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Pablo Martín-Aceña, Elena Martínez-Ruiz and Pilar Nogues-Marco

Abstract

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Keywords: gold standard, monetary policy, Bank of Spain

JEL Classification: E42, E58, N10

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FLOATING AGAINST THE TIDE: SPANISH MONETARY POLICY, 1870-1931

1. Introduction

The gold standard is not the monolithic metallic monetary system that it was once believed to be. Country cases and detailed studies of the actual workings of the system have shown that the gold standard was not a rigid mechanism for adjustment to external disequilibria, and that it enabled core and peripheral nations to tailor it to their needs. Exchange rate stability was achieved by various means. Some countries followed the so-called ‘rules of the game’, while others systematically evaded the rules and resorted to a variety of methods to keep the price of their currencies fixed against gold. Moreover, gold coins were a major part of the money in circulation in some countries, while gold did not circulate at all in others. Gold convertibility was usual in the core countries but, to a certain extent, specie convertibility was the exception in peripheral nations. As has recently been stressed, a re-conceptualisation of the gold standard system has brought to the fore its reputational aspects and its status as a “contingent rule”, instead of the traditional approach, which focused on adherence to strict patterns of behaviour and well-defined rules. According to the new approach, the monetary policies that were followed in the short term mattered little, provided that in the long term a country was fully committed to the regime and that the financial community believed this to be true¹. We also know now that countries’ monetary authorities’ commitment to a fixed exchange rate regime (in the form of target zones) did not lead to them entirely relinquishing their monetary independence, as long as agents considered the countries’ commitment to be credible. In consequence, as long as economic agents considered a country’s commitment to gold as credible, the country could violate the rules of the game in the short term to further other policy goals. Moreover, evidence shows that the objectives of central banks under the gold standard regime was not simply convertibility and the stability of the exchange rate but, rather, a combination of goals, including profit maximization, just as with any other private financial institution².

The gold standard began to emerge as a universal monetary system in the late 1870s, and it had spread throughout the world economy by 1900³. It was unusual for nations to be off the gold standard, and it meant that they were detached from the international financial community. World War I led to the complete breakdown of the gold standard. Exchange controls were introduced almost universally, with the sole exception of the United States, international flows of capital were interrupted, and world trade collapsed. The Armistice of November 1918 did not lead to the immediate restoration of the gold standard. The war was followed by a serious and protracted economic and financial crisis, and all the European currencies experienced wild fluctuations, which were particularly acute in the nations of the former Axis powers. Although currency stabilisations began in 1923-24 under the auspices of the League of Nations, the reintroduction of the gold standard was marked by the British pound sterling’s return to gold at its pre-war parity in 1925. By the end of 1929, when the New

¹ The challenge to the traditional view of the gold standard began with Triffin (1964). More recently Flanders (1993), Bordo and Kidland (1995), Bordo and Rockoff (1996), and an excellent state of the art in Morys (2011)

² Recent country studies that reexamine the monetary policy of the central banks, Contamin (2003), Ögren (2007), Reis (2007) and Jobst (2009).

³ Eichengreen and Flandreau (1996); Gallarotti (1995)

York Stock Exchange crash ushered in the Great Depression, most European currencies were once again linked to gold⁴.

Spain never joined the gold standard club in any of its versions, either before or after 1914. Unlike the vast majority of the European currencies, the peseta's exchange rate fluctuated, sometimes widely, against gold and gold currencies⁵. Gold convertibility was suspended in 1883 and never resumed. Nevertheless, the monetary authorities were aware that the Spanish economy, off the gold standard, was an outlier in the international economy and made plans to put the peseta on gold both before and after 1914. No matter how forcefully they were pursued, all attempts ultimately failed because policy measures were not always consistent with this goal. Neither the Treasury nor the Bank of Spain was prepared to take the necessary measures to choose an appropriate par and to make the commitment to maintaining it. The Ministry of Finance was unable to balance the budget and to follow an orthodox fiscal policy along the lines required to keep the exchange rate stable. Meanwhile, the minutes of the board of directors of the Bank of Spain show that its private interests, i.e. paying high dividends to its shareholders, always prevailed over the public interest (a stable peseta). One conclusion of this paper is precisely that: the adoption of the gold standard was a mere 'wish' but, ultimately, the actual monetary and fiscal policies were not oriented towards that goal, or at least they were not pursued with sufficient conviction.

The monetary experience of Spain, which was until very recently a poor and peripheral country, may be of interest for several reasons. First, it is the only European country in which the gold standard was never implemented, despite the fact that the monetary authorities repeatedly declared their intention to peg the peseta's exchange rate to gold. Why Spain never adopted the gold standard is a complex issue, and our paper offers a possible answer by examining the behaviour of an issuing bank that refused to accept, or resisted, its role as a central bank. Our study also provides a basis for a comparison between the Bank of Spain, some of its features and policies, with other peripheral issuing institutions. Moreover, our paper encompasses both the pre-war and the post-war periods, which allows us to present both the similarities and the differences in the exchange and monetary policies of the Spanish authorities during the era of the classical gold standard and the years of the gold exchange standard.

We have chosen to focus our analysis on the policy and behaviour of the Bank of Spain which enjoyed the monopoly of issue for the entire country from 1874 onwards⁶. In the following section, we provide a brief outline of the main constraints and determining factors in the Bank's policies. Section three is devoted to examining the Bank's behaviour during the classical gold standard period. A similar analysis for the interwar period is conducted in section four. The paper concludes with a final section, which is both brief and speculative.

⁴ For the interwar period, an excellent summary in Drummond (1987)

⁵ The Spanish monetary experience has been studied by Martín-Aceña (1993 and 2000a); the gold standard issue has also been dealt with by Sardá (1948), Tortella (1994), and more recently in papers by Serrano Sanz, Gadea and Sabaté (1998), Cubel (2001), Llona (2001), Serrano Sanz (2004), García-Iglesias (2005) and Ródenas and Bru (2006). For the long term evolution of the peseta exchange rate, Sabaté (1993) and Aixalá Pastó (1999).

⁶ Three recent papers with the history of the Bank of Spain for the period 1874-1962, Tedde (2006), Tortella (2006), and Martín-Aceña (2006).

2. Capital mobility, fiscal deficits and the balance of payments

Members of the gold standard club are supposed to behave appropriately in order to maintain the stability of the exchange rate, and the convertibility of its currency into gold. They must allow capital to move freely, i.e. they cannot raise barriers to the exportation and importation of gold; and they must avoid persistent imbalances in the country's government budget and in the current account balance of payments.

Capital mobility was the rule before 1914. Foreign investment flowed unimpaired into the country. Likewise, foreign investors could repatriate interests and dividends as often as they wished and without any obstacles. Gold inflows and outflows were not controlled or subject to any type of official intervention⁷. Railways, banks and industrial firms could borrow freely on the international markets, and the government floated bonds in the London and Paris stock exchanges, provided that guarantees of repayment were given. One of the key features of the workings of the gold standard was thus in place. The experience with capital mobility during the interwar years was more complex. Mild and partial exchange controls were introduced as early as 1919 to contain the depreciation of the peseta. The systematic administrative intervention on the exchange market began in 1928 and intensified during the following years, and Spain was one of the first countries to introduce a formal exchange control apparatus⁸. Capital mobility was not then a feature of the period, but was also not part of the international economy. However, this did not prevent many countries from adhering to the so-called gold exchange standard.

With the exception of one year, the Spanish budget closed with significant deficits between 1874 and 1898, which were particularly large at the end of the century due to the extraordinary expenditure required by the colonial wars in Cuba, Puerto Rico and the Philippines. The outstanding public debt tripled as a consequence, and part of it found its way into the portfolio of the Bank of Spain, contributing to the increase in the amount of high-powered money. The monetisation of the debt thus led to an increase in the quantity of money in circulation slightly over GDP, which made Spanish prices diverge from the relentless decline in international prices. After 1900, fiscal reform and a drastic conversion of the debt turned the government accounts around, and the budget ended with surpluses for nine years in a row. Thereafter, the deficit made a return and new debt issues were necessary. The Treasury went to the Bank and to the market but eventually most of the securities were monetised. Had the Bank of Spain attempted to follow an independent monetary policy during those years, it would have come into conflict with the Treasury and its financial needs. The budget deficit persisted during the 1920s and 1930s, although the Ministry of Finance introduced reforms to increase revenues and measures to curtail spending. These were insufficient to balance the annual budgets⁹. It can therefore be argued that public finance, i.e. the government's inability or unwillingness to eliminate the deficit, may have been one of the impediments to adopting the gold standard. Exchange rate stability was certainly an official goal, but actual fiscal policy was inconsistent with such a goal. Nevertheless, the reverse argument is also plausible and has to be explored. Adherence to the gold standard required fiscal discipline, at least in the long term. If the Spanish monetary authorities had committed to the gold standard, they would have been forced to rationalise spending and above all to reform and modernise the fiscal structure.

⁷ Sardá (1948) and Broder (1976)

⁸ Eguidazu (1978); Martínez-Ruiz (2000)

⁹ The relationship between the Treasury and the Bank of Spain in, Anes and Tedde (1976), and Martín-Aceña (1985). The link between monetary policy and fiscal policy in, Sabaté Sort, Gadea and Escario (2006)

Moreover, a well-behaved Treasury would have been in a better position to impose its will (exchange rate stability) upon a Bank of Spain with a franchise as sole issuer that depended on the government. Faced with the alternative of losing its privilege or contributing to the maintenance of the gold standard and the gold convertibility of the peseta, it is probable that the Bank would have preferred the latter, and its transformation into a genuine central bank would have occurred earlier.

