Journal of Markets & Morality
Volume 23, Number 1 (2020): 27–44
Copyright © 2020

The Morality of Fractional Reserve Banking

Jeffrey Haymond
Dean, School of Business Administration and Professor of Economics
Cedarville University

Ryan Beach
Financial Advisor,
Edward Jones Investments

Scholars who consider the morality of fractional reserve banking are often critical not only because of its inflationary impact but also the impossibility of meeting all legal requirements: When deposits are loaned out, they cannot at the same time be redeemed on demand. Given the promise to return demand deposits and the impossibility to do so for all, some Christians have condemned fractional reserve banking as inherently fraudulent. This article will review fractional reserve banking and other institutional arrangements that lead to bank runs and inflation (legal tender laws, central banking, et al.) to determine if fractional reserve banking *by itself* is necessarily immoral. It will survey existing scholarly thought and ask the question: "Are there any circumstances where fractional reserve banking could be morally justified?" We conclude that fractional reserve banking is not necessarily immoral, when not combined with central banking and legal tender laws.

Introduction

In the wake of the 2007–2008 financial crisis, diverse voices ranging from the University of Chicago's John Cochrane[1] to the *Financial Times*' Martin Wolf[2] called for 100 percent reserve banking to replace a fractional reserve banking (FRB hereafter) system, since less than 100 percent reserves on deposits leaves financial institutions potentially at risk for a bank run. The financial crisis was essentially a bank run, albeit primarily on the shadow banking side of the financial system. Yet these criticisms are technical in nature, criticizing the vulnerability of less than 100 percent reserves, while failing to address possible moral

objections. Fractional reserve banking is the norm in modern banking and is widely accepted as a way to provide an "elastic" currency to meet the fluctuating needs of commerce. The most popular economic textbooks fail to identify any moral issues associated with FRB, even while discussing how FRB can lead to bank runs.[3]

Calls for 100 percent reserve banking revive the debate over the institution of FRB, which was historically criticized from both moral and (often related) technical considerations. From a technical perspective, critics argue that FRB is necessarily inflationary and a primary mechanism of creating business cycles.[4] Yet the strongest criticisms are related to the morality of FRB, with charges that it is inherently fraudulent and necessarily involves theft—the theft of a counterfeiter. FRB's morality is questioned from both a secular perspective (such as Rothbard), as well as a Christian perspective (such as North and Hülsmann), almost always by those associated with the Austrian school of economics.[5] While the morality of FRB is usually questioned on the basis of fraud, the proof of its immorality often rests on the combined institutional arrangements of FRB, legal tender laws, and central banking. Selgin and White offer a secular rebuttal to moral criticisms of FRB, noting that while FRB may appear to be fraudulent, it is not, based on the legal status of deposits (reviewed further below).[6] In addition, they note that other criticisms of FRB conflate problems related to fiat money (with legal tender laws) and central banking. Selgin and White conclude that when FRB is voluntarily chosen as part of a free banking system[7] (i.e., no legal tender laws, no central banks, and competitive banknote issuance), the ills commonly attributed to FRB (e.g., business cycles) are not present. In this article, we survey the literature surrounding the morality of FRB and specifically assess the question of whether FRB is inherently an immoral institution.

What Is Fractional Reserve Banking?

To assess the morality of FRB, we need to review how money creation under FRB differs from 100 percent reserve banking. In a 100 percent reserve system, if a bank customer deposits $100, the bank is required to keep it all as reserves to meet possible redemptions. In this case, the depositor maintains command over the same present resources that she did when she held cash. Thus, participation in the banking system has no effect on the overall money stock or on the purchasing power of the monetary unit—no new money is created by the change from currency to checkable deposits (demand deposits).

In an FRB system, however, the bank is not obligated to keep all deposits as reserves but only a fraction—typically 10 percent in the United States. So, in

our hypothetical example of a $100 deposit, the individual bank is free to loan up to $90, while required by regulation to hold $10 in reserves for potential withdrawals. In this situation, the person making the deposit still has command over $100 of current purchasing power, while the borrower likewise has command over $90 of newly produced current purchasing power. Although no additional present goods have been created by the act of the banking system creating additional deposits through the loan process, there are increased potential claims for present goods. Increasing claims on present purchasing power while current goods and services stay constant necessarily means the purchasing power of each claim must fall, *if* all claims are exercised.

This review helps us identify the key issue for understanding the morality of FRB: *FRB allows the creation of additional claims for current consumption of goods and services, without the necessity of anyone agreeing to abstain from current consumption.* Further, the grantor of the new claims on purchasing power (the bank) will specifically not be forced to curtail current consumption if all claims are exercised. Rather it is other holders of the currency that will find their purchasing power reduced, which is especially problematic when there are legal tender laws mandating the acceptance of money. While the recipient of newly created claims to current purchasing power (the borrower at a bank) promises to pay back in the future with interest, in the current period it is potentially other holders of money that will suffer loss.

