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Adam Smith and the History of Economic Thought: The Case of Banking

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Adam Smith and the History of Economic Thought: the Case of Banking

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Adam Smith's analysis of banking is often studied as part of the history of banking in Scotland, of free banking, or of the Real Bill doctrine debate[i] (e.g.: Checkland 1975b; Munn 1981; Glasner 1985; Selgin 1989; Glasner 1992; Gherity 1994; White [1994] 1995; Arnon 2011; Rockoff 2011; Rockoff 2013)— topics that are not part of traditional mainstream economic doctrines. It is seldom center-stage in the Smith scholarship. Banking in Smith's thought is also mentioned, but not generally analyzed in depth, in Smith's analysis of the relation between free market and state intervention[ii] (e.g.: Viner 1927; Stigler 1971). Smith believes in the free market, but he also supports banking regulations that would seem to violate that same 'natural liberty' associated with free markets.

I suggest that there is more in Smith's analysis of banking than an historical account of free banking in Scotland and than a contribution to a technical issue of economic theory. When historians of economics look at Smith on banking and focus only on the historical or technical aspects of Smith, they often narrow the focus, often narrowing (or losing) the picture of the bigger project Smith seems to envision, generating what seem like contradictions in Smith's thought. I suggest instead that Smith's analysis of banking is a reflection of Smith's bigger picture of society[iii] (e.g.: Buchanan 1978; Evensky 2005)—the banking systems that Smith describes, like markets, through a complex web of relationships, create efficiency and are able to develop and support moral social life—resolving, at least in part, some of the tensions presented by the literature regarding otherwise

puzzling calls for regulations and state interventions in an economy which should be self-regulating instead[iv] (e.g.: Viner 1927; Stigler 1971; Billet 1978).

According to Smith banks should be allowed to issue their own money and compete in a minimally regulated environment. On the one hand, competition, including the possibility of bank failures, generates discipline, and discipline generates prudent behavior. On the other hand, competition in the banking sector is generated and maintained by prudent behavior. The prudent behavior of morally responsible banks is rewarded with economic success and it supports the economic and moral development of society; and the economic success of banks allows for morals to flourish.

In recent years there is an increasing number of calls for a more integrated view of economics in general[v] (Smith 2008; Wagner 2012) and of Adam Smith in particular (Paganelli forthcoming)[vi] (Paganelli forthcoming). Markets are powerful promoters of social wellbeing but they cannot be conceived outside their legal and moral framework. Laws and regulations if enlightened and designed with communal wellbeing in mind (a heroic assumption, granted, as Smith was well aware), enhances the powers of the market. If not, they can destroy the benefits originating from the market. Banking is, like any other parts of Smith's analysis, an integral part of a complex web of entangled relationships between the economy, the polity, laws, and morals—an example of the complexity of the natural system of liberty which promotes prosperity and the development of moral, free, and responsible individuals. And if banking is an example of how symbiotic individuals, society, morals, the market, and its legal framework are for Smith, state regulation and self-regulation may no longer be in contradiction.

If we see that for Smith wealth develops in conjunction with morals and justice, we can appreciate his commitment to both free banking and banking regulations. Given the multiplicity of individuals in society, it is possible that some have conflicting goals. As a result there will be times when some

individuals may benefit at the expense of the majority of members of their communities, and other times when the majority of members of a community may benefit at the expense of some minority of individuals[vii] (Paganelli 2009). In cases where there are conflicting interests, Smith tends to side with the one which makes the majority of the individuals better off. David Levy[viii] (1995) describes Smith as a median utilitarian, that is to say that one of Smith's major concerns is the wellbeing of the median, of the majority of the population.

Smith favors the formal and informal institutional arrangements which align the interest of individuals with the interest of society and which allow society to prosper peacefully and ethically. Competition, morals, the rule of law, and, occasionally, regulation, are part of these formal and informal institutional arrangements. In this light, we may understand Smith's position on banking. The competition of free banking enhances the majority of the people both materially and morally, and if some regulations are needed to support the smooth functioning of the banking system, those regulations are welcomed. On the other hand, if some banking regulations favor some at the expense of the majority, therefore inhibiting material growth and incentivizing immoral behaviors, those regulations are, in Smith's view, to be criticized and hopefully avoided. Using the vision that historians of economics recognize in Smith also for understanding Smith's views of banks may help us not only using a more coherent method of analysis of Smith, but also decrease some of the contradictions allegedly attributed to Smith.

