Banking on the Future

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with additional material by
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Contents

Introduction 1

1. **The failure of state money** 3
Simon McIlwaine & Iain Smedley
1.1 The costs of inflation
1.2 The Public Choice critique
1.2 The failure of exchange rate targets

2. **Reforming the Bank of England** 8
Iain Smedley
2.1 A brief history of the Bank of England
2.2 The case for an independent central bank
2.3 Models of independence
2.4 The New Zealand model
2.5 Improving incentives: privatization
2.6 The Office of Banking Regulation
2.7 Conclusion

3. **Competition in currency** 20
Iain Smedley, Antoine Clarke & Simon McIlwaine
3.1 The reality of currency competition
3.2 Overcoming objections to private money
3.3 Establishing a choice system
3.4 Introducing competition in the UK
3.5 Possible alternative suppliers of currency
3.6 Monetary standards
3.7 Retail chains as currency issuers
3.8 Conclusion

4. **The history of free banking in Scotland** 34
Iain Smedley
4.1 Banking in Scotland 1695-1845: a brief history
4.2 The development of the note exchange
4.3 The monetary controversies, 1825-1845
4.4 The demise of free banking
4.5 Conclusion

5. **Free banking around the world** 45
Iain Smedley
5.1 The United States of America
5.2 Canada
5.3 Chine
5.4 France
5.5 Sweden
5.6 Other countries
5.7 Conclusion

Notes 52

Introduction

Since the Conservatives took office in 1979 there has been an important transformation of the political culture of the country. Privatization, and the empowerment of consumers of formerly monopoly state-supplied services, have combined to produce a new and healthy scepticism regarding the ability of government, as opposed to private enterprise, to promote economic and social welfare.

Despite the recessionary gloom in the run-up to April 9th 1992, this scepticism underlay the Conservatives' return to office for a fourth term – an event unprecedented in modern politics.

But the margin was close. The Conservatives were nearly the victim of this inherent inability of governments to shape the economy to their own objectives. The recession, of course, had been preceded by an renewed inflationary boom in 1987-1988. From an electoral perspective its effects could scarcely have been experienced by the government at a worse time. The political cycle became out of phase with the economic cycle.

The causes and effects of inflation have become so well known that it is almost unnecessary to re-state them here. Suffice it to say that it is now beyond dispute that the source of inflation is government over-expansion of the money supply, with the whole process producing distortions in the economy which become manifest when the (inflationary) monetary pump is turned off and the painful corrective process – a recession – ensues.

However, as the experience of 1980 to 1987 demonstrates, the cycle of inflationary expansion and recession *can* be broken if the government is sufficiently resolute. The boom-bust cycle is certainly not a fate to which our country *need* be predestined.

There can be little doubt that the present government, painfully aware of the political anxiety which it faced in the run-up to the election, would welcome a programme designed to prevent the recurrence of such phenomena once and for all. The central problem is the state monopoly and political control of the money supply.

Just as the privatization of a whole host of monopoly state services and industries has produced incomparably greater efficiency, innovation and consumer responsiveness, the time is now right to focus on methods of bringing the forces of the marketplace to bear on a crucial element in the market economy – the currency itself.

In this report we examine ways of breaking the state monopoly of the money supply and transferring it into the private sector: something which really does have a right to be called 'the ultimate privatization'.

The first Chapter examines the record of state-controlled money, and surveys the theory of private and competing currencies. Chapter Two looks at how the Bank of England could be made independent of political control, and ultimately privatized. Chapter Three explores new policy options to introduce currency competition in the UK, and forecasts what might result from such competition. Systems based on competing currencies have existed at many times and in many places. Chapter Four describes the successful system of competing currencies which operated in Scotland in the eighteenth and nineteenth centuries, and Chapter Five surveys the numerous other examples of currency competition around the world.

1. The failure of state money

We are used to the supply of currency being a government monopoly. Indeed, it has become almost a universal assumption, prevalent even amongst enthusiasts for private enterprise, that the creation and control of the supply of money is an inalienable function of government, and government alone.

It seems strange that, while the failure of governments as operators of economic enterprises is recognized, the historical failure of governments to bring the supply of money under permanent and effective control is not. Yet sound money is the basis of the price mechanism, of economic calculation, and hence of all entrepreneurial activity.

1.1 The costs of inflation

The principal failure of state control of money, in the UK and elsewhere, has been the failure to maintain the value of money. Money's core functions are as an effective medium of exchange and a store of value. A failure in one of these central attributes is a serious failing, and an indication that the money which we have been supplied with by the state is far from perfect.

The harmful effects of inflation are well known, and do not need to be repeated at length here. Inflation harms those on fixed incomes by reducing their value, reduces the value of savings, and through 'fiscal creep', acts as a back-door way of increasing taxes.

The fundamental harm done by inflation is in its distortion of the price mechanism. Prices are central to economic calculation; they demonstrate relative scarcity and the strength of the forces of demand and supply. Changes in prices act as a signal of changing economic circumstances or preferences, and also provide incentives for entrepreneurs, consumers and others to change their behaviour. Prices are the 'language' of the market. Inflation introduces 'noise' into this language, and makes it harder to distinguish between changes in relative prices (which reflect real changes in economic conditions) and changes in the general price level. This makes economic decisions in general, and long-term plans in particular, more difficult to make.

It is now widely accepted, including by many non-monetarist economists, that the main long-term effect of monetary expansion is on prices – inflation. Economists may disagree about the short-run effects of monetary expansions, but the long-term effects are clear and are known to be damaging.

Those responsible for producing currency – the monetary authorities – have in general taken the view that inflation is undesirable, and should be limited. Many types of targets have been tried, including inflation itself, monetary indicators, interest rates and exchange rates.

The target which is most sustainable over time is for price stability – zero inflation. Any other target will be harder to achieve, because people try to anticipate future inflation and thereby add to inflationary pressures. Thus, the historical records show clearly that inflation becomes more variable at higher levels. This distorts the price system more severely, and also makes achieving any (non-zero) target more difficult. If we wish to design a monetary regime which will achieve price stability, there are a number of problems that must be overcome.

Political intervention in monetary policy – the notion of 'fine tuning' the economy – is not a viable policy for long-run price stability. Despite the long-term damage caused by inflation, politicians' eyes are often on the short-term. There is often a temptation to alter monetary policy (allowing a monetary expansion, cutting interest rates, etc.) for short-term political reasons. Even if the short-term effects are positive, the long-term effects will not be. Furthermore, short-term interventions undermine confidence in the longer-term policy. They will therefore ultimately be self-defeating.

Incentives must be appropriate. The monetary authorities should have good reason to be virtuous. If the goal is to be price stability, then there should be incentives for those within the monetary authorities to achieve it. Appropriate incentives might include performance-related pay and competitive pressure – that if price stability is not achieved by one set of monetary authorities then others will be glad to take over the work. These incentives should be both individual and institutional.

The relevant *information* must be available to enable the monetary authorities to act. How are they to know what quantity of money is required to produce price stability? Monetary data are highly complex and difficult to collect, revealing problems only long after decisions have been made.

This report identifies a progressive programme of reforms which address and overcome these three problems. In order to do this, the reasons for the failure of state-produced, politically-controlled, monopoly money to provide price stability need to be examined in more detail.

1.2 The Public Choice critique

Many of the arguments against state planning of the economy in general can also be levelled at state monopoly of the money supply. In analyzing the role of the state it is vital to take into account the effect on the decision-making process of political and bureaucratic interests. When the state has control of the money supply, political considerations will often have a negative influence on monetary policy. Furthermore, the users of money are faced with a monopoly and hence have no means of ensuring that their desires for a stable currency will be satisfied.

Public Choice theory recognizes that politicians, bureaucrats and pressure groups have incentives, motivations and vested interests of their own – interests which compete for advancement and promotion in the political process. This more 'hardheaded' perspective is in sharp contrast to the traditional view that they can be treated as beneficial bodies

which 'stand above' mere private interest and intervene only when it is in the broader public interest to do so. As F.A. Hayek explained:

> "The tragic illusion was that the adoption of democratic procedures made it possible to dispense with all other limitations on governmental power. It also promoted the belief that the 'control of government' by the democratically-elected legislature would adequately replace the traditional limitations, while in fact the necessity of forming organized majorities for supporting a programme of particular actions in favour of special groups introduced a new source of arbitrariness and partiality and produced results inconsistent with the moral principles of the majority ... the result of this process will correspond to nobody's opinion of what is right, and to no principles; it will not be based on a judgement of merit but on political expediency."[1]

Democratic governments are constantly pressured to expand in response the manipulation of the decision-making process by organized lobbies or vested interests. The clandestine method of financing this process is the inflation of the currency, which is very tempting for politicians, given that its effects in the short-term are not as immediately visible as taxation to voters.

While the present Treasury commitment to the eradication of inflation cannot be denied, a monetary system which rests on the 'virtue' of any Chancellor of the Exchequer is a house built upon sand.

Even if a government keeps faith and genuinely tries to control the money supply, how can we be sure that it will get the balance right? Exactly the same arguments which can be levelled against the government having sufficient knowledge of resources, tastes, and aptitudes to 'plan' economic activity, can be levelled against government's attempts to manage the money supply.

How can central bankers, bureaucrats or politicians possibly know, for sure, in advance, what the optimal quantity of money will be? Indeed, how is the supply of money most effectively to be measured? Is the 'correct' measurement M0, M1, M2, M3 or M4?

Goodhart's law states that when the monetary authorities attempt to control one form of money, people start using others. Measurements therefore become ineffective guides to policy. The fact that monetary indicators became perceived as unreliable led to Nigel Lawson abandoning the monetary targets as set out in the Medium Term Financial Strategy, and adopting exchange rate targets instead.

1.3 The failure of exchange rate targets

Indeed, exchange-rate stability has been the straw at which government currency controllers have clutched for some time. One of the most striking features of government control of the money supply has been the tendency of governments, since the Second World War, to engage in attempts at international exchange-rate co-ordination.

Governments have used exchange rates in part as a benchmark to assess whether their economic management is more or less sound than that of other countries. In the absence of monetary targets, the exchange rate becomes an attractive alternative target to ensure stability.

However, Goodhart's law can be extended to international markets. The London-based Eurodollar market developed in response to tighter controls in the USA. By the 1960s, the development of substantial movements of private, as opposed to governmental, funds through this and other international money markets, made nonsense of the attempts by governments to maintain exchange rate parities within the Bretton Woods system.

Attempts to direct policy towards exchange rate targets, or co-ordinate policy to maintain relatively stable exchange rates, have historically proved unsuccessful. Attempts to do this have often led to unintended monetary expansions, and subsequently to inflation. By contrast, 'benign neglect' of exchange rates, as practiced in the early years of the Reagan presidency resulted in relative stability in the monetary base and in prices.[2]

A further danger of exchange rate co-ordination is that of getting the 'fix' wrong. Notoriously, this happened in 1925 when Winston Churchill took Britain back onto the Gold Standard, at the pre-war parity of $4.86, plunging the UK into a painful deflation of prices and wages.

The problem with attempting to get the 'fix' right is that essentially the government must 'second guess' the market by assessing the ideal, equilibrium price for its currency on the international money markets. But the optimal price of a currency, as of any other commodity, is something which can only emerge through the process of buying and selling.

Just as we cannot know all the factors behind the emergence of a particular price for any commodity in the market place, so too we cannot know for sure the reason behind fluctuations in current exchange rates. Such fluctuations may depend upon all sorts of factors, and indeed the exchange rate may fall despite domestic monetary tightness.

The danger with the most recent form of exchange rate co-ordination, the European exchange rate mechanism (ERM), is that, in the absence of exchange controls and other institutional barriers to capital movements, interest rates must become the instrument by which exchange rates are co-ordinated.

Not only could this entail interest rates rising to an absurd level, in response not to the needs of domestic monetary policy, but simply to maintain an artificially high price for that currency on the European money markets. This indeed is what happenened on 'Black Wednesday' in September 1992, when interest rates rocketed in an attempt to prevent the pound from falling below the lower band of the ERM.

With interest rates, as opposed to barriers to the movement of capital, being the instrument for exchange rate co-ordination within the ERM, if a fall in the exchange rate of a currency is anticipated, then capital movements in money markets will soon produce a fall in the exchange rate no matter what rearguard action is taken by the central bank or finance minister to prevent it. This is the so-called 'Walters Critique'.[3]

A more desirable alternative policy is not to target exchange rates, but to allow them to be freely determined. Confidence in domestic monetary policy will be reflected by increased stability on the foreign exchange markets. Paradoxically, this is more likely to ensure exchange rate stability than any direct attempt to achieve it.

If monetary indicators are not very effective, and attempts to target the exchange rate are liable to be counterproductive, what can be done to make sure that we are avoiding inflation?

There is now a general consensus that independence for the central bank will reduce the problems of political interference, and improve incentives. Chapter Two examines how the Bank of England can be placed on a truly independent basis, by privatizing it.

Independence may not, however, be enough. We should enable people to avoid inflation themselves by dropping their use of currencies which they have no faith in and allowing them to adopt others. That is the subject of the remaining Chapters of this report.

2. Reforming the Bank of England

This Chapter considers how reforming the structure and operation of the Bank of England could improve monetary management in the UK. It is our view that making the bank private and autonomous would resolve many of the difficulties inherent in a politically-controlled central bank.

2.1 A brief history of the Bank of England

The Bank of England was established in 1694. Until as late as 1946 it was owned privately rather than by the state: though its operations were of course intimately connected with the machinery of government. After its foundation, it rapidly acquired unique legal privileges: it held sole custody of the government's bank account; until 1858 it was the only bank whose shareholders had limited liability; until 1826 it was the only note-issuing bank allowed to have more than six shareholders. This combination of limited liability and freedom from the 'six partner rule' made the Bank larger and more important than any other bank in England. The Bank became a quasi central bank in the 1700s and a fully-fledged central bank in the 1800s, growing into its present role as a government-owned regulatory agency and lender of last resort, and abandoning its commercial banking functions. This development of increasing privileges by the Bank can be contrasted with the experience of the Bank of Scotland which failed to obtain special privileges and had to engage in competition with the other note-issuing banks (see Chapter Four).

