

Economic Regeneration through Banking Reform

A Report to the Chancellor of the Exchequer

by the

Adam Smith Institute



Adam Smith Institute

Introduction

It has been the common view since at least the second world war that the way to bring about economic growth in the poorer parts of Britain was through government intervention; through negative measures such as industrial development certificates, and through positive measures such as subsidies, grants, and cheap loans. Equally, it has been commonly argued that the way to generate growth in general is through increased government spending, financed as often as not through inflation of the money supply.

Both views have become progressively more difficult to sustain in the light of actual experience, of deprived areas remaining so despite the aid they receive (while the areas financing regional aid themselves decline), and of periodic bouts of inflation creating transient growth at the cost of long-term depression and unemployment.

But, if failure is the predominant feature of post war policy the example of an earlier period might well indicate the way forward towards a more prosperous future. Between 1750 and 1844, Scotland raised its standard of living from half that of England to somewhere near parity and did it without government activity, interference, or control. The engine behind that remarkable record of growth was a banking system free of all but the most minimal restrictions and isolated from the activities of any central bank.

From the start, Scottish and English banking differed dramatically. Whereas the Bank of England was founded in 1694 to lend money to the government, the Bank of Scotland was formed in 1695 to lend money to business (and indeed was prohibited by law from lending to the state). While the Bank of Scotland was given a total monopoly of banking within Scotland for only twenty-one years, the Bank of England enjoyed a much more privileged position. In England no joint-stock banks with more than six partners or shareholders were permitted. But that prohibition persisted until 1826, whereas the Bank of Scotland's monopoly lasted from that date, banking in Scotland operated for nearly 130 years on precisely the same footing as any other kind of business. Anyone who wished to establish a bank could do so and in 1716.

Freedoms and restrictions - the contrasting consequences

At a time when legislation is promised to complete the amalgamation of the trustee Savings Bank Movement into a new national joint-stock bank, when the Royal Bank of Scotland is integrating its operations with its English affiliate, Williams and Glynn, and when non-banking financial institutions such as building societies are increasingly offering banking-type services, it would seem appropriate for a radical review of the regime within which British banks have to operate and the consequences that regime has created for their customers.

Any bank which attempted to issue more of its notes than the public were willing to accept found that they were quickly returned for payment in gold or some more acceptable notes, a process facilitated by the early development of a clearing system between the banks that provided for a speedy return to their issuers of notes deposited at another bank. Excessive issue of

Competition brought almost immediate rewards. It was the Cottish banks who invented the concept of the overdraft and who pioneered branch banking. But, above all, the free competitive system brought monetary stability and economic growth.

and in 1727, all further banks were required to accept unlimited
accept them. After the formation of the Royal Bank of Scot-
land names were published, the customers and public could judge
ability on the part of their partners or shareholders. Since
themselves the likelihood of being able to meet that
ability should a failure occur. In fact, failures were rare
and in virtually every case all liabilities were met in full.
The collapse of the Ayrshire Bank in 1772, for example, left a
loss of £2/3 million, a spectacular figure for the time. It was
set in full by the bank's 241 shareholders. At the time of the
assage of the Bank Charter Act of 1844, it was estimated that
the total losses to the Scottish public had amounted to only
£32,000 - an insignificant figure compared to the losses incurred
by the customers of banks in England.

In England the restrictions imposed to protect the position of the Bank of England ensured that banks were largely local and small. While they were under the same pressure towards prudential management, they could not insulate themselves from the often irresponsible behaviour of the Bank of England. Behind the protection of its privileged position and the limited liability of its shareholders the Bank of England was periodically guilty of seriously overissuing its notes and then falling back on the passage of a series of Acts of Parliament to protect it from having to redeem them. Unfortunately for the private enterprise

restriction on the use of Scottish bank notes because of their greater strength and confidence. Cumberland and Westmoreland petitioned the government against any circulation of the notes of the local banks. Indeed, in 1826, citizens of to the notes of the local banks. Indeed, in 1826, citizens of Circulated freely throughout the North of England in preference to those of coinage in common usage well over a century before England followed suit during the first world war but also took the place of coinage in common usage not only favourably were Scottish bank notes regarded that they not only the drastically different situation in England. So much more upon favourability by Karl Marx among others, and contrasted with out the eighteenth and early nineteenth centuries was commented the remarkable monetary stability enjoyed in Scotland through-

The remarkable monetary stability enjoyed in Scotland through failure and the possibility of its proprietors having to meet the liabilities. The pressures operating to encourage prudence were powerful. Therefore, brought the guillity bank face to face with bank notes, therefore, brought the guillity bank face to face with

Despite the clear and obvious superiority of the Scottish banking system controlled by the Bank of England, the system gradually, to the present position of a centralized banking system which introduced the controls that have led, gradually but charactristic of England that led to the 1844 and 1845 legislation despite the free banking, it was the history of crises and failure system of free banking.

