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Will History Rhyme?

The past as financial future.

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No exercise in futurism can afford to ignore the lessons of history. As we look forward and consider the future development of capital markets, one key question is whether the 21st century will resemble the 20th. The close parallels between world finance 100 years ago and world finance today suggest that the past might help us prepare for events to come.

The turn of the 19th century is widely regarded as the first great age of globalization. The future of financial markets at that time must have seemed limitless.

Then, as now, markets were expanding, barriers to capital flows were low, and businesses could tap vast pools of investor wealth through the public capital markets. Thousands of different issues of stocks, bonds, options, and futures were traded on large and well-organized global exchanges in the major European capitals of London, Paris, and Berlin. Farther afield, there were securities exchanges and sophisticated banking institutions in cities like New York, Hong Kong, Shanghai, St. Petersburg, Tokyo, and Buenos Aires, to name but a few. Indeed, by 1904, there were active stock and bond exchanges in at least 40 countries around the world, and European investors were being urged by experts to internationally diversify their portfolios.[1]

Exhibit 1, an empirical study of the securities issued on the world's exchanges in 1910, shows Britain, U.S., France, and Germany as the dominant money markets—but other European nations represented a significant share of world finance as well. Note the unusual source.[2]

Then, like today, investors relied upon quantitative research as an aid to portfolio construction. Guides like Lowenfeld's *Investment: An Exact Science* [1909] demonstrated to British investors how a well-diversified global portfolio could reduce risk.

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Exhibit 2 is taken from that book. It charts the individual prices and dividends of ten securities from around the world. Despite dramatic individual security price movements over the period 1897–1906, Lowenfeld's diversified portfolio remained remarkably stable. The implication? That international investing made your nest egg safer.

This global investing approach was not limited to Britain. On the continent, Rudolf Taeuber's *Die Börsen der Welt* [1911] showed German investors how to access global equity markets as well.

Faith in the capital markets as a mechanism for savings made possible an unprecedented burst of infrastructure development extending throughout North America, South America, Asia, and Africa—all financed by the massive export of capital from French, British, and German investors seeking returns and diversification through cross-border investment.

The securities listed on the Stock Exchange of London in 1900 demonstrate the sheer magnitude of opportunity. The June 1900 volume of *The Investor's Monthly Manual*, a comprehensive list of the Exchange, includes prices for 9,250 individual securities. Roughly half of these were foreign or colonial obligations.[3]

For an informal sense of the reach of British foreign investments at the time, read the lyrics to "Fiduciary Fidelity Bank" from the musical *Mary Poppins*. A song to lure a child into an investment of tuppence goes, in part:

> …you'll be part of Railways through Africa,
> Dams across the Nile,
> Fleets of ocean greyhounds,
> Majestic, self-amortizing canals,
> Plantations of ripening tea. . . .
> Bonds! Chattels! Dividends! Shares!
> Bankruptcies! Debtor sales! Opportunities!
> All manner of private enterprise!
> Shipyards! The mercantile! Collieries! Tanneries!
> Incorporations! Amalgamations! Banks!

A more serious commentator on this period of financial expansion, Pulitzer Prize winning historian Herbert Feis [1930] called turn-of-the-century Europe "The World's Banker," and noted close connections between the world of finance and the world of diplomacy. In his view, the global financial architecture of the time depended on the expansion of national interests and shareholder protections to distant countries—an expansion facilitated by colonial or semicolonial rule. The British colonization of Egypt, for example, resulted directly from a financial workout in the 1870s of the Ottoman Khedive's enormous debt, a workout that included foreign control of domestic revenue sources. Through similar financial processes, the entire world was ultimately carved up into a few major colonial empires.

EXHIBIT 1

Financial Securities Current in 1910 (in millions of francs)

Great Britain	142	Holland	12.5
United States	132	Belgium	7.5
France	110	Spain	7.5
Germany	95	Switzerland	6.25
Russia	31	Denmark	3.75
Austria-Hungary	24	Sweden, Norway, Rumania, etc.	2.5
Italy	14		
Japan	12		

Source: Lenin [1917].

