"Dormant securities": Imperial guarantees for colonial loans, 1840-1940"

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The financial relations between imperial powers and their colonies were not uniform. While some colonies enjoyed a considerable degree of political and financial autonomy, others depended entirely on the fiat of the imperial government. Colonies received grants or loans from the imperial power or floated securities in European stock markets. Contemporaries and historians agree that colonies did not borrow on their own credit (Accominotti et al. 2011, Sunderland 2004, Degive and Oosterlink 2021) and that colonial bonds were only priced on their liquidity (Alquist 2010, Chavaz and Flandreau 2017).

Despite this, Britain and France created a distinct category of "guaranteed loans" for some of their colonies (Farr 1955, Attard 2007 and 2012, Sunderland 2004 and 2007).[1] The first guaranteed loan for a colony was approved in 1842 for Canada by the British government, after some discussions in Parliament. The purpose of this loan was to help Canada build fortifications and railways to improve its navigation and commerce facilities. This loan was followed by 36 others spanning a century (**Figure 1**). An explicit guarantee appears redundant if all colonial loans were an implicit responsibility of the imperial government, a point often made by contemporaries (Clarke 1878) and historians since. In this paper, we explore a century of financial relations with colonies bookended by the first colonial guaranteed bonds of the 1840s and the early World Bank loans to British colonies in the 1940s, which carried an explicit British guarantee.

We address three questions. First, we test whether markets priced these guarantees. We approach this question from two angles. For colonies with guaranteed bonds, we compare them to non-guaranteed bonds of the same colony and compute spreads between them. In this way, we eliminate colony-specific factors such as the distinction between self-governing and crown colonies. We then test for the financial autonomy of colonies by using panel VARs. Alternatively, we use a large panel dataset to parse between the guarantee premium and other bond properties, such as their liquidity and some regulatory enhancements.

During our sample period, several legal regulations were introduced in the UK to increase the popularity of colonial bonds as low risk assets, including the 1860 Trustee Investment Act, and the Colonial Stock Acts of 1877 and 1900. The main enhancements from these regulations were the inscription of colonial bonds and their inclusion in the trustees list of secure investments. This regulatory evolution eventually led to a tiered system of colonial issues. At the lowest level were ordinary colonial loans issued by any self-governing or crown colony. A subset of these ordinary issues was inscribed, a property that made the bonds more liquid for Europe-based investors. And finally, a subset of the inscribed colonial stocks was included in the Trustee list. This list ringfenced the set of assets in which trustees could invest on behalf of savings banks, charities and other endowments. In practice, the list created by fiat an equivalent to today's certification of safe assets by credit rating agencies. Initially populated only with British government bonds and bonds (colonial and foreign) explicitly guaranteed by the British government, the trustee list was progressively expanded to include other colonial bonds, the debt of British municipal corporations and the stock of major British railways and utilities.

[1] Big creditor countries before 1914 issued guaranteed bonds also for other sovereign states (Esteves and Tuncer, 2016).

Interestingly, we document that on different occasions, colonial governments lobbied for some or all three enhancements (guarantees, inscription and trustee status), suggesting they were partly substitutable ways of making colonial securities popular with British investors. We find that markets priced all enhancements and that guarantees were especially important in the earlier part of our period. This guarantee premium, however, declined over time and was close to zero by the start of the twentieth century (**Figure 2**).

The second question is under what circumstances colonial governments lobbied for the three types of enhancements, none of which was a free lunch. A guarantee might add prestige to a colony by giving its bonds a status similar to consols. However, a guarantee could also be seen as a sign of fiscal weakness and sometimes entailed a loss of autonomy because of conditionality attached to it. For instance, a guaranteed New Zealand loan of 1857 was offered conditional upon fiscal and political centralisation of the colony.

A final question regards the motivations of the British and French governments to grant these guarantees. In Britain at least, the process was public and subject to parliamentary scrutiny, offering an inroad into the political and financial tradeoffs involved. In the background was the clear understanding that guarantees were a direct charge on the British taxpayer, and the financial concerns of the Treasury sometimes collided with the political interests of the Colonial Office. Some British officials worried that guaranteed bonds might turn into ‘dormant securities’ which could later sour the relations between Britain and the colonies.

Nevertheless, prior to World War I there was interest in creating new classes of safe securities as steady primary surpluses cut back the supply of consols. Guaranteed bonds were among the first securities to be included in the trustees lists after UK public debt. The interwar period was a transition period when the imperial guarantee system gained a more developmental focus. During this period British colonies in East Africa (Tanganyika, Nyasaland and Mauritius), and the Middle East (Palestine and Sudan) secured imperial guarantees for irrigation and infrastructure projects, as well as to tackle certain fiscal crises and natural disasters, e.g. hurricane damage in Mauritius (**Figure 3**). This orientation became even more pronounced after World War II with the passing of The Colonial Loans Act of 1949 which enabled the Treasury to guarantee the loans made by the International Bank for Reconstruction and Development to the governments of British colonies.