Only solution lay in reducing the issue to the point where redemption of notes for gold could be resumed. Therefore, conversion of notes by the Bank and that the problems was the overissuance of notes by the Bank and that the country's monetary problems, reported in 1810 that the cause of such was the chaos created by the Bank of England that the Bullion Committee, set up by Parliament to investigate the

Such was the chaos created by the Bank of England that the Bullion Committee, set up by Parliament to investigate the country's monetary problems, reported in 1810 that the cause of such was the chaos created by the Bank of England that the Bank in all closed their doors, an average of one in 250 per year.

banks, they could not escape the consequences of this irresponsibility.

The results were predictable. The number of joint-stock banks in Scotland have fallen to three although they still account for two-thirds of the bank notes in circulation there. In England, banking is now concentrated in the hands of the big four banks and no bank has retained the right to issue its own notes. The last to lose it was Fox, Fowler & Co., Ltd. of Wellington in

In neither country was the establishment of any new banks of issue permitted. With other restrictions this worked effectively to ensure that few if any new banks were ever created.

In England there were 279 banks entitled to issue their own currencies within England. Henceforth they were allowed to maintain the same level of issue only so long as they neither closed, merged with another bank or set up business within sixty-five miles of London, probably over the printing of bank notes. At that time, the Bank monopoly over the printing of bank notes. At that time, the Bank was already responsible for nearly two thirds of the notes circulating within England.

When the mid-nineteenth century controls were imposed Scotland had nineteen banks issuing their own notes. Henceforth they were to be allowed to maintain their issue at that level but any additional notes would have to be covered by gold (or later by Bank of England notes). Banks which merged could combine their entitlements, but any which went out of business lost the right.

unfortunate. Unfortunatelly, however, such innovation tends to be more attractive package of banking services than the banks themselves. It is now often the building societies that offer a better fitting their operations to the needs and demands of their members. More banking financial institutions that have demonstrated a distinctive loss of choice for the consumer and a reduction in both the variety and quality of service. Increasingly, it has been the results of this concentration of banking services has been more policies and Mergers Commission.

This centralization of banking into the hands of very few large banks operating overseas, the Standard Chartered Bank and the Royal Bank of Scotland as a base for their operations within Britain Hong Kong and Shanghai Banking Corporation to take over the Royal Bank of Scotland by the government after an adverse report from the were stopped by the government after an adverse report from the were significant entry into the United Kingdom. Attempts by British new banks and reinforced by barriers to overseas banks making a companies has been aided by the effective ban on the formation of GLYns Bank and is, itself 16% owned by Lloyds Bank.

In addition to this concentration within each of the two countries, there has been increasing collaboration across the border. The Clydesdale Bank is a wholly owned subsidiary of the Midland Bank, The Bank of Scotland is 35% owned by Barclays Bank while the Royal Bank of Scotland parent group owns Williams and GLYns Bank and is, itself 16% owned by Lloyds Bank.

Some set, which merged with Lloyds in 1921.

aimed at the individual consumer rather than at the industrial or commercial customer. The reorganization of the Trustee Savings Bank will certainly produce a welcome increase in competition to the established large banks. It has already shown a willingness to experiment that is in market contrast to the established conservatism of its competitors. It will, however, be competition strengthened only from a source that already exists. And, again, the establishment of new banks is currently so strictly controlled by the Bank of England that there is unlikely to be any significant increase in competition from new banking companies.

In these circumstances there is a clear need to rethink the whole basis of our banking policy with a view to restoring the freedom and competition upon which previous generations of banks flourished and funded the economic development of Scotland and, to a lesser extent, the rest of Britain.

would involve no cost to the Treasury nor any loss of control over the economy, since each note issued would have to be covered by a holding of Bank of England notes. It would, however, allow the TSB to compete with the existing joint-stock banks on fair and equal terms within Scotland where it will be little different in size from the Clydesdale Bank, itself also a subsidiary of an English bank.

