

Regulated vs. Free Banking Systems

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Introduction

The concept of free banking is one that is unpopular amongst both economists and politicians. Free competition between banking entities requires little or no government regulations in the banking system as a whole. The free market's reputation for being chaotic or unstable, whether accurate or not, is much of the cause for this concept's unpopularity. Basic economic principles state that when an industry is more competitive, firms will be more efficient in their resource allocation. From this it can be argued that if the loosening of banking regulations increases the number of firms entering the industry, the industry as a whole will become more efficient. Whether or not optimum efficiency is society's goal remains as a relevant question.

There has been no historical account of a banking system that operates completely of state control. A banking sector of this nature would have no government deposit insurance programs, no reserve requirements, and lack minimum capital requirements. Ideally, individual banks would be much more competitive with their various prices such as interest rates on deposits, loans, and commercial paper. Further, banking entities would be able to issue their own currencies and the value of these would also be competitive between banks. Given this vast difference between a free banking system and the heavily regulated banking systems of the 21st century developed countries, one can doubt the feasibility of such a system coming to fruition.

As stated above, actual instances of perfectly free banking systems have not been recorded. However, there have been examples of systems in which governments have enacted few regulations, eliminating many of the barriers to entry seen currently. These examples show both the benefits and costs of deregulation in the banking sector. Section two of this paper will

take from the few various historical examples of free, though not completely unregulated, banking systems and compare models of market structure, growth, efficiency and stability. It will also examine instances of “wildcat” banking, their costs, and their overall impact on the economy as a whole.

Free Banking Defined

One of the most referenced time periods with regards to free banking would be the pre-civil war United States. This period ranged from the closing of the Second Bank of the United States in 1836 to the passage of the National Banking Act in 1862. At this time, individual states were free of most federal intervention in their respective banking sectors, and they were allowed to devise their own regulatory structures.¹

Prior to 1836, entry into the banking sector required that bankers petitioned their state legislatures for a bank charter. This charter granted banks the privilege of printing and issuing their own notes which would be exchanged for gold and silver coin and circulated as money. Charter banks were required to redeem these notes for gold and silver on demand. If this requirement was not met, the charter bank would be declared bankrupt. Each bank’s charter limited the liability of the bank’s stockholders as well.²

The movement to free banking is largely due to the perceived political clout required to obtain approval of the legislature to receive a banking charter.³ This new system took away the

¹ Bodenhorn (1990), p.682.

² Economopoulos (1988), p. 250

³ Ng (1988), p. 879.

required consent of the legislature and seemed to remove a barrier blocking many individuals from establishing banks. All that was necessary of banks in order for them to commence with operations was that they met a minimum capital requirement, which usually ranged from \$25,000 to \$100,000. The ability to print and issue bank notes would seem to be a characteristic of free banks, but this privilege was taken away as the charter system gave way to what is considered to be the free banking system.⁴

What replaced a charter bank's ability to issue notes was the individual state banking authority's issuance of notes after a bank had deposited state or federal bonds with the banking authority. Each state had defined its own "legal" price for a bond, usually the bond's market value. Some states did, however set the legal bond prices as their face value. This setting of bond prices arguably led to "wildcat" banking, which is one major criticism of the free banking period that will be addressed later.⁵

This system of bank note issuance had one major deviation from that of the charter banks. "Free banks had no limit on the amount of bank notes they could receive from the state and issue to the public."⁶ This created the potential for unlimited monetary expansion, although individual banks limited themselves. Economopoulos states that the reason for banks self limitation on monetary expansion is unknown, yet one can speculate that competition between the note values of different banks could have forced the profit maximizing bank to set its own limit and not issue notes in excess which would devalue them.

⁴ Economopoulos (1988), p. 250.

⁵ p. 250

⁶ p. 251

One final characteristic of this free banking system contrasting it from the charter bank system is that the “free bank stockholders were personally liable for the debts of the bank up to the amount of their investment.”⁷ This was a larger incentive to keep banks from failing, and it also may have contributed to the banks setting their own limitations on monetary expansion. The history put forward in Economopoulos (1988) and also discussed in Bodenhorn (1990) and Ng (1988) leads one to ask questions weighing benefits and costs of the transition to this system from charter banking.

