

APPENDIX I: ON WHETHER HONEST BANKING CAUSES BUSINESS CYCLES.

—WHERE WE REPLY TO THE CONTENTION THAT “HONEST BANKING DOES ALSO CAUSE BUSINESS CYCLES.
HENCE, THE IDEA THAT FRAUD LIES AT THE ROOT OF THE BUSINESS CYCLE IS INVALID.”

Imaginary wealth is exchanged for real wealth; and the real wealth
is consumed by those who have produced nothing in place of it.

— *Garet Garrett*

Introduction

The critic who believes also honest banking can cause business cycles would have good reason to use this as an argument against our present thesis; in order to confidently state that fraud is the general cause of *all* business cycles, it must be clear that *only* fraudulent practices, and never bona fide practices, can cause business cycles. We therefore invite the reader to join us in investigating the case in which all parties that are involved with the financial activities of a certain fractional reserve bank are perfectly aware of what happens with the money that is entrusted to that bank, i.e., the case of honest fractional reserve banking.

There are a number of theorists who have already analyzed this possibility. In a 1996 article, Walter Block and Kenneth M. Garschina, discuss the argument that fractional reserve banking can be practiced in an honest fashion. They acknowledge that this is logically possible, but hold that it is nonetheless “implausible”.¹ Next, Guido Hülsmann discusses the possibility of honest fractional reserve banking in his 2000 article, “Banks Cannot Create Money”.² He similarly concludes that the practice is possible, and admissible (since “no law should suppress any foolish activity just because it is foolish”), but nonetheless “would lead a fringe existence in a truly free economy”. Jesús Huerta de Soto (1998), as we understand him, holds that “honest” fractional reserve banking can not be justified at all, because even the use of an option clause will never prevent third parties from being affected by the harmful effects of fractional reserve banking.³ De Soto's argument is fairly short, and it is

1 Walter Block and Kenneth M. Garschina, “Hayek, Business Cycles and Fractional Banking: Continuing the De-Homogenization Process”, published in *The Review of Austrian Economics* 9 (1)(1996): 77-94. Block and Garshina use the example of the “fractional reserve parking lot”, whereby the owner of the parking lot (analogous to the banker working with fractional reserves) does not sell the right to a parking lot, but rather the chance to find a free parking lot where one can park his car; a “lottery ticket for money”. In the words of the authors:

“If the “fractional reserve parking lot” were to be an accurate analogy to monetary practice, instead of being called a “demand” deposit, it should be called “purchasing a lottery ticket for money” or some such. Further, in every other way—publicity, explicit contracts, etc.—banking procedures would have to be brought into line with parking lot practice. Then, and only then, could the charge of fraud be dropped. Under such conditions there would still be the empirical question of whether or not anyone would purchase a “lottery ticket money deposit”.

In a later article by Walter Block and William Barnett II, where the authors discuss the possibility of the honest fractional reserve bank at length, the notes issued by honest fractional reserve banks are called “play money”, and “monopoly money”. See “In Defense of Fiduciary Media—A Comment; or, What's Wrong with “Clown” or Play Money?”, *The Quarterly Journal of Austrian Economics*, Vol 8, No. 2 (Summer 2005): 55-69.

2 Jörg Guido Hülsmann, “Banks Cannot Create Money”, *The Independent Review*, v.V, n.1, Summer 2000, ISSN 1086-1653, pp. 101–110.

