THE RATIONALE OF CENTRAL BANKING

A Liberty Press Edition

Vera C. Smith

THE RATIONALE OF CENTRAL BANKING and the Free Banking Alternative

PREFACE BY LELAND B. YEAGER

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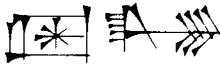

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Preface

Vera Smith's *The Rationale of Central Banking* invites us to reassess our monetary institutions and give reform proposals due consideration. The decades since it first appeared in 1936 have restored its themes to relevance. Government-dominated monetary systems have continued to perform poorly. Other experience, as well as the work of James Buchanan and the Public Choice School, has heightened skepticism about government generally. People are now willing to discuss what Vera Smith set out to examine: "the relative merits of a centralized monopolistic banking system and a system of competitive banks all possessing equal rights to trade" (p. 3).

After a biographical sketch of Vera Smith, I survey the leading themes of her book. I then offer some embroidery on them and consider how they bear on current issues of money and banking reform.

Vera Smith wrote *The Rationale of Central Banking* as a doctoral dissertation at the University of London School of Economics under the supervision of Friedrich A. Hayek. She received her Ph.D. degree there in 1935, having enrolled as an undergraduate in 1930. She studied with Hayek, Lionel Robbins, T. E. Gregory, J. R. Hicks, and Dennis Robertson; in 1933–34 she was Hugh Dalton's research assistant. Thanks not only to the school's faculty but also to a group of students who, like herself, were to become renowned economists, Smith experienced the London School

in what were perhaps its golden years. In 1936–37 Smith served as economic assistant at the Imperial Economic Committee.

In April 1937, Smith married the German economist Friedrich Lutz, who was an assistant to Walter Eucken in Freiburg and had held a fellowship of the Rockefeller Foundation in England in 1934–35. In the year of their marriage Friedrich Lutz received another Rockefeller fellowship, and the couple traveled to the United States. After a year and a half back in Europe, the Lutzes returned to the United States just before the outbreak of World War II. (Lutz's traditional-liberal orientation blocked him from an academic career in Nazi Germany.) During the war Vera Lutz served on the research staffs first of the International Finance Section of Princeton University and then of the League of Nations, also in Princeton. In the latter post Vera Lutz worked with such noted economists as Alexander Loveday, Gottfried Haberler, and Ragnar Nurkse.

From 1939 to 1953 Friedrich Lutz held positions from instructor to full professor at Princeton University. After a year in 1951–52 as visiting professor at Freiburg, in 1953 he moved to the University of Zurich, where he taught until retiring in 1972. He was a visiting professor at Yale in the winter of 1962–63. From 1950 to 1963 Mrs. Lutz spent frequent periods for research at the Bank of Italy, the development agency for southern Italy, and the Banca Nationale del Lavoro. From 1963 to 1969 she frequently visited Paris for research on French indicative planning. She never chose to accept a teaching position. Professor Lutz died in Zurich in 1975; Mrs. Lutz, born at Faversham, Kent, England, on 28 April 1912, died in Zurich on 20 August 1976.[1]

[1] Biographical and bibliographical facts come mainly from articles assembled by Ente per gli Studi Monetari, Bancari e Finanziari "Luigi Einaudi," 1984, especially those by Rosaria Giuliani Gusman and Gottfried Haberler; from Verena Veit-Bachmann's article on Friedrich Lutz; and from a letter and enclosure dated 26 June 1989 written by Mrs. Brenda K. Fowler, the sister of Vera Smith

Vera and Friedrich Lutz were both prominent members of the Mont Pelerin Society, and Friedrich was its president from 1964 to 1967. The Society's international membership consists mainly of scholars but includes journalists and business people also. It was established under the leadership of F. A. Hayek in 1947 with the purpose of fighting socialism and revitalizing classical liberalism.

