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OTTOMAN BORROWING IN THE PRE-OPDA PERIOD: THE PATH TO THE DECREE OF *MUHARREM*

The crisis in Ottoman finance and reform attempts

In the Ottoman Empire, the land was principally owned by the Sultan and was rented to the peasants in return for taxes. Until the sixteenth century, taxation was primarily based on the *tımar* institution. *Sipahis* were state employees who were assigned by the Sultan as administrators of state land and were responsible for the collection of taxes. In return, *sipahis* were obliged to use these revenues locally to maintain a local army, and provide the central administration with a predetermined number of cavalry units in times of war.[1] Although very common, the *tımar* system was not practiced in all conquered territories. In many remote areas, such as Eastern Anatolia, Iraq, Egypt, Yemen, Romania, Moldavia and the Maghrib, the Ottoman government collected tributes through local officials and left the local administrations largely unaltered to avoid popular unrest. This practice also minimized the transaction costs in tax collection. Local governments were likely to be in a better position to minimize the costs of measuring and collecting variable taxes, due to their closer proximity to the tax base.[2]

Until the second half of the sixteenth century, the existing decentralized military structure based on the *tımar* system functioned well, and the Empire continued to expand. During this period, the financial position of

the Ottoman Empire was underpinned by the revenues obtained through rapid territorial expansion. Therefore, the state did not feel the need to alter the tax system in order to increase the revenues collected at the center. However, in the late sixteenth century, advances in arms technology, mainly the introduction of firearms, created a need for a modern central army. This development undermined the basis of the *tımar* system in two ways. On one hand, it led to the replacement of light cavalry provided by *sipahis* with infantry. On the other hand, the establishment of a central Imperial army required the development of new financial sources. Hence, it increased the pressure on the state to collect the tax revenues at the central treasury. This led to the gradual dissolution of the *tımar* system and its replacement by the *iltizam* system.

İltizam was based on tax-farm auctioning and subcontracting, thus providing the cash flow required for financing the central Imperial army. In late medieval and early modern Europe, domestic borrowing by sovereigns was financed by the banking houses.[3] In the Ottoman Empire, domestic borrowings were mainly handled through these tax-farming arrangements by which individuals possessing liquid capital assets advanced cash to the government in return for the right to farm the taxes of a given region or fiscal unit for a fixed period of time. In this period, former government officials, merchants and certain other wealthy individuals became the new tax collectors. The emerging local elite, *ayans*, gradually turned economic control over their territories into political power and became involved in numerous provincial revolts against the central government.

In need of immediate resources for financing the modernization of the military, the government began to increase the length of the tax-farming contracts, demanding an increasingly higher proportion of the auction price in advance.[4] This trend led to the introduction of the *malikane* system in 1695, in which the revenue source was farmed out on a life-term basis in return for a large initial sum and annual payments.[5] Nevertheless, neither of these attempts to reform the tax collection system brought a long-term solution to the Ottoman budget deficits, which were often financed by debasements in the coinage. Towards the end of the eighteenth century, for the first time, the Ottoman administration considered borrowing from abroad. However, due to the economic difficulties in Europe arising after the French Revolution, and the reluctance on the Ottoman side, this possibility was not pursued any further, until after 1854.

In 1839, the Ottoman administration introduced extensive tax reform as part of the administrational reorganization under the *Tanzimat* reforms. An important measure related to tax reform was that all the taxes would in future be collected by the salaried government agents, *muhassıls*.

This system worked favorably in the case of many urban taxes. In rural areas, however, the government encountered great difficulties in the collection of tithes, *öşür*, which accounted for a considerable part of state revenues.[6] The major motive behind the implementation of the tax reform in these areas was to curb the power of the provincial elite, the *ayans*, and restore central authority. Yet the economic consequences of this political move turned out to be costly for the treasury. First of all, there were simply not enough new bureaucrats willing and able to act as salaried *muhassıls*, returning all their collections to the treasury. The existing tax farmers had already turned into businessmen and such an arrangement was not profitable for them; hence they opposed the reform. Under these conditions, the salaried agents sent out to the countryside faced many difficulties due to their lack of local knowledge and connections. Consequently, the new system failed to fulfill expectations and *öşür* revenues fell drastically in 1840, forcing the government to revert to the tax farming system.[7] It was only after the accession of Abdülhamid II in 1877 that the tax farms were abolished by a law passed by the parliament. The same law established the department of cultivation and sheep tax for the collection of *öşür* revenues. Even then, the opposition of the tax farmers delayed the establishment of the new system throughout the Empire until late in the reign of Abdülhamid II.[8]

Another major restriction on the development of state revenues was the commercial treaties (capitulations) imposed on the Ottoman Empire by the European powers.[9] The capitulations granted extraterritorial privileges to foreign subjects conducting business in the Empire under Islamic law. Initially, these privileges were granted voluntarily by the rulers with the main motive being the stimulation of interregional trade in the Empire, which would lead ultimately to an increase in their tariff revenues.[10] However, with the gradual decline of the Ottoman Empire in world politics, the capitulations took the form of impositions restricting the sovereignty of the rulers and instruments of discrimination against the local population. By the nineteenth century, the destructive consequences of these treaties on the state finances were so evident that it was even

admitted by Adam Block, the representative of the British and Belgian Bondholders in the OPDA:

> The fetters of a contractual trade regime deprive the State of the legitimate means of raising money to defray those expenses without which political and administrative reform is an impossibility.[11]

According to Adam Block, the system of free trade as practiced in the Ottoman Empire restricted every attempt at industrial expansion, impeded the development of its considerable resources, and created *de facto* foreign monopolies, thus contributing to the impoverishment of native enterprise. Block's opinion on capitulations was shared by Charles Morawitz, a foreign observer and a specialist on the Ottoman economy, who argued that the restrictions imposed by the capitulations were among the major obstacles to reform in the Empire.[12]

The first major restriction imposed by the capitulations was that the Ottoman government was deprived of its sovereign rights to set customs duties in a way that maximized its revenues whilst protecting local industry. European governments exercised such rights; indeed, at a time when most of the European powers were endeavoring to protect their own industry and agriculture from foreign protection, the same powers were constantly pressurizing the Porte to lower customs barriers.[13]

In the Ottoman Empire, customs taxes were among the charges sanctioned by the Islamic law, *sheriat*, and were traditionally imposed at the *öşür* rate of 10 percent for foreign and 2.5 percent for internal trade.[14] The capitulations granted to European powers starting in the sixteenth century lowered the duty on foreign goods below 5 percent. After the capitulations of 1673, granted first to France, both exports and imports were fixed at a uniform rate of 3 percent *ad valorem*. Additionally, the buyers of foreign goods paid a supplementary duty of 2 percent, while exporters of foreign goods had to pay higher duties and were subjected to many prohibitions and monopoly restrictions, particularly in the case of essential goods such as wheat and rice. An extra 8 percent internal duty was also imposed on goods carried by land.[15]

Among the capitulations, the most controversial one – because of its perceived destructive effects on native production – was the 1838 Trade Agreement, also known as the Baltalimanı Treaty. In contrast to the previous capitulations, this treaty did not directly lower the customs duties. Tariffs were even raised to 5 percent on imports and 12 percent on

exports. However, it removed all monopolies and restrictions on foreign trade, hence foreign subjects were allowed to export or import all sorts of goods without restrictions.[16] The agreement would apply to all parts of the Empire including Egypt, where Mehmed Ali had established an elaborate system of state monopolies and a protective foreign trade policy.[17] Moreover, the crucial element of the agreement regarding duties was the privileges granted to foreign subjects in terms of internal duties. According to the terms of the treaty the transit duties imposed on goods were dropped to 3 percent for foreigners, even as local merchants continued to pay 8 percent. Hence, the resultant tax regime put local merchants at a profound disadvantage when competing with their foreign counterparts.[18]

In 1861, at the insistence of the Porte, new treaties were signed with foreign powers, raising import duties to 8 percent and providing for the gradual reduction of export duties to 1 percent. Further attempts at modification of the treaties were rejected by the powers until 1907, when the import duties were raised to 11 percent with the support of the OPDA, which took control of these revenues under the assignments of the Decree of *Muharrem*. Both the OPDA and the Ottoman government constantly appealed to the foreign powers for a further 4 percent increase in import duties, which could only be realized in 1914.[19] After the Ottoman government's entry into the war, the capitulations were abolished and a more protective trade policy was adopted. In this context, in 1916, the uniform *ad valorem* tax was replaced by differentiated specific duties designed to yield more revenue and protect the developing local industries.[20]

While trade protection has its obvious disadvantages, such as preserving inefficient industries in their existing form, the free trade regime as practiced in the Ottoman economy prevented the state from taking any protective measures to stimulate the development of infant industries. As confirmed by Adam Block's comments, it was not only local producers who sought protection. A very large portion of the foreign direct investment in the Empire went to monopolies or sectors that were not exposed to foreign competition, such as the tobacco industry, railways, tramways, ports, gas, electricity and waterworks. In this context, it is hardly surprising that the foreign-owned tobacco monopoly was also the largest foreign enterprise in the economy. In addition, due to these unilateral compromises, the Ottoman Empire was deprived of the

opportunity of bargaining with other European states to lower the trade barriers applied to their products. For instance, the high tariffs on Turkish wine in France and Italy, a major complaint of the OPDA, could have been made a bargaining issue, had these countries not already been granted privileges.

The second major restriction imposed by the capitulations concerned state monopolies. In most developed countries state monopolies existed in various sectors of the economy, such as salt, tobacco, alcohol, matches, playing cards, petroleum, cigarette paper, etc. and the revenues derived from these monopolies made up a considerable portion of state revenues. However, the Ottoman Empire was deprived of the right to establish monopolies in sectors other than salt and tobacco. According to Adam Block, these treaties, by preventing the establishment of monopolies, constituted a 'serious obstacle to the progress and security of the country'.[21]

Adam Block was right in addressing the fact that deprivation of the right to establish monopolies also deprived the Ottoman state of considerable revenue. Considering the state's inability to collect tax on the profits of the commercial activities of foreign subjects, this particular source of income gained more importance.

In terms of its effects on the general economy, this argument has both its pros and cons. In a country such as Turkey where capital accumulation in private hands was extremely limited, establishing state monopolies could also be considered as the only way to establish large factories that could benefit from economies of scale. However, it is also true that establishing such monopolies would impose costs on the economy by blocking private attempts at industrialization in these sectors. As we will see in the case of the Régie Company, the establishment of the tobacco monopoly had been costly for the economy by causing the emigration of cigarette producers. Some of these entrepreneurs moved to Egypt, because of the absence of such restrictions in the Egyptian tobacco sector, and later formed the backbone of Egyptian industrialization.

The final major restriction imposed on the development of state revenues was the tax privileges granted to foreign citizens. This privileged population included not only foreigners but also a number of minorities in the business world, the protégés of the European powers.[22] With the exception of real estate, these foreign subjects were exempted from direct taxation unless their governments gave consent. Only in real estate were they subject to the same status as the Ottomans, except in Hidjaz where

they were not allowed to own property. Hence, foreign observers regarded the situation of the foreigner engaged in Turkey as 'highly enviable' since their fiscal privileges were allowed in no Western state.[23] As we will later discuss in detail, the increasing role of this privileged population in the economy and the gradual replacement of Muslims in business activities seriously hampered the Ottoman tax revenues as well as OPDA revenues after 1881.

