Adam Smith's Support for Money and Banking Regulation: A Case of Inconsistency?

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The enduring principle of Adam Smith's *The Wealth of Nations* is of course the doctrine of natural liberty. In monetary matters, however, Smith violated this principle in some degree, advocating regulations whose effect was to limit entry into banking. In particular, Smith argued that banks should be restrained from issuing notes of small denominations (recommending a lower limit of £5) and should be required to repay all bank notes on demand (i.e., they should not have the option to defer payment until a later date with interest). More strikingly, Smith endorsed the late-seventeenth and early-eighteenth century legislation which established the monopoly position of the Bank of England as the only English bank which had limited shareholder liability and which was allowed to have more than six partners. Although Smith was highly critical of monopolies, and particularly of a "Monopoly Of Money" (Smith, in Gherity 1992, 277), Smith seems to have been unaware of the Bank of England's monopolistic character.

In a recent paper, Edwin G. West (1997) argues that Smith's position on money and banking regulation is a case of inconsistency.¹ The objective of Smith's banking theory was to devise a "neutral" banking system, one that would coordinate circulation and equilibration processes without distorting the value relations that would obtain in a barter or pure commodity money economy (Santiago-Valiente 1988, 44). Possible inconsistency arises from Smith's belief that freer competition in banking is itself a force which promotes monetary neutrality by discouraging overissue of banknotes. Measures which limit entry into banking, such as Smith's proposed regulations and support of the Bank of England charter, would then appear to conflict with Smith's objective.

In the present paper I shall argue that although Smith's complacency with respect to the Bank of England is somewhat puzzling, there is no inconsistency in Smith's reasoning. Fundamentally, Smith believed that if there is complete and unconditional convertibility of banknotes into specie, then excess currency issue would be curbed by the mechanism of monetary reflux. Money would then be "neutral" and economic instability would stem not from monetary causes but from factors exogenous to the banking system. To prevent instability arising from exogenous sources, Smith advocated banking regulations which limit the extent of competition in banking. Smith's advocacy of both competition and regulation is not a contradiction. It is simply a theory which recognizes an important role for competition while maintaining that *unfettered* competition is undesirable. It reflects an economic vision which does not idealize the free market, but presumes that the parameters in which competition operates must be institutionally defined.²

The paper is divided into five parts. Since an understanding of Smith's objectives in proposing banking regulations requires a general understanding of Smith's money and banking theory, I begin in part 1 with a brief sketch of the place of money and banking theory in Smith's overall theory, and set out Smith's money and banking theory in part 2. It is concluded that
Smith regards monetary reflux as an adequate safeguard against bank-initiated overissues of banknotes, but that there remain forces exogenous to the banking sector which may compel overissue, and it is these that necessitate Smith's proposed banking regulations, discussed in part 3. In part 4, I examine Smith's support of the Bank of England charter - a position which at first seems hard to reconcile with the role of competition in Smith's banking theory. However, in part 5, I conclude that Smith's money and banking theory is not inconsistent, but is a striking case of consistency in monetary theory. Centrally, it embodies the Banking School principle that the mechanism of monetary reflux necessitates that monetary institutions be crafted in such a way that channels for reflux of excess circulating media be kept open. The crafting of such institutions is a social undertaking.

The paper is motivated in part as a response to West (1997). But more fundamentally, it is an attempt to define Smith's position in an environment of increasing support of free banking doctrine (see, e.g., White (1989), Selgin (1988), Dowd (1989), and Glasner (1989a)), a trend which inevitably motivates a reexamination of classical monetary thought which arose in a time when free banking (as in fact was practiced in Scotland) was a live option. My argument is not offered as a definitive interpretation of Smith's monetary theory, for the sketchiness of Smith's exposition entails that a coherent interpretation must be somewhat tentative. But I believe that the paper does show that a more complex "institutionalist" reading of Smith provides a richer, more sensible interpretation than the view that Smith was an inconsistent free banking advocate - which is the implication of West's paper.

1. The Role of Smith's Theory of Money and Banking

Despite a rich tradition in pre-classical monetary thought of concern with "short-run" monetary dynamics, Smith was unpreoccupied with such matters. The dominant concern of The Wealth of Nations is the long-term real dynamics of growth. In delineating the mechanism of growth, Smith anticipated Say's law:

> Whatever a person saves from his revenue he adds to his capital, and either employs it himself in maintaining an additional number of productive hands, or enables some other person to do so, by lending it to him for an interest, that is, for a share of the profits (WN, 358).

An important purpose of Smith's banking theory would then be to identify the conditions required for a "neutral" banking system, a system under which the basic macroeconomic relationship between income, savings, and capital formation, identified by Smith as the mechanism of growth, is preserved. Saving then would flow smoothly into investment without the interruption or miscommunication which may occur, for example, when banks overissue currency (Perlman 1989, 77-9).

