Lessons of the Spanish Empire, or the curse of resource abundance[1]

by

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1. Natural resources and socio-economic development

The role of natural resources in contributing to stable economic development is of growing interest to economists and politicians. In evaluations of the prospects for development of a given country it was once assumed that rich natural resources and a vast territory provided favorable conditions for successful socio-economic development. However, in recent decades this assumption has been qualified: it is now realized that these conditions create only the *potential* for growth, whereas actual economic development can turn out to be unimpressive.

Even a superficial review of trends in global economic development in the second half of the twentieth century is sufficient to demonstrate that there is no obvious link between natural resource endowment and level of development. The overwhelming majority of countries with a high average per capita gross domestic product (GDP) (Western Europe, Japan) cannot be said to be rich in natural resources.[2] The same is true of the relationship between natural resources and “catching-up development” in the modern world. After the Second World War, the levels of economic development of Africa and South-East Asia (SEA) were comparable and, if anything, the prospects of the countries of the “Black Continent” seemed to be more promising. given their endowment in natural resources and relative proximity to European markets. However, events turned out contrary to expectations: Africa “marked time” and remained a region of extreme poverty, whereas the countries of South-East Asia began rapidly to develop. Many of them have succeeded in noticeably reducing the gap separating them from the world leaders.

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[2] The obvious exceptions are the USA, Canada, Australia and Norway and these will be commented upon later.

During the past two decades there have been a number of statistical analyses of the relationship between natural resource abundance and level of economic development. What these seems to suggest is that there is a significant negative correlation between abundance of natural resources and the socio-economic development of a country.[3] The political and socio-economic circumstances that explain this are as follows:

Firstly, the availability of significant natural resources provides the political and business élites with an incentive to assume control over natural resource rent and obviates any need to increase labor productivity and implement structural economic reforms that would serve to modernize the economy.

Secondly, the inflow of funds generated by natural resources has a debilitating effect upon the ruling groups: governments succumb to populism – they engage in outlandish and irresponsible economic policies, reassured by the belief that the cost of failure will be offset by abundant inflows of finance. This is the notorious problem of "moral hazard", the behavior of people who are under the illusion that they are immune from the consequences of the risks that they take. There is also an enhanced risk of corruption, as is invariably the case when a government has responsibility for sharing out natural resource rent.

Thirdly, dependence on natural resources makes for the formation of a lopsided, often single-product, economy and, in particular, of single-product export. The effect of the 'Dutch disease' is to impede the development of the non-exporting (in this case the non-raw material) sectors of the economy: exports guarantee an inflow of "cheap" foreign currency; this makes for an appreciation of the exchange rate of the domestic currency which, in turn, undermines the competitive capacity of domestic producers oriented in the internal market. The same process makes for a reduction in the activity of both domestic and foreign investors, given that the importing of goods becomes more profitable than the production of these same goods at home. Import substitution becomes practically impossible and an economy becomes dangerously vulnerable to fluctuations in prices for its own exported goods.[4]

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[3] Karl T. *The Paradoxes of Plenty: Oil Boom and Petro-States*. Berkley, CA: University of California Press, 1977; Sachs J., Warner A. *Natural resource abundance and economic growth*. NBER Working Paper Series. No. 5398. Cambridge MA, 1998; Isham J., Woolcock M., Pritchett L., Busby G. *The Varieties of Rentier Experience: How Natural Resource Endowments Affect the Political Economy of Economic Growth*. Mimeo, 2002; Gylfason Th., Zoega G. *Natural resources and Economic Growth: The Role of Investment.* London: CEPR, 2001.

[4] Strictly speaking, the 'Dutch disease' can also develop when exports are diversified and there results a growing discrepancy between the interests of sectors oriented towards export and those oriented towards domestic

Fourthly, there are risks for political development. An abundance of natural resources is a serious impediment to political democratization. That this is so is indirectly confirmed by the fact that the vast majority of countries that are rich in natural resources have never been democratic. The processes underlying this state of affairs are easily understood. As we have seen, a high natural resource rent, in restricting economic growth, retards the attainment of the level of economic development that is a prerequisite of the formation of stable democratic institutions.[5] This is particularly true of countries where revenues to the state budget derive from a single source – as a rule, from the export of a single raw material (for example, oil). Control over this resource brings in sufficient revenues to meet the needs of the government and to ensure social stability. The government is able to ignore other sources of revenue and neglect the deficiencies of the tax system. Exempt, relatively speaking, from the requirement to raise taxes, the government is able to ignore the political demands of the population and to offer a peculiar kind of implicit 'social contract' – "*We shall not levy taxes if you will not demand political rights and control over the budget.*" This is essentially how things stand in the absolute monarchies of the Persian Gulf. As S. Huntington has remarked in relation to these countries, "no taxation without representation" might be the political rallying cry, but the actual state of politics can be summed up as "*no representation without taxation*". [6]

Fifthly (and finally), as some scholars have argued, there exists a negative quantitative relationship between an abundance of natural resources and the amount of attention paid by those in power to the educational needs of the population. Sectors of the economy that are based on raw materials can function with a low-skilled labour force and the domination of these sectors is therefore associated with a weak demand for educational services. This can have very dangerous consequences in the long run.[7]

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consumption. However, this situation is typical of more highly developed countries and has no direct bearing on endowment with natural resources.

