

# From Debasement to External Borrowing: Changing Forms of Deficit Finance in the Ottoman Empire, 1750–1914

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## I. Introduction

Large fiscal deficits arising mostly from wars were a major problem for many of the European states during the early modern period but less so in the nineteenth century. The existing literature examines the strategies pursued and choices made by individual governments as they attempted to finance these deficits over the long term subject to the constraints and opportunities provided by the domestic and international financial markets. These public sector financial policies, of course, had far reaching implications not only for money and monetary policy but also for the economy at large.<sup>1</sup> During the eighteenth and nineteenth centuries the central budgets of the Ottoman empire also showed large deficits during periods of war. When the frequency of these extraordinary periods increased, the cumulative effects of the deficits tended to create major pressures on state finances and the economy.

This paper identifies and analyzes an important change in the way the budget deficits were financed before and after the 1850s. The Ottoman budget deficits tended to increase after the late 1760s and reached their peak during the 1820s and 1830s. In response, the state attempted to increase its control over revenue sources, relied on internal borrowing, and when the short term fiscal pressures mounted, resorted to debasements. The timing and magnitude of debasements during this period suggests that the governments were quite sensitive to the costs of debasements, especially the urban political opposition they generated.

Then, in the middle of the 19th century, bi-metallism was embraced, new standards were adopted for coinage and the government began to borrow in the European financial markets. From the 1850s to World War I, debasements were abandoned, relative monetary stability was maintained and external borrowing remained the most important mechanism for financing the budget deficits. The paper examines the reasons for as well as the consequences of this shift. It is argued that the shift was due to the combination of European

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<sup>1</sup> For examples, see Weir (1989), Bordo and White (1991) and Velde and Weir (1992); also Parker (1974).

pressure and a desire on the part of the Ottoman government to maintain credibility in and access to the European financial markets. In the long term, however, the Ottomans paid a heavy price for borrowing abroad without establishing fiscal discipline since European creditors established financial control over Ottoman finances after the moratorium of 1875.

## 2. The Eighteenth Century: Relative Peace and Stability

The eighteenth century until the 1760s was a period of relative peace, stability and economic expansion for the Ottoman empire. While the available evidence on production is limited, it does point to an increasing trend for agriculture and artisanal activity as well as investment in manufacturing for many parts of the Balkans and Anatolia.<sup>2</sup> There also occurred a considerable expansion in the trade between the Ottoman empire and central and western Europe during this period especially through the Mediterranean, and to a lesser extent, across land in the Balkans. French merchants based in Marseille controlled the maritime trade until the French revolution.<sup>3</sup> This was also a period of stability for state finances. From the 1720s until the end of the 1760s, the evidence on Ottoman finances suggests that the overall trend was towards balanced budgets and surpluses were enjoyed in many years. The favorable financial conditions were especially apparent during the extended period of peace in mid-century, 1747 to 1768.<sup>4</sup>

The silver kurush (or guruh or piaster) was the leading unit of account as well as the leading means of exchange in the eighteenth century Ottoman monetary system. Virtually all prices and government obligations were expressed in terms of this unit. The state also minted a number of gold coins without face value. Their exchange rates against the kurush were determined by the markets although during extraordinary periods the government attempted control these rates. Gold coins including the Venetian ducat played a limited role in daily transactions. They were used in large payments and for store of value purposes. In addition, the European silver such as the Dutch thaler and Spanish eight real piece were used both in international trade and domestic payments. The exchange rates of these coins were also determined in the local markets.<sup>5</sup>

The Ottoman kurush was relatively stable during this period. In addition to the favorable state finances, the Ottoman currency was supported by the rising levels of output in the new silver mines of Anatolia, in Gumushane, Keban, Espiye and Ergani whose total output reached 35 to 40 tons per year in mid-century. The older silver mines in the Balkans, in Sidrekapsi and Kratova continued to contribute as well. Numismatic and archival evidence summarized Figure 1 shows that the silver content of the kurush declined at a moderate pace, by a total of 40 percent until the end of the 1760s.

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<sup>2</sup> Genç (1984).

<sup>3</sup> Panzac (1992), Frangakis-Syrett (1992), Paris (1957).

<sup>4</sup> Tabakoglu (1985), pp. 74–113.

<sup>5</sup> Pamuk (2000), pp. 159–70.

From the 1760s until the end of the century, however, Ottoman state finances and money were jolted by two exhausting wars, 1768 to 1774 and 1787 to 1792, the first with Russia and the second with Russia and the Habsburgs. Although the first of these created financial difficulties, a major debasement was avoided by relying on the reserves accumulated in the earlier era of peace. During the second war, however, the government was forced to reduce the silver content of the piaster by about one third. The debasement was accompanied by a demand, which included a reference to the ongoing holy war, that the public surrender to the government all available silver at official, below market prices.

