The Problem of Fractional Reserve Banking, Part 1 |

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Part One: Legal and Ethical Questions – the debate over fractional reserves

We recently came across an article by Robert Murphy, 'The Fractional Reserve Banking Question', in which he briefly comments on a controversy within the Austrian School, between what could be termed the 'neo-Currency' and 'neo-Banking' schools, a terminology introduced by Joseph Salerno, harkening back to the 'currency' and 'banking' school debate of the early 19th century.

Now Murphy doesn't really take a firm position on the question of whether fractional reserve banking is fraudulent – he merely comes to the conclusion that 'fractional reserve banking is plain weird'. It certainly is, but that's definitely not all there is to it.

We must note here that in the current monetary system, with a privileged and highly regulated banking cartel revolving around a central bank with unlimited money creation capabilities, fractional reserve banking is of course ***not*** considered as fraudulent per the legal statutes in force at present. This *de facto* legal status should however not deter us from pondering the question of whether it constitutes fraud from an objective ethical standpoint as well as from a legal standpoint in terms of the historical evolution of law and the basis of a correct interpretation of jurisprudence on the question more generally.

Via Murphy's article, we became aware of a blog post by Joseph Salerno on Mises.org, where numerous links to the above-mentioned debate as well as a very lively and extensive discussion, occasioned by Salerno's post, can be found.

As far as we understand the neo-Banking schools argument in *favor* of the creation of fiduciary media (the translation of Ludwig von Mises' original German term 'Umlaufsmittel'), this is to say, in favor of the creation of deposits via fractional reserves banking, it goes something like this: in a truly free market with free banking (as opposed to the state-sanctioned and regulated – and incidentally, once again insolvent – cartel we currently have in reality), fractionally reserved lending should be possible, as long as it is done voluntarily, this is to say as long as depositors *agree* that certain banks will only keep a fractional reserve at hand to cover money deposits.

Furthermore, they argue, the creation of fiduciary media (this is to say, bank deposits *ex nihilo*) is actually economically beneficial, as long as it merely counters unexpected 'increases in the demand for money', which might otherwise prove disruptive to commerce (we happen to believe that a general, widespread increase in the demand for money does not just drop from the sky unbidden. Normally such an increase in the demand for money is observed precisely when an inflationary boom turns to bust. It is a reaction to the uncertainties created by the boom's failure).

We support the demand to take all monetary matters out of government's hands and leave money and credit fully to the free market. In fact, we strongly suspect that the 'neo-Banking' school would soon discover that fractionally reserved banks would have no future in a truly free market – depositors would shun them, as absent a 'lender of last resort' with unlimited money creation abilities, the risk of depositing money with fractionally reserved banks would be deemed too high.

The proponents of the neo-Banking school frequently refer to von Mises' support of free banking as favoring their approach, but appear to have misunderstood his central idea – he favored it precisely *because* he thought it would hold credit expansion in check. As a 'second best solution' Mises proposed a 100% reserves regime imposed by the government, but as others have pointed out, at the time von Mises wrote his seminal work on 'The Theory of Money and Credit', there was still a residual belief that government could potentially be relied upon to administer a monetary system free of abuse. Clearly such a belief appears dubious in light of both historical and modern day evidence.

We will look at the economical questions raised by fractional reserve banking in part 2 of this article, and first consider only the legal and ethical aspects.

Two different types of contracts

In this context, we want to point to Jesus Huerta de Soto's excellent book 'Money, Bank Credit and Economic Cycles', which is our main reference in the following explications.

One of the major proponents of the neo-Banking (i.e. pro-fractional reserves) school, Steven Horwitz, wrote (in 'Monetary Evolution, Free Banking and Economic Order') that the historical examples of bankers misappropriating their customers deposits began as *'an act of true entrepreneurship as the imaginative powers of individual bankers recognized the gains to be made through financial intermediation'*. This strikes us as akin to lauding a highway robber for his imaginative mugging of innocent travelers.

