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Monetary policy objectives and
instruments used by the privileged
National Bank of the Kingdom of Serbia
(1884-1914)

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SEEMHN

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Editorial

The South-Eastern European Monetary History Network (SEEMHN) is a community of financial historians, economists and statisticians, established in April 2006 at the initiation of the Bulgarian National Bank and the Bank of Greece. Its objective is to spread knowledge on the economic history of the region in the context of European experience with a specific focus on financial, monetary and banking history. The First and the Second Annual Conferences were held in Sofia (BNB) in 2006 and in Vienna (OeNB) in 2007. Additionally, the SEEMHN Data Collection Task Force aims at establishing a historical data base with 19th and 20th century financial and monetary data for countries in the region. A set of data has already been published as an annex to the 2007 conference proceedings, released by the OeNB (2008, Workshops, no 13).

On 13-14 March 2008, the Third Annual Conference was held in Athens, hosted by the Bank of Greece. The conference was dedicated to *Banking and Finance in South-Eastern Europe: Lessons of Historical Experience*. It was attended by representatives of the Albanian, Austrian, Belgian, Bulgarian, German, Greek, Romanian, Russian, Serbian and Turkish central banks, as well as participants from a number of universities and research institutions. Professor Michael Bordo delivered the key note speech on *Growing up to Financial Stability*. The participants presented, reviewed and assessed the experience of SE Europe with financial development, banking and central banking from a comparative and historical perspective.

The 4th Annual SEEMHN Conference will be hosted by the National Serbian Bank on 27th March 2009 in Belgrade. The topic of the Conference will be *Economic and Financial Stability in SE Europe in a Historical and Comparative Perspective*.

The papers presented at the 2008 SEEMHN Conference are being made available to a wider audience in the Working Paper Series of the Bank of Greece. Here we present the thirteenth paper, by Milan Sojic and Ljiljana Djurdjevic.

July, 2008

Sophia Lazaretou

SEEMHN Coordinator

Member of the Scientific and Organizing Committee

MONETARY POLICY OBJECTIVES AND INSTRUMENTS USED BY THE PRIVILEGED NATIONAL BANK OF THE KINGDOM OF SERBIA (1884-1914)

Milan Sojic
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ABSTRACT

In the first thirty years of its operations, key functions of the privileged National Bank of the Kingdom of Serbia (1884-1914) were those of a creditor of the economy, issuer of currency and banker to the government. The National Bank's success in the performance of its functions was mainly determined by the state of government finances. Peace and stability are a prerequisite for economic development and when we look at Serbia's history from 1884 to 1914, all we see is a chain of wars. 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 – to promote trade and economic activity by providing credits.

Keywords: National Bank of Serbia; Central banking; Central bank objectives; History of finance; Financial institutions; Monetary policy.

JEL classification: E58; N13; N23.

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1. Introduction

Monetary policy objectives and instruments used by the privileged National Bank of the Kingdom of Serbia (1884-1914)¹ are a logical outcome of its three key functions: creditor of the economy, issuer of currency and banker to the government. At the time, most other central banks performed similar functions.

Pursuant to the 1883 Law on the National Bank, the Bank's objective 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 adopted prior to passing of the 1920 Law. Until the end of World War I, the National Bank's primary activity was **credit expansion**. Money bureaux (as credit institutions) kept their privileged status until 1920. Namely, they used to borrow from the National Bank at an interest rate, which was around 5 percentage points lower than the prevailing market rates. The discount rate of the National Bank was kept at around 6% and was raised several times throughout the period under review in order to ease political unrest. A more radical measure – full suspension of gold credits for over one year – was implemented in 1908 during the Annexation Crisis, when Serbia experienced a massive outpouring of gold amid fears of the potential outbreak of war. The National Bank did not change the level of its rate to ease the pressure on gold reserves (normally lower than the market interest rate), but rather to encourage commercial banking and create conditions for the economic development of the country.

As an **issuing institution**, the National Bank was **responsible for the stability of the national currency** – issuing of banknotes and maintaining gold and silver convertibility of the dinar at a fixed parity. The first gold-backed 100-dinar banknote was issued immediately after the establishment of the National Bank in 1884. However, as these banknotes could not remain in circulation, silver-backed 10-dinar banknotes were issued in 1885, marking the introduction of bimetallism. Bimetallism remained the basis of Serbia's monetary system well until the end of World War I. Due to Serbia's poor production capacities, as well as the increasing budget deficit and foreign debt, gold

¹ In the period under review, Serbia was ruled by three kings from two Serbian dynasties: Milan Obrenović (1882-1889), Aleksandar Obrenović (1889-1903) and Petar I Karađorđević (1903-1921).

reserves could no longer sustain the gold convertibility of the domestic currency at a fixed parity. Currency exchange was performed against an additional payment of the Agio. As the difference between domestic money (silver-backed 10-dinar banknotes) and gold which was used for the settlement of international obligations, widened further, the Agio was an indicator of the depreciation of the dinar against gold. At times, the National Bank could not eliminate the Agio by direct interventions, i.e. by selling gold, but it did manage to moderate oscillations in its value. Although the price of the dinar was slightly lower in international money markets than at home, it remained a relatively stable currency.

The National Bank's efforts to preserve the value of the domestic currency often clashed with its function of the **banker to the central government**. Financing government's emergent spending needs, at times of war and hardship, was made the top priority of the National Bank. To finance the budget deficits that protracted over 25 years (1878-1903), the government resorted to substantial borrowing from the National Bank. In 1898, the government debt to the National Bank was nearly three times higher than the total debt of all money bureaux taken together. In 1903, the relations between the National Bank and the government were re-defined in the context of a new set of principles. In particular, the government conducted strict supervision of budget revenue and expenditure flows. It was also defined that its borrowing from the National Bank should be only temporary and short-term. As a result, the National Bank of Serbia managed to be more successful in implementing both credit policy measures and those aimed at stabilizing the dinar.

2. The National Bank: the Creditor

Prior to the establishment of the National Bank, the scale of lending in the Kingdom of Serbia was quite modest. Credit needs were largely covered by mutual lending between craftsmen and merchants, while the interest rate applied exceeded the officially authorized ceiling of 12% p.a. (reaching in some instances as much as 50%). Faster development of trade and craftsmanship felt victim to the dearth of capital, and although various crafts were up and running, industrial manufacturing was practically

non-existent. The main Serbian products were cereals and livestock. Exporters used domestic capital and credits to the extent that the general circumstances allowed. They often entered into partnerships with merchants from Zemun, Mitrovica and Budapest to procure necessary liquidity. As the importers were mostly commissionaries of Viennesse and Budapest stores, they borrowed abroad.

With a view to offering better credit terms, the government extended loans from the school and single mother funds, as well as from guardianship funds, which were under the remit of courts (mortgage-backed loans with repayment period up to three years and at a rate of 6% p.a.). These were small funds managed centrally by the Fund Administration. The bulk of credits were made available in Belgrade (51%) and small Serbian towns (36%). Paradoxically, the remaining 13% were distributed to farmers who made up 96% of the total population.² Merchants and craftsmen borrowed from money bureaux founded by private capital. Despite the small size of funds, money bureaux were proved beneficial for the domestic economy at times of instability faced by the *Prva srpska banka*³ and the Fund Administration. On the eve of the establishment of the National Bank, seven money bureaux operated in Serbia and provided credits to their members. Besides money bureaux, district savings banks also operated and extended credits to the farmers with a repayment period up to 3 years and at a rate of 7% 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 the farmers.

Yet, seven money bureaux, district savings banks and the Fund Administration could not fully 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

² Milić, Danica (1994, p. 81).

³ 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 an 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 Viennesse and Pest money markets only precipitated the bank's collapse (see, Milić, Danica 1994, p.81). The bankruptcy of the most renowned merchants – members of the bank's management board - had an adverse effect on the further development of banking in Serbia. In fact, for several years no one took the initiative to set up a new bank.

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.