At a more fundamental level, Smith's value theory requires that long-term price formation and thus the price level be governed by the relative cost of production of metals and final commodities. Vickers (1975) complains that Smith, committed to his long-run value relations, ignored monetary factors as a source of short-term instability or as a possible independent long-run influence on the economy. Others (e.g., Laidler 1981) have praised Smith's "long run" focus, but have criticized Smith for ignoring the price dynamics of the quantity theory of money and Hume's price specie flow mechanism (191).

More recent authors (Glasner 1989b and 1992; Skaggs 1991) have taken a much more positive view of Smith's short-run monetary dynamics, maintaining that Smith ignored the quantity theory and the price-specie flow mechanism not out of neglect but because he rejected
them, and in their place substituted two opposing theories: the theory of a competitively supplied convertible currency and the monetary approach to the balance of payments. The latter doctrines comprise the core theoretical apparatus of the Banking School approach to monetary policy. Hence Smith's paternity of these doctrines suggests that Smith was a founding figure in the Banking School tradition.

2. Smith's Theory of Money and Banking

The central issue in monetary theory at the time of the composition of *The Wealth of Nations* was "the proper limits to the creation of bank notes," whether banknotes should replace or merely supplement metallic currency, while "other elements of monetary debate, including the terms of entry into banking, related directly to this" (Checkland 1975, 513). Thus debate focused on the changing role of banks as money evolved from a purely metallic money to a mixed currency.

Smith saw this development as both an opportunity and a potential problem. It created the opportunity of substituting paper currency for gold and silver, thereby economizing on the costly use of precious metals. Merchants, Smith wrote, must always keep on hand a stock of money to bridge the gap between receipts and payments:

The London merchant must keep by him a considerable sum of money in order to answer the demands continually coming upon him for payment for the goods which he purchases upon credit... By being obliged to keep so great a sum unemployed...the number of people employed in preparing his goods for the market, must be less by all those that [this amount of money] could have employed. The merchant in Edinburgh, on the other hand, keeps no money unemployed for answering such occasional demands. When they actually come upon him, he satisfies them from his cash accounts with the bank...with the same stock, therefore, he can, without imprudence, have at all times in his warehouse a larger quantity of goods than the London merchant; and can thereby make a greater profit himself, and give constant employment to a greater number of industrious people (*WN*, 317-8).

Banks advance to merchants sums in paper equal in value to merchants' idle balances of specie which, as international money, can be exchanged abroad for "stocks of material, tools and provisions, in order to maintain and employ an additional number of industrious people" (312). Thus, by substituting bank credit for "that part of his capital which a dealer is obliged to keep by him unemployed, and in ready money for answering occasional demands," this "dead stock" is converted "into active and productive stock; into materials to work upon, into tools to work with... into stock which produces something both to himself and to his country" (340-1). This is the limited use which Smith envisions for banknotes - as a substitute for metallic currency, always strictly equal in value to the coin displaced.

The potential problem that the existence of such facilities poses is that banks may go beyond this function and issue credit in excess of the "needs of circulation." Suppose, Smith says (*WN*, 310-1), that "the annual produce of the land" is such that the needs of circulation in a country are satisfied with one million sterling in gold and silver. If banks now issue promissory notes equal in value to one million sterling, and retain £200,000 in gold and silver in their coffers to cover withdrawals, the circulating media of the country would expand to £1,800,000 - £1,000,000 in banknotes and £800,000 in specie. But since the annual product "cannot be immediately augmented by those operations of banking," one million sterling only are required for circulation. Thus £800,000 are now superfluous, "that sum being over and
above what can be employed in the circulation of the country" (WN, 311). Since superfluous gold and silver can be sent abroad, whereas paper money cannot, agents, perceiving "that they had more of this paper than was necessary for transacting their business at home .... would immediately demand payment of it [in gold and silver] from the banks.... There would immediately, therefore, be a run upon the banks to the whole extent of this superfluous paper, and, if they shewed any difficulty or backwardness in payment, to a much greater extent; the alarm, which this would occasion, necessarily increasing the run" (WN, 318-9).

Given Smith's assumption of a constant level of "commerce," any addition to the circulating media without a compensating withdrawal of specie either to foreign lands or into bank reserves must result in overissue. Underlying this fundamentally is Smith's value theory, which entails that in long-run equilibrium the quantity of a competitively-produced commodity money must exactly suit the requirements of circulation: "If the quantity of specie in the world market exceeds these requirements, then prices rise, the purchasing power of specie falls below its cost of production, and the rate of profit in mining falls below the general rate of profit. Capital exits the mining industry, and production falls until the rate of profit in mining is restored to the general rate of profit.

