Monetary Conditions in the Kingdom of Serbia (1884-1914)

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Abstract: From 1884 to 1914, the Privileged National Bank of the Kingdom of Serbia managed to establish and maintain relatively stable monetary conditions. On the one hand, its interest rates and lending policy contributed to the lowering and stabilization of exceptionally high market interest rates, and on the other, the National Bank managed to preserve relative stability of the domestic currency. The conversion of paper money to gold or silver was ensured at all times, except in two instances – at the outbreak of the Balkan Wars and World War I. The National Bank could not eliminate agio, but did the best it could to ease its fluctuations. Agio declined as a result of a sharp turnabout in public finances never again to reach the level prior to 1903.

The effectiveness of the National Bank in achieving relatively stable monetary conditions is particularly important in light of the circumstances prevailing at the time: wars and economic crises, budget deficits and internal political upheavals. It would be right to say that monetary conditions were largely shaped by the state of public finances. As budget expenditures outstripped the revenues, the government was forced to look for additional funds to cover the deficit by borrowing either abroad or locally, primarily from the National Bank. This had a direct negative effect on the level of gold reserves and indirectly affected the stability of the domestic currency and Bank lending activity. Once the public finances were put in order in 1903 and capital began to flow in from abroad, the National Bank was able to implement measures aimed at stabilisation of the dinar and to stimulate lending activity with more success throughout World War I.

Key words: National Bank; monetary conditions; interest rates; exchange rate of the dinar; agio; money circulation; government borrowing.

JEL Code: E58; N13; N23.

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1. Introduction

It would be right to say that the National Bank was successful in establishing relatively stable monetary conditions given the circumstances in which it operated. Such an assessment is based on the fact that the National Bank's relatively low and stable interest rates throughout the period under review contributed to the lowering and stabilisation of interest rates in the market, as well as on the fact that the National Bank managed to achieve relative stability of the domestic currency despite exceptionally difficult circumstances. An assessment of monetary conditions in Serbia must be made in light of the wars and political bickering which took a tremendous toll on the country's economic development.

During the period under review, the National Bank's discount rate generally revolved around 6%, but was raised substantially on several occasions due to political upheavals. A more drastic measure – total discontinuation of gold-backed lending – was implemented in 1908 only, during the Annexation crisis, when Serbia witnessed a major outflow of gold prompted by fears of imminent war.

Through its lending policy, notably the level of interest rates, the National Bank attempted to lower two-digit market interest rates which not infrequently reached even usurious levels. At the time the National Bank was established, loans were given on trust and considered personal obligation/ liability rather than granted against bills of exchange, i.e. their repayment was guaranteed by one's word of honour or pledged against family name, and no strict repayment deadlines and legal formalities were specified».[1] The founding of the National Bank prompted the development of credit institutions in Serbia, most notably, money bureaus, which received preferential treatment from the National Bank all through to 1920, meaning that they were granted credits at an interest rate which was several percentage points lower than the prevailing market rates.[2] The National Bank did not change the level of its rates to ease the pressure on gold reserves (normally lower than market interest rates), but rather to encourage commercial banking operations and create conditions for the economic development of the country.

The value of domestic currency was relatively stable. The dinar complied with all currency requirements envisaged by the Latin Monetary Union: the exchange rate of the dinar vs. the franc was *al pari* as both currencies had the same content of gold. However, due to Serbia's poor production capacities, as well as the increasing budget deficit and rising foreign debt, gold reserves could no longer sustain the gold convertibility of the domestic currency at fixed parity. Currency exchange was performed against an additional payment of agio. As the difference between domestic money and gold which was used for the settlement of international obligations, agio was actually an indicator of dinar depreciation against the value of gold.

Agio is, so to speak, as old as the dinar, and represented one of the key economic issues even before the founding of the National Bank. In the 1980s agio equalled 3–4%, which was slightly lower

[1] Monograph of the National Bank 1884–1934. (1935), p. 26.

[2] In addition to the National Bank, the following credit institutions were active at the time: 1) Fund Administration as a government mortgage bank with two smaller similar bureaus; 2) money bureaus in the form of joint stock companies (often called: banks, credit bureaus, savings banks, cooperatives, etc.); 3) private banking and exchange offices, which engaged to a certain extent in credit activities; 4) usurers, i.e. private lenders; 5) agricultural cooperatives which extended credits to farmers (there were few craftsmanship cooperatives and they had no major impact).

than in the period before. It peaked between 1893 and 1903 primarily as a result of high budget deficit recorded over a span of 25 years (1878-1903). Deficit financing through borrowing abroad and in the country, most notably from the National Bank, reflected on the level of gold reserves, and thus, on the stability of the domestic currency and Bank lending activity. Agio persisted until the Great War, but was significantly lower from 1903 onwards as the budget gap was closed, government borrowing from the National Bank reduced, and exports and inflow of foreign capital gathered pace.

2. Interest rates and lending activity

Pursuant to the 1883 Law on the National Bank, the principal objective of the Privileged National Bank of the Kingdom of Serbia was "to promote trade and economic activity by providing access to cheap capital and viable credit arrangements". This objective was incorporated into all relevant legislation prior to the adoption of the 1920 Law. Until the end of World War I, the National Bank's primary activity was the extension of credit.

1.1. Lending activity before the establishment of the National Bank

Prior to the establishment of the National Bank, the scale of lending in the Kingdom of Serbia was quite modest. There was little capital in the country, and even that was in different foreign currencies. Credit needs were largely covered by mutual crediting between craftsmen and merchants, while the interest rate applied reached in some instances as much as 50%. Exporters often entered into partnerships with merchants from Zemun, Mitrovica and Budapest to procure necessary liquidity, while importers, as commissionaires of Viennese and Budapest stores, borrowed abroad.

Farmers, accounting for the majority of population, were in the most difficult situation.[3] «A farmer could get a loan only from a village merchant or other private capitalist enterprise, and usually on rather unfavourable terms. This applied particularly to those who extended loans against a pledge of crops, usually before harvest time, wherefore they were named *zelenaši* (usurers, *zelen* means *green, unripe* in Serbian). A 100% interest rate was not a rarity».[4]

With a view to offering better credit terms, the government extended loans from the school and single mothers funds, as well as from guardianship funds administered by courts (mortgage backed loans with repayment period up to three years and per annum interest of 6%). These were small funds managed centrally by the Fund Administration.[5] Bulk of credits was made available in Belgrade (51%) and small Serbian towns (36%). Paradoxically, the remaining 13% were distributed to farmers who made up the largest part of total population.

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[3] According to the 1884 census, of the total population (1.90 million), 84.11% engaged in agriculture, 6.56% in industry, 2.36% in trade and transport, and the rest in other activities; Pantić, M. Dušan (1910), p. 161.

[4] Borrowing gained such traction that in 1836 Prince Miloš had to set a minimum land lot with movable and immovable property, which could not be used for debt settlement. In 1873 the minimum land lot was raised to 5 acres (2,875 hectars) of land, house, vehicle, etc.). Kukla, Stanislav, 1924, p. 15.

[5] From 1862 onwards, the above funds were managed centrally by the Fund Administration which approved mortgage-backed loans at 6% interest per year. The Fund Administration had the right to collect savings deposits from private individuals and municipalities. Even though it was not as yet a mortgage bank, the Fund Administration represented the beginning of credit institutionalisation in Serbia.

In 1871 the government started setting up district savings banks with a view to bolstering lending to farmers, but this made hardly any difference. The capital of district savings banks comprised church and monastery assets, municipal duties, deposits with courts and municipal authorities and private deposits (interest on savings deposits was 5% and on sight deposits, 3%). District savings banks approved mortgage-backed loans in their counties only, with a repayment period of 6 months to 3 years, at a 7% interest p.a. By setting up savings banks across districts and making the sources of finance more accessible, the government intended to even out the distribution of credits to the benefit of farmers. Nevertheless, all five district savings banks failed – the available funds were soon spent on loans for trade and speculative purposes, and the farmers were left empty-handed.

