# F R E E and not so free B A N K I N G T H E O R I E S

# A M O N G THE C L A S S I C A L S

OR

## Classical Forerunners of Free Banking

## and Why They Have Been Neglected

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**Abstract**

The paper provides a critical reexamination of the history of free banking, arguing that the explanations for its decline proposed by some 20th century advocates of free banking (Vera Smith (1936) White (1984)) were incomplete. Both scholars considered Henry Parnell to be a classical forerunner of free banking, but I shall argue that they underplayed significant changes in his thinking and underestimated the extent to which these were due to theoretical weaknesses in his initial formulations. In order to evaluate Parnell's positions, and his proposed candidacy as a forerunner of the 20th century free banking school, I turn first to Adam Smith and to criticisms of his views on money and banking developed by Thornton and Ricardo. I then present Parnell's views as they evolved in his major texts of 1827 and 1832 and in his debate with McCulloch, and offer an interpretation of the decline of classical free banking positions, emphasising its analytical weaknesses. Finally, an analysis of the positions of the classical 'free banking school' and of the better known theorists associated with the Currency and Banking schools point to the one-dimensional interpretation offered by modern free banking advocates who overemphasise the importance of note issuing in the monetary system.

## I INTRODUCTION

Throughout the 20*th* century the application of *laissez faire* to money and banking was rejected by most economists and policy makers. However, in recent years a different view advocating the application of free trade to money and banking has gained support. Several modern advocates of 'free banking' argue that their view has forerunners in classical monetary literature. Some maintain further that the free banking approach was abandoned in the mid 19*th* century not because of theoretical inadequacies but because of the concerted opposition of 'interventionists' helped by the rise of the activist 'State'.

The laissez faire view of money and banking has been advanced in recent years both at the theoretical level, with several researchers attempting to prove the feasibility and efficiency of a competitive banking regime (e.g. Black (1970), Klein (1974), Hayek (1976), Fama (1980); for a recent review of the literature see Selgin and White (1994)), and at an historical level, where researchers have sought and examined precedents for such a regime (e.g. Sechrest (1991), White's response ($1991_b$), White ($1991_a$), Munn (1991), Dow and Smithin (1992) where references to other relevant papers can be found). White in his influential book (1984) emphasised the Scottish experience, and argued that not only was there a (successful) free banking regime functioning in Scotland before 1845, but that an important group of political economists during the 1820's and 1830's, the Free Banking School, approved of it. As did V. Smith before him, White singles out Parnell as a leading member of this school. Thus, White writes: "Parnell's [1827] should indeed be considered the first major work of advocacy by the Free Banking School" ((1984) p. 62). Vera Smith describes Parnell as "the chief adherent" of extending Free Trade to banking.[1]

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[1] The subject was discussed several times in the Political Economy Club. "This club had been founded by Tooke to support the principles of Free Trade, and it was not unnatural that reference should be made to the possibilities of extending Free Trade to banking. The chief adherent of such an extension was Sir Henry Parnell, who moved a discussion on whether 'a proper currency (might not) be secured by leaving the business of banking wholly free from all legislative interference'". Vera Smith (1936) p.

Several modern commentators have re-examined the historical case of Scottish banking and cast doubts as to whether it really 'proves' the case for free banking (Sechrest (1991), Dow and Smithin (1992)). However, White's claim to have significant ancestors in classical political economy during the 1820's and 1830's has remained virtually unchallenged, as has his explanation for the disappearance of this tendency from main-stream thinking.

Why did the Free Banking School lapse into near silence in 1844? One of the school's

> leading pamphleteers and spokesmen, Parnell, had died in 1842. It is likely that most of the others were, to put it baldly, coopted by the way in which Peel's acts offered to cartelize the bank note-issuing industry. (White (1984) p.78)

Thus, according to White, the Free Banking School lost the battle in the 1840's, and lapsed for so long into silence, due to coincidence and capitulation.

In this paper I provide a critical reexamination of this view, surveying some aspects of the history of classical free banking and, in particular, of its decline. First, I shall ask whether we can identify classical forerunners to modern free banking. Here I will reexamine Parnell's views, who was accorded such significance by both White and V. Smith, and discuss to what extent he really was a pioneer of free banking. In addition, I shall argue that there was an earlier free banking position, represented by Adam Smith and Ricardo before his "Plan for a National Bank" (1824) and shall ask why White chose to focus mainly on Parnell. Second, I shall reexamine the fall of the Free Banking School in order to develop the argument that this was due not only to the causes noted by White, but also to recognition of certain theoretical weaknesses. In this paper I do not discuss all the figures whom White cites as members of the Free Banking School. However, my analysis can be seen as a first step towards a critique of the view that a separate free banking school existed in the mid 19th century.

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In section 2 I briefly examine free banking as it is treated by Vera Smith and White. In spite of important differences between them, they agreed that Parnell should be considered a classical forerunner. In order to evaluate Parnell's positions, and his proposed candidacy as a forerunner of the new free banking school, we will have to turn first, in section 3, to Adam Smith and, very briefly in section 4, to several criticisms of Smith's views on money and banking (Thornton, Ricardo). In section 5 I follow Parnell's views as they evolved in his major texts and in his debate with McCulloch. In section 6, I examine the relations between the figures White described as 'free bankers' and the better known theorists associated with the Currency and Banking schools. I shall then be in a position in section 7 to offer a preliminary reevaluation of the relevance of the classical experience to modern free banking.

**II Vera Smith and White**

As noted above, the modern free banking school has many supporters, who differ among themselves in their theoretical and methodological foci. The departure point for the present paper is the analysis offered by White (1984) in his important work on free banking. Not only is White one of the leading modern advocates of Free banking, but he is also unusual in his historical perspective. White defined free-banking as a "system under which there are no political restrictions on the business of issuing paper currency convertible into full bodied coin" (1984 p. 1). Thus, according to White laissez faire in banking is equivalent to lack of intervention in the business of issuing convertible notes. Moreover, White interpreted the history of economic thought on money and banking as basically a reflection of different positions on note issuing. This led him to the novel argument that in addition to the familiar Currency and Banking Schools, one can identify among the classical political economists a separate Free Banking School, whose members advocated reforms in banking which would enable competition in note issue.[2] In this interpretation of the debates on money and banking since Adam Smith, White is, in fact, departing from a thesis developed by Vera Smith in her pioneering work entitled <u>The Rationale of Central Banking</u> (1936). While these two scholars share the same basic sympathy for free banking and criticism of central banking, Vera Smith did not interpret the monetary debates of the 19th century in such a 'one dimensional' manner. Reading her book carefully one will not reach the conclusion that note issuing was the main dividing subject, and that there was a separate 'free banking' school. Rather, Vera Smith finds supporters for Free Banking among both the Banking School and Currency School (see her table p.127 which is attached to this paper). However, despite this difference, to which I shall return later, one should clarify that on the major issue which concerned them both, that of Free versus Central Banking, V. Smith and

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2 For a concise and clear summary of White's interpretation see his scheme on p.135 (1984) in a table which is reproduced at the end of this paper.

