Are free-market fiduciary media possible?

On Credit intermediation, banking, and money production in the free market*

ABSTRACT: Recent debates in monetary theory has centered on so-called free banking and its role in a pure market economy. In this paper we intend to tackle this question from a different angle, as we examine how and to what extend fiduciary media can emerge in a pure market economy.

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Introduction

There has in recent decades been a fierce debate among Austrian economists and monetary theorists about so-called free banking, which admits a large role for fractional reserve banking in the monetary system, versus what we here will call the full reserve school, which denies any social benefit from fractional reserve banking and the issuance of fiduciary media. A lot of the controversy has centered on the question whether fiduciary media – money substitutes not covered by reserves – are fraudulent or not and therefore whether they are at all legitimate in a pure free market based on complete respect for property rights and freedom of contract.

In this paper we intend to examine the question of the emergence of fiduciary media in a pure market economy, where all men and institutions, and specifically all banks, are subject to "the rule of common law and the commercial codes that oblige everybody to perform contracts in full faithfulness to the pledged word" (Mises 1981, 440). This is not a normative issue, but rather a fundamental question about how a free market monetary system would function absent all government intervention.

It is our contention that the full reserve theorists are mistaken when they insist that money substitutes must be interpreted as always being money titles, as this is at odds with the theory of value. A callable loan, for instance, can become a fiduciary medium if it is judged to be just as certain and serviceable as money proper by acting individuals. The free bankers too, however, are mistaken when they claim a large role for the circulation of fiduciary media in a pure market economy. It is fundamentally erroneous to consider a mere claim on a person or an institution as equivalent to money, and as all errors in the free market, it tends to be corrected in the process of entrepreneurial profit and loss, leading to the virtual elimination of all fiduciary media from the market economy.

Free banking school and full reserve school

There are two opposing, mutually exclusive positions in the debate on the status of fiduciary media: the free banking school and the full reserve school. The free bankers believe that fiduciary media are a useful part of the money supply, and that no fraud is necessarily involved in issuing them, while what we here term the full reserve school is of the opposite view: fractional reserve banking is necessarily fraudulent, and not only is it not beneficial, the use of fiduciary media is positively harmful, as it causes inflation, Cantillon effects, and the business cycle. While these controversies have a long history reaching back into the 19th century and the great British monetary debates, the current debate among modern Austrian and Austrian-inspired economists really started after the demise of Ludwig von Mises.

Both schools draw much inspiration from the works of Mises, but we are not here going to weigh in on the interesting question on just which side Mises, at the end of the day, came down in the debate. Some of his remarks (Mises 1998, 439) indicates sympathy for the full reserve principle, while he in other places (Mises 1998, 440) appears closer to the free banking school. It is therefore legitimate to consider him the common point of departure of both contending schools.

Murray Rothbard can be considered the founder of the full reserve school. He first clearly advanced the position that all fiduciary media are necessarily fraudulent, as he saw all money substitutes as titles to a sum of money (Rothbard 2008; 2005). He also categorically denied any economic advantage to society as a whole from the use of fiduciary media, and considered their use the basic cause of the business cycle as well as the problems of inflation (Rothbard 1963, 34–36). Other full reserve theorists follow this basic framework. Huerta de Soto has argued with a foundation in Roman law that money substitutes are a type of irregular deposit and therefore cannot be increased beyond the amount of money on reserve (Huerta de Soto 2009, 1–36, 119–24) and he too considers the elasticity introduced

in the money supply by their use as central to understanding the problems of the business cycle. Hoppe (2006b; 2006a) clearly enunciates the Rothbardian position, for instance when he writes (2006b, 200):

> "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."

While Murphy too belongs to the full reserve school, he has avoided engaging the question of legality in his recent contribution (Murphy 2019) and focused exclusively on the issue of distortions introduced by fiduciary media and fractional reserve banking. Philipp Bagus, David Howden (Bagus and Howden 2010) and their co-authors (Bagus, Howden, and Block 2013; Bagus, Howden, and Gabriel 2015) have entered the lists on behalf of the full reserve school, arguing for the impermissibility of fractional reserve banking, involving as it does a confusion between deposits and loans.

Salerno (2010) and Hülsmann (1996; 2003a) are also here placed in the full reserve camp, although their positions differ slightly from it. On the one hand, Salerno is fully in agreement with Rothbard when he says that "the 100 percent reserve requirement is not arbitrarily imposed from outside the market, but is dictated by the very nature of the bank's function as a money warehouse" (Salerno 2010, 362); on the other, he allows that in a fully denationalized system, the shares of banks or money funds, that invest part of their "reserves", may become the predominant means of payment in the economy (Salerno 2010, 364). Hülsmann for his part allows for the possibility of 'callable loans plus a redemption promise' (IOU + RP) circulating on par with money proper (Hülsmann 2003a). Both clearly, however, see no social benefit from stimulating the issue of fiduciary media and both think that

it is a historical truth that the vast majority of actually circulating fiduciary media were and are fraudulent, which is why we don't hesitate to include them among the ranks of the full reserve school.

