INTERVIEW

George Selgin

Editor's Note: *This is an abbreviated version of RF's conversation with George Selgin. For the full interview, go to our Web site: www.richmondfed.org/publications.*

To many, the idea that an economy can function without a central bank to issue currency or serve as a lender of last resort will seem bizarre. To economist George Selgin, the idea is one that needs to be taken more seriously.

Selgin, a monetary theorist and historian, has recently published a book titled *Good Money: Birmingham Button Makers, the Royal Mint, and the Beginnings of Modern Coinage, 1775-1821*. In it, he tells the story of how competition between private coin makers provided much-needed currency during a critical time in Great Britain's economic history.

Selgin's interest in monetary economics was piqued after he graduated from Drew University in 1979 with degrees in both economics and zoology. Upon reading a paper on "free banking" — a system in which private banks are able to compete with each other in the issuing of currency and operate without government restrictions — Selgin decided to pursue graduate studies at New York University under the paper's author, Lawrence H. White. After graduating from NYU in 1986, Selgin became a leading alternative voice in monetary economics.

Since 1989, Selgin has been a professor of economics at the Terry College of Business at the University of Georgia. Last summer he took leave from Georgia to serve as the BB&T Professor in Free Market Thought at West Virginia University.

Stephen Slivinski interviewed Selgin on the WVU campus on Dec. 11, 2008.

PHOTOGRAPHY: TIM TERMAN, DIRECTOR, PR AND COMMUNICATIONS, WEST VIRGINIA UNIVERSITY

RF: Describe free banking. How does it differ from the sort of system we have in the United States today?

Selgin: I use the term to mean laissez-faire banking — banking without any special government regulations or restrictions. Like free trade, it's an ideal concept. It doesn't refer to any specific or actual banking system, although some, like Scotland's in the early 19th century, came close.

My own ideal version of free banking would have no special requirements for note issuance. Private banks would be able to issue their own notes on the same basis as they create demand deposits. They would also be free to open branches and invest in all kinds of securities. Finally, there wouldn't be any sort of implicit or explicit government guarantees, like deposit insurance.

RF: Is a commodity standard necessary in your hypothesized free banking environment? Or, to put it another way, is "fiat money" incompatible with free banking?

Selgin: I think a distinction needs to be made between the banking regime on the one hand and the monetary base regime on the other. The way I envision free banking, it does not rely on a particular base regime. It's true, as a matter of history, that if you had free banking from the get-go, you wouldn't have central banks and you would almost certainly have a commodity money standard, probably gold. But one can conceive of free banking in a modern fiat money setting. What would make it free is that the central bank would not have a monopoly on issuing paper currency the way central banks do today almost everywhere.

> We should take private production and issuance of circulating money more seriously than we do.

A modern proposal for free banking that doesn't radically alter the monetary base regime is one that freezes the monetary base, lets banks issue any sort of liabilities — including currency — and gets rid of deposit insurance. The central bank would still maintain the monetary base but, in principle, it would just be a question of making sure it mopped up old central bank notes and otherwise maintained a fixed stock of reserve credit for banks to settle with. In that case, you'd have free banking with a fiat money standard.

The fiat money we currently have is purely the product of central banks. I think it's pretty clear that if we never had central banks, we wouldn't have fiat money. Instead, we'd still have commodity money. I don't think there were any evolutionary forces at work that would have weaned monetary systems off of established commodity standards, particularly gold and silver. What would have happened instead, and what was tending to happen while we still had those standards, was that the actual need for gold and silver as money would have fallen, thanks to financial innovations, to very trivial amounts.

In the Scottish free banking system, for example, actual gold coin reserve ratios had already fallen to as low as 1 percent to 2 percent of the banks' outstanding demand liabilities by the 1820s. Most of the liabilities were banknotes back then — deposits weren't so important. At any rate, the Scottish banks didn't need a lot of gold, and the system was always finding new ways to economize on it. But the ultimate standard was still gold, and I think it would have remained so in the absence of government interference.

