Free Banking in Sweden 1830–1903: Experience and Debate

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Between 1830 and 1903, Sweden experienced one of the longest and most successful free-banking periods in history. During this period, private note issuing banks[1] were allowed and prospered. This paper describes the rise and fall of the Swedish free banking system and shows that the system could be considered a true free banking system, in spite of legal restrictions. Finally, the paper provides a comprehensive summary of the critique raised against the Swedish free banking system.

The renaissance of free banking research—a topic virtually unheard of since Vera Smith's classic dissertation *The Rationale of Central Banking* (1990)[2]—began in 1978 with the Nobel Laureate Friedrich Hayek's *Denationalization of Money* (1978).[3] Hayek's book was followed by a number of publications during the 1980s, the most important being White (1984), Selgin (1988), Goodhart (1988), Dowd (1990), and Sechrest (1993). The Swedish free banking system has been surveyed from a free banking perspective in three different studies: Jonung (2000), Lakomaa (2000), and Hortlund (2001). In addition numerous general studies of the nineteenth-century Swedish banking system have been run: Nilsson's four books on André Oscar Wallenberg (1981, 1984, 1989, 1994), Brisman's three volumes on the Swedish commercial banks (1924, 1931, 1934), and Gasslander's

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[1]The terms private banks and *enskilda* banks are used interchangeably throughout.

[2]Friedrich Hayek was—as Smith's tutor—also involved in the creation of this work. In fact the project was initiated by Hayek and then completed by Smith.

[3]Hayek's renewed interest in free banking could have been inspired by the publication of Murray Rothbard's *What Has Government Done to Our Money?* in 1963. Rothbard's book however has never become influential in its own.

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study about Stockholm's *Enskilda* Bank (1962). These studies are more or less critical of free banking, or at least of the *enskilda* banks, since the concept of free banking is not used by any of them. Ögren (2003) covers some of the same issues as does this paper. Despite the fact that Sweden had one of the longest-lasting and well-developed free banking systems in the world, the research is, as shown, quite limited. This paper is not a survey of the theory of free banking but a historical exploration of one real-world example of free banking. For elaborations on the theoretical functioning of free banking systems see White (1984), Selgin (1988), Goodhart (1988), Dowd (1990), and Rothbard (1990).[4]

1. The Development of Free Banking

As a result of the 1834 Banking Act, Sweden adopted the international silver standard and introduced the silver *Riksdaler* as the national currency.[5] The act furthermore allowed the establishment of private note issuing banks—*enskilda* banks. The first private bank, *Skånes Privatbank*, was founded in 1831 and was soon followed by another twenty-five banks.

In 1873, the Swedish currency unit was changed from the Riksdaler to the Krona and was tied to the gold standard and would remain so for the entire free banking period. In the late nineteenth century, opposition to private note issue mounted in the Parliament. In 1898 the free banking system was abolished. The private banks were, however, allowed to remain in service until 1903, when they were forced to turn into commercial (nonnote issuing) deposit banks or to close down.

Since its inception in 1688 until 1897, the *Riksbank*[6] had been owned and controlled solely by Parliament. In 1897, the Parliament, however, granted the king the right to appoint the chairman of the *Riksbank* in exchange for legislation abolishing the private note issuing banks. The struggle between king and Parliament is central to the history of free banking in Sweden.

Even though free banking was relatively common during the nineteenth century, the Swedish free-banking system was unique because of its longevity and particular circumstances. The free banking system in Sweden emerged out of a political vacuum as a result of the power struggle between the king and the Parliamant and also the influence of economic *laissez-faire*. Another reason for the widespread support for free banking in Sweden was the country's experience

[4]Other important works about free banking are: Dowd (1992 and 1996), Meulen (1934), Selgin and White (1987 and 1994), White (1990).

[5]There were actually two kinds of *Riksdalers*, *Riksdaler Riksmynt*—short form *Rdr rmt*—and *Riksdaler Banco*—short form *Rdr bco*. *Riksdaler riksmynt* was the most common. Their exchange rate was fixed so that four *rdr rmt* was equal to five *rdr bco*. In this paper *riksdaler* means *rdr rmt*.

[6]Before 1867 the legal name of the *Riksbank* was *Riksens ständers bank*—the bank of the estate Parliament.

with public banking. Bank failures, due to state intervention or mismanagement, had been commonplace throughout Swedish banking history. The first bank in Sweden, the semi-private *Palmsturchska Banken-Stockholm Banco*,[7] founded in 1651, went bankrupt in 1668 and was replaced by the *Riksbank*. During the Great Nordic War in the early eighteenth century, the government issued emergency coins made of copper in a desperate attempt to finance the war effort. This resulted in high inflation and the reputation of the state operated banking system was ruined for a long time. Furthermore, the formal credit market almost disappeared due to the failure of the discount companies in 1818. The discount companies were private institutions that discounted trade paper. Due to reckless lending and mismanagement they collapsed in 1818 and had to be bailed out by the government.[8]

In the wake of the 1818 collapse, the king, in 1822, appointed a committee to investigate reestablishing a banking market in Sweden. As a consequence, two important decisions were made by the Parliament in 1830: to adopt the international silver standard and to create a credit market by allowing the establishment of private banks.

The proposal to allow private note issuing banks met little resistance in the estate Parliament (Ögren 2003 and Nilsson 1981).[9] The farmers and the clergy were willing to support any system that would increase the availability of credit, whereas the nobility saw the establishment of banks as an investment opportunity. Only among the members of the bourgeois estate was there any significant resistance.

