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Should We Let Banks Create Money?

— ◆ —

GEORGE SELGIN

You've heard the joke before: If you laid all of the world's economists end to end, they still wouldn't reach a conclusion. Side-splitting, isn't it? In truth, we economists do reach conclusions, and we agree with one another more often than our detractors appear to realize. Yet a certain amount of disagreement among us is actually a good thing. It suggests that economics is an ongoing scientific enterprise rather than a body of blindly accepted dogma.

Disagreement is healthy even within a particular economic school of thought. One case in point is an ongoing debate among academics associated with the Austrian School of economics. This debate concerns whether commercial banks ought to be allowed to continue their commonplace practice of generating redeemable IOUs, including checkable bank deposits and (less commonly nowadays) circulating bank notes, in amounts exceeding their available reserves of standard money. Because Austrian-School economists generally favor a gold standard over an irredeemable paper or "fiat" standard, the debate can be framed as one between defenders of fractional gold bank reserves on one hand and their critics who favor one hundred percent gold reserves (so that all bank-issued exchange media are fully backed by gold) on the other. I, together with Lawrence H. White, have been among the defenders of fractional reserve banking (see Selgin and White 1996), whereas Hans-Hermann Hoppe (1998) and the late Murray Rothbard (1962) have been two of the more prominent advocates of one hundred percent reserves.

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Both sides in this debate have devoted much effort to determining whether the great Austrian economist Ludwig von Mises himself favored fractional reserve banking. The truth seems to be that Mises saw both advantages and disadvantages to the arrangement, so that both sides have been able to quote him in their favor. Perhaps Mises's views on this subject changed over time. But what Mises did or did not believe is largely beside the point. However much one respects Mises's contributions to economic science, the merits of fractional reserve banking must ultimately be assessed by means of rational argumentation and not by an appeal to authority.

Arguments against Fractional Reserves

The critics of fractional reserve banking condemn it for at least three reasons. First, they claim that the practice is practically or even inherently fraudulent: although some critics admit that fractional reserve banking would not be fraudulent if banks were to write contracts expressly indicating to their customers their intention to invest most of their gold deposits, these critics insist, nonetheless, that fractional reserve banks have never been explicit about their reserve-holding policy. According to this view, fractional reserve banking has survived up to the present only because of bankers' dishonesty and (in more recent decades) government-mandated deposit insurance.

Second, critics of fractional reserve banking claim that, under a gold standard, any issue of bank-created exchange media unbacked by gold ("fiduciary media") will fuel the business cycle. They maintain that bank loans funded by outstanding bank notes and demand deposits are ultimately financed by "forced" savings: in issuing spendable IOUs to borrowers, banks reduce interest rates below their "natural" levels, promoting investment at the expense of other producers and consumers who find themselves bidding against bank borrowers for scarce resources. Eventually this bidding war will force up prices and interest rates, restoring the purchasing power of the money stock to its pre-expansion value. But by that time, resources will already have been improperly invested in projects that are not sustainable given the amount of voluntary (as opposed to forced) savings available from the public. The collapse of unsustainable projects, followed by the consequent restoration of a pattern of resource use something like the pattern that preceded the issue of fiduciary media, marks the bust and recovery stages of the business cycle.

Third, fractional reserve banking systems are said to be fragile and vulnerable to collapse whenever their customers lose confidence in them. Because no fractional reserve bank, no matter how well managed, can afford to pay off all its IOU holders at once should they simultaneously demand their money back, each bank faces a positive probability of catastrophic failure at any moment.

Let us consider each of these arguments in turn, to see if any of them justifies suppressing fractional bank reserves by force of law.

The Fraud Issue

Is fractional reserve banking really just a massive, worldwide, centuries-old swindle? Are bank customers truly unaware that their demand deposits are not fully backed by bank reserves? Or do they actually agree to support fractional reserve banking because they prefer it to the one hundred percent reserve alternative?

Let me concede at the outset that the answer cannot be readily inferred by observing the “demonstrated preferences” (the phrase is Murray Rothbard’s) of bank customers in the United States today. Most of these bank customers have not voluntarily agreed to hold fiduciary media *and to bear any associated risks of bank failure*. Rather, they (with the exception of some holders of large accounts) have agreed to hold fully insured bank deposits—a no-brainer of a decision that does not by itself indicate any willingness to hold fiduciary media that are not being propped up by government-mandated guarantees.

But what about the large number of persons who maintain demand deposits in fractional reserve banking systems in Switzerland, New Zealand, Argentina, Hong Kong, and other places where deposits are uninsured, or the still larger number who patronized fractional reserve banks in the United States and other countries during the many centuries before deposit insurance? Is it really conceivable that all or most of them have been unaware that their banks have been lending rather than holding on to most of their cash deposits? Can these customers really have gone on believing such a condition to be the case even while earning interest on their account balances, or at least maintaining them free of storage fees? Have these bank customers never wondered how banks manage to profit from their business?

