, unlike much bigger and richer countries. Finland is nowadays regarded here as the outmost example of honesty. American tourists visit our country repeatedly and Finland's beauty, culture and art are aspired. The achievements of the Finland's economy are followed and Finns coming here for different purposes are welcomed exceptionally well etc. Due to Finland's good reputation people with Finnish origins have much better chances to achieve something and work in this land.⁴³⁰

Indeed, during the years 1933–1936 almost 3 000 articles concerning Finland and its war debt payments were published in the American press. According to Riitta Hjerppe and Vappu Ikonen, the typical caricature of a Finn in the American press became clearly more positive during the years that followed the moratorium. Also the US government noticed Finland; President Roosevelt recognized Finland's action in his opening speech to the Congress. The speech was broadcasted also to a larger audience.⁴³¹ The US government benefited from the publicity as well. Through Finland's example it was able to shake a finger at other Europeans who had defaulted on their payments. The United States felt that it had offered them important help during the war, but was now let down. On one occasion the Finnish ambassador was invited to visit the US Secretary of the Treasury, Henry Morgenthau, to commemorate Finland's semi-annual war debt payment to the US government. The ambassador soon noticed that he was not alone in the meeting; several journalists from the American press and cinematographic had also been invited to show the world Finland's commitment.⁴³²

Later it has been discussed on various occasions the economic and political impact of Finland's clean debt record and, in particular,

⁴³⁰ Ministry of Foreign Affairs archives, Group 58, Section 19, United States, Finland's food loan, Eero Järnefelt to the Ministry of Foreign Affairs, 22.1.1938.

⁴³¹ Hjerppe and Ikonen, 1995: 22.

⁴³² Ministry of Foreign Affairs archives, Group 58, Section 19, United States, Finland's food loan, Hjalmar Procopé to the Ministry of Foreign Affairs, 16.6.1939.

Finland's faithful service of its war debts to the United States.⁴³³ One example is provided by Finnish historian Hannu Rautkallio, who has assumed that the US public opinion and emerging diplomatic interest of the United States might even have had an impact on Kremlin during the crucial Winter War (1939–1940) peace negotiations in March 1940. Finland's heroic fight was greatly appreciated in the United States, not least due to the work of 'The Finnish Relief Fund' that provided aid to Finland and affected American public opinion. The fund was headed by the former President and father of the war debt moratorium Herbert Hoover.⁴³⁴

The earlier Finnish studies on the impacts of the decision to service the war loans have emphasised its publicity value in the United States. But did it really enhance Finland's credibility in the American financial markets? To find this out, one alternative is to look at prices of government's marketable bonds in the American financial markets. The yield premium between Finnish government bonds and the American prime corporate bonds reached its peak in the summer of 1932 and returned thereafter close to the levels that had existed prior to the collapse of the international gold exchange standard, although never below.⁴³⁵ This would imply that Finland's credit premium in the American bond markets recovered from the Depression and the consequent financial distress, which enlarged yield premiums, although it does not yet tell anything about the reasons for the revival.

Partly the effects of Finland's action can be sorted out comparing the performance of state's bonds to those of other countries. By the end of 1933 the prices of the Finnish government bonds on the New York stock exchange had, following the total collapse in autumn of 1931, on average climbed back to 88 per cent of the value they had had in the end of 1929. For comparison, the Estonian government 7s stood in the end of 1933 at 73 per cent, Polish government 6s at 80 per cent, Czechoslovakian 8s at 78 per cent and Belgium 7s at 86 per cent of the end-1929 value. All foreign governments mentioned above defaulted on their war debts, unlike Finland.

⁴³³ Juhani Suomi has even claimed that Finland continued to service its war debt despite of the moratorium, giving an impression that the moratorium was permanent. According to him the decision not to default was from an economic point of view disadvantageous, even difficult to understand, although providing 'advertising value'. Suomi (1989), 102–109.

⁴³⁴ Rautkallio, 2002: 262–264.

⁴³⁵ Global Financial Data; Homer and Sylla, 1996: 350.

In other words, the Finnish government bonds had performed somewhat better than those issued by other small and medium-size European states, which had no clean default record in the United States. The prices of Norwegian government securities on Wall Street had recovered at a similar rate with the Finnish bonds; Norway never had any war debts to the United States.⁴³⁶ Comparisons of bond prices after 1933 are not anymore adequate, as the Finnish government began to redeem its outstanding dollar bonds; this put a strong upward pressure on the prices of the Finnish central government bonds.

Due to the collapse of American foreign lending, Finland could barely reap the benefits of its commitment to serve the war debts in the capital markets; no new issuance was executed. Nevertheless, in 1934 the state converted some of its older dollar bonds that it had issued in 1925 and 1928 into a new loan furnished with a lower coupon rate. According to Risto Ryti, this was partly doable due to Finland's decision to pay the instalments of the war loans, which had bolstered trust in Finland in the United States.⁴³⁷ After a break of 30 years the Finnish central government continued bond issuance on Wall Street, and still utilised the publicity gained from the war debts; caricatures of honest and reliable Finns paying war debt instalments – originally they had been published in American press, mainly in the 1930s – were shown to American investors during state's investor road-shows. How much this really affected the pricing of the state's bond issues in the United States is difficult to quantify.⁴³⁸

One rational for Finland's action was rather obvious: the state wanted to avoid a situation it had faced 10 years earlier after the enactment of the Bond Act. The battle over the pre-war gold bonds was still remembered, even in the United States, where the Finnish central government had never had any direct conflicts with the investors. For example, in April 1932 Ambassador Åström reported to Helsinki that the American press had published articles about the Finnish Bond Act and described Finland's reluctance to serve its liabilities in France. The articles probably reflected the great anxiety in the United States over foreign defaults. During the same time, several South American defaults had raised a storm in the United States, which had reached also the Congress.⁴³⁹

⁴³⁶ New York Times 1.1.1930 and 1.1.1934.

⁴³⁷ Ministry of Foreign Affairs archives, Group 32 O, United States, letter from Risto Ryti to Antti Hackzell, 21.12.1933.

⁴³⁸ Nars, 2002.

⁴³⁹ Ministry of Foreign Affairs archives, Group 58, Section 19, United States, Finland's food loan, L. Åström to the Ministry of Foreign Affairs, 1.4.1932.

Under the nervous and volatile market conditions, Finland did not want to hamper its credibility, and its access to the American capital market, again. The Finnish authorities responsible for government's foreign borrowing were eager to utilise the decision similarly with their American counterparts. Risto Ryti stated in November 1934 in an American newspaper: 'We signed a contract. We promised to pay. It is the only honest thing to do.'⁴⁴⁰

6.7 Econometric assessment

In this section my aim is to examine the credit risk associated with the central government of Finland through regression analysis and to find out whether the observations presented earlier can be further supported by statistical relationships. It is important to notice that the long time span used in the regression analysis probably contains regime shifts meaning that the results should be assessed with some caution. However, I feel it is worthwhile to also look at whether the earlier findings can be supported by statistical relationships.

6.7.1 Regression model

In the model the dependent variable is the yield spread between the Finnish government foreign bonds and the British government bonds, the latter of which was commonly regarded as the risk-free benchmark of the gold standard financial markets. There are six independent variables. International financial market volatility seemed to be of importance for the performance of Finnish bonds; it is measured through yield spreads between average non-benchmark bond yields and yields on British consols ($R_t^* - R_{UKt}$). I will employ one political risk variable, which reflects political and economic crises in Russia. It is a dummy-variable that captures the Russian revolutionary movement in 1904–1906, the regime changes in 1917 and the consequent Russian civil war in 1918–1921. During the crisis years this variable will have a value of 1. The presumption is that Russian crises should enlarge the credit premium between Finland and Britain, because it would affect relatively more Finnish securities than British securities due to a number of geographical and historical reasons.

⁴⁴⁰ Hjerpe and Ikonen, 1995: 23–27. Ryti's statement originally published in an American newspaper 'El Paso' on November 26, 1934.

Another political variable would evidently measure Finland's 'internal' political conditions. Given the information of the previous chapter, the degree of Finland's autonomy, particularly during the years of oppression (1899–1905 and 1908–1917), might have been another variable reflecting political risk. This variable, however, was not significant in the applied regressions. One reason is probably that the credit risk is measured here as a yield spread against the British consols. During 'the first period of oppression' the yield differential widened mainly against other Scandinavian sovereign bonds but not against the consols due to the international yield convergence, which depressed yield differentials between British consols and other peripheral sovereign bonds. Moreover, the end of Russian oppression did not diminish Finnish bond yields – in fact, the opposite happened: yield spreads widened starting in 1917.

In the light of the earlier chapters, Finland's adherence to the classical gold standard and gold exchange standard seemed to be of interest to foreign financial markets. Later the impact of gold adherence on credit premiums in the international bond markets has raised a great deal of attention. Michael Bordo and Hugh Rockoff found evidence that adherence to the classical gold standard from 1870 to 1914 was a signal of fiscal rectitude that shaved off some 40 basis points from the credit spreads between government bonds on the European bourses. In other words, governments' willingness to commit to the discipline of the gold standard lowered the costs of servicing the public debt.

Later Bordo, Edelstein and Rockoff argued that the financial markets of the United States also during the interwar period viewed adherence to the gold exchange standard as a 'Good Housekeeping Seal of Approval' that lowered the credit premiums. According to their study, this signalling effect was stronger if countries returned to the gold standard at the old pre-war parity. Marc Obstfeld and Alan Taylor have confirmed the evidence regarding the classical gold standard, but claimed that the interwar gold exchange standard was less credible and returning to gold at par value brought no benefits to the issuers. Recently, Marc Flandreau and Frédéric Zumer have even challenged the signalling effect of gold adherence during the classical gold standard and underlined the significance of the fiscal variables, that is, interest expenses in relation to state revenues and the borrower's default history.⁴⁴¹

⁴⁴¹ Bordo, Edelstein and Rockoff, 1999: 26–31; Bordo and Rockoff, 1996: 408–416; Flandreau and Zumer, 2004: 38–39; Obstfeld and Taylor, 2003: 241–244; 265–266.

This study, dedicated to examining the evolution of the credit risk associated with the central government of Finland, does not naturally try to find general results on the impact of gold adherence. Nevertheless, as it seems in the light of previous sections to be something that clearly mattered (positively) to the financial markets when evaluating Finland, Finland's adherence to gold is included in the regression analysis through a dummy variable, which takes a value of 1 when both Finland and Britain were in the gold standard. Because Britain joined both gold standards before Finland and left them, de facto, at the same time, it actually reflects Finland's participation in both of the gold standards in 1879–1914 and 1926–1931. The presumption is that Finland's adherence to international gold standards should reduce the credit premium between Finnish and British government bonds.

I use three variables that reflect the prevailing economic circumstances in Finland: fiscal sustainability, monetary stability and economic performance. They are all measured in the model through each indicator's dissimilarity between Finland and Britain, for the reason that also the dependent variable indicates a difference, ie the yield spread on bonds. The exact construction of the Finland-specific variables relies heavily on Marc Flandreau's and Frédéric Zumer's research, which studied the evolution of credit risk during the classical gold standard through a large pool of countries.⁴⁴² The starting point is the views and beliefs of the contemporary market participants, those responsible for buying and selling Finnish government securities in the contemporary financial markets. As already mentioned, the most important implication of this methodology is that gross domestic product (GDP) is not incorporated into the regression analysis, because it was not regularly calculated in Finland prior to the Second World War.