Following the Glorious Revolution of 1688, there was a perceived need for a Bank based in London, primarily to help finance King William's war with France. Various schemes were put forward; the Bank was founded on the basis of a proposal sponsored by William Paterson (ironically, Paterson was a Scot, and the Bank of Scotland was founded in the following year by an Englishman) and backed by powerful promoters. Paterson's initial proposal was for one million pounds, required by the government, to be raised "upon a fund of Perpetual Interest" rather than a fixed term loan – i.e. the establishment of a National Debt. The 1694 Finance Act, which chartered the Bank, incorporated a slightly revised version of this proposal, and prohibited any other company or body being chartered to carry out banking business.

The question of note issue was highly contentious. The goldsmith bankers had derived considerable profit from it, and a widely-acceptable issue, such as the Bank of England's, would be highly lucrative. Paterson's original scheme, rejected by the Commons, was for a Bank that could issue legal tender notes. The Bank aimed to combine the roles of a provider of funds for the government, and a competitive enterprise benefitting from legal privilege. Its need and desire to issue notes soon became apparent; the first meeting of

the Bank's court provided that those who deposited money at the Bank could, among other options, receive 'running cash notes' payable on demand.

The Bank's concern over the potential for competition led them to extend their privilege over note-issue by getting an Act passed, in 1708, which prevented associations of more than six partners from issuing notes. The issue of formal printed notes for regular amounts (£20, £30, £40, £50, £100) began in 1725, once problems of forgery had been resolved. Expansion of the national debt, and a shortage of silver coin, led to a larger note issue, including smaller denomination notes (£10 and £15 notes were introduced in 1759).

By this time, many of the smaller banking houses, descended from the goldsmith-bankers, had ceased issuing their own notes. Outside London, country banking houses did begin to issue notes, but from 1777, they were prevented from issuing notes for quantities smaller than £5, and throughout the period they had to operate subject to the restriction on the number of partners. The Bank's charter frequently came up for renewal, and was renewed in return for further loans to the government.

In the late eighteenth and early nineteenth centuries, England experienced currency problems largely caused by the large expenditures required by the government for the wars against France. Bank of England notes for £1 and £2, restamped Spanish bullion, and tokens issued by merchants, were all used to meet the shortage of domestic currency. The 1810 Commons Select Committee (the Bullion Committee) criticised the Bank's policy and blamed overissue of paper for currency depreciation.[4]

Following the banking crisis of 1825 (see Chapter Four), an 1826 Act was passed which limited the Bank of England's monopoly of note-issue to within 65 miles of London. This allowed the establishment of joint-stock banks with more than six partners (although without limited liability), but also enabled the Bank to establish branches around the country. Following a government enquiry in 1833 the Bank's charter was extended again, but deposit-taking London banks were permitted to operate, providing they did not issue notes.

By the time of the 1844 charter, the Bank of England was firmly at the centre of the banking system. It had achieved special status as 'Banker to the Government and Registrar of Government Stocks' in the eighteenth century, and also became the 'bankers' banker', acting increasingly as lender of last resort to the banking system. Banking theory was also changing, with influential opinion inside the Bank of England and the government becoming convinced that centralized note issue was desirable. In the 1830s, the suggestion was first made that the Banking and Issue Departments of the Bank should be separated, and the Bank's monetary function separated from the ordinary business of banking. These principles, and the doctrine limiting the Bank of England's note issue to a specified amount, were enshrined in the Charter Act of 1844. The Act also exempted short-term bills from the usury laws, enabling the Bank to vary its interest rates.

This Act also prohibited banks from entering the note-issue business anew, and limited the issue of existing note-issuing banks. The intention was for the Bank of England to monopolize note issue in England and Wales. Although the last country bank to issue notes did not lose its right to do so until 1921, there was no longer any effective

competition in note issue, as the quantity and mechanism of issue became tightly controlled.

The latter half of the nineteenth century saw increased attention paid to the Bank's role as holding the nation's banking reserves – a defining function of a true central bank. This was a matter for debate, as the Bank was also very much a commercial bank engaged in retail activity. Another important function, the Bank's role in the clearing system, also began at this time. The joint stock banks established a clearing house in 1854, whereby clearing by transfer of bank notes was replaced by the transfer of cheques drawn on the bankers' accounts at the Bank of England. Furthermore, use of the Bank Rate became a major instrument of monetary management and thus of economic policy.

The Bank's role was reassessed further by the Revelstoke Committee, established in 1917 following criticism of the Bank's practices and relationship with the government during the war, its alleged secrecy and the concentration of power in the hands of the Governor. The Committee did not favour control or acquisition of the Bank by the state, but did have to assess the arguments on this subject carefully.

The Bank of England evolved into a fully-fledged State central bank only in the inter-war period, under the governorship of Montagu Norman. Britain returned briefly to the gold standard (which had been abandoned in 1914) in 1925, but the convertibility of bank notes to gold coin was abandoned. The Bank became involved in economic reorganisation and rationalisation projects, and in banking reform overseas. The Bank of International Settlements – the central bankers' central bank – was set up in 1930. The Bank of England also disengaged itself from all normal commercial banking activity, focussing on its central bank role. The Bank's role in managing exchange fluctuations on behalf of the Government was also formalised at this time, with the establishment in 1932 of the Exchange Equalisation Account. By the time of the Bank's 250th anniversary in 1944, its then Governor, Lord Catto, was able to say that, "neither the Bank nor any other body working for the government can determine policy: the power to do that is the prerogative of government and Parliament alone. What the Bank does is to give independent and candid advice based upon experience."

The logical conclusion from this argument came with the post-war nationalization of the Bank. The development of the Bank from a commercial to a central banking role made some change in its status seem inevitable. There was little organized opposition to the 1945 Bank of England Bill which set out how the Bank would be nationalized, with stock transferred to a government nominee, the Bank's proprietors compensated with Treasury stock, and the new relationships between the Treasury, the Bank of England and other banks. The Chancellor, Hugh Dalton, described the Bill as "a model, a streamlined Socialist statute." The Bill received Royal Assent on 14 February 1946, and the Bank came under state ownership on 1 March of that year.

The transition to state central bank was complete, but the nature of the Bank's relationship with government remained a matter for debate. The failure to control inflation in the post-war period has led to calls for the relationship to be reviewed.

2.2 The case for an independent central bank

At present, the Bank of England has wide discretion but is ultimately responsible to the Treasury; key decisions, for instance on setting interest rates, rest with the Chancellor. There is now an increasing body of opinion in favour of giving the Bank of England a greater degree of independence from the Treasury. Former Chancellors Nigel Lawson and Norman Lamont both alluded to the idea in their resignation speeches, and Bank staff have been giving the idea an increasingly favourable reception. A wide section of informed opinion is now aware of, and in favour of, independence. The House of Commons Treasury and Civil Service Select Committee recently (1993) held an enquiry into the Bank's role which focussed on the question of independence. A CEPR working party chaired by Lord Roll, and containing many distinguished bankers and academics, concluded in favour of independence on a contractual basis.[5]

But independence is an elastic concept, and various proposals have approached the issue in different ways. The aim of our proposals is to reduce political influence over monetary policy, since we believe that an independent central bank would be better able to achieve a stable currency value.

International comparisons of central banks lend weight to the view that independence tends to produce lower inflation. A study by Bain and Parkin of the performance of 12 countries from 1973-1986 supports the view that central banks free of 'policy type' influence – influence by government over bank board appointments and over the final say on monetary policy – "delivered significantly lower inflation than did those susceptible to such influence." This view was supported by a separate study of Pacific Basin countries.[6]

The critical argument in favour of central bank independence is that the Bank's day-to-day political accountability undermines monetary policy and hence confidence in monetary stability. With an independent central bank, it is argued, it would not be possible for government ministers to manipulate interest rates and other policy instruments for short-term political advantage. Independence would therefore bolster confidence in the commitment to beat inflation; the expectations generated by such confidence would themselves help keep inflation low.

Plans for European Economic and Monetary Union require central bank independence as a condition for Stage Two. Under this imperative, Europe's central banks are moving towards independence, usually on the Bundesbank model. For example, a plan to give the Bank of Spain autonomy to define monetary policy, based on a legislated 'prime end' to ensure price stability was discussed by the Spanish parliament in 1993.

It is sometimes suggested that any central bank should be under political control for reasons of democratic accountability, and this argument has been used against the establishment of independent European central banking institutions. But just as an independent police and judiciary may act as limits on the power of politicians to intervene in the law-enforcement and judicial process for political ends, so too might it be more appropriate for the monetary system to be outside political control. The poor record of political central banking suggests that this may well be the case.

Some form of accountability may be necessary, particularly in order to control a bank with a privileged or monopolistic position. Methods could be devised to give arm's length control which would satisfy such demands. These could include an overall target set by Parliament or the Treasury, or a system based on competition. But probably the best form of public accountability is that direct responsibility to customers, including those seeking to hold sound currency notes, that emerges under a competitive banking system.

In November 1988, while Chancellor, Nigel Lawson submitted a proposal for independence of the Bank of England, with the intention "to entrench the use of monetary policy to fight inflation and secure price stability".[7] Lawson proposed a new statutory framework for the Bank, with an explicit statutory obligation on it to achieve the sole objective of preserving the value of the currency. He identified the need to end confusion and possible conflict between policy objectives and remove political and electoral pressures from calculations over monetary policy. Lawson also stressed the extra market credibility which independence would provide, and made the interesting point that "there would in practice be powerful market sanctions against the repeal of the legislation by a future government: the mere announcement of the intention to do so would be so damaging to confidence that a future government would be extremely reluctant to attempt it".[8] The Treasury would be responsible for government borrowing, and would be restricted to issuing medium-term and long-term debt to avoid adding to liquidity. Accountability would be ensured by a parliamentary Select Committee before which the Governor of the Bank would appear. However, Lawson reports that Margaret Thatcher was "wholly unreceptive. She ... argued that it was something that could be considered only when inflation was low and coming down ... [in other circumstances, independence] would look as if the government were admitting that, after all, it was unable to bring inflation down itself, which would be highly damaging politically."[9] Lawson's proposal was finally revealed in his resignation speech of 31 October 1989; the minute he submitted to Thatcher in 1988 gives an overview of the operation of independence for the Bank.[10]

2.3 Models of independence

None of the existing models of independence go as far as we believe is necessary to have the full benefits of non-political money. In all the options now being discussed, currency issue remains a monopoly subject to state control. However, there is considerable evidence that independent central banking has many advantages over central banking under political control. Even if, for political reasons, it is decided *not* to adopt the competing currencies model, independence would still be valuable.

Germany's Bundesbank is held out as a model of independent central banking, and its perceived ability to curb inflation is widely envied. The Bundesbank's strength is based partly on formal independence (a 1957 statute requires it to support the government's general economic policy as long as this does not prejudice the performance of its functions to ensure stable prices, high employment, balanced foreign trade and economic growth) and partly on the contrast between the economic disaster of hyperinflation in the early 1920s and the Bundesbank's success in containing inflation. The Bundesbank is

intimately connected with the political process; the federal president appoints its president, vice president and up to eight council members (the other council members are heads of the regional central banks). The Bundesbank is often successful at resisting political pressure, but recent history, particularly concerning the handling of currency union at reunification, indicates that considerable political influence does exist.

2.4 The New Zealand model

A more appropriate parallel for the UK may be found in New Zealand. New Zealand's system of government is based on the UK model; their experience has many direct parallels with the UK. The Reserve Bank of New Zealand Act 1989 placed the central bank of New Zealand on an independent footing. The Act defined its function and roles in monetary policy, foreign exchange, currency and other financial activities such as banking regulation. In relation to currency issue, it is in essence on contract to the government.[11]

Like many other advanced economies, in the 1960s and 1970s New Zealand's record of economic growth was poor, and inflation tended to be high. The government embarked upon a programme of reform similar to – but in many ways more radical than – that in the UK, including privatization, deregulation and public sector reform. Following the 1984 election, financial markets were deregulated, including the removal of controls over the banking system, the abolition of exchange controls, and floating the NZ dollar. New Zealand's central bank, the Reserve Bank of New Zealand, was operating on the basis of a 1964 Act which stated that monetary policy "shall be directed towards the maintenance and promotion of economic and social welfare, having regard to the desirability of promoting the highest level of production and trade, and full employment, and of maintaining a stable internal price level." The operation of monetary policy was reviewed, resulting in the 1989 Act based on a more limited and more realistic approach to monetary policy, which would "present citizens ... with proof that the Reserve Bank was permanently protecting New Zealand from inflation", with the explicit aim of reducing expectations of inflation.[12]

Under the 1989 Act, the Reserve Bank is explicitly given the function "to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices."[13]

Price stability is the goal; this is aimed for via published inflation range targets. Definitions and targets are agreed by the Governor of the Bank and the Minister of Finance and set out in a Policy Targets Agreement, which are set for five-year periods to give medium-term stability. The current agreement, made in March 1990, defines price stability as 0-2% annual increases in the Consumer Prices Index (CPI), and also requires the Bank to monitor other indices. This goal has to be achieved by December 1993; the Bank has set out indicative inflation rates consistent with achieving this goal. Setting price stability as the sole usual objective reflects official acceptance of the view that "monetary policy cannot sustainably affect output and employment. Attempts in the past to produce a lasting increase in output and employment using monetary policy, have resulted in higher inflation".[14]

The provision of targets allows the government to weigh up other economic factors and consider the trade-offs between monetary policy goals and other objectives. However, unlike New Zealand's pre-1989 system (and the current situation in the UK) these trade-offs are made explicit and open. If the government wishes to specify an objective other than price stability, this must be done by tabling an Order in Council in Parliament. This explicit provision to over-ride the price stability goal may paradoxically make it more likely that the goal will be adhered to: the government will be reluctant to use the facility because of the effect on confidence.

