152. EUROPEAN STATE FINANCE (1348 TO 1700): SPAIN

By

Mauricio Drelichman
The University of British Columbia and CIFAR
997-1873 East Mall
Vancouver, BC V6T 2G2
Canada
drelichm@interchange.ubc.ca

Forthcoming in Gerard Caprio (ed.)
The Encyclopedia of Financial Globalization
Elsevier

Synopsis

In the early modern era, Spain went from being a fractious European backwater to rule over one of the largest empires in history. By 1700, it had once again sunk into relative obscurity. This article surveys the political institutions and the public finance instruments that made such a remarkable historical trajectory possible.

Table of Contents

Introduction

Political organization

- a) Crown and Kingdom
- b) Nobility
- c) The Church
- d) Dominions and Colonies

Revenues

- a) Direct taxes
- b) Indirect taxes
- c) American silver

Debt

- a) Juros
- b) Asientos
- c) Bankruptcies

Keywords

Bankruptcy, Bonds, Castile, Debt, Default, Habsburgs, Loans, Revenue, Silver, Spain

JEL Codes

N23, N43, F34, H1, H2

Glossary

Alcabala: A sales tax, technically amounting to 10% of all transactions in the kingdom of Castile, but almost always collected at a lower rate. It was the most important source of Crown revenue.

Arrendamiento: A tax farming arrangement whereby the Crown gave a private party the right to collect a tax in exchange for a lump sump payment. The tax farmer was entitled to keep any tax proceeds exceeding the payment to the Crown.

Asiento: A short-term loan between the Crown and international financiers.

Cortes: The representative assembly of the cities of Castile.

Encabezamiento: An agreement between the Crown and the Cortes, allowing the cities to manage tax collection in their own territories in exchange for a lump sum payment.

Juro: A lifetime or perpetual bond, backed by a specific revenue stream.

Medio General: The settlement of a default on short term debt.

Servicios: Direct taxes voted by the Cortes, and generally levied through personal impositions.

Tercias reales: A portion of the ecclesiastical tithes transferred to the Crown.

Tres gracias: Three taxes - the *subsidio, excusado*, and *cruzada*, collected by the Church on behalf of the Crown.

Reconquista: The seventh-centuries long process (8th - 15th) whereby the Christian kingdoms gradually expelled the Muslim rulers of Medieval Spain.

Introduction

In a strict sense, Spain did not exist as a political entity before 1700. Much like the idea of Italy survived the disintegration of the Roman empire and persisted until its nineteenth-century political reemergence, the Roman *Hispania* was a vague concept overhanging the military and political processes, commonly grouped under the name of *Reconquista*, that saw a smattering of Medieval kingdoms advance over the fragmented remnants of what had once been the mighty Caliphate of Cordoba. By the mid-thirteenth century, the Christian kingdoms had regained control over most of peninsula. While the emirate of Granada remained independent, from 1238 on it was a tributary of the kingdom of Castile.

The end of major fighting against the Muslim rulers produced a wave of political consolidation among the Christian kingdoms, with the final union between Castile and Leon under Ferdinand III in 1230 being the most relevant one. The kingdom of Castile would henceforth be the dominant political force in the peninsula, followed by Aragon and Portugal. The crowns of Castile and Aragon would be unified only in in 1475, following the marriage of Ferdinand of Aragon and Isabella of Castile, known as the Catholic Kings. Portugal would retain a separate king until 1580, when Philip II would unify the crowns of the entire peninsula. The upheaval of 1640, when the Count-Duke of Olivares tried to force political and military unification on Portugal and Catalonia, would give Portugal the chance to regain its independence for good.

This article is chiefly concerned with public finance in the Kingdom of Castile, which accounted for about 80% of fiscal revenue and economic activity in the territories that conform modern-day Spain. While the term Spain is used -as it was by contemporaries-to refer to the combined monarchy of Castile and Aragon, it is necessary to remember that the fiscality of both kingdoms was always kept in strict separation. Portugal is not discussed in this article.

Another important qualification is that, while a contemporary treatment of public finance consists of a discussion of fiscal institutions, revenues, expenditure, and debt, the expenditure part is omitted here. The machinery of the early modern state was extremely simple when compared to that of modern-day nations. The bureaucracy was limited and the only public good provided internally was the administration of justice. Upwards of 90% of expenditures were devoted to the military, sometimes used for conquest, sometimes for survival, and often as a piece of a geopolitical game with no clear winners or losers. Decisions over expenditures were made exclusively by the king and his entourage, with only a brief, unsuccessful attempt by the representative assembly to gain a degree of control. As a result, the history of expenditures of the Spanish kingdoms is the history of their military enterprises, which are best discussed elsewhere.

