

SECHREST ON SCOTTISH FREE BANKING

Kevin Dowd

Larry Sechrest offers a thoughtful and stimulating perspective on Scottish free banking, which makes a very useful contribution to the free banking controversy. I would like to focus my comments on three main points.

The first is the relative failure rate between English and Scottish banks, which presumably sheds some light on the crucial issue of whether the Scottish free banking system was more stable than its regulated English counterpart. I do not believe that the data support Sechrest's claim that the Scottish failure rate was as high as the English one. Let X be the difference between the English and Scottish failure rates. We wish to discriminate between Sechrest's null hypothesis that X has a mean of zero, and White's alternative hypothesis that the mean of X is positive. Sechrest estimates the means of the English and Scottish failure rates using different observations for each and finds that these means are so close that his null hypothesis cannot be rejected. However, this procedure is only valid if each of the English and Scottish failure series can be assumed to be random samples from populations that have trendless means and variances, and these requirements rule out any systematic (or trend) behavior in bank failure rates.

A more defensible procedure would be to suppose that the difference between the failure rates is a random sample with the required properties—systematic influences on bank failures would then be allowed provided they did not affect the relative failure rate. A t-test on Sechrest's 37 observations of the difference between the failure rates then gives a test statistic of 1.52, which has a probability value between 10 percent and 5 percent. This result gives considerably

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less support to Sechrest's null hypothesis than his own test purports to give, but we would still accept his null hypothesis if we adopted the conventional 5 percent decision rule. To assess how robust this conclusion might be, I dropped the first two observations—1784 and 1793—and repeated the exercise with the remaining data. The test statistic then came out to be 2.34, which has a probability value of around 2.5 percent and indicates that we would now reject Sechrest's hypothesis in favor of White's. We also get much the same result if we use Sechrest's data over the 1809–1830 period that White covers, and we get a much stronger rejection of Sechrest's null hypothesis if we use White's data for the same period. (The first exercise gives us a probability value of around 2.5 percent; the second gives one that is negligible.) Sechrest's conclusion is thus acutely sensitive to the choice of data set as well as to the period covered.

These calculations lead me to the conclusion that the balance of evidence so far favors White's hypothesis over Sechrest's, but there is an obvious need for further work to focus on the derivation of the data and on the sensitivity of the results to plausible modifications in the inference method, the period covered, and the data set itself. I would also stress that the ultimate issue is not about bank failure rates per se, but about the relative stability of the two banking systems, and there are other indicators of relative stability besides the comparative failure rate. The relative volatilities of interest rates and bank lending come readily to mind, and these factors also need to be looked at before we can pass a reasonably definitive judgment on the relative stability of the Scottish banking system.

Turning now to the convertibility issue, let me begin by outlining what I understand free banking theory to predict. Competitive pressures would force banks to make their issues convertible, but in a mature free banking system we would not expect it to be efficient for banks to redeem their issues with the same commodity as that whose banknote price they peg (i.e., the medium of redemption would differ from the medium of account). The currency would therefore be "indirectly" convertible—banks might use financial instruments to redeem their issues, for example, but those financial instruments would have a given value in, say, gold. We might also expect bank issues to involve an "option clause" that would give the bank the choice of deferring redemption for some period provided it compensated the holders later on. (It was unfortunate that I described option clause convertibility as "imperfect" in my book [Dowd 1989, p. 156]. I am grateful to Sechrest for making me see how misleading that label is.) It follows that we would not expect free banks on a gold standard—such as the Scottish banks—to use gold to redeem their

issues, and we must also reckon with the possibility of an option clause.

The evidence Sechrest presents demonstrates only that the Scottish banks did not issue a “directly” convertible currency. This point is a useful one to make—I tried to make it myself in Dowd (1989, pp. 156–57)—but I see it as *confirming* rather than rejecting one of the predictions of free banking theory. It certainly does not establish, as Sechrest seems to suggest, that the Scottish currency was inconvertible as such, and there is other evidence to suggest that the inconvertibility hypothesis is rejected. The fact that the Scottish banks resumed their normal redemption policies after the Bank of England suspended specie payments in 1797 indicates how competitive pressures compelled the banks to maintain convertibility. And the apparent absence of any major discrepancy between the value of the Scottish pound note and gold for most if not all the free banking period would seem to confirm the convertibility of the Scottish currency. (Let me suggest, however, that the issue can be settled reasonably definitively by compiling a series on the price of gold in terms of Scottish pound notes. The inconvertibility hypothesis predicts that the series should be non-stationary, i.e., trended. I believe that this prediction would be rejected.)

Let me make one last point. Sechrest presents evidence that the small-notes ban, usury laws, and privileges of the larger banks meant that the Scottish banking system departed in significant ways from the theoretical ideal of a *laissez-faire* banking system. I readily acknowledge that there were (unfortunately) important departures from the *laissez-faire* ideal, but the key issue is not how “pure” Scottish free banking actually was, but the extent to which these departures invalidate specific conclusions we may draw from a free banking interpretation of the Scottish experience (such as White 1984, 1990, 1991). I see no reason to believe that these departures invalidate the important conclusions (a) that the Scottish banking system was more stable than the English one, or (b) that it issued a convertible currency.

References

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WORKING FOR IRVING FISHER

Hans Cohrssen

I have had the exceptional good fortune to meet an exceptional personality, and work for him for 10 years—from 1932 to 1942. In 1932 the country was engulfed by the Great Depression. Together with millions of others, I had lost my job in New York. Six of us—an engineer, a schoolteacher and his wife, a mechanic, a clerk—shared an apartment, at the cost of less than \$8 a month per person. What had gotten us together was our commitment to the teachings of Silvio Gesell, a German businessman, who had attributed a large share of the world's economic problems to monetary causes, specifically to monetary instability.

I had decided to “do something” about the Depression. It did not take me long to realize that I was ill-equipped for the task. That is how I landed at the office of the Stable Money Association, which Irving Fisher and his friends had founded in the early 1920s to promote monetary stability. It turned out I was the only user of its special library. As I learned later, Fisher personally had selected the titles. Mr. Birdwell, the man in charge, soon became ill, but before he went to the hospital he gave me the key to the place. Soon afterwards he died. I called up Professor Fisher to ask what I should do about the key. If I was interested, he said, I should take the books home, and turn the key over to the janitor. That library became the basis of my economics studies—hand-tailored to prepare me to work for Fisher.

The Stamp Scrip Scheme

At the moment, however, I was active on behalf of the “Free Economy League,” which we had formed to promote Gesell's

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