Domestic borrowing and the financial monopoly of the Galata Bankers

In the second half of the eighteenth century, the Ottoman government sought new methods to broaden the base of state borrowing and reach beyond the limited numbers of large *sarrafs*, who tended to dominate the *malikane* auctions, towards a larger pool of small and medium-sized lenders.[24] For this purpose, in 1774 the Ottoman government introduced a new system of domestic borrowing called *esham*. *Eshams* were issued by the government to pay for the goods and services for which ready money could not be found, and for the repayment of short-term loans over longer terms. These securities were secured on anticipated revenues from particular sources. When the funds of the ministries were exhausted, payments were also made in *sergis*, an official promise to pay at a later date.

Another form of government paper issued for the same purpose was the *kaime*. *Kaimes* were treasury notes, the first issued in 1840 with a life term of eight years. From 1840–44 they carried interest of 12.5 percent per annum, paid half yearly. Thereafter, they bore a rate of 6 percent per annum, until maturity. These notes were issued in standard currency denominations, but initially only in very large ones. After a while, they came to be used as a medium of exchange in daily transactions. In 1852, the *kaime* was transformed into a paper currency when the government started issuing large amounts of non-interest bearing *kaimes* in low denominations. These paper currencies, unbacked by specie, were increasingly used for the payment of the official salaries. By the end of the Crimean War, the *kaime* had become the main form of currency used in İstanbul. However, the growing mistrust of the *kaime* and its depreciation was a major problem for the economy. Therefore, its withdrawal from the market and replacement by a sound metallic currency became an urgent priority both for the sake of Ottoman commerce and the restoration of the state's finances.[25]

Before the 1850s, the Porte employed exclusively native *sarrafs* (Galata Bankers) for the relatively limited financial accommodations of the Empire. These Galata Bankers – called after the financial district of Galata – were generally Greeks, Jews, Armenians and Levantines.[26] The Galata Bankers provided the Ottoman government with short-term advances, for one or two years at the most, often in return for *eshams*. The rates of interest charged by these bankers were quite high; they usually ranged between 12 percent and 18 percent, but could go considerably higher. This range not only reflected the scarcity of capital in the Empire, but also the high risks involved in lending to the government and the high transaction costs incurred in the enforcement of debt contracts; particularly due to the commissions paid to third parties within the bureaucracy to ensure the repayment of the debt. As noted by Clay, 'the government had never yet formally defaulted on its debts, but there could be little certainty about exact dates of repayment and until well within living memory individual creditors had been subject to the arbitrary confiscation of their assets and even execution'. [27]

It is hard to argue that *eshams* were as successful as originally planned in broadening the base of state borrowing beyond the large financiers. The recipients of *eshams* and *sergis* were often unwilling or unable to wait for the highly uncertain maturity date. Consequently, they cashed these papers by selling them to the Galata Bankers at a considerable discount. Through this system the government securities were gathered in the hands of this small minority of *sarrafs* who accrued substantial profits.[28] It was extremely hard for small creditors (either contractors, or state officials paid in promissory notes) to receive their payments from the government, particularly in times of hardship. The Galata Bankers were undoubtedly more powerful; not only because they were the only major source of capital the government could borrow from when needed, but also they had close ties with *Paşas* through whom they could exert some influence on the government and guarantee the repayment of their loans, at least to some degree:[29]

> A poor pensioner who has no influential contractor, or a contractor whose further services are not for the moment required, may be put off from day to day, from week to week, from month to month, and even from year to year; whereas a superior official of the Palace, an influential Pasha, a contractor who regularly supplies the troops, or a Galata banker who is

> ready to make a little advance in moments of extreme difficulty, cannot be so unceremoniously treated.[30]

Hence, the beneficiaries of the growing financial instability and uncertainty in the Empire were the Galata Bankers and their collaborators in the bureaucracy. The bankers charged the holders of government securities premiums for undertaking the risk and managed to encash these papers rather easily by means of their connections. As the financial needs of the Empire grew, the Porte became more dependent on these bankers. Until the 1850s, the Galata Bankers enjoyed exceptionally high interest on their credits thanks to their unrivaled position in the domestic market and built a reputation in Europe as the 'Galata Vampires'.[31]

External borrowing and institutional reforms to improve the credit of the Empire: 1854–75

Ottoman foreign borrowing in the pre-OPDA era

Until the 1850s the Ottoman government managed to meet its budget deficits without resorting directly to foreign credit, using various means such as the debasement of the coinage and the issue of securities and banknotes. However, foreign capital hardly remained indifferent to the high interest rates offered by the government. Foreign money flooded into the country through the local intermediaries, the Galata Bankers, most of whom either had direct links with foreign banking houses in financial centers or had established their own branches in Western capitals.[32] They borrowed from abroad and lent to the government, often enjoying substantial profits for their intermediary roles. Through this system the government continued to borrow from the local bankers at higher interest rates and avoided borrowing directly from foreign creditors.

The major reason for the Porte's reluctance was the potential political costs of foreign borrowing.[33] It was not uncommon for European governments to demand political concessions from the borrower as a precondition to open their markets to their bonds. Above all, the Porte feared the possibility of foreign intervention in case of any difficulty in servicing debt. In 1850, Reşid Paşa decided to break the monopoly of the domestic bankers and signed a successful foreign loan agreement for Fr 55 million. However, shortly after agreeing the loan, Reşid Paşa was removed

from power, and the contract was cancelled by the government due to these concerns.[34]

In 1854, the great treasury crisis caused by the expenses incurred during the Crimean War forced the Ottoman Empire to reconsider the borrowing opportunities in foreign markets. In the same year, with the support of its allies Britain and France, the government contracted its first official foreign loan in the European markets, in spite of all the concerns about its consequences. The original amount of the loan was £3 million; the bonds were floated in Britain at an 80 percent issue rate, carrying 6 percent interest. The loan was secured against the Egyptian tribute, which would be deposited directly by the Khedive of Egypt at the Bank of England. Thus, the collateral would be secured in the creditor country. Moreover, in the prospectus of the loan issued by the underwriting banking house in London, the approval of the British government was specifically emphasized. This, of course, did not mean a guarantee in any legal sense (as in the 1855 loan) but played a crucial role, along with the collateral, in securing better terms for the loan.[35]

Some Ottoman historians argued that the issue of the 1854 loan marked the date the Ottoman government was 'pushed' into indebtedness by the European powers.[36] This interpretation overlooks the fact that the Ottoman treasury was not left with many other alternatives. By the time a new loan was floated in the European markets, much of the money had in fact already been borrowed from the domestic market in the form of short-term advances, or would have to be borrowed in the near future in order to meet the payments on earlier loans. In this sense, the successive foreign loans were nothing more than a series of consolidation operations through which the domestic short-term loans carrying high interest rates were repaid by foreign long-term borrowing carrying considerably lower interest rates. Moreover, as argued by Clay, the complaint of the Ottoman officials was not that the European powers pushed them to borrow from abroad unnecessarily, but that they refused to lend on demand.[37]

In 1854, the government had already exhausted all its domestic borrowing alternatives. The interest rates charged by the Galata Bankers on their short-term advances had reached over 15 percent. Large issues of *kaimes* had already started causing problems. Further depreciation of the currency would bring nothing but more political unrest. On the other hand, the terms of the 1854 loan were very attractive, considering the financial difficulties of the Empire during the Crimean War. The effective interest rate on this loan was 7.9 percent, significantly below the interest

asked by the local bankers. In this sense, it was the most successful foreign loan contract in the pre-OPDA era, with the exception of the guaranteed loan of 1855.

The net receipts from the 1854 loan fell far short of the accumulated expenses incurred by the Ottoman government whilst waging war in Crimea. Hence, the Ottoman government issued another loan in 1855, this time under the official guarantee of its allies who demanded that the loan be devoted to financing the war. 'The guarantee of the British and French governments', Blaisdell notes, 'brought the most conservative bankers into the field, and the price reflected this competition'.[38] The 1855 loan was the most favorable foreign loan contracted by the Ottoman government, in economic terms. The £5 million loan was issued at 102.6 percent, which simply means that the government received 2.6 percent more than the face value of the bonds, yielding 4 percent nominal interest. The loan was secured on the Egyptian tribute held by the Bank of England and the customs revenues of İzmir and Syria.

These two loans were called the Egyptian Tribute loans, secured on the most liquid and the least risky collateral the Empire had to offer. The support of the allies was without a doubt another crucial factor that contributed to the success of these loans, despite the war conditions. After the war, the government continued to borrow from foreign markets. In 1902, Morawitz noted 'There are things that are very quickly learned. The art of indebtedness is among them. As soon as the Ottoman Empire was initiated it made rapid progress in this direction.'[39] First used for meeting the demands of the war, then for retiring the progressively depreciating *kaimes*, foreign borrowing eventually became a major instrument for meeting budget deficits. However, with each loan the credibility of the Empire depreciated even further.

Contractors of the Ottoman bonds often enjoyed a large commission and/or a wide spread between the contract and issue prices (the price the government received from the contractor and the price at which the contractor offered the loan to the public) in return for the risk borne by underwriting the transaction. Also, in many contracts an option clause was introduced, according to which the issuing house, buying outright a part of the issue, reserved the right to float the remainder at a price of its choosing. On the other hand, the issuing house was liable to pay a fixed price to the government. Even though this process entailed some risk for the issuers, it almost invariably worked in their favor.[40]

Table 2.1 Ottoman foreign debt in the pre-OPDA era: 1854–77

Year	Amount of Debt (£)	Rate of Issue	Amount acquired (£)	% Acquired	Nominal Interest	Effective Interest	Allocated to	Pledges	Major Investor
1854	3,000,000	80.00%	2,286,285	76%	6.0%	7.9%	Crimean war	Egyptian tribute	B
1855	5,000,000	102.63%	5,131,250	102%	4.0%	3.9%	Crimean war	Egyptian tribute, customs-İzmir, Syria	B
1858	5,000,000	76.00%	3,687,500	74%	6.0%	8.1%	Support the exchange rate	İstanbul octroi and customs	B
1860	2,037,220	62.50%	1,273,262	62%	6.0%	9.6%	Budget deficit	Indirect contributions	F
1862	8,000,000	68.00%	5,440,000	68%	6.0%	8.8%	Withdrawal of the *kaimes*	Taxes on tobacco, salt, stamps, profits	B
1863	8,000,000	71.00%	5,680,000	71%	6.0%	8.5%	Repayment of debt	Customs, silk, olive oil, tobacco, salt tithes	F
1865/1	6,000,000	66.00%	3,960,000	66%	6.0%	9.1%	Repayment of debt and Budget deficit	Ergani mines	F
1865/2	36,363,636	50.00%	18,181,818	50%	5.0%	10.0%	Repayment of 1854 loan	General debt	F , B
1869	22,222,220	54.00%	12,000,000	54%	6.0%	11.1%	Repayment of debt and Budget deficit	Tithes from various vilayets	F
1870	31,680,001	32.13%	10,177,109	32%	3.0%	9.3%	Rumeli railway	General debt	A,G,I
1871	5,700,000	73.00%	4,161,000	73%	6.0%	8.2%	Budget deficit	Egyptian tribute	B,F
1872	11,126,200	98.50%	9,457,276	85%	9.0%	10.6%	Budget deficit	Revenues of Salonica, Edirne, Danube, sheep tax of Anatolia	B, A,G
1873/1	11,465,450	55.00%	6,306,000	55%	5.0%	9.1%	Consolidate the treasury bonds issued in 1872	General debt	F,B
1873/2	27,777,780	54.00%	15,000,000	54%	6.0%	11.1%	Budget deficit	Revenues of Aleppo, Danube and animal tax of Anatolia	F
1874	40,000,000	43.50%	17,400,000	43%	5.0%	11.5%	Floating debt	General debt	F, B
1877	5,000,000	52.00%	2,600,000	52%	5.0%	9.6%	1877 Russian War	Egyptian tribute	F

A=Austria, B=Britain, F=France, G=Germany, I=Italy. Source: Annual Reports of the CFB; Kıray, 1995; Pamuk, 1994; Suvla, 1966.

