Private Money: The Path to Monetary Stability
Kevin Dowd
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Is there anything inherently special about what we call "money" that dictates its supply should be provided by a monopolist? Kevin Dowd, a lecturer in economics at the University of Nottingham in England, addresses this question by utilizing a Public Choice framework to analyze monetary policy. He concludes unambiguously that the answer is "no." Once government is involved in note issue, political and bureaucratic interests inevitably overwhelm any public-interest motivations on the part of policymakers. Therefore, the best course of action would be to abolish central banks and introduce a system of "free banking."

Dowd begins his analysis with a discussion of the virtues of competition, invoking the "invisible hand" arguments of Adam Smith. Dowd then argues that money is no different from other commodities, and thus consumers should be allowed to enjoy the benefits of unfettered competition in its supply. Indeed, Dowd puts the burden of proof on supporters of central banking to identify what is different about money that its issuer should be granted monopoly powers.

Next, Dowd describes how a free banking system would operate. The controversy over free banking rests on two concerns: (1) whether there are methods available to prevent the over-issue of bank notes; and (2) whether the banking system can protect itself against destabilizing runs—in short, whether a private lender of last resort would emerge.

In a free banking environment, protection against over–issue of notes is provided either by private citizens or by private clearinghouses. The ability to return notes to the issuing institution for redemption effectively disciplines banks in their note-issuing activity. However, once monopoly power is granted in note-issue and inconvertibility is introduced, this discipline breaks down. Notes in such a world cannot be returned to the (single) issuer. The equilibrating mechanism in the money market is then an increase in the price level. Evidence of these propositions is provided by contrasting the early 19th-century free banking system in Scotland with the monopoly control exercised by the Bank of England. Note issues were relatively stable in Scotland, while over-issues resulted in a series of acute crises during the same time period in England.[1]

The emergence of private clearinghouses addresses the second concern about free banking. In the spirit of Richard Timberlake and Gary Gorton, Dowd describes how in several instances private clearinghouses effectively

[1]See Lawrence H. White, *Free Banking in Britain: Theory, Experience, and Debate, 1800–1845* (Cambridge: Cambridge University Press, 1984) and George A. Selgin, *The Theory of Free Banking: Money Supply under Competitive Note Issue* (Towota, N.J.: Roman and Littlefield, 1988).

acted as lenders of last resort in response to banking panics.[2] Further, these clearinghouse arrangements are superior to a government-sponsored central bank because the former are not subject to the political constraints under which the government-run bank operates. The clearinghouses' essential task is to distinguish between sound and unsound banks, and it is in their self-interest to do this. Dowd is careful to point out, however, that the clearinghouses will not prevent *all* bank runs. Some runs actually can serve a *useful* function. Extensive depositor withdrawals put unsound banks out of business. Dowd argues that runs generally are not contagious and that when they do occur, they seldom spread beyond one bank or a related group of banks. In such situations, depositors would not hoard their funds, but instead would transfer them to other banks that are believed to be safe. So, rather than a contagious loss of deposits to the banking system as a whole, runs generally involve a transfer of deposits from one bank to another.

Restrictions imposed on banks under most central banking systems actually *increase* the vulnerability of the financial system to panics. Bureaucratic procedures and judgments, along with political influences, ultimately replace the conventions and the predictability of the clearinghouses. Dowd provides a very interesting discussion of the political factors involved in central banking along the lines suggested by Edward Kane's "scapegoat" hypothesis.[3]

After highlighting the mechanics of a free banking system, Dowd turns his attention to the role of the monetary standard in such a system. Dowd provides an excellent history and explanation of the role of a monetary standard, tracing its evolution from a commodity-based system to a fiat regime. Government intervention in the monetary system springs primarily from a desire to raise revenue. Here Dowd provides an illuminating discussion of the interplay of political coalitions in determining the outcomes of monetary policy. The focus is on the benefits and costs associated with an inflationary policy along with consideration by the central bank of the reputational constraints under which it operates.

The final section deals with proposals for reform. Nothing less is called for than a change in the institutional environment. In line with this recommendation, Dowd examines and rejects alternative proposals, such as membership in the European Monetary System or calls for a European contral bank. Dowd's reform measures include (1) deregulation, by which he means an end to the power of central banks to impose reserve requirements, capital adequacy ratios, credit limits, and so forth; (2) placing the monetary standard beyond political control by redefining the standard in terms of a particular commodity or basket of commodities; and (3) abolishing the Bank of England,

[2]See Richard H. Timberlake, "The Central Banking Role of Clearinghouse Associations," *Journal of Money, Credit, and Banking* 16 (February 1984): 1–15, and Gary Gorton, "Clearinghouses and the Origin of Central Banking in the United States," *Journal of Economic History* 45 (June 1985): 227–83.

[3]Edward J. Kane, "Politics and Fed Policymaking: The More Things Change the More They Remain the Same," *Journal of Monetary Economics* 6 (April 1980): 199–211.

and presumably all central banks, as they would have no useful role to play in Dowd's world.

Questions and concerns persist, however, about potential spillovers from unanticipated runs on unsound banks to sound banks and the additional failures they could precipitate. Dowd's analysis would be strengthened by acknowledging the potential impact of unwanted spillover effects on sound banks from runs on unsound banks. Recent work by George Kaufman and by Art Rolnick and Warren Weber on bank runs provides insights into the characteristics of panics and on the relative importance of contagious runs in U.S. banking history.[4]

Dowd points to examples of runs experienced in Texas and Alberta that failed to spread. It seems unwise, however, to make use of the current experience with bank runs to draw conclusions for a system of free banking. The institutional framework that currently exists, as Dowd acknowledges, is far different from what would exist in a world of private money.

Also, to provide a more complete description of the U.S. experience with free banking, some mention could be made of the presence of so-called "wildcat" banks. While their role in the free banking era is a subject of debate,[5] some of these banks undertook note issues in far greater volumes than they could hope to redeem over a sustained period. They thus presented a problem in some states during this time period.

Finally, given the current asset quality problems that plague a number of banks, Dowd would strengthen his arguments by including a discussion of the transition costs that would be entailed in the move toward a free banking environment.

In our view, current difficulties are the result of the interplay of economic, regulatory, and managerial factors. A downturn in economic activity, coupled with a regulatory framework that encourages management to adopt a high-risk profile has resulted in widespread financial distress. Dowd forcefully points out the dangers of partial deregulation. Nowhere is this more evident than in deregulating bank activities while leaving in place the current system of Federal deposit insurance with its subsidies for risk taking. Given current difficulties, fundamental reform is called for.

The focus of Dowd's book, *Private Money*, is primarily on the U.K. monetary system, but it also offers excellent reading material for undergraduate money and banking courses here in the United States. It is quite accessible to the layman as well. Dowd's study should inspire some rethinking on the

[4]See George G. Kaufman, "Bank Runs: Causes, Benefits, and Costs," *Cato Journal* 7 (Winter 1988): 559–85; Arthur J. Rolnick and Warren E. Weber, "New Evidence on the Free Banking Era," *American Economic Review* 73 (December 1983: 1080–91; and idem, "The Causes of Free Banking Failures,"*Journal of Monetary Economics* 15 (November 1984): 267–91.

[5]See Hugh Rockoff, "The Free Banking Era: A Reexamination," *Journal of Money, Credit, and Banking* 6 (May 1974): 141–67, and Rolnick and Weber, "The Causes of Free Banking Failures."