White's Free-Banking Thesis: A Case of Mistaken Identity

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Lawrence H. White's fascinating work entitled *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845* has had a not inconsiderable impact upon monetary economists. Everyone seems now to be, at the very least, aware of the issues relevant to the free banking versus central banking controversy. (Of course, White is not alone in his endeavors. See also the recent work of Rolnick and Weber,[1,2,3,4] Rockoff,[5] and Rothbard[6].) Furthermore, White's depiction of the Scottish system between the years 1695 and 1845 appears to have gone unchallenged as to its historical accuracy. This article examines several of White's key assertions, as well as several tangential ones, in light of the available historical documentation. Wherever possible, sources are quoted rather than paraphrased so as to reduce to a minimum any interpretive bias.

What emerges from the process is the realization that—rather than White's model of a laissez-faire system devoid of a central bank, solidly based upon the unquestioned convertibility of notes into specie, with each bank bearing its full liquidity costs by holding its own specie reserves—the Scottish system was *de facto* a central bank system in which individual private banks pyramided their note issues upon the reserves of the three chartered banks, which, in turn, pyramided their issues upon the reserves of the ultimate source of liquidity for the entire British Isles: the Bank of England. In short, White's thesis that the Scots enjoyed free banking fails to be supported by the evidence.

Parenthetically, I would like to point out that I draw these conclusions despite the fact that I am myself an advocate of free banking. White's theoretical model is elegantly stated and, furthermore, workable in the real world.

The author is indebted to Murray N. Rothbard for the suggestion that this line of inquiry might prove productive.

Review of Lawrence H. White, *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845* (Cambridge, Eng.: Cambridge University Press, 1984).

It is simply in trying to fit the Scottish experience to that model that White goes astray.

Convertibility of Notes

First of all, it behooves me to clarify just what is necessary if one is to have "free banking." White defines it as "the unrestricted competitive issue of specie-convertible money by unprivileged private banks" (p. ix). Vera C. Smith adds that (1) notes issued by such banks must be redeemable upon demand for gold and (2) such banks should not be able to "call upon the Government or any other such institution for special help in time of need."[7] It should be, in other words, a "system of 'each tub on its own bottom'," to quote White himself (p. 43).

There must be neither—if a given system is to be categorized as free banking—frequent refusals to redeem notes for specie nor regular recourse to a central bank in order to fulfill the bank's liquidity needs. Those needs should be met via "interbank lending of existing reserves" within the system.[8] Furthermore, notes should (if truly convertible on demand) trade at par with gold coin. Finally, as White claims for the Scottish banks, a free banking system should be conducive to stable economic growth rather than to successions of crises.[9]

Of the numerous citations that follow, the lion's share goes to the man who has written the definitive history of Scottish banking, Professor S.G. Checkland of the University of Glasgow.[10] Please notice that my reliance upon Checkland is fully consistent with White's own statements: in *Free Banking in Britain,* White refers to "S.G. Checkland's authoritative chronicle of the industry" (p. 33), while in personal correspondence, White declares that Checkland "*is, of course, the authority on the facts.*"[11] Other citations will be from Vera C. Smith, Adam Smith, Frank W. Fetter, Ludwig von Mises, and Henry Meulen—all mentioned in White's book.

Certainly a cornerstone of the Scottish system as White portrays it is the absolute convertibility of bank notes into specie upon demand. Admittedly, before 1765, Scottish banks sometimes failed to redeem on demand because they utilized the "option clause," which allowed the bankers (at their discretion, not that of the note holder) to delay redemption for six months in exchange for the payment of interest—usually 4–5 percent—on the notes held.[12,13] But what of after 1765, the year in which both the option clause and notes smaller than £1 were declared illegal?

