

response will be to give the authorities more statutory power to intervene, not less.

One of the advantages of the earlier chartered bank system was that the charters had a fixed time period. The need for renewal provided an occasion for debate and discussion of such issues, an occasion which would not normally be colored by crisis and its immediate aftermath.

### The Theory of Free Banking

In addition to the historical claims that free banking was relatively stable and successful, free bankers also argue that there are theoretical reasons why this should be so. This was the main thesis of Selgin,<sup>22</sup> and the same analysis is presented and extended by Sechrest in chapters 2 and 3 of *FB*. Again I am unpersuaded. I accept that the need to maintain convertibility into gold will provide some limit to the variability of the money stock and credit expansion. So free banking should be stable in the large. But the same would be true for a central bank on the gold standard. Sechrest, however, follows Selgin exactly in claiming that a free bank's demand for reserves "depends not only on the total volume of transactions, but also on the frequency of those transactions" (14). Consequently, the argument goes, if velocity shifts, the money supply automatically responds to restore monetary equilibrium. Thus a free-banking system incorporates a quasi-automatic, self-balancing mechanism. This is implausible. While desired cash reserves should be a positive function of the inherent variability, the variance, of cash flows, especially at the end of the day when adjustment via the money market may be more difficult, they should be negatively related to the frequency of transactions (with a given volume);<sup>23</sup> the more small transactions there are, the less likely is it that expected cash reserves will be disturbed by purely random fluctuations in deposits or withdrawals.

More seriously, Sechrest fails to distinguish between the universal *acceptance* of money, as a (possibly very) temporary abode of purchasing power, and the demand *to hold* money. He writes, "the demand for inside money is equivalent to the supply of loanable funds. This stems from the fact that banks make loans by crediting a customer's deposit account. Unless the customer is (at least

briefly) willing to hold that additional inside money, no new loan can be created" (50). But the customer borrows money in order to spend it, not to hold it for any longer than is strictly necessary, particularly since the margin between the interest rate offered on deposits and that charged on loans, i.e., the spread, will be adverse. Sechrest ties the market for loans and deposits together, since "deposits represent the supply of credit and loans represent demand for credit" (50), without having to analyze how the two separate markets interact through shifts in relative interest rate differentials and portfolio adjustments by both bankers and their customers.

There is, indeed, little specific attention given to the asset side of bank portfolios; to Sechrest this is just a reflection of the volume of deposits. Since most bank crises result from a fall in the market value of bank assets, I cannot help having some doubts whether Sechrest's model is appropriate to the matter under consideration. His model concentrates purely on the demand and supply of money and the elements in the money multiplier, i.e., the banks' desired reserve ratio and the public's desired currency deposit ratio. Apart from choosing their reserve ratios, bankers appear to do very little in this model. There is no analysis of their asset portfolio choice, apart from their choice of reserve ratio, and there is little or no analysis of what they are trying to achieve (in economists' terms what is their objective function) or how they go about it. There is, to my mind, remarkably little about actual banking in Sechrest's, or Selgin's, model.

Current standard analysis attributes the fragility of (free) banking to the fact that banks have both assets with uncertain, time-varying market values on the one hand, and, on the other, nominally fixed-value deposits whose withdrawal is on a first-come, first-served basis in conditions of limited information. If so, it is essential to assess the determinants of variations in bank asset prices and the nature of the information available to the various players, i.e. to banks, to borrowers, and to depositors. Sechrest fails to do so.

One of the earlier classic works in this field is by Diamond and Dybvig,<sup>24</sup> who stress uncertainty over the volume of deposit withdrawals rather than asset uncertainty. The authors of both books take aim at Diamond and Dybvig's (abstract theoretical) suggestion that bank runs might arise randomly (e.g., *EFB* 30, 113; *FB* 173n14). The concept of such random runs was always more of theoretical