Political organization

a) Crown and Kingdom

The key political construct governing the medieval and early modern Spanish polities was the distinction between "Crown" and "Kingdom". The Crown, or government, was personified in the figure of the king, and consisted of a system of councils with executive responsibility over the different areas of public administration. This system evolved over the late Middle Ages and became consolidated under the Habsburgs in the sixteenth century. Although the Bourbon reforms of the 1700s altered their composition somewhat, the councils as key organs of government survived largely untouched until the liberal reforms of the 1830s.

In contrast to the Crown, the "Kingdom" was the set of different social strata, corporations, municipalities and organizations of the realm. The institution that gave life to the Kingdom was the Cortes, a representative assembly that dated back at least to the 12th century, and that in theory was to be constituted with the broadest representation. From the fourteenth century on, however, voting in the Cortes became reserved to the representatives of Castilian cities. The number of voting cities was definitively set at seventeen in the first half of the fifteenth century, with Granada becoming the eighteenth vote after its capture in 1492. From the late middle ages, therefore, the Cortes became the standard bearer of the urban elites. Although in the fifteenth century the Cortes convened at irregular intervals, from the sixteenth century on they sat on average every three years. Because their meetings could easily last one or two years, the result was that they were in almost permanent session.

The most important function of the Cortes was to vote on supply to the king. A number of taxes required Cortes approval. The most important among them were the sales taxes known as *alcabalas*, closely followed by the personal taxes called *servicios* (both discussed below). The Cortes could be reasonably expected to renew the previous level of supply; refusing to do so would have been considered an act of rebellion. When the king requested an increase in taxes, however, the Cortes could and did refuse, delay, or request concessions in return. The ability of the assembly to resist royal pressure was much diminished after the standoff between Charles V and the Cortes of 1519, which had been convened to authorize Charles' trip to accept the Holy Roman Crown. The cities resisted the move, knowing that Charles imperial ambitions were likely to be financed out of Castilian tax revenues. Charles moved the sessions of the Cortes to remote La Coruña, and either bribed or strong-armed the representatives into compliance. The vote was received with outrage throughout Castile, and a number of cities openly rebelled in what became known as the *Revuelta de las Comunidades*. Charles quashed the uprising, cementing power in his hands. The Cortes would nonetheless regain prominence in times of crisis, especially when large tax increases were required to revert dire military situations.

One key feature of the Cortes' role in granting supply was the designation of an income stream as "ordinary" or "extraordinary". In Medieval times, ordinary streams were permanent ones, while extraordinary revenues had to be reauthorized at every sitting. By the early modern period, both types of revenues were renewed as a matter of course, but the distinction still mattered, as long-term debt could only be issued against ordinary revenues. The Cortes, therefore, held one important tool of fiscal control, as the designation they attached to the different revenue streams effectively established a ceiling for long-term debt.

b) Nobility

The *Reconquista* had presented the monarchs with the need to consolidate their control over vast unpopulated areas. To do so, they enticed migration by granting a large degree of freedom to newly incorporated villages and cities. This process resulted in a very weak feudal structure, with the powers of the lord (*señor*) of a town severely restricted by the privileges previously granted to the municipal corporation. Some groups of towns, called *behetrías*, were even granted the ability to select their own feudal lord. Many territories did not become subject to a lord altogether, remaining in the king's demesne as late as the second half of the sixteenth century, when the Crown began to sell them to noble families to raise funds.

The group of feudal lords comprised the upper nobility. From the late Middle Ages on, their rights were usually limited to collecting rent over their lands, as well as certain other feudal dues. The administration of justice transitioned into royal hands early on, as did military service, which by the fifteenth century was entirely professional or mercenary. The nobility was thus drawn closer to the king, who kept it in check by carefully distributing key government posts among different noble lineages, assigning nobles to military command posts in remote locations, and periodically extracting monetary contributions.

d) The Church

The Catholic Church played a key role in the political and financial fortunes of the Spanish kingdoms. Starting with Ferdinand the Catholic, the kings of Spain were the closest allies and staunchest supporters of the papacy. In exchange, in the first quarter of the sixteenth century the Pope granted the monarchs the privilege of *patronato*, which entailed the authority to appoint bishops and prelates. The Crown also relied heavily on the Church as a fiscal institution, using its vast network of parishes, cathedrals, and charitable organizations to collect an array of taxes. In return, the Church enjoyed tax exemptions that gave it an advantage in owning land. Its position was further favored by the interpretation that long-term leasing of land from the Church did not constitute usury. Because land acquired by the Church could not subsequently be sold, this made it, in short order, the largest landowner in the kingdom.

d) Dominions and Colonies

In addition to the territory of modern-day Spain, early modern Spanish kings were the hereditary rulers of a number of European territories. The most important among them were Flanders and the Low Countries (inherited through the Burgundian ancestry of Charles V), the Kingdom of Naples and the Two Sicilies (a domain of the Crown of Aragon), and a smattering of northern Italian territories, North African enclaves, and Mediterranean islands. The richest of these were undoubtedly the Low Countries, although, from the mid-sixteenth century on, they would be an enormous drain on the Crown's finances as first Philip II, and the Philip III and Philip IV unsuccessfully tried to put an end to the Dutch Revolt.

