

# The Myth of Free Banking in Scotland

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## “Free Banking” in Scotland

Professor White's *Free Banking in Britain* has already had a substantial impact on the economics profession. The main influence has been exerted by one of the book's major themes: the “wonderful” results of the system of free banking in Scotland, a system that allegedly prevailed from 1716 (or 1727) until suppressed by the Peel Act in 1845.<sup>1</sup> White's Scottish free-banking thesis consists of two crucial propositions. The first is that Scottish banking, in contrast to English, was free during this era; that while the English banking system was dominated by the Bank of England, pyramiding their notes and deposits on top of the liabilities of that central bank, the Scottish system, in stark contrast, was free of the Bank of England. In White's words, Scotland “rather maintained a system of ‘each tub on its own bottom.’ Each bank held onto its own specie reserves.”<sup>2</sup>

The second part of the syllogism is that this free system in some way worked much better than the English. Hence, the triumphant conclusion: that free banking in Scotland was far superior to centrally controlled banking in England. White claims that the salutary effects of free banking in Scotland have been long forgotten, and he raises the hope that current public policy will heed this lesson.

The influence of White's thesis is remarkable considering the paucity of his research and the thinness of his discussion. In a brief book of less than two hundred pages, only 26 are devoted to the Scottish question, and White admits that he relies for facts of Scottish banking almost solely on a few secondary sources.<sup>3</sup> And yet, White's thesis on Scottish banking has been hastily and uncritically accepted by many diverse scholars, including the present writer.<sup>4</sup> This has been particularly unfortunate because, as I shall demon-

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Review of Lawrence H. White, *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845* (Cambridge University Press, 1984).

strate, both parts of Professor White's syllogism are wrong. That is, the Scottish banks were (1) not free—indeed, they too pyramided upon the Bank of England—and (2) not surprisingly, they worked no better than the English banks.

Let me take the second part of Professor White's syllogism first. What is his basis for the conclusion that the Scottish banks worked significantly better than the English banks? Remarkably, there is not a word that they were significantly less inflationary; indeed, there is no attempt to present any data on the money supply, the extent of bank credit, or prices in England and Scotland during this period. White does say that the Scottish banks were marked by greater "cyclical stability," but it turns out that he does not mean that they generated less inflation in booms or less contraction during recessions. By cyclical stability, White means solely that the extent of Scottish bank failures was less than in England. Indeed, this is Professor White's *sole* evidence that Scottish banking worked better than English.

But why should lack of bank failure be a sign of superiority? On the contrary, a dearth of bank failure should rather be treated with suspicion, as witness the drop of bank failures in the United States since the advent of the FDIC. It might indeed mean that the *banks* are doing better, but at the expense of society and the economy faring *worse*. Bank failures are a healthy weapon by which the market keeps bank credit inflation in check; an absence of failure might well mean that that check is doing poorly and that inflation of money and credit is all the more rampant. In any case, a lower rate of bank failure can scarcely be accepted as any sort of evidence for the superiority of a banking system.

In fact, in a book that Professor White acknowledges to be the definitive history of Scottish banking, Professor Sydney Checkland points out that Scottish banks expanded and contracted credit in a lengthy series of boom-bust cycles, in particular in the years surrounding the crises of the 1760s, 1772, 1778, 1793, 1797, 1802–03, 1809–10, 1810–11, 1818–19, 1825–26, 1836–37, 1839, and 1845–47.<sup>5</sup> Apparently, the Scottish banks escaped none of the destabilizing, cycle-generating behavior of their English cousins.

Even if free, then, the Scottish banking system worked no better than central-bank-dominated English banking. But I turn now to Professor White's central thesis on Scottish banking: that it, in contrast to English banking, was free and independent, with each bank resting on its own specie bottom. For Scottish banking to be "free," its banks would have to be independent of central banking, with each redeeming its notes and deposits on demand in its own reserves of gold.

From the beginning, there is one embarrassing and evident fact that Professor White has to cope with: that "free" Scottish banks suspended specie payment when England did, in 1797, and, like England, maintained that suspension until 1821. Free banks are not supposed to be able to, or want to,

suspend specie payment, thereby violating the property rights of their depositors and noteholders, while they themselves are permitted to continue in business and force payment upon *their* debtors.

White professes to be puzzled at this strange action of the Scottish banks. Why, he asks, did they not “remain tied to specie and let their currency float against the Bank of England note?” His puzzlement would vanish if he acknowledged an evident answer: that Scottish banks were *not* free, that they were in no position to pay in specie, and that they pyramided credit on top of the Bank of England.<sup>6</sup> Indeed, the Scottish banks’ eagerness for suspension of their contractual obligations to pay in specie might be related to the fact, acknowledged by White, that specie reserves held by the Scottish banks had averaged from 10 to 20 percent in the second half of the eighteenth century, but then had dropped sharply to a range of less than 1 to 3 percent in the first half of the nineteenth. Instead of attributing this scandalous drop to “lower costs of obtaining specie on short notice” or “lower risk of substantial specie outflows,” White might realize that suspension meant that the banks would not have to worry very much about specie at all.<sup>7</sup>

Professor Checkland, indeed, presents a far more complete and very different account of the suspension crisis. It began, not in 1797, but four years earlier, in the banking panic that struck on the advent of the war with France. Representatives of two leading Scottish banks immediately went to London, pleading for government intervention to bail them out. The British government promptly complied, issuing Treasury bills to “basically sound” banks, of which £400,000 went to Scotland. This bailout, added to the knowledge that the government stood ready to do more, allayed the banking panic.