[5] The interrelation between the formation of a democratic system and the achievement of a certain level of economic development and public welfare is discussed in many works. See, for example, Lipset S.M.. *Political Man. The Social Basis of Politics*. New York: Doubleday, 1960; Huntington S.P. *The Third Wave: Democratization in the Late Twentieth Century*. Norman and London: University of Oklahoma Press, 1991; Vanhanen T. *Prospects of Democracy: A Study of 172 Countries*. London and New York: Routledge, 1997; Mau V. *Ekonomicheskie reformy skvoz' prizmu konstitutsii i politiki. [Economic Reform: Through the Prism of Constitution and Politics]*. M.: Ad Marginem, 1999. Chapter 2.

[6] Huntington S.P. *The Third Wave…* p. 65.

[7] T. Gylfason. *Nature, Power, and Growth* // Ekonomicheskii zhurnal VShE [The economics journal of the State University – Higher School of Economics]. 2001. Vol. 5. No 4. P. 473 - 474.

An additional danger arises when a country is suddenly flooded with revenues thanks to a leap in the price of their natural resources. If a government takes it into its head that these new prices are stable and immune to future fluctuations, it begins to restructure the economy accordingly. Upon the assumption of stable and abundant future revenues, a variety of investment projects and social programmes are launched – usually with the active participation of the state. Ambitious and expansionist foreign policies are brought forward. And then, in order fully to exploit the new opportunities, the state begins actively to borrow supplementary funds both domestically and abroad. As a result, despite an abundant inflow of funds, the financial situation, instead of improving, significantly deteriorates and this becomes manifest in a chronic budget deficit and a growing volume of government debt.

In short, such a country is soon faced with two kinds of problems: on the one hand, it becomes involved in a series of complex and ineffective political and economic projects. The economic projects often turn out to be ineffective owing to insufficient commercial and technical preparation - an assured abundance of “cheap” money is not conducive to serious cost-benefit analysis. It can also become embroiled in reckless foreign policy adventures, conceived, likewise, under the inebriating effect of financial abundance

At the same time, the country’s socio-economic priorities are transformed in conformity with the new, favorable, conjuncture. Faith in an endless supply of “cheap” money results in the neglect of “real” economy, since the shortcomings of domestic production can always be offset by imports. The quality of the output of domestic producers begins to deteriorate or the volume of output is reduced, but for some time this does not concern the government, such is their infatuation with economic growth based on extraordinary revenues from the export of raw materials.

However, when this source of revenues is suddenly curtailed (for example, owing to a change in market prices), a full-scale crisis ensues. Since the country’s economy has become imbalanced by the structural and budgetary maneuvers of the preceding years (or even decades) of prosperity, any structural adjustment of the economy to the new level of prices precipitates a severe crisis – sometimes of a systemic character.

There have been instances of such upheavals in various countries in recent years as a consequence of the fluctuations in oil prices that followed the oil crisis of 1973. During the years of plenty a number of oil exporting countries had restructured their economic systems but now they were beset by serious crises. Mexico, the Soviet Union, and Iran under the rule of the Shah are the most obvious examples.

By the end of the 1970s, oil prices had reached the level of U.S. $90 per barrel and it seemed that exporters had found the answer to all of their problems. At that time Mexico's President, Jose Lopez Portillo, declared proudly: "We must learn to administer abundance." Soviet leaders pursued an active "oil-for-food" policy, purchasing abroad not only foodstuffs but also consumer goods and equipment for expanding oil and gas production. In Mexico, the policy of "administering abundance" (Portillo's expression again) consisted in a steep increase in growth rates and the pursuit of self-sufficiency by means of development of the state sector. The government launched a number of investment programs; growth rates increased from 3-4 percent (1975-1977) to 8-9 percent (1978-1981); the average annual increase in investment reached 16 percent. During all of this time the budget remained in deficit, since, in the expectation of future revenues the government felt able to disregard this parameter. As the oil boom continued, the budget deficit, instead of reducing, actually increased. Mexico's economic health began to deteriorate when, at the beginning of the 1980s, the trend in oil prices began to change: GDP growth rates became negative; the peso was devalued by over 40 percent; foreign debt increased from U.S. $40 billion in 1979 to $97 billion in 1985. Capital flight accelerated, and the gold and hard-currency reserves plummeted to U.S. $1.8 billion. Much had been expected of Portillo, both at home and abroad, when he came to power; but towards the end of his six-year term of office he was being accused of wasting oil revenues, concluding "extravagant" foreign-loan deals and of excessive budgetary expenditure. Following his resignation, he was forced to leave the country. When he died in early 2004, he did not even receive the customary state funeral.

The case of the collapse of the Soviet Union is well known.[8] After a series of incoherent attempts at reforming the economy between 1965 and 1972, the Soviet government completely abandoned reform initiatives and sought instead to secure steady (albeit modest) rates of economic growth and social stability by stepping up energy exports. The decline in oil prices and a growing budget deficit forced Mikhail Gorbachev and his colleagues to take a number of decisive measures aimed at reducing the country's dependence on raw materials - the so-called policy of "acceleration". However, their attempt to boost

[8] For further details, see Starodubrovskaya I. V., Mau V. A. *Velikie revolutsii. Ot Kromvela do Putina*. [The Great Revolutions. From Cromwell to Putin.]. 2nd edition. M.: Vagrius, 2004; Gaidar Ye. T. *Dolgoe vremia. Rossia v mire. [The "longue durée": Russia in the World]*. M.: Delo, 2005. P. 341 – 345.

economic growth rates resulted in economic disequilibrium and, eventually, to the collapse of the system.[9]

Iran is another country where the régime first benefited from an oil price boom and then suffered a complete fiasco. Iran, moreover, by contrast with other countries, descended into crisis at a time when conditions on the world oil market were at their most favourable, and not because these conditions had deteriorated. The principal force for destabilization in Iran was the policy of accelerated economic modernization introduced by the government of the Shah. This policy was administered largely from above and had no foundation in the realities of social and economic life. It made for a sharp increase in social conflict which culminated in the "Islamic revolution" of the late 1970s.