While the European territories captured the lion's share of Spain's military efforts, it would be the New World colonies, quickly established after 1492, which would prove the one reliable source of income for the Crown. The silver from Potosí and Zacatecas allowed Spain to project its imperial power far beyond what other European monarchs could dream of, while the rich trade in goods and specie made Seville the commercial focal point of the West for a century.

Revenues

The process of state formation, which did not fully stabilize until the sixteenth century, left the Crown of Castile with a wide variety of revenue streams, the nature of which was largely dictated by historical events.

a) Direct taxes

The Medieval fiscal structure relied heavily on direct taxes. The most important among these were the *servicios*, contributions voted by the Cortes and apportioned among the different municipalities of the kingdom. Each municipality was free to collect its quota as it best saw fit; poll taxes and impositions proportional to wealth were both common. These received the collective name of *pechos*, and the contributors were therefore called *pecheros,* a word that became synonym with commoners. Nobles, clergymen, and the indigent were exempt.

A number of direct taxes were collected through the Church. The oldest of these were the *tercias reales*, which consisted of two ninths of the ecclesiastical tithes. The *tercias* were granted to the Crown in the thirteenth century on a temporary basis, and were made permanent by pope Alexander VI after the conquest of Granada. In the sixteenth century, three other ecclesiastical revenue streams - collectively known as the "three graces" - acquired importance as well. The first two were the *subsidio,* a tax on the rent perceived on Church property, and the *excusado*, an arrangement that gave the Crown the right to the entire tithe of the richest parishioner in each parish. Because of the difficulty of assessing the value of these two taxes, the Crown regularly negotiated a yearly lump sum payment with the bishops. The third grace, the *cruzada,* was a tax intended to finance wars in defense of the faith; it was first granted by the papacy during the war of Granada, and by the second half of the sixteenth century it was renewed as a matter of course. The tax was apportioned between parishes, where it was collected by Church officials and forwarded to the Crown. Overall, revenues collected through the Church fluctuated between 13% and 18% of royal income in the second half of the sixteenth century.

b) Indirect taxes

Direct taxes were the most efficient source of income while the extent of the market was limited. Once the *Reconquista* was over, Castile experienced a major growth spurt in population and economic activity. At the same time, Atlantic trade emerged as a major engine of growth. These developments made it possible to expand the scale of indirect taxes, which quickly became the dominant source of revenue.

The main indirect tax - and, indeed, the overall most important source of revenue - was the *alcabala*, or sales tax. Legally, the *alcabala* was payable by everybody regardless of social status, and was applicable to every transaction at the same rate of 10%. In practice, this was never applied, as, for an early modern economy, it would have been both extremely onerous and impractical to collect. Instead of direct collection, the king opted for one of two systems, which were employed in different periods or, sometimes, concurrently in different parts of the kingdom. The first option was farming out the collection of the tax in a figure called *arrendamiento*. The cities often objected to tax farming, as the arrangement made the tax farmers the residual claimants of the collected amounts, which prompted them to behave in an overzealous or downright abusive manner in the hopes of squeezing additional taxes out of the populace. The alternative, which became increasingly common in the sixteenth and seventeenth centuries, consisted in a negotiated yearly payment between the king and the Cortes, which then apportioned the total amount among the different jurisdictions. This system was called *encabezamiento*. Participant cities were free to collect their quota in any way they saw fit; they often did so by taxing only certain easy to monitor goods, such as those sold through licensed establishments. Cities could opt out of the arrangement and revert to a tax farm or direct collection.

In the sixteenth century, the *alcabala* eclipsed all other sources of revenue, representing roughly a third of royal income. Because of this, the value of the *encabezamiento* was the main bargaining tool that the Cortes had when trying to extract concessions from the king. This could result in tense standoffs, such as the one that emerged in the Cortes of 1573, when the king requested a tripling in the value of the *encabezamiento*. When the Cortes balked, the king threatened them with pulling out of the agreement altogether and collecting the tax at the 10% statutory rate. Knowing that the he did not have the manpower or the fiscal structure to do so, and that any attempt at forcibly raising taxes would make him extremely unpopular, the Cortes called the king's bluff. The negotiations dragged into 1575, and the impasse became a determining factor in that year's bankruptcy. With a default in royal debt looming, both the king and the Cortes compromised, agreeing to a doubling in the *encabezamiento*, which nonetheless came too late to avoid the suspension of payments. Only two years later, the Cortes complained that the tax was too high a burden on economic activity; having settled his debts and finding himself in a somewhat better financial position, the king agreed to a minor reduction.

