

# ***The Spanish Financial System and the Role of the Bank of Spain***

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## ***The Legal Framework***

It is difficult to overestimate the role of banking legislation in the evolution of any financial system. The official criteria set out the legal framework that delimits the performance of the credit entities and conditions their development. The legislation also determines the level of competition or the degree of freedom within the sector. The more restrictive the banking legislation, the less competitive the system in general, and the less effectively will it accomplish its intermediation functions. In this section we review the historical evolution of Spanish banking legislation, paying special attention to its most significant landmarks.

The Commercial Code of 1829 contained only a few articles that regulated banking activity and the only thing that was demanded on the founding of financial institutions was that they were approved by the Commercial Tribunal. Under this system three banks of issue emerged, one in Barcelona, one in Cádiz and the Banco de Isabel II, in Madrid; this institution merged later with the Banco de San Fernando, created in 1829 out of the Banco Nacional de San Carlos - the most remote antecedent of the Bank of Spain-, whose origins hark back to 1782. Alongside them were numerous small-credit houses dedicated to the discount of bills of exchange and extending commercial and mortgage loans. The 1848 European financial crisis and the excessive speculation, with the creation of all kinds of

companies that lacked viable economic plans or a solid financial position, led in Spain, as in other countries, to the introduction of significant restrictions on the creation of joint-stock companies. The *Ley de Sociedades por Acciones* (Joint Stock Company Law) made the establishment of credit entities subject to their approval by Parliament provided that they could, when established, prove that their operations would be in the 'public interest'. Soon afterwards, in 1849, another Act, inspired by the English Law of 1844, prohibited the creation of new banks of issue. This left only the San Fernando (the result of the merger between the old San Fernando and Isabel II) in Madrid, and the banks in Barcelona and Cádiz as the only issuing banks of notes and, because of its size, they also tended to monopolise the credit market. The restrictive effects of the laws of 1848 and 1849 were considerable because, over the next decade, very few new institutions were established, and this paralysed considerably bank development in Spain.

Political change in 1854 with the arrival of the liberals to government brought about a modification in the economic environment. Two years later, in 1856, this change was manifested by the public announcement of two important norms that did away with the restrictive period and instigated an extensive phase of financial activity. The *Ley de Bancos de Emisión* (Law of Issuing Banks) ensured that a plurality of institutions could issue notes, although it limited them to opening one establishment in each city or town. The law demanded that the capital of the banks of issue was completely paid-up, no limits were placed upon the volume of issue, nor was a ratio of reserves set. Institutions were simply advised to keep a sensible relationship between notes in circulation, current accounts and deposits, specie reserves and short-term securities held in their portfolio. The same law changed the name of the Banco Español de San Fernando to the Banco de España and the government tried cautiously to increase its control over the bank. The second of the laws, *Ley de Sociedades de Crédito* (Law of Credit Companies), was even more liberal since, in practice, this liberalised the establishment of non-issuing banks, which were only subjected

to a simple governmental decree, and were allowed to perform any kind of banking operation. No ratios were placed on cash, liquidity or guarantees, so that those in charge of the institutions were free to adopt the liquidity and investment policies that suited them. One year later, in 1869, a new *Ley de Sociedades Anónimas* (Joint-Stock Company Act) repealed the previous 1848 Law and completely liberalised banking business by declaring that regional, agricultural, issuing, discount and credit companies could be established freely. Banking history had passed from an extremely restricted regime in 1848, to one of moderate intervention in 1856, and then to one of total freedom by 1869. The effects of this legislation were apparent from the start. Some eighteen banks of issue and over thirty public limited companies of credit were created. Moreover, the entrance of foreign capital into the sector was facilitated and important investment promoters of the period, including the Pereire brothers and members of the Rothschild family, came to Spain, as well as other prestigious intermediary financiers like Alfred Prost. Soon afterwards, a significant number of large Spanish financial entities were established, such as the Banco de Bilbao, the Banco de Santander, the Sociedad General de Crédito and the Compañía General de Crédito.

The period in which there was a plurality of note issue lasted until 19 March 1874, when a government decree authorised the Banco de España to have the monopoly over all note-issuing throughout the national territory. The institutions that had enjoyed this privilege until that moment had to become credit companies or else merge with the Banco de España. The concession of the monopoly was linked to the State's budgetary needs which, in return, obtained a high advance payment from the Bank. It was also true that the concession represented an important step in the consolidation of the Banco de España as a central institution. However, the monopoly concession meant a reduction in the degree of competition in the system because it placed enormous power into the hands of one single organization so that it could control the monetary and credit market. The Bank did not always exercise this

power in accordance with the responsibilities that, at least in theory, it bore as an institution of issue.

The next significant legislative change was the *Ley de Ordenación Bancaria* (Banking Ordinance) of 1921. It attempted to regulate, organise and restructure the banking industry that, according to the text, "cannot be a totally free industry". The aim was to put in order a system that had grown rapidly and somewhat anarchically, and had undergone ongoing crises, the last of which occurred just as the World War ended. One of the objectives of the 1921 law was to transform the Banco de España into a real central bank and convert it into the principal instrument of monetary policy. The law extended the monopoly of issue for another twenty-five years, until 1946, authorised an increase of capital and set a limit on bank notes in circulation, at the same time that it established requirements with respect to specie reserves. Norms for joint action by the Bank and the government were made in order to intervene, when necessary, in the foreign-exchange market; the relationship was tightened between the Bank and private banking through reductions in published interest rates in operations with member banks of the Banking Control Council. In short, the aim was to place the bank of issue at the heart of the monetary system, so that it could then assume the role of true banker's bank, reduce its relationship with the non-banking private sector and increase its relationship with the rest of the financial institutions. It would also become more responsible for monetary policy and, in particular, it would be involved in defending exchange-rate stability.