Of course, what is crucial is not the existence of natural resources per se, or the intelligence of economic policy, but the fact that in certain circumstances an abundance of natural resources can become an obstacle to the elaboration of a conscious, effective economic policy.[10] The factors and circumstances that we have outlined by no means apply in all cases. There are countries with abundant natural resources that have reached a very high level of economic development. Sometimes there are circumstances that can neutralize the negative potential of an abundance of natural resources. An understanding of these circumstances can provide the key to reducing the negative effect of natural resource abundance upon a country's socio-economic development.

Firstly, the susceptibility of natural resources to monopoly control is of considerable importance. Natural resources that are "scattered" throughout a territory are less vulnerable to state monopoly control and do not constitute a serious obstacle to economic development. P. Sutela, arguing this case, has pointed to the example of Norway, where prosperity from the outset derived from rich fishery resources, primarily cod. The manner of extraction of this resource contrasts markedly with the extraction of hydrocarbons: the fish were available

[9] The policies of the governments of the 1970s could at least be 'justified' by the fact that until that time there had been no precedent of oil prices falling dramatically. The present situation is fundamentally different: practical experience has shown that prices for Russia's principal exports can indeed rise and fall and that these movements are unpredictable. A responsible economic policy must take this into account. Besides, as we shall demonstrate later, there have been instances in the past when crises were triggered by resource-oriented policies and when the resources did not belong to the fuel and energy complex.

[10] One of the most eminent experts on this problem, T. Gylfason, has written: 'Experience appears to indicate that extensive natural wealth, if not well managed, reduces economic growth in the long run. True, it does provide nations with short-term wealth, often quite considerable, but in the long term this appears to slow economic growth' (T. Gylfason. *Nature, Power, and Growth*. p. 465).

simultaneously in different regions; fishing did not require substantial investments; and the state could neither exercise rigid control over access to fishing, nor acquire ownership over this resource for subsequent exploitation. This meant that almost any Norwegian could engage in the fishing business and in this way the foundations were laid of economic and (as a concomitant) civil liberties in relation to the state. "…the point is not whether a country is rich in resources. The point is, rather, whether the resource provides a natural foundation for oligarchy and autocracy by being point specific, or whether it provides a natural foundation for democracy by being widely dispersed."[11]

Another factor is the extent of natural resource diversification. Natural diversity and the absence of any marked economic preference for particular kinds of resources provide a basis for competition between different producers: the formation of a single-product economy or single-product exporting is avoided and the economy can become diversified. Diversification of control over natural resources and the avoidance of state monopoly control are important factors that facilitate gradual economic development and the emergence of political democracy.[12] The same principles apply to, say, forestry or agriculture. The experience of the USA during the nineteenth century, when it was richly endowed with natural resources, provides a graphic example of this kind of development.

Secondly, the level of political development at the moment when an abundance of natural resources begins to be exploited is of great importance. There have been cases (admittedly, rather few) when countries possessing a very high level of economic and political development and the full panoply of modern democratic institutions unexpectedly became

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[11] Sutela, P., *The Sweet Word of Competitiveness* // Helanterä, A., Ollus, S.-E., *Why they, why not we? An analysis of the competitiveness of Finland and Russia*. Sitra Reports Series 46. Helsinki: Edita Prima Ltd, 2004. p. 147. "Hydrocarbons are usually point specific and so their exploitation is easily controlled and monopolized. This is why they serve as a natural basis for oligarchy and autocracy. Cod was widely spread in the fjords; controlling and monopolizing its catch was practically impossible. Since it is also a perishable commodity, even the most martial of the Viking kings would have thought twice before trying to accumulate the entire fish catch of the country. Cod did not make Norway wealthy, but it did facilitate the spreading of the little wealth there was widely among the population." (Ibid.)

[12] "Democracy is rule by the many, and autocracy is rule by the few. The concentration of power resources leads to autocracy, and the distribution of power resources among the many leads to democracy". On reaching this conclusion, Vanhanen hypothesizes that "democratization takes place under conditions in which power resources have become so widely distributed that no group is any longer able to suppress its competitors or maintain its hegemony" (Vanhanen T. *Prospects for Democracy*.., p. 24). Similar views are expressed by M. Olson who argues that "autocracy is prevented and democracy permitted by the accidents of history that leave a balance of power or stalemate – a dispersion of force and resources that makes it impossible for any leader or group to overpower all the others…If the theory offered here is right, the literature that argues that the emergence of democracy is due to historical conditions and dispersions of resources that make it impossible for any one leader or group to assume all power is also right." (Olson M. Dictatorship, 'Democracy, and Development'. in: *American Political Science Review*, 87. 1993. N 3).