The government sets targets for inflation, but the Bank has "effective independence to implement monetary policy in pursuit of its statutory objective, without limitations on the technique".[15] This is an interesting mix of discretionary and rule-based monetary policy; whilst the goal is set in the form of a rule (a target range for inflation), the monetary authorities have discretion over methods. The only constraints on the Bank's policy is that it "shall have regard to the efficiency and soundness of the financial system [and] consult with, and give advice to, the government and such persons or organisations as the Bank considers in implementing monetary policy are consistent with the policy targets."[16]

The Bank is required to publish six-monthly reports which cover monetary policy and inflation rates (measured using a number of indices including consumer and producer prices). This statement must specify the Bank's policies by which it intends to achieve monetary policy targets, state the reasons for adopting those policies, provide an outlook for monetary policy in the next five years and contain an assessment of the previous half-year's monetary policy. This is scrutinised by a Select Committee of Parliament which examines the Bank's activities.

The Governor of the Bank is appointed by the Finance Minister on the advice of the Bank's board, for a renewable term of five years. The Governor can be removed from office by the Governor-General of New Zealand on advice of the Finance Minister, if "the performance of the Governor in ensuring that the Bank achieves the policy targets … has been inadequate".[17] This provides a direct and personal incentive for good performance in meeting the targets on the part of the Governor. The Governor is supported by up to two Deputy Governors and the Bank's board of directors, who advise the Governor and monitor his performance on behalf of the Minister of Finance.

The Bank implements policy by operating in the market. It does not have powers to impose reserve or liquidity requirements, or other direct controls, on the commercial banks, but influences short-term interest rates by controlling the supply of 'settlement cash' needed by the banking system for daily clearing purposes.

Reform has helped to reduce inflationary expectations; the Reserve Bank reports that independence under the framework of the 1989 Act "has contributed importantly to stronger policy credibility. Surveyed inflation expectations are at record lows."[18] A recent survey of business and financial market professionals show inflation expectations of 2%; a survey of economists shows this 2% expectation stretching ahead for seven years.

The reforms have been broadly successful in reducing inflation; in the year to March 1992, the inflation rate (according to the Consumer Price Index) was measured at 0.8%,

the lowest for 31 years. Underlying inflation was estimated to have been 1.3%, compared to a level of around 4% in 1989. According to the Bank, "the firm stance of monetary policy over the last several years has been central to the reduction in the rate of inflation to its current level."[19] These levels are not low by historical standards for New Zealand; from 1871-1934, CPI inflation averaged 0.3% *per annum*. However, the 1970s saw 12% CPI inflation, and 11.4% in the 1980s; independence does seem to have curbed the expansionary zeal of that period.

Criticisms that price stability could be achieved only at the price of high interest rates have proved unfounded. Five-year government bond rates have fallen from over 16% in 1987 to 7.2% in 1992, mortgage rates are down from 20% to 9%, and New Zealand's risk premium (the difference between New Zealand's long-term interest rates and those of its trading partners) has fallen from 3.5% to 1.5%.

The Finance Ministry retains residual powers to intervene in foreign exchange markets, direct the Bank's foreign exchange activities and fix exchange rates for the Bank's dealings. The Bank's monopoly of currency issue, and legal tender laws, are reconfirmed by the Act.

The majority of the 1989 Act is concerned with the Reserve Bank's functions as banking regulator. The Act sets standards which must be met before a bank can be registered for supervision by the Reserve Bank. The intention is to allow free competition, and open and automatic access to the New Zealand banking market, subject to those conditions.

The similarity of New Zealand's political traditions and system to our own, and the successful operation of the Bank since independence, suggest that this should be seriously considered as a model for development in the UK. There is certainly an influential body of opinion within the Bank of England that might support such a move. On his appointment as Governor of the Bank, Eddie George said that "there is a good case for making the setting of the strategic objective and the operational responsibility for achieving that objective separate" and he is known to have argued in the past for "a central bank with a high degree of operational independence, with a statutory obligation to aim for price stability".[20] Deputy Governor Rupert Pennant-Rea has also stated his support for independence.

We recommend that the Bank of England is set upon a footing similar to that of the Reserve Bank of New Zealand. A contract set by the government should identify a clear goal of price stability, specified in terms of a target inflation rate; 0-2%, as in New Zealand, would be appropriate. The bank would have full day-to-day control of the methods used to achieve this target. Accountability would be retained by expanding upon existing mechanisms, such as the Bank's monthly monetary policy reports. This contractual basis would make the Bank's operation more transparent and would greatly reduce political interference in monetary management.

The Bank's performance of its contract should be carefully monitored. As in New Zealand, there should be incentives both for the institution and the individuals concerned to ensure that the targets are met. These should include performance-related pay for staff and – most importantly – the possibility that the contract may be withdrawn if performance is unsatisfactory.

2.5 Improving incentives: privatization

Independence on these lines would have many advantages. Even greater benefits would, however, be possible if the Bank of England were not only made independent but also privatized. Whilst the privatization of the national bank may appear to be a radical step, it should be remembered that the Bank was only formally nationalized by the Attlee government in 1946. Before that time, it was a private institution, albeit one with intimate ties with the state and acting on the basis of exclusive privilege.

The Bank of England could be privatized either by a trade sale to a consortium of financial institutions or by a public share offer. A share offer would have a number of advantages, notably that the Bank's independence could be enhanced, rather than be perceived to be reduced. It would also provide an excellent opportunity for widening popular share ownership – as with the utilities, UK citizens are familiar with the Bank of England's role and activities. Widespread individual shareholding in the Bank would also create a large group of people with a direct personal interest in good monetary management, and the ability to affect it. Privatizing the Bank of England would clearly illustrate the advantages of genuine public control by shareholders, over 'public' control by politicians. Privatization would generate revenue for investors, and benefits to the Exchequer both through initial sale proceeds and tax revenues from future activities.

Privatization would have a number of important benefits for the Bank. Experience of other privatizations in the UK has shown that performance, profitability, industrial relations, customer service and responsiveness to new market and technical changes have all improved. There is every reason to expect that similar effects would occur if the Bank of England were privatized.

Competition and private sector skills could be introduced into operations such as the printing of banknotes. A number of private firms provide security printing services, and banknotes in many other countries (including Scotland) are printed by specialist commercial printers. A privatized Bank of England could benefit from efficiency gains in this regard, possibly by contracting its note printing to another company or selling its note printing operation. Private security printers are known to be more efficient – output per employee is over 3 million notes in the largest private firm, compared with 2.3 million notes at the Bank of England's own print works – and overheads and R&D costs could be applied to a wider range of note production. Whether the Bank sold its operation, or simply modernized its systems in order to compete with the private sector, efficiency would improve and shareholders would benefit.

Similar economies will be possible in other parts of the Bank's operation. Privatization would free the Bank from remaining political interference in managerial matters such as location decisions, investment programmes, remuneration policy and staffing levels. Employee share ownership, which has proved successful in other privatizations, would also be of benefit to the Bank.

There a number of new types of business which the Bank could develop if it were private. The Bank already provides personal accounts for its employees and clearing accounts for the high street banks. If privatized, it would be able to develop this business.

The Bank of England, if privatized, would also be able to provide merchant banking services. Private provision and financing of infrastructure projects is increasingly important both in the UK and overseas. Many major utilities and other institutions are likely to require assistance in financing extremely large-scale investments. The Bank of England would have both the prestige and size necessary to organize merchant banking services for such projects. Particularly as more developing countries discover the advantages of privately-financed infrastructure, this will be a growing and potentially lucrative market.

An important source of new business would be advising monetary authorities in developing and post-communist countries on currency management. Despite Britain's less-than-perfect inflation record, the Bank of England remains respected for its monetary and economic expertise. Many privatized UK utilities, including gas, electricity and water companies and BT, have successfully and profitably expanded into overseas markets, and there is little doubt that the Bank could do likewise. In addition to monetary management, the Bank's security printing, minting and other services could develop new markets both overseas and for private-sector clients in the UK. As we have seen with other utilities, the freedom to explore these markets and make the necessary investment decisions to develop new businesses is really possible only in the private sector.

In addition, there are a number of features of the Bank's core currency-issuing operation which make privatization an attractive option. Technical and routine aspects of the Bank's operation – such as physically distributing notes and coins to the High Street banks – would benefit from the improved efficiency which private sector expertise would bring.

In particular, privatization would provide an excellent incentive for the Bank to ensure monetary stability. If the Bank of England was under contract to the nation to provide currency, and if it was understood that the contract could be renegotiated or offered to another institution, then the need for the Bank to meet the terms of the contract and retain the value of the currency would be strong. Shareholders in the Bank would be acutely aware of the importance of this contract and its value to the Bank. This would introduce long-term priorities for the Bank which would far exceed any short-term pressure which a government might attempt to bring to bear to influence the Bank's anti-inflationary policy. This is the single most important benefit of privatization, which is a logical continuation from the contract-based model and the government's existing policy of market testing and contracting out what have traditionally been state-supplied functions.

2.6 The Office of Banking Regulation

Whether the Bank is to be privatized or merely made formally independent, we recommend the establishment of a separate institution to deal with the regulation of commercial banking and to mediate between the government and the Bank in the setting of policy targets. This institution would be an Office of Banking Regulation – Ofbank.

Separation of regulation from the currency and monetary functions of the Bank has been recommended on a number of occasions. The Bank has already lost some of its regulatory monopoly thanks to criticisms arising from the Johnson Matthey affair. The

Board of Banking Supervision, established in 1987, contains a majority of non-Bank members, and oversees the Bank's supervisory duties. This was a compromise arrangement; according to Lawson, Margaret Thatcher wanted to separate the functions of bank supervision from monetary policy. Lawson identifies the "inherent conflict of interest between the task of monetary policy and that of bank supervision, with the former requiring a stern unbending and single-minded stringency and the latter favouring a judicious laxity to prevent bank failures."[21] The Bingham report into the BCCI affair also strongly criticised the operation of banking regulation by the Bank of England, as did many former BCCI customers.

There is some recognition within the Bank of England that there are alternatives to the current system of bank supervision and regulation which may be desirable. In a recent speech, Mr Brian Quinn, the Bank's Director responsible for supervision, hinted that the Bank's role as protector of bank deposits should be given to an outside body, but that supervision of the banking and payments system should remain with the Bank.[22]

Banking regulation is separated from monetary management in many countries, including Germany, Canada and Switzerland. Separation helps avoid conflicts of interest which may arise between maintaining sound money and preventing bank failures, and also enables banking regulation to be placed on a similar basis to the regulation of other financial institutions.

It is somewhat incongruous that the Bank has remained responsible for the regulation of retail banking, when other retail financial services are handled by the Securities & Investments Board (SIB) and its associated self-regulatory organizations (SROs). Ofbank could take on this function, freeing the Bank of England to develop commercial operations without any conflict of interest. Such a conflict of interest actually already exists: "[the Bank's] semi-official role as the spokesman and champion of the City makes it reluctant to take stern action against leading institutions".[23]

Introducing a separate and independent regulator would avoid any potential conflicts of interest if the Bank of England wished to develop commercial and investment banking business.

As well as its important role in regulating retail banking, Ofbank would also be responsible for the Bank of England's 'licence to print money'. The Bank of England would be on contract to the government to provide sound currency, and Ofbank would be responsible for monitoring the delivery of that contract obligation. While the Bank retains a monopoly, it is appropriate for government to set targets for inflation (as in New Zealand); supervision of this would be handled by Ofbank, where more attention could be paid to technical details. If the Bank does not fulfil its contract – to provide inflation-free currency – satisfactorily, then it should face the possible loss of that contract. Monitoring of the contract by Ofbank would enable alternative sources of currency supply to be considered.

2.7 Conclusion

The practical evidence is strong that independent central banks, free from political control, are both more credible and more successful in keeping inflation low than their politicised counterparts.

Yet any monopoly bank charged with maintaining price stability, even if it operates in a depoliticized framework which ensures market confidence, is faced with the twin problems of incentives and information. What incentives do the bankers have to ensure that their duty of maintaining price stability is carried out?

Powerful incentives *are* possible in an independent bank – including the dismissal of bankers who do not perform. The personal reputations of the bankers involved (and hence their likely career prospects) will be likewise affected by their performance. The addition of the profit motive, in a privatized bank as suggested above, might be a powerful extra incentive.

Even if the central bank was faced with strong incentives to behave well, it has to cope with the information problem. Monetary indicators are notoriously difficult to measure and tend to reveal problems of misjudged currency issue which will lead to inflation only a long time after the overissue has occurred. In a rapidly changing financial and economic market, how does the bank know what quantity of money to issue? Competition between many banks, rather than a single currency-issuing central bank, can provide an answer to both these problems. The following Chapter will examine how competition could be introduced.

3. Competition in currency

We have described the benefits of privatizing the Bank of England and establishing an independent institution – Ofbank – to regulate banking and monitor the Bank's performance of its contract to provide sound currency. This Chapter examines how competition might be introduced, identifies possible sources of competition, and considers some of the important issues which would-be competitors would have to address.

There *is* an alternative to the state monopoly of currency: allowing people to use the currencies of other countries (the dollar, or other European currencies, for example), and even competition between private currency issuers. Such a system is known as 'currency competition' or 'free banking'. Under such a system, individuals have a choice of currencies. They are therefore able to choose the 'best' currency – one which is an effective store of value (i.e. is not inflationary) and medium of exchange (i.e. is widely acceptable).