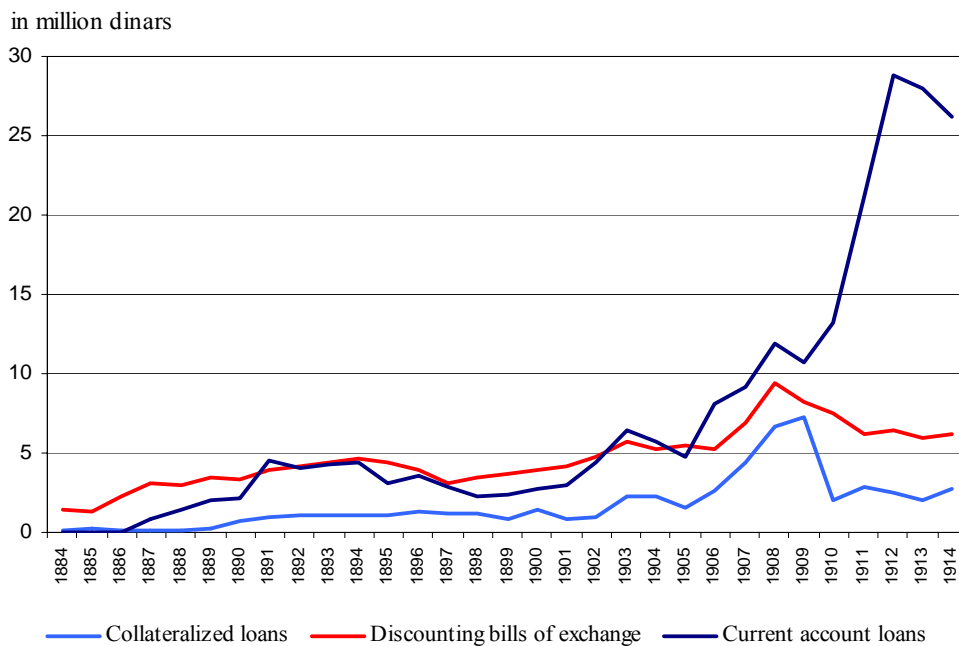
From the beginning of its operations in 1884 to 1920, the primary function of the National Bank was to organize credit arrangements (see Chart 1). Pursuant to the Law and Statutes of 1883, including the 1885 amendments thereto, the Bank's objective was "to promote trade and economic activity by providing access to cheap capital and viable credit arrangements, and to organize the 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 not place into circulation banknotes more than 2.5 times the amount of gold and/or silver kept in its vaults". Banknotes were backed by 92-day maturity bills of exchange, short-term warranties and government and public loan coupons with maturity of no longer than 92 days, as well as government bonds in the amount of up to 75% of their market value.

The National Bank also extended paper and Lombard loans. Two years after it had started operations, it began granting current account loans, taking into account its credit portfolio liquidity. The National Bank exercised its most important legal and statutory role of placing banknotes into circulation by discounting the bills of exchange of merchants, industrialists, craftsmen and even the money bureaux. In order to be able to meet its obligation to exchange banknotes for coins, the Bank discounted only short-term bills of exchange. For the same reason, it only discounted the most secure bills of exchange available in the market, i.e. "at demand" bills, bearing at least two authorized signatures.

The creditworthiness of each signatory to the bill submitted for discount was closely scrutinized. Moreover, all credits were reviewed in annual joint meetings of the Managing and Discount Board, which considered the property holdings of each credit beneficiary as well as the use of approved funds to ensure that the National Bank's credits were not used to finance consumption. In case that any unfavourable data were to become

known, the credit was either reduced or cancelled altogether. The Management Board also considered statistical data on bills of exchange protested with the Belgrade Commercial Court, which pointed to the Bank’s scrutiny of its borrowers. The Bank, therefore, rarely had problems with collecting its receivables from the credits approved.

Chart 1 **NBS Lending (1884-1914)**



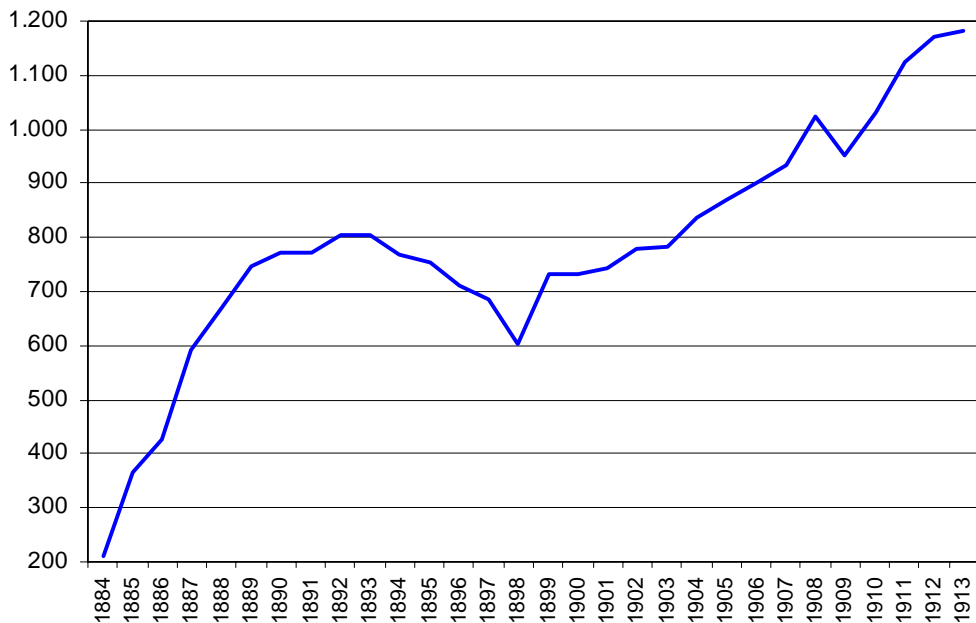
Source: Monograph of the National Bank 1884-1934 (1935).

As seen in Chart 2, the bill of exchange credits, however, recorded only modest growth, while after 1908 they were declining. This was due to several reasons. First, as the number of large trading and industrial enterprises was limited, high-quality bill of exchange material (“trading” bills of exchange) was scarce. Moreover, despite being offered a lower-than-market interest rate, traders and craftsmen resorted to the Bank’s credits comparatively rarely, as the Bank did not allow the bills of exchange to be repaid in instalments, but only redeemed in full. On the other hand, due to economic and political problems, all money bureaux introduced the possibility of the repayment of the bills of exchange in instalments. Traders and craftsmen, therefore, frequently opted for

borrowing at a higher interest rate, but subject to easier terms of repayment. It should be also noted that the National Bank was subject to a legal limitation regarding the amount of resources for lending to the trade and craftsmanship sectors. Due to the limitation on the issue of silver-backed banknotes, each year the Bank found itself 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 the highest demand. The problem became more pronounced as trade and craftsmanship developed further. The decline in the bill of exchange credits after 1908 resulted mainly from the fact that a large number of money bureaux decided not to take the Bank's credits. In order to use these credits they had to agree to a limitation of the maximum interest rate charged from their clients (three percentage points above the Bank rate).

Chart 2

Number of Borrowers in Respect of Discounted Bills of Exchange and Current Accounts (1884-1913)



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

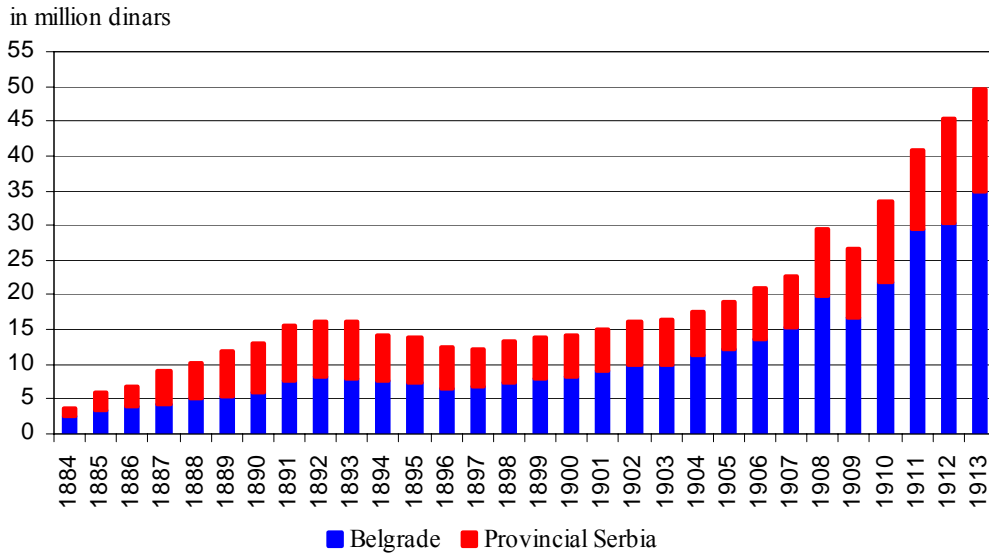
Lombard (collateralized) loans were another avenue for the Bank to issue its banknotes. For the issuing institution, Lombard loan operations were secondary in significance, not quite on a par with discount operations, and were subject to the main principles of issuing institutions, i.e. safety and liquidity. Lombard loans were extended for a maximum of three months, against collateral in gold or silver, Serbian state bonds, government-guaranteed bonds and state Treasury coupons with a maturity of no 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 was government bonds almost fully invested abroad, as well as government guaranteed bonds, which were very few, collateralized loans made up only a very small portion of the Bank's balance sheet. In the initial years of the National Bank's operations, collateralized loans exhibited low rates. Thereafter, they quickly picked up and, until 1903, moved at around RSD 1 million. After 1903, the sum of collateralized loans in the 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, placing its debentures or government bonds as collateral. The management of the Bank believed that Lombard operations could have developed just like any other bank operations if the legal regulations had permitted the Bank to accept as collateral other (nearly) secure domestic assets, which were to appear later in the market.⁴

In order to stimulate the money market and consolidate its own position, in 1886 the National Bank decided to allow money bureaux to disburse current account overdrafts against coverage in bills of exchange equalling 125% of the debt (see Charts 3 and 4). The debt had to be settled at the end of the quarter. Maximum credit amount to be granted to a single money bureau was one-half of the subscribed capital, 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 debt. Current accounts were particularly adequate as they also functioned as giro accounts that the National Bank did not maintain at the time.