What FRB Is Not: Financial Intermediation

As we examine FRB's morality, it is important to note that questions regarding FRB are typically not a blanket indictment of banking *per se*. With financial intermediation, savers (those who are willing to forgo current consumption in favor of a greater amount of consumption in the future) are matched with investors (those who want purchasing power today and are willing to pay back in the future with a greater amount of purchasing power). Financial intermediation is necessary because most investors and savers are not aware of each other, leading banks to specialize in coordinating *intertemporal* consumption—consumption across time. If a saver wants to release a claim on purchasing power for five years, the financial intermediation process must coordinate with an investor who has an opposite need, that of consuming today with a larger payback in five years' time. Those bankers who successfully coordinate consumption across time will make profits; those who do not will suffer losses, as making loans to those who do not pay back will subtract from the bank's equity. Fractional reserve banking is distinct from financial intermediation: There is no consideration of intertemporal

consumption coordination.[8] Indeed, the problems of FRB occur precisely because of that lack—FRB creates additional claims on current consumption without requiring any abstention from current consumption. The potential inflationary pressures lead critics such as Dempsey to claim the institutional process of FRB stands condemned:

> An erratic element has been introduced into the pricing process; someone has entered the market for the common appraisal with a significant handicap; there is some price which is not a common price and somewhere a gain from a loan to which no adequate title corresponds. No single person would be convinced by a Scholastic author of the sin of usury. But the *process* has operated usuriously; again we meet systematic or institutional usury.[9]

Moral Objections to FRB—Is FRB Inherently Fraudulent?

Perhaps the most common argument against FRB is that it is necessarily fraudulent, with several variations as to the nature of fraud. The first way is that depositors are given the promise that when they make a deposit into a bank, the bank is obligated to return their money upon request—hence the term "demand deposits." Yet FRB ensures that there is no possibility that all promises could be kept. As Hoppe says, "Two individuals cannot be the exclusive owner of one and the same thing at the same time."[10] In this view, the bank is counting on not being found out for its fraud, since customers seldom all ask for their money back at the same time.

Rothbard concurs with this understanding of fraud but highlights a different dimension: "In my view, issuing promises to pay on demand in excess of the amount of goods on hand is simply fraud, and should be so considered by the legal system."[11] In the first view, fraud is perpetrated on those depositing at the bank; in the latter view the fraud cascades to the entire social community that uses the common monetary unit, as the additional claims on present purchasing power are necessarily inflationary. How does this fraud arise? Rothbard describes the origins of FRB this way: "First … the deposit bank must develop a market reputation for honesty and probity and for promptly redeeming their receipts whenever asked. But once trust has been built up, the temptation for the money-warehouse to embezzle, to commit fraud, can become overwhelming."[12]

Rothbard recognizes that courts have decided against his interpretation (reviewed below), yet he contends that morality should call for fraud to be confronted. For Rothbard, fraud that is considered legal by the judicial system is still fraud.[13]

He thus advocates "a change in the juristic framework to conform to the economic realities."[14]

Rothbard, a secular atheist, applies the morality of his non-aggression principle (and the corresponding property rights he argues it supports) to oppose FRB.[15] Gary North criticizes FRB as fraudulent, but *contra* Rothbard applies Scripture as the moral basis for this fraud. In North's view of fraud, he focuses on money's function as the unit of account, where the value of the currency has a weight associated with it (usually of precious metals). While the value of any good is subjectively determined, North highlights the need for an objective standard behind any measurement, to include the measurement of prices. North cites many verses that condemn the debasement of coinage, such as in Ezekiel 22:18–21:[16]

> Son of man, the house of Israel has become dross to Me; all of them are bronze and tin and iron and lead in the furnace; they are the dross of silver. Therefore, thus says the Lord God, "Because all of you have become dross, therefore, behold, I am going to gather you into the midst of Jerusalem. As they gather silver and bronze and iron and lead and tin into the furnace to blow fire on it in order to melt it, so I will gather you in My anger and in My wrath and I will lay you there and melt you."

North's point is well made: Surely God's use of the concept of debasement of coinage (which at least implies that the illustration would be well known to the intended audience) to condemn the Israelites means that debasement of fiat money is similarly condemned. North also highlights the many verses that condemn false weights and measures (e.g., Deut. 25:13–16; Prov. 11:1). If money is indeed defined as a certain weight of gold or silver and has been deceitfully debased, then this standard for condemnation has been met.