3 “However, even if a “safeguard” clause were introduced and participants (bankers and their customers) were fully aware of it, to the extent that these individuals and all other economic agents subjectively considered demand deposits and notes to be perfect money substitutes, the clause referred to would only be capable of preventing the immediate suspension of payments or failure of banks in the event of a bank run. It would not prevent all of the recurrent processes of expansion, crisis and recession which are typical of fractional-reserve banking, seriously harm third parties and disrupt the public order. (It does not matter which “option clauses” are included in contracts, if the general public considers the above instruments to be perfect money substitutes.) Hence, at most, option clauses can protect banks, but not society nor the economic system, from successive stages of credit expansion, boom and recession.” Jesús Huerta de Soto, *Money, Bank Credit, and Economic Cycles* (Auburn, Ala.:

hard to figure out whether his analysis is to be considered in a context of centralized planning of money production (legal tender, central bank) or rather in the context of free and decentralized coinage. Still and all, to us it seems only fair not to assume failure, but to grant our adversaries in this issue an fair chance by assuming that the honest businessman who believes in fractional reserve banking can actually find a contract that is indeed harmless both to his contracting clients as well as to third parties. It is with this assumption in mind that we begin our investigation into the nature of such a contract. Once we have more clarity on what that contract entails, we can investigate what the economical effects of its implementation could be (i.e., whether it can cause business cycles).

Reply to the objection

For the purpose of clarity, let us restate the objection: “Honest banking does also cause business cycles. Hence, the idea that fraud lies at the root of the business cycle is invalid.”

On the contrary, we hold that truly honest banking can never lead to business cycles. Fractional reserve banking differs from 100 percent reserve banking by the fact that the fractional reserve banker does not safekeep a part of the money that has been entrusted to him, but goes on to use it as if it is his own: speculating, writing out loans, etc. As a consequence, the bank in question cannot at all times repay the agreed upon sum to its customers. The customer of the honest fractional reserve bank is aware of this. This means that the client's entitlement to immediate availability can not be part of the contract between the banker and the client. In other words, the fractional reserve banking contract *cannot be a deposit contract*.⁴ In his article “Should we Let Banks Create Money?”, George Selgin recognizes this fact, and uses it to answer his adversaries in the free banking debate:

“In a recent twist on the conventional fraud argument, Hans-Hermann Hoppe and his co-authors (1998) argue that holders of fiduciary media are, in fact, not victims of bank fraud at all but co-conspirators who assist bankers’ fraudulent undertakings by misrepresenting themselves “as the owners of a quantity of property that they do not own and that plainly does not exist”. Apart from begging the question of who are the victims, this novel fraud argument is based on a simple failure to recognize that redeemable banknotes and deposit credits are not “titles,” as Hoppe and his co-authors claim.”⁵

An additional reason why it is not possible for an honest fractional reserve banker to make use of a deposit contract is the fact that deposit contracts presume no transfer of property; the deposited goods are at all times to be kept safe by the depositary for the depositor. However, precisely by assuming command over his reserves and using them for his own benefit, the honest fractional reserve banker confirms to us that he does not safekeep them at all. In fact, the only possible way whereby a person can justifiably use goods as if they were his own, as the fractional banker does, is by becoming their *actual owner*. Thus, given that in any valid and sound contract the essential facts should be accurately and adequately described, the contract with the honest fractional reserve banker should evidently not be a deposit contract, but instead a contract in which the transfer of property is described in clear terms.

Now, in the course of history, people have come up with a classical solution for transfer-of-property agreements whereby one party accepts money or goods from an other, not to safekeep it for the latter, but to put it to use for himself. Given the fact that within such an agreement it is technically impossible that the trustee always keeps the goods required to be returned available to the trustor, another kind of contract was designed to deal with these circumstances: the loan or *mutuum* contract.⁶ This loan or mutuum contract requires that both

Ludwig von Mises Institute, 2006) , p. 163.

He reiterates his position in chapter 8 of the same work:

“For even an agreement found satisfactory by both parties is invalid if it represents a misuse of law or harms third parties and therefore disrupts the public order. This applies to monetary bank deposits which are held with a fractional reserve and in which, contrary to the norm, both parties are fully aware of the true legal nature and implications of the agreement.” (Ibid., p. 711-12)

4 “. . . if a person knowingly puts money into an interest-bearing account, this contract would *ex hypothesi* not be of the deposit contract type.” Ludwig van den Hauwe, *Foundations of Business Cycle Research*, p. 1239. For an elaborate discussion, see Jesus Huerta de Soto, *Money, Bank Credit, and Economic Cycles*, chapter 1.