The defeat of the "Invincible Armada" at the hands of the British in 1588 was a national disaster that permanently changed Spain's self-perception. On the financial front, the outfitting of the fleet had cost a full two years' worth of revenue. The destruction of a good portion of it, coupled with the impending threat of British and French invasion, required that its power be restored as quickly as possible. The Cortes were asked to vote a new set of excises, known as the *servicio de los ocho millones*, after the eight million ducats it was supposed to raise over six years. The tax was approved in 1591, but not before the Cortes extracted for the first time some degree of control over its use. This was the first time that the powers of a representative assembly in a large European state included control over expenditure, but it was not to last. Within a decade the king managed to pack the commission overseeing the *millones*, which retained control only in name. In successive years, the Cortes were asked to reauthorize the tax repeatedly, soon making it permanent for all practical purposes.

There were also several taxes on specific large-scale economic activities. The most important were those on the production of silk in Granada (*renta de la seda*), and the taxes over migratory sheep flocks (*servicio y montazgo*), which reached their peak in the late fifteenth and early sixteenth centuries.

After the excises, the most important indirect taxes were the internal and external customs. The former, called *puertos secos*, experienced a relative stagnation and decline throughout the modern period. At the same time, the large expansion in Atlantic trade switched the center of gravity to the import and reexport duties collected at the port of Seville and, to a lesser extent, in the northern ports. There were several duties imposed at different times and ports; the most important ones were the *almojarifazgo* and the *avería*. Also significant was the *derecho de las lanas*, which taxed exports of merino wool. By 1596, custom duties amounted to approximately 10% of total revenue.

The final large source of indirect taxation were the crown monopolies, which gained prominence in the final decade of the sixteenth century, and grew into one of the main royal revenue streams in the seventeenth. These monopolies were sometimes chartered, but often operated directly by the Crown. The most important ones, both established in the seventeenth century, were those on the paper required for all official acts (*papel sellado*) and on tobacco.

There were also a large number of minor income streams, many of them carryovers from medieval times. Since most taxes were stipulated in nominal terms, most of these vanished into insignificance after the large inflation of the seventeenth century.

c) American silver

Early Spanish explorers in the New World were especially single minded in their quest for precious metals. Although the early contact with the Mesoamerican civilizations rewarded them with a few stashes of plundered gold, true riches would come with the discovery of the rich silver mines in Potosí and Zacatecas in the 1540s. After a few years spent refining the method for smelting the low-grade Potosí ore, production started in earnest, and veritable rivers of silver made their way from the Bolivian plateau down to Lima to be assayed. From there, a fleet carried the bullion to Panamá; it was then transported overland to the Caribbean, and again by sea to Havana, the assembly point for the treasure fleets that crossed the Atlantic twice a year, bound for Seville. Production at Zacatecas did not reach significant volumes until the seventeenth century; once online, silver was shipped overland to Veracruz, and onwards by sea to Havana to join the treasure convoys.

The exploration of the New World was largely a private affair. The Crown did not have the resources or the political will to immerse itself in the discovery and colonization enterprise, preferring to charter exploration voyages and to step in with its political apparatus once the settlements acquired a permanent character. As a result, the vast majority of silver production was private. The Crown did nonetheless enforce a trading monopoly; all silver, as well as any other goods of colonial provenance, had to make their way to the city of Seville, where they were deposited in the House of Trade to be assessed and taxed. Only after the king had collected his share were they released to their owners. While such a system would normally encourage a healthy amount of smuggling, this was limited by the fleet system. If they wanted to avoid capture by pirates, commercial ships had no option other than to sail with an escort of armed galleons provided by the king; these same galleons then ensured that every last ship sailed up the Guadalquivir river to deposit its cargo in the House of Trade. Some smuggling did still take place, courtesy of corrupt ship captains who were subject to execution for stealing from the king if caught. Illegal commerce, nonetheless, did not reach a significant scale until the seventeenth century, when the king's penchant for confiscating the private holdings of silver deposited in the House of Trade made it more attractive.

Silver reaching Seville was taxed at a flat rate of 20% - the "royal fifth". In the second half of the sixteenth century, silver revenue grew to reach 25% of all royal income, second only to the *alcabala*. Bullion flows were very volatile from year to year. Production at the American mines suffered from large swings, caused mostly by the mortality inflicted on the local workforce by European-borne diseases. The sailing of the silver fleets, on its part, was strongly dependent on Caribbean weather patterns. In many years one fleet was either delayed or forced to cancel its sailing; on a few occasions both yearly fleets were altogether prevented from sailing, causing a cash crunch in the peninsula. These fluctuations could be smoothed through short-term borrowing, provided by international financiers. Their role is described in the section on debt below.

One crucial feature of the silver income was that mineral resources were considered part of the royal domain, and hence not subject to oversight by the Cortes. The king could use the proceeds from silver taxation as he best saw fit. The Habsburg monarchs took full advantage of this ability, leveraging the royal fifth to obtain large short-term loans from international bankers, and in turn using these funds to finance Spain's bid for European hegemony. Had the Americas not been so rich, the kings of Spain would have had to bargain more intensely with the Cortes for revenue. While a similar process in England led to the establishment of parliamentary democracy, Spain was never forced to take the key steps could have led to a broader spread of power.