The free banking school takes its modern beginning from the works of Lawrence White and George Selgin (White 1995; Selgin 1988; Selgin and White 1987; 1996) and also includes economists such as Kevin Dowd (1993) and Larry Sechrest (1993). The point at issue here, the possibility of fiduciary media in a free market, is a key component of free banking theory, and has been defended at length by the free bankers. The basic claim is that the issue of fiduciary media can take the legal form of a loan, or a note with an option clause. Historically, White (2003) has claimed, bank notes indeed took the form of a loan, not a title of ownership to underlying money. This is a strong argument against the full-reserve school's insistence on interpreting all money substitutes as ownership titles.

Given that a free banking system means freedom of contract, free bankers have argued that interfering with and redefining contracts, changing loans into deposits, would be incompatible with the system (Salin 1998) and an unwarranted imposition of the economist's own ethical judgments on other people (Rozeff 2010). Banks and their clients would be free to make whatever contracts they want, as these do not impinge on other people's property rights, thus clearly contradicting Hoppe's position quoted above.

Money and fiduciary media

It is clear that the point at issue is whether callable loans can come to circulate as fiduciary media. Issuing more money titles than the issuer has in his reserves would clearly be fraudulent, but it is by no means clear that issuing callable loans would. On the contrary, there seems to be nothing in this practice at odds with respect for property rights and freedom of contract. The basic question we have to answer is, would such loans circulate at par with money and thus be fiduciary media?

We will adopt Hülsmann's (2003a) idea of a callable loan plus redemption promise as our starting point,[1] but in order to solve the problem, we will have to go back and consider the essence of economic goods and money.

Carl Menger first described the prerequisites for a thing becoming an economic good (Menger 2007, 52ff), yet his account was still too objectivistic: where he thought that it was necessary for a thing to be objectively able to satisfy a human want in order for it to have goods-character, Mises corrected this (Mises 1998, 120–21). All that is necessary for a thing to become an economic good is that the acting individual believes that command over it will help him attain his goals; it is his subjective judgment of the suitability of a thing for satisfying his wants that confer value on a good. Man's judgment may be erroneous, and he may find from experience that he was wrong in thinking a thing a good – thus realizing that it was only what Menger termed an imaginary good (Menger 2007, 53–54) – but until he revises his judgment, the thing in question will continue to be a good, no matter what the objective facts of the case may be.

Wrong judgments are usually corrected when confronted with reality, as can easily be seen in the case of consumer goods and producer goods. For consumer goods, this happens when the individual realizes that he does not attain the end he thought he would by using it; e.g., when a man discovers that sea water is not good drinking water. For producer goods, an erroneous judgment concerning a good will be corrected when the production process in which the good, mistakenly thought to be suitable in this production process, fails. In both cases, what was previously considered a good immediately loses its goods-character once its employment in action proves that the actor's judgment was mistaken. Just as acting man profits from correct, so he loses from incorrect judgments. In other words, entrepreneurial

1 White's (2003) criticism of Hülsmann, that banks don't promise to pay but contractually obligate themselves to pay is, for our purposes, immaterial. What matters is how these claims are judged, not their legal nature.

profit and loss is the basic mechanism that teaches man to conform his thinking and judgment to reality, as wrong judgments are punished and correct judgments rewarded when confronted with reality.

The same holds true for money, although we cannot speak of correct and incorrect judgments in exactly the same way in this case. In a society employing gold as money, the acting individual will usually only accept pieces of gold in exchange and only consider his gold part of his money balance. Mistakes in this matter are usually quickly corrected, as other people will also only accept gold as money. A man may, for instance, think that lead is just as serviceable as gold, but he will quickly be disabused of this notion once he tries to pay with it. The crucial difference from consumer and producer goods is this: what gives money goods-character is exclusively the subjective judgments of individuals, that is, it is never confronted with reality in the same way. Whether a given commodity (or claim) is considered part of the money supply depends on how it is judged by other people in the community. To continue with the example of a man who thinks lead and gold are interchangeable: if his trading partners disagrees with this judgment, he will quickly realize that he was in error and that lead is not in fact gold. However, if other people accept lead as money in the same way as they do gold, lead becomes part of the money supply for as long as this mistaken judgment is not corrected.

