The Politics of Confederate War Debt in Europe

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Abstract

During the American Civil War, the Southern Confederacy borrowed only one percent of their war expenditures from European capital markets. The South floated two small loans; cotton bonds that traded in England and junk bonds in Amsterdam. The Confederacy serviced the cotton bonds for the entire war and did not make interest payments on the junk bonds. Perhaps the Confederacy knew that many members of British Parliament planned to purchase cotton bonds. Although these politicians failed to secure recognition of the Confederacy in British Parliament, this episode suggests that countries may issue debt as a financial incentive for military intervention or support.

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"There is no doubt that Jefferson Davis, and other leaders of the South have made an Army. They are making, it appears, a Navy. And they have made-what is more than either-*they have made a nation*." (British Chancellor of the Exchequer, William Gladstone, October 7, 1862)

The standard story in economics is that countries borrow to smooth tax revenues over time. During a war, borrowing is a more efficient method for financing government expenditures than imposing higher taxes that can reduce work effort. The theory of tax smoothing has been tested for many countries over various time periods, including the American Civil War. In a recent paper, Grossman and Han (1996) investigate why the Southern Confederacy borrowed only 1 percent of their war expenditures from European capital markets. They conclude that the Confederacy did not need to borrow from abroad. Prior to the battle of Gettysburg, the South "had a large amount of mobilizable resources relative to its expected post-war resource endowment (p. 214)."

This paper provides new evidence that tax smoothing cannot explain the small amount of Confederate borrowing in Europe. Rather, Confederate debt policy in Europe was driven primarily by "political considerations." The Confederate government turned to London debt markets only after failing to lure England and France into the war via a cotton embargo and bribe, respectively. Perhaps encouraged by Gladstone's public statement above, the South floated a small 3 million pound sterling loan in March 1863. Underwritten by a French firm, Emile Erlanger and Co., the bonds contained several features to minimize default risk. The Confederacy honored these provisions for the entire war. The issue was denominated in sterling, paid interest in sterling -7 percent per annum-, and could be converted into cotton on demand. The only catch was that investors had to take delivery of the cotton in the Confederacy. Cotton not only backed the war bonds but provided an incentive for debt holders to put pressure on British Parliament to break the Northern blockade of Southern ports.

The cotton bonds were oversubscribed 5 times when they came to market in London. The security initially rose to a premium above the offering price of 90 pounds sterling. The debt issue captured the attention of British dailies and brought the fledgling nation much needed positive publicity following their defeat at Antietam. Cotton bond prices remained stable until news of Confederate defeats at Gettysburg and Vicksburg in early August 1863 sent the bonds tumbling to a price of 36 pounds sterling by the end of the year. Investor confidence in the Confederacy plunged along with the South's ability to pay off their war debt.

Critical battle defeats in the summer of 1863 effectively prevented the Confederacy from selling more debt in international capital markets. Southern attempts to sell large quantities of junk bonds in Amsterdam failed during late 1863 and early 1864. For the few bonds the Confederacy managed to sell, they chose not to service them, invoking the default clause outlined in the terms of issue. The South was apparently not very concerned about the effects of a bad bond market reputation in Amsterdam on their war debt trading in London. This suggests that reputation spillovers across markets may not be as large as indicated in theoretical models of sovereign debt (cf. Cole and Kehoe, 1994).[1]

Confederate debt policy in Europe focused primarily on the cotton bonds. The South hoped to score a political victory by selling cotton bonds to important British subjects, especially politicians. Several Members of Parliament in addition to the Chancellor of the Exchequer owned shares in the Southern security valued at par in excess of a thousand pounds sterling. Many of these bondholders tried to secure recognition of the Confederacy in Parliament after the cotton bonds came to market. Although they failed, this episode from financial history provides evidence that governments may issue sovereign debt as a financial incentive for military intervention or support.

Empirical evidence from financial markets supports the hypothesis that the South protected their preferred British creditors for the duration of the war. Market prices for the Confederacy's senior debt obligation, cotton bonds, retained a large premium to all other Southern debt prices. A vector autoregression analysis shows that war shocks had a much smaller impact on cotton bond prices than other Confederate war debt prices *ceteris paribus*. Governments can undertake debt management policies that protect senior creditors even under the most extreme macroeconomic conditions (Calomiris, 1991).

III. The Foreign Debts of the Confederate States of America

The Southern Confederacy initially financed the war through domestic sources. The government floated 2 major loans during the first two years of the war, the 15 million-dollar loan of 1861 and the 100 million-dollar loan of 1862. The Confederacy originally pledged to service these issues in specie, but ultimately reneged, making interest payments in depreciated Grayback notes. The South's inability to service their domestic debt stems from a states' rights minded Congress and a central government that refused to levy taxes. Taxes accounted for only 10 percent of revenues, forcing the Confederacy to rely on the inflation tax (Ball, 1992; Burdekin and Weidenmier, 2000).

As shown in Figure 1, real Confederate revenues derived from money, debt, and taxes peaked in October 1862, only to fall for the remainder of the war, as the South's take from the inflation tax plummeted with skyrocketing prices. The Confederacy lacked the resources to fight a total war.[2]

European capital markets potentially offered the Confederacy a large market for war finance. However, several factors precluded this possibility. Early in the war, the Confederate government imposed a cotton embargo in hopes of crippling the British economy and inciting British intervention. Unfortunately for the South, the policy not only failed to bring England into the war, it also prevented them from using cotton as collateral to secure foreign loans (Ball, 1992). The Confederacy ultimately abandoned this strategy as the United States increasingly tightened its hold on Southern ports with a naval blockade.

Shunned by England, the Confederacy next sought to enlist France by bribing Napoleon III. They offered the French Emperor a 12.5 million pound "subsidy" to break the Union blockade of Southern ports (Ball, 1992). In turn, James Slidell, the Confederate representative in Paris, promised the shipment of vast quantities of cotton to France to mitigate the effects of the American Civil War on European economies. Napoleon ultimately declined the offer despite repeated attempts by the Confederate foreign service.

By the fall of 1862, the Confederacy had failed to enlist the services of either the British or French. At this time, the South began to have discussions with several European financial houses that could underwrite a foreign loan for the Confederacy. One problem for the South was that underwriters viewed them as a bad credit risk. As noted by Lebergott (1983), war risk was one of many sources of default risk for the Confederacy. They lacked a bond market reputation because they elected a President who openly advocated the repudiation of state debts while a member of the U. S. Senate. Davis twice supported default of state bonds issued by Mississippi and Arkansas (Walker, 1864). Europeans held many of these bonds and Northern officials made sure that foreign investors were aware of this fact by publishing a pamphlet of the former Senator's speeches supporting repudiation (Walker, 1864). The United States government even placed a representative in Europe, Robert Walker, to disseminate information about Davis' views on repudiation to European financial houses.[3] Lebergott (1983) also notes that the South's inability to sell bonds within its own borders because of a small tax base was a signal for European investors to stay away. All of these factors apparently contributed to the South's inability to secure adequate war finance from international capital markets.

