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Development of Financial Markets and Institutions

VIII. The Free Banking Debate

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VIII. THE FREE BANKING DEBATE

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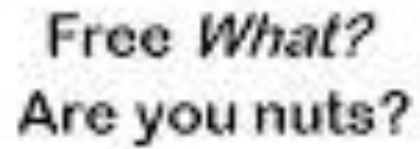

1. FREE BANKING

INTELLECTUAL BACKGROUND

Denationalization of Money – Hayek 1976

- Hayek argued that money production does not have to be a government monopoly
- A new approach to money – somewhat

Smith's (1936) Free Banking Research

- Vera Smith (1990) published research on the banking debates of the 19th century
- Primarily focused on banking vs. currency school
- Also discovered a strain of "free banking" theory

WHITE AND SELGIN

Lawrence White (1984) *Free Banking in Britain*

- Opens the modern debate on free banking
- Examines the Scottish banking system 1700-1845, finds that it was stable and efficient
- Each bank had its own reserves, both for inter-bank clearing and redemption

Selgin (1988) *The Theory of Free Banking*

- expands on White, deepens the theory
- Freely competing banks can efficiently provide the monetary medium
- Under free entry, no special privileges, no government guarantees
- A free banking system is both efficient and stable

FREE BANKING AND THE MONEY SUPPLY

Banks and the Money Supply

- Outside money: the commodity or paper money produced outside the banking system
- Outside money are the reserves for the banks
- Inside money: the money produced by the banking system, claims on the banks
- Inside money are redeemable into outside money

Effects of Bank-Supplied Currency

- Resource saving if on a commodity standard since resource cost of bank money is zero
- Less resources used for producing outside money commodity
- The banking system speedily adjust to changes in demand for money balances
- Inside money can be virtually immediately produced

THE PRINCIPLE OF ADVERSE CLEARING

Factors Determining Bank Reserves

- Expected redemption demands by customers
- Expected clearing demands from other banks

The Rule of Excess Reserves

- If a bank has more reserves than necessary, it can expand credit
- Its outstanding liabilities (notes or deposits) grow, balance sheet expands

The Principle of Adverse Clearing

- The bank cannot expand credit beyond the demand for bank money
- Excessive notes will eventually find their way to rival banks
- Redemption of notes forces the bank to contract credit

THE PRINCIPLE OF ADVERSE CLEARINGS

Assumptions (Selgin 1988, 41)

- Total demand for bank notes is determinate, surplus notes are parted with
- Most surplus notes end up in rival banks
- Banks return their rivals' notes for redemption
- Note-brand discrimination

Note-Brand Discrimination

- Most of the notes that are returned to the issuing banks will be those of the overexpanding bank
- The public's demand for notes of specific banks is also determinate
- The public discriminates between notes of different banks

BANK CLIENTELE AND CLEARINGHOUSES

Overall Determinants of Bank Money Supply

- Demand for bank money (bank liabilities) is key
- Proportion of bank money demanded to outside money the limit on bank money issue

Bank Clientele

- those members of the public willing to hold the bank's notes or liabilities
- The size of each bank's clientele determines each bank's share of the bank money issue

Clearinghouses Clear Inter-Bank Balances

- In bankers' interest: it lowers the amount of reserves necessary against bank clearing
- Excessive issues more speedily returned to the expanding bank
- Bank competition enhanced, bank system made more robust

FREE BANKING AND MONETARY EQUILIBRIUM

Monetary Equilibrium and Disequilibrium

- Equilibrium: demand equals supply of money
- Disequilibrium: excessive money creation and excessive (unforeseen) money demand
- Disequilibrium undermines the coordination of the market process (Horwitz 2000)
- Changes on the money side disturb the market process, causing crises etc.

