COMMUNICATIONS

FREE BANKING IN SCOTLAND: A DISSENTING VIEW

Larry J. Sechrest

Introduction

The increasing attention devoted to free banking in the last few years has certainly been both invigorating and long overdue. Much of the credit for this reanimated interest must in all fairness be given to Lawrence H. White for his research into Scottish banking of the period 1765 to 1845 (see, especially, White 1984). However, despite its stimulating content, White's work on Scottish "free banking" is not without some questionable elements. The present paper will review some of the reasons for such skepticism.

It should be understood, first of all, that this controversy is not merely some trivial dispute over an arcane bit of history. In many writers' minds the theoretical case for free banking has been intimately tied to the alleged success of Scottish banking. White himself contends that free banking in Scotland (1) "provides unique evidence on the workability of monetary freedom" and (2) can help answer "questions concerning the stability or efficiency of an unregulated monetary system" (White 1984, pp. 137, 141). Furthermore, White's interpretation of Scottish banking has gained a fairly wide circulation. Among those who have cited White favorably one finds Friedman and Schwartz (1986, pp. 49–51), Selgin (1988, pp. 7, 81, 140; 1989, p. 450), England (1988, pp. 795–96), Palasek (1989, p. 400), O'Driscoll and Rizzo (1985, pp. 10, 225), O'Driscoll (1986, pp. 601–2), Glasner (1989, p. 37), Dowd (1989, pp. 153–57), and Miller and Pulsinelli (1989, pp. 211–12).

As for objections, there have been only a few. Sechrest (1988, 1990), Carr and Mathewson (1988), and Cowen and Kroszner (1989)

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The author is Assistant Professor of Economics at Sul Ross State University.

have posed challenges to White's historical work; while Munn (1985) and Goodhart (1987) have offered short critical reviews.

The issues to be raised here are (1) high bank failure rates, (2) note inconvertibility, (3) restrictions on small-denomination notes, (4) the Usury Law as a constraint on competition, and (5) the privileges of the chartered banks. It has yet to be demonstrated how these factors can be consistent with either "pure" free banking or any reasonable approximation thereto. This writer will gladly concede, however, that White has now rather plausibly dealt with one early criticism: namely, the suggestion that the Scottish dependence upon the London money market and the Bank of England for liquidity necessarily violated the principles of free banking (White 1989a, 20–34). Perhaps the key error committed by critics—including this writer—was a failure to distinguish ex ante from ex post dependence.

Much of the evidence presented in the following sections will be drawn from the survey of Scottish banking written by S. G. Checkland (1975), which White (1984, p. 33) has called "S. G. Checkland's authoritative chronicle of the industry." Moreover, White has declared that Checkland "is, of course, the authority on the facts" (letter to Peter Lewin and the author, 30 April 1986).

Bank Failures

Certainly one of the key dimensions along which one would want to measure the success of any banking system is the rate of firm failure. White must agree, for he provides a table comparing English and Scottish banks in the period 1809–1830, which shows the average annual failure rates per thousand as 18.1 and 4.0,[1] respectively (White 1984, p. 48). Not surprisingly, he concludes that Scottish banks were substantially less failure-prone and calls the Scottish system one of "remarkable monetary stability" (p. 23). However, the rates change dramatically when one examines a broader segment of the "free banking" period. Gathering data from Pressnell (1956, pp. 11, 537–38) and Checkland (1975, pp. 132, 177–78), one finds that from 1772 to 1830 the average annual failure rates per thousand for England and Scotland are 14.90 and 14.88, respectively (see Table 1). The rate for Scotland is thus *not statistically different* from that for England at the 99 percent confidence level.[2]

[1]Actually, White miscalculates the averages slightly. From his own table, the figures work out to be 17.54 and 4.46.

[2]To test the hypothesis that $\overline{X}_1 = \overline{X}_2$,

$$\sigma_{\bar{x}_1 - \bar{x}_2} = \sqrt{\frac{\sigma_1^2}{n_1} + \frac{\sigma_2^2}{n_2}} = 8.061$$

It should be noted that making such a comparison over the longer time period surely conveys a more accurate picture than does White's table. Furthermore, this expanded comparison is consistent with White's own statement that "the act of 1765 left Scotland with free banking" (1984, p. 30).[3]

Convertibility

White (1984, p. ix) goes so far as to define free banking as "the unrestricted competitive issue of *specie-convertible money* by unprivileged banks" (emphasis is mine). And recently he has reaffirmed that the defining characteristic of competitive inside money "is its redeemability" (White 1989b, p. 368n). Thus, if convertibility was not, in fact, consistently practiced in Scotland, then one may conclude that a significant element of free banking was absent. Of course, before 1765 it is well known that immediate redemption did not always occur because banks sometimes invoked the "option clause," i.e., they delayed redemption in exchange for the payment of explicit interest to the noteholder. But what of after 1765, the year the option clause was made illegal?