Given the preceding considerations, it is not surprising that the Confederacy operated at a considerable disadvantage when negotiating terms for a foreign loan. The South finally agreed to float a 20-year, 3 million pound sterling issue with the French firm, Emile Erlanger and Company. Originally, Erlanger offered to float a much larger issue, but the Confederacy declined because they viewed the terms of the loan as unfavorable. Although some of the funds from the cotton bond issue were used to purchase goods and services for the Confederacy, political advantages -foreign aid, foreign military support, etc. - appear to be the primary reason the Confederacy issued the cotton bonds. Judah Benjamin, the Confederate Secretary of War, alluded to the possible financial and political incentives of the cotton bonds in the following correspondence with James Slidell, the Southern diplomat in Europe entrusted with negotiating the cotton loan.

> "Your intimation of political advantages likely to be derived from the [cotton] loan possessed great weight, though not as much as if you had felt at liberty to express yourself more definitely. *We finally agreed, in view of that intimation, to make a sacrifice*..."[4] (Emphasis added) (Benjamin to Slidell, January 15, 1863, also quoted in Ball (1992, p. 76)

The terms of the Erlanger Loan suggest that the Confederate government intended to service the issue. The twenty-year security was denominated in sterling and also paid interest in sterling, 7 percent per annum, to minimize currency risk. The war bonds contained a sinking-fund provision that retired one-fortieth of the principal semiannually through a lottery drawing. The underwriting firm agreed to sell the bonds at 90% face value and collect an 18% brokerage fee. As a result, the South received only 2,160,000 (72%) of the 3 million pound issue (*Economist*, March 21, 1863, p. 1).

The war bonds contained an additional provision that allowed holders to convert the security into cotton on demand. The cotton clause not only backed the debt obligation, but created an incentive for European investors to pressure their governments into breaking the Northern blockade of Southern ports. For example, a bondholder exchanged their war bonds for cotton certificates with the Confederate European representative. The investor then ran the blockade, took possession of the cotton in the South, and returned to Europe running the blockade a second time.[5] The transaction could be quite profitable considering that New Orleans middling cotton sold for 24 pence per pound in Liverpool, 4 times the price offered by the terms of the cotton bonds. To facilitate the exchange, the Confederacy agreed to transport the cotton within ten miles of a navigable river or port (*The Economist*, March 21, 1863, p. 1). On the other hand, investors could wait until after the war to exercise the cotton option. In this case, debt holders were given six months following the ratification of a peace treaty to convert their bonds int cotton.

The Confederacy serviced the cotton bonds for the duration of the Civil War, despite a deteriorating military and financial situation. As noted by Weidenmier (2000), the war bonds were exchanged for cotton in accordance with the terms of the loan. Moreover, the South continued to make scheduled interest payments in sterling as late as March 1865, a month before the fall of Richmond. It appears that the Confederacy remained committed to servicing their war debt in hopes that their British "ally" might provide foreign aid or military support.[6]

In addition to the widely studied cotton bonds, the Confederate government also sold domestic bonds in Amsterdam during the late summer of 1863 and early 1864 (cf. *Amsterdamsch Effectenblad*, 1863-1865). The Dutch bonds have been largely ignored in the annals of financial history. Christopher Memminger, the Confederate Secretary of the Treasury forgot about the issue and failed to mention them in his Treasury reports and memoirs (Ball, 1992). The Confederate government shipped between 3 and 10 million dollars of domestic debt to Europe. But, as pointed out by Todd (1954), the issue failed to generate much interest among European investors even though security was officially endorsed by the Amsterdam exchange. Waning confidence in the Confederacy following defeats at Gettysburg and Vicksburg was probably a sign for investors to stay away. Moreover, the Dutch bonds contained a default clause that allowed the Confederacy to postpone interest payments:

"Eight percent Confederate Loan of the Confederate States of America, authorized by the Act of Congress C. S. A. of February 2nd, 1863,..., upon the Fxpress condition that said

Confederate States may from time to time extend the payment for any period not exceeding thirty years from this date, at the same rate of interest upon the surrender of the bond." (Bosch, 1948, p. 133)

Indeed, the *Amsterdamsch Effectenblad* did not report interest payments on the security during 1864 or 1865 (*Amsterdamsch Effectenblad*, 1863-1864; Bosch, 1948). The South's failure to service the obligation suggests that the Confederacy did not believe that default in the Amsterdam market would have a large negative effect for their bond market reputation in London. This suggests that reputation "spillovers" across markets may be smaller than indicated in the some recent models of sovereign repayment (cf. Cole and Kehoe, 1994).

IV. British Foreign Policy and the Holders of Confederate Cotton Bonds

The Confederate government had good reason to believe that England could be a viable and important ally. Two members of the British cabinet, Chancellor of the Exchequer William Gladstone and Foreign Secretary Lord John Ferguson openly supported the Southern Confederacy. Gladstone even had dinner with a Confederate agent, Henry Hotze, July 30, 1862, at Lord Campbell's house. They apparently discussed the war as well as a "suitable border" between the North and South following the cessation of hostilities. Shortly thereafter, Gladstone sent Prime Minister Lord Palmerston a memorandum about the question of British mediation in the American Civil War. The British cabinet met August 2, 1862 to discuss whether "to move or not move" on the American question. They ultimately adopted a wait and see attitude following news of the Confederate defeat at Antietam (Shannon, 1982, p. 463).

The Confederacy may have thought they could develop stronger relationships with British politicians by floating the cotton bonds. Perhaps they knew that many important Englishmen planned to purchase shares in the Confederate security. Table 1 reports an incomplete list of prominent cotton bondholders published in the *New York Times* over eight months after the war, December 9, 1865.[7] The article listed the title and occupations of many important investors, in addition to the number of bonds held by each holder. Unfortunately, the article did not designate whether the bond(s) possessed by a given holder were of the 100, 250, 500, or 1,000 pound sterling variety. However, the holdings for each investor, assessed at par value, can be calculated by assuming each bond equaled the smallest denomination (100 pounds sterling). Table 1 indicates that some prominent British owned cotton bonds valued at more than 10,000 pounds sterling at par. The editor of the *Times*, John T. Delane, owned 100 cotton bonds while several Members of Parliament (MPs) including W. S. Lindsay, W. Sholefield, and W. H. Gregory had holdings in the thousands of pounds sterling. The most notable investor on the list was Gladstone, a holder of 20 cotton bonds (Bigelow, 1905).[8]