When the Scottish banks followed the Bank of England in suspending specie payments in 1797, White correctly notes that the suspension was illegal under Scottish law, adding that it was “curious” that their actions were not challenged in court. Not so curious, if we realize that the suspension obviously had the British government’s tacit consent. Emboldened by the suspension, and by the legality of bank issue of notes under £1 after 1800, a swarm of new banks entered the field in Scotland, and Checkland informs us that the circulation of bank paper in Scotland doubled from 1793 to 1803.

Before the Scottish banks suspended payment, all Scottish bank offices were crowded with depositors demanding gold and small-note holders demanding silver in payment. They were treated with contempt and loathing by the bankers, who denounced them as the “lowest and most ignorant classes” of society, presumably for the high crime of wanting their money out of the shaky and inherently bankrupt banking system. Not only the bankers, but even elite merchants from Edinburgh and throughout Scotland complained, in 1764, of “obscure people” demanding cash from the banks, which they then had the effrontery to send to London and profit from the rate of exchange.<sup>8</sup> Particularly interesting, for more than just the twenty-four years

of the British suspension, was the reason the Scottish banks gave for turning to suspension of specie payments. As Checkland summed up, the Scottish banks were “most gravely threatened, for the inhibitions against demanding gold, so carefully nurtured in the customers of Scottish banks, was rapidly breaking down.”<sup>9</sup>

Now I come to the nub: that, as a general rule, and not just during the official suspension period, the Scottish banks redeemed in specie *in name only*; that, in substance, depositors and note holders generally could not redeem the banks’ liabilities in specie. The reason that the Scottish banks could afford to be outrageously inflationary, i.e. keep their specie reserves at a minimum, is that, in practice, they did not really have to pay.

Thus, Professor Checkland notes that, long before the official suspension, “requests for specie [from the Scottish banks] met with disapproval and almost with charges of disloyalty.” And again:

The Scottish system was one of continuous partial suspension of specie 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. They expected, rather, an argument, or even a rebuff. At best they would get a little specie and perhaps bills on London. If they made serious trouble, the matter would be noted and they would find the obtaining of credit more difficult in future.<sup>10</sup>

At one point, during the 1750s, a bank war was waged between a cartel of Glasgow banks, which habitually redeemed in London bills rather than specie, and the banks in Edinburgh. The Edinburgh banks set up a private Glasgow banker, Archibald Trotter, with a supply of notes on Glasgow banks, and Trotter demanded that the banks of his city redeem them, as promised, in specie. The Glasgow banks delayed and dragged their feet, until Trotter was forced to file a law suit for damages for “vexatious delay” in honoring his claims. Finally, after four years in court, Trotter won a nominal victory, but could not get the law to force the Glasgow banks to pay up. *A fortiori*, of course, the banks were not shut down or their assets liquidated to pay their wilfully unpaid debts.

As we have seen, the Scottish law of 1765, providing for summary execution of unredeemed bank notes, remained largely a dead letter. Professor Checkland concludes that “this legally impermissible limitation of convertibility, though never mentioned to public inquiries, contributed greatly to Scottish banking success.”<sup>11</sup> No doubt. Of one thing we can be certain: this condition definitely contributed to the paucity of bank failures in Scotland.

The less-than-noble tradition of nonredeemability in Scottish banks continued, unsurprisingly, after Britain resumed specie payments in 1821. As the

distinguished economic historian Frank W. Fetter put it, writing about Scotland:

Even after the resumption of payments in 1821 little coin had circulated; and 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. There was a core of truth in the remark of an anonymous pamphleteer [writing in 1826] “Any southern fool [from south of the Scottish–English border] who had the temerity to ask for a hundred sovereigns, might, if his nerves supported him through the cross examination at the bank counter, think himself in luck to be hunted only to the border.”<sup>12</sup>

If gold and silver were scarcely important sources of reserves or of grounding for Scottish bank liabilities, what was? Each bank in Scotland stood not on its own bottom, but on the very source of aid and comfort dear to its English cousins—the Bank of England. As Checkland declares: “the principal and ultimate source of liquidity [of the Scottish banks] lay in London, and, in particular, in the Bank of England.”<sup>13</sup>

I conclude that the Scottish banks, in the eighteenth and first half of the nineteenth centuries, were neither free nor superior, and that the thesis to the contrary, recently revived by Professor White, is but a snare and a delusion.