Fiscal sustainability is measured here as the ratio of interest expenses to state revenue (government interest expenses/government income), capturing the methodology of the *Crédit Lyonnais* rank-order table from 1898, which was presented earlier. The presumption is that this variable should have a positive sign; if the burden of the state debt increased in Finland in relation to Britain, this should have raised the credit risk associated with the Finnish central government. Monetary stability is captured by relating central bank reserves to outstanding stock of banknotes (central bank reserves/banknote circulation). The presumption is that higher note cover ratios should have reduced the

⁴⁴² Flandreau and Zumer, 2004.

credit spread; if Finland had more reserves in relation to banknotes than Britain, this should have lowered the credit premium associated with Finland. The performance of the national economy is measured through the development of exports (exports in 1926=100). This variable should have a negative sign; if Finnish export development outperformed British exports, the credit risk associated with the central government in Finland should have decreased, for example, due to the higher tax revenues they generate for the central government.

Following the introduction and rationale for the right-hand side variables, the final regression model is presented below⁴⁴³

$$\begin{aligned}
 R_{\text{FINt}} - R_{\text{UKt}} = & \alpha + \beta_1(R_t^* - R_{\text{UKt}}) + \beta_2\text{RUSSIA}_t + \beta_3\text{GOLD}_t \\
 & + \beta_4\text{D}(\log\text{FISCAL}_{\text{FINt}} - \log\text{FISCAL}_{\text{UKt}}) \\
 & + \beta_5\text{D}(\log\text{MON}_{\text{FINt}} - \log\text{MON}_{\text{UKt}}) \\
 & + \beta_6\text{D}(\log\text{EXP}_{\text{FINt}} - \log\text{EXP}_{\text{UKt}}) + e_t
 \end{aligned} \tag{6.1}$$

where $\alpha, \beta_1, \dots, \beta_6$ are parameters to be estimated. In the regression, the last three variables have been differenced because they do not seem to be stationary. The regression is run for the years 1863–1931 meaning that it covers Finland’s adherences to silver and gold standards. Due to the unavailability of (comparable) data it was not possible to continue it after 1931. In addition, the same regression model is run for a shorter period, that is, for the years 1863–1914, in order to test whether the statistical relationships were different during the pre-World War I era, which did not contain the same sort of financial crises and financial market volatility as the post-1914 period.⁴⁴⁴

⁴⁴³ The exact construction of the variables is described in the appendix.

⁴⁴⁴ The regression model bears some resemblance to the Capital Asset Pricing Model (CAPM), one of the classical models of the modern portfolio theory. The CAPM provides an expression which relates the expected return on an asset to the systematic risk. Systematic risk, which is also referred as undiversifiable risk or market risk in the CAPM, is the part of an asset’s risk that cannot be eliminated via diversification of the investment portfolio. Although the model used here is very far removed from the classical model, it still offers the same sort of advantages as the CAPM by taking into account market volatility, ie the systematic risk component of the classical portfolio model. For example, Bordo and Rockoff (1996) and García-Iglesias (2002) have used modified versions of the CAPM when studying interest rate differentials.

6.7.2 Results

The OLS regression results are presented in table 6.3. Heteroskedasticity and autocorrelation consistent standard errors are shown in parentheses. For both periods, two different models were run; one containing variables reflecting market-wide fluctuations, Russian crises and adherence to the gold standards and another one which in addition to the above-mentioned variables also included differenced variables reflecting Finland's fiscal and monetary stability and economic conditions through export performance.

Table 6.3 **OLS regression results**
(dependent variable: yield spread)

	Long period (1863–1931)		Short period (1863–1914)	
	(1)	(2)	(1)	(2)
	Coefficient (S.e.)	Coefficient (S.e.)	Coefficient (S.e.)	Coefficient (S.e.)
Constant	1.30* (0.69)	1.30* (0.59)	1.52** (0.45)	1.60** (0.43)
Market situation	0.52* (0.23)	0.56* (0.28)	0.17 (0.22)	0.13 (0.21)
Russian crises (1 = crisis years)	2.06* (0.75)	2.06** (0.79)	0.57** (0.12)	0.58** (0.14)
Gold adherence (1 = gold standard)	-0.98** (0.36)	-0.98** (0.37)	-0.42** (0.17)	-0.44** (0.17)
Fiscal sustainability	-	-0.35 (0.35)	-	-0.07 (0.31)
Monetary stability	-	0.35 (0.58)	-	-0.57** (0.21)
Exports	-	0.16 (0.32)	-	-0.52 (0.38)
Sample size	69	68	52	51
Adjusted R-squared	0.54	0.52	0.25	0.27

Notes: Heteroskedasticity and autocorrelation consistent (Newey-West method) standard errors are in parentheses. Individual coefficients are statistically significant at the * 5% or ** 1% level.

The results of all four regressions were highly similar in two respects: in every regression political and economic upheavals in Russia and adherences to gold were statistically significant. The revolutionary movement in Russia in 1904–1906 and the regime changes in 1917 and the consequent civil war increased the credit risk associated with the central government of Finland. In contrast, Finland's adherences to international gold standards diminished the credit premiums against the British consols.

The interest-rate fluctuations of the international financial markets affected the credit risk when the regression was run up until 1931. However, during the shorter period (1863–1914) it was not statistically significant. Results concerning other variables seem to be very robust, but this variable should be assessed with care. Its significance and impact are dependent on the choice of data and firmer results would require access to a larger pool of data.⁴⁴⁵

The fact that none of the three remaining economic variables was statistically significant in the longer regression, and only one of them in the shorter regression, can reflect, for example, the availability of information. As stated earlier, only export statistics were available to the contemporary people without a very long time-lag, ie changes in state revenues, note circulation or central bank reserves were not immediately or even soon available. The *Crédit Lyonnais* analyses, for example, show that the financial markets were aware of the usually superb condition of Finnish state finances, but this fact is probably not captured by these regression models that concentrate on changes in economic conditions and their impact on bond market assessments.⁴⁴⁶ Moreover, evaluation of the credit premiums in chapter 5 quite clearly indicated that the solid condition of Finnish state finances could not prevent the widening of the credit premium in the early 20th century: political risks overweighed all fiscal considerations.

The results might also indicate that the international financial markets did not reward Finland's fiscal and monetary policies or the export performance as such. Instead, the rewarding effect might have operated through the exchange rate regime arrangements; Finland's adherences to classical and gold exchange standards could have signalled overall fiscal and monetary rectitude. One reason might be that in a world of asymmetric information Finland's position as an unknown borrower located on the outermost edge of Europe was emphasised; it was more peripheral than many other nations outside the core markets, even lacking full sovereign status. In this situation, Finland was able to partly identify itself with more developed

⁴⁴⁵ In these regressions, only yields of four government bonds have been utilised for the calculation of market-wide fluctuations. They are mainly London quotations after 1914 and stand for countries which were affected by the financial turmoil after the First World War and during the Great Depression. If one includes domestic quotations of some 'safe-heaven' countries, which are presented by Homer and Sylla (1996) and therefore available, such as Netherlands, Switzerland and France (in the early 1930s), the variable reflecting international market fluctuations is no longer statistically significant. For sources: appendix 1.

⁴⁴⁶ Another model was constructed including the first lags of the explanatory variables. However, it did not bring any major changes to the results.

countries though its adherence to gold: this decreased the credit risk associated with the state.

Overall, the results of the applied econometric analyses seem to complement and support reasonably well the results which were presented earlier. They support the historical evidence that Finland was not isolated from Russia's political and economic instability. Moreover, the spread of the international gold standards favoured Finland's borrowing. That international financial turmoil, which characterised the capital markets during the post-war years and the Great Depression, also affected the state's credibility is probably not very surprising. It is important to notice that Finnish government bonds were much more severely hit than those of many other countries.

6.8 Peace, prosperity and respect for commitments

The descriptions of the loan negotiations during the 1860s seem to confirm the quantitative observations of chapter 5 on the credit risk associated with the central government; there were great difficulties in acquiring new loans. For the outside world, Finland remained an unknown and peripheral corner of Europe. The Grand Duchy had only begun the gradual process enhancing its unique and distinct status in the Russian Empire. The international financial markets hardly yet understood the fact that the developments of the 1860s separated Finland's destiny from that of Poland's or the Baltic Germans, although liberal circles in Finland even compared Finland's autonomy to that of Norway's. The Finnish state suffered from the international financial volatility, stemming from the Polish uprising and Germany's unification wars, and from its own fiscal misery. Many of the first foreign loans became expensive, but the Grand Duchy was, fortunately, able to raise them because they made possible important monetary reforms and construction of the first railway lines.

During the last few decades of the 19th century Finnish state's creditworthiness reached its culmination. International financial conditions improved quickly after the end of the Franco-German war, not least because France managed to pay its war indemnities at an astonishing pace. Common adherence to the gold standard became the backbone of the international financial system characterised by growing financial market integration. International stability was accompanied by Finland's internal reforms, which were implemented

with great success. Economic growth got new steam; the 1870s are often regarded as the dawn of the long catch-up process of the Finnish economy. Due to prudent fiscal policies and solid economic growth the condition of state finances was, according to the private foreign market analyses, one of the best in the world in the end of the century. Fiscal austerity was accompanied by monetary prudence. The monetary policy of the Bank of Finland was successfully adjusted to the gold standard rules. The value of the mark was the same as that of the French franc; prior to 1914 it stayed at par, usually within an interval of one percentage point.⁴⁴⁷

Political risk remained minute. Internal stability was accompanied by external security. The gradual process of Finland's separation from the Empire culminated during these decades. Nonetheless, at the turn of the century the political calm was replaced by political anxiety. Suddenly, the loan negotiations contained a new sort of excitement, stemming from the Russian efforts to suppress Finland's autonomy. Prior to the First World War, the financial markets did not doubt the state's economic solvency, but its political autonomy. This implied that the Grand Duchy's creditworthiness became highly similar to that of the Imperial government, which was shadowed by the growing political tensions that, in particular, ravaged the Russian society during and after the disastrous Russo-Japanese war.

Finland's fiscal and monetary situation was under great distress after World War I. The state's failure, however, to return to the international bond markets did not, first and foremost, stem from the internal economic conditions. Instead, international financial turmoil greatly hampered prospects for new issuance. And above all, the deep-rooted fear of the international capital markets of Bolshevism troubled the state's creditworthiness. The revival of the international financial order – highlighted in the reconstruction of the gold standard – enabled the state to return to the international financial centres, but much later than other Nordic countries. Access to western financial markets did not free Finland from the shadow of its communist neighbour. The financial markets' distrust was not limited on left-wing radicalism; the right-wing Lapua movement likewise frightened the capital markets during the depression years.

The state's second period of reliance on the international bond markets during the 1920s barely lasted for five years. During that short period Finland resumed its pre-war economic status; economic growth got new steam, state finances were stabilised and monetary

⁴⁴⁷ Autio, 1992: 9–10, Autio, 1996: 8–9.

policy was anchored by adherence to the gold standard. The economic downturn brought to an end American foreign lending, which had been a key to the functioning of the interwar financial markets. In 1931, the collapse of the international gold exchange standard sealed the world financial disintegration. Fortunately, the improved domestic monetary conditions and enhanced external balance of the economy enabled the state to depend on domestic savings in the 1930s.