Smith and Banking.

The banking system that Smith describes consists of several competing banks, each issuing their own notes: "It is chiefly by discounting bills of exchange, that is, by advancing money upon them

before they are due, that the greater part of banks and bankers issue their promissory notes" (WN II.ii.43, p. 298) and "[by] invent[ing] ... another method of issuing their promissory notes; by granting, what they call, cash accounts, that is by giving credit to the extent of a certain sum ... to any individual who could procure two persons of undoubted credit and good landed estate to become surety for him, that whatever money should be advanced to him, within the sum for which the credit had been given, should be repaid upon demand, together with the legal interest" (WN II.ii.44, p. 299).

In stark contrast to David Hume, who wishes the abolition of banks and paper money[ix] (Paganelli 2013b), Smith sees banks and banking as institutions that facilitate economic development, and therefore the material wellbeing of the majority of people, while at the same time improving the moral behavior of individuals by encouraging individual responsibility. We could speculate that Smith may actually care more about presenting this vision than a meticulous description of reality[x] (see also: Hueckel 2009): Smith's analysis of the Scottish banking system seems to have some elements that are historically quite accurate[xi] (e.g.: Gherity 1995; Skaggs 1999; Rockoff 2013), but others that are not, despite Smith's familiarity with the banking system that he describes(Checkland 1975a, 504-523)[xii] (Checkland 1975a).

Smith tells us that he favors banking because of its role in the development of Scotland: "That the trade and industry of Scotland ... have increased considerably during this period, and that the banks have contributed a good deal to this increase, cannot be doubted" (WN II.ii.41, p 297). But Smith's praises are qualified. It is judicious banking that is beneficial. He repeats the word several times in a few pages. It is the "judicious operations of banking" that contribute to popular well-being and align the self-interest of the bankers and of the merchants with society's benefits.

> "the *judicious* operations of banking enable him [a dealer] to convert his dead stock into active and productive stock; into materials to work upon, into tools to work with, and into provisions and subsistence to work for; into stock which produces something both to himself and to his country" (WN II.ii.86, p. 320. Emphasis added).

It is the "most *judicious* operations of banking" that increase productivity by, figuratively, free some fertile fields, previously used as highways to transport goods, by moving the highways from the ground to the air:

> 'It is not by augmenting the capital of the country, but by rendering a greater part of that capital active and productive than would otherwise be so, that the most *judicious* operations of banking can increase the industry of the country … The part of his capital which a dealer is obliged to keep by him unemployed, and in ready money for answering occasional demands, is so much dead stock, which … produces nothing either to him or his country. … The *judicious* operations of banking, by substituting paper in the room of a great part of this gold and silver, enables the country to convert a great part of this dead stock into active and productive stock … The gold and silver money which circulated in any country may very properly be compared to a highway, which, while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either. The *judicious* operations of banking, by proving, if I may be allowed so violent a metaphor, a sort of wagon-way through the air; enables the country to convert, as it were, a great part of its highways into good pastures and corn fields, and thereby to increase very considerably the annual produce of its land and labour.' (WN, II.ii.86, 320-1. Emphasis added)

Banks, *judicious* banks that is, provide a useful service to the community and should be supported.

That said, we cannot assume that bankers are moved by public spirit rather than self-interest. And indeed Smith does not make that move. For Smith bankers are moved by their self interest. But their self-interest aligns with the interest of the community and with morality—at least in the long run. If banking is left as a competitive industry, markets will do their work of channeling self interest in the direction of virtuous responsibility and the community's interest through competition.

