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# THE 1802 KINGDOM OF PORTUGAL BOND ISSUE

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The Portuguese government's tapping of the capital markets in February 2002 represents a remarkable coincidence for it is exactly 200 years since Portugal first borrowed in the international markets. In 1802 the then Kingdom of Portugal issued 13 million guilder bonds (the equivalent of 80 million euro at today's prices) redeemable by 1812 and having a 5% coupon. In 2002 the Republic of Portugal is issued 2.5 billion euro 5% bonds with a maturity date of 2012.

That said, there are, of course, significant differences. In 1802 the bonds were backed by impressive security in the form of Brazilian diamonds and the country's tobacco revenue. Indeed, without this security package the bonds would never have found a market. And the proceeds were needed not for the development of the Portuguese economy but to pay wartime reparations to France.

For Portugal the 1802 transaction represented a milestone in its economic and fiscal history, the country never before having accessed the markets. The earliest date usually given for the Portuguese government's issuance of debt in the markets is 1823 so the 1802 transaction has, to an extent, been lost from view.

The bankers chosen to lead the transaction were Barings of London and Hopes of Amsterdam. For Barings - now part of ING of the Netherlands - it was also a milestone. This was the firm's first significant issue of securities.

The years spanning the end of the eighteenth and the beginning of the nineteenth centuries were miserable ones for the then Kingdom of Portugal. In the 1790s the country, allied with Britain, became embroiled in conflict with France and its ally, Spain.

The country's cross border trade with its neighbour suffered. Worst still, damage inflicted by Spanish pirates operating off Portugal's coast threatened the country's vital commerce with its colony, Brazil, and with its major trading partner, Britain. As a result, the Portuguese government's revenues were severely reduced.

Matters came to a head in 1801 when France and Spain provoked a military campaign in Portugal. Supported only by a few financial subsidies from the British government, Portugal quickly succumbed and sued for peace, which was sealed at the Treaty of Madrid at the end of September.

But for Portugal this treaty represented the onset of a whole new series of problems. Napoleon took advantage of the treaty to extract a rich prize from the exhausted country in order to fill his own depleted coffers. He wanted money and he wanted it quickly - about 11 million Dutch guilders (or £900,000).

The challenge for Portugal was how to raise such an enormous sum. It was immediately apparent that the cash could not be generated from a country so ravaged by war and disrupted by trade restrictions. Instead the Portuguese government would have to mortgage its future revenue in what appears to have been an unprecedented and historic move in order to access the international markets.

In 1802 this was to be no easy matter. On the one hand, Portugal's economy was depleted and investors were as adverse then as they are today to weak sovereign debt. On the other, the country had no rating in the markets as it had never before tapped them. And added to all of this was the disarray of the markets themselves.

At this time Amsterdam was the leading international capital market but under wartime conditions it had largely closed to business. In late 1794 French forces had occupied the city and merchants and bankers had fled. The most notable evacuee was the leading merchant bank of Hope & Co, which shifted its residence to



London. There it joined forces with London's most powerful merchants, the Barings. Their massive capital stocks were combined and employed by them in a succession of major transactions, drawing in particular on Hopes' experience gained over many decades in marketing bond issues for sovereign states in the Amsterdam market. Together in 1803 and 1804 they were to issue US$11.25 million US Government bonds to finance the United States' purchase of the Territory of Louisiana from France. It was as a prelude to this that in late 1801 the two had joined together to fund the requirements of Portugal.

In raising finance in what seemed like hopeless circumstances, the government in Lisbon could call on two priceless assets. The first was the so-called tobacco revenue, a significant and easily collected tax levied on a product whose consumption did not vary greatly from day to day. Smoking in the 19$^{th}$ century was as addictive as it has proved to be in the 21$^{st}$.

The second, and far greater, asset was more exotic but less easily controlled. In the eighteenth century Portugal's empire extended to Brazil and in particular to its rich province of Minas Gerais. The wealth of this province came from its diamond mines, the largest in the world, and their output was brought to Europe and sold for the benefit of the Portuguese government. The so-called Diamond Contract - a concession granted by the government for the sale of Brazilian diamonds for a set period at a guaranteed price per carat - was fiercely competed for by wealthy merchants across Europe. For many years its control had been a glint in the eye - but only that - of Hopes of Amsterdam.

