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Sixteenth Century Spanish Fiscal Mismanagement and Debtor Emperors: An Economic History Review of Spain under Charles V in 1528 and under Philip II in 1575

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-- Brian S. Jeon

Introduction

There is a story often told about early modern Spain, one of a meteoric rise and equally resounding fall from the kingdom's zenith of immense wealth, power, and international influence over the course of the sixteenth century. In this story, Spain's rise to power in the sixteenth century is attributed to the wealth found in its monopolies in the Americas, which fueled massive expansion of its military might. Yet, the bold obviousness of the New World monetary windfall often prevents recognition of the fact that, by the turn of the sixteenth century, Spain was already well-poised in the European political landscape to become the region's most powerful nation. Moreover, Spain was equally poised for downfall long before its glory could be enjoyed.

The bankruptcies of Philip II were numerous despite the purported wealth of Spain under the Habsburg kings. Philip inherited massive debts from his father Charles V, and Philip's Spain defaulted in 1557, 1559, 1574, and 1596. The intricacies behind each bankruptcy revealed faults in the Spanish financial system; yet while past research has maintained these defaults to be a result of poor fiscal and debt management, the most recent research has quantitatively offered us a different perspective. It remains evident that each bankruptcy was damaging, and often detrimental to the financial standing of the Spanish empire, albeit for different reasons that many would think. The frequency and the continuous nature of the defaults reveal that Philip was able to borrow regardless of his insolvency. This fact alone reveals that something far more insidious was behind the decline of the Spanish financial position than simple mismanagement.

Economic research into sixteenth-century Spain has been a centuries-old endeavor. The Spanish empire's meteoritic rise to wealth and power in the sixteenth-century was followed by bankruptcies and financial ruin that devastated Spain for centuries. Twentieth-century investigations of the financial trends in the sixteenth century followed numerous global financial crises in the 1930s and 1980s; more recently, the 2008 global economic meltdown has once again renewed interest in case studies of nations with declining economic health, with sixteenth-century Spain being almost legendary in its perceived failings. The economic and econometric tools developed in the twentieth century allowed for quantitative analysis that examined long-run effects of debt and capital management, and sixteenth century Spain became a focal point of exemplary failures of debt management and fiscal management in general. Yet these researchers encountered a problem that persists to even today: data from the period is difficult to find, and much of the archival sources are difficult to locate and compile. Not only this, Spanish scholars long lamented the sudden loss of their Golden Age era, and lasting bias against Spanish fiscal management during the sixteenth century perpetuated by iconic works like Fernand Braudel's *Mediterranean* created a vision of Spain that was more than despondent. The sudden decline of Spain following its powerful reign during the sixteenth century proved puzzling and even depressing to those who wondered if Spain could have maintained its position.

The dialogue and research surrounding sixteenth-century Spain has evolved considerably in the twenty-first century, as recent analysis suggests that Charles and Philip had a sound fiscal position to operate from.[1] The shift in the twentieth century from research on early modern Spanish agriculture and wars towards a focus in the early twenty-first century on Spain's actual fiscal management has been monumentally revealing in deciphering the true causes of the Spanish decline.

The multiplicity of factors impacting Spain's numerous bankruptcies in the latter half of the sixteenth century under the rule of Philip II made it difficult to pinpoint what was responsible for the sudden fiscal disasters following Charles's reign. Furthermore, scholars have overlooked multiple causes in favor of finding a unifying trend. Earl J. Hamilton wrote possibly the most influential study into the price revolution of sixteenth-century Spain in *American Treasure and the Price Revolution in Spain, 1501-1650;*[2] he contended that the fiscal position of the Habsburg kings were not only poor, but slowly made weaker by inflation. His latter point remains valid to this day, but Hamilton's former point that the fiscal position was weak has been disproven. His later works also correlated the inflationary pressures of war in Spain; omitted, however, was the larger fiscal position of Spain and its healthy grow of commerce that masked the effects of inflation earlier on in the century. Henry Kamen wrote many comprehensive works on the political sphere

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[1] Hans Voth and Mauricio Drelichman, *Lending to the Borrower from Hell* (Princeton University Press, 2013). Voth and Drelichman's data analysis offers compelling evidence to that the fiscal position was relatively healthy, but rather mismanaged. Refer to chapters 3, 5, and 6 in this book for more informed reading on debt analysis. Several standardized regression models utilized by Drs. Voth and Drelichman clearly demonstrate with reasonable assumptions that debt was largely sustainable, and sophisticated lending markets actually were comparatively healthier in comparison to competing nations like England throughout the sixteenth century.

[2] Earl J. Hamilton, *Revisions in Economic History: VIII – The Decline of Spain*, "The Economic History Review," Volume A8, Issue 2 (1938), 168-179.

and the economic pressures of multiple banking cartels; he maintained the catastrophic nature of Philip's defaults.[3] The general view of national bankruptcies in the modern day creates erroneous assumptions about bankruptcies in the sixteenth century as well: the results of the serial bankruptcies by Philip were much less destructive vis-à-vis the economy than what one would imagine to occur if a nation defaulted today.[4]

Thus, earlier research by historians like Hamilton, Kamen, and Braudel has attributed Spain's troubles to one of several problems, e.g., constant and expensive wars or poor management of its fiscal position. This paper will argue that these factors were among a multitude of problems that had an active role in the decline of Spain's fiscal position. The fact that Spain experienced a financial decline becomes even more surprising when the most recent research by scholars suggests that Spain enjoyed a healthy debt-to-equity ratio throughout the century, but was merely subject to price level shocks. Thus, if we are to properly understand the fiscal difficulties under Charles and Philip, we must analyze a multiplicity of trends without sacrificing each component in favor of a unifying trend. We must also examine the question of how Spain had healthy debt levels but nonetheless declared bankruptcy five times in the sixteenth century.

First, before any meaningful discussion of sixteenth-century Spanish defaults can be had, it is critical to fully comprehend the nature of the defaults themselves.

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[3] Henry Kamen, *Empire: How Spain Became a World Power.* (New York: Harper Perennial, 2004).

[4] Bankruptcy by a nation in today's world would be catastrophic. Essentially, all trade with the said nation would stop, its population would rebel and riot, and it would not be able to borrow for some time, preventing a speedy recovery. This was not the case in sixteenth-century Spain, as I will discuss at length later on in the paper. For example, Spain in the sixteenth century was not catastrophically destroyed like Greece in 2008, when Greece defaulted and essentially had to sell off nationalized companies to pay off existing debt, and saw a sharp decline in GDP and trade.

Understanding Spanish defaults of the sixteenth century cannot be done in an anachronistic fashion; that is to say, the catastrophic nature of modern day defaults by governments follows from a singular event by which a government cannot pay its obligations, whereas sixteenth-century restructuring followed a much less definitive procedure, particularly due to the fact that repayment of loans was constantly negotiable. In Spain, this was partly a result of the massive amount of collateral that Philip held with his ownership of Crown lands, but mostly because lenders were flexible in repayment terms and conditions so long as they were compensated for the late payments. Default only occurred when these re-negotiated contracts were not met, and contrary to popular belief, default occurred on both sides of the banking parties, with some lenders not being able to give Philip withdrawal of deposits, and Philip not being able to meet lending conditions.[5] Moreover, the lenders were constantly willing to lend to Philip, as the loans remained profitable despite occasional defaults.[6] Not only this, the wealthy banking cartels of the day, e.g. the Fuggers of the Holy Roman Empire and the Genovese banking cartels, had agreements to ensure mutual survival and benefit: Philip II was only able to default if he had another lender willing to lend to him; otherwise, he would have to maintain good relations with his current lenders. Thus, the successful lending houses mutually agreed not to lend to Philip if he defaulted to either one of them, essentially creating a unilateral relationship between Philip and a massive

[5] Drelichman and Voth, *Lending to the Borrower from Hell*, 38.
[6] Ibid.

international banking cartel. He would have to pay his loans, or face the possibility that he could not borrow from any other major house.[7]

Secondly, the high number of defaults by Philip in the latter half of the sixteenth century led some to believe that the lenders lost tremendous amounts of monies by lending to him. This is not logical: the lenders clearly kept lending to Philip throughout his reign, regardless of the fact that he defaulted frequently; this was simply due to the fact that there exists no evidence that the bankers lost monies from his defaults, having made sufficient profit prior.[8]