The Lutzes collaborated on several works, including *Monetary and Foreign Exchange Policy in Italy* (1950) and *The Theory of Investment of the Firm* (1951). Books written by Mrs. Lutz alone include *Italy, a Study in Economic Development* (1962) and *Central Planning for the Market Economy: An Analysis of the French Theory and Experience* (1969). Besides writing many articles on money, credit, banking, public finance, the theory of the firm, economic development, economic planning, and the labor market, Mrs. Lutz translated books by Wilhelm Röpke, Oskar Morgenstern, and Fritz Machlup from German into English.

A central bank, as Smith notes, is not a product of natural development. It originates through government favors and bears special privileges and responsibilities. Typically, it serves as banker for the government and for the ordinary banks and monopolizes or dominates the issue of paper money. From this privilege derive the secondary functions and characteristics of a modern central bank: it guards the bulk of its country's gold reserve, and its notes and deposits form a large portion of the cash reserves of ordinary banks. It is constrained under a gold standard, though less tightly than competing banks would be, by the obligation to keep its notes redeemable. When unable to meet this obligation, it typically suspends payments and goes off the gold standard, while its notes acquire forced currency. (One excuse for such actions is that reserves held with it can be guaranteed

Lutz. I am grateful to Mrs. Fowler for going to the trouble of preparing her valuable information.

safe only if its notes remain in circulation even with their redemption suspended.) Control over the volume of its own note and deposit issue gives the central bank power over the size or scale of the country's money and banking system and over the general credit situation.

Smith touches on the aims and origins of central banks. A central bank may originate as a privately owned profit-seeking institution. Another motivation, not incompatible with the first, is to help in the financing of government. Smith reminds us of that reason for establishment of the Bank of England, and she shows similar motivations at work in France and elsewhere.

The special privileges and dominant position of a central bank thrust responsibilities onto it that dilute or override its profit orientation. This is true of fully evolved central banks like today's Bank of England and the Federal Reserve System in the United States. As "lender of last resort," the central bank is supposed to come to the rescue of the ordinary banks during shortages of reserve funds and scramblings for currency, lending them its own freshly issued bank notes. Disregarding narrow profit considerations, it is supposed to use its influence over money, credit, and interest rates to serve public objectives such as, before 1914, keeping the country's currency firmly on the gold standard and, nowadays, resisting inflation while promoting production and employment (to the extent that those objectives are feasible and compatible).

Free banking, as Smith defines it, is a regime allowing banks to operate and even to issue bank notes under no restrictions beyond compliance with general company law (pp. 169–170). A bank may enter the field without special permission if it can show profit prospects, raise sufficient capital, and win public confidence in itself and its notes. It has the same rights and responsibilities as other business enterprises. Its notes are "promises to pay," redeemable in

whatever the basic money might be (under the gold standard, this is gold or instruments redeemable at full value in gold). As Smith points out, "A general abandonment of the gold standard is inconceivable under these conditions" (p. 170). No bank could keep irredeemable notes in circulation by having them declared legal tender. Any bank suspending redemption would be declared bankrupt and liquidated, its assets being applied to meet the claims of its creditors. Stockholders would lose all or part of their investment.

Smith reviews the banking histories of England, Scotland, France, Germany, and the United States. She also surveys controversies in these countries, mainly in the nineteenth century, over whether a central bank with its distinctive responsibilities and powers is desirable or, on the contrary, private banks might advantageously be left free of central domination. (She sets aside, as she notes, a review of Italian and Spanish writings.) She reviews by countries rather than by topics, presumably finding it convenient to group together the arguments of writers who were largely commenting on each other's writings.