Free Banking and Equilibrium

- Free banking ensures monetary equilibrium – always
- Excessive money creation impossible → adverse clearing
- Increase in money demand is met by an increase in the issue of bank money

FREE BANKING AND MONETARY EQUILIBRIUM

Free Banking and Supply Shocks

- An overexpanding bank will continually incur net debits in clearing
- As a result, reserves will drain from it
- To avoid bankruptcy, it will have to stop expansion and might even have to contract

Free Banking and Demand Shocks

- A fall in the demand for (bank) money means people present notes for redemption
- This causes a contraction of the money supply
- A rise in the demand for money leads to credit expansion
- People will be willing to pay higher loan rates to get money
- The higher loan rate in turn induces banks to make more loans

2. HISTORICAL EPISODES OF FREE BANKING

MANY SUCH CASES

Key Historical Cases

- Scotland 1700-1845
- Sweden 1830-1903
- Switzerland

American "Free Banking" in the 19th Century

- very prominent in the literature
- But clearly not a case of free banking, since it was highly regulated

FREE BANKING IN SCOTLAND

The Classic Case of Free Banking (White 1984)

- Competitive note issue
- Minimal regulations
- Each bank kept its own reserves – no central bank
- The Scottish banking system was resilient, it lasted for 150 years
- Only ended due to government intervention (Peel's Act)

Outside Money (Reserves) in the Scottish System

- 10-20 percent in the second half of 18th century
- Fell to 0.5-3.2 in the 19th century
- Reason for fall: lower cost of acquiring specie, lower risk of outflows

State of the Money Market.

England.

Scotland.

FREE BANKING IN SCOTLAND?

Critiques

- Specie suspension 1797 in line with the BoE suggests the banks were privileged
- BoE notes also privileged in Scotland: if anyone tried to settle debts with these (e.g., a bank redeeming its own notes), he was protected from arrest for debt
- Is a low failure rate proof of an efficient system (per White) or of protection?

Ties to the Bank of England

- Scottish banking not really independent, free
- Redemption in London drafts and BoE notes – not specie
- Legal protection from courts when specie redemption demanded

ROTHBARD (1988) ON SCOTTISH BANKING

Now I come to the nub: that, as a general rule, and not just during the official suspension period, the Scottish banks redeemed in specie in name only; that, in substance, depositors and note holders generally could not redeem the banks' liabilities in specie. The reason that the Scottish banks could afford to be outrageously inflationary, i.e. keep their specie reserves at a minimum, is that, in practice, they did not really have to pay.

[Quoting Professor Checkland] The Scottish system was one of continuous partial suspension of specie payments. No one really expected to be able to enter a Scots bank … with a large holding of notes and receive the equivalent immediately in gold or silver. They expected, rather, an argument, or even a rebuff. At best they would get a little specie and perhaps bills on London. If they made serious trouble, the matter would be noted and they would find the obtaining of credit more difficult in future.

WHITE'S RESPONSE

The traditional contrast between the Scottish system and the more restricted English system is warranted. The privileges of the chartered Scottish banks may have generated some small rents worth protecting, but they did not impede competition in intermediation or in the provision of inside money. The chartered banks may have played a special leadership role before 1810, but did not control, direct, or cartelise the Scottish banking industry. The Bank of England was not a lender of last resort to the Scottish system before 1844. Nor was it a central bank in the sense of providing a reserve base of high-powered money for the Scottish banks, except perhaps during the restriction period. The Scottish banks used the London financial market to meet occasional liquidity needs, but this did not imply reliance on the good graces of the Bank of England.

At least from 1810 to 1844, then, the traditional free-banking model is valid for understanding the Scottish banking system.

FREE BANKING IN SWEDEN

Lakomaa (2007) on Sweden 1830-1903

- Private note-issuing banks competed directly with the Riksbank
- Banking on a fractional reserve basis
- Reserve ratio declined from about 40 percent to below 20 percent over the period
- Private notes were a large share of the money supply: 50-60 percent from the 1870s

But…

- Swedish banks criticized for high profit rates, suggesting a lack of competition
- Banks blamed for periodic credit contractions
- Ultimately, the abolition of the system had non-economic causes: due to a change in political ideology, a move away from laissez-faire

FREE BANKING IN SWITZERLAND

Fink (2014) on Free Banking in Switzerland 1826-1882(-1907)

- He concludes that the episode was a success from the point of view of money users
- There were only two bank runs in the period
- Bank notes were never devalued

But…

- Business cycles were not absent from Switzerland – even if the banks were stable, the economy as a whole wasn't
- There was a drain to France of reserves, caused by an excessive not issue
- But note that this drain only emerged in the 1880s and 90s – after Swiss banking had become restricted

OTHER EPISODES OF FREE BANKING

Rome

- Collins and Walsh (2014) investigate the question of free banking in ancient Rome
- No central bank, no obvious regulations – but a system of free banking?
- “We can postulate that many Roman banks must have operated on fractional reserves.”