Free Banking and Barriers To Entry

Comparing the barriers to entry into the banking sector regarding both systems is warranted. In many sectors of the economy, the relaxation of barriers to entry leads to more competitive firms in an industry, causing efficiency gains. This reasoning could also be applied to the banking sector. Removing the requirement of obtaining a charter from the state legislature and setting the only limitation for a bank to commence with operations as a minimum capital requirement can be seen as lowering many barriers to entry into the banking sector. Kenneth Ng examines whether this is true regarding the United States free banking era in his paper “Free Banking Laws and Barriers to Entry in Banking, 1838-1860.” He states that “newspaper accounts, legislative documents, and personal papers show bank presidents, stockholders, and directors were opposed to free banking laws, presumably because the laws would reduce entry barriers, thus, eliminating the monopoly rents earned from owning a bank charter.”⁸

⁷ Economopoulos (1988), p. 251.

⁸ Ng (1988), p. 878.

Ng also cites a study by Richard Sylla that “examines the link between growth rates of industry assets and the passage of free banking laws.”⁹ In theory, the increased competitiveness of banks caused by the lowering of entry barriers should lead to increased growth of industry assets. Ng states that “increasing growth of assets following the passage of free banking laws is a necessary but not sufficient condition for the hypothesis examined here to hold.”¹⁰ The original conclusions by Sylla was that it was unsure whether total assets grew because of free banking laws or the increase of assets in non-free banking states. He cites other factors outside of banking that could have contributed to this such as population, increases in the stock of gold and silver, and technological changes.¹¹ Since Sylla’s inconclusive results were disappointing, Ng proposed an alternative test.

Ng states that “a comparison of state growth in total assets to total asset growth for the industry can offer a simple test of the lower barriers to entry theory.”¹² This theory will be accurate if the state-level growth in output increased in free banking states relative to the state-level growth in states without free banking laws. This theory can be rejected if there is no discrepancy between the different growth rates. Ng explains that possible reasons for rejection are that existing barriers remain unaffected by the free banking law, competitiveness was

⁹ Ng (1988), p. 879

¹⁰ p. 879

¹¹ p. 879

¹² p. 881

prevalent in the industry before the law was enacted, or that the industry was already unconstrained.¹³

Ng conducted his test by comparing the growth rates of total banking assets in seven individual states to the growth rates of total assets nationally. For each state, the results were mixed. Asset growth in Michigan and Ohio was less than the national level. There was little discrepancy in the asset growth rates of Connecticut, Louisiana, and New Jersey when compared to the national level. Yet, there was a higher growth rate of assets in Indiana and New York. If one aggregates the seven free banking states studied here and compares their growth rates to the national level, the national level is actually higher by one percent. When comparing these growth rates five years later, however, the free banking states together are experiencing a growth rate that is higher by one percent.¹⁴

These results do not support the thesis that the free banking laws lowered barriers to entry into the banking sector. Ng suggests that the movement from the legislative charter system to this so-called free banking system was exchanging one set of barriers for another.¹⁵ He states that the conclusion that free banking laws lowered barriers to entry “was the result of inordinate attention paid to the innovative provisions of free banking laws which, unlike the legislative charter system, created well-defined conditions for obtaining a charter and placed no limit on the

¹³ Ng (1988), p. 881.

¹⁴ p. 882-886,

¹⁵ p. 887.

number of free banks.”¹⁶ (Ng, 888) Most historians looked to the New York free banking experience and attributed that to the rest of the free banking states.

The conclusions of Ng are challenged in Howard Bodenhorn’s paper, “Entry, Rivalry, and Free Banking in Antebellum America.” Bodenhorn analyses inter-firm rivalry to determine the market structure in free banking states. If overall rivalry has increased, one can argue that the industry has a more competitive market structure.