CONTRACTION

The first blow to global financial architecture in the young 20th century was a war of surpassing scale. World War I drained European investment coffers in a few short years, shutting down the world stock markets for many months and ultimately crippling the once-dominant London Exchange.

The second blow was ideological. In 1917, a political backlash against international finance culminated in the repudiation of international debts by the Bolshevik government in Russia, as well as introducing a vast nationalization of industry and the virtual elimination of property rights on which the foundations of financial claims rested. Surprisingly, the financial markets in Russia and the world's capital markets did not seriously anticipate the magnitude of the reversal of fortune that awaited. Like many capital markets, the St. Petersburg Exchange was closed from 1914 to early 1917. When it opened in February of that year, Russian share prices were significantly *higher* (correcting for inflation) than when the market had closed in 1914. However, that was its final fluorescence. The Russian market shut down the following month due to political upheaval and did not reopen for more than seventy years.[4]

The Bolshevik revolution in Russia was the beginning of the deconstruction of the integrated global economy, only the first of many catastrophic ruptures. The post-World War I period will long be remembered as an era of protectionism enforced by rising tariffs, erosion of the gold standard, and hyper-inflation, not to mention the emergence of fascism in Europe, which sought to enable a strong nationalistic government to marshal the power of business and industry to its designs.

By 1930, *The Economist* had ceased publication of its comprehensive statistical supplement, *The Investor's Monthly Manual*. Markets themselves began to close in the 1930s and 1940s. Hyperinflation shuttered the exchanges in Ger-

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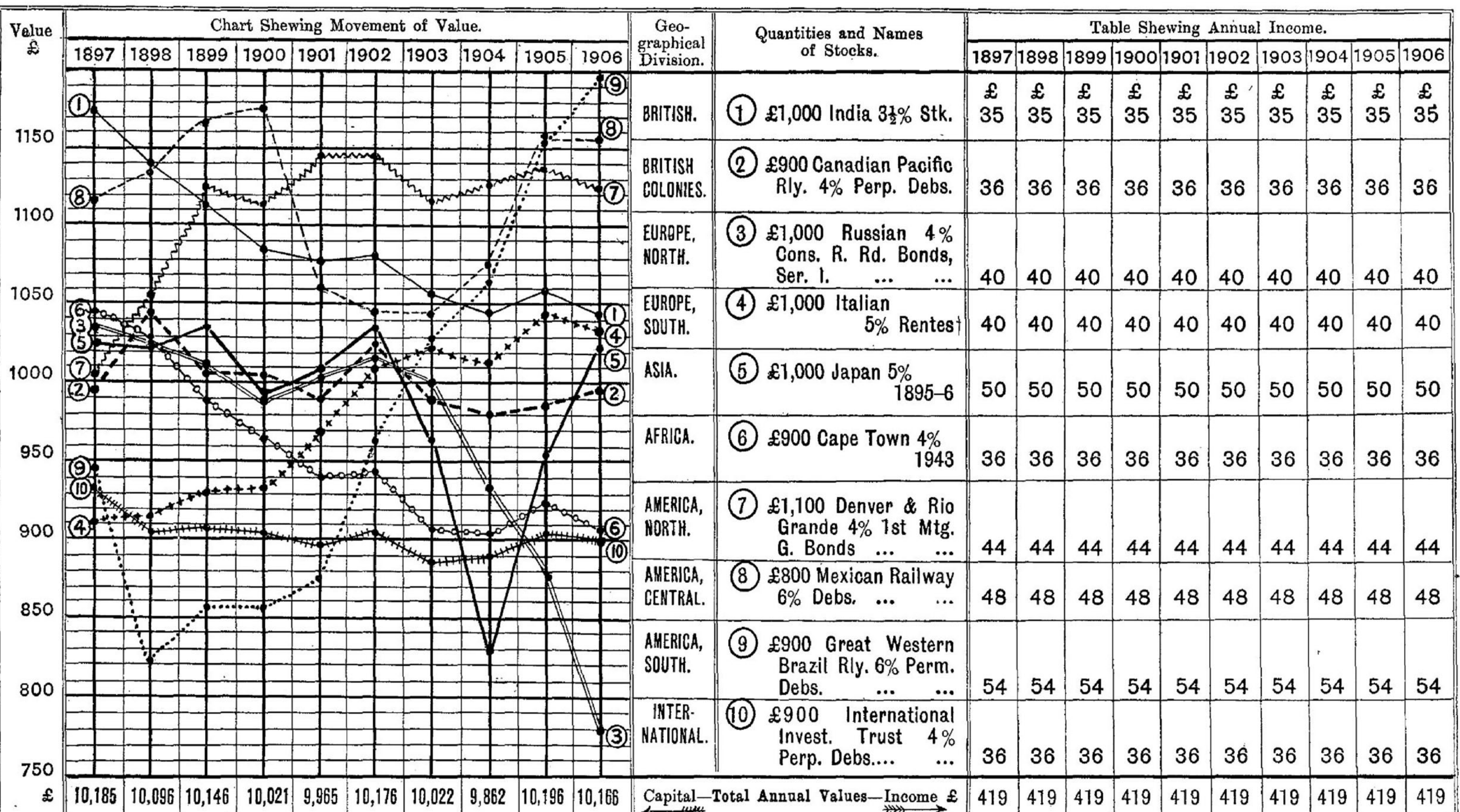
Exhibit 2