External imbalance is another possible reason for Spain's unusual monetary experience¹⁰. Until the mid-1880s, the persistent current account deficits in the balance of payments were amply covered by capital inflows that were channelled into railways and banking companies, as well as into government bonds. The stream of foreign investment ended in the 1880s and the current account ran a surplus until 1898. The trade deficit returned thereafter, but so did foreign capital. The current account closed with increasingly large surpluses from 1905 onwards. As Spain was a neutral country, the war years fostered exports and limited imports, and the balance of payments ended with large surpluses as a result. However, during the interwar period the external balance was reversed. In the 1920s, the trade deficits were huge, and the balance of payments was also negative in the 1930s, despite the adoption of strict exchange controls.

The balance of payments results over these six decades do not lend themselves to an easy interpretation as regards the question of the gold standard and its long-term sustainability. Our view is that, contrary to some arguments, the balance of payments was not a constraint on the choice of monetary regime, if only because when deficits occurred they amounted to a relatively small percentage of GDP. Furthermore, a credible commitment to the gold standard would have certainly improved access to the global capital market and reduced transaction costs with other gold standard nations. Periods of balance of payments difficulties would have mattered less or not at all because the current account deficits would have been settled with capital inflows. In fact, given the historical experience during the pre-war era, when funds from London, Paris and Berlin financed world trade and covered current account imbalances, there is no reason to suppose that Spain would have not received as much capital as it needed to compensate any deficit, whether external or internal. The interwar era admittedly poses more problems but the argument is still valid, since we know that peripheral countries on the gold standard in Europe and elsewhere were able to obtain capital in New York until at least 1929.

3. The monetary policy of the Bank of Spain during the Classical Gold Standard, 1874-1913

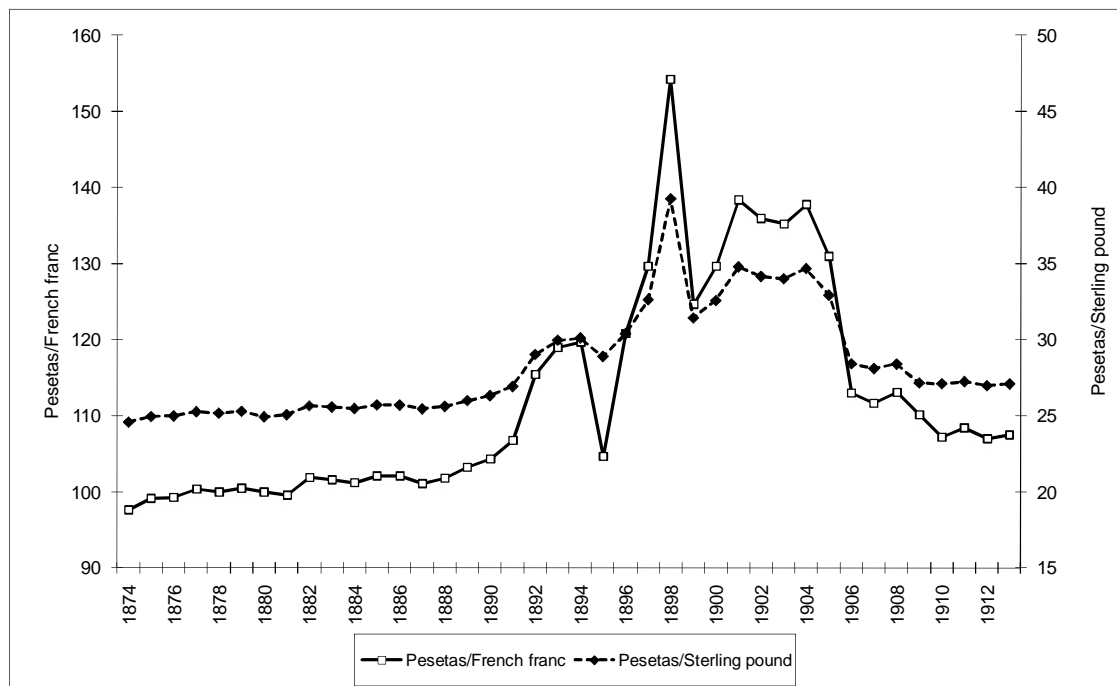
Spain never adopted the gold standard. The country retained a bimetallic monetary system until 1883, at which point the peseta's gold convertibility was suspended and the exchange rate shifted to a floating regime within an international context of the gold standard¹¹. Figure 3.1 shows the rate of the peseta against the pound sterling and the French franc, which were considered benchmark currencies at the time. The developments in this respect fall into three periods. During the first period, until the early 1890s, Spain maintained the price of the peseta within a narrow range by controlling the monetary aggregates. In the second period, from the early 1890s onwards, when the peseta depreciated considerably due to an excess of issue, there was an exchange rate crisis in 1898 due to the excessive monetisation of the public deficit

¹⁰ Spain's international trade and balance of payments position in Tena Junguito (1992) and Prados de la Escosura (2011)

¹¹ Sardá (1948), pp. 183-184

due to the financing of the colonial wars. In the third period, after the loss of the last colonies, the peseta appreciated because economic policymakers strove to correct the increase in the money supply caused by the excessive budget deficit.

Figure 3.1: Nominal exchange rate, 1874-1913



Source: Martín-Aceña and Pons (2005), p. 704

Despite being off the gold standard system, Spain always maintained a political interest in joining the gold standard monetary system.¹² In this section, we examine the monetary policy adopted by the Bank of Spain during the era of the classical gold standard. Our objective is to analyse whether the Bank of Spain's monetary policy was oriented towards the objective of joining the gold standard, or if its policy was based on goals other than the gold standard.

The traditional literature defined the monetary policy that central banks had to follow to sustain the gold standard as 'the rules of the game'. These rules forced central banks to implement a restrictive monetary policy when the country was losing gold and an expansionary monetary policy when the country was accumulating gold in order to restore equilibrium in the balance of payments¹³. Compliance with the rules of the game was measured by two indicators. The first indicator was based on the relationship between the change in reserves (non-earning international assets) and the change in domestic income-generating assets. If the country began to lose gold, the central bank had to sell bonds from its portfolio for cash, reducing the money supply and therefore restricting the outflow of gold. Both the reserves and the domestic income-generating assets were reduced as a result, and a positive correlation between the changes in two variables showed that the central bank was following the rules of the game. The second indicator was based on the relationship between the change in the interest rate and the change in the reserve ratio (reserves divided by sight liabilities, notes plus deposits).

¹² Junta Consultiva de la Moneda, 1876-1880. Record books: vol. 22859.

¹³ Nurkse (1944), Bloomfield (1959)

The central bank had to raise the interest rate to reduce the money supply when it was losing reserves, and lower the interest rate to increase the money supply when it was gaining reserves. A negative correlation between the rates of change in the interest rate and the reserve ratio therefore shows that the central bank was following the rules of the game.

Spain did not follow the rules of the game in the classical gold standard era of 1880-1914¹⁴. The annual variation in the Bank of Spain's domestic income-generating assets and reserves presents a negative correlation for more than 40% of this period. In addition, there was no systematic negative correlation between changes in the interest rate and the reserve ratio. The Bank of Spain's interest rate underwent a few changes throughout the entire classical gold standard period, and there was only a negative correlation between changes in the interest rate and the reserve ratio in the early 1880s (1879-1884) and in the late 1890s (1896-1903), when the reserve ratio fell significantly, which threatened convertibility and in fact led the Bank of Spain to cease converting its notes into gold in 1883.

However, these results are not surprising. Bloomfield (1959) tested the rules of the game followed by the countries belonging to the gold standard monetary system and found that central banks did not follow the rules of the game but enjoyed uninterrupted convertibility.¹⁵ The reason for this is that central banks did not implement monetary policy based on the balance of payments as required by the rules of the game, but instead used the rule of convertibility as a *de facto* monetary target, i.e. a fixed exchange rate sustained by interventionist policies in the market¹⁶. The classical gold standard was an exchange rate band, in which exchange rate movements were limited by the gold points¹⁷. The central banks guaranteed convertibility by applying exchange rate policies to maintain exchange rates within the gold band. The most common policy of intervention followed by central banks was the sale of gold against their own notes in the domestic bullion market, which enabled them to stabilise the exchange rate and enjoy discretion in monetary policy at the same time. Interest rates did not react to the loss of reserves when the exchange rate was strong, only doing so when the exchange rate was weak and convertibility threatened.

Some peripheral countries such as Portugal, which had a small domestic bullion market, applied exchange policies based on importing gold and exchange rate manipulation to maintain the changes within the gold band¹⁸. Others, such as Sweden, adopted passive policies to defend convertibility. The central banks in the gold standard system were required to convert their notes on demand into metallic coins on demand - gold coins in the gold standard system. The convertibility of notes into gold stabilised the exchange rate because if the exchange rate went beyond the gold points, the arbitration process would readjust the exchange rate as long as the Bank had enough reserves to change its notes until the exchange rate was restored. This passive defence of convertibility required a high reserve ratio, which ranged from 50% to 100% in the case of Sweden. The Riksbank strangled domestic credit, keeping interest rates high to protect the specie standard¹⁹. The monetary policy applied by the Bank of Spain after

¹⁴ Martín-Aceña (1993)

¹⁵ See also White (1933) for France, Drummond (1976) for Russia, Dutton (1984) for England, Jonung (1984) for Sweden, McGouldrick (1984) for Germany and Reis (2007) for Portugal. For a review and summary see Michaely (1968), Drummond (1987) and Ford (1962).

¹⁶ Bordo and MacDonal (1997), Bordo and MacDonal (2005), Flandreau and Komlos (2006), Jobst (2009, and Flandreau (2008).

