

A Critical Analysis of Central Banks and Fractional-Reserve Free Banking from the Austrian School Perspective

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The theory of money, bank credit, and financial markets constitutes the most important theoretical challenge for economic science on the threshold of the twenty-first century. In fact, it is no exaggeration to say that, now that the “theoretical gap” represented by the analysis of socialism has been covered, perhaps the least known and, moreover, most significant field is the monetary one. As Friedrich A. Hayek has rightly stated,¹ methodological errors, lack of theoretical knowledge and, as a result thereof, systematic coercion originating from the government prevail throughout this area. The fact is that social relations in which money is involved are by far the most abstract and difficult to understand, meaning that the social knowledge generated and implied thereby is the broadest, most complex and hardest to define. This explains why the systematic coercion practiced by governments and central banks in this field is by far the most damaging and prejudicial. Moreover, this intellectual lag in monetary and banking theory has had serious effects on the

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¹F. A. Hayek, *The Fatal Conceit: The Errors of Socialism* (Chicago: University of Chicago Press, 1989), pp. 102–4.

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evolution of the world economy. At present, in spite of all the sacrifices made to reorganize the western economies after the crisis of the 1970s, the same errors of lack of financial and monetary control have unfailingly been committed, inexorably leading to the appearance of a new worldwide economic recession of considerable magnitude.

The fact that the recent monetary and financial abuses mainly originated in the second part of the decade of the 1980s in the policies applied by the supposedly conservative-libertarian administrations of the United States and United Kingdom, dramatizes even more the importance of making theoretical advances in order to avoid, even in the libertarian field, political leaders such as Ronald Reagan and Margaret Thatcher committing the same errors. It is important to make such leaders capable of clearly identifying the only monetary and banking system truly compatible with a free society. In short, it is necessary to develop an entire research program aimed at conceiving what the monetary and banking system of a non-interventionist society should be—a system which it is evident that many libertarians do not see at all clearly.

In the present article, we propose a new approach to the analysis of the problems of monetary and banking theory. We aim to provoke a renewal of the intellectual debate over some aspects of the doctrinal controversy between the advocates of free banking and those who defend central banking, particularly why the institution of central banking may not be a spontaneous and evolutionary result arising from the market. We also hope to throw some light on many specific problems of economic policy of great current importance, in particular the future evolution of the European monetary system.

The Debate Between the Theorists of Free Banking and Central Banking

Beginning with the doctrinal controversy between the supporters of central banking and those who favor free banking, it is first necessary to state that our analysis does not entirely coincide with the nineteenth century controversy between the theorists of the banking and currency schools. In fact, many of those who defended free banking based their reasons on the fallacious and defective inflationist arguments of the banking school, while the majority of the currency school theorists aimed to attain their objectives of financial solvency and economic stability by the creation of a central bank to put a stop to monetary abuses.

From the beginning, however, some reputable currency school theorists considered it impossible and utopian to think that a central bank would not make the problems even worse. They were aware that the best way of putting a stop to the creation of fiduciary media, and to achieve monetary stability was through a free banking system subject, like all other economic agents, to the traditional principles of civil and mercantile law. In addition, paradoxically, the majority of those who defended the tenets of the banking school were, in the end, pleased to accept the establishment of a central bank that, as last resort lender, guaranteed and perpetuated the expansionist privileges of private banking. The privileged bankers tried, in this way, to evade their commitments and devote themselves to the lucrative "business" of creating fiduciary money through the expansion of credit, without having to worry excessively about liquidity problems, thanks to the support implied by the establishment of a central bank.

It is important to emphasize the fact that most of the currency school theorists, even though the heart of their theoretical contributions was correct, were incapable of appreciating that the same defects they rightly attributed to the freedom of the banks to issue fiduciary money in the form of notes, were fully and identically reproduced, though in a more hidden, and therefore, dangerous way, in the "business" of expansively granting credits against the banks' demand deposits. And, moreover, these theorists erred in proposing, as a more appropriate policy, the establishment of legislation which would merely put an end to the freedom to issue notes without backing and create a central bank to defend the most solvent monetary principles.