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Figure 1. Guaranteed colonial bonds issued by Britain and France

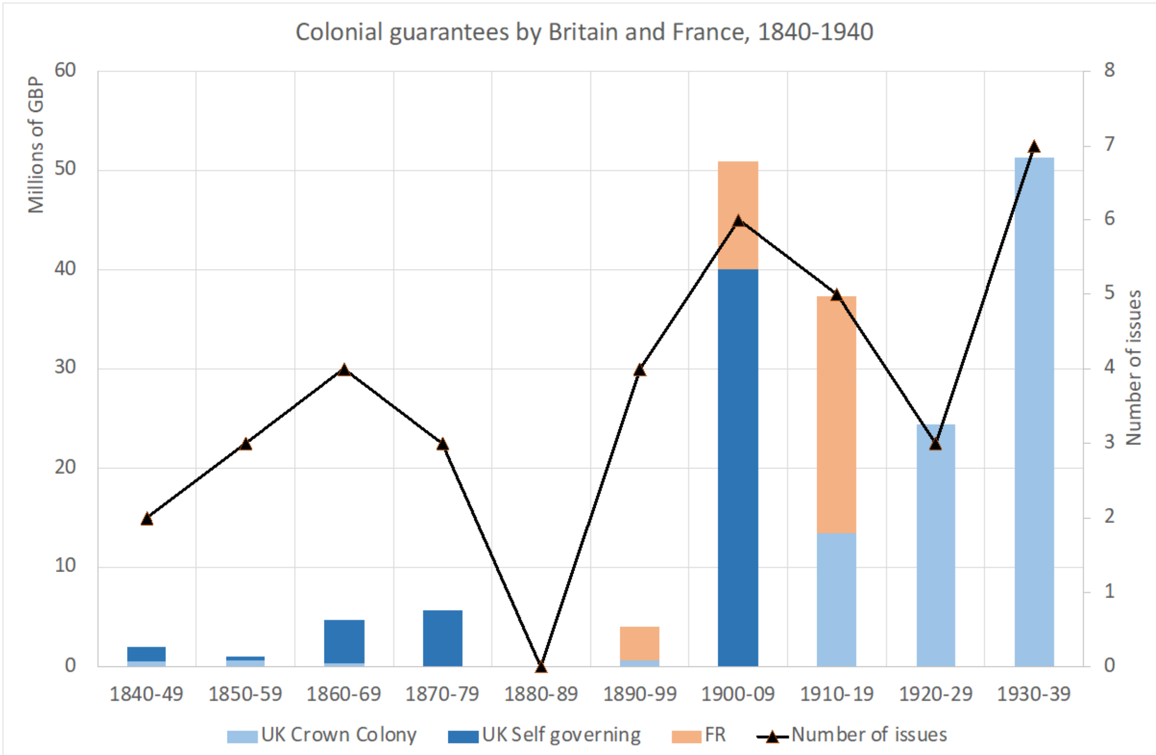

Figure 2. Average spreads between guaranteed and non-guaranteed bonds (by quinquennia)

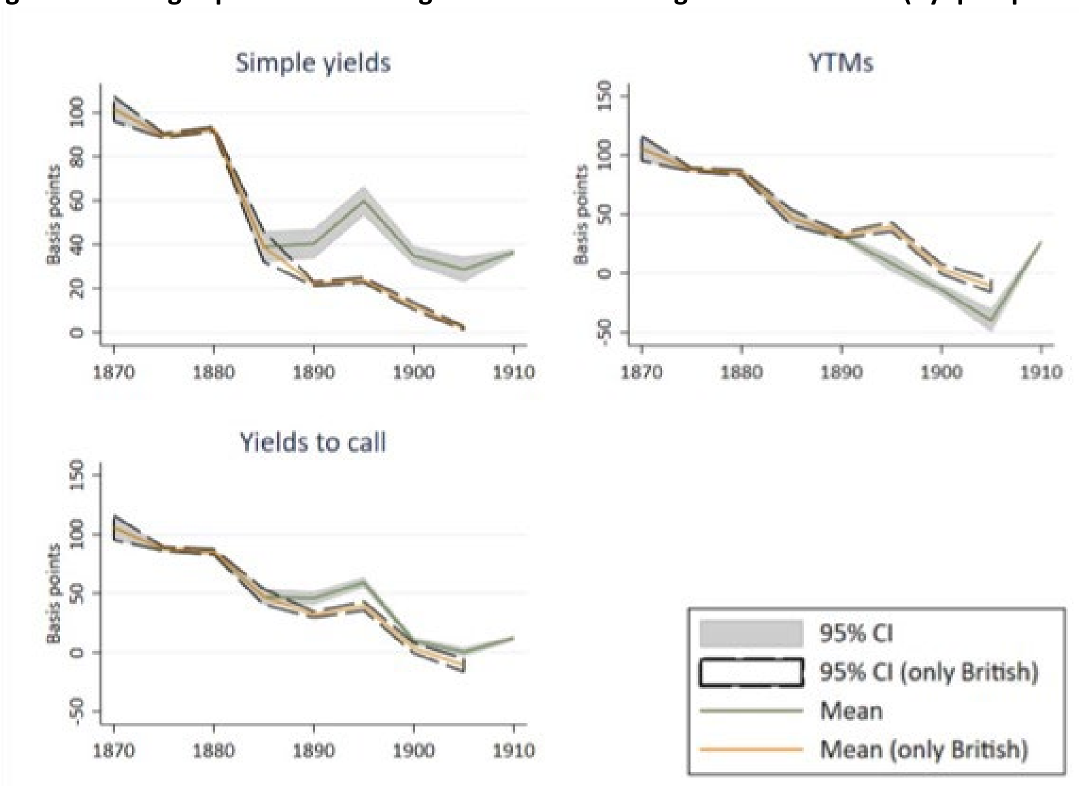

Figure 3. Guaranteed colonial bonds by issue purpose