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THE THEORY OF FREE BANKING

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ABSTRACT

This papers analyses three theoretical propositions about the theory of free banking. The first one defends the operation of an interbank clearing mechanism checks oversissue by an individual bank. The second proposition assures that private issuers in a competitive system have incentives to establish confidence in the value of the moneys they produce and in the quantity they can safely emit. The third proposition said that restriction of discounting by banks to real bills limits the quantity of money they issue and it is only legal restrictions that account for the absence of private currency issues, which are demonstrably efficient. The conclusion of the text says that if the free banking system were adopted, bank failures would occur. Finally, the author proposes a set of precautions to be imposed on owners and managers that would give them the incentive to be prudent in making loans and investments on penalty of losing their equity and management jobs.

A coterie of advocates of monetary reform primarly in the Austrian tradition in recent years has given pride of place to free banking as the vehicle for restructuring the monetary system. The design of the existing system is based on the belief that competitive banking is unstable, and that discretionary monetary policy stabilizes the economy. The restructuring would undo the nineteenth century of the right of note issue in the hands of monetary authorities and remove central banks as discretionary managers of the banking system in which they operate a lenders of last resort.

Free banking for these monetary reformers is a competitive, unregulated banking system. They rely on historical evidence to refute the traditional objection that competition in banking is an invitation to overissue. They deny that banks are special. The business of banking is not an exception on this view to the rule that competition is the most efficient way of supplying goods and services of money. Apart from competitive banking, the other essential characteristic of a stable monetary system, the reformers agree, is that the liabilities of competitive banks be convertible into a real asset. The convertibility requirement would not be government mandated but a voluntary undertaking of free banks.

Recent literature that makes the case for the elimination of government regulation of a banking system rests on a variety of theoretical propositions. Each of these propositions, addressing the question whether self-regulation by banks will set

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an external limit on their issues, reaches an affirmative conclusion. The first two are the building blocks of free bank advocates primarily in the Austrian tradition. The *third proposition* was long discredited but has recently been revived by writers whose framework is the *overlapping generations model*. The three propositions are:

(1) The operation of an interbank clearing mechanism checks overissue by an individual bank and, in some versions of the theory, by the system as a whole.
(2) Private issuers in a competitive system have incentives to establish confidence in the value of the moneys they produce and therefore limit the quantities they can safely emit.
(3) Restriction of discounting by banks to real bills limits the quantity of money they issue. A related proposition is that only legal restrictions that account for the absence of private currency issues, which are demonstrably efficient.

These prepositions are concerned with eliminating government intervention in the provision of inside money by private sector banking institutions. It is, however, essential in addition to formulating the theoretical basis for the belief that unregulated private sector banks will not overissue also to discuss the asset side of their balance sheets. Free banks in the past have failed either as a consequence of individual managements' questionable loans and investments even when price stability prevailed or of mistakes in investment policy induced by unsustainable increases and subsequent decreases in outside money.

Hence it is not sufficient to build a case for a competitive currency supply by demonstrating theoretically that the banks' monetary liabilities will not be excessive. It is also necessary to demonstrate that the provision has been made to counter investment risk competitive free banks might assume that could threaten their good performance and impose costs on nonbanks.

The paper proceeds as follows. Section 1 to 3 examine each of the theoretical propositions in support of competitive unregulated banks as providers of inside money. Section 4 summarizes flaws in these propositions and offers my own views on the operation of the bank intermediaries. Section 5 discusses the proposals in monetary reform literature for outside money and for the elimination of central banks.

My conclusion with respect to inside money is that banks should be free to establish offices where they choose, to pay whatever interest is required to obtain funds, and to acquire assets yielding the highest return as they judge it. I do not favor constraining the writ of free banks, but free banks may make mistakes in their investment decisions. Therefore, the system should be so designed that risk is borne by owners and managers, not by money holders, other creditors and taxpayers.

Why do I propose this design? Because I regard failures by banks as the kind of event that invites government intervention either to bail out management or to make whole bank depositors and creditors, using taxpayer funds. I want to preclude such government intervention. With respect to outside money, I emphasize the importance of its stability in minimizing investment mistakes by unregulated banks.

Advocates of free banking believe that central bank can be shorn of any regulatory function, and any responsibility for the currency, and that they are not needed as lenders of last resort. The case in theory is strong, but I am skeptical that it is realistic. Central bank are entrenched.

1. THEORY OF THE CLEARING MECHANISM

Adam Smith was among the first to propound the doctrine that a clearing house provides an automatic mechanism of adverse clearing that serves to regulate the issues of its members. Later writers applied the doctrine, originally applied to note issues, to clearing of both notes and deposits. The doctrine is a prominent feature of recent advocacy of a self-regulated banking system.