Debt

The large yearly fluctuations in income and expenditures required the extensive use of debt instruments. Since the late Middle Ages, the Crown borrowed in long-term debt markets, using tax revenues as its collateral. In the early sixteenth century, Charles V started borrowing from international bankers short term as well, using the growing silver remittances from the American colonies as his implicit repayment guarantee. Throughout the sixteenth century, the credit system of the Spanish Crown acquired many of the characteristics associated with modern sovereign debt. Though lacking the crucial element of exchange-tradable bearer bonds (developed in the Netherlands), the Genoese loans to Philip II introduced contingent clauses and complex collateralizations that have since only reemerged in financial instruments in the early twenty-first century.

a) Juros

The long-term debt instruments were annuities or perpetuities known as *juros*. These instruments were akin to French *rentes*, Dutch *renten,* and Genoese *compere*. Their origins date back to the Medieval period, when they were used by monarchs to reward distinguished service by their subjects. At that time, *juros* mostly took the form of lifetime pensions, payable from specific revenue streams. By the fourteenth century, *juros* were regularly sold by the monarchs as a way of raising funds in exchange for surrendering the right to future revenue. Together with their commercialization, *juros* saw their term being lengthened to two lives and, eventually, in perpetuity.

The value of *juros* was determined by a number of characteristics. Chief among them were their term (lifetime or perpetual), their yearly payment, and the revenue stream backing them. To protect the Crown from a fall in interest rates, most *juros* were redeemable at the sovereign's discretion, but a few were not callable. All *juros* were issued in the name of a specific person, who was the only one authorized to collect the yearly payments. The Crown, however, regularly granted requests for transfer of title of perpetual *juros* in exchange for a fee (lifetime *juros* could only be transferred in special circumstances, as their value to the Crown depended on the age of the holder). Thus, while *juros* were never true bearer bonds, there is ample evidence of a healthy secondary market for them.

One important feature of *juros* was that they only bound the monarch to service them as long as the tax stream backing them produced sufficient funds. In that sense, they represented a contingent claim on fiscal resources, with the lender bearing the downside risk. *Juros* carried different levels of seniority, indicating the order in which they would be paid. Seniority had an impact on the price at which *juros* could be sold, with junior bonds fetching lower prices, and the gradient becoming steeper the more doubts there were about the health of a given tax stream. Because the eventuality of non-payment was built into the bond, failures to service *juros* when the specific tax revenues backing them proved insufficient were not considered bankruptcies.

The second half of the sixteenth century was a golden era for Castilian long-term debt. During the reign of Philip II, *juros* were considered one of the safest investments in Europe, and they could be found in the portfolios of banks and sophisticated investors throughout the continent. The Genoese banking families that underwrote the short-term debt contracts of the Crown also acted as its financial agents in long-term debt markets, purchasing or otherwise obtaining *juros* for large amounts, and selling shares in the bonds to individuals and institutions at the various European financial fairs. A number of factors contributed to the prominent standing of *juros* among international financial assets. First, they could only be issued against tax streams designated as "ordinary" by the Cortes. Between 1555 and 1596 only 55% of total income was considered ordinary, thus all but ensuring that the Crown would not issue *juros* in excess of its ability to service them. Second, although juros circulated widely throughout Europe, the vast bulk of them were held by domestic elites. Defaulting on them would have a large political cost for the king. Finally, while the king was technically not responsible for servicing juros whose underlying revenue streams underperformed, the Crown's actions revealed an implicit guarantee against catastrophic losses. For example, when the taxes on silk production in Granada collapsed as a consequence of the *morisco* rebellion of 1568, the king compensated the holders of *juros* backed by that revenue stream by swapping them for performing ones. Throughout the sixteenth century, *juros* accounted for the vast majority of Castilian borrowing, averaging well over 80% of outstanding debt.

As the financial difficulties of the Crown mounted, the status of juros deteriorated in the seventeenth century. As early as the 1610s, the treasury started defaulting sporadically on their service. In some years only half the payment was delivered to juros holders (*media* *anata*); in others, the payment was skipped completely (*anata*). At the same time, the rapid inflation caused by the issuance of *vellón* currency eroded the value of the coupon payments. Unsurprisingly, the Crown found it ever more difficult to sell new issues of juros, and had to settle for prices well below par. While juros were traded and serviced until the liberal reforms of the 1830s, their importance as a borrowing instrument and as an international investment of choice declined rapidly after 1600.

b) Asientos

Although juros accounted for the bulk of the Crown's borrowing, it was the short-term lending instruments, called *asientos*, that attracted the most attention from contemporaries and scholars alike. The term *asiento* designated a legal form that could be used for a wide variety of contracts, the most famous one being the chartering of the slave trade. Charles V first used *asientos* to seal short-term lending agreements with the German Fugger and Welser families. The first Fugger loan allowed Charles to outspend Francis I in buying electoral votes, and thus secure the Imperial Crown in 1519. Subsequent *asientos* allowed him to pursue military campaigns all over the continent. At a time when American silver production was still in its early stages, it was the growing economy of Castile that supplied the resources to service them.