Since money renders all its use in the act of exchange, erroneous judgments may persist for longer here than in other areas of economic life, but there are powerful incentives at play to verify and certify the money commodity. Nobody has an interest in receiving false coins or bad checks in exchange for their goods, and the precious metals gold and silver were selected as money to a large extent because it is comparatively easy to distinguish them from other materials (Menger 2009). In the case of modern paper money, a lot of care is taken to ensure that genuine money are easily distinguished from fakes, for instance by using a special quality paper, watermarks, magnetic strips, and so on.

This brings us back to callable loans and their possible use as fiduciary media (Hülsmann 2003a). In the normal course of affairs, we would expect a loan to be valued according to its maturity and its safety, that is, when would it come due and how certain is it that the debtor will be able to pay. Both of these factors would impose a discount, as individuals would tend to judge a loan, even if instantly redeemable, as less valuable than actual possession of the amount of money in question. This is so since objectively, such loans can never be as secure as money proper or fully secured money certificates – there is always some uncertainty attached to them.[2] However, as we have just argued, the primary factor in establishing a thing as a good is the subjective judgment of individuals, and there is nothing to stop people from subjectively deeming callable loans on a par with money certificates, and they may therefore gain the status of fiduciary media and constitute part of the money supply without any fraud or other violation of property rights having been committed.

That said, this does not mean that such loans will constitute money substitutes for any length of time. There is first of all the problem that the community as a whole has to accept the loan as a money substitute. One individual may have no doubts on the matter, as he trust the issuing bank implicitly; but he cannot force other people to accept the claims at par value, and until everybody does so accept them, they will trade at a discount to money. While the clients of the same bank may treat its liabilities as equivalent to cash in their mutual exchanges, it is not clear how they can induce those who are outside the bank's orbit to accept them at par.

Secondly, a claim's character as a money substitute depends on there never being any doubt as to its safety and ability of the issuing institution to redeem it in full without delay. What the issuer requires to maintain his credit is a special kind of goodwill, without which the fiduciary media will immediately lose their character as money. Mises explained this very lucidly (1998, 442):

2 The only exception would be the case where the debtor kept on hand full reserves at all times.

> “What makes a banknote a money-substitute is the special kind of good will of the issuing bank. The slightest doubt concerning the bank's ability or willingness to redeem every banknote without any delay at any time and with no expense to the bearer impairs this special good will and removes the banknotes’ character as a money-substitute. We may assume that everybody not only is prepared to get such questionable banknotes as a loan but also prefers to receive them as payment instead of waiting longer. But if any doubts exist concerning their prime character, people will hurry to get rid of them as soon as possible. They will keep in their cash holdings money and such money-substitutes as they consider perfectly safe and will dispose of the suspect banknotes. These banknotes will be traded at a discount, and this fact will carry them back to the issuing bank which alone is bound to redeem them at their full face value.”

Yet since loans are inherently less certain than money or true money titles, accepting them on par with money constitutes an entrepreneurial error no less than in the other cases of mistaken identity detailed above. The status of any claim as fiduciary media is therefore, we suspect, inherently perilous on the free market. As soon as the slightest doubt arises as to the issuer’s ability to redeem them in full and without delay – as soon as he loses the goodwill of the public – all his circulating credit will lose its character as fiduciary media, trade at a discount to money and return to the issuer.

In an advanced economy, people will often employ what Mises termed secondary media of exchange (Mises 1998, 459–63): various nonmonetary goods that nevertheless possess a high degree of marketability. By employing these in transactions, men may economize on the need to hold cash. Callable loans, bills of exchange and other financial instruments and claims have been employed in this role, and this extra demand for these claims have lowered their yield and stimulated their issue. This, however, does not change their character into that of money substitutes, and it is unlikely that they will jump this divide. After all, the issuers of secondary media are in precisely the same difficulty as we

detailed above: they will have to invest the borrowed funds in order to make a return, leaving him unable to at all times “redeem” the claims at par.[3] The fact that these secondary media are heterogeneous, different products, and thus requires a separate evaluation in each case, is also significant, as it imposes a cost on their use as media of exchange.[4]

Banking and the confusion of demand for money and demand for credit

One of the main claims of the free bankers is that a flexible money supply is necessary to compensate changes in the demand for money. An increased demand to hold money is in their system met by an increased issue of fiduciary media in order to maintain monetary equilibrium. This, however, overlooks the fact that there is no reason to consider the supply of money fixed, especially not on a gold standard, as we have here been assuming. There is also no reason to assume that an increased demand for money has to be compensated in any way: increased demand for money necessarily implies a decreased demand for non-monetary goods and should therefore naturally lead to lower prices. In the short run there may be instability and a prolonged adjustment period caused by “sticky” prices, as entrepreneurs are unwilling to adjust their prices downward. However, the process of entrepreneurial profit and loss will quickly overcome this, as those entrepreneurs who make the necessary price adjustments profit at the expense of those who are reluctant to do so: the longer an entrepreneur refuses to sell his inventory at the market price, the greater his loss will be. It is therefore unreasonable to suppose that sticky prices will be a long-term problem in the absence of government intervention.