The essentials of the process by which a deposit in one bank leads to an expansion of the aggregate money supply as a multiple of the reserve ratio that banks maintain were also understood early on and have been restated in the recent literature. Under the clearing mechanism, a bank that increased its issues disproportionately to those of other banks would experience a drain of its reserves. It would find balances running against it at the clearing house and be forced to contract. The mechanism thus provide a check to individual bank overissue. Advocates stress the importance of frequent-clearing of notes and checks as means to prevent overissue. In the main, however, neither early writers on the subject nor more recent ones have understood that a clearing house provides no check at all if all banks expand simultaneously

The chief error of the clearing house paradigm is the inference that the limits to expansion to which an individual bank is subject apply also to the banking system as a whole acting in unison. White (1984, 17) does not make this error, noting that adverse clearings will not arise among a group of banks sharing a common expansion. Selgin (1988,80) attempts to respond to this criticism of the effectiveness of a clearing arrangement as a method of controlling the supply of money by arguing that "spontaneous in-concert expansions will be self-correcting" because the growth in total clearings will increase the variance of clearing debits and credits.[1] Banks in his view will protect themselves against the risk of default at clearing house at any clearing session, leading to a unique equilibrium supply of inside money.

Perhaps under conditions of stable outside money self-correcting in-concert expansions would be observed but, if even under the gold standard, we observe in-concert expansions leading to boom and bust, the self-correction phenomenon appears questionable.

Clearing houses were formed to minimize the costs of note exchange and check clearing but in time acquired a monitoring and supervisory role in the banking industry. The clearing house in that aspect provided self-regulation for the industry. Membership in a clearing house attested to the adequacy of a bank's capital. Audits by clearing house which also required the banks to publish statements of condition supplemented the regulatory demands of government supervisors.

Most of the recent discussion of the role of clearing houses does not emphasize their direct supervisory activities in enforcing limits on overissue by member banks and thus creating monetary confidence but rather concentrates on the restraint

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[1] Yet in discussing Austrialian experience, Selgin notes that "prices were fairly stable, and the principal of adverse clearings insured that no single bank could step out of line with its competitors. If by chance the entire system went out of line, adjustment would come as a consequence of gold losses abroad" (Selgin, 1980, p.50). He here ignores his own dictum of self-correcting in-concert expansions.

imposed by adverse clearings. One commentary, however, links monitoring by clearing houses of the product quality of demand deposits to the information-related disadvantages of checks, thus serving to control the behavior of bank managers (Gorton and Mullineaux, 1987, p. 458-460).

2. PRIVATE COMPETITIVE MONEY ISSUE

The theory is an argument against the classical view that unregulated competition in the supply of fiduciary money would lead to overissue, the destruction of its value, and an infinite price level. Overissue would be possible if private money producers offered a homogeneous money, convertible into the interchangeable products at fixed exchange rates. The contrary view is that, for competitive production of fiduciary money, differentiated output is essential for consumers to acquire information about the quality of the monetary service flow from a producer's money. Consumers need to know the brand name attached to each producer's money. The brand name is not only information for the consumer but also capital for the producer (Klein, 1974, 431-35).

With moneys differentiated according to the issuers and with flexible exchange rates among the products, a single producer might gain a short-term profit from overissue but at a cost of disinvestment in his brand name capital. A decision by a producer of money to overissue would be at the expense of his long-run profit in making his product acceptable to the market. A competitive money producer creates confidence in his product by limiting its issue.

What we know about historical examples of domestic competing monies is that they were all convertible into a single outside money that served as the unit of account. The monetary arrangements were closer to internal fixed exchange rates than to internal flexible rates among the competing monies. Such arrangements presumably arose to minimize money changing and transaction and information costs of competitive independent monies.

The historical examples are drawn from the period when bank liabilities were predominantly notes and when competitive issuers operated without a central banking authority.

3. THE REAL BILLS DOCTRINE AND THE LEGAL RESTRICTIONS THEORY

Adam Smith was among the first to uphold the *real bills doctrine*, although he also insisted on subjecting banks to the legal requirement to convert their notes on demand into specie.[2] Later adherents included the antibullionists who absolve the Bank of England of the charge of overissue during the Napoleonic period when convertibility of its notes into specie was suspended. They argued that, even when inconvertible, overissue of notes was impossible if they were emitted on loans collateralized only by sound, short-term commercial paper.

The *Banking School*, whose chief proponents were Thomas Tooke, John

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[2] Siu-Ki-Leung argues that Smith's espousal of the real bills has been misunderstood by later economists, who interpreted his views as concerned with short-run monetary dynamics. Smith, however, proposed discounting of real bills in relation to long-term economic growth, to give the economy a foudation of "judicious banking" (Leung, 1993, chap. III)

Fullerton, and John Stuart Mill, denied that a convertible currency could be overissued because the needs of trade automatically limited the quantity of money. Moreover, if banks lent on long term or for speculative purposes instead of on real bills only, the Law of Reflux would cause issues to return immediately to banks to repay loans.