“resource abundant”. In these countries with highly developed political systems, where the economic system was diversified and highly efficient, governmental decision-making in relation to resource exploitation was transparent and corruption was virtually non-existent. Great Britain and, especially, Norway, following the discovery of oil and gas in the North Sea, are examples. These countries avoided any deceleration in growth or degeneration of the economy. Even these countries, however, are not immune to the dangers of populism. Judging by Norway’s experience during the last 20 years there is a substantial of risk that government economic policy will succumb, in the medium term, to the influence of interest groups of one kind or another. [13]

Thirdly, in conditions of natural resource abundance an economy can successfully develop even in absolute monarchies. In so far as the state budget in these countries is practically co-extensive with the budget of the ruling dynasty and that concern for future generations is, in a very literal sense, "close to home", the authorities are more capable of thinking “long-term” and of taking sensible decisions, for example in the sphere of general social welfare. However, in our day and age this type of régime is exceedingly rare and their policies do not always have successful outcomes, as we can see from the record of the Gulf states. Even so – and we should like to emphasize this point – such states are quite capable of achieving economic prosperity.

Our discussion has been based mainly on materials pertaining to the second half of the twentieth century. However, the same logic of events can be discerned in the past. Of course, most problems of economic policy have to be examined in their historical context, with due regard to the concrete circumstances, taking into account above all the level of technological development (as Marx put it, the “level of development of productive forces”). Even so, it seems to be the case that governments in the past, when faced with similar problems, have responded with similar measures and made similar mistakes. Let us take the example of a country that acquired an abundance of natural resources – a benefit that arrived unexpectedly and facilitated this country’s political ambitions. [14]

[13] See Hoj J., Wise M. *Product Market Competition and Economic Performance in Norway*. OECD Economic Department Working Paper N 389. Paris: OECD, 2004.

[14] Another example of similarities between countries is provided by full-scale revolutions. As we have demonstrated in another work, the revolutionary governments of different countries and different epochs respond in very similar ways to the economic and political challenges of a revolutionary era and they always employ the same methods. See Starodubrovskaya I. V. Mau V. A. *Velikie revolutsii. Ot Kromvela do Putina*. [The great revolutions. From Cromwell to Putin.]. 2nd edition. M.: Vagrius, 2004.

2. Spain in the 16th and 17th centuries: American gold and the downfall of a superpower

In the sixteenth century Spain was one of the most powerful states in Europe and, therefore, in the entire world. Following the unification of the Kingdoms of Castile and Aragon, the possessions of the Spanish Crown rapidly expanded. By the middle of the century, the dominions of Charles I, King of Spain from 1516 to 1556, included a large part of the Iberian Peninsula, the Netherlands, Sardinia, Sicily and the whole of Italy south of Rome. In the north, they traversed to the East European dominions of the Habsburgs. They also included the newly discovered lands in America. This was a mighty empire that had evident potential for further expansion. The country had a strong army (with Europe's best infantry), an excellent navy and extensive dynastic ties with the leading Royal houses of the Old World. There was every prospect of the emergence of a vast new empire, especially after Charles became Holy Roman Emperor, as Charles V, in 1519.

The aspirations of the Spanish monarchs were not only territorial, they were also pronouncedly messianic and included the suppression of Islam and Protestantism and the unification of the whole of Catholic Europe. Economic circumstances seemed to favour the Spanish monarchy in its bid to become a superpower. At a time when economic prosperity was based predominantly on agriculture, Spain held the leading positions in horticulture and sheep farming. These branches of the economy laid the foundation for a successful development of textile manufacturing. Additional advantages were a high level of economic development in the Spanish Netherlands (in agriculture and in several branches of industry) and the possession of significant mineral resources (iron, copper, tin and silver) in the Spanish-controlled areas of Central Europe.

However, the principal source of the growth of the political and economic and power of the Spanish empire were the precious metals that became available after the discovery of America. At the time this must have seemed like a double godsend, for not only did the new lands became a source of metal money – all the more valuable in that the price of silver in Europe had recently risen, bringing about fall in the prices of other goods - but also, new technological methods had recently been introduced that considerably reduced the cost of extraction of silver in the New World [15]

[15] Hamilton E.J. *American Treasure and the Price Revolution in Spain, 1501-1650*. Cambridge, MA, 1934. p. 34.

So it was that from the very beginning of the sixteenth century the New World became a source of both gold and silver and by the second half of the 1530s these metals had begun to be delivered in quite substantial volumes. The flow of revenues from the import of precious metals is described in Table 1. These revenues became directly available to the Crown (in modern terminology, to the state budget) and an even greater proportion was acquired by private interests. This proportion, of course, also supplemented the state budget by way of taxation, revenues from coinage, and by other indirect routes.

Table 1: **The purchasing power of the Spanish peso (in thousand pesos)**

Period	**Total imports of precious metals**	**Total Crown imports of precious metals**	**Price index summary (relative to 1580) %**	**Purchasing power of precious metals of the Crown**
1503–1505	371	97	37.5	261
1506–1510	816	213	43.24	494
1511–1515	1195	313	39.78	787
1516–1520	993	260	41.91	620
1521–1525	134	35	49.09	71
1526–1530	1038	272	52.8	514
1531–1535	1650	432	53.23	812
1536–1540	3937	1350	55.76	2422
1541–1545	4954	757	59.45	1274
1546–1550	5508	1592	66.68	2388
1551–1555	9865	3628	70.75	5128
1556–1560	7998	1568	77.98	2011
1561–1565	11207	1819	89.81	2025
1566–1570	14141	3784	91.53	4134
1571–1575	11906	3298	99.18	3325
1576–1580	17251	6649	99.61	6675
1581–1585	29374	7550	108.15	6981
1586–1590	23832	8043	110.52	7277
1591–1595	35184	10023	114.32	8767
1596–1600	34428	10974	129.01	8506
1601–1605	24403	6519	140.65	4365
1606–1610	31405	8549	132.69	6443
1611–1615	24528	7212	127.34	5664
1616–1620	20112	4347	132.06	3292
1621–1625	27010	4891	127.76	3828
1626–1630	24954	4618	131.85	3503

1631–1635	17110	4733	132.60	3570
1636–1640	16314	4691	130.1	3608
1641–1645	13763	4543	126.01	3685
1646–1650	11770	1665	138.01	1206

Source: Flynn D.O. Fiscal crisis and the decline of Spain (Castile). The Journal of Economic History, Vol. 42, Mar. 1982, P. 142.