White are very similar in both their definition and their advocacy of free banking.

Both Vera Smith and White identify the best mechanism for issuing notes as one where competition prevails; i.e. many issuers of convertible notes are free to act according to their discretion. From both analyses it is clear that their support for such a regime is based on several arguments:

A. the quantity of money in such a system, which in their view includes coins and convertible notes, will be the 'right' one. Such optimality is generated through an automatic mechanism where no authority interferes: If too many notes are issued, the holders of those notes will return them to the issuer, either directly or indirectly, through a clearing system. To prevent the threat to their solvency, and in particular to their gold reserves, the banks will not issue too many notes. Thus, it is the threat of gold outflows which plays the role of the regulator of the system as a whole. In this sense their argument is based on a mechanism similar to the famous specie-price-flow mechanism, which too is an automatic one.

B. Other forms of bank liabilities, e.g. deposit accounts, and bank assets, e.g. loans, should not be a target for those concerned with the smooth functioning of the economy. In other words, it is sufficient to determine the conditions under which money is created. The competing banks will then provide not only the right amount of money but also the right amounts of other liabilities and assets.

Taken together, this kind of reasoning put Vera Smith and White, their differences aside, in a unique position concerning the famous debates of the classical school to which we will soon return.

The mechanism at work under a regime where competitive banks issue convertible notes is described by Vera Smith through the exchange between Parnell (1827,1832), the chief advocate of free banking in her view, and McCulloch (1831), representing the interventionists. White also views Parnell as the pioneer of free banking. At this point one should note that other modern advocates of free banking (e.g. Glasner, 1985, 1992) trace their ancestry to Adam Smith. The lack of any reference to Adam Smith by Vera Smith, and the limited importance which White ascribes to him in the rise of the free banking tradition, is intriguing and will be discussed below. This discussion will also help account for the importance ascribed by both V. Smith and White to Parnell.

## III Adam Smith

Adam Smith is a natural departing point for classical monetary theory and in particular for issues such as the application of free trade to banking.[3] In The Wealth of Nations, in the fourth chapter of Book I entitled "The Origins and Use of Money" Adam Smith discussed money before he approached his main subject, the division of labor. In Book II Smith examined a system in which convertible bank notes existed alongside commodity money. Smith emphasized that reducing the quantity of commodity money (mainly gold coins) will increase wealth by transforming "dead stock" into "productive capital".

Smith described the well-known process which led to a mixed circulation. He insisted that as long as coins continue to circulate alongside convertible notes issued by the various banks, there will be no danger of surplus in the internal circulation, since the surplus will be exported, just as in the case of a pure commodity money circulation. However, Smith argued further that even if the entire circulation was composed of convertible bank notes, which cannot function themselves directly as international money, the right quantity could still be maintained as long as the many competing issuing banks act in a 'responsible' manner, which reflects their self-interest (see Smith (1776) pp. 310-11, 318-21).

Smith thought that as long as the quantity of notes in circulation corresponded to the needs of entrepreneurs for money to answer "occasional demand", there will be no surplus

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3 On Smith's monetary thought see Hollander (1911), Vickers (1975), Laidler (1981) and Gherity (1994).

in circulation.[4] Such desired correspondence could be achieved by the simultaneous use of two methods. First, banks issuing notes should give loans against "real bills", defined as bills which represent real transactions: sales of commodities on credit, between two respected dealers, who promise to transfer money and repay the debt within a short period. This is the essence of Smith's well-known Real Bills Doctrine.[5] The second method he recommended, known as "cash accounts", was popular in Scotland, and in Smith's view had contributed to the development of the Scottish economy in the previous 25 years. In modern terms, this method involves the opening of a credit line by the bank to a dealer able to provide "two persons of undoubted credit and good landed estate to become surety for him" (p. 316). The bank allows the dealer to withdraw any sum up to this limit whenever he wants --an authorized overdraft.

As long as the banks follow both methods--discounting only real bills and opening cash accounts--the <u>right quantity of notes</u> in circulation will be maintained. Smith noted that these methods are exactly those which follow from the banks' own self-interest (ibid pp. 319-20)[6]. However, Smith does not clarify why the quantity of notes so issued will

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4 "What a bank can with propriety advance to a merchant or undertaker of any kind, is not either the whole capital with which he trades, or even any considerable part of that capital; but that part of it only, <u>which would otherwise be obliged to keep by him unemployed, and in ready money for answering occasional demands</u>" Smith (1776) p.322-3. My emphasis.

5 "When a bank discounts to a merchant a real bill of exchange drawn by a real debtor, and which, as soon as it becomes due, is really paid by that debtor; it only advances to him a part of the value which he would otherwise be obliged to keep by him unemployed and in ready money for answering occasional demands . . . The coffers of the bank, so far as its dealings are confined to such customers, resemble a water pond, from which, though a stream is continually running in . . . the pond keeps always equally, or nearly equally full" (Smith, [1776], 1976, pp. 322-323). For a critical review see Mints (1945) and for a different view about Smith and the Real Bills Doctrine See Perlman (1986).

6 For a different interpretation see Laidler (1984). However, Laidler does not relate to the statement made by Smith that this type of behavior reflects the self interests of the individual banks and not just imposed legal restrictions.

correspond to the "ready money ... for answering occasional demand" mentioned above. A possible explanation is related to the statement that "The whole paper money of every kind which can easily circulate in any country never can exceed the value of the gold and silver... which... would circulate there, if there was no paper money". The mechanism which Smith describes, though not by name, is similar to the Banking school's 'law of reflux': the excess notes will return to the banks, exchanged for gold and exported (ibid pp 318-9).