5 George Selgin, “Should We Let Banks Create Money?”, *The Independent Review*, v.V, n.1, Summer 2000, ISSN 1086-1653, p. 96. Selgin refers to the article “Against Fiduciary Media”, which is mentioned further in the text.

6 Isidore of Seville, the seventh century church father, wrote in his authoritative work *Etymologies*: “Something borrowed is named *mutuum* because, that which is given to you from me, becomes yours from mine, *ex meo tuum*.” Priscilla Throop, *Isidore of Seville's*

contracting parties agree beforehand on a set term, whereby the debtor commits himself to have the loaned goods, or their equivalents (goods of the same quantity and quality), plus a possible extra fee (the interest) available for the lender by the end of the term. Writes Jesús Huerta de Soto:

“... a *fixed term* is an essential element in the loan or *mutuum* contract, since it establishes the time period during which the availability and ownership of the good corresponds to the borrower, as well as the moment at which he is obliged to return the *tantundem*. Without the explicit or implicit establishment of a *fixed term*, the *mutuum* contract or loan cannot exist.”⁷

Let us consider for a moment the proposal of a proponent of fractional reserve free banking, just to see whether the fractional reserve contract as he describes it can be classified as a loan contract. In the article we just quoted, George Selgin maintains that fractional reserve bankers in fact engage in an IOU with their customers:

[Redeemable banknotes and deposit credits] are ... IOUs, so there is nothing inherently fraudulent about there being more of them in existence at any moment than the total stock of what they promise to deliver. ... A person who deposits gold in a bank in exchange for a redeemable banknote does not retain ownership of the gold, but instead gives it up, albeit for an indefinite period of time.⁸

George Selgin thus holds that the contract of the fractional reserve banker with his customers is an IOU whereby the trustee can postpone his repayment “for an indefinite amount of time”. Selgin's proposal implies, first, that the means given up by the trustor to the trustee are given up by the former “for an indefinite amount of time”, and second, that there is no fiduciary duty at all: the banker can freely choose to postpone his repayment indefinitely. This certainly is not a loan contract, because as Selgin acknowledges, in fractional reserve banking there clearly is no fixed term. This illustrates the fact that for our investigation into the possible nature of the honest fractional reserve banking contract, we have to rule out the loan contract as well.

We can now come to a first important conclusion, namely that the bona fide banker who works with fractional reserves is *neither a depositary, nor a debtor*. The pieces of paper he writes out to his customers in exchange for their money are not directly exchangeable property titles (deposit receipts), nor titles for reimbursement at a previously set term (loan receipts). But what can they be then? Below we show, in line with de Soto, that the only remaining possibility for a practice whereby both the fractional character of the reserves, as well as the bona fide character of the contract remain intact, is that the paper received by the customers be “gamble tickets”.

Let us begin by repeating that a fractional reserve bank is by definition (exactly because it does not hold a 100 percent reserve) not able to repay at all times the sums of money that appear on the banknotes. This means that customers of this “honest” bank, when they close an agreement with the bank, must be fully aware that they not only give up the full ownership of the money handed over, but moreover that they explicitly, *embedded in the agreement*, acknowledge that there is a real and significant chance that they will not see the sum of their investment again. If the banker fares well and if the customer exchanges his bank note in time, the latter can make a good profit. However if the banker ends up in dire straits or if the customer in question is preceded by too many others in exchanging his notes, then he will lose his entire investment. Given the fact that we here assume full transparency, both possibilities must also be clearly described in the contract between the honest fractional reserve banker and his customers. In other words, it should be perfectly clear for the customer that he does not buy the service of safekeeping (that would be a deposit), and neither does he buy future goods (this is the case with a loan), but rather what is bought is the *chance* to win back a larger sum than his original investment. This should be made clear to him in what is commonly called an “option clause”.⁹