Furthermore, because sixteenth-century borrowers and lenders had much less financial information to operate on, there was a permanent sense of uncertainty regarding financial stability, one that both the Spanish crown and the bankers fully understood. For example, ships carrying monies could be late or they might be pirated; in this multitude of uncertainties, the lending and repayment terms were already flexible. Technical defaults did occur as a result of any combination of these unfortunate events leading to late payment, but did not result in much punitive measures.[9]

Thirdly, there remains a misconception stemming from twentieth-century economic history vis-à-vis the fiscal management by the Spanish crown. With limited data, lack of computational powers, and a reliance on outdated secondary sources that all decried the failures and embarrassing defaults of the Spanish Crown, much of the twentieth-century research purported to demonstrate the errors of the

[7] Ibid., 36.
[8] Ibid., 38.
[9] Ibid., 39.

sixteenth-century Spanish fiscal policy. The Spanish Habsburgs were portrayed as fiscally irresponsible immediately following their reigns, with their governments falling behind in terms of accounting and proper management of monies.[10] Even venerated historians such as Braudel pointed out detrimental practices of the Spanish government, including granting tax deductions to the bourgeoisie.[11] Yet the fiscal position and maintenance of accounts by the Spanish were much better than their competitors at least until 1580; despite the outmoded and cumbersome nature of Castilian tax codes at the ascension of Charles V, Castile was a thriving nation whose economy was the envy of most other European powers throughout the sixteenth century.[12]

Following these realizations from the most current research, there remain several puzzling questions: why was Charles V able to avoid default in 1528 when Philip II defaulted five times in his reign from 1557 to 1598? Why was the Spanish empire positioned for decline for the next two centuries? If debt levels averaged ~500% of GDP throughout Philip II's reign, is it feasible that, while debt was sustainable, it was unmanageable? This paper aims to answer these questions using long-run data analysis of Italian GDP from 1500-1800, as well as tracing the long-run effects of Spanish bonds (*juros*) during the reign of Philip starting in 1557. Finally, it will explore the fact that Charles V and Philip II had neither econometric tools nor access to data that hindsight offers us, thus proving that their management could not be as fluid and well-informed as those of modern day governments.

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[10] John A. Marino, "Creative Accounting in the Age of Philip II? Determining the 'Just' Rate of Interest." *The Historical Journal*, 36 (1993), 764

[11] Fernand Braudel, *Mediterranean: The Mediterranean World in the Age of Philip II,* Vol. II, trans. Sian Reynolds. (Berkeley: 1995), 725-726.

[12] Drelichman and Voth, *Lending to the Borrower From Hell*, 60-79.

This paper will explore two critical points in sixteenth-century Spanish economic history, namely 1528, under Charles V, and 1573, under Philip II. The year 1528 was a critical time for Charles V, who nearly had to declare bankruptcy, as he was unable to remain liquid enough to pay creditors, and yet he staved off the embarrassment of default by utilizing American territories as collateral. Philip II experienced constant anxiety in terms of having to pay off creditors during his reign, due to the fact that his armies would mutiny if the creditors were not paid: the armies' wages were paid by the creditors, and if the creditors were not paid, neither were Philip's armies. Charles V's brush with insolvency involved the German banking family of the Welsers in 1528, while Philip II was indebted to the Genovese banking cartels for much of his short-term debt and was still saddled in 1575 with the long-run debt accrued by his father with the Fuggers years before. By examining how the numerous factors linked together, we can trace how each component impacted both Charles V and Philip II, and what caused Philip to default when his father was able to avoid such a calamity.

Part I: 1528: Charles V's Brush Against Financial Insolvency

When Charles V of the Habsburgs began his reign in Spain, he was but a young man. In fact, he was only sixteen years old at the time of his ascension in

1517[13]; only a short three years later would he be elected Holy Roman Emperor in Germany. His Spanish inheritance had also given him the Americas, with their as yet undiscovered riches that he would soon plunder for glory. This was an empire like Europe had never seen. With his inheritance in Spain, Austria, and Burgundy, Charles V controlled realms that by sheer landmass, nobody had seen since the *Pax Romana* over a millennium prior. With his Spanish coronation, Charles also controlled large portions of Aragonese territory in Italy, much to the frustration of Pope Clement VII and Francis I of France, both of whom had military ambitions to take over the Italian peninsula. Indeed, as caretaker of these lands, Charles V inherited both greatness and a great burden. His enemies were many, with the Turks to the East, Lutheran dissidents in Germany, military pressures in Italy, and France conspiring against him. It was in this dangerous political landscape that Charles would have to conduct his stately business.[14]

The beginning of Charles's reign was most inauspicious. Upon his coronation in 1517, his foreign birth and education were met with open hostility by some of his Spanish subjects. But neither the Spanish merchants nor the *Cortes* found the foreign king distasteful enough in 1520 to fully support the commoners in the Rebellion of the *Comuneros*, which Charles' armies promptly subdued.[15] Spanish dissidents initially resisted Charles's reign over them, mistrustful of his commitment to other realms: the *Comuneros* were in fact rebelling against the fact that Charles

[13] Technically, Charles did not inherit the throne for quite some time, as his mother did not abdicate, but he took over power; due to her alleged mental instability, his mother was labeled Joanna the Mad and confined to a castle where she had no political power. J.H. Elliot, *Imperial Spain: 1469-1716* (New York: Penguin, 2002), 140-150.
[14] Kamen, *Empire: How Spain Became a World Power,* 5-12.
[15] Ibid., 50.

was physically seldom ever in Spain. Charles was not even present in Spain during the rebellion, having already left a mere two years after his coronation to be elected Holy Roman Emperor in Germany. The religious and political divisions in Germany stemming from the Luther affair occupied Charles's attention. Upon returning to Spain, Charles was pleased to find the *Comuneros* Revolt had been put down. Charles magnanimously refused his advisers' calls for public executions and granted a general pardon to the rebels, hoping to mend his relationship with the alienated subjects. He went so far as to agree to many demands of the rebels, most importantly, their call for him to reside in Spain instead of absenting himself to attend to his other numerous realms.[16] The Spanish populace would eventually come to admire their king, particularly as he began effectively defending his realms against foreign invasions.[17]

When Francis I of France invaded and captured the northern Italian city of Pavia in 1525, Charles quickly retaliated to reclaim Spanish territory.[18] At the Battle of Pavia in 1525, Charles's forces captured Francis; moreover, the Spanish saw first-hand how their new king would protect their territories. However, even as Charles rejoiced in his military success, he was called away by the delicate politics surrounding his other kingdoms. He was simultaneously fighting numerous battles in Germany to ward of the advances of the Turks, and to make matters worse, the French King's ally, Pope Clement, had demanded the release of Francis I; as a

[16] Henry Kamen, *Philip of Spain* (New Haven: Yale University Press, 1997), 1.
[17] Kamen, *Empire: How Spain Became a World Power,* 56.
[18] Ibid., 43-75. Kamen explains how Spain had over the previous century accrued key provinces in Italy, and grew to control the entire peninsula during Charles's reign.

Catholic king, Charles had to obey.[19] This left Charles with the politically humiliating task of releasing Francis I and relinquishing control of the realms under Francis's rule that he had captured. To make matters worse, upon his release from imprisonment, Francis I disregarded the political concessions that had been a prerequisite for his release. Despite marrying Charles's eldest sister Eleanor during his captivity, Francis I had greatly embarrassed Charles and cast doubt on his ability to enforce treaties.[20] The alliance of Francis I and the Pope undoubtedly complicated matters for the Catholic Charles. Charles's temporarily unsupervised armies had sacked Rome in 1525 after defeating Francis; this soured matters between the Pope and Charles, and compounded the Pope's resentment towards Charles, particularly due to the fact that the Pope had personal desires to control more of the Italian Peninsula.[21]

More than this, defending his realms was a costly business for Charles. The battles in Italy from 1525 to 1527 had cost Spain dearly. As there was no standing army save for the nobles who maintained their battle gear simply for showcasing purposes, Charles had to commission expensive mercenaries and generals from Switzerland and Germany to fight his numerous battles.[22] These veteran mercenaries were no doubt skilled, but also required an extremely high maintenance fee. The instability of his realms meant that Charles had no respite from these expenses, but had to constantly employ these mercenaries to defend his realms from foreign attack.

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[19] Ibid.
[20] Ibid.
[21] Ibid., 58.
[22] Ibid., 48.

