

Answer to “Duplications” by Drelichman and Voth

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The interpretation of the finances and the financial crises of Philip II that we presented in the EHR, which was reinforced in more recent work (2015a), is different from most of the recent literature³ in economic history on the financial crises of Philip II. That literature has been warped by blind references to contemporary economic models on sovereign debt between a borrower and lenders. DV are in the middle of that literature. In DV 2010, p. 1205:

“We argue that bankers' ability to cut off Philip II's access to smoothing services was key. A form of syndicated lending created cohesion among his Genoese bankers. As a result, lending moratoria were sustained through a cheat-the-cheater mechanism. Our article thus lends empirical support to a recent literature that emphasizes the role of bankers' incentives for continued sovereign borrowing.”

The relation between Philip II and the Genoese bankers was not of the standard sovereign debt type. We have been very much influenced by the historians Fortea-Pérez (1990, 2008) and Elliott (1992), and we place the domestic conflict between Philip II and the cities of Castile in the *Cortes* at the center of our interpretation. Note the order of the protagonists in our title. Our interpretation contradicts the various interpretations of DV that were not consistent through their publications: focusing on the Crown-bankers relation, they first argued for “liquidity crises,” (DV 2010); later, they went for a risk-sharing mechanism with debt reduction after a shock (DV 2015). We cannot at the same time refute and duplicate.

DV complain first that we do not cite them for their statement in DV 2011a: “The boom-and-bust cycles of the sixteenth century Spanish monarchy reflect the efficiency and flexibility of private-order institutional arrangements.” Álvarez-Nogal (AN) had considered the relation between Philip II and the bankers as part of a system many years before DV started on their work. He presented the argument of “institutional arrangements” in AN 2003, p.7:

“In order to explain the Spanish Monarchy's case, this paper presents a model focused on the sovereign's incentives to extend cooperation over time rather than on the lenders' power to punish him or the existence of an institution to control him. Here we consider two important elements: First, the powerful self-enforcing nature of the value that a stable cooperation with the bankers over time had for the sovereign. It does not depend on the lender's penalty but on the conditions that make the credit cooperation an essential part of

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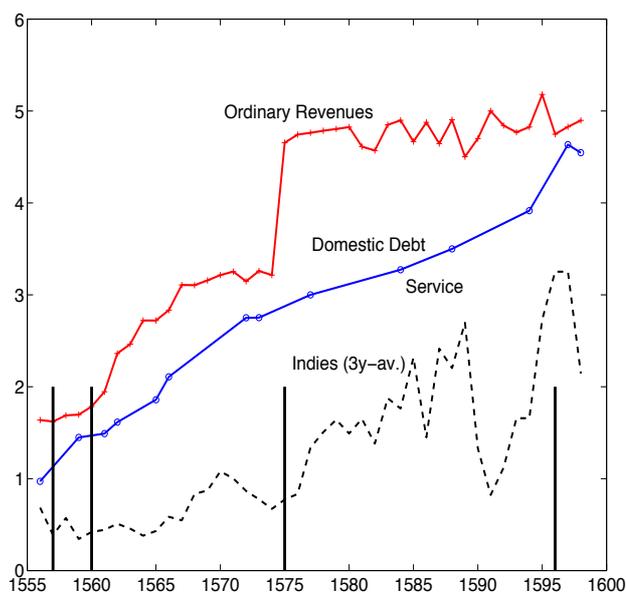
³ Lovett (1980, 1982), Conklin (1998).

the financial system of the Crown. And second, we show the importance of the banker's beliefs about the true interest of the king in keeping his promises.”

One should add that “stable and effective system for financing” is a bit vague.⁴ Do we have to remind DV that “effective” should be defined with respect to some constraints and objectives? It takes a very different meaning in our argument. The best way to learn this argument is to read our papers. Many important features cannot fit in a summary. In the abstract (Álvarez-Nogal and Chamley, hereafter ANC 2014a, p.192), we write:

“The credibility of the debt, mostly in perpetual redeemable annuities, was enhanced by decentralized funding through taxes administered by cities making up the Realm in the Cortes. The accumulation of short-term debt depended on refinancing through long-term debt. Financial crises in the short-term debt occurred when the service of the long-term debt reached the revenues of its servicing taxes. They were not caused by liquidity crises and were resolved after protracted negotiations in the Cortes by tax increases and interest rate reductions.”