The *asientos* between Charles V and the German bankers were largely personal loans. The king took them out in his own name, and the bankers lent based on their friendship and political alliance with him. The contractual forms were straightforward; a delivery of funds, followed by one or several repayments augmented by interest and, often times, by a currency conversion advantageous to the banker. Charles V clearly staked his reputation on the timely service of his loans. In the secret instructions left to Philip II upon his abdication, Charles strived to impress upon his son the need for fulfilling his financial obligations with international bankers with the utmost priority, even at the cost of neglecting other obligations to his own subjects.

Philip could not live up to his father's wishes for long; the crisis he inherited forced the first payment stop on *asientos* in 1557, soon followed by the second one, in 1560 (these bankruptcies, as well as those that would follow, are discussed in detail in the next section). Philip eventually settled the German claims by ceding control over the masterships of the military orders (which collected rent over vast tracts of land) and over the mercury mines at Almadén. Short-term lending resumed in full by 1566, when several Genoese families entered the sovereign debt market. The Genoese introduced a number of innovations that enhanced the yield profile of the *asientos*, allowed for a wide variety of contingencies, and closely aligned the king's repayment incentives with those of the bankers.

The first, and perhaps most important change introduced by the Genoese was the way they spread the risk of short-term loans. Rather than commit the bulk of their financial fortunes to the often rocky repayment record of the Crown, they leveraged their network of business associates and their ability to tap into international capital markets to build diversified portfolios that could withstand even the most severe crisis. After agreeing to underwrite an *asiento* for the king, bankers would then offer shares in it to their trading partners at the European payment fairs, as well as to smaller financial companies in Genoa. This practice allowed them to transfer as much risk as they wished downstream, while collecting a financial intermediation fee that averaged 1%. As a result, the large families that underwrote the *asientos* seldom had any enormous exposure to the Crown.

For example, when in 1575 Philip defaulted on 14.6 million ducats of short-term debt, only four families had an exposure in excess of 100,000 ducats of their own capital. This spreading of risk was multi-tiered. The smaller banks that bought shares in the *asientos* would in turn offer shares in their own participation to their retail customers in Genoa, in other Italian cities, and at the local exchange fairs. The short-term financing of the Spanish Crown thus became a multinational affair, trickling down to all levels of society with the ability to muster together even modest savings.

The Genoese also introduced a number of contractual structures designed to enhance the yield of their loans. In an age were usury laws were pervasive and could be readily invoked to call into question the legality of a lending agreement, no one was willing to explicitly charge interest in excess of the legal maximum. This limit varied between 8% and 12% in Philip's time, reaching 16% in the early years of the seventeenth century. Given the urgency with which some loans were requested, and the dire straits the Crown found itself in, many *asientos* commanded far higher premiums. Some of this excess return was obtained in the old-fashioned way, by contracting in different currencies and inflating the exchange rate. The Genoese, however, took advantage of their preeminent position as intermediaries in the juros market to open an additional channel for increasing their returns. In many *asientos*, the bankers requested that the king post collateral in the form of *juros* as a repayment guarantee for the principal and interest. If the king failed to repay the short-term loan as agreed, the bankers could then sell the collateral juros (called *de resguardo*) on the open market and recoup their investment. If the king repaid, the bankers had to return the juros. The bankers often used their clout with the king to demand the best available juros as collateral. They would then often be allowed to substitute the original bonds for others of the same face value and seniority, but backed by inferior revenue streams. These bonds could be purchased below par in the open market, thus allowing the bankers to increase their returns.

Another innovation introduced by the Genoese was the use of contingent clauses. Most contracts specified the source of funds intended for repayment, but also stipulated alternative scenarios. For example, a banker might be promised 100,000 ducats from the silver brought by first fleet arriving from the Indies. The contract might further stipulate that if the fleet did not arrive by a specific date the banker might be entitled to a penalty rate, to collect payment from other sources, or to liquidate the collateral. The combination of contingency and collateral clauses allowed the king and the bankers to contract over a wide variety of states of the world in a time where long-distance trade and large scale military enterprises created large volatility in the free cash flow of the Crown. Often adverse events - such as the late arrival of a fleet or the failure of a particular tax stream - allowed the king to lengthen the maturity of a contract, switch repayment locations, and even lower his overall payments. In other cases, the bankers were given the option to obtain early repayment by selling the collateral even if the loan was in good standing.