Money bureaus were also set up as private capital ventures. Their purpose was to enable mutual assistance and savings of their members – merchants and craftsmen. Despite the small size of funds, money bureaus proved very beneficial at the time of instability of the Prva srpska banka[6] and Fund Administration. They experienced major development only after the Berlin Congress, when Serbia's independence was internationally recognized and its territory expanded to the southeast by three districts.

The capital of money bureaus was divided into the so-called "lots", which were gradually subscribed. Namely, the stakes (later on shares of Serbian bureaus) usually referred to small amounts (50 or 100 dinars) and were regularly paid in, 1 or half a dinar a week. Thus, it took 100 weeks for the entire lot to be paid in. It was a kind of «forced» savings, also observed in cooperatives in other countries, which proved to be very important for the development of lending activity. Notwithstanding their modest beginnings, many of the Serbian money bureaus have had a prominent role in development of the country's economy (e.g. Belgrade Cooperative). On the eve of establishment of the National Bank, seven money bureaus operated in Serbia and provided credits to their members.

Amid a dearth of domestic capital, the first foreign bank in Serbia, founded by the Vienna-based Länderbank in cooperation with the Paris-based Comptoir d'Escompte in 1882 under the name "Srpska kreditna banka", was exceptionally well received. In the beginning, Srpska kreditna banka imported Austrian and, indirectly, French capital, but in negligible amounts.

Yet, seven money bureaus, district savings banks and the Fund Administration could not meet Serbia's credit needs. Hence, one of the main tasks of the authorities was to establish a central credit institution not only to promote trade and economic activity by providing cheap money and viable credit arrangements, but also to give a boost to public finance. The solution to this challenge was to set up an issuing institution which, based on gold and silver withdrawn from circulation, would issue a proportionately larger quantity of banknotes to increase domestic capital two to three times and, consequently, make credits cheaper.

[6] The first bank in Serbia, called "Prva srpska banka", was founded in 1869 as a private capital venture. Failures in the stock exchange deals, and more importantly ill luck in the railway construction abroad (Rijeka-Karlovac railway) and extension of credits, led to its bankruptcy in 1871. As one of the bank's founders was the Pest-based French-Hungarian Bank, turmoil in the Viennese and Pest money markets only precipitated the bank's collapse (Milić, Danica (1994), p.81). Bankruptcy of the most renowned merchants – members of the bank's management board had an adverse effect on further development of banking in Serbia – in fact, there were no initiatives to set up new banks for another several years.

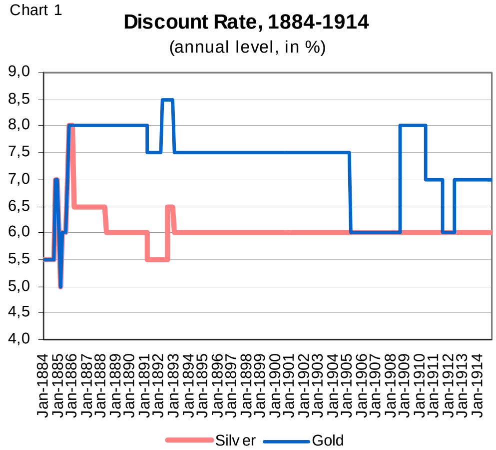
1.2. National Bank's impact on interest rates and lending activity

From the beginning of its operations in 1884 all the way through to 1920, the primary function of the National Bank was to lower market interest rates and bolster lending activity. Pursuant to the Law and Statutes of 1883, including the 1885 amendments thereto, the Bank's objective was "to promote trade and economic activity by providing access to cheap capital and viable credit arrangements, and to organize domestic market by discounting bills of exchange and warranties issued against pledged Serbian products and extending loans against collateral of government bonds". According to the said regulations, the Bank "could at no time place into circulation more banknotes than 2.5 times the amount of gold and/or silver kept in its vaults".

Throughout the period under review, the National Bank's interest rate was several percentage points lower than the free market rate. The National Bank started its operations by extending bills of exchange credits at an interest of 5.5%, and Lombard credits at an interest of 6.5% per year. After two years, the National Bank started approving loans on current accounts, taking care of the liquidity of its portfolio.

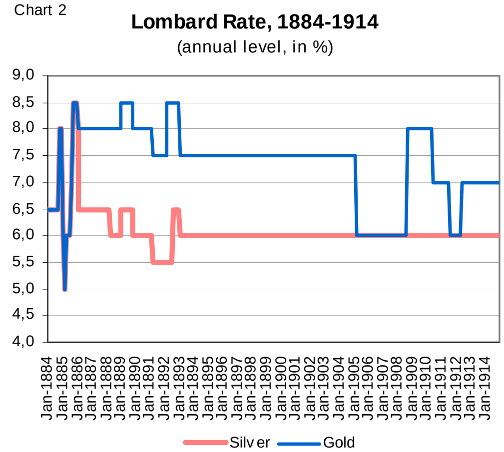
Although half of the money market interest rate, the discount rate did not induce a decline in the cost of capital, as banknotes obtained in respect of credits were immediately exchanged for gold, thus eroding the bank's metal backing. This prompted the Bank to raise the discount rate to 7% and the Lombard rate to 8% in the same year, although, even after this rise, these rates remained around 5 percentage points below the market rate. In 1885, when the stock of metal backing improved, the Bank decided to cut the discount rate to 6% and further down to 5%, in order to intensify its lending. A fresh outflow of gold, however, triggered another two rate hikes: to 6% in April 1885 and to 7% in August of the same year. Three months later, when the impending announcement of the Serbian-Bulgarian war threatened the stability of the Bank's metal backing, the discount rate was raised once again, to 8%. The rate would have probably been raised even further up, but the issue of a silver-backed banknote created scope for investment of the Bank's resources. The spread between the rates on silver and gold loans was then introduced. Thus, in 1886, the Bank set the discount rate on silver at 6.5%, while retaining the discount rate on gold at 8%.

Chart 1



Source: Monograph of the National Bank 1884-1934

Chart 2



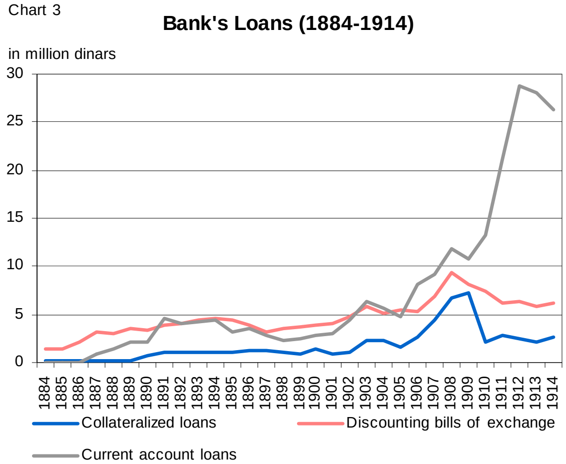
Source: Monograph of the National Bank 1884-1934 (1935).

The interest rate on silver loans was cut to 6% in 1888 and further down to 5.5% in 1891. In the latter year, the interest rate on gold loans was reduced to 7.5%, as Bank had sufficient gold reserves in its vaults. When the metal backing began to decline in the following year, however, the interest rate on gold loans was raised to 8.5% and that on silver loans to 6.5%. With the activation of the bank's share in a railway loan in early 1893, the interest rate on gold was lowered to 7.5%. The interest rate on silver loans was lowered to 6%, and remained at this level until end-1919. The interest rate on gold loans remained unchanged until 1904, when it was revised downwards to 6% as a result of a rise in the Bank's metal backing. The Customs War with the Austro-Hungarian Empire and the Annexation Crisis in 1908 caused a financial crisis in Serbia. The Bank's interest rate on gold loans rose to 8%, but the extent of the crisis was such that lending in gold had to be suspended all the way until 1910 when gold in circulation reached a sufficient level. The rate on gold loans was then cut to 7% and further down to 6% in 1911. In 1912, however, after the outbreak of the Balkan Wars, the interest rate on gold loans was raised to 7% and remained unchanged until 1920.

