

MILTON FRIEDMAN AND THE CASE AGAINST CURRENCY MONOPOLY

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A longstanding tradition in economics, dating back at least to Adam Smith, looks askance at statutory monopolies, condemning almost all of them as unnecessary barriers to economic progress. Thanks largely to this tradition most of the monopolies present in Smith's day are no longer tolerated. The few exceptions are found mainly in less developed countries, where they remain a cause of impoverishment. Needless to say, economists have also generally opposed the monopolization by fiat of undertakings that were already at least somewhat competitive in Smith's day.

But there is one set of notable exceptions to the last claim: government monopolies of paper money. During the late 18th and the 19th century such money consisted almost entirely of redeemable notes issued by commercial banks; and while complete legal freedom of entry into the paper currency business was rare, so were outright monopolies. In some countries, moreover, the paper-money industry "playing field" was more or less level, with numerous banks sharing similar privileges.

During the late 19th and early 20th centuries, however, competitive note issue gave way almost everywhere to monopoly as governments awarded exclusive note-issue privileges to favored banks. Although significant numbers of economists opposed this development during its early stages (see Smith 1990; White 1995: 63–88),

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others either favored it or were indifferent. As monopoly became the norm, the opposition ceased—or did so until the mid 1970s, when Friedrich Hayek succeeded in reopening it, if only on a very small scale.

Milton Friedman's views on the matter of currency monopoly offer a particularly interesting case study. Despite having been an unflinching champion of classical liberalism and free markets, he at first (Friedman 1960: 4–9) shared the common view concerning the necessity of official currency monopolies. But Friedman came to revisit and revise his original opinions in light of the renewed interest in the question Hayek's work helped to stimulate. Although Friedman ultimately concluded (Friedman and Schwartz 1986: 52) that there is, after all, "no reason currently to prohibit banks or other groups from issuing hand-to-hand currency," his opposition to official paper currency monopolies remained lukewarm. In effect, he took a stand resembling Walter Bagehot's of over a century before: although Bagehot thought competitive note issue a better and more "natural" arrangement, he considered it futile to oppose the Bank of England's monopoly, which was by then already firmly established. "You might as well, or better, try to alter the English monarchy and substitute a republic," he wrote, "as to alter the present constitution of the English money market" (Bagehot [1873] 1999: 330).¹

I plan to argue that the case for abolishing official paper currency monopolies is in fact much stronger than Friedman believed it to be even in his later writings. By way of doing so I hope to convince at least some economists, and followers of Milton Friedman's work in particular, to take up the cudgels for competitive note issue.

Friedman's Early Views on Currency Monopoly

Friedman's early views concerning the necessity of state involvement in monetary affairs occur in his 1959 Millar lecture, "The Background of Monetary Policy" (Friedman 1960: 1–23). Although Friedman claimed at the time that he was "by no means certain" that monetary and banking arrangements ought not to "be left to the market, subject only to the general rules applying to all other economic

¹The frequently repeated claim that Bagehot endorsed the creation of monopoly banks of issue, so that they might serve as lenders of last resort, is an unpardonable calumny.

activity,” he believed that there were several “good reasons” for the general, historical failure of even relatively liberal governments to take this approach (1960: 4). As summarized later by Friedman and Anna Schwartz (1986: 40), those good reasons were:

[1] the resource cost of a pure commodity currency . . . ; [2] the peculiar difficulty of enforcing contracts involving promises to pay that serve as a medium of exchange and of preventing fraud in respect to them; [3] the technical monopoly of a pure fiduciary currency which makes essential the setting of some external limit on its amount; and finally [4] the pervasive character of money, which means that the issuance of money has important effects on parties other than those directly involved.

