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Book Review

Free Banking: Theory, History, and a Laissez-Faire Model.
By Larry Sechrest.
Auburn, Ala.:
The Ludwig von Mises Institute, 2008.

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Complete with an extensive new preface, the republication of Larry Sechrest's *Free Banking* is well-timed. The new preface is an important contribution to the ongoing debate within Austrian circles over banking freedom versus 100 percent reserve banking. Easier access to the book will be an asset for those wishing to better understand and/or teach the fundamental importance of money and the monetary framework, the role of banking, and the role of financial intermediation for a well-functioning market economy. The release of the book is also well-timed, coming just as fallout over the current meltdown has rekindled the important debate

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over money and financial market reform. This debate will occur both within Austrian circles as well as in the broader economics profession. Because the current cycle has attracted wider interest in and receptiveness towards Austrian perspectives—particularly toward the claim that central banks are the likely causal or enabling agent of bubbles and boom-bust cycles (Leijonhufvud 2008, p. 1 and Cochran, 2010)—Austrian economists have an enhanced opportunity to become important players in this debate. Stressing the elimination of central banking as an important first step in avoiding future crises of this type should be at the forefront of the Austrian contributions. However, the banking freedom debate, of which *Free Banking* is an important contribution, is a critical subsidiary in the broader debate over the foundations of a stable monetary framework.

The book, first published in 1993, was an attempt by the author "to further the evolution of free banking theory" with the hope that the book would be of value to both the "professional economist and the interested layperson." Believing that the "case for fractional reserve free banking based on a commodity 'outside money' had been persuasively presented" by Lawrence White, George Selgin, and Kevin Dowd as well by the original edition of this book (2008, p. 1), Sechrest turned his scholarly endeavors to other aspects of money, capital theory and business cycles, as well a pursuit of a personal interest in merchant sailing ship performance. However, a growing literature[1] in the Austrian tradition (in particular, Jesus Huerta de Soto's warmly received tome, *Money, Bank Credit, and Economic Cycles*[2]) attacking laissez-faire fractional reserve banking and supporting 100 percent reserve banking, on legal, ethical, and economic grounds, has stimulated a re-examination of the critical issues. While Professor Sechrest was conducting his own review, correspondence with him led me to re-examine these new arguments. I had taken an extensive look at the issue of banking freedom during research that had also been stimulated by comments in an email exchange with Professor Sechrest, prior to my 2003 Mises lecture (Cochran, 2004, p. 22, n. 4). This led to an

[1] See Block (2008).

[2] Huerta de Soto (2009). The first Spanish edition appeared in 1998 as *Dinero, Crédito Bancario y Ciclos Económicos*.

eventual inclusion of an "agnostic" discussion of banking freedom in the context of sound money. The result of Larry's most recent, careful review of this literature is summarized in the new preface. While many may not agree with his conclusions, which I found often mirrored my own assessment of the new literature, his lucid discussion alone is worth the price of the new book.

Other than the preface, the book is a reprint of the 1993 edition. The primary focus is on contrasting free banking with central banking. While alternative models of free banking are considered, the formal model presented and supported is a variant of the White-Selgin analysis. Besides developing a formal model, the presentation explores free banking in the context of the micro-foundations of macro analysis with an emphasis on Say's Law/Walras's Law and monetary equilibrium. He effectively reviews and criticizes the then-significant literature, studies historical episodes of free banking, reviews common criticisms, and provides a defense of the White-Selgin approach as well as thoughts on future research.

In an important theoretical argument, Sechrest suggests that free banking is an important element in an institutional monetary framework that would contribute to the stability of both financial and goods markets. He argues that "Walras's Law cuts to the heart of the matter. If monetary equilibrium (as defined earlier) holds, then there can be no monetary disruptive influence that might fuel a business cycle. The only possible disruptive influence will be real shocks that cause temporary disequilibria in specific markets. But if monetary equilibrium is maintained more or less continuously, he contends, then such real shocks will have neither pervasive nor lasting effects" (2008, p. 49). The new release of the book has already stimulated commentaries and discussions on this claim, as reflected in Van Den Hauwe's (2008) criticism of both this interpretation of Walras's Law and its application in support of free banking as a stabilizing institution. Other aspects of his argument are also open to criticism and refinement. Hopefully, additional attention will be paid to some of Sechrest's other potentially controversial claims, the clarification of which will be critical if banking freedom is to be a viable theoretical and practical alternative monetary framework.