Note, however, Smith's statement that the annual produce "cannot be immediately augmented by those operations of banking." Thus in the short run an expansion of the circulating media has no real effects, a position most economists (then as now) would find implausible. Is Smith here simply so rapt in his long-term real dynamics that he overlooks short-run monetary effects? Or is there some mechanism here which may legitimately allow expansions of the circulating media to occur without associated price or income effects? The mechanism at work here is the Law of Reflux (Glasner 1989b and 1992; Skaggs 1991) whereby means of payment in excess of the "needs of trade" return to their point of origin. Smith does not provide detail on how agents recognize that currency is "excessive," but that he wished to imply that reflux may prevent expansions of currency from raising prices is clear:

The increase in paper money, it has been said, by augmenting the quantity, and consequently diminishing the value of the whole currency, necessarily augments the money price of commodities. But as the quantity of gold and silver, which is taken from the currency, is always equal to the quantity of paper which is added to it, paper money does not necessarily increase the quantity of the whole currency (WN, 345).

The Law of Reflux makes the quantity of the circulating media endogenous, since reflux under the condition of convertibility allows the banking system to supply only as much circulating media as the public desires. Whether reflux operates as quickly as Smith envisions may be beside the point. The important point is that in "ignoring" the short-run effects of money on the price level and economic activity, Smith is not merely deferring to his long-run value relations but appears to be substituting his own theory of short-run monetary dynamics for the then-dominant quantity theory of money.

Thus Smith is said to have originated the theory of a competitively supplied convertible currency (Glasner 1989b and 1992; Skaggs 1991) - that in a competitive banking system under conditions of convertibility, reflux operates automatically to prevent overissue of circulating media. The conceptual basis for the theory is an implicit distinction between the two monetary functions "media of circulation" and "means of settlement." The latter is simply "money proper," that asset which is acceptable as part of liquid balances by all agents. For Smith this is strictly gold and silver. Media of circulation, on the other hand, are highly elastic transaction arrangements made at the time of transacting. These arrangements in Smith's time included
transfers of gold and silver and of convertible promissory notes, but also of bills of exchange which may be used to finance transactions pending delivery of the final means of settlement. The importance of the distinction is that because credit instruments can be used to make exchanges, the media of circulation are never constrained by the quantity of money proper. Reflux, however, is a mechanism which constrains the quantity of circulating media to a level determined by the public's demand for money.

Some writers (Bloomfield 1975, 480; Laidler 1981, 191; Humphrey (1981) 1993; and Glasner 1989b) have suggested that Smith's notion that an excess of circulating media causes money to flow abroad without affecting prices is an early statement of the monetary theory of the balance of payments. An increase in the circulating media above the needs of circulation causes a balance of payments deficit. For a "small" country on an international metallic standard, this should have little if any effect on the price level. Thus an external drain of specie would not be problematic for Smith, as it would for later Bullionist and Currency School theorists who would base their argument on the price-specie flow mechanism.

A crucial element of the theory of a competitively supplied convertible currency is free competition in banking. Smith summarizes the importance of competition in banking in the closing paragraph of the chapter "Of Money":

The late multiplication of banking companies in both parts of the united kingdom, an event by which many people have been much alarmed, instead of diminishing, increases the security of the public. It obliges all of them to be more circumspect in their conduct, and, by not extending their currency beyond its due proportion to their cash, to guard themselves against those malicious runs, which the rivalship of so many competitors is always ready to bring upon them. It restrains the circulation of each particular company within a narrower circle, and reduces their circulating notes to a smaller number. By dividing the whole circulation into a greater number of parts, the failure of any one company, an accident which, in the course of things, must sometimes happen, becomes of less consequence to the public. This free competition too obliges all bankers to be more liberal in their dealings with their customers, lest their rivals should carry them away. In general, if any branch of trade, or any division of labour, be advantageous to the public, the freer and more general the competition, it will always be the more so (WN, 350).

Free entry into banking has two benefits. First, the more banks there are, the "more circumspect in their conduct" banks will be, since excess banknotes deposited in competing banks will be returned to originating banks. (Moreover, customers will take their deposits elsewhere should the credibility of a bank come into question.) Second, by "dividing the whole circulation into a greater number of parts," the social impact of any particular bank failure is minimized. Hence, freer competition in banking both discourages overissue and limits the negative effects of overissue when it occurs.

Although Smith believed that it was in the self-interest of banks never to overissue, experience suggested that banks tended to overissue nevertheless:

Had every particular banking company always understood and attended to its own particular interest, the circulation never could have been overstocked with paper money, but every particular banking company has not always understood or attended to its own particular interest, and the circulation has frequently been overstocked with paper money (WN, 320).

Thus convertibility, though necessary, is not a sufficient condition for avoidance of overissue.
Why do banks sometimes misunderstand or fail to attend to their self-interest? The reasons are complex but generally involve the incursion of factors exogenous to the banking system - factors such as human nature (misjudgments of bankers, deceptions of "projectors"), the volatility of the real sector, and outside events such as wars and bad harvests. Smith's solution is a combination of regulation and advice on banking conduct. Taken together, these measures, Smith believes, should prevent overissue and foster the monetary neutrality he sought.

3. Smith's Support of Banking Regulations

Smith supported two regulations on banking: a restriction on note issue to sums of £5 and above; and a ban on the "option clause" which gave banks the right to defer redemption of notes for a six-month period with the obligation to pay interest on the deferred notes.

