The Free Banking School

Subjects: Economics

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The Free Banking School is a term used for economists who study the costs and benefits of the competitive issue of currency by banks.

Austrian School Depository Institutions Business Cycle Medium of Exchange

1. Introduction

Members of the free banking school of thought tend to agree on one fundamental idea: if the invisible hand of the market works well in allocating most scarce goods and services, then it follows that the invisible hand of the market could be used to allocate the money supply for a society. Rather than establish central banks, which create monopolies over the money supply, commercial banks and market forces would determine the supply of money in circulation.[1]

Free bankers view the extension from competition for deposits, which already is a crucial part of any banking system, to competition for notes as a small step. As Steve Hanke (2007) puts it,

We do not usually think of deposits from different banks as being different types of currency, but in effect they are—at least, they are different brands of a common unit of account. By holding a deposit at one bank rather than others, a depositor is choosing that bank's management, portfolio, and services over those of its competitors.[2]

Thus, the move to competition in notes should be a small one for most banking systems, members of the Free Banking School would argue.

2. Agreement and Disagreement within the School

Many of today's free bankers have been heavily influenced by the writings of Ludwig von Mises, F.A. Hayek, and the Austrian School of Economics. Though influenced by many of the same people, there is plenty of disagreement within the free banking literature. For example, Austrian economist and free banking proponent, Murray Rothbard[3], believed any free banking system had to ultimately settle on gold or silver as the medium of exchange. By this, he meant that any non-commodity money's value must have originated as a commodity valued for a nonmonetary purpose. By contrast, Austrian economists F.A. Hayek[4] and Lawrence White[5] argue that free banking systems do not require any kind of commodity backing the value of the currency. Ultimately, this question is one that would be decided by what would actually happen if free banking were to occur again in practice.

Though there is plenty of disagreement among free bankers, the common ground shared by most free bankers is that individuals should be free to introduce their own currencies as they see fit. Beyond providing the government with basic company information, the currencies should not need any kind of certification from the government. Instead, their value and legitimacy will actually come from the main purposes they serve: acting as a medium of exchange, store of value, and unit of account.

In addition to being free from government certification, bank notes in a free banking environment are not controlled by fractional reserve rules. Each bank can freely set its reserve requirements and can deal with runs on its banks as it sees fit, instead of having to turn to a centralized authority like the Federal Reserve under extreme conditions. Over time, competition weeds out the most ineffective producers of currency and these producers are constrained by current competition and the threat of new competition.

3. Historical Evidence on Free Banking

One of the most successful experiments in free banking occurred in Scotland between 1716 and 1845; part of the period is documented in Lawrence H. White's (1995) *Free Banking in Britain: Theory, Experience, and Debate, 1800-1845*. Other experiments with fairly limited banking regulation include the era of state chartered banking in the United States and the period from 1892-1940 in Zimbabwe, which Steve Hanke has described as "among the least restricted banking regimes that ever existed."[2] Scholars such as Rothbard dispute this claim because the Bank of England was always in the background, able to provide liquidity if necessary.[6] Similarly, Tyler Cowen and Randall Kroszner question the use of the Scottish case as a true example of free banking given a number of regulations, such as barriers to entry of new banks.[7] While Lawrence White disputes this interpretation of the historical record, according to Briones and Rockoff "there is considerable agreement that lightly regulated banking was a success in Scotland."[8][9]

With the Second Bank of the United States failing to become rechartered as the national bank in 1836, the free-banking era in the United States began.[9] While there was no central bank or national bank that regulated banks, commercial banks were regulated under state law. During this period, states experimented with a variety of different regulatory arrangements, some of which allowed fren entry into banking and note issuance. Early accounts of this period frequently refer to wildcat banking as being the norm. A wildcat bank is one that prints more notes that it can continuously reedem. Beginning with the work of Hugh Rockoff,[10] monetary economists reexamined the United States experiment with free banking and found that the actual losses and failure rates under antebellum free banking were exaggerated; in other words, free banking was more successful than previously thought.[11][12] In addition to being more economically viable at an industry level, free banking in the US preserved the value of money throughout the 19th century.

Sixty historical episodes of multiple private note issuers across a number of countries have been identified by economist Kurt Schuler. [13]

4. Arguments Against

Critics argue that free banking is too complex. Moreover, they maintain that the natural direction of currencies is for less, rather than more. Federalism in the US and a common currency area across Europe are evidence that the overall benefits of a common currency (in terms of lower costs of making transaction) are greater than the benefits of solid but unique currencies. In addition, they point to US business cycles in the 19th century and argue that they were more pronounced than 20th century business cycles. Over time, then, centralization of banking helped eliminate inherent inefficiencies.

As aIn a way, however, these normative arguments against free banking are beside the point. When we look at the historical record, the rise of central banks and end of free banking appears to be driven not by normative arguments but because of public choice ones.[14]

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