Whilst a vigorous academic debate on the case for private currency has developed over the past twenty years, the concept of money being issued by anybody other than a state central bank remains alien to most people and has as yet to enter the political – and still less the public – consciousness.

It is worth pausing to reflect on the origins of money and the banking system. The Austrian economist Carl Menger, writing in 1892 on *The Origin of Money*, illustrated how money emerged not as the conscious plan of any one individual, king or prince, but as an unplanned or 'spontaneous' event.[24] Money, according to Menger, gradually evolved. Individuals seeking to minimize the number of barter transactions necessary to obtain the commodities they wanted, learned that certain goods were more widely marketable than others and began to accumulate trading inventories for the exclusive purposes of exchange. The evolution of money eliminated the would-be trader's need to search among the sellers of the commodities he wanted to acquire in order to find those few sellers who, in turn, wanted to acquire the particular commodity or service that he had to offer – like hungry barbers having to seek out bakers in need of haircuts. Without an effective means of storing value (i.e. saving) long-range planning and exchange would be impossible.

The acceptability of a given medium of exchange to all the participants in an economy depended on two main factors – durability and high value. Having the attributes of great relative scarcity, durability and a high unit value (and consequent ease of portability) luxury metals such as gold and silver emerged as the increasingly favoured stores of value and media of exchange. It soon became apparent that an ambitious ruler had literally a golden opportunity to raise the funds necessary to finance his military adventures against his rivals by insisting on the exclusive right of coinage and to establish his hegemony and

implant his image in his subjects' minds by engraving it on the currency. The emergence of state money can thus be seen as a *political* as opposed to an *economic* phenomenon.

There are in fact considerable and well documented historical precedents for successful private currency issuance. In Chapters Four and Five, we examine the historical experience of free banking in Scotland, the United States and other countries. Whilst many of these episodes are little-known and under-researched, they do suggest that free banking is practical and that currency competition leads to monetary stability.

3.1 The reality of currency competition

But we do not need to rely on history alone for examples; there is competition in the provision of currency today. UK citizens can hold accounts denominated in foreign currencies, giving them an opportunity to select a currency which meets their needs. Increasing numbers of businesses which trade extensively with firms in other countries maintain a second-currency account, which may be denominated in dollars, deutschemarks or ECUs. These are intended primarily to reduce the transaction costs by making frequent conversions of currency unnecessary, but they could also be used as a safeguard against domestic inflation. International money markets move substantial sums in and out of various currencies in order to profit from exchange-rate and interest-rate variations.

Institutions can purchase financial instruments in a wide range of currencies. Individuals and companies, where it is convenient to do so, can already use dual or multiple currencies, the most obvious small-scale example being in border situations where people commonly hold cash balances in more than one currency and use them without much confusion.

The most striking contemporary examples of choice in currency and the use of parallel currencies come from Eastern Europe. The failure of domestic money supplied by the Eastern European governments has led people to adopt alternative currencies. Despite legal obstacles and outright prohibitions on the use of hard currency in many such countries, people have found it worthwhile to use dollars or deutschemarks, simply because hard currency is a much better store of value than the inflationary domestic currency, and in consequence has become a more effective medium of exchange. The desirability of hard currency, initially to buy goods outside the eastern economies, has become self-perpetuating. As increasing numbers of people used hard currency it became more attractive.

To take one of the many specific examples, let us look at Macedonia. The official currency has been in turmoil. The Yugoslav dinar was replaced with a so-called Macedonian coupon, prior to the introduction of a new Macedonian dinar. The public sector has had no option but to go along with this, but the private sector, which has the choice, has unofficially adopted the deutschemark as a parallel currency. Deutschemark notes brought back to Macedonia by people who have been working as migrant workers in Germany and Switzerland have effectively provided a parallel currency for the private sector in Macedonia. It is estimated that there were about US$750m worth of deutschemarks brought back to Macedonia and used in this way in 1991/92.

Similar stories could be told for many Central and Eastern European countries, mainly centring around the use of the deutschemark and the US dollar as parallel currencies. This has been quite widely recognised. The 1991/92 OECD report on Germany identified the increasing use of the deutschemark in Central and Eastern Europe as a parallel currency as being one factor that has required increases in the deutschemark money supply.

In some countries, people have even gone to the extent of creating their own money in the market place. The *Financial Times* (20 February 1992) reported that a group of entrepreneurs in the Urals had decided to create 'the Ural franc'. One of the group explained the problem: "It is easier to buy things with a trainful of wood than with a stack of roubles. Factories want wood and they do not want roubles." In order to solve this problem these entrepreneurs have identified a market niche and have introduced the Ural franc which they intend to establish as a hard convertible Russian currency to exist alongside the rouble. At the time of the article, they had printed 2m Ural franc notes and were intending for a circulation of 50m, equivalent to 50bn roubles in total. Unfortunately, there has been no further commentary regarding the success of that scheme; it would be interesting to see if these entrepreneurs have overcome the problems of acceptability which plague the issuers of any new type of currency.

The difficulty of getting people to adopt new currencies when there is no established confidence in their value is shown by the experience of many countries in the former rouble zone that have tried to issue their own currencies. Examples such as the Latvian rouble, the Estonian kroon, the Ukranian couponed rouble and the Lithuanian coupon have shown that it is extremely difficult to get people to accept a new currency unless they have a fundamental belief in its underlying strength as money.

In many Central and Eastern European countries, where the domestic currencies suffer from rapid inflation, the dollar, deutschemark and other western currencies are in day-to-day use as a parallel currency. Where the state monetary system has utterly failed, individuals and businesses have been able to use an alternative, despite the restrictions on use of foreign currencies.

Local Exchange Trading Systems

Systems of local currency networks called Local Exchange Trading Systems (known as 'Lets') offer interesting further examples of how private currencies can be used. There are a number of Lets schemes operating in different parts of the United Kingdom. The scheme is intended to provide an 'alternative' to capitalism: what it actually provides is a network of privately issued currencies.

A group of people can set up a Lets by organising a club in their local area. Members trade among one another using a local currency invented for the purpose. These are known by a local name, such as the 'oliver' in Bath or the 'bobbin' in Manchester, or a generic name such as the 'green pound'. Services traded through the system are denominated in the Lets currency rather than sterling; the customer writes a Lets-cheque for the relevant amount. Many Lets schemes issue a directory of members and shops which will accept the local Lets currency as payment or part-payment for goods or services. Settlements are made through a clearing house, which in some cases publishes accounts of members' transactions, thereby enabling the credit-worthiness of members to be monitored. Because

Lets are intended to be non-profit making, overdrafts do not result in interest being charged; but in a scheme where every members' balance is available for inspection, potential defaulters are spotted at a relatively early stage.

Lets schemes start on a very small-scale and local basis; this is one of their main advantages. The largest Lets scheme, based in Stroud, Gloucestershire, has 250 members. Their founders' views reveal a mixture of environmentalism, localism and self-help. One enthusiast, Dr Michael Hodges, "sees the proliferation of such schemes as the result of a loss of faith in governments to control the global economy". According to him, Lets scheme members "are saying, 'Why leave to Westminster and Brussels something you can organise yourselves, which has concrete results within a short space of time?'".[25]

The value of Lets currencies tends either to be initially based directly on sterling, or on a 'labour theory of value' basis (e.g. that one Lets-unit is equivalent to one hour of work). Lets schemes have been described as a method of "monetising favours", and are undoubtedly a simple form of private money. Lets system operators have not found any major legal difficulties with their currencies; they tend to convert Lets into sterling for tax purposes.

The growth of Lets in the UK has been rapid: there were only eight in April 1991, but by February 1992 there were 20 with 12 more being established at the time. In April 1993, Letslink, a body which provides information on Lets systems, claimed 45 member currency-schemes and expected that the number would pass 100 in the course of 1993.[26]

It should be emphasized that the authors of this report do not consider Lets to be a fully developed private currency. The adoption of such schemes by 'alternative economics' movements (based mostly on ecologist groups) is not a precedent one would expect the High Street banks to follow. Nonetheless, if Lets can spread at the rate which they have done since 1991, there is no reason to suppose that more professional, commercially-oriented currency-issuing enterprises would fail.

3.2 Overcoming objections to private money

The first objection that is usually voiced in response to suggestions for breaking the state's monopoly over the supply of money is that the private enterprise issuance of money would lead to widespread over-issue and monetary chaos. Underlying the 'competition = overissue' argument is a fundamental fallacy: that there can be only one kind of currency in a country and that competition means that its amount would be determined by several agencies issuing that uniform currency independently – so that there would be no clear barriers against over-issue, and every supplier would have an incentive to do just that.

True choice in currency, however, entails issuers supplying clearly distinguishable kinds of currency. The value of the currency issued by one bank would not necessarily be affected by the supply of other currencies by different institutions (be they private or governmental) any more than the overissue of dollars should (assuming floating exchange rates) adversely affect the purchasing power of the deutschemark.

Secondly, if a bank is to keep a large and growing amount of its currency in circulation (and hence increase its market share) it will not be the demand for borrowing it but the willingness of the public to hold it that is the critical factor. An incautious increase of the current issue (which would be quickly spotted by the commentators of the financial press) may result in notes flowing back to the bank growing faster than the public demand to hold them.

John Stuart Mill, in *Principles of Political Economy*, reviewed the actual experience of free banking:

> "The reason ordinarily alleged in condemnation of the system of plurality of issuers ... is that the competition of these different issuers induces them to increase the amount of their notes to an injurious extreme ... [But] the extraordinary increase in banking competition occasioned by the establishment of the joint-stock banks … has proved utterly powerless to enlarge the aggregate mass of the bank-note circulation; that aggregate circulation having on the contrary actually decreased."[27]

A further blow to the 'overissue' argument against choice in currency was delivered more recently by Benjamin Klein, who demonstrated that inflation due to overissue would be impossible where the brand names or 'trademarks' of the various privately issued token monies were protected from counterfeiting:

> "If the established firm legally possesses a trademark in its money ... the new firm's production [of money that is indistinguishable from an established bank's money] represents a violation of the established firm's property right and is called counterfeiting; lack of enforcement of an individual firm's property right to its particular name [its 'brand name capital'] will permit unlimited competitive counterfeiting ... this merely points up the difficulties in the usual specification of competitive conditions ... indistinguishability of the output of competing firms will lead to product quality depreciation in any industry."[28]

So, theory and practice both demonstrate that a money-producing bank that attempted to cheat its customers by deceitfully expanding (or counterfeiting) the supply of a brand of money would be punished by the competitive system, which correspondingly would reward a firm that operated to preserve its customers' choice and the value of its own issue. There is now a well-developed body of theory outlining how systems of competing currencies would work; economists such as Kevin Dowd and Lawrence White have built on the work of F.A. Hayek, and rediscovered writings on free banking theory by earlier writers.

3.3 Establishing a choice system

Much of the discussion of private – as opposed to government – money has focussed on how a system allowing choice in private currency would work once it had become well established. There has been little discussion of the practicalities of ending the existing state monopoly of the money supply.

There are a number of problems that would have to be overcome if such competition was to be successfully introduced. For a start, how do you persuade people to switch over to a new currency (even assuming that there are no legal obstacles)? Value, like beauty, is subjective and nothing better demonstrates this proposition than people's willingness (or lack of it) to hold a given currency. The fact of the matter is that the overwhelming bulk of the population are totally unfamiliar with the concept of non-government money and no amount of theoretical reasoning is likely to be sufficient to persuade them to hold a new and unfamiliar medium of exchange.

A second problem is the 'you first' phenomenon.[29] Suppose an individual in Manchester is convinced that everyone in the UK would be better off using deutschemarks. It would only be rational for him to switch over to deutschemarks if he expected others to switch as well. Hence, he is likely to start using deutschemarks only if enough other people have already made the switch, in other words, if there is a big enough deutschemark network in his area to compensate him for the loss of his pound sterling network. He decides therefore not to switch until this happens. But others in Manchester are just like him and therefore adopt the same decision rule; and so no-one makes the switch. The 'you first' problem means that everyone can be lumbered with a currency that they all regard as unsatisfactory.

People may continue to use a currency which is unsatisfactory, because alternative currencies are not widely accepted – and until they are, it is not worth switching to them. Indeed, reluctance to change may be such that people are prepared to put up with a highly defective and inflationary existing currency rather than risk changing to another.

The essence of the problem is familiarity. What is needed in order to establish any choice-in-currency system is to familiarize the public with 'private pounds' – since their unfamiliarity with private money will deter them from accepting currency from anyone other than safe, trusted, familiar institutions.

The network problem means that any new currency must be sufficiently similar to the existing Bank of England pound so that it can 'access' this network and yet be able to compete with it. In other words, free enterprise money does not entail a totally new and completely unfamiliar currency, but, if you like, a different 'brand' of the currency, based on a different (and hopefully more reliable) value formula or different commodity standard.

Another objection levelled at proposals for choice in currency is that the 'inconvenience' would outweigh any potential benefits. But the economic historian Hugh Rockoff has offered evidence which suggests that the benefits of a multi-issuer system may in fact outweigh the possible inconvenience to consumers. Rockoff suggests that the use of cheques for payments presents similar difficulties to the use of multiple types of bank notes (people receiving cheques must make a judgement about their quality) yet this is not reckoned to be a significant problem; mechanisms have been devised to simplify the process and reduce risks and costs.[30]

And indeed, the world market affords numerous examples of different currencies circulating side by side. Airports, major stores, hotels are already familiar with the concept of accepting payment in a whole array of currencies. In Luxembourg, shops will

accept payment in French Francs, Belgian Francs, German Marks, as well as the local currency, and give change in whichever the customer requires. Shopkeepers employ cash registers which translate prices according to the currency being used. The same is true of border towns across the world. Even children in places such as Singapore know the exchange rates for pounds, US dollars, Australian dollars and other frequently-used currencies.