The National Bank placed banknotes into circulation by discounting bills of exchange presented by merchants, industrialists, craftsmen and money bureaus. In order to be able to meet its obligation to exchange banknotes for coins, the Bank discounted only short-term bills of exchange.

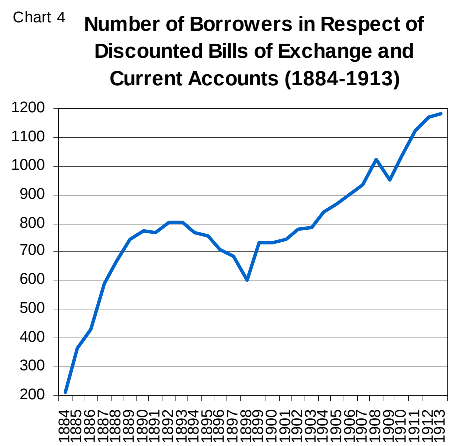
Bill of exchange credits recorded only modest growth, while after 1908 they were even on a decline. This was due to several reasons. First of all, high-quality bill of exchange substance ("trading" bills of exchange) was scarce. Moreover, despite being offered below the market interest rate, traders and craftsmen were reluctant to resort to Bank credits as the bank did not allow for the bills of exchange to be repaid in instalments, but redeemed in full only. On the other hand, due to economic

Chart 3



Source: Monograph of the National Bank 1884-1934 (1935).

Chart 4



Source: Monograph of the National Bank 1884-1934

and political concerns, all money bureaus introduced the possibility of repayment of bills of exchange in instalments. Traders and craftsmen, therefore, frequently opted for borrowing at higher rates of interest, but subject to easier terms of repayment. It should also be noted that the National Bank was subject to a statutory limitation regarding the share of its lending potential earmarked for the trade and crafts sectors. Due to the limitation on the issue of silver-backed banknotes, each year the Bank was faced with the same problems during the exports season when money demand was at its peak. As the Bank could not breach the above limitation, it repeatedly had to suspend the discounting of bills of exchange precisely at the time when silver-backed banknotes were in highest demand. The problem arising from such statutory limitation on the issue of silver-backed banknotes became even more pronounced as trade and crafts developed further. The decline in bill of exchange credits after 1908 resulted mainly from the fact that a large number of money bureaus decided not to take Bank credits, as their use was subject to a cap on lending rates they could charge (three percentage points above the Bank rate).

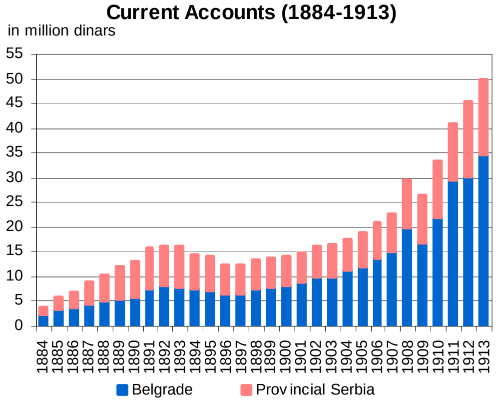
Lombard (collateralized) loans were another avenue for the Bank to issue its banknotes, but such operations were considered lesser in significance and not quite on a par with discount operations. Lombard loans were extended for a maximum of three months, against collateral in gold or silver, or in Serbian state bonds, government-guaranteed bonds and state Treasury coupons with a maturity of not more than 92 days. The loans extended by the National Bank could equal no more than 75% of the market price of these security instruments.

As the only collateral accepted by the Bank were government bonds, which were almost fully invested abroad, and government guaranteed bonds, which were very scarce, collateralized loans made up only a very small portion of the Bank's balance sheet. It was only after 1903 that the sum of collateralized loans in the Bank's balance sheet swelled, as this item came to include the stock of loans of the Fund Administration which resorted to the National Bank's credits against the collateral of its debentures or government bonds. The management of the Bank believed that Lombard operations could have developed as well as other types of bank operations if the regulations had permitted the Bank to accept as collateral other (nearly as) secure domestic securities which later appeared in the market.[7]

In order to stimulate the money market and consolidate its own position, in 1886 the National Bank issued a decision allowing money bureaus to use **current account loans** secured by bills of exchange equalling 125% of the loan amount. The debt had to be settled at the end of the quarter.

Chart 5

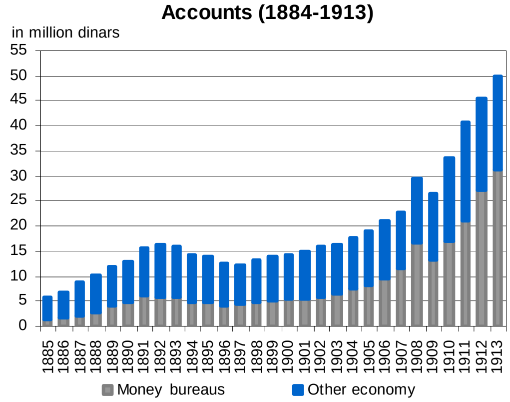
Approved Loans in Respect of Discounted Bills of Exchange and Current Accounts (1884-1913)



Source: Monograph of the National Bank 1884-1934 (1935).

Chart 6

Approved Loans in Respect of Discounted Bills of Exchange and Current Accounts (1884-1913)



Source: Monograph of the National Bank 1884-1934 (1935).

[7] Monograph of the Privileged National Bank of the Kingdom of Serbia 1884-1909 (1909), p. 125.

Maximum credit amount to be granted to a single money bureau was set at one half of the subscribed capital amount, on condition that the Bank supervised such money bureau's operations. The Bank also approved current account loans to strong trading firms against coverage in bills of exchange equalling 133% of the loan amount. Current account loans were particularly adequate for the credit circumstances of the day, as they also functioned as gyro accounts which the National Bank did not maintain at the time.

Movements in current account overdrafts were aligned with the development of banking institutions in Serbia. In the early years of the National Bank's operations, the number of banking institutions was small but growing. The increase in current account loans followed suit. And whereas in 1887 the value of such loans barely exceeded 80 thousand dinars, they reached close to 12 million dinars in 1908.

On several occasions the Bank had to discontinue granting of (discount and collateralized) silver loans, but for periods not longer than one to three months. Silver loans were suspended because of legal limitation on the issue of banknotes and high government debt with the National Bank. Gold loans, on the other hand, were suspended at times of drastic reductions in the Bank's metal backing which threatened to fall below the legally prescribed minimum. In 1908, for instance, political problems caused by the annexation of Bosnia and Herzegovina led to a massive outflow of gold and withdrawal of savings deposits, and, consequently, to a suspension of gold loans until June 1910.

By keeping its interest rate at a low level, the Bank intended to induce lowering of the market interest rate. Our data on the rate are incomplete, but they testify to the high price of loans in Serbia. At the outset of the National Bank's operations, interest rate on prime bills of exchange ranged from 9% to 11%, but declined gradually to 6–8% in Belgrade and 8–10% in rest of Serbia in 1892. Numerous smaller bureaus, mainly in the rest of Serbia, prescribed the highest interest rate stipulated by law. In circumstances when demand for money was much higher than supply, the legal stipulation of the maximum interest rate could be easily circumvented. Some money bureaus thus approved loans at the effective interest rate of over 20% and even 30%, under excuse of high costs, commissions, etc.[8] As of 1895, the free market interest rate on prime bills of exchange picked up again to range from 8% to 10% in Belgrade and 10–12% elsewhere in Serbia. With occasional departures, it remained within this range up until World War I.

In an effort to lower the market interest rate, the Bank also resorted to administrative measures. Thus in 1891, the Bank made lending to money bureaus conditional upon their setting their interest rates at the following maximum levels: 8% if they had been operating for three years, 9% if they had been operating for two years and 10% if they had been operating for one year. Such measures, however, failed to yield the desired results. A similar thing happened in 1908, when, in a bid to bring interest rates down, the government enacted a law on the extension of privilege, requesting money bureaus to set their interest rates at no more than 3 percentage points above the Bank's interest rate if they wished to use the Bank's loans. Out of 84 bureaus with which the Bank operated at the time, only 44 consented to such limitation of the interest rate level. As a consequence, in late 1909 the National Bank did business with only 54 bureaus, or 30 less than in 1908. The market interest rate remained unchanged, while a large number of bureaus found it more profitable to borrow with larger Belgrade

[8] Kukla, Stanislav, 1924, p. 57.

bureaus or abroad, at a higher interest rate than that offered by the bank, but with no limitations regarding the interest rates charged from their clients.