North joins Rothbard's condemnation, quoting his analysis of how the process of money creation is akin to counterfeiting, when counterfeiters add 20 percent to the existing money supply:

> What will be the consequences? First, there will be a clear gain to the counterfeiters. They take the newly-created money and use it to buy goods and services.… The new money works its way, step by step, throughout the economic system. As the new money spreads, it bids prices up—as we have seen, new money can only dilute the effectiveness of each dollar. But this dilution takes time and is therefore uneven; in the meantime, some people gain and other people lose.… The first receivers of the new money gain most, and at the expense of the latest receivers. Inflation, then, confers no general social benefit; instead, it redistributes the wealth in favor of the first-comers and at the expense of the laggards in the race.[17]

North concludes, "Rothbard's analysis indicates why God so opposes monetary inflation, whether practiced directly by the State or simply private fraud which is tacitly sanctioned by the state. Currency debasement is theft."[18]

Rothbard's analysis above is useful in several ways. First, it crystalizes the nature of the fraud. The holders of the existing coinage have no way to know that the value of their money is being diluted. Of course, any holder of commodity money should know that the exchange value of their money is not constant; it will be subject to supply and demand just as any other asset. Yet supply of commodity money will only increase by the arduous process of mining, which over long periods of time leads to a stable exchange value (albeit with some volatility such as when new discoveries or new mining techniques allow more precious metals to come to the market). Fraud is not simply a change in the exchange value of money but rather the way it is diluted—involving no sacrifice on the part of the counterfeiter. The second benefit of this example is to show that the purpose of the counterfeiter is not only to gain current purchasing power through fraud but also to increase current consumption with no future reduction in purchasing power necessary. This is contrasted with the FRB process outlined above, where gaining current consumption involves a promise of paying back in the future with interest. Rothbard's conclusion that inflation results in no social benefit does not therefore necessarily apply to FRB. Ludwig von Mises would not have agreed with Rothbard; speaking of fiduciary media (banknotes issued during the FRB process), Mises said,

> The progressive extension of the money economy would have led to an enormous extension in the demand for money if its efficiency had not extraordinarily increased by the creation of fiduciary media. The issue of fiduciary media has made it possible to avoid the convulsions that would be involved in an increase in the objective exchange value of money, and reduced the cost of the monetary apparatus. Fiduciary media tap a lucrative source of revenue for their issuer; they enrich both the person that issues them and the community that employs them.[19]

Vera Smith rightly notes that a major objective of central banking is to finance the government's debt.[20] In our current system, when the government issues bonds, a large portion of them end up expanding the Federal Reserve's balance sheet.[21] Thus issuance of government debt ultimately leads to additional inflation when the central bank stands ready as the "lender of last resort" for government as well as troubled banks. Yet this type of inflation is a separate criticism from FRB, since in a fiat money system the central bank could still increase the amount of base money to purchase government debt, even in a system of 100 percent

reserves. In North's and Rothbard's criticism above, they allude to the counterfeiter as simply consuming from society with no positive value. Yet neither FRB nor government deficit spending is exactly analogous to the counterfeiter: the counterfeiter seeks to consume today without work, and he *never* intends to repay his consumption. The government ostensibly promises to pay back its use of resources in the future, when some other politician will have the courage to raise taxes that the current generation of politicians is unwilling to do.

But even in the generous case of assuming that at some point politicians will responsibly pay off the debt previous generations have incurred, note that it can only do so by taking assets away from the private sector: It does not produce any additional goods to share.[22] This is contrasted with private sector FRB; when credit is extended, it is always with a promise to pay back, with interest, out of the proceeds that the credit creation enabled. And should the future promises not be kept, the first to suffer would be the bank's equity.[23] The borrower in the FRB system desires current purchasing power and signs a contract to provide future purchasing power in exchange (which is *ex ante* a real amount in excess of that consumed in the present). Thus, the analogy of counterfeiting seems to fall short with FRB.

The basic idea of borrowers seeking purchasing power in the present in exchange for a greater amount of purchasing power in the future is certainly not immoral; it is the basis of all financial intermediation where borrowers are linked with savers. Yet in the traditional financial intermediation process, the saver must agree to release command over present resources for the borrower to obtain credit. This is clearly not the case in FRB, where any depositor correctly perceives his or her checking account as a present good, payable on demand.

Legal Response to Fraud Arguments

According to one definition of fraud, it "must be proved by showing that the defendant's actions involved five separate elements: (1) a false statement of a material fact, (2) knowledge on the part of the defendant that the statement is untrue, (3) intent on the part of the defendant to deceive the alleged victim, (4) justifiable reliance by the alleged victim on the statement, and (5) injury to the alleged victim as a result."[24] Does FRB meet this standard?

