

Liberty, Ethics, and 100% Reserve Banking

by Michael S. Rozeff

I will argue a simple proposition about fractional-reserve banking. Suppose that, in a free market situation, depositors in a bank agree to make deposits in the bank, knowing full well that the bank intends to lend out some of these deposits. Depositors may also know full well that they may lose some of their deposits. An analogous case is that of making any risky loan in which there is a chance that the loan will not be paid off in full. My proposition is that, in this free market characterized by willing and voluntary behavior by both depositor and banker, with all actions being known and above-board, the actions of the fractional-reserve banker are not inherently criminal. That is because what private parties agree to among themselves (without coercing others) cannot be called criminal. If this proposition is true, then, in this free market scenario, vilifying the banker, accusing him of embezzlement or fraud, worrying that he is printing money out of thin air, or worrying that he is creating two titles to the same property – none of these have any special place ethically. They express tastes or preferences as to ethical arrangements that others are making, but they have no claim to being more ethically right than what others have agreed to.

This article does not get into what may or may not have occurred historically. It does not get into whether or not a bank of this type can or will survive in a free market. It does not get into central banking questions. It does not get into what the received laws on demand deposit accounts are. My goal is strictly limited. It is to argue that fractional-reserve banking is not inherently immoral or unethical in a free market setting. It should be noted that banks today do not operate in a free market setting.

By way of understanding how it is that a deposit could be made to a bank that is then loaned out, we may think of analogous cases for other kinds of firms. Every day billions of dollars are loaned to corporations doing all kinds of business, and the managers of these companies take the money and invest it as they see fit, sometimes under a variety of constraints that the lenders impose on them. They do not hold the money in a warehouse ready to be returned to the lenders at a moment's notice. These loans are, of course, perfectly legitimate and moral. They are also risky, as payment at maturity is not assured, but this risk is compensated by a higher rate of return than the return on a more safe loan. Every day, stock brokers lend securities that have been left with them in margin accounts. The buyers of these securities have signed hypothecation agreements with their brokers. These agreements allow the brokers to lend the securities. The securities are then carried in "street name," which means the buyers do not have title to them. The buyers instead have property rights defined by their account agreement. The account owner retains the right to sell these securities. Called upon to sell a stock that he has loaned out, the broker then obtains the stock elsewhere or from his reserves and sells it for his client. All of this is legitimate and moral. It should be plainly evident, even at this point, that it is possible for a bank in a free market to contract with depositors in much the same way that stock brokers today contract with their customers. A bank depositor may give up money in exchange for an account with certain rights defined by an agreement between banker and depositor.

I should explain what I mean by a free market. When people transact in a free market, they

transact in a condition called liberty. A free market assumes that people have come up beforehand with rules of property that they accept, since in the market they are exchanging property that they own. The liberty aspect comes into this in several ways. Liberty means that their exchanges are uncoerced. They are not forced on them by anyone else. They decide on them of their own accord. But liberty also comes in even before there is a free market with exchanges, because there cannot be liberty unless one willingly accepts the rules of property for that property that one may wish to exchange. There cannot be coercion in choosing the basic rules one lives under and obeys in one's interactions with others, or else liberty is absent.

To expand on the last statement, having liberty means that each person has the decision rights or rights to choose to dispose of his property himself, which by definition means choosing without compulsion by others. Liberty means more, however. It means freedom to choose one's religion and government and not have them imposed against one's will, one's choice, or one's beliefs. Religious and governance arrangements are singularly important because of their foundational importance in a person's life. Given liberty, a person may choose to believe in a God or no God, to obey his God or not to, and to obey rules of living with others that he has agreed to.