The 1921 Banking Law also restructured and regulated private banking. The concept of a bank was clearly defined, and an official register of all banks and bankers was drawn up. Every institution operating in the country was obliged to register according to banking geographical zones. As mentioned, the Banking Control Council was also established. This was an organisation where members of the Banco de España and private financial entities would be represented in order to facilitate the relationship between these institutions and the authorities. The Council was empowered to do

many things such as to fix the minimum capital of the institutions, to establish the minimum relationship that should exist between capital, the reserve funds and the amount of creditor accounts, to determine the minimum rate payable on current accounts and time deposits, and the proportion that should exist between short-term assets and sight liabilities, and to set rates and minimum commissions for all banking operations. In addition, the banks would have to send their balance sheets to the Council on a monthly basis. The Council had the power to inspect the institutions and impose sanctions in instances where the legal norms had been violated. To sum up, the 1921 Banking Law facilitated the restructuring of the financial system, established the minimum requirements for the constitution and development of banking business and represented a notable turnaround in banking policy by advancing State intervention, and putting an end to the long phase of unhindered banking freedom. Ten years later, the partial reform of the law went further by accentuating the interventionist role of the State and increasing the mechanisms of control and security. For the Banco de España, the 1931 reform brought about genuine novelties since it reinforced the State's control over it by naming three persons to the Board of Directors; it also raised the percentage of its participation in the institution's profits and increased its control over the operations with private banking. It could be said, then, that, by 1931, the cycle, opened in 1859, whereby the financial system enjoyed a high degree of economic freedom, was closed.

The civil war implied significant changes in the financial and monetary environment and, therefore, in the Banco de España. The disappearance of specie reserves, the expansion of fiduciary circulation caused by the conflict, and the high levels of Treasury indebtedness with the bank of issue rendered some of the precepts of the 1921 Banking Law (reformed in 1931) almost inapplicable. In response, new monetary norms were announced on 9 November 1939: Banco de España notes were declared legal tender and, at the same time, the system of specie guarantees was suspended. Equally, the Treasury was granted unrestricted access to Bank's credit and no limit was set

to the volume of government securities in its portfolio. Perhaps of even more importance was the creation, in the same year, of the *Instituto Español de Moneda Extranjera* -IEME- (Spanish Foreign Currency Institute). This split off the external functions of monetary policy from the Banco de España, by putting the new organization in charge of the exchange rate and foreign-currency transactions. Its appearance on the Spanish monetary scene meant a transcendental change for two reasons. Firstly, because the new organization took over all activities in the field of the control and trading of foreign currency. Secondly, because the power to deal with foreign currency was removed from the Ministry of Finance and the Banco de España and passed to the Ministry of Industry and Trade. With this decision the exchange rate lost both its roles as an objective and as instrument of monetary policy, and broke the relationship between domestic and foreign monetary policy.

In 1946, the Law of Banking Organisation of 1921 was replaced by another law of the same name. Essentially, this consolidated the monetary and banking principles that had been established between 1939 and 1942 and, in addition, renewed the issuing privilege of the Banco de España. The Bank continued to be a private institution although it was subject to considerable public control. The law also included a section that established the general norms for the so-called official banks, at that moment, Hipotecario, Exterior, Crédito Industrial and Crédito Local. At the head of each establishment was the government-named commissary of the official bank, and the Ministry of Finance had to approve the interest rates, service tariffs and commissions. The law also concerned the statutes of private banking. The Register of Banks and Bankers was created so that only those registered in the same year of the law's publication were authorised to work in the banking profession. Concurrently, it was established that the founding of new institutions would require governmental authorisation, after a report from the Banking Control Council, which applied an extremely restrictive policy that did not allow the entrance of new competitors so that the banking "status quo", initiated by ministerial order on 19 October 1939, was

consolidated. The 1946 Banking Law kept the strict rules on banking operations. The Ministry of Finance fixed the maximum rate payable to current accounts and time deposits; set the rates and minimum conditions in all active operations; dictated general and obligatory rules about the distribution of dividends and about the publication of balance sheets and income statements. The Ministry of Finance also kept the power to fix the minimum capital of banks, the minimum relation that should exist between the current assets and the liabilities and the upper limit of determined credit accounts. In addition, the Ministry of Finance was in charge of forcing banks to make a special deposit of up to twenty per cent of the liabilities in the Banco de España. At the same time, increases in capital, provision of reserves, dividend distribution, exchange and acquisition of shares by other financial institutions and the opening of offices or branches were all subject to Ministerial approval. The 1946 Banking Law certainly put an extremely rigid framework into place characterised by considerable State intervention and a strong trend towards administrative regulation. Although the Banco de España had not been nationalised, it came nonetheless heavily under the control of the government through the overwhelming influence exercised by the Ministry of Finance. To summarise, the banking laws passed between 1939 and 1946 radically altered the monetary system that up to then had been in place. The obstacles that the Public Treasury had experienced in accessing to the Banco de España resources disappeared, and this led to a reduction in its traditional responsibilities as a central entity, the institution was transformed into a mere appendix of the Ministry of Finance, and with the only task of obeying its orders. The 1946 Banking Law represented a step backwards in the transformation of the Banco de España into a central bank. With the IEME in place, that domestic and foreign monetary policy were split up, and this lasted several decades, rendering effective monetary control impossible. Without a real purpose, or with the sole purpose being to finance the Treasury, the Banco de España vanished as a central bank until the end of the 1950s.