Table 2.1. illustrates the original amount of issue, the issue rate, and the nominal/effective interest rates on the Ottoman bonds issued by the government in 1854–77. As observed from the table, most Ottoman bonds were issued at significantly lower rates than their nominal value with the exception of the second loan in 1855.

As the Empire's credibility declined in the markets, the underwriters charged larger risk premiums. Thus, in some cases the amount acquired by the government fell below 50 percent of the amount of debt incurred by bond issues (in 1870 and 1874) and effective interest rates rose to around 11.5 percent. Moreover, at each loan the Ottoman government saw itself obliged to pledge the most productive of its remaining sources of revenue. The surplus of the Egyptian tribute, the sheep tax, customs revenues, the tobacco revenues, the copper mines and various other tithes, were all hypothecated one by one to the different issues.

As noted by the European press the process was very similar to 'the shifts of a ruined family, where every article of value follows each other to the pawnshop'.[41] Particularly after the 1860s the Porte had difficulty in finding acceptable securities to be pledged for new bonds, and issued treasury bonds secured on the general revenues of the Empire. These bonds could be issued in larger amounts since there was no need to pledge special revenues. However, they also carried significantly higher effective interest rates. Since the Empire had already exhausted its attractive collaterals the only alternative way to raise another loan was to improve the general credit of the treasury by creating new commitment mechanisms through new institutional arrangements.

Institutional arrangements to improve the credit of the Empire in the pre-OPDA era

There are two conditions for a state to be able to borrow from the domestic market at reasonable terms. First, national savings must reach a sufficient level and secondly, the holders of these savings must have confidence in the state. As argued before, in the Ottoman Empire neither of these conditions existed. To acquire foreign loans, on the other hand, the borrowing country must show some effective guarantees of its capacity for future repayment. In the Ottoman case, a budget system, which was part of the 1839 reform program, had not as yet been established by the Porte. The existing accounts of the treasury were unreliable and it was extremely difficult for creditors to monitor these

accounts. Therefore, it was very difficult for the government to issue loans secured on the general revenues of the treasury. In other words, special revenues had to be pledged as collateral.[42] The more liquid and monitorable the collateral, the more confidence would it command in foreign markets. Moreover, the collateral had to be easily and costlessly seizable by the creditors in case of default, otherwise it would not be very credible. Hence, when the revenues of the treasury are considered, the tributes were probably the most attractive collaterals, both in terms of stability and liquidity. In this sense, the Egyptian tribute was a practical solution to these problems but it was already re-mortgaged to guarantee bond issues during the Crimean War. The customs revenues of İstanbul and İzmir were also among the attractive collaterals, but had already been used to raise the loans in 1855 and 1858. For every attempt to raise a new loan the Porte had to rely more on less attractive collaterals. This led to a reluctance amongst investors to lend money to the Porte and gave rise to high-risk premiums associated with uncertainty. Following the 1860s, the Porte initiated several institutional reforms in order to improve the credibility of the government.

Budget reform and European concerns about the reliability of the Ottoman financial records

In the 1850s very little was known in the European markets about the state of the Ottoman finances. Ambassadors sometimes reported back to their governments about the economic condition of the country. However, the information they could obtain was very limited and the reliability of the figures was often questionable. Moreover, this information hardly reached the small investors, and when it did it was usually through a couple of lines in the newspapers along with some other inaccurate information rarely substantiated with numbers.

On the other hand, with each loan the markets became more doubtful about the state of the Ottoman finances. Consequently, effective interest rates on these loans (with the exception of the 1855 Tribute loan officially guaranteed by the British and French governments) were steadily climbing. For the 1860 loan rates of the issue had plunged to 62.5 percent, and the effective interest offered by the government had reached 9.6 percent. Moreover, in the very same year the government had attempted to raise another loan, contracted by the infamous French banker Jules Mirès, which had failed because of the French government's refusal to allow the loan's quotation on the French Bourse.[43] These were all signs of

the erosion of the Porte's already limited financial credibility. The first Ottoman budget was prepared under these adverse conditions by the newly appointed Grand Vezir Fuat Paşa in advance of the financial year 1860–61.[44] Fuat Paşa was convinced that to access further loans with lower interest rates the Porte had to restore its credibility in the foreign markets. He therefore initiated a series of reforms in this direction and the establishment of a budget system was at the top of the list.[45]

However, the Ottoman budget system remained short of fulfilling the expectations of foreign investors as budgets were nothing more than vague estimations of expected revenues and expenses of the state.[46] In 1862, after a long investigation, Mr Foster and Lord Hobart reported to the British Parliament that the Porte itself simply had no means of obtaining accurate information about its receipts and expenditures.[47] As late as 1885, Vincent Caillard, the president of the OPDA, wrote 'The state accounts are rarely, if ever balanced. The budgets, drawn up at the commencement of each financial year, are mere approximate estimates, never revised at the close of the year, but left to work themselves square by a kind of process of evolution.'[48]

According to Caillard, the Turkish budget system illustrated 'the evils of the financial decentralization in their most aggravated form'.[49] The Ottoman Empire was divided up for administrative purposes into 31 *vilayets* (provinces). The local budgets of these *vilayets* were prepared by the local officials. Later on, they were sent to İstanbul for the approval of the government and to be corrected if necessary. Finally, the Imperial budget was constructed from these local budgets provided by the provinces. One common principal-agent problem that arose during the preparation of budgets was the strategic reporting of the local authorities. It was habitual for the local authorities to understate their revenues and overstate their expenditures, for the following reasons. First, knowing that the Imperial Treasury would increase its demands on their revenues, they wanted to retain sufficient funds to run their administration. Second, they aimed to avoid being flooded with cash demands by the central government, and to make provisions for future calls on their resources. Hence, the government itself had no accurate data at its disposal by which trustworthy conclusions could be drawn as to the real state of the finances of the Empire.

Also, the common use of *havales* (drafts) for the repayment of loans to creditors and contractors made the system very complicated to monitor

for the bondholders as well as for the Ministry of Finance. *Havales* were the payment orders delivered by ministers to pay the state bills when the ministry was short of cash. These payment orders were issued on the revenues of different provinces, and were often negotiated at a considerable discount to the recipient. Blaisdell notes that favoritism among ministers and between ministers and creditors created the gravest abuses in the *havale* system.[50] Therefore, even the Ministry of Finance found it impossible to come up with an accurate estimate of total state expenses for the coming year.

Another major complaint regarding the reliability of the Ottoman budgets was that there was virtually no control mechanism over the borrowings of the sovereign and his use of the proceeds.[51] The private budget of the Sultan was not included in the state budget. It was under the control of a minister responsible only to the Sultan and required to obey the Sultan's orders in order to maintain his post.[52]

Under these conditions of uncertainty, the Ottoman government often exaggerated its revenues and underreported its expenditures to enable it to borrow from the international markets at lower rates.[53] On the other hand, European newspapers constantly protested that the government allowed budgets to stand in place of yearly financial accounts, and pointed out that no reliance could be placed on the figures shown in the budget. As argued by the investors, the newly issued budgets were of little use without the past budgets and the final accounts for the respective years, which were required to assess the accuracy of the estimates in the budget.[54]

The National Bank Concession and the establishment of the BIO

Another item in Fuat Paşa's reform program was the national bank concession. In 1863, after three failed attempts to create a national bank, the Ottoman government granted a concession to the BIO (La Banque Impériale Ottomane).[55] The first attempt had been in 1853. The concession was granted to the Ottoman Bank, but it failed due to the Crimean War. The second one, the INBT (Imperial National Bank of Turkey) concession in 1856, collapsed due to the deterioration of the financial conditions in Europe in the winter of 1856–57 before the bank commenced its operations. The third concession was granted to an Anglo-Greek consortium, NBT (National Bank of Turkey), in 1859, which required the withdrawal of *kaimes* from the market at least three months before the bank commenced its operations. The concessionaires inserted this clause to the concession because they argued that if other forms of

money remained in existence, the monopoly on the note issues, the most important privilege of the bank, would be meaningless.[56] Furthermore, withdrawal of *kaimes* required the raising of a new loan large enough to wipe out the progressively depreciating currency. However, the lack of confidence both in the domestic and foreign markets was the main reason behind the government's consent to the establishment of a national bank controlled by foreign bankers. The growing financial difficulties of the government made it impossible to withdraw *kaimes* in the following years. Instead, in 1861, after a failed attempt to raise a new loan in the foreign markets (Mirès Loan in 1860), the government again resorted to *kaimes* and issued a record amount of paper currency. Consequently, *kaimes* flooded the markets and the exchange rate against the gold lira plunged to 400 paper piastres – causing a major wave of inflation.[57] Hence the national bank concession failed once again. The Ottoman government tried to break out of this impasse with the fourth concession.

Under the Convention of 1863, the Anglo-French concessionaires were granted the privilege of establishing a state bank in the Ottoman Empire, which was to bear the name BIO. All senior officers and most shareholders of the bank were foreign. Concerned about the possibility of foreign interference, the Porte underscored that the bank was bound to operate in accordance with Ottoman law, which meant it could not enjoy capitulatory status.[58]

Government's involvement in the management of the bank was one of the major issues during negotiations. This role was to be kept to a minimum in order to command confidence in the European money markets. In other words, the 'bank could be of service to the state if it was entirely independent of the state'.[59] Hence, the Porte was obliged to accept a role for its representatives that would be little more than maintaining the appearance of an Ottoman element in the hierarchy of the bank. The government would also appoint a *nazır* (minister) for inspection purposes and a *muhasebeci* (accountant) to supervise the financial operations between the bank and the treasury, but take no part in the actual running of the bank.