The *Riksbank* started redeeming its notes for silver in 1834 and the first charter for a private bank, *Skånes Enskilda Bank*, was granted in 1831. King Carl Johan XIV, who granted the charters, did not at first explicitly allow banks to issue notes but the private banks did so anyway, without any countermeasures by the government. In 1834, a majority of parliamentarians favored a private banking system based on note issue. Four new bank charters, *Örebro Enskilda Bank*, *Smålands Enskilda Bank*, *Östgöta Enskilda Bank*, and *Stora Kopparbergs Läns och Bergslagens Enskilda Bank*, were granted in 1836–37.

The king later became hostile toward the *enskilda* banks. In 1842 he proposed a system with semi-governmental[10] *filial* banks, or *Riksbank* branches, to replace, or at least to compete with, private banks. The *filial* banks were not allowed to issue notes but to operate with credit from the *Riksbank*. Despite opposition from the nobility, which held economic interests in the private banking sector, the Parliament, agreed to the king's proposal. The last of the previously granted charters was to expire in 1847 and the *filial* bank system

[7] *Palmsturchka banken* began issuing notes in 1661 and was the first note-issuing bank in the world.

[8] Notes from the Parliament, May 7, 1873, no. 54, pp. 20–21.

[9] The parliament consisted of four estates, the nobility, the clergy, the bourgeoisie, and the farmers.

[10] Private investors were allowed to own up to 50 percent of the *filial* banks.

was to replace the *enskilda* banks. However, in 1844 King Carl Johan XIV died and was succeeded by his son Oscar I—an economic liberal and a supporter of private banking. The succession proved to be crucial for the free banking system. King Oscar I refused to sign the new banking bill and instead passed a new law, extending the king's power over the banking system. He soon granted two additional charters for *enskilda* banks. The demand for credit was large and the *filial* banking bill was revitalized. In the 1850-51 parliamentary session, a new *filial* banking bill was approved by parliament—this time as a complement to the *enskilda* banks (Nilsson 1981, p. 56). Despite the fact that government subsidies to banks had been illegal since 1824, *filial* banks received subsidies from the government. A total of 19 *filial* banks were established. Four new charters for *enskilda* banks were also granted. Among them was *Stockholms Enskilda Bank*, founded by A.O. Wallenberg. Four separate types of banks were in operation in Sweden during the period:

1. *Enskilda* banks—private note issuing banks
    - fractional reserve banks
    - private unlimited partnerships
    - could lend or borrow
    - could issue notes, except low denomination notes
    - notes should be redeemable and the banks held reserves in *Riksbank* notes or gold
    - received no state subsidies
2. *Affärsbanker*—private commercial banks
    - fractional reserve banks
    - could lend or borrow
    - private partnerships or limited companies
    - could not issue notes
    - received no state subsidies
3. *Filialbanker*—State chartered semi-private deposit banks
    - fractional reserve banks
    - could lend or borrow
    - private partnerships under government influence
    - could not issue notes
    - received state subsidies
4. "*Riksbank*"—the Bank of Sweden
    - fractional reserve bank
    - could lend or borrow
    - could issue notes, also low denomination
    - notes should be redeemable and the *Riksbank* held reserves in gold
    - received state subsidies
    - run as a government agency

None of these types of banks however operated with 100 percent reserves.

In 1862-63, the government credit to the *filial* banks was withdrawn. The Parliament realized that the *filial* banks were not able to compete with private banks and that the support for them was gone. At the same time, new restrictions were placed upon the *enskilda* banks—among them a .2 percent tax on private note issue, and a ban on small denomination notes—but except for these measures, the *enskilda* banks were free to manage their own business.

The parliamentary reform in 1866 greatly increased the power of the farmers, who were known to be hostile to the free banking system. This was, however, not enough to form a parliamentary majority against the system. Even though a majority in the second chamber was now in favor of a ban on private note issue, the first chamber rejected all such proposals. Sweden went on the gold standard in 1873 and the name of the currency was changed from *Riksdaler* to *Krona*. This decision did not affect the private banks much except for making them exchange their silver holdings for gold.

During the entire free-banking era, the *Riksbank* tried, though unsuccessfully, to outcompete the *enskilda* banks. The system was also heavily debated in Parliament and in the newspapers. The different regimes were soon connected to different political factions. The note issuing private banks were supported by the king, while the national bank and the semi-private *filial* banks were supported by the Parliament. Many parliamentarians saw private banks as a threat to a profitable source of income for the state. Thereby, the development of a *de facto* unregulated-banking system came to be governed by coincidence, and influenced by innovative financial entrepreneurs like A.O. Wallenberg, rather than by deliberate decisions in Parliament. Control of the *Riksbank* by the Parliament obviously played a significant role in this process. The more economically liberal forces became opponents of private banks while more conservative supporters of the king proposed free banking (Nilsson 1981).

A similar political battle took place between those in favor of a liberal credit policy and those who, in order to encourage thrift and discourage excessive consumption, preferred a strict one. Farmers, dependent on credits, were often found in the first group. Paternalistic conservatives—claiming that the people could not resist the lure of cheap money—formed the other. Nilsson (1981) writes that the charter for a state sponsored *filial* bank in the town of Lund was rejected as the Parliament thought that "the foundation of a public lending institution in a University town is always questionable" (Nilsson 1981, p. 74, also pp. 66ff).

