Free Banking in America: Disaster or Success?

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Even among the strongest proponents of free markets, there is widespread agreement that there is a role for government in money. We can trust the invisible hand to organize pin factories, but not to issue currency. And in a world where central banks have come to dominate around the world, it becomes hard to imagine any system other than a government monopoly on money. But that wasn't always the case. History has seen many examples where banks freely competed, generating bank notes at their own discretion, usually backed by a commodity but not by a government. In the last thirty years, even as monetary systems have largely converged to centralization, there has been a resurgence in research surrounding alternative arrangements. Economic history has a large role to play in this resurgence. Studying past examples of banking systems, analyzing their strengths and weaknesses, could help us understand and improve modern banking institutions.

The American "free banking era," which lasted from roughly 1836-1862, is one example of a monetary system that has generated substantial research and debate. Before 1836, banks in the United States required a charter from the state they were located in, giving them permission to issue currency. However, starting with Michigan in 1836, many states began to enact laws allowing free entry of banks and by 1860, the number of free banking states had grown to eighteen. Traditional accounts paint a picture of the free banking era as a period of monetary chaos. Lack of regulation allowed "Wildcat banks" to issue more currency than could ever hope to be redeemed, making banking panics frequent. More careful research of the period has since challenged the conventional view, arguing that many states found modest success with free banking. Findings surrounding the era ultimately remain mixed, but even though it likely doesn't offer a viable alternative to a central bank issued currency, free banking remains a topic ripe for research.

Before delving into the American experiment in free banking, it may be helpful to look at some of the theoretical arguments for and against free banking. In 1959, Milton Friedman laid out four "good reasons" for the government to issue currency rather than private banks. For the purposes of evaluating free banking, the most important of these include difficulties in enforcing contracts and preventing fraud, and the fact that issuing money produces externalities for those not directly involved (Friedman and Schwartz, 1986). A common criticism stemming from Friedman's concerns is the possibility of bank runs where a sudden increase in demand for liquidity can cause even well run banks to fail. Similar arguments provided the justification for government deposit insurance and the creation of the Federal Reserve as a lender of last resort. More recently, these arguments have been formalized in models that demonstrate the tendency for unregulated bank issue to lead to bank runs (Diamond and Dybvig, 1983).

Challenging these theories, a strand of literature has put forward a theoretical case for free banking. Perhaps the most important source of renewed interest in free banking theory was a 1976 proposal by Friedrich Hayek to remove all restrictions on private issuance of money. Frustrated with governments that abused their control of the currency to print money and cause inflation, Hayek argued that competition would ensure more stable prices as banks that attempted to devalue would be driven out of the market (Hayek, 1976). Hayek claims that his research "opened a possibility which in two thousand years no single economist had ever studied" (Hayek, 1977).

Following Hayek, some economists have begun to consider free banking not only as an interesting historical phenomenon, but as a replacement for a centralized monetary system. George Selgin, one of the leading proponents of free banking, outlines the theoretical argument in his 1988 book. He shows that a private banking system can theoretically produce equilibrium in the money market better than a system based on a centralized issuer. He also describes a process by which bank runs could be prevented by the use of private clearinghouses that take the place of government deposit insurance (Selgin, 1988). Other research has also found that private clearinghouses can be more effective than government programs in reducing the incentives for bank runs (Calomiris, 1999), although this has been challenged (Aghion et al., 2000).

As with many economic issues, theory does not give us a definitive answer to whether free banking systems would work well in practice. However, history provides us with many examples that allow us to analyze the merits of each theory. Larry White provides an example of one of the most successful free banking episodes in his analysis of Scotland from 1800-1845. White finds that the Scottish banking system was remarkably stable, especially when compared to its English counterpart, which had a central bank at the time. During the period, White notes that 109 banks entered the industry and by 1845, 20 remained (compared to 3 banks today that can issue currency). Although there were failures, the banks were on average less prone to bankruptcy than those in England and White also claims that common problems like counterfeiting were actually more likely to occur in English banks (White, 1995).

Historically, free banking has been more common than most people realize. In a survey of free banking, Kurt Schuler documents around 60 periods where competitive currencies existed. Interestingly, he finds that "free banking systems showed no apparent tendency to develop a lender of last resort — or to need one" (Dowd, 2002). In other words, central banks were not inevitable. Evaluating the usual criticisms of free banking, Schuler finds that counterfeiting was rare, panics were not a major problem, and free banks appear to be conducive to growth as well as price stability. Of all the free banking experiences, the United States' may be the most controversial. The remainder of this paper will focus on evaluating that period in greater detail.