Each of us, in a state of liberty, decides for himself what arrangements to conclude with others who are also deciding in liberty. Since, in the condition of liberty, these arrangements are up to us, to be conducted as we see fit, to be enforced and adjudicated as we see fit, to be dissolved as we see fit, there can be no universal or absolute arrangements that hold for all unless they are universally agreed to by all. Choosing our rules of conduct ourselves, as persons in liberty, equivalently means deciding upon our ethics and not having them decided for us by others – unless we choose to have them do so, which is still our choice made in liberty, but at one step removed. When we choose our governance, in liberty, we are choosing the rules by which we agree to interact with others socially. This means we are choosing our rules of conduct and agreeing to obey them. But since rules of conduct are ethics, we are choosing our ethics. If someone else has a different ethics and makes us obey the rules of conduct that their ethics state, then we are not in liberty.

The immediate implication of these statements about choosing your own ethics when you have liberty is that each person acting in liberty may conclude his own arrangements with others of a like mind who share the same ethics, and when that is done, someone with a different ethics cannot find any grounds to infringe on the arrangement without at the same time infringing on the liberty of those who have voluntarily made that arrangement.

You, with your wealth and in liberty, may conclude an arrangement with a business firm in which that firm agrees to hold and guard your wealth in your name, for you and only you, without disturbing that wealth, and available to you at all times for withdrawal. You and that firm may agree to whatever stipulations you wish with regard to the disposition and storage of your wealth. You may instruct that firm to send you a monthly stipend. The firm may agree to unannounced audits or daily or weekly audits. The number of possibilities is very great. The case being described, which is one in which you and the firm agree that the firm may not lend your wealth, we may call the 100% reserve case.

By the same token, I, with my wealth and in liberty, may conclude an arrangement with a business firm in which the firm may lend my wealth. The range of possible stipulations is large.

The bank may pass through part of the earnings on those loans in the form of other services to me, such as checking and clearing of transactions with others, or the bank may pay interest on my wealth. I may arrange to withdraw my wealth upon demand, if and when the funds are available. The arrangement may or may not obligate the owners of the firm to make good on this demand, even if delayed. The firm's owners may agree to place their personal wealth at my disposal to make good a return of my wealth. I may agree to the bank's creation of demand deposits for a borrower. The number of possibilities is very great. The case being described, which is one in which I and the firm agree to the lending of my wealth through the firm's intermediation, I will call the fractional-reserve case.

It should be noted that in the fractional-reserve case, no third parties are obligated to accept bank notes that the bank may produce when it makes loans to borrowers. In a free market, there are not legal tender laws; there are no forced currencies. If a third party accepts a bank note, he does so willingly, as in any free market exchange.

As I made explicit earlier, we need not, for purposes of understanding the ethics of these contrasting cases, analyze the economics of these two cases or specify them in detail or examine them in an historical context, although all of that is of interest in other ways. For, in the case of liberty, either of these arrangements (or none of them) may be concluded by you or by me. You cannot, if we are both living in liberty, impose your arrangement for 100% reserves on me, and I cannot impose my arrangement for fractional-reserving on you.

This concludes the statement and proof of the proposition. To sum up the main argument, if there is liberty, there is a free choice of ethics or rules of conduct by participating and agreeing parties, always assuming that they do not act coercively toward innocent bystanders. If there is liberty, then the arrangements that some people willingly make cannot be forcibly altered by others who have different ethics without thereby infringing on the liberty of those making these arrangements.

I also, in passing, noted that in today's economy, there are many arrangements whereby persons make loans or own assets that they deposit in which the recipient can then use the proceeds in flexible ways and does not merely store the person's wealth for them. A free market bank could do much the same. That arrangement makes the depositor into a creditor, and the banker into a borrower. A borrower may take possession of the title to the borrowed assets. But that is only one of many possibilities. There is also the possibility of the creditor retaining an option to call assets of similar value from the borrower, and that call option can be modified in a great many ways. Two or more parties are basically contracting over the division of future cash flows and assets, and they can write contracts that express various divisions of these cash flows contingent on the various states-of-the-world that may transpire in the future. These observations, distinct from the proof, merely express some aspects of the viability of the fractional reserve banking arrangement. But a full discussion of that is reserved for the future.