Both the farmers and the conservatives were critical of private banking. Farmers as private bankers, although they did extend credit, put strict conditions on the borrowers (as opposed to the *Riksbank*, which was often liberal with credit to borrowers lacking good collateral) and the conservatives because of the credit expansion *per se*. At the same time, liberals[11] and conservatives

[11]In this paper "liberal" is used in the European sense meaning "Whig" or "classical liberal."

fought in Parliament about the general economic policy. This time the liberals won. The private note issue was now defended by the liberals, who found it inconsistent not to give the same right to lend to a corporation, as to the persons forming the corporation (Nilsson 1981, p. 129). *Göteborgs Handels- och Sjöfartstidning* writes: "freedom, only restricted by the general law should be the sole governor of money and credit" (Nilsson 1981, p. 138). It should be mentioned that private banks did not have a formidable competitor in the *Riksbank*. Notes from private banks seemed to be preferred by the public to the *Riksbank* notes, as long as the customers had the opportunity to choose. Further evidence of this is that the private bank notes traded at par and that their combined market share was larger than the market share for *Riksbank* notes.[12] The only advantages the *Riksbank* notes held as legal tender seem to have been less inconvenience with payment of taxes. Although private notes were generally accepted taxes could only be paid with *Riksbank* notes. In this regard the effect of the legal tender status was nil. The tax collectors usually accepted private notes for a small fee (fixed or proportional). The fee was generally paid by the banks. "Sundsvalls *Enskilda* Bank for example paid the tax collector in Sundsvall 50 *rdr* annually to accept its notes" (Tunander 1964, p. 20).[13]

Mortimer Agardh, a member of parliament, even warned the government that the private banknotes might drive the *Riksbank* notes from the market (Nilsson 1989, pp. 213f.).

Few questioned the solidity and the credit granting capacity of the private banks. Instead, they were criticized for other reasons. The conservative minister of finance Palmstierna warned that the private banks were vulnerable to runs and that they were too liberal with credit—something that might stimulate consumption rather than thrift (Nilsson 1981, pp. 75f., 67).

The fact that the Swedish private banks were partnerships—"*enskilda*" means "partnership"—gave the system some special features. The form of organization required that the partners themselves were solvent and known for their honesty. This was even more important if the bank was to issue notes because the names of the partners had to be published in the newspapers (Jonung 2000, p. 5). These demands on the owners limited the number of banks as the number of solvent and wealthy prospective partners was low in most areas, especially in rural areas. This, however, does not seem to have curbed the competition significantly. At the time, warnings of too fierce

[12]See diagram 2, p. 36. In the countryside the private notes were regarded to be as good as *Riksbank* notes (Malmberg 1987, p. 37). One objection that the finance committee of 1852 raised against the *enskilda* banks was that their notes were not accepted by the tax collectors. The committee however didn't question the legal tender status of *Riksbank* notes—even though this was the cause of the problem. The public at the time did not hold *Riksbank* notes unless they had to (Nilsson 1981, p. 15).

[13]Similar examples could be found in Jonung (2000).

competition were voiced.[14] Even though the banks were partnerships, the number of partners, in some cases, tended to be large, sometimes up to a thousand (Tunander 1964, p. 50).

The development of a *de facto* unregulated banking system in Sweden was driven by specific factors. One factor was the economic liberalism of the nineteenth century with examples from Scotland. Scotland was the model for both advocates and opponents to free banking in Sweden, and it is easy to understand why the Scottish system was such a popular role model. The competition between banks as well as the importance of trust forced banks to become highly innovative. During the Scottish free banking period, a number of important banking services, e.g., the checking account, were developed. The checking account did not, however, gain acceptance in Sweden until 100 years later, when A.O. Wallenberg ran an extensive campaign in order to explain its advantages. The opponents of free banking often emphasized that in Scotland, deposits were a more important money source than note issue, as compared to Sweden (Nilsson 1981, p. 371).

One explanation of this practice were the much stricter usury laws in Sweden, but at the time it was more controversial to abolish these laws and let supply and demand determine interest rates than to allow competing currencies. The usury laws, were therefore not abolished until 1864. The supporters of free competition instead emphasized the self-regulating mechanisms and the stability of the Scottish system; here the opponents were forced to agree (Nilsson 1981, p. 205).

Economic liberalism was the dominant ideology and those who supported *laissez-faire* enjoyed the benefit of the doubt. The founder of the largest private bank (Stockholms *Enskilda* Bank) and member of the bourgeois estate in Parliament A.O. Wallenberg was also an ardent supporter of unregulated banking. Wallenberg had been inspired by harmony economists like Frédéric Bastiat, and by the success of free banking in Scotland and Spain. His prime source of inspiration, however, was the bishop and economist C.A. Agardh's pamphlet *Om det skotska banksystemet* (On banking in Scotland) published in 1844, and his own experiences from the American banking crisis in 1837 (Nilsson 1981, pp. 35, 146, 241; 1984, pp. 312, 315, 357, 405, and 415). Wallenberg was not at this time a typical representative of the bourgeois estate. Conversely, the nobility was now regarded as the most liberal estate when it came to banking (Nilsson 1981, p. 209).

Another explanation for the success of the free banking system in Sweden was that the use of notes was widespread and generally accepted as means of

[14] The toughness of competition varied between different parts of Sweden. The toughest competition was found in Östergötland, The Stockholm Region and in Scania, where the number of banks was large. At the same time banks in less densely populated areas, such as the North, faced little competition; this is, for example, indicated by the high profitability of the *Filialbanken i Sundsvall*, which enjoyed much higher returns than other *filial* banks (Nilsson 1988).

payment (Nilsson 1981, p. 328). Scarcity of specie had accustomed the Swedes to bank notes. As in Scotland, notes were not traded below par during the free banking period, and were generally preferred to coins in business transactions. In other countries, central banks (or private banks with special privileges) had used their monopolies for inflationary financing of government expenditures. This happened in France during the late eighteenth century and in the U.S. in the 1830s—the most well-known example being the suspension of convertibility in Michigan that Wallenberg experienced in person. Although the Swedish *Riksbank* did occasionally inflate the currency, this was not as common as in other countries. When Sweden adopted the silver standard in 1834, it was another clear signal that the government had ruled out inflation as a source of income.