Geographically Distributed Investments Producing 4% per Annum



Geographical Division.	Quantities and Names of Stocks.	1897	1898	1899	1900	1901	1902	1903	1904	1905	1906
		Table Shewing Annual Income.									
BRITISH.	(1) £1,000 India 3½% Stk.	£ 35	£ 35	£ 35	£ 35	£ 35	£ 35	£ 35	£ 35	£ 35	£ 35
BRITISH COLONIES.	(2) £900 Canadian Pacific Rly. 4% Perp. Debs.	36	36	36	36	36	36	36	36	36	36
EUROPE, NORTH.	(3) £1,000 Russian 4% Cons. R. Rd. Bonds, Ser. I.	40	40	40	40	40	40	40	40	40	40
EUROPE, SOUTH.	(4) £1,000 Italian 5% Rentes†	40	40	40	40	40	40	40	40	40	40
ASIA.	(5) £1,000 Japan 5% 1895–6	50	50	50	50	50	50	50	50	50	50
AFRICA.	(6) £900 Cape Town 4% 1943	36	36	36	36	36	36	36	36	36	36
AMERICA, NORTH.	(7) £1,100 Denver & Rio Grande 4% 1st Mtg. G. Bonds	44	44	44	44	44	44	44	44	44	44
AMERICA, CENTRAL.	(8) £800 Mexican Railway 6% Debs.	48	48	48	48	48	48	48	48	48	48
AMERICA, SOUTH.	(9) £900 Great Western Brazil Rly. 6% Perm. Debs.	54	54	54	54	54	54	54	54	54	54
INTER-NATIONAL.	(10) £900 International Invest. Trust 4% Perp. Debs.... ...	36	36	36	36	36	36	36	36	36	36
Capital—Total Annual Values—Income £		419	419	419	419	419	419	419	419	419	419

* NOTE.—Geographical Division of Capital necessitates an equal division over similar stocks, every one of which is subject to a different trade influence. In the above Chart the conditions of similarity in quality and difference in trade influence only have been complied with, the Capital division is quite uneven. If an even Capital division had been adopted all zig-zag price lines would of necessity have started from the same point, and this would have made the Chart quite undecipherable. For this reason the above is not a perfect investment list from a practical point of view.

† Italian Tax of 20% deducted.

Source: Lowenfeld [1909].

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many, Hungary, and Greece for much of 1931 and 1932. Spanish markets closed from 1936 to 1940 due to war. From 1938 through 1941, most continental stock markets closed intermittently, and when they were open prices were sometimes sharply regulated by the government.[5]

Virtually all the Eastern European markets closed for good at the end of World War II. Although many South American markets remained open, the real economic returns to investors in equity markets such as Chile and Peru were both poor and volatile.

