Punks, Historians and Free Bankers: Strange Comrades?

Tom Lyons – Senior Sophister

Many would see little connection between punk rockers and the advocates of a free banking system. Nonetheless, in his lively style, Tom Lyons describes such a connection before analysing the performance of free banking systems throughout history. He concludes that judgements on the system have been harsh, and sees a role for free banking in promoting stability in emerging markets.

Introduction

"If economics is not to remain the victim of history...it must develop or rediscover...historical perspective."

E.J. Hobsbawn, 1997.

"We don't see eye to eye, but we have a common interest: your money."

Johnny Rotten, announcing the reunion tour of the *Sex Pistols*, 1996.

Nobody quite knew what to make of the *Sex Pistols* when they first started playing in basement strip clubs in Soho. Ripped clothed and wild-eyed, they scarred their skin with glass and spat at the crowd and critics. In between, they fought each other. Some said they would bring anarchy. Others felt they were swindlers. A few thought they had something to say. They saw them as cynical challengers of accepted truths. With blunt lyrics they attacked the status quo with insight. In doing so, though they might not have recognised it, they drew on a much older culture of protest that grew in the mines, the streets, and the factories.

Except for the strip clubs, clothes sense and self-mutilation the free banking movement is the modern economic equivalent of a punk rock band. They have faced similar name-calling and have a similar fascination with our money. It is in the spirit of free banking writers such as Selgin, White and Glasner that parallels with punk rock are most distinctly seen. They contest convention, reinvent themselves and propose an alternative. They are also rooted in a long tradition, hence the quotation from Eric Hobsbawn. Hobsbawn contends we must integrate the past into our view of the future. The interface between Free Banking experience and theory is one aim of this essay.

How would a monetary and banking system operate under laissez faire?

An answer to this question is essential for a proper, critical understanding of the effects of government intervention in the monetary system. Just as it would be impossible to understand the full implications of restrictive tariff policies without reference to a theory of free trade, so too is it impossible to understand the full implications of legal restrictions in banking without reference to a theory of free banking, an understanding that is crucial both to understanding monetary history and to making predictions concerning the likely consequences of future deregulation and financial innovations.

What is meant by Free Banking or Six Nos (Make a right?)

Free banking is, perhaps, best defined by six negatives. At its most explicit Free Banking is a situation where there is:

- No governmental control of the quantity of the exchange medium.
- No state-sponsored Central Bank.
- No legal barriers to entry, exit or branching to the banking system.
- No restrictions on the quantity, type or mix of debt and equity claims a bank may issue or hold.
- No government deposit guarantees.
- No restrictions on the terms of contracts between banks and customers beyond standard legal practice.[1]

This brief synopsis needs development. The definition of Free Banking has not been historically or theoretically static. In the 19th century it was more likely to mean free in the sense of entry being possible without legislative charter. At one extreme Free Banking has arisen entirely free of government interference. Most notable, were Belgium (1835-1851), Bolivia (1887-1914), France (1796-1803), Rhodesia (1892-1939) and Thailand (1888-1902). In the middle lies the most studied groupings which exhibited many but not all of the characteristics of pure Free Banks. Scotland (1716-1845) experienced the constraints of a usury ceiling of 5% and a ban on small denomination banknotes. Canada (1817-1914) had a dual scenario where government and Free Banks both issued. Australian banking (1817-1914) was limited only by barriers to interprovincial branching and government legal tender issue. At the other extreme lie numerous situations were a few Free

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[1] Adapted from Selgin & White (1994) p. 1718-1719.

Banking characteristics were co-opted.[2]

Selgin and White (1994) make three distinctions within Free Banking. Firstly there is a school that advises unregulated money and banking with a distinct base money possibly made up of metal, private monies and traditional banknotes and transferable deposits redeemable in base money. This is the school most recognisable to the nineteenth century. Free Banking supporters. The second school advocates plural brands of non-commodity base money issued by private firms. This basically means competitive systems of money between parallel private fiat type monies. Finally there is the "New Monetary Economics" or "Legal Restrictions theory". This comprises a competitive payments system without any base money and a common media of exchange consisting entirely of claims paying competitive rates of return on banks or money-market mutual funds. These three schools show Free Banking has no single meaning but contains a shared desire to revise the current paradigm.