¹⁷ Eichengreen and Flandreau (1997)

¹⁸ Reis (2007)

¹⁹ Ogren (2007)

inconvertibility became a matter of fact in the early 1880s was also adopted as passive policy defence based on a high reserve ratio. The higher the reserve ratio the greater the credibility the Bank enjoyed²⁰.

The guarantee of convertibility was legally regulated by the establishment of ceilings on the issuance of notes based on two variables - reserves and share capital. The relationship between the issue of notes and reserves acted as a guarantee of liquidity while the relationship between the issuance of notes and capital was the guarantee of solvency. Table 3.1 summarises the limits on issue imposed on the Bank of Spain.

Table 3.1: Legal maximum for banknotes issued by the Bank of Spain, 1874-1913

	Minimum reserves	Minimum capital
Decree 19 March 1874	reserves $\geq 1/4$ notes	500 millions pts (1874-1881) 750 millions pts (1882-1890) (notes ≤ 5 paid-up capital)
Law 14 July 1891	reserves $\geq 1/3$ notes gold reserves = $1/2$ reserves	1500 millions pts (notes ≤ 10 paid-up capital)
Decree 9 August 1898	0-1500 mill notes: reserves $\geq 1/3$ notes 1500-2000 mill notes: reserves $\geq 1/2$ notes 2000-2500 mill notes: reserves $\geq 2/3$ notes and for all notes: gold reserves = $1/2$ reserves	2500 millions pts (notes $\leq 16 \frac{2}{3}$ paid-up capital)
Decree 2 August 1899	0-1500 mill notes: reserves $\geq 1/3$ notes 1500-2000 mill notes: reserves $\geq 1/2$ notes and for all notes: gold reserves = $1/2$ reserves	2000 millions pts (notes $\leq 14 \frac{2}{3}$ paid-up capital)
Law 13 May 1902	0-1200 mill notes: reserves $\geq 1/3$ notes (1/2 gold) 1200-1500 mill notes: reserves $\geq 60\%$ notes (40% gold and 20% silver) 1500-2000 mill notes: reserves $\geq 70\%$ notes (50% gold and 20% silver)	2000 millions pts (notes $\leq 14 \frac{2}{3}$ paid-up capital)

Source: Galvarriato (1932, pp. 212-215, 236-237)

The legislation set limits on the issue of notes in the 1874 decree that granted the Bank of Spain the monopoly of issue. These limits required that the gold or silver reserves were at least one quarter of the banknotes in circulation and that the paid-up capital amounted to at least one fifth of the banknotes in circulation. Subsequent laws set stricter issue limits in terms of reserves, although no longer related to the paid-up capital. In the negotiations with the Treasury, the Bank of Spain strongly defended its monopoly of issue, and the Bank's directors aimed at separating the legal issue limit from the institution's share capital²¹. The law of 1891 changed the criteria for issue, and required that the reserves amounted to at least one third of the value of notes, with at least half of the reserves in gold. The issue limit was set at 1,500 million pesetas, with no direct link to the capital which, given the paid-up capital of the Bank at that time, in practice amounted to a very substantial reduction in the issue limit equal to 10 times the capital. The 1898 decree authorised the Bank of Spain to increase the issue of notes to 2,500 million pesetas (16 $\frac{2}{3}$ of its capital), with reserves guaranteed in tranches: a reserve ratio of one third was maintained for up to 1,500 million pesetas; a reserve ratio of one half was set for the band between 1,500 million and 2,000 pesetas and a reserve coefficient of two thirds was set for the band between 2,000 and 2,500 million pesetas; half the reserves had to be in gold for all the bands. The decree of 1899 reduced the maximum issue to 2,000 million pesetas (14 $\frac{2}{3}$ of the capital) and maintained the

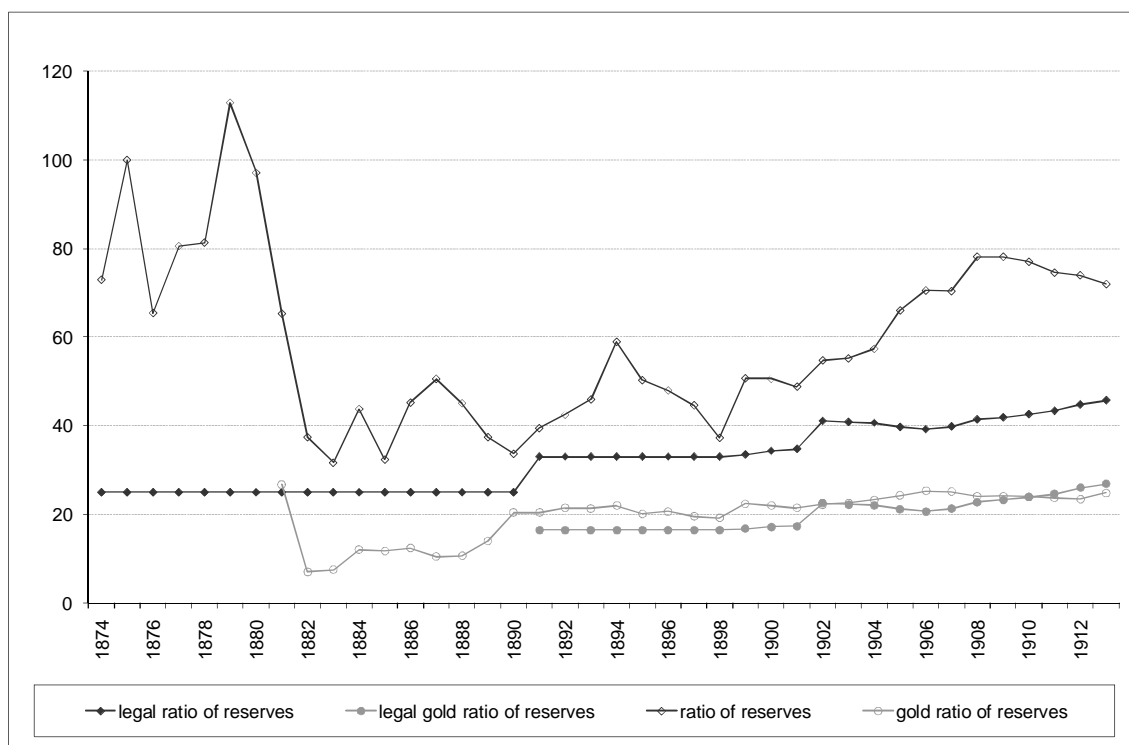
²⁰ Bank of Spain, *Annual reports* (1894, p. 29 and 1898, p. 26-27)

²¹ Serrano Sanz (2004), p. 73

reserve limits which had been established in the decree of the previous year. Finally, the law of 1902 maintained the issue limit at 2,000 million pesetas and left unchanged the reserve ratio for up to 1,200 million pesetas at one third (with half in gold), although it increased reserve ratio to 60% for the issue band between 1,200 and 1,500 million pesetas (40% in gold and 20% in silver) and 70 percent for the band between 1,500 and 2,000 million pesetas (50% in gold and 20% in silver).

The Bank of Spain always had a reserve ratio above the legal limit for silver, but it remained at the limit established by law for gold (see figure 3.2). The Bank considered the surplus reserve ratio to be an indicator of credibility for conversion. This conversion of notes for cash had taken place exclusively in silver since 1883 and, as such, maintaining a surplus in the silver reserve ratio was all the Bank had to do to ensure its convertibility. The gold reserve ratio remained at the limits specified by law and, as a rule, these limits were lower than the 33% used by the gold standard countries²². In order to have been able to join the gold standard, the Bank of Spain would have had to reduce its note issue substantially, but the Bank of Spain did not feel committed to exchange rate stability or the convertibility of banknotes into gold²³.

Figure 3.2: Bank of Spain reserve ratio, 1874-1913 (reserves/notes) (%)



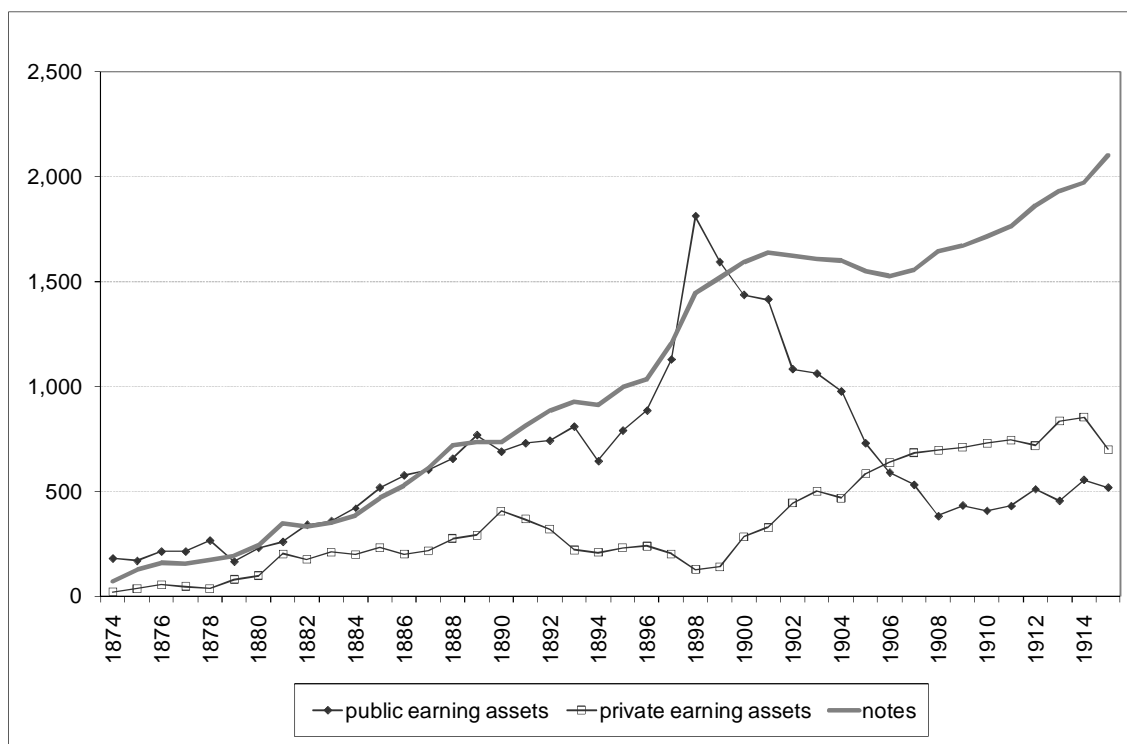
Sources: reserve ratio calculated from the Bank of Spain balance sheets, Anes (1974b, pp. 143-156 and 1974c, p. 114). Legal reserve ratio from Galvarriato (1932, pp. 212-215, 236-237) (see Table 3.1). The balance sheet of the Bank of Spain did not specify if its reserves were gold or silver until 1881. Spanish legislation did not oblige it to keep a percentage of its reserves in gold until 1891.