## The Free-Banking Theorists Reconsidered

The bulk of *Free Banking in Britain* is taken up, not with a description or analysis of Scottish banking, but with analyzing the free-banking controversies in the famous monetary debates of the two decades leading up to Peel’s Act of 1844. The *locus classicus* of discussion of free versus central banking in Europe is the excellent work by Vera C. Smith, *The Rationale of Central Banking*.<sup>14</sup> While Professor White makes a contribution by dealing in somewhat more depth with the British controversialists of the era, he unfortunately takes a giant step backward from Miss Smith in his basic interpretation of the debate. Miss Smith realized that the currency school theorists were hard-money men who saw the evils of bank credit inflation and who tried to eliminate them so that the money supply would as far as possible be equivalent to the commodity standard, gold or silver. On the other hand, she saw that the banking school theorists were inflationists who favored bank credit expansion in accordance with the “needs of trade.” More importantly, Miss Smith saw that for both schools of thought, free banking and central banking were contrasting means to arrive at their different goals. As a result, she ana-

lyzes her monetary writers according to an illuminating 2 × 2 grid, with “currency school” and “banking school” on one side and “free banking” and “central banking” on the other.

In *Free Banking in Britain*, on the other hand, Professor White retreats from this important insight, misconceiving and distorting the entire analysis by separating the theorists and writers into three distinct camps, the currency school, banking school, and free-banking school. By doing so, he lumps together analysis and policy conclusions, and he conflates two very distinct schools of free bankers: (1) those who wanted free banking in order to promote monetary inflation and cheap credit and (2) those who, on the contrary, wanted free banking in order to arrive at hard, near-100 percent specie money. The currency school and banking school are basically lumped by White into one group: the pro-central-banking faction. Of the two, White is particularly critical of the currency school, which supposedly all wanted central banks to levy “arbitrary” restrictions on commercial banks. While White disagrees with the pro-central-banking aspects of the banking school, he is clearly sympathetic with their desire to inflate bank credit to supply the “needs of trade.” In that way, White ignores the substantial minority of currency school theorists who preferred free banking to central bank control as a way of achieving 100 percent specie money. In addition, he misunderstands the nature of the inner struggles to find a correct monetary position by laissez-faire advocates, and he ignores the vital differences between the two wings of free bankers.

On the currency school, it is true that most currency men believed in 100 percent reserves issued either by a central bank monopoly of note issue or by an outright state bank monopoly. But, as Smith pointed out, the aim of the currency men was to arrive at a money supply equivalent to the genuine free market money of a pure specie commodity (gold or silver). And furthermore, since currency men tended to be laissez-faire advocates distrustful of state action, a substantial minority advocated free banking as a better political alternative for reaching the desired 100 percent gold money than trusting in the benevolence of the state. As Smith notes, Ludwig von Mises was one of those believing that free banking in practice would approximate a 100 percent gold or silver money. Free banking and 100 percent metallic money advocates in the nineteenth century included Henri Cernuschi and Victor Modeste in France, and Otto Hübner in Germany.<sup>15</sup> Mises’ approach was very similar to that of Otto Hübner, a leader of the German Free Trade Party. In his multivolume work, *Die Banken* (1854), Hübner states that his ideal preference would have been a state-run monopoly 100 percent specie reserve bank, along the lines of the old Banks of Amsterdam and Hamburg. But the state cannot be trusted. To quote Vera Smith’s paraphrase of Hübner’s position:

If it were true that the State could be trusted always only to issue notes to the amount of its specie holdings, a State-controlled note issue would be the best system, but as things were, a far nearer approach to the ideal system was to be expected from free banks, who for reasons of self-interest would aim at the fulfilment of their obligations.<sup>16</sup>

Henri Cernuschi desired 100 percent specie money. He declared that the important question was not monopoly note issue versus free banking, but whether or not bank notes should be issued at all. His answer was no, since “they had the effect of despoiling the holders of metallic money by depreciating its value.” All bank notes, all fiduciary media, should be eliminated. An important follower of Cernuschi’s in France was Victor Modeste, whom Vera Smith erroneously dismisses as having “the same attitude” as Cernuschi’s. Actually, Modeste did not adopt the free-banking policy conclusion of his mentor. In the first place, Modeste was a dedicated libertarian who frankly declared that the state is “the master . . . the obstacle, the enemy” and whose announced goal was to replace all government by “self-government.” Like Cernuschi and Mises, Modeste agreed that freely competitive banking was far better than administrative state control or regulation of banks. And like Mises a half-century later (and like most American currency men at the time), Modeste realized that demand deposits, like bank notes beyond 100 percent reserves, are illicit, fraudulent, and inflationary as well as being generators of the business cycle. Demand deposits, like bank notes, constitute “false money.” But Modeste’s policy conclusion was different. His answer was to point out that “false” demand liabilities that pretend to be but cannot be converted into gold are in reality tantamount to fraud and embezzlement. Modeste concludes that false titles and values, such as false claims to gold under fractional-reserve banking, are at all times

equivalent to theft; that theft in all its forms everywhere deserves its penalties . . . , that every bank administrator . . . must be warned that to pass as value where there is no value . . . to subscribe to an engagement that cannot be accomplished . . . are criminal acts which should be relieved under the criminal law.<sup>17</sup>