As mentioned above, the US free banking era began in 1936 with the passage of legislation in Michigan allowing anyone to establish a bank. While entry was essentially unrestricted, there were still some requirements banks must satisfy, which varied somewhat across states. A businessman wishing to start a bank was generally required to purchase government bonds to use as collateral as well as keep a reserve of gold and silver. Banks were also not allowed to establish branches. Despite these restrictions, the banking sector in some states grew rapidly following the passage of free banking laws. In

New York, 120 banks were set up within the first two years following the passage of the law. (Dowd, 2002)

Given our reliance on a fiat dollar as the primary unit of account, it may be hard to imagine a system where many bank notes with different prices circulated simultaneously, but that's exactly what happened in many states during this period. Bank note reporters like *Van Court's Counterfeit Detector and Bank Note List* listed the relative prices of various banknotes and it was up to merchants to decide whether to accept each note (Gorton, 1999). A historical account describes how a person evaluating a bank note "turned it up to the light and looked through it, because it was the custom of the banks to file the notes on slender pins which made holes through them. If there were many such holes the note had been often in bank and its genuineness was ratified." Although such a system seems unwieldy by modern standards, the American people at the time "treated the system with toleration and respect" (Sumner, 1896, p. 408-409). As the banking system grew and became increasingly complex, private clearinghouses developed to manage the exchange of bank notes and played a similar role to a modern central bank (Gorton, 1984).

The standard story surrounding the effectiveness of free banks is not a positive one. History textbooks are filled with examples of fraud and dishonesty as bankers tried to avoid the rules set forth by regulators. One account describes the practice of bankers showing the exact same specie in multiple banks—using it in one bank one day and then shipping it off to another before regulators got there. "Wildcat banks" earned their name by being impossible to find, established in places where only wildcats lived. Traditionally, the period has been depicted as one of chaos as "Gold and silver flew about the country with the celerity of magic; its sound was heard in the depths of the forest: yet like the wind one knew not whence it came or whither it was going." (Briones and Rockoff, 2005)

Beginning in the 1970s, economic historians began to reexamine the period and question the standard textbook view. A 1974 paper by Hugh Rockoff was one of the first to rigorously examine the impact of wildcat banking and the success of the banking system as a whole. Although he finds that wildcat banking had an impact, especially in Michigan, the losses were probably not as large as is usually assumed. (Rockoff, 1974). In other work, he notes that international crises probably deserve more of the blame than any flaws inherent in the system itself (Rockoff, 1972). Expanding on Rockoff's findings, Arthur Rolnick and Warren Weber examine New York, Wisconsin, Indiana, and Minnesota and evaluate their success based on three metrics: failure rates, years in business, and noteholder losses. By each criterion, they argue that the conventional case against free banking is overstated (Rolnick and Weber, 1983).

Rolnick and Weber also try to move away from wildcat banks as the main driver of bank failure, putting forth the hypothesis that falling asset prices can explain the majority of free bank failures. Whereas wildcat banks issued more notes than they could legitimately expect to redeem, Rolnick and Weber's story does not involve fraudulent behavior from bankers. Instead, they argue that since banks were required to back their notes with bonds, falling bond prices could cause a run on the bank that they would be unable to withstand. They assert that this explanation can explain 74 out of 96 bank failures in their sample while the wildcat explanation can only explain 11. (Rolnick and Weber, 1984). Economopoulos finds similar results in applying the two theories to Illinois (Economopoulos, 1988).

Looking specifically at the ability of banks to price risk, Gary Gorton also provides evidence against the wildcat banking explanation of free bank failures. Gorton develops a model of bank note pricing based on the Black-Scholes formula to argue that markets were able to price risky banks remarkably well. Comparing the pricing of notes in free banks and chartered banks, Gorton also finds that after controlling for factors like branching and insurance laws, free banks were not perceived as being more risky than chartered banks (Gorton, 1999). He suggests that accurate pricing enabled the system to overcome the problem of wildcat banking. Bad banks were simply priced out of the market. Corroborating these findings, Gorton also explains that reputation played a large role in the pricing of bank notes, which held banks accountable and prevented wildcat banking from taking hold (Gorton, 1993).

