

Austrian Economics Newsletter

The Other Side of the Coin: Free Banking in Chile

by Murray N. Rothbard

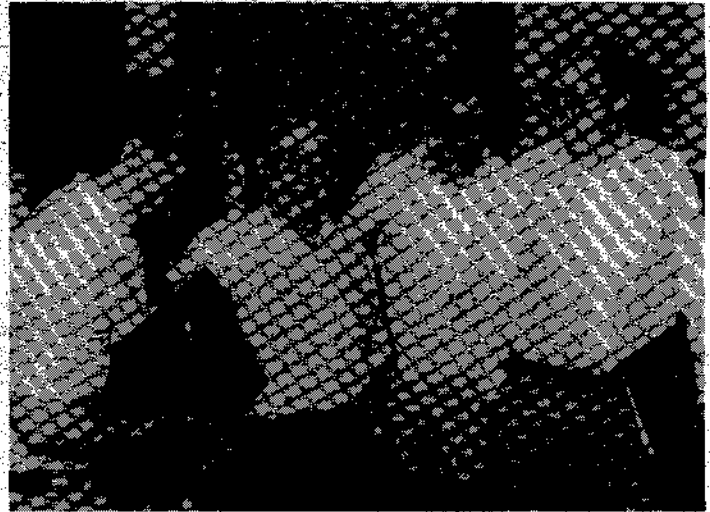
In recent years, disillusionment in central banking has understandably set in among many economists. As a result, some writers have turned to the alternative of free banking, praising both the theoretical model and historical cases in which free banking has allegedly worked effectively. But there may have been an unwise rush to judgment.¹ It is high time that we call attention to the other side of the coin: the apparent disaster of free banking in nineteenth-century Chile.

During the first half of the nineteenth century, Chile was a haven of monetary and financial stability, the envy of Latin America. The reason was not simply that the country had no central bank; more importantly, Chile had no paper money or fractional reserve banking at all! For the Chilean leadership was devoted to the idea of pure, 100 percent commodity money. Thus, in 1824, the Chilean Finance Minister strongly opposed the introduction of even convertible, fractional reserve bank notes. Such notes would be admitted, he warned, "only at the point of the bayonet. The person who dared to propose it would be looked upon as a dreamer, a tyrant, even a heretic."²

Throughout the 1830s and 1840s, Chile rejected proposals for a governmental paper bank, due to fears of mismanagement and inflation. In 1839, the government passed a law banning any bank paper issue without government permission, and required that any permitted issue had to be fully guaranteed by the bank. The result was the virtual absence of paper money in Chile. In 1848, the Minister of Finance, Manuel Camilo Vial, ruefully stated that he would have liked to establish a governmental bank, but found it politically impossible to do so: "I would not have hesitated to propose the establishment of a bank by the government were I not aware of the almost insuperable opposition which many of the most distinguished citizens of the country have to such an idea..."³ Three years later, the then-Minister of Finance prayed: "May we hold ourselves aloof from institutions such as banks of issue!"

Only one breach of this principle occurred before the end of the 1850s. In 1849, the government granted the right of note issue to the Banco de Chile: but large-scale protests by merchants and an adverse Supreme Court decision caused the bank to close its doors the following year.⁴

Into this idyll of hard money and monetary stability, there stepped, unfortunately, one man with an idea. As an



Students and faculty alike find the informal discussion time a valuable aspect of the Mises Institute's summer conferences. Dr. Gordon, Professors Rothbard and Hoppe and a student continue a discussion during a break at last summer's Introductory Course in Austrian Economics at Dartmouth.

undeveloped country, Chile was understandably in awe of European knowledge and civilization, and in 1853 it hired as its first professor of economics in the new University of Santiago the French economist and banking theorist Jean Gustave Courcelle-Seneuil (1813-1892), who was also to serve as an official economic adviser to the Chilean Ministry of Finance.⁵ Courcelle-Seneuil was devoted to free trade and laissez-faire in general, but his major interest was in the abolition of central banking and the establishment of a free banking system. Entering an academic vacuum, Professor Courcelle-Seneuil quickly became extremely influential in Chile, persuading the government to enact a free banking law drafted by himself in 1860. His

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charismatic teaching style produced a host of highly influential disciples, who dominated Chilean economic thought and political economy for decades.