3.4 Introducing competition in the UK

There are various ways in which competition could be introduced. A variety of possibilities involving monopoly, duopoly, or restricted competition exist, which fall short of unbridled competition but still enable some of the benefits of a private Bank of England, subject to competitive pressure, to be enjoyed.

The example of telecommunications illustrates how a carefully-devised policy of increasing competition can enable a relatively smooth and successful transformation from a state monopoly to a competitive and relatively free market. Whilst the analogy between telecommunications and money is by no means exact, there are some notable similarities, in particular that both industries rely critically on the existence of a widespread network of users and the wide acceptability and use of standards.

When British Telecom was privatized, the Office of Telecommunications Regulation (Oftel) was established, and provision made for restricted competition in the form of a regulated duopoly. (It is argued that full competition could not have been introduced immediately, due to the dominant position of BT and the inherent difficulities of establishing a rival network.) Mercury was allowed access to the BT network and was licensed to compete, initially in certain specified market segments. Both BT and the new competitor were subject to service obligations and other controls by the regulator. Following the successful growth of Mercury, Oftel allowed other competitors to enter the market, and liberalization of the UK telecommunications market continues.

The options for Ofbank

The Bank of England's initially privileged position would be of great benefit to its shareholders: its contract to supply currency in the UK would be its main initial asset. This would enable the Bank to be sold at a good price, but more importantly it would place pressure on the Bank to perform well and make good use of its privileges.

With the Bank under contract to produce price stability, the possibility must be considered that, if the Bank repeatedly fails to meet its contractual conditions, then the contract could be awarded to another institution. The possibility must be a *realistic* one if the Bank is to take it seriously. There must be alternative institutions willing and able to take on the contract, and willingness on the part of the government (though Ofbank) to take such a step.

The complete replacement of one supplier of currency with another would be a drastic step, and one that the government would understandably be reluctant to take. The alternative method of competition, that Ofbank should have the ability to license new

suppliers of currency to operate alongside the Bank of England and in competition with it, therefore appears preferable.

Ofbank would also have an important role in ensuring that technical barriers did not prevent competition, for example by reviewing the legal tender laws, contract law, and tax systems which currently are arranged to cope with payments in (Bank of England) pounds sterling. Whilst these technical issues are relatively easy to resolve, and do not constitute the main barrier to acceptability of a competing currency, they do have to be resolved and Ofbank is the ideal institution to do this.

There would be a number of different options initially open to Ofbank. The main options we envisage are:

- allowing Ofbank to license one or more competitors, even though it may choose not do this if the Bank of England meets its inflation targets;
- specifically establishing another supplier, either an existing institution or a new one formed for the purpose, to operate alongside the Bank of England;
- allowing limited competition, for example in certain geographical areas or for certain types of activity;
- allowing the Scottish banks to increase their fiduciary issue or break the link with English notes, generating genuine competition between Scottish and English pounds.

Any of these options could possibly be preceded by a period of monopoly for the Bank of England. This would enable the Bank to establish its new private status effectively. A period of regulated competition would enable many of the benefits of competition to be enjoyed, without raising any concerns that unregulated competition might lead to monetary chaos.

As in other cases where monopoly or near-monopoly utilities have been privatized and regulatory regimes established, the initial option chosen should be open to review in due course, for example after seven years of operation of the new system. The outcome of such a review would depend on the performance of the Bank of England and other licensed currency-issuing banks, public acceptability of competition in currency, and the desire of other institutions to enter the market.

The threat of entry

For the benefits of competition to be achieved, it is not essential that one or more competing currencies should appear immediately. A 'contestable' market where competitors but where there are no immediate competitors still keeps the pressure on suppliers. The mere *threat* that new competitors may enter the market is enough. Even in a situation of monopoly, the monopolist will not 'misbehave' if he believes that this will lead to competitors emerging. If, for example, the monopolist charges excessive prices or provides poor-quality products, then competitors will be attracted to enter the market in search of profits earned from providing better value to customers. Only where market

entry is not possible, due to technical or legal barriers, will monopolistic behaviour occur. Even technical barriers can be overcome in time; legally-enforced monopolies tend to be longer-lasting.

It is important therefore that Ofbank should have the power to license competitors to the Bank of England. Use of this power may not be necessary, but its existence would keep the possibility of competition on the minds of the directors of the Bank of England.

One policy option is that Ofbank would not license new competitors if the Bank of England fulfilled its contract criteria, but only if inflation rose above the permissible levels. Whilst actual competition would be preferable to potential competition, the market pressure to satisfy demand is present in both cases. Problems with the supply of Bank of England currency (for instance if it was over-issued and hence inflationary) would encourage other banks to issue their own currency, the supply of which they would individually control. In such cases, the Bank of England stands to lose part of its market share. Therefore, preventative action by the directors of the Bank of England can be expected as soon as the end of its monopoly in currency issue is announced. The result would be a Bank of England that was dynamic and orientated towards satisfying market demands before the onset of new competitors, instead of a government crisis-managment committee reacting to change, always after the fact.

There would however be some advantages in introducing a competitor even if the Bank of England was performing well. Future performance might not be so satisfactory, and etablishing a competing currency would inevitably take some time. A situation of regulated competition, established in conditions of low inflation, would enable the creation of an institution that would develop experience of managing a currency and become a viable large-scale competitor (or potential competitor) in due course. The options outlined above offer alternative approaches to this end.

3.5 Possible alternative suppliers of currency

For any form of competition, whether actual or potential, regulated or free, to be effective, there must be institutions capable of supplying a competing currency. There are many existing institutions which could fulfil this role.

Other countries' central banks supply currency for use in their domestic markets; it would be possible for UK citizens to use these currencies as well. At present, companies engaging in substantial overseas trade often have second bank accounts, denominated in another currency, in order to reduce their exchange risk. Foreign-owned companies operating in the UK often pay expatriate employees at a rate negotiated in their domestic currency rather than in sterling. With sterling inflation at relatively low levels, however, there is little incentive for wider use of foreign currencies.

The ECU could be adopted as a parallel or competing currency. John Major's proposal for a 'hard ECU' involved competition between the ECU and existing national currencies. The 'hardness' of the ECU means that it will not devalue in the same way as national currencies and therefore is likely to be adopted in preference to them over time. Variants of this proposal involve linking the ECU to a commodity basket rather than

national currencies. ECUs might be issued by private institutions or by a European monetary authority. In any case, a system involving the parallel use of the ECU as a common currency will involve competition. The network problem is reduced due to the ECU's attractions for cross-border trade: advocates of a parallel ECU recommend that all EC member state governments enable use of the ECU at once.[31]

The Scottish Banks (the Bank of Scotland, the Royal Bank of Scotland and the Clydesdale Bank) currently issue their own notes, a legacy of the period of currency competition in Scotland described in Chapter Four, as do the banks in Northern Ireland (The Bank of Ireland and Ulster Bank). The amount of notes they issue is at present controlled by the Bank of England. If this control were removed, they would be effective competitors as might potential newcomers to note issue, such as TSB Scotland.[32] The network problem is avoided – because the notes are 'pound' notes already – yet the notes are clearly distinguishable and branded. Accounts held at the Scottish banks could continue to be denominated in (Bank of England) pounds sterling or transferred into the bank's own currency, depending on the account-holder's wishes.

High Street banks might also wish to issue currency. Whilst Barclays, Lloyds, Midland, Nat West and TSB do not have the advantage of having their own-brand notes already circulating, the public is familiar with other financial instruments (cheques, credit, debit and cashpoint cards) which are branded by these institutions. As with the Scottish banks, the network problem would be avoided by the issue of 'branded' pounds. Indeed, the banks might wish to enter the currency-issuing business in order to safeguard customers' deposits against inflation, an attractive selling point for the banks.

Other financial institutions such as building societies are also potential issuers. Although their public profile is generally lower than that of the banks, these institutions have tended to be more dynamic and innovative in recent years. This capacity for innovation might extend to the provision of new currency.

Retailers are already using electronic banking technology to process payments and distribute cash to customers. With a major High Street presence, but facing stiff competition in their core retailing business, supermarkets might find it attractive to expand into banking and currency provision. We consider below how this might be done.

Whether under regulated or free competition, potential new suppliers of currency would have to resolve certain problems. In particular, they would need to decide on which monetary standards to use and how to encourage the public to use their notes. The remainder of this Chapter considers how new competitors might deal with these questions, and how retail chains could emerge as players in the currency-provision market.

3.6 Monetary standards

Any issuer of a new currency must consider the basis for its value. There has been much debate about the desirability of backing a currency with tangible assets, such as gold. During the 1970s and early 1980s, the wild fluctuation in the price of gold led to other options being examined.[33] Although recent price fluctuations have not been as dramatic,

there are grounds for pessimism about the adoption of gold as the single standard of monetary value.

In the first place the two major producers of gold are South Africa and the former Soviet Union. This concentration of gold production is a reason why there is relative stability in world prices: whenever the price rises a fraction, either the Russian authorities or South African producers unload a large quantity of bullion. Furthermore, gold depositories such as Fort Knox concentrate a considerable proportion of the world's gold stocks. The problem with this arrangement is that if gold became the standard of monetary value, Russian and South African producers, or the depositories, would have the ability to ransom the world economic order against the threat of major depression or inflation in the world bullion supply. This would seem to defeat the purpose of gold as an objective monetary standard.[34]

The second point to consider is the medium to long term stability of the former Soviet Union and of South Africa, both of which offer serious grounds for concern. The effect of a civil war in Russia or South Africa, leaving aside the possibility of both simultaneously, could be as disruptive as the oil crisis of 1973.

In 1976 Hayek proposed an alternative to gold: the 'Commodity Reserve Standard'. A bank issuing currency based on this standard would regulate the quantity issued so as to maintain parity with the price of a basket of raw materials at spot prices determined on the international commodity markets. Accounts and notes denominated in this standard (called, for example, 'Barclays Commodity Reserve Pounds') would be redeemed on demand for pounds sterling at a variable rate of exchange. A large number (forty in Hayek's proposal) of different quotations of internationally traded raw materials and foodstuffs weighted according to their turnover on world markets would form the basis for the basket. Provided the aggregate value of the basket is unchanged, the weighting could be changed to reflect real-world changes in trading patterns.

There are three broad advantages to the 'Commodity Reserve Standard' over gold as a basis for a currency. First, the basket is made up of widely traded commodities sold on regular markets; second, prices on these markets are promptly reported; finally, changes in monetary conditions are reflected more rapidly in raw material prices than in consumer prices. Early corrective action to forestall general price movements is made easier in this way.

The outcome of monetary freedom is not fully predictable. Nothing in the proposals here for commodity based monetary standards should be taken as excluding the possibility of other precious commodities being used, either singly or in a basket. For example, Alan Walters has proposed a bimetallic standard: a currency unit would be based on gold and silver, for example in a proportion of one ounce of silver for 0.02 ounces of fine gold.[35]

3.7 Retail chains as currency issuers

Various possible providers of competing currencies are considered above. Amongst the companies with the capacity to experiment with the introduction of private currency are

the mass retailers. These offer a wide variety of products, have an extremely high turnover of stocks, are amongst the most secure enterprises in times of economic crisis and are developing an embryonic financial sector. Marks & Spencer plc has a credit rating of 'AAA', which is better than many banks. In 1991, M & S made a profit of £11 million on its financial services activities. Most stores have 'own-brand' charge cards, some will cash cheques, and check-out till technology is ready for private currency.

Hayek's proposal was for a basket of durable commodities, the prices of which would vary individually but which together would form a standard that could provide overall stability. Whereas the discovery of a new supply of gold would cause disruption to monetary stability under the Gold Exchange Standard, a wide spread of (say) a hundred commodities would not be as easily upset. A retailer could achieve this stability by including in its standard the one hundred products with the highest turnover, for example. By offering a stardard comprised of finished products, customer confidence can be ensured. Offering the same quantity of products of a fixed standard of quality can be more easily explained to customers (and is of more practical value to them), than a pure commodity standard such as a collection of pieces of metal or other commodities. Whereas Hayek was looking for durability in his commodity standard, in this case turnover and overall stability of demand would be the guarantors of value.

If a store like Marks & Spencer already offers charge cards, with interest being paid for credit, the only remaining barriers to them becoming private issuers of currency are the threats of fraud, competition from other stores and restrictions on credit emission. The problem of fraud is largely solved by applying the same technology as is used to verify the status of credit cards at present, enabling a retailer to know whether the card has been stolen, whether it is genuine and the basic credit-worthiness of the customer. Widespread use of such devices offers the possibility of wider confidence in plastic money.

Some stores discriminate in their checkout facilities by offering special tills for their own brand of charge card and slower queues for 'outsider' cards. Following a Monopolies & Mergers Commission report,[36] ministerial orders have made it legal to offer different prices for cash users and card users. It is also legal to accept certain cards and not others. This offers mass retailers an opportunity to create an alternative to ordinary currency: plastic convertible currency. Provided that the Bank of England does not have the ability to prevent charge card users from offering preferential prices to cash customers, it is difficult to imagine how the development of this idea, based on such examples as the telephone card, could be opposed.

Already one can obtain tokens, the value of which is not directly linked to sterling, but to goods and services.[37] The Air Miles concept is a perfect example: the value of an 'air miles' token in sterling is nominal, whereas it does have a value in terms of air travel. Already several retail chains have used such devices as sales gimmicks. Burger King offered 'Burger King dollars' as a sales gimmick. These 'dollars' – promotional coins similar in appearance to a US dollar coin – were offered with change, and could be used to buy a hamburger in any Burger King store, despite the fact that prices vary in different parts of the UK. A number of other retail chains have offered a variety of promotional schemes whereby customers are awarded 'units' of some type which can later be exchanged for goods.