2. The legal framework

Vera Smith defines free banking, in contrast to central banking, as:

> A régime where note-issuing banks are allowed to set up in the same way as any other type of business enterprise, so long as they comply with the general company law. The requirement for their establishment is not special conditional authorisation from a Government authority, but the ability to raise sufficient capital, and public confidence, to gain acceptance for their notes and ensure the profitability of the undertaking. Under such a system all banks would not only be allowed the same rights, but would also be subjected to the same responsibilities as other business enterprises. If they failed to meet their obligations they would be declared bankrupt and put into liquidation, and their assets used to meet the claims of their creditors, in which case the shareholders would lose the whole or part of their capital, and the penalty for failure would be paid, at least for the most part, by those responsible for the policy of the bank. . . . No bank would have the right to call on the Government or on any other institution for special help in time of need. No bank would be able to give its notes forced currency by declaring them to be legal tender for all payments. . . . A central bank, on the other hand, being founded with the aid either direct or indirect of the Government, is able to fall back on the Government for protection from the disagreeable consequences of its acts. The central bank, which cannot meet its obligations, is allowed to suspend payment . . . while its notes are given forced currency. (Smith 1990, pp. 169-70)

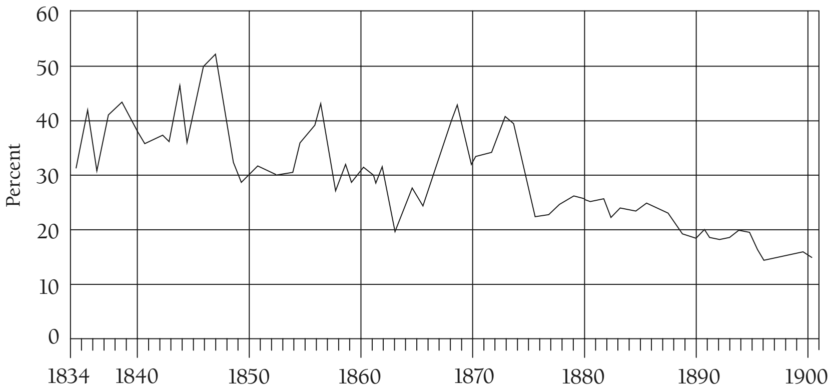
The Swedish system obviously did not, *de jure*, fulfill the Smithean definition, and some researchers, notably Ögren (2003), have preferred to use the term *competitive note issue* in order to distinguish the Swedish system from systems which were unquestionably free banking systems, such as the Scottish system. Nevertheless, the restrictions were so marginal that they did not become binding restrictions. Hence, it is still possible to claim that the system *de facto* was unregulated.

In contrast to most free banking systems, the Swedish system had reserve requirements. Dowd writes:

> Most competitive issue systems lacked binding legal reserve requirements. Where legislatures did not readily authorize suspensions of redemption, profit maximization generally induced banks to hold adequate reserves. (Dowd 1992, p. 199)

From this, it can be concluded that the Swedish system was in fact regulated. In order to draw this conclusion, it is first necessary to demonstrate that the political restrictions *de facto* did decide the size of the reserves. The fact that the banks, e.g., as a response to demands from customers, would hold reserves larger than the legal minimum, is hardly important. The Banking Act of 1874 required the banks to hold 10 percent of their equity capital in specie. This granted them the right to issue notes equal to 50 percent of their equity capital (SFS 1874:44; Ögren 2003, p. 156). These levels were well below the reserves that were actually held by both the *enskilda* banks (see figure 1). Furthermore, Ögren (2003) also notes that "the Enskilda banks never came close to their legal note issuing limits."

Figure 1
Reserves in Specie and *Riksbank* Notes Held by the *Enskilda* Banks as a Proportion of Demand Deposits and Issued Notes



Source: Ögren (2000)[15]

The reserves held by the *enskilda* banks were in every single case higher than the legal minimum today (5 percent). Newly founded banks, that had not yet acquired the trust of the customers, had to hold high reserve ratios while older, respected, and established banks could lower their reserves and thereby increase profitability. By international standards, the reserves held by Swedish banks were low. The same applied to the *Riksbank* (Ögren 2000, p. 54). The average reserve ratio held by the *Riksbank* was 40 percent, more than most private banks (Ögren 2000, p. 30; 2003, p. 150). Why the *Riksbank* held

[15]Because the volume of notes is missing for 1837 and 1867, the volume of notes in these years is assumed to be the average of the adjacent years.

such high reserves is unclear but one could assume that the historical mismanagement of the *Riksbank* tainted its reputation and thereby forced the bank to hold higher reserves in order to attract customers. In the absence of relevant legal restriction, the customers decided which reserve ratios the banks were to hold, something which supports the hypothesis of a free banking system (Sechrest 1993, p. 14; Selgin and White 1994, p. 1720; and White 1984, pp. 21f.).

The decreasing reserve ratios over time was not a unique Swedish phenomenon; the same applied to Scotland. The reserves held by Scottish (country) banks declined from 10–20 percent in the late eighteenth century to .5–2.3 percent in the early nineteenth century, indicating that customers required lower reserves from older, trusted banks. Joint stock banks, however, had to hold much larger reserves, between 35 and 48.4 percent during the early eighteenth century (White 1984, p. 43; Checkland 1975, pp. 240, 740f.).