The quickly changing interwar international monetary conditions caused great harm to the state, both in the aftermath of the war and again during the Great Depression. Its attempts to find feasible and justifiable solutions to the handling of pre-war bonds, through the enactment of the Bond Act in 1921, distorted foreign funding for many years and hampered its financial credibility, especially in France. For the state, it was never an attempt to default. It tried to prevent currency speculation under temporary and abnormal circumstances. Indeed, the Bond Act was only a second clause of a law enacted to adjust to the new monetary circumstances; the first clause of the law exempted the Bank of Finland from the gold peg. The law was also meant to be temporary 'in order to not hamper the country's credibility'.⁴⁴⁸

The failure to arrange international monetary relations invoked defaults by several countries on the war debt payments in 1932–1933. This time Finland carefully took care of its creditworthiness and, unlike other states, continued to serve its war debts. Finland's reputation was lifted by relatively small sacrifices; the annual instalment was 0.4 per cent of total state expenditure in 1932 and declined rapidly thereafter because the Finnish mark appreciated against the dollar and state expenditure as a whole grew.⁴⁴⁹ In addition, in 1934 the United States government approved an interest reduction to the loan.⁴⁵⁰

Overall, the state's debt management policies during the 1930s were a great success. The state called foreign high-coupon bonds or bought them from the secondary markets and in this way considerably reduced its debt expenditures; it did not have to continue servicing foreign currency loans, which had become expensive after the mark's depreciation. Moreover, it executed the call options in a cost-efficient manner; the US dollar denominated bonds were called in 1934, that is,

⁴⁴⁸ Parliament documents, Book I, Government proposal No: 20, 27.5.1921.

⁴⁴⁹ Autio, 1992: 110; Suomen taloushistoria 3: 357.

⁴⁵⁰ Hjerpe and Ikonen, 1997: 22; Ministry of Foreign Affairs archives, Group 32 O, United States, letter from Stuart from National City Bank of New York to L. Åström, 15.12.1932.

following the dollar's depreciation, whereas the French franc bonds were called in 1938, after France had abandoned the gold standard and its currency had depreciated. The foreign redemptions were also well grounded from the cyclical point of view. Finland's national production rose, on average, 6.6 per cent annually in 1932–1938:⁴⁵¹ debt reduction helped prevent the economy from overheating. Simultaneously, the development of domestic bond markets was enhanced; for example, due to the enactment of a new tax law in 1929 bond trading in Finland was exempted from stamp-duties.⁴⁵²

The central government's debt management in the 1930s was arguably nothing else but imitation of the Swedish policies 15 years earlier: foreign debt was redeemed as soon as the economy's external balances and budget situation allowed it. The end of foreign borrowing also resulted from the collapse of the international financial system; the switch to the domestic market did not only reflect Finland's decisions. Nevertheless, due to the new direction in borrowing, the state did no longer had to suffer from constant and substantial exchange rate losses nor did it have to be dependent on foreigners' assessment of its credibility, which was often irrational and dependent on factors that were determined outside Finland – in particular, reflecting developments in Russia – although the inflow of foreign currencies, undoubtedly, had earlier also been extremely beneficial for Finland.

⁴⁵¹ Hjerppe, 1989: 48.

⁴⁵² Tudeer, 1932: 22.

7 Significance of foreign funding

The construction of the nation-wide railway network, and a railway line connecting the Grand Duchy to St. Petersburg (and in 1913 to other parts of the Empire), was almost solely financed through funds raised by the state from the foreign capital markets. The railways gradually integrated Finland internally into one economic area and drew new parts in the interior of the country to take part in the modernisation process and catching up with more advanced nations; agriculture was commercialised and it started to become economically profitable to the forest industry to utilise forest reserves in the northern parts of the country. After the First World War the state raised foreign funds to acquire ownership of some strategically important industries and build economic infrastructure, including hydroelectric power; foreign loans enabled the new independent state to implement its development strategy inspired by economic nationalism, as described by Markku Kuisma.⁴⁵³ Its ability to access foreign fixed-income markets also enabled the state to replace older foreign and domestic bonds with more cost-efficient new loans, both in the end of the 19th century and during the interwar years.

Thoroughly evaluating the impact of the state's infrastructure investments on Finland's economic development would probably require a study of its own. In this study, my aim is much more modest. I will only examine the importance of *foreign borrowing as such*. An obvious alternative way of financing the infrastructure investments, in addition to raising taxes and other state income, would have been to tap domestic savings.

This was never done, however, to any great extent before the Great Depression. The state relied extensively on foreign capital markets and put a lot of attention on its credibility in the eyes of foreign investors, which was a precondition for the extensive and frequent importing of foreign capital until the late 1920s. Whilst evaluating why reliance on the foreign financial markets was important, I will, whenever possible, also employ the views and beliefs on the contemporary people. The fundamental methodological choice of this research, ie looking at the world from the perspective of the people that lived that era, will apply also for this evaluation.

⁴⁵³ Kuisma, 1993: 258–261.

7.1 Domestic savings for private use

First and foremost, the state wanted to leave the domestic financial market to private use. The risk of crowding out of domestic investments by state's domestic borrowing was already in the minds of the 19th century Finnish decision makers, as is evident from a letter of the Finnish Diet from 1882. It discussed the pros and cons of domestic and foreign loans. The Diet assumed that it was not yet time to concentrate only on domestic borrowing, because capital accumulation in Finland was not sufficient to meet the borrowing needs of the state. Extensive domestic issuance would distort the domestic capital markets and damage Finland's economic life. The Diet admitted that Finnish investors had bought relatively large portions of the state's foreign bonds back to Finland from the secondary markets during the 1870s. This led the Diet to conclude that in the longer run a significant part of the state's foreign bonds will inevitably return to Finland, but it was nevertheless assumed to induce fewer distortions if domestic ownership widened only gradually, instead of large one-time discretionary domestic bond issues.⁴⁵⁴ In a very similar fashion, according to Ivar Sundbom, the Swedish state concentrated its borrowing abroad; it wanted to leave the domestic financial market for private use.⁴⁵⁵

The same anxiety regarding the crowding-out effects was later emphasised by Senator Leo Mechelin. In his survey over government borrowing from 1895 he underlined the small size of the domestic capital markets in relation to the government's funding needs, which made it necessary for the state to tap foreign bond markets. However, Mechelin also noticed the growing potential of domestic savings, which had greatly accumulated.⁴⁵⁶ Mechelin's remarks were not without grounds; deposits in domestic banking institutions grew from 27 million Finnish marks in 1870 to 236 million marks in 1895. By 1914 they amounted already to 1 029 million marks.⁴⁵⁷

The size of available domestic savings, instead of bank deposits, is maybe more correctly evaluated through the magnitude of domestic bond holdings. In 1905, bond portfolios of the largest Finnish institutional investors, that is, the state, banks, insurance companies

⁴⁵⁴ Parliament documents, Book II, letter by the Finnish estates to the Emperor, No: 22, 5.6.1882.

⁴⁵⁵ Sundbom, 1944: 230–231.

⁴⁵⁶ Mechelin, 1895: 65–66.

⁴⁵⁷ Suomen taloushistoria 3: 328–331.

etc. amounted to 132 million marks. Ten years later, in 1914 bond investments had climbed to 160 million marks.⁴⁵⁸ For comparison, the state debt, all of which was classified as foreign, amounted to 171 million marks in 1914, of which over 90 per cent was owned by foreign investors. Despite of the fact that the size of domestic savings manifold exceeded the amount of the state debt in 1914, domestic bond holdings were only roughly at the same level with state debt.⁴⁵⁹

The state was not the only domestic bond issuer. The total amount of outstanding bonds issued by Finnish entities, ie state, municipalities, credit institutions and industries, was 533 million marks in 1914.⁴⁶⁰ That was more than three times the bond holdings of Finnish entities. The statistics show that Finland imported substantial amounts of foreign capital through foreign bond issuance. Given these figures, it is unlikely that the state could have easily attracted a great number of domestic investors, although domestic savings were expanding. Finland was, after all, a capital importer.⁴⁶¹ The difficulty in increasing the appetite of domestic investors was evidenced by the poor success of the state's last domestic bond issue prior to the World War I; out of the donation land issue of 1890 the state funds had to subscribe to almost 2/3 partly due to the lack of private domestic demand.⁴⁶²

Another, somewhat related question was the large size of the state's own bond holdings, which increased constantly from 1870 to 1903 and stabilised thereafter; they amounted to some 60 million marks in 1903–1913.⁴⁶³ This raised some negative attention after the turn of the century when the terms of the central government's foreign funding worsened. It was doubted, whether it was wise to borrow at higher costs abroad and simultaneously invest state funds' surplus capital in foreign securities that offered a lower return. According to the criticism, the state should have replaced new foreign issuance by unwinding its portfolio investments, ie the state's own savings should have been cut.⁴⁶⁴ As indicated, this partially happened: the growth of the state's portfolio investments came to a standstill. However, the Senate still probably wanted to maintain some liquid assets and, on the other hand, to continue its presence on foreign stock exchanges. This

⁴⁵⁸ Obligationsitilasto vuosilta 1905–1914: 1.

⁴⁵⁹ Obligationsitilasto vuosilta 1905–1914: 9–10.

⁴⁶⁰ Obligationsitilasto vuosilta 1905–1914: 5.

⁴⁶¹ According to Bärlund (1992) Finland's current account showed deficits during the years of autonomy. See also Hjerpe (1989), 154–155, 259–260.

⁴⁶² Nevanlinna, 1907: 451–452.

⁴⁶³ Kuusterä, 1989: 385–386.

⁴⁶⁴ Donner, 1906.

would help to keep foreign financing channels open and remind foreign financial markets that Finland was still an independent financial actor, especially vis-à-vis Russia.

During the 1920s the demand for credit and interest rates were exceptionally high in Finland.⁴⁶⁵ The state directed its borrowing abroad; domestic issuance would probably have heated the domestic financial market and raised interest rates even further, ie the risk of crowding out of domestic investments was still considerable. In this respect, the state's reliance on foreign capital markets was still essential, as is evident from statistics concerning domestic holdings of bonds; in 1930 domestic bond holdings accounted only for one third of all outstanding bonds of Finnish entities, ie reliance on foreign capital had stayed high.⁴⁶⁶ Only due to the improved external balance of the economy and laxer monetary conditions could the state during the 1930s leave foreign capital markets and concentrate on domestic borrowing.

An additional aspect is that the diversion of the state's borrowing abroad did not only leave the domestic markets for private issuers, but it paved way for the other domestic borrowers to the international bond markets, as was highlighted by Risto Ryti and also observed in Sweden.⁴⁶⁷ Both during the pre-World War I and interwar periods the state's entry to the foreign financial markets was followed by the flow of other Finnish issuers to the international bond markets.⁴⁶⁸ Foreign investors were familiar with the name Finland. They had a conception of the country risk; listings of the state's bonds and their relatively tight pricing indicated that issuers from this country did not bare intolerable political or economic risk. Moreover, foreign investors had an opportunity to use government bonds as a price reference when making their investment decisions on securities issued by other Finnish borrowers.⁴⁶⁹

In addition to avoiding crowding-out effects Finnish politicians and central bankers had another important reason to steer the state's borrowing toward international bourses. Foreign currency denominated loans enabled the Bank of Finland to build up the foreign currency reserves during the currency reforms, ie adoption of the

⁴⁶⁵ Suvanto, 1982: 298–299; Tudeer, 1932: 11.

⁴⁶⁶ Tudeer, 1932: 14.

⁴⁶⁷ Schön, 1989: 248; Ryti, 1933: 221.

⁴⁶⁸ Larjavaara, 1969: 10–31; Neovius, 1915: 351–356; Schybergson, 1909: 160–163.