After the Soviet Union extended its political sphere to Eastern Europe, and China ultimately consolidated under a Marxist government in 1949, the world effectively became divided over whether finance was a force for great good or great evil. After mid-century, Arab socialism effectively nationalized Egyptian industry and Marxist-socialist revolutions in Cuba, Chile, and Portugal cut these nations off from the economic freedoms provided by world capital markets in favor of localized and severe government control. In just a few decades, the world capital markets had gone from a Golden Age to the Dark Ages.

Did 19th century financiers recognize the signs of an impending global backlash to financial expansion in the early years of the 20th century? Criticisms of capitalism were legion in the era following the publication and distribution of Karl Marx's *Das Kapital* starting in 1867.

Two of the most important rebukes to the global expansion of financial markets were Hobson's [1902] *Imperialism: A Study*, and Lenin's [1917] *Imperialism: The Highest Stage of Capitalism*—the first by an economist, the second by a revolutionary. The former developed a shrill ideology and lexicon around anti-imperialism that remains largely intact in academic discourse today. In the latter, however, Lenin often let the facts and figures of global financial expansion speak for themselves. What we now read as evidence of financial progress Lenin viewed as *prima facie* evidence of exploitation.

Lenin's book is filled with tables documenting European foreign investment. Exhibit 3, for example, estimates the growth in foreign investment by Great Britain, France, and Germany between 1862 and 1914. Exhibit 4 shows the geographic distribution of the three countries' capital in 1910.

Lenin interpreted these tables as evidence of a new stage in the development of capitalism. In his words:

> Typical of the old capitalism, when free competition held undivided sway, was the export of goods. Typical of the latest stage of capitalism, when monopolies rule, is the export of capital.

In Lenin's view, this export of capital had become a "basis for the imperialist oppression and exploitation of most of the countries and nations of the world, for the capitalist parasitism of a handful of wealthy states!" Of course foreign investors did not see it this way. They found it difficult to believe that such extreme views of capitalism could actually prevail.

EXHIBIT 3

Capital Invested Abroad (millions of francs)

Year	Great Britain	France	Germany
1862	3.6		
1872	15.0	10 (1869)	
1882	22.0	15 (1880)	?
1893	42.0	20 (1890)	?
1902	62.0	27-37	12.5
1914.	75-100.0	00	44.0

Source: Lenin [1917].

EXHIBIT 4

Distribution (Approximate) of Foreign Capital in Different Parts of the Globe
(circa 1910 in millions of marks)

	Great Britain	France	Germany	Total
Europe	4	23	18	45
America	37	4	10	51
Asia, Africa, and Australia	29	8	7	44
Total	70	35	35	140

Source: Lenin [1917].

In December 1917, for example, at the London annual meeting of the venerable Kyshtim Mining Corporation, a major copper concern in the southern Urals, board member Leslie Urquhart assured shareholders:

> As to the question of how the vital interests—that of the ownership of our properties—are likely to be affected by the happenings in Russia, I would say as definitely as I possibly can that the statements of the absurd Bolshevik usurpers as to the repudiation of contracts should not be taken seriously; they are the ravings of crazy men. . . . Are all of these people going to give up their heredity and private ownership rights in order to satisfy the socialistic ravings of madmen and the greed of the landless proletariat of the towns? . . . I have a passionate certainty of conviction that all this chaos and anarchy is but the cleansing fire which will get rid of all that is rotten and make Russia purer and greater (hear, hear).[6]

Urquhart's fiery speech put a brave face on the real circumstances for investors. No dividends had been paid on Kyshtim for years, and the annual accounts were unavailable to shareholders due to the revolution. Remarkably, though,

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those investor expectations in 1917 may have coincided with Urquhart's optimism. Kyshtim stock had traded relatively stably between 2¾ and 1½ through the years 1915 through 1918—and then it ceased to be quoted.