The most widely publicized view in opposition to fractional-reserve banking is that of the Rothbard-Hülsmann-Hoppe-de Soto school, identified with the Mises Institute, but not at all with von Mises! It holds to the illegality and/or immorality of fractional-reserve banking. Its view is that a bank deposit is property owned by the depositor, and there cannot be two property titles to

"the same thing." A bank is therefore, in this view, not entitled to issue claims against such a deposit. It is true that there cannot be two titles to the same property. But it is not necessarily true that a free market bank deposit is going to be property owned by a depositor, or that it must be property of a nearly safe kind such as a warehoused and audited asset. A bank depositor, like any creditor, may turn assets over to the bank and, in return, receive a new property title that defines his interests in ways far different from the warehouse receipt that this school of thought envisages as the only legal and moral possibility. The bank may pool all sorts of assets and issue all sorts of claims against them. The Rothbard school of thought fails to understand that people can slice and dice property in many subtle ways and create sophisticated obligations and conditions that are agreed upon, contingent on various states-of-the-world occurring. Their thinking ignores the fact that property and property rights are a malleable thing. Claims to cash flows can be rearranged financially at the will and with the willingness of all parties concerned. With this blind spot, the Rothbardians can see nothing else but two claims to the same property. They do not realize that they are precluding the rearrangements of property interests by voluntary means. The "property" they imagine has two claims on it can be subdivided and reworked, with new contingent interests created, so that it can have multiple claims on each part. The possibilities are endless. In short, the Rothbardians are begging the question of what the property is, ignoring that it is created by people in liberty, and imposing their own assumptions on what the property rights in a deposit account must look like.

The remaining discussion in this article likewise is distinct from the proof already presented. Its aim is to bring out further meaning and perhaps suggest deeper possible offshoots of the analysis.

First off, I note that if you have different ethics, you may wish to object to the ethics of those engaging in fractional-reserve banking. You have the freedom to tell me that my firm is criminal, that it is embezzling my wealth, and that the firm is engaging in theft. You may insist that a wrong has been done to me. You may ardently desire my protection. You may tell me that your characterization of my transaction as theft is what libertarian law implies. You may tell me that it is what natural law ethics implies. You may even wish to go one step further and advocate outlawing the arrangement I have made with my firm. You may tell me that my arrangement is inconsistent with a free market. You may express your belief that firms should not be allowed to lend wealth in this way and that such lending is both immoral and fraudulent.

None of this gainsays the proof provided earlier. All of it represents no more than an expression of your tastes and preferences. I will reply that, based upon our respective liberty, you are entitled to your opinions about ethics and the content of free markets and I am entitled to mine.

I will now make a deeper and more radical argument. I will argue that one person *cannot* substitute his judgment of happiness for that of another free person without undermining that person's liberty and reducing his happiness. In other words, it is impossible for one person to impose his ethics on someone else without harming that person.

I argue that my values are subjective and internal to my consciousness and person. You cannot get under my skin or into my head. I argue that, if my arrangement makes me happy, you can argue that I am objectively being made unhappy by your criteria, but you cannot prove that argument. And if you make me behave otherwise, then you will decrease my happiness.

More generally, you cannot prove to me that I am being wronged. You could do that if you could show that you had an objectively correct ethics and I did not. However, I believe that you cannot prove that there is an objective ethics or absolute ethics or natural law ethics that condemns my banking firm as a criminal and makes me out to be a victim when we both agree to the exchange. For authority on this matter, I will cite the arguments of Ludwig von Mises, who, on page 14 of *Human Action*, states the following:

“The ultimate goal of human action is always the satisfaction of the acting man's desire. There is no standard of greater or lesser satisfaction other than individual judgments of value, different for various people and for the same people at various times. What makes a man feel uneasy and less uneasy is established by him from the standard of his own will and judgment, from his personal and subjective valuation. Nobody is in a position to decree what should make a fellow man happier.”

