Lynne Pierson Doti and the Economic History of Unregulated Money and Banking

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Currently, the theoretical literature on unregulated banking (free banking) is extensive. However, the empirical evidence of unregulated banking is thin, relative to the empirical evidence underlying regulated banking. The purpose of this article is to argue that Lynne Pierson Doti's work on Californian banking in the 19th century offers an underappreciated but important roadmap for future research regarding banking activities in unregulated environments. Replicating studies like that of banking in California would enlarge the corpus of empirical evidence regarding free banking theory.

In the wake of the financial crisis of the late 2000s and of the weak recovery that ensued, financial history has emerged as something of a "hot topic". Unfortunately, the emerging new literature is based on an implicit assumption: that regulation is desirable. Given the (quite debatable) belief that the financial crisis was caused by too little regulation, this assumption is quite understandable. However, this is a faulty assumption.

Since the 1980s, there has been emerging literature on unregulated banking and free banking (I will use the two terms interchangeably). This literature is at its strongest on theoretical grounds (Selgin, 1988; White, 1984, 1999; Horwitz, 1992; Selgin & White, 1987, 1994). George Selgin, one of the fathers of this school of thought, compared his endeavor as making the theory of free banking as relevant to the study of banking as the theory of free trade is relevant to the study of international trade. Selgin and White (1994) stated that:

> Just as the positive understanding and normative assessment of tariffs require the hypothetical benchmark of pure free trade, so the understanding and assessment of current monetary regimes require the hypothetical benchmark of pure monetary laissez-faire (p. 1718).

In essence, theorists of free banking suggest that financial institutions are capable of regulating the money supply in order to meet changes in money demand without creating bubbles. The most interesting aspect of this literature is the idea that monetary systems are evolutionary and, if unregulated, can adapt easily to shocks and strengthen as a result (Selgin & White, 1987; Horwitz, 1992). Basically, monetary systems emerge out of unhampered human action.

These theorists have provided some case studies, notably Scotland in the late 18th and early 19th centuries and the private coining of money in England during the early days of the Industrial Revolution. The case most often referred to is that of Scotland which was related in the work of White (1984), although there have been some criticisms towards the validity of this particular case (Sechrest, 1993). In terms of private coinage, the study of private mints in England during the French Wars and the early days of the Industrial Revolution by George Selgin (2008) is probably the best example one can think of. These cases, which support the theory of unregulated banking, are quite few in numbers relative to those supporting the literature on "regulated banking". Since free banking and unregulated banking episodes occurred mostly in the late 19th to early 20th century, this relatively small empirical literature has been mostly invested in by economic historians. Further evidence regarding the viability of unregulated banking needs to be collected in order to advance the case for free banking. In that regard, the works of Lynne Pierson Doti are interesting for those who might wish to further investigate this field. Concentrating on a frontier economy, that of California, Doti showed the story of a monetary system that evolved from barter to a stable and well-advanced banking system in less than a few decades. Her research is not only a strong piece of supporting evidence for the theoretical literature mentioned above, it also provides a template of research for scholars interested in banking history.

The Evolution of Monetary Order

In their work, Selgin and White (1987) argued that there were three stages to the evolution of a free banking system. The first is the evolution of a system of money transfers that avoid the transportation of specie. The second is the creation of negotiable bank liabilities, and third, the emergence of a clearing system for money. At the core of this idea of the "evolution" of free banking is the concept that (robust) monetary institutions can emerge out of unhampered human action (Horwitz, 1992, p. 114). More specifically, self-interested behavior on the part of individuals may generate institutions that create a stable framework of exchange enabling the coordination of production by many individuals. Money is an example of such an evolving process (Menger, 1892). Small tribal communities may use barter by sheer virtue of their size and the simplicity of exchanges undertaken between tribe members. However, if exchanges become more complex and the size of a society increases, achieving the double coincidence of needs becomes harder. Thus, barter becomes a costly monetary institution and alert entrepreneurs have an incentive to find a marketable commodity (gold, wampum, and shells) that will be commonly accepted by others (White, 1999, p. 6-7). But this new monetary institution is suited to the context of a relatively simple economy. As an economy grows in size and complexity (more long-distance trade for example), carrying coins, wampum, or shells for trade becomes costly. In such cases, an alert entrepreneur can provide warehousing services which transfer money via accounting books, thus avoiding the costs of evaluation and transport of money (Selgin, 1988, p.19). Eventually, these warehouses use the deposits they have to finance productive investments and offer interest on deposits. Progressively, claims against these warehouses (which have now become banks) start to circulate and, as more banks appear, prompting the need for notes exchange, clearinghouses eventually emerge. None of these stages are planned. They emerge through self-interested individuals pursuing the satisfaction of their desires.

