

# FREE BANKING AND FRACTIONAL RESERVES: REPLY TO PASCAL SALIN

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Pascal Salin's (1998) critique of my article "Free Banking and the Free Bankers" (1996) raises several important issues about the theory of banking. However, I think that a closer look at them strengthens rather than weakens the case for a 100-percent-reserve system.

Salin claims that under 100-percent-reserve banking "there is not a perfect certainty that money holders can get their money back, since the issuer of money substitutes may go bankrupt" (p. 61). This observation is entirely correct. Yet no advocate of 100-percent reserves has ever claimed that this system would *exclude* business failures. The argument is that it leads to *fewer* bankruptcies than does fractional-reserve banking. The very existence of fractional reserves implies an additional source of bankruptcy, that is, a source of failure that is absent from 100-percent-reserve systems. For the same reason, Salin's statement that under 100-percent reserves "the issuer of money substitutes necessarily fails, except if he can find some means to make people pay for the services he offers them" (p. 61) is also true but irrelevant. For this is the *definition* of failure. *Every* business fails if the entrepreneur does not manage to make people patronize his services. No particular feature of 100-percent reserves is involved here.

On the problem of how a note-issuing bank can make people pay for the cost of gold storage, Salin states that "notes issued at different dates would have different gold prices and would no more be perfect substitutes, so that their liquidity would be lowered" (p. 62). It is true that 100-percent reserves would *in praxi* mean that most small and medium-size payments would be effectuated in specie and that most people would store their money by themselves rather than pay banks for storage services. Salin's observation suggests that bank notes would, in most cases, be used only once and only for large-scale payments. Yet is there really any problem involved? Is it an end in itself that bank notes be used? Only if this were the case would Salin's objection hold true.

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I do not think that the use of bank notes could ever be justified as an end in itself and that, therefore, the real issue is *how many* bank notes should be used. Now, what is the standard of reference by which one can discern the *right* quantity of money substitutes? I submit that there is but one possible standard, namely, to accept the decisions of the money owners. Whatever quantity of notes is issued on a 100-percent-reserve basis is, *ex ante* at least, the right or optimal quantity. If one violently prevents the banks from issuing this quantity then this would be a case of forced disassociation. And if a fractional-reserve system were imposed on the market participants, this would then be a case of forced association.

Salin's point of view is a different one. He claims that "optimality cannot be defined independently of the wants of individuals" (p. 62). However, this standard of reference is conceptually meaningless and practically irrelevant since it presupposes that inter-individual comparisons of utility are possible. The problem is that the wants of individuals can be contradictory. My preference is that my banker does not lend out my money holdings to other people. My banker's preference is precisely the opposite. What, then, is the right decision to take on the basis of the "wants of individuals?"

Salin might respond that whether my deposits are 100 percent covered or not is a matter of agreement between my banker and me. Yet in taking this stance he would admit that property, not wants, is the real standard of reference to which the optimality of a system must be gauged. And this is the whole point that the opponents of fractional reserves are trying to make. They do not decide "*from outside* that a 100-percent-reserve system is optimal." Rather, they judge the matter from the only possible point of view, namely, from the standpoint of voluntary agreements between property owners. Because this is the point of view that any participants in this debate implicitly adopt, it is senseless to accuse me of "constructivism." True, it is a form of "constructivism" to advocate the establishment and maintenance of property rights because there is another logical possibility, namely, to advocate a system of catch-as-catch-can. However, there is no such thing as society and markets outside a framework of private property. And whoever sets out to discuss problems that can only emerge within society (for example, problems of banking) takes private-property rights for granted. The very fact that Salin analyses banking problems implies that he too adopts a "constructivist" position. But whereas mine is a coherent constructivism, his is contradictory.

With this in mind, it is easy to answer the question whether the market would select a 100-percent-reserve system. Because this banking system is the only one that conforms to the fundamental condition of any market, namely, respect for private-property rights, there is a market in banking *only if and insofar as* all money substitutes are covered 100 percent. In short, it is meaningless to talk about a "market" that selects fractional-reserve banking. One could as well claim that the market selects robbery to acquire cars or that it selects murder of present jobholders or tenants to get their jobs or apartments. People might choose very bad ways to acquire the goods that they desire, but only if and insofar as they

choose to respect their fellows' property can they be said to interact within a market framework. From this it follows that we do not have to make experiments to know what a market in banking would be like in this respect.

A real market in banking *implies* 100-percent reserves. The fact that people have an incentive to use fractional-reserve banking is no more surprising than the fact that robbers have incentives. It is not competition (which presupposes private property) but malice or ignorance that induces people to choose a fractional-reserve system. And the fact that in the real world both fractional- and 100-percent-reserve banking might coexist is due to the same reason that tax-financed production might coexist with production that is exclusively financed by private patrons. Such coexistence merely displays the moral condition and the degree of enlightenment of the population. The instability of fractional-reserve banking is an emanation not of market failure but of moral and intellectual shortcomings.

Even in historical retrospect, Salin's contention that "fractional systems were selected not as a consequence of some state regulation forbidding 100-percent-reserve systems, but because they better met the needs of producers and holders of money substitutes" (p. 63) is questionable. The fact is that in the early nineteenth century, British and American courts ruled against 100-percent-reserve banking in a series of important decisions: *Carr v. Carr*, *Devaynes v. Noble*, and *Foley v. Hill et al.* The courts ruled that bank deposits were not bailments but credits to the banks (Rothbard 1983, pp. 93ff; 1994, pp. 42f). The consequence was that, rather than seeing the bankers as embezzlers (criminals), the depositors were depicted as bad investors. These decisions, instances of state intervention in the market economy, were crucial for the modern history of banking. One might object that even private courts could have taken these decisions. My response would be that it does not matter how violations of property originate. If and insofar as property is violated there is no market.

