Why Free Banking Died

Free bankers expect the outcomes of "free" markets to be inherently preferable to those achieved through the political mechanism, not least because the latter is quite likely to result in central rather than free banking. Thus, Sechrest claims that "attempts at countercyclical policy (despite their enormous political popularity) have failed to attain their avowed objective" (6); again, quoting James Buchanan, Sechrest suggests that a circumstance "where voters may exert direct pressure on the monetary authority, suffers from the well-known problem of having to satisfy the median voter. . . . That voter tends to be 'myopic' regarding inflation. That is, he has an incentive to place great weight on the short-term gains in terms of employment that he may experience and to have little concern for the long-term harm done to the economy as a whole. The predictable result is an economic environment that is unstable and inflationary" (72). Thus, people voting with their dollars are supposed to be rational and to reach an efficient outcome, but when they vote with their ballots, they may not achieve their own best interests. I have always found it difficult to perceive the logical basis for this dichotomy.

The suggestion that electorates have been unable to realize where their true best interests lay (i.e., in free rather than central banking) is, however, a secondary theme in free bankers' explanations of the demise of free banking and the success (as a continuing institutional practice) of central banking. Schuler addresses this issue straight on in chapter 2 of EFB and gives three primary reasons for the end of free banking in some 60 historical cases: "theory," "seignorage," and "crisis." By his count 39 episodes were mainly ended by "theory," including those in Germany, the United Kingdom, Canada, the United States, Australia, New Zealand, and India, as compared with 13 by "seignorage," including France, Italy, Brazil, and China, and 11 by "crisis," including Belgium, Argentina, South Africa, and Japan.

By Schuler's reckoning, then, "theory" has been the main reason for the adoption of central banking. What he means by "theory" is the claim, initially made by the British currency school, that the growth of (some components of) the money stock should be controlled by a rule (e.g., determining the growth of the note issue, or more recently the monetary base) rather than by the operation of a

free market, as proposed by the free banking school, or by the discretion of a central bank, as proposed by the banking school. Free banking economists tend to regard the currency school and its latter-day successors, the monetarists, with some admiration for having articulated a sophisticated and widely accepted theory. But they regard its reasoning as flawed. One reason they adduce is that the theory has been preoccupied with one part of the money stock (Schuler, EFB 33), and hence is susceptible to innovations in the monetary system and breakdowns in formerly stable relationships, such as demand-for-money functions.

Currency school theory was, indeed, largely responsible for the 1844 Bank Charter Act, as was monetarism for the adoption of intermediate monetary targets in the 1970s. But in both cases the fragility of the underlying theoretical apparatus was quite quickly perceived, leading to the suspension of the 1844 Act three times in 1847, 1857, and 1866, and to the abandonment of intermediate monetary targets by most countries in the mid-1980s, when stability in the relationship between monetary growth and subsequent changes in nominal incomes and in inflation deteriorated. Thus, the central bank model that countries actually adopted after 1844 was, and remains, a much more discretionary, banking-school institution than that proposed either by David Ricardo or Milton Friedman.

Schuler believes that much of this analysis was simply not understood by economists as of the First World War, "a great divide in free banking history."

After the war, the 1920 Brussels and 1922 Genoa monetary conferences . . . recommended that central banks be [generally] established. The League's recommendation proved influential. Free banking by then had no significant support among economists. The chief reason appears to have been that economists had little understanding of the difference between free banking and central banking. The controversy over gold versus silver as the monetary standard, and then the debate over the quantity theory of money, diverted attention from the earlier Currency School-Banking School-Free Banking School debates, which, as a practical matter, the Currency School seemed to have won (36-37).

Is the institutional success of central banking indeed largely due to a long-standing analytical failure among economists? Prophets