The finest virtue of emerging monetary orders is that they are impressively stable and they sustain economic growth. For example, the Scottish Free Banking system, which is considered to be one of the closest to a case of pure free banking, exhibited low rates of failure and created a stable banking system in the otherwise messy world of the time (White, 1984). Similar systems like the one observed in Sweden generated similar outcomes (Ögren, 2006). Less optimistic assessments mentioned higher rates of failure which were compensated by higher rates of output growth as poor banks were eliminated (Bodenhorn, 1990; Ager & Spargoli, 2013). But overall, the results were seen as generally very positive (Schweikart, 1991; Dowd, 2015). Arguably, one key feature of a free banking system is its ability to withstand the shock of demand for money by changing their reserve ratios (Gerlach & Kugler, 2015).

Lynne Pierson Doti and Banking in California

The work of Lynne Pierson Doti is a highly instructive attempt to illustrate the emergence of an unplanned monetary system. Doti's work on banking concentrates on the American West, but mostly California (Doti, 1978, 1991, 1995; Doti & Runyon, 1996; Doti & Cassell, 1997; Schweikart & Doti, 1998). Broadly speaking, her work tells the story drawn by Selgin and White (1987) and Horwitz (1992) but over a very short time frame — a few decades at most.

In essence, 19th century California was a frontier economy — far removed from economic centers, thinly populated, recently settled where labor and capital were scarce but land was abundant. Early settlements generally had very simple economies centered on the production of a very limited range of produce. This was also the case in Canada, where French settlers during the 17th century traded in wampum and fur pelts and paid their duties, tithes, and taxes in wheat and peas (Heaton, 1928). Early American settlers in the 17th and 18th centuries also predominantly resorted to barter (Hummel, 1978). According to Doti, most trading in California was done by barter until the 1830s (Schweikart & Doti, 1998). As the economy of California grew, cries of "specie scarcity" grew louder and there were complaints about the absence of banks. Historians have too often been willing to accept these cries as well-founded. Rarely do they point out the crucial difference between shortage of money and denominational shortages. By definition, there can be no shortage of money. However, because of transaction costs, there can be shortages of small denominations (e.g., Selgin, 2008; Timberlake, 1993). With the gold rush in the late 1840s, private mints emerged very quickly and thereafter, banks as well. The gold rush into California meant rapid and deep changes to the structure of the local economy. Simultaneously, there was an important increase in living standards for Californians — some of which included a desire to send remittances back east to their families as well as use their newfound wealth to acquire goods from elsewhere. In such a situation, the transport, storage, and minting of gold represented a major impediment to trade. To answer this issue, Schweikart and Doti (1998) pointed out that banks rapidly emerged out of merchant stores that acted as bankers in practice. These merchants issued drafts which were sufficiently trusted for Californians to exchange them for gold in order to simplify transactions. These banks also issued notes for very low denominations – some for as little as 25 cents which was the standard price of a shot of whiskey at the time (Doti & Runyon, 1996). Progressively, stores acting as banking-services providers emerged into formal banking, issuing their own bank documents which acted like notes (Schweikart & Doti, 1998). Banks invested considerably in advertising the safety of their facilities (Schweikart & Doti, 1998) which created brands of banking trusted by consumers (Horwitz, 1992).