The legal framework of the Spanish financial system changed again with the *Ley de Bases y Ordenación del Crédito y la Banca* (Law of Basis and Organisation of Credit and Banking) and with the Decree-Law of Reorganisation and Nationalisation of the Banco de España, both of which were passed in 1962. The first profoundly modified the financial structure and initiated the process of liberalisation. The Banco de España would control and supervise the banks; the existing mixed banks could continue in the same structure and business, but the new banks that were established had to specialise as business institutions (industrial banks) dedicated to financing companies in the medium to long term, and strictly commercial banks (deposit banks) dedicated to discounting and short term lending. The entry barriers to the sector were relaxed, as was the expansion of existing banks through new branches throughout the country. The *Instituto de Crédito de las Cajas de Ahorro* (Institute of Credit of Savings Banks) was introduced to regulate and supervise the savings banks, while the *Instituto de Crédito a Medio y Largo Plazo* (Institute of Medium and Long Term Credit) was established to co-ordinate and control the official bank. The liberalisation of banking operations only advanced a little since the majority remained subject to the control and approval of the Ministry of Finance, though the policy was loosened, allowing greater banker's initiative. In return, banks and savings banks were obliged to channel part of their resources under special conditions towards economic sectors deemed priority by the government. The "status quo" that had lasted over two decades concerning access to the banking profession was broken, albeit gradually, since the requirements for access continued to be restrictive and authorisation was still discretionary. This explains why the new banks established after the 1962 reform did not become powerful enough to genuinely compete with the large mixed banks. The law undoubtedly stimulated the quantitative growth of the banking system, and brought it out of its former lethargy, but it did not introduce a dose of competition, since it remained regulated and subject to heavy administrative control. The Decree-Law of 7 June 1962 finally nationalised the Banco de España, thus ending its long history as a private bank. The Banco de

España was put in charge of freely issuing legal tender and service to the State Treasury and to other bodies according to Treasury requirements. The Bank would also take on all the functions belonging to a banker's bank, both commercial and financial operations, as well as those concerning inspection and discipline. In addition, the Bank was converted into a Government's body of advisors for matters concerning money and credit. Preparations were made so that foreign payments and the centralisation of specie reserves and exchange would go through the nationalised Banco de España, but the decision was postponed, and the IEME maintained responsibility for foreign monetary policy until 1973. Regardless of the progress made in 1962, the nationalisation had some important defects. The relationship between the Banco de España and the Ministry of Finance remained undefined. Communication between the two was not properly established, and this limited the capacity to influence the Bank during the process of taking monetary decisions. The note-issuing Institute also received very little autonomy from the Ministry of Finance. The Ministry reserved not only the right to define monetary goals but also kept considerable powers to manipulate monetary instruments. The only objectives left to the Bank were to consult and inspect private banking. Besides, the Banco de España had to share its role as a consultant because the law diversified the number of organizations with the responsibility of giving advice on credit and financial policy. The Institute of Medium and Long-Term Credit, the Institute of Credit of Savings Banks, and the Treasury Director General, could all advise the Ministry of Finance and the government. This generated considerable confusion. Finally, in relation to the instruments of monetary control, the legal text did not contain many novelties. The Ministry of Finance fixed the exchange rate, excluding all autonomous intervention from the Bank. The Ministry also reserved all responsibilities in open-market operations; as for the rest, the law did not refer to a third and fundamental regulatory tool, the cash and/or liquidity ratios.

The real liberalisation of the Spanish financial system commenced in 1974 when a series of decrees was announced that reformed the

most restrictive aspects of the 1962 Law. The difference between commercial and industrial banks was eliminated, the administration's discretion power of creating new institutions and open offices was diminished, the structure of ratios was rationalised and, above all, the first steps were taken towards interest-rate liberalisation, both for assets and liabilities operations. The reforms continued until 1977, particularly in relation to the deregulation of banking operations and of control over interest rates, towards progressively removing the obstacles to competition among institutions, a process that would continue at a faster pace over the next two decades until the system was fully liberalised. The authorities' decisions had three main ends: the reinforcement of the instruments of monetary policy with the objective of making their future use more efficient, the liberalisation and approximation of the interest rates to free market conditions as an essential requirement of greater efficiency in the workings of the financial markets and, finally, the modification of the structural characteristics of financial institutions' workings.

The Banco de España was reformed in 1980 with the *Ley de Organos Rectores* (Law of the Governing Council). This gave it greater autonomy in its internal workings and as an instrument of monetary policy within the general guidelines set out by the government. The Bank was defined as a public-law institution, having its own legal entity and full public and private capacity so that, in order to fulfil its responsibilities, it could act autonomously with respect to the administration. Although this did not constitute a functional rule, it helped the institution assume higher levels of autonomy. Apart from the traditional responsibilities of issue, such as banking supervision and the centralisation of foreign exchange, it was established that, with respect to monetary policy, the Banco de España "would be in charge of foreign and domestic monetary policy: in accordance with the general objectives set by the government, it would apply these in a way that it considered the most adequate for the fulfilment of its aims, especially in safeguarding the value of money". In addition, it stated - and this is important - that it should inform and advise the government in all these matters "with the capacity to take the initiative

of elaborating the reports it deems pertinent". The text of this law assumed a large recognition of autonomy with respect to monetary policy since, within the objectives that the government drew up, the Banco de España enjoyed an extensive decision-making capacity. This greater autonomy was reinforced by the capacity to elaborate reports on its own initiative, and was an aspect that, over the next few years, it would deploy forcefully and use as a potent mechanism to widen the influence of the Banco de España. Finally, the *Ley de Autonomía del Banco de España* (Law of Autonomy of the Banco de España) on 1 June 1994 signalled the complete transformation of the context in which monetary policy develops in Spain. The Law of Autonomy responded to the demand contained in Article 108 of the Maastrich Treaty that, in order to join the European Monetary Union, the Banco de España would specifically have to be "subordinated to the government in general terms, and enjoy full autonomy of decision-making in the field of monetary policy with the aim of better preserving the objective of price stability". At the same time it gave the issuer the responsibility of formulating what it considered the most effective policies, establishing intermediate growth targets for monetary aggregates, or interest rates, or using other procedures that were deemed appropriate.