While the Portuguese government was aware of other schemes for generating finance - at one stage it had offered to Barings its African colonies - it quickly realised that the streams of revenue from tobacco and diamond sales would be critical in meeting its obligations to France. In October it approached Barings and Hopes, via their merchant friends in Lisbon, and asked them to float a bond issue in the London market based on this stream of income and source of security.

P. C. Labouchère (1771-1839)

The houses were unquestionably the two most powerful merchant banks in Europe, and therefore in the world. Both had longstanding links with Portugal; Barings, for example, had done business with Portuguese merchants since the 1760s. Both were



anxious to help since, in addition to the current opportunity, they saw sources of future profitable business. While Hopes cherished control of Portugal's diamond trade, Barings sought an on-going appointment as the government's financial agents in London.

Initially the Portuguese government specified an amount of £1.2 million (or 14.4 million guilders) which would settle the debt to France and "provide at once for all the exigencies of the Government for a long period". The money, it reckoned, would be needed for 10 years. As security it offered diamonds valued at around £275,000 which would be deposited in the Bank of England for account of the bankers. Principal and interest would be paid out of the proceeds of their sale and also out of Portugal's tobacco revenue.

The bankers, excited by these prospects, dispatched their representative to Lisbon. When looked at from the perspective of the 21st century, it is astonishing from a political point of view that they were allowed to go ahead with this venture. Britain, of course, remained at war with France and would do so until the signing of the Peace of Amiens at the end of March 1802. In the meantime, any money raised by Barings for Portugal would be paid to France and used to make war against Britain. However, the age of "total war" had yet to arrive and, in the British government's view, the money would be a small price to pay for the rescue of a valued ally from its calamitous position in the clutches of France.

Dispatching a banker to Lisbon was one thing, but in 1801 getting him there was quite another. A young banker and partner in Hope & Co, Pierre Labouchère, was selected for the mission and, in the company of George Baring, Sir Francis Baring's son, left London for Lisbon in early December. Having negotiated the Pyrenees on mules in bitter winter conditions, they finally arrived in Lisbon on January 28th 1802.

Hard negotiations now followed and, notwithstanding instructions on key points, Labouchère's seniors in London left everything in his hands. Of course, given the length of time required to communicate with London they had little choice. Two early decisions were reached. Firstly, Barings and Hopes would only countenance a loan of £700,000 (8.4 million guilders), at least as a first step. Secondly, in view of a critical shortage of time and as a gesture of goodwill, an immediate advance of £100,000 was agreed.

But Labouchère struggled in his negotiations, single-handedly arguing his case; he was lawyer, accountant, banker and translator. Matters were complicated by the decision, late in the day, to transfer the place of primary issue from London to Amsterdam. This would, in theory, be facilitated by the return of Hopes to Amsterdam in the latter part of 1802. Henceforth the loan would be denominated in guilders and not sterling.

Labouchère's poor knowledge of Portuguese proved to be a major stumbling block. In translating documents into Portuguese differences of emphasis occurred repeatedly "causing him to rack his brain in an effort to detect contrasts of word and nuance in a language which was strange to him". But in difficult circumstances he proved triumphant. Time was on his side. Pressed by France, Portugal needed its money urgently and had a weak hand to play.

The Court asked for 13 million guilders (£1.083 million or, at today's value, about 80 million euro) payable in monthly instalments of 1 million guilders from January to November 1802 with the final 2 million guilders payable in December. Labouchère countered with the offer of 6.5 million guilders but with the possibility of a larger amount in due course and after due consultation with his seniors on his return home. He proposed a 5% bond and initially suggested a take over price of 90 later increased to 92. A good deal, he said, pointing out that if a 6% bond stood at par then one of 5% could reasonably be priced at 83.5. Of the loan proposed, 4.5 million guilders would be made available after signing off the contract and the placing of 114,000 carat diamonds to the bankers' order in Portugal. The remaining 2 million guilders would be made available following the arrival in Europe and the transfer to the bankers of some 100,000 carat diamonds from Brazil. Their total



value would be some 5 million guilders - surely a quite acceptable margin! To complete the deal it was agreed that tobacco revenue amounting to 1.7 million guilders would be earmarked annually to meet interest and principal repayments - although it would reduce in proportion to the amount generated through sales of diamonds.