Luckily, while Charles faced many troubles on the European continent, Spain's American expeditions had been immensely successful, with the successful campaign of Hernan Cortés in 1521 having secured Mexico.[23] Spain had established a naval and military presence in the region, with its influence spreading far beyond the famous Aztec conquest to encompass the northern regions of South America. While Francisco Pizarro had yet to conquer the Incas in 1532, Spain's American Empire had expanded greatly. Charles' debt would hinder the rapidly expanding campaigns in the Americas, as he was already unable to pay a key creditor in 1528. Charles would have to leverage his American territories to keep up his credited accounts.

The famously wealthy Augsburg merchant house of Welser had extended credit to Charles, and the young emperor was unable to pay the great deficit he had accrued. As the creditors financed his mercenaries, it was imperative that Charles maintain good relations with them. The delicate situation caused by the military disaster of the Sack of Rome[24] meant that Charles had gained nothing from his armies' Italian campaigns. Worse still, Charles had lost political capital in all of Christendom as a result. Consequently, Charles needed to sustain his debt to maintain his armies – France and Italy bordered not only Spain, but also his other realms in the Low Countries and in the Holy Roman Empire, requiring a state of constant readiness. Charles was desperately short of monies. His expenses were already far beyond his revenue, and he had to resort to undertaking great amounts

[23] Ibid., 27.

of debt to supply his deficit.[25] Charles could not rely on his Empire's tax base anymore: he required a larger form of collateral.

The Welsers constituted one of the major European banking houses, and had established a base of operations in Spain, catering to Charles' incessant need for borrowed capital. They also set up operations in the Spanish settlement of Santo Domingo,[26] conveniently positioning their firm to reap the benefits of Spanish exploration. It is evident that the Welsers saw the value of expeditions to the Americas, as they had poised themselves in these locations. In a hasty deal forged between the Welsers and Charles in 1528 with a quasi-legal amalgamation of exploration and corporate interest, Charles granted Welser agents, Heinrich Ehinger and Hieronymus Sailer, the right to explore the coast of Venezuela from the easterly point of Cape Marcapana to Cape de la Vela some distance away to the west. In essence, Charles was granting the right to them to explore a very large portion of coastal regions that would have been ideal for settlement. Charles then allowed the Welsers to forge a joint venture with the explorers to settle the regions they found appropriate. The charter given to these explorers was akin to the rights given to conquistadors like Cortés.[27] This charter was a forfeiture of lands claimed by Spain to the Welsers in an effort to settle the debts Charles could not repay.

Beyond the charter itself, Charles also granted the Welsers special rights that had not previously been enjoyed by any firm. The Germans were allowed to build a settlement just as Spanish conquistadors had done, and were instructed to build

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[25] Bernard Moses, *The Spanish Dependencies in South America: An Introduction to the History of Their Civilization.* (London: Smith, Elder, & Co., 1914), 58.
[26] Santo Domingo was a port city located in the current-day nation of the Dominican Republic that the Spanish utilized during this period as a base of operations.
[27] Moses, *The Spanish Dependencies in South America*, 58.

military fortifications just as Spanish conquistadors were required to do. However, buried in the multiple contracts forged with the Welsers was a key component that made it evident why the debts Charles owed would be forgiven: the Welsers had stipulated that they be permitted to bring miners to their settlement. The profits from the mining operations, furthermore, would have no "obligations to the King."[28] In essence, the Germans had just been given Venezuela to mine and to plunder the natural resources as they saw fit, and all of their profits were tax-free. They would not pay the Spanish Crown at all, despite the fact that the Spanish fleet and military in the region guaranteed both their safety and a steady supply of necessary goods.[29]

Furthermore, the Germans promptly defied the King's orders once they had settled in Venezuela after 1528. It was stipulated that the colonists would not enslave the Indian population unless the Indians were actively subversive.[30] The Welsers ignored this entirely and promptly began capturing local Indians and selling them as slaves to make a profit of over 80,000 ducats a year.[31] When the Spanish *Cortes* attempted to intervene by passing legislation forbidding this practice in 1530, the Welsers wrote directly to the King. Charles replied himself to the Germans. He wrote in 1531 reiterating the old order allowing the enslavement of indigenous populations if and only if the Indians were subversive; he clarified,

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[28]Ibid., 60.
[29] Ibid.
[30] While the reasons for this portion of charter were not explicitly stated in secondary sources researched, I believe this requirement is a remnant of Queen Isabella I's *Requerimiento*. This edict was created in 1513 to stem violence against the indigenous populations in the Americas. It is understood to have been motivated to enforce the idea that conquistadors were God-fearing individuals who worked to glorify his name through spreading Christianity around the world through righteous conquest. Slavery and murder of populations was counteractive to the efforts to convert them to Christianity. This well-known edict has been understood to have been largely ignored by the conquistadors themselves, as they simply read the Spanish text that the Indians clearly had no way of understanding; they often proceeded to create wanton panic and destruction. However, even this formality emphasized the religious undertones of the Spanish government and its explorers, something the Germans wholeheartedly ignored. It seems, profit was a better motivator than fear of God's wrath.
[31] Ibid.

however, that the Welsers were not allowed to export the slaves.[32] The Germans promptly disregarded the King and proceeded as though nothing had happened.[33] The interests of the foreign corporation were more powerful than the words of the King himself.[34] Charles had begun a cycle of humiliating concessions to the foreign bankers that would define his political career for decades to come.

Yet Charles had maintained the dignity of his throne. He had avoided being publicly known as a defaulter. It is economically disastrous in the modern day for a nation to go bankrupt, but beyond economic health, early modern sovereigns depended on their honor; a bankruptcy would have been most scandalous.[35] His sovereign power was intact, as was the honor of his throne. One may wonder whether the price of dignity was worth sacrificing valuable revenue from Spain's American territories, but this was strictly business: Charles had accrued debts, and he honorably gave collateral when he could not repay with cash. It would appear that Charles was able to achieve both goals, namely keeping his good name and conducting good business. By trading Venezuela in exchange for the forgiveness of his massive debt with the Welsers, Charles's credit was maintained with the bankers; he could continue borrowing without much difficulty. But there was something more insidious lurking underneath this transaction between Charles and the Welsers: Spain would be able to repay its debts so long as it had viable collateral. What would happen when its supply of such collateral ran out?

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[32] Ibid.
[33] Ibid.
[34] Ibid., 65.
[35] Elliot, *Imperial Spain*, 230-238.

1575: Philip II's Third Bankruptcy

Philip II ascended to the Spanish throne in 1557, a time of crisis. A mere year after his inheritance of the Spanish Empire from his father, Philip would be forced to declare bankruptcy; it would take him a further eight years to fully settle with the Fuggers of Germany, a feat only achieved by a personal visit from the then-elderly Hans Fugger to Madrid to restructure the debt himself. The Fugger account was one of the biggest lending sources utilized by Charles, and the long-term debts that Charles had contracted were maturing precisely at the time of the ascension of Phillip.[36] By his fifth year as king, Philip would default yet once more, entering into the 1560s with two bankruptcies. He would be mired in even more military conflict than his father had to contend with. Forced to defend his realms from threats like the Ottoman Empire and revolts in the Spanish Netherlands, Philip over his reign spent 146 million ducats on financing war out of his non-debt total expenditure of 168 million ducats.[37] That amounts to approximately 87% of total state expenditures spent on wars. Of the 146 million ducats Phillip spent on warfare, he spent almost half of that amount, 77 million ducats, quelling rebellion in the Netherlands alone.[38] Indeed, Philip's need for constant revolving credit lines stemmed from his incessant conflicts against enemies both foreign and domestic.

The debt crisis of 1575 was Philip's first true major bankruptcy. He had defaulted on his inherited debts in 1557 and 1560, but they were largely 'forgiven'

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36 Voth and Drelichman, *Lending to the Borrower from Hell,* 25.
37 Ibid., 128.
38 Ibid., 66.

by the lenders, who restructured the loans for Philip and continued lending to him to manage the transition period of repayment and debt stability. Some debts were forgiven, i.e. erased, and other portions of debt were exchanged into bonds (*juros),* which in effect gave the lenders access to state taxes within Spain.[39] The remaining debt was consolidated into some short-term debt that Phillip promised to repay. This was in the interest of the bankers and Phillip: the former being able to keep lending and maintain revenue, and the latter becoming more financially liquid. Yet in 1575, even the most loyal lenders, the Fuggers of Germany, refused to issue new credit to the troubled king, rendering his armies restless and his kingdoms unstable.[40] Rebellion would break out amongst the soldiers once more, and Philip was for the first time in a tight bind without funds from the lenders, with lending levels dropping nearly 40% in 1575.[41] Philip's accountants hastily turned toward Italy, in an effort to ward off another embarrassing default; the king himself attempted to stop this default from ever taking place, and his failure would be demonstrative of his reliance on short-term debt.