Frank W. Fetter states that: "To a large degree there was a tradition, almost with the force of law, that banks should not be required to redeem their notes in coin. Redemption in London drafts was the usual form of paying noteholders."[14] Checkland confirms this:

> The Scottish system was one of continuous partial suspension of payments. No one really expected to be able to enter a Scots bank, perhaps especially a public bank [the Bank of Scotland, the Royal Bank and the British Linen Bank were publicly chartered institutions], with a large holding of notes and receive the equivalent immediately in gold or silver. At best they would get a little specie and perhaps bills on London.[15]

Checkland adds that: "Much emphasis was laid on the loyalty of the banks' customers—requests for specie met with disapproval and almost with charges of disloyalty."[16]

Henry Meulen—himself no friend to the gold standard—alleges that the typical Scottish banker "paid notes instead of gold to any depositor who might call, and was thus able to operate with a smaller reserve of gold than would otherwise have been necessary."[17]

Nor are these quotations the only such comments on the issue of convertibility. Meulen[18] and Checkland[19] both make additional comments that do not depart significantly from the statements already cited and that, therefore, will not be quoted here. The unambiguous nature of the foregoing compels one to question seriously White's claim that Scottish bank notes were redeemable in gold upon demand.

If notes were often not readily redeemable in gold coin, then one may fairly ask: why would bank customers be so willing to accept them? Why, in other words, was most Scottish business conducted entirely in terms of bank notes? (That this latter state of affairs was indeed the case is confirmed by Checkland,[20] Vera Smith,[21] and Adam Smith.[22]) The answer is of two levels. (1) The banks, in their quest for profits, sought the greatest possible circulation for their respective notes. To accomplish such circulation, they offered very easy repayment terms to those who had discounted bills of exchange and were willing to accept notes rather than specie.[23] (2) It became accepted practice for merchants who had received said bank notes to either require their employees to accept their wages in those notes rather than coin or to offer higher wages to those employees who were willing to do so.[24]

Notice what is implicit in the preceding: if notes were truly convertible on demand and, therefore, traded at par with specie—as White claims was the case—why were such inducements necessary? This suggests that notes perhaps did not trade at par. And, indeed, there is evidence that they did not. Adam Smith records that, in regard to transactions involving bills of exchange in the towns of Carlisle and Dumfries, notes traded at 4 percent below par because "at Carlisle, bills were paid in gold and silver; whereas at Dumfries they were paid in Scotch bank notes."[25] Meulen certainly concurs: "There were frequent instances of notes circulating at a discount for months on account of diminution of public confidence in the bank of issue and inability to apply for immediate redemption of the paper in coin."[26] As Mises

has stated with characteristic clarity, the only way to prevent money-substitutes such as notes from trading at a discount against money (gold coin in the British case) is to guarantee their prompt and unconditional conversion into money on demand.[27] Conversely, if one witnesses notes trading below par, one can safely conclude that the reason is the failure to redeem them for specie.

Privileged Banks

Recall White's definition of free banking as involving "*unprivileged private* banks" (emphasis is mine). At least one other commentator disagrees with White's claim that such a characteristic was present in the Scottish system. Checkland states categorically that "the three public institutions (Bank of Scotland, Royal Bank, and British Linen Bank) enjoyed limited liability [the private banks and the joint-stock banking companies were all subject to unlimited shareholder liability] and so were in a preferred position relative to all others."[28] Later he notes that "the State had created two public banks [and later added the third] and continued to confirm their preferred position, through their limited liability and through their public identity and perpetual succession."[29] To this can be added the observation that "there was a long-standing government instruction to the officers of the customs to accept only the notes of the chartered banks in payment of duties, and to 'refuse the Notes of every other bank without exception'."[30] Clearly, there were privileges held by the chartered banks that were denied to all others.

Along with these privileges, however, there apparently were attendant responsibilities. The three chartered banks were expected to function somewhat like local reserve banks for the private bankers and the joint-stock banking companies. Notice, for example, that during the 1797–1821 suspension of specie payments, the large private firm of William Forbes and Co. paid its depositors not with its own notes but with the notes of the public banks.[31] Indeed, "it became the custom of other banks, both private bankers and provincial banking companies, to hold part of their cash in the notes of the public banks, rather than hold cumbersome gold. When there was a demand for coin at crisis times, such banks would pay out such notes, telling their clients to go to the public banks for specie."[32] Fetter clearly confirms this when he states that "Scottish private banks held most of their reserves in the notes and deposits of the chartered banks of Scotland."[33] This practice would, of course, compel the chartered banks to maintain large liquid reserves on behalf of the other banks, this being a key manifestation of the "traditional responsibility of the older chartered banks of Scotland to keep the system in order."[34]