RF: Do you consider fractional reserve banking inherently problematic? Does free banking require a commodity standard so private banks don't issue too much currency?

Selgin: The advantages of free banking are distinct from those of the gold standard or any commodity standard. That doesn't mean that I think there is no advantage to a gold standard. As a matter of history, I think it's a shame that the gold standard was dismantled. That dismantling really began in earnest during World War I, and the gold standard that was restored afterward was a jury-rigged and, ultimately, very unstable standard. But one can have a better banking system under free banking whether there is a gold standard or not. Fiat money would also work better with free banking than without it.

As for fractional reserve banking, I think it's a wonderful institution and that it's crazy to argue that we need to get rid of it to have a stable monetary regime. Those self-styled Austrian economists, mostly followers of Murray Rothbard, who insist on its fraudulent nature or inherent instability are, frankly, making poor arguments. I don't think the evidence supports their view, and that they overlook overwhelming proof of the benefits that fractional reserve banking has brought in the way of economic development by fostering investment.

The main thing to keep in mind is that a competitive bank of issue is one that can issue circulating currency but has no monopoly on doing so. So it isn't in a position to print up its own reserves or to print anything that other banks can be counted on to treat as reserves. Free banks compete, as it were, on an even playing field in issuing paper IOUs, which are basically what banknotes are. They have to redeem those IOUs on a regular basis: The competition among different issuers means that their notes will be treated the same way that checks are treated by banks today. They will be accumulated for a day or so and then sent through the clearing system for collection. It's this competition among issuers that assures that none of them has the power to lead the system into a general overexpansion.

That's quite unlike the situation you have when you have a monopoly bank of issue. Even in the presence of a gold standard, when the privileged banks' IOUs are themselves claims to gold, a monopoly bank of issue can expect other banks to treat its paper notes and its deposit credits, which are close substitutes, as reserve assets — that is, to treat them as if they were gold themselves. As a result of that tendency, which exists only because the recipient banks are deprived of the right to issue their own paper currency, the less privileged banks become dependent on the monopoly currency provider and, therefore treat its notes as reserve money. Now that monopoly bank has the power to generate more reserves for the whole system and it, in turn, is free of the discipline of the clearing mechanism. That's where central banks' power comes from. This is what allows central banks to promote a general overexpansion of credit and inflation.

What I just described is exactly the sort of thing that triggered many of the financial crises of the 19th century. The irony is that people now see these periodic crises, especially in England, as proving the need for a central bank and a lender of last resort. Walter Bagehot, on the other hand, recognized that the boom-and-bust cycles were a product of a monopoly in currency issuance.

Today, poor Bagehot must be spinning in his grave, because your average central bank apologist likes to cite him as having argued that every country should have its own central bank. That is a calumny. Bagehot in fact wrote very explicitly that he thought it would have been best had there never been a Bank of England, and if England instead had a competitive banking system like Scotland's. In that case there would have been no need for any lender of last resort. In recommending that the Bank of England serve as such a lender, Bagehot wasn't recommending a solution to problems inherent in unregulated banking. He was just trying to get an inherently flawed Bank of England to behave itself.

RF: You've already mentioned the Scottish banking system of the early 19th century as the best historical example of a functional free banking system. How did the Scottish system emerge?

Selgin: The Scottish system was unique, and that's because of politics. After the 1707 Treaty of Union, English authorities did not want Scotland to end up with an institution with the same power and prestige as the Bank of England. They more or less insisted that Scotland allow open entry into the note-issuing business. So the Bank of Scotland, chartered in 1695, was followed by the Royal Bank of Scotland, and then by other note-issuing banks, until Scotland had a couple of dozen banks of issue — some big, some small — all competing. In this way the English quite unintentionally gave Scotland the world's most stable, most envied banking system, and one far superior to its own. For one thing, Scotland was relatively free of crises while England was buffeted by one crisis after another.

By the way, the same comparison can be made between the U.S. banking system and the Canadian banking system in the last half of the 19th century. Neither was a free banking system, but the Canadian system was freer in crucial respects, like allowing banks to issue notes without special collateral requirements and allowing nationwide branch banking. This greater freedom made the Canadian banking system the envy of U.S. commentators at the time.