²² The Palmer rule established a minimum ratio of reserves of 33%, which was calculated as reserves divided by sight liabilities, i.e. notes plus deposits. Spanish legislation established the ratio of reserves only with regard to notes, regardless of sight deposits. The gold reserve ratio would therefore be even lower if the sight deposits were also considered.

²³ Conant (1915), pp. 315-316; Serrano Sanz (2004), p. 80

In part, the excess issue of banknotes was the result of the monetisation of the public deficit, which is why Spain could not join the gold standard (see figure 3.3). The Bank of Spain was not a government institution and, as such, the Treasury did not share in the institution's profits, but the government granted the Bank the monopoly of issue in 1874 in exchange for a loan of 150 million pesetas. The Bank of Spain advanced cash to the Treasury in exchange for government bonds that the Bank kept in its portfolio. In the first years of the monopoly of issue the accumulation of public debt did not result in increases in the amount of money.²⁴ However the monetisation of the deficit became widespread in the mid 1890s and increased sharply with the conflict between Spain and the United States in 1898, which led to a precipitous fall in the peseta's exchange rate. The Bank of Spain increased the circulation of notes by an average of 10% per year throughout the period in exchange for assuming the Treasury's debt. After the independence of the last Spanish colonies in the early twentieth century, the government decided to end fiscal indiscipline and prohibited borrowing from the Bank without prior legal authorisation. It also undertook to reimburse the Bank within 10 years (1902-1911) for the bonds that the Bank retained in its assets²⁵. However, the Bank did not reduce the notes in circulation proportional to the reduction of public earning assets, which would have provided a gold reserve ratio sufficient to enter the gold standard. Instead, the Bank maintained the volume of notes in circulation and increased short-term silver reserves because of the lack of turnover to replace the public earning assets portfolio with private earning assets²⁶.

Figure 3.3: Bank of Spain portfolio and notes, 1874-1915 (million pesetas)



Source: Data from the Bank of Spain balance sheets, Anes (1974b, pp. 143-156)

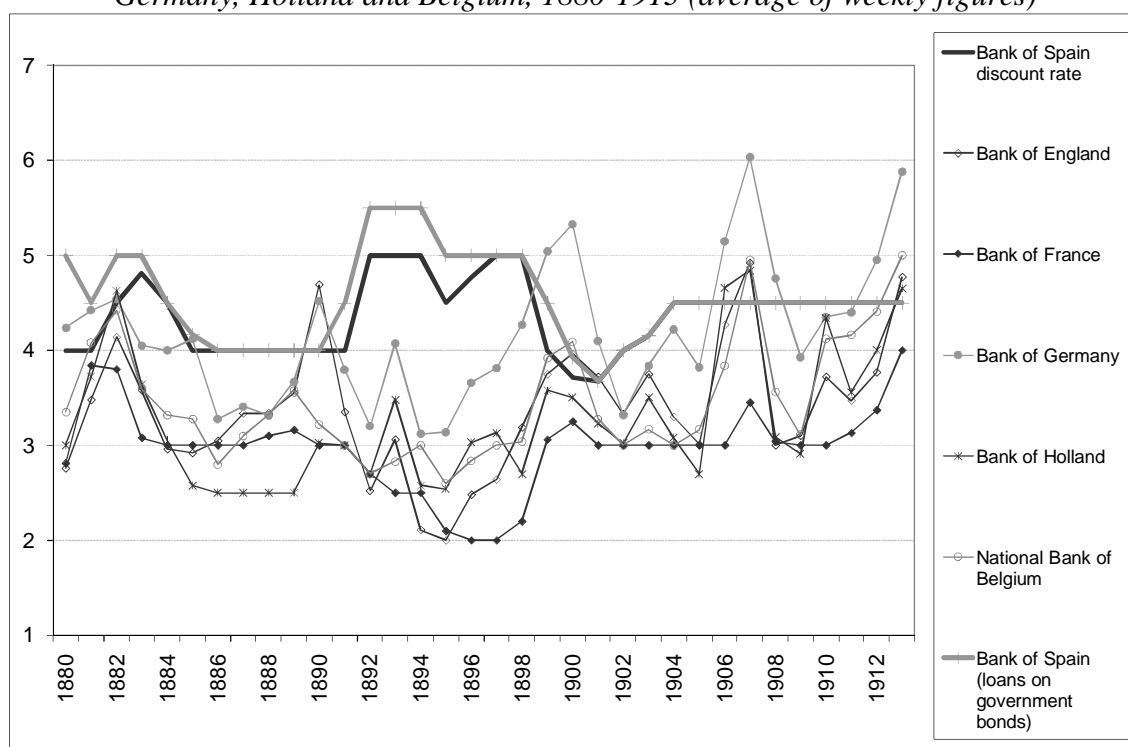
²⁴ Martín-Aceña (1985)

²⁵ Tortella (1970); Anes (1974a); Sabaté Sort and Serrano Sanz (2006)

²⁶ Conant (1915), p. 318)

The excess silver reserve ratio, which reached almost 80%, was not compensated by high interest rates to maintain profitability. On the contrary, the Bank of Spain's level of interest rates was at the international level, albeit with a different fluctuation pattern (see figure 3.4). As noted, the Bank of Spain's interest rate changed little during the era of the classical gold standard. There were two periods of rising rates linked to the loss of reserves, in the early 1880s and in the late 1890s. During the remainder of the period, interest rates remained stable at levels of between 4% and 4.5%, set at levels to minimize the service cost of the public debt²⁷. On the other hand, the policy of the Bank of Spain was to offer loans guaranteed with government bonds at an interest rate lower than the rate earned by the public bonds themselves, thereby encouraging speculators to borrow at much as possible by pledging public bonds, use the loan to buy more public bonds and use them once again as a guarantee for another loan to buy more public bonds, and so on²⁸.

Figure 3.4: Comparison of annual average discount rates: Spain, England, France, Germany, Holland and Belgium, 1880-1913 (average of weekly figures)



Source: White (1933), p. 331. The data for the Bank of Spain comes from the Minutes of the Shareholders' General Meetings, 1880-1913.

The Bank maintained the surplus reserves as a measure of credibility, but it was aware of the loss of profits that holding a percentage of reserves above the minimum required by law entailed²⁹. This loss of potential profits was compensated by larger note issue with regard to the paid-up capital (see table 3.1), which enabled the Bank to have

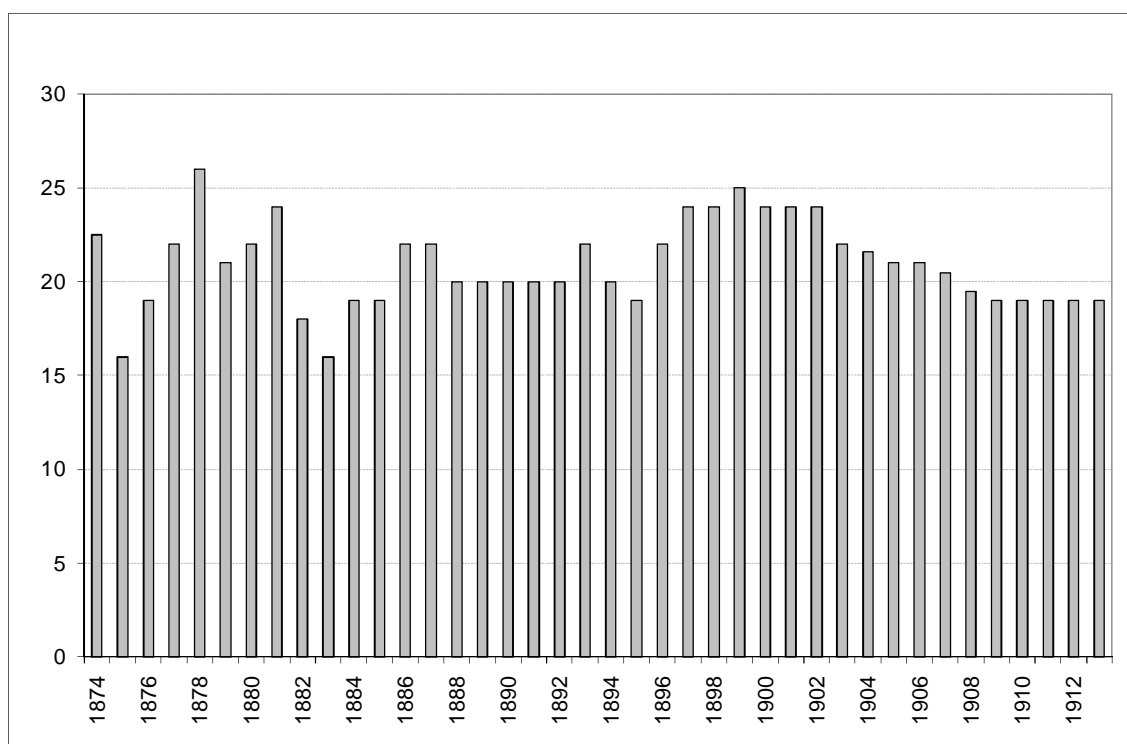
²⁷ Martin Aceña (1993), pp.150-151

²⁸ Conant (1915), p. 314-315

²⁹ The Bank calculated the losses as the excess reserves multiplied by the discount rate. It justified these losses by saying that they were more than offset by its public credibility. By having large silver reserves, banknotes holders were assured that convertibility was never jeopardized (Bank of Spain, Annual report, 1898, pp. 26-27)