Italy was the focal point of the Spanish empire's finances. While the Americas were churning out metallic wealth, Italy was closer physically and therefore more reliable in terms of taxation and revenue sourcing for the Spanish crown. Large portions of debt were sourced from Italy, and the geographical closeness of Italy to Spain meant that Philip II had much more immediate access to cash. Of course, Italy in this time was split into many separate city-states, duchies, and principalities, but

[39] Ibid., 36
[40] Ibid., 157.
[41] Ibid., 153.

Spain effectively controlled the entire Italian peninsula by the time Philip II ascended. Particularly important of these states was Naples, [42] which had served as the source of both monies and mercenaries even after the capture of Milan. Spain used Naples as a front-line defense against the mounting threat of the Turks in the Mediterranean, and as such it had a considerable Spanish military presence. To maintain these armies and protect Spanish interests in Italy, Philip II often borrowed from Genovese bankers, and much of the taxes Spain derived from Naples went precisely towards paying the armies.[43]

In 1575, Philip's royal accountants proposed to remedy the mounting Spanish debt by requesting prepayment of taxes from Naples.[44] This was the only proposal that they devised. This point was critical: the Spanish empire was on the verge of its third bankruptcy in twenty-five years, and the royal accountants produced one fiscal proposal. This pointed to a rather alarming unpreparedness of the Castilian accountants for the deepening debt.[45] Whilst the accountants proved ineffective in their attempt to hastily fix up the Spanish balance sheets, the Spanish Exchequer utilized a more forceful way to ensure the Spanish empire would not fail: it declared default on behalf of the Spanish Crown, effectively stopping all major payments to bankers.

Philip II had attempted to prevent this bankruptcy, remembering the difficulties he faced after the Flemish revolt at the time of his first bankruptcy while in office. Restructuring his debts in 1557 while managing revolt in the Spanish

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[42] Angus Magkay, "Recent Literature on Spanish Economic History." *Economic History Review*, xxxi, (I978), 129-45.
[43] A. W. Lovett, "The Castilian Bankruptcy of I575." *Historical Journal*, 13, 4(I980), 899-911.
[44] Marino, "Creative Accounting in the Age of Philip II?", 764
[45] Ibid.

Netherlands proved difficult, particularly because the armies there were paid by debt. Not eager to relive this difficult time, Philip convened a special *junta* to regulate and attempt to solve this issue of increasing Spanish debt in 1573. This proved too late and too sudden an attempt to fix what had been a problem for decades. The *junta* actually recommended a voluntary bankruptcy in April of 1574, which included better accountant training and restructuring of the Spanish debt to the rate of 3.3%. This memo was not published in public records until 1576, but was signed by the Marqués de Auñon, who was ultimately sacked in 1575 prior to the default;[46] consequently, the memorial had to have been written prior to the bankruptcy in 1575. The Marqués de Auñon was the Castilian Treasurer-General,[47] and his sacking shortly before the bankruptcy suggests that Philip wanted a different solution: Even though there is no direct evidence supporting this claim, the Marqués de Auñon ouster after supporting a preemptive bankruptcy seems plausible, suggesting that Philip desired to avoid another default if at all possible.

In a devastating loss for Spain's creditors, Philip's ministers offered a solution. Philip's ministers forced the bankers to accept a lower interest rate of 3.3%, lowered from the rate of 9%. This was no negotiation, but an ultimatum: the bankers would essentially have to accept the lower rate or risk not receiving any money at all. Philip's accountants declared to the bankers that there was simply no money to repay the bankers at such a high rate of interest: thus, the bankers would take some money or nothing at all.[48] This brute-force method sent a strong message

[46] Marino, "Creative Accounting," 766-770.
[47] Ibid., 768.
[48] Lovett, "The Castilian Bankruptcy of I575,", 899-911.

that either the bankers would lose all their capital, or they would have to simply accept the terms. This seems almost fantastical by modern day standards. The term "too big to fail," popularized by the media in 2008 in response to the failure of mega-corporations seemed to have been applicable nearly six hundred years ago with respect to Spain. Collapse of the Spanish debt and a total bankruptcy would have meant the collapse of not only Spain's Italian territories, but also the German banks as well. This marked the first recorded default in the sixteenth century in which the lenders considerably lost capital; until this time they had maintained regular profits despite the numerous restructuring efforts by Philip II. In previous defaults, the bankers had simply reduced their revenue, but maintained profitability.[49]

The bankruptcy of 1575 did not indicate that the Spanish empire was unable to pay back its debts completely, but that it could not pay back the debts as previously agreed. The interest rates that had been steadily rising since the reign of Charles V reverted to a rate similar to what was in place nearly fifty years prior to the bankruptcy of 1575. The interest rates had risen as a result of Spain increasing its total debt load, which allowed for more liquidity for Spain but also created a bigger risk for the bankers, and consequently rising interest rates.[50] Considering the fact that the interest rates in place fifty years prior to 1575 were on mostly long-term securitized debts, and the default restructuring was meant to remedy the short-term debts that were maturing faster than Philip could repay them, the bankers were clearly in a state of loss. This was due to the fact that longer-term debt and short-term debt loads were similar to modern day standards; while long-term

[49] Voth and Drelichman, *Lending to the Borrower from Hell,* 35-43, 120-128.
[50] Ibid.

debt was essentially accrued by bonds, short-term debt was securitized with much higher interest rates derived directly from property and lucrative tax bases.[51]

The fiscal proposal to Naples was the attempt of last resort by the Castilian accountants. By no means was this a long-term fix, but another way to extend the Spanish debt until 1590. The accountants proposed that Naples would prepay Spain further debt to pay off the existing debt on hand. Naples, for this generosity, would be given the special privilege of not having to pay property taxes due to Spain until 1590. The accountants then reduced the interest rate to 3% instead of 9%, reasoning the 100,000 ducats lost from the property tax exemption would be made up by the reduced interest. The Castilian accountants also reminded the Naples government of the importance and necessity of military expenditures to protect the Spanish realm against the Turks.[52] As real as the threat of invasion was, this was in essence a veiled threat: if the prepayment was not met, then there was the real possibility that the Spanish would not defend Naples. Of course, this was impossible, as Naples was a crucial port for the Spanish, but the pressure placed on the Napoli government was evident nonetheless.

Philip II desperately needed the monies to keep flowing to maintain stability in the Netherlands, where his armies were on the verge of revolt yet again by 1573. Whilst Charles V faced opposition early in his reign for being a foreign king in Spain, Philip II faced a similar dilemma in the Netherlands; his only method of control was keeping mercenary armies to prevent large-scale rebellions.[53] This method had a

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[51] Ibid.
[52] Albert Lovett, "The General Settlement of I577: an Aspect of Spanish Finance in the Early Modern Period." *Historical Journal*, 26(1) (I982), 22.
[53] Voth and Drelichman, *Lending to the Borrower from Hell,* 35-43, 120-128.

tendency of backfiring more often than not, as the mercenary armies themselves mutinied if not paid on a timely basis; to make matters worse, as Philip II restructured and paid the armies, the same troops who had mutinied remained to keep order with the populace.[54] This demonstrated Philip's frustrating lack of loyal military forces that he could rely on without solely money as an incentive. This critical problem of keeping his dominions safe and under control was a problem not unknown to other royals in Europe, but it proved a more dangerous pursuit for the Spanish in the sixteenth century because of their massive empire.