For Smith, borrowers have the tendency to over-borrow as they over-estimate their probability of success because of the natural over-confidence in one's good fortune that any man in reasonable good health has. They also tend to like promissory notes more than loans in precious metals because they free idle capital, and because they could pay back a little at a time. For Smith, bankers, inexperienced bankers at least (see below), have incentives to over-issue paper money because they gain from the interest on the notes. The interest on the notes is revenue to the bank. The more notes issued, the more interest collected, the more revenue generated, and allegedly, the higher the profits for the bank. If banks discount bills of exchange with promissory notes rather than with gold and silver, they could make even more profit (WN II.ii.43, p. 298-9). Creditors, therefore, are tempted to ask for over-issuing of credit, and banks are tempted to over-issue credit.

There is therefore a tendency to over-issue paper and cause crises. But if a bank over-issues, for whatever reasons, that bank will not only fail to make profits, but it may actually fail. If a bank over-issues, the extra notes will be considered as extra notes in the hands of the notes holder. Rather than holding paper money, the merchant has incentives to go to the bank and redeem the paper money for specie and send that specie abroad for a more fruitful investment. The bank is under obligation to pay on demand and it will have to, unless it is willing to face a bank run which would mean the potential for bankruptcy (WN II.ii.48, p. 301). To pay for the incoming notes the bank needs specie. If it over-issues, that specie will not be readily available. The bank must get specie by borrowing

from another bank, or more commonly, from London. This is expensive because of the transaction and transportation costs and because often the rate at which it can draw from other local banks and/or London is higher than the interest it receives from its borrowers. Indeed, "The Scotch banks, no doubt, paid all of them very dearly for their own imprudence and inattention" (WN II.ii.56 p. 304). This can be done on occasions, but not regularly. If it is done regularly, the bank will eventually go out of business. Indeed that was the case of the Ayr Bank. To avoid losing profits or a bank run, the banks learn to decrease the amount issued (WN II.ii.49-56, p. 301-304) and learn how to be judicious.

Competition among issuers allows banks, via trial and error, to understand what allows for individual profits and what instead leads to bankruptcy and social distress. It is this learning that characterizes "judicious" banking and it is the competition among issuers that allows for the development and strengthening of this judiciousness. Smith is also convinced that competition and the risk of failure will (and did) teach bankers individual and social responsibility[xiii] (Cowen and Kroszner 1994; White [1994] 1995). Moreover, if something goes wrong, the damage is more limited because each bank is small and its failure has limited effect (WN II.ii.106, p. 329).

Once banks understand what they have "not always understood," they will not (and did not) over-issue. And because every man is driven by his desire to better his condition, there is no reason to believe that banks will continue to "not attended to [their] own particular interest." In fact, Smith also observes, the learning process of banking companies leads them to innovation and to the development of innovative institutions which promote banking stability: the establishment of the Note Exchange is a successful example of private institutions which promote the stability and therefore the long term development of individual banks, the banking system in general, and the well being of the community.

The competition generated by a self-regulated banking system, according to Smith, generates incentives to have a successful system of development of individual banks, the community, and individual responsibility. Irresponsible and "greedy" bankers would paint themselves into a corner and face the losses, up to bankruptcy, that the discipline of competition imposes. What Smith favorably describes seems therefore to be a system of incentives generated by competitive forces which promote the development of an ethical system and of a system of justice, based on prudence and judiciousness. The system of credit that the competitive banking system uses, especially regarding cash accounts, is a system that uses virtue as a signal of creditworthiness. Smith echoes Wallace's claim that 'None will give credit but to men of integrity, prudence, and activity, or to men of substance. Here then are natural checks and limits, beyond which credit will not be extended' (Wallace [1758] 1969, 28). Chiara Baroni[xiv] (2002) elaborates how Smith sees a 'man of credit' as a virtuous man to whom it is worth lending.

Smith had a favorable view of a system of self-regulated banks because its competitive pressures incentivize individuals to act prudently and judiciously so that the banking system can be stable and generate prosperity for the entire community.

Smith on Banking Regulation.

But what about regulation? After all Smith not only lauds free banking but also calls for regulation of it, as we are often reminded by historians of economics[xv] (e.g.: Viner 1927; Stigler 1971). I believe this is consistent with Smith's focus on the wellbeing of the majority of the individuals, that is, of the community. I show why this may be the case by looking at Smith's reaction to regulation of notes and coins.

