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Legislating Instability

By Tyler Goodspeed, University of Oxford

On June 27, 1772, as the city of Edinburgh reeled from its worst financial crisis since the collapse of the Darien Company in 1700, David Hume posted an anxious letter to Adam Smith, who was then working on *An Inquiry into the Nature and Causes of the Wealth of Nations*. Hume noted:

> We are here in a very melancholy Situation: Continual Bankruptcies, universal Loss of Credit and endless Suspicions. There are but two standing Houses in this Place, Mansfield's and the Couttses . . . Mansfield has pay'd away 40.000 pounds in a few days; but it is apprehended, that neither he nor any of them can hold out till the End of the next Week, if not Alteration happen. The Case is little better in London . . . even the Bank of England is not entirely free from Suspicion.

He concluded by inquiring of Smith whether "these events any-wise affect your theory? Or will it occasion the revisal of any chapters?"

Two weeks earlier, on June 10, the London banking house of Neale, James, Fordyce, and Down had been issued a commission of bankruptcy upon news that one of their partners, Alexander Fordyce, had racked up a staggering £300,000 in trading losses. Fordyce had for months been shorting some £1,000,000 (approximately £114,200,000 in 2014 prices) of East India Company stock. But with East India share prices flat since late 1771, and facing an additional margin call of 10 percent, Fordyce absconded to France, leaving his partners liable for an estimated £243,000 in debts. Realizing the extent of their liability, the remaining partners immediately suspended payments in a futile attempt to safeguard creditors from a disorderly liquidation. Runs quickly formed against several of their principal counterparties in Exchange Alley, and by the following Wednesday, no fewer than 10 London banks had failed.

The worst, however, was yet to come. It took just 43 hours for a rider to carry word of the collapse to Edinburgh, where several leading banking firms had been relying heavily on Neale, James, Fordyce, and Down, the largest buyer of Scottish bills in London, to roll over short-term debt. Fordyce himself being a Scotsman, and with two Scottish houses in London having already stopped payment owing to his failure, the fear was that the sudden evaporation of liquidity for Scottish bills, which had lately been flooding the London discount market, would render it nearly impossible for Scotland's banks to obtain vital refinancing as outstanding drafts came due.

With the news arriving late Friday afternoon, Edinburgh's bankers were largely spared for the weekend, but upon reopening Monday morning, panic set in. By the end of the day, the small private bank of Fordyce, Malcolm & Co. had been forced to stop, followed, on Tuesday, by Arbuthnot and Guthrie. Pressure was particularly intense, however, on Douglas, Heron & Co., the "Ayr Bank," who on Tuesday evening distributed advertisements throughout Edinburgh offering a reward of £100 to anyone who discovered the source "of some ill-grounded reports raised by foolish or malicious persons" respecting the bank's solvency.

Editor, Jeffrey Miron, Harvard University and Cato Institute

In private, however, the banking behemoth was scrambling to shore up an increasingly desperate internal position. Already the day before, they had approached directors of the Bank of Scotland and Royal Bank of Scotland to insist that, though the extent of their exposure to Neale, James, Fordyce, and Down did not exceed £22,000, they required an immediate six-month loan of £20,000 from each bank to resolve what they claimed was a temporary lack of liquidity. The directors of the two chartered banks sensed a bluff, and were "of Opinion that it would be Improper for them to Agree to the Proposals" made to them by the bank.

Nevertheless, Douglas, Heron & Co. managed to struggle through until the end of the week. But the following Monday, June 22, their head office at Ayr, where notes could previously be redeemed for specie, did not reopen after the weekend. Two days later, a second entreaty to the chartered banks for an emergency line of credit was refused, with the Bank of Scotland and Royal Bank of Scotland further informing Douglas, Heron & Co. that they could no longer accept the latter's notes in payment.

Within 24 hours, the largest bank in Scotland finally capitulated, announcing via public advertisement that the bank had resolved to "give over, for some time," the payment of specie for their notes. They assured their creditors, however, that "the country, who have received the most liberal aids from this company, cannot entertain the smallest doubt of the solidity of its foundation," and further pledged that 5 percent interest would be paid on all outstanding Douglas, Heron & Co. notes, until paid, and duly registered a bond to that effect with the Court of Session.

Evidently, the Scottish public was unassuaged. By week's end, just 4 of Edinburgh's 18 private banks remained standing. Of the country's 11 provincial banks, just 8 reopened for business on the following Monday morning, of which three were already seeking assistance from Edinburgh. In Perth, the General Bank of Perth would soon wind up. The Scots Magazine reported that the ongoing crisis was "said to be the greatest that ever happened in Scotland," worse even than the aftermath of the South Sea Bubble or the collapse of the Darien Company. Horace Walpole wrote that "one rascal" could thus "shake the mighty credit of such a nation as Great Britain," yet 20 years would be insufficient to "remove the prejudice that men will contract against bankers."

Among those contracting such prejudice was, in fact, none other than Adam Smith, for whom the events of June 1772 did indeed seem to "occasion the revisal" of at least one chapter of the still incomplete *Wealth of Nations*, perhaps not coincidentally, as several of his intimate friends and associates were financial casualties of the Ayr Bank's demise, as well as shareholders in the failed bank itself.