Smith's opposition to notes of low denomination was the only limitation he imposed on the principle of free trade in banking assuming convertibility and such a loan policy. The main justification for this position was the protection of the weak. Since consumers cannot be expected to distinguish between "responsible" and "mean" bankers, they should be protected against bankruptcies by provisions which would ensure that transactions between consumers and dealers--which involve small sums--be conducted in coins alone.[7]

It is important to note that Smith distinguished, albeit not systematically, between money and credit. In his terms, coin is money and convertible bank notes are called paper money (p. 310). These latter have a dual function. On the one hand, they are substitutes for coins and thus function as money, but on the other hand, they are issued by the banks as loans, and thus function as credit. However, in spite of this, it is clear that for Smith notes function primarily as money, i.e. they were first and foremost a close substitute for coins. The right quantity of commodity money is determined by the distribution of precious metals in the world. The right quantity of convertible bank notes is determined so that, together with the quantity of coins in circulation, it will equal the right quantity of a pure

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7 Smith was aware that this limits free trade and "may no doubt, be considered as in some respect a violation of natural liberty." However, he justified it thus: "But those exertions of natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments; of the most free, as well as of the most despotical. The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty, exactly of the same kind with the regulations of the banking trade which are proposed." (Smith [1776] 1976, pp. 344-345). See also Gherity (1994) for a detailed review concerning the development of Smith's position on this issue.

commodity money circulation. Thus, the banks, under the above-mentioned weak limitations, can be left to compete both in discounting real bills and in opening credit lines. In other words, Smith accepted competition in note issuing and thus saw no need for the intervention of any central body in determining their right quantity.

One should note that the Bank of England was a private bank and should thus be subject to the same principles of competition which applied to any bank. However, Smith recognized that it was not just a private bank, but also an "engine of state", dealing with state debts and taxes, whose actions sometimes resulted in overstock of banknotes in circulation through no fault of the managers. The Bank of England also assumed responsibility for the miscalculations of other banks since it converted their notes into gold when they overissued (p. 322). Although Smith was not explicit on the application of the Real Bills Doctrine to the Bank of England, this does not change his general support for free trade in issuing notes. Increases in the number of banks and in the competition between them contribute to greater caution on the part of the bankers, to less danger of "malicious runs" and to greater protection for the public. Smith's conclusion is clear: subject to convertibility and limitations on low denomination notes he saw banking as one of the trades and, as always, supported competition. Thus, Smith's position on banking can be described as an extension of his famous invisible hand argument to include this economic branch as well. In a paragraph, which the Free Banking School supporters often quote, Smith stated:

> "This free competition too obliges all bankers to be more liberal in their dealings with their customers, lest their rivals should carry them away. In general, if any branch of trade, or any division of labor, be advantageous to the public, the freer and more general the competition, it will always be the more so." (Smith [1776], 1976, p.350).

**IV Criticisms of the Invisible Hand Position:**

**Thornton's (1802)** and **Ricardo's (1824).**

The belief that a competitive banking system will provide the necessary conditions under which England will prosper was put to the test in the coming decades. The instability in the economy, including the recurring incidences of financial as well as more general, crises, was blamed, at least in part, on the banking system. The most dramatic incidence, in February 1797, resulted in the suspension of cash (specie) payments throughout Great Britain, but instability occurred also before that year (1783,1793) and after. The theoretical explanations for the fragility of the financial system from 1797 and till 1821, when convertibility was again in effect, known as the Restriction period, intertwined with policy recommendations as to the return to gold. During the Restriction it was hard to distinguish between analysis of the then inconvertible system and analysis of convertible systems which is the focus of this paper.

The application of the Smithian position implied a return to convertibility and continuing laissez faire in banking. But the theoretical doctrine on which this view depended came very soon under severe attack. One of the better known criticisms of the Real Bills Doctrine and the Smithian approach to money and banking was provided by Henry Thornton in his An Enquiry into the Nature and Effects of the Paper Credit of Great Britain (1802).[8] In this study, which was often cited by his contemporaries and clearly influenced the Banking School[9], Thornton explained why it was not possible to control the quantity of notes via an automatic mechanism or a simplified rule alone. The right quantity of notes in circulation, he argued, depended on various economic conditions which the Bank had to assess; in the light of this assessment the Bank then did its best to reach that

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8 Thornton's criticism of Smith's formulations can be found throughout the book; see in particular chapter 2 pp. 82-89.

9 Concerning the neglect and re-discovery of Thornton see von Hayek's introduction to the re-issue of the Paper Credit in 1939 [1978]. For another view concerning Thornton's role in the development of classical monetary theory, and in particular his influence on the Banking School, see Skaggs (1995).

quantity. Thus, the Bank of England had to control the quantity with more than the exclusive guidance of either gold or the Real Bills Doctrine. Thornton was a pioneer of the modern concept of central banking and hence stood in clear opposition to the application of laissez faire in banking.

> "It has been evinced, however, in the present Chapter, that we derive a material advantage from the power enjoyed by the Bank of England of exclusively furnishing the paper circulation of the metropolis. ... If a rival institution to the Bank of England were established, both the power and the responsibility would be divided; and, through the additional temptation to exercise that liberality in lending, which it is the object of competition to promote, the London notes, and also the country bills and notes, would be more liable to become excessive. Our paper credit would, therefore, stand in every respect on a less safe foundation." (ibid. PP. 228\9)

Thus, the Bank of England can and should direct the system according to macroeconomic considerations. Monopoly has some advantages, since the existence of rival institutions restrict the power of the Bank and increase instability. This 'modern' analysis stood in clear contrast with the passive Smithian tradition.[10] Thornton's discussion "Of Country Banks- Their Advantages and Disadvantages" in <u>Paper Credit</u> (chapter 7) is carried out within the framework of an organised banking system, where the Bank of England plays a central role. Though country banks contribute, of course, to the wealth of society, they cannot, according to Thornton, regulate themselves. His position on this issue is explicitly different from that of Adam Smith, which is the target for criticism.

Part of the explanation for the huge difference between Adam Smith and Thornton can be found in the changes in the structure of banking. During the last quarter of the 18th century there were many more country banks, the London bankers stopped issuing notes, the usage of checks increased and in London a clearing house was established. In addition

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10 See also Hicks (1967) chs. 9 & 10.

the Bank of England established itself as the banker's bank. Moreover, the disturbing phenomena of crises which was not central to Smith, became the focus of many 19th century economists, among them Thornton (see Hayek 1939 pp.37\8).