Of the four reasons, only the second and the fourth, concerning the risk of fraud and the presence of externalities, supply grounds for official monopolies of paper currency.² “The very performance of its central function,” Friedman observes (1960: 6),

requires money to be generally acceptable and to pass from hand to hand. As a result, individuals may be led to enter into contracts with persons far removed in space and acquaintance, and a long period may elapse between the issue of a promise and the demand for its fulfillment. In fraud as in other activities, opportunities for profit are not likely to go unexploited. A fiduciary currency . . . is therefore likely to be overissued from time to time and convertibility is likely to become impossible. Historically, this is what happened under the so-called “free banking” era in the United States and under similar circumstances in other countries. Moreover,

²In contrast, reason [1] supplies grounds for resorting to fiduciary media (that is, paper money and transferable deposits not fully backed by commodity money) and, perhaps, for doing away with commodity money altogether in favor of a fiat money system. Reason [3] in turn serves to rationalize official monopolies of fiat money only, without suggesting any need to prohibit private parties from issuing paper notes that are themselves redeemable claims to fiat money. This last point is obscured somewhat by Friedman’s unfortunate use of the expression “pure fiduciary currency” to refer to what we now term fiat money. The usage is unfortunate because the trust (“fiducia”) that keeps fiat currency in circulation is of an entirely different kind than that which sustains a redeemable currency, and also because it suggests that commercial banknotes that are themselves claims to a fiat outside money are in some sense “impurely” fiduciary.

the pervasive character of the monetary nexus means that the failure of an issuer . . . has important effects on persons other than either the issuer or those who entered into a contract with him in the first instance or those who hold his promises. One failure triggers others, and may give rise to widespread effects.

The best solution, Friedman concludes (1960: 7), is to do away with convertible currency altogether, replacing it with a “purely fiduciary” (i.e., fiat) outside currency issued by a public authority.

Friedman’s Reconsideration Reconsidered

Just over a quarter-century after stating his original arguments against monetary *laissez-faire*, Friedman reconsidered those arguments in light of subsequently published research. The resulting paper, co-written with Anna Schwartz, revisits all four of Friedman’s proposed “good reasons” for intervention in money. In particular, it re-engages what Friedman and Schwartz term the “free-banking” question, which they frame as follows: “Given a well-defined outside money . . . can and should strict *laissez-faire* be the rule for banking—broadly defined to include the issuance of inside money in the form of currency as well as deposits?” (Friedman and Schwartz 1986: 41).

According to Friedman and Schwartz, the free-banking question encompasses three “sub-issues,” namely, whether a public lender of last resort is necessary or desirable, whether regulatory restrictions on lending and investing by private financial institutions are necessary or desirable, and whether hand-to-hand currency ought to be a government monopoly. My immediate concern here is with the last of these sub-issues only. However, as I hope to make clear later on, it and the second sub-issue are not strictly independent, for in monopolizing the supply of hand-to-hand currency, governments necessarily limit the extent of lending and investing by private financial intermediaries.

Friedman and Schwartz ultimately conclude that there are in fact no good economic arguments to support government monopolies of hand-to-hand currency. Nevertheless, they claim that to oppose these monopolies would be futile. I hope to show that this conclusion is far from justified—that is, that the reasons for opposing official currency monopolies are at least as compelling as those for opposing

most other statutory monopolies. Friedman and Schwartz's contrasting view is unjustified for several reasons. First, it rests on a reading of the history of banking which, though far better informed than Friedman's 1959 reading, still understates both the advantages of freedom of note issuance and the disadvantages of monopoly. Second, the conclusion overlooks several important theoretical advantages of competitively supplied paper currency. Finally, the conclusion depends on an unjustified appeal to a supposedly given degree of political feasibility of radical reform.

History

Although Friedman and Schwartz concede that the historical record, interpreted in light of post-1959 research, fails to supply adequate grounds for official currency monopolies, their revised reading of history continues to suggest that the case against monopoly is far from overwhelming.

Thus, although they acknowledge the excellent record of the Scottish free banking system, Friedman and Schwartz (1986: 50) also note features of the Scottish arrangement which, they claim, cast doubt upon its general relevance. These features include (1) the fact that Scottish bank shareholders "assumed unlimited liability" for their banks' obligations and (2) the fact that Scottish banks "had access to the London financial market, which performed the equivalent of some modern central bank functions for Scotland."