⁴ See, the monograph of the privileged National Bank of the Kingdom of Serbia 1884-1909 (1909, p. 125).

Chart 3 Approved Loans in Respect of Discounted Bills of Exchange and Current Accounts (1884-1913)

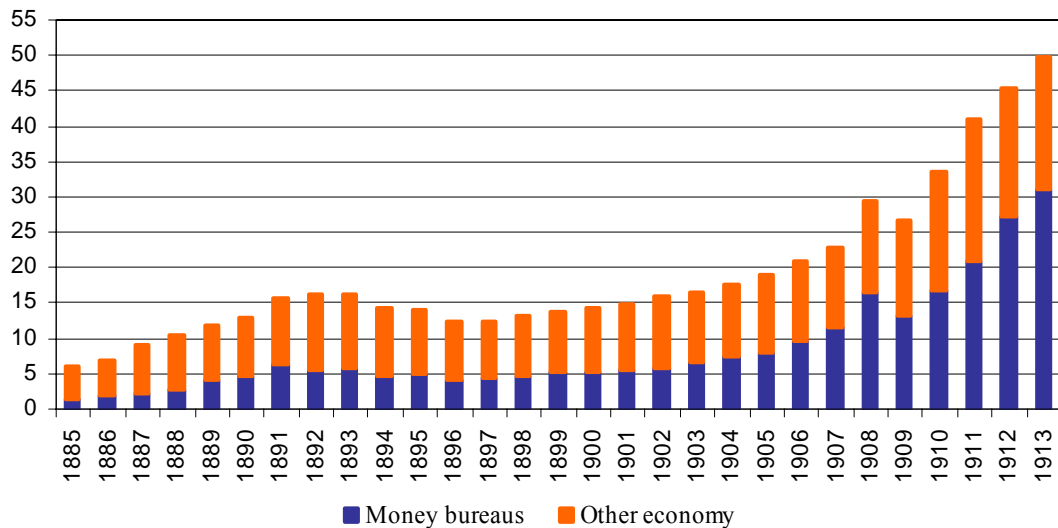


Source: Monograph of the National Bank 1884-1934 (1935).

Movements in current account overdrafts were aligned with the development of banking institutions in Serbia (see Charts 5 and 6). In the early first years of the National Bank, the number of banking institutions was low but growing. Current account loans followed suit. While in 1887 they barely exceeded 80 thousand dinars, in 1908 they reached close to 12 million dinars.

Chart 4 **Approved Loans in Respect of Discounted Bills of Exchange and Current Accounts (1884-1913)**

in million dinars



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

It is also worth noting that money bureaux (as well as various exporting and industrial firms) received preferential treatment from the National Bank from 1886 until end-1919. For instance, they were granted credits at an interest rate which was around 5 percentage points lower than the prevailing market rates (although as of 1892 there were no facilities for borrowing in gold). The Bank, in fact, wanted to stimulate the development of commercial banking and to create conditions favourable for the country's economic development. In 1884, Serbia had only seven money bureaux with a total capital of 3.25 million dinars.⁵ In 1886, their number rose to 21 and in 1890 to 42, while their total capital climbed to around 12 million dinars.

As new money bureaux were constantly being incorporated, their number reached 140 in 1907 and their total capital came close to 34 million dinars. However, when the bureaux began to be founded for political reasons and due to conflicts within craftsmanship guilds, the Bank tried to discourage this process by not approving loans to

⁵ See, the History of the Serbian People VI, Belgrade (1982, p. 17).

newly founded bureaux, but only to such bureaux which in a two- to three-year period recorded good operating results.

In a way, money bureaux were the branches of the National Bank, as it is through these bureaux that the Bank performed payments and collections in the provincial Serbia, and they were the main source of information on persons and firms financed by the Bank. Once a year, it conducted supervision of operations of the money bureaux with which it did business. The report on the supervision conducted by the Bank's general manager formed the basis for taking decisions on lending to a particular bureau.

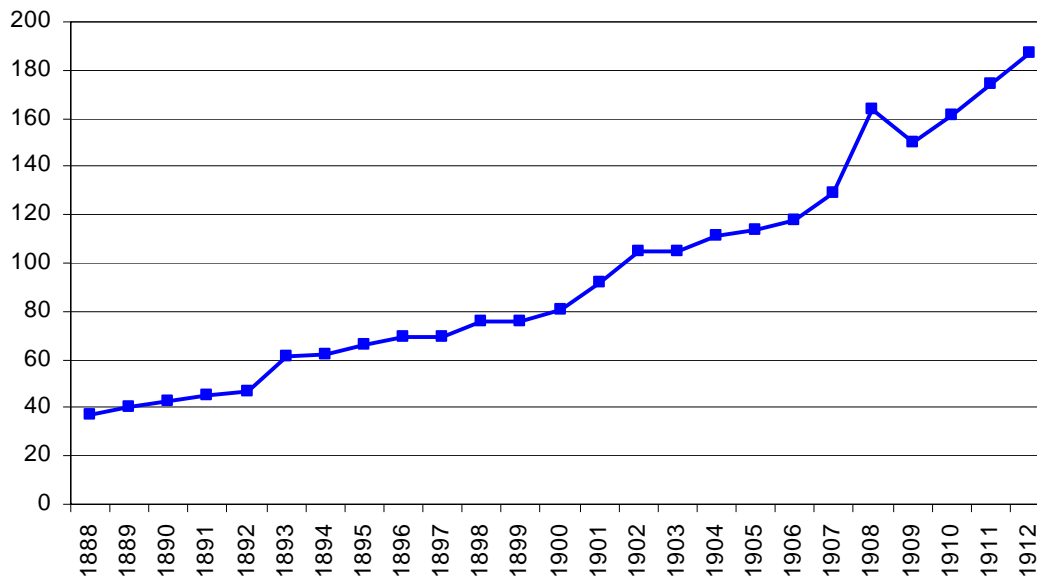
Credits approved by the Bank to money bureaux were either regular or extraordinary. Regular credits were approved to finance regular operations throughout the year, but bureaux could be requested to settle the debt every three months. Extraordinary credits were extended on a quarterly basis only, at the outset of the exports season, to bureaux catering to exporters.

In time, the original purpose of money bureaux, namely mutual crediting of members and, subsequently, non-members though at a somewhat higher interest rate was abandoned and the bureaux, 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 craftsmanship 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.

Throughout the 1884–1914 period, the Bank rate remained lower than the free market interest rate (see charts 7 and 8). Such low interest rate was applied by the Bank primarily on credits granted to money bureaux as a credit policy instrument to foster the development of trade and craftsmanship. On several occasions, the Bank had to suspend the granting of the discount and collateralized loans, but for periods no longer than one to three months. Silver loans were suspended for two main reasons: first, due to the legal limitation on the issue of banknotes and, second, due to high government borrowing from 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.

Chart 5 Total Number of Banking Institutions (1888-1912)



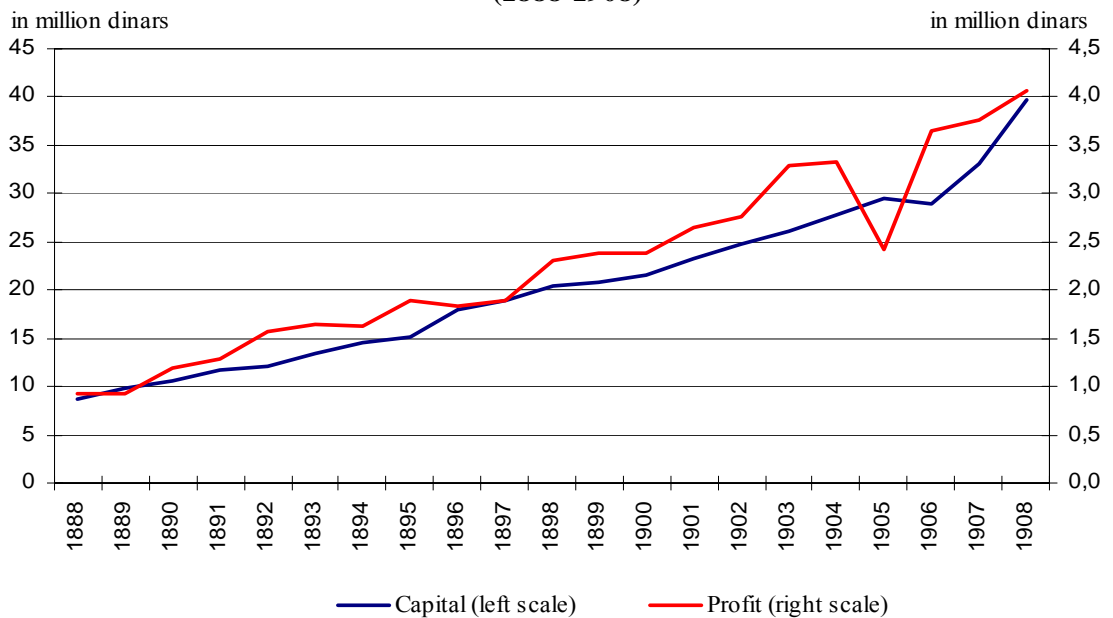
Source: Statistical Yearbook of the Kingdom of Serbia (1913).