The Bank approved loans to money bureaus in order to stimulate the development of commercial banking and to create conditions for the country's economic development. In the early years of Bank's operations, Serbia had only 7 money bureaus with a total capital of 3.25 million dinars.[9] Already in 1886, their number rose to 21 although their development was slowed down due to political turmoil and the 1885 war with Bulgaria. In 1890, the number of money bureaus rose to 42, with total capital of around 12 million dinars. As new money bureaus were being incorporated, in 1907 their number reached 140 and total capital came close to 34 million dinars. However, when the reasons

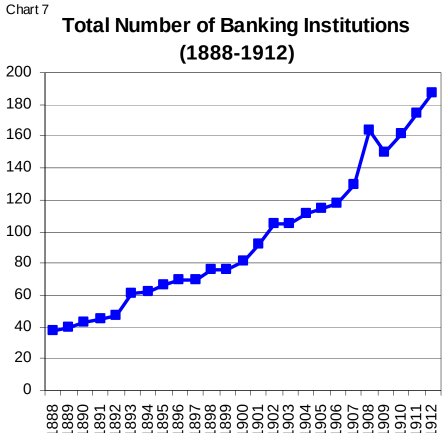
Table 1

Money bureaus

	Year	Number of bureaus	Paid principal (in thousand dinars)
Establishment of the National Bank	1884	7	3,250
	1889	37	7,600
	1895	66	15,100
	1900	80	16,619
Beginning of the Customs War	1906	118	23,917
Annexation Crisis	1909	150	33,457
End of the Customs War	1910	161	39,399
	1911	174	45,222
The Balkan War	1912	187	51,193

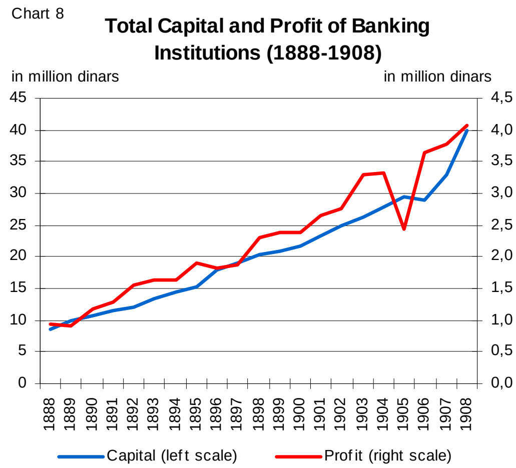
Source: Kukla, Stanislav, 1924, p. 22.

Chart 7



Source: Statistical Yearbook of the Kingdom of Serbia

Chart 8



Source: Statistical Yearbook of the Kingdom of Serbia (1913).

9 History of the Serbian People VI, Belgrade, 1982, p. 17.

for setting up new bureaus turned political as a result of conflicts within craftsmanship guilds, the Bank tried to discourage this process by declining to approve loans to newly founded bureaus, and extending them only to bureaus with a two- to three-year track record of good operating results.

The original purpose of money bureaus – inter-member lending, which later on included non-members as well (though at a somewhat higher interest rate) – was abandoned and the bureaus, as private joint stock companies, grew into genuine credit institutions. They contributed to the accumulation of domestic savings and, consequently, to an increase in working capital necessary for the trade and crafts sectors. In 1895, savings deposits rose to 12.3 million dinars (5.1 in Belgrade and 7.2 in the rest of the country), while by 1907 they reached around 47 million dinars. In 1912, deposits rose to 65.03 million dinars, and 6.89 million dinars with money bureaus and the Fund Administration respectively (total 72 million dinars). Interest rates on savings deposits with leading Belgrade bureaus ranged between 3.5% and 6%, and between 6% and 9% in case of other bureaus, primarily those located outside Belgrade.

According to data on the main indicators of operations of money bureaus, the subscribed capital of Belgrade bureaus was greater than that of all other bureaus in the country taken together, which is understandable given the greatest concentration of trade in Belgrade – all wholesale trade, export and a significant portion of import trade and industry were concentrated in the capital. Further, the greatest number of industrial enterprises from the rest of Serbia was financed mainly by Belgrade bureaus. The subscribed capital of only 8 out of 174 bureaus exceeded 1 million dinars. The best performing bureau was the Belgrade Cooperative, founded in 1882, with the capital of 2.5 million dinars, whereof shareholders paid 1 million, and the Bank paid the rest from its own funds in 1910.

Table 2

Money bureaus

31.12.1911	In Belgrade	The rest of Serbia	Total
Number of bureaus	40	134	174
(in thousand dinars)			
Paid principal	23,442	22	45
Reserve funds	3,229	3	7
Stakes	26,808	38	65
Creditors	41,564	17	59
Discount	22,110	57	79
Lombard	9,175	5	14,042
Borrowers	53,329	11	64,142
Real estate	4,904	3	8,239
Net profit	1,715	2	3,594
31.12.1912			
Number of bureaus	44	143	187
(in thousand dinars)			
Paid principal	29,269	21,923	51,193
Reserve funds	3,786	3,286	7,072
Stakes	28,306	36,717	65,033
Creditors	81,842	20,406	102,249
Discount	25,343	58,494	83,837
Lombard	7,320	2,966	10,287
Borrowers	83,456	12,556	96,012
Net profit	3,106	1,714	4,820

Source: Kukla, Stanislav, 1924, p. 60.

3. Exchange rate

The introduction of the gold standard in Serbia could not be possible without the existence of developed fiscal and monetary institutions. The 1878 Law on Money set out the procedure for minting of the gold dinar, and the first gold-backed notes were issued immediately after the establishment of the National Bank in 1884. However, as these banknotes could not be retained in circulation, silver-backed 10-dinar banknotes were issued in 1885, marking the introduction of bimetallism that continued to be the basis of Serbia's monetary system all the way through to the end of World War I.

The gold dinar fulfilled the requirements envisaged by the Latin Monetary Union: given the same gold backing of the dinar and the franc, the dinar exchange rate vis-à-vis the franc was *al pari*. The exchange rate against other currencies was established on the basis of the quantity of gold represented by a monetary unit. Still, the price of the dinar was slightly lower in international money markets than at home. Its exchange rate against the French franc and the Balkan currencies remained unchanged, while its price relative to other foreign currencies declined somewhat: 1 koruna = 1.05 dinars in gold; German mark = 1.234 dinars; 1 pound sterling = = 25.252 dinars.

Due to Serbia's poor productive capacity, widening budget deficit and rising external debt, gold reserves could not sustain the gold convertibility of the domestic currency at fixed parity. Currency exchange was performed against an additional payment of agio. As the difference between domestic money (silver-backed 10-dinar banknotes) and gold which was used for the settlement of international obligations, agio was actually an indicator of dinar depreciation against the value of gold.

3.1. Agio and its determinants

As additional payment in silver for the difference between the nominal value of gold and domestic money, agio was an indicator of depreciation of the dinar against gold as international means of payment. It is worth noting that agio in our country dates back to the times of introduction of the dinar. It was a major issue even before the National Bank began its operations. Agio equalled 5-6% in 1866, 5% in 1875, 3-4% in 1880, and 4% in 1884 when the Bank started to operate.[10]

The level of agio normally varied in the course of the year – during the exports season when gold would be brought into the country and its supply increased, agio would in consequence decline. As exports weakened and less gold was brought into the country, it became more expensive, and agio rose.