The answer to fraud, then, is not administrative regulation, but prohibition of tort and fraud under general law.<sup>18</sup>

For Great Britain, an important case of currency men not discussed by Smith are the famous laissez-faire advocates of the Manchester school. Hobbled by his artificial categories, Professor White can only react to them in total confusion. Thus, John Benjamin Smith, the powerful president of the

Manchester Chamber of Commerce, reported to the chamber in 1840 that the economic and financial crisis of 1839 had been caused by the Bank of England's contraction, following inexorably upon its own earlier "undue expansion of the currency." Simply because Smith condemned Bank of England policy, White chides Marion Daugherty for putting J.B. Smith into the ranks of the currency school rather than the free bankers. But then, only four pages later, White laments the parliamentary testimony during the same year of Smith and Richard Cobden as revealing "the developing tendency for adherents of laissez-faire, who wished to free the currency from discretionary management, to look not to free banking but to restricting the right of issue to a rigidly rule-bound state bank as the solution." So what were Smith, Cobden, and the Manchesterites? Were they free bankers (p. 71) or—in the same year—currency men (p. 75), or what? But how could they have been currency men, since White has defined the latter as people who want total power to accrue to the Bank of England? White avoids this question by simply not listing Smith or Cobden in his table of currency-banking-free-banking school adherents (p. 135).<sup>19</sup>

White might have avoided confusion if he had not, as in the case of Scottish banking, apparently failed to consult Frank W. Fetter's *Development of British Monetary Orthodoxy*, although the book is indeed listed in his bibliography. Fetter notes that Smith, in his parliamentary testimony, clearly enunciates the currency principle. Smith, he points out, was concerned about the fluctuations of the commercial banks as well as of the Bank of England and flatly declared his own currency school objective: "it is desirable in any change in our existing system to approximate as nearly as possible to the operation of a metallic currency; it is desirable also to divest the plan of all mystery, and to make it so plain and simple that it may be easily understood by all."<sup>20</sup> Smith's proposed solution was the scheme derived from Ricardo, of creating a national bank for purposes of issuing 100 percent reserve bank notes.

The same course was taken, in his testimony, by Richard Cobden, the great leader of the Manchester laissez-faire movement. Attacking the Bank of England and any idea of discretionary control over the currency, whether by the Bank or by private commercial banks, Cobden declared:

I hold all idea of regulating the currency to be an absurdity; the very terms of regulating the currency and managing the currency I look upon to be an absurdity; the currency should regulate itself; it must be regulated by the trade and commerce of the world; I would neither allow the Bank of England nor any private banks to have what is called the management of the currency. . . . I would never contemplate any remedial measure, which left it to the discretion of individuals to regulate the amount of currency by any principle or standard whatever.<sup>21</sup>



In short, the fervent desire of Richard Cobden, along with other Manchesterians and most other currency school writers, was to remove government or bank manipulation of money altogether and to leave its workings solely to the free-market forces of gold or silver. Whether or not Cobden's proposed solution of a state-run bank was the proper one, no one can deny the fervor of his *laissez-faire* views or his desire to apply them to the difficult and complex case of money and banking.

Let me now return to Professor White's cherished free-banking writers and to his unfortunate conflation of the very different hard-money and soft-money camps. The currency school and the free bankers were both launched upon the advent of the severe financial crisis of 1825, which, as usual, was preceded by a boom fueled by bank credit. The crisis brought the widespread realization that the simple return to the gold standard, as effected in 1821, was not enough and that something more had to be done to eliminate the instability of the banking system.<sup>22</sup>

Among four leading free-banking advocates of the 1820s and early 1830s—Robert Mushet, Sir John Sinclair, Sir Henry Brooke Parnell, and George Poulett Scrope—Professor White sees little difference. And yet they were split into two very different camps. The earlier writers, Mushet and Parnell, were hard money men. Mushet, a long-time pro-gold-standard “bullionist” and clerk at the Royal Mint, set forth a currency-principle-type of business cycle theory in 1826, pointing out that the Bank of England had generated an inflationary boom, which later had to be reversed into a contractionary depression. Mushet's aim was to arrive at the equivalent of a purely metallic currency, but he believed that free rather than central banking was a better way to achieve it. Once again, White's treatment muddies the waters. While admitting that Mushet took a currency school approach toward purely metallic money, White still chooses to criticize Daugherty for classifying Mushet with the currency school, since he opted for a free- rather than a central-banking method to achieve currency goals (p. 62 n). The more prominent Parnell was also a veteran bullionist writer and Member of Parliament, who took a position very similar to Mushet's.<sup>23</sup>