The functions and privileges granted to the BIO could be summarized as follows:[60]

1- The most important privilege of the BIO, and the major reason behind the consortium's demand for the concession, was the exclusive privilege of issuing notes. Through this privilege the bank would obtain an

interest-free loan from the public for the difference between the amount in circulation and the specie required to be held in reserve. Although it was often misinterpreted, only in the case of the issue of paper money was the bank granted a monopoly.[61]

2- The bank would also keep the accounts of the government in İstanbul. It was charged with handling the operations of the treasury, collecting the revenues and making the payments ordered by the Ministry of Finance. Outside the capital, where it had branches, it would collect the revenues assigned to it. However, the proportion of the government revenue handled by the bank remained far below initial expectations.

3- The BIO would also provide the government with cheaper short-term credits, through the *sergis* issued by the Ministry of Finance. This practice, the government hoped, would end the reliance on the Galata Bankers. The amount of *sergis*, previously issued by each ministry, would be fixed monthly in agreement with the bank and only be issued by the Ministry of Finance. The advances would be secured by the government revenues assigned to the bank. Since the securities against which the advances were to be provided would be unimpeachable, the credits would carry a relatively lower interest.

4- The BIO would act as the financial agent of the government both inside and outside the Empire charged with servicing domestic and foreign debt payments, and raising new loans. In return, the BIO would receive 1 percent commission on the sums handled, in addition to an annual fee of LT 20,000.

The national bank concession granted to the BIO, an Anglo-French consortium, helped the government to raise three loans in 1862–65, contracted by the bank. In 1862, the government raised a loan to withdraw the *kaimes* from the domestic market before the bank commenced its operations. The original amount of the loan was £8 million, the issue rate was 62 percent and the effective interest was 8.8 percent. In 1863 and 1865, the Porte signed two other contracts for a total of £14 million with effective interest rates of 8.5 percent and 9.1 percent respectively.[62] After the failure of the Mirès Loan in 1860, the government's reform attempts had once more provided access to the international markets. According to Eldem, 'the mere presence of this institution [the BIO] in a country that had lacked any permanent and formal representation of Western financial interests was sufficient to give a sense of security to European investors, already reassured by the success of the 1862 loan'.[63] However, the risk premiums on these loans were still

considerably high. The level of spread between the yield of British consols and that of the Ottoman bonds during the period suggests that the reforms might have provided some sense of security to foreign investors, thus enabling the Porte to raise new loans. Yet, the credibility of the reforms was still being questioned in financial circles.[64]

The 1874 reform program

In 1874, the government was unable to borrow from the Galata Bankers even at interest as high as 25 percent.[65] The credit of the Empire was no better in foreign markets. So far, the coupons of various loans had usually been met at maturity. As early as 1866 the payment of general debt coupons had been deferred for two months, followed by a failure to maintain provisions for the charges on several foreign loans during 1871. Subsequently, a proportion of the coupons had remained unpaid.[66] However, rumors of bankruptcy began circulating in the European markets. It was often argued in the newspapers that the country's finances were finally exhausted, the budgets were untrustworthy, nobody knew anything about the condition of the Empire's exchequer, and the administration was corrupt and totally uncontrolled in matters of finance.[67] The credit of the Empire plunged to its lowest level so that, at one point in 1873, bonds of 6 percent had become unsellable at 46 percent of their face value.[68]

In a period characterized by mounting political problems and loss of power in the international arena, the Porte's main and immediate concern was accessing external funds on the most favorable terms in order to finance the modernization of the army. For this purpose, it initiated several reforms. However, as observed after the budget reform, instead of preparing a reliable budget that would secure the confidence of the financial circles in the long term, the government chose to overstate its revenues in order to secure loans with lower risk premiums. In the short term these budgets helped the Porte to raise additional loans, but in the long term, as more investors questioned their reliability, they contributed to the further erosion of the Porte's credibility. This generated a need for the Porte to compromise its autonomy by delegating some of its financial responsibilities to third parties who could command confidence in European financial circles. This was the main logic behind the 1874 reform program.

In 1874, desperately needing to improve its credit in the financial markets, the government resorted to drastic measures, which meant further compromising its financial autonomy. These measures included the establishment of a financial commission to control the Imperial budget and the extension of the BIO's privileges, which made the bank responsible for the supervision of the state finances.

In order to improve the credibility of the Ottoman budget, the government set up a commission to control and approve the 1874–75 budget. The commission comprised the principal functionaries of the state, bankers and directors of the leading financial establishments in İstanbul. Out of thirteen members of the commission, only three held government posts. All the rest were leading figures from İstanbul's banking community, some of whom were very well known in the European financial markets, including the General Director of the Ottoman Bank and the bank's two other directors. As far as domestic financial businesses were concerned, these were the very people who needed to be convinced that the government was going to eliminate its budget deficits. Furthermore, the government was relying on the reputation of these figures outside the Empire.[69]

The commission was well aware that the Ottoman government's bad reputation was common knowledge among European investors and posed a major obstacle to the success of any kind of economic reform. For this reason, they attached special importance to public relations. Following approval of the 1874–75 budget, the commission issued a report, to be published in major European journals. The report argued that 'successive adverse circumstances' had discredited the Empire's finances, but its negative reputation was not justified by the facts. The commission claimed that they would reveal the truth about Turkish finances and regain the confidence of European investors: 'a complete and truthful statement of the financial situation, even in its most unfavorable details, is the only means of inspiring well-founded confidence'.[70]

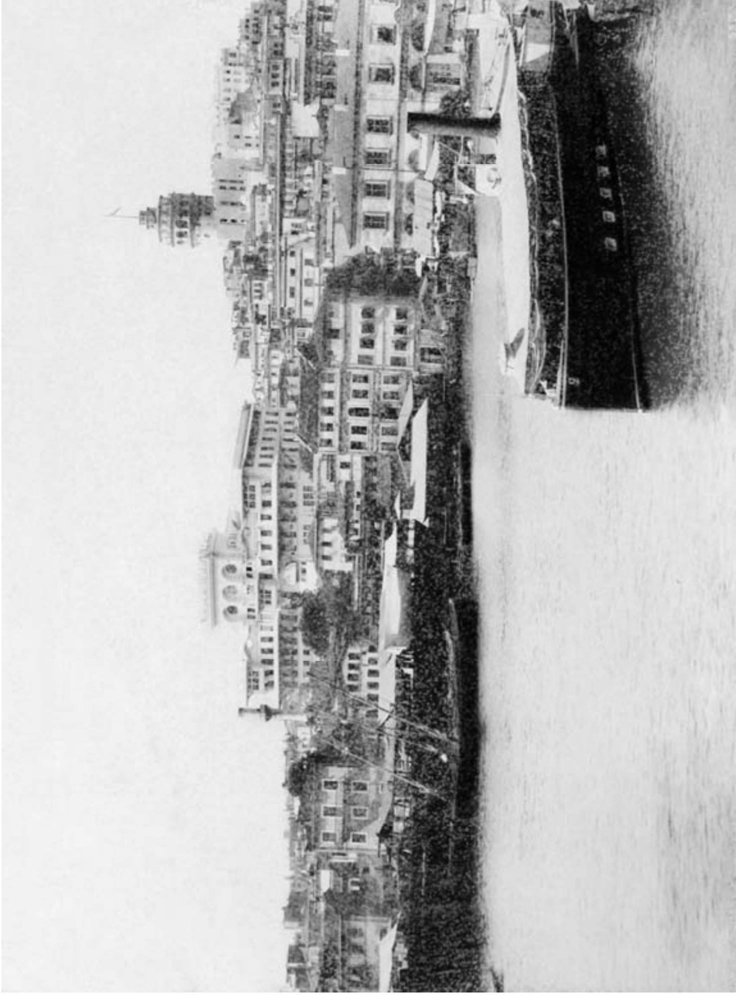
Another measure taken by the government for issuing a new loan was the consolidation of the BIO's privileges as a state bank. According to the convention signed between Sadık Paşa and BIO administrators on 18 May 1874, the bank would be the 'treasurer and the paymaster of the Empire'. As such, it would take over the finances of the Empire. In this context, all the tax revenues of the government both in İstanbul and the provinces would be deposited into a nearby branch of the BIO, which would extend

its branch network. Likewise, the BIO was charged with making all payments on behalf of the government, including the debt service.[71]

Hence, in spite of the increasing debt burden and the risks associated with it, the Ottoman government managed to raise another loan of £40 million in the British and French markets, with the help of the new reform program.[72] The 5 percent bonds were issued at 43.5 percent of their face value on average, and the effective interest was about 11.5 percent, which was the highest rate in the history of Ottoman foreign borrowing. Still, considering the economic difficulties of the Empire, and the fact that no special hypothecations were made for the loan, the issue was interpreted as a 'success' in the European press.[73]

Although they helped the government to raise another loan, the high rate of effective interest suggests that the reforms, which entailed the establishment of an independent financial commission to control the Imperial Budget and the delegation of tax collection to the BIO, did not satisfy the European bondholders. First of all, the credibility of a commission consisting of bankers whose interests were intertwined with those of the Porte was questioned by the bondholders. After all, these bankers were the largest domestic creditors of the government and had vested interests in the issue of the new loan, which would be used mainly for the payment of the short-term domestic debt. The frequent use of this argument demonstrated the eroding confidence of the European investors in the administration of the BIO, the largest domestic creditor.[74] As the bankruptcy of the government drew near, the conflict of interest between the bank and foreign creditors became more and more apparent:

> With all respect to the English members of the Commission individually, we do not think the composition of it is in any way satisfactory. The object being to inform English creditors of the true condition of Turkish finance, it must surely be evident that certificates of soundness from a commission composed of Turkish officials, Constantinople bankers, and the directors of establishments identified justly or unjustly, in the public mind with the interests of the Turkish government, cannot be worth the paper they are written upon. If the Turkish government is to gain authority for its budgets at all, the commission appointed to report should consist of English financiers of repute, if possible with a parliamentary reputation, and above all known to be independent by the mass of English creditors of Turkey.[75]



The BIO building in Karaköy. Istanbul University (IU), *Nadir Eserler Kütüphanesi*, 90839-0043.

The convention between the government and the BIO was another factor that helped raise public expectations in Europe regarding the future of the Empire. Some newspapers welcomed the extension of the privileges of the BIO, as a bank governed by Europeans who were acquainted with European accounting techniques such as double-entry bookkeeping.[76] Moreover, the convention was regarded as a guarantee that the government was sincere in its wish for sound reform. However, authorities also warned investors to be cautious when investing in Ottoman securities. First, the BIO did not have any absolute power to check the extravagance of the government or to prevent peculation and extortion by revenue collectors.[77] Secondly, this could be just another desperate attempt by a government on the brink of bankruptcy to persuade investors to issue another loan. The proposed supervisory role of the BIO would require an extensive network of branches in the provinces, which the BIO did not have. Hence, it would take a while before the convention was put into practice, and it could be canceled after the issue of the loan. Future developments confirmed these warnings: the convention was never completely practiced as originally envisaged because of the default in 1875 and the ensuing political crisis.[78]

Ottoman borrowing during the default period: 1875–81

The unproductive use of external resources for the import of military goods or for consumption by the state bureaucracy during the 1860s resulted in a growing debt burden. As a result, in the 1870s the Ottoman state had severe debt service problems. The economic conditions of the Empire worsened further in 1875. The annual harvest had been extremely poor in several provinces and the government was compelled to provide food to prevent famine. This was followed by severe floods and an outbreak of disease in several provinces.[79] Consequently, the tithes and other tax revenues remained far below the Porte's expectations.[80] The cost of dealing with the insurrection that broke out in the Balkan provinces further aggravated the situation.