The Law of 1860 created a free bankers' paradise in Chile. Anyone or any group could set up a bank and issue notes. There were no reserve requirements, no minimum capital or loan requirements, no limits on loans to directors, and no inspection by government agencies. Only two minor restrictions were imposed: a maximum note issue of 150% of the bank's capital, and a ban on very small denomination notes under 20 pesos. All else was permitted, within, of course, the standard free-banking framework of requiring banks to redeem their notes in gold on demand.⁶ The Law of 1860 continued to be the basic banking law of Chile until 1925.

As a result of the new system of free banking, however, Chile rapidly embarked on a long-run, generally accelerating course of inflation. The old haven of hard money and financial stability was no more.

It took less than five years for the brave new free banking system to collapse. In 1864, Spain and Peru went to war over the Guano Islands off the coast of South America, and Chile went to the aid of Peru, declaring war on Spain on September 24, 1865. By the outbreak of war, the free banks had inflated to such an extent that they were vulnerable to insolvency in a major crisis. Hence, the war scare of 1865 led to massive withdrawals of bank deposits and the cashing of notes from the fractional reserve banks. At the point of insolvency, the banks were promptly saved by the Chilean government, which now embarked on a path of inconvertible bank paper. First, five days after the declaration of war, it authorized the new Banco Nacional de Chile to issue a mass of inconvertible bank notes, stipulating (a) that the inconvertibility

Edwin W. Kemmerer, the American "money doctor" on one of his trips to South America to help with monetary "reforms" that led to the creation of the Chilean central bank.



would last only for 90 days and (b) that the maximum note issue would be 1.5 million pesos. The fiat notes would not be legal tender, but would be receivable in taxes or other payments to the government. Second, the government induced four of the leading banks to agree to receive the Banco Nacional notes at par, and also to turn over to the government all coin taken in to help eventually redeem the bank notes received by the government. Third, the government agreed to issue 1 million pesos worth of bonds to be kept as a guarantee for any of the inconvertible bank notes received by the government.

As always happens with monetary expansion, this first step was but the tentative beginning of the inflation program. Another law was passed at the end of December, delaying specie convertibility until six months after the war with Spain was over, or, at the latest, by the end of June 1867. In addition, more inconvertible bank notes were made receivable in taxes.

Fiscal needs escalated rapidly as the blockade by the Spanish navy led to a fall in customs revenue, and to difficulty in repaying the public debt, held mainly by England. The next step in the acceleration of inflation came in July 1866. The government borrowed massively from banks to help pay the foreign debt; in return, the government bestowed a host of special privileges on the banks. The law of the previous December was repealed. From now on, there were to be no restrictions on the amount of loans or note issue by the banks; all bank notes would be inconvertible until six months after the war, or June 1867 at the latest. All banks lending money to the government would agree to receive each others' notes at par for twenty-two years, to the extent of 4.5 million pesos. For this massive set of privileges, the banks agreed to pay the government a fee of 2 percent per annum on any inconvertible notes outstanding.

Fortunately, the war was shortly over, and convertibility into specie was soon resumed. But the signal had been given to the banks that the government would bail them out in times of real financial trouble, and so an inflationary boom soon began, fueled by bank credit expansion and ensuing speculation. The bank credit boom after 1866 led to a speculative boom in mining, as well as an increase in wheat and copper prices. Frank Fetter notes that "the banks were doing business on a very small margin of safety."⁷

Booms always give way to busts, and a depression set in by 1874. Farmers and landlords went even more heavily into debt, and total agricultural debt in arrears rose to 11.7% in 1877 and to a staggering 33.6% in 1879. There was a heavy depression in the mining industries. The Chilean government incurred heavy deficits from 1874 on. Having exhausted private nonbank credit sources after several years, the government in June of 1878 finally turned to the already overextended banks, borrowing 2.5 million pesos per year for two years. In turn, the Treasury allowed the lending banks to issue 10.1 million pesos in bank notes, to be receivable in taxes.

This inflationary issue of bank notes led to domestic inflation and to a rapid export of specie. The "free" banks were now on the ropes, then quickly, on July 23, 1878, the

Chilean government authorized all of the banks participating in the recent loan to immediately suspend specie payments "temporarily"—until the end of August 1879. In the meanwhile, these now fiat bank notes would serve as legal tender. In fact, this "temporary" inconvertibility was to last for nearly fifty years. Chile had been plunged into the inflationary world of fiat money, and had done so in the absence of a central bank, in fact in the midst of a supposedly ideal system of free banking.