To keep prices from rising both as a result of this operation and in the face of wartime shortages, the government tried to enforce a system of price ceilings (*narh*) for most goods in urban areas, especially in the capital city. These price ceilings were extended to the exchange rates of other coins, both gold and foreign, against the silver piaster. The available evidence is too scanty to attempt an evaluation of this package of intervention. It appears, however, that the government was not particularly successful in achieving its ends. Even though mint records are not available, it appears that the government could not induce significant flows of silver to the mints. Mint output, therefore, remained limited until the government later raised the mint price of silver. At the same time, the price ceilings only exacerbated the shortages in urban areas, especially in the capital. Merchants in the provinces simply refused to send goods to the capital. This was in fact the first and the last time in the eighteenth century that the government attempted to use coercion to generate seigniorage revenue. It was also the most severe crisis of provisioning faced by the urban areas, especially the capital city.<sup>6</sup>

### 3. Financial Reform and Attempts at Internal Borrowing

The reign of sultan Mahmud II (1808–1839) was a very difficult period for the Ottoman empire and especially the central government. During these three decades the central government was forced to deal with a series of uprisings, nationalist revolutions and a series of wars abroad. While it was able to suppress the various uprisings of notables in both the Balkans and Anatolia, the Serbian and Greek revolutions led to the secessions of these territories from the empire. Much more costly to the state finances than any of these were a series of wars against Russia (1806–1812 and 1828–29), Iran (1820–28) and Egypt (1831–33 and 1838–39). This was also a critical period of Western style and centralizing reform for the Ottoman empire. The attempts to establish a western style army had started earlier, during the reign of Selim III (1789–1807) but progress had been limited due to the opposition of the janissaries. After the suppression of the janissary revolt and the abolition of the order in 1826, the efforts to establish a new army (*Nizam-ı Cedid*) gained new momentum.<sup>7</sup> Another important and difficult task was the reorganization and modernization of the internal administration of the empire. In this respect, the strategy of

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<sup>6</sup> Pamuk (2000), pp. 170–1.

<sup>7</sup> Shaw and Shaw (1977), pp. 1–54.

Mahmud II was the elimination of intermediate authorities both in the capital and the provinces and the centralization of power in his own hands. As the reform movement began to spread beyond the military field in the 1820s, to administration, justice, and education, the demands for resources increased as well. While precise budget figures do not exist, recent estimates suggest that after adjusting for inflation, the expenditures of the central government increased by 250 to 300 percent from the end of the eighteenth century until 1840. Roughly half of the budget expenditures were being allocated for military purposes and this share rose considerably during periods of war. To deal with changes of such magnitudes, of course, constituted a financial task of enormous proportions for the central government. As a result, one of the key goals of the reform process was the financial re-organization of the empire and greater centralization of the revenues.<sup>8</sup>

During the eighteenth and nineteenth centuries, the political and administrative capacities of the Ottoman government often determined the limits on fiscal revenue. Without an administrative network for tax collection, the government was forced to share tax collections with the powerful groups in the provinces. Beginning in the 1820s, the state was able to reduce the power of the alliance between high level bureaucrats and financiers at the capital and the locally powerful groups at the provinces. It thus became possible to exert greater control over the tax collection process. Through this centralization the state was able to increase, in real terms, the revenues collected at the center. However, the expenditures continued to rise at a faster pace throughout this period. For this reason, in addition to its efforts at financial re-organization and centralization, the government devoted a considerable part of its energies, from the late eighteenth century until the 1840s, to developing new methods of long term internal borrowing.

Ever since the sixteenth century, the state had relied on the financiers at the capital for short term loans. Even though these financiers, or bankers without banks, expanded their activities considerably in the second half of the eighteenth century, their lending capacity was still small in relation to the needs of the state. One obvious way for the government to borrow on a long term basis was to link the borrowed funds explicitly to the revenue sources of the state. In fact, the malikane or life-term tax-farm system which was initiated at the end of the seventeenth century, was based on this principle.

After the end of the war of 1768–1774 which had dramatically exposed the military as well as financial weaknesses of the Ottoman system, the financial bureaucracy started a system of long term domestic borrowing called *esham*. In this system which was based partly on the malikane system, the annual net revenues of a tax source were specified in nominal terms. This amount was divided into a large number of shares which were then sold to the public for the lifetime of the buyers. The annual revenues of the source continued to be collected by the tax farmers.<sup>9</sup>

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<sup>8</sup> Cezar (1986), pp. 279–281.

<sup>9</sup> These arrangements were similar to those used by the European states in the early modern era, most notably in France. See Weir (1989) and Parker (1974).