⁴⁶⁹ In case state's foreign indebtedness would dramatically grow this could harm possibilities of private entities to raise foreign loans, see, Alho, Lassila and Murto (1992), 41–43. However, this usually was not a problem in Finland.

silver standard in 1865, gold standard in 1878 and gold exchange standard in 1926, all of which were highly prioritised in Finland, as, for example, the studies on the history of the Bank of Finland by Schybergson, Tudeer and Pipping point out.⁴⁷⁰

In addition to its impact on monetary reforms, the government's foreign borrowing played an important role in the gold standard balance-of-payments adjustment mechanism. Finland's trade account showed deficits throughout the classical gold standard period. According to estimates of Ragni Bärnlund, the sum of Finland's goods, services and transfer payments showed deficits most of the time from 1890 to 1913. This was offset by imports of foreign capital.⁴⁷¹ As a result, the Bank of Finland's foreign reserves increased rigorously most of the time from 1868 until 1914; the largest temporary downturn took place in the mid-1870s.⁴⁷² This would lead to a similar assumption that Lars Jonung has drawn concerning Sweden; the accumulation of foreign reserves by the central bank was based on the imports of foreign capital.⁴⁷³ In addition to the central government, there were other Finnish entities issuing foreign bonds, including mortgage institutions and several towns. In contrast to large foreign portfolio investments, the inflow of foreign direct investments remained constantly small.⁴⁷⁴

As regards the central government's foreign bond issues and their impact on the central bank reserves, some aspects must be kept in mind. A significant part of the state's foreign bond issues was actually used for redemptions of older outstanding foreign bonds. These transactions naturally did not affect the central bank's foreign reserves. Moreover, often the proceeds of the loans were left in the state's foreign bank accounts and used abroad for purchasing railroad equipment, such as rails and locomotives.⁴⁷⁵

The state of affairs stayed more or less similar in the 1920s. The Bank of Finland encouraged Finnish borrowers to raise foreign loans in order to strengthen its foreign reserves and to ease the domestic monetary conditions. The need for foreign capital became acute during the late 1920s when the current account dropped deeply into the red. This situation was reversed after the recession in the 1930s; the current account showed substantial surpluses. Under the new

⁴⁷⁰ Pipping, 1961, 1969; Schybergson, 1914; Tudeer, 1939.

⁴⁷¹ Bärnlund, 1992: 38–40.

⁴⁷² Ikonen, 1998: 23–25.

⁴⁷³ Jonung, 1989: 379.

⁴⁷⁴ Hjerpe, 1989: 155.

⁴⁷⁵ Ryti, 1930: 67.

circumstances, the Bank of Finland favoured quick redemption of foreign loans in order to limit the expansion of domestic liquidity.⁴⁷⁶

Regarding the impact on the money stock, for example, in Sweden long-term borrowing from abroad was of central importance in explaining the relatively rapid expansion of the money stock from 1870 to 1913. Similar developments can also be observed in Finland, although Vappu Ikonen has also argued that in Finland the central bank sterilised the changes in the foreign reserves, both during the classical gold standard and interwar gold exchange standard. It altered its domestic lending and ‘kept development of the money supply stable’.⁴⁷⁷

The discount rate policy of the Bank of Finland followed the gold standard ‘rules of the game’: the discount rate was used to stabilise the balance of payments. The central bank raised its discount rate if foreign reserves declined and cut it if they increased. For example, a discount rate hike attracted funds from abroad and increased the amount of the central bank’s foreign reserves. Due to the integration of the world capital markets and increased capital flows in the late 19th century this became the prime mechanism for the balance-of-payments adjustment, replacing the need for adjustment through downward changes in the domestic price level, which would also have corrected the situation through an improved current account.⁴⁷⁸

Emil Schybergson described the Bank of Finland’s discount policy during the early 20th century. Although the balance-of-payments adjustment mechanism is usually considered to have operated mainly through the movement of short-term capital, the Bank of Finland responded also to long-term capital movements; it cut its discount rate in response to new foreign bond issues by Finnish entities, eg the state and towns, during the early years of the 20th century.⁴⁷⁹

7.2 Foreign loans and notion of sovereignty

A very much different sort of topic from the economic considerations is an idea that through foreign borrowing Finland strengthened its sovereign status, the notion of the ‘state’. The concept of the Finnish state is relatively young; according to Osmo Jussila, until the national

⁴⁷⁶ Rossi, 1951: 271, 327.

⁴⁷⁷ Ikonen, 1998: 24–25; Jonung, 1984: 378–379.

⁴⁷⁸ Autio, 1996: 8; Bordo, 1984: 23–27; Ikonen, 1998: 24–25.

⁴⁷⁹ Schybergson, 1914: 255–263.

awakening of the 1860s Finland was understood to form one province in the Empire, with some distinct features. From the 1860s onwards, there spread in Finland an ever-wider notion that Finland actually formed a 'state', although its meaning was interpreted in a different fashion by different political groupings. For example, (extreme) Finnish liberal circles maintained that Finland was a sovereign state forming a real union with Russia, comparable to Norway.⁴⁸⁰ Interestingly, the development of the understanding of Finland as a 'state' is contemporaneous with the state's foreign borrowing, which began in 1862.

A clash of views between the borderland and the centre became inevitable towards the end of the 19th century, when in Russia emerged an ever-stronger tendency to form a more integrated Russian state. As Osmo Jussila notes, after the Finnish national awakening in the 1860s, in the political circles in St. Petersburg there emerged the notion of a Russian state, 'one and indivisible', of which Finland formed a part, while at the same time the doctrine of Finland as a separate state, belonging not to the Russian state but to the Empire only, gained currency in the Grand Duchy'.⁴⁸¹

Finland's distinct position was a result of a gradual process. The Finns enforced their autonomy through several successive reforms from the 1850s onwards which, as they were often implemented only in Finland, in practise separated the Grand Duchy from other parts of the Russian Empire. Indeed, there was never any constitution designed for the Grand Duchy; the only part of the planned constitution act that was implemented was the Parliament Act of 1869.⁴⁸²

Partly due to the absence of any constitution or such, the notion of the distinct 'state' was first something that came to people's minds and later got concrete expressions through various reforms implemented in Finland.⁴⁸³ In the end, this notion gained ground abroad; Finland's unique status gradually received international recognition. Regular meetings of the Finnish Diet began in 1863; it started to open the backlog of legislation, which had mounted since the only meeting already in 1809. In reality, the new legislation and reforms steered Finland effectively in its own distinct direction. Finland gained new national symbols, including stamps (1856),

⁴⁸⁰ Jussila, 2004: 11–26; 257–328; Klami, 1981: 69–113; Klinge, 1997: 221–230.

⁴⁸¹ Jussila, Hentilä, and Nevakivi, 1999: 75.

⁴⁸² Jussila, 2004: 329–330.

⁴⁸³ Jussila, 2004: 270–283.

money (1860, 1865) and military (1878). The national symbols integrated the people and expressed and steered nationalism.⁴⁸⁴

Also the texts in the foreign bonds clearly expressed the distinct nature of the issuer with its own administration: *Grand Duchy of Finland, sanctioned by His Majesty the Emperor and Autocrat of all the Russians, Grand Duke of Finland, &c, &c, and with the Authority of the Imperial Senate for the Grand Duchy of Finland and the guarantee of the Diet of Finland*⁴⁸⁵. Although the wording of the bonds remained almost the same throughout the time of autonomy, some semiotic changes took place. Until the 1880s the bonds included a coat of arms of the Russian Empire, the double-headed eagle. A small Finnish coat of arms, the lion, was located in middle of the eagle. Since the 1880s only the Finnish coat of arms was printed in the bonds, the Russian eagle disappeared.⁴⁸⁶

According to Matti Klinge, although the development did not result from a conscious decision, the state's new central agencies manifested Finland's statehood, as well as the foreign bonds issued in the 1860s by the central government through Rothschild and Erlanger.⁴⁸⁷ In this respect, Finland's foreign borrowing not only had an economic meaning but also political one; it manifested Finland's autonomy, even sovereignty. Later during the interwar period, the government's foreign borrowing, and especially the continuation of the payments of the American war loans after the Hoover moratorium in the 1930s, spread knowledge of the new independent state in a positive light.

The international knowledge about Finland grew both through the issues of new state bonds and the quotations on the bourses of the world financial capitals. At the primary stage, Finnish bonds were sold to a variety of investors in major European countries, and in the 1920s in the United States. The number of investors was relatively large and, importantly, to protect their own financial interests they required information on the securities they were engaged in. Interest about Finland in the foreign press grew and the banks incorporated the unknown Finland into their analyses and marketing. Foreign newspapers contained sizeable Finnish bond advertisements, and annual notifications of the bonds that had been drawn lots for amortisation.

⁴⁸⁴ Klinge, 1981: 280.

⁴⁸⁵ Crédit Lyonnais archives, DAF 00110-2, BE 1727, the text of the sterling loan of 1909.

⁴⁸⁶ State Treasury archives, original bond books.

⁴⁸⁷ Klinge, 1997: 247–248.

Also Finland's overseas 'financial recognition' was a gradual process; in the beginning knowledge on Finland spread foremost only to circles with a considerable amount of investment capital. For example, in 1882 Mayer Carl von Rothschild wrote to the Bank of Finland and regretted that the recent underperformance of the Russian government bonds affected prospects for a new Finnish issue: 'Although the Grand Duchy of Finland is very distinct, this is not appreciated by the public appropriately; in their superficiality they put everything into one pot'.⁴⁸⁸ Nevertheless, shortly before his death Mayer Carl von Rothschild thoroughly explained that one of his greatest achievements during the past 24 years – during the period he had been arranging the Finnish government bond issues – had been the promotion of the Finnish state credit to larger audiences.⁴⁸⁹

The arrival of a new type of banking with a wide network of local branches to the European financial markets altered the situation towards the end of the 19th century: information spread to ever broader circles. Letters sent by Adrian Mazaret, one of the directors of *Crédit Lyonnais*, in 1898 to the bank's 28 local branches in all major French cities in French speaking Europe and Algeria provide a revealing example. The letters were intended to provide local branches information on Finland, which they could use in marketing the Finnish government's bond issue of 1898 to the bank's customers. According to Mazaret, the loans of the Northern European governments, Sweden, Norway, Denmark and Finland, present the highest degree of safety. The bonds issued by these governments have 'developed greatly', due to their prudent administration and excellent management of state finances and, furthermore, due to the rise of the knowledge of their securities in Europe. In another letter to the local offices Mazaret underlined that it would be difficult to present to the public a loan with greater guarantee than the Finnish government bonds.⁴⁹⁰

Surely, the letters by the Paris headquarters were intended to encourage local offices in their selling efforts. They indicate, however, what sort of information about Finland was presented to large number of French investors: Finland was a prudently managed country, comparable to Sweden, Denmark and Norway.

⁴⁸⁸ Bank of Finland archives, the archives of the Board, letter from M.A. von Rothschild und Söhne 28.8.1882.

⁴⁸⁹ Bank of Finland archives, the archives of the Board, letter from M.A. von Rothschild und Söhne 8.4.1886.

⁴⁹⁰ *Crédit Lyonnais* archives, DAF 00255-1, BE 1729, letters by Adrian Mazaret 30.4.1898 and 25.7.1898.