1970s

Von Hayek's *Denationalising Money* (1978) provided new impetus to the debate. He wrote in the context of Public Choice Theory and an inflationary period. Institutions allow democratic governments monetize debt and use deficit finance to retain electoral power. The Central Bank, von Hayek argued, facilitated this process. Studies of the pre-Civil War U.S. "free banking era" by Hugh Rockoff, Arthur Rolnick, and Warren Weber around the same time showed that this regime was far more successful than had previously been supposed. Selgin, White and Glasner also began to break onto the scene (as did the Pistols).

"Filthy Lucre"[3]

Free market economists treat money as the big exception. There is a mentality that has arisen among economists since the Great Depression that has had too much experience with managed systems. Episodes of free banking are treated as interesting oddities or, worse, only of interest to antiquarians. Banking, it is felt, has a special status and must be insulated by regulations, centralisation and hierarchies.

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[2] Dowd (1992) provides the best available survey I have read.

[3] 1996 reunion "funding" tour by the *Sex Pistols*. Artistic shambles, minus Sid Vicious, yet very much an economic success.

It is felt the market has proven itself insufficient. The price of efficiency gains has been increased risk, it is judged. Free Banking has been accused of causing inflation, prone to suspend convertibility, destabilising, maintaining too low reserve ratios and having few redeeming qualities. The business of creating and maintaining filthy lucre is best left to Central Banks. This has not been the historical experience.

The desirability of rules or discretion for monetary authorities has been much discussed. The rational for having these authorities at all has been relatively neglected. As Vera Smith notes, "to suggest its abandonment is to invite ridicule"(1984: 137). It may be time to invite "ridicule" by defending free banking.

Free banking has not been proven to be inflationary. In all historical cases free bankers anchored themselves to real commodities. They thus had only a limited ability to effect prices. The price of the anchor commodity is what really deserves attention. The fact that gold, the anchor of choice, proved of fluctuating value and led to instability does not condemn free banking but rather condemns the wider scheme of monetary thought. This is a fact recognised by John Law, whose system's unfortunate failure would prove a major setback in the search for a more reliable commodity bundle.

Further, no Free Bank chose to abandon convertibility. This was always a decision forced by government. As Dowd concludes, *"the claim that competition among unregulated banks would lead to an explosive money supply and rapid inflation has no support in historical record"*(1992:3). The over-issue of notes was not profitable when rapidly returned through the clearinghouse system draining reserves. The Ayr bank failure is a case in point. Scottish authorities did not fold and sanction suspension of convertibility easily so there was no incentive for periodic over-issue. The one general suspension followed not from local over issue but was enforced at the Bank of England's request.

Equally, the destabilising argument has little historical basis. Clearing house systems disciplined over-issuing banks by providing a reflex mechanism to return excess notes and deposits to their issuers. Further there is no evidence of interest rates being unstable. Finally without lenders of last resort they tended to prudence, wildcat banking has been greatly exaggerated.[4] As Dowd (1992) points out the real contagion effects came not from with the free banking system but from

[4] Rolnick & Weber (1983) have shown for the U.S. evidence of wildcat banking is largely anecdotal. Note issuing regulations may even have facilitated wildcats.

without. This can in the effect of crises in London and New York destabilising Scotland and Canada retrospectively. In the US case crises came from outside requirements to hold state debt.[5]

The Scottish experience also supports the proposition that under free banking required reserve ratios will not go too low. All but three of Scotland's banks maintained unlimited liability. Rapid growth indicates a more optimal amount of banking risks was undertaken. Note holders and depositors chose for themselves the risk they wished to assume. Even in the 1860s/1870s when limited liability became available the unchartered banks of Scotland chose not to accept. Scotland never experienced the kinds of internal drains experienced in England due to unsound practices fostered by legislation. The Scottish public trusted their banking system not to abuse reserve ratios. *"The Scottish system was based on confidence, the British on fear"*(White, 1984: 142). More generally the historical evidence seems to argue Free Banks suspended less frequently then banking under a Central Bank system (Schuler & White, 1992).