The above named "features" of Scottish banking are more imaginary than real. While unlimited liability was compulsory for most of Scotland's banks prior to the passage of the Companies Act of 1862, Scotland's three "chartered" banks—the Bank of Scotland, the Royal Bank of Scotland, and the British Linen Company—enjoyed limited liability. Although Friedman and Schwartz recognize these exceptions in a footnote, they fail to mention that they were all very large and highly reputable banks: as of 1845, the British Linen Company had the largest note circulation of all Scottish banks, while the Bank of Scotland and Royal Bank of Scotland ranked fourth and seventh, respectively (White 1990: 44). The latter two banks, together with the Clydesdale Bank, continue to supply most of Scotland's paper currency today. On the whole, then, evidence from Scotland does not support Friedman and Schwartz's suggestion that unlimited liability was a

crucial pillar of Scotland's successful private currency system.³

As for access to London, although Scottish banks did occasionally draw funds from London correspondents, they did this, not because they needed a lender of last resort, but simply because London was then the world's financial center, and because legal restrictions prevented them from establishing their own branches there (White 1990: 56–8). U.S. banks likewise relied on indirect access to the New York money market throughout the latter 19th century, although the United States at the time had no central bank. Evidently, a bank may require access to a major money center without being in need of a public lender of last resort. On the contrary: access to private money center financial institutions is properly regarded as a substitute for access to public monetary authorities.

Significantly, in making his original case for currency monopoly, Friedman did not refer to Scottish experience at all. Instead he rested his case on U.S. experience alone, while claiming that “similar circumstances” prevailed elsewhere. Perhaps the most surprising aspect of Friedman's later reassessment of his earlier views is the extent to which he continues to regard early U.S. experience as accurately representing the consequences of the competitive supply of redeemable paper currency.

Thus, Friedman and Schwartz (1986: 50), referring to Bray Hammond's monumental (1957) *Banks and Politics in America Before the Civil War*, claim that, in the United States prior to 1836, “In the main, laissez-faire prevailed in banking, despite the existence of the two Federal banks. . . . There was nothing that prevented a system from developing along Scottish lines. Yet it did not.” In fact Hammond himself explicitly rejects this view, observing instead that during the period in question state governments never came close to embracing a laissez-faire approach. “The issue,” Hammond wrote (1957: 186), “was between prohibition and state control, with no thought of free enterprise.” In many western states and territories, including Wisconsin, Iowa, Oregon, Arkansas, California, and Texas, banking was altogether outlawed. Elsewhere states granted a charter

³It is also far from clear that the unlimited liability requirement to which Scotland's unchartered banks were originally subject was in fact a binding restriction on entry. As White (1990: 43) notes, the unchartered banks chose to retain unlimited liability for two decades following passage of the Companies Act, even though that act would have limited their owners' liability for all their obligations apart from circulating notes, which then made up less than 8 percent of Scottish bank liabilities.

to a single bank only, or perhaps to a small number of banks, while attaching all kinds of strings to the enabling legislation, often including mandatory loans to themselves. Most crucially, charters usually prevented banks from opening branches, so that even those states that were relatively liberal in granting them, such as Massachusetts and New York, denied their citizens ready access to banking facilities except in a few relatively large towns and cities. Together with outright prohibition of banking and limited banking charters, branching restrictions substantially increased the extent to which U.S. citizens, in employing paper currency, were forced “to enter into contracts with persons far removed in space and acquaintance.” They also encouraged fraud by impeding the active redemption of banknotes, which was a crucial feature of less-regulated private currency arrangements.

Thanks to restrictions on branching, the United States, instead of having a banking system dominated by a relatively small number of nationally branched banks, ended up with tens of thousands of tiny “unit” banks. These banks were necessarily undercapitalized and underdiversified compared to their nationwide counterparts, and as such were prone to failure—a fact amply illustrated during the Great Depression, when several thousand U.S. banks failed, but none failed in Canada, where banks were free to branch nationwide. Within the United States, and controlling for state-by-state differences in the extent of economic decline, the share of deposits in failed banks was smallest where branching was most prevalent (Wheelock 1995).