The secondary market quotations manifested Finland's statehood or sovereignty alike. Finnish government bonds were listed in the same categories with other governments. On the Hamburg bourse, Finnish bonds were listed immediately after bonds issued by the German public sector entities in the same section with bonds issued by Nordic cities and states, ie Sweden, Denmark and Norway. They were named state loans ('Finnländische Staats-Anleihe'). In London, the Investor's Monthly Manual listed Finnish bonds in the 'Foreign Government Stocks' section. Interestingly, almost all other issuers in this section were fully independent states, autonomous Egypt, Prussia and Hungary providing the only exceptions.⁴⁹¹

Finnish politics after the turn of the century were divided into two groups; the conciliation line advocating collaboration with St. Petersburg and the constitutionalists, arguing for strict resistance. Senator Leo Mechelin, a central figure in the constitutionalist camp, maintained a wide international contact network and utilised it to raise awareness of the political situation in Finland.⁴⁹² Mechelin was also one of the initiators of the idea of a separate Finnish 'state', connected to Russia through the common Emperor. Indeed, the last letter from Mayer Carl von Rothschild to Finland, prior to his death in 1886, included words of thanks to Mechelin for sending his book 'Précis du droit public du Grand-Duché de Finlande'.⁴⁹³

Finland's sovereignty was reinforced by the investment bank analyses from the 1890s onwards. They seem to have reflected the views of the constitutionalist line. According to the Crédit Lyonnais analysts, Finland formed a constitutional monarchy with Russia. As regards international law, Finland was part of Russia with no diplomatic mission abroad. However, the Crédit Lyonnais analysts stated that Finland resembled Norway; nobody could doubt its 'personality' as a state ('la personnalité de cet Etat').⁴⁹⁴ Some of the analyses of the Crédit Lyonnais were dedicated to bank's internal use, probably to relatively small circles working in the foreign loans affairs in the headquarters in Paris, but, undoubtedly, some of it also reached investors through the bank's sales force.

It was not only a question of the notions and beliefs about Finland that reached an international audience and underlined Finland's sovereign status. Finland also organised the practical implementation of borrowing in such a manner that it strengthened Finland's distinct

⁴⁹¹ Hamburgische Börsen-Halle 1.7.1886; Investor's Monthly Manual, 1909.

⁴⁹² Jussila, Hentilä, and Nevakivi, 1999: 66–78.

⁴⁹³ Pipping, 1967: 76.

⁴⁹⁴ Crédit Lyonnais archives DEEF 73251, BE 1372, Finlande, 1905.

position. The Russian financial markets were fully neglected by the Finns. No Russian banks were included in the issuing syndicates after 1859. Moreover, the Finnish government bonds were never denominated in Russian rouble, although starting in 1897 the rouble was in gold standard. Similar policies were followed in the government's funds' portfolio investments, which were allocated almost solely to non-Russian assets since the 1880s.⁴⁹⁵

As a consequence of the February manifesto of 1899 the Finns became anxious about possible Russian interference in state finances, including the government's foreign borrowing. Bank director Emil Schybergson hastened K.A. Wallenberg in organising the Finnish loan of 1901, as he feared that the Russians might even put their hands on Finland's foreign borrowing.⁴⁹⁶ Schybergson's warnings were not without grounds. Newly appointed Governor-General, hardliner Nikolai Bobrikov tried to prevent the Finns from raising a new loan from the western financial markets. In discussions with Minister State Secretary von Plehwe Bobrikov recommended replacing the loan, which was planned to be issued on the Paris bourse and to amount to 35 million Finnish marks, with a much smaller domestic loan. Although Bobrikov's interference in the matter did not cause its cancellation – only its size was decreased by the Emperor – its issuance remained uncertain until the last minute. Still a couple of weeks before the Emperor's final approval Vice Chairman Linder in the Senate was absolutely certain that the new loan would not receive the necessary final approval from St. Petersburg.⁴⁹⁷

Moreover, the wording of the 1901 loan raised attention in St. Petersburg. Following the launch, the Finnish senate received a notification from the State Secretary office in St. Petersburg concerning the wording of the loan agreement. During the preparations of the loan issue of 1903 the Russian authorities directed their attention to the same matter once again; the Senate sent the loan agreement to St. Petersburg for the Emperor's approval and received it back in an altered format, which no longer underlined the statehood nature of the borrower.

In the original agreement the borrower had been referred to as the Government of the Grand Duchy of Finland ('le Gouvernement du Grand Duché de Finlande') or similar variations of the Finnish

⁴⁹⁵ Kuusterä, 1989: 308–309.

⁴⁹⁶ SEB archives, Ankomna brev 1901, letter from Emil Schybergson to K.A. Wallenberg, 5.2.1901.

⁴⁹⁷ SEB archives, Svenska sekretariatets dossier, Akt 27(korrespondens), letter from O. Nykopp to K.A. Wallenberg, 3.4.1901.

government. In the returned version the borrower was referred as the Imperial Senate for Finland. The Emperor's title had also been altered from a short version 'Sa Majesté l'Empereur de Russie, Grand Duc de Finlande' to a longer version 'Sa majesté Imperiale, Autocrate de toutes les Russies, Tsar de Pologne, Grand Duc de Finlande etc. etc. etc'. Finally, the name of the State Treasury had been modified from 'Comptoire de l'Etat de Finlande' to 'Comptoire d'Etat finlandais'.

The loan agreement received a new adjusted format and the bond books were printed in a slightly modified format. The Emperor's title was lengthened and the State Treasury's name was altered to satisfy Russian demands. The Finance Committee of the Diet regretted that the 'political intentions' of recent years had affected also this matter.⁴⁹⁸

The same sort of disputes emerged also later. During the preparations for Finland's parliamentary reform in 1906 the Russian members of the Russo-Finnish negotiating body complained about the term 'state,' which was used when referring to the loans issued by the Grand Duchy's Senate. According to the Russians, it did not correspond with reality, as the Grand Duchy had never enjoyed a position of an independent state. The Finns tactically collaborated: the respective Russian language version of the new Parliament Act was modified to satisfy the Russian demands but the Finnish language version was left intact.⁴⁹⁹

In the course of the negotiations of the failed 1908 bond issue, the question concerning the participation of Russian banks in the loan syndications was touched upon. Following the new system of presenting proposals to the Tsar, the loan affair went to the Russian council of ministers, prior to presentation to the Tsar. In addition to budgetary considerations, finance minister Kokovtsov wondered why no Russian banks were involved in the loan negotiations.⁵⁰⁰

Also the nationalistic Russian press presented severe criticism against Finland's western orientation in its borrowing. For instance, the Russian newspapers in 1889 criticised the Finnish government for including in the terms of the bond a clause 'payable also during a war'. For Russians, this was a sign of Finnish separatism.⁵⁰¹ In 1909 the nationalistic 'Novoje vremja' attacked Finland's reliance on western capital, stirred by Emil Schybergson's article in Finsk

⁴⁹⁸ Parliament documents, Book IV, report on state debt, memorandum of the Finance Committee of the Diet, No: 4, 1904–1905; State Treasury archives, original bond books.

⁴⁹⁹ Mylly, 2006: 215–216.

⁵⁰⁰ Paasikivi, 1957: 23–24.

⁵⁰¹ Pipping, 1967: 81.

Tidskrift⁵⁰² and a new bond issue by a Finnish mortgage bank. Schybergson had carefully explained in his article the western orientation of the Grand Duchy's borrowing policies.

Novoje Vremja referred to Schybergson's text and explained how the Finnish government had in 1862 turned to the German capital market and left the Russian one. This was done despite the fact that the terms of the German market loan were worse than, for instance, those of the last Russian market loan issued by the Finnish government in 1859. According to Novoje vremja, the purpose of the Finns was to emancipate Finland financially from Russia and increase foreigners' presence in Finland. This had been possible because the Finnish Senate had been granted too much influence on financial matters. The newspaper underlined that the success of the Finnish fiscal policy was not only based on the insightfulness of the Finns, but on the Russian benevolence, allowing foreign banks to organize Finnish loans. The newspaper concluded that this would not have been possible in any other country.⁵⁰³

The total exclusion of Russian banks was probably a close call. Regarding the franc loan of 1909, the Bank of Finland and a Finnish commercial bank Kansallis-Osake-Pankki had been in contact with Banque du Nord in St. Petersburg, which had shown considerable interest in taking part in the issuing syndicate in order to make contacts in Finnish business circles and familiarise with the Grand Duchy's borrowing activities. However, because the issue of the loan was cancelled due to the lack of appetite of the French investors, Russian participation was never realised.⁵⁰⁴

The Russian administration had similar considerations also on the investment policies of the Grand Duchy. For the Russian government it was difficult to understand that the state funds had allocated their portfolio investments to Central European securities and totally ignored Russian bonds and stocks. On top of that, the portfolios were even deposited in Central European banks. The practical implications of the criticism remained limited, although the state's bond investments came to a standstill after 1903.⁵⁰⁵

Russia's dependency on the western European capital markets forced it to pay attention to the interests of western financiers. Measures that would have seriously hampered the Grand Duchy's

⁵⁰² Schybergson, 1909.

⁵⁰³ Novoje vremja, 1909.

⁵⁰⁴ Crédit Lyonnais archives, DAF MO/2, letter from Loubard from Banque du Nord from St. Petersburg to Alfred Bonzon, Crédit Lyonnais, 16.6.1908.

⁵⁰⁵ Kuusterä, 1989: 309.

possibilities to service its foreign securities might have been difficult to implement. Hugo Pipping has even assumed that the Rothschilds' involvement prevented the Russian authorities from finishing Finland's monetary autonomy in 1889–1890.⁵⁰⁶ After all, the state's importing of foreign capital was also in the interest of the Imperial Government; a great deal of the funds was used in a manner that integrated Finland into other parts of the Empire and had vital military aspects, such as the railway lines to St. Petersburg and later to the Swedish border in Tornio, both of which enabled faster and more secure transportation of the army to the Empire's western borders. In other words, Russia had also for these reasons good grounds to tolerate the presence of the Finnish government in the international financial centres.

Following Finland's independency in 1917 the setting naturally changed; Russia could no longer directly interfere in Finland's affairs. Despite the separation, Finland's international position remained weak due to several reasons. Finland's geographical closeness to Russia/the Soviet Union fed foreign suspicions over its international position and security, as became apparent also during the loan negotiations during the 1920s. Furthermore, most of the newly independent border countries of the Russian and Austrian Empires suffered from weak economic performance and fragility of their democratic systems, although Finland was able to clearly follow a different development pattern; it maintained its democratic political system and successfully realigned its economy more closely toward prosperous Western Europe. However, regarding trade relations with the West, as Markku Kuisma emphasizes, Finland in the 1920s and 1930s was still a semi-peripheral producer of raw-materials and semi-finished goods. Nevertheless, Finland managed to steer her exports to Western European markets after the total collapse of its important eastern trade in 1917.⁵⁰⁷

Under the interwar circumstances the state's reliance on western financial markets still offered a route to spread the notion of Finland's new and wider sovereignty. Loan negotiations in financial centres were handled by Finland's foreign embassies: this linked even more closely the state's financial affairs with its foreign policies. As an example, according to Lähteenkorva's and Pekkarinen's study on the building of the official international image of Finland ('Suomi-kuva'), even films presenting Finland to foreigners had to be scripted in such

⁵⁰⁶ Pipping, 1967: 82–83.

⁵⁰⁷ Kuisma, 1993: 244–252.

a manner that did not hamper Finland's prospects in the financial markets, for example, by underlining Finland's geographical closeness to the Soviet Union. On the other hand, positive financial events, such as the state's commitment to pay its war debt to the United States in the 1930s, were eagerly utilised in the republic's foreign public relations.⁵⁰⁸

Above all, the state was eager to underline its geographical and cultural closeness to Scandinavia, not to the other new border-states of the Soviet Union. The National City Company's prospectus of the state's 1926 dollar bond, 'the Niagara of Finland loan',⁵⁰⁹ of which the content was influenced by the state, introduced Finland as a country 'adjacent to that section of Europe commonly known as the Scandinavian Peninsula.' Finland was also described as being 'geographically and culturally allied to the countries comprising the Scandinavia group.' The prospectus also underlined the long history of Finland's own fiscal system and the Grand Duchy's accustom of issuing bonds on the financial centres of Europe prior to 1914, at coupon rates that were practically the same as those paid by other Scandinavian countries.⁵¹⁰

⁵⁰⁸ Lähteenkorva and Pekkarinen, 2004: 21, 370–371.