The theory provides three key propositions supporting free banking: firstly, free banking maintains monetary equilibrium in the face of an increase in the Cambridge k (reduction in velocity)

and hence a constant price level and nominal spending stream; secondly, free banking would facilitate necessary price changes following an increase in productive efficiency; and thirdly, time and money markets will remain in equilibrium individually and in relation to each other. The third proposition is the critical link between free banking and the Austrian theory of the trade cycle and, if complete and true, explains why a free banking system would not be subject to such cycles.

The strongest case for all three propositions appears to be closely tied to two assumptions. The first is that specie will seldom appear in circulation in a mature free banking system, since money holders will have an almost 100 percent preference for notes or deposits from competing banks. The second is that while note and deposit holding represents a demand for money, it also is a form of capitalistic saving and hence the issuing of inside money is term intermediation, not credit creation.[3] Hence with free banking, the "supply of inside money, investment, and loanable funds all move together" (p. 50–52). While plausible, the argument is not entirely convincing and either ignores, downplays, or assumes away an important three-part distinction between holding money as a present good, purchasing present goods, and purchasing provisions for the future, i.e., saving and investment (Cochran and Call, 2000, 46–48). If the first did not hold in a mature free banking regime or only holds if banks maintain nearly 100 percent specie reserves, then both the money market equilibrium arguments become suspect (see the short discussion on redemption, pp. 33–37) and the intermediation argument becomes problematical or suspect. On the other hand, proponents of 100 percent reserve banking so expand their definition of money that the assault becomes not an assault on fractional reserve banking but an assault on term intermediation.

The book, and the free banking literature in general, pays too little attention to a more troubling case of potential deflation which is particularly relevant today—the multiple contractions of inside money brought on not by an increase in redemption demand (i.e., by an exogenous increase in the demand for holding money in

[3] For a critique of this type of term intermediation in the context of banking freedom with cycle implications, see Barnett and Block (2009).

specie [outside money]) but by loan default or the threat of widespread loan default which could perhaps trigger an endogenous redemption crisis and potentially corrosive deflation.

It is more critical than ever before that researchers keep in mind Mises's injunction that "the question of banking freedom must … be discussed again and again, on basic principles" (Mises, 1978, p. 45). The release of the book forwards this discussion, and the book truly meets its author's intention that it serve as a reference for those wishing to teach, better understand or undertake serious research and participate in the either the narrower free banking debate or the broader financial market reform debate. It is too bad that time and costs did not permit a more significant update of the book or at least allow for consideration of some the significant work on the topic since the book's original 1993 release, such as White (1999) or Horowitz (2000).

Yet even without the update, *Free Banking* provides a great reference and an accessible introduction to and assessment of the theory and history of banking freedom. While Professor Sechrest's book will be an asset for further research, his recent, untimely death has not only cost many of us a dear friend, but will also deprive the continuing debate of his sound scholarship, open mind, and willingness to actively engage in the search for truth. How he would have relished the chance to read, evaluate, and respond to such recent contributions as that of Henderson and Hummel (2008), who view the Greenspan era as potential evidence that free banking is a viable institution for macro stability, or Selgin (2008), who defends free banking, but views that policy era as one of instability generated by central banking policy. How I would have relished seeing his contributions to the application of Austrian analysis and business cycle theory to the current ongoing crisis.

To Larry, a true scholar and gentleman, may the future literature in this area develop in the spirit with which you pursued all your endeavors. Your voice of reason, your principled defense of liberty, and your friendship will be greatly missed.

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