During the imports season, gold was brought into the country but was also quickly taken out for purposes of importing almost all industrial products (Serbia's industrial production was undeveloped at the time). Serbia traded most with the Austro-Hungarian Monarchy, and through it, with other European countries.[11] By the beginning of the 1880s, foreign trade deficit was registered primarily due to a wide deficit with the Austro-Hungarian Monarchy.[12] Such a situation persisted until 1888. In later years, Serbia began to record an inflow of gold from its trade-related activities. Note should also be taken of a significant inflow of gold arising from the transit of foreign goods through Serbia, which picked up in the second half of 1880s when the new railway system was built. However, ever lager repayments of the government external debt resulted in the balance of payments deficit and outflow of gold, which reflected on agio.

Agio peaked between 1893 and 1903 when the silver-backed 10-dinar banknote dominated circulation. In 1894, agio hit record high of 18%. As an issuing institution, the National Bank of Serbia was responsible for the circulation and stability of the national currency, and a large number of its critics held it responsible for the agio hike.

The National Bank dismissed the allegations concerning the rise in agio and opposed the restrictions on circulation of silver-backed notes, claiming that agio had reached its highest value at the time when circulation of money was most restricted. The Bank explained that agio rose primarily in response to a rise in external borrowing, that is the repayment of foreign debt and government borrowing from the National Bank, as well as adverse political circumstances.

[10] Monograph of the National Bank 1884–1934. 1935, p. 38.

[11] By the Trade Agreement from 1881, the Austro-Hungarian Monarchy protected its imports of Serbian agricultural products from foreign competition, and at the same time its exports of industrial products to the Serbian market. Formally, these were cross-border trade benefits. For instance, customs duty on oxen from Serbia was 4 forints, whereas on oxen from Germany, it was 12.75 forints.

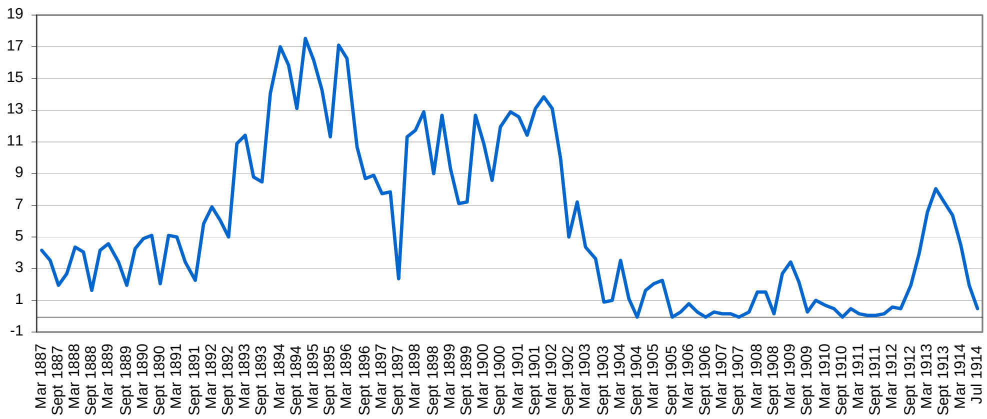
[12] The trade deficit also stemmed from a precipitous drop in exports to Bosnia (which fell under the economic sway of Austro-Hungarian Monarchy after signing a secret convention), and later on from a drop in exports to Turkey and Bulgaria.

After borrowing relatively small amounts abroad during the 1860s and 1870s for the purpose of financing the war for national liberation from the Turks[13], the first somewhat larger foreign loan (100 million French francs) that Serbia took in 1881 was intended for construction of the railroad network. In the same year, another loan agreement was concluded with the Union Generale – the so-called Lottery Loan (or Bontu Loan). The loan was intended to bring order to government finance. After the Railroad and Lottery Loans, government finances deteriorated: old loans were no longer repaid, and the new ones, for their major part, were not disbursed in full. This continued to negatively affect the terms under which Serbia borrowed abroad after the downfall of the Union Generale.

Chart 9

Agio Movements (1887-1914)

in %



Source: Monograph of the National Bank 1884-1934 (1935).

In view of Serbia's total economic power, foreign debt servicing was a rather demanding task. Purchase of gold for the repayment of external debt raised its price and agio went up. In late 1880s, it became clear that government finance could be put in order only by finding new sources of income to cover growing government expenditure and piles of debts. Tax reform of 1884 failed to produce the expected results. The structure of budget expenditure was such that its reduction could not be counted on (debt repayment and expenses of the Ministry of Military Affairs accounted for two thirds of government expenditures). As more significant sources of government revenues were pledged as a guarantee under external loans, the pledge first had to be repurchased from foreigners (repurchase of monopoly on tobacco, railroad exploitation and salt).

Owing to the repurchase of monopoly on salt, tobacco and railroad use, government revenues picked up considerably in early 1890s. Apart from this, in 1895, the government signed debt conversion agreement with representatives of the three creditor banks: Ottoman Bank from Paris, Berlin Trade Company and Lenderbank from Vienna. At the time, Serbia was paying annually 20.8 million dinars redeemable in gold for the purpose of servicing 15 external loans concluded between

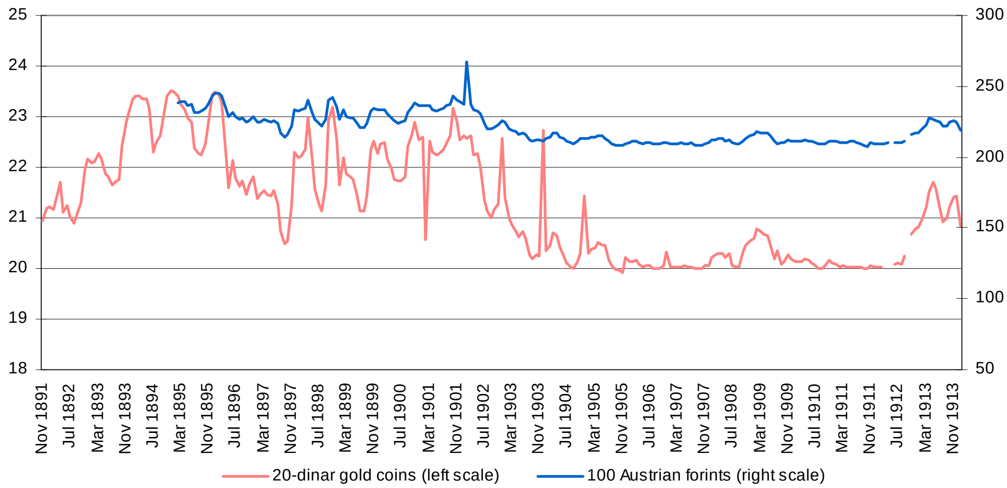
[13] Serbia addressed foreign creditors for the first time in 1862. Against a guarantee issued by Russia, Serbia was granted a loan worth 150,000 ducats in London, at 6% interest rate and 2% in respect of repayment, and a 50-year repayment period. After early repayment of that loan, two more were taken: one in London and the other one in Russia. When it gained independence at the Berlin Congress in 1878, Serbia's external and internal debt stood at 39.5 million dinars and 24.7 million dinars respectively.

1876 and 1894; total remaining debt equalled 370 million dinars. Debt conversion, which enabled the lowering of interest rate and extension of repayment terms, enabled a notable improvement in the servicing of government debt at annual level. On the one hand, annual annuities declined by 4.9 million dinars, and on the other, total amount of debt rose by 44.7 million dinars.

However, although Serbian government revenues gradually increased, owing primarily to a more timely tax collection and state monopolies, they were not sufficient to cover expenditures, which made a radical turnabout in the management of public finance inevitable.

Chart 10

Exchange Rates in Belgrade (price in dinar)



Source: calculated based on daily data published in "Serbian Newspapers" - for the period before 1899 and after 1908; Statistical Yearbook of the Kingdom of Serbia (1913) - for the period 1899-1908.