Several MPs listed in Table 1 tried to persuade Parliament into recognizing the Southern Confederacy as a sovereign nation. The leading proponent of Confederate recognition in Parliament was W. S. Lindsay, the largest cotton bond investor in Table 1. Lindsay made several speeches in favor of recognition of the Southern Confederacy. Curiously, *Hansard's Parliamentary Debates* does not record a discussion of "recognition" until after the cotton bonds came to market in March 1863. Presumably, MPs with shares in cotton bonds had more than just a passing interest in the Southern Confederacy. MPs now had an incentive to end the war through diplomacy/intervention so that they could cash in their war bonds for cotton and make a large profit. Consider Lindsay's address to Parliament, July 10, 1863:

"The question now before the House is one of far greater importance: it affects the peace and happiness of ten millions people: and as I hold the opinion, that if the word "recognition" was pronounced by England in concert with the Emperor of France and other European powers, that word would go forth as a harbinger of peace, and would restore peace with all the blessings that attend it..." (*Hansard's Parliamentary Debates*, p. 560)

Lindsay was not alone in his outspoken support for the South. Other prominent cotton bondholders, including Lord Robert Cecil (future Prime Minister), G. E. Peacocks, and W. S. Gregory expressed views in favor of recognizing the Confederacy during Parliamentary debates (see *Parliamentary Debates*, July 10, 1863). The question remained lively until leading members of Parliament pressured pro-Southern MPs into withdrawing their motion (*Parliamentary Debates*, July 10, 1863, p. 661). Evidently, the British government decided that they should keep a neutral position in the conflict. Even Gladstone reversed his stance in mid-July and adopted a wait and see attitude (Shannon, 1982). Although these MPs failed to persuade Parliament on behalf of the Confederacy, the Southern government may have thought otherwise.

V. Empirical Evidence

The historical evidence as well as the terms of issue suggests that the Confederacy's preferred debt, the cotton bonds, should have traded at a sizable premium to other war debt obligations. Figure 2 plots cotton bond prices, BOND, against the prices of other Confederate debt obligations for the period March 1863 to April 1865. The gold price of 100 Confederate Graybacks in Richmond, MONEY, is taken from newspapers in the Eastern Confederacy (see Weidenmier, 2001). The Richmond gold market reported trades in Graybacks and gold until late February 1865. Price quotes for Confederate bonds trading in Amsterdam, JUNK, are taken from the *Amsterdamsch Effectenblad*. The Dutch paper did not report junk bond prices until after news of Confederate defeats at Gettysburg and Vicksburg reached European financial markets in August 1863. The domestic bond series, DBOND, is the gold value of the 8% $100 million loan, floated in Richmond during 1862. This series, taken from Richmond newspapers, is available on a weekly basis until the summer of 1864, when the Confederate Currency Reform Act temporarily dried up the market for the security (Burdekin and Weidenmier, 2000). As shown in Figure 2, activity in the domestic issue resumed in the fall of 1864.

The cotton bonds initially fluctuated around their offer price of 90 pounds sterling. The Confederate government secretly repurchased nearly half of the original float in April and May of 1863 to buoy debt prices (Gentry, 1970; Weidenmier, 2000). Evidently, Confederate leaders in Europe were concerned that a precipitous drop in cotton bond prices would generate negative press for the South in London dailies (Ball, 1992). Presumably, this would hurt the South's chances of recognition in British Parliament.

Figure 2 shows that Confederate debt prices tended to fluctuate in response to battles that changed investors' views of the South's chances of winning the war and servicing their debt. Although Confederate asset prices fell precipitously following news of defeats at Gettysburg and Vicksburg in July 1863 and Atlanta in September 1864, cotton bond prices retained a considerable premium to all other debt prices. Junk bond prices possess a premium on other Confederate obligations because they are denominated in sterling to eliminate currency risk. The largest discrepancy between cotton bond prices and other Confederate debt prices occurred during 1864. Cotton bond prices increased from their December 1863 low of 34.5 pounds sterling to over 80 pounds sterling in early September 1864. Weidenmier (2000) provides empirical evidence that the large runup in cotton bond prices can be attributed to increases in the price of the underlying collateral of the war bonds, New Orleans middling cotton. In contrast, other Confederate debt issues declined in price during this period as Confederate victory prospects waned. The junk bonds, for example, lost nearly 50 percent of their value during the first nine months of 1864, falling from a high of 22.5 pounds sterling in January to 12 pounds sterling in September.

The sizable divergence between cotton bond prices and other Confederate debt obligations suggests that the Confederacy segmented default risk across different classes of creditors (Calomiris, 1991). The South protected the holders of their senior debt, cotton bonds, while defaulting on their (junior) domestic and foreign debt obligations. This implies that war shocks should have had a smaller impact on cotton bond prices than other Confederate war debt prices *ceteris paribus*. Confederate money prices, for example, should have depreciated more than cotton bond prices following a Southern military defeat.

Foreign and domestic equations for Confederate debt prices are specified to compare the effects of war news on different classes of Southern debt. Two systems are estimated on account of data availability. The foreign system consists of four variables; cotton bond prices, BOND, Confederate money prices, MONEY, New Orleans middling cotton prices, COTTON, and British Consol prices, CONSOL. Cotton prices are included in the system to control for the effects of cotton prices on cotton bond prices. Grayback prices are employed to estimate the effects of war news on the Confederacy's senior debt obligation. Money prices were chosen over junk bond prices and domestic bond prices since Grayback prices are available for almost the entire war. British Consol prices are used to capture general bond market conditions and business cycle effects on war debt prices. For comparative purposes, a second system consisting of Grayback money, MONEY, and domestic bond prices, DBOND, is estimated to measure the effects of war news on junior debt prices.

A VAR of the four-variable system is estimated for the period March 23, 1863 to February 27, 1865 using weekly data for a total of 109 observations. A lag length of three is chosen for a log specification of the system using the Akaike Information Criteria (AIC) and Schwarz Information Criteria (SIC). The domestic equation also employs weekly data and spans the period January 17, 1862 to April 29, 1864 for 120 observations. A lag length of 4 is chosen for a log specification of the system using the AIC and SIC.

Granger-Causality tests are usually carried out following estimation of a VAR to examine the statistical relationships among the variables. However, these tests are based on the assumption that the underlying data generating process is normally distributed and stationary. These assumptions are unlikely to hold during a period of war when economic time series are subject to large shocks. Moreover, unit root and cointegration tests are notorious for poor size and power properties, especially in short time series. A more appropriate methodology is to use the VAR to calculate impulse response functions with standard errors that are bootstrapped to account for large war shocks.