Sir John Sinclair and George Poulett Scrope, however, were horses of a very different color. White admits that Sinclair was not a pure free-banking man, but he characteristically underplays Sinclair's fervent lifelong views as being concerned with “preventing deflation” and calls Sinclair a “tireless promoter of agricultural interests” (p. 60 and 60 n). In truth, Sinclair, a Scottish nobleman and agriculturist, was, all his life, a determined and fanatical zealot on behalf of monetary inflation and government spending. As soon as the pro-gold-standard, anti-fiat paper Bullion Committee Report was issued in 1810, Sir John wrote to Prime Minister Spencer Perceval urging the government to reprint his own three-volume proinflationist work, *History of the*

*Public Revenues of the British* (1785–90), as part of the vital task of rebutting the Bullion Committee. “You know my sentiments regarding the importance of paper Circulation,” Sinclair wrote the Prime Minister, “which is in fact the basis of our prosperity.” In fact, Sinclair’s *Observations on the Report of the Bullion Committee*, published in September 1810, was the very first of many pamphlet attacks on the Bullion Report, most of them orchestrated by the British government.

When Britain went back to the gold standard in 1819–21, Sinclair, joining with the proinflationist and pro–fiat money Birmingham school, was one of the most energetic and bitter critics of resumption of specie payments. It is no wonder that Frank Fetter should depict Sinclair’s lifelong enthusiasm: “that more money was the answer to all economic problems.”<sup>24</sup> It is also no wonder that Sinclair should have admired the Scottish “free” banking system and opposed the currency principle. But one would have thought that Professor White would feel uncomfortable with Sinclair as his ally.

Another of Professor White’s dubious heroes is George Poulett Scrope. While Scrope is also characterized as not a pure or mainstream free-banking man, his analysis is taken very seriously by White and is discussed numerous times. And he is mentioned prominently in White’s table as a leading free banker. Scrope’s inveterate inflationary bent is handled most gently by White: “Like Sinclair, he [Scrope] placed higher priority on combating deflation” (p. 82 n). In fact, Scrope not only battled against the return to the gold standard in 1819–21, he was also the leading theorist of the fortunately small band of writers in Britain who were ardent underconsumptionists and proto-Keynesians. In his *Principles of Political Economy* (written in 1833, the same year as his major pro–free-banking tract), Scrope declared that any decline in consumption in favor of a “general increase in the propensity to save” would necessarily and “proportionately diminish the demand as compared with the supply, and occasion a *general glut*”.

Let us now turn to the final stage of the currency school–banking school–free-banking controversy. The financial crisis of 1838–39 touched off an intensified desire to reform the banking system, and the controversy culminated with the Peel Acts of 1844 and 1845.

Take, for example, one of Professor White’s major heroes, James William Gilbert. Every historian except White has included Gilbert among the members of the banking school. Why does not Professor White? Despite White’s assurance, for example, that the free-banking school was even more fervent than the currency school in attributing the cause of the business cycle to monetary inflation, Gilbert held, typically of the banking school, that bank notes simply expand and contract according to the “wants of trade” and that, therefore, issue of such notes, being matched by the production of goods, could not raise prices. Furthermore, the active causal flow goes from “trade” to prices to the “requirement” for more bank notes to flow into circulation.

Thus said Gilbart: “If there is an increase of trade without an increase of prices, I consider that more notes will be required to circulate that increased quantity of commodities; if there is an increase of commodities and an increase of prices also, of course, you would require a still greater amount of notes.”<sup>25</sup> In short, whether prices rise or not, the supply of money must always increase! Putting aside the question of who the “you” is supposed to be in this quote, this is simply rank inflationism of the banking school variety. In fact, of course no increase of money is “required” in either case. The genuine causal chain is the other way round, from increased bank notes to increased prices, and *also* to increased money value of the goods being produced.

Professor White may not be alive to this distinction because he, too, is a follower of the “needs of trade” (or “wants of trade”) rationale for bank credit inflation. White’s favorable discussion of the needs-of-trade doctrine (pp. 122–26) makes clear that he himself is indeed a variant of banking-school inflationist. Unfortunately, White seems to think all this to be consonant with the “Humean-Ricardian” devotion to a purely metallic currency (p. 124). For one thing, White does not seem to realize that David Hume, in contrast to his banking-school friend Adam Smith, believed in 100 percent specie reserve banking.

While Professor White, in the previous quote from Gilbart, cites his Parliamentary testimony in 1841, he *omits* the crucial interchange between Gilbart and Sir Robert Peel. In his testimony, Gilbart declared not only that country bank notes increase solely in response to the wants of trade and, therefore, that they could never be overissued. He *also* claimed—in keeping with the tenets of the banking school—that even the Bank of England could never overissue notes so long as it only discounted commercial loans! So much for Professor White’s claims of Gilbart’s alleged devotion to free banking! There followed some fascinating and revealing colloquies between Peel and the alleged free banker (i.e., *pro-free-banking, pro-gold-standard*) James Gilbart. Peel sharply continued his questioning: “Do you think, then, that the legitimate demands of commerce may always be trusted to, as a safe test of the amount of circulation under all circumstances?” To which Gilbart admitted: “I think they may.” (Note: nothing was said about exempting the Bank of England from such trust.)