Central banking and free banking are not the only two possible monetary alternatives. A third route is freedom of banking within a firm matrix of 100 percent specie reserves.

The fateful suspension of specie payment in 1878 was blamed, as usual in such situations, on the "unfavorable balance of payments," no recognition being given to the cause of that balance—the domestic bank credit inflation. The actual reason for the suspension was the imminent bankruptcy of several of the largest banks participating in the government loan. Just before the suspension, on June 30, 1878, demand liabilities of the Chilean commercial banks totalled 46.8 million pesos; specie reserves of the banks totalled only 3.45 million pesos, a reserve ratio of 7.4%. Even during prosperity at the end of 1869, total reserves had constituted only 8% of demand liabilities. The largest lending bank, and the most ardent advocate of suspension, the Banco Nacional, was the most unsound of the banks. Not only was its reserve ratio in 1869 far lower than the average of 5%, it also engaged in large-scale loans to its own directors. Just before suspension, on July 11, it had loaned out no less than one-half of its capital to its own directors.

During the next half-century, Chile made only one feeble attempt to return to gold. In 1895, when the market exchange rate between the peso and English pound was 14 pence to the peso, the Chilean government insisted on returning to gold at 18 pence to the peso. The subsequent appreciation of the peso and monetary and price deflation in Chile led to a run on the banks in 1898, and a permanent return to fiat money.

The fiat system and the legacy of Professor Courcelle-Seneuil finally came to an end in 1925, when the American "money doctor," Edwin W. Kemmerer, in a mission to Chile, succeeded in imposing yet another of his monetary "reforms." The 1925 reform repealed the Law of 1860, imposed a Central Bank, and engineered a return to a gold exchange standard, in which the peso was only nominally tied to gold, and was actually tied to the dollar. A few years later, the Chilean experiment joined the other gold-exchange standard nations in the dustbin of history, and fiat paper money was established permanently.⁸

And what of Courcelle-Seneuil? He had the good fortune to return in triumph to France in 1863, after the victory of his ideas and before their consequences would

become apparent. While in Chile, his *magnum opus*, a two-volume treatise on political economy, was published in France in 1858, and the grateful Chilean government financed a Spanish translation. After his return to France, he continued as a prolific writer on banking, economic and historical topics, and himself translated works on political economy from the English into French. He was appointed a member of the Council of State in 1879 and elected a member of the prestigious Academy of Moral and Political Sciences three years later.

Unfortunately, Courcelle-Seneuil's reputation did not fare nearly so well in the country of his major influence. Courcelle-Seneuil is still, to this day, de-nounced bitterly by Chileans as being personally responsible for the continuing history of inflation as well as for nearly all other economic ills. As Albert Hirschman notes, Courcelle-Seneuil has been "demonized."⁹ Unfortunately, his free-banking inflation also in retrospect discredited other, far superior reforms due to his influence: e.g., a drastic cut in Chilean tariffs in 1860, as well as the privatization of nitrate mines conquered in a war against Peru in the early 1880s. Thus, Professor Courcelle-Seneuil's legacy in banking was successfully used to discredit his other, more beneficial contributions to the Chilean economy.

The Chilean experience highlights an important point: that central banking and free-banking are not the only possible monetary alternatives. A third route is freedom of banking within a firm matrix of 100 percent specie reserves, any fractional reserve issue being considered a violation of the general laws against fraud and theft.

Notes

I am greatly indebted to Professor Joseph Salerno of Pace University for calling my attention to this problem and to the relevant literature.

¹On the most prominent example of this undue haste, see Murray N. Rothbard, "The Myth of Free Banking in Scotland," *Review of Austrian Economics*, 2 (1988), pp. 229-245; and Larry J. Sechrest, "White's Free-Banking Thesis: A Case of Mistaken Identity," *Review of Austrian Economics*, 2 (1988), pp. 247-257.

²Albert O. Hirschman, *Journeys Toward Progress* (New York: Doubleday, 1965), pp. 221.

³Frank W. Fetter, *Monetary Inflation in Chile* (Princeton: Princeton University Press, 1931), p. 7.