WE HAVE COME A LONG WAY— BACK TO THE PAST

Although Lenin may be turning over in his tomb, we have now finally regained the scale and scope enjoyed by the international financial capital flows of a century ago. Virtually all the states that left the global financial markets in the 20th century have returned in one way or another, even though our financial architecture is much different now from what it was in 1904. We are no longer configured as a set of colonial empires and international financial trusts.

While money center markets like the New York Stock Exchange are growing in importance as sources of capital through direct listing, in our politically segmented, post-colonial world, many countries have developed their own internal capital markets with domestic exchanges, securities laws, and regulation. International institutions like the World Bank and the International Monetary Fund now serve as a buffer between debtor and creditor nations, interrupting the dynamics that led in the past to the compromise of national sovereignty. Indeed, some of the very problems of "unfettered capitalism" decried by Lenin were corrected in the 1930s in the United States and other countries with the evolution of anti-trust laws and financial market regulation.

Today, an increasing number of people have a stake in the continued expansion of the capital markets. In particular, finance is a growing portion of the U.S. economy. According to government statistics, the finance, insurance, and real estate sector of the economy grew from 13% of U.S. gross domestic product in 1959 to 21% in 2002, roughly doubling its share of national employment.[7] This expansion of the financial sector may lead to a greater, broad-based commitment to its success, at least in the U.S.

At the same time, it is difficult to gauge the penetration of the financial industry in emerging markets. The rapid emergence of a professional class in China and the growth of Shanghai as a financial center suggest that the U.S. trends are international, even though China's recent policies have sought to redirect growth toward other sectors of the economy as well.

WILL HISTORY RHYME?

Will all the modern structural changes to the global financial sector prevent a backlash of the kind experienced in the early 20th century? As Russia and China appear poised to reenter the global financial community, can we really say that the structural collapse of global finance after World War I could not happen once again in the 21st century? Might there be a fundamental contradiction between the prerogatives and imperatives of the modern nation-state and investor motivation to transcend borders? To answer this question, it is worth considering whether the factors that led to the attack on financial capitalism are no longer a threat.

The near-complete rejection of Marxism-Leninism in Russia in the last decade, and the more gradual but persistent erosion of anti-capitalist rhetoric in China over the same period suggest that the century-long ideological attacks on capitalism and financial markets may have finally abated. The reasons for this are clear.

Capital is a necessary input to economic development, regardless of ideology. Indeed, modern Chinese leaders do not regard the listing of Chinese company shares on the New York Stock Exchange as incompatible with their policies.

In light of this, it is worth considering the possibility that Marxist ideology was not the sole cause of the anti-capitalist revolutions around the world. Instead, one might argue that the rejection of capitalism in Russia in 1917 and China in 1949 was not due to their failures in international capital markets but rather to their success in attracting foreign investment. This logic would imply that foreign investment may plant the seeds of nationalistic expropriation.

ANOTHER LOOK AT THE RUSSIAN AND CHINESE EXPERIENCES

Consider the success that pre-revolutionary Russia enjoyed in tapping external capital for development. Although Lenin railed against external control of the Russian banking system, the fact is that foreigners around the turn of the century were nearly falling over themselves to invest in Russia. Twenty-five percent of France's foreign investment in 1914 was in Russia alone. The foreign ownership of Russian debt grew from 30% in 1885 to 48% in 1914. Feis [1930] estimates that by 1914, one-third of Russia's private enterprise was financed by French investors, one-fourth by British investors, and one-fifth by German investors. Even if this is an overestimate, if anything close to 80% of private Russian enterprise was financed abroad, it would seem to have engendered a powerful nationalistic incentive to reclaim assets from foreign capitalists.

The motivation for China's first revolution in 1911 is also instructive. Since the beginning of the century, China had been remarkably successful in attracting foreign funding for domestic railroad development. China's loans were widely sought for issuance by international syndicates of investment banks, and were cross-listed on all the major European exchanges. Thanks to the globalization of financial markets, in the span of about 20 years, China built

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much of its modern railway system.