Peel then asked the critical question. The banking school (followed by Professor White) claimed to be devoted to the gold standard, so that the “needs of trade” justification for bank credit would *not* apply to inconvertible fiat currency. But Peel, suspicious of the banking school’s devotion to gold, then asked: In the bank restriction [fiat money] days, “do you think that the legitimate demands of commerce constituted a test that might be safely relied upon?” Gilbart evasively replied: “That is a period of which I have no personal knowledge”—a particularly disingenuous reply from a man who had

written *The History and Principles of Banking* (1834). Indeed, Gilbert proceeded to throw in the towel on the gold standard: "I think the legitimate demands of commerce, even then, would be a sufficient guide to go by." When Peel pressed Gilbert further on that point, the latter began to back and fill, changing and rechanging his views, finally once more falling back on his lack of personal experience during the period.<sup>26</sup>

Peel was certainly right in being suspicious of the banking school's devotion to the gold standard—whether or not Professor White was later to reclassify them as free bankers. In addition to Gilbert's revelations, Gilbert's fellow official at the London & Westminster Bank, J.W. Bosanquet, kept urging bank suspensions of specie payment whenever times became difficult. And in his popular tract of 1844, *On the Regulation of Currencies*, John Fullarton—a banker in India by then retired in England and a key leader of the banking school—gave the game away. Wrote Fullarton:

And, much as I fear I am disgracing myself by the avowal, I have no hesitation in professing my own adhesion to the decried doctrine of the old Bank Directors of 1810, "that so long as a bank issues its notes only on the discount of *good* bills, at not more than sixty days' date, it cannot go wrong in issuing as many as the public will receive from it."<sup>27</sup>

Fullarton was referring, of course, to the old antibullionist position that so long as any bank, even under an inconvertible currency, sticks to short-term real bills, it cannot cause an inflation or a business-cycle boom. It is no wonder that Peel suspected all opponents of the currency principle to be crypto-Birmingham men.<sup>28</sup>

The only distinguished economist to take up the free-banking cause is another one of Professor White's favorites: Samuel Bailey, who had indeed demolished Ricardian value theory in behalf of subjective utility during the 1820s. Now, in the late 1830s and early 1840s, Bailey entered the lists in behalf of free banking. Unfortunately, Bailey was one of the worst offenders in insisting on the absolute passivity of the British country and joint-stock banks as well as in attacking the very idea that there might be something worrisome about changes in the supply of money. By assuring his readers that competitive banking would always provide a "nice adjustment of the currency to the wants of the people," Bailey overlooked the fundamental Ricardian truth that there is never any social value in increasing the supply of money, as well as the insight that bank credit entails a fraudulent issue of warehouse receipts to nonexistent goods.

Finally, Professor White ruefully admits that when it came to the crunch—the Peel Acts of 1844 and 1845 establishing a Bank of England monopoly of note issue and eliminating the "free" banking system of Scotland—his free-banking heroes were nowhere to be found in opposition. White con-

cedes that their support of Peel's acts was purchased by the grant of cartelization. In short, in exchange for Bank of England monopoly on note issue, the existing English and Scottish banks were "grandfathered" into place; they could keep their existing circulation of notes, while no new competitors were allowed to enter into the lucrative note-issuing business. Thus, White concedes:

He [Gilbart] was relieved that the [Peel] act did not extinguish the joint-stock banks' right of issue and was frankly pleased with its cartelizing provisions: "Our rights are acknowledged—our privileges are extended—our circulation guaranteed—and we are saved from conflicts with reckless competitors." (p. 79)

Very well. But White avoids asking himself the difficult questions. For example: what kind of a dedicated "free-banking" movement is it that can be so easily bought off by cartel privileges from the state? The answer, which White sidesteps by avoiding the question is precisely the kind of a movement that serves simply as a cloak for the interests of the commercial bankers.

For, with the exception of the older, hard-money free-banking men—such as Mushet (long dead by 1844) and Parnell (who died in the middle of the controversy in 1842)—virtually all of White's free bankers were themselves officials of private commercial banks. Gilbart had been a bank official all his life and had long been manager of the London & Westminster Bank. Bailey was chairman of the Sheffield Banking Company. Consider, for example, the newly founded *Bankers' Magazine*, which White lauds as a crucial organ of free-banking opinion. White laments that a writer in the June 1844 issue of *Bankers' Magazine*, while critical of the currency principle and monopoly issues for the Bank of England, yet approved the Peel Act as a whole for aiding the profits of existing banks by prohibiting all new banks of issue.

And yet, Professor White resists the realization that his entire cherished free-banking movement—at least in its later inflationist "need of trade" manifestation—was simply a special pleading on behalf of the inflationary activities of the commercial banks. Strip away White's conflation of the earlier hard-money free-banking theorists with the later inflationists, and his treasured free-banking movement turns out to be merely special pleaders for bank chicanery and bank credit inflation.

## Notes

1. On "wonderful" results, see White, *Free Banking*, p. xiii.
2. *Ibid.*, p. 43.
3. Most of the White book, indeed, is devoted to another question entirely—a

discussion and analysis of free-banking theorists in Britain during the first half of the nineteenth century. I shall deal with that part of his book subsequently.