Criticism of the real bills doctrine has an equally long history. Henry Thornton denied that the quality of the loans securing note issues provided a limit on the size of the issues. Ricardo was also a prominent critic. One problem with the doctrine is that, even if each loan were made on short-term commercial paper, the volume of bills depends on the turnover of goods in process. The same goods sold a number of times could generate an equal number of bills. The same applies to the term of the bills, which might exceed the period of turnover the goods. Hence the money supply could greatly exceed the needs of trade.

The fact that an increase in money supply contributes to the rise in the prices of commodities would justify a still further increase in the money supply to meet the needs of trade. The money value of real transactions therefore cannot serve as an effective regulator of the quantity of money. A further fallacy of the doctrine is its implicit assumption that no one would pay interest on unneeded borrowed funds but instead would return such loans to his bank. The doctrine ignores the fact that the loan rate of interest may be below the expected rate of return on borrowed funds. Such a differential encourages borrowing so money and prices rise as long as the interest rate differential exists on discounted real bills (Humphrey, 1982, p.3-13). In short, the real bills criterion provides no effective limit on money or prices.

Recently, "something of a rehabilitation of the real bills doctrine" has been claimed (Sargent and Wallace, 1982, p. 1214). The version of the doctrine supposedly rehabilitated, however, bears little resemblance to the actual doctrine. That version is based on a model of an overlapping-generations consumption economy, and there is no production. In this model Sargent and Wallace show that a *laissez-faire* banking regime leads to price level instability or indeterminacy. Since real bills advocates believed that the doctrine guaranteed price stability, and its critics argued that it did not Sargent and Wallace clearly have not rehabilitated the doctrine (even if their version of it were accurate) but have instead confirmed its critics' views.

The Sargent and Wallace version of the doctrine as one characterized by the absence of government restrictions on bank intermediation, however, is a caricature. The actual doctrine was not a defense of *laissez-faire* in banking, but one that mandated specie convertibility of notes on demand and prescribed the class of bills eligible for discount. Moreover, in the Sargent and Wallace model, banks make unlimited consumption loans whereas, according to the actual doctrine, banks were to lend only to finance current production and distribution and eschew all other types of lending (Laidler 1983, p. 149-155).

The legal restrictions theory is also based on an overlapping generations model in which money is a store of value, not a medium of exchange. On this view it is only legal restrictions that account for the absence of privately issued currencies. It is assumed that the government and private currency issues are perfect substitutes, both valued for their pecuniary return, not for nonpecuniary liquidity services, and both default free (Wallace, 1983). If private issues unlike government issues, however, are subject to investment risk, legal restrictions may not be the reason privately issued currencies are absent.

4. VALIDITY OF THEORIES OF UNREGULATED INSIDE MONEY

The propositions offered by monetary reform advocates for unregulated inside money are flawed in the ways indicated in sections 1 to 3. In addition, they are incomplete in emphasizing only the factors that limit liabilities of free banks and ignoring the quality of assets they acquire. Consideration must also been given to the incentives banks are exposed to that encourage risky undertakings. A case can be made for giving utmost scope for lending and investing by depository intermediaries, without interference by government, while recognizing a need for precautions.

A sine qua non of a banking system in which the activities institutions engage in are no longer monitored is that the conduct of owners and managers would be subject to a set of admonitions. Any mistakes they make that wipe out capital and reserves would prompt the immediate closing or reorganization of the institution. Stockholders might be liable for an assessment equal to their equity, and managers would lose their jobs. Depositors and creditors under these arrangements would be fully protected, as net worth would not have turned negative, should the marginal costs of products and services the institution offers the market turn out to exceed market prices. Whatever risks institutions were prepared to undertake, whether the activities were on or off balance sheets, the mistakes would be borne by the owners and managers, not by depositors, creditors and taxpayers. A set of precautions that would safeguard against excessive risk taking might include capital requirements, marking assets to market, provision of information to authorities, and double liability for shareholders.

In such a banking system, each institution would have an incentive to be prudent in acquiring assets and funding their acquisition, on penalty that foolhardy owners and managers would lose their equity and stake in the institution.

5. OUTSIDE MONEY WITH NO CENTRAL BANK

Even a competitive free banking system providing stable inside money is not sufficient to guarantee price level stability. Only if outside money into which inside money is convertible is stable will price level stability, banking stability, and economic stability be attainable.