As de Soto explains, in the history of banking stretching back to old Greece, there has always been a clear difference between the irregular deposit contract and the loan (or *mutuum*) contract. The difference between these two types of contracts is perfectly logical and has been upheld legally throughout the history of Greek and later Roman banking practice (which doesn't mean that bankers did not quite often yield to the temptation of misappropriating the funds entrusted to them – but the legal situation was at all times perfectly clear).

Let us first explain what these contracts are and why they are different. A deposit of a good is done for the purpose of safe-keeping or warehousing. Such a deposit is termed 'irregular' when it is comprised of a fungible good, which allows a great many deposits to be intermingled, and confers upon the depository institution only the duty to pay to the depositor the so-called ***tantundem*** on demand, this is to say an amount of the good similar to the amount deposited, but not necessarily the completely identical units of the good deposited.

Note here that this type of deposit could refer to e.g. grain deposited in a grain silo, or oil deposited in an oil storage facility, or any other fungible good, including of course money. To the depositor it obviously doesn't matter upon withdrawal whether the gold ounce he receives is the very same one he deposited originally.

What matters is that it is a gold ounce indistinguishable in weight and appearance from the originally deposited one. The reasons for depositing money in a bank are

1. the safekeeping function the bank provides (the risk of theft or loss of the money is reduced) and

2. certain services such as payment services the bank can render on behalf of the depositor. It is clear though that the deposit is expected to be ***available on demand***, which is to say, anytime.

This is true of every deposit a bank receives, and thus to actually fulfill this essential feature of the deposit contract, the *tandundem* equal to all deposits must be kept at hand at all times. In other words, if the bank takes some percentage of the deposits entrusted to it and uses it for its own business ventures, it misappropriates funds.

De Soto then contrasts the irregular deposit contract with the loan contract, in which an exchange of present goods for future goods takes place. This is a fundamentally different transaction, in that the saver who lends money to the bank for a specified term at interest relinquishes his use of the money for the term, in exchange of receiving back his money plus interest in the future.

The bank then has full use of the money for the duration of the contract, and can e.g. use it to lend it out at a higher interest rate to an entrepreneur in need of funds. Here the bank plays a legitimate role as a financial intermediary, as an institution that furthers economic coordination by bringing lenders and borrowers together, and making a legitimate profit for rendering this service.

By contrast, in the case of the bank lending out funds it is supposed to safeguard, i.e. money held in demand deposits, a situation is created that flies in the face of common sense. The depositor has not relinquished use of the money deposited after all, so when the bank lends some this deposited money out – a process that creates an additional deposit in favor of the borrower – then two parties have a concurrent claim on the same money.

The reason why bankers had the idea to misappropriate deposits in this manner is of course that they noticed than in 'normal times', it would rarely happen that a majority of depositors would want to withdraw their deposits all at once. So by keeping only a fractional reserve, they could make large profits for themselves by making use of the money that had been entrusted to them for mere safekeeping (employing the aforementioned 'imaginative powers' of bankers that Horwitz finds so laudable).

However, it was always held by jurists throughout antiquity that this misappropriation of deposits was clearly illegal. In Roman law, bankers who could not pay out deposits on demand due to such misappropriation were fully liable and forced to pay a fine for late payment. As de Soto explains, this led to some legal confusion later on, as canonical laws against usury were circumvented in medieval times via the so-called '*depositum confessatum*'.

This was in fact a loan contract that was *disguised* as a demand deposit, which allowed an interest payment to be attached to it by disguising it as a fine for late payment. This led legal scholars subsequently astray, as the idea of the deposit being the same as a loan contract began to take root.

The history of fractional reserve banking

De Soto then shows that the history of banking is a sequence of booms, busts and bankruptcies, all of which were the logical consequence of the misappropriation of deposits. Governments soon realized that they could also profit from such misappropriations, and privileges for bankers were enacted allowing them to fractionally reserve deposits, as governments too could then borrow large sums previously not available to them.

Naturally, governments quite often ended up defaulting on their obligations, which in turn then bankrupted the banks.