Suppose that we accept, for the sake of argument, the view that most past and many present fractional reserve bank customers have been woefully misinformed concerning what their banks have been up to. In that case, we must question our fundamental beliefs concerning the market’s ability systematically to exploit available profit opportunities. Were U.S. bank customers really ignorant of what was backing their bank-issued IOUs in, say, 1924, a decade prior to the introduction of federal deposit insurance? If so, then any entrepreneur who was in on the secret—and only a gigantic conspiracy could have kept everyone, including bank employees and professional economists, in the dark—could have made a fortune by opening the nation’s first genuine one hundred percent reserve bank. (There has never, to my knowledge, been a law here or anywhere else prohibiting one hundred percent reserve banking, although there have been many instances in which banks have been required by law to maintain minimum reserve ratios.) The prospective one hundred percent reserve banker could promote his bank through an advertising campaign, announcing to all the world his rivals’ unsafe (and dishonest) practices. If one hundred percent reserve proponents are correct in their belief that the public would never knowingly agree to

fractional reserves, such an entrepreneur would either capture the entire market for bank money or force all other bankers to abandon their fractional reserve scheme in order to stay in business. Thus, to support their claim that fractional reserve banking has always been based on fraud, critics of fiduciary media are forced to postulate implicitly the existence of massive and persistent entrepreneurial incompetence.

By the way, in retrospect we can say that some U.S. bank customers really would have been better off switching to one hundred percent reserves in 1924: during the following decade, bank depositors suffered billions of dollars in losses as thousands of banks failed. Still, it does not follow that those depositors failed to switch because they were ignorant of the fact that their banks held only fractional reserves. Perhaps a few were so ignorant; but most simply took a calculated risk, and lost. In less regulated banking systems in other countries, with larger and more fully diversified banks, the risk of failure was much lower, making customers' willingness to take a chance with fractional reserves seem pretty wise even in retrospect. Thus, during the entire Scottish free-banking era, which lasted for more than a century ending in 1845, Scottish-bank liability holders lost a grand total of £32,000, notwithstanding that for much of this period the typical Scottish bank held gold reserves equal to less than 3 percent of its outstanding notes.

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" (21–22). Apart from begging the question of who are the victims,¹ 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. They are instead 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. (If all IOUs had to represent existing property in order to be nonfraudulent, most loan transactions would be fraudulent.) 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. (I return to this issue later.) The bank, in issuing IOUs against itself, is not analogous to a counterfeiter, as Hoppe and his co-authors claim, for the simple reason that the bank acknowledges its own debts, whereas a counterfeiter issues IOUs with someone else's name on them.

1. The answer provided by Hoppe, Hülsmann, and Block, that the victims of fractional reserve banking are gold holders, the value of whose holdings declines as fractional reserves take the place of one hundred percent reserves, is far from satisfactory. Of course, whenever a cheaper substitute for any asset becomes available, the original asset loses value. An expansion of fiduciary media permanently lowers the value of gold to the extent that fiduciary media are considered good substitutes for gold. That is bad news for gold miners and owners. But what does fraud have to do with it?

Banking and the Business Cycle

Anyone who finds even a grain of truth in the Austrian theory of the business cycle appreciates that excessive growth of the money stock can trigger or worsen industrial fluctuations. It does not follow, however, that fractional reserves are to blame for such fluctuations, or that an economy relying on one hundred percent reserve banks only would necessarily be cycle-free.

In truth, whether an addition to the money stock will aggravate the business cycle depends entirely on whether or not the addition is warranted by a preexisting increase in the public's demand for money balances. If an expansion of the supply of bank money creates an overall excess of money, people will spend the excess. Borrowers' increased spending will, in other words, not be offset by any corresponding decline in spending by other persons. The resulting stimulus to the overall level of demand for goods, services, and factors of production, together with changes in the pattern of spending prompted by an artificial lowering of interest rates, will have the adverse business-cycle consequences described by the Austrian theory. But no such consequences follow an expansion of the stock of bank money that merely accommodates a prior increase in the demand for money holdings. Such an expansion, instead of adding to the flow of spending, merely keeps that flow from shrinking, thereby sustaining normal profits for the "average" firm. The expansion therefore serves not to trigger a boom but to avoid a bust. As far as business-cycle consequences are concerned, it makes no difference whether the new money is or is not backed by gold. The extent of gold backing does matter as far as the liquidity of the banking system is concerned. But that is another issue, to which I shall return.