Selgin offers an alternative view to Rothbard of FRB's origins, which would implicitly deny each of these elements. Selgin notes that there is little evidence to support the conventional wisdom that goldsmiths decided to surreptitiously create additional warehouse receipts to gold stored in their vaults. In conventional wisdom, after the initial fraud benefited some goldsmiths, competition forced

other goldsmiths to do likewise and eventually all competed for depositors' funds by offering interest and other banking services. Selgin argues that FRB was common in Italy during the Middle Ages and likely practiced by both the Greeks and the Romans, thus predating the goldsmiths. Further, goldsmiths paid interest (or at least did not charge fees) from the earliest days, suggesting that deposits were not being treated as a bailment[25] but as a debt. Finally, contemporary testimony does not record goldsmiths being charged for embezzlement of funds.

While it is not denied that goldsmiths practiced FRB, Selgin argues they did not originate the practice, nor were their actions considered illegal at the time.[26] In Selgin's view, when customers saw improvements in services and reduction of fees, they knew what they were getting, hence there is no possibility of fraud:

> Because such innovations were only possible to the extent that goldsmiths profited by lending coin placed with them, and because they allowed depositors and note holders themselves to benefit from such lending, they supply strong *prima facie* grounds for supposing, not only that the goldsmiths' customers were perfectly aware of the fact that their balances due were only partly backed by coin reserves, but that the customers preferred this circumstance to one in which they were denied interest and assessed fees in return for having their coins locked away.[27]

Beyond Selgin's *prima facia* argument, the most significant legal case for FRB was *Carr v. Carr* in 1811, which determined that deposits at a bank were a debt, not a bailment.[28] This legal decision means that bankers are not required to keep deposits for safekeeping (as would be required if deposits were a bailment); their only legal requirement is to meet their contractual requirements to satisfy a debt obligation. Subsequent legal decisions reiterated the status of depositors' funds being treated as debts. To treat deposits as debts, which is what the courts have found them to be, means *de facto* is *de jure*—making the charge of fraud untenable.

Fractional reserve banking critics such as Rothbard acknowledge these cases have established the legality of FRB yet conclude these decisions were incorrect. As Rothbard laments, "Furthermore, if only special bank deposits where the identical object must be returned (e.g., in one's safe-deposit box) are to be considered bailments, and general bank deposits are debt, then why doesn't the same reasoning apply to other fungible, general deposits such as wheat? Why aren't wheat warehouse receipts only a debt? Why is this inconsistent law, as the law concedes, 'peculiar to the banking business'"?[29]

Yet the obvious (and often stated) rebuttal to those arguing that bankers must treat deposits as bailments is that this option is currently available via the safety

deposit box. Since consumers have not embraced this option, proponents of FRB suggest that the market has demonstrated a clear preference for FRB. Further, the frequency of bank runs prior to FDIC insurance suggests that customers well understood that banks were not keeping all deposits for safekeeping.

Biblical Response to Fraud Arguments

Rothbard's and Hoppe's fraud arguments are not compelling from a historical perspective, as argued by Selgin and White, and ultimately rely on the inability of banks to meet all claims simultaneously. Thus fraud can be fraud even if there is no deceit! This argument cannot be supported biblically.[30] If we were to extend fraud to Rothbard's criterion of inability to satisfy all potential claims, we would have to call most insurance plans fraudulent, since they are based on statistical incidence rates of death, disaster, and accident. We would have to outlaw all sales promotions that are limited to stock on hand, or indeed, any advertised sale prices. This extension of fraud is both practically and biblically problematic.

North's criticism of FRB seems to be the only biblically valid (as well as legal) criticism of FRB—that of fraud occurring when the monetary issuer deceitfully violates the implicit contract inherent in money. If a sovereign (or private mint) defines a monetary unit in terms of a certain weight of metal and, knowingly and deceitfully, does not meet their advertised standard, this action meets the legal definition of fraud outlined above, as well as the biblical standard noted by North. So does FRB necessarily violate North's biblical criteria? If consumers have both choice and understanding, if consumers are not coerced by legal tender laws to take money, and if they are informed as to what FRB entails, it seems hard to call this practice fraudulent. What if there were a sign in every bank, "WARNING: We practice Fractional Reserve Banking. This means that while generally you have immediate access to deposited funds, we may, at our discretion, temporarily deny requests for cash"? What if every banknote stated clearly that it was a debt? If people then freely choose to deposit their money with an FRB bank, how could this be fraud?

Is FRB Inherently Inflationary?