Etymologies: Complete English Translation, (Charlotte, Vermont: Medieval MS, 2005), v.25.13. In so doing, he followed the 2nd century Roman jurist Gaius. The modern interpretation, however, is that *mutuum* derives from "mutare", which means "to change", "to swap", and which is related to "munus", a "friendly turn". For a commentary on the etymology and history of the *mutuum* contract, see Reinhard Zimmerman, *The Law of Obligations: Roman Foundations of the Civilian Tradition*, (New York: Oxford University Press, 1996), pp. 153-187. See also Jesús Huerta de Soto's authoritative *Money, Bank Credit, and Economic Cycles*, pp. 2-4 (section "Mutuum") and pp. 119-146 (section "Why it is Impossible to Equate the Irregular Deposit with the Loan or Mutuum Contract").

7 Jesús Huerta de Soto, *Money, Bank Credit, and Economic Cycles*, pp. 3-4. Italics in original.

8 George Selgin, “Should We Let Banks Create Money?”, *The Independent Review*, v.V, n.1, Summer 2000, ISSN 1086-1653, p. 96. In the IOU (“I owe you”) as proposed by Selgin, the “debtor” can postpone his repayment indefinitely and thus does not factually owe anything to the beneficiary. Also when seen from a more general judicial perspective, we can say that the contract Selgin describes does not count as a trust, which we defined as an act (or series of acts) that is regarded as beneficial in the eyes of the trustor, in return for one or more favours from the part of the trustor”. If the trustee can postpone the favor he owes the trustor indefinitely, there is no (fiduciary) *duty*—and thus no trust. The contract Selgin proposes is a meaningless agreement because it is unrealizable, and thus null and void by means of an *error in negotio*. For a detailed discussion on the *error in negotio* related to deposit and *mutuum* contracts, see again *Money, Bank Credit, and Economic Cycles*, p. 142-146.

It should be clear that a bank such as we've just described would be (as far as we know) an unseen anomaly. However, it is only in this way that a banker operating with fractional reserves can remain an honest businessman: neither the deposit contract nor the loan contract suffice to describe the practice of fractional reserve banking. An idealistic or foolhardy entrepreneur that would attempt to establish a bank on the basis of the contract as described above, would probably, sooner rather than later, find himself tempted to draw a veil over the contents of the contract, to minimize the risks in its description, or to unjustifiably present the seemingly permanent availability of the goods entrusted to him as real. However, by doing so, he would immediately end up joining his mala fide colleagues who choose to not reveal their customers the truth of the matter, with the familiar consequences of malinvestment, overconsumption, and the inevitable boom, crisis, and depression.

When we take a closer look at the contract of our honest fractional reserve banker, we in fact note, concurring with de Soto, that it is an *aleatory contract*, whereby the services delivered by the bank are “in any case an uncertain event which depends upon circumstances particular to each case”.¹⁰ From this it follows that the banker, as long as he gives an “honest chance” (according to the rules of “the game”) to his customers, for example by not dishonestly giving privileges to certain among them, *cannot go bankrupt* if all or a lot of his customers at the same time decide to exchange their bank notes. After the “bank run” the counter is reset to zero, and customers have to wait until enough people have bought new gambling tickets and enough time has passed to take their chance to reap a profit. And so in the case of honest fractional reserve banking we are dealing with a situation where, analogous with the world of casino's, “the bank always wins”. Of course, our bank can go bankrupt because of bad management, but the point of importance is that it is not *inherently* bankrupt: there is no stock of goods the customers of the bank can justifiably claim as “theirs”, because they've clearly given up their initial ownership in exchange for a *chance* to win it back at some future point in time. In an honest fractional reserve bank as described above, the banker is never obliged to hold reserves beyond the amount he himself chooses (and/or the customer allows him) to hold. We can even state, in line with Ludwig van den Hauwe, that in this case there are no reserves at all, because “[a] bank cannot hold “fractional reserves” if the money it is not holding in reserve is money the bank isn't supposed to hold in reserve in the first place”.¹¹