Furthermore, we can see that the banks, at least during the later part of the free banking regime, were not subject to any legal barriers to entry. The charters were in the 1840s reduced to a mere formality, and after 1851 new banks, provided they were partnerships, only had to register at the Town Hall (Nilsson 1981, pp. 134, 246).[16]

As long as the banks were partnerships and did not threaten the *Riksbank's* monopoly on certain obsolete credit services, they were not subject to any other restrictions than the general business law. Nilsson (1984, pp. 395f.) summarizes: "With Stockholms Enskilda Bank as a pilot case, banks were now given full freedom to conduct their business within the framework of general business law." Or, as Jonung (2000, p. 4) writes:

> The note issue was initially neither controlled by any legal reserve requirements nor by government inspection. The note banks were chartered with the explicit rule that the authorities would "under no circumstances" intervene to support a private bank in financial trouble. Nor could the banks expect to get any help from the Riksbank since this bank was their main competitor.

In the Banking Act of 1834, it was also stated that private banks were never to be given any governmental support or subsidies (the same already applied to the *Riksbank*):

> The private banks could neither now nor later count on any kind of support from the government and the government may under no circumstances interfere with, support, or bail out, their business more than they do for other kinds of businesses.[17]

[16]The charters had formally a duration of ten years, even though they were automatically renewed this tended to limit long-term planning and the accumulation of reserves.

[17]Translation of the Banking Act of 1834 is mine.

The reason for disallowing governmental support to private banks in the 1834 Banking Act was the failure of the discount companies in 1818 (Nilsson 1981, p. 216). The banks also used the absence of government regulation to create trust. Wallenberg assured the customers of *Stockholms Enskilda Bank* that the bank would never accept governmental support; this was also stated in the articles of association (Nilsson 1981, p. 319).[18] The bank could in this way signal that it would not assume more risk than the partners could bear.

The conclusion is thus that even though the Swedish banks were subject to some restrictions *de jure*, these restrictions did not restrict the banks *de facto*, except for limiting their competitiveness in relation to the *Riksbank*. The most damaging restrictions were the ban on small denomination notes and the special taxes levied on the private banks (Jonung 2000, p. 23).

The Ban on Small Denomination Notes

The regulation that harmed the private banks the most was the prohibition on issuing small denomination notes. These were the most profitable for banks to issue, since they tended to remain longer in circulation. In 1846, the issue of notes with smaller denominations than five *rdr* was prohibited, and the smallest legal denomination was intended to be raised to ten *rdr* at the 1850–51 parliamentary session. The decision was, however, postponed due to the expected difficulties for private banks.[19] When the lowest legal denomination was set to five instead of two *rdr*, the currency stock contracted by 22 percent. This demonstrates the importance of small denomination notes. When the ban on five *rdr* notes was proposed, these made up 38 percent of the notes in circulation (Nilsson 1981, pp. 63f.; Jonung 2000, p. 35).

One argument used to support the ban on small note issue was that they would primarily be held by private citizens (and women) who would have difficulties knowing the financial soundness of the issuing banks.[20] Vera Smith (1990, p. 188) writes: "Small notes were, in the first place, particularly liable to come into the hands of the poorer and more ignorant classes who were most unable to discriminate between the issuers."

Small notes were also deemed to be too profitable for the banks. As they tended to stay in circulation longer than larger notes, a bank could reduce its reserves without risking illiquidity. That would imply higher returns on capital. It is obvious that the ban strengthened the competitive position of the

[18] *Stockholms Enskilda Bank* was however forced to accept an emergency loan from the state during the international banking crisis in 1878 (Jonung 2000, p. 27).

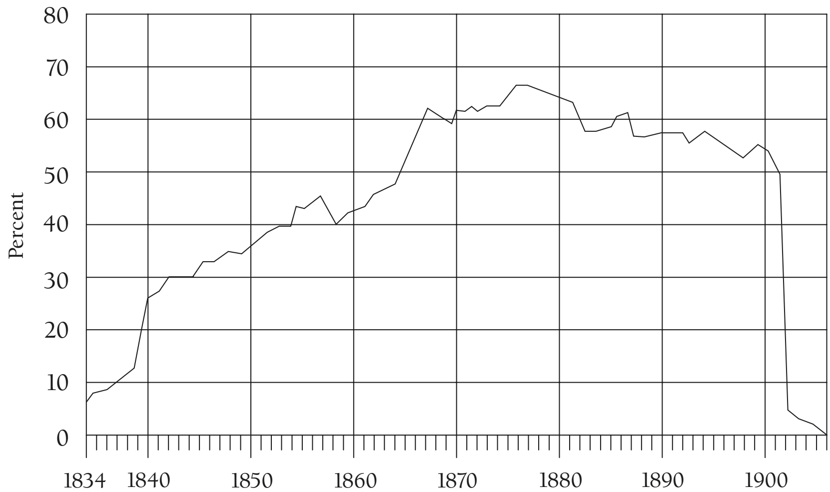
[19] In 1846 5 *rdr* was a fairly large amount of money—but not large enough to keep five *rdr* notes out of the hands of lower income people. In 1846, 5 *rdr* could be used to buy 3.75 kilos of sugar or 17.8 kilos of wheat flour, Myrdal (1933, p. 200f). In Scotland they even banned the issue of notes with lower denominations than 1 pound. This is equivalent to over 300 U.S. dollars in today's prices; see Cowen and Krozner (1989, p. 398).