To prevent spillovers, banks tried to establish brand reputation just as with consumer durables. This discouraged over-issue and quick seignorage gains. Modern Central banks have no such incentives; indeed the Federal Reserve makes some $20 billion dollars per annum by this method, a method that is unlegislated and for which the Fed is practically unaccountable. Legal tender forces acceptance and allows good money drive out bad.

In answer to how close Scotland approximated free banking, White (1990) notes that while chartered Scottish banks may have earned small rents this was not enough to seriously impede competition. Nor was the Bank of England a shadow Central Bank for Scotland as alleged (Cowen, Krozner, 1989). It did not act as a lender of last resort prior to 1844 nor did it provide a reserve base of high-powered money prior for Scottish banks except during the restriction. Scottish banks may have used the London financial markets to meet occasional liquidity problems but they did not lean on the Bank of England. The accusation of Scottish Free Banking being puppets is an exaggeration.

Further Free banking would remove the elasticity of the money supply problem. For example consider the problems of 1929-1933. An increase in the demand for currency at the expense of checking deposits causes banking reserves to

[5] Dowd (1992) finds the only exception to this may be Australia.

fall and credit to contract, so there is a decline in the total money available. This problem would not exist under free banking as currency and deposits would be on the same footing.

On the contrary, Free Banking has tended to innovate. The Free Banking era in Scotland (1716-1845) saw the pioneering of the cash credit account, a forerunner of the overdraft as well as the payment of interest on deposits. Branching too brought economies of scale as well as pooling risk. Finally it should be noted Scottish per capita income in 1745 was half of England's. A century later it was almost equal despite England's rapid growth and despite Scottish resource and location disadvantages. Only in education and in its banking system had it the edge. This seems a powerful argument in favour of Free Banking, which the more broad research of Cameron (1972) supports. At the heart of opposition to Free Banking is however the threat of bank runs and over-issue. It is to these charges towards which I will now turn.

Bank Runs

As one Hindmarsh director recalls talking to an old man who despite government intervention still insisted in withdrawing all of his money from his account. *"The old man said 'Mate, I couldn't afford to take the chance – it's all I've got.'"* Free banking envisages an interbank market that when runs occur funds will move from weak to strong institutions. This being done, deposits can then be recycled back, via interbank markets, to banks under attack. The Hindmarsh case, in Australia commencing in October 1974, illustrates the danger of a drain of cash to under the mattress holding accounts (Lewis, 1996). Free banking creates a fear not based so much on explicit theory but on disastrous events. Artificial barriers are under pressure from innovation so old fears about free banking are resurfacing. At the heart of this fear is a real threat that of bank runs.

How real the threat of crisis is, from contagion effects leading to endemic bank failure under Free Banking, is another matter. Diamond and Dybvig (1983) show a run on a solvent banking system can arise from individual mistakes by the public but also from well-informed rational behaviour. If each agent expects the other to redeem his claims against a bank, it is rational to follow. A bank run becomes self-fulfilling. Free bankers believe self-interest will create contractual arrangements to counteract such contingencies. Clearing houses could assume lender of last resort roles as in the American National Banking System before the Fed.

Option clauses as used in Scotland before they were banned in 1764 could be used to delay redemption at a cost of paying interest.[6] Finally deposit insurance could be used to safeguard against extraordinary demands. I will look at this last case in greater detail.

After Federal Deposit Insurance (hereafter FDI) was introduced in the US it was certainly true the number of bank failures fell to virtually zero. In 1933 4,000 banks failed. Since 1934, never more then 100 failed, in fact between 1943 and 1974 bank failure rates in the US were in single digits (Glasner, 1998a). Does this mean the US has mastered banking or is something being brushed under the carpet? This seems likely. Insolvent 'zombie' banks continue to operate as they carry assets at their book rather then market value. Information is kept from the public with problem banks being merged away. This intensifies moral hazard, encouraging devil-may-care attitudes. The bank is literally betting. For fear of bad headlines and political discomfort, the US banking system seems to be playing a sophisticated game of Jenga. Writing in 1932 the Chicago Clearing House Association showed foresight when it wrote *"[The national guarantee system] proposes to tax good banks to support bad..."* (Glasner, 1998a: 181).