It was not that Smith wished for credit and banking to be rigidly bound by gold and silver manacles. But the "party walls" Smith advocated to fireproof the banking trade—prohibition of small-denomination banknotes, a maximum legal rate of interest, and prohibition of contingent liability banknotes—could hardly have been expected to deliver effective protection against what Smith called the "accidents" of both the "unskillfulness" of bankers as well as causes against which no amount of "prudence or skill" on their part, but only public regulation, might guard.

The simple explanation is that all three regulations were already law seven years before the crisis of 1772. More curious still is that these restrictions were the products of intense political lobbying by none other than the very bankers—many of them intimate and lifelong friends of Smith's— whose trade they were intended to regulate. Moreover, the available historical and statistical evidence reveals that, far from attenuating financial sector instability, the banking regulations championed by Smith actually exacerbated the risk of that for which they were purportedly the cure; Smith's financial "party walls," in other words, belong among the contributory causes of the 1772 crisis, not among its mitigators.

That the "Ayr Bank Crisis" in Scotland should be seen, at least in part, as a consequence of bank regulation is itself odd. For, largely unaffected by the Bubble Act and exempt from the Bank of England Act of 1708, which had effectively granted the Bank of England a monopoly on note issuance in England by prohibiting all other banks of more than six partners, Scotland from 1716 to 1845 is widely considered by economic and financial historians to have been one of the closest ever historical approximations to "free banking"—namely, the competitive issuance of convertible currency by non-privileged banks, in the absence of any additional legal or regulatory restriction beyond those applying equally to all commercial enterprises.

While scholars of free banking have quibbled over how closely the Scottish financial system during this period fit the mold of idealized free banking, no one disputes that from the expiration of the Bank of Scotland's monopoly charter in 1716 to the passage of the Scottish Bank Act of 1845, Scottish banking functioned with no official central bank or lender of last resort, no public (or private) monopoly on currency issuance, no mandated capital or reserve requirements, no legal restrictions on entry, and no limits

on bank size analogous to England's six-partner rule. Moreover, few dispute that the Scottish economy during these 130 years was characterized by faster economic growth and greater financial stability than occurred contemporaneously in England, or subsequently in Scotland itself.

The central argument of my research is thus that the salient financial crisis of the Scottish free-banking period, the obtrusive exception to the hypothesis of greater financial stability under free banking in Scotland, was made more rather than less likely by precisely those regulated or "unfree" elements of Scottish banking which the author of *The Wealth of Nations* promoted. Further, I argue that this conclusion should hardly be cause for surprise once we realize that it was none other than the oldest, largest, and most established banks in Scotland that had lobbied for Smith's legal restrictions on banking; regulations that raised barriers to entry, lowered competition in the provision of short-term credit, increased the efficient scale of banking, and therefore amplified the level of systemic risk in Scottish credit markets.

Finally, I find that both the relative competitiveness of the Scottish financial system and the unlimited legal liability of shareholders in Scottish private banks were sources of considerable financial stability, both in 1772 and previously. In particular, in the absence of a formal lender of last resort, the unlimited liability of the partners in Douglas, Heron & Co. ultimately served that role. Upon declaring bankruptcy in August 1773, the firm was essentially transformed into a "bad bank" whose sole function was to gradually work off its toxic assets and repay creditors while the immense landed wealth of its proprietors' personal estates provided a financial backstop. A £500,000 bond issue, secured by £3,000,000 in mortgages to the shareholders' estates, allowed the firm to satisfy creditors, at 5 percent interest, as the company's assets, and those of its partners, were gradually liquidated. But only after an act specifically authorizing the bond issue, which otherwise would have been prohibited under the Bubble Act of 1720, passed Parliament in early 1774, did Scottish credit markets begin to thaw.

To be clear, it is not my contention that the introduction of legal restrictions into Scottish banking caused the 1772 crisis, but rather that they critically undermined the flexibility and resilience previously exhibited by Scottish finance, and thereby elevated the risk that adverse economic or financial shocks might metastasize into broader threats to financial stability. The Bank Act of 1765, advocated for by Smith, not only misdiagnosed the source of Scotland's macroeconomic troubles as one of too many bankers, but also did nothing to resolve the fundamental problem that Scotland's was a rapidly developing economy with a fixed exchange rate, large external debt, and chronic current account deficit balanced by large but often highly volatile capital inflows.

Moreover, by effectively restricting entry, raising the minimum efficient scale of banking, and removing the voluntarily contracted option of selective capital controls, the act also undermined some of the strengths that had previously enabled the Scottish banking system to absorb such volatility. In other words, in the wake of 1765, you still had an unresolved perennial balance-of-payments problem, but now with the additional problems of bigger, more systemically important financial institutions, higher barriers to entry for new banks, and no contractual "circuit-breaker" to allow temporarily illiquid but otherwise solvent banks to liquidate assets without incurring fire-sale losses. The result was that when a major external financial shock hit in 1772, the flexibility and resilience that the system had previously exhibited, most notably in 1756 and 1763, was substantially diminished. Thus, while there were certainly macro-prudential motivations for Scotland's largest banks to lobby for regulatory intervention, the unintended second- and third-order effects were no less adverse on account of somewhat noble intentions. It is a cautionary tale of the risks of rushing to regulate in the middle of an ongoing financial crisis and before the causes of that crisis are sufficiently understood.

NOTE

This research brief is based on Tyler Goodspeed, *Legislating Instability,* Harvard University Press, 2016.