Clearly, one motivation here was to broaden the base of state borrowing and enable the state go beyond the limited numbers of large financiers who tended to dominate the malikane auctions and to reach a larger pool of small and medium sized lenders. However, the inability of the state to control or limit the sales of the esham between individuals and the difficulties in preventing the heirs of the deceased from continuing to receive payments seriously limited the fiscal benefits of this system. As a result, it proved to be a rather costly system of long term internal borrowing. Many Ottoman thinkers argued in favor of abolishing it especially when the fiscal pressures subsided. During the next half century the state vascillated between abolishing the esham during periods of fiscal stability and continuing and even expanding it when fiscal pressures mounted and additional funds had to be secured with little regard for their longer term cost.<sup>10</sup>

During the war of 1787–92 the Ottoman government also considered the possibility of borrowing from abroad, which would have been a first for the Ottoman state, from France, Spain or Netherlands. In response, the Dutch government indicated in 1789 that it was not in a position to lend and referred the Ottoman government to the private sector. However, due to difficulties both in Europe arising from the French revolution and the Ottoman side, this possibility could not be pursued any further. Another proposal was to borrow from Morrocco because it was a friendly Muslim country, but it was obvious that the ability of Morrocco was quite limited. From the late eighteenth century until the 1840s, extraordinary wartime taxes and the expropriation of the wealth of prominent individuals especially of those who accumulated their wealth as a public servant or in their financial dealings with the state continued to serve as other means of raising fiscal revenue during troubled times.<sup>11</sup>

#### **4. The Great Ottoman Debasement (1808–1839)**

In addition to these long and short term measures, the Ottoman government made extensive use of currency debasements during this extraordinary period. When the centralizing and reformist sultan Mahmud II ascended the throne in 1808, the standard kurush still contained 5.90 grams of silver, unchanged since the debasement of 1789. During the next three decades, the silver content of the Ottoman currency declined at times sharply, at times more slowly. The lowest point for the kurush was reached in 1831–32 at 0.5 grams of silver although it subsequently rose to 0.9 grams in 1832 and then to 1.0 gram in 1844 where it stayed until World War I. In other words, the kurush lost more than 90 percent of its silver content until 1832 and then recovered somewhat. All in all, from 1808 to 1844 it lost 83 percent of its silver content. (Figure 1)

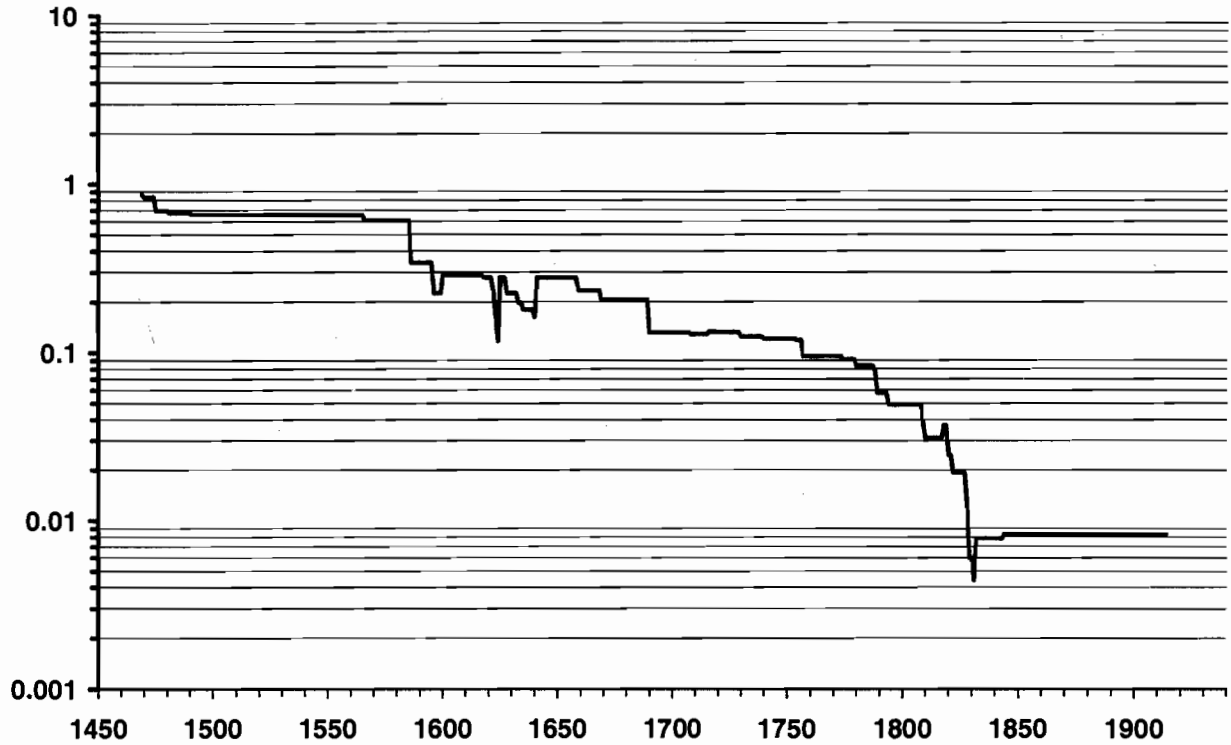
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<sup>10</sup> Cezar (1986), pp. 128–34, 198–200.