From the middle of the XIXth century, Spanish banking legislation, like that in other European countries, passed along one trajectory only to return to where it had started. After a very restrictive episode imposed by the 1848 Law, the banking system operated during the 1854-69 period within a relatively liberalised framework. The monopoly of issue given to the Banco de España in 1874 reduced the amount of freedom in the sector, but the rest of banking activities were allowed to develop with very few regulations that could constrict their operations. The situation started to change in 1921, when there was a will to reorganise the system that had grown very quickly, but that also had undergone successive crises; at the same time, there was an attempt to place the Banco de España at the core of the system, in order that it might assume the responsibilities of a central bank. The intervention inaugurated by the 1921 Law was reinforced by the 1931 reform, but it was not until after

the civil war when this would reach greater levels of intensity. The provisions of 1939 and 1946 converted banking business into one of the most regulated in the Spanish economy, since all its activities and operations were subject to strict administrative control. In a few decades, there had been a shift from a relatively liberal legislative framework to one that was highly regulated. However, the return journey started in 1962. Ways of liberalising the system were introduced cautiously: the "status quo" was eliminated and the main operations of financial institutions were deregulated. At the same time, the Banco de España was given greater degrees of autonomy, which it had completely lost in 1939. The full liberalisation of the financial system was completed after the accession of Spain into the European Community in 1985 and the Banco de España became fully independent in 1994.

### ***The functions of a central bank and the slow learning process of the Banco de España***

As Forrest Capie has recently reminded us, central banks should fulfil two functions. Firstly, a macroeconomic function, the maintenance of price stability and that of the exchange rate. Secondly, a microeconomic function, which is to keep the financial system stable. These functions have not always been understood in the same way, and the banks that have these functions today were created originally with different objectives. Central banks, like any other essential State institutions, are a product of history. Charles Goodhart noted that, when the first central banks emerged, like the Riksbank in Sweden, the Bank of England or the Bank of France, nobody expected that they would take on the functions they assume today. They were set up on the initiative of individual governments as private commercial entities with special privileges. These privileges differed but always included having a monopoly over note issue. In return for government privileges, central banks provided financial help to the government. In Spain, the situation was similar, since the Banco Nacional de San Carlos, the oldest antecedent of the Banco de España, was established to sustain the value of the debt issued by the State (*vales reales*).

In addition to their function as State bankers, Goodhart indicates that another duty of national banks was to maintain the convertibility of notes and specie deposits, in gold and/or silver, depending on whether they operated in mono-metallic or bi-metallic standards. In time, ensuring note convertibility became one of their main objectives, in particular, from the moment that they were allowed the monopoly of issue. This responsibility had to be made compatible with the banks' character as profit-maximising private commercial companies. The question that was asked, that had not been foreseen, was how these banks were to fulfil this commitment that logically restrained their freedom to behave in the way they wished, while they were simultaneously working as normal commercial banks.

The second question, which is closely linked to the first, was the role the bank of issue had in relation to the rest of the financial system. On the one hand, it competed with the other banks in the banking business by trying to attract greater amounts of deposits and clients. However, this behaviour as a private entity could, and indeed did, come into conflict with its role or function as a central authority responsible for convertibility and as the owner of the reserves on which the system was founded. Thus, a national bank competed with the other banks but, at the same time, it had to provide liquidity in the system while also looking after the system's stability. These tasks were not at all easy and, logically, they generated many problems and tensions. The resolution of these conflicts was time-consuming and meant that, gradually, the national banks became less and less commercial. On the other hand, the relationship between these banks and the government was uneasy and subject to serious tensions. In this case, the conflict was between a bank that had to ensure note convertibility and a government that constantly demanded liquidity to finance its expenditures, especially during periods of war. In this case, the adherence, shared between those responsible in the central bank and in the Treasury, to some kind of metallic standard was the only way in which the conflict could be resolved.

Thanks to the extensive literature on central banks, we know that the learning process about the functions assigned to central banks

has been slow in all cases. We believe, however, that the process of conversion has been easier and quicker when certain circumstances have been present that favoured this transformation. One such favourable condition was what we may call 'external exposure'. The learning process has been facilitated when the institution carrying out the role of the central bank has been in contact with foreign markets and has had close links to the international monetary system. Thus, central banks that participated in the gold-standard system and were obliged to be concerned about currency stability and convertibility learned how to fulfil their role as monetary authorities much more effectively than central banks that had never had to participate in the gold standard. The degree of openness of the economy and the structure of the financial system, as well as its level of competition, constituted other factors that led to good central-banking practice. A central institution that operated within a regulated system, or a highly oligopolistic system, had few opportunities to learn how to carry out its role as a banker's bank. Competition within the system forces a bank to acquire more quickly the knowledge required in order to manage monetary policy and act as a lender of last resort. Another important circumstance in the learning process is the type of relationship and links with the Public Treasury. Central bankers that were more autonomous from the Treasury, either because of the statutory rules in place, or for other reasons, were those that progressed first. This is because they enjoyed greater independence and freedom and, therefore, also became better central banks. On the contrary, central banks that are like a department of the Treasury have rarely had to behave as monetary authorities since their principal and sometimes exclusive mission was to provide liquidity to the Treasury. The fourth factor that should be taken into account is the human factor: the quality of the banker. Studies of central banks and the available biographies of governors and directors show the financial capacity of some of the people who directed the central institutes, their grasp of the facts and their interpretation of monetary phenomena. The director of a central bank is an important element in the evolution of a bank of issue into a real central bank.

