The experience of free banking

Professor Kevin Dowd, Professor of Finance and Economics, shares...

So, what is free banking, I hear you ask?

Hint: it's not a contract with your bank in which your bank provides banking services for free. It's much more interesting than that.

A free banking system is a system of banking with no central bank, in which banks issue their own banknotes in competition against each other, and those banknotes are redeemable on demand against some precious metal such as gold or silver.

I suspect most of you haven't heard of it. I hadn't heard of it myself until I was a PhD student studying monetary economics, when I stumbled across it one evening in the University of Toronto library poking around the monetary shelves, as one does. My immediate reaction was that it must be crazy, but after a few minutes' thought I realised it was right. I was soon hooked.

I tried it out on my PhD supervisor at Western Ontario, who is himself a famous student of the late great Milton Friedman. I won't name him but let's call him David.

"I think I know where you monetarists have got it wrong," I told him, not too modestly. "You want to tell the monopoly issuer of the monetary base [i.e. the central bank] what it should do, but you shouldn't have such a monopoly in the first place!"

David was dismissive: "It's just a case of the monopoly of the monetary base," he said. "Now be a good boy and finish your thesis," he advised. His advice was wise, but I instantly knew he didn't get free banking.

I knew I was onto something!

A few others came across the idea at about the same time, and a new 'free banking' movement was born. It was (and still is) a small movement, however. We could just about fit into a taxi. And we didn't dare fly together, lest the entire movement be wiped out if the plane crashed.

Free banking wasn't really new either. It turns out that there'd been big debates about it in the past, especially in the 19th century. And all over the world too. The free bankers lost the argument (or should I say – not that I'm partial – were deemed to have lost, history being written by the winners), and they and our movement were gradually forgotten.

By the mid 20th century, all that remained in the collective folk memory of even the better American monetary and banking specialists was that free banking had somehow 'failed' because of the nefarious activities of 'wildcat bankers' who issued notes that could only be redeemed 'where the wildcats roam', and no-one wanted to meet wildcats when they went to their bank.

Then we rediscovered free banking and gave it a new breath of life.

Free banking systems produced stable prices, exhibited considerable financial stability and bank failures were rare. What's not to like?

The new edition of *The Experience of Free Banking* is a collection of historical experiences or case studies of free banking, mostly 19th century ones, and there were at least 60 cases worldwide. There are chapters on free banking in Australia, Belgium, Canada, Chile, China (two chapters in fact, Foochow and Manchuria, and I know of others), Colombia, France, Ireland, Italy, Peru, Scotland, Sweden, Switzerland and the United States in the period from the mid 1830s to the outbreak of the Civil War in 1861. The United States 'experience' is actually a collection of different state-by-state banking experiments in its own right and 'wildcat banks' are notable by their almost complete absence.

The Scottish case is poignant for me. As a kid growing up in Middlesbrough, I saw that Scottish bank notes were still highly regarded – a throwback to the old Scottish free banking system, although I had no idea at the time that it'd even existed.

These experiences show that historical free banking systems worked well – they produced stable prices, exhibited considerable financial stability and bank failures under free banking were rare. What's not to like?

The historical record also shows that free banking was much superior to the crisis- and inflation-prone systems of central banking that replaced them and performed so badly over the last century and more since.

If free banking was superior, why did it end, you might ask?

Easy: it was suppressed for a combination of ideological, political and most of all, fiscal (or government finance) reasons. You see, governments like to have a pet bank that can give them cheap loans or print money to hand over to them. That's why most (but not all) countries now have central banks.

If you want a policy conclusion, it's this: let's get rid of central banks and go back to a system that historical experience tells us works much better.

But there is a 'but' – and it's a big but too.

At our height in the early 1990s, I recall being at a big monetary conference in Washington DC where a senior Fed official declared that "The free bankers have won the argument" and there wasn't a murmur of protest. I was dumbfounded. We'd won, or so I thought. I started to wonder what I might turn to next.

By this point even Milton Friedman was won over to the intellectual arguments for free banking. However, as he put it around 1993, when the British-American journalist Peter Brimelow asked him about my proposal to abolish central banking, Friedman responded that free banking was correct in theory, but was not politically realistic.

He was right, unfortunately: we're nowhere near to getting free banking into the Overton window – the range of politically acceptable policy recommendations.

We have a banking system that we know works much better than the one we now have.

And that's the problem.

So, there you have it. A history of free banking from the side that lost the war but had the right arguments.

But rest assured, we will be back – but I may not live long enough to see it.

We have a banking system that we know works much better than the one we now have. We just need policy makers to be open to it, which might happen after the current system has collapsed entirely. There's always hope.

In the meantime, we can at least hold the flag to it. With that in mind, the book also has a literature guide for future generations of monetary and banking scholars who might be interested in getting into free banking – there's still much to be done.

The Institute of Economic Affairs will soon be publishing the second edition of *The Experience of Free Banking*, edited by Kevin Dowd. The first edition was published by Routledge in 1992.

Scan the QR code for more information on Professor Dowd and his research interests.
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