There were strong negative domestic reactions to sourcing external capital, however, and to the extra-territorial concessions required to do so. In particular, large-scale public protests were sparked by Imperial capitulation to foreign financial institutions associated with issuance of the Hukuang Railway loan of May, 1911. The Chinese resented not only the terms of the contract but also the preferential rights and treatment accorded foreign rail companies as compared to those given to firms controlled by domestic investors. The Imperial government fell within a few months of that event.

Negative stereotypes of capitalism have a long life. The revolution that brought the current Chinese government to power adopted much of the same anti-capitalist and anti-foreign investment rhetoric of the 1911 revolution.[8]

LESSONS FOR THE FUTURE OF FINANCE

It is easy to interpret the expansion and contraction of markets in the 20th century as the result of an ongoing struggle between capitalism and communism. Yet this does not entirely capture the more fundamental conflict between foreign and domestic stakeholders apparent in both the Russian and the Chinese revolutions. Although both China and Russia today have begun to embrace forms of capitalism, this trend may still mask an inherent resistance to foreign ownership or claims upon domestic enterprise. With the demise of Marxism, we might expect to see the rise of alternative ideologies that align domestic antagonism against external capital.

Consider, for instance, the Islamic revolution in Iran, which nationalized large parts of Iran's industry in 1979. Foreign ownership fell victim once again to national interests. The once-vibrant stock market in Teheran languished until the mid-1990s when Iran sought to revitalize it as a source of financing. Fearful of foreign control, only recently has the government allowed significant foreign ownership of corporations. The rejection of foreign influence in Iran has had the same effect of isolating this economy from the global financial markets for ideological reasons.

The financial lesson of the Islamic revolution in Iran is that extremist rejection of international investment and financial institutions continues into modern times under different guises. When these reactions occur, events can move rapidly and with little warning of their ultimate extent or result. While such withdrawals from the international financial network can be reversed, healing happens slowly and fitfully, and requires a difficult process of institutional readaptation.

It is heartening nevertheless to see that Iran has begun to follow China's lead in privatization, and is willing to allow limited international ownership of shares in domestic corporations.

FINANCIAL PERSPECTIVE

One of the most insightful theories in modern finance is the capital asset pricing model. Although it depends on many restrictive assumptions, the CAPM makes sharp predictions about portfolio investing and the ownership of assets in an ideal world. Assuming frictionless capital markets where claims on all assets can be freely traded, and where there are no competitive informational advantages, the CAPM implies that all investors will hold the same diversified portfolio of the world's assets with portfolio weights based upon each asset's market capitalization.

This means that investors in the United States will hold a significant portion of their portfolios in U.S. stocks, while investors in, say, Somalia, will export nearly all their capital. In a small economy, most investors will be foreign investors, because the investor base of any stock will be proportional to the relative wealth of world investors. Few if any countries will have their assets owned predominantly by domestic investors. In a CAPM world, all countries would find Bill Gates to be their largest investor, but of course even he would not have enough of a stake to exert personal control.

Interestingly, this equilibrium is not driven strictly by theory, but rather by the investor's very real motivation to pick each new investment according to how it will affect the risk of the portfolio. This is the very motivation that inspired Henry Lowenfeld's 1909 recommendation of a geographically diversified array of international securities.

WHAT IS THE PROBLEM?

Like many theories in economics and finance, the CAPM has some often overlooked political implications. If one believes that businesses should act in the national interest rather than in shareholder interests, the CAPM in an international setting presents a problem. The stakeholder view of corporations is that they exist to provide positive externalities such as jobs or infrastructure (see Roy [1999], for example). To the extent that domestic ownership of corporations will make these positive externalities more likely, the CAPM world is not necessarily an attractive one to citizens of a state.

In the CAPM world, domestic investors keep exporting their capital overseas, despite local development needs, and investors willing to invest locally have no personal stake in domestic social and environmental conditions unless they affect their financial claims. For the most part, the ideal, diversified investor portfolio in a CAPM world cuts across national boundaries and ignores government.

Although international versions of the CAPM modify this conclusion somewhat—particularly when exchange rate risk comes into play—it remains a broad equilibrium theory about all the world's investors and all the world's assets. The CAPM thus predicts that investors' interests will always

be in conflict, or at least orthogonal, to many of the interests of the nation-state.