In Spain, none of the above circumstances were present until very recently. Firstly, the participation of the Banco de España in foreign affairs has been historically quite limited, thus the peseta was not linked to the gold standard, either before or after the First World War. Secondly, if we compare Spain with its European peers, the level of openness and competition in the Spanish economy have been relatively restricted. Thirdly, financial requirements of the budget led to a close relationship between the Banco de España and the Public Treasury since the latter needed the bank to finance its ongoing deficit. Finally, we know that the directors of the Spanish central bank always preferred to behave like private bankers, trying to avoid what was for them the inconvenience of accepting the role as lender of last resort. Therefore, until its nationalisation, they avoided assuming the responsibility that they bore as the leaders of the country's most important financial institution.

In the following section, we set out four monetary episodes that show that the Banco de España, by 1935, before the outbreak of the civil war, still had not become a central bank. It is, however, true that some of the episodes reveal also that some signs of that transformation was already underway. The first episode takes place during the First World War, the second refers to the banking crisis in the middle of the 1920s, the third concerns the attempt made by the Spanish authorities between 1927 and 1929 to implement the gold standard, and the fourth discusses the behaviour of the Banco de España during the 1930s economic crisis.

During the First World War, Spain remained a neutral country and, like the other non-belligerent countries, it gained a large surplus in its current account balance, registering a massive influx of gold, which was channelled into the coffers of the Banco de España. The bank of issue happily received this influx of gold that reinforced its specie reserves because at the same time it produced a spectacular appreciation in the exchange rate of the peseta in comparison with other European currencies, which approached the theoretical parity that had been defined in 1868 (25.2 pesetas per pound sterling). The Bank's authorities believed that the influx of gold was

responsible for bringing about the appreciation of the exchange rate.

What was the attitude of the Banco de España in the face of this 'avalanche' of gold? It sat back, watched what was happening, and took no decisions. It did not take any measures to introduce a sterilization policy, as was done in Denmark, Sweden, Norway and Finland during the same period. As a consequence, there was an extraordinary increase in the money supply between 1914 and 1918. This increase triggered considerable inflation, and the Public Treasury deficit of the same period had the effect of adding more fuel to the fire. Naturally, the inflationary process eroded the real gains of businessmen and workers made between 1914 and 1918. If this occurred it was largely because the Banco de España did not know exactly what were the consequences of this influx of gold, used an erroneous theory of the exchange rate, and believed that foreign exchange depended on the quantity of gold it had in its coffers. Given this inaccurate and basic interpretation of the facts, the outcome is not at all surprising. The gold served only to improve temporarily the exchange rate of the peseta, while its inflationary effect was to liquidate the prosperity generated by the war in only a few months.

The second episode concerns the prolonged banking crisis of 1920-1924. This emerged because of the serious industrial difficulties of the post-war period. A significant number of financial institutions confronted serious problems of liquidity and solvency that frequently resulted in suspensions of payments and sensational bankruptcies. The banks with heavy investments in mining companies and iron and steel works, which were the sectors that most suffered after the war, could not withstand the situation. Neither could those that, at the beginning of the 1920s, had operated imprudently in the unstable foreign exchange market. Between 1920 and 1924, over a dozen entities were closed down, and a much large number encountered serious financial difficulties, among them the Central Bank, one of the key institutions in the Spanish banking organisation.

In the face of the crisis, the position of the Banco de España was, firstly, to ignore the situation and, secondly, when pressured by the

government, to argue that it had nothing to do with the banks' situation, since it could not take responsibility for their problems. If bad loans had been made, it was logical that bankruptcy would result. If banks had a high level of irrecoverable credit, the directors were to blame. At the beginning, when only the small banks collapsed, the system resisted. However, when the crisis hit a big private institution named the Central Bank, the situation became more dangerous. The Banco de España's advisors did not think that the bankruptcy that had occurred in a few institutions threatened the stability of the overall financial system. Even when the crisis worsened, affecting nearly one third of the system and threatening the stability of the banking system as a whole, the Banco de España remained intransigent. In the face of the Banco de España's passiveness, the government was forced to intervene, led at the time by General Primo de Rivera. He ordered the Bank's governor to assist entities experiencing a lack of liquidity and, in particular, to support the Central Bank. It was precisely this personal intervention by the Dictator that made the bank of issue behave as the lender of last resort.

The third episode occurred between 1927 and 1929 when the Spanish authorities tried to stabilise the exchange rate of the peseta and implement the gold standard. The initiative came from the Finance Minister, Calvo Sotelo, an expert in Spanish finance, who saw the opportunity and necessity - partly in order to gain political prestige, but also for economic reasons - to link the Spanish monetary system with that of the international economy. The exchange rate to which the Finance Minister wished to fix the peseta was that of the theoretical parity of 1868, as did the Banco de España. However, neither Calvo Sotelo, nor the directors of the bank of issue, realised that this parity, which clearly overvalued the peseta, demanded a strongly restrictive monetary policy and a high level of financial discipline. Adopting the gold standard implied that the Banco de España would have to compromise its important gold reserves in defence of the exchange rate when necessary.