Ricardo's famous pamphlets on monetary issues were mostly written during the Restriction Period, when notes were inconvertible[11]. For our purposes, his views on a convertible system are more interesting. These are summarized in his 1824 text written after the Resumption, when notes were made convertible again[12]. In this posthumously published Plan for a National Bank Ricardo first distinguished between the two functions of a bank: to issue notes and to act as an intermediary. Furthermore, Ricardo believed that these functions should be carried out by two distinct bodies, directed by quite different principles. The first body, labeled the Issuing Department (of the Bank of England) will be the sole issuing bank responsible for the creation (and destruction ) of convertible notes. It will be guided by a strict rule: always exchange gold for notes and notes for gold at a given rate of exchange. The amount of notes would be the correct one, since these would be given only "in exchange for gold at the price of £ 3 17s 10½d per ounce," and not against discounts. Thus, "regulating their issues by the price of gold, the commissioners would never err" (IV, pp. 293). The commissioners in charge of the Issuing Department do not have to lend to the government, which should finance itself. In addition, at this point Ricardo demanded that country bank notes be withdrawn from circulation (IV, p. 287, the seventh proposition). Thus for the first time since Ricardo started writing on monetary issues he clearly rejected

11 Ricardo's most important texts on monetary questions during the Restriction were: The High Price of Bullion (1810, III, pp. 45-127); Reply to Mr. Bosanquet (1811, III, pp. 45-127); Proposals for an Economical and Secure Currency (1816, IV, pp. 43-141); all in the Collected Works and Correspondence edited by P. Sraffa in collaboration with M. Dobb.

12 Plan for the Establishment of a National Bank (1824, IV, pp. 271-300). See also Sayers (1953) and Arnon (1987).

competition in issuing notes, and departed from the Smithian approach. Only the second separate body, the Banking Department, will be free to act as any non-issuing bank: i.e. to maximize profits by lending the funds it can raise.

Ricardo's proposals, which called for a change in the institutional framework under which the banks then operated led to an effective monopoly in issuing notes. It seemed that the directors in charge of this monopoly, who were guided by the above rules, were to have no responsibility apart from handling their own banking business. However, in this last text Ricardo allowed the Bank's directors certain discretionary activities with its securities.

"If the circulation of London should be redundant, it will show itself by the increased price

> of bullion, and the fall in the foreign exchanges, precisely as a redundancy is now shown; and the remedy is also the same as that now in operation; viz. a reduction of circulation, which is brought about by a reduction of the paper circulation. That reduction may take place two ways; either by the sale of Exchequer bills in the market, and the cancelling of the paper money which is obtained from them,--or by giving gold in exchange for the paper, cancelling the paper as before, and exporting the gold." (IV, pp. 296-7)

The first way is a well-known method for applying central banking, in the form of "open market operations", and is clearly incompatible with competition in banking in general and with the Real Bills Doctrine in particular. Only here, maybe after examining the practical working of the resumed convertible system, did Ricardo arrive at conclusions quite contrary to those of the spirit of the Real Bills Doctrine, arguing that the quantity of notes should not be determined in competition between issuers.

Furthermore, while his proposals paved the way to the monopolization of note issuing, Ricardo went beyond the simple rule described above for the determination of the quantity of notes. In the 1824 text Ricardo discussed not only the responses to developments in the gold market, but also interventions aimed at influencing the quantity in circulation according to overall macroeconomic circumstances.  As is clear from

Ricardo's discussion, he recommended not merely a defense of convertibility, but control of the money supply.[13] Thus, Ricardo's position in this last text differed significantly not only from his own earlier views, but also from those of the Currency School which we will describe below. Not only did he explicitly reject both competition and a strict rule as the right methods for determining the quantity of notes, he openly recommended discretion. Thus, his system is closer to what we would call central banking than it is to the automatic mechanism characteristic of the Currency School's proposals, which left almost no place for discretion in either money or credit. Thus, Ricardo was moving toward a rejection of the application of the invisible hand mechanism to money and credit and adopted a basically visible hand theory. One should note that this visible hand position was contrary to Ricardo's own writings on monetary issues before this text and moreover, this new view was not accepted. What people usually described as Ricardo's monetary positions were either his basically Smithian position before his Plan for a National Bank or his recommendation to concentrate issuing in the hands of a single bank. As we shall see below, contemporaries and in particular Parnell, noticed the change in Ricardo's approach.

Smith, Thornton and Ricardo provided the theoretical background against which one should read the debates on monetary theory prior to the 1844 Bank act. The fact that Adam Smith advocated competition in note issue is well-known, and several modern advocates of free banking do indeed claim Adam Smith as their most distinguished predecessor (Glasner (1989) and Skaggs (1991)). However, the above analysis suggests that early doubts about competitive note issue seem to have been fueled largely by the theoretical critiques of the free banking approach by important figures such as Thornton and the 1824 Ricardo, as well as by other political economists and policy makers, and, in particular, by criticism of the Real Bills Doctrine. In an interesting thesis, Glasner (1992) develops a case for grounding Adam Smith's theoretical approach to free banking not in the

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13 For a detailed study of the changes in Ricardo's views see Arnon (1987).

vulnerable Real Bills Doctrine, but in a theory of competitive note supply. However, it is important to remember that theorists of the time did understand the Real Bills Doctrine to be at the basis of Smith's theoretical case for free banking. It is not clear why White does not attribute more importance to the influence of Smith on free banking, although I shall offer a few speculations later. As I discuss below, it seems clearer why White attributed so much importance to Parnell and several of his immediate contemporaries. However, a closer reading of Parnell's last important pamphlet suggests that Parnell may have been less of a freebanker than is generally thought.

**V Parnell**

Henry B. Parnell, an Irish landowner, was active in British political economy both as a politician, and on a more theoretical level. He was born in 1776, entered Parliament in 1802, was a member of the Bullion committee, and was involved in various other committees. He served for a short time as Secretary of war and for several years as Treasurer of the Navy and Paymaster General. He was mainly interested in financial reform and wrote his most influential book on this topic[14]. Since 1822 and until his death in 1842 he was a member of the famous Political Economy Club.