The Ban on Small Notes

In arguing in favor of restriction of note issue to sums of £5 and above, Smith claims that by preventing small note issues, paper currency will be confined to use by "dealers" in wholesale transactions (WN, 343). Thus paper money will not be used to finance consumption but may perform its proper role of economizing on the use of precious metals by merchants. In addition, Smith argues that:

Where the issuing of bank notes for such very small sums is allowed and commonly practiced, many mean people are both enabled and encouraged to become bankers. A person whose promissory note for five pounds, or even for twenty shillings, would be rejected by every body, will get it to be received without scruple when it is issued for so small a sum as a sixpence. But the frequent bankruptcies to which such beggary bankers must be liable, may occasion a very considerable inconveniency, and sometimes even a very great calamity, to many poor people who had received their notes in payment (WN, 343).

Thus Smith believes that "many mean people" will be "enabled and encouraged to become bankers" because the public will not scruple very much over notes of petty sums. Smith's argument suggests two presumptions with regard to risk-taking behavior. First, that when a possible loss is small, people are more willing to take risks (thus more willing to accept banknotes of questionable backing). Second, that when possible gains are high, a certain class of people ("mean people") is willing to take large risks, risks which may have negative welfare effects. It is therefore necessary to limit entry into banking, if possible, to responsible parties.

Smith's argument here is very similar to his argument in favor of the usury law (an argument worth quoting in full):

If the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten percent, the greater part of the money which was to be lent, would be lent to prodigals and projectors, who alone would be willing to give this high interest. Sober people, who will give for the use of it, would not venture into the competition. A great part of the capital of the country would thus be kept out of the banks which were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it. Where the legal rate of interest, on the contrary, is fixed but a very little above the lowest market rate, sober people are universally preferred, as borrowers, to prodigals and projectors. The person who lends money gets nearly as much interest from the former as he dares to take from the latter, and his money is much safer in the hands of the one set of people, than in those of the other. A great part of the
capital of the country is thus thrown into the hands in which it is most likely to be employed with advantage (WN, 379).

The usury argument, unlike the argument about note issue, concerns economic efficiency, not potential negative effects on "poor people." Nevertheless the underlying assumption about human nature is the same: a certain class of agents is attracted to high-risk ventures, and it is therefore necessary to set up economic institutions in a manner that does not itself encourage these high-risk activities, given their negative social consequences. The usury argument is a much stronger argument than that about small note issue. (Indeed it is an argument relevant to modern banking practice.) The important point, however, is not that the argument about small note issue is well-founded, but that it is based on a legitimate appraisal of human propensities, propensities which (as with the usury law) appear to make some degree of institutional regulation warranted. Ceteris paribus, freer entry into banking may be socially beneficial. But the ceteris paribus clause does not apply if a by-product of freer entry is overissue arising from another source.

Gherity (1994, 434-40) suggests that Smith's opposition to small note issue was actually motivated primarily by his recognition that even with a ban on the option clause (discussed below) and with banks following the rules of conduct prescribed by Smith, banks would still be vulnerable to "outside events," i.e., events exogenous to the banking sector. There was general agreement among Smith and his contemporaries that outside events played a major role in the monetary problems of Scotland then influencing Smith's monetary thought. Gherity hypothesizes that Smith meant to represent the influence of outside events by way of a rather far-fetched example that has long puzzled Smith's interpreters. Smith argues (WN, 341-2) that small note issue should be prevented to keep coin widely dispersed among the population rather than centrally concentrated in the capital where it would be subject to easy expropriation by a conquering enemy. Smith, according to Gherity, may have meant to represent outside causes in general through this example, but was unable to say so explicitly because of personal animosity toward Sir James Steuart, the "most conspicuous" of Smith's contemporaries "who named such factors as the principle [sic] cause" of Scotland's monetary difficulties (438-9).

Speculative though this argument is, Smith's illustration (hypothetical or not) clearly exemplifies an external event affecting monetary stability in a way that no amount of self-interested prudence in banking practice could avoid. Moreover, Smith's concern with the potential influence of outside events fits very well with Smith's general view of the banking system and its role of preserving monetary neutrality in the face of an inherently volatile real sector (discussed below).

The Option Clause

Smith regarded prohibition of the option clause (enacted by Parliament in 1765) as an essential (even definitional) aspect of the unconditionality of convertibility. Smith's concern was that the "uncertainty of payment" thereby created "necessarily degraded [promissory notes] below the value of gold and silver money" (WN, 346), thus undermining convertibility.

West (1997, 130), following White (1989), Selgin (1988), and Dowd (1989), maintains that in an unregulated banking environment, the option clause may actually promote stability by providing banks with the flexibility needed to avoid runs on their liquidity during crises. Moreover, free competition would prevent banks from imposing the option clause on a public unwilling to accept it, thus depriving banks of the monopoly power necessary to degrade their notes below par, as Smith feared. This analysis, however (as West points out), presupposes the
ideal circumstances of a freely competitive banking environment, an environment which did not exist in Smith's time. The usury laws, for example, were an impediment to freely competitive capital markets. So whereas Selgin's and Dowd's option clause implies full compensation through interest at market rates during any suspension of convertibility, this would often be hindered in the usury laws' fixed interest regime. Smith, who approved of the usury law, had obviously tied his hands in this respect (West, 130).