[20] *Stockhoms Enskilda Bank* explicitly tried to get female customers. Women were previously not allowed to take part in economic transactions, but in 1858 new laws granted unmarried women over 25 years of age that right and opened up a new market for the banks.

Riksbank (which was allowed to issue one *rdr* notes) but despite that the private banks finally were prevented from issuing five and, in 1879, ten rdr notes. The *Riksbank* did not manage to increase its market share more than marginally. When private bank notes were banned in 1903 the currency stock fell dramatically indicating that the public preferred specie to *riksbank* notes when they had to exchange their private bank notes (Nilsson 1981, p. 21; Jonung 2000, pp. 13, 15).

The ban on issuing small denomination notes can also be viewed as a destabilizing measure. The smaller denomination notes tended to stay longer in circulation and, according to Jonung, the holders of such notes might be less afraid that they would lose their value—the loss would be limited due to the low par value of the notes. This would imply that the holders would be less inclined to run on the banks compared with holders of larger denomination notes (Jonung 2000, p. 26). The impact of this effect, however, needs further research. It would, for example, be interesting to see if the same applied in Scotland.

Figure 2
Market Share for Notes Issued by *Enskilda* Banks in Sweden 1834–1906



Source: Jonung (2000)[21]

The Impact of the Usury Laws

Another important factor in the success of the banking system was the abolishing of the usury laws in 1864. The usury laws, stemming from the Middle Ages, had over the years significantly hampered economic development,

[21]The ratio should not be taken as exact because most *enskilda* banks held some quantity of *Riksbank* notes as reserves. Some *enskilda* banks also held notes from *Stockholms Enskilda* Bank as reserves. These factors tend to distort the true ratio. The market share for the *enskilda* banks when it came to day-to-day transactions might well be higher because part of the stock of *Riksbank* notes were idle.

even though the financial markets early learned how to avoid the most damaging effects:[22] In order to charge higher interest rates than the allowed 6 percent, a part of the interest was called commission or loan fee. The usury laws were nevertheless one of the major reasons why many note issuing banks, but few deposit banks, were founded in Sweden. The note issuing banks could finance their lending at lower cost and they could therefore also offer lower rates than the deposit banks. The interest rate ceiling on lending also kept deposit rates down, making it hard for banks to attract depositors.

Note issuing thereby became the dominant way of financing for the banks. Following the abolishing of the usury laws, deposits increased and banks that did not issue notes were founded. However, most of them never gained any significant market share and the note issuing *enskilda* banks remained dominant. Some influential private commercial banks–*Handelsbanken* and *Skandinaviska Kreditaktiebolaget*–financing their lending through deposits emerged. Although well known and influential, they never became dangerous competitors to the existing banks.

The usury laws were not the only reason for the limited number of depositors. Other laws and regulations limited the popularity of deposit banking. The banks were, for example, by the Banking Act of 1846, prevented from accepting deposits of less than 500 *rdr rgs* (Brisman 1924, pp. 229ff.; Nilsson 1981, pp. 68, 315).[23] Because the *enskilda* banks financed their lending with note issue, and the bulk of their customers were wealthy, the effect of this restriction was, however, limited.

3. The Opposition to Free Banking

The private banks largely contributed to the enormous credit expansion that took place during the last half of the nineteenth century. This credit expansion was not only the foundation of the transformation of Sweden from an agricultural to an industrial economy, it also coincided with a period of relatively stable prices (Heckscher 1934).

When private banks first emerged in the 1830s, the banking system was underdeveloped and there was an urgent demand for credit. The first private banks could thus reap high profits by supplying the public and the industrialists with credit and means of payment. The issuance of notes allowed private banks to provide cheaper credit than ever before. Despite this, they were criticized for their restrictive credit policies–even the new banks could not meet the large demand for credit. The competition was at first restricted by

[22]Mokyr (1990, p. 213) claims that the usury laws delayed the industrial revolution by several hundred years.

[23]Here it should also be noted that the formal ten-year charter might have functioned as a destabilizing mechanism by discouraging the build up of reserves and long-term planning; see Nilsson (1981, p. 246). At the same times S and L companies "Sparbanker" offered deposit services for not so weathy clients.

the small number of banks, but even during the later parts of the free-banking period, when competition was fierce, banks were able to achieve high profits, indicating that the demand on the services of the private banks was huge (Brisman 1934, p. 126; Hortlund 2001, p. 66). The private banks posted returns on invested capital at between 16 and 21 percent. Also the semi-private filial banks were quite profitable. *Sundsvalls Filialbank*—the most profitable of the filial banks—had a rate of return of 11.9 percent (Nilsson 1981, p. 332 and 1984, p. 398; Jonung 2000, p. 22). Wallenberg wrote in a letter to his son Knut Agathon on the profits of *Stockholms Enskilda Bank*: "the business gave good, even splendid returns" namely 10–20 percent annual returns (Nilsson 1981, p. 18; 1989, pp. 104f.). Also *Sundsvalls Enskilda Bank* was highly profitable. In 1865, one year after its founding, the return on investment was 6 percent. In 1872, it had increased to between 12 and 14 percent. During 1881–85, it rose further to 16 percent at a significantly increased turnover (Tunander 1964, pp. 22, 28, 31). *Vadstena Enskilda Bank* (VEB) at the same time paid dividends of 6.25 percent on invested capital, which increased to 8.3 percent during 1871–76, despite a recession (Segrell 1993, p. 69). *Östgöta Enskilda Bank* (ÖEB), the dominant bank in the county of Östergötland, paid on average annual dividends of 18.2 percent on invested capital (Malmberg 1987, p. 38; Nilsson 1984, p. 83). High dividends were paid despite declining profitability, caused by the establishment of the competing *Norrköpings Industri Bank* and VEB in 1858. The returns for ÖEB this year fell to 2 percent but profits rose steadily (Nilsson 1989, p. 231).