Illustrative examples are found in the medieval banking history of the Italian city states such as Florence. The Florentine banking houses had begun to lend out money held in demand deposits in the late 13th and early 14th century, which created a sizable economic boom. When early in the 14th century Neapolitan princes began to withdraw funds and England was found incapable of repaying loans it had received from these banks, the artificial boom could no longer be sustained. In addition, the public debt of Florence had been financed by speculative bank loans, and the value of these government bonds also began to decline dramatically.

The entire Florentine banking industry went under between 1341 and 1346, with depositors getting back only between one fifth to one half of their deposited funds, after a long waiting period. Moreover, a credit shortage developed, which in turn led to the failure of many other businesses as well. The inflationary boom had turned to bust.

A similar fate awaited the famous Medici Bank in the late 15th century. Initially, the bank was not a deposit bank, but only accepted money on loan.

However, it then began to accept demand deposits as well, and soon yielded to the temptation of lending them out. Its reserve ratio had fallen to 50% of its deposit liabilities when the artificial inflationary boom began to falter, and during the inevitable recession, this ratio fell to as low as 10%. The bank, and most of its competitors at the time, naturally failed. This is a recurring phenomenon in the history of private banking – as soon as the banks began to yield to the temptation of keeping only fractional reserves, economic booms followed by severe busts and the failure of the banks concerned inevitably were the result.

For instance, there exists documentary evidence that of 163 banks operating in the late medieval period in Venice, ***at least 93 failed***.

Giovanni di Bicci de Medici, founder of the Medici Bank of Florence

(Painting by: **Cristofano dell'Altissimo,** via Wikimedia Commons)

During the medieval period, banking also redeveloped in Spain, where initially strict legal safeguards were introduced to keep the 'ingenuity' of bankers in check. As de Soto writes:

> "For example, on February 13, 1300 ***it was established that any banker who went bankrupt would be vilified throughout Barcelona by a public spokesman and forced to live on a strict diet of bread and water until he returned to his creditors the full amount of their deposits***. Furthermore, on May 16, 1301, one year later, it was decided that bankers would be obliged to obtain collateral or guarantees from third parties in order to operate, and those who did not would not be allowed to spread a tablecloth over their work counter.
>
> The purpose was to make clear to everyone that these bankers were not as solvent as those using tablecloths, who were backed by collateral. Any banker who broke this rule (i.e., operated with a tablecloth but without collateral) would be found guilty of fraud"

As de Soto then dryly remarks,

> "In view of these regulations, Barcelona's banking system must initially have been quite solvent and banks must have largely respected the essential legal principles governing the monetary bank

deposit.”

However, it appears that bankers still yielded to the temptation of misappropriating deposits, as the laws governing bank bankruptcies were modified further in 1321.

> “It was established that those bankers who did not immediately fulfill their commitments would be declared bankrupt, and if they did not pay their debts within one year, they would fall into public disgrace, which would be proclaimed throughout Catalonia by a town crier. Immediately afterward, the banker would be beheaded directly in front of his counter, and his property sold locally to pay his creditors.”

In 1360 one Francesh Castello in fact ended up being beheaded in front of his bank after failing to settle his debts. Indeed, in the recurring banking crises of the late Middle Ages, the Spanish banks held out a little longer than their Italian counterparts, which de Soto believes may have largely been due to the far stricter sanctions faced by Spain's bankers at the time if they were found unable to pay depositors. As he puts it, the regulations governing banking in Catalonia were

> “[...] one of the few historical instances in which public authorities have bothered to effectively defend the general principles of property rights with respect to the monetary bank-deposit contract”.

Nonetheless, the Catalonian banks also failed in the late 14^{th} century, with depositors complaining that they were increasingly put off ('come back later') or fobbed off with inferior coin. Subsequent attempts at reviving banking in Spain first led to the founding of a government bank, the *Taula de Canvi* of Barcelona. A large portion of the banks reserves ended up financing the city of Barcelona, and predictably the bank suspended payments in 1468.

In reaction, the bank was granted more privileges that assured it of a steady income (such as serving as the depositary for all funds attached in judicial seizures, and all administrative deposits). Later, under Charles V., banking began to flourish in Seville. Charles was in constant need of funds, and eventually, after a long incestuous relationship with the banks that financed his adventures, dropped all pretense and simply began to confiscate bank deposits.