In Bodenhorn’s model, the banking markets in Baltimore, Boston, New Orleans, New York, Philadelphia, and Providence are analyzed. These are the only markets with sufficient data for his model. Banks are ranked from largest to smallest in each market by deposits. He then calculates “mobility” by summing the changes in the top five largest banks in each year. His model tests to see how mobility depends on entry into the market, the existence of free banking laws, the average size of the five largest banks, market growth, and the concentration of the markets. Bodenhorn stresses that the existence of free banking should have a positive influence on mobility due to it lowering barriers to entry.¹⁷ This differs from Ng’s conclusion. Bodenhorn’s defense is that “free banking laws may have increased competitive behavior by increasing *potential* entrants and the probability of entry.”¹⁸ (Italics mine).

Bodenhorn concludes that entry and the existence of free banking had a positive effect on inter-firm rivalry. He again stresses that barriers to entry were lowered with the enactment of free banking laws, adding that “increasing the possibility of entry and the number of potential

¹⁶ Ng (1988), p. 888.

¹⁷ Bodenhorn (1990), p. 682-683.

¹⁸ p. 684.

entrants changed the competitive posture of the existing firms.”¹⁹ From Bodenhorn’s findings, one can conclude that Ng’s test for lower barriers to entry may have been flawed. As one would expect, the loosening of regulations led to an increase in competition between banking entities.

Competition and Stability Trade-off

Many economists would argue that an increase in competition of banking firms would decrease financial stability. Allen and Gale discuss this apparent trade-off in their paper, “Competition and Financial Stability.” Their analysis does not cover the free banking era discussed earlier, but it is relevant to the discussion because it does discuss an increase in competition due to deregulation in the banking sector. They consider many different models including “general equilibrium models of financial intermediaries and markets, agency models, models of spatial competition, Schumpeterian competition, and a model with a contagion.”²⁰ Each of these models yielded differing results, neither accepting nor rejecting the existence of a trade-off. Allen and Gale state that there needs to be a coexistence of both competition and regulation to ensure stability.²¹

Criticisms can be made with Allen and Gale’s paper concerning their treatment of the dramatic increase in bank failures of the 1980’s. They rightly state that with the deregulation of the financial sector in the 1970’s and 1980’s led to increases in competition and reduction in monopoly rents. This, along with the existence of government deposit insurance, gave bank owners the incentive to take excessive risks. These excessive risks led to the increase in bank

¹⁹ Bodenhorn (1990), p. 685.

²⁰ Allen and Gale (2004), p. 478.

²¹ p. 478.

failures.²² After Allen and Gale go through these points, they state that this appears to show the relationship between competition and financial instability. This example also shows that there can be a relationship between a regulation, government deposit insurance, and financial instability. Bank owners would be more risk averse if there was no insurance program, and if banks are taking fewer risks, they are less likely to fail. Allen and Gale's conclusions, and some would argue their omissions; leave the relationship between competition and financial stability up for debate. There may be other causes of instability in the banking sector as well.

Information Externalities

Kam Hon Chu discusses financial instability in free banking systems stemming from information externalities. The data used in Chu's model comes from the Hong Kong banking system during 1964 and 1965. The Hong Kong system was chosen because "there was no central bank, lender of last resort, discount window, or deposit insurance."²³ It was not completely free, though, because currency was not printed and issued by each individual commercial bank.

Chu's model tests if there is a signal to consumers to show the quality of an individual bank, or the probability of failure. If this signal hypothesis was accepted, it would counter a common argument against free banking: "it is impossible for depositors to tell whether a high deposit rate offered by a bank is due to its high efficiency or risky lending strategy."²⁴ Under this argument, the increase of uncertainty of depositors about the quality of their respective bank would increase bank runs on both high and low quality banks. In a system without deposit

²² Allen and Gale (2004), p. 454.

²³ Chu (1999), p. 753-754.