Furthermore, it should be pointed out that the few existing records of the public and private banks do seem to bear out the previously mentioned relationships. The average reserve ratio of specie to demand liabilities for six provincial banking companies was 10 to 20 percent in the late eighteenth century, but dropped to 0.5 to 3.2 percent in the early nineteenth century.[35] By comparison, the average ratio of investments and liquid assets to total assets for the Royal Bank and the Bank of Scotland for the years 1814, 1817, 1819, 1822, 1823, 1825, 1833, and 1838 was 48.4 percent as opposed to 35 percent for the three public banks together in 1802.[36] In other words, as the private banks and provincial banking companies continued to economize on specie by redeeming notes less and less often, the public banks held ever more liquid assets to serve as a cushion for the others. I want to emphasize here that the extant data are quite sketchy, so only the most general of conclusions can be justified; nevertheless, the data do not seem to contradict what one might expect given the foregoing quotes from Checkland and Fetter.

Stability of the System

What of the cyclical stability of the Scottish system? White refers to the "relative mildness of Scottish cycles"[37] and produces a table of bank failures (1809–30) in the English and Scottish systems, respectively, which demonstrates that the percentage of bank failures during that period was greater in England (1.81 percent to 0.40 percent).[38] First of all, I must comment that that percent difference does not seem tremendously large intuitively even though statistically the percentages are significantly different at the 1 percent confidence level. More importantly, if one reviews the entire "free-banking" period (1765–1845, according to White), the picture changes somewhat dramatically.

White depicts the Ayr Bank failure of 1772 as relatively minor in import, having brought about an increase in money demand in Edinburgh for less than a day, and as an incident that "did not imperil the Scottish banking system as a whole."[39] Checkland sees it a little differently. He maintains that "no less than thirteen Edinburgh private bankers fell with the Ayr Bank, never to rise again."[40] However, Checkland does agree with White that little permanent damage was done to the system as a whole.[41]

The point is that if one looks at the period 1772–1830 in regard to Scottish bank failures, one finds that the inclusion of the 1772 closures as well as the seven failures that occurred between 1773 and 1808 changes White's ratio noticeably.[42] The mean average of the annual Scottish bank failures per thousand banks becomes 13.28, whereas the comparable figure for English banks (1809–30) is 14.1 or 18.1—depending on whether one uses Gilbart's or

Pressnell's data.[43] But in either case, the failure rates of Scottish and English banks are now not statistically different at the 1 percent confidence level.

It also may be noted that financial crises seemed to hit Scotland very frequently—specifically, in 1762–64, 1772, 1778, 1787, 1793, 1797, 1802–03, 1809–10, 1818–19, 1825–26, 1836–37, and 1839.[44] Further, Checkland's description of the expansionary phases that preceded each "crisis" sounds much like the scenario of credit-induced malinvestment that lies at the heart of the classic Misesian business cycle. Checkland sums it up well when he states: "In principle, it [the Scottish system] should have been capable of stability or, at least, of fairly easy contraction. In reality, it was not."[45] Due, perhaps, to its being established upon the wrong principle?

And how, one may ask, did the Scottish banks extricate themselves from these frequent liquidity crises? Did they, as White claims, solve the problem among themselves via interbank loans?[46] Although such interbank loans do seem to have occurred, the largest and most frequent loans were from that paradigm of central banking, the Bank of England. I will cite but a few of the many examples of such loans. (1) In the crisis of 1793, a total of £404,000 was granted to several Scottish banks. (2) When the Ayr Bank failed in 1772, the first place it sought a loan—for £300,000—was the Bank of England. (After rejecting the Bank of England's terms, the Ayr Bank asked for £50,000 each from the Royal Bank and the Bank of Scotland—and was turned down.) (3) In November 1830, the "Royal Bank negotiated a credit with the Bank of England of £500,000; the Bank of Scotland, one of £200,000."[47]