Only Ludwig von Mises, following the tradition of Cernuschi, Hübner and Michaelis, was capable of realizing that the currency school theorists' recommendation for a central bank was erroneous and that the best and only way of achieving the credible monetary principles of the school was through a free banking system subject, without any privileges, to private law. This failure on the part of the majority of the currency school theorists was fatal. It not only led to the fact that Peel's Act of 1844, in spite of its good intentions and its elimination of the free issue of bank notes, did not eliminate the creation of fiduciary credit. Instead, Peel's Act in effect led to the creation of a central banking system which, subsequently and above all due to the influence of banking school theorists like Marshall and Keynes, was used to justify and promote policies containing a lack of monetary control and financial

abuses much worse than those it was originally intended to remedy.

The Evolution of the Banking System and the Central Bank

The central bank is not a natural product of the development of the banking system.² On the contrary, it is coercively imposed from outside the market as a result of governmental action. Such action, as a consequence of a series of historical accidents, gave rise to a monetary and financial system very different from that which would have emerged spontaneously under a free banking system subject, without privileges, to private law and not coerced by government through the central bank. It is impossible to know what knowledge and institutions the banking entrepreneurs would have created freely if they had been subject to the general principles of law and not to any kind of state coercion.³ Yet we may imagine a generalized system of investment funds in which current "deposits" would be invested, and endowed with great liquidity, but without a guarantee of receiving the face value (which would be subject to evolution of the market value of the corresponding units); a network of entities providing payment and accounting services, etc., operating in free competition and charging fees for their services; and, separately, *without any connection with credit*, a series of private institutions devoted to the extraction, design and offer of different types of private money (also charging a small margin for their services).⁴

In fact, the current central banking system is merely the logical and inevitable result of the gradual and surreptitious introduction by private bankers, historically in complicity with the governments, of a banking system based on a fractional reserve. And it is here essential not to fall into the same intellectual trap as

²Vera C. Smith, *The Rationale of Central Banking and the Free Banking Alternative* (Indianapolis, Ind.: Liberty Press, 1990), chap. 12, p. 169.

³Israel M. Kirzner, *Discovery and the Capitalist Process* (Chicago: University of Chicago, 1985), p. 168.

⁴F. A. Hayek, *Denationalization of Money: The Argument Refined*, 2nd ed. (London: Institute of Economic Affairs, 1978), pp. 119–20. Hayek concludes, "I expect that it will soon be discovered that the business of creating money does not go along well with the control of large investment portfolios or even control of large parts of industry." I am afraid, however, that Hayek gives insufficient recognition of the fact—central to Mises's theory of money—that free market money must be a *commodity* money, and that competing kinds of money are dysfunctional of the very purpose of a medium of exchange, as the free market always generates a tendency of the convergence toward *one*, universally employed commodity money.

the majority of the theorists who have defended the free banking system. With the honorable exception of Mises and very few others,⁵ they do not realize that the only way to achieve a truly free banking system is to reestablish the legal principle according to which it is necessary to keep a reserve of 100 percent of the sums of money received as demand deposits.

In the final analysis, the question is the application in the monetary and banking field of Hayek's seminal idea according to which, whenever a traditional rule of conduct is violated, either through institutional coercion on the part of the government or by the latter's granting special privileges to certain persons or entities, damaging and undesired consequences will, sooner or later, appear, seriously prejudicing the spontaneous social process of cooperation.

The traditional rule of conduct violated in the case of the banking business is the principle of law according to which, in the contract for the deposit of fungible money (also called *irregular deposit*), the traditional obligation of *custody*, which is the essential element of all non-fungible deposits, requires that, at all times, a reserve of one hundred percent of the amount of fungible money received in deposit be maintained. This means that all acts which make use of that money, specifically the granting of credits against it, are a violation of that principle and, in short, an illegitimate act of undue appropriation.

In the continental European juridical tradition, there is a long-established principle that dates back to the old Roman Law according to which *custody, in irregular deposits, consists precisely of the obligation to always have an amount equal to that received at the depositor's disposal*. The custodian of a deposit must "have always available a quantity and quality equal to that received of certain things," regardless of whether they are continually renewed or substituted. This requirement is the equivalent, for fungible goods like money, of the continued existence of the item *in individuo* for infungible goods.⁶ This general legal

⁵Before Mises, the most distinguished author who defended the one hundred percent reserve requirement was David Hume in his essay "Of Money" (1752), where he states that "no bank could be more advantageous, than such a one as locked up all the money it received, and never augmented the circulating coin, as is usual, by returning part of its treasure into commerce." David Hume, *Essays: Moral Political and Literary* (Indianapolis, Ind.: LibertyClassics, 1985), pp. 284–85.