The impulse response functions for the foreign equation are estimated using a Bernanke-Sims decomposition. The advantage of this approach over the standard Choleski decomposition is that it allows for many variables to have a contemporaneous effect on one or many of the time series in the system. In the case of cotton bond prices, the graphical and historical analysis suggests that both cotton prices and war news are important determinants of cotton bond prices. Thus, an appropriate model would allow both cotton prices and war news to have a contemporaneous effect on cotton bond prices. This structure is imposed on the variance covariance matrix of the residuals for the foreign system. For the domestic equation, the impulse response functions are estimated using a Choleski decomposition. Money prices are given the first ordering followed by domestic bond prices. Selected impulse response functions along with 80 percent standard error bands are plotted in Figures 3-5.

The time series analysis support the hypothesis that war shocks had a much smaller impact on cotton bond prices than domestic debt prices. In the foreign equation, Figure 3 shows that a 1 percent shock to Confederate money leads to only a 1.45 percent increase in cotton bond prices after 5 weeks. In Figure 4, a 1 percent shock to cotton prices results in almost a 2 percent increase in cotton bond prices over a 5 week period. Cotton provided investors with insurance that hedged against war risk. In contrast, Figure 5 shows that domestic debt prices increase by nearly 5 percent in response to a 1 percent shock to Confederate money after 5 weeks. War news clearly had a much larger effect on the Confederacy's junior debt obligations. The econometrics buttress the historical and graphical analysis that the Confederacy segmented default risk, protecting their British creditors.

VI. Confederate Bonds in the Aftermath of the American Civil War

Market activity in Confederate cotton and junk bonds continued even after the war. The cotton bonds traded for 6 pounds sterling as late as July 1865, three months after Lee's surrender in mid-April. Liverpool newspapers continued to post cotton bond prices daily for the next couple of years, but reported only 3 trades (at 6 pounds sterling) between July 1865 and December 1866 (*Liverpool Daily Post* and *Liverpool Mercury*, 1865-1866).

Europeans apparently attached some small probability that the United States or individual states would assume Confederate war debts even in the event of Southern defeat. Investors may have been encouraged by discussions in Parliament concerning the fate of Confederate war debts. W. S. Gregory, an MP and a large holder of cotton bonds (see Table 1), inquired about the status of the cotton bonds just prior to the fall of Richmond in 1865. Gregory wanted to know if her Majesty's government had taken steps to protect British citizens' claims on cotton in the United States, specifically in the South. The politician was obviously referring to cotton bondholders whom had exchanged the war bonds into warrants and were waiting until after the war to pick up the cotton in the South. The House Speaker replied that the United States did not plan to service Confederate war debts, but that British citizens with claims on *private property* in the United States should keep legal documentation (*Parliamentary Debates*, March 1865).

Perhaps the possibility of intervention by Parliament on behalf of British investors explains the small positive price for the cotton bonds after the war. In any event, Parliament never followed up Gregory's query or placed pressure on the United States government to repay the war bonds.

Another possibility is that investors thought the underwriting firm, Emile Erlanger and Company, might assume a portion of the cotton bonds. Indeed, a group of cotton bond investors formed an association after the war to look into the possibilities of getting repaid by Erlanger or the United States government. Both Erlanger and the United States government said that they were not liable and would not honor the war bonds (*Economist*, July, 1865).

The Confederacy's Dutch obligation continued to trade on the Amsterdam exchange until May 1866. Junk bond prices, plotted in Figure 3, increased from one-half pound sterling in May 1865 to nearly 5 pounds sterling in the days leading up to the semiannual coupon payment date July 10, 1865. Prices for the defaulted issue stabilized around 2 pounds sterling in early 1866, and traded around this level for the next several years. Apparently the firm underwriting the war bonds offered investors a bonus to exchange the defaulted debt for "good" bonds.

"It is desired that the [8% Confederate bonds] bonds be exchanged for other officially stamped and available bonds. The bonus (*bonificatie*) demanded for them will be readily granted. Holders of the above mentioned bonds who are so inclined should direct themselves to inquire at the Booksellers Ipenhuur and Van Seldam, Damrak, Nr. 160." (*Amsterdamsch Effectenblad*, July 13, 1865)

The move was obviously designed to improve Ipenhuur and Van Seldam's reputation as a broker of government debt that was probably tarnished by their connection with

Confederate war bonds. The firm may have felt compelled to offer the bonus because the Amsterdam Stock Exchange officially endorsed the Confederate security.

VII. Conclusion

This paper provides evidence that governments will issue sovereign debt as a financial incentive to encourage foreign intervention during wartime. The Confederate States of America consciously pursued a debt management policy designed to lure England and France into the conflict. Although the Confederacy failed in this endeavor, they protected their preferred British creditors for the entire war. The war bonds were denominated in sterling, paid interest in sterling, and were backed by cotton. The cotton bonds successfully hedged against war risk as prices for the innovative instrument retained a large premium to other Confederate debt obligations. In contrast, the Confederacy did not service their Dutch issue, invoking the default clause outlined in the terms of the issue. The Confederacy probably believed that the Dutch were unlikely to provide the Confederacy with financial or military support. It appears that governments do not always issue war debt to smooth taxes. Politics can matter.

Endnotes

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1. Garber (1991) examines U. S. war debt during the American Revolution and also finds that reputation spillovers might be smaller than suggested in theoretical models of sovereign debt.

2. As discussed earlier, Grossman and Han (1996) argue that the South did not need to borrow from international capital markets at the beginning of he war. They calibrate a theoretical model of moral hazard that indicates foreign markets charged the Confederacy a sufficiently high interest rate such that the South did not undertake additional foreign borrowing. Grossman and Han's argument is inaccurate. The time path of real revenues indicates that the South needed foreign aid -in large amounts- by the fall of 1862. Grossman and Han's analysis also assumes that the cotton bonds were the only debt obligation sold in Europe by the Confederacy. Grossman and Han also fail to control for the value of the cotton option in their general equilibrium model. As shown by Weidenmier (2000), the ability to convert the war bonds into cotton propped up the price of the war bonds.

3. There is some debate about Walker's success in thwarting European financial houses from loaning to the Confederacy. A letter to the Editor of the *Times* dismissed claims that Jeff Davis' support of state defaults in Mississippi and Arkansas tarnished Confederate war debt. The letter noted that "Virginia, Georgia, and other honorable states (sic) were also part of the Confederacy," could pay off Confederate debts in the event of Southern defeat (*The Times*, March 19, 1863). However, the author of this letter was allegedly James Spence, a well-known Southern sympathizer (*New York Times*, December 9, 1865).