RF: Supporters of central banking claim it is superior to free banking because the central bank can serve as a lender of last resort in a crisis or a contagion. Are there characteristics of a free banking environment that would obviate the need for a lender of last resort?

Selgin: The standard view is that banking systems are inherently fragile and that they'll be subject to frequent bank runs, which with fractional reserve banking will have very serious consequences. But there's no good evidence for this view.

Two things need to be said. First, truly irrational and random runs on banks, out of pure ill-informed panic, are the exception. In most cases the runs turn out to be based on relatively accurate information about which banks are insolvent and which ones aren't. In other words, so-called bank "contagions" tend to be very limited.

Secondly, the tendency for banking systems to suffer failures, especially big clusters of failures, depends on the regulatory environment. Had we had nationwide branch banking all along in the United States, that alone would have allowed us to avoid many of the bank failures and problems we've experienced.

So, the question that has to be asked is not whether heavily regulated and structurally weak banking systems in the past could have benefitted from a lender of last resort. Perhaps they could have. It's whether the first-best solution is to get rid of the regulations that rendered these systems so artificially fragile in the first place. I don't think that laissez-faire or free banking systems, or the closest approximations we have been able to study, have demonstrated the sort of fragility that suggests the need for a lender of last resort at all. In my opinion, a lender of last resort is a second-best solution to problems caused by misguided regulation of banking systems.

Freedom to issue notes is important too. When banks can't issue their own notes, well, they need a lender of last resort to supply them with notes. If we told companies that manufacture shoes that henceforth they could only make shoes for left feet, lo and behold, there would be a need for an "emergency" source of shoes for right feet, which could be created by establishing a new government agency for the purpose. Eventually people would say, "Thank goodness for the Government Shoe Agency. How would anyone be able to walk otherwise?"

RF: What is the "big problem of small change?"

Selgin: The big problem of small change — which is the title of a very good book by Thomas Sargent and François Velde — refers to the problem of trying to keep smaller denomination coins circulating alongside larger denomination coins. Say you have a gold standard. If the mint strikes only full-bodied gold coins, the smaller denominations will end up being too tiny. You actually have historical examples of very tiny coins being issued. But people lost them, and they were otherwise very inconvenient. So, what else can you do? You can switch to silver or copper, but then your large denomination coins would be huge. In practice, no one metal can be convenient for the full range of denominations people need.

Instead, you can have two kinds of metal circulating as coins — that's called "bimetallism." But bimetallism has its own problem. So long as the mint sticks to a single unit of account, its coining rates will imply a fixed relative price for the two metals. But that price is bound eventually to differ from the world relative price. When it does, the metal that's relatively undervalued at the Mint will no longer be offered to it, and already-existing coins made from it will disappear from circulation unless they're badly worn.

The other solution, and the one that was adopted everywhere, is to use "fiduciary" or "token" coins. Here, the metal isn't the source of the coins' value, which instead rests on a contrived scarcity or their convertibility into nonfiduciary money. The trouble with respect to such coins is that they can be a tempting object for counterfeiters.

This brings us to the British case. By the 1780s, it was estimated that more than 90 percent of the token copper coins in circulation in Great Britain were fake. And the real ones were in terrible condition. Merchants and factory owners could not get hold of enough decent coins for making change and paying workers. Of course, these problems were interrelated. The lack of decent official coins just made it easier for forgers to market counterfeit coins, while the extent of the counterfeiting discouraged the Royal Mint from producing more legitimate coins. At last, for several decades starting in 1775, the Mint decided not to produce any copper coins at all.

Great Britain also used silver coins as not-so-small small change, but because Great Britain's official bimetallic ration caused silver to be undervalued at the Royal Mint throughout the 18th century, no silver was being brought to the Mint to be coined. In other words, from 1775 onward, the Royal Mint produced hardly any small change of any kind.