The banks were heavily criticized for their high profitability (Malmberg 1987, p. 45). In a speech to the farmer's estate in Parliament in 1848, Sven Heurlin called the private banks "a plague" and referred to them as "this cancer, these blood suckers that slowly and secretly grow large" (Nilsson 1981, p. 24). The leader of the nobility in Parliament, Leonard Rääf, agreed: "Alongside the *Riksbank* a number of companies have been allowed to emerge and they have invented a way of collecting rents by issuing a vast amount of totally worthless paper" (Nilsson 1981, p. 25).

Rääf also claimed that private banks threatened a sound currency, encouraged indebtedness and consumption and made prices rise (Nilsson 1981, p. 25).[24] Voices were also raised on "unreasonable profits . . . gained at the expense of the Riksbank" and the high dividends paid by private banks were regarded as "provocative." This criticism resulted in an extra tax on banking profits above 6 percent (Nilsson 1981, pp. 23, 154, 27). The profitability of the private banks induces criticism even today. Göran B. Nilsson, the most influential of the researchers on free banking in Sweden, writes, for example, on the note issue of private banks:

[24]The *Riksbank* was itself criticized for its reckless lending during the crisis of 1857.

> Anyway, this [the right to issue notes] had caused a gradual fall in the profits of the Riksbank and thereby also in the revenue for the State, to the disadvantage of tax payers but to the advantage of a small number of partners in the private banks. (Nilsson 1981, p. 331)

He also states that note issue is a zero-sum game, where one man's gain is another man's loss (Nilsson 1981, p. 330). Nilsson continues:

> It was not unreasonable to consider private banking as an instrument, by which, by institution and tradition, the power possessing groups in society tried to defend and strengthen their positions, that the economic development threatened to undermine. (Nilsson 1981, p. 332)

However, this could not be regarded as criticism of free banking, but rather as a general criticism of the market economy. The functioning of the *enskilda* banks should be considered in contrast to the functioning of the *Riksbank*. The question is what would have been different if the *Riksbank* had been allowed to keep the monopoly on note issue?

The Scottish system was regarded as a well-functioning alternative to the Swedish system (Nilsson 1981, pp. 28, 30, 31). Profits were lower in Scotland, indicating even fiercer competition. The dividends paid by Scottish banks before the deregulation of the banking market in 1728, were between zero and 30 percent (on average 15.5 percent). Thereafter they fell to between 3.27 and 6.25 percent (on average 5 percent) (Dowd 1992, p. 161).

The criticism against the private note issuing banks raised by Nilsson requires special attention because of his position as one of the leading experts on the Swedish banking system during the nineteenth century. The present day aversion among economists and economic historians of free banking could stem from Nilsson's, monumental, yet free banking hostile, books on A.O. Wallenberg. He claims that private banks were "very sensitive to the business cycle" both in booms and recessions (Nilsson 1984, p. 311).[25] The criticism of free markets aired by Nilsson was also shared by Gasslander (1962), another prominent banking historian.

The foundation for Nilsson's criticism is that the private banks would not have survived without subsidies from the government. According to Nilsson, subsidies can be given either as loans with interest rates lower than the market rate (as was given to the filial banks) or as the right to issue notes (Nilsson 1989, p. 223; 1981, pp. 14, 334).

To consider the issuing of notes a subsidy is, however, a mistake, or requires at least the somewhat strange premise that a state monopoly on note issue is the state of nature.

[25]Walter Bagehot (1962, chaps. 6–7) agrees, if the volume of credit was adjusted to the business cycle, booms and bust might be emphasized—this is not however a free banking specific problem.

Several problems can be raised concerning this premise. First, private note issuing banks were founded before the creation of a state monopoly on note issue. Second, if free entry to a market really was a subsidy or a privilege it would also be reasonable to view the right for Volvo to make cars or for Wal-Mart to sell groceries as subsidies from the government, a claim few would agree with.[26] Nilsson further claims that a free banking system is inherently unstable and that: "banks would have difficulties if inflation was not accepted" (Nilsson 1981, p. 14). However, after Sweden adopted the silver standard in 1843, inflation was curbed and during the entire free-banking period, the inflation remained lower than in most western economies today. In spite of this, private banks survived and prospered. Nilsson's claim about instability can also be questioned. During the entire period, only one bank, *Vadstena Enskilda Bank*, was closed down. The reason was fraud and theft committed by the manager of the bank, J.A. Holmberg, but the customers of the bank did not incur any losses when it was closed. Furthermore, it is not reasonable to use one incident during the entire free-banking period of seventy years as proof for the inherent instability of the *enskilda* banks. Contrary, few banking systems have been as stable as the Swedish free banking system. Nilsson's criticism is paradoxical as he agrees that the ideal system was the Scottish system, which was at least as unregulated as the Swedish.

This interest in the Scottish system as a role model is not new. Conservatives during the free-banking period also praised it. Baron Knut Philip Bonde, former advisor to King Oscar I, was a strong supporter of the Scottish system. Still, he opposed note issuing banks and proposed that the government would support the growth of private commercial banks by granting them access to cheap loans (Nilsson 1981, p. 40).