I do not mean to suggest that Friedman and Schwartz are unaware of the disadvantages of unit banking. Moreover, they recognize that “the U.S. has been almost unique in preserving a unit banking system,” and that it had achieved this distinction by means of legal “barriers against interstate banking” (Friedman and Schwartz 1986: 54). Yet Friedman and Schwartz appear to overlook the obvious way in which these observations contradict their assertion that “nothing” prevented the U.S. banking system from developing along Scottish lines.

Besides restrictions on branch banking, the most significant barrier to the development of the U.S. banking system along Scottish lines consisted of various regulatory impediments to freedom of note issue. Misleadingly named “free banking” laws, eventually adopted

by 18 states, may have lowered barriers to entry into the banking business.⁴ But they also compelled banks to secure their notes with specified bonds, which were held in trust by state banking authorities. During the Civil War free banking became a dead letter, thanks to a tax, made effective in August 1866, which made it altogether unprofitable for state banks to issue their own currency.⁵ But the “bond-deposit” idea lived on as part of the National Banking acts, which required national banks to back their notes with federal government securities. That stipulation, originally aimed at aiding the Union government’s finances, helped to bring about the currency shortages and banking crises that ultimately led to passage of the Federal Reserve Act.⁶

If Friedman erred in basing his 1959 case for currency monopolies on an appeal to U.S. experience alone, Friedman and Schwartz deserve blame for drawing on only two experiences—those of the United States and Scotland—to build a weak case against monopoly. In truth Scotland’s was only one of several banking episodes that came closer than U.S. experience ever did to exemplifying the workings of a genuinely free market in currency and banking. Other significant episodes took place in Australia, Canada, Colombia, China, France, Ireland, and Switzerland.⁷ Canada’s experience is especially worth mentioning here, because it allowed Canada to avoid the bewildering assortment of bank notes, recurring currency shortages, and waves of bank failures that beset the United States at various stages of its banking history. While the United States was prevented from developing its own currency system “along Scottish lines,” Canada was able to do just that, and with a degree of success no less remarkable than Scotland’s own.⁸

⁴See Ng (1988) for a contrary view.

⁵See Selgin (2000) for a critical assessment of this measure.

⁶While Friedman and Schwartz (1963: 23) argue that “the published market prices of government bonds bearing the circulation privileges were apparently always low enough to make note issue profitable except in the years 1884 to 1891,” later writers (e.g., Champ, Freeman, and Weber 1999) question the calculations underlying this “puzzling” conclusion, especially by noting that the calculations overlook the marginal liquidity (redemption) costs of note issuance.

⁷Dowd (1992) includes brief case studies of each.

⁸Why, then, did Canada establish a monopoly bank of issue in 1935? The answer is that this decision had more to do with regional politics than with any inherent shortcomings of competitive note issuance. For details, see Bordo and Redish (1987).

Theory

The historical record alone suggests that the competitive supply of hand-to-hand currency is not only workable in practice, but potentially advantageous. However, a complete reckoning of the advantages of competition—and corresponding disadvantages of monopoly—in currency supply is possible only with the aid of theory, which can bring to light consequences of monopoly that may not be immediately evident in the historical record, or that may be evident only once theory has shown historians what to look for.

Friedman and Schwartz do not take account of several theoretical contributions that supply important grounds for condemning official currency monopolies. These contributions mainly concern three issues: (1) the behavior of the money stock under free banking, (2) the necessity of deposit insurance or a public lender of last resort, and (3) the adverse growth effects of restrictive bank regulations. Because much of the work in question appeared after 1986, Friedman and Schwartz can hardly be blamed for ignoring it. But some important work, particularly concerning the last topic, appeared prior to 1986, thereby contradicting Friedman and Schwartz's assertion that "Vera Smith's 1936 *Rationale of Central Banking* provides . . . as accurate and complete a summary of recent theoretical arguments for and against 'free banking' as it does of earlier arguments" (Friedman and Schwartz 1986: 42).