As none of these demands were fulfilled, the attempt to introduce the gold standard and the convertibility of the peseta was a resounding failure. The Treasury was unwilling to impose the necessary financial

discipline, although it is true that it managed to reduce the level of the budgetary deficit. The Banco de España resisted raising its interest rates and containing monetary expansion; nor did it offer its specie reserves in order to make stabilisation possible. For those in charge of the bank of issue, the factor that determined the exchange rate was the trade balance, and the trade balance was determined by prices. At the same time, they argued, prices were not determined by the money supply. Their argument followed another line of causality since, they said, the increase in the money supply was supported by the specie reserves. For the Bank, the stability of the peseta did not depend on variations in the quantity of money, but on the existence of an abundant gold reserve. On the other hand, the Banco de España's advisors considered that monetary and exchange-rate policy was the Government's responsibility, while its function consisted of looking after the note issue, helping the Treasury when necessary, and taking care of its interests as a commercial company. To sum up, in view of this, we can affirm that by 1930, the Banco de España was not aware of its macroeconomic functions nor of its microeconomic duties.

The fourth set of events refers to the role carried out by the Banco de España during the financial crisis of the spring and summer of 1931. In Spain, as in other European countries, there was a liquidity crisis in 1931. Two reasons contributed to the fall in banking deposits: firstly, the dramatic financial events that occurred in Austria and Germany, whose effects contaminated economies throughout the entire continent, including that of Spain; secondly, the internal political events that led to a radical change of regime, the substitution of the monarchy by the Second Republic in April 1931, which triggered general alarm among investors. Additionally, as in other areas, the banking panic was accompanied by strong pressure on the exchange rate that provoked the collapse of the peseta in relation to the pound sterling and the dollar.

In the face of the sudden fall in the exchange rate of the peseta, the Spanish authorities put shock measures into place that essentially consisted of raising at various times the discount rate of the Banco de

España, agreeing foreign credit guaranteed by gold with the Bank of France and the Bank for International Settlements, and reinforcing the foreign-exchange regulation that had already been introduced some years before. Defending the peseta took up most of the energy of the Ministry of Finance and used up most of its credit, but did not prevent the fall in the exchange rate. Administrative measures were no more successful despite the fact that greater controls were placed on capital movements. The struggle to obtain monetary stability was temporarily abandoned in September, after the pound sterling left the gold standard by the end of the year. From then on, the policy for the peseta consisted of expanding the foreign -exchange regulation system.

Action taken in the face of the financial crisis was effective and, for the first time, the Banco de España, in collaboration with the Treasury, behaved as an authentic lender of last resort, promoting liquidity in the system in order to avoid a general collapse of banks and savings banks. Through its lines of discount and loan facilities, within three months, the Banco de España confronted the problems of financial entities and compensated for the withdrawal of deposits by supplying the cash that the public required during this generalised climate of panic. This is, perhaps, one of the first instances when the Banco de España behaved as an authentic bankers' bank. Those in charge of the bank realised that the difficulties encountered by credit entities were not due to insolvency but rather to panic among the public that threatened to paralyse the country's financial system. Unconsciously, they followed the famous rule established by Walter Bagehot for those situations whereby a domestic and foreign crisis occurred simultaneously: lend freely but at a high interest-rate.

During the inter-war period, the Banco de España did not make much progress towards the objective of becoming a central bank. In the banking crisis at the beginning of the 1920s it wanted to wash its hands of the difficulties encountered by a significant number of financial entities and it only behaved as a lender of last resort when the government forced it to do so in order to avoid the collapse of a large bank that would have endangered the entire financial system. Although its attitude in 1931 was somewhat different, and it helped

banks that were in need without restrictions, it is still true that the Ministry of Finance had to pressurise it by convincing the Bank's directors that, without their collaboration, the system would go bankrupt. As regards the stability of the peseta, the Banco de España never considered itself responsible for the exchange rate, nor did it wish to support the Ministry of Finance's projects to implement the gold standard. In contrast to other European central banks, it did not consider that one of its responsibilities was to look after the stability of the exchange rate, above all, because it feared defending the peseta could compromise its gold reserves that, in 1930, were among the highest in the world. To sum up, by 1936, before the outbreak of the civil war, the Banco de España had not become a modern central bank that took responsibility for monetary policy.

### ***The evolution of the Banco de España over the last fifty years***

As mentioned in the first section, after the civil war, Franco's regime introduced a new monetary system that, logically, affected the Banco de España. On the one hand, although the bank of issue was not nationalised until 1962, it completely lost its autonomy and became deeply dependent upon the Ministry of Finance. On the other hand, all the responsibilities concerning exchange-rate policy were transferred to a new body, the Spanish Foreign Currency Institute, which depended on the Ministry of Trade. In this way, the powers to manage domestic monetary policy were passed to the Ministry of Finance and those of external monetary policy to the Institute. The Banco de España, therefore, was left without a mission or, perhaps, with the sole mission of financing the Treasury.