<sup>11</sup> Cezar (1986), pp. 89–92, 137–38.

Figure 1

**Silver Content of the Ottoman Monetary Unit, Akçe, 1469–1914**  
in grams; 1 kurush = 120 akçe (source: Pamuk, 2000)



Closely following the debasement of the currency, of course, was the sharp fall in its exchange rate and the rapid rise in the general price level both of which were equally dramatic. In 1788, 5 and a half kurush exchanged for one Venetian ducat and 11 kurush for one British pound sterling. In 1844 one ducat equalled 50–52 kurush and the British pound exchanged for 110 kurush. In other words, during these six decades the price of these leading currencies in terms of the kurush had increased 9 to 10 fold or the Ottoman unit had lost about 90 percent of its value against them and most other European currencies.<sup>12</sup> Consumer price indices for Istanbul constructed by the present author from the account books of the imperial kitchen at Istanbul indicate that food prices paid by the palace kitchen increased approximately 8 fold from between 1780 and 1845, reflecting closely the changes in the silver content of the currency and its exchange rate against the leading European units. (Figure 2).

<sup>12</sup> The slide of the kurush against the most European currencies slowed down during the Napoleonic Wars as the others also depreciated but resumed with the end of European hostilities. Issawi (1980), pp. 329–31, Pamuk (2000), pp. 191.

## 7. Conclusion

After using debasements for deficit finance for many decades, the Ottoman government, along with many others around the world, embraced bi-metallism in mid-19th century and began to borrow in the European financial markets. From the 1850s to World War I, debasements were abandoned, relative monetary stability was maintained and external borrowing remained the most important mechanism for financing the budget deficits. The paper has examined the reasons for as well as the consequences of this shift. It has been argued that the shift was due to the combination of European pressure and a desire on the part of the Ottoman government to maintain credibility in and access to the European financial markets.

What was the long term balance sheet, then, for the mid-nineteenth century regime change? Monetary stability, rapid expansion of foreign trade and European direct investment should appear on the positive side. Annual rate of growth of Ottoman foreign trade averaged close to 5 percent in real terms during the nineteenth century. There is also some evidence for economic growth from mid-century to World War I. If true, this economic growth was certainly related to the growing commercialization of the Ottoman economy. Monetary stability undoubtedly contributed to that process. However, the Ottoman default in 1875, the establishment of the Ottoman Public Debt Administration and the surrender of some of the leading sources of revenue to the European creditors in 1881 suggest that the Ottomans paid a heavy price for borrowing large amounts from abroad before putting their fiscal house in order.

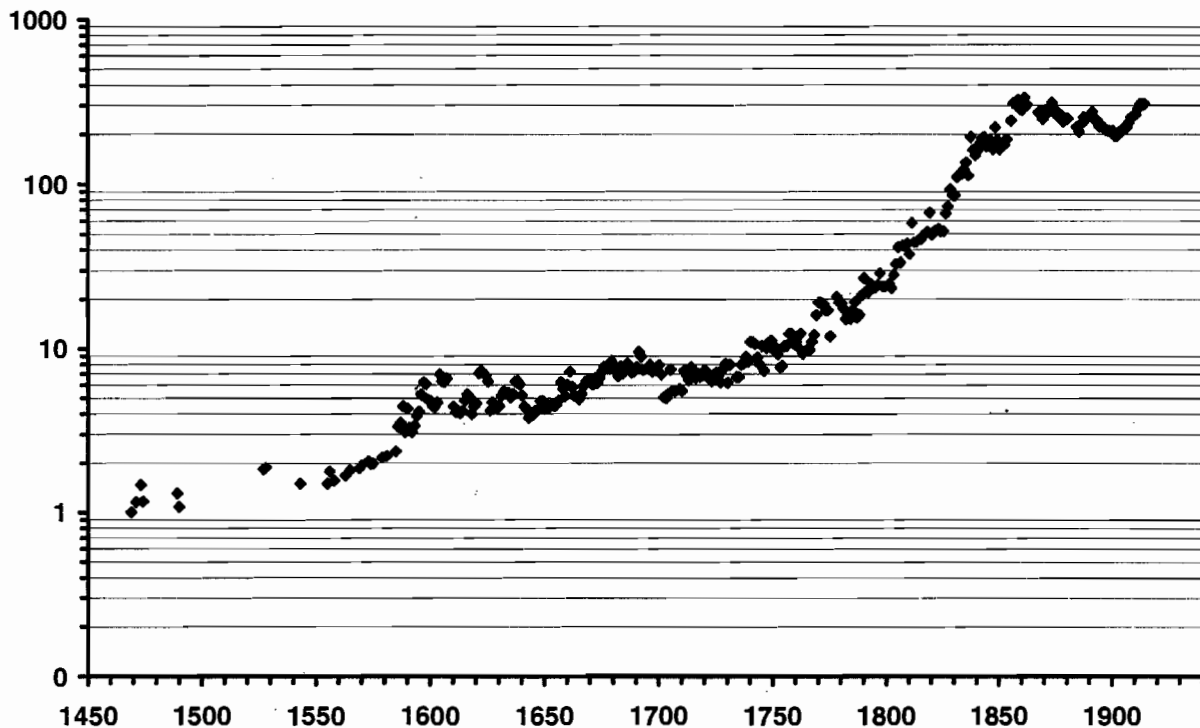
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Figure 2

