Review of Finance (2006) 10:483–486
DOI 10.1007/s10679-006-9016-5

PREFACE

The *Review of Finance* seeks to promote publication of research in newly emerging areas of finance as well as more traditional ones. It does this by organizing occasional special issues on particular topics that bring together a collection of articles on a particular theme. One such theme is history and one of the most important developments in finance over the past few years has been the discovery of history.

For the most part, finance has been a contemporary subject focusing on the operation of capital markets today and in the recent past. In contrast, while business and economic historians study financial markets in the past, they have not widely employed the techniques and approaches used by financial economists. What has happened over the last few years is a convergence of the two subjects: financial economists have begun to look back over several centuries and economic and business historians have embraced the techniques of modern finance. The result has been significant: the discovery of large volumes of previously untapped sources of data and information by financial economists and of highly insightful methods of theoretical and empirical analysis by economic and business historians.

The importance of history has also become more evident as financial economists have sought to understand how major institutional and political changes such as wars and ideological revolutions affect the evolution of capital markets. To find an analogue to the modern pace of globalisation it is necessary to look back at least a century, to a time when there were active capital markets in most of the world's major cities, and a free international flow of goods and labour. The lessons from the contraction and re-configuration of the global financial markets in early 20th Century may provide a useful perspective to 21st Century market analysts and participants. From the viewpoint of financial economics one of the greatest benefits of history is that it can help us appreciate that static equilibrium models that are built to fit to modern Post-War circumstances must also be applicable to earlier and potentially vastly different markets. Thus, financial history challenges our modern theories, as well as providing us with a rich domain in which to test them.

One often overlooked benefit of financial history is that it can provide inspiration for future financial development. Finance can be thought of as a technology to address problems of savings, investment, ownership transfer, revelation of information and other functions served today by capital instruments, markets and institutions. Our historical predecessors confronted many of these same problems and solved them in ingenious ways. By studying past technological innovations, understanding why they worked or why they did not, modern financial innovatviors may learn that such seemingly outmoded tools as lottery bonds, tontines and privatization of government debt might be useful in the modern age.

This issue of the *Review of Finance* illustrates some of the opportunities that the intersection of financial economics and history provides. It is based on a conference on *Early Securities Markets* that the Centre for Economic Policy Research (CEPR) and the *Review of Finance* organized in October 2004. The conference brought together leading financial economics and business and economic historians to discuss the evolution and performance of early securities markets. What emerged was a highly productive dialogue that provided new insights into the operation of financial markets, the role of institutions, the influence of regulation and international aspects of capital markets. This issue of the *Review of Finance* is devoted to papers on this topic, most of which were presented at the conference.

One of the subjects that has occupied the attention of modern finance is the role of financial institutions in overcoming capital market failures. In particular, in the context of debt finance it is argued that financial institutions may be able to impose credible commitment devices that individual investors are unable to sustain.

According to one set of theories, a financial institution can distinguish between excusable and inexcusable lapses in interest payments by borrowers. For example, they charge high interest payments when economic conditions are favourable and offer repayment holidays during difficult times. Michele Fratianni examines San Giorgio in this context in a paper entitled "Government Debt, Reputation, and Creditors' Protections: The Tale of San Giorgio". San Giorgio, which operated between the 15th and 19th century, was a formal non-governmental association that sought to protect creditor rights and reduce the risk of debt repudiation by the Republic of Genoa. Consistent with modern theories, Fratianni reports that it reduced creditor risk and returns and thereby allowed the Republic of Genoa to borrow at comparatively low cost.

The effect of debt repudiation in a later era is examined by Kim Oosterlinck and John Landon-Lane in "Hope Springs Eternal – French Bondholders and the Soviet Repudiation (1915–1919)". The paper examines the movement of Russian bonds traded in Paris before and after their repudiation by the Soviet Union. The paper considers a number of factors that could have buoyed bond prices – the possibility of debt recognition by the Soviets, a Soviet overthrow, a bailout by the French government, a bailout by a government of a ceding country or a repayment by defeated Germany. The paper shows that until January 1919, large price changes were mainly driven by expectations of a French bailout and Soviet statements regarding debt repayment. After January 1919, military news from Russia became the main driving force of prices. The paper therefore suggests that bond prices were affected by a "Peso problem" by which several events of a different nature had some probability of becoming reality.

One new area of research of the last few years has been long-run studies of the evolution of ownership and control of firms. An illustration of this in this volume is the paper by Julian Franks, Colin Mayer and Hannes Wagner, "The Origins of the vii German Corporation – Finance, Ownership and Control". The paper documents that despite active stock markets in Germany, ownership remained concentrated at the beginning of the 20th century primarily in the hands of other companies and banks. In contrast in the UK, ownership concentration became rapidly dispersed. Investor protection was weak in both countries and therefore does not explain the difference. Instead, the paper suggests that banks played an important role in allowing equity markets to operate and retaining high levels of concentration of ownership.

Thomas Gehrig and Caroline Fohlin's paper "Trading Costs in Early Securities Markets: The Case of the Berlin Stock Exchange 1880–1910" uses modern microstructure models to look at the potential effects of increasing bank participation in the Berlin market in the decades preceding the First World War. They find little evidence that the institutional changes taking place in the equity markets during this period, regulatory shifts and the increasing role in the economy of large universal banks had any effect of the price discovery process. Indeed equity spreads throughout this transition era were practically as narrow as they are in modern times. Their paper suggests that the Berlin market of more than a century ago was not only informationally efficient, but that legal restrictions separating banking functions from market-making functions – even as banks expanded their role as intermediaries in other sectors – had no apparent positive or negative effect on spreads.

One might be excused for thinking from a reading of current controversies that globalization is a recent phenomenon. However, the academic literature on the history of capital market integration reveals that that is far from the truth and dates financial globalization to the post 1870 era. In "Integration of Trans-Atlantic Capital Markets, 1790–1845", Richard Sylla, Jack Wilson and Robert Wright argue that even that is too late: financial globalization occurred more than 50 years earlier. They use information on the prices of American securities in the US and European securities markets during the period 1790 to 1845 to establish the degree of financial market integration. They find little evidence of convergence of prices before 1815 but a considerable amount post 1816.

One of the market abuses that was common during the 19th century in US capital markets and became less commonplace during the 20th century was market cornering. Cornering of securities is interesting theoretically because it represents a supply-based boundary condition for derivative pricing processes. In the normal operations of markets it is common to ignore the potential for strategic restrictions of supply, and consequent market failure. The study of corners is difficult because they are so rare in modern markets. In "Large Investors, Price Manipulation, and Limits to Arbitrage: An Anatomy of Market Corners", Franklin Allen, Lubomir Litov and JianPing Mei use data from the second half of the 19th century and the 20th century to examine market corners. They show that it might be rational for uninformed investors to participate in markets that are subject to corners. Arbitrageurs only take short positions in stocks when potential profits offset the risk viii of being cornered. For prices close to the expectation of the stock's payoff, it is not worthwhile for them to take a short position. As a consequence, the market is less efficient than when corners are not possible. Consistent with this, Allen, Litov and Mei report that market corners tend to increase market volatility and have an adverse impact on the prices of other assets. The implication is that laissezfaire markets have the potential for inefficiencies and that an important role for regulation exists in the presence of the possibility of extreme negative outcomes.

Hence, modern regulators should pay careful attention to the avoidance of corners, and be aware that the market is not always a self-correcting mechanism.

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Special Issue Editors