an average annual shareholder return of over 20% throughout the period of the classical gold standard (see figure 3.5). The ROA (Return on Assets) decreased steadily throughout the period due to the increase in reserves, but the ROE (Return on Equity) remained high and stable thanks to the surplus issue on capital, which enabled the Bank to maintain the high shareholder return (see figure 3.6). The risk posed in order to sustain a very high ROE was offset by the excess silver reserve ratio. The drawback of this policy was to keep the country off the gold standard, because joining the gold standard would have meant reducing the note issue, and therefore the shareholder return. The Bank of Spain, as a private bank, gave priority to the profitability aim over the ‘public good’ of exchange rate stability. We can therefore conclude that the Bank of Spain was uninterested in joining the gold standard because it was not a modern central bank, but a private bank which had been granted with issuing privilege in exchange for monetising the government debt. The Bank of Spain had been granted the monopoly of issue but its private constitution was in conflict with the public duties of a genuine central bank³⁰.

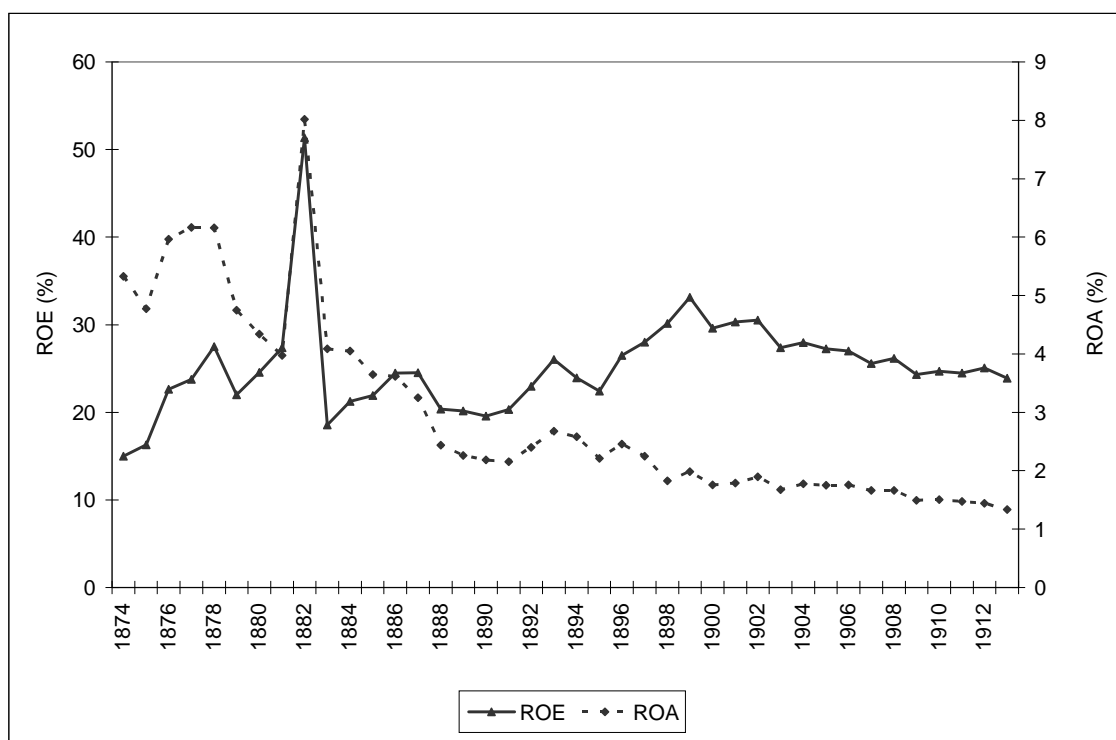
Figure 3.5: Bank of Spain annual shareholder return (%), 1874-1913



Source: Shareholder return = dividend/paid-up capital. Figures from the Minutes of the Shareholders' General Meetings, 1874-1913.

³⁰ The argument for the contradiction between 'privately owned issue banks and their responsibilities as central banks in Goodhart (1988)

Figure 3.6: Bank of Spain, ROE-ROA (%), 1874-1913



Source: ROE (%) = profits/owner's equity. ROA (%) = profits/total assets. Owner's equity and assets have been taken from the Bank of Spain balance sheets, Anes (1974b, pp. 143-156). Profits from: Minutes of the Shareholders' General Meetings, 1874-1913 (appendix D: 1874-1891, and appendix C: 1892-1913), Archive Bank of Spain.

4. The Bank of Spain and the Gold Exchange Standard, 1914-1931

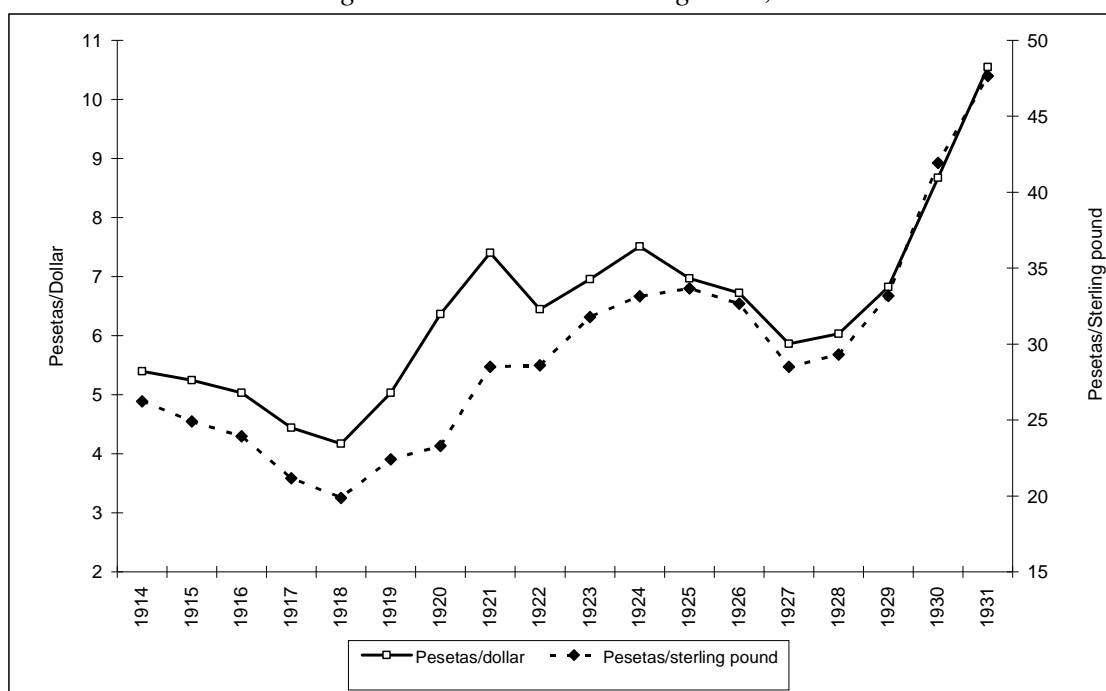
Spain also failed to adopt the Gold Exchange Standard. The peseta continued to float freely on the international markets until 1931, although, given the many interventions that took place, the situation might be better characterized as of a 'dirty' float. World War I created a very favourable situation for the economy of a neutral country such as Spain, which posted substantial trade surpluses between 1914 and 1918. Due to the conviction that only gold could provide adequate safeguards in that uncertain environment, currencies obtained were quickly converted into gold, coins and bullion. Between 1914 and 1918, the Bank of Spain acquired approximately 463 tons of gold, which was worth 1,595 million pesetas at the parity established in the currency reform of 1868, which was theoretically still in force. This all led to a significant appreciation of the peseta in the international markets (figure 4.1). The increase in gold reserves and the increase in the value of the currency revived the discussion on adopting the gold standard. Indeed, the preconditions had never before been as favourable, as the two factors mentioned above were joined by a rising silver price that made its demonetisation less costly³¹. However, after the exceptional circumstances of war, the Spanish economy once again posted high trade deficits, as well as a persistent imbalance in the country's government accounts. In 1919, the belligerent countries gradually abandoned the extraordinary measures taken during the war and their respective currencies began to realign themselves according to the new situation³². The peseta began to fall in the international markets from 1919 onwards, as did most

³¹ Martinez Mendez (2005)

³² Eichengreen (1992)

European currencies. Thereafter it remained relatively stable between 1922 and 1925. A gradual appreciation of the peseta exchange rate in 1926 and 1927 gave new hope to advocates of Spain's membership to the so-called gold exchange standard. However, from 1928 onwards, the peseta external value of the peseta began a continuous downfall and all official attempts made to stabilize it met with a complete failure. As had happened before 1914, the Spanish currency remained outside the dominant monetary standard of the period.