Hoppe and other opponents of fractional reserves deny that an increase in the public's willingness to hold bank money constitutes an increase in the extent of savings that may safely be translated into bank loans. They insist that the holding of bank money does not constitute an act of saving at all, because the bank money (unlike, say, a bond or certificate of deposit) can be exchanged for goods at any moment. Their error is one of confusing a difference of degree with one of kind. Of course, a person holding a redeemable bank IOU is free to spend or cash the IOU at any moment; but until the IOU is spent or cashed, anyone holding it is no less engaged in an act of saving than someone holding a bond having the same face value. Fractional reserve bank managers, unlike managers of bond-issuing institutions, must reckon with the fact that the funds being supplied to them by holders of their IOUs are available only for indefinite and often short periods. (A bank with a large customer base can, however, take advantage of the tendency for increased spending by some of its claimholders to be offset by an increased willingness to hold claims on the part of others.) But the fact that fractional reserve banking presents a managerial challenge does not in any way undermine the claims (1) that holdings of fractionally backed, redeemable bank IOUs

do in fact represent savings, and (2) that an increase in the real demand for such IOUs represents an increase in the supply of savings to the banking system.

Just because fiduciary bank money *may* be issued in a manner that does not contribute to the business cycle, it does not follow that banks cannot overexpand credit in practice. Central banks routinely cause more bank money to be created than is needed to accommodate growth in the public's demand for money balances. Competing commercial banks, to the extent that they are not encouraged by fresh infusions of central-bank money, are far less capable of overexpansion, although they may still be guilty of overexpansion now and then. This fact alone does not, however, justify any condemnation of fractional reserve banking: elsewhere I have argued that a thoroughly deregulated, or free, fractional reserve banking system, in which banks are allowed to issue notes backed by a naturally scarce reserve medium (such as gold or a permanently "frozen" stock of central bank money), tends automatically to adjust the supply of bank money in response to prior changes in the demand for money balances (Selgin 1988). If I am right, one can throw out the monetary-overexpansion bathwater without also discarding the fractional-reserve baby.

Banking Crises

Fractional reserve banking is undeniably riskier than one hundred percent reserve banking. The question is whether the extra risks are outweighed by benefits. I have already argued that, in the eyes of many past and present bank customers, fractional reserve banking does seem to be worth the risk. But can we say that the extra risks are also worthwhile from an economy-wide perspective, or are individual bank customers inclined to patronize an arrangement that ultimately makes other people worse off?

Notice first that the mere riskiness of fractional reserve banking is no reason for doing away with it. We would not condemn a building because it might not be able to withstand a freak earthquake. Likewise, we should not insist that banks must be one hundred percent liquid. Some degree of illiquidity may be worthwhile if there are benefits to be had from it.

Episodes of systemwide bank failures and serious bank over- and underexpansion have been less common than is often supposed. The episodes that have occurred can generally be shown to have resulted not from any problem inherent in fractional reserve banking but from central bank misconduct or misguided government regulation or both (Selgin 1989, 1992, 1994). Where fractional reserve banks have operated free of both significant legal restrictions and the disturbing influence of central banks, as in nineteenth-century Scotland, Canada, and Sweden (to name just a few cases that have been studied), serious banking and monetary crises have been rare or nonexistent.

Supposing one grants that fractional reserve banking is less inherently risky than is often assumed, what benefits justify the risks that remain? The answer is very substantial benefits indeed. To see what they are, imagine a poor nation whose citizens

lack the means for investing in stocks, bonds, or most other savings vehicles. Even such a poor nation, if it is to take advantage of the division of labor, must have a medium of exchange. The question then is, can the very limited financial wealth embodied in the nation's money holdings be used to fund productive investments that will eventually rescue the society from poverty? If money consists of gold coin alone or of bank-issued IOUs fully backed by gold, the answer is no: the nations' scarce savings will be invested in an accumulation of gold, and that's all. If, on the other hand, money consists of bank-issued IOUs backed mainly by bank loans, then its citizens' scarce savings will contribute toward a general process of industrialization, with investments made where (risk-adjusted) rates of return appear greatest. According to many scholars, including Adam Smith, the industrialization of the West and of developed countries elsewhere was crucially dependent on funds mobilized by fractional reserve banks. Other nations' failure to industrialize has to a significant extent been due to their repressive financial legislation, including laws (typically aimed at enhancing central bank profits) forcing banks to maintain needlessly high reserve ratios (Cameron 1967, 1972).

Freedom and Fractional Reserves

Nothing I have said in defense of fractional reserves should be taken as arguing for the legal *suppression* of one hundred percent reserve banks. Adults should be free to engage in voluntary acts of fractional reserve banking or to place their money in one hundred percent reserve banks as they see fit. And anyone should be free to try to establish a market for bank money backed by one hundred percent reserves. Still, if history is any guide, a would-be one hundred percent reserve banker faces an uphill battle. Given a choice, most people prefer to let their banks create money only fractionally backed by cash reserves. And they are not fools for doing so.

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