While critics call FRB "fraudulent" or "usurious," their moral criticisms are often buttressed by technical concerns. Our review of the process of money multiplication shows clearly that money supply creation leads to additional present claims to purchasing power, without a concomitant increase in real resources. With FRB, the banking system can create claims to current purchasing power

without anyone agreeing to abstain from current consumption. These new claims to purchasing power necessarily reduce the value of all previous claims, assuming all claims will be exercised. Joining Mises,[31] theologian R. C. Sproul Jr. highlights the negative effects of inflation on capital accounting (a technical concern) and then ties that to a moral conclusion: "Blame the government that sets itself above its own laws and the laws of God by practicing policies that debase its own currency."[32]

Even worse, according to some critics, the new claims will be spent immediately, becoming the first step in the price adjustment process. Borrowers will purchase at pre-existing prices, while previous money holders will find the price level rising and their dollars able to purchase less. Thus, another moral criticism of FRB is that it transfers wealth from those who have previously produced to those who have not. Rothbard highlights this inflation tax on the current holders of money, arguing that it changes the existing distribution of income.[33] As Hülsmann states, "Clearly, such incomes offend any notions of natural justice and are impossible to square with the precepts of Christianity."[34] Inflation not only benefits the recipients of new credit, but also businesses that receive new credit.[35]

If inflationary credit creation is large enough (and part of an ongoing process), such that it lowers the market interest rate below the Wicksellian natural rate, then it can generate a boom/bust business cycle.[36] In the Mises/Hayek business cycle framework, when the market interest rate falls below the natural rate, long-term investments (higher-order goods in Menger's terminology) are relatively more profitable than goods nearer to consumption. This artificial incentive drives increased investment (malinvestment) into higher order capital goods that do not reflect true consumer intertemporal consumption preferences. As consumers bid up lower order goods according to their true time preferences, inflation rises, ultimately driving interest rates back up to their natural rate. As interest rates rise, the boom will be shown to be false and the malinvested capital will have to be liquidated—the bust follows the boom. Business cycles often cause large societal harms, and the pain is not equally distributed. If FRB causes business cycles, it is a strong argument against the institution. A related criticism (mentioned in the introduction) is that FRB is inherently vulnerable to runs; this can lead to a deepening crisis and secondary depression.

A secondary depression is possible with FRB because, while inflation is created with new credit, the reverse is also true: When debts are paid off (or written off), deflation occurs. This is one of the reasons the Great Depression was so severe. When the banking system took bad loans off the books, the money supply dropped precipitously. Instead of the textbook money multiplier, it was a money

divider. Conventional macroeconomics considers money supply increases as enabling an increase in aggregate demand (AD), but as Friedman and Schwartz showed, the Great Depression is a tragic testimony of the power of monetary policy to contribute to a reduction in AD.[37] Thus a more complete criticism of FRB is that it could lead not only to inflation during an expansion but also deflation during a contraction.

Technical Response to FRB Inflation

The problems associated with inflation lead to two related questions: (1) Does FRB necessarily lead to inflation? (2) Would the problems noted above still result if FRB were not accompanied by legal tender laws and central banking? Whether FRB results in inflation depends on both the rate of growth of new claims as well as the growth in money demand. As is shown by the quantity theory of money, if the velocity of money is stable, money demand will grow proportional to economic growth. If new credit creation via FRB simply meets the requirements of new money demand, there will be no inflation.

Before we examine whether this is likely to be so, let us consider the impact of a growing economy in a banking system with a 100 percent reserve requirement. As the economy grows and produces more goods and services, there are only two possibilities (or a combination thereof): Either (1) the greater purchasing power of each monetary unit will lead to increased production of the monetary unit (with significant real resource costs if money is defined as a precious metal), or (2) all prices must adjust downward to reflect the increased relative scarcity of money. Resource costs of the gold standard are a primary objection of even those who favor sound money, and those costs increase under a 100 percent reserve system.[38] While both Mises[39] and Rothbard argue that conceptually any quantity of money will suffice to meet the needs of trade,[40] Mises highlights the possible painful adjustment process that FRB production of fiduciary media (e.g., banknotes) can avoid:[41]

> In fact, the development of the clearing system and of fiduciary media has at least kept pace with the potential increase of the demand for money brought about by the extension of the money economy, so that the tremendous increase in the exchange value of money, which otherwise would have occurred as a consequence of the extension of the use of money, has been completely avoided, together with its undesirable consequences.… [If not for these developments] the welfare of the community would have suffered."[42]

It is not a question of costs associated with inflation under FRB, compared with no costs for 100 percent reserve banking; there are potential costs and benefits with either institutional arrangement.