4. The Confederacy's senior diplomats in Europe, James Mason and James Slidell, also discussed the political advantages likely to be derived from selling bonds collateralized by cotton in Europe. Consider Mason's comments on the Erlanger Loan: "These terms, although vastly better than the outline of the contract made in Paris were considered by us so onerous that we were unwilling to take the whole amount offered, and would have declined it altogether but for the political considerations indicated by Slidell." (*Official Records*, p. 650). Confederate leaders obviously believed that the cotton bonds provided a financial incentive for England and/or France to enter the war.

5. Weidenmier (2000) provides historical evidence that a few cotton bondholders exercised the option, picked up the cotton in the Confederacy, and sold the staple at the high prices prevailing in Liverpool.

6. One might argue that the possibility of British sanctions or interventions induced the Confederacy to service the cotton bonds, as predicted in gunboat models of sovereign repayment (see Bulow and Rogoff, 1989a, 1989b). Although the gunboat model may explain Confederate debt management policy during the war, there is no way to verify

whether the South intended to service the cotton bonds after the war. We do not know if the Confederacy feared trade sanctions or gunboat diplomacy from Britain. The Confederate experience does not provide clear evidence in favor of the gunboat model of sovereign repayment. The author would like to thank William English for bringing this point to the attention of the author.

7. Unfortunately, an examination of Amsterdam and New York dailies did not yield a similar list of bondholders for the Confederacy's junk bonds trading in Amsterdam and Frankfurt. It seems unlikely that many important British subjects held large stakes in the gold bonds given the absence of references to the debt obligation in the *Economist* and *The Times*.

8. There is some controversy about whether Gladstone was a cotton bondholder. Morley (1903) denies Bigelow's claim that the future Prime Minister owned Confederate cotton bonds. The weight of the evidence seems to support Bigelow's view, however. Not only did Gladstone meet with Confederate agents, but he apparently dabbled in Egyptian bonds during their crisis in 1882.

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Table 1

Some Prominent Holders of Confederate Cotton Bonds

Name	Title	Number of Bonds	Min. Value (par)
Hon. Evelyn Ashley	Private Secretary of Lord Palmerston	10	1,000
Lord Eustice Cecil	M. P.	13	1,300
Lord Robert Cecil	M. P.	15	1,500
Lord Campbell	Son of Lord Chancellor Campbell	10	1,000
R. W. Crawford	M. P.	12	1,200
John T. Delane	Editor of The *Times*	100	10,000
Earl of Fitzhardinge	Privy Councillor For the Queen	50	5,000
Rt. Hon. George C. W. Forester	M. P./Privy Councillor	5	500
W. H. Gladstone	Chancellor of the Exchequer	20	2,000
W. H. Gregory	M. P.	30	3,000
W. S. Lindsay	M. P.	150	15,000
Lawrence Oliphant	M. P.	4	400
G. E. Peacocke	M. P.	50	5,000
Sir Frederick Pollock	Lord Chief Baron of the Court Exchequer and Privy Councillor	100	10,000
W. Scholefield	M. P.	100	10,000
D. M. Solomons	M. P., former Lord Mayor of London	6	600

Notes to Table 1

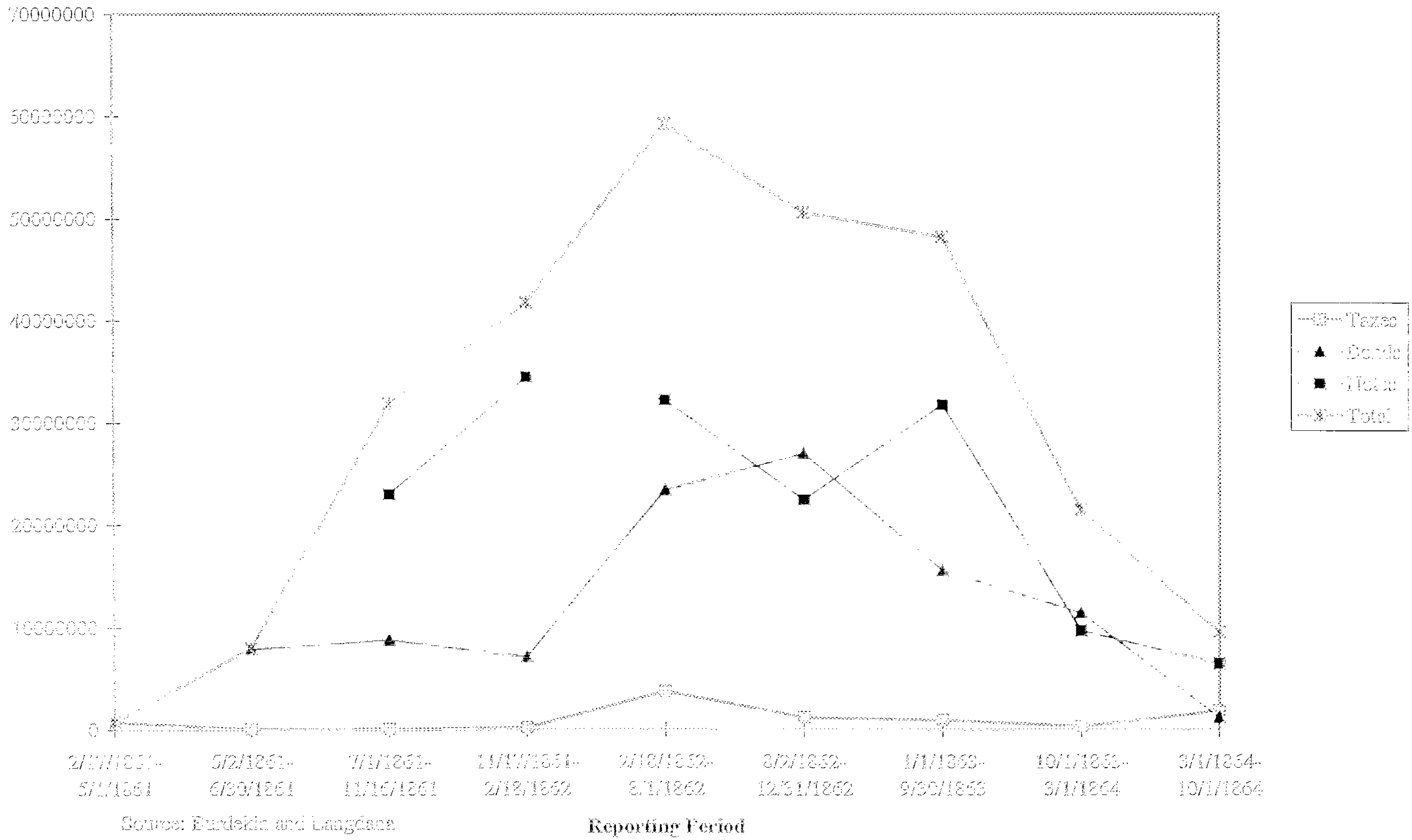
M. P. denotes a Member of Parliament

Privy Councillor - advisor

Chancellor of the Exchequer - member of the British cabinet in charge of public income and expenditures

Source: *New York Times*, December 9, 1865.