State interventionism also was apparent in the financial system via a rigid regulation of the credit system. The Ministry of Finance subordinated all banking operations to strict regulations which ranged from fixing the interest rates of active and passive operations to the establishment of dividends to share among the credit entities, including the imposition of investment ratios that obliged them to buy public and private bonds of low profitability, or concede long-term credit

for certain activities. To this should be added the maintenance of what was called the banking "status quo" policy, which ended the interventionist cycle. This was adopted as a provisional and emergency measure in 1936, but in 1940, various regulations led to it becoming permanent. In accordance with this post-war rule, it was forbidden to create new banking entities or open new offices or branches. It was also not allowed to make legislative changes, increase its capital, launch public offer shares or let bankers attempt take-overs in any other banking business than that established for the entity in which they worked. Although successive regulations eliminated and diluted the initial norms, the "status quo" survived almost intact until the Law of Reorganisation of the Financial System (*Ley de Reorganización del sistema financiero*) in 1962.

During the 1940s and 1950s, the fundamental duty of the Banco de España was to attend to the financial requirements of the Treasury. A careful reading of the records of meetings of the Board of Directors and annual reports leave no room for doubt: during this prolonged period the bank of issue did not manage or implement monetary policy. The sporadic decisions that were taken, in total six modest modifications to the discount rate, were all taken by the Ministry of Finance, the organization which was, in fact, in charge of managing domestic monetary policy. The Banco de España's Board of directors lacked initiative and autonomy: their role was limited to obeying orders and following instructions passed down to them from the Finance Minister. For the entire decade, the bank of issue was wholly dependent upon the Ministry. This is proved by the everyday and irrelevant nature of the affairs discussed by the Board of directors. Though it may seem paradoxical, monetary topics were rarely discussed during meetings of the supreme council of the Bank's Administration. If a matter relating to the excessive increase in the money supply and its effects on prices was raised, the governor and the State representatives immediately declared the meeting over.

Monetary instruments were hardly used and monetary policy was abandoned. For this reason the period between 1940 and 1959 was

characterised by a policy of monetary management that resulted in the creation of resources at an artificially low interest rate, and in a policy of administrative control of foreign transactions, exercised by the Institute, that was in charge of foreign-exchange regulation from 1939. The creation of means of payment was produced in these two decades in one way: issuing public debt to finance the budgetary deficit, placement in the bank and savings banks and subsequent monetization of this debt in the Banco de España itself; that is, through the monetization of the State debt. The consequences of this passive monetary policy were reflected in an uncontrollable expansion in the money supply that increased at the explosive rate of nine per cent annually between 1941 and 1945, then at thirteen per cent between 1945 and 1952, until it reached nineteen per cent between 1953 and 1959. As the growth of GDP was clearly well below these percentages, a considerable "inflationary gap" appeared, between ten and fifteen per cent, that gives us an idea of the unbalance in the Spanish economy. From 1940 to 1949, the wholesale price index grew at twelve per cent, and from 1950 to 1950 at fifteen per cent. To fight against this inflation, the governments of the time resorted to all types of control and price regulation and, occasionally, credit rationing. However these efforts were not very effective.

The time for active monetary policy came with the preparation in 1959 of the Stabilisation Plan, in which the Banco de España worked hard in elaborating and executing. In 1957, there had already been a reactivation of the discount policy and the Ministry of Finance stopped the issue of monetized public debt with the aim of preventing monetary expansion. In 1958, conversations started about Spain's entry into the international economic organisations that emerged from the Bretton Woods, such as the International Monetary Fund, the International Bank for Reconstruction and Development, as well as the OECD. Officials from various ministries as well as economists from the Banco de España took part in these talks. The stabilisation programme included typical measures to obtain monetary and exchange-rate market stability: a big increase in the interest rate, a limit on credit to private banking, a cutback in budgetary expenditure

and a drastic devaluation of the exchange rate to correct the deficit of the balance of payments. In order to ensure the operation was successful the Spanish authorities obtained a significant loan in dollars from the international organisations. The results of the measures adopted could be noticed within a year and, by the end of 1960, the main imbalances had been corrected; the public deficit was transformed into a significant surplus and the current-account balance of payments' net position was favourable with the consequent recovery of international reserves. At the same time, inflation fell significantly and during the years after the Plan prices remained quite stable.

For the Banco de España, this new direction in the Spanish economy meant a change in its trajectory as a central bank. In particular, created a greater role in Spain's political economy. However, its inadequate institutional framework (it was still a private entity) and its lack of monetary instruments were put into sharp relief. In order to resolve these problems and bring about a liberalisation of the financial system, the Law of Bases of Organisation of Credit and Banking (*Ley de Bases de Ordenación del Crédito y la Banca*) was approved in 1962 that considered the nationalisation of the Banco de España. As has already been pointed out, the 1962 reform attempted to define responsibilities for the Banco de España, so that, with adequate tools, it would be able to develop monetary policy effectively. However, the new regulation was approved with important faults. The relationship between the Banco de España and the Ministry of Finance remained undefined: the Institute of Issue did not receive much autonomy and the Treasury reserved for itself not only the facility of setting the objectives of monetary policy but also expanded its duties in the field of monetary instruments. The Bank lacked the power not just to elaborate the immediate objectives of monetary policy but also to put into practice those established by the government. It was left only with the mission of consulting and inspecting private banking, although it had to share this responsibility with other organizations; it did not tackle the technical problems connected with the instruments of monetary control; the split between domestic and foreign monetary policy remained, and the Bank

continued to be totally subordinated to the Ministry of Finance. In brief, the 1962 Banking Law nationalised the Banco de España, but it did not go as far as to convert it into an authentic institution of issue responsible for monetary policy.