Damaging to White's case is the declaration by Checkland (1975, p. 185) that

> the Scottish system was one of continuous partial suspension of payments. No one really expected to be able to enter a Scots bank . . . with a large holding of notes and receive the equivalent immediately in gold or silver. At best they would get a little specie and perhaps bills on London.

Checkland (1975, p. 184) adds that "much emphasis was laid on the loyalty of the banks' customers—requests for specie met with

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$$Z = \frac{\bar{X}_1 - \bar{X}_2}{\sigma_{\bar{x}_1 - \bar{x}_2}} = \frac{14.90 - 14.88}{8.061} = 0.00248.$$

Therefore, one cannot reject the hypothesis at the 99 percent confidence level.

In contrast, using White's figures,

$$\bar{X}_1 = 17.54 \quad \sigma_1 = 14.33, \quad n_1 = 22$$
$$\bar{X}_2 = 4.46 \quad \sigma_2 = 5.98, \quad n_2 = 22$$

$$\sigma_{\bar{x}_1 - \bar{x}_2} = \sqrt{\frac{\sigma_1^2}{n_1} + \frac{\sigma_2^2}{n_2}} = 3.31$$

$$Z = \frac{\bar{X}_1 - \bar{X}_2}{\sigma_{\bar{x}_1 - \bar{x}_2}} = \frac{17.54 - 4.46}{3.31} = 3.95.$$

Thus, one must reject the hypothesis at the 99 percent confidence level.

[3]More recently White (1989a, pp. 15–16, 35) seems to be retreating from his original position. Now he appears to defend only the period 1810–1844 as exemplifying free banking.

TABLE 1

BANK FAILURES PER THOUSAND, 1772–1830

Year	England	Scotland	Year	England	Scotland
1772	n.a.	451.6	1802	7.6	0
1773	n.a.	0	1803	14.6	0
1774	n.a.	0	1804	14.5	0
1775	n.a.	0	1805	11.4	0
1776	n.a.	47.6	1806	4.2	0
1777	n.a.	0	1807	5.8	0
1778	n.a.	0	1808	5.2	54.1
1779	n.a.	0	1809	5.7	0
1780	n.a.	0	1810	25.6	27.0
1781	n.a.	41.7	1811	5.1	0
1782	n.a.	0	1812	20.6	0
1783	n.a.	0	1813	8.7	14.3
1784	25.2	0	1814	28.7	0
1785	n.a.	0	1815	27.3	9.0
1786	n.a.	0	1816	44.5	14.1
1787	n.a.	0	1817	4.0	0
1788	n.a.	0	1818	3.9	0
1789	n.a.	0	1819	16.5	0
1790	n.a.	0	1820	5.2	13.2
1791	n.a.	0	1821	12.8	66.7
1792	n.a.	0	1822	11.6	13.0
1793	17.9	90.9	1823	11.6	0
1794	3.7	0	1824	12.8	0
1795	n.a.	0	1825	46.4	12.0
1796	6.6	0	1826	53.1	11.1
1797	17.4	0	1827	11.9	0
1798	12.8	0	1828	4.5	0
1799	n.a.	0	1829	4.4	11.4
1800	8.1	0	1830	20.9	0
1801	10.4	0			

SOURCES: White (1984, p. 48), Checkland (1975, pp. 132, 177–78), and Pressnell (1956, pp. 11, 537–38).

NOTES: mean (England) = $\bar{X}_1$ = 14.90, mean (Scotland) = $\bar{X}_2$ = 14.88, standard deviation (England) = σ_1 = 12.90, standard deviation (Scotland) = σ_2 = 60.01, observations (England) = n_1 = 37, observations (Scotland) = n_2 = 59.

disapproval and almost with charges of disloyalty." Frank W. Fetter (1965, p. 122) agrees with Checkland: "To a large degree there was a tradition, almost with the force of law, that banks should not be required to redeem their notes in coin. Redemption in London drafts was the usual form of paying noteholders." Similarly, Henry Meulen (1934, p. 136) alleges that the typical Scottish banker "paid notes instead of gold to any depositor who might call, and thus was able to operate with a smaller reserve of gold than would otherwise have been necessary."