But Smith's support of the usury laws, as noted, arose from his assessment of inherent propensities in human risk-taking behavior. Thus, barring an alteration of human nature, the ideal of a freely competitive banking environment is simply not to be entertained in Smith's view of the world, even if such an environment would eliminate the need for a ban on the option clause.

Smith was well aware of the conflict between his support of bank regulation and his principle of natural liberty:

To restrain private people, it may be said, from receiving in payment the promissory notes of a banker, for any sum whether great or small, when they themselves are willing to receive them; or, to restrain a banker from issuing such notes, when all his neighbours are willing to accept of them, is a manifest violation of that natural liberty which it is the proper business of law, not to infringe, but to support.... But those exertions of the natural liberty of a few individuals, which might endanger the security of the whole society, are, and ought to be, restrained by the laws of all governments; of the most free, as well as of the most despotic. The obligation of building party walls, in order to prevent the communication of fire, is a violation of natural liberty, exactly of the same kind with the regulations of the banking trade which are here proposed. (WN, 344-5).

In sum, Smith believed that monetary stability was so important that violations of natural liberty are justified in this case. The "fire" requiring that "party walls" be erected is economic instability that arises when monetary reflux is inhibited. But what is the source of this inhibition? Beyond the bad judgment of bankers, it is the "over-trading of some bold projectors," by whom bankers are misled, which "was the original cause of this excessive circulation of paper money" (WN, 322). The "overboldness" of "projectors" in turn appears to arise from the basic human propensities described above, and again described in this passage:

The over-weening conceit which the greater part of men have of their own abilities, is an ancient evil remarked by the philosophers and moralists of all ages. Their absurd presumption in their own good fortune, has been less taken notice of. It is, however, if possible, still more universal. There is no man living who, when in tolerable health and spirits, has not some share of it. The chance of gain is by every man more or less over-valued, and the chance of loss is by most men under-valued, and by scarce any man, who is in tolerable health and spirits, valued more than it is worth (WN, 120).

The "absurd presumption" of "the greater part of men" in their "good fortune" creates a bias favorable to foolish investment projects. Avoidance of inefficiency and other social costs thus requires care that bank resources be used only to economize on the use of precious metals by merchants, even if restrictions on natural liberty are required to stem inherent human propensities to do otherwise.

The chaotic nature of real profitability adds an additional element to the inherent volatility of the real sector. Profit, Smith says, is "very fluctuating," "affected...by every variation in price,...by the good or bad fortune both of [a merchant's] rivals and his customers,
and by a thousand other accidents...," and therefore varying "not only from year to year, but from
day to day, and almost from hour to hour" (WN, 98-9). Fluctuations in profitability make sober
assessments by "projectors" of their "good fortune" still more unlikely.

A fully free banking environment would provide little defense against outside events or
the deception of "projectors" with inflated expectations. Thus Smith did not advocate a fully
competitive banking system,12 although fully competitive banking may have eliminated the need
to ban the option clause.

Smith's "Real-Bills Doctrine"
Smith recognized that even with complete and unconditional convertibility and the prohibition
on small notes, banks are not omniscient (Gherity 1994, 434) and therefore overissue would still
occur.13 He therefore provided additional advice to banks on how to maintain solvency and
liquidity, advice proffered primarily by way of his "real-bills doctrine," now generally
recognized as comprising a minor component of Smith's monetary theory (Perlman 1989;
real-bills doctrines, one applied to a single bank, the other to the entire banking system. Smith
applied it to a single bank. As such it is simply a rule of conduct which a private bank would
do well to follow in view of frequent fluctuations in the public's demand to hold money. By
discounting only "real, short-term, self-liquidating, collateralized" bills, a bank can better
synchronize the size of its asset portfolio to the public's demand for its liabilities, thus avoiding
"the need to sell illiquid assets at a loss or to borrow at penalty interest rates" (869).14

It is important to recognize the status of Smith's "real-bills doctrine" as simply practical
advice on banking conduct, not a doctrine in any fundamental sense.


With respect to Smith's support of the Bank of England, as West observes, Smith's account of
the development of the Bank "is delivered in flat terms and with little indication of the extent
of the monopolization that had occurred" (West 1997, 128). While Smith acknowledges that
"No other banking company in England can be established by act of parliament, or can consist
of more than six members" (WN, 340), he appears not to have grasped the limits on competitive
banking that these measures imposed. Moreover, as West points out, banking is an industry in
which there are substantial economies of scale. Restricting the Bank's competitors to six
partners meant that private banks were "severely undercapitalized" (West, 128).15 Hence there
is a clear tension in Smith's views.