Unless we can understand the reasons banks failed, it is impossible to make a judgement regarding the success of the system as a whole. If wildcat banks were the primary cause of failure, it suggests that free banking incentivized fraudulent behavior. Alternatively, the falling asset price explanation puts the blame on events outside the control of the banking system. In fact, one could argue that without the requirement that deposits had to be backed by government bonds, free banks could have diversified their asset portfolio and avoided many of the failures that did take place. In any case, the findings of Rockoff, Rolnick and Weber, and Gorton cast doubt on the claim that free banking was a total disaster.

All of the studies described to this point help to debunk many of the perceived flaws of free banking, but they do very little to highlight its virtues. This gap is partly due to the difficulties in measuring the effectiveness of a banking system. In his 1974 paper, Rockoff briefly looks at the efficiency of free banks in allocating capital, but can do little more than look at bank profits in free banking vs non-free banking states. He estimates that while there were likely some efficiency gains, they were not substantial. But perhaps the main reason that research on the gains from the free banking system is sparse is that there wasn't much gained at all.

Two theoretical benefits of free banking—that it increases competition and improves growth—have been challenged empirically. On the first point, Kenneth Ng examines the number of banks and output of banking services in each free banking state and claims that only New York saw an increase after the passage of free banking legislation (Ng, 1988). Matthew Jaremski and Peter Rousseau attempt to address the question of economic growth by comparing free banks to the remaining state chartered banks. They estimate that an increase of 10% in the number of free banks would only increase the growth of manufacturing capital by .5% per decade, while the same increase in state chartered banks would increase it by around 3.3% (Jaremski and Rousseau, 2013). Continuing along these lines, Jaremski finds that the National Banking Acts, which essentially ended the free banking era, improved growth. If anything, it appears that free banking was more of a hindrance than a help in terms of growth (Jaremski, 2014).

To interpret the research on the American Free Banking Era, it is important to keep in mind the question we want to answer. What does the period tell us about the effectiveness of a free banking system? The case for free banking presumes that competition between banks will improve efficiency, encourage growth, and stabilize prices. The case against envisions frequent panics, bank runs, and fraud. If we evaluate the American system based on those stories, it doesn't seem to match either one well. And should we expect it to? Even within the United States, the specifics of each system were not the same across states. To place the same label of "free banking" on the successful New York system and the disastrous Michigan one hides this fact. Even using the name free banking evokes of unregulated laissez-faire, but as Briones and Rockoff put it, "lightly regulated banking" is a much more accurate label.

In fact, even though the regulatory burden on banks during the Free Bank Era was low by today's standards, two of the requirements that were in place were instrumental in causing many of the system's problems. One of these, the requirement for banks to back their notes using government bonds, has already been discussed. The other major restriction placed on free banks was the prevention of branching. Gorton (1999) finds that differences in branching restrictions was probably more important than differences in barriers to entry, which is the usual determinant of whether a state had "free" banking or not. As Charles Calomiris notes, Canadian banks' ability to establish branches helped them maintain stability relative to the smaller unit banks of the United States (Calomiris, 2009). It's likely that this feature also helped Canada during the Great Depression, where they experienced no bank failures despite the lack of a central bank. If bank branching restrictions were as important as these studies imply, categorizing banks based on entry requirements would seem to be a false dichotomy.

What can be said about the American Free Bank Era? Two facts are apparent from surveying the literature. First, the view that the system was inherently unstable and prone to counterfeiting and fraud from wildcat banks is almost certainly false. Failures happened, but it is not obvious that these were a signature feature of the free banking system or that some other system could have done better. But the other fact is that free banking (at least in its American manifestation) didn't seem to have any clear advantages.

Its impact on efficiency was probably small and it doesn't appear to have helped growth. Perhaps the restrictions regarding bonds and branching constrained these advantages, but it remains difficult to point to any area where free banking performed especially well. These conclusions highlight the challenges in evaluating and designing banking systems. For those that believe that the Federal Reserve system has performed poorly, free banking could represent a workable alternative, but for anyone who believes the Fed has done its job well, there is no obvious reason to return to a competitive banking system. Unfortunately, the evidence doesn't allow us to say much more than that.

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