Smith cross-groups writers into four camps (as in her table on page 144–145) according to their acceptance of the doctrines of either the currency school or the banking school and their advocacy of either central banking or free banking. The first two schools are mainly associated with British monetary debates from the 1820s on.[2] The currency school accepted the quantity theory of money and generally wanted to make a mixed system of gold and paper currency behave much as pure gold money would have done. The banking school accepted doctrines tinged with fallacy, doctrines about "real bills," about accommodating the quantity

[2] See Anna J. Schwartz (1987), under the reference listing that follows, for a discussion of different schools. Subsequent in-text citations are to references in this listing.

of money, even over the business cycle, to changes in the supposed needs of trade, and about a supposed automatic reflux of excessive bank notes.

The controversy over free versus central banking is distinct, says Smith (pp. 171–172, 176): it raises arguments additional to and independent of the points disputed by the banking and currency schools. Both Lawrence White (1984) and Anna Schwartz (1987) have since collapsed Smith's four categories into three: the free-banking school, the currency school, and the banking school. Perhaps the explanation is that White and Schwartz dealt almost exclusively with British controversies, whereas Smith extended her study to the continent. Few writers seem to have adhered to the currency and free-banking schools both, but Smith did find at least the Germans Otto Michaelis and Otto Huebner, the Austrian Ludwig von Mises, and the Frenchman Henri Cernuschi in that position. As she says (p. 176), theirs could be a perfectly consistent position so far as they aimed at checking fluctuations in the volume of money and credit.

Historically, support for central banking was more closely connected with the currency than with the banking school, and the currency school's success in theoretical controversy was claimed as a victory for central banking as well. The free-banking school came under suspicion, especially in France, for placing so much emphasis on banking-school ideas, even inflationary ideas, including the denial of the quantity theory and claims that bank notes cannot be issued in excess provided that they are issued by way of loans of appropriate kinds (p. 172).

The banking school placed ill-conceived emphasis on bankable assets. Smith repeatedly uses the German term *bankmässige Deckung,* evidently regarding it as untranslatable. Literally, it means "bankwise cover" and refers to the idea that a bank's monetary liabilities should be matched by

holdings of suitable assets. These, according to the notorious "real-bills doctrine," were quintessentially short-term, self-liquidating commercial and industrial loans, loans to finance the production or marketing of additional goods within a very few months. Banking conducted on such a principle would properly match the money supply to the supply of goods coming to market. Besides overlooking the fallacy of composition involved, the banking school ignored the point that not even a merely short-term general overissue of bank notes can be quickly remedied without disturbing business conditions. It was just such disturbances that the currency school aimed at preventing (pp. 173–174).

The supposed principles of bankable assets and especially of automatic reflux of excessive notes might have a certain validity applied to a free-banking system, but they would not apply to a centralized system. The difference involves competing banks' demands for settlement of claims on each other and the restraint posed by adverse clearing balances (p. 174 and later in chapter XII). In practice, a centralized fiduciary note issue constrained by a fixed limit and a decentralized system with gold convertibility would not differ greatly in their results.

Smith interprets Walter Bagehot as adopting a compromise view (p. 143). He found Britain's banking system anomalous—not what people would have deliberately designed from scratch. But it existed, and Britons had to make the best of it by clearly recognizing its weaknesses and having the Bank of England accept its attendant responsibilities and hold reserves adequate for meeting them.

In her concluding chapter especially, Smith reconsiders the main arguments on central banking versus free banking. This reconsideration was necessary, for "the superiority of central banking over the alternative system became a dogma which never again came up for discussion and was accepted without question or comment in all the later foundations of

central banks'' (p. 167). For answers to most of these arguments, the reader should see Smith's own discussion.

One argument against free banking is that the notes of a particular bank do not remain in the hands of the persons who dealt with it voluntarily, as by borrowing from it. Routine circulation thrusts them even onto persons scarcely in a position to discriminate between good and bad notes. The government should therefore impose some uniformity onto the note issue (p. 177).