While we never expect to achieve those ideal, theoretical conditions under which the CAPM holds in the world economy, the historical processes of globalization suggest that as transparency and investors' legal recourse increase, and barriers and frictions to cross-border capital flows are lessened, investors tend to behave as predicted by the theory. They broaden their international investment portfolios and diversify their holdings. The increased number of foreign corporation listings on U.S. exchanges over the past two decades bears this out.

The globalization of investment during periods of liberalization may be reason for caution. History suggests that it is precisely when barriers to capital flows are lowest that religious fanaticism and xenophobic suspicion of foreign capital can emerge, and ideological arguments and caricatures of capitalism may be used to whip up resistance to financial markets and institutions.

CONCLUSIONS

My personal views on the future of finance? Like J.P. Morgan's possibly apocryphal forecast of the stock market, I expect it to fluctuate. If history is any guide, we should expect the capital markets to enjoy periods of great success. These markets move investors, firms, and governments closer to an equilibrium characterized by positive rates of return on investment, along with a supply of liquid capital. Open access to capital brings with it a dramatic reduction in risk to individual savers through extended international diversification. We are in such a period now, and I hope it will continue for a long time.

The positive policies on stock markets and on cross-border listing of securities from governments traditionally hostile to capitalism and foreign investment are a cause for optimism, but it remains to be seen whether government enthusiasm for liberalization is shared by individual citizens and domestic interests. To the extent that the openness of capital markets around the world enhances local opportunities for domestic entrepreneurship and domestic investor diversification in all the world's markets, modern globalization has a long future.

On the other hand, the nature of humanity is that we distrust outsiders and are jealous of others' good fortune. Thus, the greatest risks of financial contraction arise in periods of expansion. Given that the past 20 years have seen nearly an unprecedented spate of financial liberalization around the globe, characterized as much as anything by cross-border investment but also by rising inequality in developed nations like the U.S., I expect we will face calls to rein in global financial markets in the near future.

What form might this take? Remember the rhetoric following the Asian currency crisis of 1997. Recall Malaysian Prime Minister Mahathir Mohamad's xenophobic speeches, the blame of international hedge fund managers for the crisis, and the tacit acknowledgment by even some leading economists that shutting the borders to investment might really be a good thing after all.

We will hear the same kind of things after another shock to the financial system, and if this rhetoric is accompanied by a popular political or religious ideology, we might see real global financial contraction once again.

ENDNOTES

[1]See Bordo, Taylor, and Williamson [2003].

Lowenfeld [1909] lists investable countries as : Great Britain, India, Canada, Australia, Tasmania, New Zealand, Straits Settlements (Singapore), Belgium, Denmark, Germany, Holland, Norway, Russia, Sweden, Switzerland, Austria, Bulgaria, France, Greece, Italy, Hungary, Portugal, Rumania, Spain, Serbia, Turkey, Japan (Tokyo and Yokohama), China (Shanghai and Hong Kong), Cape Colony, Natal, Transvaal, Egypt, U.S. (New York), Mexico, Argentine, Brazil, Chile, Peru, and Uruguay.

[2]Lenin draws these figures from the *Bulletin de l'institut international de statistique*, t. XIX, livr. II, La Haye, 1912. Data concerning small states in the second column are estimated by adding 20% to the 1902 figures.

[3]A complete database of the securities on the London Stock Exchange is available for download at the website of The International Center for Finance, Yale School of Management, www.icf.yale.edu.

[4]A complete database of shares traded on the St. Petersburg Exchange is available for download at www.icf.yale.edu.

[5]See Goetzmann and Jorion [1999].

[6]*The Times*, Saturday, December 15, 1917, p. 12.

[7]See *The Economic Report of the President, 2004*, Table B-12.

[8]Economists Rajan and Zingales [2001] have developed their own theory to explain the great advances and declines of global financial markets. It is based on a model of entrenched domestic financial interests resisting incursions by foreign investors. It is different from and perhaps more sophisticated than the model presented here, although the two are not necessarily contradictory.

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