Analysis of 1528 and 1575

The readiness of Charles V to fully utilize collateral and American incentives to ward off creditors in 1528 and the curious ineptitude of Castilian accountants in 1575 reveal a crucial fault in the financial system. I will argue that Spain's dependency on sophisticated debt restructuring and lending methods created a significant disconnect between the Crown's perceptions and the economic reality of the Spanish empire. Philip II's dependence on short-term lending was an extension, if not an evolution, of Charles V's utilization of long-term debt. Indeed, both Philip and Charles utilized long-term and short-term debt contracts, but as the sixteenth century progressed, there was a markedly increased dependence on short-term debt by Philip. Meanwhile, while economic trade did thrive and grow unilaterally throughout the sixteenth century, major portions of the Spanish empire were in

[54] Ibid.

decline in terms of GDP; moreover, the devastating influence of inflation impacted the general population as real wages fell. The disparity of funding ability of the government and the access the citizenry had to cash demonstrated that sovereign solvency was in fact less critical than the position of the economy to maintain healthy growth. Finally, the genuinely captivating question of whether or not Philip and Charles could have avoided the debt situation remains: their royal duty to protect their realms was possibly the single largest motivating factor in their borrowing. Would it have been possible for the Habsburg kings to maintain such large armies without debt? It would be historically anachronistic to suggest 'what should have been,' and therefore contemporary solutions shall be sought.

First, it must be noted that Spain's debt, as stated before, was sustainable. The defaults, were, in effect, a failure to react aptly to shocks in the economy by the Spanish Crown and its accountants; the bankruptcy of 1575 was a prime example, but also the failure to balance the debt at healthy levels even during Charles's reign shows a constant lack of foresight. Yet it is equally evident that debt was sustainable in the sense that bankers made consistent profits from lending to Philip and Charles, despite the restructuring efforts that reduced their margin;[55] moreover, Philip and Charles were both able to settle their accounts through creative methods of restructuring and exercises of royal power, like seizing and selling Crown lands. The immense material and mineral wealth of Spain meant that they had considerable amounts of collateral throughout the entirety of the sixteenth century, but remained largely insolvent due to the lack of cash on hand. The long-term debt that financed

[55] Ibid., 26-32.

wars and maintained state order was necessarily coupled with short-term debts to provide cash to the Empire to deal with internal issues. When considering why short-term cash at relatively expensive interest rates was necessary, one does not need to look further than to Spain's constant wars.

In 1528, Charles was recovering from the collapse of his campaigns in Italy against the French king, Francis I. Furthermore, Charles was committed to protecting the borders in the Holy Roman Empire, which were threatened with near-constant attacks by the Ottomans. The years of relative peace like 1528 were the years during which Charles would settle his accounts. The bankers provided reliable funding to his mercenaries, often sending armed couriers to bring the monies themselves.[56] This was a small detail that was nevertheless crucial: the bankers at all times knew the successes, failures, and needs of the armies of Charles V, if not better than him. The bankers were flexible in lending to Charles precisely because they knew the loyalty of the mercenary armies to the monies, demonstrated by such events as their lack of restraint in the sack of Rome, and the high level of dependence of Charles on said armies. Because of this dependence, the Fuggers, Welsers, and the Genovese banking cartel all exercised and enjoyed immense political power in Spain. Numerous bankers who had been imprisoned or against whom the King himself had filed a lawsuit were able to escape any type of prosecution because their partners included in new lending contracts that these bankers who had fallen out of favor with the king would be freed and reinstated.[57]

[56] Ibid., 128.
[57] Ibid., 157.

In effect, the bankers were colluding to escape lawful prosecution against them by utilizing their monetary power.

For many years Charles's revenues to maintain his Empire stemmed from Flemish taxes; the influx of Spanish metallic wealth remained largely irrelevant to his finances due to its low production levels until 1535.[58] Despite this fact, Charles was able to utilize the promise of the New World wealth as collateral to his biggest lenders. Indeed, he had been forced to sell Crown lands in both continental Europe and in the Americas, much to the chagrin and protest of the Castilian *Cortes*, a practice that Philip would inevitably have to continue.[59] The Spanish economy was during this time just beginning its shift from agriculture and raw material production, e.g. wool, towards mining and capitalization markets.[60] Thus, Charles was able to start taking advantage of the increased metallic production in the Americas as a preview of sorts to his lenders, giving them more incentive to keep the monies flowing. Even without this incentive, the bankers had no qualms about lending to the man who essentially controlled all of Western Europe, as evidenced by the sheer amount of funds lent to Charles. The relinquishment of Venezuela to the Welsers opened the possibility that the bankers could unlock the potential of the New World. Charles was expanding the horizon for his bankers, just as they helped him maintain his realms.

In stark contrast to Charles's success in refinancing his debt, Philip failed to settle his debts in 1575, resulting in default yet again. The Flemish armies were

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[58] Braudel, *Mediterranean,* 672.
[59] Voth and Drelichman, *Lending to the Borrower from Hell*, 158.
[60] Braudel, *Mediterranean,* 648-665.

already becoming restless by 1573, nearing full-blown revolt by 1575.[61] This suggests that the bankers had begun stemming funds to the Netherlands in 1573, giving Philip two years to settle his accounts or face disaster. This attitude greatly differed from the management of Charles's funds by his bankers. Despite exercising their power through lending, Charles's bankers had not stemmed his funds so drastically. While no concrete evidence exists to support any theories as to why the bankers cut off Philip II in such a manner, I conjecture that the bankers were becoming uneasy over Philip's continued reliance on short-term debt. The sophisticated lending mechanisms conjured up by the bankers all but guaranteed profit for them, and the only reason they would pause in funding the Spanish king would have stemmed from their fear of great loss.

This conjecture can be supported by the fact that bankers lent to Philip despite earlier deviances from payment plans. When Philip first ascended to the throne and defaulted on his father's debt in 1557 and again in 1560, Hans Fugger came to Madrid to settle the accounts and restructure with write-offs. During this time of restructuring, which took nearly eight years to complete, the Fuggers kept funding the Spanish fully.[62] Yet in 1575, even the lengthy relationship between the Fugger banking dynasty and the Spanish Habsburgs did not prevent them from halting all funding to Philip II. Philip hastily released a huge number of bonds (*juros*) and forced the bankers to accept a lower interest rate on existing debt to remedy the situation by 1576, when lending resumed. Thus, 1575 could be seen as the first 'true' state bankruptcy, namely when an insolvent state could not pay back its loans

[61] Voth and Drelichman, *Lending to the Borrower from Hell*, 36-45.
[62] Ibid.

and had to meet bankers' higher-collateralized criteria for tentative lending to resume. Much like the International Monetary Fund (IMF) funding procedures today, large portions of taxes, like that of Naples, had to be sacrificed to satisfy the creditors.[63] The bonds themselves were based on future tax revenues to the state, and when combined with the efforts to obtain liquidity by exempting Naples from future taxes, clearly demonstrate that the Spanish empire was not only short for cash, but did not have available collateral. This reveals not only an extremely sophisticated lending mechanism by the bankers, but also the fact that they still had a vested interest in the survival of Spain as a powerful state.

Certainly, it was during this time that Spanish mines in South America were generating incredibly high amounts of silver.[64] One may ask why Philip did not simply seize the mining companies as Charles had sometimes done to pay off the creditors. The choice to not opt for this procedure was simple: Spanish silver in 1575 was becoming less desirable due to the difficulty of exporting the silver out of Spain, and the exceedingly long periods one would actually have to wait for the silver. The native population in the Americas was dying off by 1575 in droves, a continued trend since the beginning of colonization efforts in the Americas; labor was so short that productivity was falling while the slave trade could not fuel the labor needs of the American mines.[65] When considering the fact that it took just under a year for one shipment of silver to reach Spain,[66] and the fact that the

[63] Marino, "Creative Accounting," 764-68.
[64] Voth and Drelichman, *Lending to the Borrower from Hell*, 210-225.
[65] Moses, *The Spanish Dependencies in South America,* 65.
[66] Voth and Drelichman, *Lending to the Borrower from Hell*, 212.

bankers would again have to petition Philip to remove silver from Spanish lands, it is unsurprising that the bankers would be hesitant to take such collateral.

It was illegal for Spanish metals to be exported, and the only way to export silver was to petition the King, while Spanish merchants contended with rising inflation and smaller returns as a result of imported items being more favorable for customers.[67] Furthermore, Philip was already receiving the *quinto*, or royal fifth, of all silver imports from the Americas, as his father had done.[68] The silver would be collateralized or used to pay off debt anyway; the bankers had no reason to hastily take for collateral what would later become their payment.[69] The inflation had made silver less desirable to bankers in Philip's time than during Charles's reign, and to compound the difficulty of collateralizing the silver mines, Philip would have been hesitant to give away what was producing so much nominal money. It was evident that Philip did not recognize the inflationary pressures of the imported silver, and simply enjoyed the constant revenue flowing in from the Americas.

