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Does fiscal policy influence monetary policy? The case of Spain, 1874–1935 [☆]

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Abstract

The Spanish peseta never formally belonged to the gold club, neither the classical nor the exchange-rate gold standards. It has been traditionally argued that the reason was the predominance of deficits in the Spanish budget from 1874 to 1935. The financing needs of the Treasury led to money creation and, consequently, to sacrificing the gold commitment and a fixed exchange rate. Applying a stationary VAR (Vector AutoRegressive) model, this paper estimates the dynamic link between budget and money and tests whether Spanish fiscal policy actually influenced monetary policy. The results confirm the dominance of fiscal policy for the period and, therefore, provide empirical support to the idea that the problems of the Treasury were behind Spain's renouncement of gold.

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1. Introduction

In 1992, the Maastricht Treaty imposed the cutting of deficits and debt on the countries committed to the building of the European Monetary Union. Implicit in the measure was the agreement that fiscal policy could interfere with the strict monetary policy needed by some economies to control inflation and fix the exchange rate against the euro. The scenario was quite reminiscent of that of a century ago when the impact of fiscal policy on monetary policy was also argued to be the main barrier to some peripheral currencies joining the gold standard or, after joining, to remain in it. This applied to the Spanish peseta in 1874–1935, a period that starts with the Bank of Spain becoming the monopolist of issue and ends with the outbreak of the Spanish Civil war. During this period, the peseta never formally belonged to the gold club, neither to the classical (until WWI) nor to the exchange-rate (after WWI) gold standards.

According to Spanish literature, the failure to control deficits for most of that period led Treasury to repeatedly look for money creation financing (*seigniorage*), provoking episodes of price divergence and preventing the peseta from maintaining gold convertibility. Nevertheless, despite the general perception that the government budget conditioned money creation in these years, there has been no econometric estimation that confirms the existence of a dynamic link between both variables. To overcome this lacuna, we start by presenting, in Section 2, the episodes of Spanish monetary history on which that perception is based. Then, in Section 3, we introduce the theory of *fiscal dominance*. Under a regime of *fiscal dominance* the deficits (contemporaneous or previous) drive the path of money creation. No matter whether or not deficits are immediately monetized through the sales of Treasury or Government bonds to the central bank, the nexus is between deficits and the present value of the revenue from *seigniorage*. For this reason, the theoretical framework of *fiscal dominance* appears especially suitable for analysing the effects of the Spanish budget on money, since a sizeable part of the deficits was financed by the sales of Government bonds to private holders. Thus, in Section 4, by applying a stationary VAR (Vector AutoRegressive) model, we estimate the dynamic link between budget and money and test whether Spanish fiscal policy actually influenced monetary policy. The results confirm the existence of a strong Granger causality from Government budget deficits to monetary base for Spain during the period 1874–1935, in line with the findings obtained for countries such as Italy, with repeated episodes of inconvertibility. On the contrary, the Spanish fulfilment of the hypothesis of *fiscal dominance* contrasts with the absence of links between budget and money in core gold countries such as the United Kingdom and the United States of America. Therefore, given that the confirmation of the hypothesis provides evidence of how Spanish fiscal authorities actually took advantage of the fact that they were not constrained by convertibility clauses, in Section 5, we conclude that the behaviour of the Treasury was responsible for untying the peseta from gold.

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