To confirm that the foregoing were not isolated incidents, please observe the following summary declaration by Checkland: "By 1810, the Bank of England, short of the state itself, was the effective final arbiter of the supply of liquidity, both for England and Scotland."[48] Fetter adds that "it [the Bank of England] was also the holder of the nation's gold reserve. The country and joint-stock banks, and the Scottish and Irish banks, either directly or through the London money market, turned to it in time of crisis."[49] This certainly seems to establish the Bank of England as the lender of last resort for the whole British Isles rather than just for England, as White tends to argue. Furthermore, those who might object that recourse to the London money market does not necessarily imply recourse to a central bank need to refute Checkland's statement that the Bank of England directly controlled both interest rates and the supply of credit in London.[50]

In addressing the issue of how to gain monetary autonomy for Scotland (something White apparently thinks the Scots had throughout the period under consideration), Checkland, who clearly thinks no such autonomy existed, asserts that:

> most important of all, it would be necessary for Scottish banking to hold its own gold reserve . . . conversely, Scottish banking, by placing itself outside

> the London system, would relieve the Bank of England of the need to hold bullion reserves against Scottish demands for liquidity . . . [yet] a willing Scottish dependence upon London had been apparent from the founding of the Bank of Scotland in 1695 . . . The Scots in expelling their gold by the vigour of their note issue, basing their banking system on the latter, had made themselves ultimately dependent upon London liquidity.[51]

How such circumstances can fail to contradict any "free banking" hypothesis I do not understand.

Further Difficulties

The institutional link between the individual private banks and joint-stock banking companies, on the one hand, and the Bank of England as lender of last resort, on the other hand, seems to have been the three chartered "public" banks—the Royal Bank, the Bank of Scotland, and the British Linen Bank. I have already noted that the nonpublic banks often redeemed their notes and deposits in the notes of the public banks, rather than in specie (i.e., much of the reserves of the nonpublic banks were held in the form of public bank notes). Similarly, "the three chartered banks of Scotland kept their reserves largely in deposits with the Bank of England."[52] And apparently the chartered banks had a ready source of liquidity in the Bank of England, for Checkland says that "the Royal Bank had access to and credits from the Bank of England from 1728, whereas the Bank of Scotland did not gain such facilities until 1791."[53]

This suggests the potential for the pyramiding of an excessive note issue upon inadequate reserves, but it does not establish that such monetary expansion actually took place. Indeed, in the absence of any reliable economic data for Scotland separate from the rest of the kingdom, one could probably never demonstrate either the truth or falsity of such a proposition in a modern quantitative way. Nevertheless, one does have some qualitative evidence: "The Scottish banks had developed so compelling a set of means for getting and keeping their paper in circulation that, in non-crisis times at least, they could provide an extraordinarily high level of liquidity, with accompanying danger."[54] No less an authority than Adam Smith went so far as to say that "the circulation (in Scotland) has frequently been over-stocked with paper money . . . The Bank of England paid very dearly, not only for its own imprudence, but for the much greater imprudence of almost all the Scotch banks."[55]

Meulen asserts that "it transpired that at times when gold was being drained both from Scottish and English banks the Scottish bankers had not restricted their note issue, but had withdrawn gold from the Bank of England

to support their credit system."[56] Notice that this directly contradicts the fact that in a true free-banking system, even when a number of banks expand and contract their note issues together, a loss of specie from the system necessitates, *ceteris paribus,* a decrease in the total note issue.[57] Meulen's assertion seems much more in keeping with a central banking system in which there is a single lender of last resort, but a multiplicity of issuers of notes and demand deposits. This latter is what I believe the Scottish system actually to have been.

Two important means by which "free banks" allegedly compete are the discounting of commercial bills and the payment of interest on deposits. If it were the case that these operations were seriously constrained by law, then one might conclude that a significant characteristic of free banking was absent. That appears to be applicable to Scotland. In 1714, a Usury Law was passed which set an upper limit on interest paid of 5 percent. This law was not changed until nearly the end of "free banking"—1833—at which time, bills of exchange and promissory notes were exempted from its provisions.[58] Checkland declares that "the Usury Law limited competition for deposits"[59] and, indeed, its effect on "any form of advance was seriously prohibitive,"[60] which conclusion is also expressed by Meulen.[61]

Three additional inconsistencies should be noted. Admittedly, they involve tangential issues which are, by themselves, trivial; yet they are perhaps instructive in that they may reveal inadequate research on White's part. White claims that Britain's first bank to ever make public its annual report was the joint-stock Union Bank of Glasgow in 1836.[62] Yet Checkland, in his chapter on banking practices from 1810 to 1850, states that the officers of the public banks and the joint-stock banks were very secretive and that "none of the joint-stock banks printed and circulated their annual reports."[63]