4. Murray N. Rothbard, *The Mystery of Banking* (New York: Richardson & Snyder, 1983), pp. 185–87. Also see the report on a forthcoming *Journal of Monetary Economics* article by Milton Friedman and Anna Jacobson Schwartz in *Fortune* (March 31, 1986), p. 163. I did have grave preliminary doubts about his Scottish thesis in an unpublished comment on Professor White's paper in 1981, but unfortunately, these doubts did not make their way into the *Mystery of Banking*.

5. Sydney G. Checkland, *Scottish Banking: A History, 1695–1973* (Glasgow: Collins, 1975).

6. In a footnote, Professor White grudgingly hints at this point, while not seeming to realize the grave implications of the facts for his own starry-eyed view of Scottish banking. Note, then, the unacknowledged implications of his hint that London was "Britain's financial centre," that the Scottish banks depended on funds from their correspondent banks and from sales of securities in London, and that Britain was an "optimal currency area." White, *Free Banking*, p. 46 n. 12.

7. White, *Free Banking*, pp. 43–44, n. 9.

8. See Charles A. Malcolm, *The Bank of Scotland, 1695–1945* (Edinburgh: R. & R. Clark, n.d.).

9. Checkland, *Scottish Banking*, p. 221.

10. Checkland, *Scottish Banking*, pp. 184–85.

11. *Ibid.*, p. 186.

12. Frank W. Fetter, *Development of British Monetary Orthodoxy, 1797–1875* (Cambridge, Mass.: Harvard University Press, 1965), p. 122. The anonymous pamphlet was *A Letter to the Right Hon. George Canning* (London, 1826), p. 45. Also see Charles W. Munn, *The Scottish Provincial Banking Companies, 1747–1864* (Edinburgh: John Donald Pubs., 1981), pp. 140ff.

A similar practice was also prevalent at times in the "free-banking" system in the United States. After the "resumption" of 1817, obstacles and intimidation were often the fate of those who tried to ask for specie for their notes. In 1821, the Philadelphia merchant, economist and state Senator Condy Raguét perceptively wrote to David Ricardo:

You state in your letter that you find it difficult to comprehend why persons who had a right to demand coin from the Banks in payment of their notes, so long forebore to exercise it. This no doubt appears paradoxical to one who resides in a country where an act of parliament was necessary to protect a bank, but the difficulty is easily solved. The whole of our population are either stockholders of banks or in debt to them. It is not in the *interest* of the first to press the banks and the rest are *afraid*. This is the whole secret. An independent man, who was neither a stockholder or debtor, who would have ventured to compel the banks to do justice, would have been persecuted as an enemy of society. (Quoted in Murray N. Rothbard, *The Panic of 1819: Reactions and Policies*, New York: Columbia University Press, 1962, pp. 10–11)

There is unfortunately no record of Ricardo's side of the correspondence.

13. Checkland, *Scottish Banking*, p. 432. Also see S.G. Checkland, "Adam Smith and the Bankers," in A. Skinner and T. Wilson, eds., *Essays on Adam Smith* (Oxford, England: Clarendon Press, 1975), pp. 504–23.

14. Vera C. Smith, *The Rationale of Central Banking* (London: P.S. King &

Sons, 1936). This book was a doctoral dissertation under F.A. Hayek at the London School of Economics, for which Miss Smith made use of Hayek's notes on the subject. See Pedro Schwartz, "Central Bank Monopoly in the History of Economic Thought: a Century of Myopia in England," in P. Salin, ed., *Currency Competition and Monetary Union* (The Hague: Martinus Nijhoff, 1984), pp. 124–25.

15. After quoting favorably Thomas Tooke's famous dictum that "free trade in banking is free trade in swindling," Mises adds:

However, freedom in the issuance of banknotes would have narrowed down the use of banknotes considerably if it had not entirely suppressed it. It was this idea which Cernuschi advanced in the hearings of the French Banking Inquiry on October 24, 1865: "I believe that what is called freedom of banking would result in a total suppression of banknotes in France. I want to give everybody the right to issue banknotes so that nobody should take banknotes any longer." (Ludwig von Mises, *Human Action: A Treatise on Economics*, 3rd rev. ed., Chicago: Henry Regnery, 1966, p. 446)

16. Smith, *Rationale*, p. 101. Mises, after endorsing the idea of 100 percent reserves to gold of banknotes and demand deposits (the latter unfortunately overlooked by the currency school in Britain), decided against it because of the "drawbacks inherent in every kind of government interference with banking." And again:

Government interference with the present state of banking affairs could be justified if its aim were to liquidate the unsatisfactory conditions by preventing or at least seriously restricting any further credit expansion. In fact the chief objective of present-day government interference is to intensify further credit expansion. (Mises, *Human Action*, p. 443, 448)

17. Victor Modeste, "Le Billet des banques d'émission est-il fausse monnaie?" [Are Bank Notes False Money?] *Journal des économistes* 4 (October 1866), pp. 77–78 (Translation mine). Also see Henri Cernuschi, *Contre le billet de banque* (1866).