Consumer Price Index for Istanbul, 1469-1914

1469 = 1,0; (source Pamuk (2004)).



During the reign of Mahmud II the government continued to issue varieties of gold coins such as *zeri mahbub*, *rumi*, *adli*, *hayriye*, *mahmudiye*, each with different and changing standards. However, these gold coinage were not subjected to such rapid rates of debasement. The overall decline in the specie content of the gold coins remained below 20 percent. It is thus clear that the government did not view the gold coins with the same seigniorage logic that was applied to the silver kurush. This was because the unit of account for the economy and state finances was the kurush and not any of the gold coins. All obligations of the state were expressed in terms of the silver kurush and not linked to any gold coin. Under the circumstances, the expected seigniorage gains from debasing the gold coins was very limited.<sup>13</sup>

<sup>13</sup> In a different context Motomura has argued that the Spanish government of the seventeenth century made a similar distinction between copper coinage on the one hand, and silver and gold on the other. The government enjoyed substantial seigniorage revenues from the minting and international circulation of silver coinage and, in order to maintain worldwide confidence in the currency, did not want to change the standards of these coins. On the other hand, the copper coinage used in the domestic economy were subjected to a policy of regular debasements. Motomura (1994).



The debasement during the reign of Mahmud II unfolded in an uneven fashion, in fits and spurts. An examination of the timing and magnitudes of each debasement should provide important insights into the motives of the government as well as the fiscal consequences. There is no doubt that the fiscal difficulties and crises created by the wars figured prominently in the decline of the currency and its timing. For example, highest rates of debasement in Ottoman history took place during and after the war of 1828–29 with Russia. Between 1828 and 1831, the silver content of the kurush was reduced from 2.32 grams to 0.53 grams, a decline of 79 percent during 4 years. As the financial conditions began to improve after 1832, however, the silver content of the currency was raised to 0.94 grams. (Figure 1)

A simple model can be employed here to examine the attitudes and behavior of Ottoman governments towards debasement during these three decades, and more generally during the period 1789–1844. In this framework the government is viewed as weighing the short term seigniorage revenues accruing from debasements against both the short term and long term costs of such action. If the state perceives these costs to be less than the expected seigniorage benefits, then, a debasement or a series of debasements may be adopted. In other words, far from being an exercise in futility, the debasements are viewed as a potentially effective instrument of fiscal policy, especially in the short term.

The fiscal benefits of a debasement are not difficult to establish. With the amount of specie at hand the state is able to issue a higher amount of money in nominal terms and thus meet a larger amount of its obligations. In addition, the state obtains additional seigniorage revenue from the old coins brought to the mint by the public. As prices and wages paid by the state rise, however, many of the state revenues which are fixed in nominal terms will decline in real terms. In other words, debasements generate an initial surge in revenues followed by their decline in real terms due to the high levels of inflation they create. In the longer term, a debasement may even lead to a real decline in state revenues if the state does not adjust upwards the taxes and other revenues which have been fixed in nominal terms.

There are a number other possible costs of debasements that may be borne by the state. If the public loses confidence in the currency and begins to anticipate further debasements, it will become increasingly difficult, for the state to take advantage of further reductions in the specie content of coinage. For example, in the open mint system, the public may begin holding another currency and stay away from the mints. Some degree of currency substitution did that place in this Ottoman episode as varieties of foreign coinage were always free to circulate.

Another cost of debasement in the Ottoman context was the emergence of widespread counterfeiting. When the state issued new coins with lower specie content, counterfeiters immediately began to mint the new coins with the same or even higher silver content in order to share the seigniorage revenues of the state. This opportunity declined, however, when the prices of metals adjust upwards along with other prices.