⁵⁰⁹ The name refers to Imatra rapids.

⁵¹⁰ Citigroup archives, prospectus and advance proof of 1926 USD 6½% loan.

8 Conclusions

This study was devoted to examining the Finnish central government's reliance on international capital centres during a period characterised by a similar type of international financial integration as that associated with the financial order at the turn of the new millennium. The study focused on an era characterised by sizeable cross-border movements of capital and fixed exchange rates, such as the classical gold standard before the First World War and the interwar gold exchange standard, although the latter period never witnessed the same sort of financial integration as the former.

My aims were, above all, twofold: to examine the magnitude and development of the credit risk associated with the state on the international financial centres and to find out its determinants, which should have reflected, *ex ante*, various aspects of Finland's economic and political developments. Through this evaluation, of which the underlying principle was to detect the thinking and beliefs of the contemporary people, my endeavour was also to participate in the current international debate on the determination of sovereign risk during the two international gold standards and the impacts of gold adherences. In addition, I intended to shed some insight on the implementation of foreign debt issuance by a small sovereign borrower – located at the extreme periphery of the contemporary international financial markets – and to assess the importance of foreign borrowing for Finland. Finland was at that time undergoing profound economic and political transformation from an extensively agrarian society to a more industrialised nation, which also gained full independency after a time of autonomy in the Russian Empire.

The relative scarcity of capital in Finland was an important reason for the state's foreign borrowing; the necessary infrastructure investments required the active involvement of the state and the state needed foreign capital to finance its participation. This combined with the government's desire to provide a favourable environment for the private economy through a stable monetary environment – which was commonly understood to function through adherence to silver and gold standards and required the creation and maintenance of the central bank's reserves – the state was unavoidably to become a frequent issuer on the international financial exchanges.

The great 19th century integration and expansion of the international financial system provided the crucial preconditions for the state's foreign borrowing. The existence of surplus capital in the core countries of the world financial system and the birth and growth

of the great multinational banking houses enabled the transfer of capital from the core to the periphery. The geographical allocation of cross-border capital was dictated, first and foremost, by three factors: the relative economic power of each lender country, geopolitical considerations of the great nations and the personal relationships between different actors in the international financial network, as the Finnish evidence shows.

The zenith of the world financial market integration took place in the last two decades preceding the First World War in form of remarkable yield convergence. As regards Finland, during these decades the state had no domestic debt outstanding. Its bonds were denominated in several currencies, they enjoyed a highly international investor base and new bonds were sold via syndicated issues arranged by banks representing various nationalities.

Although Finland integrated itself into the core European capital markets – by adapting the mainstream issuance procedures and making contacts with the leading international banks – its ability to attract foreign investors showed great variation due to the changes in the credit risk associated with the state. In order to evaluate these changes I constructed a time series of long-term exchange-rate risk free interest rates for the central government of Finland from 1863 to 1938 and compared that to the yields of the market benchmark, British consols, and to those of Finland's peer group, that is, to other Nordic countries and Russia.

The interest rate differential vis-à-vis the British government consols – the main proxy for the credit premium associated with the central government of Finland – gradually declined towards the turn of the century. In 1904–1905 a sudden and considerable widening between the British consol and the Finnish government bond yields took place. As regards yield differentials against other Nordic state securities, similar developments could be observed, although a widening of the interest rate differentials took place already at the turn of the century.

It turned out that since the turn of the century yields on Finnish government bonds correlated with the Russian government foreign bonds, which greatly underperformed against many other European sovereign bonds after the Russo-Japanese war and the subsequent Russian revolutionary movement in 1904–1905. The correlation between Finnish and Imperial Russian government securities ended permanently as late as in the latter half of 1919, that is, over two years after Finland's declaration of independence and the announcement of default on all Imperial government loans by the new Russian Bolshevik government.

The yield spreads between Finnish government bonds and those issued by the Swedish and Norwegian governments were highest in the aftermath of the First World War. Similarly, the yield differential between the British consols and Finnish government securities rose sharply in 1919–1920 and again in 1932. During the 1920s the interest rate differential vis-à-vis British consols markedly declined but never to the levels observed in the end of the 19th century.

Indeed, the last few decades of the 19th century can well be regarded as the high point of Finland's creditworthiness in the eyes of foreign capital markets, not reached again until the end of the 20th century and the birth of the common European financial market. During the interwar years Finland never again reached the same advantageous state of affairs in terms of yield differentials, underlying the fragility of Finland's position in the eyes of the international financial markets during the beginning of its independency. This means that the state's long-lasting goal of being identified with the reliable and credible group of sovereign borrowers to which other Nordic countries belonged was met only in the end of the 19th century.

By international comparison, Finland's fiscal and monetary policies most of the time displayed exemplary fiscal prudence. The level of the central government debt was kept at a low level and was only very exceptionally used for non-productive purposes whereas monetary stability was anchored by adherence to the international silver and gold standards. Moreover, the state showed a great inclination to maintain its clean default record. This policy was highlighted after the Hoover moratorium, when Finland's commitment to respect its war loans greatly boosted Finland's reputation in the United States. The only crack to this policy was the unfortunate Bond Act enacted in 1921, which greatly hampered the state's foreign borrowing.

Unfortunately for the Finns, Finland's foreign credibility was not in its own hands. Political risk, stemming from the upheaval of the Russian society, overran all fiscal and monetary considerations. It was the most important determinant of the credit risk associated with the central government of Finland.

The farther away Finland was able to draw itself from Russia and the more compassionate the Russian policies towards Finland were, the more propitious was the foreign assessment. From the 1860s onwards the Grand Duchy had widened the sphere of its autonomy and formed a distinct and separate status in the Russian Empire. Under Russian benevolence and protection Finland prudently managed its economy and identified itself with the other Nordic states in the eyes

of foreign investors and bankers; as a consequence of this, the borderland was assumed to be politically and economically more developed than the centre, in contrast with the other great Empires of the 19th century.

The Russian efforts to integrate the Grand Duchy more closely into the Empire and to curtail the sphere of its autonomy at the turn of the century questioned the state's character as a separate and independent actor in the international financial centres. Suddenly, credit risk associated with the Grand Duchy became similar to that of Russia's, which was greatly hampered by the events of 1904–1905 exposing to the world the vulnerability of the Tsarist government. The Bolshevik takeover in October 1917 disturbed the state's borrowing even further. Despite its formal separation from Russian rule, it was only towards the end of 1919 that the destinies of the old Grand Duchy and the Empire separated: Finland moved toward democracy and the political centre through free elections and a new constitution, whereas in Russia the reds headed toward an unavoidable victory in the civil war. Nevertheless, western capitalists' deep fear of Bolshevism and the fragility of Finland's political position, affected by its geographical closeness to the Soviet Union, prevented the state's new foreign bond issuance for many years – and, in fact, affected adversely the state's borrowing for the whole of the interwar period.

In addition, international financial disorder – which had its origins in the political conflicts in various quarters of Europe, culminating in the First World War and the economic disarray of the Great Depression – hampered the state's access to the international bond markets. The behaviour of the foreign capital markets showed that Finland suffered from financial market volatility to a disproportional extent. The prices of Finnish government securities were affected more than those that had been issued by its Scandinavian peers. Moreover, it lacked access to the world financial centres during economic upheavals for a longer time than its western neighbours. It can be summarised that as an extremely peripheral borrower, the central government of Finland suffered more from financial disorder than core issuers – and benefited more from such international financial arrangements, either formal or informal, that promoted the maintenance of international financial stability. World financial integration was very much in Finland's interest.

In a like manner, adherence to the international gold standards probably lowered the state's funding costs. In the case of a small unknown issuer, the interest of the foreign investors was not always considerable enough to get them to focus on economic indicators.

Instead, they concentrated on the bigger picture. Such grand indicators were Finland's adherence to the international gold standards, through which Finland identified itself with the group of most developed countries in the world. This result confirms in the case of Finland that gold adherence signalled financial credibility to the international investor community.

The great integration of the world financial markets and right sort of domestic policies enabled the state to import a substantial amount of foreign capital to promote Finland's modernisation and overcome hurdles posed by domestic capital scarcity. Through foreign borrowing the state even strengthened Finland's separate and independent status, particularly vis-à-vis Russia and simultaneously improved its future borrowing prospects. Finland's reliance on western capital markets was highlighted by the fact that although Finland's foreign trade was overwhelmingly directed toward Russia before 1917, in financial matters it almost exclusively depended on Western Europe.

This narrative represents an example of the profound benefits of world financial integration to a small, poor and peripheral sovereign borrower. This integration process not only facilitated the availability of foreign capital, but also decreased borrowing costs and brought wider, non-economic benefits.

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Appendix 1

Regression variables

Dependent variable

Yield

Finnish bond prices are compiled from newspapers accessible in the Helsinki University library (Helsingfors Dagbladet, Huvudsstadsbladet, the Times), the Bank of Finland library (Mercator), Institut d'Études Politiques de Paris (Le Rentier) and the Hamburg University library (Hamburgische Börsen-Halle). Yields are calculated from prices using Reuters bond pricing tool. The terms of loans are gathered from bond certificates located in the State Treasury archives and from the state statute books. British yields are from Klovland (1994) and from Global Financial Data.

Independent variables

Market-wide fluctuation

The sample consists of four government bonds, two from Europe (Germany and Norway) and two from South-America (Brazil and Chile). Some missing years have been interpolated.

Yields on German bonds are from Homer and Sylla (1996) and from the League of Nation's Statistical year-book (German Dawes-loan quotations in London).

Yields on Norwegian bonds are obtained from Klovland (2004) until 1920 and thereafter based on the author's own calculations, presenting medium-term yields until June 1931. They stand for London quotations starting in 1915.

Yields on Brazilian bonds are obtained from Global Financial Data Inc. presenting London quotations.

Yields on Chilean bonds are from Homer and Sylla (1996) and from the League of Nation's Statistical year-book (London quotations).

Interest expenditure

For Finland, interest expenses are collected from the closing of the state accounts since 1901. Until 1900 they are from redemption and interest payment schedules printed in state statute-books or in original bond books. British interest expenditure is subtracted from Mitchell (1962): table Public Finance 4.

State Revenue

Finnish state revenue is from Pihkala (1977) for the years 1870, 1880, 1890 and 1900 and from Suomen taloushistoria 3 starting in 1901. The missing years are estimates calculated by using existing series for direct taxes and customs duties. It has been assumed that the relation of total revenues to these series was stable during the years missing from Pihkala's series. British revenue is from Mitchell (1962): table Public Finance 3.

Central Bank Reserves

Finnish central bank reserves are from Ikonen (1998) starting in 1868 and from Pipping (1961) for the years 1863–1867. British central bank reserves are collected from Mitchell (1962): table Banking and Insurance 2.

Banknote circulation

Note circulation in Finland is from Ikonen (1998) from 1868 onwards and from Schybergson (1914) for 1863–1867. British note circulation is from Mitchell (1962): table Banking and Insurance 2.

Exports

Finnish exports are collected from Riitta Hjerppe's data. British exports are from Mitchell (1962): table Overseas Trade 13. British export indices have been transformed to give the same base year used in Hjerppe's series (1926=100). British exports for 1914–1918 are estimates calculated by using information available in Mitchell's study; it contains only part of British exports during the World War 1.