Concerning the issues raised in the debates around Free Banking we will turn to Parnell's two pamphlets which associate him with laissez faire in banking. The first is Observations on Paper Money, Banking, and Overtrading (1827) which according to White "...should be considered the first major work of advocacy by the Free Banking School" (1984 p.62). The second A Plain Statement of the Power of the Bank of England (1832).

Parnell approved of Adam Smith's approach to banking, and complained that his principles had never been fully applied.

Notwithstanding the length of time that has elapsed since the publication of the Wealth of

> Nations, there is not perhaps any work in which all the leading principles, which relate to paper money and banking, are more fully and clearly stated than in the chapter of Adam Smith's work... (1827 p. 2-3).

The important missing reform was that which would end the Bank monopoly in London. Since 1819, Parnell tells us, he had been demanding that in addition to convertibility, of which he of course approved, an end to monopoly was necessary. The responsibility for the 1825 crises lay, according to Parnell, with the Bank of England. On this he quoted

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14 On Financial Reform (1830).

Tooke, who suggested that "...at the expiration of the present charter of the Bank of England, the whole system, as connected with the circulation of promissory notes, should be entirely remodelled." (Tooke (1826) p. 123; quoted in Parnell (1827) p. 16). One should note that this position reflected Tooke's pre Banking School views. (Arnon 1990). Parnell suggested that in order to prevent

> "...the recurrence of similar [to the 1825] distress... it is necessary - That the banking system should be wholly changed; first, by diminishing the capital of the Bank of England, so as to admit of new banks entering into competition with it; secondly, by allowing joint stock companies to be established in London, with the power of opening branch banks in the country, so that the capital of the metropolis may be brought into operation in supporting the country circulation; and thirdly, by requiring that every bank should give security" (ibid p. 21).

Thus, the most important reform in banking was to change the law which prevented more than six partners from joining in an issuing company. The existing law "...has taken away, as to the Bank of England, the great check over abuses in issuing paper money, namely, the competition of rival banks;" and "led to the establishing of weak banks in the country" (P. 35).

A perfect system of banking must be a secure system, tells us Parnell. However, security can not be guaranteed and there is always a certain danger in the banking system. Why? Because:

> "The chief part of the difficulty of establishing a safe system of banking, arises from the trade being profitable according to the proportion in which the amount of notes, that is kept in circulation by a bank, exceeds the amount of capital which is kept in reserve for the payment of them." (p. 84)

This might cause banks to over issue since this unique state of affairs in banking is a "powerful stimulus in tempting bankers to issue more notes than in prudence they ought to do". Even if they resist this temptation bankers are "exposed to great difficulties by sudden and unforeseen demands". Parnell then explained why and how, in spite of this temptation, free banking would be safe. He argued that in a system of banking where several banks exist, each one with sufficient capital, the mechanism of clearing notes between the banks will provide the safeguard against improper functioning. This point is of major importance to today's free banking school.

"each bank will daily have paid into it the notes of some of the other banks; but no bank will reissue these notes, because it would be throwing away, by doing so, the opportunity of making profit by issuing its own notes; The banks will therefore be driven to exchange the notes so paid in with each other; and every bank, that has a balance against it, will be under the necessity of paying the amount of that balance in gold...In this way an efficient check is established against over issues;" (p.87).

Such a system, argued Parnell, would protect the economy from fluctuations as well as from panics. The rival banks will correct each other and even if they all "were to combine to increase the quantity of paper beyond what the circulation required..", thus, acting as a cartel the system as a whole would remain secure. Although this combined action by the banks might work, and increase the note circulation beyond the 'right' amount, it will do so only for a short time. Parnell argued that the mechanism which will correct this collusion might be delayed, but it will apply soon, and such disturbances will be short lived. The mechanism which will put discipline to the colluding banks will be the exchange of gold against the excess banks' notes. Moreover, the correction which will result will cause the banks to "suffer more in the end from their combination than they could gain by it" (p. 89), thus, rational bankers would not start such a process.

Parnell, an experienced politician and well informed economist, knew that this competitive system was not perfect. He was aware of the danger of over-issue, since the working of the system depended on human beings, who have the tendency to miscalculate, among them respected bankers as well. They, sometimes, were taken by a spirit of unfounded optimism that was felt through the whole economy.

"But although a system of banking might be established, by leaving free the operation of the influence of the principles of convertibility, of profit, and of private interest, which would admit of paper money being extensively used, with perfect security from bank failures, the banks would still be able to make those large issues of paper when prices are high, and a spirit of speculation existed, which would encourage overtrading. But this is no reason against employing bank notes, because, under such circumstances, if the currency were wholly metallic, over-trading would go on, as it has always gone on, in Lancashire, with the help of bills of exchange, and the system of indorsing them from one party to another." (p. 90)

Thus, the free banking system was not perfect, but neither was the pure metallic system. The reason for the additional danger caused by issuing banks was clearly explained by Parnell:

"The improvident conduct of banks, in issuing paper too freely when prices are high, arises from the same cause as the miscalculations of merchants upon the future state of prices, namely, negligence in inquiring into the causes of their being high, and too much confidence in their permanency."

At this point Parnell seemed confident that the system would work. However, it is important to note that here he does not suggest a theoretical mechanism by which the problem of over-issue, caused by the above mentioned imperfect bankers, would be overcome. Rather, he expressed his hope that the bankers will eventually learn from their mistakes:

"But as the late distress has taught the banks their past errors, it may be expected that they will adopt a different line of conduct when prices again become very high...."

Thus, it is the belief that private individuals will soon learn how not to err in their future actions which justifies free banking.

It is not surprising that White saw in Parnell and in this paper a forerunner of modern free banking. Parnell expressed here unequivocal support for the principle of free banking in note issue. Moreover, one must remember that Parnell was writing at a time in which the Bank of England had a monopoly on note issue in London, so, unlike Smith, Parnell's position also incorporated policy recommendations to change the banking system (as do those of modern free bankers). However, under the influence of political economists such as McCulloch, Parnell developed a somewhat different analysis which also led him, in my view, to modify his position on free banking and propose some limitations on competition in banking.

**Parnell's argument with McCulloch**

McCulloch (1831) provided, according to Vera Smith, the "first important theoretical argument for the case against free banking". McCulloch questioned whether belief in the tendency of private bankers to learn to avoid over-issue could alone provide a sufficiently solid base for leaving the business of money and banking in the hands of private interests. Does this belief constitute a convincing argument for applying the invisible hand to the business of banking, while withholding any policy tools from the hands of the Bank of England Directors?