3 “Redemption” is here just a metaphor, as there is no legal obligation to redeem in the case of secondary media.
4 Perhaps the main secondary medium used today is US treasuries. The fact that these do not trade at par and is not considered part of the money supply indicates that even in the absence of the problem of heterogeneity, secondary media cannot jump the gap and become money substitutes.

In any event, should the demand for money increase, the purchasing power of money (gold) will increase and stimulate the supply of money (White 1999, chap. 1; Herbener 2002). While this may be a slower response than issuing fiduciary media, there is no reason to assume that the money supply could not adjust to increased demand for money in the absence of fractional reserve banking.

In the free banking system, the issuance of new money takes the form of loans, which means that increased demand for money is mistaken for an increased demand for credit. It is here immaterial that the new loans are of very short, i.e., instant, maturity, as this does not matter for the credit structure (Machlup 1940). It has been argued that increased demand for money is a form of saving, and that it is therefore legitimate to transfer these savings from the savers to investors by means of fiduciary media, but even though we may grant that increasing one's cash balance can be increased saving, it does not follow that more credit should be extended.

Holding any kind of asset instead of using it amounts to savings-investment (Hülsmann 1996, 34), as it necessarily means that resources are allocated to an expected future need instead of being consumed in the present. This is also true of money and thus of increased demand for money. This does not, however, mean that additions to people's cash balance are available to be invested; rather, they constitute a peculiar form of investment. Following Bagus and Howden (2010, 41), we may say that there is a continuum of investment projects of different duration. Investing in cash balances is peculiar in that money is the present good par excellence (Rothbard 2009, 375), and increasing one's cash balance therefore does not liberate resources for more roundabout projects – quite to the contrary, as it is possible that increased demand for money reflects decreased demand for investments of longer duration.

If we examine the fundamental cause of demanding any money at all, we realize that money is not only the present good par excellence, it is also the most certain good, as we avoid all the uncertainties

affecting particular consumption goods and investment opportunities when we add to our cash balances instead of buying consumer goods or investing our money. We can elucidate this by considering the quality of money (Bagus 2009; 2015): Money of high quality is such as can be expected to maintain a stable or increasing purchasing power in the future, while money of lower quality is that which is expected to lose purchasing power. On a gold standard, for instance, money production will be constrained by the same factors that constrain the production of other goods. Additional money will only be produced if there is a sufficient return, that is, a sufficient spread between the quantity of product (in gold ounces) and expenditures (in gold ounces) (Hülsmann 2003b).

It is therefore possible to forecast with some accuracy the future evolution of gold's purchasing power, and it is reasonable to expect it to be stable or even increasing slightly. Fiat paper money, on the other hand, is completely subject to the policies of the issuing institution, which may have to serve political interests at odds with sound monetary policy, and which may be guided according to erroneous economic principles. Even a relatively sound central bank is always at risk of being taken over by more inflationary leaders, which introduces an element of uncertainty that simply does not exist in the case of commodity money.

This does not mean that money is an absolutely certain good, only that it is usually the comparatively most certain way of investing one's resources in the market. Holding any money at all, then, is fundamentally a hedge against uncertainty (Rothbard 2009, 264–65), and adding to one's cash balance is therefore best understood as an investment in reducing one's felt uncertainty (Hoppe 2012).

Money, considered as an investment object, is therefore at one end of two spectra: it is the most present good, and stands at one end of the spectrum of investment possibilities considered with respect to their duration; and it is the most certain good, and thus at one end of the spectrum of investment possibilities when considering their risk or uncertainty. Consequently, a man who, wanting to add to his cash

balance, increases his holding of fiduciary media, is fundamentally in error: he wants to reduce the uncertainty of his investments by increasing his cash balance, but fiduciary media are precisely *not* the most certain investment option; they are claims on other people, whether individuals or institutions such as banks. As such, they are always liable to the risk of default and nonpayment. Wanting to increase his uncertainty, by increasing his holding of fiduciary media, the individual renders himself liable to lose all if the issuing institution suspends redemption.

