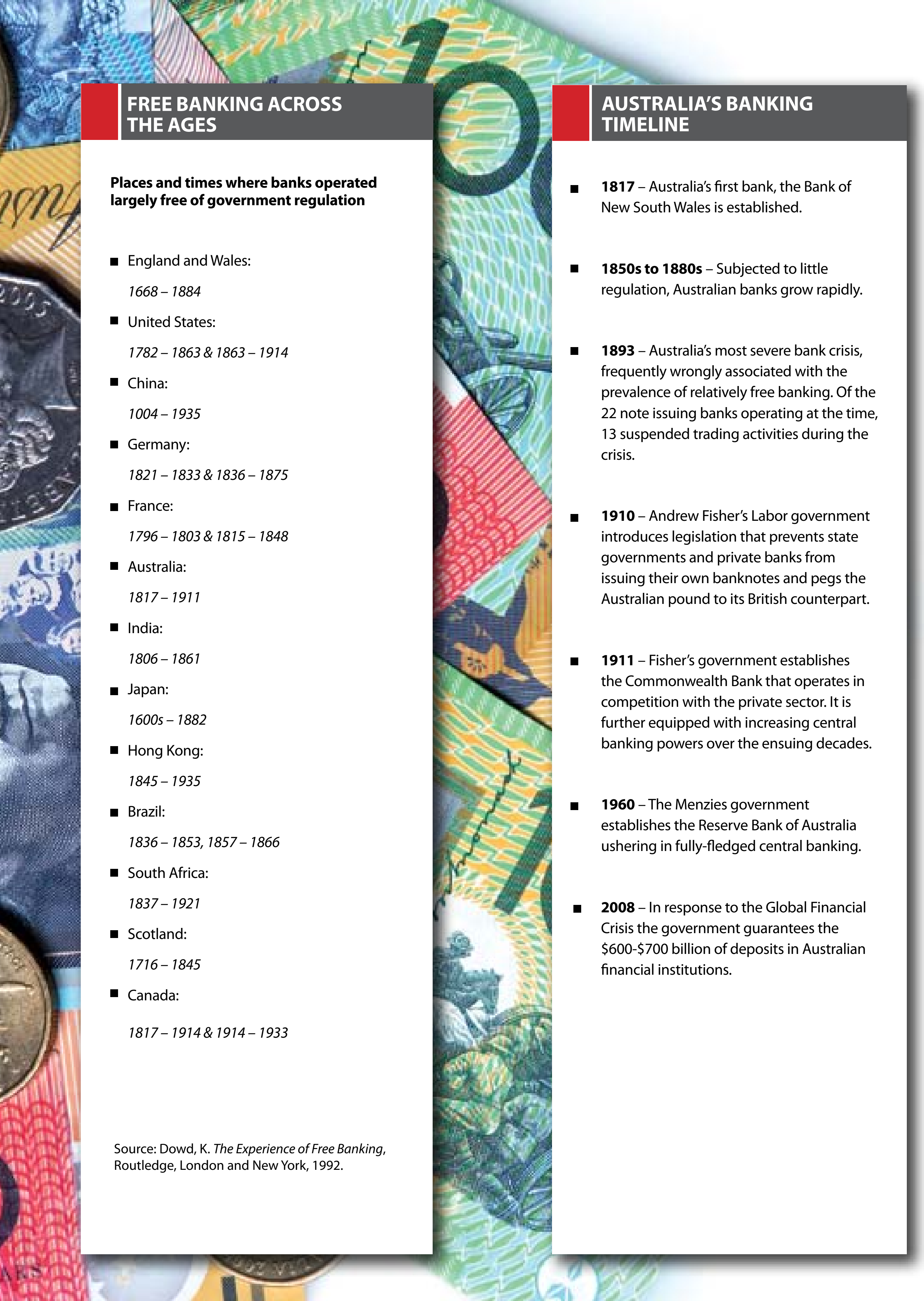


FREE BANKING ACROSS THE AGES

Places and times where banks operated largely free of government regulation

- England and Wales:
  1668 – 1884
- United States:
  1782 – 1863 & 1863 – 1914
- China:
  1004 – 1935
- Germany:
  1821 – 1833 & 1836 – 1875
- France:
  1796 – 1803 & 1815 – 1848
- Australia:
  1817 – 1911
- India:
  1806 – 1861
- Japan:
  1600s – 1882
- Hong Kong:
  1845 – 1935
- Brazil:
  1836 – 1853, 1857 – 1866
- South Africa:
  1837 – 1921
- Scotland:
  1716 – 1845
- Canada:
  1817 – 1914 & 1914 – 1933