By their very nature, *asientos* were much riskier than *juros*. Although the contracts might specify the intended sources of repayment, no funds were specifically earmarked upon signing. If the cash flow situation was critical, the treasurer might delay issuing the repayment orders. At least 20% of *asientos* issued during Philip II's reign were not repaid on the timeline originally specified; payments could be delayed from a few weeks to several months. In some cases, the king and the bankers would renegotiate a consolidation of outstanding payments into a new *asiento*, with additional interest added to compensate for the unmet obligations.

c) Bankruptcies

Castilian *asientos* did not become famous because of their innovative contractual structures. They rather earned their celebrity status through their central role in the seven bankruptcies declared by the Crown between 1557 and 1647. Philip II first defaulted on the Fugger and Welser loans contracted by Charles V in 1557 and again in 1560. In 1575 he suspended payments on 14.6 million ducats of outstanding *asientos*, roughly two years' worth of revenue. In 1596, another payment stop affected the equivalent of two thirds of annual revenue. Philip III defaulted again in 1607, and Philip IV in 1627 and 1647. Spain went on to establish the record for the most defaults by a sovereign state, reaching 13 by the end of the twentieth century.

Scholars have long wondered what drove bankers to keep lending to a state so prone to defaulting on its obligations. Early explanations highlighted the belief that bankers were lured by high interest rates, thus giving monarchs the chance to ruin successive generations of lenders. A different theory posited that bankers could bring recalcitrant monarchs to their heels by refusing to transfer funds to the troops in the field, thus dooming the Spanish military efforts. Recent studies based on the full text of the contracts offer a more complete view. During the second half of the sixteenth century, Genoese bankers structured their lending relationships in overlapping syndicates. About one third of all loans during this period were underwritten by more than one lender, even though a single banker could have easily supplied the required amounts. The composition of these small-scale syndicates varied from loan to loan. The contracts also reveal a web of interlocking obligations among bankers, including cross-collection arrangements and cross-posted collateral. Taken together, these lending structure aligned the incentives of the participating banking families, ensuring that they could present a unified front to the king in case of a default. Although not all bankers participated in this coalition, those who did concentrated over 70% of total lending to the king, essentially making themselves irreplaceable. If the king defaulted, they could withdraw all lending. During settlement negotiations they presented a unified position, keeping the king honest and ensuring the best final terms possible.

Generally, bankruptcies started with a suspension of payments decree. The bankers, in turn, suspended all financial transactions with the Crown and opened up negotiations. Although occasionally the larger bankers would negotiate by themselves, the coalition structure eventually ensured that the king would end up bargaining with a group representing the majority of the outstanding debt. Offers and counteroffers were exchanged, and a settlement - known as a *medio general* - was eventually reached. Lending resumed shortly thereafter.

The resolution of the sovereign defaults in the sixteenth century was extremely efficient by modern standards. The 1575 default was resolved in less than two years with a reduction in capital of 38%. The 1596 default took less than a year to settle, and the capital reduction was 20%. In comparison, twentieth-century bankruptcies took an average 8 years to resolve. The Argentine default of 2001 saw the value of claims reduced in excess of 80%.

What allowed for such a smooth resolution of defaults in the sixteenth century? First, the cohesiveness of the Genoese network left the king little room for maneuver. Defaults on individual bankers were not possible, and information was exchanged quickly among all lenders. As a result, the king could not default opportunistically; he only stopped payments when he had run out of other options. This usually happened after a string of negative fiscal shocks. In 1557 and 1560, the wars initiated by Charles the V had consumed an enormous amount of resources without resulting in any tangible gains. In 1575, the Dutch Revolt and the Lepanto campaign were also major drains, while three years with low silver remittances left the king with no free cash flow. In 1596, the demands of rebuilding the fleet destroyed in the attempted invasion of England together with the onset of the Elizabethan war and one low silver year resulted in the same outcome. These events were all observable to the bankers. In terms of the modern sovereign debt literature, defaults were excusable.

Because the bankruptcies were caused by adverse fiscal events, settlements became possible as soon as a positive shock reversed the situation. Good fiscal news came from two sources. First, years of low silver remittances were usually followed by above average ones, as the nature of silver production and Caribbean weather conspired to create a cyclical pattern in the silver fleets. Second, and most important, the bankruptcies were very effective in convincing the Cortes that the king needed additional funds. Major tax increases often followed.

Bankers, on their part, were content to continue participating in the market once the defaults were settled. Bankruptcies were not catastrophic unforeseen events. Their likelihood was well known, and the potential losses were priced in when *asientos* were negotiated. Thus, the average *asiento* had a contracted rate of return of 19.7%. After accounting for losses sustained in the defaults, the ex-post rate of return amounted to

15.5%. Even allowing for transaction and intermediation costs, bankers would have obtained at least 2-3% in excess of the average *juro* yield. The question of why bankers kept lending to the Spanish crown in spite of the repeated bankruptcies has a straightforward answer: because, in the long run, it was profitable.