Under these circumstances, the Porte attempted to issue another loan in foreign markets. Yet, it was hard to find an acceptable security with a reliable yield not pledged to former creditors. Hence the only alternative available was to issue another loan on the general revenues of the treasury for which no special security had to be shown. Following the establishment of the BIO, the Porte had increasingly resorted to these

treasury bonds, taking advantage of the credibility of the BIO in the financial markets. Still, the effective interest yields of these bonds were considerably higher than the others. After some consultations with the possible contractors, it became apparent that the issue price of the loan would be around 34 percent – a rate that had previously been refused by the government – or even less.[81]

On 6 October 1875 the Grand Vezir Mahmut Nedim Paşa issued a public statement declaring partial default on interest payments of the foreign loans: 'in the presence of a budget deficit of five million (LT), it (the Porte) has decided to pay only the half of the coupons…'.[82] In April 1876, after the partial default, the Porte declared a total default, suspending all the interest payments on the foreign loans, except the 1855 Loan guaranteed by the British government, which continued to be paid in full. By the time the government unilaterally decided to freeze interest payments, more than half of its revenues were committed to the debt service.[83]

Following the default, bondholders started to organize in order to exert pressure on the Porte through their governments. Creditor governments were quick to protest the unilateral suspension of the debt service. The default was also heavily criticized within the Empire. Several prominent figures of the time questioned the reasoning of Nedim Paşa in declaring a default unilaterally, without even attempting to renegotiate the terms of the debt contracts with creditors. Cevdet Paşa criticized the default decision, arguing that Nedim Paşa had not only isolated the Empire from Europe, but also created negative public opinion about the Ottomans in a period when the Empire was facing great military threats particularly from Russia. Hence, Cevdet Paşa argued, the default decision had alienated the former allies of the Empire and benefited no one other than Russia. Some writers went even further and accused the Grand Vezir of treachery, arguing that the Paşa was serving Russian interests, not those of the Empire.[84]

Amidst the continuing disunity among the bondholder committees, the Porte managed to borrow both from domestic and international markets, which undoubtedly enabled the country to survive the Russian War and delay debt renegotiations. The following section analyzes government borrowing in the default period resulting from the lack of coordination among the Ottoman bondholders, and aims to explain the reasoning of the relevant actors.

Foreign borrowing during the default: Tribute bondholders and the defense loan of 1877

When the Ottoman Empire declared itself bankrupt, a portion of its loans were secured on the hypothecation of special revenues while the rest were secured on the general revenues of the treasury. The Egyptian tribute loans, the loans of 1854, 1855 and 1871, represented the former case. These loans also had a peculiar advantage compared to other hypothecated loans since their security was directly deposited from Egypt to the Bank of England without passing through the Ottoman Treasury. After the default, the Khedive of Egypt continued to send the tribute to the Bank of England. To avoid any government interference, the Ottoman government continued to make payments on the 1855 loan which was guaranteed by the French and British governments. Yet, the Porte insisted that the general law that reduced the interest on all loans to one half was applicable to the bondholders of the 1854 and 1871 tribute loans. Hence, after the payment of the 1855 loan was made, the remainder of the tribute remained locked up in the Bank of England, which refused to give the money back to the Ottoman government, but also could not hand it over to the bondholders without the official order of the Ottoman ambassador.[85]

The Ottoman default raised controversy both among the tribute bondholders, and between the bondholders and the British government. The 1854 loan was issued to cover military expenses during the Crimean War. The British government of the time, as an ally of the Empire during the war, had publicly announced its favorable opinion of the loan, yet had never issued an official guarantee. The bondholders of the 1854 loan always held the government morally responsible for the issue of the loan, and maintained that they were also entitled to its support.[86] The following letter written by one of the 1854 bondholders sums up the basis of their claims.

> I am the widow of one of her Majesty's officers with four children, and I found myself in October, 1875 with the little all of my fatherless children invested in the Turkish 1854's money was placed in this loan not as a speculative investment …, but because it was considered a sound investment for the following reasons: 1. The money was raised and spent to enable the Queen's ally to keep his armies in the field against the Queen's

> enemies. 2. Lord Clarendon, the then Foreign Minister, recommended the loan to the public in an official memorandum from the Foreign Office, dated Aug.15, 1854.[87]

The 1854 bondholders, as the first mortgagees of the tribute, also argued that the holders of the 1855 loan had no right to the balance of the tribute until their payments had been fully repaid.[88] On the other hand, the 1871 bondholders contrived to place themselves on an equal footing as they also had claims to the tribute money.[89] The British government argued that its liabilities were limited to the 1855 loan that had been officially guaranteed by the government and hence rejected the requests for government interference for any other loan.

Consequently, the holders of the tributary loans of 1854 and 1871 formed the Tribute Bondholders League to start negotiations with the Ottoman government. The aim of the league was to convince the Porte to release the tribute held in the Bank of England, and secure the debt service in the future.[90] On the other hand, the Council of Foreign Bondholders (CFB), representing other Turkish loans, was pressing for a general settlement. The CFB aimed to form a committee under its leadership that would unite the interests of all classes of bonds in one body to avoid the 'possibility of any conflict or disunion'.[91] However, the holders of the tributary loans objected to a general settlement and argued that placing their interests in the hands of the CFB, which was also occupied with the general interests of all other Turkish loans, would weaken their privileged position.[92] The Tribute Bondholders League was determined to remain out of the general schedule, and to be ranked in a special category. They claimed that the attempts of the CFB to 'melt the tribute bondholders in the hotchpotch of Turkish bondholders', ignoring their privileged position, would favor the bondholders possessing no such security.[93] Hence, the tribute bondholders decided to pursue an agreement on their own.

As far as the Porte was concerned, the conditions were quite favorable for a partial settlement. Particularly after the outbreak of the Russian War in 1877, the Porte was anxious to make a new bargain with the tribute bondholders. The government had once again resorted to the issue of *kaimes* to finance the military campaign. Nevertheless, the resulting inflation had already begun to cause political disturbances. The treasury was desperately in need of new resources to finance the war, and to make some payment to the local bankers to keep them lending to the government. Therefore, the Porte aimed to get the creditors to agree to a

reduction in the originally agreed terms of the loan payments and raise another foreign loan upon the security of the remainder of the tribute. Only with their consent would the Bank of England release the portion of the tribute that remained locked up. For a government in default, this was also the only way it could raise another loan in the foreign markets, since the Porte could not interfere with the payment of the Egyptian tribute.

The total amount of the tribute was £681,000, whereas the total interest and amortization charged on the tribute loans amounted to £859,000. Hence, for the full service of the loans, the government needed to find an additional £178,000 apart from the tribute.[94] The initial offer of the bondholders was to accept less than what was legally due, so that the 1855 loan could be repaid entirely out of the tribute. However, the government asked for a larger concession to have sufficient surplus in the tribute to raise another loan. In July 1877, a compromise was arrived at fairly easily between the government and the representatives of the bondholders.[95] Soon after, the Ottoman government issued a new loan secured upon the £280,623 per annum tribute released after the reduction of interest on 1854 and 1871 loans.[96]

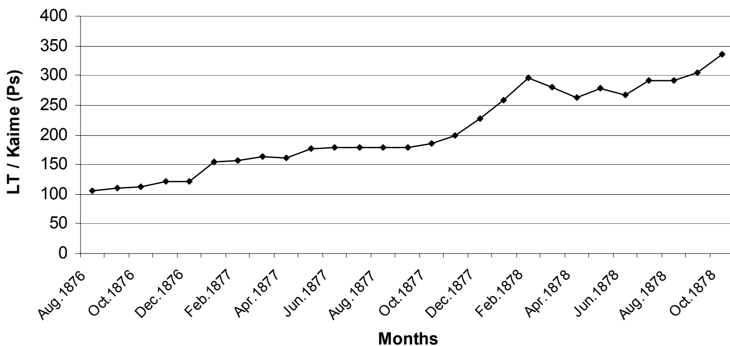
The Ottoman Defense Loan, as it was called, was issued by the BIO and Glyn Mills, Curie and Co. in Britain and France. The original amount of the loan was LT 5 million, the issue rate was 52 percent, and the effective interest rate was 9.6 percent. The defense loan had obviously been very costly, considering that debt service had been secured in the best possible manner. However, the bond was not quoted at the stock exchange due to the continuing defaults, and bonds of a bankrupt, militarily imperiled state were not attractive enough to investors.

The agreement between tribute bondholders and the Porte infuriated the other bondholders and the British press. 'So long as Turkey is a defaulter, even to its unsecured creditors, all attempts to borrow must fail', noted a British newspaper.[97] Another added, 'though it [The Porte] ate its cake long ago, it would very much like still to have it'.[98] While some bondholders repeated their demand for government interference, others, once more, urged the bondholders of all groups to unite in an effort to achieve a resolution.[99] Obviously, the bondholders had lost a golden opportunity to force the Porte, which was in desperate need of new funds, to a favorable settlement because of the lack of coordination between the bondholders.

Domestic borrowing in the default era: Revival of the Galata Bankers

After the default, the Porte once again resorted to the notorious *kaimes* as a means for domestic borrowing. The issue of *kaimes* continued throughout the Russian war (from September 1876 to January 1878), and the government issued over LT 10 million of *kaimes*.[100] Once again, the government was faced with a precipitous decline in the value of the *kaime*. As illustrated in Figure 2.1, the exchange rate of Ottoman lira against *kaime* rose from Ps 106 in August 1876, to Ps 178 in August 1877, and to Ps 291 in August 1878. The sharp depreciation of *kaime* eroded the confidence in these banknotes.[101] *Sarrafs* refused to change the currency at the official rate, shopkeepers were reluctant to accept it, and even when they did they charged very high rates. Moreover, it led to unrest both among the civilians and the soldiers who were paid in *kaimes*. Therefore, by the summer of 1878 this alternative was simply exhausted, and no further additions were made to the circulation. With the military situation becoming increasingly grave, the government sought new alternatives.

Figure 2.1 Exchange rate of Ottoman lira against the *kaime*: 1876-78



Source: Clay, 2000: 348.

During the period of foreign borrowing (1854–75), the Galata Bankers had lost their privileged position and their role in the government finances was reduced considerably, to one of furnishing the government with short-term loans between major bond issues in the European financial markets.[102] During the years of default when the Porte was excluded from

the international financial markets (with the exception of the 1877 loan), the government increasingly relied on domestic borrowings from Galata Bankers and the BIO.