The most ardent supporter of free banking in Parliament was the economist and bishop of Karlstad, Carl Adolf Agardh. In a pamphlet supporting free banking, Agardh (1845, p. 11) wrote:

> When we despite the unlimited freedom for the banks to conduct their own business, find that they do it with exceptional honesty, it will cause great astonishment, especially in our country where so much attention is devoted to the invention of necessary controls against all kinds of misconduct in the banking system.[27]

Even though the enthusiasm toward the Scottish banking system was common among economists at the time, there were some critics. The president of the

[26]Even stranger is Nilsson's accusation of economic liberals that supported the corporation as being inconsistent. Nilsson claims that because *laissez faire* is an individualistic concept, liberals must oppose all kinds of corporations (1981, pp. 28f.).

[27]For further references to Agardh see Heckscher (1963, pp. 224–44) and Brisman (1924, pp. 166–69), Brisman, however regards Agardh as more conservative than Nilsson and Heckscher do. It is also remarkable that Nilsson, with a reference to Berthold Brecht, calls Agardh naïve (Nilsson 1981, p. 34).

National Board of Trade (*Kommerskollegium*) and former finance minister Carl David Skogman, claimed that in order to make free banking work, Swedish citizens must be turned into Scotsmen (Nilsson 1981, p. 34).

Private banks were also blamed for political failures such as the so-called "strangle system,"[28] which caused a credit contraction which hit even solvent creditors hard during recessions. However, the strangle system was a result of the usury laws, which prevented banks from adjusting the interest rate to the demand of money (Myhrman 1994). When lending volume could not be adjusted by means of interest rate, the volume of credit was adjusted. The Enskilda banks were heavily criticized for this so called "strangle system," which in many ways were connected to the regulations for the issuing of notes for the *Riksbank* and the Enskilda banks, but which most of all had its ground in the usury laws (Segrell 1993, p. 20, Nilsson 1981, p. 14, and Nygren 1981, p. 19). After the usury laws were abolished in 1864, this problem was reduced significantly. Nevertheless, both the private banks and the *Riksbank* continued to reduce the volume of credit in recessions in order to keep sufficient reserves.

When private note issue was abolished in 1903, this was not due to any malfunctions. Contrary, the system was abolished because it worked too well. The main reason was the increasing political interest in active management of the currency. At the turn of the century, the idea of *laissez-faire* was challenged by new political ideas all having in common an acceptance of vastly increased political domains (Norberg 1999, pp. 197–201).[29] With competing currencies, it was impossible to pursue an active monetary policy.[30] The popularity of free banking had also decreased significantly among economists. Dowd (1992, p. 36) writes that "[f]ree banking, by then, had no significant support among economists" and one of the earliest demands from the League of Nations was that all countries should monopolize the money supply.[31] Vera Smith continues:

> An examination of the eventual decision in favour of a central bank as opposed to a free banking system reveals in most countries a combination of political motives and historical accident which played a much more

[28]The strangle system (Swedish: *Strypsystemet*) was a policy imposed on the *Riksbank* that said that the bank should contract its lending—instead of raising the interest rates—in case of external currency drains. The result was sharp fluctuations in the volume of credit.

[29]It could be noted that the ban on private note issue in Sweden coincided with the rise of William Jennings Bryan and the populists in the U.S. and their demand for easy money.

[30]The ability to finance government expenditure in crisis such as wars using the printing press was also sometimes used as an argument for the monopoly.

[31]The modern central bank function was more or less invented by Walter Bagehot (1873) in his book *Lombard Street*.

> important part than any well-considered economic principle. (Smith 1990, pp. 4–5)

According to Metelius, the main reason for bank monopolization was that private banks were too profitable and were perceived as "stealing" seignorage rents that "rightfully" belonged to the state. This is why the *Riksbank* then became the Swedish Central Bank (Metelius 1984; Hortlund 2001, p. 75). In the late nineteenth century, several restrictions were put on the *enskilda* banks. Among them was the previously mentioned ban on small denomination notes and special taxes on note issue. These taxes were increased to .3 percent in 1887, to .5 percent in 1892 and to 1 percent in 1893 (Jonung 2000, chap. 4).

In 1896 the king proposed abolishing private note issue in combination with joint control of the *Riksbank*. The deadlock between king and Parliament had now finally come to an end, as well as the Swedish free-banking era.

4. Conclusion

This paper has covered the debate on the Swedish free banking system. Evidence has been presented, supporting the hypothesis that the system's longevity, in spite of opposition in Parliament, was due to the king being a staunch supporter of free banking. Not until the king changed his mind could a central bank monopoly be formed.

Furthermore, the paper has examined another kind of criticism against the Swedish free banking system, i.e., that the Swedish banks were too regulated to be called free. As presented in section 2, there is evidence for the hypothesis that the Swedish system *de facto*—but not *de jure*—fulfilled Vera Smith's definition of free banking. The reserves held by the banks were significantly larger than the legal requirements—reducing the law to a mere formality. Furthermore, the charters were, after 1851, nothing more than a requirement of registration of new banks and therefore no restriction on the operations.

The various forms of government intervention in the banking system, bans on small denomination notes, the usury laws, special taxes, etc., cannot be considered as ways of stabilizing the free banks. They are rather means to improve the competitive situation of the *Riksbank*.

As the analysis in section 3 has shown, the criticism against free banking, both during the period in question and today, is based more on a general distrust of free markets or on fiscal or paternalistic grounds than on the functioning of the system. Such arguments are used by both historians and opponents in the Parliament. Furthermore, most opponents also considered the Scottish system—which was even less regulated than the Swedish one—as a better alternative. This further demonstrates that the criticism was not a criticism of free banking.

When the system finally was abolished and replaced with a modern central bank, it was a consequence of a general change in political sentiment. The time of *laissez faire* was over and politicians were now in favor of pursuing an active monetary policy.

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