Existing proposals by reformers for outside money include convertibility of inside money into gold (Selgin 1988), or by a contractual arrangement for redemption in unspecified commodity and financial instruments to be determined by an expert commission (Dowd, 1989), or by indirect convertibility into the amount of purchasing power that would stabilize a wage index (Glasner, 1989). To simplify the discussion, I confine my observations to gold as outside money, since we have some historical experience by which to judge its stability.

When unstable outside money produces an unstable monetary environment, price level instability prevails. Price level or inflation surprises occasion mistakes in banks investments. I grant that the record of price stability under the classical gold standard surpassed that of subsequent forms of outside money. However, even under the gold standard, episodes of faulty credit analysis leading to disastrous investment decisions by banks occurred. If even under a relatively stable outside money regime, bank owners and managers make mistakes that wipe out capital and reserves, the case is made for imposing safeguards against excessive risk taking to protect holders of bank liabilities. The possible precautions noted in section 4 are intended to assure that if depository institutions have been mismanaged, they will be closed or reorganized before losses have been sustained.

In this scenario central banks would not be needed to provide outside money. With free banks' funds secure, failures would not precipitate runs or panics. Panic in the past was created by a demand to convert deposits into cash or cash into the medium of account, say, gold. A sudden demand to convert deposits into notes could not be met under nineteenth century conditions since the possibility of increasing the supply of notes that monetary authorities issued was limited. Under free banking competitive banks would have no problem in satisfying the increase in demand for notes in the unlikely event of a loss of confidence in the system that would also lead to a shift from bank monetary liabilities to gold.

If deposit insurance were maintained, it could be privately administered, with the aim of providing depositors and creditors in reorganized or closed institutions immediate access to the full value of their claims. Some would argue that a lender of last resort would still be needed to bail out insolvent insurance funds, but if the precautions I suggest are implemented, it is hard to envision so total a collapse of the system.

If all these changes came to pass, as proposed by the advocates of free banking, central banks could be shut down or exist as vestigial bureaus of the federal treasury or finance ministry. As indicated earlier, I am doubtful that disestablishment of central banks is likely in the foreseeable future.

6. CONCLUSION

My concern about free banking is that, despite its virtues, if it were adopted, bank failures would occur. The claim made for the Scottish free banking system is that it functioned safely and efficiently for over a century until the Bank Charter Act of 1844 and the Act of 1845 restricted Scottish bank note issues. Even so, Scottish banks failed. Their failure rate was lower than that of English banks from 1809 to 1830, but not significantly lower measured from 1772 to 1830 (White, 1984, p.44; Sechrest, 1988, p. 251-252). Failure is an acceptable feature of an efficient market economy. What is unacceptable is to allow the costs of failure to fall on entities other than owners and managers, and to have governments intervene at that juncture to bail out failures and use taxpayer funds to make depositors and creditors whole.

Adam Smith's discussion is well known of the failure of the Scottish bank established at Ayr. It extended loans at 5 percent and funded itself by borrowing in London paying, "in the way if interest and commission, upwards of eighty percent" (1937, 299; 1776). This is an example of an egregious investment risk that a bank assumed. Banks may assume other risks not necessarily as egregious as that of the Ayr Bank.

I can think of no more apt summation of the theme of this paper than to quote Adam Smith, and then to amend his statement. He proposed that the trade of bankers be restrained in two ways ("from issuing any circulating bank notes or notes payable to the bearer, for less than a certain sum; and if they are subjected to the obligation of an immediate and unconditional payment of such bank notes as soon as presented"), of which only the second way is an acceptable restraint. Otherwise, he held "their trade may, with safety to the public, be rendered in all other respects perfectly free" (Smith, 1937, 313).

I propose a set of precautions to be imposed on owners and managers that would give them the incentive to be prudent in making loans and investments on penalty of losing their equity and management jobs. Otherwise, they would, "with safety to the public, be rendered in all other respects perfectly free."

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SINOPSE

A TEORIA DA DESREGULAMENTAÇÃO DA ATIVIDADE BANCÁRIA

Este trabalho analisa três proposições teóricas sobre a teoria da desregulamentação da atividade bancária. A primeira delas defende a idéia de que a existência de um mecanismo interbancário de compensação impede o excesso de emissão por parte de um banco individual A segunda propõe que um sistema competitivo provê incentivos suficientes para que os emissores individuais busquem a credibilidade das suas moedas e, com isto, mantenham-se nos limtes de segurança de emissão. A terceira propõe que a restrição do desconto bancário às *real bills* limita a quantidade de moeda que os bancos emitem e que são apenas as restrições legais que impedem a criação de moedas privadas, que são demonstavelmente eficientes. O texto sugere que a adoção de um sistema totalmente desregulamentado implica em falências bancárias. A autora propõe algumas precauções a serem impostas sobre os proprietários e gerentes que dariam incentivos à prudência nos empréstimos e investimentos.