Thus a retailer could offer customers a free charge card which can store units of value (or credit points, stamps or tokens) that were pegged to a fixed quantity of specific goods and services available at that retailer or elsewhere. The take-up rate of such schemes could be enormous, given that at least 75 per cent of the UK's population uses one or several supermarkets. Retailers' staff are already offered bonus vouchers, redeemable as a discount on goods in the store. In fact, there have certainly been cases where these vouchers were traded by employees – for sterling cash – to non-employees. There is a demand for such a scheme which is partially being satisfied by a black market.

Already, retailers, banks and credit-card agencies market to their customers a wide range of services such as insurance and other products. Such a chain therefore has a market on which to launch a private currency and the skills to hold stocks of the appropriate commodities. The added marketing incentive of offering price-stability would only encourage greater stock control efficiency.

Many consumers use several retail chains on different occasions. Not only is this not a problem, it is an actual incentive to the development of a linked service similar to that which exists between many building societies for users of their cashpoint cards. Private pensions and benefit payment could be made electronically at the check-out till, reducing the administrative cost of such schemes and delivering the benefit where it is likely to be most needed.

In addition to vouchers, some sort of 'token credit book' (analogous to a bank cheque book) could be offered to credit-worthy customers. High Street banks could generate business by clearing these token credits in much the same way as banks currently offer foreign currency accounts.

The acceptability of 'token' money

We believe it is unlikely that new currencies would appear or be accepted overnight. During the gradual process of establishing a private currency, the issued certificates would not immediately be greeted by money users as currency. At the outset, they would be supplied to the public in the form of money substitutes, supplied under an explicit contract guaranteeing the bearer some minimum rate of exchange between these 'certificates' and one or more commodities or pre-existing currencies – just as is the case with Air Miles, trading stamps and other saving or incentive schemes today. Currency entrepreneurs would of course decide which commodities or monies to use in this process and users would then choose from among the alternatives offered.

Only later, after the issuing bank had fostered sufficient consumer confidence in its trademarked tokens by making the necessary investments in its 'brand-name capital', would the issued notes begin to take on a monetary life of their own.

The point marking this transformation is reached when currency users effectively acknowledge the new currency as 'monetized' by no longer routinely demanding that it be converted into another more liquid asset. Instead, transactors begin circulating the notes as an independent exchange medium in their daily business. At present, promotional tokens, vouchers and trading stamps are often traded informally. The point

at which some tokens become a currency is when third party transactions are openly carried out using them.

Individuals are willing to use 'tokens', even when these are only indirectly linked to sterling – telephone cards and the promotional tokens mentioned above are examples of this. It is possible to buy postage stamps which are marked 'first class', without a sterling price. Stamps of this type, bought when first-class postage was 24p, are now worth 25p sterling (an increase in sterling value of over 4%). Moreover, it would become possible for interested but wary potential users of new currencies to insure against falls in their value, in the same way as people can hedge against currency risk.

3.8 Conclusion

There are several political attractions in the proposals and suggestions that are set out in this report. The first and most obvious one is, we believe, the end of expansionary, inflationary monetary policies and the political unpopularity which must inevitably accompany the deflationary programmes that are then required to repair the damage. The government would no longer have to face the charge of 'boom-bust' economic management.

Secondly, stable money has other, less immediately obvious but no less important, political advantages. One of the main reasons why the issue of old-age pensions is so politically sensitive – and such a headache for a government – is because past governments have followed unsound monetary policies. As a result, many pensioners found that when they reached retirement age their savings had become almost worthless and, with a sense of grievance which was not wholly unjustified, looked to the government to redress the balance. We believe that our proposals would, in conjunction with the government's encouragement of private pension schemes, facilitate long-term and medium-term personal planning.

Last but not least, the determination of the exchange rate would cease to be a political headache. Not only would it cease to be something which the government would be under pressure to defend, but also 'pounds' issued by the Bank of England and other banks would be respected as stable currency units on the international money markets. This respect would, we believe, be reflected in greater exchange rate stability – something for which the government could, if it adopted our proposals, take political credit for having achieved.

Competition in the supply of currency is not only theoretically desirable, it has been shown to work in practice both in historical examples and – to a limited extent – in current practice. Chapters Four and Five describe the historical experience of competing currencies in more detail.

We believe that our proposals will, if implemented, transform the monetary culture of this country for the benefit of its people. We have charted a course which, we believe, will lead to the squeezing out, once and for all, of inflation.

4. The history of free banking in Scotland

Historical experience supports the theoretical arguments in favour of free banking. Far from being an unrealistic and utopian proposal, currency competition *has* worked in practice. The best researched case is that of Scotland in the early nineteenth century, the subject of this Chapter. Chapter Five gives a brief survey of other cases of free banking. Although less well-documented than the Scottish experience, they illustrate the wide potential for free banking.

The best documented case of competitive issue of banknotes, substantially free from regulation, occurred in Scotland from 1727 to 1845. Competitive note-issue was part of the everyday experience of Scottish commerce in that period, the product of the actions of profit-seeking individuals and companies in a framework of minimal regulation. Lawrence White's recent appraisal of the Scottish banking system suggested that it had several advantages over the English system of central banking in the usual fashion, including a lower rate of bank failure, better stability and retention of the value of money, and greater innovation in banking services.[38]

4.1 Banking in Scotland 1695-1845: a brief history

The Bank of Scotland, established in 1695, was granted a 21-year monopoly of note-issue in Scotland. It was the first joint-stock bank established by private individuals using private capital. The Bank of Scotland was forbidden from lending to the state, and was entirely independent of it. Bank notes had no privileged legal status, but were accepted because they were easier (and hence cheaper) to store and transfer than the equivalent amount in coins. The Bank established branches in Aberdeen, Dundee, Glasgow and Montrose in addition to its Edinburgh base, in order to spread its notes across the country.

Following the expiry of the Bank of Scotland's monopoly, the Royal Bank of Scotland was chartered in 1727. Not content to be an equal competitor, it launched a commercial 'attack', with the aim of forcing the 'Old Bank' out of business or into a merger. Large numbers of Bank of Scotland notes were collected, then suddenly and arbitrarily presented for conversion into coins, with the intention of provoking a run on the bank and hence forcing it out of business. However, this was expensive and unsuccessful, and the banks had to accept co-existence.

Because of the new competition, both banks became highly innovative, introducing the cash credit account (a form of overdraft) and the 'option clause' (giving the bank the option of deferred payment with interest as a protection from 'note-duelling') and employing regional agents to extend their operations by wider note-issue. The banks

agreed to accept one another's notes, eliminating the costly note-wars and enabling them both to concentrate their fire on the other banks that were becoming established.

Banknotes greatly extended the credit facilities available in Scotland, and £1 notes begun to displace gold and silver in smaller transactions. Adam Smith wrote that: "the business of the country is almost entirely carried on by means of the paper of those different banking companies ... Silver very seldom appears ... and gold still seldomer".[39] Scotland's banking system was arguably the most advanced in the world.

From 1745 onwards many smaller provincial banking companies were formed, and the existing small-scale private bankers in some cases began to issue banknotes. Stable provincial banking companies grew up in Glasgow, Dundee, Perth and Aberdeen. The first Glasgow banks, the 'Ship Bank' and 'Arms Bank', were initially sponsored by the Bank of Scotland and Royal Bank of Scotland respectively, in both cases to promote circulation of the Edinburgh banks' notes. However, the Glasgow banks began issuing their own notes, and managed to survive note-duelling tactics much as the Royal Bank had done previously.

In the 1750s and 60s, 'petty notes' began to proliferate, with notes for 10/-, 5/- and even 1/- being issued by private bankers and tradesmen. There was no legal restriction on such issues, and due to the chronic shortage of silver coin, people were prepared to accept payment in any form available.

The Bank of Scotland and Royal Bank of Scotland attempted to get legislation giving them 'an exclusive privilege of banking and of issuing printed notes' by negotiating with the government. In August 1763, they began proceedings to bring a Bill 'to remedy the growing evil of so many banking companies' before Parliament. The banks' London delegates were instructed to offer, if necessary, that the banks would each pay £1,500 annually to a government fund for economic development and that the banks would be willing to give up the controversial option clause in return for monopoly privilege, reflecting the potential value that the banks saw in such a privileged position.

Advocates of free banking, particularly the Glasgow bankers who would have been excluded from note issue by the plan, campaigned against this legislation. The government's response was a clear defence of free banking. The Privy Council committee delegated to deal with the question stated that:

> "the Trade of Banking is a matter not for Publick favour but of Right to every Subject in Common ... nothing that would have the appearance of an exclusive privilege in favour of the Banks would be listened to by the people of this country"[40]

Although notes under £1 and the optional clause were both banned, all banks continued to be free to issue notes. Adam Smith supported a modest degree of regulation but generally believed that the banking trade 'be rendered in all other respects perfectly free' and further wrote that:

> "the late multiplication of banking companies ... increases the security of the public. It obliges all of [the banks] to be more circumspect in their

conduct, and, by not extending their currency beyond its due proportion, to guard themselves against those malicious runs, which the rivalship of many competitors is always ready to bring upon them ... This free competition too obliges all bankers to be more liberal in their dealings with their customers, lest their rivals should carry them away."[41]

The benefits of competition in note-issue were widely recognised. An anonymous 1765 pamphlet explained that:

"as soon as a manufacturer shall amass five pounds, he will become impatient to get a note for it ... as such a sum will appear to him an object of importance, he will naturally choose to have the best note for it, and will then learn to distinguish between one note and another. This will effectually knock all inferior Banks on the head."

It was not easy for the established public banks to know what attitude to take towards the new banks. The proliferation had partly been inspired by their own failure to expand banking facilities. Note wars had proved expensive and unproductive, and their other attempt to prevent competition – restricting entry by legislation – had failed.

4.2 The development of the note exchange

The establishment of Douglas, Heron & Co. (the Ayr Bank) in 1769 catalysed institutional change. From the outset, it accepted all other banks' notes at face value, unlike the Bank of Scotland and Royal Bank of Scotland.[42] The Bank of Scotland decided that it must do the same, and in 1771 established a twice-weekly note exchange for this purpose, which functioned rather like today's cheque clearing system. The Bank of Scotland, and then the Royal Bank of Scotland, agreed to receive payments of the notes of reputable provincial banking companies. The Ayr Bank collapsed in 1772; yet this did not seriously impair banking development, despite causing the closure of a number of small private bankers at the time. The Ayr Bank's losses were met by its shareholders, and creditors, including noteholders, were paid in full. The note exchange (which had ceased to operate in the wake of the Ayr Bank collapse) re-opened in 1774, the Bank of Scotland accepting notes of all Scottish banks and also of the two Newcastle banks.

The note-exchange was of general benefit. In S.G. Checkland's words:

"There was now the possibility in Scotland of an automatic control on over-issue, through the very rapid return of notes upon the offending bank, together with an indicator of banking behaviour through the weekly balances at the note exchange."[43]

From a theoretical perspective, George Selgin shows that competing banks have a financial incentive to accept each other's notes,

"regular note exchange had advantages that guarantee that it will eventually be adopted ... Note duelling ceases to be advantageous to any

bank as all of them learn how to protect themselves … Because of this, banks soon find it more convenient to accept their rivals' notes only as they are brought to them for deposit or exchange. … rivals' notes are immediately returned at once to their issuers for redemption … The clearinghouses serve a variety of other uses, becoming 'instruments for united action among the banks in ways that did not exist even in the imagination of those who were instrumental in [their] inception' … the most important of the unintended effects … is their ability to regulate strictly the issues of their members through the automatic mechanism of adverse clearings."[44]

Selgin's theoretical discussion mirrors accurately the reality of the establishment of the Scottish note-exchange. The two public banks were in a very strong position, and were able to impose additional conditions on banks wishing to join the exchange, strengthening their self-image as the 'banking establishment' responsible for the overall conduct of the system. The public banks had established the exchange system in order to gain wider circulation for their notes, as a competitive strategy to use against the newer banks. Most provincial banks accepted that the note exchange conferred the benefits of increased public confidence and respectability, which helped convertibility and hence the acceptability of their notes, and hence joined it. As Charles Munn reports:

> "Some banks saw it principally as a limitation on the amount of business they could do. Others saw its potential as a controlling influence over the dangers of excessive note issue, and there is no doubt that it had a moderating effect on the volume of notes which a bank could keep in circulation."[45]

This was the view of the free banking school and many contemporary bankers. The exchange's success in preventing over-issue was commented on by the Scots bankers' evidence to the Parliamentary Select Committee of 1826, and explained by Archibald Bennett:

> "It is evident therefore that it is impossible for any Bank to issue Notes beyond that sum required for their Ordinary and real business with advantage to themselves, since any improper issue must immediately find its way to other Banks and be provided for in the course of a very few days with real funds."[46]

The vast majority of Scottish bankers and the press were aware that "the practice of exchanging notes … acts immediately and efficiently as a bar or check to the over-issue."[47]

By 1826, in addition to the three chartered banks (the British Linen Company being the third), there were 26 other issuing banks, with a total of 134 branch offices. Competition in note-issue provided an incentive for banks to have a broader regional base; they were able to spread risk more easily, and note-holders were demanding more widely-acceptable bank notes as inter-regional trade increased. The mature Scottish system was, because of the note-exchange, a system of one standard with many producers which, by all accounts, served Scotland well.

4.3 The monetary controversies, 1825-1845

Whilst banking in Scotland was largely successful and stable, the English experience was very different, with frequent failures of the English country banks. The worst case of this was in 1825-6, which brought down a number of England's most reputable country banks, many London banking houses, and scores of smaller banks. Virtually the entire country banking industry asked the Bank of England for assistance. Around eighty English country banks were declared bankrupt, and the Bank of England itself was, according to Walter Bagehot, "within an ace of stopping payments" due to depleted reserves.