By keeping its interest rate at a low level, the Bank intended to lower the market interest rate and the high cost of borrowing. At the outset of the National Bank's operations, the 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 ranging from 8–10% in Belgrade and to 10–12% elsewhere in Serbia. With occasional departures, it remained within this range up until World War I.

The National Bank's interest rate followed a different path. When the National Bank was established, it was decided to set the interest rate on discounting bills of exchange at 5.5% and the interest rate on collateralized loans at 6.5% p.a. Despite being two times lower than the money market interest rate, the discount rate did not succeed to

decrease 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 they remained around five 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 and to 7% in August 1885. Three months later, when the impending announcement of the Serbian-Bulgarian War threatened the level of the Bank's metal backing, the discount rate rose 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 interest rate on discount in silver at 6.5%, while retaining the rate on discount in gold at 8%.

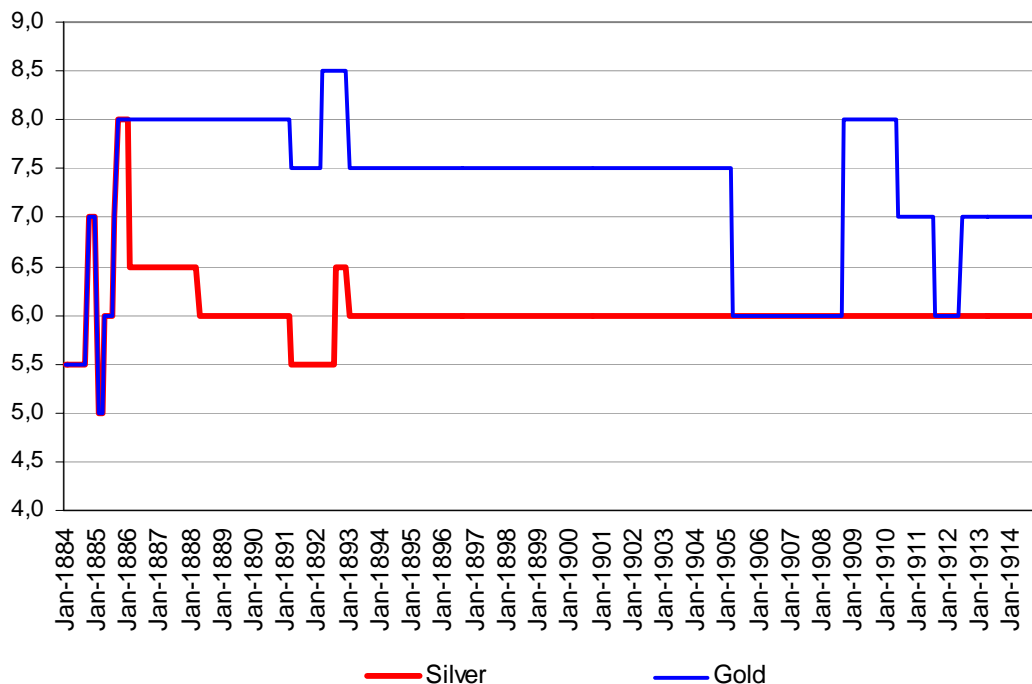
Chart 6 **Total Capital and Profit of Banking Institutions**
(1888-1908)



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

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 the 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 lowered to 7.5%. The interest rate on silver loans 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.

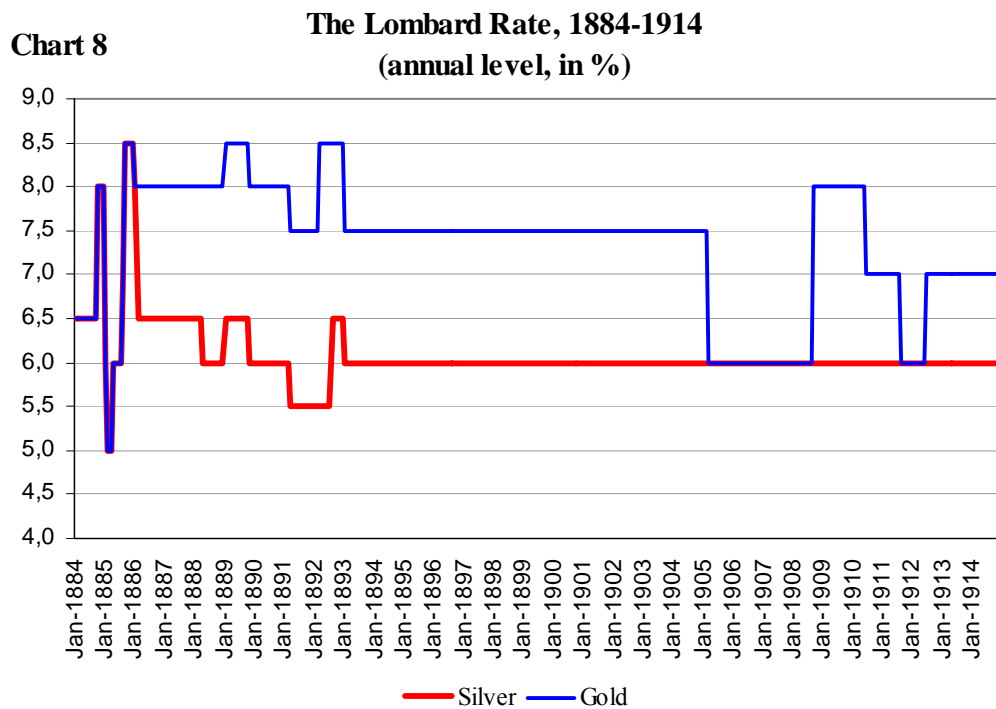
Chart 7 **The Discount Rate, 1884-1914**
(annual level, in %)



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

The Customs War with the Austro-Hungarian Empire (1906-1911) put a stop to Serbia's years of peaceful development, causing disruptions in all sectors of the economy. Because of the intermediation of the government with the National Bank, the

Bank decided to breach the limitation on the issue of banknotes but only on a temporary basis. Total circulation thus ranged between 37 and 65 million dinars. The Annexation Crisis of 1908 represented the climax of the Customs War. Fears of war and the economic blockade by the Austro-Hungarian Empire plunged Serbia into a financial crisis. The Bank's interest rate on gold loans rose to 8%, but the tension of the crisis was such that lending in gold had to be suspended throughout 1910 when gold in circulation reached sufficient levels again. The rate on gold loans was then cut from 7% and further down to 6% in 1911. In 1912, however, after the outbreak of Balkan Wars, the interest rate on gold loans increased to 7% and remained unchanged until 1920.



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

In an effort to lower the market interest rate, the Bank also resorted to administrative measures. Thus, in 1891, the Bank lent to money bureaux 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 bureaux 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 bureaux with which the Bank operated, only 44 consented to such limitation to the level of the interest rate. Consequently, in late 1909 the National Bank did business with only 54 bureaux or 30 less than in 1908. The market interest rate remained unchanged, while a large number of bureaux found it more profitable to borrow with larger Belgrade bureaux or abroad, at a higher interest rate than that offered by the Bank, but with no limitations regarding the interest rates charged to their clients.