Figure 1
Real Confederate Revenues



Source: Burdekin and Langdana

Figure 2
Confederate War Debt Prices

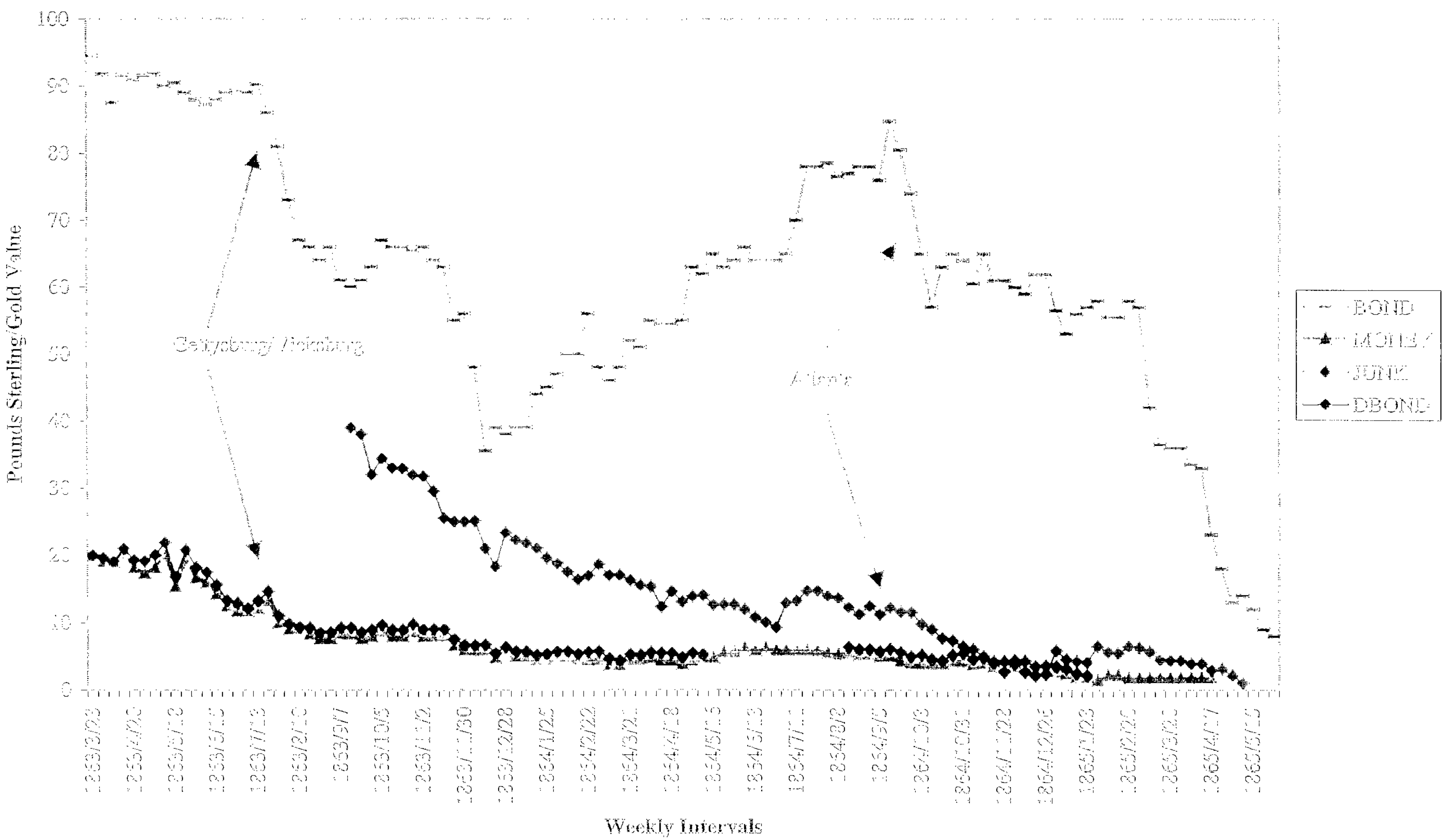


Figure 3
Response of Cotton Bonds to a 1% Shock to Confederate Money