The pace of California banking development was remarkable. In contrast, consider the case of Canada where the first bank emerged in 1817 (Shortt, 1986). In Canada, when it was under French rule, unlike California, private mints were prohibited to exist since all coinage had to be made in France. The emergence of private mints in capital-scarce California is a notable fact and a strong endorsement of the view that unregulated monetary systems can generate welfare-enhancing outcomes. In Canada, colonial governments frequently attempted to design monetary systems — most of which ended very poorly. From the 1680s to the 1710s, the French colonial administration issued money notes printed on the back of playing cards which were backed against incoming gold shipments from France. The note issues became increasingly large and were backed against increasingly dubious assets (notably, securities drawn against the Parisian Parliament and shipments of fur pelts to Europe). The experiment ended in failure and a widespread distrust in paper notes. Many observers complained that the peasants of Canada returned to barter. It was later repeated in the 1750s which led to further distrust of promissory notes (Armstrong, 1984). Even in the first years of free banking in Canada, there was widespread distrust toward paper money which seems to have been fueled by the prior attempts to design a monetary system. It was only with the emergence of private banks like the Bank of Montreal that bank notes emerged. In the interceding years, Canadians frequently complained about the scarcity of small denominations (Redish, 1984) and the poor quality of the money supply. These denominational hindrances encouraged barter, swaps, and exchanges in kind. These were costly exchange devices (Timberlake, 1993). It was only with the emergence of private banks that the popularity of such devices lessened as banks had a strong incentive to monetize exchanges. In California, the evolution from barter to well-developed clearing houses took less than four decades. Complaints about the scarcity of specie were seen by alert entrepreneurs as profit opportunities and they rapidly responded. Yet both economies had similar initial situations: frontier areas with very small populations far removed from commercial centers. In fact, Canada had slightly better conditions since its initial settlement basins had access to the Atlantic Ocean when they were not ice-locked and were in close proximity to the United States.

By contrast, California was isolated. The fast pace of the evolution of the Californian banking system was quite significant when seen in this contrast.

What is more impressive is that this occurred in spite of government action. Kevin Dowd (2015) pointed out, in his survey of the free banking experience in the United States, that California basically prohibited banking but that the outcome of this ban produced uncertain results. Indeed, the first draft of the Constitutional Convention of 1849 basically prevented banks from issuing bank notes. However, the final version of the Constitution had certain loopholes which permitted a relatively unregulated banking system but imposed restrictions on the issuance of money. However, most individuals did not take notice or care. According to Doti, “banking continued to develop and numerous documents exist from the period that are indistinguishable from bank notes” (Doti & Cassell, 1997, p. 312). She points to some examples, such as the acceptance without question of a note from a month-old bank at a restaurant (Doti & Cassell, 1997). Schweikart and Doti (1998) summarized the failure of this ban in the following quote:

> In reality, the constitution and the legislature’s stipulations regarding paper money and banks already had been rendered obsolete and irrelevant by the market, which daily saw hundreds of miners exchange gold for drafts – a reality to which the legislatures finally acceded (p. 221).

What is noteworthy is that this banking system thrived in a hostile environment until 1905. Until the enactment of the National Banking Act during the Civil War, the United States operated under a free banking system regulated at the state level. After the adoption of federal banking legislation, severe restrictions were imposed on banks — taxes on notes, capital requirements, etc. However, states were still free to regulate and charter banks (Doti & Cassell, 1997). The state of California (alongside Illinois) was one of very few states that maintained a relatively unregulated banking system up to 1905. In 1862, savings banks were allowed to incorporate and, in 1864, they were permitted to carry on commercial activities if their capital stock was greater than $300,000 (Doti & Runyon, 1996). In essence, regulations were so loose that the distinction between commercial and savings banks was purely semantic. The 1878 California Banking Act illustrates very well this lax form of regulation. Banks only had to pay a licence fee, file reports, and submit to audits. The following year, the banking-related sections of the state constitution were dropped (Doti & Runyon, 1996). This meant little banking regulation in California while the National Banking Act was tightening the regulatory framework.