The turnabout had to take place in government borrowing from the National Bank as well, which was made subject to circulation of silver-backed notes. The quantity of silver-backed banknotes in circulation rose, and agio on gold increased in parallel. The National Bank was accused that its interventions in the gold market were the main contributor to the rise. In 1896, however, it was resolved to limit the quantity of silver-backed banknotes in circulation, which seriously affected economic flows. As a consequence, in 1898, the government was allowed to borrow from the National Bank 10 million dinars above the limit set for the quantity of money in circulation. Government debt with the National Bank already accounted for a significant share of the quantity of money in circulation, and in 1898 it doubled on a year earlier to 15.9 million dinars, almost threefold the amount of borrowing by all money bureaus from the issuing bank. In 1900, the government was granted another loan, this time in the amount of 2 million dinars, subject to terms approved in the case of the earlier 10-million dinar loan. This loan also exceeded the upper limit on the quantity of money in circulation and was backed by precious metals. It is important to note that the National Bank did not only lend to the government but also extended credits to municipalities, counties and regions, to finance construction of infrastructure.

3.2. Direct interventions of the National Bank by trading in gold

Although its interest rates were lower than those prevailing in the market, the National Bank did not use them as an instrument to ease the pressure on gold reserves.[14] Instead, the National Bank intervened directly in the market by trading in gold. The National Bank could not eliminate agio by trading in gold, but could ease its fluctuations. The Bank purchased gold during autumn season when there was enough of it in circulation, and sold gold usually in March when it was scarce and when the agio went up.

Direct interventions of the National Bank through sale of gold got into the limelight in early 1890s when they provoked heavy criticism by the government and the public. Namely, in 1890, agio began edging up and the National Bank decided to sell 10,000 napoleondors to traders at an exchange rate lower than the market rate – with an agio of 0.48 dinars. As agio did not decline but rose instead, the National Bank intervened by selling additional 5,000 napoleondors with a 0.95 dinar agio. Nearly 50,000 napoleondors were sold to the government in the same year and that is how the Bank managed to contain agio in 1891 below 1 dinar.

Nevertheless, in early 1892 agio started spiralling higher. As early as in April, exchange rate of napoleondor stood at 212.90 dinars. The Bank decided to sell 20,000 napoleondors at a price lower by 0.10 dinars than the market price. The aim was to resume the sale at a price lower than the market rate by 0.05 dinars once the prices declined.

In autumn that year, agio plummeted to 0.80 dinars, but shortly thereafter started edging up only to reach 3.00 dinars on the back of smaller inflow of gold occasioned by weaker export performance. Met by sharp criticism and accusations that it creates agio, by the end of October, the Bank had to discontinue its activities aimed at suppressing agio. The government decided to take control and resolve the problem of agio by limiting the amount of silver-backed 10-dinar banknotes in circulation.

3.3. Limited circulation of silver-backed notes

Since additional agio was paid on gold purchased by silver-backed banknotes, a large amount of silver-backed banknotes in circulation was thought to have been the main reason for agio. Consequently, the bank was asked to reduce the amount of silver-backed banknotes in circulation and to increase the amount of gold-backed bills.

The Bank opposed such requests in vain explaining that the conditions for sustainability of gold-backed banknotes in circulation were not yet met. The Bank argued that gold-backed banknotes would be repeatedly exchanged for gold, which would eventually result in stripping off the Bank of its gold-backing. The Bank stressed that “agio was not as much affected by the silver-backed banknotes, as by the negative international balance and bad public finance; it would take an improvement of the overall economic environment for the agio to disappear and the currency to stabilize“[15]. Analysis of

[14] When a country is running a balance od payments deficit and is hence, facing an outflow of gold, gold reserves of the central bank decline. The central bank raises its discount rate so as to reduce the volume of lending and money supply, i.e. price levels. The process of adjustment would be supported by higher short-term interest rates that attract foreign capital.

[15] Monograph of the Privileged National Bank of the Kingdom of Serbia 1884-1909, pp. 155-161.

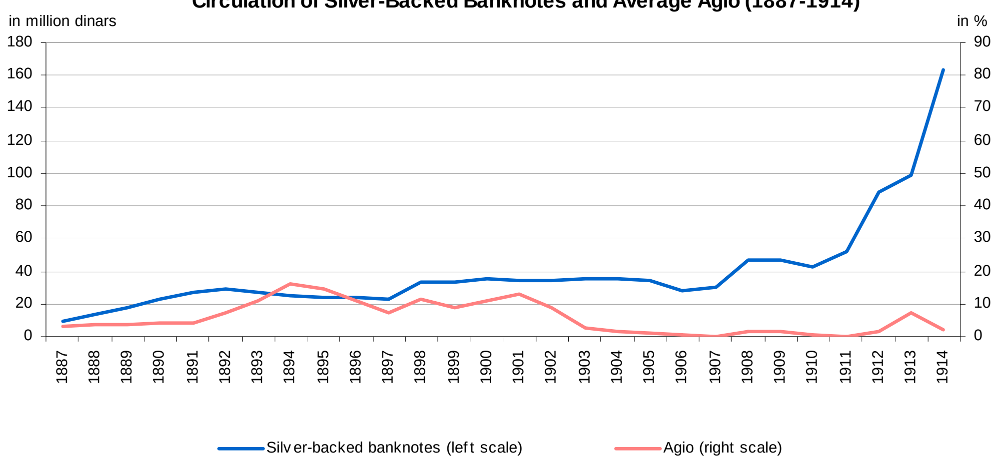
movements in agio and total value of silver-backed banknotes in circulation shows that agio was at its lowest when circulating banknotes were at their highest, and vice versa.

In the debate on limiting the circulation of silver-backed banknotes, the Bank and the government differed in their interpretation of legal provisions pertaining to metallic backing of the monetary issue. Namely, the Bank's understanding of these legal provisions allowed for the use of gold for backing silver banknotes, which led to a situation where metal backing of currency and money in circulation were in a completely inverse proportion: gold prevailed in the structure of backing, while silver banknotes accounted for around 95% of circulating banknotes. The government was, by contrast, of the opinion that gold backing could represent a base only for the issue of banknotes redeemable in gold, and that the issue of banknotes redeemable in silver depended exclusively on silver backing. This meant that 20 million dinars in silver-backed 10-dinar banknotes were in excess of the permitted level. At the time, in 1893, around 30 million dinars were in circulation in the form of silver-backed 10-dinar banknotes, and the silver backing amounted to 4 million dinars, implying that only 10 million dinars could have been issued in silver-backed banknotes. The Government insisted that the withdrawal of silver-backed banknotes be performed in the course of five years which called for a 20% cut in the volume of lending p.a.

Deflationary policy implemented at the time took its toll on the lending by monetary bureaus and the economy practically came to a standstill. Agio hit its peak of 18% in 1894 in the face of the ongoing sales of gold. The government came to realize its mistake and resumed its earlier practice in 1896 according to which the metal backing for banknotes redeemable in silver could be in silver or gold. At the same time, however, the maximum amount of banknotes redeemable in silver was set at 25 million dinars, irrespective of the level of backing. Limiting the overall circulation of banknotes redeemable in silver proved to be a bad decision, and its consequences manifested the following year when the extension of credit for autumn farming activities was halted at the height of the season. For this reason, the limit was raised to 30 million dinars in 1898, and remained unchanged until 1908, when a Law was issued to extend the National Bank's privilege for another 25 years and to make the quantity

Chart 11

Circulation of Silver-Backed Banknotes and Average Agio (1887-1914)



Source: Monograph of the National Bank 1884-1934 (1935).

of total circulating banknotes redeemable in silver dependent upon total amount of paid-in capital in proportion 1 to 5. That year, the National Bank's paid-in capital equalled 7.5 million dinars in gold, implying that the amount of circulating banknotes redeemable in silver could have reached 37.5 million dinars, or ultimately, 41.25 million dinars if an additional 10% increase was approved by the government, which was possible in extraordinary or emergency circumstances. As the same Law envisaged that the whole capital in the amount of 10 million dinars had to be paid in until 1913, circulating banknotes redeemable in silver could have reached 50, that is, 55 million dinars that year.

Extension of the privilege to the National Bank in 1908 proved to be of paramount significance since reserves of the monetary bureaus were depleted and the discount terminated amid the Annexation crisis and fears of the outbreak of war. Increase in the issue of silver-backed money in 1908 had immediate positive effects and helped Serbia to overcome the crisis.