Yet another cost of was the adverse implications of debasements for the ability of the state to borrow domestically. One of the reasons why the state did not pursue further the option of long term internal borrowing was that, for a variety of reasons, this process was perceived to be too costly. When the state begins to resort to debasements, however, it loses whatever credibility it might have in these markets. There is evidence that with the acceleration of debasements after 1808, rates of interest increased even further and it became even more difficult for the state to sell the esham.

In the Ottoman case, probably the most important cost of debasements was the political opposition it generated amongst the urban groups, especially in the capital city. Since incomes of some groups were fixed in nominal terms, they stood to lose from debasements and the subsequent price increases unless their wages and salaries were also adjusted upwards. Best organized and most powerful amongst them were the janissaries stationed permanently in the capital. In Ottoman history, there are a number of successful revolts by the janissaries against the debasements of the state. Their opposition was a major constraint faced by the governments considering debasements. During the reign of Mahmud II, the janissaries were an especially important part of the political picture in the capital as they opposed his efforts of western style reform. Mahmud II wanted to replace the janissaries with a western style army. However, during the early years of his long reign, he did not have the political support to make this critical move.

Into this equation of costs and benefits, wars enter as exogeneous shocks, events which raise both the need for short term revenues for the state and the willingness of the public to accept or excuse extraordinary measures such as debasements. As the urgency of generating revenues increased, the state often invoked references to holy wars and even linked the new coinage explicitly to the ongoing wars, by calling the new issues of coins and bonds, *cihadiyye*, for example.

During the reigns of both Selim III and Mahmud II under examination here, the governments were well aware of the limitations imposed by the janissaries. Hence, debasements were used only in connection with wars. After the janissaries were finally defeated and the order was abolished in 1826, in what is usually considered as one of the most important political events of this period known as *Vaka-i Hayriye* or the Auspicious Event, a major constraint in the way of debasements was lifted. While the government did not embrace debasements as a peacetime policy, it is not a coincidence that during the first major war following this event, it undertook the largest debasement ever in Ottoman history, reducing the specie content of the *kurush* by 79 percent within a period of four years.

It is interesting that by reducing the borrowing requirements of the state, these seigniorage revenues also brought down the interest rates in domestic financial markets and provided indirect benefits for the state treasury. In addition to any amount the state may have borrowed in the domestic markets, the decline in interest rates provided fiscal relief through its impact on the tax farming system. The tax farmers who entered state auctions for the right to collect specific tax revenues of the state were required to make a certain fraction of these payments in advance for which they typically borrowed from the private

financiers. When the domestic interest rates declined, therefore, the auction prices of tax farms tended to rise, thereby increasing the net tax revenues of the state.

This examination of the currency policy of the Ottoman government during these three turbulent decades shows both the benefits and limitations of debasements. While the Ottoman administrators were well aware of the seigniorage calculus and state did obtain obvious fiscal benefits, it is also clear that they were reluctant to view debasements as a permanent instrument for raising revenue, to be used during peace as well as wartime. The time series I have constructed for the silver content of the Ottoman currency also shows that twice during this period, in 1818 and 1832, the government raised the silver content of the kurush after the return of peace, confirming those limits of debasement as perceived by the government. (Figure 1)

## **5. A New Strategy: Stable Money and External Borrowing**

From the perspective of Ottoman economic and monetary history, the nineteenth century, especially the period after 1840, constitutes a period quite different from the earlier era. On the one hand, it was characterized by major efforts at Western style reform, in administration, in economic, fiscal and monetary affairs as well as education, law and justice. This was also a period of integration into the world markets and rapid expansion in foreign trade particularly with Europe turning the Ottoman economy increasingly into an exporter of primary products and an importer of manufactures. It is estimated that the foreign trade of the areas within the 1911 borders of the empire, Macedonia, Anatolia and Syria, increased by more than 12 to 15 fold between 1820s and World War I.<sup>14</sup> This process was facilitated by the construction of ports and railroads and by the establishment of modern banking institutions by European capital. As a result, the commercialization of agriculture proceeded rapidly in Macedonia, western Anatolia and along the Syrian coast. The rural population was drawn to markets not only as producers of cash crops but also as purchasers of imported goods, especially of cotton textiles. These developments substantially increased the demand for and the use of money in these more commercialized regions of the Empire.

For the European governments and especially the British, the success of reforms was considered essential for maintaining the territorial integrity of the retreating empire. They also believed that rapid expansion of commercial ties with Europe based on the principle of comparative advantage and European direct investment in the Ottoman economy which would contribute to that end were essential for the economic development of the country. In this context, monetary stability was perceived as an important pre-requisite for both reform and the expansion of international trade. As a result, the Europeans and especially the British began to exert considerable pressure on the Ottoman government to establish a more stable monetary system. They also made clear that they were ready to provide the technical expertise necessary for this purpose. The Europeans also linked future

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<sup>14</sup> Issawi (1980), Chapter 3 and Pamuk (1987), Chapter 1.