The nature of the only possible contract between a fractional reserve banker and his customers, as described above, is specific enough for us to come to a conclusion *vis-a-vis* the effects it can produce in the economy. The situation is as follows: the transparent operation of the honest fractional reserve bank allows its customers to know very well which risks they take by buying bills from the bank; they buy reliable fiduciary tokens, tokens with a title that describes the conditions of the formal relationship between the banker and his customer in an adequate way. These conditions are that the customer has the right to an “honest chance” in winning back the sum of his investment, plus a premium. Customers of the honest fractional reserve bank thus know perfectly well that this bank is not the best place to rely on for their old day, in the same way as that people usually do not put all their life savings on the betting table in the next casino. Because the customers of our bank are not deceived or misguided, there are also no deceitfully inflated expectations and no malinvestments (on top of the usual entrepreneurial errors) that take place. At the point of a general “bank run”, the losers may be disappointed, but they are not experiencing anything beyond their reasonable expectations. In short, *honest fractional reserve banking does not produce the familiar effects that lead to boom, crisis, and depression; it does not bring about business cycles.*

Now, how likely is it that, in a free market environment, this kind of “banking” would become widespread? We hold that it is very small.¹² In a free market, honest fractional reserve bankers would find it very hard to compete with the bills written out by their competing “full-reserve” bankers. The fractional reserve bills will have

9 For Jesús Huerta de Soto's discussion of the option clause, see his *Money, Bank Credit, and Economic Cycles*, p. 710-712, and the passage quoted above in footnote 93.

10 *Money, Bank Credit, and Economic Cycles*, p. 142.

11 Ludwig van den Hauwe, *Foundations of Business Cycle Research*, p. 1239. This is the full quote:

“One can even argue that it is nonsensical to speak of the keeping of “fractional” reserves on which contracting parties would have agreed. How can a bank keep “fractional” reserves if it keeps exactly the amount of reserves it is supposed to keep by the customer (because this is what they both agreed to)? A bank cannot hold “fractional” reserves if the money it is not holding in reserve is money the bank isn't supposed to hold in reserve in the first place.”

Van den Hauwe further states, on the same page:

“Only if the bank and its client have—*ex hypothesi*—concluded a deposit contract does it make sense to impose and enforce a prohibition on fractional-reserve banking by force of law. This prohibition amounts to no more than that the bank should honour its contractual obligations.”

a low relative saleability on the market (most people do not have a high preference for gambling), which is why the chance that these bills will at a given point be seen and used as real money, which is exactly defined by its high saleability, becomes very small.

Finally, after having analyzed the nature of the only honest contract thinkable between a fractional reserve banker and his customers, after having established that such a practice would not lead to business cycles, and after having demonstrated the low likelihood of such a model becoming widespread in a free market, we may question the name “honest fractional reserve bank” itself: is it suitable to use the word “bank” for an institution that is no financial intermediary nor a safekeeper of deposits, and whose core activity consists of writing out gambling tickets? This, we'll leave for the reader to decide.

12 See also the paper of Ludwig van den Hauwe, “The Uneasy Case for Fractional-Reserve Banking”, where he states:

“In fact, for several reasons it cannot be credibly maintained that fractional-reserve free banking would pass the market test; in other words, fractional-reserve banking cannot be conceptualized as belonging to the set of institutions which would emerge as the outcome of an invisible-hand process, that is, a process in the course of which the individual rights of property and contract of all market participants would be correctly defined and strictly enforced.” Ludwig van den Hauwe, “The Uneasy Case for Fractional-Reserve Banking” (*Munich Personal RePEc Archive*, MPRA Paper No. 120), p. 38.