The 1763 pamphlet, "Thoughts Concerning Banks, and the Paper-Currency of Scotland"
(hereafter "Thoughts"), recently attributed to Smith by James A. Gherity (Gherity 1993), shows
the tension clearly. In 1763-4, a period of monetary instability in Scotland, two chartered
Scottish public banks petitioned the London Privy Council (the body through which government
intervention into Scottish banking would take place) for the exclusive privilege of issuing
banknotes in Scotland. There is evidence (Gherity 1993, 245-8) that Smith was consulted in the
matter and that he produced "Thoughts" (a substantially revised version of a pamphlet originally
written by one or more of Smith's Glasgow banker friends) on behalf of private Scottish banks
who opposed the public banks' proposal. Smith centers his objections on the fact that the
proposed legislation would establish "the most extensive, and the most dangerous, monopoly,
that could have been contrived; no less than The Monopoly Of Money" ("Thoughts," Gherity
1993, 277).
One of Smith's arguments is the following:
By the constitution of a bank *Established By Authority*, the proprietors are no further bound, than to the amount of their respective shares of the bank-stock: whereas every partner of a private banking-company, is not only bound to the amount of the stock advanced, but is further liable to the whole extent of his fortune, for every obligation that is contracted. Thus *The Establishment By Authority* makes a difference very material in favour of the bank-proprietor, and as material against the general prejudice ("Thoughts," 277-8).

Here Smith applies a clear double standard, since the Bank of England, as a chartered bank, had limited shareholder liability, in contrast to private banks in England which lacked this privilege. The difference between the Bank of England and the Scottish public banks (if their proposed legislation were to be enacted) was that the Bank of England was not, strictly speaking, a monopoly:

The bank of England, though incorporated by act of parliament, has no exclusive privilege of issuing bills or notes, nor pretends to any: it allows the private bankers, undisturbed, to follow the same branches of business with itself, without thinking of procuring any law to restrain them in the extent of their business, or of the sums to be inserted in their notes;... ("Thoughts," 275)

For Smith, whether a bank's liabilities circulate should be at the discretion of the public. And Smith clearly felt that the liabilities of the Bank of England met this test - the Bank's prominence arising only from "that preference in the esteem of mankind, which only can, and must be acquired by the superior extent and stability of its establishment, and by the long experienced wisdom of its regulations, joined to their uniform and steady execution" ("Thoughts," Gherity, 275). In reality, legislation of 1709, which limited the Bank's competitors to banks with six or fewer partners with full liability, goes far to explain the Bank's prominence. It must be acknowledged a mystery that so shrewd an institutionalist as Smith either disregarded or did not perceive the effects on competition of the six-partner rule.

But however misguided was Smith's understanding of the Bank, there is no internal inconsistency in Smith's views, given his assumptions about the nature of the Bank. It is of course these assumptions that are curious. Why was Smith so unmindful of the Bank's monopolistic character? One possibility, in "Thoughts," is that support of the Bank was politically expedient in allowing Smith to contrast the "good" public bank of England with the "bad" public banks of Scotland in a way that might appeal to English government officials. However, this seems implausible since Smith's view of the Bank appears to have remained unaltered as late as *The Wealth of Nations*. Another possible explanation, relating to Smith's money and banking theory, is discussed in the conclusion.

5. Conclusion

West (1997, 133) argues that the regulation of private banks, of which Smith approved, appears to have aided and abetted the government alliance with the monopolizing bank. The suppression of small notes had the effect of reducing entry into banking while the legal abolition of the option clauses...made private banks more vulnerable to runs on their liquidity. The fact that the same process strengthened the relative monopoly position of the Bank of England should have been obvious to Smith, at least by about 1780.

In sum, Smith advocated regulations which aided and abetted the attainment of monopoly power
by the Bank of England, a result Smith presumably would not have wanted. Had Smith lived to see how "the accumulation of an array of privileges" would lead to the suspension of convertibility in 1797, the establishment of a fiat currency (which Smith opposed) shortly thereafter, and the "widespread dismantling of the competitive banking system he championed" (133) in subsequent years, would Smith's attitude toward regulations and the Bank of England have been different? With respect to regulations, that seems unlikely, given their grounding in considerations integral to Smith's banking theory and not directly related to the Bank.

With respect to the Bank, two tendencies in Smith's thought suggest different possible answers. First, Smith's hostility toward monopolies of all kinds, and particularly a "Monopoly of Money," suggests a Free Banking perspective akin to that of early nineteenth century Free Banking advocates such as H.B. Parnell, James William Gilbert, and Poulett Scrope. In a system in which no bank holds a monopoly of note issue and banks freely compete in all aspects of banking services, banks would be restrained from overissue because of the necessity of maintaining public confidence in their currencies. This requires that they maintain convertibility of their notes into specie on demand, in turn requiring that they limit the quantity of banknotes. Smith's aversion to monopoly in banking and recognition of the role of competition in maintaining convertibility suggest that he may have sympathized with this perspective. Smith's support of the Bank of England charter would then indeed seem an odd inconsistency.