The current system encourages risk and moral hazard though it may well prevent runs. Provided Central Banks can supply enough money, runs need not take place. The price of this is future taxation and inflation. Innovation may offer a safer more efficient alternative without FDI.[7] Loss of confidence leads to dangerous bank runs because depositors have fixed nominal claims they are entitled to redeem on demand. Money-Market Mutual Funds (MMMF) *has "introduced a run-proof monetary instrument,"* (Glasner, 1998a: 195). The argument goes that a shareholder does not have a fixed claim. If the value of a fund falls this is felt instantaneously, so there is less incentive to cash them in then with fixed deposits. As part owners, there is less incentive to induce a run. Depositors should deal with the bank that most fits their risk profile. If they wish to avail of keenly competitive service, they should deal with free banks, but if they would rather security, they can deal with banks with close to 100% fractional reserve ratios.

[6] Sweden also used such clauses, during its Free Banking era 1831-1902 and not a single bank failed or was suspended.

[7] See Glasner (1989a) chpt. 9 for discussion of how this might occur.

Reform is not enough. Adjusting premiums will not work due to lack and lags in information. Thus when it becomes clear a bank has been imprudent, increasing the premium will not only aggravate the situation but may well induce failure. Finally, FDI agencies are heavily politicised as a result of being government agencies as van Hayek (1978) earlier pointed out.

Overissue

Smith, Thornton, Ricardo, Mill and the Banking School in contrast to the Currency School denied competitive banks would over-issue, so long as they had to convert their obligations into an outside asset at a fixed exchange rate.[8] The modern Free Banking position has changed little in this respect.

Criticism of free banking is on two fronts: firstly on the liability, and secondly on the asset side of bank balance sheets. Competitive banks have an incentive to over-issue liabilities as they fight for market share. The argument, then, contends that this over-issue of bank notes or deposits increases public spending. This causes money to depreciate driving up prices. Under the Gold Standard, a drain in gold reserves would place a sharp break on the economy under a fiat-based system this would continue until the Central Bank steps in to restrict credit.

However this simple cause-and-effect narrative assumes banks always find it profitable to expand at the margin. But as Glasner (1998a) points out, this could only be the case, if banks were not paying competitive interest rates on these liabilities. If they were there would be no incentive to over-issue. This undermines one of the key arguments against Free Banking. Glasner goes further however in asserting that FDI does the opposite of what it was intended for. It is a destabilising force, which props up established banks almost no matter how poorly they are managed. It is a servant of banking cartels not the public. Unlike any other form of insurance, FDI insurers do not adjust premiums to reflect risk, thanks to a congressional ruling. The moral hazards this creates are a mainstay of the Free Banking literature. It means that regulation assumes control. However its objectives are diluted by additional legislation, which prevents diversification and forces uneconomic loan making rather then focusing on punishing imprudence. This situation is by no means limited to the US.

As a postscript, Hayek in 1937, reintroduced the idea of privately issued

[8] See Cassidy (1998) for a discussion of their differences in this debate.

currencies acting as a discipline upon over issue by governments. He imagined competition forcing authorities to improve the quality of government money or face extinction by market forces.[9] This is an interesting idea, but if private issue proved more efficient, perhaps due to the ability to focus less on political concerns, how long would it take governments to find a suitable reason to interfere?

"No Future...?"[10]

"If it ain't broke, don't fix it"-conservatism will probably continue to prevail. As long as inflation remains low and the banking system is not collapsing, the potential benefit from reform is not big enough to outweigh the perceived risk from trading the monetary system we know for one we don't.

But the case for some measure of Free Banking in Less Developed Countries and former Eastern Bloc needs to be considered:

There, the banking systems often lack the stability necessary for development. Without secure monetary institutions, these countries have far more to gain by experimenting with introducing some elements of free banking. Free banking is suited to overcoming the systemic problems that now frustrate the attempts of LDCs to achieve monetary stability.

The reason is a private issuer of inside money has more credibility than a sovereign issuer of inside money, because people understand a sovereign has less to lose than a private bank by reneging on a convertibility commitment. A defaulting bank forfeits its assets to its creditors while a devaluing government has less to lose.