In the final stage of the Franco regime, between 1962 and 1975, monetary policy was used to serve development policy, and price stability was sacrificed on the altar of maintaining high growth rates in production and income. Olivier Feiertag and Pablo Martín Aceña have shown in a recent article that compares the experiences of the central banks in France and Spain that, in both countries, monetary control was almost non-existent, while 'money' was sacrificed to the 'economy'. What this means is that money creation was subordinated to the general policy of development. As all the authors who work on this topic have shown, after nationalisation, the Spanish authorities practised a system of passive money in which the money supply was adapted to the requirements of money demand. In addition, in the years where Keynes exerted a strong influence, there was significant scepticism about the effectiveness of monetary policy; studies, with little justification, promoted the idea that private investment demand was not sensitive to the rate of interest and this was wielded as a decisive argument against monetary policy. It also served as an excuse to justify policies of "cheap money" because these facilitated post-war reconstruction and the enormous burden of the public debt in public hands was reduced, whose refinancing required the least cost possible. Monetary policy was used only in a transitory way in moments in which the difficulties of the balance of payments appeared to threaten the continuity of the process of growth. Monetary rigour, when it was used, was attained not by soft and continuous regulation of the monetary base, but by quantitative limits to the growth of private-sector credit and especially through deposits following importation. However, during most of the period, the economy enjoyed a comfortable liquidity that the Banco de España supplied through automatic rediscounting of the credit-instruments of those sectors that were considered priority. The Banco de España did not possess adequate instruments, such as a flexible discount policy or

effective liquidity ratios, neither could it carry out open-market operations due to the insufficiency of the institutional framework and the excessive level of regulation within the financial system.

However, it is true that during the course of the 1960s there was a mild effort to provide monetary authorities with more efficient tools to control policy. In 1969, a greater level of flexibility was introduced into the management of the rediscount rate; in 1970, the legal cash ratio was approved and, one year later, special credits generated from special automatic facilities were eliminated. However, Spanish monetary policy only started to have adequate means of actively and continuously managing monetary variables from 1973. In this year, the Banco de España took over all the functions that had been given to the Foreign Exchange Institute so that, finally, it could recover control of external monetary policy. At the beginning of the 1970s, the Banco de España had two basic tools with which it could potentially control actively the liquidity in the system: cash ratios and ordinary lines of rediscounting. Its most important limitation was that it was dealing with discontinuous instruments of intervention. The next step would be, in the second half of the 1970s, to create active money markets and design a scheme of monetary policy that was capable of exercising effective control over the system's liquidity.

The Banco de España's behaviour during the 1940s, 1950s, and even during the 1960s, deserves to be assessed in a negative light. Apart from the very brief stage of the Stabilisation Plan, the Spanish central bank lacked all initiative and failed to carry out its role as the monetary authority. From the macroeconomic point of view, it did not fulfil its function of stabilising prices, but, on the contrary, was one factor that, under the control of the Ministry of Finance, added fuel to the fire to provoke further inflation. Even though financial stability was a very important aim, the Banco de España was simply not worried about it. The system was rigidly regulated and banking business grew up for many years at the margin of the rules of the market, without liquidity problems, because of an abundant portfolio of public bonds that could be monetised. During the 1960s, the Banco de España was at the service of different sectoral development plans

and its duty was, essentially, to supply all the liquidity required in the economic system at a low price. As has been shown, macroeconomic stability was sacrificed for the objective of rapid industrialisation.

The Banco de España was slow to take up the functions of a central bank of issue. Its delay was compounded by structural features of the Spanish economy, distortions imposed by the obligations to attend to financial requirements of the Public Treasury, sclerosis in the financial markets and an inadequate institutional framework. The impossibility of developing under the restrictions of an active policy of monetary regulation oriented to macroeconomic stability led to conflicts with the autarchic economic policy of the post-war period that endured until the end of the 1950s and was maintained in general, with small alterations, until the 1960s. A market economic policy with interventionist characteristics and closed to the rest of the world sat uncasily with the workings of the markets and revealed the scarce appreciation of the values of economic stability. In reality, it is not strange that, under similar circumstances, the Banco de España had all its active roles in economic policy removed.

This model of central banking corresponds to an economy with a highly interventionist and closed nature, with a simple financial system and regulated operations, with rigid foreign-exchange controls, where free trade is restricted and the free circulation of capital prevented. In the 1960s, when the process of economic liberalisation and openness to foreign markets started, the model could survive when unravelling itself in an international climate with relatively low inflation and stabilised exchange rates, and without the yet generalised processes of financial innovation that proceeded to characterise the development of capital markets and financial systems world-wide. After the 1970s crisis the instability of the exchange rate and inflation made the authorities and the general public realise that the relationship between economic growth and inflation was a short-term one, and that expansive monetary policies did not ensure high rates of growth in the long term. In fact, they deterred them. It also gave rise to the belief that all persistent processes of inflation were exacerbated by an excessive growth of the money in circulation. This conviction that inflation is in the medium and long

term an essentially monetary phenomenon made the Banco de España, like the majority of European central banks, adopt rigorous monetary policies aimed to control the money supply in order to ensure stability of prices and exchange rates. As a consequence of these developments, the model of the central bank that existed at the beginning of the 1970s became irrelevant and had to be replaced by one that responded to the challenge of macroeconomic stability. This is exactly the history that began in 1980 and led to the Law of Autonomy of the Banco de España in 1994 that, in fulfilment of the Maastricht Treaty, obliged future members of Economic and Monetary Union to ensure they have independent institutions of issue. From this date, the context in which the Spanish monetary policy would develop was transformed, and its future was inextricably linked to the evolution of its role within the European Union.

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