As seen in Figures 7 and 8, a simple inspection of the trend movements of the Bank rate and the market rate reveals that, except in the first two years of the Bank's operations, the discount rate for silver loans ranged between 5.5% and 6.5% (most often moving at 6%), while the market rate varied widely, and sometimes was as much as two times higher than the Bank rate. A question is thus raised: Why the National Bank kept its interest rate practically unchanged for so long (1891-1920). Let us quote the following explanation provided by the Bank's management: "When setting the discount rate, the management of the Bank considered all the consequences of raising and lowering the country's official interest rate, with a special emphasis on safeguarding the Bank's metal backing and encouraging the inflow of short-term foreign capital. At the same time, however, the Bank's management had to take equal, if not even greater, care of the country's emerging financial market and to endeavour keeping the prevailing market interest rate as low as possible, as its legally defined objective. Special circumstances in the domestic money market required that the Bank's credits extended by the issuing institution should be cheaper than the credits extended by other money institutions. For that reason, the National Bank's rate could not equal or exceed the market rate".⁶

⁶ Monograph of the National Bank 1884-1934 (1935, p.59).

3. The National Bank: the Issuer

To achieve its primary objective of promoting domestic lending activity, the National Bank was granted the exclusive right to issue banknotes. “The right to issue banknotes at an amount of 2.5 times higher than the Bank’s metal reserves lies on the benefits that the issuing institutions bring to the country as well as on the profitability of the operation of issue. By issuing banknotes and lending them at a low interest rate to domestic business entities and traders, the issuer, i.e. the National Bank, increases domestic capital. In other words, it achieves the objective of promoting trade and economic activity by providing access to cheap capital and viable credit arrangements.”⁷

The main feature of money issue before World War I was bimetallism – a monetary standard in which two metals, gold and silver, were used to back the nation’s currency. At first, the idea was to issue only banknotes redeemable in gold, but as they could not remain in circulation, it was abandoned and silver-backed banknotes were issued again. The Bank issued banknotes against both gold and silver backing, but the value of gold-backed banknotes in circulation was negligible compared to the silver-backed ones, which grew from year to year. Immediately after being put into circulation, the silver-backed banknotes became the main mean of payments, so when we talk about banknotes in circulation, we are actually referring primarily to the silver-backed ones.

100-dinar gold-backed banknote. When founded in 1884, the National Bank was vested with the authority to issue 100-dinar gold-backed banknotes, and later also 50, 500 and 1,000-dinar gold-backed banknotes.⁸ The Law read as follows: “All banknotes placed into circulation shall have backing in gold and other securities, both trade-related and financial, that can easily and safely be converted into gold. ... The Bank shall never place more banknotes into circulation than 2.5 times the amount of gold it holds in its vaults.

⁷ Monograph of the privileged National Bank of the Kingdom of Serbia 1884-1909 (1909, p.144).

⁸ On the eve of the First Serbian-Turkish War, the state coffers were badly in the red and there was an initiative to issue national paper money. In January 1876, a decision was enacted to issue paper money. This money was printed in July 1876, but it was never placed into circulation. Instead, the matter was resolved through foreign and domestic borrowing.

No more than one quarter of gold can be replaced with silver, either”.⁹ However, the banknote was not overly well received and did not remain in circulation for long; instead, it was immediately converted into gold. Such non-acceptance was because banknotes were never used before in the domestic money transactions, their denomination was too high and the Agio was on gold.¹⁰

50-dinar gold-backed banknote. As the denomination of the 100-dinar banknote was too high, it was expected that a low denominated note, i.e. the 50-dinar note, would manage to remain in circulation. However, this banknote, placed into circulation in February 1885, was not well received too. Both 100- and 50-dinar notes were readily redeemed into gold. When it became apparent that neither of the two gold-backed banknotes could remain in circulation, the National Bank requested permission from the minister of finance to print 10-dinar gold-backed banknotes. This met with more opposition than expected, as the government intended to issue by itself banknotes of the same denomination.

Silver-backed 10-dinar banknote. For almost a year, the Bank operated without making much headway. Its income was barely sufficient to cover its costs, while projections for 1885 envisaged a balance of payments deficit. The Bank needed a banknote that would not be exchanged for metal and return to its vaults, but rather would remain in circulation. A very important political reason behind the introduction of a 10-dinar silver-backed banknote was the looming war with Bulgaria, which could not be waged with empty state coffers. As the government would not allow the issuing of low denomination gold-backed banknotes, the Bank accepted to issue a silver-backed 10-dinar banknote rather than to remain without a 10-dinar banknote altogether. This marked the beginning of bimetallism that continued to be the basis of Serbia’s monetary system until the end of World War I.

⁹ See, the Law on the National Bank, 1883.

¹⁰ As the gap between domestic money and gold used for the settlement of international obligations widened, the Agio indicated the depreciation of the dinar against the value of gold.

The 1885 Law introduced a silver-backed 10-dinar banknote, prescribing that “the National Bank shall exchange its 10-dinar banknotes against silver, and its 50, 100, 500 and 1,000-dinar banknotes against gold, at full nominal value without any deductions, as soon as the banknote is presented for redemption at its main cash vault. The Bank shall never place more banknotes into circulation than 2.5 times the amount of gold it holds in its vaults. No more than one quarter of gold can be replaced with silver”.

Money issue was based on the principles of security and liquidity and due observance of the law. After initial setbacks occasioned by the mistrust in paper money and the size of the first banknote, the Bank’s operations stabilized as early as in late 1885. The legally prescribed minimum backing for banknotes in circulation was observed at all times. In the years of economic instability and agricultural downturn, the backing for circulating banknotes was significantly higher than that was prescribed by the Law.¹¹

The quantity of circulating silver-backed banknotes kept rising, by around 4 million dinars per year, hence encouraging the National Bank’s lending activities. On average, silver-backed notes made up 95% of total circulating money supply. They were rarely converted into silver, and when they were, it was mainly due to the shortage of change money. As a result, silver-backed notes gained weight over gold-backed ones, which accounted for around 5% of total banknotes in circulation.¹² It might be concluded that money demand in domestic trade was mainly satisfied by silver-backed banknotes and silver coins (used exclusively as change money), and that gold coins, of which only a small amount was in circulation, were used for the settlement of international financial obligations.

The circulation, as a rule, peaked in autumn, during the agricultural season. Any rise in circulation was usually followed by a rise in the Agio on gold, which came about because of a number of bad agricultural years, the high level of borrowing abroad, unsettled finances and adverse political circumstances. The Bank tried to prevent a rise in

¹¹ After the Customs War with Austro-Hungary in late 1906, the backing equaled 74%; during the First Balkan War in 1912 it was 86%, whereas in the first year of World War I, it reached as much as 116%.

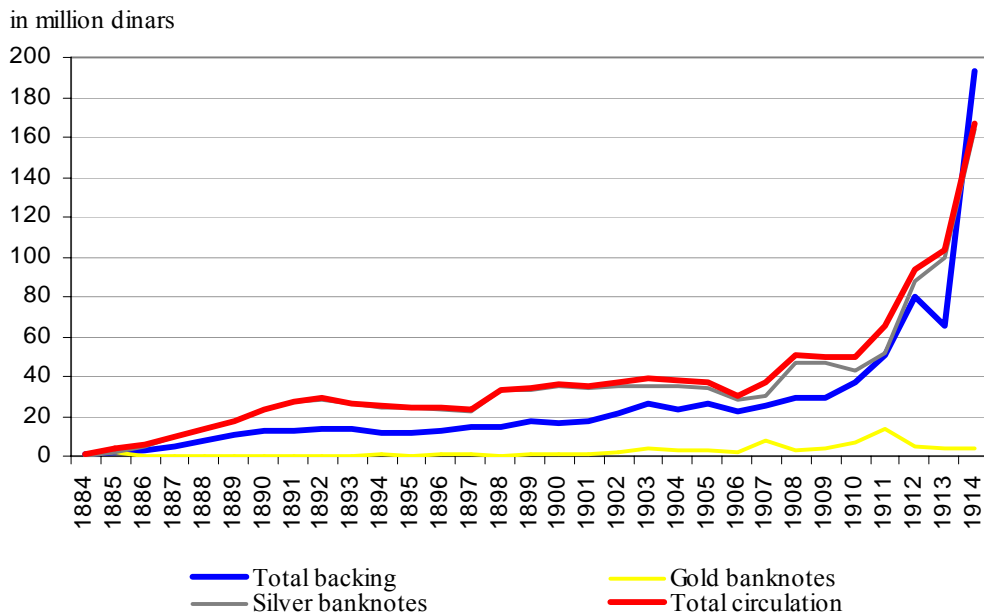
¹² In the period 1891-1900, the share of gold-backed banknotes in total circulating money supply equaled mere 1.48%, whereas in the period 1901-1910, it rose to 8.48%. The share of gold-backed banknotes reached the highest level in 1911 owing to the renewal of the trade agreement with the Austro-Hungarian Empire.

the Agio by selling gold for silver-backed banknotes, but it was accused of inducing money expansion, which was not used to finance the productive sectors of the economy. As the Agio was charged on gold purchased in exchange for silver-backed banknotes, the rise in the Agio was attributed to the large number of silver-backed banknotes in circulation.