Ottoman access to European financial markets explicitly to fiscal reform and monetary stability.

As for the Ottoman government, the monetary conditions had reached chaotic proportions by the end of the 1830s. While the government had succeeded in raising short term revenue from frequent debasements, the resulting inflation had brought unfavorable political consequences. In addition, the production of large variety of coins each with different standards since the beginning of the century and the inability of the government to retire the earlier series from circulation had added to the difficulties. The earlier coins exchanged according to their silver content rather than the nominal value at which they had been issued. The quality of the many types of gold coinage that were produced during this turbulent period had also deteriorated although these were not debased as often or as extensively. While these conditions created difficulties for daily transactions, they made it even more difficult to carry out international trade. At the same time, the appeal and use of European coinage had increased especially in international trade and for store of wealth purposes.<sup>15</sup>

A reform in coinage was undoubtedly in order, and after the death of Sultan Mahmud II in 1839, the new government openly expressed that intention in 1840 as one of the first items in its agenda. Mint technicians and other specialists were invited from England and France to provide advise the ottoman government about the new standards of coinage. New machines and technology was imported from England.<sup>16</sup>

After some delay, the decision was made to adopt the bimetallic standard, a system in which the silver kurush and the new gold lira were both legal tender, freely convertible at the fixed rate of 100 kurush for one gold lira and obtainable at the government mint. The government began to produce the new gold coins in 1843 and the following year the new silver coins were issued along with an official declaration from the imperial mint, setting out the reasons for the reform. The gold-silver ratio was fixed at 15.09.<sup>17</sup> In practice, however, the government did not command sufficient resources to withdraw all the previous coinage from circulation by compulsory redemption. As a result, it was soon forced to recognize them as legal tender and even announce the official rates at which each of these, especially the large silver coins minted in the 1830s, would be accepted. Some of these coins remained in circulation until World War I.

The Ottoman governments abandoned debasements as a means of raising fiscal revenue after 1844. All silver and gold coinage minted until 1922 adhered to the standards established in 1844. (Figure 1) In addition, copper coinage of small denominations continued to be minted for daily transactions. Nickel coinage was introduced for the same purpose in 1910.

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<sup>15</sup> For a detailed list of all coinage, both Ottoman and foreign, circulating in the Balkans, for example, see Cohen (1976).

<sup>16</sup> Olçer (1970), p. 17.

<sup>17</sup> Pamuk (2000), pp. 206–8.

The stability of coinage did not mean the end of fiscal difficulties and the need to raise additional revenue, however. Throughout the century, the Ottoman administrations had difficulties balancing the budget and resorted to a variety of methods to deal with its fiscal problems. One method of raising fiscal revenue which began to be used in 1840 was the printing and circulation in the Istanbul area of interest bearing paper money called *kaime-i muteber-i nakdiyye* or *kaime* for short. As their volume remained limited until 1852, the *kaime* performed reasonably well despite problems with counterfeiting. During the Crimean War, however, large amounts of *kaime* were printed and the market price expressed in gold Liras declined to less than half the nominal value. One gold Lira began to exchange for 200–220 kurush in *kaime*. As a result, this first experiment in paper money resulted in a major wave of inflation. The *kaimes* were finally retired in the early 1860s with the help of short term loans obtained from the Imperial Ottoman Bank.<sup>18</sup>

There were two other occasions, both of them during major wars, when the government resorted to non-convertible paper money as a fiscal measure. The second *kaime* episode took place during the war of 1877–78 with Russia and they circulated in most parts of the empire. Because of their large volume, however, they declined to one quarter of their nominal value within two years even though the government agreed to accept some payments in paper currency. Similarly, during World War I, non-convertible paper circulated regularly and was one of the leading sources of fiscal revenue. By 1917 one gold Lira equalled six paper Liras. Once again, the use of *kaime* resulted in considerable rise in prices expressed in paper currency. For the period 1844–1914 as a whole, then, non-convertible paper remained an exception used only under extraordinary circumstances.

The most important method adopted by the Ottoman government after mid-nineteenth century to deal with the recurring budget deficits was borrowing in the European financial markets. This process was initiated in 1854 during the Crimean War. In the early stages, the Ottomans were supported by their wartime allies, the British government, which fully guaranteed the first bond issue against the Ottoman annual receipts from the Egyptian tribute. In the following two decades, the Ottoman government borrowed very large sums in London, Paris, Vienna and elsewhere under increasingly unfavorable terms. The net proceeds of these issues were directed almost entirely towards current expenditures. Only a small fraction was spent on infrastructure investment and on increasing the capacity to pay back. By the second half of the 1860s, the Ottoman finances had deteriorated to the point where new bond issues had become necessary to maintain the debt payments. A moratorium was in sight but the financial markets kept up the process lured by the unusually high rates of return.<sup>19</sup>

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<sup>18</sup> Davison (1980).