Russian dummy

Value 1 in 1904–1906 and 1917–1921, otherwise 0.

Gold adherence dummy

Value 1 in 1879–1914 and 1926–1930, otherwise 0.

Appendix 2

Exchange rate risk-free bond yields

Table A1. **Yields of Finnish central government's foreign bonds 1863–1892**

Year	Quarter	Yield	Year	Quarter	Yield	Year	Quarter	Yield
1863	1	5.59%	1873	1	4.82%	1883	1	4.44%
	2	4.91%		2	4.75%		2	4.30%
	3	4.71%		3	4.75%		3	4.31%
	4	4.71%		4	4.76%		4	4.30%
1864	1	4.71%	1874	1	4.75%	1884	1	4.26%
	2	4.71%		2	4.76%		2	4.26%
	3	4.56%		3	4.64%		3	4.27%
	4	4.56%		4	4.64%		4	4.16%
1865	1	4.48%	1875	1	4.64%	1885	1	4.02%
	2	4.72%		2	4.69%		2	4.03%
	3	4.72%		3	4.95%		3	3.90%
	4	4.72%		4	4.89%		4	4.12%
1866	1	4.72%	1876	1	4.93%	1886	1	4.00%
	2	4.72%		2	4.96%		2	3.94%
	3	4.72%		3	5.39%		3	3.98%
	4	4.72%		4	5.27%		4	3.97%
1867	1	5.50%	1877	1	5.11%	1887	1	4.06%
	2	5.51%		2	5.21%		2	4.01%
	3	5.51%		3	5.15%		3	4.01%
	4	5.52%		4	5.15%		4	4.03%
1868	1	5.77%	1878	1	5.09%	1888	1	4.00%
	2	5.78%		2	5.15%		2	3.92%
	3	6.19%		3	4.94%		3	3.92%
	4	5.95%		4	4.74%		4	3.92%
1869	1	5.95%	1879	1	4.84%	1889	1	3.61%
	2	5.97%		2	4.65%		2	3.61%
	3	6.00%		3	4.67%		3	3.63%
	4	5.82%		4	4.67%		4	3.70%
1870	1	5.58%	1880	1	4.50%	1890	1	3.72%
	2	5.54%		2	4.49%		2	3.68%
	3	5.56%		3	4.54%		3	3.78%
	4	5.42%		4	4.50%		4	3.93%
1871	1	5.30%	1881	1	4.41%	1891	1	3.90%
	2	5.31%		2	4.41%		2	3.93%
	3	5.06%		3	4.41%		3	3.99%
	4	4.97%		4	4.48%		4	4.30%
1872	1	5.07%	1882	1	4.46%	1892	1	4.31%
	2	4.98%		2	4.50%		2	4.30%
	3	4.82%		3	4.48%		3	4.33%
	4	4.82%		4	4.48%		4	4.45%

Source: Quotations are those of the following bonds: 1863 Q1–1874 Q2: 4.5% of 1862; 1874 Q3–1881 Q4: 4.5% of 1874; 1882 Q1–1883 Q 1: 4.5% of 1881; 1883 Q2–1886 Q4: 4% of 1882; 1887 Q1–1888 Q4: 4% of 1886; 1889 Q1–1892 Q 4: 3.5% of 1889. They are from the Helsinki bourse until 1876 Q3 and thereafter from the Hamburg bourse.

Table A2.

Yields of Finnish central government's foreign bonds 1893–1922

Year	Quarter	Yield	Year	Quarter	Yield	Year	Quarter	Yield
1893	1	4.12%	1903	1	3.81%	1913	1	4.94%
	2	4.19%		2	3.78%		2	5.40%
	3	4.25%		3	3.93%		3	5.05%
	4	4.00%		4	3.94%		4	5.02%
1894	1	3.89%	1904	1	4.28%	1914	1	5.01%
	2	3.86%		2	4.44%		2	5.13%
	3	3.72%		3	4.64%		3	-
	4	3.72%		4	4.66%		4	-
1895	1	3.54%	1905	1	5.13%	1915	1	5.67%
	2	3.53%		2	4.80%		2	5.78%
	3	3.50%		3	4.94%		3	6.56%
	4	3.54%		4	4.44%		4	6.87%
1896	1	3.55%	1906	1	4.88%	1916	1	6.82%
	2	3.32%		2	4.75%		2	6.21%
	3	3.52%		3	5.34%		3	5.84%
	4	3.47%		4	5.08%		4	7.06%
1897	1	3.57%	1907	1	5.18%	1917	1	7.69%
	2	3.47%		2	5.21%		2	7.50%
	3	3.58%		3	5.34%		3	7.36%
	4	3.47%		4	5.17%		4	9.74%
1898	1	3.52%	1908	1	5.31%	1918	1	9.84%
	2	3.46%		2	5.23%		2	8.24%
	3	3.55%		3	5.18%		3	8.51%
	4	3.38%		4	5.06%		4	7.82%
1899	1	3.66%	1909	1	4.97%	1919	1	7.16%
	2	3.50%		2	4.98%		2	7.59%
	3	3.69%		3	5.09%		3	8.32%
	4	3.67%		4	4.72%		4	10.38%
1900	1	3.81%	1910	1	4.61%	1920	1	10.55%
	2	3.71%		2	4.81%		2	14.26%
	3	4.21%		3	4.89%		3	13.44%
	4	4.15%		4	4.49%		4	12.71%
1901	1	4.08%	1911	1	4.38%	1921	1	11.74%
	2	3.87%		2	4.23%		2	11.58%
	3	3.91%		3	4.50%		3	11.03%
	4	3.81%		4	4.42%		4	13.56%
1902	1	3.99%	1912	1	4.65%	1922	1	10.92%
	2	4.00%		2	4.68%		2	9.25%
	3	3.86%		3	4.90%		3	9.13%
	4	3.78%		4	5.07%		4	9.75%

Source: Quotations are those of the following bonds: 1893 Q1–1900 Q2: 3.5% of 1889; 1900 Q3–1914 Q2: 3% of 1898; 1915 Q1–1922 Q4: 4.5% of 1909. They are from the Hamburg bourse until 1895 Q4, from the Paris bourse from 1896 Q1 until 1914 Q2 and thereafter from the London bourse.

Table A3.

Yields of Finnish central government's foreign bonds 1923–1938

Year	Quarter	Yield	Year	Quarter	Yield	Year	Quarter	Yield
1923	1	8.84%	1933	1	7.40%			
	2	7.53%		2	6.90%			
	3	7.33%		3	6.33%			
	4	7.90%		4	5.81%			
1924	1	8.04%	1934	1	5.75%			
	2	7.99%		2	5.89%			
	3	7.43%		3	5.88%			
	4	7.26%		4	5.63%			
1925	1	7.20%	1935	1	5.54%			
	2	7.10%		2	5.58%			
	3	7.08%		3	5.53%			
	4	7.09%		4	5.48%			
1926	1	6.82%	1936	1	5.53%			
	2	6.94%		2	5.43%			
	3	6.97%		3	5.49%			
	4	6.88%		4	5.61%			
1927	1	6.48%	1937	1	5.75%			
	2	6.50%		2	5.90%			
	3	6.62%		3	5.75%			
	4	6.58%		4	5.55%			
1928	1	6.35%	1938	1	5.75%			
	2	6.28%		2	5.74%			
	3	6.31%		3	6.16%			
	4	6.26%		4	5.79%			
1929	1	6.23%						
	2	6.22%						
	3	6.59%						
	4	6.75%						
1930	1	6.20%						
	2	6.39%						
	3	6.60%						
	4	6.88%						
1931	1	6.84%						
	2	7.40%						
	3	8.09%						
	4	9.77%						
1932	1	11.70%						
	2	11.79%						
	3	8.32%						
	4	9.00%						

Source: Quotations are those of the following bonds: 1923 Q1–1924 Q2: 4.5% of 1909; 1924 Q3–1938 Q4: 6% of 1923 (coupon 5% from 1934 Q4). They are from the London bourse.

Appendix 3

Finnish central government debt, 1860–1938

Table A4. **Real and nominal debt, total amounts and in relation to production**

Year	Total real debt million FIM, at market prices	Total nominal debt million FIM, at market prices	Real debt / GDP %	Nominal debt / GDP %
1860	22.7		7.2	
1861	22.4		6.6	
1862	34.3		10.5	
1863	31.9		9.3	
1864	30.3		8.9	
1865	29.1		8.2	
1866	24.2		7.2	
1867	29.4		9.9	
1868	48.7		14.5	
1869	45.4		12.7	
1870	44.5		11.9	
1871	43.5		11.1	
1872	45.7		10.9	
1873	45.3		9.8	
1874	63.7		12.7	
1875	62.7		12.5	
1876	62.0		11.6	
1877	59.8		11.5	
1878	59.5		13.3	
1879	59.2	61.3	13.9	14.4
1880	60.2	62.4	12.7	13.2
1881	59.4	61.4	12.5	12.9
1882	68.0	70.1	13.4	13.8
1883	66.5	68.6	12.9	13.3
1884	65.4	67.2	12.9	13.3
1885	63.9	65.8	12.9	13.2
1886	69.2	71.2	14.3	14.7
1887	67.8	69.9	14.0	14.4
1888	71.0	72.5	14.0	14.3
1889	83.8	85.1	14.9	15.1
1890	81.1	82.1	13.6	13.8
1891	76.3	77.7	12.1	12.4
1892	74.0	75.3	12.1	12.3
1893	73.1	74.2	11.8	12.0
1894	72.1	73.2	11.3	11.5
1895	87.8	88.8	13.2	13.4
1896	85.4	86.4	11.9	12.0
1897	83.7	84.3	10.5	10.6
1898	114.5	115.0	13.1	13.1
1899	112.4	112.4	12.4	12.4
1900	111.4	111.4	11.5	11.5
1901	135.4	135.4	14.3	14.3
1902	134.2	134.2	14.6	14.6

Year	Total real debt million FIM, at market prices	Total nominal debt million FIM, at market prices	Real debt / GDP %	Nominal debt / GDP %
1903	142.9	142.9	14.1	14.1
1904	141.6	141.6	13.7	13.7
1905	140.3	140.3	12.9	12.9
1906	138.9	138.9	12.0	12.0
1907	137.5	137.5	11.2	11.2
1908	152.1	152.1	12.2	12.2
1909	179.7	179.7	14.0	14.0
1910	178.0	178.0	13.4	13.4
1911	176.3	176.3	12.5	12.5
1912	174.6	174.6	11.5	11.5
1913	172.9	172.9	10.8	10.8
1914	171.2	171.2	10.9	10.9
1915	217.7	179.4	12.6	10.4
1916	240.4	197.5	9.9	8.1
1917	258.9	240.5	6.9	6.4
1918	1308.8	1048.2	24.2	22.0
1919	2245.8	1836.0	26.2	17.3
1920	2424.3	1936.1	17.7	14.2
1921	3752.9	1933.8	23.3	12.0
1922	3250.8	1877.9	18.4	10.6
1923	3508.5	2415.2	18.5	12.7
1924	3367.6	2279.4	16.7	11.3
1925	3641.3	2475.3	16.8	11.4
1926	4067.2	2846.8	18.0	12.6
1927	3627.3	2695.0	14.3	10.6
1928	3470.4	2939.6	12.7	10.8
1929	3547.3	3023.6	13.4	11.4
1930	3566.3	3057.1	14.9	12.7
1931	5840.9	3242.2	27.4	15.2
1932	5901.0	3471.9	27.5	16.2
1933	4453.3	3507.7	19.3	15.2
1934	4379.7	3381.8	16.8	12.9
1935	4021.5	3166.0	14.6	11.5
1936	3818.1	3119.2	12.6	10.3
1937	3828.2	3452.5	10.7	9.7
1938	3673.5	3371.3	9.6	8.8

Source: Real debt is acquired from parliamentary documents (reports on state debt and state auditors' reports), from state statute-books and for the years 1921–1925 from Tudeer (1931). Exchange rates are from Autio (1992). Nominal debt is from Statistical yearbooks of Finland. GDP is from Hjerpe (1989).