The National Bank intervened directly by selling gold in the foreign exchange market to preserve the stability of the domestic currency. The Bank did not eliminate the Agio, but it managed to smooth oscillations in the value of the currency. The Bank would purchase gold when banknote circulation was sufficiently high, usually during the autumn season, and would sell gold when circulation was low and when the Agio rose, which was usually in March. Direct interventions of the National Bank were particularly significant in the early 1890s, but at the same time, this measure was severely criticized by both the government and the public. In late October 1892, the Bank had to abandon its efforts to suppress the Agio amid accusations that such efforts resulted in the creation of the Agio itself. The government decided to take the matter into its own hands and resolved the problem by limiting the quantity of 10-dinar silver-backed banknotes in circulation.

The 1885 Law, which introduced a new silver-backed banknote, set no limitations on the circulation of such banknotes, as their issue could equal two and a half times the stock of metal backing available to the Bank. The circulation of silver-backed banknotes remained unlimited until 1893, when the government came to interpret the Law as setting a limit on the issue of silver-backed banknotes at around 10 million dinars. In fact, the Bank and the government differed in their interpretation of the legal provisions relating to the metal backing of the money issue. The National Bank interpreted the relevant provisions as meaning that gold backing could be used for the issue of silver-backed banknotes. As a result, metal backing and currency in circulation came to stand in an inverse proportion: gold was prevailed in the composition of backing, whereas approximately 95% of silver-backed banknotes were in circulation (see Charts 9 and 10).

Chart 9 Backing and Circulation (1884-1914)



Source: Monograph of the National Bank 1884-1934

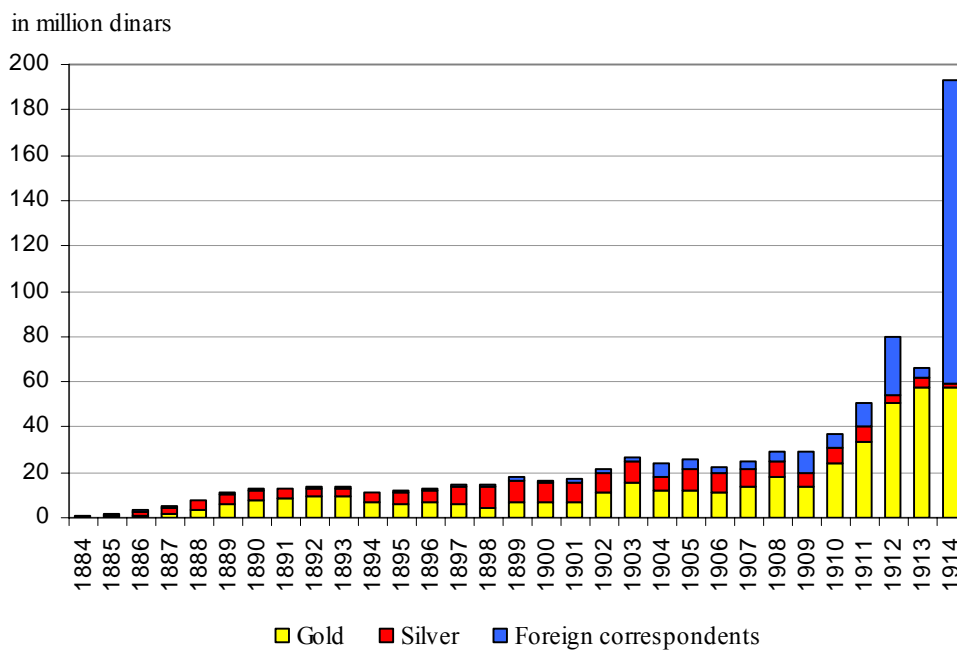
By contrast, the government maintained that gold might be used only as the backing for the issue of gold-backed banknotes, while the issue of silver-backed banknotes depended exclusively on silver backing. In practical terms, this meant that the authorized limit was already exceeded by 20 million dinars in silver-backed 10-dinar banknotes, as total circulation of silver-backed 10-dinar banknotes was around 30 million dinars in 1893. As the silver backing amounted to a mere 4 million dinars, only 10 million dinars could be issued in silver-backed banknotes.

The Bank opposed such interpretation, but in vain. It pointed out that “the Agio was not so much a consequence of the issue of silver-backed banknotes as of a poor international balance and a poor state of government finances; for the Agio to be eliminated and the currency to return to normal levels, overall economic conditions needed to improve”.¹³ An analysis of the movements of the Agio and the quantity of silver-backed banknotes in circulation reveals that the Agio was at its lowest level when the circulation of banknotes was at its highest, and *vice versa*.

¹³ See, the monograph of the privileged National Bank of the Kingdom of Serbia 1884-1909 (1909, p.155).

The government, however, insisted that silver-backed banknotes should be withdrawn over a five-year period, and that only a third of all banknotes should remain in circulation. This could be done by cutting credits by 20% per year that the National Bank did, warning, however, of the fact that “the national economy would suffer greatly as the result of the implemented deflationary policy”.

Chart 10 Banknote Backing (1884-1914)

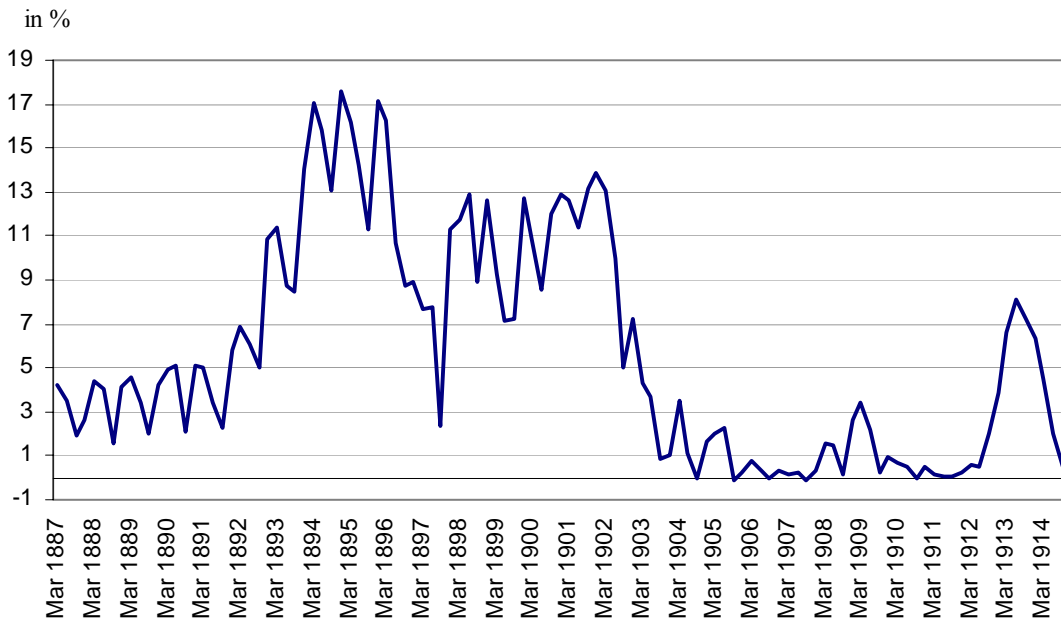


Source: Monograph of the National Bank 1884-1934 (1935).

The deflationary policy took its toll on the practice of lending by the money bureaux and the economy practically came to a standstill. Despite constant sales of gold, the Agio peaked at 18% in 1894, as seen in Charts 11 and 12. The government eventually realised its mistake and, in 1896, restored the earlier practice according to which the metal backing for silver-backed banknotes could be either in silver or in gold. The amount of silver-backed banknotes, however, remained limited to 25 million dinars, regardless of the level of backing.

Chart 11

Agio Movements (1887-1914)



Note : Based on napoleon d'or movements.

