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Tyler Beck Goodspeed, *Legislating Instability: Adam Smith, Free Banking, and the Financial Crisis of 1772* (Cambridge, MA: Harvard University Press, 2016), pp. 224, $39.95. ISBN: 9780674088887.

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Legislating Instability is a short book grounded on impressively long primary sources research. It is a detailed, documented analysis of the effects of the changes in banking regulation that took place in 1765 in Scotland. Among the effects, Goodspeed demonstrates, was the Scottish financial crisis of 1772. The 1765 regulation included provisions that Adam Smith saw as beneficial. Goodspeed proves that Smith was wrong to support these measures. All three provisions that Smith advocated in the *Wealth of Nations*—usury laws, abolition of the optional clause, and a ban on issuing small-denomination notes—contributed to, rather than deterred, financial instability.

In the second half of the eighteenth century, Scotland was a small developing country with a fixed exchange rate, and very rapid economic growth connected in part to large infrastructure development and foreign trade. The local banking system, with its free entry in the private notes-issuing market, was able to manage this fast growth with innovation and adjustments, thanks to its intense competition.

The two major chartered banks of Edinburgh attempted to reduce competition through regulation. The 1765 banking legislation was the result of intense lobbying of all the interested parties. Legislation was drafted by the parties directly involved, creating, in the way Goodspeed describes it, almost a textbook case of regulatory capture: it prohibited the issuing of small-denomination notes and it abolished the optional clause, eliminating two financial safety valves and therefore introducing more instability.

The prohibition of small-denomination note issuing caused de facto a reduction in competition, raising barriers to entry. The small notes were promissory notes used by suppliers and employers. They filled a vacuum in the market. Their elimination not only created a shortage of means of payment but also, and most importantly, imposed, in practice, higher capital requirements for banks. This meant that fewer and larger banks could now enter the market. And, in combination with the abolition of the optional clause, it increased balance-sheet risk and the likelihood of bank failure.

The optional clause, the clause that allowed banks to temporarily suspend convertibility of their notes, was actually never used domestically, but it served as a deterrent against raids by rival banks. Domestically it functioned as a deterrence against over-issuing.

It was instead used, very selectively, as a private form of capital control, given the fixed exchange rate, in case of large "hot money" outflows, for which there was no other possible response, given the presence of usury laws.

Goodspeed substantiates all his claims with data. And he also offers possible alternatives for his finding that banks became bigger after 1765. The increase could have been due to a demand-side increase. But he quickly dismisses this possibility because no changes could be seen on the demand side. On the supply side, the abolition of the optional clause as well as small notes implied the maintenance of higher reserves and higher minimum capital requirements.

Bigger banks, fewer banks, and more bank failures are all visible in the figures plotting data pre- and post-1765, despite larger capitalization and larger reserves than before 1765. Why? To maintain profits, and unable to cut costs, banks needed to raise the yield of their assets: that is, to increase the average maturity and risk level of their loan portfolio. Banks assets shifted away from short-term bills to revolving loans, exactly the opposite of what Adam Smith would see as good banking practice.

In addition, without the optional clause, solvent but illiquid banks were now forced to temporarily close their doors when faced with overwhelming demand for species. But closing their doors implied indiscriminate suspension of payment on all their notes and uncertainty regarding their reopening: a very disorderly alternative to the more stable, predictable, and selected actions of the optional clause. The increased uncertainty prevented notes from being acceptable as payment and increased the redemption demands, encouraging bank runs and instability in the system.

All the pieces were therefore in place for the creation and failure of Douglas, Heron & Co., the so-called Ayr Bank, a very large bank that spectacularly collapsed in 1772. The size of the bank increased its monitoring costs and information asymmetries. Usury laws prevented allocation of credit on a price-mechanism base, favoring insider lending instead. The bank collapsed but the consequences of this collapse were not as severe as one could imagine because of a feature of the Scottish banking system that Adam Smith briefly mentions but does not analyze: unlimited liability. Thanks to the immense estates of the bank's proprietors, depositors and other creditors were all made whole, contagion was circumscribed, and from the Ayr Bank's ashes several new banks emerged.

The question that remains unanswered is why Adam Smith was so off? Why would he support such regulations as the ones of 1765 and usury laws, when at least some of their possible destabilizing effects were predictable? Why did he maintain his views even after the crisis of 1772? He kept using the metaphor of paper money's being an elevated highway from his lectures to his last edition of the *Wealth of Nations*, the only difference being the introduction of Daedalian wings to paper money. Goodspeed speculates only on why Smith remained basically silent about the benefits of unlimited liability. Smith received a considerable pension from one of the major shareholders of the Ayr Bank for having been his tutor and maintained a close relation to him.

This is not an introductory text to the 1772 Scottish financial crisis or to the thought of Adam Smith on it. It is a scholarly, documented analysis meant for an audience already familiar with the free banking period of Scotland. This is also a text that future scholars of this topic will not be able to ignore.

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