Now, this was no small matter. Britons needed small silver and copper coins for all payments under a guinea. Banknotes didn't help, because the smallest until 1797 were for five pounds sterling. This was at a time when the average British worker was lucky to get 10 shillings, or half of one pound sterling, per week. So, retail exchange, wage payments — any transactions among the poor — there was no decent, official money for any of it. At the same time, the Industrial Revolution was gearing up. But that revolution depended crucially on the growth of retail exchange and the expansion of the factory system. It depended, in other words, on precisely the sort of exchange media that the government was no longer supplying. So the small-change shortage threatened to slow down the process of British industrialization.

Yet the British government, instead of trying to fix the problem, threw its hands up at it, leaving it to private merchants and industrialists to figure out a solution, which they did, ultimately, by minting and issuing their own coins.

RF: Tell me about your research into this historical episode.

Selgin: This private coinage episode, which is the subject of my book, was not a small thing. It was not a sideshow. In the course of 10 years, from 1787 to 1797, private coiners issued half again as many copper coins — in tons as well as in value terms — as the Royal Mint had issued throughout the previous half century. Later, the private coiners would issue silver coins too. So, for a big chunk of the early Industrial Revolution, the greatest part of the exchange medium used to sustain that revolution came from the private sector.

George Selgin

➤ Current Positions

BB&T Professor in Free Market Thought, West Virginia University (2008-2009); Professor of Economics, University of Georgia (1989-present)

➤ Education

B.A., Drew University (1979);
Ph.D., New York University (1986)

➤ Selected Publications

Good Money: Birmingham Button Makers, the Royal Mint, and the Beginnings of Modern Coinage, 1775-1821 (2008);
The Theory of Free Banking (1988);
co-author, with Lawrence H. White, of "How Would the Invisible Hand Handle Money?" in the *Journal of Economic Literature* (1994)

Very few people know this story. What's more, it was only thanks to lessons learned from Great Britain's private coiners, both concerning how to make coins and how to administer the coining system, that the British government and other governments were finally able to get their official coinage arrangements in sufficient order to allow them to provide for the coinage needs of industrial economies. Yet governments still aren't very good at doing this. To this day there continue to be serious coin shortages around the world. Argentina has been in the grips of one for years. As long as we insist on letting government monopolize coinage, we can expect such shortages to occur.

That's where Sargent and Velde go wrong in their book. They insist on treating the small-change problem as being due either to government authorities not having the right theory about how small change should be supplied or to their not having the right equipment with which to implement the theory. They never really consider what one might call the "public choice" problems behind change shortages, including the perverse incentives involved in a bureaucratic and centralized mechanism for supplying coins. If you look carefully at the British story, the problem there was very clearly not a lack of sound theory or a lack of adequate equipment. Most of Great Britain's private or "commercial" coins were made using ordinary screw presses and were designed, issued, and administered by people who never lost a moment's thought to any theory, new or otherwise.

RF: How is your book relevant today to monetary policy?

Selgin: The real lesson I want to get across with the book is that we should take private production and issuance of circulating money more seriously than we do. Through their unthinking failure to question governments' coinage "prerogative," economists set a precedent that made it all too easy for them to excuse governments' subsequent monopolization of paper currency, which in turn paved the way to fiat money, unlimited government guarantees, and the prevailing international monetary chaos.

I wrote *Good Money* to challenge the oldest and most fundamental belief behind modern governments' control of money, by looking at a rare case where government didn't issue coins, but the private sector did. Contrary to what people assume, the episode suggests that the private sector alone is fit to coin money.

RF: Do you see reforms such as currency boards in

developing countries as a step toward your ideal of free banking?

Selgin: I think the view that currency boards represent a step toward free banking, perhaps even a big step, is partly due to the tendency to equate free banking with the lack of a central bank. I'm not saying that tendency is wrong, but it's a little bit misleading. There are ways of getting rid of central banks that may still leave commercial banks far from free, and currency boards are an example.