A second argument concerns monetary expansions and contractions, leading to inflations and depressions. ''Any attempt to make a final evaluation of the relative merits of alternative systems of banking must look primarily to the tendencies they manifest towards instability, or more particularly to the amount of causal influence they exert in cyclical fluctuations'' (p. 192). Opponents of free banking (such as Mountifort Longfield, discussed below) argued that aggressively expanding banks might impose the burden of restraint, or even the necessity of going out of business, onto more conservative banks (pp. 85–88, 177–178).

A third argument holds a central bank better able than competing banks to command public confidence and to cope with crises, as by serving as lender of last resort (pp. 185ff). A fourth argument finds a central authority necessary for a ''rational'' monetary policy (pp. 189–190); a fifth regards central banks as essential to international monetary cooperation (p. 190).

These last two arguments had become in Smith's time ''the almost exclusively motivating reasons for the foundations of new central banks'' (p. 192). Modern thinking tended to favor ''intelligent planning'' over automatic rules. A related argument presumably at work, as in the establishment of the Federal Reserve System in the United States, is one Smith does not state explicitly: other countries already have central banks. Why remain backward or out of step?

Nowadays, furthermore, it seems reasonable to suppose that central banks are valued for providing prestigious and comfortable jobs.

Before turning to specific issues of monetary reform, let us ponder what Smith calls "by far the most important controversial point in the theory of free banking" (p. 88; cf. pp. 85–88, 177–185, 197–199). She attributes the controversy to Mountifort Longfield, who, in an article of February 1840, imagined a system of two banks initially doing the same volume of business and holding equal gold reserves. Now one bank aggressively expands its loans and note issue. Later on, as the public starts demanding gold, let us say for export after the monetary expansion and resulting price inflation has caused a balance-of-payments deficit, the public will not selectively present the notes of the guilty bank for redemption. This demand falls, rather, on both banks. As a result, the gold reserve of the bank that did not increase its note circulation falls in greater proportion than its circulation. If this moderate bank wishes to restore its original reserve ratio, it must shrink its volume of business, which, however, enables its aggressive rival to expand even further. The moderate bank may be driven out of business altogether, unless it too expands aggressively in self-defense.

To generalize: a country with several or many note-issuing banks will suffer under alternations of business excitement and depression, of high and low prices. A bank will gain most by expanding during the period of excitement and being quick to contract as the panic arrives. A system more injurious to a country's prosperity could scarcely be devised.

Smith examines this argument in her concluding chapter; some restatement and interpretation may be in order here. One flaw in Longfield's argument, she says, is that it overlooks how continuous expansion by one group of banks and contraction by the moderate group will cause an increasing

proportion of the gold outflow to impinge on the expanding banks' reserves, which will be exhausted before the moderate banks have been driven out of business.

A relatively minor flaw in Longfield's argument was his stress on the return flow to an expanding bank of its own and other banks' notes as its borrowing customers repay their loans. That strand of the argument neglected the lag between the granting and the repayment of loans, an interval during which increasing amounts of the expanding bank's notes would nevertheless be presented for settlement at the clearinghouse.

Furthermore, Longfield's argument considers only the *public's* demand for redemption of notes. It overlooks the incentive each bank has to demand redemption of other banks' notes as it receives them from depositors or from borrowers repaying loans. In a competitive system, no bank will pay out the notes of rival banks over its own counter. It will return them to their issuers through the clearing process. If one bank expands out of step with the rest, balances at the clearinghouse will go against it, and it will lose gold paid to its rivals in settlement. This mechanism would work at an earlier stage than the external drain of gold; the bank would begin to suffer reserve drain almost immediately (a point stressed by Lawrence White and George Selgin, cited below). This effect comes in addition to the immediate arithmetical reduction in the ratio of reserves to the bank's expanded note issue.

Smith's discussion brings to mind one distinction between two kinds of money, bank notes and checking accounts. Passively and at least temporarily, the ordinary transactions of a member of the public will thrust onto him notes issued by banks besides his own. The same is not true of checking accounts. He will promptly deposit or cash any checks received, which will quickly be routed for payment to the banks they are drawn on.