And yet, the rapidly evolving financial system of California was quite stable. In the book version of her doctoral dissertation, Doti (1995) observed a strong level of competition between banks with very diversified strategies. As Schweikart and Doti (1998) pointed out, the adoption of branch banking in California, which was not prevalent elsewhere in the United States, created a system that remained stable. Failures grew increasingly less frequent between 1878 and 1905 as well as the relative importance of those failures (Doti & Runyon, 1996) — which was an achievement by itself — given the inability of the National Banking Act to generate a stable system at the national level (Bordo, Rappoport, & Schwartz, 1991; Grossman, 1993). It also seems to have been widely trusted and accepted since Californians selected a variety of exchange mechanisms that matched their needs and desires. Essentially, exchange mechanisms were privately developed (those that emerged organically as opposed to those designed as a result of government intervention).

Taken together, the story of the California banking system told by Doti offers strong support to the proposition that monetary order does not need to be planned. A frontier society with a population boom following a resource boom managed to generate a robust financial system with very little guidance from government and probably in spite of government. Given California's rapid economic growth observed between 1880 and 1910 (Klein, 2013), the role that a stable banking system might have played in harnessing savings for productive uses is considerable.

The manner in which Doti developed her proposition is also relevant. Instead of being concerned solely with econometric estimates (which are crucial to determining the proper importance of certain factors), Doti linked economic history and business history together. In her work, one can move from data-driven results to examples of particular bankers and merchants and their role in the emergence of this organic monetary order. This is quite important. Consider in comparison, George Selgin's (2008) work on the emergence of private mints in England. Selgin's (2008) main question was how the shortage of small denominations in England at the onset of the industrial revolution was hindering growth and development. His answer was that private mints did emerge and produced token coins which were widely accepted and, as a result, made transactions easier and cheaper. While some data is used to frame the wider issue, Selgin's (2008) main attention went to the individual minters and how they crafted solutions to very real problems, including how artwork was used to avoid counterfeiting. His work is about economic history, but it reads like a piece of business history. In an evolutionary monetary order, different conditions might generate different solutions. In studying the business history of this process, one showcases the wide variety of solutions that can be brought about to create spontaneous order. In Doti's work, considerable attention was given to the business history of banking in California which made her work exactly like that of Selgin's regarding private coinage. In telling the business history side of things, the evolutionary process no longer appeared like a dry economic process but instead as a vivid story of human ability to generate strong and robust institutions in the absence of a master plan.

Conclusion

Other areas are worth considering if one wishes to expand on Doti's work. For example, Illinois was another state that maintained a relatively free system after the Civil War — an exception worth studying. Many countries are worthy of attention similar to that which Doti gave to California. The Canadian provinces had different rules regarding banking in their early days and very different experiences emerged. As previously mentioned, Canada was a frontier economy just like California and should be a prime candidate for the study of free banking. Until now, Canada's free banking system prior to Confederation in 1867 has received little attention. However, if one follows the template drawn by Doti, one could use Canada to draw out what local conditions, endowments, and constraints affected the course of the evolution of that country's banking system.

By adding Canada, Illinois, or other regions, a picture of the evolution of the "organic monetary order" would emerge from which broad stylized facts could be established. This would help to build a strong counter-argument to those who argue for the need for more regulation (or smarter regulations). But more importantly, it would vindicate the claim that we should treat free banking like we treat free trade. Pure free trade may never exist. Pure free banking may never exist as well. Nonetheless, we use pure free trade as counterfactual to understand the effects of barriers (both natural and man-made) as we should use pure free (unregulated) banking as a counterfactual for assessing the effects of barriers and regulations. While we have a considerable quantity of examples that support the use of such counterfactual in international trade, we do not have the same supply of examples with regard to free banking. Lynne Doti's work increased that supply by providing a striking example and has given a template to further increase that supply.

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