Curiously, White (1989a, p. 36) claims that statements such as the foregoing have been rebutted by Kevin Dowd (1989). In fact, Dowd (1989, p. 156) agrees that "Scottish notes were imperfectly convertible, even after the passage of the 1765 Act." What Dowd (pp. 156–57) does dispute is that such inconvertibility represented a departure from free banking. And yet both White (1984, pp. 6–19) and Selgin (1988, pp. 94–96) have argued forcefully that (1) free banks issuing debt-based (i.e., specie-convertible) notes and deposit credits are constrained from overissuing such liabilities by the fact that these firms face rising marginal costs, and (2) these marginal costs rise principally because of liquidity costs, i.e., the costs of acquiring and holding specie for the purpose of redemption in the course of either interbank or bank-customer transactions (the processes of "adverse clearings" and "reflux").

In the absence of convertibility "free banks" would experience a much-relaxed constraint on overissuance. Indeed, when discussing "free banking" in Michigan, Dowd (1989, p. 137) states that "the suspension of convertibility removed the main check against overissue, and so a monetary explosion was to be expected." Clearly, convertibility is essential to any (specie-based) system that merits being characterized as "free banking."

Small-Denomination Notes

In 1765 the British Parliament imposed on Scotland legislation that prohibited not only the option clause but also the issue of notes smaller than one pound. The option clause has been often discussed (see, e.g., Selgin 1988, pp. 137, 161–62) and Dowd (1989, pp. 119, 122), but the prohibition of small-denomination notes seems to have received little attention.

Three aspects of this are of importance. First of all, one needs to realize that the one-pound note of 1765 had roughly the purchasing

power of $150 to $170 in the United States today.[4] The implication is that, after 1765, many day-to-day transactions could not be conducted in terms of banknotes; recourse to coins was necessary. And the control of coinage rested with the Royal Mint and the Bank of England (Clapham 1958, vol. 2, pp. 51–53). In other words, Scottish banks were systematically excluded from competition by means of notes for the business of those whose currency needs were relatively small in scale.

This restriction likely had two further effects. It may have served as a "barrier to entry" for small banks since it might deny them the "niche strategy" of catering to small entrepreneurs and to the less wealthy consumers. Furthermore, since small-denomination notes always tend to circulate more rapidly than those of large denominations (White 1984, p. 8), it would seem that the Act of 1765 must have reduced to some extent the effectiveness of the "reflux" process: it should have raised the average period of circulation for Scottish banknotes and, thereby, increased the possibility of inflationary overissues. And, consistent with this hypothesis, one finds Adam Smith's observation in 1776 that in Scotland "the circulation has frequently been over-stocked with paper money" (Smith 1937, p. 286). One may add to this the facts that (1) food prices fell from 1717 to 1750 but rose strongly in the latter part of the 18th century, as did coal, cattle, and grain prices, and (2) Scottish net exports declined after 1775, and were generally negative from 1780 to 1805 (Lythe and Butt 1975, pp. 102–3, 113, 116–17, 162, 247). All of this suggests—but does not prove—the existence of an inflationary monetary expansion.

Interest Rate Ceilings

In 1714 the Usury Law, to which the Scottish banks were subject, established a legal maximum rate of 5 percent to be charged by financial institutions. The last remnants of this law did not disappear until 1854 (Clapham 1958, vol. 2, p. 224). Of these facts there can be no doubt. However, White has questioned, first of all, whether the 5 percent ceiling applied to one of the key sources of revenue for Scottish banks—the discounting of commercial bills of exchange (letter to Peter Lewin and the author, 30 April 1986). It did indeed: the Usury Law was applicable to "the entire bill market" until 1833, when 90-day bills were made exempt (Homer 1963, p. 205).

[4]Cowen and Kroszner (1989, p. 224) cite an estimate of $200. My estimate is based on the facts that British prices are presently 90 to 100 times the level of 1765 (Mitchell 1988, pp. 719–34) and that the exchange rate is $1.70 per pound.