It follows also from this insight that the doctrine that increased demand for money liberates resources for investment is fundamentally wrong. What the acting individual wants in holding fiduciary media is control over present goods (Rothbard 2009, 800ff), not future goods, and he therefore does not invest in a longer production structure when he increases his cash balance.[5] Demand for money is not demand for loans, but by mistaking fiduciary media for money certificates, the individual unwittingly extends credit. As with all errors of judgment, it is liable to be corrected by the mechanism of profit and loss. Specifically, the individual may find one day that he cannot redeem his claims at par, or someone else has realized this already, and as the issuing institution has lost the good will of the market, the claims now circulate at a discount and are no longer part of the money supply.

It is also possible that entrepreneurial error takes another form, as the acting individual may recognize that fiduciary media are not money of the same character as cash, but he judges it a safe investment anyway as other people are willing to accept it on par with money. Since he recognizes the difference he may very well think himself able to profit from the interest on media while still being able to realize his assets before the claims lose their money-character, as he judges he will always be able to get rid of them at par – or at least do so before the rest of the populace panics and a bank run develops. Fiduciary media and fractional reserve banking are fundamentally unstable institutions however, and always

5 This is not meant to imply that increasing one's cash balance necessarily shortens the production structure. If the cash balance is increased by reducing consumption, it may be that the production structure is actually lengthened.

liable to collapse. In that case, the prudent entrepreneur who thought he could get out in time will be just as trapped as anybody else.

Theory and history

The free bankers often look to the historical record to bolster their position. After all, there is clear evidence from many countries that had a more or less free banking system in the past, that fiduciary media circulated widely. Canada, Sweden, Scotland and Switzerland are some of the countries used as examples (White 1995; Fink 2014).

We do not intend here to examine these examples in detail, but would rather suggest that the free bankers are mistaken, at least from a Misesian viewpoint, in looking to the historical record for confirmation of their theory. The historical record does not speak for itself, it always has to be interpreted and explained according to the independently developed praxeological science (Mises 1962, 41–46). The theory of money and fiduciary media has to be elaborated in order that we may explain the historical record.

Rothbard (2008, 269–91) and Murphy (2019) have questioned the validity of some of the historical episodes advanced in support of fractional reserve free banking, and White (2003) has criticized Hülsmann on the basis of the historical record of Scottish banking, but these questions, strictly speaking, are irrelevant to the theoretical issue. If we had no historical examples of free banking and yet believed the free banking theory was correct on theoretical grounds, we would have to conclude that free banking was the proper monetary system under conditions of strict laissez-faire. Conversely, if the full reserve theorists are correct, even were there no evidence at all to suggest that historical free banking relied on special privilege and government support, we would have to conclude that this lack of evidence did not mean conditions of laissez-faire prevailed. Rather, we would have to conclude that

the historical record was deficient and that somewhere some institutional deficiency or government intervention created the system of fractional reserve banking. For instance, we may suspect that fiduciary media were somehow favored in exchange by the government, which would at the very least bring Gresham's law into operation.

The theory of the origin of money may provide a useful illustration of this. Today we have rather good information of the historical record, which is clearly most favorable to the Austrian theory of the spontaneous emergence of money (e.g., Le Rider 2001; Kroll 2008). Yet even in the absence of any historical evidence, we would have to conclude that Menger's account of the origin of money (Menger 2009) would have to be true, as Mises has proven this conclusively on theoretical grounds (Mises 1981, 110ff) in the course of elaborating his famous regression theorem.

Conclusion

We have in this paper examined the question of fiduciary media and their possible existence on the purely free market. While we have to disagree with Rothbard when he claims that all money substitutes have to be interpreted as money titles, we are in the main in agreement with what we have here termed the full reserve school, but which is perhaps best understood as the modern version of the Currency School. Fiduciary media will not have any role to play in a free market. While they can exist without involving fraud, they can only exist due to entrepreneurial error: specifically, due to individuals erroneously judging an uncertain claim to money as certain as a money title or money proper.

As all errors on the market, this erroneous judgment and its consequences will tend to be temporary, ephemeral and self-correcting, as the reality of the situation asserts itself. Since there are no institutional causes for the emergence and spread of fiduciary media in the free market, these will tend to be local and temporary, as people unfamiliar with the claims in question will not accept them in lieu

of money. In the same way, the societal consequences of fractional reserve banking – malinvestment, inflation, and so on – will also be very limited in scope.

Finally, while we have stated our case forthrightly and without hedging, it is perhaps fitting to end on this note of warning from Mises (1998, 444): "It is extremely difficult for our contemporaries to conceive of the conditions of free banking because they take government interference with banking for granted and as necessary."

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