Also, according to White's list of Scottish bank failures (1809–30), there were no failures in 1821.[64] However, Checkland states that in 1821, both the Galloway Bank and the Kilmarnock Banking Company went under.[65]

Finally, White declares that "private bankers in Edinburgh did not issue notes, whereas provincial banks typically were banks of issue."[66] In contrast, Checkland remarks that Edinburgh private bankers did indeed issue notes—although not before the 1760s and not in any great quantity.[67]

Conclusion

This article has examined in some detail the historical evidence regarding Scottish banking in the eighteenth and early nineteenth centuries. The focus has been upon the following question: is Lawrence White's contention that this period was one of free banking supported by other commentators? The

unavoidable answer—and one that I accept with regret—is that the evidence does not support White on several key points.

First and foremost, the Scottish banks do not seem to have actually practiced note convertibility (into specie). They also had frequent recourse to the Bank of England as their primary source of liquidity in time of crisis. The three chartered banks possessed both privileges and responsibilities that were not possessed by the private banks and the joint-stock banking companies. Overall, the system does not appear to have been very productive of stable economic conditions: expansionary, inflationary periods were followed with rapidity by contractionary, deflationary periods. The source of such fluctuations seems to have been largely the Bank of England, an observation consistent with the 1810 Bullion Committee's report that "the circulation of the Bank of England had an important influence on the circulation of the country banks and of the Scottish banks."[68] (As evidence of this, one may notice that, for example, in 1818, the Bank of England restricted both money and credit, and prices in Glasgow plummeted—sugar, grain and timber by about 33 percent, cotton by 50 percent—while commercial bankruptcies in Glasgow and Aberdeen hit new highs.[69])

But was this a straightforward central-bank system with one issuer of notes? Clearly not. There was indeed competition in note issuance as well as some competition (limited due to the Usury Law) in advances and deposit issuance. Yet there was, unmistakably, a single lender of last resort—a single ultimate source of liquidity. Thus, there also was some pyramiding of notes upon inadequate specie reserves. This was a hybrid system: part free banking, part central banking, possessing both the virtues of the former and the vices of the latter.

Notes

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11. Letter dated April 30, 1986; quoted with the permission of Lawrence H. White.
12. White, pp. 26, 29–30.
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14. Fetter, Frank W. *Development of British Monetary Orthodoxy, 1797–1875*. Fairfield, N.J.: Augustus Kelley, 1965, p. 122.
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19. Checkland, pp. 186, 222, 438.
20. Checkland, pp. 185, 236, 434.
21. Vera C. Smith, p. 22.
22. Smith, Adam. *An Inquiry into the Nature and Causes of the Wealth of Nations*. New York: Modern Library, 1937, p. 281.
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29. Checkland, p. 275.
30. Checkland, p. 186.
31. Checkland, p. 222.
32. Checkland, p. 186.
33. Fetter, p. 34.
34. Checkland, pp. 353, 360, 450–51.
35. White, footnote p. 43.
36. Checkland, pp. 240, 740, 741.
37. White, p. 44.
38. White, pp. 48–49.
39. White, p. 32.
40. Checkland, p. 132.
41. Checkland, p. 133–34.
42. Checkland, pp. 177–78.
43. White, p. 48.
44. Checkland, pp. 213–14, 403.
45. Checkland, p. 214.

46. White, p. 45.
47. Checkland, pp. 131, 219, 410.
48. Checkland, p. 276.
49. Fetter, p. 152.
50. Checkland, p. 447.
51. Checkland, pp. 447–48.
52. Fetter, p. 34.
53. Checkland, p. 76.
54. Checkland, p. 236.
55. Adam Smith, pp. 286, 288.
56. Meulen, p. 141.
57. White, pp. 17–18.
58. Checkland, pp. 192, 443.
59. Checkland, p. 432.
60. Checkland, p. 192.
61. Meulen, p. 92.
62. White, p. 36.
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65. Checkland, p. 406.
66. White, p. 33.
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