Figure 4.1: Nominal exchange rate, 1914-1931



Sources: Martínez Méndez (2005, table A26.1)

There were two options available to economies wanting to return to the gold standard in the 1920s: to devalue or to deflate. As is well known, the cases of France and Britain are the classic examples of both choices³³. In Spain, the need to stabilize the peseta exchange rate and the possible adoption of the gold standard were hotly debated, as is evident in the numerous publications and reports published during the interwar years³⁴. However, the attempts of successive governments throughout the period to take definite steps in that direction were offset by the obstructive attitude of the Bank of Spain, which was strongly opposed to devaluing the peseta below its legal parity of 1868, which would have led to a strong appreciation of the Bank's external assets³⁵. The appreciation of the reserves would have entailed the appearance of substantial extraordinary profits, leading to a political problem over its attribution to the government or to the shareholders³⁶. Moreover, the Bank flatly refused to support any

³³ Eichengreen (1996), pp.51-60.

³⁴ Examples include Olariaga (1929 and 1987); Sardá (1936), Belda y Pérez de Nuevos (1928); Flores de Lemus (1929); Ceballos Teresí (1930); Bernacer (1930); Fernández Baños (1930), and Comisión del Patrón Oro (1929).

³⁵ The same thing happened, for example, in France in 1928. See Margaraiz (2003), p.424

³⁶ The Bank's high profits in 1921 due to its purchases of gold during the war had already led to heated political debate and a great deal of controversy in public opinion that had a very negative impact on the institution's public image (Martínez Méndez, 2005).

measure that would involve committing its metallic reserves to ensure (gold) convertibility or to the maintenance of a stable exchange rate³⁷.

Spain's economic policy at no time aimed at deflation. The Bank of Spain's monetary policy did not follow the classic rules of the game that forced players to react to losses of reserves by limiting the system's liquidity³⁸. The income-generating domestic assets therefore evolved independently from the reserves. The changes were in the opposite direction in almost 40 percent of cases. On the other hand, the discount rate was rarely used to counteract movements of reserves, as evidenced by a correlation index of 0.021, but with a positive sign³⁹. In fact, this instrument was barely used, as the discount rate changed only nine times between 1914 and 1931. During this period, as in the previous one, the issuing bank preferred to use "gold devices" whenever it had to deal with situations requiring an increase in the price of money. On several occasions, internal instructions were given to ration credit and, on some occasions, silver coins were put in circulation instead of issuing banknotes⁴⁰.

The passive strategy of maintaining a high reserve ratio continued, in the belief that only the existence of a large volume of metal (gold and silver coins and bullion) in the vault of the Bank ensured confidence in the paper notes in circulation. Besides, the gold newly acquired during the war enabled the issuing institution to increase its reserve ratio to the point that the metallic cover exceeded 70 percent in most years, as shown in figure 4.2. Hence, a basic difference between this period and the previous one is that Spain was easily able to comply with the Palmer rule. In fact, the Bank of Spain's gold coverage remained at around 60 percent throughout the interwar period, well above the international level⁴¹.

³⁷ Martin Aceña (1984), p.44

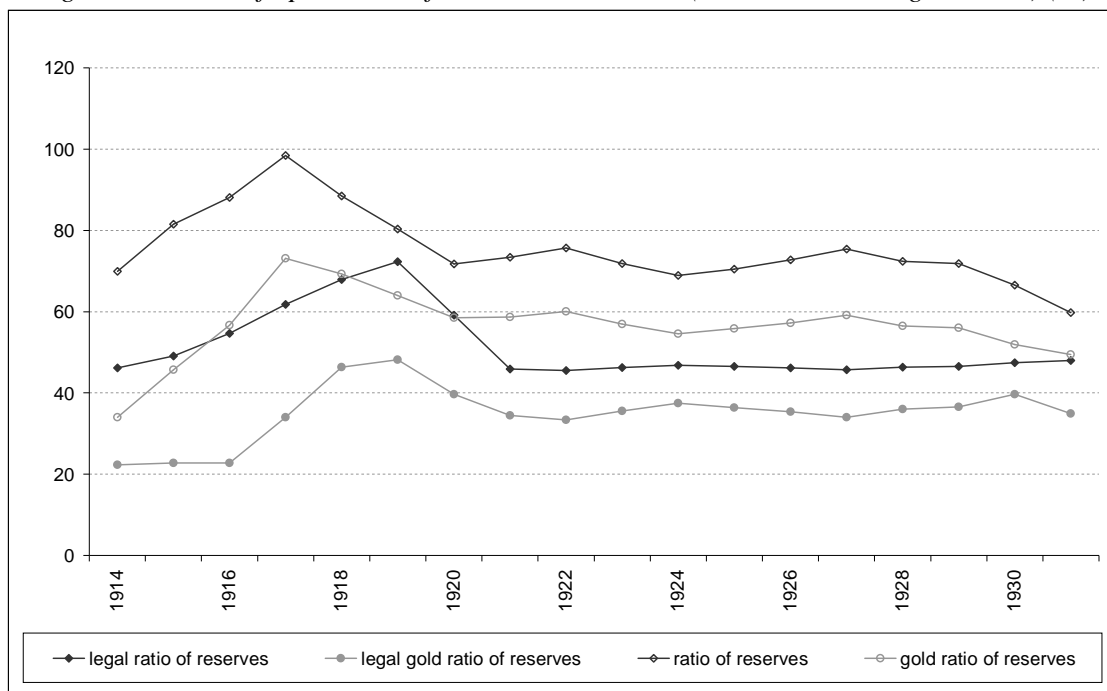
³⁸ Nurkse (1944)

³⁹ The same is true of any other relevant interest rate, such as the interest rate for loans secured with securities.

⁴⁰ Banco de España, Annual reports, 1920-1929

⁴¹ Nurkse (1944), pp.94-98.

Figure 4.2: Bank of Spain ratio of reserves, 1914-1931 (reserves/notes or gold/notes) (%)



Sources: ratio of reserves (notes/reserves) and gold ratio of reserves (notes/gold) calculated from the Bank of Spain balance sheets, Martín-Aceña (1985, table IV-1 and IV-2). Legal ratio of reserves and legal ratio of gold reserves from Martínez Méndez (2005, table 15.2.)

Between 1914 and 1920 the issue limit was extended six times reaching 5,000 million pesetas. However, despite this strong monetary expansion, the Bank of Spain had enough gold to back the banknotes in circulation for the first time since gold convertibility was interrupted. In fact, the large purchases of gold during the war enabled the Bank to maintain an amount of excess reserves far above the legal ratios, as shown in figure 4.2. Until 1919 the previously stipulated coverage obligations were maintained after each increase in the issuing limit, and coverage of 100% in gold was stipulated for the total new issuance⁴². When the war ended the purchases of gold were reduced and hence the rules for reserve ratios were changed.

⁴² The sole exception was the increase in August 1914, which did not provide for any minimum in gold or a maximum in silver. The issue limit was increased by 500 million pesetas on each occasion.

Table 4.1: *Legal maximum for banknotes issued by the Bank of Spain, 1914-1931*

	Minimum reserves		Min. Gold - Max. Silver	Maximum issuing/ Min. Capital
Decree 5.8.1914	up to 2000	according to earlier regulations		2500
	beyond 2000	100%		(notes < 16 2/3 paid up-capital)
Decree 10.3.1917	up to 2500	according to earlier regulations		3000
	beyond 2500	100%	100% gold	(notes < 20 paid up-capital)
Decree 6.8.1918	up to 3000	according to earlier regulations		3500
	beyond 3000	100%	100% gold	(notes < 23 1/3 paid up-capital)
Decree 2.1.1919	up to 3500	according to earlier regulations		4000
	beyond 3500	100%	100% gold	(notes < 26 2/3 paid up-capital)
Decree 27.12.1919	up to 4000	according to earlier regulations		4500
	beyond 4000	100%	100% gold	(notes < 30 paid up-capital)
Decree 7.10.1920	up to 2000	46.5%	28.5% - 18%	5000
	beyond 2000	70%	60%-10%	(notes < 33 1/3 paid up-capital)
Law 29.12.21	up to 4000	45%	40%-5%	5000
	beyond 4000	60%	50%-10%	(notes < 28 1/4 paid up-capital)
Decree 6.5.1931	up to 4000	45%	40%-5%	5200
	beyond 4000	60%	50%-10%	(notes < 29 2/5 paid up-capital)
Decree 27.5.1931	up to 4000	45%	40%-5%	6000
	beyond 4000	60%	50%-10%	(notes < 33 9/10 paid up-capital)

Sources: Data from Martínez Méndez (2005, table 15.2.). There was no legal limit on issue with regard to the bank's social capital in this period, and as such the above figures are an estimate.

Despite the fact that the Bank of Spain had enough reserves to sustain the stability of the peseta exchange rate, monetary policy was not conducted in way that would have led to the adoption of the gold standard. As shown in figure 4.3, the official discount rates were changed only occasionally and for many years the Spanish interest rates remained similar to -or even, at times, below- those of the major countries, although the balance of payments on the current account was persistently closed with deficits. The figure portrays both the official discount rate (for commercial transactions) and the rediscount rate (set at one point below the official rate which was applied only to financial institutions)⁴³. As was the case in the previous period, the profitability of the issuing bank was not maintained as a result of high interest rates.