It was anticipated that gold from America would pave the way for the realization of the ambitious political goals of the Spanish monarchy. Quite possibly, Charles viewed the new source of boundless riches as God's blessing upon his Catholic mission.

The pursuit of superpower status inevitably aggravated foreign relations. Spain became embroiled in a series of protracted wars in different regions of Europe. Charles waged war with the Turks in the Mediterranean region and in Central Europe, with the Protestants in Germany, with France for hegemony in the Catholic world and with a number of other countries. This policy was continued by his successors – Philip II of Spain (1558–1598), Philip III (1598–1621) and Philip IV (1621–1665). In the 1580s, despite the division of the House of Habsburgs (it was Charles's brother, Ferdinand, who succeeded as Holy Roman Emperor), the Spanish Empire under Charles's son, Philip II reached the zenith of its power and territorial aggrandizement. However, this was at the expense of wars that lasted for decades (the 80-years-long war in the Netherlands, the Thirty Years' War in Europe, conflicts with France and England and in other parts of Europe).

Superpower status has never come without a cost. Spain's prolonged military campaigns, which extended over almost a hundred and fifty years, made enormous demands on the state budget. An additional factor was the "`Gunpowder Revolution" – the transition during this period from cavalry to more expensive firearms.[16]

It seemed at first that silver and gold could indeed serve as the reliable foundation of Spain's finances, given the increasing circulation of coin. The inflow of precious metals made for a sharp increase in the money supply and in the budgetary resources at the disposal of the government. However, this abundant money supply enabled the rulers of Spain to ignore the state of the economy and opportunities for bringing tax and budgetary policies up to the standards of the time.

[16] See Nef J.U. *War and Human Progress. An Essay on the Rise of Industrial Civilization*. Cambridge, Mass.: Harvard University Press, 1950.

As would frequently be the case in later resource-rich economies, the economic policy of the Spanish government was astonishingly shortsighted. Spain had no long-term strategy for stimulating production and the isolated measures taken by the government were aimed primarily at easing social tensions and attracting additional revenues. Price regulation, the distribution of monopolies in the production and trading of valuable goods, high and inequitable taxes and the retention of customs barriers inside the country were the key instruments of economic management of the Spanish Crown. Even by the sixteenth century these instruments had begun to look somewhat old-fashioned.

For example, to combat increases in the price of grain, the government imposed price controls and succeeded only in creating a grain shortage. It then decided to encourage grain imports, which had the effect of ruining domestic grain production and turning the country into a grain importer for centuries thereafter. Similar errors were committed with regard to textile production.

The Spanish tax system was archaic and tax levels were among the highest in Europe. Although around 97 percent of all lands belonged to the aristocracy and the Church, direct taxes were levied only on the peasantry, artisans and merchants. A number of taxes were collected by the aristocracy, who transferred the revenues to the Crown. This very narrow tax base was ineffective as a source of budgetary revenues. The system of taxation, being purely fiscal in conception, had the effect of suppressing, rather than stimulating, economic growth. Customs barriers continued to exist between different parts of the Empire (even inside the Iberian Peninsula), a state of affairs that was motivated in part by fiscal considerations, in part by the clinging of the authorities to tradition. Different currencies circulated within the Empire and currency conversion was a laborious procedure in both domestic and external transactions.

In due course the abundant inflow of precious metals gave rise to serious political and financial problems.

The first was that the needs of the Crown for money grew faster than the revenues obtained the overseas dominions. The state budget came under pressure and the national debt increased. For all its ample monetary resources, the state entered into a prolonged period of budget deficit. This had never happened before the reign of Charles I. His predecessors had occasionally resorted to borrowing but for specific and temporary purposes only. Now the budget deficit became chronic.

The logic of the unfolding financial crisis is crystal clear. On the one hand, the Crown felt able to engage in unlimited borrowing, deriving confidence from its vast silver and gold reserves; on the other, creditors willingly lent money (at usurious rates of interest) against the collateral of future supplies of precious metals. In this way, there developed the condition that is known in contemporary social theory as "moral hazard "– when decision makers consider themselves to be immune from the consequences of decisions taken.

The Crown's debt began rapidly to increase. In the first half of the 1570s, Spain's annual budgetary expenditure exceeded revenues by 50 percent and huge sums were spent on the repayment of old debts. In 1575 alone, 36 million ducats – an amount equivalent to six years of budgetary revenues – were spent on paying off old debts. In 1577, the Crown had revenues of 13 million ducats, but by 1582 accumulated debt amounted to 80 million ducats. According to some estimates, two-thirds of the payments made in 1598 (when Philip II died) covered only the interest on government debt. Thereafter, the national debt continued to increase, reaching 180 million ducats by 1667, an unprecedented total for that time.[17]

The second problem was inflation. The financial system was caught in a bind: the abundance of precious metals were the source of substantial monetary resources but this very abundance made for a fall in the per-unit purchasing power of these very precious metals. (see *Table 1*). This inflationary spiral had the effect of devaluing the Crown's revenues.