Source: Dowd, K. *The Experience of Free Banking*, Routledge, London and New York, 1992.

AUSTRALIA'S BANKING TIMELINE

- **1817** – Australia's first bank, the Bank of New South Wales is established.
- **1850s to 1880s** – Subjected to little regulation, Australian banks grow rapidly.
- **1893** – Australia's most severe bank crisis, frequently wrongly associated with the prevalence of relatively free banking. Of the 22 note issuing banks operating at the time, 13 suspended trading activities during the crisis.
- **1910** – Andrew Fisher's Labor government introduces legislation that prevents state governments and private banks from issuing their own banknotes and pegs the Australian pound to its British counterpart.
- **1911** – Fisher's government establishes the Commonwealth Bank that operates in competition with the private sector. It is further equipped with increasing central banking powers over the ensuing decades.
- **1960** – The Menzies government establishes the Reserve Bank of Australia ushering in fully-fledged central banking.
- **2008** – In response to the Global Financial Crisis the government guarantees the $600-$700 billion of deposits in Australian financial institutions.

The end of money as we know it

Julie Novak explains Australia's unique history of free banking, and why we may need it again.

JULIE NOVAK
Research Fellow at the Institute of Public Affairs

The Western world's post global financial crisis stagnation has shaken faith in the idea that central banking and monetary policy activism can resuscitate sick economies back to life.

This has been reinforced by the fact that controversial policies initiated by central bankers and their governments, including zero or near zero interest rate settings, 'quantitative easing', money printing rounds and bank bailouts have failed in their objective of initiating economic revival in countries where they have been most vigorously implemented.

While most economists argue for piecemeal reforms as the solution to fix the prevailing system, others have gone much further, arguing for the elimination of central banking and government involvement in financial affairs more generally.

The most comprehensive reform agenda is proposed by the 'free banking school' of monetary economics, advocating the absence of a central banking monetary authority and no restrictions on note issuance by individual financial institutions, the elimination of government financial regulations such as reserve requirements and deposit guarantees, and other deregulatory reforms.

Under a free banking system, banks and other institutions could issue notes backed by gold, silver or any other commodity, or instead issue their own fiat (paper) currencies.

Even electronic monies, such as bitcoin, could offer the prospect of genuine monetary deregulation, substantially reducing the power of governments to tax, regulate and inflate.

Which forms of money would prevail would ultimately depend upon the preferences of money users, with monetary stability maintained by self-imposed constraints and market disciplines preventing the supply of currencies of certain attributes or amounts that the market does not want.

All other key aspects of financial sector operations, such as financial product attributes and lending practices, and how assets are to be managed, would be left up to individual banks and other financial institutions, with savers, borrowers and other clients deciding what standards are appropriate to their financial needs.

Lest free banking be perceived as nothing but a pipe dream, consider that central banking is a strictly modern invention and, further, that Australia once tolerated a degree of free banking.

Subjected to little regulation, at least compared with today, Australian banks grew substantially from the 1850s gold rush period through to the 1880s as pastoral, urban development and other landed interests expanded.

During this period there was no central bank, and the private banks that did exist effectively issued their own, competing currencies. Although the extent of private note issues were not overly significant to the overall banking business of the late 19th century, there was reasonable price competition among the major banks reflected in low interest rate margins.

With banks unable to significantly increase their respective market shares, competition was exhibited through strong non price competition, via the setting up of new bank branches in different regions, and the efforts of financial institutions to attract British investors eager to share in the proceeds of the Australian land boom. Non bank financial institutions also grew and diversified during this period.