McCulloch agreed that convertibility would provide a mechanism of control over the supply of notes by the Bank of England, as well as over any other individual bank. In Vera Smith's words:

"An over issue can admittedly depress the value of the whole circulation, gold as well as paper, in the country concerned, but immediately this overissue takes place, gold starts going abroad, notes are presented to the issuer for payment, and they, in order to prevent the exhaustion of their reserves and to maintain their ability to redeem their obligations, are obliged to contract their issues, raise the value of money and stop the gold efflux. There is, therefore, in his [McCulloch] opinion always a check on over-issue by way of the public's bringing notes to the banks for redemption"

(Vera Smith (1936) pp.63/64).

However, he argued that this mechanism would not suffice in the case of numerous, competing banks. Rather, McCulloch thought, as have many theorists since, that there are forces in a competitive banking system which will force the system as a whole to overissue. Competing banks will often be forced to decrease the discount rate and expand their note issuing in reaction to one of their competitors who was doing the same. The banks will be forced to 'follow the leader' in this dangerous route for fear of losing market share. The result will be overissue. Moreover, it is doubtful whether over-issuing bankers will learn to mend their ways. The initiator will not be 'punished' since customers will convert notes of all banks and not just those of the trouble maker. This analysis led McCulloch to endorse the continuation of the Bank of England's monopoly over note-issue.

In contrast, in his 1832 pamphlet, Parnell seeks to combine his rejection of such a monopoly with his recognition of at least some of McCulloch's warnings about the over-issue inherent in unrestricted competition. The monopoly power of the Bank "...gives it an unbounded influence :- first over the Currency; secondly, over Commercial Credit; thirdly, over the prices of the Funds; and, fourthly, over the Government." (p.4). The former was the focus of this pamphlet; historical data was gathered to prove the case that the "real source of the misconduct of the Bank was the motive of realizing the largest possible profit on the Bank capital" (p. 49). This pattern, in Parnell's view, was the cause for the changes in the quantity of money which were behind many of the financial and economic crises in England.

However, he was also influenced by McCulloch's argument that convertibility was not sufficient to prevent over-issue in the event of free competition. On the one hand, he argued that a clearing mechanism like that working between the banks in Scotland provided some restriction on over-issue. However, he also agreed that as long as public redemption of banknotes remains the primary force on which the control of banks depends, there is always the possibility of imperfections. Either the public will not be informed in due time or, even if informed, there will be a time lag. One should note that here Parnell is not concerned with financial crises, but rather with the potential for over-issue during times of normal business.

Parnell's solution was to let joint-stock issuing banks operate in London. Those will bring discipline to the issuing business through a mechanism described by Parnell as 'federative capacity':

> "Each of them knows perfectly well to what injuries he is exposed, and what ought to be done to avoid them; but instead of each Banker depending upon his own independent power to protect himself, they all combine together, and employ their united powers, to stop, at once, the loss which they would all sustain, immediately, or remotely, by the failure of a single Bank of mere speculation, and unprovided with a proper amount of capital." (p.72/3).

This is basically an argument against both numerous small banks and one large one, and in favor of a system where a few, 'big' banks, act in a coordinated, 'federative', manner. Thus, the 'banking trade' should be 'managed' by a few banks who will consider the state of the exchanges as well as other factors. Such a market structure, whereby a few banks combine together on a regular basis, and not just in times of financial crisis, characterises what modern terminology refers to as a cartel.[15] Such a 'cartel' would in Parnell's view prevent risky banks from entering the trade and would prevent overissue by strong banks. Moreover, the coordinated decisions of a few strong banks would provide the country with the right amount of money whatever this might be. Thus, a few private banks would

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15 At this stage Parnell argued that the Scottish system was managed by few strong banks; see in particular Parnell (1832) pp. 66-76. Parnell did not like small banks: "What has been the cause of the failure of Country Banks in England? The facility with which every cobbler and cheesemonger has been able to open a Bank, in consequence of the limitation of the number of partners having forbidden the existence of numerous opulent Banks. What has been the cause of so few failures in Scotland? The freedom of the Banking Trade, and the establishment of opulent Banks" (p. 73). However, the main issue remained the control and determination of the money-supply and not this hint at a minimum capital requirements.

assume the role and function of a public central bank.

"As these Banks would all be injured by one or more of them issuing paper in excess, they would, as in Scotland, act in a federative capacity, in checking every deviation from true Banking principles; and they would certainly have the means of keeping the currency at all times at a proper amount; for with all this paper, issued to accommodate trade, a moderate limiting of it, in a way to make it operate generally and equally, would admit of a contraction being quietly and easily made, when the price of bullion, or the state of the exchanges, indicated that the circulation had become redundant" (p. 76; emphasis added)

This is an argument in favor of discretionary control of money and not for automatic rule or free banking, albeit with a unique twist concerning the allocation of power between the public and private sectors. It is not clear how those banks will reach and apply their decisions.

The interpretation that Parnell is here arguing in favour of a discretionary monetary policy is supported by his appeal to Ricardo's 1824 paper. Parnell approvingly quoted Ricardo "whose practical authority on a matter of this kind cannot be disputed". Parnell argued that in this text on a Government Bank, Ricardo "made his whole case depend upon what he conceived to be the facility of dealing with the currency with reference to the foreign exchanges. The way by which he proposed to give steadiness of value to his circulation, to consist wholly of paper, was, by contracting, or increasing the amount, according to the fall or rise in the foreign exchanges, and in the price of bullion" (ibid pp. 65-66). While raising this argument Parnell also defended the Scottish system, where several banks, not only one as in London, carried the 'management' task.

"Now, in order to understand how far this system is fit for London, let us suppose that the twenty millions of paper which are now issued by the Bank of England, were issued by five opulent London Banks, that they acted entirely on the Scotch system, as to deposits, cash credits, exchanges of notes, and settling of balances. 1. These Banks would have full power to prevent any Bank, without capital, from establishing itself." (ibid p. 76)

Parnell is clearly opposed to free entry to banking, however, also concerning adequately capitalised banks, decisions could not be left just to competitive forces. 'Federative capacity' is necessary to 'control...against over-issues of paper'. For him, the true banking principles were those advocated by Ricardo in his 1824 paper, which, as I argued above, do not represent a free banking position. Moreover, Parnell's enthusiastic support for a system which he understood to represent managed rather than free banking supports the interpretation that by this stage Parnell was no longer an unequivocal "free banker".

