Markets under Siege: How Political Beliefs Move Financial Markets

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Abstract :
Can beliefs about politics, particularly the benefits of war and peace, move thick financial markets? During and after the Siege of Paris by the Prussian army (1870- 71) we document that the prices of the French 3% sovereign bond (rente) differed persistently between the Bourse in Paris and elsewhere, despite being the most actively traded financial asset in continental Europe. Further, these differences were large, equivalent to almost 1% of French GDP in overall value. We show these differences manifested themselves during the period of limited arbitrage induced by the Siege and persisted until the peace terms were revealed. We show that as long as French military resistance continued, the rente price remained higher in Paris than the outside markets. However, when the parties ceased fire and started negotiating peace terms, this pattern was reversed. Further, while the price in Paris responded more negatively (positively) to defeats (victories), the price responded more to peace events elsewhere. These specific patterns are difficult to reconcile with other potential mechanisms, including differential information sets, need for liquidity, or relative market thickness. Instead, we argue that these results are consistent with prices reflecting the updating of different prevailing political beliefs in Paris and elsewhere about the benefits of war versus peace.