Smith favors two regulations of notes: a ban on issuing of small notes, and a ban on the 'option clause', a clause that allows temporary suspension of convertibility of notes into species. In Scotland at the time of the banking boom, there was a chronic lack of specie. The emergence of bank notes may be seen as either an answer to the scarcity of coins, or as the cause of the scarcity of coins. Regardless, the lack of small denomination coins was a problem, especially since wages could not be paid in the absence of coins. Small denomination notes substitute for coins and laborers' wages would be paid in notes.

But, Smith points out, "where the issuing of bank notes for 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 beggarly bankers must be liable, may occasion a very considerable inconveniency, and sometimes even a great calamity to many poor people who had received their notes in payment" (WN II.ii.90, p. 323). Smith therefore advocates banning notes of less than five pounds. This ban would confine notes to transactions between dealers and dealers and not extend them to transactions between dealers and consumers. On top of stability, this policy would, according to Smith, allow the reintroduction of coins (WN II.ii.92, p. 323).

What is interesting about this call for regulation is the distinction Smith makes between the effects of a failure of a bank that issues large denomination notes, and of a failure of a bank that issues small denomination notes. In the case of large denomination notes, the negative effects are limited and the positive effects are large. In the case of small denomination notes, the opposite seems true: if a "beggarly banker" goes bankrupt, the poor may face something like a "great calamity." The

protection of the poor, and, given their large number in the total population, the consequent protection of the wellbeing and stability of society, seems therefore to take priority over a small convenience. Smith himself says that such regulations might seem to be a

> violation of natural liberty. But those exertions of 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 despotical. The obligation to build party walls, in order to prevent the communication of fire, is a violation of natural liberty, exactly of the same kind with the regulation of the banking trade which are here proposed." (WN II.ii. 94, p. 324)

In addition, small denomination notes are afflicted by another problem. Especially, but not only, with these small denomination notes there is the tendency to over-issue. Some banks accept small denomination notes from rival banks. They may collect enough notes and then go to the issuer and ask for their redemption all at once. The issuing bank must have enough reserve to honor the notes. If not, the bank risks a run and failure. This has the beneficial effect to put a check on the amount issued by each bank and to maintain the appropriate level of reserve. But it is also true that the risk of bankruptcy increases and the consequences may become "catastrophic" for the poor. To prevent depletion of their species reserves, banks start temporarily suspending convertibility.

Banks start issueing notes with an 'option clause', meaning that the bank may convert the notes back to precious metals upon demand, but with a delay up to 6 months, while paying interest for those months. The clause, when exercised, buys the bank time to find the precious metals it does not have in reserve. While prima facie the option clause seems an instrument of stability, in reality it is not: the option clause, temporarily suspending convertibility, generates instability as it dilutes the incentive to restrain over-issuing. There is now an increased threat of bank runs. Bankers eventually

realize it and wish to eliminate this clause. But "as voluntary agreement to ban the clause was not possible because of the bad feelings amongst the banks, it was decided, independently by the bankers in Edinburgh and Glasgow, that legislation should be sought to put an end to it and to the issue of bank notes of small denomination" (Munn 1981, 19)[xvi]. In 1765, Parliament passed an Act abolishing the option clause and limiting the issuing to notes above the value of 1 pound. The implication of this is that banks had to pay their notes on demand. But while banning notes below one pound contracted the banking system, banning of the option clause increased the popularity of notes and allowed the system to expand. Smith supports this idea and favors the legal banning of the option clause.

Notice that at the same time at which restrictions on the denomination of notes was proposed, the two Scottish public banks petitioned for monopoly privileges and the extinction of the provincial banking companies in exchange for an annual fixed payment to the Trustees for Improving Fisheries and Manufactures. The petition failed, finding a strong opposition amongst the Scottish M.P.s. And Adam Smith, while supporting ban of small notes and on the option clause, does not support bank privileges in particular and monopoly privileges in general[xvii] (Checkland 1975): these regulations favor a few at the expense of the majority of the people in the community.

