Crisis as the Source of Central Banking

In Schuler's taxonomy, a prior financial crisis was, by his count, the least common of the main reasons given for the end of free banking and the adoption of central banking. I do not accept this tally. Most of the periods of study and debate that eventually led to the generation of theories about banking were provoked by an experience of crisis, including the panic of 1825 in England; the crises under the U.S. National Banking System, culminating in the 1907 crisis; the 1893 crises in Australia and Italy; the 1870 crisis in Switzerland, and so on. The adoption of central banking in Canada was also prompted by a crisis—the Great Depression—even though in Canada this was not specifically a banking crisis. Schuler categorizes all of these central banks as being primarily the result of "theory."

It is true that once the main Western industrialized countries had embraced central banking as the best means of dealing with the crises that had stimulated the theoretical debates, they encouraged with evangelical zeal the adoption of similar institutions in other countries over which they had influence. One of the many missions of the indefatigable Professor Kemmerer, to Colombia, is detailed in chapter 5 of EFB, by Adolfo Meisel; and Sir Otto Niemeyer was nearly as exercised in taking central banking to the far-flung outposts of the British Empire. But the main impetus had initially been the analysis of how to deal with the experience of crisis.

Free bankers disagree strongly either that crises can be cured by establishing central banks, or that they are less likely once central banks are in place. They claim that crises were less frequent under free banking than under centrally controlled banking (e.g., in Scotland vs. England or in Canada vs. the United States); they claim that when such crises did occur under free banking they were due to vestiges of state control (e.g., the requirement in the United States that the notes of free banks be backed by state bonds, which could and did fall in price, impairing bank capital, (EFB ch. 11 and FB ch. 6). They claim that the extent, impact and contagious effects of such crises have been exaggerated; thus Sechrest quotes Rolnick and Weber that "the conventional view [of the evanescence of U.S. free banks] is overstated. In our free banking states, only sixteen percent of the free banks were in business under a year, while the average number of years in business was over five" (99). And they claim that downturns in free-banking economies were due to real shocks to which the free banks had to adjust. This latter thesis is proposed by Dowd (EFB ch. 3), who bravely chooses to examine one of the most dramatic collapses in free banking history, in Australia in 1893; he claims that the evidence "does not support the claim that the bank 'crash' contributed in a major way to the severity of the depression" (68).

Frankly I am not convinced. Not only my own historical studies, but my reading of the historical chapters in these two books suggests that, despite the protestations of the authors, worry about the stability of a fractional reserve free-banking system remained a continuing and justifiable cause for concern among both the public and the experts. It is partly a matter of perception: Is the glass half full or half empty? Where I would hope that we might agree is that it was the perception by contemporaries that relatively free, fractional reserve banking systems suffered from instability that led to the adoption of central banking. Free bankers can still argue, of course, that this perception was wrong or at least overstated (see the earlier section on theory).

Yet if the perceived crises and failures of "free banking" led toward central banking, then why haven't the apparent crises and failures under central banking, such as the Great Depression in the United States, led in the opposite direction? To some extent they have. Intermediate monetary targets in the mid-1970s were in part a reaction to the monetary disturbances of 1971-74; central bank independence is a proposed answer to recent endemic inflation. But there is possibly a more general answer. Any perceived economic "crisis" is liable to lead to a call, often hurried and ill-considered, for more intervention, rather than less: the "We must make sure that that can never happen again" syndrome. Even though crises under a central bank regime may, to some variable extent, be due to shortcomings of the monetary authorities themselves, the standard re-