In vindication of its position, the National Bank repeatedly insisted on debating which type of backing was better for the issuing of banknotes, instead of offering an explanation for the amount of banknotes in circulation in excess of the amount needed[16]. Owing to its predominantly agrarian character, economic activity in Serbia picked up in the second half of the year. It was the time when attempts were made to strike balance between the requisite and actual amount of currency in circulation, and agio declined. As opposed to this, in the first half of the year, economic activity slowed down, and as money supply was not reduced, banknotes redeemable in silver squeezed out banknotes redeemable in gold and agio went up.

Attempts to curtail agio by limiting the amount of silver-backed banknotes induced not only a slowdown in economic activity, but also a disagio of 0.5% in the course of 1905. Disagio, i.e. additional charge on gold had to be paid from time to time all the way until 1908. Such a phenomenon has never been registered ever since the introduction of gold-backed currency in international payments!

3.4. Effects of the turnabout in public finance management

A radical turnabout in the management of public finance took place in 1903 – the budget was put in balance, and even recorded a surplus. Serbia received an inflow of gold owing to the 60 million dinar external loan (Monopoly Loan, 1902), a number of bumper years, favourable prices of exported products and the fact that the government did not have to set aside any substantial amounts for procurement from abroad. Agio was cut down to below 1 dinar and after 1903 never came close to its earlier levels.

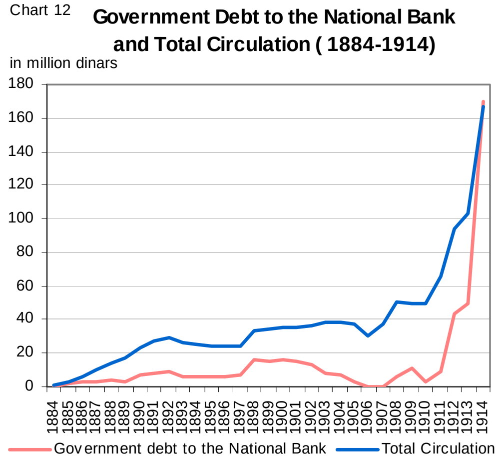
During the years from 1906 to 1910, with no exception at all, Serbia recorded a budget surplus. Agio almost disappeared and the stability of prices was restored. Economic growth continued into 1911, which saw a surplus on the foreign trade balance and an unprecedented budget surplus of 14.7 million dinars. Similar results were achieved in the following year. However, economic growth was halted by the onset of the Balkan Wars. Due to large-value procurements of military equipment, agio went up. As domestic resources did not suffice, in September 1913, the Serbian government entered with a consortium of French banks into a loan agreement in the amount of 250 million dinars

[16] Dugalic, Veroljub et al. (2004), p. 38.

redeemable in gold. The loan was disbursed in 1914 and helped to keep a balanced budget even in the year when World War I broke out.

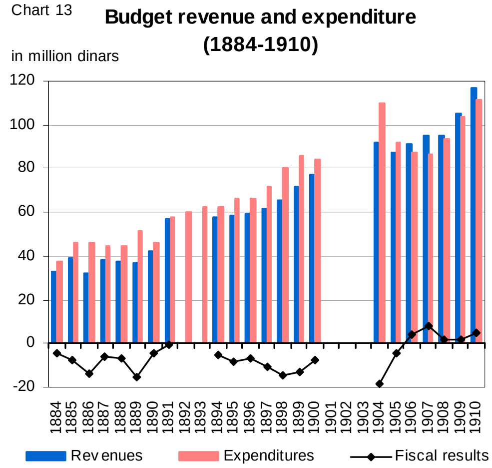
The relationship between the National Bank and the government was regulated after the establishment of the budget equilibrium. From 1904 until the start of the First World War, government borrowing from the National Bank was temporary and short-term in character, which is confirmed by data on the 10 million-dinar loan: government debt to the National Bank declined from 4.1 million dinars in 1904 to 3.4 million in 1905, while in the following two years, 1906 and 1907, government debt to the central bank was nil. This enabled the National Bank to be more successful in implementing measures aimed at stabilization of the dinar and agio was soon suppressed.

Chart 12



Source: Monograph of the National Bank 1884-1934

Chart 13



Source: Statistical Yearbooks of the Kingdom Of Serbia (1913).

In 1908, the government obtained additional possibility to borrow from the National Bank – it obtained the right to dispose of temporary, three-month advances on the basis of extraordinary coupons in the amount of 10 million dinars, but it did not fully avail of this possibility until the Balkan War. Furthermore, there was a special type of lending to the government – the so-called temporary exchange. Under this arrangement, the government could exchange gold in unlimited amounts with the National Bank against an appropriate amount of silver-backed banknotes and vice versa, exchange silver-backed banknotes against gold without any deductions whatsoever. Banknotes issued in respect of temporary exchange were not included in the contingent with a backing of 40%. This enabled the government to exchange gold against silver-backed banknotes without any losses on agio, regulating at the same time market gold supply and strengthening metal backing. As it later proved, this type of exchange enabled, above all, simple and efficient financing of budget expenditure in extraordinary circumstances.

Economic upswing in the 1909-1911 period provided for stabilization of economic circumstances. During 1911, agio was at a minimum level, ranging between 0.05 and 0.15 dinars per napoleondor, whereas in January and February 1912, it came to zero. Following the enlistment, agio rose to 0.85 dinars per napoleondor to stabilize at 0.75 dinars by end-1912. In 1913, due to disturbances caused by the war and weak harvest, economic expansion from the previous period came to a halt. Budget revenues declined, and the government stepped up its borrowing with the National Bank. High budget expenditures during World War I were financed with National Bank funds as well.

4. Assessment of monetary conditions

The National Bank managed to establish relatively stable monetary conditions in the period 1884–1914. Such an assessment is based on the fact that its relatively low and stable interest rates throughout the period contributed to the lowering and stabilisation of market interest rates, as well as the fact that the National Bank managed to safeguard relative stability of the domestic currency in the face of exceptionally difficult circumstances.

The first discount rate of the National Bank was set at 5.5%, while interest rate on Lombard credits equalled 6.5% (for silver and gold credits). Over the years that followed, the discount rate ranged between 5.5% and 8%, and the Lombard rate between 5.5% and 8.5% all the way until 1893. In the same year, the discount rate on silver credits was set at 6% and remained unchanged for 38 years, whereas the rate on gold credits was unchanged until 1905 when it began fluctuating between 6% and 8%. The 6% rate on Lombard silver credits remained unchanged over the following 30-year period, while the rate on gold Lombard credits ranged from 6% to 8%.

By keeping its interest rate at a low level, the Bank intended to induce a lowering of market interest rates and high costs of borrowing prevailing in Serbia at the time. At the outset of the National Bank's operations, interest rate on prime bills of exchange ranged from 9% to 11%, but declined gradually over the subsequent years to 6–8% in Belgrade and 8–10% in the rest of Serbia. As of 1895, the free market interest rate picked up again to range from 8–10% in Belgrade and 10–12% elsewhere in Serbia. With occasional departures, it remained within this range up until World War I.

Analysis of Bank and market interest rates during the period under review shows that the discount rate on silver credits was mainly around 6%, while market rates fluctuated, sometimes even exceeding double the Bank rate. The question is why did the National Bank keep its rate almost unchanged for such a long period. The Bank provided the following explanation: «When setting the level of discount rate, Bank management had to take into account all the consequences that raising or lowering of the official interest rate could bring about, as well as the protection of the Bank's metal backing and providing attractive terms for short-term foreign investments. Bank management also, if not to a greater extent, had to pay attention to the nascent domestic money market and, in line with the Bank's legal mandate, strive to keep the general market rate as low as possible. Due to the special features of our money market, credits from the issuing institution had to be cheaper than those provided by other monetary agents. This is the reason why the Bank rate could be made neither equivalent to nor higher than the free market rate».[17]

The dinar was relatively stable throughout the period under review. The obligation to convert paper money into gold or silver money was continually met, except in two instances – at the outbreak of the Balkan Wars and World War I. As an indicator of the depreciation of the dinar, agio was at its highest in the period 1893–1903, above all due to the disordered public finances (budget deficit which ran for a period of 25 years (1878-1903)). The National Bank could not eliminate agio, but tried to ease its

[17] Monograph of the National Bank 1884-1934 (1935), p. 59.

fluctuations through direct interventions, i.e. by selling gold in the market. Agio persisted all the way until the Great War, but was significantly lower from 1903 when public finances were put in order and exports and inflow of foreign capital gathered pace. Already in 1903 a substantial amount of gold flowed into the country as a result of a 60 million dinar government loan: agio was cut to 1.5%, the circulation of gold-backed banknotes increased and the Bank's metal backing was significantly reinforced. In 1905 agio fell below the *al pari* rate of exchange, and for the first time since the introduction of the dinar, turned negative (0.5% disagio). Disagio came about as a result of exceptionally good harvest, i.e. higher exports of agrarian products, government debt reduction with the National Bank, and an appropriate decline in currency in circulation (disagio was registered in 1905, and it disappeared in 1908 when the government resumed borrowing).