18. This policy conclusion is completely consistent with Mises' objective: "What is needed to prevent any further credit expansion is to place the banking business under the general rules of commercial and civil laws compelling every individual and firm to fulfill all obligations in full compliance with the terms of the contract." Mises, *Human Action*, p. 443.

For more on fractional-reserve banking as embezzlement, see Rothbard, *Mystery of Banking*, pp. 91–95.

19. White, *Free Banking*, pp. 71, 75, 135. Also see Marion R. Daugherty, "The Currency-Banking Controversy, Part I," *Southern Economic Journal* 9 (October 1942), p. 147.

20. Quoted in Fetter, *Development*, p. 176.

21. *Ibid.*

22. One measure of partial reform accomplished by the British government was the outlawing, in 1826, of small-denomination (under £5) bank notes (an edict obeyed by the Bank of England for over a century), which at least insured that the average person would be making most transactions in gold or silver coin. Even Adam Smith, the leading apologist for Scottish "free" banking, had advocated such a measure. But it is instructive to note, in view of Professor White's admiration for Scottish banking, that political pressure by the Scottish Tories gained the Scottish banks an exemption from this measure. The Tory campaign was led by the eminent novelist, Sir Walter Scott. Hailing the campaign, the spokesman for Scottish High Toryism, *Blackwood's*

*Edinburgh Magazine*, published two articles on “The Country Banks and the Bank of England” in 1827–28, in which it wove together two major strains of archinflationism: going off the gold standard and praising the country banks. *Blackwood’s* also attacked the Bank of England as overly restrictionist (!), thus helping to inaugurate the legend that the trouble with the bank was that it was too restrictive instead of being itself the major engine of monetary inflation. In contrast, the *Westminster Review*, the spokesman for James Mill’s philosophic radicals, scoffed at the Scots for threatening “a civil war in defense of the privilege of being plundered” by the banking system. See Fetter, *Development*, pp. 123–24.

23. Professor White has performed a valuable service in rescuing Parnell’s work from obscurity. Parnell’s tract of 1827 was attacked from a more consistent hard-money position by the fiery populist radical, William Cobbett. Cobbett averred that “ever since that hellish compound Paper-money was understood by me, I have wished for the destruction of the accursed thing; I have applauded every measure that tended to produce its destruction, and censured every measure having a tendency to preserve it.” He attacked Parnell’s pamphlet for defending the actions of the country banks and for praising the Scottish system. In reply, Cobbett denounced the “Scottish monopolists” and proclaimed that “these ravenous Rooks of Scotland . . . have been a pestilence to England for more than two hundred years.”

24. Fetter, *Development*, p. 22. Among his other sins, Sinclair, an indefatigable collector of statistics, in the 1790s published the twenty-one-volume *A Statistical Account of Scotland* and actually introduced the words *statistics* and *statistical* into the English language.

25. Quoted in White, *Free Banking*, p. 124.

26. The interchange between Peel and Gilbart may be found in the important article by Boyd Hilton, “Peel: A Reappraisal,” *Historical Journal* 22 (September 1979), pp. 593–94. Hilton shows that Peel (far from being the unprincipled opportunist he had usually been portrayed as by historians) was a man of increasingly fixed classical liberal principles, devoted to minimal budgets, free trade, and hard money. Not understanding economics, however, Hilton characteristically brands Peel’s questioning of Gilbart as “inept” and sneers at Peel for scoffing at Gilbart’s patent dodge of lacking “personal knowledge.”

Moreover, not being a classical liberal, Hilton ridicules Sir Robert Peel’s alleged inflexible dogmatism on behalf of *laissez-faire*. It is most unfortunate that White, in his eagerness to censure Peel’s attack on inflationary bank credit, praises Hilton’s “insightful account of Peel’s little-recognized dogmatism on matter of monetary policy” (p. 77 n). Does White also agree with Hilton’s denunciation of Peel’s “dogmatism” on free trade?

27. Quoted in Fetter, *Development*, p. 193.

28. Neither is the example of James Wilson reassuring. Wilson, founding editor of the new journal, *The Economist*, was dedicated to *laissez-faire* and to the gold standard. He entered the monetary debate quite late, in spring 1845, becoming one of the major leaders of the banking school. Though of all the banking school, Wilson was one of the friendliest to free banking and to the Scottish system, he *also* claimed that the Bank of England could never overissue notes in a convertible monetary system. And though personally devoted to the gold standard, Wilson even made the same



damaging concession as Gilbart, though far more clearly and candidly. For, of all the major banking school leaders, Wilson was the only one who stated flatly and clearly that no banks could ever overissue notes if they were backed by short-term, self-liquidating real bills, *even* under an inconvertible fiat standard. See Lloyd Mints, *A History of Banking Theory in Great Britain and the United States* (Chicago: University of Chicago Press, 1945), p. 90.