The argument begins with the domestic debt, the *juros*. That debt was not a modern domestic debt with a centralized government. The best *juros* were serviced by each of the 18 cities that were represented in the Cortes of Castile. They voted on their contractual annual contribution, the *encabezamiento*. The service of the *juros* issued on a city (and not by a city—*juros* were issued by the Crown—) had a first claim on the *encabezamiento* of that city. The institutional setting enhanced the credibility of the debt and lowered its cost to the Crown, but crises occurred when the fixed contribution had to be raised because of the growth of the economy and military expenditures (1557-60, 1575-77 and 1596-97). In that sense, the setting had efficient properties, at the cost of the crises. Figure 2 in the paper (reproduced here) illustrates how all the suspensions of payments on the *asientos* coincided with the times when the service of the *juros* nearly reaches the “ordinary tax revenues”. (The definition of these revenues is discussed around Table 1 in our article). The financial crises that apparently took place on the *asientos* were actually caused by crises in financing the *juros*. When the Cortes resisted an increase the *encabezamiento*, they put a de facto ceiling on the service of the *juros*, and because the interest rate was about constant, such a block was



⁴ The use of "efficient" by Thompson (whom we cite) is also just a statement with no details.

equivalent to a ceiling on the stock of juros and on the ability of the Crown to refinance the unfunded asientos into the funded debt. In particular, the main crisis (1575-1577) is clearly the result of a power play between the Crown and the Cortes (ANC 2014b).

A modern analogy may be helpful. In the summer of 2011, a debt ceiling crisis occurred in the US: Congress had to vote for an increase of the legal ceiling of the public debt; for the same reasons as in Castile, (the nominal growth of the economy and government expenditures), that ceiling had become binding. Some partisans threatened to oppose that increase in order to limit government expenditures. The economy was barely recovering from the financial crisis. It was not the time for a showdown. In 1575, the contest between Philip II and the Cortes was similar, but it led to a dramatic financial crisis.

Now suppose that the US government would have been forced to suspend payments on its debt for a couple of years, and that, many years later, DV would have run the IMF test of the sustainability criterion (no need to know the test) as they did for Philip II in DV 2010 (p. 829-830). You can bet that they would have declared that the fiscal position of the US was sustainable and that “the defaults (of Philip II) therefore reflected short-term liquidity crises, and were not a sign of unsustainable debts.” The expression “liquidity crisis” would explain nothing about the true cause of the payment stop, i.e. the contest between the executive and the legislative. In DV 2011b, they repeat (p. 4): “Defaults thus reflected temporary liquidity shortfalls.”

Our argument is very much in the line of the “composite monarchies” that has been put forward by others before (Eliot, 1992, Grafe, 2006, 2008) whose work we cite. The above application of the IMF criterion makes no sense in the setting of a composite monarchy, In the words of “Duplications”, the IMF criterion on sustainability “is the simple inter-temporal budget constraint from any standard course in macroeconomics.” Precisely. It is the budget constraint of a single agent, a contradiction with the composite monarchy in the political economy sense that we develop.

For DV, a composite monarchy seems to be a disorganized monarchy. In DV 2010 (p. 810): “Philip II himself – like most early modern rulers– had very limited information about the state of his finances. The decentralized nature of early modern states, combined with rudimentary information collection, hinders attempts at reconstruction.” Or, in “Duplications”, “we clearly discuss the constraints faced by the Spanish Monarchy, its failed attempts to centralize control over tax collection, as well as the absence of a budget policy.” These terms have nothing to do with the idea of composite monarchies in Eliot, Grafe and with our argument, which is grounded in the context of the political economy. Using economic reasoning, we show that is that it was in the interest of the Crown NOT to have centralized control over the collection of the *encabezamiento*. Our argument is not about lack of information by the Crown on its budget, it is about the political economy of Castile.

DV deliberately misrepresent the core of our argument when they assert that we “fail to do justice to the earlier, important contribution by Conklin”⁵ (1998). Conklin is one of the pillars of the literature that pitched the Crown against the bankers. On p. 484, he wrote: “In 1575, when the Genoese cut off new lending, the Crown resisted their demands and broke off negotiations. The Genoese imposed an embargo.”

For Conklin, the lending moratoria of the syndicate took place when the stock of asientos, net of the collaterals by juros, reached about 10 million ducats: that amount was the financial equivalent of the penalty that the syndicate could credibly impose on the Crown. It was estimated, very roughly, at one half (because of bilateral monopoly bargaining) of the monetary value of Netherlands (measured by the present discounted value of 2 million ducats per year for military spending). To word “ceiling” (on the asientos) takes a totally different meaning in our argument that is centered on the financing of the juros and the domestic issues in Castile.

The argument of Conklin may have been appealing in a mainstream journal because it fitted with some theoretical literature. It has been completely refuted, in particular by DV. Moreover, the data of Conklin has never been published, except for a few unusable graphs that have no scientific value. No one has ever published, with scientific standards, an annual series of the actual outstanding stock of asientos, even without collaterals. After a long experience in the archives, we doubt that it can be done and DV may even agree with us on this particular point.