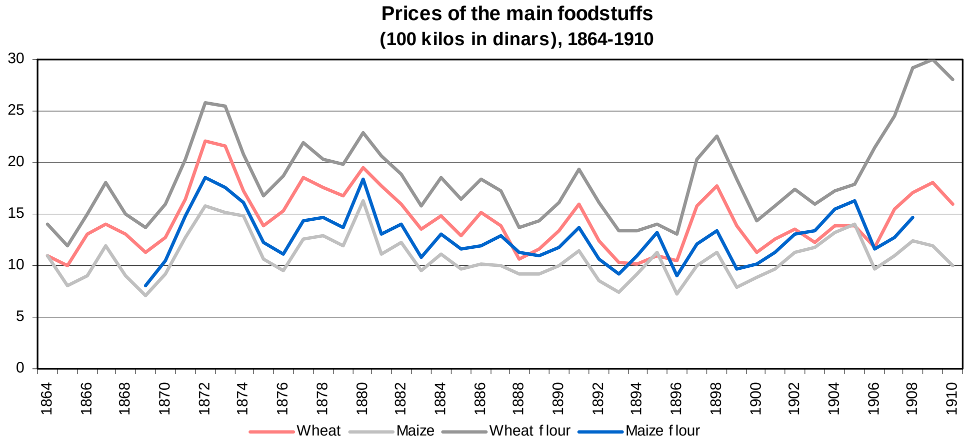
It can be said that monetary conditions were largely shaped by the state of public finances. Widening budget deficit compelled the government to seek additional sources of finance through borrowing at home and abroad, the former referring mainly to borrowing from the National Bank. This reflected not only on the level of gold reserves, but also on the stability of the domestic currency and the Bank's lending activity. «The capital at its disposal was modest, and the Bank could not have achieved more than it did.».[18] The National Bank's success in achieving relatively stable monetary conditions gains special importance in light of the circumstances in which it operated. When we look at Serbia's history from 1884 to 1914, we see a chain of wars: first with Bulgaria in 1885, then in 1906–1911 with the Austro-Hungarian Empire (Customs War) which, albeit not an armed conflict, had a negative effect on the economy, and finally the Balkan Wars (1912–1913) and World War I.

In such circumstances, Serbia did make significant economic headway, and the National Bank did do its best to achieve the goal it was set up to perform, which was to promote trade and economic activity by providing credits. If we exclude spells of economic crisis and wars, prices were relatively stable from 1884 to 1914. According to available data on the prices of key agricultural and food products, in the period 1882–1908 non-weighted price growth equalled mere 2.2% p.a.

From 1906 to 1910, 121 industrial enterprises were founded, many of which exported or manufactured products that used to be imported. The year 1910 has been remembered as the year of strong capital inflow, above all from France and Slav-populated parts of Austro-Hungary. A Paris Consortium took over the Fund Administration's debentures and set up Francusko-srpska banka. The Prague Credit Bank opened its first branch office in Belgrade, and Srpska banka from Zagreb established Podunavsko trgovačko akcionarsko društvo (Danubian Joint Stock Trade Company). Capital flowed in also under direct borrowing to Serbian money bureaus. Economic activity continued to grow at a brisk pace in 1911 as well. Serbia recorded a foreign trade surplus and an unprecedented budget surplus of 14.7 million. It seemed that a new era in the development of the Serbian economy was about to begin. However, the prospects of development and prosperity were soon shattered with the outbreak of the Balkan Wars, and finally the Great War in 1914.

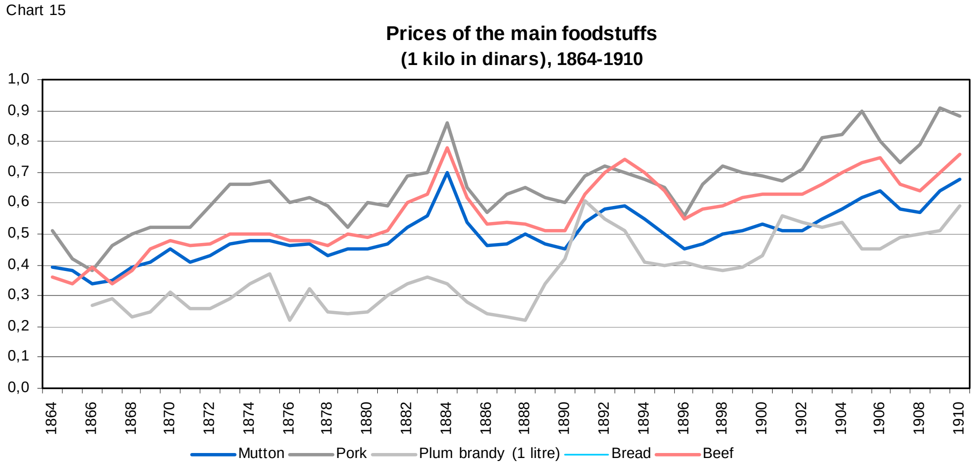
[18] Quoted Pera Maksimović at the central shareholders' meeting, 1913, Kosijer (1924), p. 116.

Chart 14



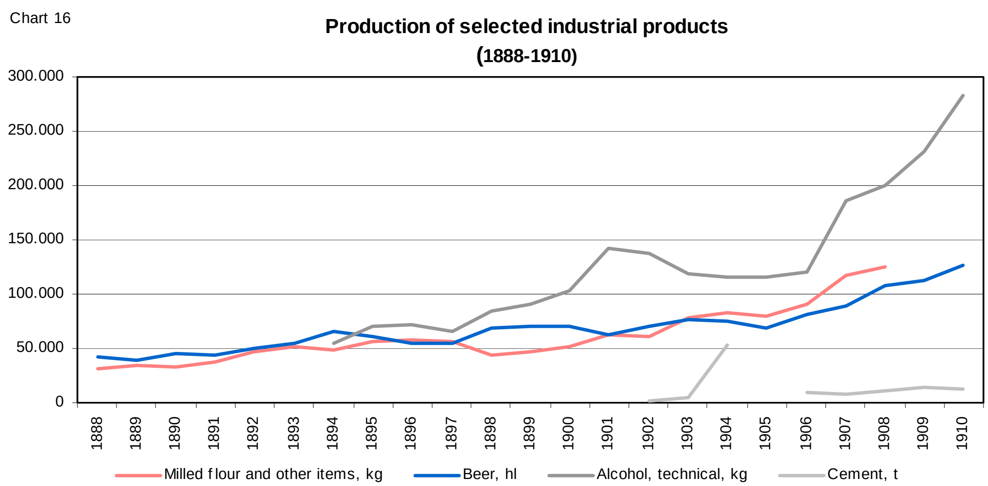
Source: Statistical Yearbook of the Kingdom of Serbia (1913), Government Statistics Administration, book twelve, 1907 and 1908, Belgrade; Two centuries of Serbian development, Staristical Office of the Republic of Serbia, Belgrade, 2008.

Chart 15



Source: Statistical Yearbook of the Kingdom of Serbia (1913), Government Statistics Administration, book twelve, 1907 and 1908, Belgrade; Two centuries of Serbian development, Staristical Office of the Republic of Serbia, Belgrade, 2008.

Chart 16



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