The suggested cause of the English crisis was the £1 note, which circulated amongst the 'lower classes' and was issued by hundreds of insubstantial banks across the country. The solutions advocated were the abolition of £1 notes and centralising note issue (quite the reverse of the policy that helped Scotland avoid the same problems) and lifting restrictions on the English country banks.

The key regulatory difference between England and Scotland was the six-partner rule in force in England until 1826, which gave the Bank of England a significant advantage in note issue, and meant that the English country banks were far weaker than their Scottish provincial equivalents. L.S. Pressnell maintains that this legislation had the result of "depriving [England] of a banking system commensurate with a period of rapid economic growth".[48] Lord Liverpool, then First Lord of the Treasury, described the English system, in an address to the House of Lords on 17 February 1826, as "one of the fullest liberty as to what is rotten and bad, but of the most complete restriction as to all that is good ... Altogether the system is so absurd, on both theory and practice, that it would not appear to deserve the slightest support." Liverpool and the Chancellor of the Exchequer, in a January 1826 official communication to the Bank of England, contrasted this with the situation in Scotland:

> "[Scotland] has escaped all the convulsions which have occurred in the money-market of England for the last thirty-five years ... [this tends] to prove that there must have been an *unsolid* and *delusive* system of banking in one part of Great Britain, and a *solid* and *substantial* one in the other."

Proposed regulation in Scotland

It was, however, suggested that regulations prohibiting small notes should also be applied to Scotland. The Scottish bankers launched a vigorous political campaign against this suggestion, the most famous part of which was the three letters of 'Malachi Malagrowther' (a near-transparent pseudonym for Walter Scott), published in the *Edinburgh Weekly Journal* and immediately reprinted in pamphlet form.[49]

The letters concentrate on general issues of nationalism (suggesting that the English had "apparent hostility towards our municipal institutions ... tending to force and wrench them into a similarity with those of England") and on the technicalities of banking. Scott wrote that:

> "The facility which [the Scottish banking system] has afforded ... has converted Scotland, from a poor, miserable, and barren country, into one,

> where … Art and Industry have done more, than in perhaps any country in Europe."

He identifies the freedom to issue notes as being of crucial importance:

> "There is as little doubt that the Banks could not have furnished these necessary funds of cash, without … their own notes being circulated in consequence."

Scott also explains the importance of the note exchange system:

> "[All the Banks] … may be said to form a republic, the watchful superintendence of the whole profession being extended to the [system's] strength or weakness … at each particular point; … No new Banking institution can venture to issue notes to the public, till they have established a full understanding that these notes will be received as cash by the other Banks. Without this facility, an issue of notes would never take place, since, if issued, they could have no free or general currency. … The public have … the best possible guarantee against rash and ill-concocted speculations, from those who are … best informed on the subject … A check is thus imposed, which is continually in operation, and every Bank throughout Scotland is obliged to submit its circulation, twice a-week, in Edinburgh, to the inspection of this Argus-eyed tribunal … This important species of check is unknown to the practice of England."

Scott claimed that the Scottish system would not be applicable to England, citing the regulations on English banks such as the ceiling on the number of partners and the limited circulation of English notes (compared to Scottish notes, which, "although they cannot be legally tendered, are current nearly as far as York") which led to a situation where:

> "the profession of provincial Bankers in England is limited in its regular profits, and uncertain in its returns … [it is] therefore more apt to be adopted … by men of sanguine hopes and bold adventure … who sink [their funds] in mines, or other hazardous speculations … and deluge the country with notes which, on some unhappy morning, are found not worth a penny."

Scott's letters were not the only part of the campaign against the proposed legislation – petitions were sent to Parliament from every town and county in Scotland. A notable petition was sent by the citizens of Cumberland and Westmorland, arguing that the Scottish banks' freedom from the six-partner rule:

> "gave a degree of strength to the issuers of notes, and of confidence to the receivers of them, which several banks established in our counties have not been able to command. The natural consequence has been that Scotch notes have formed the greater part of our circulating medium."[50]

Opinion in Scots newspapers was mixed. Some were in favour of the change, largely on grounds of uniformity, and that the Scots system did not provide adequate protection

against bank collapses. However, even before the first Malagrowther letter, the Edinburgh *Observer*, *Advertiser*, and *Courant* all opposed the government, as did all the main provincial papers except the *Perth Courier* and *Dundee Advertiser*.

The public outcry persuaded the government to set up, on 16 March 1826, a committee to consider the question. Evidence presented to the Parliamentary Select Committee was decisive. The arguments put forward were twofold; that Scotland's self-regulating system worked very well, and that the issue of £1 notes was essential to it. The bankers put up a strong case, supported by much of the press and public opinion. The Bank Act of 1826 contained no regulations for Scotland; united and principled opposition had defeated the proposed legislation.

The Free Banking School writers

Accounts of the monetary controversies in England in this period, as seen in the 1810 Bullion Report and afterwards, normally focus on debate between the Banking and Currency schools of thought.[51]

Lawrence White identifies the Free Banking school as an important third strand in the debate. The Free Banking school, including Sir Henry Parnell, Samuel Bailey, and James William Gilbart, drew on Scottish experience, and held that the key factor was that of regulation, rather than those of stability and trade-cycles dwelt on by Banking and Currency school writers. This third group held that only a central bank could overissue, and that free banking with a note-exchange system, as in Scotland, would prevent this.

The views of this school are reflected in the views of many Scottish bankers and businessmen, who derived their approval for the Scottish system from a combination of such theoretical insights and their practical experience. The free bankers were described by *The Bankers' Magazine* of 1844 as "not less numerous and important [than the advocates of central banking]".

Increased Regulation, 1826-45

The period 1826-1845 was one of increasing privileges for the Bank of England and increasing regulation for the Scottish banks. In 1828, they were prevented from circulating their notes in England, despite petitions from English businessmen demanding that they should continue to be allowed to do so. In 1833, the Bank of England's charter came up for renewal, prompting discussion on the overall structure of the banking system. The 1833 Act strengthened the Bank of England's position by making its notes legal tender. This, in combination with other measures, further centralised note issue, and gave an impetus to the growth in England of non-note-issuing joint-stock banks. However, the joint-stock bankers, unlike their counterparts in the Scottish provincial banks, had insufficient experience and suffered heavy losses again in 1837-8.[52]

The rise of the Blair view

Probably the most significant development in the debate about Scottish banking in this period was the development of an establishment-corporatist view within the Bank of

Scotland and Royal Bank of Scotland of banking in general and the chartered banks' rôle in particular, which can be named the 'Blair view' after Alexander Blair, Treasurer of the Bank of Scotland, the prime force behind it. Blair, along with Thomas Corrie of the British Linen Company and John Thomson of the Royal Bank of Scotland, believed the three public banks should have the dominant position as – to quote Corrie – "national establishments", with provincial bankers following their leadership, as they thought had occurred previously. Their domination was now being threatened by the rise of strong, note-issuing, joint-stock banks, which also squeezed their profits. Blair believed strongly in the older banks' traditional responsibility to keep the system in order, as shown by the threats of exclusion from the note-exchange delivered against the Western bank.

Checkland describes Blair as "the most important Scottish student of banking theory and practice ever to come from among the professional bankers"; he certainly had a developed theory on many aspects of bank operation. His view was that all banks should be chartered and directly under state control. This would end freedom of entry, which the Scottish public banks had opposed since the 1760s. Blair was also insistent on the maintenance of adequate liquid reserves. He supported paper currency, and saw deposits, rather than note-issue, as the crux of banking theory.

Blair's programme implied far more state control and centralization than had previously been the case even in England. After 1845, Blair unsuccessfully proposed a merger between the three public banks to form a central bank.

4.4 The demise of free banking

In preparation for general legislation on banking in the 1840s, as in 1826, a Select Committee was formed. The Select Committee on Banks of Issue was appointed in 1841, and heard representations from interested parties, notably bankers. The main proposals concerning Scotland, enacted in 1845, were to regulate the note-issue of existing banks and prevent new banks entering the note-issuing industry. Opinion amongst bankers was divided as to the merits of the proposals. Whilst some were convinced to the importance of free competition to the success of Scottish banking, many – including influential members of Edinburgh's banking establishment – favoured regulating note-issue.

The clearest defence of the free banking position can be found in the Bankers' Resolutions of 16 April 1841. A General Meeting of the Bankers of Scotland passed eight resolutions, which they ordered printed for circulation so their views might be widely known. The resolutions, which provide probably the most comprehensive and straightforward defence of free banking from a contemporary perspective, were summarised as follows:

> "1. That the existing system of Banking in Scotland has been carried on prosperously for about a century and a half.
>
> "2. That the Scotch Banks are all Banks of Issue as well as Deposit; that the Currency of Scotland consists almost entirely of their

promissory notes ... [their obligations] to the public are amply secured.

"3. That the remarkable steadiness and moderation in amount of Notes in circulation in Scotland ... further demonstrates the great economy and safety of the system ... the free competition of Issues ... contains within itself protection against excess, through the control exercised by the Banks on the Issues of each other, combined with the action of the public at large.

"4. The Banks in Scotland allow a fair and uniform rate of interest to the Depositors ... [deposits are employed] in the form of Discounts or Cash loans to the enterprising and industrious

"5. Convertibility ... offers further security ... the periodical pressures and revulsions of trade ... do not arise from any derangement or irregularity in the state of her Currency.

"6. A single Bank of Issue ... would be the introduction of an expensive for a cheap system of Currency ... the real question is whether Scotland, which at present enjoys the most economical Banking system in the world, shall have an untried and expensive system arbitrarily imposed ... and be forced to submit to a diminished national prosperity and great extent of actual suffering.

"7. The extinction of the Notes of the Scotch Banks would necessarily compel them to withdraw their Branches from many of the rural districts.

"8. The question ... is not that of any particular *class*, but a national one ... competent and impartial witnesses should be examined, who are not intimately connected with Banking."

Such views were common amongst commercial men also, as shown by evidence submitted to the second Select Committee by the Glasgow Chamber of Commerce. The report expresses "surprise and apprehension" at the prospect not only of suppressing one pound notes, but also the "establishment of a single Bank of Issue". It cites massive public approval for the present system:

> "if there be one subject on which all classes in Scotland, from the Peer to the peasant, are of one mind, it is in approbation of that system of Currency ... it has even become a point of national pride to contrast with the less perfect practices of other countries. ... It seems somewhat extraordinary, that whilst Scotch banking has been the theme of general panegyric ... the system itself should be sought to be overturned, not on account of any practical defect complained of in Scotland, but from theoretical ideas of possible or contingent evils."

The directors of the Chamber of Commerce expressed their belief that note issue "is incapable, by any exertions of the issuers, of being extended beyond what the actual payments of the country require, and therefore stands in need of no regulation but what is inherent in itself". They believed that Peel's proposals were "altogether uncalled for as a regulator of the circulation, which is already regulated with the most accurate adaptation to the requirement of the country" and were "equally unnecessary for the security of the circulating medium which ... is held to be perfectly safe". Their case is summarised in five points: (1) the introduction of a single issuing bank would be unnecessary, (2) it would fail to attain the goal of eliminating trade cycle instability, since (3) the causes of this do not lie in note-issuing, and (4) it would "inflict a serious evil upon the agriculture, commerce, manufactures and general interests of Scotland" by (5) increasing "the trouble and cost of money transactions" and ending branch banking and cash accounts.

However, the establishment bankers, with a very different view of banking regulation, held the upper hand. There is evidence of collusion between the three chartered banks in accepting the regulations. This was a very rational position for the establishment bankers to adopt. As White suggests, Peel in essence bought the support of all existing banks by suppressing potential entrants and competition for market share. The regulation protected the existing banks' position because it would prevent new note-issuing banks becoming established.

Profitability under free banking was low due to stiff competition. By contrast, in a situation of regulated oligopoly, the existing banks could extract monopoly rent. The Edinburgh public banks had aimed, from 1763 onward, to gain this sort of insulation from potential competitors.

Likely losers from regulation, such as Scots businessmen and potential entrants into the banking industry, were not organised lobbies. In marked contrast to 1826, there was very little press complaint over the proposed regulation. Only the Edinburgh *Courant* took a strong stance against the abolition of Scots notes; the *Scotsman*, "while admitting that the proved stability of the Scottish system made interference less expedient than in 1826 ... argued against the indispensability of the small note" and supported Peel's proposals as a "small interference". By this time, the conventional view of state regulation of currency was very different from that of 1765. As an anonymous pamphleteer of 1875 put it:

> "A new theory of currency had been promulgated in England, the fundamental principle of which was that it was the prerogative of the State to issue paper representatives of money, just as it was its right to coin metallic money. This theory found favour with statesmen [despite it being] utterly unknown to the common law."

This view afforded a justification for the self-interest of bankers in securing monopoly privilege, and found favour with politicians due to the advantages for the state of a monopoly bank. Peel adopted it cautiously. He did not actually assert the State's right to issue paper, rather that "the wisest plan would be to *claim* for the State the exclusive privilege of the issue of promissory-notes" due to the "danger of unlimited competition in the issues of paper".

And so, Scottish banking was regulated in 1845 with an Act analogous to the English Bank Charter Act of 1844, prohibiting new banks of issue and limiting issue by existing banks. Whilst multiple issuing continued, the era of free competition in note-issue was over.

4.5 Conclusion

The role of empirical, anecdotal and critical evidence rather than purely theoretical arguments, in supporting the case for competition in currency, should not be underestimated. As Meulen writes:

> "[W]here people had the opportunity to experience in practice the different results of Scottish and English banking legislation, they arrived at decisions to which apparently no quantity of theoretical pamphlets could bring the rest of the English people."