The operative word here is *decree*. You may suggest what will make me happier, but you are in no position to decree my behavior so as to make me happier.

Mises uncompromisingly tells us that it is *impossible* for one person to substitute his judgment for the judgment of another person. (Judgment is by definition freely-made and not the subject of torture or coercion.) In *Theory and History*, he writes at length on this matter. A few quotations make the point:

“The characteristic mark of ultimate ends is that they depend entirely on each individual's personal and subjective judgment, which cannot be examined, measured, still less corrected by any other person. Each individual is the only and final arbiter in matters concerning his own satisfaction and happiness.” (P. 13.)

“Judgments of value are voluntaristic. They express feelings, tastes, or preferences of the individual who utters them. With regard to them there cannot be any question of truth and falsity. They are ultimate and not subject to any proof or evidence.” (P. 18.)

No one yet has discovered a way to measure preferences or happiness quantitatively for a person. No one has yet discovered a way to measure happiness across different persons with a “happiness yardstick.” This is because, from one instant of time to the next, we do not and cannot know or fathom the inner workings of another person. We have partial and incomplete knowledge at times, but really to know completely and with certainty what is in the mind of another person is impossible. That impossibility is part of what makes us separate acting and creative persons. Human action, which involves the person's choice of means to attain ends, itself is thus an irreducible ground of human being. And since human action seeks the attainment of happiness or the “satisfaction of the acting man's desire,” one person cannot substitute his judgment of happiness for that of another person.

The liberty of persons logically precedes the arrangements that persons make in the realm of market exchanges. The details of a free market are not something that can be described *a priori*. They are the outcome of the decisions that free persons make, and we do not know what those

decisions will be. Furthermore, the free market is not static, because free persons change their exchange arrangements. That is human action in action. To elevate an abstraction called the free market above human liberty is to put the cart before the horse. It is bound to confuse. Therefore, to speak of arrangements that *must* comprise a free market is inconsistent with the concept of personal liberty and human action. We may *prefer* certain arrangements, but others may prefer other arrangements. Therefore, we cannot say that a free market is consistent with only gold being used as money. We cannot say that a free market in money precludes paper money. We cannot say that a free market is consistent only with 100% reserve banking. There are many, many more statements such as these that cannot be viewed as conclusive or necessary conditions of a free market. They instead must be viewed as preferences of the person asserting them.

I am dissatisfied with my lack of monetary freedom. I am unhappy with the prospect of my wealth evaporating because central banks and governments force a currency on us and are able to depreciate its value. I am displeased with the unnecessary economic hardships that are visited upon vast numbers of persons because they lack monetary liberty. I have seen the effects of it upon the lives and health of members of my family.

There are many who blame fractional-reserve banking for economic problems such as these. The analysis of the economics of banking is separate from ethics and not considered here. I am here concerned with the condemnation of fractional-reserve banking as immoral and with the repeated references to it as theft, counterfeiting, and fraud. That line of thought is apt to confuse the uninitiated and subtly undermine the case for liberty if it leads to the idea that existing arrangements must be replaced by one safe and/or golden alternative, known to the enlightened as being the only proper banking method! Let us be careful to understand that the particular institutional arrangements that we now live under do not arise from a condition of liberty to make monetary choices. *We do not have monetary freedom.* What any believer in liberty wants necessarily includes monetary liberty. That means the liberty to conclude any desired monetary arrangements. *These may well include fractional-reserve banking.* The details of banking when there is monetary freedom cannot be pre-judged as necessities (like gold) or not necessities (like paper.) They cannot be pre-judged as inherently unethical, immoral, or criminal, without indulging in a basic inconsistency with the concept of human action explained to us by von Mises. A believer in liberty cannot make these value judgments for others without going against the meaning of liberty. He cannot possibly argue that fractional-reserve banking is immoral *for all* or by some standard of objective morality, for there is no such standard that has yet been proven.

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