Are the inflationary costs of FRB greater than the costs of 100 percent reserve banking? This is where isolating the issue of FRB from central banking and legal tender laws is critically important. Under a system of free banking (no restrictions on note issue, no lender of last resort, no deposit insurance, and no legal tender laws), FRB *cannot* produce increased fiduciary media in excess of increased money demand (at least on a continuing basis). As Mises argues, no single bank is in a position to be able to expand its issuance of fiduciary media beyond the public's demand for it.[43] Due to the principle of adverse clearings (or alternatively, the law of reflux), unwanted notes will come back for redemption in the clearing process. Adverse clearings arise if banks issue notes in excess of demand by the note-holding public. If banks issue notes in excess, their reserves will fall as the public returns their notes for redemption; this will necessarily curtail further lending. Selgin has more fully developed the principle of adverse clearings, reaching an even stronger conclusion: As banks get larger, "the growth in total clearings will bring about a growth (though perhaps less than proportionate) in the variance of clearing debits and credits, which increases the precautionary reserve needs of every bank."[44] As White says, "While it is cheap to print up notes, or load smart cards with digital balances, and to put them into circulation, a bank can use currency issue to expand its portfolio of earning assets only if the currency *stays* in circulation."[45] For White, Mises, and Selgin, a system of free banking is likely to be the best institutional arrangement. Even North seems to agree with this assessment: "[I]n any case, the benefits of free banking, with or without the 100 percent reserve law, would provide a remarkably sound monetary system."[46]

Historically, free banking generally led to good results on most measurements (inflation, growth, financial stability, etc.), but proponents and critics of free banking can point to other factors which lead to good or bad results.[47] For example, the US free banking period in the 1800s was hampered by branch restrictions and requirements to hold state bonds as assets (both of which contributed to instability), while successful free banking in Canada and Scotland had quasi-central bank support potentially available (through politically favored banks).[48] But as Briones and Rockoff conclude, "A lot of good banking was done in lightly regulated banking systems … that could serve as models for sound banking systems."[49] In a review of over sixty historical free banking episodes, Dowd offers a stronger conclusion:

> First, historical experiences of free bankers were *not* prone to inflation. In apparently every case, free banks issued convertible currency whose value was tied to the value of some real commodity, usually gold. The price level was therefore tied to the relative price of the 'anchor' commodity, and if the banks had any ability to influence prices at all, it was distinctly limited.… It is worth noting that no free banking system ever abandoned convertibility, and wherever convertibility was abandoned it always took explicit government intervention to do it … [and] was always followed by later monetary expansion and inflation.[50]

Both the historical record and theory suggest free banking with FRB alone would not necessarily lead to inflationary problems, while avoiding the large real resource costs that would be necessary with 100 percent reserve banking.

Conclusion

We do not disagree with Hülsmann, a prominent Austrian critic of FRB, who argues, "Legal monopolies, legal-tender laws, and the legalized suspension of payments have unwittingly become instruments of social injustice. They breed inflation, irresponsibility, and an illicit distribution of income, usually from the poor to the rich."[51] Yet as this review has shown, FRB as an institution is not necessarily immoral. It is not inherently fraudulent if depositors are informed and freely choose a money issued by an FRB bank. Further, FRB is not likely to be inflationary if not combined with central banking (as a lender of last resort) and deposit insurance. And if there are no legal tender laws, consumers are free to choose a different money—in the absence of legal tender laws, Gresham's law will not hold—good money will drive out bad money rather than the reverse.

Even if not inherently immoral, FRB may still be extremely problematic—we have to consider what the real-world implementation of any monetary system would look like. Historically, political interference in monetary affairs has led to tremendous problems. As Hayek said,

> Though an indispensable requirement for the functioning of an extensive order of cooperation of free people, money has almost from its first appearance been so shamelessly abused by governments that it has become the prime source of disturbance of all self-ordering processes in the extended order of human cooperation. The history of government management of money has, except for a few short happy periods, been one of incessant fraud and deception. In this respect, governments have proved far more immoral than any private agency supplying distinct kinds of money in competition possibly could have been.[52]

Mises would agree.[53] His support of free banking was in large part due to his distrust of leaving any role for government in monetary management given the historical record of state interference in the banking sector to finance the state and/or to manipulate interest rates. Nevertheless, the state has always had (and seemingly will always have) a strong role in the provision of money—so what are the best monetary arrangements in the second-best world we live in? In a world of central banking and legal tender laws, perhaps a 100 percent reserve standard would be a superior solution. Yet, if a free banking system is ever a political possibility, there seems to be no moral reason to demand 100 percent reserves if the public prefers FRB.