Unless the new currency, upon introduction, is made convertible into an accepted medium of exchange, the consensus about its future value required for a fiat currency to serve as money may be lacking. LDCs cannot create stable monetary systems based on inconvertible fiat currencies, because their political regimes lack

[9] Lewis (1996) pp. 3-4. He also made a distinction between holding and using money. Government money would be used for transactions but people would not be willing to use it as a store of value in preference to private issue. He preceded Glasner is envisaging this issue to be pegged to some commodity basket valued by consumers.

[10] Lyric taken from "God Save the Queen," *Never Mind the Bollox* (1977) by the *Sex Pistols*.

the credibility to impose stable monetary institutions by fiat. Lacking widely accepted money about whose future value expectations are secure, such regimes cannot create acceptable money out of thin air, because they cannot impose a consensus about the future value of a fiat currency.

New fiat currency often bring a hyperinflationary environment, because with no public confidence in the future value of the currency, the public will be willing to hold very little of it. This does not mean that demand for money of any kind is small. The demand for a stable money in which people had confidence would be much greater than the demand for a new fiat money. An attempt to force more than this small amount into circulation, say, to finance the government deficit, causes rapid inflation. And the inevitable attempt to overreach the limits of that revenue source by printing even more money triggers a vicious inflationary cycle that causes a complete monetary breakdown.

All Money is not equal

Our models make two assumptions that lead to misguided policies for LDCs/East:

1. They assume that all money is alike, so that there is a given demand for money, which any instrument so designated can satisfy.
2. They assume that total output is independent of the amount of money. Not all moneys are equal and an inferior money in which people have no confidence cannot perform the services that a superior money could.

Moreover, while money serves as working capital for households and businesses and adds to their productivity, monetary stability provides a kind of intangible infrastructural capital that adds to the productivity of all economic agents independent of the amount of money they hold individually. Policies aimed at achieving monetary stability in developing countries by restricting the quantity of the available fiat money treat a minor symptom but ignores distrust of the available money makes it useless and deprives the economy of desperately needed monetary services.

Thus in such circumstances free bankers argue the only feasible way to create a consensus about the future value of a currency is to make it convertible into another money, e.g., the dollar, about whose future value expectations are secure.

Governmental commitments to establish and maintain convertibility, (see Mexico), are obviously not always credible, because a sovereign that defaults on such a commitment faces no effective sanction. Devaluations are thus a dime a dozen.

Nevertheless, given sufficient reserves, and given some institutional constraints on money creation and on government borrowing, governments can maintain a fixed exchange rate for a limited time. With sufficient resolve, they may do so indefinitely. However, such pegs are fragile. Once a shock occurs, the expectation of a future devaluation becomes almost irresistible even for a developed country.

A currency board whose sole function would be to issue domestic currency in exchange for an equivalent amount of some foreign currency in terms of which the domestic currency would be defined is then usually suggested. Such a system, if maintained, converts the domestic currency into a denomination of the foreign currency in terms of which it is defined. However, currency boards have found it difficult to avoid being politicised.

For the above reasons Free Banking is well suited for less-developed and former Eastern Bloc countries. By making the commitment to maintain convertibility, one which holders of money can enforce through legal means against private banks instead of one that can be abrogated by the government or Central Bank at will, free banking avoids the barrier that sovereign irresponsibility places in the way of creating monetary confidence.

Under free banking, private banks would be allowed to issue currency (banknotes) and create deposits denominated in units of their own choosing. Thus, if the public wished to use dollars, free banks would be willing to create money denominated in dollars. However, since there would be legal problems in issuing banknotes denominated in dollars, free banks would instead define new denominations (say, the crown) in terms of dollars (one crown equals one dollar), so that prices could be quoted interchangeably in either dollars or crowns. Because it would allow private banks to supply the hand-to-hand currency needs of the public, free banking would be preferable to simple dollarization which would require a country to import the dollars required for hand-to-hand circulation by means of a costly export surplus.

Conclusion

An interventionist dynamic has been unleashed in banking in the developed world. This has not always historically been the case nor have alternatives been necessarily failures. Technology increasingly is introducing into the banking system elements of free banking. It is thus vital that economic theory respond by studying the issue if for no other reason then that vulnerable emerging economies can learn from our mistakes. Johnny Rotten these days is more a celebrity then a rebel. Free banking ideas too must prepare for integration into the mainstream while trying to maintain its punk vitality.

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