Our work that led to the EHR article was presented in a conference at the EHESS, in May 2010, to which we had invited Drelichman and Voth. The title of our presentation was “The Crown and the Towns: Fiscal Policy with Asymmetric Information under Philip II.” This work was put online as an IED discussion paper (Boston University), in May 2011. In October 2012, Chamley presented in a seminar at UBC, on the invitation of Mauricio Drelichman, the final revision of the paper that had been sent to EHR before. (The published version differed only by minor edits).

Immediately after that visit, on October 13, Mauricio Drelichman wrote a two page e-mail (available) with no major objection. He noted some differences on technical issues. (His “main concern” was on *crecimientos*, which are the subject of a forthcoming paper by us, on the triggering of the crises, and on the nature of some taxes). He also recommended a new paper that would be published later (DV, 2015)⁶:

He concluded by the following paragraph, *in extenso*:

⁵ Conklin is cited in AN 2003, p. 5 and 30, ANC 2011, p. 5 and 16, ANC 2014, p. 194, note 11 and p. 199).

⁶ In that paper, DV shift to a new interpretation of the payment stops of Philip II. It rests the risk-sharing between the Crown and the bankers: “In sum, we find that 16th century Spanish defaults occurred in “bad times”. ... The defaults were 'excusable' in the sense of Grossman-van Huyck.” Although, this interpretation is radically different from the “liquidity short-falls” of DV 2010, and DV should be upfront about that, it still belongs squarely to the framework Crown versus bankers.

“As a general comment on the paper, when I started reading it I thought you were going to take me into a purely financial argument, in the style of your JEH piece on English debt conversions. Instead, it ended up drifting in the direction of a political economy argument (which I like). I realize that the refereeing process tends to twist and torture a paper in unexpected ways, and perhaps this is a reflection of that. I still felt that there was room to tighten up the introduction so that it would be more consistent with the rest of the argument.”

All this was normal scholarly exchange. We certainly did not ignore DV. We cited them 6 times in pages 194 and 195. After that last e-mail of October 2012, the next news from DV was the first draft of “Duplications...,” in June 2014. The content is the same as in the text that has been accepted for publication, except for a cleaning of the most unseemly parts.

Additional comments on the use of data

DV criticize us for using their data without reference. We stayed far away from any of their data. Period. In ANC 2015a, we document in details that their use of the primary sources is careless and flawed. On the secondary sources, we do not have to cite them. We can however, make two additional comments.

Our statement on the maturity of asientos was made only for context. It was intentionally vague and it was derived from works independent of DV, published years earlier in (Ulloa, 1977, p. 138), Carlos Morales (2008, p. 79, Table 1), and from our own research in the archives de Simancas (e.g., Table 2, ANC 2014 and ANC 2015a and b).

On the profitability of the lending for the Genoese bankers, our argument was data free, with no number. It was only qualitative and relied on simple economic common sense.⁷ Implicit in the argument is the issue of the bankers' equity in the asientos. DV perhaps object to our argument because their method actually provides no precise information on the bankers' profitability, contrary to what they want the reader to believe. Any precise idea on the bankers' profitability requires information on the bankers' participation in each asiento, and the possible repartition of losses in case of default. These are not in the contracts. However, almost all the contracts contain a clause that exempt bankers from legal restrictions on the funds that they would raise in the credit markets for the business of the particular asiento. In addition, for some contracts (*factorias*), all the funds were to be raised on the credit markets. DV confuse the reader about bankers' and contracts'

⁷ On page 195, we write: “Interest reductions were conducted during the crisis resolutions of 1575-77 and 1596-97. Interest reductions were not default as often alleged. We certainly do not deny that some of the debt was reduced, but we think that the quoted amounts (for example those given by Drelichman and Voth) are overstated. More work is needed on this issue, however.” Did DV read our footnote 18? “A central point in Drelichman and Voth is that Genoese bankers did rather well on their loans, *ex post*, in spite of the debt reductions. Our argument about interest reduction reinforces their conclusion.”

profitability. They may occasionally mention the difference between the two, but in DV 2011b, they squarely and repeatedly equate the two notions.

For the revenues of Philip II, DV use only secondary sources, mainly Ulloa (1977).⁸ Everyone uses Ulloa and adds only some tinkering with his data. Contrary to DV, Ulloa published the details of his data construction: they can be verified and compared to the archival documents. Our data on revenues is also based on the work of Ulloa. It is completed by findings in other works (Gelabert 1997, Lorenzo Sanz 1979, Martin Acosta 1992 and Zabala Aguirre 2000, ANC 2014a, p. 199), and in our own research.

Our Figure 1 on revenues (ANC, 2014a) is different from Figure 1 in DV 2010, mainly for the years 1574-1577, and it covers more years. The difference for 1574-1577 is important in our analysis of the crisis, as it is explained in our article. Our classification and the plateaus of encabezamientos are from our own research (in connection with our classification in our Table 1).