By the late 1880s some banking executives and financial analysts were warning against the prospect of significant losses on speculative investments in real estate, with larger banks such as the National Bank of Australasia, the Union Bank of Australia and Bank of New South Wales all seeking to reduce their exposure against a prospective property downturn.

CONTINUED

During the early 1890s a severe economic depression affected Australia as property prices fell drastically, company bankruptcies increased, and British capital inflows dried up. From 1891 a range of building societies, land banks and other fringe financial institutions collapsed, with the adjustment process continuing as 13 of 22 note issuing banks suspended trading activities in 1893.

While the 1890s depression obviously entailed significant consequences for financiers who were saddled with non performing loans, a number of economists have subsequently claimed the depression as a mortal blow against free banking models altogether.

However a number of factors explaining the depression were exogenous to the Australian financial system, such as the collapse of Britain's Barings Bank in 1890 which fostered a wave of negative sentiment among investors towards financial investments in colonial areas and third world countries.

Although the larger banks were also obviously affected by the depression, they emerged from the traumatic economic episode relatively intact. There is some evidence that the larger banks benefited from a 'flight to quality' effect as depositors switched from smaller, weaker institutions.

Misguided government interventions also played their role in worsening the financial sector dysfunction during the period.

Writing in the prestigious Economic Journal in 1893, economist Arthur Ellis criticised Victoria's commercial laws which encouraged banks to reconstruct on financially advantageous terms and a mandatory five day 'bank holiday' which exacerbated panic amongst depositors as factors destabilising the financial system.

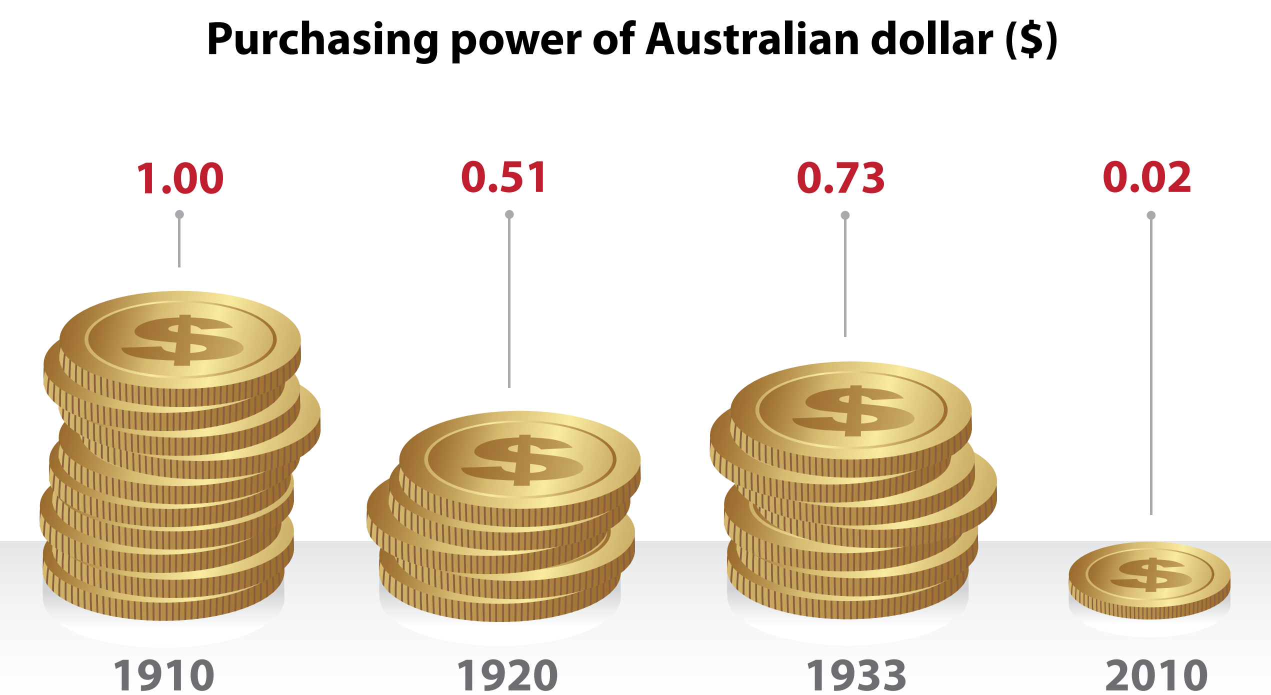
Further, Ellis warned against further government regulations on the basis that 'enough damage has been done already by interference from above.'