⁴During the 1850s, two commercial houses in Santiago began to issue and circulate notes, but at least one of them, the Banco de Valparaiso was prohibited from issuing notes by a special law in 1855. *Ibid.*

⁵Born in the Dordogne, Courcelle-Seneuil had studied law, managed an industrial firm in his home province, had written many articles for the *Journal des Economistes*, and had published a small book in 1840 on *Credit and Banking*. He briefly held a high post in the French Ministry of Finance after the 1848 revolution, and published a successful textbook on banking in 1852. Albert O. Hirschman, "Jean Gustave Courcelle-Seneuil (1813-1892)," *The New Palgrave: Dictionary of Economics*, I (London: Macmillan, 1987), pp. 706-708.

⁶Before independence from Spain, the Chilean currency consisted solely of freely circulated European gold and silver coins. Independent Chile imposed a bimetallic

standard, but the fixed rate of 16.5:1 overvalued gold and undervalued silver, and the result was an effective gold standard. In 1851, the fixed ratio was changed to 16.4:1, but silver was still undervalued, and the gold standard continued.

⁷Fetter, *Monetary Inflation*, p. 25.

⁸On the farflung activities of Edwin O. Kemmerer in imposing the gold-exchange standard and central banking in the Third World, see Robert N. Seidel, "American Reformers Abroad: the Kemmerer Missions in South America, 1923-31," *Journal of Economic History*, 32 (June 1972), pp. 520-545; Emily S. Rosenberg and Norman L. Rosenberg, "From Colonialism to Professionalism: the Public-Private Dynamic in United States Foreign Financial Advising, 1898-1929," *Journal of American History*, 74 (June 1987); and Murray N. Rothbard, "The Origins of the Federal Reserve," (unpublished MS), pp. 50, 60-61.

⁹Hirschman, "Courcelle-Seneuil," p. 707.

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The Implications of Freedom in Banking and Note Issue

by George A. Selgin

(This article is the first of two parts based on a lecture given at the Mises Institute's Austrian Economics Colloquium at Auburn University.)

I wish to defend two controversial claims in this article. The first is that the monopolization of banknote issue by monetary authorities all over the world has been the greatest blunder ever committed in monetary and banking policy. The second is that economists' failure to clearly understand the implications of monopolized note issue has been the greatest blunder ever committed in monetary and banking theory. Monopolized note issue is a policy blunder because it has been the main cause of instability of money supply and of consequent monetary disturbances. Had note issue been allowed to develop freely and competitively, we probably would not have come to think of money as something that "will not manage itself." The failure of theorists to understand the implications of monopolized note issue has been a blunder of theory because it has led to their approval of monopoly in the one industry where it could do the greatest harm.

Note Issue and Monetary Stability

What is meant by monetary stability? How do we want the banking system to behave? I take for granted that monetary stability means that the supply of money is neither excessive nor deficient relative to the wants of the public. To accomplish this, a banking system should increase the supply of bank money whenever the public's demand for it—relative to some given level of income—grows, and it should reduce the supply of money whenever the public's demand for it relative to its income falls. At all other times the supply of money should not be changed at all. Finally, the banking system should supply the public with the right mixture of different types of bank money, including currency and deposits of different kinds.

Obviously, real-world banking systems do not work this way. Why is that? The three most important reasons are as follows: 1) unwarranted changes in the supply of "base" or "high-powered" money—the stuff banks hold in reserve; 2) unwarranted changes in the reserve ratio; and, 3) unaccommodated changes in the public's relative demand for currency. The first of these reasons is the main cause of undesirable, secular maladjustment of the money supply, whereas the third is the most important cause of cyclical maladjustment. This, at least, has been true for all banking systems with a centralized currency-issue. But how significant would these causes of disequilibrium be in a system with competitive note issue? The answer is, not very. Compared to centralized banking, free banking offers relatively little scope for disequilibrium money supply.

Consider first the matter of the monetary base. In monetary systems with centralized note issue, the liabilities—both currency and deposits—of the privileged bank of issue inevitably become part of the supply of base

endogenous. Most of the alleged gold "supply shocks" in history actually occurred in response to falling prices, that is, they were provoked by an increase in the relative price of gold. They therefore represented movements along a gold-supply schedule rather than shifts in that schedule. Furthermore, many of these movements were a result of government interference in the monetary system, which

volume of clearings, the new, optimal reserve ratio will be lower than the actual ratio of bank reserves to liabilities. Assuming that the nominal supply of reserves is fixed, banks will adapt to the new situation by expanding their balance sheets through new loans and note issues until the volume of gross clearings returns to its former level. In effect, the banks offset changes in the velocity of money