He also was not, of course, a convert to monopoly note-issue. The last section of Parnell's 1832 pamphlet is devoted to a reply to McCulloch. The message is clear. A banking system where several strong banks, with adequate capital, compete with each other cannot deviate from the public's interests. None of those banks will be able to expand when the economic conditions are not suitable, neither will it contract when not expected to. While Parnell explains clearly why a particular bank might over-issue, arguing that the others will correct this greedy bank.

"...this effect of an over-issue will be a direct injury to the other Banks; the means by which the over-issue has been brought about will be considered by them as unfair and hostile to their interest, and as a breach of an implied compact [contract?]. When, therefore, the Banks discover, by the exchanges, that the over-issuing Bank has violated the rules of fair dealing, they will seek to obtain redress, and to protect their own interests, by taking those means which they possess to force the transgressing Bank to retrace its steps." (p. 87-88)

This line of reasoning assumes that in a cartel there exists a natural allocation of production, as well as a clear agreement as to the amount of total production.

It is interesting that Parnell insists that he is following in the footsteps of both Adam Smith and Ricardo (prior to the 1824 text) on the issue of laissez faire in banking, although at this point he favored restricted competition and advocated discretion. However, one must remember that he still rejected Bank of England monopoly over issuing convertible notes in London. He seems to be relying on Adam Smith and Ricardo to convince his readers that the founding fathers were closer to himself than they were to McCulloch, who rejected the application of laissez faire to banking altogether and defended the monopoly power of the Bank over issuing notes in London.

To conclude, I suggest that in this last important paper, Parnell appears as neither a 'free banking' nor a 'one bank' advocate. In this case, one can question White's identification of Parnell as an unequivocal Classical forerunner of modern free banking positions. Moreover, it seems that Parnell himself modified his position not as a result of coincidence or capitulation, but because he was influenced by certain theoretical weaknesses in his original position. In this context, I suggest that Parnell's support of the Scottish system be understood not as evidence for his advocacy of unrestricted competition, but rather as evidence for his acceptance of some discretion. Thus, the foregoing discussion also raises questions about White's use of the Scottish example as evidence that a free banking system has worked in the past. Thus, a careful reading of Parnell seems to support modern writers such as Sechrest (1991) and Munn (1991) who question White's interpretation on the grounds that the Scottish experience was not an example of pure free banking (see also Checkland (1975), Munn (1981) and Cowen and Kroszner (1991)).

We are now in a position to ask whether theoretical problems, such as those that seemed to have troubled Parnell, featured in the debates around the 1844 Bank Act and what role, if any, they played in the eventual abandonment of competitive note issue.

## VI The Banking and Currency Schools on Laissez Faire in Banking

The return to convertibility in 1821 did not bring with it the desired stability in the monetary system. Crises in the economy continued to trouble both practical persons active in 'real' economic life and theoreticians. The crisis in 1825 triggered the debate between Parnell and McCulloch and also led to a reform in banking legislation in 1826 (see Fetter (1965)). The various reforms did not stop the cycles in the economy and 'bad' years returned in 1836/7, 1839, 1847/8, 1857/8, 1866. The belief that the monetary system was responsible, at least in part, for this dismal performance, was widespread and led to heated debates about a new and better reform which culminated in the 1844 Bank Act.

This act marked the victory of the Currency School over the rival Banking School. The Currency School rejected the application of laissez faire to banking, in particular concerning note-issuing. Their strong distrust of bankers led them to reject competition in note issuing and they agreed with Thornton that the monetary system should be managed and not left to the invisible hand. However, they did not follow him in endorsing some form of discretion. Rather, they sought an alternative method for determining the quantity of convertible notes in circulation. They adopted the principles of Ricardo's Plan, but endorsed a strict rule with no discretion. Their position is most clearly expressed in the 1844 Bank Act according to which every change in the quantity of Bank of England notes would equal the change in the amount of precious metals in the reserves of the Issue Department. Thus, changes in the quantity of notes would not depend on the banking system's discretionary actions, but rather on the public's will. The Act freed the bankers from all responsibility other than obeying the 'rule'. The Act thus provided an automatic mechanism for controlling the money supply--coins plus convertible banknotes.

Thus, the Currency School held a strange position. Although their rejection of competition for money should have led them to reject free banking and accept some form of visible hand policy and central banking, they clung to the alternative solution of "rules", even in the years following the Bank Act, when a succession of crises (1848, 1857, 1866) necessitated discretion. Moreover, they did not think it important to control aggregates other than notes. Thus, although they rejected competition for notes and their proposals for reform paved the way to central banking, paradoxically, they accepted laissez faire in banking for other liabilities, such as deposits.

As we saw earlier, Parnell too focused mainly on note issuing, but did not, of course, endorse a rule. In this, his position was close to that of the rival Banking School. However, in contrast with both Parnell and the Currency School, the Banking School was concerned with more than just note issuing. The Banking School's strong commitment to free trade and their acceptance of a competitive mechanism for money (i.e. notes), at least outside London, brought them close to a Free Banking position for note issue. However, while this aspect of their thought has led to a common view that they were close to Smith's laissez faire views, their consideration of other assets and liabilities complicates the picture. In 1844, Tooke, the leading Banking School theorist, rejected both the Real Bills Doctrine and competition as the mechanisms for regulating other liabilities and assets of the banking system, a position which should have led to some form of visible hand policy. However, although Tooke continued to refine this distinction between money and credit, he did not translate his implied endorsement for competition in note issue but not in credit, to clear policy recommendations.[16] Although he was concerned to prevent what he considered as over-legislation and unnecessary interference in the banking system, he did not recommend complete free banking, nor did he recommend specifically how to control deposits or other assets and liabilities.

Parnell, who wrote on similar issues before the heyday of the famous Currency versus Banking school debate, focused mainly on the appropriate issuing policy in London. Like Adam Smith, Ricardo and the Currency School, he accepted free banking for assets

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16 Tooke developed a unique attitude among the classicals towards the relation between credit and cycles in the economy. According to Tooke there exists no automatic mechanism by which the banks can control and 'fine-tune' the cycles in the economy. However, led by the Bank of England, they can, and should, act as stabilizers in the economy after their managers have determined the direction of the cycles.

and liabilities of the banking system other than convertible notes. However, although he endorsed less competition in note issuing than did Adam Smith, he clearly endorsed more competition than did the Currency School. Thus, though he died in 1842, he probably would have opposed the 1844 Bank Act, as did the Banking school. However, whereas the Banking school did not propose a significant reform concerning the Bank of England, Parnell preferred a reform: a non-monopoly regime.