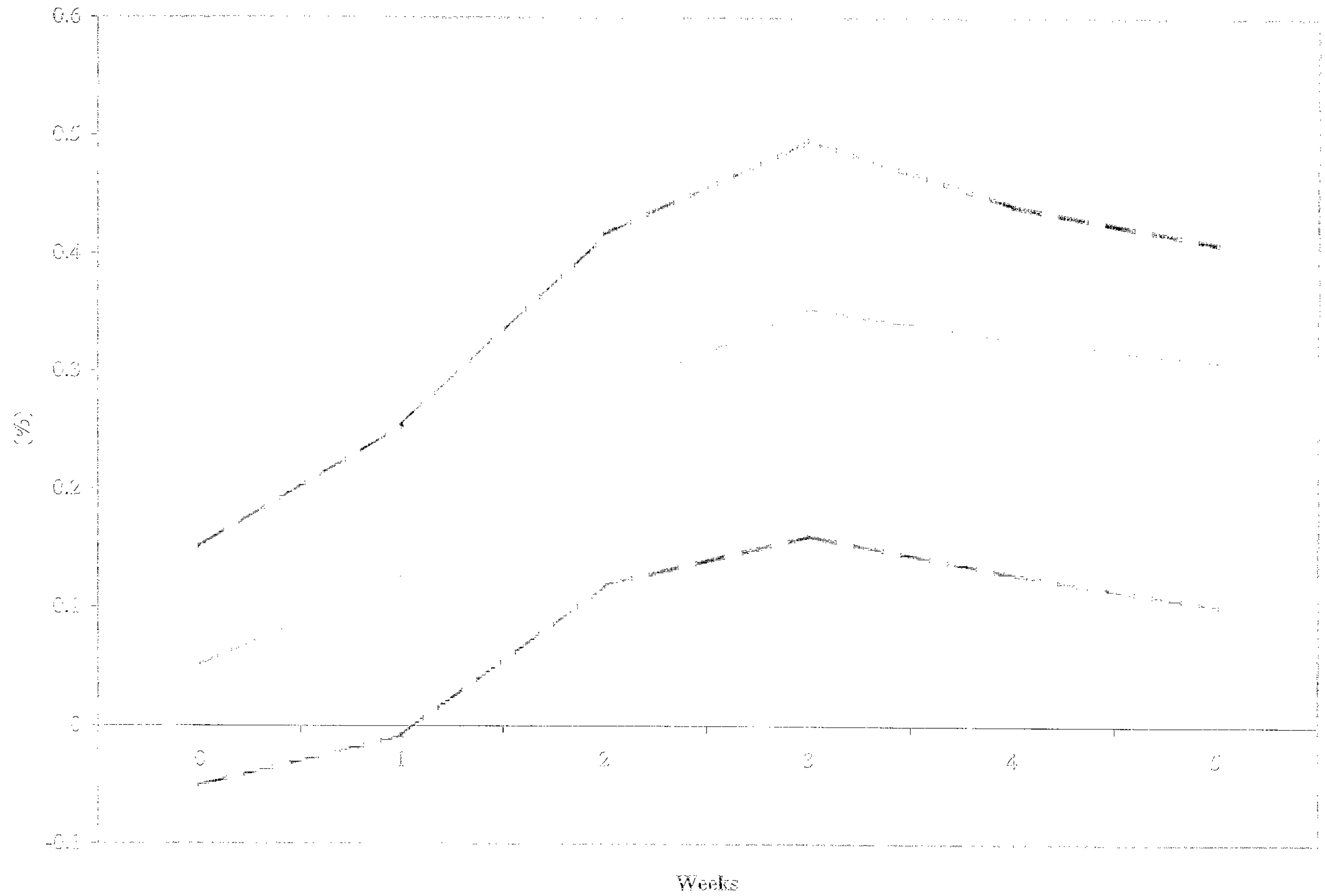


Figure 4
Response of Cotton Bonds to a 1% Shock to Cotton

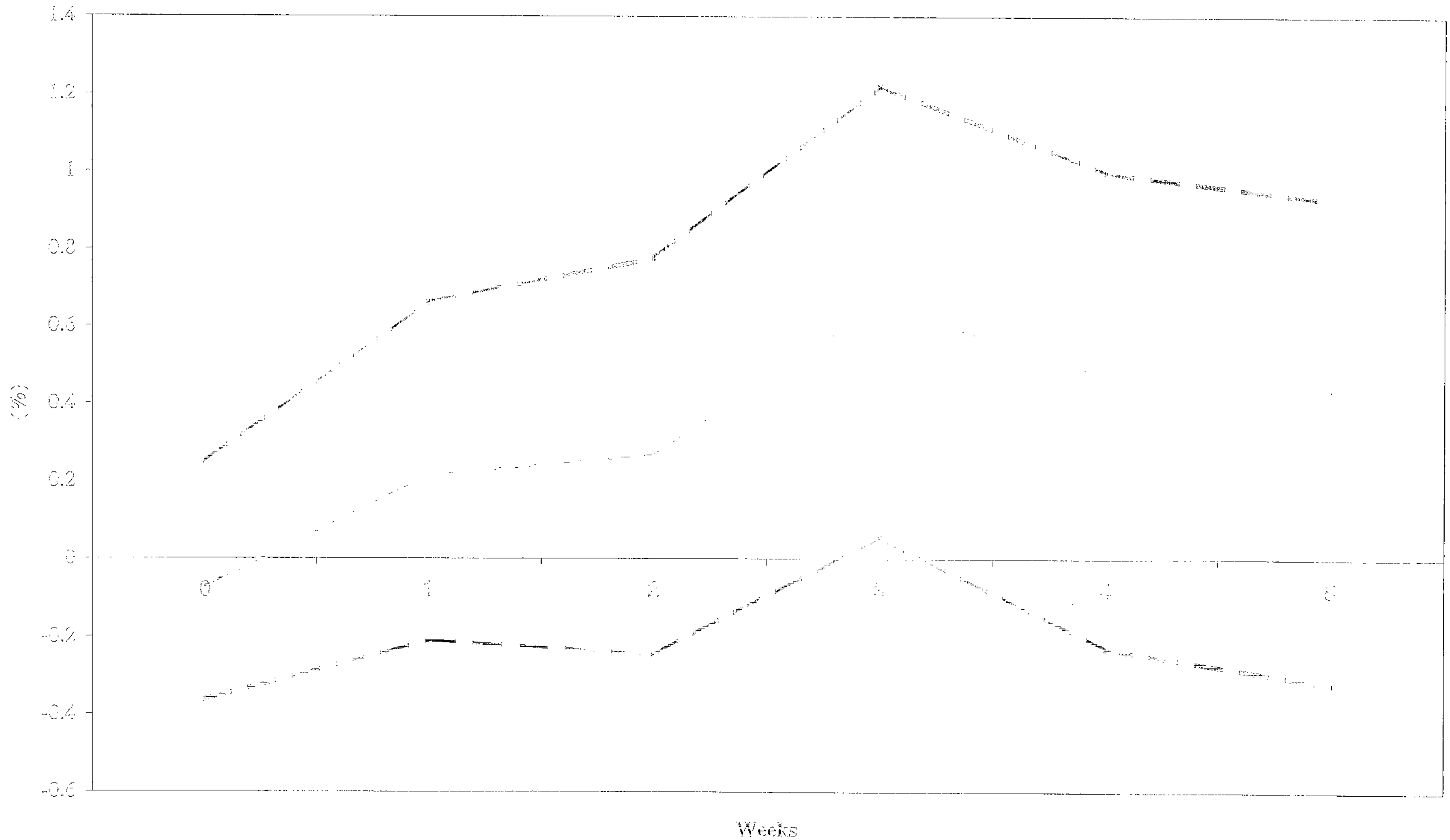


Figure 5
Response of Domestic Bonds to a 1% Shock to Confederate Money