While debt levels could be maintained despite strained relations with the bankers, the difference between 1528 and 1575 shows that the bankers were becoming weary of the borrowing practices of the Spanish Crown. Charles had minimal difficulty negotiating and maintaining a healthy relationship with the bankers, whereas Philip's encounters with the bankers were tumultuous and strained. Spain was borrowing to maintain its empire, but it was the borrowing itself

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[67] Kamen, *Empire: How Spain Became a World Power,* 58-70.
[68] Ibid.
[69] Voth and Drelichman, *Lending to the Borrower from Hell*, 190-205.

that was becoming its Achilles' heel, making it vulnerable to liquidity shocks and hasty renegotiations by Philip's time.

Analysis of Inflationary Pressures and General Decline of Economic Health

There is a misconception that the Spanish economy was stagnating in the sixteenth century. As evidence of Spain's decline, early twentieth-century scholarship often cited Spain's reduced agricultural output, with increased ranching to fuel the military-industrial complex. It was argued by prominent scholars like Earl J. Hamilton in the 1930s that this change in production ultimately caused prices of primary goods to rise, resulting in diminished returns for the general citizenry along with reduced revenues to the state.[70] Already by the 1960s, it was recognized by academics like Ladislas Reitzer that this story was not true.[71] Agriculture was thriving in northern Castile, as was production of raw materials like wool; the shift of some lands to pasturing was motivated by the fact that the wealthy were deriving their profits from mining and American exploits.[72] Spain enjoyed thriving trade, increased production (measured by GDP), and a relatively healthy trade balance when compared to its rivals. Yet the Spanish economy was poised for decline from inflationary pressures. Mostly due to the vast amounts of silver arriving from the Americas, the inflation created an unhealthy environment for stable growth: the growing trade and economy often masked the fact that inflation provided a

[70] Hamilton, *The Decline of Spain*, 168-179.
[71] Ladislas Reitzer, "Some Observations on Castilian Commerce and Finance in the Sixteenth Century," *The Journal of Modern History* 3 (1960), 217.
[72] Ibid.

secondary instability to the general economy from price shocks, the primary being the instability of the state funding capability.[73]

It may be difficult to fathom that a nation that was growing in its wealth annually would crumble from within due to a simple mismanagement of monetary supply. Unmanaged inflationary pressures create trade deficits by making foreign goods more desirable as a result of local items becoming more expensive; while this was not studied in economics until after the sixteenth century, seventeenth-century commentators immediately after Philip's reign were already publishing criticisms of unchecked inflation.[74] They noticed how silver was worth nearly four times its value in Netherlands when compared to Castilian Spain, and how "more money makes it worth even less than it is."[75] They also note how this trend has been "happening throughout the rule of the 'foreign kings of Spain,'" even though they do not provide explicit dates.[76] This realization shows a remarkably sophisticated analysis, noting how money could have different valuations than face value. The reference towards the "foreign kings" also indicates that they analyzed from the reign of Charles onward, something that modern analysis has revealed to be true.[77]

Indeed, the entirety of the sixteenth century appears at first sight to be much too broad a scope in which to examine the intricate components that may have contributed to the economic decline. However, as economic analysis requires a long

[73] John Munro, "Money, Prices, Wages, and 'Profit Inflation' in Spain, the Southern Netherlands, and England During the Price Revolution Era: c. 1520 - c. 1650, " *Historia e Economia: Revista Interdisciplinar* 1 (2008), 6.
[74] Anonymous, *Advertencias para el papel del crecimiento de la plata, que los reynos han pedido: en que se prueua, y ajusta lo que vale mas la plata en Flandes, y en las otras prouincias, que en España, y se declara lo que las dichas prouincias ganan en las remissiones de la moneda por cambio, y en especie, y en pasta, y lo que Su Magestad pierde en los assientos, y se aclara, y sunda mas la materia*, (Madrid: 16??), 15.
[75] Ibid.
[76] Ibid.
[77] Munro, "Money, Prices, Wages, and 'Profit Inflation' in Spain," 6-15.

time period in which to show quantitative data, it is sufficient to examine the entire century to view the trends. Fortunately, the quantitative data from sixteenth-century Spain is very neat with unilateral increases in inflation and national income save for a single year in Philip II's reign;[78] this realization allows for generalizations in the century-time frame that would be much more difficult had the quantitative relations not been unilateral. Furthermore, conclusive data shows unilateral trends in rising prices of composite goods and rent, providing further assurance that generalizations may be made on the century-scale.[79] Lastly, econometric analysis is accurate in analyzing the direct impacts of monetary expansion over the entire sixteenth century, allowing for a generalization that can be made for the period with regards to inflation caused by monetary expansion.[80] Spain's Italian dominions also suffered a great decline in real GDP concurrently with the inflationary pressures in the Iberian Peninsula.[81] As Italy was taxed and controlled by Spain during this period, it was critical that the Italian realms were suffering a slow decline during the sixteenth century as well.

Monetary expansion in economic terms refers to the release of more physical currency into the market. In the case of sixteenth-century Spain, the monetary expansion came as a direct result of the newfound deposits of silver and gold in the Americas. While the American treasure certainly raised Spain to new heights of

[78] Hans-Joachim Voth and Mauricio Drelichman, *"The Sustainable Debts of Philip II: A Reconstruction of Spain's Fiscal Position 1560-1598," The Journal of Economic History* (2006), 820.
[79] Mauricio Drelichman and David Agudo, "What Price a Roof? Housing and the Cost of Living in Sixteenth Century Toledo," *Working Paper at Vancouver School of Economics* (2012), 39.
[80] Peter Kugler and Peter Bernholz, *The Price Revolution in the Sixteenth Century: Empirical Results from a Structural Vectorautoregression Model* (University of Basel, 2007), 17.
[81] Paolo Malanima, "The Long Decline of a Leading Economy: GDP in Central and Northern Italy, 1300-1913," *European Review of Economic History* 15 (2010), 1.

wealth, the Crown released much of the silver inflows directly into the market.[82] As modern economics has established, the influx of new currency into the market directly correlates with the inflationary pressures it creates. This phenomenon, known as the Quantitative Theory of Money, arises from a simple supply and demand structure.[83] Because there is more supply than is demanded, in this case, silver in sixteenth-century Spain, prices are inflated as the real value of silver declines while the nominal amount of silver increases. The real value declines because there is more silver than everybody needs, and the nominal amount of silver increases for the obvious reason that the Crown released the silver coins into the market by minting them. An alternative to releasing the silver would have been to hold it in reserves, which would have restricted silver supply and have created a deflationary pressure instead.[84]

Econometric analysis shows definitively that the monetary supply expansion was the direct cause of the inflation in sixteenth-century Spain, far more than any other externality.[85] To make matters worse, as John Munro aptly notes, "In particular, distributions of increased money stocks, regionally or nationally, may

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[82] Kugler and Bernholz, *The Price Revolution in the Sixteenth Century*, 1-6.

[83] Quantitative Theory of Money (QTM) is a well known economic theory that was developed by John Locke in the 17th century, and is an underlying analysis of inflationary or deflationary pressures. It was countering mercantilists who chose nominal money quantities to wealth, when QTM actually suggests that increase in supply of money need to coincide with an increase in net wealth, as the money can become less valuable as it is subject to the same supply-and-demand scheme of any goods. Please refer to: Milton Friedman, *Studies in the Quantity Theory of Money* (Chicago: University of Chicago Press, 1956).

[84] This follows the QTM in that less money in circulation with equal demand will create deflationary pressures as a result of money becoming more valuable (inflation is money becoming less valuable as a result of supply exceeding demand).

[85] Kugler and Bernholz, *The Price Revolution in the Sixteenth Century*, 17. Kugler and Bernholz use what is known as vectorautoregression in econometrics to accurately estimate a generalizable trend caused by monetary supply expansion. The vernacular literally describes the vector of velocity of money (basically rate of transactions of money between individuals), and regression describes the mathematical tool used to find a statistical trend in said velocity of money. Their estimation effectively removes any short run shocks or changes that are ultimately outliers in the defining equation of the trend. Their conclusion is reached using a long run effect equation using price indices that are accurately notated. That is to say, their data is accurate and representative of the overall impact caused by monetary supply expansion over the entire sixteenth century.

have benefited some economic sectors more than others, thus allowing some groups or socio-economic strata to gain relatively greater increases in money incomes."[86] The inflation would prove to be devastating for the majority of the populace who were not wealthy enough to discount the impact of inflation.