French Revolution

- White (1990) examines the episode of free banking during the French Revolution
- Laissez-faire banking 1791-2, hundreds of banks formed
- This period really too short to say anything decisive
- Bank notes redeemable into assignats, bank notes accepted in payments of taxes

3. CRITIQUES OF FREE BANKING

SEVERAL POINTS OF CRITICISM

Free (Fractional-Reserve) Banking is Fraudulent

- An ethical-legal argument – not a question of positive economics
- Can we ultimately avoid questions of acceptable rights and contracts?
- Economics deal with interpersonal exchanges – what can justly be exchanged?

Free Banking is Inherently Unstable

- Free banking leads to business cycles
- Free banking causes Cantillon effects – redistribution in favour of money creators
- Free banking theory rests on flawed monetary theory
- Historical cases adduced in favour of free banking were not really cases of free banking

FREE BANKING IS FRAUD?

Rothbard (2008) and the Fraud Argument

- Bank money are titles to money or “warehouse receipts” (Hoppe 2006) – not loans
- If a bank issues more titles or receipts than it has money on reserve, it commits fraud
- There cannot be more than one exclusive property title to the same property

Must Money Substitutes Be Titles to Money?

- Bank money can be considered as another kind of claim, e.g., callable loans
  - (Selgin and White 1996; White 2003)
- Such loans are not fraudulent, and if they are seen as fully secure they become money
- We must not confuse the legal and economic concepts of ownership (Hansen 2021)
- But it’s unlikely that claims will circulate for long – they are inherently unstable

IS DEMAND FOR MONEY A SUPPLY OF CREDIT?

Holding Bank Money Means Lending Money

- By holding money, a person supplies capital for investment (Selgin 1988, 22; Horwitz 2000,72)
- The demand to hold inside money reflects the public's willingness to supply loanable funds through the banks whose liabilities it holds
- To hold inside money is to engage in voluntary saving. (Selgin 1988, 54)

Holding Money Is Saving, But not Lending

- Money is part of one's savings, yes – but not supply of capital (Hülsmann 1996)
- Money is held to be presently available, it therefore cannot be lent out to other people
- That would frustrate the purpose of holding it, disarranging the monetary system

HÜLSMANN (1996, 35, 41)

He [acting man] must fail if he errs in his appreciation of the amount of goods he can dispose of. If an institutional arrangement implies that the acting persons under its influence err systematically, the arrangement itself can be said to lead to necessary failure. This is exactly the character of fractional reserve banking.

…

Fractional reserve banking is frequently seen as a kind of multiplier of reserves. In fact, it is a multiplier of error. Fractional reserve banking is an iron chain that links the errors of one or a few market participants with the errors of all the others.

ARE VARIATIONS IN BANK MONEY NEUTRAL?

Variations In Money Supply

- If the demand for money changes, the amount banks issue also changes
- This leads to the same effects we otherwise see resulting from money creation
- Even when banks cannot create money at will, the money supply *still* varies

Cantillon Effects and Business Cycles

- Bankers and bank customers are in fact systematically favoured through seigniorage
- Seigniorage: the gain from money creation
- Newly-created money percolates through the economy
- This leads to changes in incomes, relative prices

BANK MONEY AND THE INTEREST RATE

Banks and Financial/Capital Markets

- Banks create money through lending to their customers
- An increase in the flow of bank money constitute an increase in the supply of credit
- This depresses the interest rate below what it otherwise would have been

A Special Case

- This is true also in the case where the real rate rises, but banks issue more credit
- The nominal interest rate remains stable due to credit expansion (Hayek 1967)
- The nominal interest rate is depressed below what the rate would have been
- The result is credit expansion and an unsustainable economic boom