Notes covered by holdings of Bank of England currency to all major banks operating in Britain. As already pointed out, the distinctions between Scottish and English banks are diminishing. With the establishment of the TSB, the creation of the integrated Royal Bank, and the wholly owned subsidiary status of the Clydesdale Bank, only the Bank of Scotland will be able to claim to be a purely Scottish Bank and even that is 35% owned by Barclays Bank. Scottish bank notes already circulate freely within England. Although they lack the status of legal tender and cannot be issued, even on request, by any of the English branches of the Scottish banks. Extending the right to such a non-fiduciary issue to all major banks would involve the Treasury in a minimal loss of income but would restore to the public a degree of choice in the forms of currency they used. It is likely, in the face of public demand, that the English banks would follow the lead taken by the Scottish ones to continue to produce £1 notes so long as the public preferred them to the unpopular £1 coin.

To go further and work towards the restoration of the

banking as it was practiced so successfully in Scotland for nearly 130 years, would require the existing banks should be given the right to issue their own bank notes without the requirement to hold an equivalent amount of Bank of England notes. It may be that the granting of that right to any individual bank should be dependent on the acceptance by its shareholders of the principle of unlimited liability, but it is by no means obvious that this is essential. In the Scottish experience, the two banks who enjoyed the privilege of limited liability accepted quite as responsibly as their more liable competitors, did not get into serious difficulty and, indeed, were often able to help out those who did. That they were the first two banks to be formed in Scotland and still exist today is striking evidence of their stability.

It would, of course, be possible for such a reform to be carried through without the Bank of England's right to issue bank notes being restricted. In our view, this would be undesirable. The presence of a state-operated competitor in any market is at best a distorting factor and can at worst be destructive. The knowledge that impudence or incompetence can always be bailed out by subsidies leads to unfair competition. Furthermore the tendency of all governments to inflate the currency from time to time would lead inevitably to some continuation of the unfor-

unate monetary policies we have suffered since the second world war and to the possibility of the serious banking crises created periodically in England during the eighteenth and early nine-

teenth centuries by earlier Bank of England irresponsibility.

What backing the banks choose to hold against demands for re-total note issue and might well be minute given the long established confidence in bank notes and the ready availability of past experience has shown, would be small in relation to the be so, particularly in the longer term. The amount involved, as their customers. While likely to be gold it need not necessarily demption of their notes would have to reflect the preferences of

activity creates additional beneficial effects elsewhere in the newly formed ones. And, of course, any increased economic and enterprise of the existing banks and the added initiative of national business activity created by the newly regained freedom further adds additional tax revenues will be generated by the addi-tional taxes the commercial banks will pay on their increased profits arising from the issue of unbaked bank notes. Yet staffing at the Bank. Part will be returned through the addi-tive. Part of the cost will be immediately offset by reduced once the transaction is made the final effect is likely to be could be phased in gradually to avoid any sudden loss. Moreover ment (through the Bank of England) £1,200 million the process while a complete loss of the note issue will cost the govern- prove attractive to the commercial banks.

except perhaps with regard to the issue of coins which might not by the ending of the Issue Department of the Bank of England, issue of bank notes to joint-stock banks should be accompanied for these reasons, any expansion of the right to a fiduciary

tion of the Bank of Scotland in 1695 up to 1841, the Scottish country and did so without significant failure. From the form sufficient to fuel the dramatic industrial development of the government interference. It provided services to its customers for 130 years, a banking system operated in Scotland free of

Conclusion

sectors or entirely new companies, were removed. banking, be they established institutions in other financial proposed reforms, it would help if barriers to new entrants to matched by the establishment of new companies. As part of our did not decline markedly. Amalgamations and closures were century controls were imposed, the number of banks fluctuated but dominated by a small handful of banks. Before the nineteenth the end result has been very restricted competition in a market no new banks were formed in the United Kingdom. As noted above, also removed. The Acts of 1844 and 1845 effectively ensured that in doing so if the barriers to the formation of new banks were England to near parity, it would be much more likely to succeed prosperity of Scotland in little more than a century from half of would stimulate the kind of enterprise that helped raise the while freeing the commercial banks from Bank of England control

less attractive than bank notes.

that now characterize the value of gold may well work to make it gold for anyone who wishes to buy it. Indeed, the fluctuations

banking public lost a total of only £32,000 through bank failures. Under the regulated English system, losses in London in 1840 alone were double that: and in England, a banking system restricted and controlled by the government with the Bank of England enjoying a privileged and protected central position in fact saw recurrent crises with widespread failures resulting from periodic inflation of the currency.

It was to deal with the difficulties created within England that the controls of 1844 and 1845 were imposed, and Scotland was forced to accept the same system. Henceforth, the Bank of England had an effective monopoly over the creation of money with the resultant government interference, both direct and indirect, that has created recurrent bouts of inflation and deflation with all the economic disruption they cause.

It is an appropriate moment to rediscover the Scottish experience of free banking and apply the lessons it has to offer to the Britain of the late twentieth century and the early twenty-first.