Concerning the behavior of the money supply, it has long been understood, by monetarists in particular, that freedom of note issue eliminates the problem of undesirable money stock changes stemming from changes in the public's preferred ratio of currency to bank deposits.⁹ More recent research has added to this the insight that this same freedom, in the absence of statutory reserve requirements, allows a banking system automatically to stabilize the aggregate flow

⁹Friedman himself recognized this fact even while still defending currency monopoly. He wrote (1960: 69), "To keep changes in the form in which the public holds its cash [that is, money] balances from affecting the amount there is to be held, the conditions of issue must be the same for currency and deposits. . . . The first solution would involve permitting banks to issue currency as well as deposits subject to the same fractional reserve requirements and to restrict what is presently high-powered money to use as bank reserves." But he dismissed this solution on the grounds that "it was precisely the problems raised by note-issuing banks that led to the conversion of note issue to a governmental monopoly."

of nominal spending, by offsetting changes in the velocity of money with opposite changes in the bank reserve (or base money) multiplier (Selgin 1988, 1994). Taken together these insights suggest that a restoration of freedom of note issue would considerably reduce the extent to which monetary stability must depend on the day-to-day central bank interventions, perhaps even rendering such interventions unnecessary. Such freedom would also considerably reduce the risk of unwanted deflation or inflation in fiat money systems lacking conventional central banks, including dollarized systems, currency-board type arrangements, and (to refer to one of Friedman's own favored reforms) a system in which the stock of fiat outside money has been permanently frozen (Friedman 1984).

Concerning the necessity of deposit insurance or a lender of last resort, since Vera Smith's day there has been a considerable change of opinion concerning the third-party effects of bank failures. The research has shown, first of all, that such effects have empirically been far less common, and less prone to lead to system-wide crises, than had once been supposed. Second, it has shown that many popular monetary interventions, including interventions limiting banks' ability to issue paper currency, are themselves destabilizing, and that such interventions have played a crucial role in past banking crises. Finally, it has shown how private-market devices, such as resort to "option clauses" on bank notes, can insulate banks from spillover effects, and can do so while avoiding the moral-hazard problems associated with deposit insurance and last-resort lending.¹⁰

Concerning banking and economic development, several important contributions date back to the years surrounding Friedman's 1959 lecture, including works by Goldsmith (1955), Gurley and Shaw (1955, 1960), and Gerschenkron (1962). These and related works explored the connection between the development of banks and economic growth, ultimately concluding that banking played a crucial part in the growth process. But the work on this topic most pertinent to the question of currency monopoly consists of a group of historical studies by Rondo Cameron and his collaborators (1967). Summarizing the studies' findings, Cameron (1967: 305–6) wrote:

¹⁰Selgin and White (1994: 1726–30) review this research.

One obvious determinant of the relative size of the banking sector is the extent to which bank liabilities fulfill the role of money. . . . The use of bank liabilities as money . . . is, in turn, related to the question of freedom of issue. In almost every case the most rapid expansion of the banking system occurred during the phase when banknotes constituted the most important liabilities of the banks. . . . The public of countries with monopolistic issuing agencies . . . did not develop the “banking habit” to the same degree as did the public in countries in which relative freedom of banking prevailed.

In other words, currency monopolies stood in the way of economic development, even if they did not prevent it altogether.