Pamuk points out that during the Russian war in particular these bankers 'adopted a variety of patriotic Ottomanist themes to mobilize support for their centuries-old customer during this difficult period'.[103] However, behind this patriotic discourse lay the vested interests of the Galata elite in the territorial integrity of the Empire. The risks involved in lending to a government that was already bankrupt and fighting a difficult war were clearly great. Yet these bankers were already owed a considerable amount of money and had a great deal to lose if the Empire were to be dismembered. In such a case, the interests of the bondholders might be safeguarded by the great powers during the peace settlement, but it was very unlikely that the local bankers, who were known in Europe as the 'Galata Vampires', would receive much consideration. Evidently, if they did not take further risks by lending the government they could eventually end up losing everything. Moreover, during the period, the bankers took advantage of the isolation of the Empire from the international markets and charged up to 24 percent interest on their short-term advances.[104]

Finally, as discussed before, the Islamic inheritance system hindered the development of durable and large partnerships, which meant that private enterprises in the Empire tended to remain small in comparison with their European counterparts.[105] Due to their small size, the credit needs of these enterprises were very limited. Consequently, the bankers in the Empire were almost completely specialized in dealings with the government, and as argued by Clay, they 'did not have any other form of business to fall back on'.[106]

The Bankers' Convention and the Administration of the Six Indirect Revenues

During the period of default, the loans of the bankers made it undoubtedly more difficult for the European investors to force the Ottoman government to reach a new settlement. On the other hand, the Galata Bankers not only enjoyed high returns on their advances, but also gained priorities on the debt services of the Empire.[107] In January 1878 the Ottoman Empire and Russia signed the Treaty of San Stefano, which ended the war. However, there was still a threat of a new war, this time with Greece, over the rectification of the border. The Porte sought a new

loan in the domestic market for the military preparations. The Galata Bankers once again made advances to the government under very stiff terms, and the most lucrative sources of state revenue, such as customs and indirect revenues, were pledged as security. This process led to the establishment of the Administration of Six Indirect Revenues (ASIR), *Rüsumu Sitte İdaresi*, a forerunner of the OPDA.

On 22 November 1879 the Porte signed a convention with the Galata Bankers (including the BIO as the largest domestic creditor), who had made advances to the government amounting to LT 8,845,000 partly secured on the İstanbul Customs.[108] According to the convention, the bankers would make an additional advance of LT 120,000, and give up their rights on the customs revenues. Hence, they would agree to accept the reimbursement of their advances on the customs over a considerably longer period than under the existing contracts. In return, the local bankers and the BIO would be entitled to administer and collect the six indirect revenues (the revenue from salt, tobacco, spirits, and stamp taxes as well as the silk tithes of İstanbul and Bursa and fish tax of İstanbul and vicinity). Galata bankers and the BIO had the first call on LT 1,100,000 of the revenues for interest at 8 percent on these advances, and for their redemption. The remainder would be appropriated to the payment of foreign debt. The arrangement would remain in force for ten years and, being merely provisional, it was declared that the rights of the foreign bondholders would be left intact.[109]

This arrangement between the government and local financiers raised protests from European bondholder organizations, particularly from the ones representing the four loans secured on the customs and the indirect revenues (1858, 1860, 1862 and 1863 loans), who called for government intervention. The local bankers, particularly the BIO, were held responsible not only for lending to a government in default but also claiming priority over the revenues that had previously been pledged for their loans. The bondholders of the 1862 loan, which was secured on the indirect contributions, called the agreement a 'shameless act of financial dishonesty'. According to the bondholders, it was morally and legally unacceptable for the Porte to obtain advances upon the security of the 1862 loan, through the aid and cooperation of the BIO who were the agents of the 1862 loan.[110] The bondholders of the General debt also criticized the convention and argued that they were offered a 'miserable pittance' in return for their loans.[111] In March 1880, the protests of the

bondholders' organizations were followed by diplomatic protests from the British and French governments.[112]

The BIO, as by far the largest domestic lender and the major shareholder of the ASIR, was at the center of protests. The BIO defended itself by arguing that the advances made by the bank had enabled the Empire to live through a period when its survival was under threat. Thus, according to BIO officials, the Banker's Convention had not violated the rights of the foreign bondholders on their collaterals or the sanctions imposed on the Ottoman Empire. On the contrary, the BIO had made a sacrifice to ensure the Porte's fulfillment of its foreign debt obligations in the future.[113]

In the meantime, foreign bondholder organizations offered alternative plans to break the convention and make a new debt settlement. In December 1879, Comte De Tocqueville, the representative of the Anglo-French bondholders Committee, arrived in İstanbul to protest the Bankers Convention and offered a large loan to break the convention and build a similar administration, the beneficiaries of which would be the foreign bondholders. However, the representative power of Tocqueville's committee was limited and lacked the support of the influential CFB and the BIO, the largest domestic creditor. The Tocqueville scheme consequently failed to produce any result.[114]

The lack of coordination among the Ottoman bondholders during the period of default

Despite the existence of an organization such as the CFB, which aimed to organize foreign bondholders to exert pressure on the defaulting sovereigns, lending to sovereigns of the periphery entailed great enforcement problems in the nineteenth century. First of all, the main focus of the CFB was the British bondholders even though it also aimed to cooperate with other bondholder organizations in different European countries. Moreover, in cases where the bondholder groups had conflicting interests, the CFB failed to coordinate these different bondholder groups even within Britain. The state of disunity and the lack of coordination among the bondholder groups was one of the major problems in the enforcement of sovereign compliance with debt contracts. The lack of coordination among the bondholders not only allowed for new loans to defaulters but also raised the risk premiums on foreign loans. Enforcement problems in lending to the Ottoman government during the

pre-OPDA era can be better understood through a brief analysis of the experiences of the Ottoman bondholders during the period of default in 1875–81.

The default announcement of the Porte caught the Ottoman bondholders at a time when they were divided among different committees. All committees aimed to exert pressure on the Porte and their home governments to bring the Ottoman government to the negotiating table. However, they were divided with regard to the priority of each loan in the amortization of the Ottoman debt. The CFB, on the other hand, aimed to bring all these committees together under its roof for the purpose of a general and lasting settlement. The key part of the CFB plan was the conversion and unification of the Ottoman debt, which would reconcile the conflicting interests of the bondholders. The British press supported the CFB and warned the bondholders to put forth a 'unified effort instead of losing themselves in sectional squabbles'.[115]

> The conversion and unification of the Turkish debt will have an important effect on the political situation of the Ottoman Empire. Henceforth, the creditors of Turkey, instead of being split up into little coteries with diverse views and interests, will be a compact and homogenous body with one mind and one purpose.[116]

Despite the warnings of the press and the efforts of the CFB to unify the different bondholder groups, the process that led to the Decree of *Muharrem* proved to be a fairly complicated one, due to the difficulties that the bondholder organizations had in taking collective action. The main reason behind the lack of coordination was that the interests of all the bondholders were not identical because of the different characteristics of different bonds and, in some cases, conflicted with each other. Then again, unless they reached an agreement among themselves it would be hard to reach a satisfactory settlement with the Porte. The disunity among the bondholders not only enabled the Porte to play one group off against another but also provided the government with an excuse to do nothing at all.[117]

A major conflict of interest arose between the bondholders regarding the priority of each group of bonds in the rescheduling of debt service. As illustrated in Table 2.1, some portions of the Ottoman loans were secured on different collaterals, while the rest were secured on the general revenues of the treasury; thus, no special hypothecation was made. The

collaterals comprised more liquid, more profitable, relatively easily monitorable and/or administrable revenues of the Porte, such as the Egyptian tribute, customs revenues, mines and the monopoly revenues. The holders of the bonds that were secured on these special revenues did not want to share their collateral with other bondholders. Each group asked to be ranked in a special category as opposed to the holders of the 'General Debt' bonds. The ongoing discussions between the bondholders of the 1858 and 1862 loans – secured on the customs and the indirect revenues – and the General Debt bondholders is the most significant example, which also led to a major schism among British bondholders. The disagreement between these bondholders could not be resolved until after the signing of the Decree of *Muharrem*.

Similar disagreements also arose among holders of the hypothecated loans. For instance, bondholders with relatively easy access to the collateral pursued separate negotiations with the Ottoman government, such as the British holders of the bonds secured by the Egyptian tribute (1854, 1855 and 1871 bonds), which was routinely channeled through London.[118] The tribute bondholders knew that the Ottoman government would avoid a general settlement, particularly while preparing for a major war. Moreover, even if the government was brought to the negotiating table, a general settlement would require them to make concessions from their easily seizable collateral in favor of other bondholders, particularly those of the General Debt, whose bonds were not secured on any specific revenue.

Another conflict of interest was among the bondholders whose bonds were secured on the same collateral.[119] As one bond issue followed another, the Porte found it harder to find new collaterals that would command confidence in the foreign markets and, therefore, pledged the same revenues over and over again as security for different issues.[120] Some attractive revenues, including the customs duties and the indirect contributions, were overstated in the budgets to convince the investors for a second mortgage. The most salient example of this kind of conflict took place among the tribute bondholders. After the default, representatives of each group had agreed on the distinctive character of their collateral and decided to negotiate with the Porte as the tribute bondholders' committee apart from the rest of the European bondholders. However, to start the negotiations with the government, certain concessions had to be made by the bondholders. Conflicts arose between the bondholders regarding the

priority of each group of bonds in the amortization process and the amount of reduction to be applied to each group. Nevertheless, the tribute bondholders eventually found common ground and made a new arrangement with the Porte, at the expense of other bondholders. The 1877 Defense Loan was issued after the partial debt settlement agreed with the tribute bondholders, upon the security of the remainder of the Egyptian tribute. The CFB and other bondholders managed to block the government's access to the London Stock Exchange or Paris Bourse, but the attractiveness of the collateral enabled the Porte to raise another loan in Britain and France. The British and French governments were reluctant to intervene during this process due to the strategic position held by the Ottoman Empire in restraining Russian expansion.

Aside from the unity of the European bondholders, successful implementation of the sanctions required the cooperation of the local actors, the Galata Bankers and the BIO. However, these bankers had strong incentives in lending to the government. Now that the borrowing alternatives of the Empire were much more limited, these bankers could charge higher interests for their short-term advances than they did before the period of foreign borrowing. Obviously, lending to a government in default entailed greater risks as compared to the former period, but also gave the local bankers an opportunity to impose additional conditions on their loans. Thus, as these bankers continued to lend to the government they also gained rights on the collection and administration of the revenues that had previously been mortgaged for the foreign loans. As mentioned before, these bankers (including the BIO, an Anglo-French consortium) had offices in financial centers of Europe and often borrowed from abroad to lend to the government. Had foreign bondholders coordinated their efforts, they could have imposed costs on these bankers (such as damaging their reputation in the European markets) and consequently increased the cost of default for the Ottoman government.

In November 1879, when the Porte issued the decree announcing the establishment of the ASIR, and granted the local bankers the right to collect and administer the 'indirect revenues' previously assigned to foreign bondholders, the foreign bondholders were divided into different organizations.