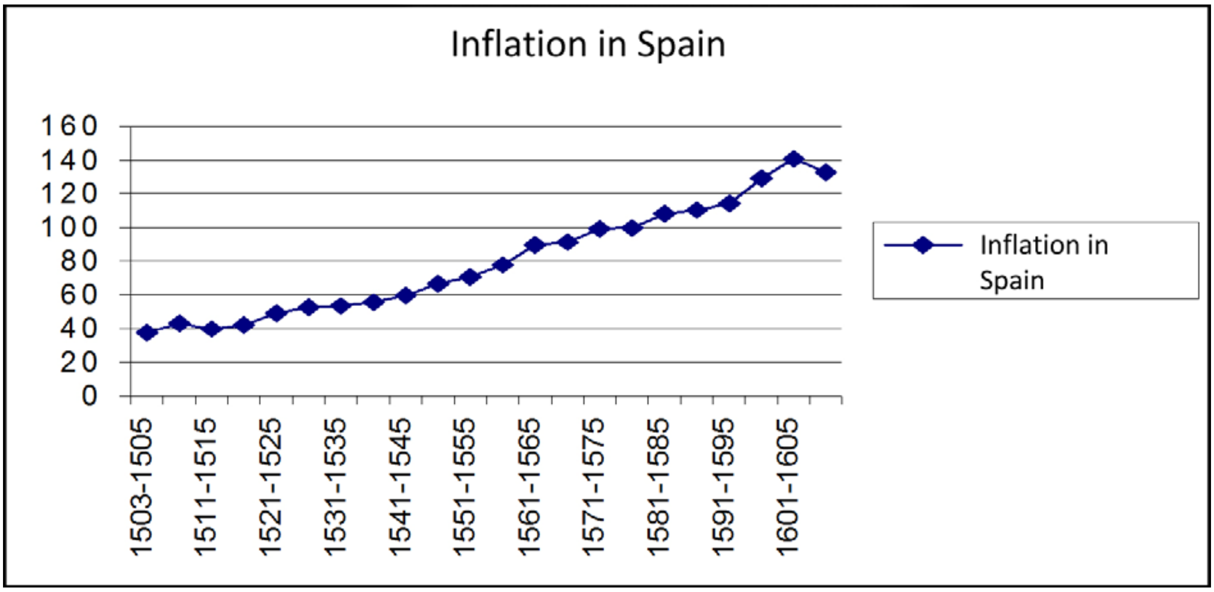
Since inflation was at that time a little-understood phenomenon in Western Europe, a large proportion of treasury revenues (and of the revenues of other economic agents) was accounted for in absolute values. After a certain period of time (in the second half of the sixteenth century), the purchasing power of budget revenues expressed in absolute values (see *Table. 2*), began to decline. For some time this loss of purchasing power was offset by inflows of American gold and silver, but, as later became clear, in quantities insufficient to provide a

[17] See Parker G. *Spain, Her Economies and the Revolt of the Netherlands 1559-1648* // Past and Present. 1970. No 49. P. 86; Parker G. *War and Economic Change: The Economic Costs of the Dutch Revolt* // Parker G. (ed.). *Spain and the Netherlands, 1559–1659*. Glasgow, 1979; Braudel F. *The Mediterranean and the Mediterranean World in Age of Philip II*. New York, 1972. Vol. 1. P. 533; Koenisberger H.G. *The Empire of Charles V in Europe* // The New Cambridge Modern History. Vol. 2. Cambridge: Cambridge University Press, 1958. p. 312.

secure financial basis for Spain's ambitious foreign policy. By the second half of the sixteenth century, the budget of Spain was, more often than not, in deficit (see *Table 3*).

Furthermore, since Spain, for obvious reasons, was the first country to be hit by the depreciation of metal currency, the competitiveness of Spanish producers declined: the cost of Spanish goods in monetary terms exceeded equivalent prices charged in other countries. Something similar to a "Dutch disease" resulted, although the impact was not as great as it would be with the development of the modern global market. [18]