<sup>19</sup> Blaisdell (1929) remains the classic treatment of this topic. For the magnitudes of funds flows arising from external borrowing, see Pamuk (1987), Chapter 4 and Appendix III.

When the financial crises of 1873 led to the cessation of overseas lending by the European financial markets, the Ottoman government was forced to declare a moratorium on its outstanding debt which stood at more than 200 million pounds sterling in 1876. After a period of prolonged negotiations, the Ottoman Public Debt Administration was established in 1881 to exercise European control over parts of Ottoman finances and ensure orderly payments on the outstanding debt whose nominal value was reduced approximately by half during the negotiations. For the following three decades until the outbreak of World War I, a sizable share of Ottoman tax revenues were controlled by the OPDA and used for debt payments. This control and the regular payments on the debt was quite reassuring for the European financial markets. As a result, the Ottoman government was able to resume borrowing towards the end of the century. With the rise of military spending, Ottoman borrowing gained momentum after the turn of the century. On the eve of World War I, the volume of annual borrowing as well as the outstanding external debt had reached unusually high proportions reminiscent of the 1870s.<sup>20</sup>

## 6. Credibility in the International Markets

From the perspective of the present paper, the important question, then, is why the Ottoman government pushed aside alternative methods of financing its deficit such as internal borrowing, debasements and/or issuing inconvertible paper and continued almost exclusively with external borrowing during these seven decades. We might point out that internal borrowing, especially long term internal borrowing, was not a serious possibility because of the limited size of the domestic market for funds in relation to the borrowing needs of the state. In addition, it might be argued that debasements of coinage had become an impractical method of seigniorage in the nineteenth century. Inconvertible paper currency often served the same purpose without some of the limitations and disadvantages of debasements. Hence, the actual choices facing the Ottomans can be reduced to two : inconvertible paper currency and external borrowing. Why did the ottoman governments insist on the latter and used the former only during exceptional periods such as wars ?

Part of the answer lies with the fact that, until the moratorium of 1875, the Ottoman government was a novice in external borrowing. Selling bonds in the European markets with maturities of 20 years or longer and thereby postponing the short term fiscal problems to the future must have appeared as an easy solution for them at the beginning, especially in view of the political and economic costs associated with debasements and inconvertible paper which burdened the Ottoman governments without any respite from 1808 until the 1860s.

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<sup>20</sup> Pamuk (1987), Chapter 4.

After the establishment of the OPDA and European control over Ottoman finances, however, inexperience can not be considered as an explanation. By that time the Ottomans had learned more about the costs and consequences of borrowing abroad without bringing the budget deficits under control. For this second period, we need to focus on a combination of pressure from the OPDA and more generally the European interests for maintaining monetary stability and the need for the Ottomans to maintain credibility in the European markets if they wanted to retain their option of external borrowing.

The reasons for European pressure on the Ottomans to maintain monetary stability were the same after 1880s as they were in the earlier part of the century. Monetary stability was considered as an important condition for the expansion of trade with Europe and for attracting direct European investment. The representatives of the OPDA also made clear that monetary stability was necessary if the Ottomans wanted to retain their access to the European financial markets. Even though the Ottoman government issued bonds in European currencies, the perception was that high seigniorage and high inflation would seriously hurt the chances for borrowing abroad both in the short and long term.

In fact, the financial control exercised by the OPDA enabled the Ottoman government to borrow long term in the European markets at 4 to 5 percent per annum, which was reasonably low at the time whereas the effective rates paid by the Ottoman government in the earlier period leading up to the moratorium had fluctuated between 10 to 12 percent at a time of roughly stable commodity prices world wide. The ability of the Ottomans to continue borrowing at these low rates, according to this argument, depended on maintaining their credibility in the European financial markets especially in view of its poor record before 1875.<sup>21</sup>

At that juncture it was clear that the Ottoman government had to be willing to burn all bridges with European commercial and financial interests in order to abandon monetary stability and return to debasements and/or inconvertible paper as the basic form of deficit finance. Instead, the government made great efforts to retire the inconvertible paper issued during the war of 1877–78, which took place after the moratorium was declared and before the negotiations with the creditors had ended. After these paper issues were retired, the government adhered to some form of the gold standard and the inconvertible paper experiment was not repeated until World War I.

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<sup>21</sup> Bordo and White have contrasted the financial and currency policies of Britain and France during the Napoleonic Wars. They argued that the reason why France, the financially weaker country followed more “orthodox” policies during this period was its poor reputation and lack of credibility in the international financial markets. Bordo and White (1991).



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