However, Smith's concern about possible effects of exogenous factors on the banking system, as discussed above, suggests that this was not Smith's conception of an ideal banking system. Like the later Banking School, Smith made a basic distinction between means of settlement (money proper) and media of circulation where the elasticity of the latter entails the futility of the Currency School objective of centrally controlling the money supply. Thus even a powerful central bank may not represent a significant threat since a monopoly of circulating media is unobtainable given a convertible currency. A basic problem, under a mixed currency, is that the law of reflux is always operative, a reality which mandates that adequate channels for reflux be kept open. Competition in commercial banking is crucial to this objective in obliging banks to maintain convertibility. But the role of competition is limited, for it offers no defense against incursions on the banking sector from exogenous sources. Smith's view appears to be that the development of a "neutral" banking system is a social undertaking requiring that the parameters in which competition operates be institutionally defined. Although Smith may have had no explicit notion of central banking, it is clear that there is room in this conception for a central banking entity (provided it behaves "properly") as a bulwark against instability stemming from exogenous sources - as indeed Smith seems to have conceived the Bank of England. Given such an entity, monopolization of note issue for private ends is a potential problem, but for Smith a solution clearly does not lie in a system of fully free banking.

I conclude that uppermost in Smith's thinking was not a system of free banking based on the principles of free competition, but fabrication of an institutional structure in which reflux of excess currency would be ensured. Free competition in banking was a means to an end, a means which should be sacrificed to the extent that it fails to obtain this end. As I noted at the outset, my argument is not offered as a definitive interpretation of Smith's views (since such does not seem possible to derive from Smith's exposition), and there are some loose ends - in particular, Smith's complacency with respect to the Bank of England charter and his support of the six-partner rule. It is these aspects of Smith's views which lend some credence to West's charge of inconsistency. However, Smith's support of the Bank of England charter is not strictly speaking an inconsistency, given that the Bank, like other private banks, is subject to the
discipline of reflux. More generally, it would seem that a political framework which would constrain the Bank of England from using its power in a harmful fashion must, in Smith's view, be left largely to historical and social forces that are beyond the reach of economic arrangements. This is not an inconsistency. It is simply a recognition of the importance of non-economic factors in shaping developments in the economic sphere.

Smith's status as a monetary theorist has traditionally been regarded as slight. However, the more subtle reading of Smith that has emerged in recent years (Laidler 1981; Glasner 1985, 1989b, 1991; Santiago-Valiente 1988), that identifies Smith as a founder of one of the two dominant schools of monetary thought, alters Smith's status as a monetary theorist. Although Banking School doctrine must be reconstructed in order to have relevance to the modern economy in which bank money is convertible not into gold coin but fiat money at par,19 the basic principle of Banking School doctrine remains the same: given that media of circulation cannot be controlled by a central banking authority, channels for reflux of excess currency must be kept open. This implies that monetary institutions must be fabricated in a manner that reflects this reality.