Around 70 percent of the total outstanding Ottoman foreign debt in the pre-OPDA era belonged to either British or French investors.[121] Despite the existence of an organization such as the CFB in Britain, the

cooperation between the bondholders was achieved fairly easily in France, as compared to Britain. There were several reasons for this. First of all, a significant proportion of the General Debt bonds, which were issued in 1865–1874 without any special hypothecations, were held in France. From the beginning the holders of these bonds, which made up 43 percent of the outstanding Ottoman debt after the default, argued in favor of a general settlement.[122] Had the bondholders of the hypothecated loans pursued partial settlements and gained possession of their collaterals, almost all the liquid and easily administrable revenues of the Empire would be taken over by these creditors. Moreover, even though the proportion is not definite, it is understood that in France the banks held a considerable portion of the Ottoman bonds. Most of these banks held both secured and unsecured loans; therefore, it was not difficult to reconcile the interests of these bondholders.[123]

On the other hand, in Britain the situation was more complicated. Despite the early efforts of the CFB to unify the bondholders of all groups, the bondholders were divided between organizations representing the conflicting interests of the different groups of bondholders. The first one was the Tribute Bondholders' League, which had already reached a settlement with the Porte. The Khedive of Egypt, politically controlled by the British government, would continue to send the tribute directly to the Bank of England, and the Porte had given up all its rights on the tribute until the amortization of the bonds. Since their payment was secured in the most effective way possible in 1877, tribute bondholders had no interest in being part of a general settlement.

The second organization was the CFB representing the 1858 and 1862 bondholders. Their bonds were secured on the revenue of the customs and the 'indirect revenues', which were assigned to the Galata Bankers under the November 1879 Convention. Another important feature of these bonds was that they were almost exclusively issued and held in Britain. These bondholders asked for a special treatment for their special securities and protested at being ranked equally with the General Debt bondholders. The CFB, while arguing in favor of a general settlement in line with its original mission, also insisted on the protection of the privileges of the hypothecated bondholders. This led to division among the British bondholders.

The third bondholders' organization was the General Committee of the Turkish Bondholders, mainly representing the holders of the General

Debt that was not secured on any special revenues. Since no securities were involved in any of these bonds, they found common cause with their French counterparts on the Anglo-French committee. This committee backed the unsuccessful Tocqueville scheme. Upon the conclusion of the November Convention between the bankers and the Porte, and the failure of the Tocqueville scheme, they again sought cooperation with the CFB and the bondholders of the 1858 and 1862 loans. 'The various classes must see the inutility of continued selfishness, and resign themselves to equitable ideas', Guedella, the chairman of the committee argued in his report.[124] According to Guedella, the securities of the 1858 and 1862 loans should not have been a matter of argument since 'not one of the dividends of the various loans had ever been paid out of the special securities hypothecated'. The debt payments for all loans were made entirely out of the general revenue or borrowed money. Furthermore, their 'vaunted securities' had been mortgaged over and over again for new loans. It was precisely by the mortgaging of these securities that the BIO and the Galata Bankers had made their advances to the government.[125] The bondholders of the General Debt agreed with the CFB on the importance of forming a unified front to prevent the Porte from making further partial or special arrangements; and argued that 'it was time for Turkey to make a comprehensive arrangement embracing the whole of the creditors'.[126] However, while they argued for equal treatment of all issues, the CFB insisted on the protection of the privileges of the hypothecated loans.

Ottoman debt settlement and the Decree of *Muharrem*

The Ottoman default was followed by the hardships of the Russian war in 1877–78. As a defaulting government, the Porte had difficulty in borrowing from abroad, and with the exception of the 1877 loan, could not raise another loan from Europe. The government, desperately in need of new financial sources, once more turned to local bankers. The notorious Galata Bankers agreed to new loans under very tight conditions and very high interest rates. Nevertheless, considering the high interest rates and the limited financial resources in the domestic economy this borrowing pattern was unsustainable in the long run.

On the other hand, diplomatic pressures from the creditor countries had intensified after the adverse outcome of the Russian war. Subsequent to the signing of the armistice between Russia and the Ottoman Empire, foreign bondholders were concerned that the territorial losses of the Empire in the Balkans and the war indemnity demanded by Russia would

make it impossible for the Porte to resume the debt service. Diplomatic pressure on the Porte reached its peak after the Berlin Congress that was called by the European powers to reconsider the terms of the Treaty of San Stefano, which Russia had forced on the Ottoman Empire. According to the terms of the Treaty of Berlin, the newly independent Balkan states would be responsible for a proportionate share of the debt. Moreover, it was agreed by the Russian delegation that the prewar foreign debt of the Empire would have priority over the war indemnity demanded by Russia. Finally, the conference recommended to the Porte the establishment of an international committee that would supervise the resources of the Empire assigned to debt service. Thus, after the Treaty of Berlin, the Porte was concerned that unless a deal was struck with the bondholders, matters might be taken out of their hands and an international commission might be imposed upon them. The proposed commission would consist of representatives of the European powers and bring a definitive end to the fiscal and political sovereignty of the Empire.

From this perspective, the signing of the November Convention, which partially resumed the foreign debt service, was an attempt to escape from the proposed international commission. However, the arrangements made with the local bankers including the partial repayment of the coupons did not satisfy the foreign bondholder organizations. By the terms of the November Convention, local bankers had been granted an administrative role over the resources previously assigned to foreign loans as well as a priority in debt service. This was unacceptable for the foreign bondholders who protested the convention and lobbied for the implementation of the recommendations of the Treaty of Berlin.

Under these circumstances, the Porte's concerns to reach larger credit markets and political pressure from the European governments led to debt renegotiations with foreign bondholders. At the invitation of the Ottoman government, negotiations between the Porte and the representatives of the Dutch, English, French, Austrian, German and Italian bondholders commenced in September 1881 in İstanbul. The negotiations covered all foreign loans apart from the guaranteed loan of 1855, and the Egyptian tribute loans of 1854, 1871, and 1877, the repayment of which had been guaranteed by previous arrangements. The negotiations also included the Ramazan certificates, delivered in exchange for the bonds drawn under the stipulations of the Decree of 6 October 1875. Including the lottery bonds, the outstanding amount in default was

£252,801,885 before the settlement. To give an idea of the magnitude of the debt, total estimated revenue of the treasury in 1874–75 made up around 9 percent of this amount, according to official statements.[127]

The crucial issue during the negotiations was the debt reduction, which was an essential requirement for a sustainable outcome. Even before the war the Empire had severe financial problems. After the Russian-Turkish war circumstances had worsened. The loss of territory and population, in Europe alone, was estimated at 82,000 square miles and 4.5 million respectively, and the loss of annual revenue in consequence was around £4.75 million.[128] Moreover, there was the issue of war indemnity. According to the terms of the Treaty of San Stefano the Ottoman government had agreed to pay LT 350,000 to Russia as war indemnity.

Under these circumstances, a reduction in the principal of the debt was indispensable and this was recognized by the creditors even before the start of the negotiations. The issue of disagreement was the extent of reduction.[129] After long negotiations, the mean between the proposals of the bondholders and the government was adopted and the principal was reduced to £96,768,278. To this amount, 10 percent of the reduced capital was added as interest arrears, making the total of the new debt £106,437,204 or LT 117,080,957. Thus, a considerable reduction would be made in the outstanding debt of the Empire. The details of the reduction are illustrated in Table 2.2.[130]

The negotiations carried on in İstanbul between the Porte and its creditors were concluded on 20 December 1881, by the issue of the Decree of *Muharrem*. The decree sanctioned the establishment of a council of administration charged with the collection and administration of revenues assigned for the service of the foreign loans and the priority debt (loans of the Galata Bankers and the BIO). Under these terms, the revenue from the salt and tobacco monopolies, the stamp and spirits taxes, the fish tax, and the silk tithe in certain districts as well as the Bulgaria tribute, the revenue from Eastern Rumelia and the surplus of the Cyprus revenue were irrevocably ceded to the OPDA, until the debt was liquidated.

Table 2.2 Ottoman foreign debt before and after the Decree of Muharrem

Series	Loan	Outstanding principal including Ramazan bonds (£)	Arrears of interest including Ramazan certificates (£)	Total debt in default (£)	Total debt after the Decree (£)	Reduction in total debt (%)
A	1858	3,684,750	1,345,410	5,030,160	3,445,316	31.51%
	1862	4,999,650	1,876,125	6,875,775	3,738,556	45.63%
B	1860	1,654,030	620,406	2,274,436	1,044,201	54.09%
	1863-64	5,188,750	1,946,999	7,135,749	3,973,682	44.31%
	1872	4,820,200	2,759,312	7,579,512	5,223,165	31.09%
C	1865	4,098,500	1,537,897	5,636,397	2,920,713	48.18%
	1869	20,650,000	7,743,750	28,393,750	12,885,600	54.62%
	1873	27,196,740	10,198,777	37,395,517	15,026,198	59.82%
D	General debt	87,197,360	27,040,279	114,237,639	43,968,396	61.51%
	Lottery bonds	31,508,000	6,734,950	38,242,950	14,211,407	62.84%
Total		190,997,980	61,803,905	252,801,885	106,437,234	57.90%

Source: Annual Reports of the CFB.

According to the terms of the settlement, revenues obtained from the sources that were ceded to the OPDA would be applied entirely to the payment of interest and to the redemption of loans subject to the negotiations. The first obligation of the administration was the payment of the annuity amounting to LT 590,000 for the priority bonds held by the Galata Bankers. The balance of receipts was to be devoted to the service of the bond series, with 80 percent apportioned to interest and 20 percent to the redemption of the debt, on condition that at least 1 percent interest on the diminished capital was distributed to the bondholders. Moreover, the maximum rate of interest was fixed at 4 percent, and the maximum rate of redemption was fixed at 1 percent. If the conceded revenues ever yielded more than 5 percent of the principal, the surplus would go to the treasury.[131] For purposes of amortization, the ten loans in default were divided into four groups based on the respective securities on which they had been floated. Group A consisted of the 1858 and 1862 loans; group B consisted of the loans of 1860, 1863–4, and 1872; and group C of the loans of 1865, 1869, and 1873. Finally, group D consisted of bonds without any special hypothecations, those of the General Debt and the Treasury Loan. The sinking fund of up to 0.25 percent would be applied exclusively to the redemption of the first group. If a surplus remained up to 0.5 percent would be applied to the redemption of the second group. If a surplus remained, it would be applied, up to 75 percent, to the redemption of the third group, and lastly if there was still a surplus it would be applied, up to 1 percent, to the redemption of the last group.