²⁴ p. 748.

insurance, a rational depositor would pay close attention to their bank's financial health. Because of this scrutiny, Chu states that banks would have an incentive "to signal the quality of their management and loan portfolios."²⁵

The results of Chu's analysis are promising. He found that depositors used an individual bank's holdings of liquid, risk-free assets and its deposit rate as a signal of quality. A better bank would have higher liquidity and more conservative interest rate policies. He found that using this as a signal, a lack of information regarding bank quality would "not lead to contagious bank runs and free banking system failure."²⁶ Still, his results show that a free banking system is not completely immune to contagious bank runs. This is due to depositors acting on beliefs regarding some aspect of a bank that is not quality. Information externalities do exist in a free banking system, but they are not as prevalent as the traditional argument would suggest.²⁷

Wildcat Banking

Another cost discussed extensively with the concept of free banking was the examples of "wildcat" banking in the United States free banking era. Ng mentions the practice without going into much detail while Economopoulos discusses it at length. Wildcat bankers would use the ability to purchase an unlimited amount of bonds with their own notes and discrepancies between a bond's legal price and its market value to their advantage. Wildcat banking states were identified by "five criteria: (1) the short life span of the free banks-generally less than one year; (2) the large number of entrants; (3) the low liquidity ratios; (4) the numerous bank failures; and

²⁵ Chu (1999), p. 749.

²⁶ p. 759.

²⁷ p. 760.

(5) the large note holder losses.”²⁸ These banks were usually located in rural areas so that their bank notes had few substitutes and could be issued quickly. If a bond’s market price was lower than its face value and the wildcat banker purchased bank notes at the face value, the banker would receive a capital gain after issuing the notes and leaving town.²⁹

Wildcat banking is blamed for many of the bank failures by Ng. He says that a sharp increase in New Jersey asset prices followed by a sharp decrease was caused by wildcat bankers taking advantage of a legislative mistake. He also attributes this to Indiana where “wildcat banking was produced by a defective free banking law.”³⁰ Ng’s analyses is in the context of his test for lower barriers to entry, and may have erroneously characterized the dramatic fall in asset prices as being caused by wildcat banking.

Economopoulos contests the notion of the prevalence of wildcat banking. While specific instances of the wildcat banking practice undoubtedly occurred, he finds that their effects on the economy as a whole were exaggerated. Economopoulos observes the Illinois free banking experience. The Illinois free banking period ranged from 1851 to 1863. He observed that 91 of Illinois’s 140 free banks with redemption information failed in this time period, with 89 of the failures occurring after 1861.³¹ He tests whether this massive amount of failures were caused by wildcat banking or the falling asset prices.

²⁸ Economopoulos (1988), p. 252.

²⁹ Economopoulos (1988), p. 252.

³⁰ Ng (1988), p. 885.

³¹ Economopoulos (1988), p. 254-256.

Economopoulos stated that individual wildcat banks had three characteristics: the short life span of failed banks, the location of free banks in remote areas, and the entry of failed free banks occurring during periods of wildcat banking profit opportunities.³² Of all the free banks in Illinois, only one had all three characteristics, and only eight had two of the three characteristics.³³ It is therefore unlikely that bank failures in Illinois during this time were caused by wildcat banking practices. Economopoulos found that the decline of bond prices and the protest of note holders that followed were major factors in the free bank failures of Illinois.

Conclusion

Historical accounts of free banking, whether they were in Antebellum America or in 1960's Hong Kong, have never been completely free of state control. Minimum capital requirements, state deposit insurance programs, and the inability to print and issue notes are conditions for free banking that have never existed in one system. Still, these are sufficient examples of banking sectors with very light regulations.

It has been shown that the deregulation of the banking system which led to the free banking era in America lowered barriers to entry, increased competition between banks, decreased the monopoly profits of the bank owners, and made the individual stockholders of the banks liable in the event of failure. These benefits came with the costs of more asymmetric information, small amounts of wildcat banking, and the large number of banking failures relative to modern times. Since it is likely that the benefits of deregulation outweigh the risks, the concept of free banking should be given some more time and not be initially dismissed.

³² Economopoulos (1988) p. 256.

³³ p. 261.

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