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

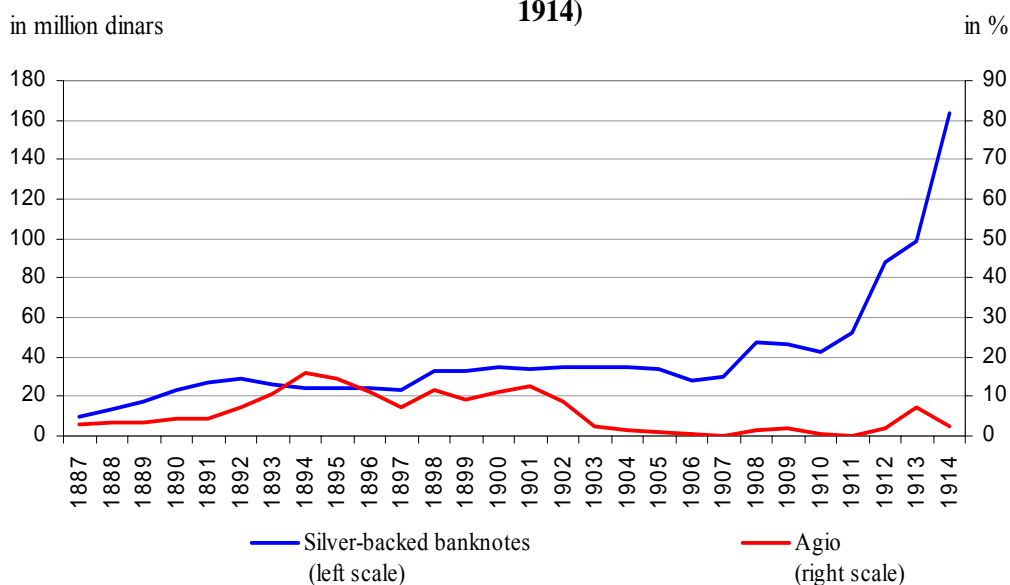
One of the proposed solutions to the problem caused by the Agio was the introduction of a **20-dinar gold-backed banknote**. In 1896, the National Bank received the authorization to issue such banknote, but it did not do so until 1907 because it believed that the failure of the gold-backed banknote was not due to its high denomination only. Once the banknote was issued, however, it did not remain in circulation for a long time. In fact, it only entered into circulation during the exports season, once the limit on silver-backed banknotes was reached. There was no Agio at that time, and the gold-backed banknote circulated as the silver-backed one. During the exports season, its circulation thus reached close to 12 million dinars, but as the exports season would near its end, the circulation of gold-backed banknotes would dwindle notably.

Soon, however, it became apparent that raising the limit on silver-backed banknotes in circulation to 25 million dinars in 1896 was still below the mark. In the next year, the financing of autumn agricultural works had been already suspended at the peak

of the season. Hence, in 1898, the limit increased to 30 million dinars, but remained unchanged until 1908¹⁴ when the Law extended the National Bank's privilege for another 25 years and set the ratio of total circulation of silver-backed banknotes to the Bank's subscribed capital at 1 to 5. That year, the subscribed capital of the National Bank equalled 7.5 million dinars in gold, which meant that the circulation of silver-backed banknotes could equal 37.5 million dinars or 41.2 million dinars if the government allowed a deviation of 10% above the maximum limit in view of extraordinary circumstances. The extension of the National Bank's privilege in 1908 was significant as the Annexation Crisis and fears of war exhausted the reserves of money bureaux. The Bank suspended lending in gold, but lending in silver continued owing to government's assistance. The government took three main measures. First, it allowed the Bank to issue a contingent advantage of silver-backed banknotes (10% of total circulation or 3.75 million dinars). Second, it allowed the Bank to lend 2.5 million dinars to the economy from the sum designated for discounting state coupons. Third, in order to suppress the Agio, it intervened in the foreign exchange market by selling 27,000 napoleon-d'ores. As a result, the Bank was able to increase the circulation of silver-backed banknotes to 43 million dinars. These measures saved Serbia from a financial breakdown and helped it weather the crisis. The law on extending the Bank's privilege envisaged that its total capital (10 million dinars) should be subscribed by 1913, which meant that, in that year, the circulation of silver-backed banknotes could reach 50 or 55 million dinars.

¹⁴ In the context of the Customs War with the Austro-Hungarian Empire, the government allowed the breach of the legal maximum and permitted the Bank to issue an additional 4 million dinars in silver-backed banknotes.

Chart 12 **Circulation of Silver-Backed Banknotes and Average Agio (1887-1914)**



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

The ensuing period from 1909 until 1911 was marked by economic progress. The economic upswing reached its peak in the year 1911. Substantial foreign capital entered the country through newly founded branches of foreign banks in Belgrade, while the circulation of silver-backed banknotes hit a high record of 59.2 million dinars in October and that of gold-backed banknotes reached as much as 19.5 million dinars. However, the economic advancement was once again halted by the outbreak of war in 1913.

4. The National Bank: the Government Banker

After the 1878 Berlin Congress, when Serbia became independent, and the subsequent proclamation of Kingdom in 1882, the government assumed substantial obligations and needed a strong monetary institution on which could rely. This was particularly clear after the collapse of the General Union which was supposed to construct railways in Serbia. The budget deficit continued rising and it became almost impossible for the government to strike a balance between budget revenues and expenditures. The

progressive government and the National Assembly thus considered the Bank as an institution to satisfy the credit requirements of both the private and public sectors. Therefore, the Bank's lending activity took two main directions: private credits and credits to the government.

Operations with the government were the first operations of the National Bank. In fact, it scarcely began operating with the government when it approved a loan of 300,000 dinars against three-month state coupons, from the funds paid in for the Bank's shares. The government continually relied on the assistance of the National Bank, which, in turn, always accommodated the government pursuant to legal regulations. "As a result, there was less money for financing trade and the economy, but the government needed financial assistance, too."¹⁵ In the period from 1880 till 1887, budget revenues equalled 202.1 million dinars and expenditures 302.5 million dinars. The government owed 254.1 million dinars in respect of "permanent" debts and 32.1 million dinars in respect of "temporary" debts.¹⁶ The government financed the budget deficits by domestic borrowing, primarily from the National Bank, but by foreign borrowing as well. Regardless of the avenue of deficit financing, lending to the government invariably influenced the operations of the National Bank.

Government borrowing from the National Bank can be divided into two periods:

- 1) from 1884 when the Bank was created, to 1903 and,
- 2) from 1904 till the outbreak of World War I in 1914.

First Period: Government's Indebtedness

Facing constantly a budget deficit for over 25 years in a row (1878-1903), the government resorted heavily to borrowing from the National Bank. In 1884, the government discounted its coupons in exchange for a total of 900,000 dinars. By the end of the year, debt declined to 304,216 dinars. The share of government debt in total

¹⁵ Monograph of the Privileged National Bank of the Kingdom of Serbia 1884-1909 (1909, p. 127).

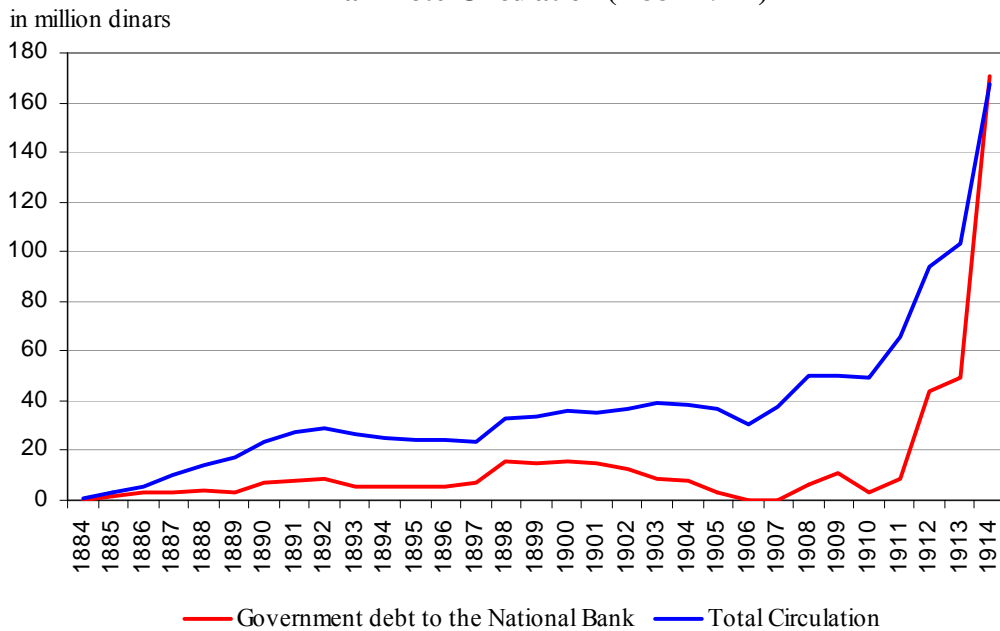
¹⁶ In the 1880s, the government financed its budget deficit by means of so-called temporary short-term loans. Obligations in respect of these loans were maintained in a special extraordinary budget, which was offset by sources other than revenues. These were short-term government debts, which needed immediate settlement, as all other expenditures booked in the so-called regular budget.

currency in circulation thus came to 38.9%. In addition to discounting of coupons, the government contracted collateralized loans with the Bank. As soon as the 1885 Law on the silver-backed banknote was enacted, the government borrowed 1 million dinars from the Bank, placing as collateral the bonds remaining under the 1881 Law. In December of the same year, the government borrowed 500,000 dinars more. Its debt thus climbed to 1.5 million dinars. Soon after, the government requested a new loan of 500,000 dinars.