Or, as 'Malachi Malagrowther' wrote in his third letter:

> "Here stands Theory, a scroll in her hand, full of deep and mysterious combinations of figures ... There lies before you a practical System, successful for upwards of a century. The one allures you with promises, as the saying goes, of untold gold, – the other appeals to the miracles already wrought in your behalf. The one shows you provinces, the wealth of which has been tripled under her management, – the other a problem which has never been practically solved. Here you have a pamphlet – there a fishing town – here the long-continued prosperity of a whole nation – and there the opinion of a professor of Economics, that in such circumstances she ought not by true principles to have prospered at all."

Contemporary opinion of the Scottish system of banking suggests that it was far superior to the highly-regulated system in England. Whilst it is dangerous to transform a historical topic such as this into a policy prescription for today's vastly different economy, the Scottish experience does indicate that competing currencies can be a practical alternative to a state monopoly of money, which repays closer study.

5. Free banking around the world

The Scottish experience up to 1845, discussed in the previous Chapter, is the best known example of free banking. But there are many other cases which illustrate that, far from being an impractical proposal, free banking has flourished and succeeded in practice.

Kurt Schuler has identified over sixty cases of free banking around the world, which lasted for periods from a few years to over a century. He identifies free banking episodes across Europe (including brief periods in Belgium, France, and Germany), in British colonies around the world, in South America and throughout Asia. Most of the free banking episodes he identifies are from the nineteenth century, but some cases of free banking continued until late in the twentieth century. By free banking, Schuler means "a banking system with competitive note issue, low legal barriers to entry, and no central control of reserves." Within this definition, the degree of regulation over banks and their currency activities within the free banking category varied considerably – Scotland and the UK colonies tended to be amongst the least regulated.[53]

Many of these examples also show that free banking comes to an end due only to state intervention; there is no market tendency towards monopoly currency issue. This contradicts the common assumption that central banks were established, at least in large part, in response to the defects of unregulated banking. Only eleven of the episodes identified by Schuler came to an end due to a crisis in the system.

Vera Smith gives a useful discussion of the 'hidden history' of the debates between free and central banking in the United States, the UK, France and Germany.[54]

Drawing on the Bibliography in Kevin Dowd's *The State and the Monetary System*, and Chapter One of Selgin's *Theory of Free Banking* in particular, we attempt below to outline some of the historical episodes of free banking.[55]

Table 1: Episodes of Free Banking

Europe		*South America*	
Belgium	1835-1851	Argentina	1887-1890
France	1796-1803	Bolivia	1887-1914
	1815-1848	Brazil	1836-1853
Germany	1821-1833		1857-1866
	1836-1875		1889-1892
Greece	1839-1920	British Guiana (UK)	1837-1951
Italy	1837-1894	Chile	1849-1850
Luxembourg	1873-1883		1854-1898
Malta	1809-1865	Colombia	1871-1886
Portugal	1850-1891	Ecuador	1860-1927
Spain	1844-1874	Paraguay	1889-1907
Sweden	1831-1901	Peru	1862-1887
Switzerland	1834-1907		1914-1922
United Kingdom:		Uruguay	1865-1896
Channel Islands	c. 1797-1914	Venezuela	1882-1940
England, Wales	c. 1668-1844		
Ireland	c. 1693-1845	*Africa*	
Isle of Man	1802-1961	Bechuanaland (UK)	1897-1921
Scotland	1716-1845	Mauritius (UK)	1832-1849
		Rhodesia (UK)	1892-1939
North America		South Africa (UK)	1837-1921
Bahamas (UK)	1888-1916	South West Africa	1915-1962
British Honduras (UK)	1904-1937		
British W. Indies (UK)	1837-1951	*Asia*	
Canada (UK)	1817-1933	Ceylon	1841-1884
Costa Rica	1863-1884	China	c. 1004-1935
	1902-1921	Hong Kong (UK)	1845-1935
Guatemala	1877-1926	India (UK)	1806-1861
Honduras	1886-1889	Japan	1600s-1882
	1912-1950	Macau	1800s-1944
Jamaica (UK)	1837-1958	Malaya (UK)	1850s-1908
Mexico	1864-1925	Philippines	1916-1942
El Salvador	1880-1934	Singapore (UK)	1846-1908
United States	1782-1914	Thailand	1888-1902
		Australia/Oceania	
		Australia (UK)	1817-1911
		Fiji (UK)	1860s-1914
		New Zealand (UK)	1840-1850
			1856-1933

Source: Schuler, in Dowd's *The Experience of Free Banking*, as cited above.
('UK' refers to British colonies for part or all of free banking period.)

5.1 The United States of America

The history of banking in the United States is particularly interesting, as there were a large number of experiments and different systems tried in different places at various times.

After the lapsing of the charter of the Second Bank of the United States in 1836, the federal government did not legislate on banking for almost thirty years, and the states pursued a variety of monetary experiments. A number of states, beginning with Michigan in 1837 and New York and Georgia in 1838, established 'free banking' laws. These allowed free establishment of banks, subject to a minimum capital requirement, but the banks had to secure their note issue with deposits of certain specified types of bond, and notes had to be redeemable on demand.

The experiments were successful in some states including New York and Louisiana, but other states suffered from the phenomenon of 'wildcat banking', whereby:

> "banks of very dubious soundness would be set up in remote and inaccessible places 'where only the wildcats throve'. Banknotes would be printed, transported to nearby population centres, and circulated at par. Since the issuing bank was difficult and often dangerous to find, redemption of bank notes was in this manner minimised."[56]

This produced a strongly negative memory of the free banking period, but it has been considered by some recent writers that free banking was more successful than traditional accounts suggest. Its degree of success was heavily influenced by the details of the regulatory system operating in each state in question. Some states adopted different banking arrangements, including a monopoly central bank or the prohibition of banks entirely. But 'free banking' did spread in the 1850s; over half the states had adopted some form of it by the outbreak of the Civil War.

The Suffolk clearing system is probably the best-known aspect of free banking in the period.[57] It was a note exchange system developed by the Suffolk Bank in Boston; banks which joined would have their notes redeemed at face value. The rapid return of notes to their issuer (as in Scotland) equalised the exchanges between notes of different banks and acted as a check on overissue. The Suffolk system proved successful, and spread beyond Boston to the rest of New England.

George Trivoli records how a free enterprise clearing system and a market 'central' bank not only operated profitably but also stabilized private note issuance. In New England, banks were free to issue their own notes (redeemable in gold). The free market note clearing system, known as the Suffolk Bank system, originated in the attempts of city banks to curtail the issues of out-of-town banks whose notes circulated widely in the cities of New England. The city banks were anxious to increase their market share, so the Suffolk Clearing Bank was founded in order to clear the notes of member banks and collect out-of-town notes for redemption. With the benefits of economies of scale the Suffolk Bank reduced the costs of redeeming out-of-town notes and curtailed the note issue of the country banks.

Member banks kept interest-free deposits of gold or silver at the Suffolk Bank, which was able to make profits by offering loans from these deposits and by charging interest on overdrafts. Whilst the member banks in need of emergency excess reserves could obtain overdrafts from the reserves on deposit at the Suffolk Bank, the Suffolk Bank had the power to insist on immediate payment of notes sent home for redemption in gold or silver coin. Unsurprisingly, this encouraged member banks to maintain conservative lending policies.

As a final resort, in cases of mismanagement, the Suffolk Bank could always remove the name of the offending bank from its list of New England banks in good standing. This was, as Trivoli tells us, "an action greatly feared by banks since it would immediately force its notes to a discount even though they were still redeemable in specie at the counter of the bank."[58]

Although overissue was thus prevented, the Suffolk system was sufficiently flexible to permit and facilitate a gradual increase in the money supply as the New England economy expanded.

5.2 Canada

During the nineteenth century, Canada's liberal banking laws allowed plural note issue; this enabled the development of branch banking and an elaborate clearing system, similar to the Scottish experience. After 1841, a bank required a C$500,000 minimum paid-in capital in order to receive a charter, and note issue was limited to that amount.

In 1908, the Canadian government monopolised issue of notes under C$5, but on a 100% marginal reserve requirement; hence such issues were non-inflationary until Canada left the gold standard. The Bank of Canada was established in 1935, and soon given a monopoly of note issue.

In the free banking period, Canada's banking system "suffered few crises and included some of the world's most prestigious banking firms. ... At the beginning of the Great Depression (several years before the Bank of Canada was established), when thousands of banks in the United States went out of business, the Canadian system proved its worth by not suffering a single bank failure."

5.3 China

Foochow, the capital of Fukien province, saw another episode of free banking. Following failed experiments with reckless issuing of government paper money as far back as the ninth century, it was decided under the Ch'ing dynasty to let note issue be a private undertaking. In Foochow, and some other cites, private banks flourished. This private paper currency was highly successful, unlike the government issues, and preferred to metal coinage. It grew in importance through the nineteenth century. Again, a note exchange operated, and notes of larger banks in Foochow circulated at par. Free banking was ended following the republican revolution of 1911.

5.4 France

Attempts by merchants to establish commercial currency-issuing banks were frustrated by government action. In the last years of the eighteenth century, a number of French banks issued notes. According to Vera Smith, "the freedom prevailing at this time in banking in France seems to have proved very satisfactory, but the march of political events destined this state of affairs for a short existence."[59]

Note issue was centralised at the end of the eighteenth century, but after the fall of Napoleon, local banks of issue were established in many towns, defying the Bank of France's monopoly. The period of competition was short-lived; after 1840 no further charters were granted to note issuing banks, and in 1848 the existing ones were absorbed by the Bank of France. There was, however, intense debate between advocates of free banking and those who wanted to see a centralized system.

5.5 Sweden

From 1831 to 1902, Sweden had an almost completely unregulated banking system. By 1902, there were 26 private banks issuing notes which competed successfully with Riksbank (the bank of the Swedish parliament) notes, despite taxes and restrictions on the private notes and the fact that only Riksbank notes were legal tender. As in Scotland, a note-exchange system was established, with notes accepted at par. According to L. G. Sandberg, the absence of banking regulations was crucial to Sweden's rapid economic growth in the latter half of the nineteenth century; this also mirrors Scottish experience in its free banking period.[60]

The government, resenting the loss of state revenue from the circulation of Riksbank notes, sought to restore a monopoly of note issue; the private banks' right to issue notes was formally ended in 1904.

5.6 Other countries

Spain had a relatively liberal banking policy until 1874, with many note-issuing banks which had a monopoly only in the province of establishment. Political factors turned the Bank of Spain from a financially conservative private institution into a fiscal agent for the state, and then in 1874, in return for a loan of 125m pesetas, the republican government granted the Bank a monopoly of note issue.

Italy had many issuing banks in the years following its independence. However, the government's need to deal with its immense debt led to an arrangement whereby all Italian banks were able to issue irredeemable paper for the purposes of monetizing the national debt. Italian economists including Fransesco Ferrarra and Guiseppe Di Nardi "suggest strongly that interference by the Italian government ruined what might otherwise have been a successful example of free banking," according to Selgin.

South Africa, Australia and *New Zealand* had plural note-issue systems, and also adopted central banking in the wake of wartime financial measures and governments' desire to borrow money on favourable terms. Until 1910, Australia had a number of note-issuing banks all adhering to a gold standard, and the banks set up a note-clearing system. In 1910, the Australian government authorised the issuing of legal tender government note; shortly after this, a 10% tax was imposed on private notes, and remaining restrictions on government issue were lifted. This gave the government a virtual monopoly of issue, which was followed by credit expansion and rapid price rises.

In the *UK colonies* generally, banking systems developed which tended to follow the Scottish pattern, albeit not by conscious design. Apart from India, banking did not begin in the colonies until the 1800s. Bank charters, relatively rare in Britain, were granted more freely in the colonies, with the chartering of new banks being a matter for political debate in many cases. Once local banks had been chartered, the British government was willing to grant charters to British bank promoters who agreed not to compete in England.

5.7 Conclusion

The examples described in this Chapter demonstrate that, in a variety of countries and for considerable periods, systems of banking have existed which did not rely on a monopoly state issuer of currency. Private banks, operating in conditions of competition, can undertake this task. Whilst a great deal more research is needed on many of these historical episodes, the evidence does seem to suggest that private and competing banks can successfully issue currencies as well as carrying on deposit-taking and lending activities.

Schuler identifies a number of characteristics common to many of the episodes he examines. There appears to be no market trend which transforms free banking into a centralised or monopoly system: the examples above, and others studied by Schuler, suggest that this transformation is the result of a political rather than economic process, and that in many cases it has led to a deterioration, rather than development, of the banking system. All the systems developed regular clearing systems, although few had formal clearing-house systems such like the Scottish note exchange. Despite the use of clearing houses as vehicles for joint action between the banks, for example to handle fraud or prevent banking panics, their use to form cartels was unsuccessful.

Schuler points to the record of free banking in producing price stability without monetary confusion:

> "Free banking systems maintained exchange-rate stability by giving people the right to convert bank notes and deposits into gold or silver at a fixed rate. ... There was not a proliferation of different monetary units; in fact, during free banking's heyday in the 1800s and early 1900s there were fewer major monetary units than there are today. ...
>
> "Because free banking was inherently a regime of convertibility into gold or silver, long-run price stability was greater than it has been under central

> banking, which has often begun as a regime of convertibility but has always become one of fiat money. Even a casual look at historical trends in price indexes confirms that long-run price stability was greater under free banking."[61]

As Schuler concludes:

> "Not long ago, most economists considered telephone systems to be natural monopolies, and justified state ownership of the telephone systems in many countries on the grounds that it was more efficient than private ownership. Today they know better. Perhaps they will change their minds about natural monopoly in banking when they consider the historical record of free banking."[62]

Notes

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