More recent empirical research has tended to reinforce earlier work treating the growth of banking as a crucial determinant of economic growth, in part by quantifying what were once merely qualitative conclusions (Levine 1997). However, because they generally rely on data from the post free-banking era, these studies are unable to shed much light on the growth advantages of competitive note issue. William Lastrapes and I have recently attempted to address this gap in the empirical literature by constructing a formal model capable of representing the growth advantages of commercial bank notes relative to fiat money (Selgin and Lastrapes 2007). Using this model, we simulate steady-state growth rate gains from various degrees of currency privatization for a small sample of developing countries. The gains turn out to be very large compared to those from more conventional forms of financial liberalization. For example, we find that, for certain (reasonable) parameter values, complete privatization would increase Chile’s growth rate by 134 basis points. These findings suggest that, at least in those (mainly poorer) countries where currency holdings are substantial relative to total commercial bank assets, the opportunity costs of currency monopoly are anything but trivial.

Politically Impossible?

Despite their incomplete and to some extent incorrect reading of the historical record, and also despite having overlooked important theoretical work pointing out the disadvantages of currency monopolies, Friedman and Schwartz ultimately reach a verdict favoring open competition in the supply of hand-to-hand currency. With respect to

Friedman's original "good reason" number 2, although they acknowledge the ever-present risk of fraudulent financial institution undertakings, they conclude that "under current conditions it [the risk] seems unlikely to be more serious for hand-to-hand currency than for deposits" (Friedman and Schwartz 1986: 51). With respect to "good reason" number 4, they accept Roland Vaubel's (1984) response that, even if such externalities can be identified—a claim disputed by Vaubel himself—their presence at best supplies an argument for deposit insurance or a lender of last resort rather than one for banning private paper money (Friedman and Schwartz 1986: 49).

Yet this conclusion did not cause Friedman and Schwartz to take a vigorous stand against official currency monopolies. In part, as we have seen, this outcome was the logical counterpart of their having underestimated the disadvantages of monopoly, in poorer countries especially. However, it also reflects their opinion that to oppose established currency monopolies would be fruitless. They suggest (1986: 41) that, though it might be technically feasible, a competitive paper currency regime would not represent a stable "political" equilibrium—that it "would . . . generate political forces leading to major changes." History, in other words, would simply repeat itself, with competition again giving way to politically inspired consolidation of currency-issuing privileges. To advocate competition would therefore amount to so-much "spitting in the wind" (1986: 45). "While we therefore see no reason currently to prohibit banks from issuing hand-to-hand currency, there is no pressure by banks or other groups to gain that privilege. The question of government monopoly of hand-to-hand currency is likely to remain a largely dead issue" (1986: 52).

The best reply to this pragmatic argument for tolerating currency monopolies is one offered by Friedman himself, in the context of his and Rose Friedman's defense, in *Free to Choose* (1980: 126), of a plan for radical welfare reform:

What is not politically feasible today may become politically feasible tomorrow. Political scientists and economists have had a miserable record in forecasting what will be politically feasible. Their forecasts have repeatedly been contradicted by experience.

That this statement applies to currency reform no less than to the reform of welfare was aptly demonstrated by Friedman himself

when, during a 1992 interview with the Federal Reserve Bank of Minneapolis's magazine *The Region*, he said concerning the Maastricht plan for a single European currency, "I believe it will not come to an achievement in my lifetime" (Friedman 1992).

Conclusion

Milton Friedman was one of the 20th century's most determined and uncompromising foes of unwarranted government intervention in economic affairs. For this reason, the fact that he saw little point in opposing official currency monopolies may be interpreted by others as proof that such monopolies do little harm. I have tried to show that Friedman's stand was based (1) on an incomplete appreciation of the costs of currency monopoly, and of the corresponding advantages of allowing private firms to enter the currency market, and (2) on his uncharacteristic and unwarranted dismissal of any prospect for achieving free-market currency reform. In truth currency monopolies are more costly than most other statutory monopolies, owing to currency's unique role as both a medium of exchange and a vehicle for financial intermediation. Although Friedman did not recognize this in 1986, he at least saw no "good reasons" for opposing freedom of note issue. The "good reasons" for opposing monopoly, on the other hand, have continued to accumulate. It is high time, therefore, that economists cease to tolerate, and begin actively to oppose, this unjustified and injurious infringement upon the public's freedom to choose.

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