Inflation at a constant rate of 1% to 1.5% sounds fantastical in the current day. However, inflation to this degree in the sixteenth century was a revolutionarily high figure.[87] Prices had been stable in the entirety of the fifteenth century with nearly zero change in prices, while prices more than doubled in the sixteenth century.[88] This well-known phenomenon impacted all of Europe during the "Price Revolution of the Sixteenth Century," but it was particularly detrimental in Spain due to the fact that Spain was the source of all the excess silver.[89] Because the lower working classes that constituted the majority of the Spanish population were paid the same nominal wages throughout most of the sixteenth century, their purchasing power was greatly decreased. As the real value of silver fell, the lower classes were paid the same nominal amount, effectively reducing the amount they could purchase with each passing year.[90] As the lower classes were already paid barely enough for subsistence, the effect of declining real wages had a severe impact on their livelihoods.[91] To make matters worse, the indiscriminate monetary expansion by the Spanish Crown had made it impossible to counter recessions, during which increased monetary expansion would actually have helped the nation come out of

[86] Munro, "Money, Prices, Wages, and 'Profit Inflation' in Spain", 6.
[87] Kugler and Bernholz, *The Price Revolution in the Sixteenth Century*, 2.
[88] Ibid.
[89] Ibid.
[90] Munro, "Money, Prices, Wages, and 'Profit Inflation' in Spain," 19.
[91] Ibid.

the slumps. This indicated that Spain would feel exaggerated recessions with little action by the Crown to ameliorate the situation by minting more money.[92] Meanwhile, the inflationary pressures from the monetary expansion had exacerbated rising prices of goods such as grain that had resulted from increased urbanization.[93]

Increasing urbanization compounded the inflation caused by monetary supply expansion. While urbanization was not the primary cause of inflationary pressures, it did not help that unskilled workers now flocked to the cities for industrial work. As populations increased in cities like Toledo, rent prices increased as the supply of available lodgings decreased over the period from 1489 to 1600.[94] Over the sixteenth century, rent prices in Toledo rose to the point that unskilled workers earned only 70% of subsistence level wages, forcing them into clear poverty.[95] To make matters worse, the concentration of population in the cities made prices of primary goods increase. Following the natural increase in prices from increased demand and restricted supply, the price of subsistence goods rose. These goods included many of the items necessary for survival, including timber, grain, and wood-fuel.[96] On top of this, because the rising prices of primary goods made less income available for expenditure on industrial goods, lower and middle class consumption of produced goods declined, further hampering the economy as a whole.[97] It should be understood that these compounding effects did not help the

[92] Ibid., 15.
[93] Kugler and Bernholz, *The Price Revolution in the Sixteenth Century*, 3-5.
[94] Drelichman and Agudo, “What Price a Roof?”, 2.
[95] Ibid., 39.
[96] Munro, “Money, Prices, Wages, and 'Profit Inflation' in Spain,” 15.
[97] Ibid., 19.

entirety of the Spanish economy, but do not account for the sustained inflation throughout the entire sixteenth century. Inflationary pressures caused by urbanization would have been offset once urbanization slowed, but the continued trend of increasing costs demonstrated that a larger force was creating long-run inflation. Short-run increases in prices of goods would have stabilized in the long run, not devolved to continuing on an inflationary trend.

It was the popular belief in the early twentieth century that Spanish exportation and trade with foreign nations was stagnant, and contributed to economic decline, as Ladislas Reitzer noted in 1960.[98] Yet this was simply untrue. While it is true that the Spanish economy shifted from cereal production in favor of ranching beginning in the early sixteenth century,[99] ranching nonetheless had significant benefits of producing excellent wool that was exported at great speed to other European nations. Spain actively exported raw material to neighboring nations and imported finished goods.[100] Spanish merchants, quite contrary to previous portrayals, have been recognized as important in international trade at the time, despite the popular belief that the Italians and English were the most enterprising traders of the era.[101] It is certainly true that the balance of payments for trade remained fairly static in Spain instead of a surplus expected from a successfully trading nation. However, this balance of payments deficiency has been attributed to the fact that the Crown prohibited the export of Spanish currency, thus

[98] Reitzer, "Observations on Castilian Commerce and Finance in the Sixteenth Century," 217.
[99] Ibid., 218-219
[100] Ibid.
[101] Ibid., 215.

restricting trade due to the immobility of the money.[102] Indeed without a trade deficit and with quite an active trading economy, the economic decline in Spain cannot be directly attributed to a deficiency in trade.[103] The popular belief that Spanish trade was slow and inactive created the misconception that failure to trade caused the Spanish decline, but that is clearly not true.

While trade was not directly responsible for the economic decline in Spain, as trade was very active both domestically and internationally,[104] the inflation caused by the monetary supply expansion would have been magnified in certain goods. As was stated before, exportation of Spanish currency was illegal under Spanish law, making the influx of the Spanish American silver even more pronounced in the environment of pronounced domestic trade.[105] Thus, had silver been available for export, the overall supply of silver in Spain would have been lessened, providing a deflationary pressure that would have lessened the effects of inflation. Philip did permit some silver to exit Spain proper for transfer to German or Italian bankers in their homelands, but this took much conflict with the *Cortes* to achieve, and more often than not was a lengthy process in each case; the *Cortes* resisted this due to the erroneous belief that this would reduce Spanish wealth, unaware of the effects of the inflation.[106] This is again a monetary policy decision, not an effect of trade or any mechanism other than the Crown's decision to keep the silver internalized.

Another key component in the economic decline of Spain can be attributed to the fiscal debt that Charles and Philip incurred through wars. While these debts in

[102] Ibid*,* 217.
[103] Ibid.
[104] Ibid*,* 219*.*
[105] Munro, "Money, Prices, Wages, and 'Profit Inflation' in Spain," 15.
[106] Ibid.

fact did not hamper the economic stability of the nation, the precarious situation of debt coupled with the inflationary pressures of monetary expansion provided ample grounds for failure.[107] The nature of the problem posed by the wars that Charles V waged across Europe may in fact lay in the long-run issue of solvency for the Spanish Crown. Because Charles V opted to incur debt to wage war, even as massive inflows of silver and gold from the Americas appeared to make Spain wealthy, the reality was building to the contrary. The debt would certainly be stable, albeit rising, due to the consistent increase in revenue, particularly from the Americas. Yet the incurred debt would render the fiscal position of Spain precariously unsustainable in light of liquidity shocks.[108]. Even more dangerously, the stability of the Spanish fiscal position would be in the hands of the bankers. The year Philip II inherited the throne from his father Charles V, Philip II chose to default on his loans from the German Fugger bank; as a consequence, Spain was forced to sell several nationalized monopolies to the bank.[109] During this period, military campaigns were temporarily put on hold while the Spanish Crown restructured its loans; as soon as lending resumed in earnest in 1566, Philip II immediately resumed many of his international conflicts, including the battles in the Netherlands and the patrols of the Mediterranean to battle the Ottomans.[110] The seizure of Spanish monopolies by the German banks and the pause on international conflicts show clearly that Spain's fiscal decisions had large impacts on not only its foreign policy but also its domestic

[107] Voth and Drelichman, *The Sustainable Debts of Philip II*, 3.
[108] Ibid., 4.
[109] Kamen, *Empire: How Spain Became a World Power,* 43-45.
[110] Voth and Drelichman, *The Sustainable Debts of Philip II*, 9.

industry. Not only did the war debts jeopardize the fiscal position of Spain, it endangered the entire economic livelihood of the nation.