In the seventeenth century, the carefully constructed system of Castilian sovereign finance gradually came undone. First, the Crown started defaulting partially on *juro* payments with no compensation offered to the holders. These confiscations put an end to the status of *juros* as the safe cornerstone asset of the entire system. In particular, this meant that there no longer was a standard, universally recognized way of collateralizing *asientos*, or of tying their repayment to tax-backed securities that would perform with reasonable certainty. At the next bankruptcy, in 1607, the Genoese openly mused about abandoning the business of lending to the Spanish Crown altogether. They continued to participate for one more round, finally withdrawing after the suspension of 1627. From then on, it would fall to Spanish and Portuguese bankers to continue to lend to the king. They, too, would drastically reduce their participation after 1647.

It is possible to think about sovereign lending to the Habsburg kings as acquiring an equity stake in the fortunes of the Spanish empire. The Genoese knew full well that the funds they supplied would be used in the war against the Dutch rebels and the attempt to invade England. They agreed to make those loans because, like most contemporary observers, they thought that the campaigns had a reasonable chance of succeeding. If victorious, Castile would have had plenty of spoils to share with her supporters. Negative outcomes prompted bankruptcies, but their effects were priced into the loans. As the crisis of the seventeenth century set in, the potential upside of lending to the Crown steadily eroded, finally disappearing with the defeat in the thirty years war. There was no further reason to invest in an irretrievably declining power whose glory days were long past. In just another half century, the fate of the Spanish Crown would be decided in a military conflict between the major powers, with Spain herself a mere bystander.

Further reading

Alvarez Nogal, Carlos. 1997. *El Crédito de la Monarquía Hispánica en el Reinado de Felipe IV*. Avila: Junta de Castilla y León.

Artola, Miguel. 1982. *La Hacienda del Antiguo Régimen*. Madrid: Alianza.

Carande, Ramón. 1987. *Carlos V y sus banqueros*. Barcelona: Crítica.

Conklin, James. 1998. The Theory of Sovereign Debt and Spain under Philip II. *Journal of Political Economy* 106 (3): 483-513.

De Carlos Morales, Carlos Javier. 2008. *Felipe II: El Imperio en Bancarrota*. Madrid: Dilema.

Drelichman, Mauricio, and Hans-Joachim Voth. 2008. Institutions and the Resource Curse in Early Modern Spain. In Helpman, E. (ed.) *Institutions and Economic Performance*. Cambridge: Harvard University Press.

———. 2010. The Sustainable Debts of Philip II: A Reconstruction of Castile's Fiscal Position, 1566-1596. *The Journal of Economic History.* 70 (4): 813-842.

———. 2011. Serial Defaults, Serial Profits: Returns to Sovereign Lending in Habsburg Spain, 1566-1600. *Explorations in Economic History* 48 (1): 1-19.

———. 2011. Lending to the Borrower from Hell: Debt and Default in the Age of Philip II. *The Economic Journal,* forthcoming.

Fortea Pérez, José Ignacio. 2009. *Las Cortes de Castilla y León bajo los Austrias: una interpretación.* Junta de Castilla y León.

Marcos Martín, Alberto. 2000. *España en los siglos XVI, XVII y XVIII : economía y sociedad*. Barcelona: Crítica.

Parker, Geoffrey. 1998. *The Grand Strategy of Philip II.* New Haven: Yale University Press.

Sanz Ayán, Carmen. 2004. *Estado, monarquía y finanzas. Estudios de historia financiera* *en tiempos de los Austrias*. Madrid: Centro de estudios políticos y constitucionales.

Thompson, I. A. A. 1976. *War and Government in Habsburg Spain*. London: The Athlone Press - University of London.

———. 1994. Castile: Absolutism, Constitutionalism, and Liberty. In *Fiscal Crises, Liberty, and Representative Government, 1450-1789*, 181-225. Stanford: Stanford University Press.

———. 1994. Castile: Polity, Fiscality, and Fiscal Crisis. In *Fiscal Crises, Liberty, and Representative Government, 1450-1789*, ed. Philip T. Hoffman and Kathryn Norberg, 140-180. Stanford: Stanford University Press.

Toboso Sánchez, Pilar. 1987. *La deuda pública castellana durante el Antiguo Régimen (juros) y su liquidación en el siglo XIX*. Madrid: Instituto de Estudios Fiscales.

Ulloa, Modesto. 1977. *La hacienda real de Castilla en el reinado de Felipe II*. Madrid: Fundación Universitaria Española, Seminario Cisneros.

Yun Casalilla, Bartolomé. 2004. *Marte contra Minerva. El precio del imperio español, c. 1450-1600.* Barcelona: Crítica.

Bio

Mauricio Drelichman is an Assistant Professor of Economics at The University of British Columbia and a Scholar in the Canadian Institute for Advanced Research. His research focuses on the institutional and financial history of early modern Spain. His publications have examined the impact of silver imports on the Spanish economy, the institutions of the lower nobility, the efficiency of the privileges granted to migratory shepherds, and the structure and impact of sovereign lending in the sixteenth century.