Notes
1. I take my title from West's paper.
2. In principle there is nothing inconsistent about Smith proposing regulations on certain branches of economic activity. Along with other classical economists, Smith took for granted some extra-market institutional context which included a positive role for government in defining the parameters in which free competition should operate. The "market-plus" approach originally discussed by Robbins (1933) and developed by Samuels (1966) is the standard approach in classical political economy. "The law...functions as an unobtrusive structuring force, exercising control over the conditions of spontaneous activity in general, and the conditions of individual participation" (Samuels, 116). Nevertheless, we may question whether Smith's support of regulation in this instance and particularly his support of the Bank of England charter are consistent with "the total set of dynamic variables within The Wealth of Nations" (West 1996, 88), to use a phrase from another paper by West whose purpose is similarly to show "tension" in Smith's views.
3. Vickers (1975, 490) writes that in the pre-classical period (the period preceding The Wealth of Nations) "the theory of the relation between the flow of money and the level of activity and employment had been examined at length and with increasing refinement. This phase of analysis had come to occupy the centre of discussion, and the remaining objectives of analysis were seen to be logically subordinate to it." The ordering of logical priority would shift dramatically with The Wealth of Nations:
4. All references to The Wealth of Nations are to the Cannan edition and are signified by WN.
5. "The proportion between the value of gold and silver and that of goods of any other kind, depends in all cases, not upon the nature or quantity of any particular paper money, which may be current in any particular country, but upon the richness or poverty of the mines, which happen at any particular time to supply the great market of the commercial world with those metals. It depends upon the proportion between the quantity of labour which is necessary in order to bring a certain quantity of gold and silver to market, and that which is necessary in order to bring thither a certain quantity of any other sort of goods" (WN, 349-50). This is a standard assumption in a commodity money economy of theorists from Smith to the neoclassicals.
6. Banks in Smith's time advanced banknotes in two ways: by discounting bills of exchange and by granting merchants cash accounts, with the latter method available only in Scotland. Here Smith discusses the convenience of the Scottish cash accounts.
7. In other words, Smith is holding the volume of "commerce" constant (Laidler 1981, 190).
8. Under the later Banking School approach credit would be seen to dominate media of circulation to such an extent that "capital finance" would be a "clearing system that cancels claims and debts and carries forward the differences so that 'money' payments come in only as a special case without any particularly fundamental importance" (Schumpeter 1954, 717). However, money does have fundamental importance as the sole means of final settlement - an essential element of the Smithian-Banking School approach.
9. The small country assumption implies that the country is a price taker in world markets - so that domestic prices are the same as international prices - and that outflows and inflows of gold have no effect on the international price of gold.
10. After more than two centuries of dispute, Smith's argument is vindicated in Stiglitz and Weiss (1981) in the context of credit rationing by banks. Also, Niehans (1997) supports Smith's argument that the diversity of profit expectations identified by Smith may be a source of welfare loss because it leads to a misallocation of capital resources.
11. Cherry (1994, 438-9) writes: "Among the most conspicuous of those contemporaries was Sir James Steuart who named such factors as the principle [sic] cause. They included some years of poor harvest that caused the importation of considerable quantities of grain, the withdrawal of funds by English investors and some Scotsmen as well in order to speculate in public funds as the war drew to a close. Additional taxes due to the Seven Years War, the absence of troops normally quartered in Scotland, the loss of 'industrious inhabitants' to the armed forces and, finally, the cutting off of 'several beneficial articles of commerce' (Steuart, 1966, 506).
12. It may be questioned why, given Smith's support of intervention in banking, he did not propose stronger measures, e.g., stiffer capital requirements which would have reduced bank failures and restrained excessive credit expansion. Not only did Smith not advocate capital requirements, he endorsed legislation (the six-partner rule) which virtually ensured that private banks would be undercapitalized. Smith provides no specific justification for the six-partner rule but simply refers to it approvingly in the context of support of legislation that established the Bank of England's dominant position. It could be that Smith did not give the matter of capitalization of banks much thought. As to whether Smith should have advocated such requirements, it should be remembered that higher capital requirements, like stronger interventionist measures in general, may limit entry into banking, thereby limiting the free competition which Smith advocated, albeit with reservations. The question then is where to draw the line between free competition and regulation, and a plausible argument could be made that stronger capital requirements would overstep this boundary. It should also be noted that Smith did advocate the existence of a highly capitalized Bank of England which, in certain passages, Smith appears to conceive of as performing a lender-of-last-resort function (see note 18).
13. A prohibition on the option clause was enacted by Parliament in 1765, as was a ban on notes issue of sums of £1 and below (although the ban did not apply to Scotland). The ban on note issue was extended to notes of £5 and below in 1772. The continuance of monetary instability beyond these dates may have influenced Smith's formulation of his "real-bills doctrine."
14. Applied to the banking system as a whole, the Real Bills doctrine states that an inflationary overissue is impossible if banks discount only real bills. The widely recognized flaw of the doctrine, first noted by Thornton ([1802] 1939), is that assumption that the nominal quantity of bills of exchange offered for discount is determined wholly by the real volume of goods under production, not by perceived profitability, which depends in part on the difference between the rate of return expected by entrepreneurs and the rate of interest charged by banks. If, in the language of Wicksell ([1898] 1965), the "natural rate of interest" exceeds the "money rate of interest," the potential supply of bills offered for discount would be without limit.
15. West remarks: "If the term 'beggary bankers' means operators with insufficient capital, one must reemphasize that the legislation limiting the number of partners to six, and without limited liability, must have had some responsibility for the bankruptcies in England (the six-partner rule did not extend to Scotland)" (129). Failures among English country banks were numerous throughout the eighteenth century.
16. "When the people of any particular country have such confidence in the fortune, probity, and prudence of a particular banker, as to believe that he is always ready to pay upon demand such of his promissory notes as are likely to be at any time presented to him; those notes come to have the same currency as gold and silver money, from the confidence that such money can at any time be had for them" (WN, 310).
18. Smith described the Bank as "the greatest Bank of circulation in Europe" (WN, 338) and observed that "The stability of the Bank of England is equal to that of the British government" (340). In "Thoughts," Smith writes:
"The credit of the bank of England, founded on real wealth, and supported by prompt payments, has long stood unshaken, even in the most difficult and trying times. This bank has afforded such aids, both to public and private credit, as might seem incredible to those who have not had access to know, not only the great loans advanced to the government, but also the immense sums it discounts on private bills, for the convenience of foreign as well as British commerce..." ("Thoughts," Gherity 1993, 275). It may even be argued that Smith conceived of the Bank as a lender-or-last-resort in some instances, e.g., when he notes its support "on several different occasions" of "the credit of the principal houses, not only of England, but of Hamburgh and Holland" (WN, 340). For Smith the Bank was evidently an island of stability in a very stormy sea.


References