4. MONETARY DISEQUILIBRIUM

DISEQUILIBRIUM AND DEBATES

A Key Conclusion of Free Banking

- Changes in the demand for money leads to disequilibrium
- This must be somehow compensated by the monetary system

Two Assumptions

- Menu costs: it's costly to change nominal prices
- Sticky prices: it's hard to change nominal prices (they are fixed by long-term contracts)

Money Supply and Equilibrium

- When these assumptions hold, disequilibrium results from a change in money demand
- A change in supply compensates, ensures monetary equilibrium
- Bagus and Howden (2010, 2011) criticize. Evans and Horwitz (2012) respond

MISCONCEIVING MONETARY THEORY

A Fundamental Criticism

- Free bankers misconceive monetary theory
- They only look on the reservation demand for money
- They focus on the stream of nominal spending (MV)

Two Errors

- The stream of nominal spending is not essential – to anything
- The interconnectedness between the "money side" and the "goods side" runs throughout the economy – there is no real dichotomy
- One must look at *both* reservation *and* exchange demand for money

DEMAND FOR MONEY AND THE MARKET PROCESS

The Value of Money and the Market Process

- Determinants of the value of money are
- The stock of money
- The reservation demand for money
- The stock of goods (and services)
- The reservation demand for individual goods (and services)

Free Banking Error

- Free bankers disregard or downplay the exchange demand for money
- I.e., they don't consider goods and services offered against money (Davidson 2012)
- This is a fundamental error!

DAVIDSON (2012, 202)

Since each good on the market has its own supply and demand schedule expressed in terms of money, money has a separate (partial) supply and demand schedule, expressed solely in terms of that good. Thus, when the social reservation demand for money changes, it is not a single supply curve that shifts, rather it is the partial supply curves of money with respect to goods individually (and hence those goods' demand curves) that shift, all to varying extents. And they do so precisely because a change in the social reservation demand for money is nothing more than a change in its marginal utility as it moves up or down each market participant's value scale, a value scale that encompasses all goods including money.

MONETARY DISEQUILIBRIUM

"Pre-Income" and "Post-Income" Demand for Money

- Exchange demand for money can also be seen as "pre-income" demand
- Reservation demand is "post-income" demand
- It is wrong to focus only on reservation demand – it is not total demand for money

Causes of Price Stickiness

- If the price system is prevented from working, disequilibrium ensues – price controls
- Changes in demand for money normally lead to adjustments of prices
- If there is "endogenous" price stickiness – contracts can be renegotiated
- A change in the nominal money supply is not necessary – the monetary unit itself "adjusts", its value changes in responses to changing conditions

HÜLSMANN (2000)

By distinct contrast, the services rendered by money depend on the demand of money, and they also depend on the supply of money. A higher demand for money brings about lower money prices and that means that the purchasing power of money – that is, the very quality for which it is desired in the first place – increases under the impact of the higher demand. Similarly, a reduced supply of money brings about lower money prices and thus increases the purchasing power of money.

Thus, the supply of money does not have to be adjusted to the demand of money. Unlike all other commodities, money itself constantly adjusts to the conditions of the market. The services rendered by any unit of money are constantly adjusted under the impact of changes in demand and supply of money.

DAVIDSON (2012, 204)

Through entrepreneurial action, price coordination ensures that, at any given time, resources are being economized in a way that is consistent with anticipated consumer value scales. Since a change in the social reservation demand for money is nothing more than a change in one or more of these value scales, it is clear that it cannot represent an interference with the coordinative process, because it is an integral part of it.

5. CONCLUSION

HAS FREE BANKING EVER EXISTED?

- Hülsmann (2003) argues that while a non-fraudulent system of free banking is possible, it has never existed in practice
- Hülsmann (2004) suggests importance of legal tender laws for growth of banking
- Hansen (2021) argues that only entrepreneurial error could lead to true free banking – and that this would quickly be corrected
- Money and money substitutes treated the same – when in fact they are heterogeneous
- Credit risk attaches to money substitutes – makes them inferior to money proper/outside money for monetary function

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