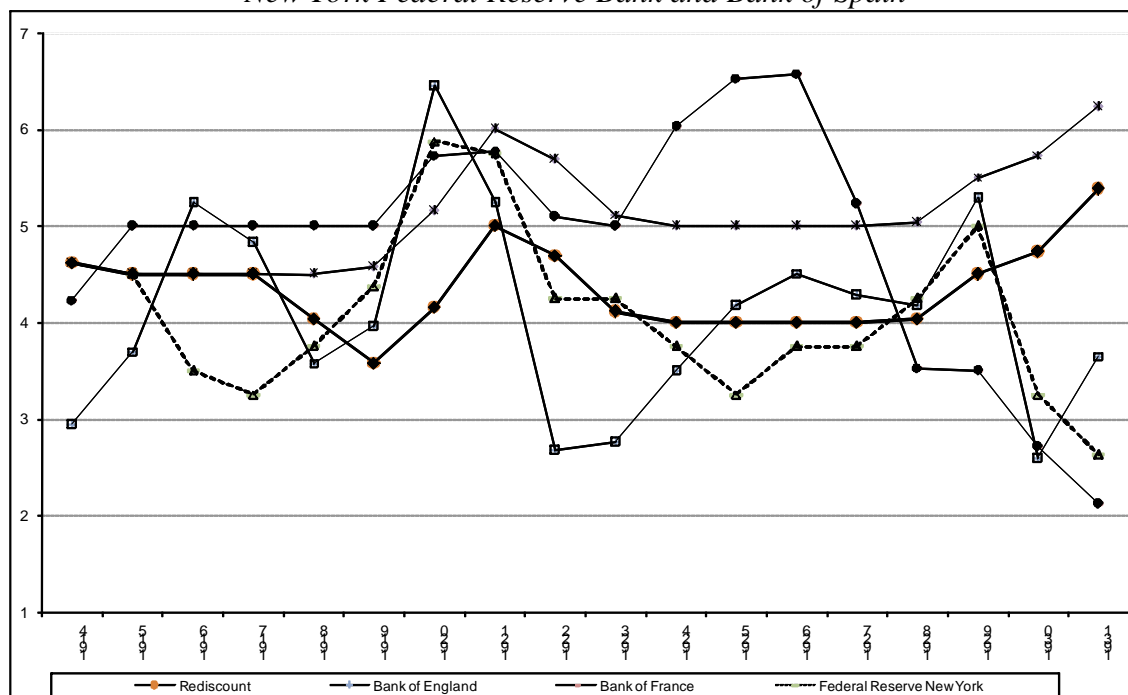
The official money rates were changed twice, first in 1920-21 and second in 1928-31. In both instances the increases came as a response to the depreciation of the peseta exchange rate. The initiative was taken by the Treasury which saw the fall of the currency as an economic and political failure, and a setback to its desire formally to join the gold standard club of nations. The government knew that the rates had to be rise in order to defend the peseta and to keep it stable thereafter. However, this policy met with the hostility of the Bank's board of directors reluctant to approve any rise because they thought it would reduce its commercial businesses and hence the level of its annual profits. Unconcerned with the stability of the exchange rate, and even less so with the government's aim to return to gold convertibility, the Bank tried to block or to minimize the increase in the discount rates. The Treasury had the upper hand in 1920 and, despite its resistance, the Bank had to give up and agree to a 1 percentage point rise. On the contrary, in the changes introduced in 1928-30 the board of the Bank was able to halve any of the government's proposed rates increases⁴⁴. Nevertheless, it is also true that the poor fiscal situation of the Treasury constrained its ability to implement a restricted monetary policy. Unable to balance the budget, high interest rates meant an increase in the cost of borrowing. Hence, the desire to stabilize the currency and adopt the gold standard at the 1868 parity, which required some degree of price deflation by raising the cost of money, was in conflict with the always pressing need to finance the budget

⁴³ After 1921 the Bank of Spain introduced a rediscount rate applied to all banks registered in the CSB

⁴⁴ Martín-Aceña (1984)

deficit. In fact, the adoption of the gold standard would have first required a drastic reduction in public expenditures and/or a radical tax reform in order to increase public revenues. Some minor fiscal changes were made but they were not sufficiently substantial to solve the intractable budget deficits.⁴⁵

Figure 4.3: Annual average discount rates: Bank of England, Bank of France, New York Federal Reserve Bank and Bank of Spain



Sources: For Bank of Spain (official and rediscount), Minutes of the Shareholders' General Meetings, 1914-1931. For Bank of England and for Reserve Bank of New York, Martínez Mendez (2005, Table A30.11). For Bank of France, NBER Macrohistory Database, <http://www.nber.org/databases/macroeconomy/rectdata/13/m13014.dat>.

The attempt to stabilize the peseta exchange rate thus was found less in the implementation of a firm and orthodox fiscal and monetary policy and more in the introduction of administrative devices. In October 1919, forward transactions were banned and some foreign financial transactions were subjected to a system of previous authorisation⁴⁶. Administrative intervention was extended in 1924, as the foreign exchange operations that could be freely performed became more limited. There then followed a short period during which the peseta appreciated and a wave of optimism led officials to believe that it was possible to adopt the gold standard at the historical parity. However, no monetary and fiscal policies were put in place in order to prepare the economy for a formal stabilization. The reversal began in mid-1928, when the peseta started to depreciate again. The Ministry of Finance reacted by establishing a new body, the Comité Inteventor del Cambio (CIC), to support the external value of the peseta. It was also the first step toward a more complete system of exchange control that came into place in 1930.

According to the Banking Act of 1921, which had empowered the government to intervene in the exchange market and mandated the Bank of Spain to assist in any attempt to defend the peseta rate and to share the expenses in doing so, the CIC was

⁴⁵ Comín (1996), pp. 81-85

⁴⁶ Eguidazu (1978), p. 44

endowed with funds provided by both the Treasury and the Bank in equal proportion. However, instead of committing part of its huge gold reserves (which would have been the most reasonable attitude), the board of the Bank invoked legal and statutory restrictions and forced the CIC to obtain a foreign loan in London to be used to intervene to shore up the peseta. When the CIC consumed the loan and no more funds were forthcoming, the value of the peseta plummeted. The intervention was costly and the loan was not repaid until the mid 1930s.

This later episode highlights once again the peculiar character of the Spanish issue institution. Despite enjoying a government franchise and the monopoly of issue, the directors and the shareholder of the Bank considered the “institution” a purely private concern. Therefore the Bank had to be run as any other financial company. Gold, as did any other assets in the balance sheet, belonged to the shareholders, not the Treasury, and should not be committed to any monetary policy adventure. For the Bank, its gold reserves were not a policy instrument that the Treasury could unrestrictedly employ. Gold was not there in the vaults of the institution even to assure the convertibility of its banknotes, but simply to maintain the confidence of the public in the Bank’s liquidity and solvency. The evidence seems to leave no doubt: by the early 1930s the Bank of Spain was still far from assuming the responsibilities of a central bank insofar as monetary policy is concerned. It also highlights that, without the cooperation of the bank of issue, it would have been extremely difficult to introduce the gold standard and to sustain the stability of the peseta exchange rate.

The evidence of the interwar years also shows the contradictions between the policies followed by the government. Monetary policy, because of the opposition of the Bank of Spain, and fiscal policy, because the Treasury’s lack of will to undertake radical tax reform, were inconsistent with the declared goal of adopting the gold standard at the ideal 1868 parity. Such a goal would have required a substantial degree of deflation, at which serious attempts were never made. The alternative to deflation would have been to opt for a more realistic parity. However, devaluation was never considered. Instead, a sort of escape route was attempted to sustain the value of the peseta: the introduction of exchange controls, although this policy was in contradiction to the adoption of the gold standard, based on the free movement of capital⁴⁷.

The enormous reserves of gold accumulated during the World War I were of no use at all in backing the government intention to join the gold standard. The Bank of Spain resisted any attempt made by the Treasury to use them to defend the exchange rate of the peseta. The Bank of Spain preferred to immobilise its gold in its vaults, and to hold reserves in excess of the already high level of reserve requirements set by the government. This way of ensuring credibility was very costly in terms of profits. However, the Bank’s shareholders were not affected, as a strategy begun in the late nineteenth century to dissociate the issue of notes from the Bank’s level of capital was continued during this period.