In fact, the Bank proved to be the ultimate option for financial excess government spending, as the war with Bulgaria virtually depleted the state coffers, while foreign credits were difficult to get and budget revenues were low and collected at irregular time intervals. The government floating debt to the Bank kept rising and the government paid only the interest and not amortisation. Two years after the start of the Bank's operations, in 1886, government debt rose to 2.9 million dinars, representing more than 50% of the issued banknotes. In the period ahead, there was a relative decline in the share of government debt in total currency in circulation, owing to a faster increase in the quantity of issued banknotes. Thus, in 1888 government debt rose to 4 million dinars; this represented 28.9% of banknotes in circulation.

In 1890, the debt to the Bank in respect of collateralized loans, coupons and the Bank's share in government loans abroad reached close to 6 million dinars. The Bank also approved the so-called intermediate loans of total amount of 1 million dinars against government guarantees (to individual ministries, state institutions, railways directorate, the monopoly on tobacco, salt, public institutions, etc). The next year, direct and indirect government loans rose to 8 million dinars.

Chart 13 The Government Debt to the National Bank and Total Banknote Circulation (1884-1914)



Source: Monograph of the National Bank 1884-1934

Until 1898, the government borrowed from the Bank pursuant to an agreement with the Bank’s management. However, since the repayment of its floating debt could not be effected from regular budget revenues nor postponed any longer, while an earlier government loan of 70.5 million dinars intended for this purpose could not be realized in Paris, the government issued a law on a temporary loan, thus binding the Bank to lend 10 million dinars more. Silver-backed banknotes issued in respect of this loan should have a metal backing in the same proportion as provided for all other banknotes. However, they were not included in the maximum allowed contingent of 25 million dinars.

The already high debt to the Bank doubled in 1889 reaching 15.9 million dinars, amounted to almost 50% of the banknote issue (see Chart 13). As the remaining half was to be used to purchase gold to cover issued banknotes, it becomes apparent that few money resources had eventually been left to finance trade and craftsmanship. As a result, the banknote contingent advantage rose to 30 million dinars.

Unsettled financial circumstances were indicative of the general state of affairs in the Kingdom. The divorce between King Milan and Queen Natalija, the abdication of the King, the frequent quarrels between the divorced spouses, rivalry and fight for influence over the underage heir Alexander invariably affected Serbian finances. The opportunism exhibited by political parties, which served primarily as political instruments to both Kings, Milan and Alexander, did not help in restoring the country's financial situation in order.

In 1900, another loan of 2 million dinars was approved in the same terms as those were applied to the earlier loan of 10 million dinars. Once again, the limit for currency in circulation was exceeded and metal backing was provided. The Bank's dissatisfaction from the following quote: "Once a high-handed approach has been adopted, it is difficult to reverse the trend. This legal solution is enacted without requesting the opinion or the consent of the Bank's management... Such legal solutions further eroded the Bank's independence, compelling it to choose in a difficult situation: to breach the laws enacted without its consent and thereby to expose itself to forced measures ... or to bend its head and apply the laws and decisions, and yet to protest against them. In general, the Bank opted for the second option, giving way before force".¹⁷ Therefore, the relations between the National Bank and the government remained strained well until the enactment of the 1904 Law.

In addition to government borrowing from the National Bank during this period, it is important to take into account the loans extended to municipalities, counties and districts for financing utility works.¹⁸

Second Period: Relations Re-defined

Pursuant the 1904 Law, the government was given the option to borrow from the Bank on a temporary basis by pledging state coupons in return for working capital worth up to 10 million dinars. All existing debts merged into a single debt, while the Bank was

¹⁷ Monograph of the Privileged National Bank of the Kingdom of Serbia 1884-1909 (1909, p. 130).

¹⁸ For more information see, Kosijer (1924, p. 110) and the Monograph of the privileged National Bank of the Kingdom of Serbia 1884-1909 (1909, p.138-141).

vested with the authority to issue silver-backed banknotes in denomination of 50 and 100 dinars. More importantly, the 1904 Law introduced an institutional framework for re-defining the relations between the Bank and the government.¹⁹ In particular, it was defined that government borrowing from the National Bank should be only temporary and short-term. The government should also finance a significant portion of its spending by foreign borrowing. The budget was struck after the change in the dynasty and when the Radical party headed by Mr Nikola Pašić came into power. The energetic radical minister of finance, Mr Lazar Paču, undertook rigorous measures to restore the health of Serbia's finances. No doubt, the key contribution to this process also came from the strict supervision of all budget receipts and outlays implemented by the National Assembly, which used to discuss the state budget, item by item, for months. Running such carefully deliberated fiscal policy resulted in the reduction of the government floating debt, from 7.52 million dinars in 1904 to 3.43 million in 1905, while in the following two years debt was nil. As a result, the Bank was able to implement successfully both credit policy measures and those aimed at stabilizing the dinar.

However, the Customs War with the Austro-Hungarian Empire and the 1908 Annexation Crisis in particular, brought about a financial crisis in Serbia. The government undertook a number of measures that saved Serbia from its financial meltdown and helped it come through the crisis. Pursuant to the 1908 Law, the government was given the option of additional borrowing from the Bank. Namely, the government was vested with the right to use temporary, three-month advance payments based on coupons worth up to 10 million dinars. In fact, however, it did not fully use this option until the outbreak of the Second Balkan War in 1913, but actually helped the Bank with the unfunded commitments under such credits in cases when the depletion of the Bank's contingent threatened private lending activity. Well-regulated state finances enabled the government to set aside 2.25 million dinars from the amount earmarked for

¹⁹ This is best illustrated by an excerpt from the speech of Lazar Paču in the assembly debate: "...the National Bank should not be a source of the government revenues. It may become such a source only indirectly: by creating conditions for encouraging development and providing viable credit arrangements, which will in return upgrade economic activity and trade, thus strengthening the primary sources of revenue to the state coffers". See, the monograph of the National Bank 1884-1934 (1935, p. 38).

discounting regular coupons and transfer them to the National Bank in order to lend to the economy, preventing thus the suspension of silver credits.

A special type of lending to the government was 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*, and exchange silver-backed banknotes against gold without any deductions whatsoever. The banknotes issued in respect of temporary exchange were not included in the contingent advantage of 40% backing. This enabled the government to exchange gold against silver-backed banknotes without any losses of the Agio, regulating at the same time the gold market supply and strengthening the metal backing of banknotes. As proved later, this type of exchange allowed, above all, the simple and efficient financing of budget expenditures in difficult times.

Economic activity gained momentum after the Annexation Crisis and events that shook the Balkans to the core. The progress achieved from 1909 to 1911, paved the way for the stabilization of state finances, and even the First Balkan War of 1912 did not disrupt it. In the course of 1911, the government did not discount regular coupons. It used working capital, but repaid its debts on time, and often even earlier than due. Hence, its debt to the Bank equaled zero at end-1910. The same also happened in 1911 and 1912 – the government debt disclosed in the Bank's balance sheets was fictional as it represented transactions with coupons for working capital for the benefit of the economy.

Economic upswing came to a halt in 1913 as a consequence of war distress and downturn in crop yields. Budget revenues declined and the government stepped up its borrowing from the Bank. On the eve of the First World War, the government debt was around 10 million dinars. The balance of temporary exchange stood at 47.8 million, while government claims in silver accounted for 25.3 million dinars thereof. Hence, net government liabilities before the start of the war equaled 32.5 million dinars. During the war, these liabilities recorded a notable increase, as huge budget expenditures were also financed by the funds provided by the National Bank.

5. Conclusion

The National Bank's success in the performance of its functions as a creditor, currency issuer and government banker was mainly determined by the state of government finances. Widening budget deficits 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. Apart from this, the crucial thing was that the government itself excessively absorbed the National Bank's treasuries. Indeed, until 1908, government borrowing from the National Bank was by far higher than the credit and debt of all Serbian institutions taken together".²⁰

However, it would be right to say that the National Bank was successful in carrying out its functions, especially in reduced circumstances in which it operated and the need for striking a balance between conflicting objectives. Through its lending activity, the National Bank contributed to the development of trade and the domestic economy in general, managed to maintain relative stability of the domestic currency and performed the role of a banker to the most demanding client, i.e. the government. It would be right to wonder whether the government would have been able to operate at all and carry out its tasks without the help of the Bank on which it relied so heavily.²¹

Neither the government nor the National Bank could, however, escape the impact of either the Customs War or the Balkan Wars which were in fact only a prelude to the First World War. Peace and stability are a prerequisite for economic development and when we look at Serbia's history from 1884 to 1914, all we see is 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 Kingdom of Serbia. The Balkan Wars in 1912-1913 came after and Serbia emerged as a winner. In such poor circumstances, the country, however, made significant economic headway, and the

²⁰ Quoted Pera Maksimović at the 1913 central shareholders' meeting, (see, Kosijer 1924, p.116).

²¹ Milić (1994, p. 83).

National Bank did its best to achieve the goal it was set up to perform, which was to promote trade and economic activity by providing credits.

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