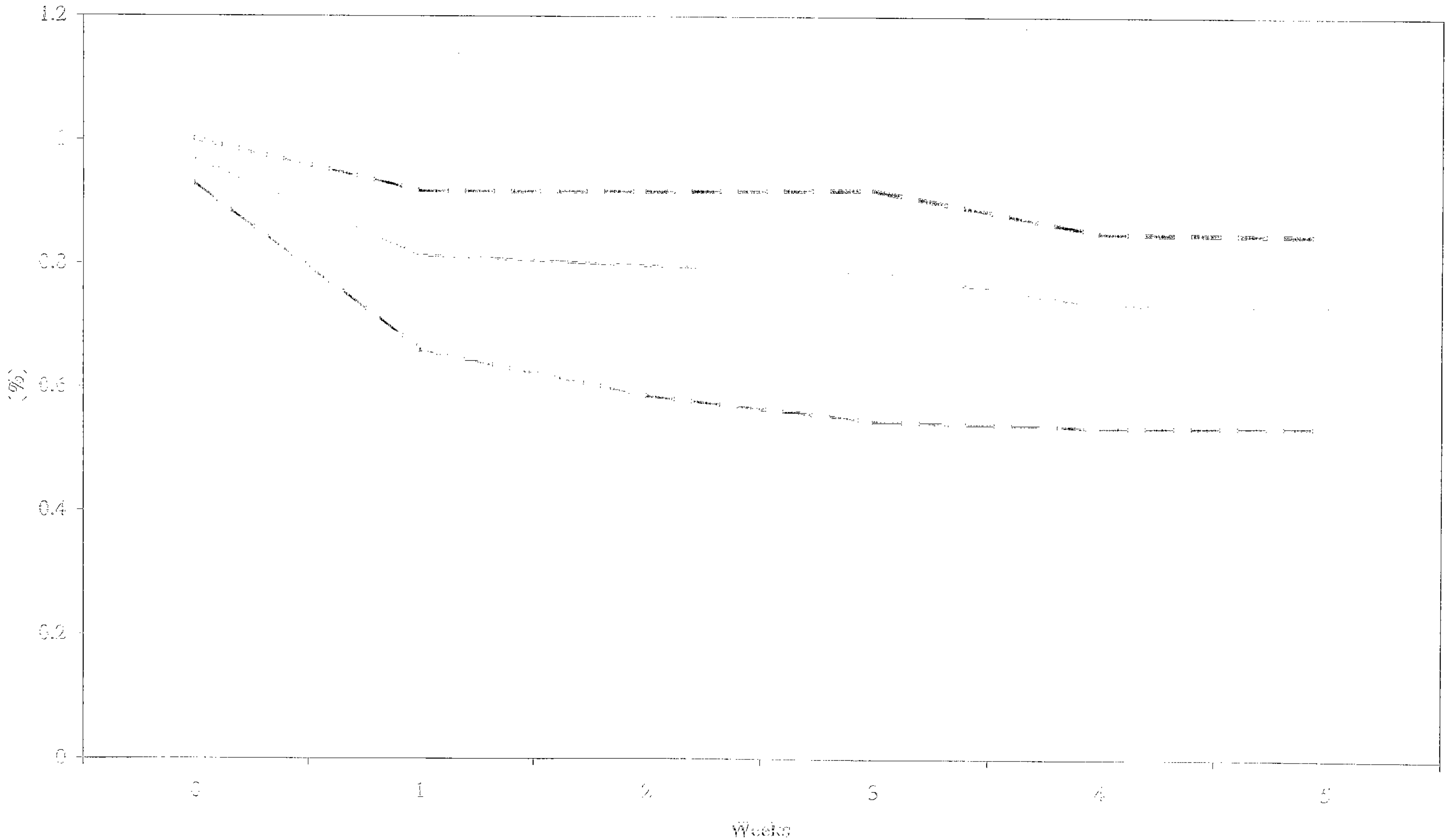
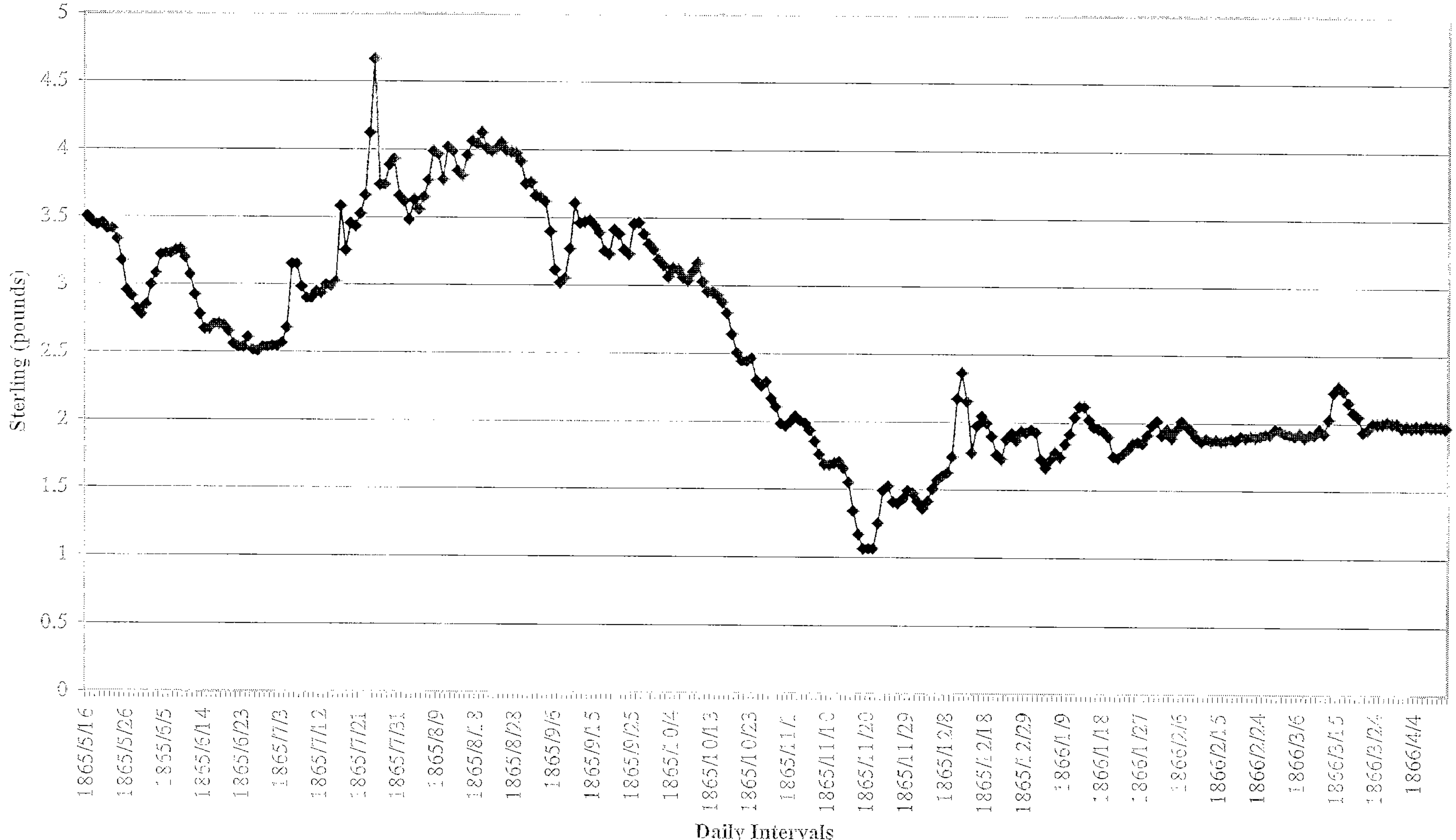


Figure 6
Confederate Junk Bond Prices in Amsterdam May 1865 - April 1866



Source: *Amsterdamsch Effectenblad*