Salin seems to misunderstand my argument against the feasibility of fractional-reserve banking. I do not claim that fractional-reserve banks can indefinitely increase their issues of fiduciary media or that there is no "optimal position" for them to reach. My point is that the banks do not *know* this optimal position and that, whereas this is admittedly a problem of all business, only in fractional-reserve systems does bankruptcy of one bank lead to the contagion-induced failure of all other banks. The conservative banking cartels that Salin describes might *delay* the breakdown of the whole system, but they cannot prevent it.

The decisive fact is that operating on a lower reserve ratio is a competitive advantage. Salin does not deny this point. Yet once it is conceded, one must admit that this advantage can only be for some time *counterbalanced* by the verdict of established and more conservative banks. But what happens if a long-since established bank, which has accumulated confidence capital over decades, announces that it will decrease its reserves? And why should this take so long in a truly free market? Today's experience can hardly tell us how dynamic a competitive banking system would be because we know the bureaucratic remnants of what were once banks.

Neither do option clauses change the imminent threat of contagion crises. They have the same effects as the introduction of central banks, namely, to provide temporary Band-Aids that do not remedy the fundamental disease. If the customers accept option clauses, the banks can issue ever more fiduciary media. Thus, the same old problem of bankruptcy and contagion emerges on a larger scale. It is also wishful thinking to indulge in the "high net worth" of a bank, which "can sell a huge amount of assets" (p. 65). How much the bank is worth and whether its assets are huge or tiny depends on the money prices paid on the market. If people do not trust fiduciary media anymore and there is a run on the banks to reclaim their money, then the quantity of money in the larger sense (which determines the height of money prices) shrinks within a second. And with it shrink the assets of the banks and their net worth is reduced to a fraction of what the bankers believed it to be. *This* is how a crisis works out. Today the central banks prevent such things at the cost of still more inflation (and regulation). Yet this should not delude us about the nature of fractional-reserve systems.

According to Philippe Nataf, whom Salin quotes, early-nineteenth-century, fractional-reserve banks in New England were spared from contagion crises. However, from this one instance we cannot infer that this system was stable *because of* the bank reserves being fractional. Theoretical insight suggests that these banks operated smoothly *despite* their adoption of the wrong system. Other factors (for example, the conviction that more than 30 percent of uncovered bank notes were "unsound") must have more than counterbalanced the negative influence emanating from the fractional reserves and thus prevented those exaggerations that precipitated banking crises in other regions.

Let us finally deal with the question of whether fractional-reserve banking is an instance of fraud. Salin discusses this problem from the point of view of someone who is offered fiduciary bank notes. In his eyes, the problem boils down to a choice between two risk-chance positions. There can be no question of fraud as long as contracts are voluntary:

If I decide that it is better for me to contract with the second producer [offering fiduciary media] and to bear the risk of illiquidity, I am totally responsible for this choice, and there is not the slightest element of fraud in the behavior of the banker and in our contract. (p. 63)

Now, at first glance it seems as if, from the point of view of this person, there is really no problem involved. Yet consider the case of a receiver of stolen goods. Would Salin go so far as to assert that it is just a question of risk and chance whether one should buy from him or from a rightful owner of that kind of good? Obviously, the moral case for fractional-reserve banking relies on an affirmative answer to this question. I need not dwell on the fact that there could be no civilization if this were a generally accepted doctrine. The fundamental fact is that freedom of contract already presupposes property rights and the respect of property rights. As Hans-Hermann Hoppe has lucidly stated:

Freedom of contract does not imply that every mutually advantageous contract should be permitted. Clearly, if A and B contractually agree to rob C, this would *not* be in accordance with the principle. Freedom of contract means instead that A and B should be allowed to make any contract whatsoever *regarding their own properties*, yet fractional-reserve banking involves the making of contracts regarding the property of third parties. (1994, p. 70)

In other terms, he who accepts fiduciary media does *not* “bear the risk of illiquidity” and he is *not* “totally responsible for this choice.” The bank customer fraudulently socializes the risks of his activity and the responsibility for his choice. To challenge this critique, Salin would have to focus on a slightly different case. Assume that you own a sum of money and that you have the choice to deposit your property either in a 100-percent or in a fractional-reserve bank. Is it not entirely up to you to choose the second alternative? And if you do so, would it not be entirely proper behavior on the part of the banker to create fiduciary money substitutes, using your money as backing? It seems to be difficult to deny this. Yet problems arise as soon as one takes a closer look at this “contract” with the fractional-reserve bank. What precisely is it about? The astonishing answer is, *one cannot tell*. For in fractional-reserve banking, all customers have the right to use the same deposited money. The owner may withdraw his deposit at any time, and the banker may use it during the whole time until it is withdrawn. This clearly contradicts the very idea of contracts, which is to determine who, and at which time, has the right to use a given object. Both the customer and the banker, in their dealings with other market participants, represent themselves as the owners of the deposit. Their “contract” implies that two titles for one and the same property are now used in market exchanges. This is a clear instance of fraud (Hoppe et al. 1998).

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