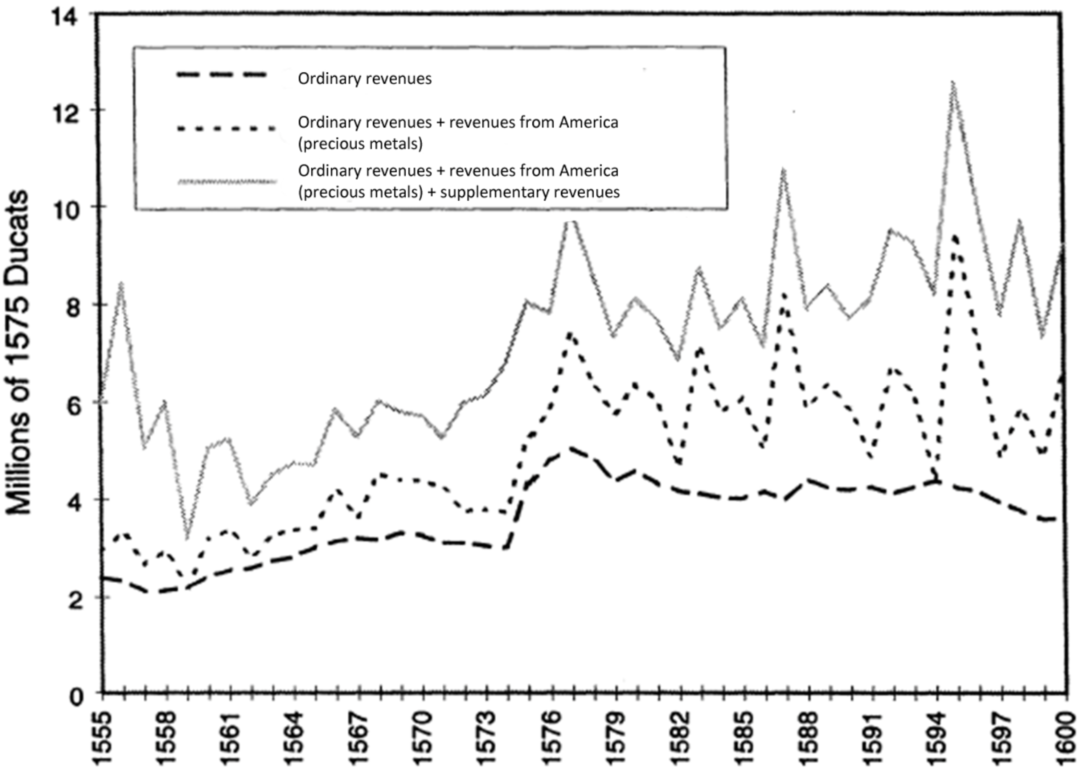
***Table 1.* Price inflation in Spain in the sixteenth century**



Source: Flynn D.O. 'Fiscal crisis and the decline of Spain (Castile)', *The Journal of Economic History*, Vol. 42, Mar. 1982, p. 142.

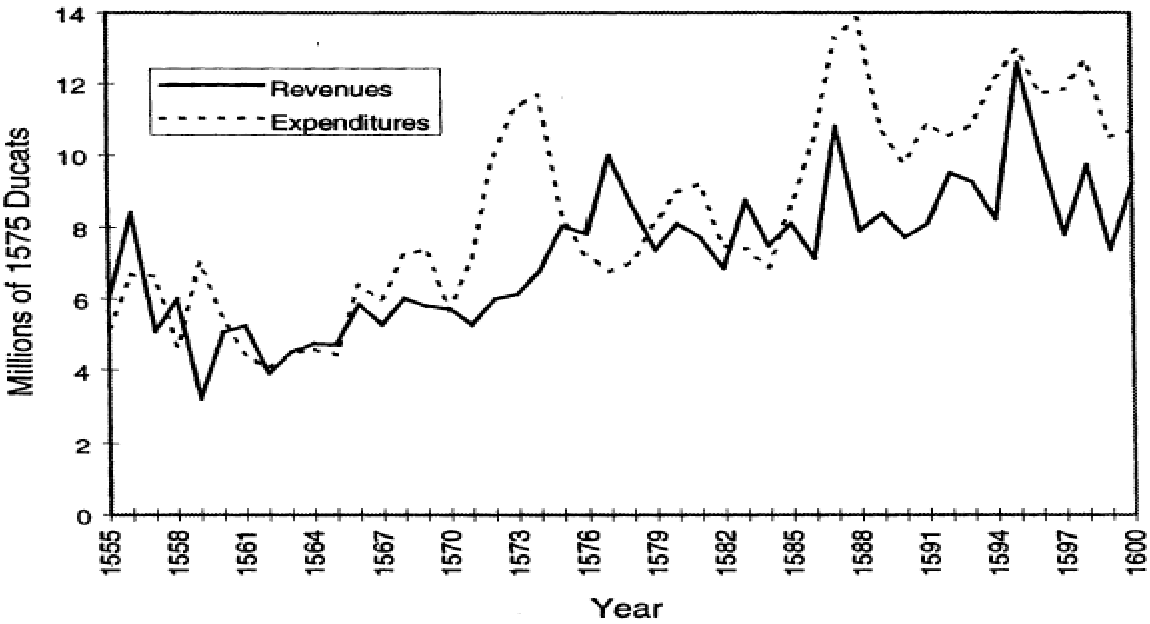
[18] This effect was noted by E. Hamilton, who thought that the rising prices and costs in Spain caused not only a drop in exports but also a decline in shipbuilding and seafaring (See Hamilton E.J. *The Decline of Spain* // Economic History Review. 1938. Vol. 8. N 2. p. 177).

Table 2. **Structure and volume of the revenues of Spain: second half of the 16th century**



Source: Conklin J. The Theory of Sovereign Debt and Spain under Philip II. The Journal of Political Economy, Vol. 106, No. 3, p. 483–513.

Table 3. **Revenues and expenditure of Spain in the second half of the sixteenth century**



Source: Conklin J. The Theory of Sovereign Debt and Spain under Philip II. The Journal of Political Economy, Vol. 106, No. 3, p. 483–513.

The third problem was a direct outcome of the first two problems: the Empire's economy and politics had been "re-structured" according to the apparent advantages conferred by currency revenues and this exposed Spain to two kinds of risk: firstly, the political and commercial weakness of the Crown became apparent to its creditors who, understanding full well that the Crown could no longer survive without their support, acquired the opportunity for blackmail; secondly, the economy and political system of the Empire became increasingly vulnerable to the impact of external events, which is to say to changes in the economic conjuncture.