The failure of Philip II to follow his father's advice also had a detrimental impact on Spain's fiscal position. Charles V had left behind an enormous list of recommendations for his son, some of which would have been quite pertinent and helpful in staving off possible insolvencies of the Spanish Crown. Charles V advised Philip II, "[to always] have a manifest copy of money in Germany [used] for the defense of Flanders." [111] In effect, Charles V had advised Philip to always keep a copy of the debt instruments on the loans from the Fuggers for the defense of the Netherlands. Thus, it can be understood that Charles V kept a close watch on his debts to the German bankers; since Charles V paid his armies through channels of debt, such as the loans from Germany, it should be further understood that the debts were crucial in maintaining a stable foreign policy. Philip's choice to neglect his father's advice and renege on the debts in Germany as soon as he took office would be very costly. Indeed, in a book full of recommendations, Charles V placed that particular advice on the first full page, prior to instructions regarding border defense and paying respects to the Pope.[112] Charles V placed such a great value on that debt that he spoke of it before national security and religious observance. The importance of that advice would become painfully clear for Philip II after he had to relinquish several Spanish monopolies and was unable to borrow again for another decade after his default in 1556. Even this mistake by Philip, however, would have

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[111] "Que conviene tener de manifesto alguna copia de dinero en Alemania por la defensa de Flanders." Carlos V, *Advertensias que el Emperador Carlos Quinto dejo escritas de su mano por rey Felipe II su hijo* (Madrid: Estado 1601), 2.
[112] Ibid., 2-3.

actually created a deflationary pressure due to the fact that decreased economic activity would have reduced the demand for silver. However, inflation persisted, coupled with the endangered fiscal position.[113] Thus, the monetary supply expansion created sufficient inflation to overcome even a heavy deflationary pressure that would have been created by Philip II's mistake with the German bank.

While the fiscal position was weakening in the Iberian Peninsula, Italy was facing a decline. I could not find sufficient evidence to suggest that the Italian duchies, city-states, and principalities were all individually aware of such a decline, but the econometric analysis done in 2010 by Drelichman and Voth suggests that Italy was entering a period of population increase and GDP decline in the sixteenth century.[114] This demonstrates that, combined with the decline of real wages in Spain proper, the Spanish territories were beginning to lose wealth simultaneously. To make matters worse in Italy, price increases observed in Spain was mirrored in effect. A unilateral decline in GDP from 1500 to 1600 can be observed in Italy, with a concurrent unilateral increasing trend in the price of goods.[115] This suggests that under Philip II, his Iberian and Italian dominions were in clear decline in terms of wages and revenues. Nominally, the taxes may have risen, but the overall wealth and economic health of the two dominions were in marked decline. This revelation would suggest that while Philip's debt was sustainable, the economy was becoming unsustainable; as his borrowing was intimately linked to the health of the economy,

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[113] Munro, "Money, Prices, Wages, and 'Profit Inflation' in Spain," 51. This graph shows that there was in fact no slowing in inflation despite the heavy deflationary pressure one would expect from losing nationalized corporations.
[114] Malanima, "GDP in Central and Northern Italy, 1300-1913,", 169.
[115] Ibid., 10-12.

what appeared to be sustainable borrowing on the surface may have been backed by a crippling system.

Some may argue that the monetary supply expansion was not the primary cause of inflationary pressures in sixteenth-century Spain, and that ongoing wars and increasing urbanization caused the relatively high inflation. However, this argument holds true for only nominal increases in prices, and does not account for the real increase in prices. That is to say, the real inflation was caused by an increase in the supply of silver, and not the simple numerical price increases that occurred as an effect of the usage of that silver. Had the silver imports not been directly introduced to the marketplace, but had been held by the crown in reserves to maintain the value of the silver at normal levels, the real inflationary pressures would have stabilized over time; because the supply of silver provided by the mint exceeded the demand of silver, prices of the silver rose. Wars and population increases would in fact have increased the demand for silver in proportion to the increase in supply of silver, providing a deflationary pressure instead of an inflationary one.[116] This is due to the fact that increased demand for silver would have effectively made silver more expensive, driving down the use of silver as it was more costly; in effect, wars and population increases would have over time stabilized prices through deflationary effects more than increasing prices. Certainly, the wars and increasing populations may have had intrinsic impacts on the real price of silver, since both wars and increasing populations were subject to consuming goods like grain that were subject to price fluctuations. However, even

[116] Kugler and Bernholz, "The Price Revolution in the Sixteenth Century," 3.

these fluctuations would not account for long run rise in prices since they do not affect silver demand in the long run.[117]

Some may argue that political mistakes such as Philip's reneging on his German debts were what damaged the Spanish economy, not the inflation caused by a significant expansion in the monetary supply of silver. This argument does not hold when the effects of monetary supply expansion become evident. While Philip's default on the German debt had a significant negative effect on the Spanish economy, the sustained increasing prices had an even harsher effect. The real wages of the lower class worker actually declined by a small amount in the sixteenth century, while real prices rose by more than 250%.[118] This had a devastating effect on the majority of the Spanish workers who were dependent on wages. As it has been shown that the monetary supply expansion was responsible for the price increases, it can be reasoned that the sustained inflationary pressures were more detrimental than the periodic political missteps. It follows that monetary expansion would prove more devastating in the long run than short-run mistakes such as the seizure of Spanish monopolies by the German banks. As the working class became financially unstable over time, their purchasing power declined. Since they composed the largest portion of the Spanish population, it can be reasoned that aggregate demand and general economic well-being would fall along with the decline in purchasing power of the working class.

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[117] Munro, "Money, Prices, Wages, and 'Profit Inflation' in Spain," 51.
[118] Ibid.

Conclusion: Analysis of Possible Solutions in Sixteenth-Century Spain

It is naturally difficult to determine what Spain should have done in the sixteenth century to remedy its difficulties with debt. Charles and Philip each had expansive territories to defend: Charles was King of Spain and its empire, elected Emperor of the Holy Roman Empire, and had control of Italy, the Low Countries, and the Habsburg's Austrian patrimony; Philip II was King of Spain, the Spanish Netherlands, married into the Portuguese royal house, and essentially controlled all of the Italian Peninsula. The multiplicity of dominions under each monarch blurs the distinction between royal duty to the whole empire, and to each state. It is irrefutable that neither Charles nor Philip could have simply left their vast dominions undefended. That would have been far more scandalous in the eyes of their subjects than defaulting on their debts, and probably devastating to their hold on power in other dominions. Although it may seem that a wiser choice would have been for the monarchs to excise the costly and detrimental states to better serve as kings to the remaining dominions, that was a not a practical option for them. Thus, the solutions remaining to them were limited at best.

With regard to debt management, it seems feasible by modern analysis that Philip could have settled his short-term debt accounts. This would have involved considerable sale of Crown lands, large sacrifices of American silver, and restructuring the debt to long-term fixed-rate loans. While inflation was not tracked and fully understood in Philip's age, many of Philip's contemporaries noted that the influx of silver was having a detrimental effect on its value.[119] Sale of Crown lands would have actually reduced maintenance costs on said lands, converting them to taxable property held in private holdings; use of American silver imports as collateral on a regular basis would have staved off inflationary pressures. Thus, there would have been a two-fold pressure to increase state revenues for Philip with this mechanism. Further restructuring his short-term debts to long-term debt would have kept the debt levels manageable and the whole economy more stable against price level shocks.

These findings help us understand the sixteenth-century Spanish fiscal position, and establish that a multiplicity of problems contributed to the worsening of the debt loads carried by Charles and Philip. By integrating the inflationary pressures, poor debt management, and the pressure of sovereign duty, it becomes evident that the Spanish economic position was made worse off by several factors. Some of these pressures and problems could have been ameliorated, particularly in view of the evidence that the debt levels were often stable. However, political pressures and the difficulty of managing numerous dominions made it difficult for Charles and Philip to maintain a healthy fiscal position with consistency. This realization removes some of the blame placed by earlier scholars on the Spanish Habsburgs kings; it becomes clear that Spain's economic health in the sixteenth century was inexorably interconnected to a multitude of different factors beyond royal control. Thus, it must be concluded that Spain declined as a result of its sheer

[119] Anonymous, *Advertencias para el papel del crecimiento de la plata, que los reynos han pedido: en que se prueua, y ajusta lo que vale mas la plata en Flandes, y en las otras prouincias, que en España, y se declara lo que las dichas prouincias ganan en las remissiones de la moneda por cambio, y en especie, y en pasta, y lo que Su Magestad pierde en los assientos, y se aclara, y sunda mas la materia*, (Madrid: 16??), 15.

size and the challenges of governing a diversity of states that had no unifying political or cultural center, which would have given the monarchs room to manipulate the ailing debt better. If the Spanish Low Countries, the Holy Roman Empire, the Italian states, Portugal and Spain were all a cohesive nation, then Charles and Philip would not have had to constantly focus on internal conflict, and could rather shift focus to maintaining the empire against external threats. As this was not the case, Spain was positioned for failure as soon as its borders were too vast and its internal political structure too weak to maintain the empire as a whole. Nevertheless, it stood as the greatest empire since Rome for nearly a century in Western Europe.

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