Hence, the Ottoman state had compromised its domestic autonomy by giving up more than one-third of state revenues that were ceded to the control of the administration. As argued by historians, the establishment of the OPDA constituted 'a severe blow to Ottoman pride and sovereignty'.[132] One major question that merits an answer is why the Ottoman government agreed to a debt settlement, which in a way meant compromising both its political and financial sovereignty? First of all, after the loss of the Russian war and in the face of escalating pressure from the creditor countries for a debt settlement, the Porte was not left with many other options. In this context, the establishment of the OPDA was an imposition of the European powers rather than a choice of the Porte itself. At the time, the primary concern of the Porte was to escape from the international commission recommended by the Treaty of Berlin. It sought a new deal that would not only satisfy the foreign bondholders but also eliminate the possibility of a takeover of a greater part of Turkish

finances by foreign governments. As argued by Blaisdell, 'it [the establishment of the OPDA] was less of an evil than would have been the establishment of an official political organization for the accomplishment of the same object'.[133]

Even though it is often overlooked, there were substantial differences between the recommendations of the Treaty of Berlin and the organizational structure of the OPDA, which made the latter more tolerable for the Ottoman government. As opposed to the international financial commission recommended by the Treaty of Berlin, the OPDA did not enjoy the official protection of the powers whose nationals were represented in the council. According to Protocol 18 of the Treaty of Berlin, the members of the commission would be appointed by the creditor governments, and thus would be responsible to their governments in the first place.[134] In the case of the OPDA, the members of the council were directly appointed by the bondholder organizations of the respective countries, and were responsible first to the bondholders. There is no doubt that these representatives were under the influence of their governments, and sometimes even handpicked by them. But on many occasions they also conflicted with the general policies of their governments in protecting their bondholders' interests, which were closely tied to the performance of the Ottoman economy.

Besides the fear of foreign military intervention, other concerns might also have played a role in shaping the Porte's decision. In many ways, the establishment of the OPDA can be viewed as a natural outcome of the increasing dependency of the central bureaucracy on outside resources to finance its recurring budget deficits. As observed from the repeated failed attempts at reformation, the state bureaucracy lacked the organizational and administrative skills to reform its finances. On the other hand, under the existing circumstances, cutting back expenses was no longer an option for the treasury. The Empire was in no position to get back on its feet through its own means. In the early months of 1881, the financial situation of the Empire was as critical as ever. According to a report sent to the Crèdit Lyonnais, the June receipts for the current year were estimated at below LT 10 million, leaving a budget deficit of at least LT 13 million. The palace had serious difficulties in paying the wages of its employees and even the palace cooks were striking on account of their unpaid wages.[135] Therefore, another concern of the Porte, though not as critical as the first one, was to regain access to international markets. By

the terms of the decree, the Porte had lowered the outstanding debt of the Empire to a relatively more reasonable level by making a strong commitment, and thereby rebuilding the credit of the Empire. In this sense, the OPDA also functioned as a commitment mechanism and became instrumental in underwriting the government's credit and ensuring that it obtained loans on much more favorable terms than in the days before the bankruptcy.

Finally, the Ottoman central authority was not as concerned about the erosion of its fiscal sovereignty by the decree as so far argued by some historians. After all, the handling of certain state revenues by the OPDA was not that different from the very common practice of tax farming. As mentioned earlier, tax farming was employed in a large part of the Ottoman Empire, because the state simply did not have the ability or the administrative capacity to collect taxes through its own means in a more effective manner.[136] Moreover, the widespread corruption in bureaucracy and the escalation of smuggling activities posed great challenges. Besides, heavy taxation of the already impoverished population could further erode the Sultan's authority. By the delegation of tax collection and the handling of other state revenues to a third party, the Sultan could avoid direct confrontation with his people and remain a respected figure or the final executer of justice. The delegation of authority allowed the Sultan to distance himself from the highly unpopular tobacco monopoly in fighting against smugglers. Thus, it was not the Sultan but the Régie officials that were the target of the widespread protests by tobacco producers.

Furthermore, even though many writers point to the Decree of *Muharrem* in 1881 as the date when the Ottomans lost their fiscal sovereignty to the Europeans, the practice of handing state revenues to foreigners was not something new. As mentioned before, a couple of years earlier, the same sources of revenue (with the exception of some minor additions in the Decree of *Muharrem*) had been ceded to the Galata Bankers and the BIO. Here it is important to note that the BIO was by far the largest shareholder in the administration.

Another important aspect of the debt renegotiations was the BIO's active role in the process, both as a creditor and as a mediator between the government and the foreign bondholders. As the major organization controlling the ASIR, the debt settlement would deprive the BIO of its privileges granted by the November Convention. So why did the BIO consent to the signing of the Decree of *Muharrem*?

The November Convention had raised numerous protests from bondholders' organizations all over Europe. Faced with the growing enmity of the foreign bondholders and diplomatic protests by the creditor governments, the BIO officials realized that the existing structure of the ASIR was not sustainable over the long term. The hostility of the bondholders could be diffused by making certain concessions from the November Convention. The initial plan of the BIO administration, and also their most favorable solution, was giving the foreign bondholders a larger share of the revenues collected by the ASIR.[137] Such an arrangement would not only allow the BIO to maintain its control over the administration, but also enable the bank, this time backed by European bondholders, to expand its economic and political power over the economy. However, the European bondholders had already lost confidence in the bank after the signing of the November Convention. Consequently, they refused outright to leave the BIO in control of the indirect contributions, and demanded the abolishment of the ASIR. Under these circumstances, the BIO could either initiate a new arrangement involving the representatives of foreign bondholders or side with the Porte and stay out of the debt renegotiation efforts of the European financial circles in order to continue its unrivaled position in the ASIR. The BIO chose the former, and initiated the international debt renegotiations that resulted in the Decree of *Muharrem*.

Several factors might have played a role in the BIO's decision to bring the government to the negotiating table, even though it meant compromising the bank's privileged position in the existing administration. One major factor was the reputational concerns of the BIO administration. As mentioned before, the BIO was a consortium of British and French bankers, and held branches both in London and Paris. Moreover, the participants in the consortium and members of the bank's general committee were well respected, influential figures in the European financial markets and the domestic politics of their respective countries.[138] After the reactions to the Banker's Convention, we might presume that they were increasingly concerned that not only the bank's reputation, but also their reputation in Europe, could be damaged in the long run.

Furthermore, the BIO administration was also concerned that, with the increasing financial needs of the treasury, the argument it formerly deployed to defend its lending on the securities that were already mortgaged to foreign creditors could be turned against itself. That is, the

Porte could offer the administration of the indirect revenues to the foreign bondholders as security for a new loan, discarding the existing agreement with the domestic creditors. Hence, the BIO and the local bankers were concerned that they would not only lose their priorities in the debt service, but they would also lose their role in the administration of the revenues. If the Porte sought a new settlement with the creditors, they would rather be involved than remain out of the process.

Another concern of the BIO was the weakness of the enforcement mechanisms behind the November Convention. These concerns were confirmed during the early months of 1881, when the Porte threatened the BIO with canceling the agreement unless they advance an additional LT 1 million to finance military preparations against Greece.[139] The government could cancel the convention unilaterally at any time, and now that the BIO had also lost the support of the other foreign creditors and governments, they had no credible threat mechanism at their disposal other than denying further credits to the government. Therefore, the existing pattern of domestic lending was unsustainable in the long term. Each time the government was in need, it would turn to the BIO for a new loan and the BIO would be forced to accept its demands to avoid risking the repayment of its existing loans. As the total amount of the loans grew, the BIO would be more and more trapped into financing the recurring budget deficits of the government.

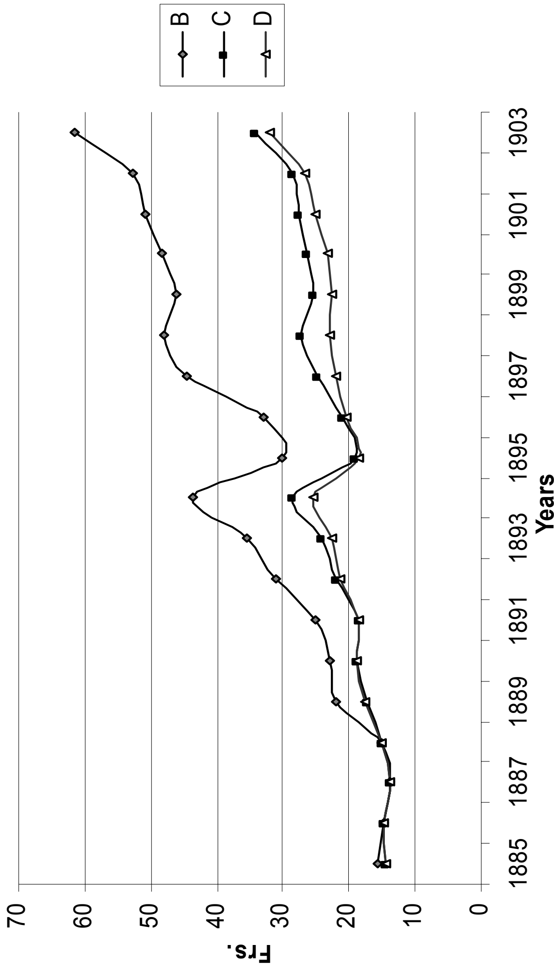
When revenues of the Administration of the Six Indirect Contributions were ceded to the OPDA, the BIO and the local bankers became the first mortgagees on the ceded revenues, while their debt (to be extinguished in 22 years) became marketable by permission granted to them for the issue of bonds, known as the priority bonds. The agreement reached with the Decree of *Muharrem*, as opposed to the arrangements under the November Convention, was hardly reversible. The agreement was signed by the representatives of bondholders from all major European powers. Their governments, although not directly involved in the negotiations, gave their unofficial support. With the decree, the BIO administration compromised its privileged role in the ASIR and consented to a reduction in its outstanding loans. In return, the settlement put the repayment of more than LT 4 million owed by the government on a basis that commanded wider international approval.[140] The bank also convinced the representatives of bondholders to farm out the tobacco monopoly, the most attractive source of state revenues, to a consortium headed by the BIO.

As far as the foreign bondholders were concerned, their incentives for signing the agreement should be analyzed under two subgroups. The bondholders of the hypothecated loans gained privileges in the amortization of their debt and the coupon payments, in return for a reduction in the principal and the interest on their loans and surrendering their rights on their collaterals to the OPDA, which was liable for the debt service in general. The uncertainty about the future of their loans was significantly reduced by the establishment of the OPDA, and their bonds became marketable once again.

As for the bondholders of the General Debt, at first glance this group might seem the most disadvantaged since they were ranked the lowest in amortization. Moreover, by the terms of the agreement, a larger reduction was made on their loans. However, these bonds had no collateral, the main reason for their profitability at the time. By the decree, holders of these bonds managed to grab a share in the revenues previously assigned to other bondholders in return for their concessions.

Despite the major advantages offered by the decree, it did not go unopposed in the European press. The representatives were heavily criticized for making a great concession.[141] Nevertheless, in few years, as the OPDA gained the confidence of foreign investors, the agreement proved to be very profitable for bondholders, since the risk assigned to the government was significantly reduced by the establishment of the OPDA. Figure 2.2 illustrates the trend in the market values of Ottoman bonds on the Paris Bourse from 1885–1903, before the unification of the debt. The figure does not show the group A bonds that were amortized as early as 1897. As illustrated in the figure, even group D bonds, which were considered to be the least secure, increased their value by more than 100 percent within the period.

Figure 2.2 Market value of the Ottoman bonds in Paris: 1885–1903



Source: Kazgan, 1985: 691.