Notes

1. John H. Cochrane, "Toward a Run-Free Financial System," Working Paper, 2014, http://faculty.chicagobooth.edu/john.cochrane/research/papers/run_free.pdf.
2. Martin Wolf, "Strip Private Banks of Their Power to Create Money," April 24, 2014, *Financial Times*, http://www.ft.com/intl/cms/s/0/7f000b18-ca44-11e3-bb92-00144feabdc0.html#axzz37w9l2IhY.
3. Two examples are N. Greg Mankiw's *Principles of Macroeconomics* and Frederic Mishkin's *Money, Banking and Financial Markets*.
4. See, for example, Murray Rothbard, *The Mystery of Banking*, 2nd ed. (Auburn, AL: The Ludwig von Mises Institute, 2008), 103.
5. This is likely due to the Austrian "micro" approach to money, with specific focus on how money is created and the intertemporal consumption coordination problems it can create. For economists who focus on the "macro" effects of money or on the long run neutrality of money (such as monetarists), their questions of morality tend to be on how inflation or deflation affects groups differentially, contrasted with the Austrian focus on how the inflation is created. Thus many orthodox economists would think an era of, say, one percent inflation as very good, while Austrians would question what is happening to specific industries and individuals, arguing that there are still relative price effects that raise moral questions.
6. George Selgin and Lawrence H. White, "In Defense of Fiduciary Media—or, We are NOT Devo(lutionists), We are Misesians!" *Review of Austrian Economics* 9, no. 2 (1996): 88–92.
7. Selgin and White, "In Defense of Fiduciary Media," 102–3. What actually constitutes free banking historically is difficult to precisely define, because the nature of the "free" part varies from episode to episode, whether it be freedom to issue banknotes, freedom to lend, capital requirements, and so forth. Briones and Rockoff suggest it

more properly should be thought of as "lightly regulated banking." Ignacio Briones and Hugh Rockoff, "Do Economists Reach a Conclusion on Free-Banking Episodes?" *Econ Journal Watch* 2, no. 2 (2005): 279–316.

8. Another alternative (and much more common) is that banks do not perfectly match intertemporal consumption desires; rather, for example, they may match an investor who requires $10,000 for five years with a saver who has $10,000 but only is willing to release the funds for two years. The bank is betting that they will find another lender in two years to continue funding; their equity is at risk if they cannot.

9. Bernard, W. Dempsey, *Interest and Usury* (St. James; London: Dennis Dobson Limited, 1948), 225.

10. Hans-Hermann Hoppe, "How Is Fiat Money Possible?—or, The Devolution of Money and Credit," *Review of Austrian Economics* 7, no. 2 (1994): 67.

11. Murray Rothbard, *The Case for a 100 Percent Gold Dollar* (Auburn: Ludwig von Mises Institute, 1991), 44–49.

12. Murray Rothbard, *The Case Against the Fed* (Auburn: Ludwig von Mises Institute, 1994), 39.

13. This is similar to Hayek's distinction between legislation and law; while something may be legislation (by either explicit legislation or through the common-law process of the judicial system), it is not necessarily law. As Hayek notes,

> Legislation, the deliberate making of law, has justly been described as among all inventions of man the one fraught with the gravest consequences, more far-reaching in its effects even than fire and gun-powder. Unlike law itself, which has never been "invented" in the same sense, the invention of legislation came relatively late in the history of mankind. It gave into the hands of men an instrument of great power which they needed to achieve some good, but which they have not yet learned so to control that it may not produce great evil. It opened to man wholly new possibilities and gave him a new sense of power over his fate. The discussion about who should possess this power has, however, unduly overshadowed the much more fundamental question of how far this power should extend. It will certainly remain an exceedingly dangerous power so long as we believe that it will do harm only if wielded by bad men.

Friedrich A. Hayek, *Law, Legislation and Liberty,* vol. 1 (Chicago: University of Chicago Press, 1973), 72.

14. Rothbard, *The Case*, 46.

15. Rothbard wrote, "The fundamental axiom of libertarian theory is that no one may threaten or commit violence ('aggress') against another man's person or property. Violence may be employed only against the man who commits such violence; that is, only defensively against the aggressive violence of another." Murray Rothbard,

"War, Peace, and the State," *The Standard*, April 1963, 2–5, 15–16, https://mises.org/rothbard/warpeace.asp. Since the process of FRB dilutes the value of one's property (the value of money), it is an act of aggression toward property.