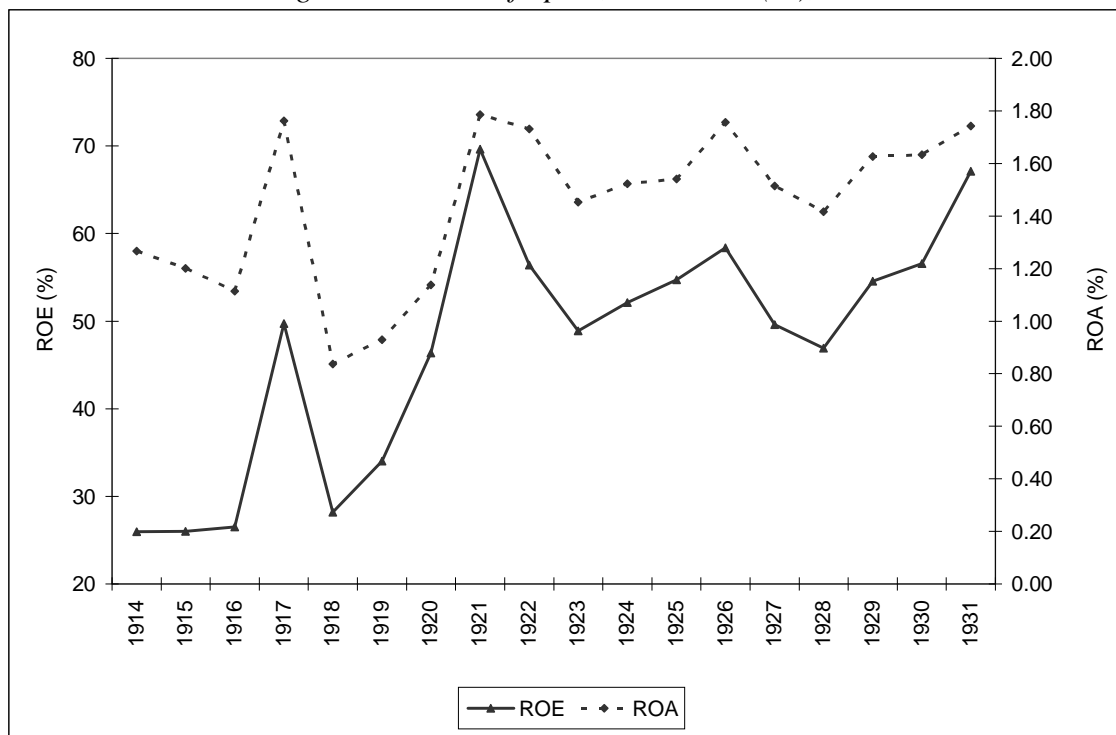
The behaviour of the two ratios that show the financial returns of the Bank’s operations and activities between 1914 and 1931 is shown in figure 4.4. The ROA fluctuated substantially during the war years and thereafter remained relatively stable at around 1.7%. On the other hand, the ROE increased to over 50% after 1920 and from 1923 onward its average value was about a remarkable level of 60%. The Bank of Spain was, indeed, profitable to its shareholders, who, on average, received a 25% return between 1914 and 1931, as can be seen in figure 4.5. This percentage was well above that obtained by the owners of the other Spanish financial institutions⁴⁸. Even in the

⁴⁷ Olariaga (1929) and Sarda (1936)

⁴⁸ Martín-Aceña and Pons (1996)

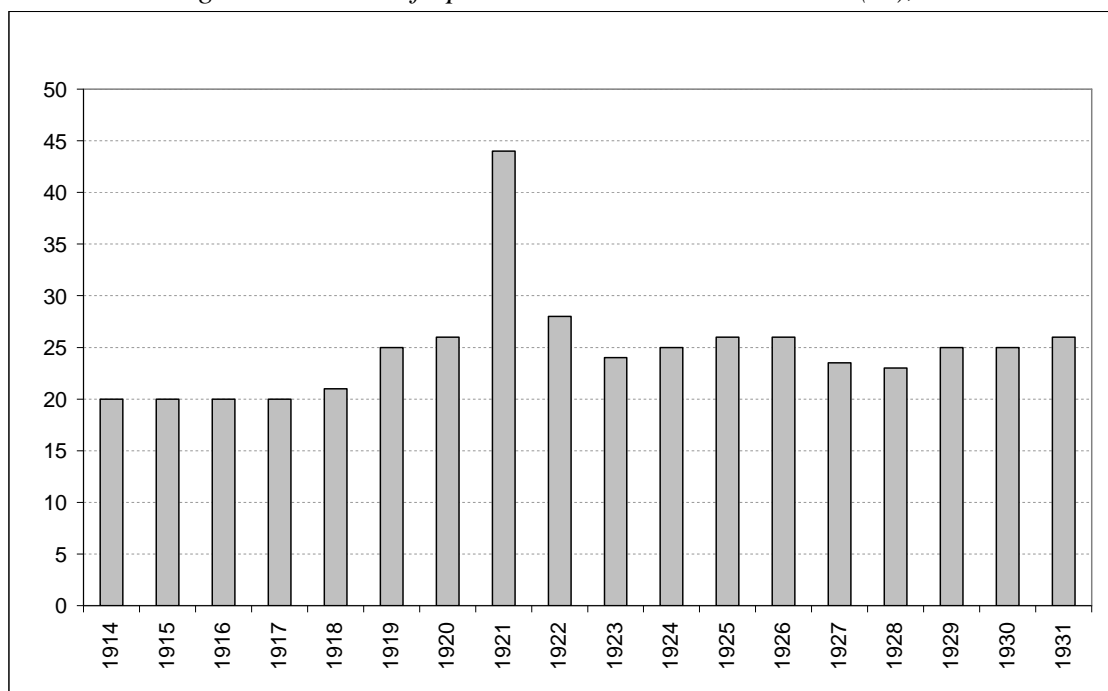
1920s, the Bank of Spain did not assume its role as a central bank. The attitude of the government to monetary matters was also inconsistent, because its inability to address the problem of insufficient public revenues was not compatible with its public concern over the exchange rate. In any event, the institutional structure made it impossible to overcome the agency problems that the government had with its banker, despite the Bank's gradual loss of independence. The beneficiaries were the Bank's shareholders.

Figure 4.4: Bank of Spain, ROE-ROA (%), 1914-1931



Source: ROE (%) = profits/owner's equity. ROA (%) = profits/total assets. Owner's equity from: Bank of Spain balance sheets, Minutes of the Shareholders' General Meetings, 1914-1931, Archive Bank of Spain. Total assets in Martínez Méndez (2005, Table 16.3). Profits from: Minutes of the Shareholders' General Meetings, 1914-1931 (appendix C), Archive Bank of Spain.

Figure 4.5: Bank of Spain annual shareholder return (%), 1914-1931



Source: Shareholder return = dividend/paid-up capital. Bank of Spain balance sheets, Minutes of the Shareholders' General Meetings, 1914-1931, Bank of Spain Archive.

5. Conclusion

There is no trace of a formal decision to interrupt the convertibility of the Bank of Spain's banknotes into gold in the minutes of the Board of Directors. However, the Bank no longer redeemed its notes in gold after the summer of 1883. The Bank's gold reserves reached a maximum of 125 million pesetas in 1881, and then fell sharply to 50 million pesetas in 1882. The drop was caused by a combination of factors, including the European financial crisis of the early 1880s, which reduced the levels of foreign investment, and a deterioration of the balance of payments on the current account. An ill-advised operation by the Treasury to reduce and to alter the maturity of the outstanding debt also contributed to the loss of gold⁴⁹. What the minutes of the Board for the years 1882 and 1883 reveal is the concern of the directors of the Bank for the lack of bullion (both gold and silver) on its balance sheet, as well as the concern that the public might refuse to accept the Bank's notes as they saw that that the institution was losing its gold⁵⁰.

No references were made to ending gold convertibility at the meetings of the *Junta Consultiva de la Moneda*, an official consulting body on monetary matters. The *Junta* had recommended the adoption of the gold standard as early as 1876, but no government decision had been taken by 1883. When gold convertibility was *de facto* suspended, the members of the *Junta* maintained absolute silence. In the few meetings of the *Junta* after 1880, the question of the lack of gold and silver coins in circulation was discussed, as well as the outflows of (gold) bullion due to the imbalance between the metallic ratio at the Madrid Mint and the market metallic ratio, which encouraged the exportation of gold. However, the *Junta* made no policy recommendation and

⁴⁹ Martín-Aceña (1994), pp. 137-39

⁵⁰ Bank of Spain, Minutes of the Board for 1882-1883

remained silent about the fact that the Bank of Spain was losing its reserves, which led it, first, to restrict and then end the convertibility of its notes into gold⁵¹.

Although it is a well-known historical fact that many countries' currencies which were on a gold standard "*lato sensu*" defined (i.e., without introducing money convertibility), the fact of the matter is that they were somehow able to maintain the stability of their respective exchange rates. Unlike most European currencies, the exchange rate of the inconvertible peseta against gold, and hence against the major currencies, fluctuated widely. This is apparent in table 3.1. The nominal exchange rate of the peseta varied a great deal, from 25.6 to the pound sterling in 1883 to a peak of 39.2 in 1898, and then back to 27.1 in 1913. During the 1920s, the Spanish authorities made various attempts to stabilise the peseta's exchange rate and to peg it to gold. figure 4.1 shows that they failed and that against the broader international trend, the Spanish currency remained off gold. The peseta experienced phases of appreciation, followed by phases of depreciation, which became particularly acute after 1928.

The minutes of the board of directors of the Bank of Spain suggest that the institution refused fully to accept its obligations as a central bank. First, it only acted as a lender of last resort under government pressure when successive banking crises jeopardised the stability of the financial system⁵². Second, the Bank's directors never considered the defence of the exchange rate to be one of their duties. Both before and after 1914, their main concern was maximising profits and the amount of dividends to be paid out to shareholders. Private interests prevailed over the public interest. Moreover, when the stabilisation of the peseta was discussed in official circles, the Bank strongly argued that the gold parity to be adopted should be that set in 1868, regardless of the circumstances and the economic changes that had taken place since that date. Any lower parity, which was also unpalatable to the Ministry of Finance, was opposed by the Bank despite the fact that it might have eased the adoption of a gold standard and stimulated foreign trade.

Spain's monetary experience is exceptional. All European countries were members of the gold standard club at one time or another. The gold standard was also adopted in America and in many Asian nations. The Bank of Spain was always willing to guarantee the silver convertibility of its paper notes. However, the stability of the exchange rate of the peseta was not among its concerns. All Spanish governments wanted the introduction of the gold standard, and deplored the instability of the peseta. Time and again, plans were made to join the international monetary system. However, the Treasury's fiscal policy was systematically inconsistent with such a goal. As stated by the renowned *Comisión del Patrón Oro* in its famous 1929 report, monetary stability was sacrificed at the altar of the public budget deficit. Spain's historic detachment from the world monetary system cost the country dearly in terms of both its debt burden and GDP growth, two questions that warrant further research.

⁵¹ Junta Consultiva de la Moneda, Minutes for 1882-1883 and Serrano Sanz (2004)

⁵² Martín-Aceña (2000b)

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