His successor Phillip II was even worse, inasmuch as he went bankrupt several times, and left the banks in the lurch in the process. Not surprisingly, all of Seville's major banking houses failed in the late 16^{th} century. When Thomas Gresham went to Seville to withdraw 320,000 ducats in deposits on the orders of Queen Mary, he only managed to obtain 200,000, after much to and fro. As Gresham wrote at the time: “I am afraid I will cause the failure of all the banks in Seville.”

Charles the Fifth, Holy Roman Emperor, King of Spain, King of the Romans and of Italy, and frequent thief of bank deposits.

(Painting by: **Peter Paul Rubens**, 1577-1640, via Wikimedia Commons)

Charles' successor on the Spanish throne, King of Naples, King of Portugal and King of England *iure uxoris* ('by right of his wife', for slightly over 4 years), Philipp II, 'the Prudent'. Clearly this was a case of severe late medieval nickname confusion, as he was anything but prudent, at least in financial matters. In his defense it must be mentioned that Charles left him with a debt of 36 million ducats and an annual budget deficit of 1 million ducats. Phillip in turn never really managed to dig himself out of that hole. Under his rule, prices in Spain rose five-fold, and the state went officially bankrupt in 1557. He borrowed money from bankers in Genoa and the Fuggers in Augsburg, with interest payments on these loans reaching 40% of government's tax revenues late in his reign. He almost managed to bankrupt the Fuggers as well.

(Painting by: **Antonio Moro**, via Wikimedia Commons)

In the early 17th century (1609), the Bank of Amsterdam was founded in the wake of the monetary chaos of previous centuries, and this time it was decided that the bank should keep a 100% reserve with respect to demand deposits. This worked extremely well for over 170 years, during which time the bank attracted more and more deposits as its well-deserved reputation grew. When John Law's experiment in inflationary bubble finance broke in the early 18th century in France, funds fled from France to the Bank of Amsterdam, which at the time held the then enormous amount of 28 million florins in deposits.

Unfortunately, the Bank of Amsterdam was the last major banking institution to keep a 100% reserve ratio with respect to deposits. Note here that during the period of the bank's operation as a 100% reserved bank, Amsterdam was widely recognized as one of the wealthiest cities of Europe, which sort of contradicts the alleged 'necessity' of fractional reserves to 'grease the wheels of commerce'.

Commerce was evidently not hindered in the least in Amsterdam by the strict adherence to keeping the *tantundem* of all sight deposits in the bank's vaults. The bank's profits however were not as spectacular as they might have been had it misappropriated deposits. In the late 18th century, the bank's adherence to keeping a 100% reserve was finally destroyed by the city's government, which ordered it to hand over its deposits to finance public expenditures (which had risen due to the Anglo-Dutch war).

The Bank of Amsterdam began to lend money out secretly, not only to the Municipal Treasury of Amsterdam, but also the Provincial States of Holland, the Masters of the Mint, the Bank van Leening and the East India Company. Initially these loans were not large, but eventually the bank's reserve ratio declined from 100% to 25%, and it ceased to exchange its deposit slips (bank notes) for specie when a liquidity crisis hit in 1790-1791. Its reputation took a rapid nosedive that eventually led to its demise. The bank that once held 28 million guilders in deposits, dwindled to an insignificant institution by 1816, when its deposit base had declined to a mere 140,000 guilders and it was closed down.

The birthplace of the Bank of

Amsterdam in 1609, Amsterdam's old Town Hall

(Painting by: **Pieter Jansz Saenredam**, 1597-1665, via Wikimedia Commons)

In the late 17th century, the bank of Sweden (the fore-runner of the Riksbank) was founded, and after initially adhering to a 100% reserve, soon began with the practice of issuing bank notes well in excess of its reserves. There is of course no economic difference between creating unbacked bank notes and unbacked deposits from thin air (this is to say deposits not backed by prior saving). This practice of over-issuing banknotes became a favorite method employed by banks in the following centuries.