My perspective on currency boards is somewhat different. I agree that currency boards and dollarization can help us move toward free banking, but they do so by eliminating vested interests that tend to be among the most powerful opponents of granting greater freedom to banks. Once you dollarize, for example, whose concern is it domestically to prevent local banks from issuing their own currency? The currency profits — the seigniorage — are all going to another country. Allowing private institutions to supply currency would convert at least some of it to domestic consumers' surplus. There's no central bank to capture the seigniorage itself, and the treasury, which might otherwise look to a central bank to buy its debt, is now more likely to gain by encouraging than by standing in the way of currency privatization. So what dollarization and currency boards do is to get rid of at least some of the bureaucratic support for restrictions on commercial banks. In that sense, they represent a movement toward free banking.

RF: Do you see recent approaches to monetary policies and Fed actions as contributors to the current economic tumult?

Selgin: I agree entirely with those who blame the Fed for fueling the subprime housing boom by holding interest rates at such low levels for the early part of this decade. I think that was a very irresponsible policy. It was so even according to a conventional sort of Taylor rule, which, in my opinion, would itself have been too easy. Elsewhere I've defended the view that, in periods of growing productivity, central banks ought to allow some *deflation* — that is, monetary policy ought to be tighter than a standard Taylor rule would have it be. If you view the Fed's actual policy in light of this argument, then the policy was very expansionary. Taylor's own simulations suggest that if his rule had been followed, the housing boom would have been something like two-thirds as big. If the "productivity norm" I favor had been followed instead, the boom would have been much smaller still.

Still, it's a mistake to blame the Fed alone for the crisis. And, to some extent, one wants to pity the Fed because the truth is that central banks cannot get the money supply right. They are trying to centrally plan it and they do not have adequate information to go by. They could do better than they have done, I think, by adopting the right rules. But they are fundamentally flawed institutions.

In any event, the Fed provided fuel for the fire, but the fuel was being directed into the mortgage market, and specifically into the subprime market, by an array of other government policies all aimed at increasing homeownership, especially among less creditworthy persons, and at helping the construction industry. The story is more complicated than that, of course, but these are the essential points.

RF: What do you think are the prospects for achieving something resembling free banking in the United States?

Selgin: Financial innovations tend to take us in the direction of free banking. Such innovations have already privatized the greater part of national money stocks, and will keep doing so in the absence of a wholesale nationalization of banks. It's only currency and coin that private firms have long been prevented from supplying.

So long as private currency remains illegal, and even if it doesn't, further financial innovation will tend to make us less and less dependent on any sort of paper currency or coins. Smart cards, debit cards, that sort of thing, have already made some inroads. And global pressures tend to favor the loosening of other kinds of bank regulations. There is, however, one kind of regulation that is growing instead of retreating and that market forces can't or won't resist, namely, government guarantees. Here things have been going the wrong way for a long time. The spread of deposit insurance and other explicit guarantees has been obvious enough. Everyone thinks you can't possibly have a stable banking system without deposit insurance, as if it weren't the case that only one country had deposit insurance nationally before 1967 and only two countries for a while after that. I think the spread of deposit insurance has been very unfortunate, and that the spread of *implicit* government guarantees has been still more unfortunate, because implicit guarantees really have no limits.

Thanks to government guarantees, moral hazard is *the* big problem in banking today. We've got branch banking in the United States, finally. We've got many good private substitutes for government currency. We've gotten rid of other restrictive regulations like Glass-Steagall. Banks have a lot of freedom now that they didn't have in the 1940s and that, so far as I'm concerned, is a good thing. But, tragically, back in the 1930s, when the government was busy saddling banks with regulations that would prove counterproductive, which it justified using false claims about banks' excessive risk-taking, it also saddled banks with deposit insurance, thereby encouraging them to take excessive risks.

I don't know how we're going to get away from deposit insurance and guarantees, but as long as we have them and expand them, we can look forward to bigger and bigger crises. So to me, the biggest banking reform we need — bigger than allowing banks to issue their own notes, bigger than allowing private mints to spring up — is to roll back federal guarantees to the banking industry. Unfortunately, doing that may prove to be an even bigger challenge politically than trying to privatize all the world's paper money and coin. **RF**