Spain received foreign loans at high interest rates from a financial cartel controlled by the Genoese, as well as from German, Flemish and Spanish bankers. By way of collateral, the Spanish Crown offered its creditors shares in silver supplies and revenues from particular taxes. The bankers were also granted licenses to service the financial operations of the Crown, including a monopoly on international money transfers and currency conversion. Given that the territories of Spain were scattered throughout Europe, these services were of exceptional importance not only economically but also from the political and military points of view. Since different parts of the Empire employed different currencies, the reliability of currency transfers was of vital importance to the maintenance of political stability. Of even greater importance was the execution of payments for the wars in which the Spanish kings were perpetually engaged. Any inappropriate action by the debtor could result in a suspension of payments by the creditors, with all of the negative consequences that would ensue.

As early as the mid-sixteenth century the dependence of Spain on the inflow of American currency became increasingly problematical. A decline in the supply of precious metals to the Treasury in the second half of the 1550s resulted in a first default by the Crown in 1557 and to another in 1560. The first default was preceded by an unprecedented political default: Charles, apparently realizing that the mounting problems were of an acute and systemic nature, abdicated in 1556 after forty years on the Spanish throne.

The data in Table 1 lend themselves to one further observation: although between 1556 and 1560 the supply of precious metals to Spain decreased by more than half compared with the previous five-year period, yet the volume remained on a par with deliveries from earlier periods (the late 1540s and earlier). However, these 15-20 years had witnessed a number of significant changes in the monetary and financial environment: on the one hand, inflation had reduced the purchasing power of “American” money; and on the other, Spain had become increasingly dependent upon new financial transfusions as it became increasingly involved in projects for imperial expansion.

By the end of the sixteenth century, Spain had become completely dependent on the output of the American mines. A country that had formerly possessed a stable financial system began repeatedly to default on its foreign debts: after the defaults of 1557 and 1560, there were defaults in 1575, 1596, 1607, 1627, 1647, 1653 and 1680.[19] For some time (under Philip II), Spain continued to expand, eventually conquering Portugal with its huge Eastern colonies. However, there ensued a series of military defeats. The crushing defeat of the "Invincible Armada" in 1588 was one of the most grievous blows. The financial crisis was followed by a monetary crisis: lacking budgetary resources, Philip III and Philip IV had recourse to a "spoiling" or "dilution" of the currency, reducing the gold and silver content of a number of coins.[20] But these measures had only a short-term impact on the state budget and were incapable of halting the process of economic decline. During the seventeenth century this decline continued inexorably and Spain ended up as a second-rate power.[21]

Despite mounting problems, the heirs of Charles I persisted with his policies, focusing their efforts on the attainment of imperial and messianic goals and ignoring the need to create favorable conditions for economic development. Spain began to lag further and further behind other European states. The Netherlands, England and France assumed leading positions in the world economy.[22] Seduced by natural wealth (the equivalent of "cheap" money), Spain had aligned its priorities with its new levels of income and succumbed to political and economic self-indulgence. [23] The crisis that ensued was profound and its effects would be felt for the next four hundred years.

To sum up - the crisis of the Spanish Empire was a result not only – and not so much – of its over-inflated ambitions as of its ill-considered and ineffective economic and budgetary policies.

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[19] R. Cameron. *A Concise Economic History of the World: From Paleolithic Times to the Present*. M.: Rosspen, 2001. p. 170.

[20] Motomura A. *The Best and Worst of Currencies: Seigniorage and Currency Policy in Spain, 1597–1650* // The Journal of Economic History. 1994. Vol. 54. N 1.

[21] Hamilton E.J. *The Decline of Spain.* P. 169-170.

[22] «Castile followed an imperialistic policy that was not realistic in consideration of its (or anyone's) resources: in plain words, politically and military, Spain had bitten off more than she could chew». (Flynn, *op. cit*. p. 143).

[23] By the beginning of the seventeenth century a number of Spanish authors had become aware of this. Sancho de Moncada wrote in 1619 that "the poverty of Spain is a consequence of the discovery of America". See Kamen, H. The Decline of Spain: A Historical Myth? // *Past and Present.* 1971. Vol. 81. November. p. 30.

First, inflated political ambitions were partly provoked by the increasing inflow of "cheap" money, which prompted the Crown to intensify its efforts to consolidate and enlarge the empire.

`Second, economic problems were triggered not so much by war as by inefficient policies. World history knows many instances when countries conducted bitter and protracted wars without experiencing financial or economic crisis. The Netherlands during the sixteenth and seventeenth centuries and Britain during the eighteenth century have demonstrated that this is by no means impossible.[24] However, neither of these countries had access to cheap financial resources and both were ruled by responsible governments that paid due attention to the interests of production and trade.[25] These countries were spared the temptations of abundant natural wealth and built their wellbeing on a more solid foundation.

[24] See: Kennedy P. *The Rise and Fall of the Great Powers*. New York, 1987; Wilson Ch. Taxation and the Decline of Empires, and Unfashionable Theme // *Economic History and the Historians*. New York, 1969. p. 120–127.

[25] 'The merchant-oriented government structure of eighteenth-century England aided its war finance and thus its rise as a major power. The Dutch Republic, Spain's most durable enemy, also had a merchant-dominated government and apparent advantages of clear taxation authority and low borrowing costs…'. (Motomura A. The Best and Worst of Currencies: Seigniorage and Currency Policy in Spain, 1597-1650 // *The Journal of Economic History*. 1994. Vol. 54. N 1. p. 124).