The Bank of England was also founded around this time, and from the very beginning was never designed to be anything but a fractionally reserved institution. Rather, it was from the outset meant to be used to finance public expenditures. Not surprisingly, it eventually failed as well, and had to suspend specie payments in the late 18th century. Around this time the idea of creating a central bank as a 'lender of last resort' began to be considered.

The colorful history of banking shows that whenever banks began to misappropriate funds entrusted to them for safe-keeping, boom-bust cycles were set into motion that inevitably led to the failure of the banks involved. Depositors were never safe, except in the 170 years during which the Bank of Amsterdam operated under the strict observance of the legal principles governing demand deposit contracts. As de Soto observes, to this day the legal situation of such deposit contracts is somewhat murky in Europe.

It is clear that from a logical standpoint, the aim of a depositor is the safe-keeping of his funds, and secondarily the use of a sight deposit as a convenient device for effecting and receiving payments. The aim of a depositor is not to 'lend the bank money'. Conversely, banks regard their deposit liabilities as loans which they can freely appropriate and use in their business to earn additional profits.

In the modern system with central banks allegedly guaranteeing bank solvency and rules establishing fractional reserve ratios with respect to deposits, the creation of additional deposits from thin air is a given – and with it, the major boom-bust cycles we have to endure.

De Soto further remarks that in Anglo-Saxon law, an unfortunate reliance on precedent cases has led to a juridical redefinition of the deposit contract as a loan contract, which leads to a 'less murky' but no less deplorable legal situation.

The idea that fractional reserves are 'unproblematic' based on an assessment of the likelihood of massive withdrawals similar to the 'law of large numbers' methodologies employed by insurance companies in insuring risk are not applicable to demand deposits. As history has shown, without a central bank, fractionally reserved banks eventually *always* fail. In all cases we can conclude that since they did not keep the *tantundem* of the deposits entrusted to them in reserve, they essentially committed fraud (at least in spirit, if not necessarily *de iure*).

We leave you with the following quite funny observation by de Soto:

> "It is a remarkable fact that three of the most noted monetary theorists of the eighteenth and early nineteenth centuries were bankers: John Law, Richard Cantillon, and Henry Thornton. Their banks all failed."

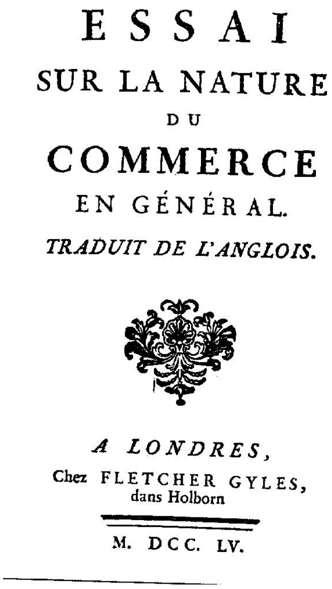
In part 2 we will look at the economic consequences of fractional reserves banking.

John Law, father of the Mississippi Bubble that brought France's economy to its knees in an inflationary conflagration. Failed banker, noted monetary theorist.

(Painting by: **Anonymous,** via Wikimedia Commons)

Richard Cantillon's 'Essay on the Nature of Commerce in General'.

(Image: Wikimedia Commons)



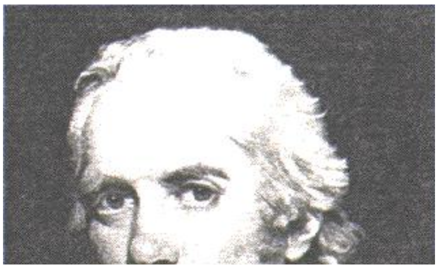
ESSAI
SUR LA NATURE
DU
COMMERCE
EN GÉNÉRAL.
TRADUIT DE L'ANGLOIS.

A LONDRES,
Chez FLETCHER GYLES,
dans Holborn

M. DCC. LV.

Henry Thornton – another noted monetary theorist. He wrote An Enquiry into the Nature and Effects of the Paper Credit of Great Britain (pdf).

(Image: Wikimedia Commons)



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