Smith is indeed ready to criticize most of the other banking regulations because those rules help some at the expense of many. The community not only does not benefit from them, but is actually hurt by them. For example, Smith claims that in North America paper money does not come from banks, but from the government. Government paper is made into legal tender. "But allowing the colony security to be perfectly good, a hundred pounds payable fifteen years hence, for example, in a country where interest is at six per cent. is worth little more than forty pounds of ready money. To oblige a creditor, therefore, to accept of this as full payment for a debt of a hundred pounds actually

paid down in ready money, was an act of such *violent injustice*, as has scarce, perhaps, been attempted by the government of any other country which pretended to be free. It bears the evident marks of having originally been, what the honest and downright Doctor Douglas assures us it was, a scheme of *fraudulent* debtors to cheat their creditors" (WN II.ii.100, p. 326. Emphasis added). Regulations and institutional settings which favor some at the expense of many – as was also the case, for example, in cases of sovereign coin debasement (see e.g. WN I.iv.10) -- receive strong criticism because thought of as immoral and incentivizing immoral behaviors such as, but not limited to, frauds.

So, it is wrong to say that Smith favors regulation of the banking system, just as it is wrong to say that Smith favours an unregulated banking system. He favours regulation in very specific cases: Smith favours self-imposed regulation, emerging from practice and experience, and generating positive effects both in terms of the morality of the incentives generated and in terms of the diffused benefits generated. He also favours government enforced-regulations for cases in which self-regulation is desired but fails to take shape, but with the consciousness that "I have never known much good done by those who affected to trade for the public good" (WN IV.ii.9, p. 456).

The two cases of regulation presented above both describe situations in which the government intervenes to regulate something that individuals would want to have regulated because it is to their benefit, but somehow fail to do it themselves. Banks eventually realized the option clause was not to their benefit and wanted to eliminate it. They were not able to do it on their own because of their history of rivalry. Small notes, similarly, are something individuals would not want, and the benefits of eliminating them would benefit everybody in the long run, even if a few individuals would have to bear the cost. Other regulations, which benefit a few at the expense of most, are judged as detrimental for material and moral growth and are not supported.

Conclusion

Economists and historians of economic thought generally think of Adam Smith as a well-rounded thinker who cares not just about efficiency but also about justice. Yet, for some topics, they seem to forget their own analysis and concentrate only on technical aspects of Smith. This narrowing of focus without reference to the broader picture, has led some to see Smith as inconsistent. I use the case of Smith's analysis of banking to illustrate the point. My hope is that in the future, before accusing Smith of inconsistency, we might take a closer look at his vision of the economy and of society as integrated systems of natural liberty which promote both efficiency and justice.

When his bird's eye view is set aside, Smith tends to be described as inconsistent: he is a vigorous promoter of free market but also favoring a heavy regulatory hand in some parts of the economy. But Smith's aim seems neither to promote an unregulated market nor a government regulated one. Smith's major concern seems instead to be the material and moral wellbeing of the majority of the people. He favors the institutional structure that would benefit the community the most and often this is a mix of self-regulated and minimally government-regulated markets.

The free banking system of Scotland at his time is for Smith the most effective institutional banking setting to promote both moral and material prosperity for the majority of the people. The competitive discipline of many small banks which must convert notes into specie on demand generates the incentives for a stable banking system which allows for economic development as well as the virtues of prudence and judiciousness. Given the multiplicity of interests in society, it is possible that those interests conflict with each other and will not reach a mutually beneficial solution. In these cases Smith believes regulation would make society both morally better and materially better off, as long as the regulation benefits the majority of the people, and not some at the expense of many. Indeed, the banking and monetary regulations which create concentrated

benefits and dispersed costs receive strong condemnation. The banking regulations that Smith calls for seem to be just a definition of the rules of the game which will allow competition to function at this best. And competitive forces allow for a fruitful moral and material development of the majority of the individuals.

Economists have taken major steps toward integrating technical issues into the big picture that Smith offers us. I think and hope that this will be an increasing trend in the future.

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