16. Gary North, *An Introduction to Christian Economics* (Nutley, NJ: Craig Press, 1973), 6.
17. North, *Christian Economics*, 7.
18. North, *Christian Economics*, 8.
19. Ludwig von Mises, *The Theory of Money and Credit* (Indianapolis: Liberty Fund, 1981), 359.
20. "But it must be admitted that it is almost certain that by far the most powerful reason leading to the maintenance of Government intervention in the banking sphere, at a time when it was on the decline in other industries, was that power over the issue of paper money, whether such power is direct or indirect, is an exceedingly welcome weapon in the armoury of State finance." Vera Smith, *The Rationale of Central Banking* (Indianapolis: Liberty Fund, 1990), 19.
21. For example, in 2011, Lawrence Goodman reported that the Fed absorbed 61 percent of new treasury bond/bill issuance. See Lawrence Goodman, "Demand for U.S. Debt Is Not Limitless," *Wall Street Journal*, March 27, 2012, http://online.wsj.com/news/articles/SB10001424052702304450004577279754275393064.
22. This is not strictly true. To the extent that government spending supports capital infrastructure (as opposed to current consumption), there will be more total goods and services to consume. But in any case there will be a "broken window," or the question, "What would the private sector have done with the resources consumed by the public sector?"
23. Objections might be that this is not sufficient deterrent; with FDIC insurance and low capital requirements the equity owners do not suffer much. But this is not a problem associated simply with FRB and could equally apply with any financial intermediation. However, the solution is easy to understand (though hard politically to implement): simply raise the capital requirements of banks significantly. See Anat Admati and Martin Hellwig, *The Banker's New Clothes: What's Wrong with Banking and What to Do about It* (Princeton; Oxford: Princeton University Press, 2013) for an elaboration of the need for increased capital.
24. "Fraud," The Free Dictionary by Farlex, http://legal-dictionary.thefreedictionary.com/fraud.
25. A bailment arises when one party (the bailor) transfers possession (but not ownership) of a good to another (the bailee) for safekeeping. In a bailment, the bailee is required to steward the property pursuant to the agreement between the parties.

26. George Selgin, "Those Dishonest Goldsmiths," April 14, 2010, 6, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1589709.
27. Selgin, "Those Dishonest Goldsmiths," 9.
28. Rothbard, *The Mystery of Banking*, 91–92.
29. Rothbard, *The Mystery of Banking*, 93–94.
30. This does not mean FRB cannot be criticized biblically from other perspectives, simply that it does not meet the biblical standard of fraud as accurately described by North.
31. Ludwig von Mises, *Human Action: A Treatise on Economics* (San Francisco: Fox and Wilkes, 1966), 549.
32. R. C. Sproul, Jr., *Biblical Economics: A Commonsense Guide to Our Daily Bread* (Dallas, GA: Tolle Lege Press, 2008), 103–4.
33. Rothbard, *The Case Against the Fed*, 23–24.
34. Jörg Guido Hülsmann, *The Ethics of Money Production* (Auburn, AL: Ludwig von Mises Institute, 2008), 87.
35. Hülsmann, *The Ethics of Money Production*, 48.
36. Mises, *The Theory of Money and Credit*, 400–401.
37. See Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton: Princeton University Press, 1971), esp. chap. 7.
38. Milton Friedman was perhaps the most notable critic of the gold standard because of the associated resource costs. See Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), 41. However, Friedman later questioned the relative resource costs of a gold standard and fiat money, noting that fiat money itself may cause enough uncertainty that even more resources are used mining gold than under a gold standard, not to mention the many other costs associated with fiat money. See Milton Friedman, "The Resource Cost of Irredeemable Paper Money," *Journal of Political Economy* 94, no. 3 (June 1986): 642–47.
39. Mises, *The Theory of Money and Credit*, 379.
40. Murray Rothbard, *Man, Economy, and State* in idem, *Man, Economy, and State with Power and Market*, 2nd ed. (Auburn, AL: Ludwig von Mises Institute, 2009), 766.
41. These are costs that Rothbard (*The Case Against the Fed*, 21) did not see as necessarily true.
42. Mises, *The Theory of Money and Credit*, 333.

43. Mises, *The Theory of Money and Credit*, 362.
44. George Selgin, *The Theory of Free Banking: Money Supply under Competitive Note Issue* (Washington, DC: Cato Institute; Totowa, NJ: Rowman & Littlefield, 1988), 82.
45. Lawrence H. White, *The Theory of Monetary Institutions* (Malden: Blackwell Publishers, 1999), 59, emphasis original.
46. North, *Christian Economics*, 43.
47. It is beyond the scope of this paper to engage the free banking literature. However, the interested reader should begin with Selgin and White's excellent summary, "How Would the Invisible Hand Handle Money?" *Journal of Economic Literature* 32 (December 1994): 1718–1749.
48. Briones and Rockoff, "Free-Banking."
49. Briones and Rockoff, "Free-Banking," 315.
50. Kevin Dowd, *The Experience of Free Banking* (London: Routlege, 1992), 13.
51. Hülsmann, *The Ethics of Money Production*, 6.
52. Friedrich A. Hayek, *The Fatal Conceit: The Errors of Socialism* (London: Routledge, 1988), 103–4.
53. Mises, *Human Action*, 441–44.