**VII Summary**

We can now return to our opening questions: were there forerunners to the new free banking view and, if so, why were they neglected for so long? The natural candidate as a forerunner was Adam Smith. He recommended the application of laissez faire to banking in both the creation of notes and other liabilities and assets. The fact that Vera Smith did not consider him a forerunner and the limited importance which White ascribed to him are puzzling. A possible explanation for the puzzle could be found in the weak theoretical structure that Adam Smith provided. The Real Bills Doctrine was criticised harshly by 19th century political economists and could not serve as a respected corner stone on which the old, or new, free banking school could build their arguments. In other words, the Real-Bills Doctrine is not defensible and hence Smith is problematic as a founding father of the new view.[17]

On the other hand, a competitive mechanism for issuing notes, where the determination of the quantity was left to market forces, particularly where a clearing system was in effect, provided a defensible argument for free banking. White and Vera Smith ascribed the introduction of this mechanism to political economy to Parnell, hence

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17 I am indebted to D. O'Brien for drawing my attention to another possible explanation which emphasises Hayek's indirect influence on Vera Smith. Hayek did not seriously discuss Adam Smith writings on money, and Vera Smith, who was his student, followed him. Still this remains an interesting puzzle.

their claim that he was the founding father of free banking. However, did Parnell really ascribe to free banking? Did he recommend free entry and no regulation of note issue? My reading of Parnell does not provide a clear yes. Parnell struggled with the arguments of the interventionists and eventually recommended a privately owned cartel which would direct the issuing business. Not only entry was limited, but, as we have seen, he expected the cartel to take responsibility for, and to correct the errors of, individual banks; moreover, he did not reject the idea that the cartel will regulate the banking system in line with macroeconomic conditions, just as Ricardo's position in 1824. In addition, Parnell did not believe in the Currency Principle, i.e. in the need to create a system where correspondence between gold and notes will always be maintained. Thus, it is not surprising that Vera Smith (1936) regarded Parnell as a Banking School member, albeit one who tended more to free banking than to central banking (see a summary table p. 127; the table is reproduced in the appendix) and White classified him as a free banker.

It is beyond the scope of this paper to elaborate on all the other candidates for the free banking school. However, two other leading figures, Bailey and Gilbart[18], do not seem to have been pure 'free bankers' either. Bailey in his 1840 text can be read as a Banking School supporter; though he raised the issue of competition within the London area, he concluded his penetrating analysis with this lukewarm recommendation:

"With regard to any change at the expiration of the present charter in the power of issuing notes within the circle now exclusively supplied by the Bank of England, it scarcely comes within the object of these pages to discuss it.....

Whether the times are ripe for adopting the salutary principles of free trade ....in this important department of economical policy, is a question which requires for its decision a more familiar acquaintance with the commercial spirit of the metropolis than the author of these pages can boast"

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18 See White (1984).

Gilbart's support for free banking was initially clearer, but he modified his position later on, after the Bank Act was passed. I do not deny the claim that one can find supporters of competition in note issuing; there were some but they were marginal to the main debate.

To summarise, Parnell's position was not a pure free banking position. It was an anti Bank of England position, and on several major issues he was close to the Banking School. While it is true that Parnell expressed sentiments for competitive note-issue, he was often criticised by his contemporaries, took their criticism into account, and as a result supported a privately regulated supply of notes mechanism. Thus, the decline of the free banking school can be explained as the result of theoretical weaknesses and not as the consequence of coincidence and capitulation.

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## Vera Smith's Table (p. 127)

| | *Free* | *Central* |
|---|---|---|
| | Parnell<br>Wilson | Tooke<br>Bonamy |
| Price | | |
| | | MacLeod |
| | Cairnes | |
| | Courcelle Seneuil<br>Coquelin<br>Chevalier | Coullet |
| ***Banking School*** | Coq<br>Garnier<br>Mannequin<br>Brasseuer<br>Horn | |
| | Wagner<br>Lasker | |
| | | McCulloch<br>G.W. |
| Norman | | |
| | | Loyd<br>Longfield<br>R.H. Mills |
| | Cernuschi | Lavergne |
| ***Currency School*** | | d'Eichtal<br>Wolowski |
| | Hubner<br>Michaelis | Tellkampf<br>Geyer<br>Knies |
| | Mises | Neisser |

**White's Table (1984, p. 135)**

**Scheme of the Currency School - Banking School - Free Banking School Controversy**

| **Issue** | **Currency School (McCulloch, Loyd, Longfield, Norman Torrens, S. Ricardo)** | **Free Banking School (Parnell, Gilbart, Bailey, Scrope Mushet)** | **Banking School (Tooke, Fullarton Wilson, J.S. Mill)** |
|---|---|---|---|
| **1.** Free trade applies to noteissue? | No; favor forced centralization of noteissue | Yes; favor end to BOE London monopoly of issue | No;[s] favor status quo |
| **2.** Who can overissue? | Single CB; CBs in concert especially likely;[t] BOE | BOE and only BOE | No bank |
| **3.** Trade cycle | | | |
| a. Origin | Nonmonetary[u] | Monetary[v] | Nonmonetary |
| b. Transmission | Monetary | Monetary | Nonmonetary |
| **4.** When is money stock self-regulating? | Only under an imposed rule (the currency principle) | Only under competition | Already |
| **5.** a. Real bills doctrine | Anti | Pro | Pro |
| **and** b. Needs-of-trade doctrine | Applies to CBs, not to BOE; is bad | Applies to CBs, not to BOE; is good | Applies to CBs to BOE; is good |
| c. Reflux of excess notes under competition | Muddled, perverse, too slow; via external drain only | Rapid; via note exchange system | Instantaneous; via loan repayments |
| **6.** a. Constructivism | Pro | Anti | Anti |
| b. System favored | Rule-bound authority | No authority | Unbound |

[s] Except Wilson and Mill.

[t] Except early Torrens.

[u] Except Torrens, S. Ricardo and Pennington.

[v] Except R. Bell and early Parnell

**Key:** BOE = Bank of England; CB = Central bank.