This not unfavourable contract was made still more acceptable in two significant ways. Firstly Barings and Hopes were granted for their services a 5% commission on the nominal amount of the loan, and received an additional 1% for interest and sinking fund payments made to bondholders during the life of the loan. More importantly, since the sale of diamonds, and therefore their price, was to be so crucial for the management of the bond issue, the sale of the output of the diamond mines in Brazil was to be placed in Barings' and Hopes' hands for the duration of the loan. In other words, the coveted diamond contract had been won for 10 years.

The contract was finally agreed in principle on February 8th and endorsed later the same month on February 26th. On March 2nd March Labouchère and young George Baring embarked for Gibraltar and arrived at Paris on April 17th. Here Labouchère was able to settle all the outstanding points. One of these was the total amount of the loan. On advice from the senior partners of Hopes and Barings, it was agreed that this would now be increased to 13 million guilders, the full amount requested by the government. Another was the issue price which would be reduced from the proposed 92 to 90 in view of the current state of the markets. It meant that, less the bankers' 5% commission, the proceeds of the loan would amount to slightly more than 11 million guilders - or about 67 million euro at today's values.

The tightness of the timetable, however, remained an embarrassment for the Portuguese government. In order to help ease their position, Labouchère obligingly undertook to use the influence of Barings and Hopes to persuade the French government to agree to a rescheduling of payments; he met with success. The equivalent of only 1.4 million guilders would now be demanded before June 1st

1802 and the final payment would be made on August 31st the following year.

Barings and Hopes now planned for the bond issue, but seemingly nothing was to be straightforward. One problem turned on the place of issue. There had always been doubt about the primary issue being made in Amsterdam as the market there had been closed for so long. However an Amsterdam issue had been stipulated in the agreement with the Portuguese government. Then, unexpectedly, the Amsterdam authorities placed onerous restrictions on new issues to prevent capital draining away from the exhausted Dutch economy. Hectic negotiations ensued which left the senior partner of Hopes, Henry Hope, with, in his own words, "a severe jolt to the nerves".

Other problems touched on the diamonds being sent from Brazil. These should have been received in Europe well before the end of 1802 but did not arrive until May 1803. The slowness and unreliability of international communications meant that confusion reigned over the amount being sent. 85,000 carat was originally mentioned but later revised upwards to 120,000 carats and then reconfirmed downwards at 104,000. Confusion was compounded by difficulties of shipping. Against the banker's wishes, 15,000 carats were sent by mail packet only to fall into the hands of the French navy following the resumption of hostilities between Britain and France in May 1803. It is a measure of the situation's absurdity that, as a result of security for the loan falling into French hands, Britain's enemy would now be paid twice over!

However, the major problem turned on the impossibility of the bankers controlling the international market in diamonds and thereby regulating prices. It will be remembered that as part of the loan deal, the bankers were given a virtual monopoly of sales so as to regulate diamond prices in the market. But this monopoly was not watertight while the French government did its very best to undermine market price through sale of the 15,000 carats captured by its navy!



However all things considered, the Portuguese loan faired well given the appalling difficulties of the time. The bonds sold well, although they were held by a relatively small group of investors linked closely to Barings and Hopes; both firms acquired as an investment large amounts for their own account. During the life of the loan Europe fell back into war and many battles were to be fought on Portuguese soil. This in itself brought terrible disruption to the economy - in particular the collection of the tobacco revenue - and these difficulties were compounded by Napoleon making further financial demands that the government had to settle without recourse to the international markets. As one observer put it, 'in these years Portugal was eaten bare'.

Until 1811 interest and principal payments were made promptly, although the December 1810 payment was only made possible through an advance by Barings and Hopes of 1.7 million guilders, which was to be repaid from the proceeds of diamond sales. However at the end of 1811 and with a continuing insufficiency of funds, the holders of the outstanding 1,600 bonds then due for redemption only received interest. This continued in 1813 and 1814. Only in December 1815, three years late, were the remaining bonds finally paid off and the loan cancelled.

So concluded an historic transaction for Portugal albeit one that has become obscure with the passage of time. It also marked the beginning of Barings' long association with the country. Throughout the nineteenth and well into the twentieth century the firm made advances and bond issues for the government. So far as the business community is concerned, Barings moved from financing the imports and exports of Portuguese merchants in the eighteenth century to providing finance and advisory services to companies in the mainstream of Portuguese business up to the present day.

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