Note: Real debt=based on spot exchange rates at the end of year. Nominal debt=based on exchange rates at time of issue of each loan. Both time series represent 'net' debt. They have been adjusted in accordance with state's repurchase of its own bonds from the financial markets, ie the amount of state's bonds held by the state have been deducted from the 'gross' state debt. The loan of 1889 has been assumed to be denominated in Dutch Guilders since 1919, following the practise of Tudeer (1931).

Appendix 4

Structure of Finnish central government debt, 1860–1938

Table A5. Foreign and domestic debt by maturity

Year	Foreign debt FIM, at market prices	Long-term FIM, at market prices	Short-term FIM, at market prices	Domestic debt, FIM, at market prices	Long- term FIM, at market prices	Short- term FIM, at market prices
1860	10.0	10.0	0	12.6	12.6	0
1861	9.8	9.8	0	12.6	12.6	0
1862	26.0	26.0	0	8.4	8.4	0
1863	27.7	25.7	2.0	4.2	4.2	0
1864	27.4	25.4	2.0	2.9	2.9	0
1865	26.8	24.8	2.0	2.3	2.3	0
1866	23.1	23.1	0	1.1	1.1	0
1867	28.4	23.0	5.4	1.0	1.0	0
1868	41.4	41.4	0	7.3	7.3	0
1869	40.4	40.4	0	5.0	5.0	0
1870	39.5	39.5	0	5.0	5.0	0
1871	38.6	38.6	0	5.0	5.0	0
1872	37.9	37.9	0	7.9	7.9	0
1873	37.2	37.2	0	8.1	8.1	0
1874	56.8	56.8	0	7.0	7.0	0
1875	55.9	55.9	0	6.8	6.8	0
1876	55.2	55.2	0	6.7	6.7	0
1877	53.2	53.2	0	6.7	6.7	0
1878	52.4	52.4	0	7.1	7.1	0
1879	51.7	51.7	0	7.5	7.5	0
1880	50.8	50.8	0	9.4	9.4	0
1881	50.1	50.1	0	9.3	9.3	0
1882	58.9	58.9	0	9.1	9.1	0
1883	57.6	57.6	0	8.9	8.9	0
1884	56.7	56.7	0	8.7	8.7	0
1885	55.3	55.3	0	8.6	8.6	0
1886	60.9	60.9	0	8.4	8.4	0
1887	59.6	59.6	0	8.2	8.2	0
1888	63.0	63.0	0	8.4	8.4	0
1889	75.9	75.9	0	7.9	7.9	0
1890	75.2	75.2	0	5.9	5.9	0
1891	72.1	72.1	0	4.2	4.2	0
1892	71.2	71.2	0	2.7	2.7	0
1893	70.5	70.5	0	2.6	2.6	0
1894	69.5	69.5	0	2.6	2.6	0
1895	86.6	86.6	0	1.2	1.2	0
1896	85.4	85.4	0	0	0	0
1897	83.7	83.7	0	0	0	0
1898	114.5	114.5	0	0	0	0
1899	112.4	112.4	0	0	0	0
1900	111.4	111.4	0	0	0	0
1901	135.4	135.4	0	0	0	0

Year	Foreign debt FIM, at market prices	Long-term FIM, at market prices	Short-term FIM, at market prices	Domestic debt, FIM, at market prices	Long- term FIM, at market prices	Short- term FIM, at market prices
1902	134.2	134.2	0	0	0	0
1903	142.9	142.9	0	0	0	0
1904	141.6	141.6	0	0	0	0
1905	140.3	140.3	0	0	0	0
1906	138.9	138.9	0	0	0	0
1907	137.5	137.5	0	0	0	0
1908	152.1	136.1	16.0	0	0	0
1909	179.7	179.7	0	0	0	0
1910	178.0	178.0	0	0	0	0
1911	176.3	176.3	0	0	0	0
1912	174.6	174.6	0	0	0	0
1913	172.9	172.9	0	0	0	0
1914	171.2	171.2	0	0	0	0
1915	207.7	207.7	0	10.0	0	10.0
1916	210.4	210.4	0	30.0	0	30.0
1917	183.9	183.9	0	75.0	0	75.0
1918	309.6	277.4	32.2	999.2	498.7	500.5
1919	1097.3	1068.7	28.6	1148.5	523.9	624.6
1920	928.8	792.3	136.4	1495.6	906.6	589.0
1921	2512.6	2356.5	156.1	1240.3	954.0	286.3
1922	2213.0	2045.9	167.1	1037.8	942.7	95.1
1923	2582.5	2582.5	0	926.0	926.0	0
1924	2513.3	2513.3	0	854.3	854.3	0
1925	2903.9	2903.9	0	737.4	737.4	0
1926	3590.5	3590.5	0	476.7	476.7	0
1927	3193.6	3193.6	0	433.8	433.8	0
1928	3124.0	3124.0	0	346.4	346.4	0
1929	3190.0	3090.7	99.3	357.4	357.4	0
1930	3209.1	3030.4	178.7	357.2	357.2	0
1931	5415.8	4826.7	589.1	425.1	360.5	64.6
1932	5211.8	4706.6	505.2	689.3	559.9	129.4
1933	3688.5	3305.4	383.1	764.8	716.0	48.8
1934	3339.4	3241.5	98.0	1040.2	990.7	49.5
1935	2764.1	2668.3	95.8	1257.5	1180.8	76.7
1936	1884.1	1815.9	68.2	1934.0	1852.7	81.3
1937	1297.0	1297.0	0	2531.2	2355.3	175.9
1938	1077.5	1077.5	0	2596.0	2539.2	56.8

Sources: See appendix 3.

Note: Debt stands for real net debt (see note in previous table). Long-term debt refers to debt with original maturity over one year.

Appendix 5

Structure of issuing syndicates of state bonds

Table A6. **Syndicate banks of Finnish state's foreign bonds, 1862–1938**

Bond	Syndicate banks
4.5% thaler bond of 1862	M.A. von Rothschild in Frankfurt am Main
6% thaler bond of 1868	von Erlanger & Söhne in Frankfurt am Main, Haller, Söhle & C:o and Vereinsbank in Hamburg
4.5% rmk bond of 1874	M.A. von Rothschild, Haller Söhle & Co and Bank of Finland
4.5% rmk bond of 1880	M.A. von Rothschild and Bank of Finland
4% rmk bond of 1882	M.A. von Rothschild and Bank of Finland
4% rmk bond of 1886	M.A. von Rothschild and Bank of Finland
3.5% rmk bond of 1889	S. Bleichröder and Direktion der Disconto-Gesellschaft in Berlin, M.A. von Rothschild and Bank of Finland
3.5% frcs bond of 1895	Crédit Lyonnais and Banque de Paris et des Pays-Bas in Paris, Stockholms Enskilda Bank in Stockholm and Bank of Finland
3% frcs bond of 1898	Crédit Lyonnais, Banque de Paris et des Pays-Bas, Belveceno et fils in Hamburg, Deutsche Bank, Dresdner Bank and Robert Warschauer & Co in Berlin, Den Danske Landmandsbank and Hypothek og Vekselbank in Copenhagen, Banque Cantonale de Berne, Banque Commerciale, Union Financière Geneve, Le filoz Dreyfus et Co and Basler Bankverein in Switzerland, Société Générale and Crédit Générale in Belgium, Hope et Co, Nederlandisch Handel, Sipperman Rosenthal, Amsterdamische Ams and Worthem et Comperet in the Netherlands, Stockholms Enskilda Bank, Nordiska Aktiebank för Handeln och Industrie in Finland, Föreningsbanken i Finland, Bank of Finland
3.5% frcs bond of 1901	Crédit Lyonnais, Banque de Paris et des Pays-Bas, Deutsche Bank, Dresdner Bank, L. Behrens & Söhne in Hamburg, Den Danske Landmandsbank in Copenhagen, Stockholms Enskilda Bank, Nordiska Aktiebank för Handeln och Industrien, Föreningsbanken i Finland, Kansallis-Osake-Pankki in Finland, Bank of Finland

Bond	Syndicate banks
3.5% frcs bond of 1903	Crédit Lyonnais, Banque de Paris et des Pays-Bas, Deutsche Bank, Den Danske Landmandsbank, Stockholms Enskilda Bank, Kansallis-Osake-Pankki, Bank of Finland
4.5% £ bond of 1909	C.J. Hambro & Son and the Union of London & Smiths Bank Limited in London, Swiss Bankverein in Switzerland
6.5% FIM/SEK bond of 1921	Stockholms Enskilda Bank, Skandinaviska Kreditaktiebolaget, Aktiebolaget Svenska Handelsbanken and Aktiebolaget Göteborgs Bank in Sweden
7% FIM bond of 1922	Stockholms Enskilda Bank, Skandinaviska Kreditaktiebolaget, Andresens og Bergens Kreditbank and Aktieselskapet Norsk Investment in Norway, Bank of Finland
6% £ bond of 1923	Hambro's Bank and J. Henry Schröder in London
6% \$ bond of 1923	Svenska Obligationskreditaktiebolaget
6% \$ bond of 1923	The National City Company and Dillon, Read & Co. in New York
7% \$ bond of 1925	The National City Company, Lee, Higginson & Co., Guaranty Co., Brown Bros. & Co. and New York Trust Co. in New York, Continental & Commercial Trust & Savings Bank in Chicago
6.5% \$ bond of 1926	The National City Company, Lee, Higginson & Co., Guaranty Co., Brown Bros. & Co., New York Trust Co., Continental & Commercial Trust & Savings Bank, Bank of Finland
5.5% \$ bond of 1928	The National City Company, Lee, Higginson & Co., Guaranty Co., Brown Bros. & Co., New York Trust Co., Continental & Commercial Trust & Savings Bank
4.5% SEK bond of 1934	Stockholms Enskilda Bank, Skandinaviska Kreditsaktiebolaget and Svenska Handelsbanken in Stockholm
4% \$ bond of 1934	Brown Harriman & Co., Edward B. Smith & Co., Lee Higginson Corporation and the First Boston Corporation in the United States, Bank of Finland

Sources: For German market issues: Pipping, 1967: 64–79; For French and English market issues: Crédit Lyonnais archives, BE 1733, DAF 2756/1, Syndication agreement of 1895 loan; BE 1732, DAF 255-2, Syndicate agreement of 1898 loan; BE 1729, DAF 277/2, Syndicate agreement of 1903 loan and a copy of 1909 loan's bond book; National Archives, Senate archives, Ha5, the Finance Committee of the Economic Department of the Senate, Syndicate agreement of 1901 loan. Swedish market issues in the 1920s and 1930s: SEB Archives, Svenska sekretariatets dossier, Akt 345 and Akt 372 A. American and English market interwar issues: State Treasury archives, syndicate agreements; the Bank of Finland archives, chairman archives, syndicate agreement of 1934 loan and prospectus; Moody's Governments and Municipals Ratings Manuals, Finland.

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