Also, in the same letter cited above, White wonders if this ceiling was ever a "binding constraint." If one takes that phrase to denote a circumstance in which market rates of interest are driven above the maximum legal rate, then one must apparently answer in the affirmative. Lythe and Butt (1975), while discussing Scottish finance in the 18th century, note that "the price for capital might be higher than the legal maximum bank rate" (p. 155). Since consols issued by the British government were not subject to the Usury Law (Homer 1963, p. 205), one might take the yield on consols to be a reflection of market conditions. And, in the years 1781, 1782, 1784, and 1796–99, this yield exceeded 5 percent (Homer 1963, pp. 161–62). During the long Napoleonic Wars (1793–1815), effective market rates were often above the maximum legal rate (Homer 1963, pp. 186, 205).[5] Short-term market rates also rose above 5 percent during the years 1836, 1837, and 1839–41 (Homer 1963, p. 208).[6] It is possible that short-term rates were greater than 5 percent during part of 1826 as well, since the average of such rates for that year was 4.5 percent (Mitchell 1988, p. 683).

It would seem from the foregoing that the interest rate ceiling must, in fact, have been a constraint on bank competition during at least part of the 1765–1845 period. Checkland (1975, pp. 432, 192) concurs when he states that "the Usury Law limited competition for deposits" and that its effect on "any form of advance was seriously prohibitive." This assessment is echoed by Meulen (1934, p. 92).

Privileged Banks

One may recall White's definition of free banking as a system of "unprivileged private banks." Yet there were two tiers to the Scottish system: (1) three chartered "public" institutions (the Bank of Scotland, the Royal Bank, and the British Linen Company), and (2) the various private banks and joint-stock banking companies. Since the three public banks enjoyed limited shareholder liability while the others were all subject to unlimited liability, Checkland (1975, p. 235) concludes that the former "were in a preferred position relative to all others." The state had created these public banks and "continued to confirm their preferred position through their limited liability and through their public identity and perpetual succession"

[5]Considering the substantial inflation in Britain during the period, it is hardly surprising that this should be the case (see Mitchell 1988, p. 720).

[6]It is unclear whether this posed an impediment to bank competition, since bills of exchange and promissory notes were exempt from the Usury Law after 1833 (Checkland 1975, pp. 192, 443).

(Checkland 1975, p. 275). It would thus seem that the non-chartered banks faced a significant regulatory barrier to entry: unlimited liability. This did not prevent the formation of a number of private banking concerns, but it imposed a constraint on such firms that was not applicable to the three chartered banks.

White, however, asserts that unlimited liability must not have been a binding constraint on the private banks because they "chose to retain unlimited liability in the 1860s and '70s even after limited liability became available to them" (White 1984, p. 143). To argue thus is less than convincing. Institutional structures must be viewed contextually: the fact that Scottish banks of the 1860s seem not to have seen unlimited liability as an odious imposition does not prove that it was not considered to be such in, say, 1780 or 1810. And there is a powerful counterpoint that one must consider. Since the three public banks expended real resources in order to obtain their charters and prevent other banks from gaining charters, one must conclude that a limited liability bank charter was perceived as conferring some significant advantage on its holder (Cowen and Kroszner 1989, p. 226).

A specific advantage of limited liability was the fact that "there was a long-standing government instruction to the officers of the customs to accept only the notes of the chartered banks in payment of duties, and to 'refuse the Notes of every other bank without exception' " (Checkland 1975, p. 186). In short, an artificial demand for the notes of the public banks was established by fiat. Yet one might wonder if the payment of customs duties was of a magnitude sufficient to produce a significant gain for those institutions. One possible measure is the proportion of total government revenues represented by customs duties. One finds that customs duties averaged 22.3 percent of annual government income over the period 1765–1801 and 27.6 percent from 1802 to 1845 (Mitchell 1988, pp. 576–77, 581–82).[7] The collection of customs duties—and, therefore, the benefit to the public banks—seems not to have been trivial.

Conclusion

Lawrence H. White's portrait of Scottish "free banking" is not entirely convincing. The failure rate (1772–1830) for Scottish banks was not lower than that for English banks; banknotes were not consistently convertible into specie on demand; the prohibition of small-denomination notes not only curtailed mutually beneficial transac-

[7]These figures are for Great Britain as a whole; separate series for Scotland do not seem to exist.

tions between banks and their customers but also may have diluted the constraints on overissue; the Usury Law limited interbank competition; and the three chartered banks held privileged positions within the system. The case for free banking does not greatly benefit from reliance on the Scottish experience.

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