⁸ Drelichman was clear about this in his October 2012 e-mail (“we use Ulloa”) when he also asked where we got a few more years of data at the end of the century. However, DV are not straightforward about their gathering of the data on revenues. They refer to work of Ulloa on revenues on in their first paper (DV 2010), after which they essentially refer to this first paper. In their book (DV, 2014), their data gathering on revenues is described only in footnote 20 (p. 82). “The discussion of revenue sources is based on Thompson 1976; Ulloa 1977; Artola 1982, 1988. Quantitative data are drawn from our previous work in Drelichman and Voth 2010.” We have met some careful readers that fell prey to the illusion that DV had made an important contribution on the revenues of Philip II.

APPENDIX

DEBT POLICY UNDER CONSTRAINTS

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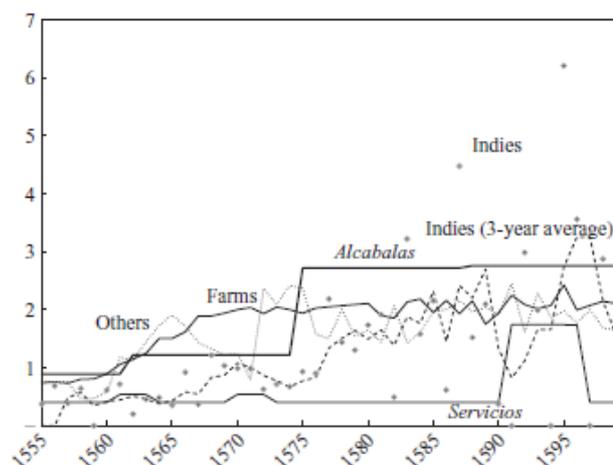


Figure 1. *Revenues*

Notes: Direct revenues from customs and monopolies are put together under 'Farms'. Note the high variability of the revenues from the Indies that are represented in actual numbers by points and in a three-year moving average by a curve. The *millones* are included in the *servicios* for the years 1591–6. Amounts are in millions of ducats (nominal).

Sources: As for tab. 1.

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Table 1. *Types of revenue*

	Ordinary	Share	Extraordinary	Share
Cortes	Fixed contributions (<i>alcabalas</i>)	27%	Temporary contributions	8%
Non-Cortes	Taxes set by the Crown	24%	Other revenues	22%
			Silver from the Indies	19%

Notes: Shares of revenues varied over time. The table presents averages for the entire tenure of Philip II (1556–98). Temporary contributions include *servicio ordinario* and *extraordinario* and the *millones* (which were in place only between 1591 and 1596). Other revenues include *arbitrios* (occasional revenues) and church revenues (on average 17%). Negotiations in the Cortes were on the two items of the first line in the table.

Sources: Gelabert, *La bolsa del rey*, pp. 385–6; Lorenzo Sanz, *Comercio de España*, pp. 263–72; Martín Acosta, *El dinero americano*; Ulloa, *La Hacienda Real*, pp. 171–687; Zabala Aguirre, *Las alcabalas*, pp. 55–64.

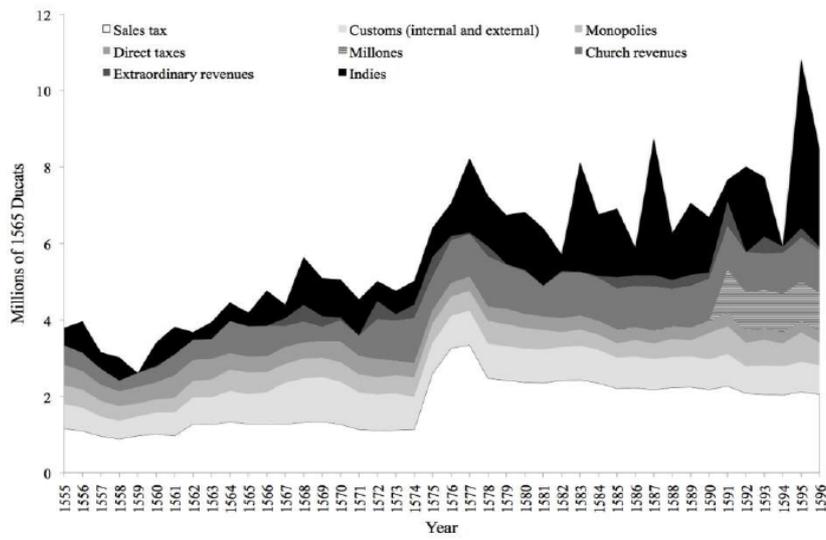


FIGURE 1
CROWN REVENUES, 1555–1596

Sources: Ulloa, *Hacienda*; Thompson, *War and Society*, p. 288; and authors' calculations.

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