Perhaps the most fundamental of responses against free banking critics is that, evidently, central banks from the 20th century have not abolished severe financial crises, with the 1930s Great Depression, 1997-98 Asian Financial Crisis, 2008-09 GFC and other episodes of dysfunction all experienced during the central banking era.

The Australian financial sector recovered from the 1890s depression, with deposit and asset values, profitability ratios and numbers of bank branches eventually returning to their pre-depression levels.

However various sectional interests, including trade unions and groups calling for a so called 'people's bank,' used the Depression experience as a stalking horse of demands for significant government involvement in monetary management and financial sector operations.

The landslide federal election win of Andrew Fisher's Labor Party



The value of the Australian dollar has been eroded over the past century since the introduction of central banking.

AS THE GLOBAL FINANCIAL CRISIS AND ITS AFTERMATH HAVE DEMONSTRATED, RELYING ON POLITICIANS AND BUREAUCRATS TO MANAGE MONETARY AND FINANCIAL SYSTEMS HAS NOT WORKED

in 1910 presented the opportunity for money central planners to have their dreams fulfilled, with two blows to free banking coming in quick succession.

The first blow was the passage of the *Commonwealth Australian Notes Act* preventing state governments from circulating their own notes as legal tender, with the second being the Bank Notes Tax Act imposing a ten per cent tax on notes issued by trading banks—effectively crowding out private notes from the market.

The Fisher government introduced a new national currency in 1910—the Australian pound (referred to by critics at the time as 'Fisher's Flimsies')—which was pegged to the British pound sterling. As the chart adjacent illustrates, the term 'flimsy' remains an apt tribute to the heavily sunken purchasing power of the Australian currency even to this day.

A year later the government established the Commonwealth Bank to perform commercial and savings functions in competition with the private sector, with the bank gradually equipped with central banking powers until the formation of the RBA by Robert Menzies in 1960.

Most, if not all of, these measures seemed to pass with barely a whimper from financial sector representatives, who remained politically chastened by the 'bank bashers' amongst sections of the Australian community ever since the 1890s depression.

Australian proponents of the monetary status quo would today argue the RBA under Governor Glenn Stevens, and the web of prudential regulatory standards imposed by the government upon local financial institutions, ensured this country remained largely unscathed from the severe monetary traumas plaguing the likes of the United States and Europe.

Putting aside the veracity of such claims, they pose an obvious conundrum for those who speak or write about them because, ultimately, the case for free banking is inextricably linked with broader notions about the role of competition, monopolies and central planning in economic affairs.

Most economists readily support competition in that it incentivises suppliers to ensure their customers prosper, and believe that monopolies reduce consumer welfare when they restrain output and raise prices.

And it is also well known that central planners face inherent knowledge problems and poor incentives when they attempt to allocate scarce resources.

So why do most economists flinch when faced with the idea of free banking, in other words competition, de-monopolisation and a lack of central planning in monetary and financial affairs?

As the global financial crisis and its aftermath have demonstrated, relying on politicians and bureaucrats to manage monetary and financial systems more efficiently and effectively than individuals and businesses has not worked.

Celebrated free market economists Friedrich Hayek and Milton Friedman both supported central banking for most of their lives. But like many others, they began to realise later in their careers that free banking is a viable alternative, particularly Hayek.

The great libertarian economist Ludwig von Mises was a resolute defender of the gold standard during the 20th century, and believed free banking which accommodated commodity currency standards would be a far superior alternative to existing central banking founded on monopoly fiat money.

Now is the time to explore the free banking option for monetary reform.