⁶On juridical considerations of the traditional legal principle in question, see not only all Title 3, Book 16 of the Digest, especially sections 7 and 8 on the bankruptcy of bankers (*El Digesto de Justiniano* 1 [1968]: 606–17, esp. 112, [Spanish edition published by Aranzadi, Pamplona], but also the fine argument by

principle which requires one hundred percent reserve banking has been upheld, even in this century, by French and Spanish jurisprudence.

A ruling of the Court of Paris of June 12, 1927 condemned a banker for the offense of undue appropriation because he had used, in accordance with common banking practice, the funds which he had received in deposit from his clients. Another decision of the same Court dated January 4, 1934 made the same ruling, and even more curious was the ruling of the Court of First Level which heard the case of the bankruptcy of the Bank of Barcelona, according to which the depositor's power to draw checks implies for the depositee the obligation to *always* have funds at the disposal of the current account holder, making it unacceptable that a bank consider the funds deposited in a current account in cash as belonging exclusively to itself.⁷ We should add that the "undue appropriation" arises when the undue act (lending the amount deposited) is committed, and not when it is discovered a long time afterwards (generally by the depositor at the counter of a bank which cannot return his money to him). Moreover, the trite argument that the "law of large numbers" allows the banks to act safely with a fractional reserve cannot be accepted, since the degree of probability of an untypical withdrawal of deposits is not, in view of its own nature, an insurable risk.

The Austrian theory of economic cycles has perfectly explained how the system of fractional reserve banking itself generates economic recessions *endogenously* and recurrently and, hence, the need to liquidate wrongly induced investment projects, to return bad loans and withdraw deposits on a massive scale. And, as all insurance theorists know, the consequences of an event (untypical withdrawal of deposits) which is not totally

the Spanish Jesuit Luis de Molina, for whom the banker with a fractional reserve "sins by endangering his own capacity to meet his debts, even if in the long run he suffers no legal difficulties because his speculations with the clients' funds turned out well (quoted from *De Iustitia et Iure*, Maguntiae [1614], in Alejandro Chafuen, *Christians for Freedom: Late Scholastic Economics* [San Francisco: Ignatius Press, 1986], p. 146 n. 1-7). See also the refined conclusions of Pasquale Coppa-Zuccari included in his definitive work *Il Deposito Irregolare* (Modena 1901), quoted by, among others, Joaquín Garrigues in his *Contratos Bancarios*, 2nd ed. (Madrid, 1975), p. 365. All these considerations are also applicable to so-called financial operations with repurchase agreements at any moment and at face value (and not at a fluctuating secondary market price), since they disguise, by fraudulently using the law for a purpose for which it was not intended, what are really deposit contracts.

⁷Ibid., pp. 367-68.

independent of the “insurance” itself (fractional reserve) are not technically insurable, for reasons of *moral hazard*.⁸

In the course of history, bankers were soon tempted to violate the above-mentioned rule of conduct, using the money of their depositors to their own benefit.⁹ This happened shamefacedly and secretly at first, since the bankers were still conscious of acting incorrectly. It occurred, for example, with the Bank of Amsterdam, when the activities of the bank were carried out, for the reasons mentioned, according to the words of Sir James Steuart, with the *maximum secrecy*.¹⁰ It should be noted that the entire prestige of the Bank of Amsterdam was based on the belief that it held a reserve of one hundred percent, a principle which, only fifteen years previously, David Hume believed to be in force.¹¹ And in 1776, Adam Smith mentioned that, at that time, the Bank of Amsterdam *continued to say* that it held a cash ratio of one hundred percent.¹²

Only later did the bankers achieve the open and legal violation of the traditional legal principle, when they were fortunate enough to obtain from the government the *privilege* of using part of the money of their depositors to their own benefit (generally in the form of credits, often granted initially to the government itself). In this way the relationship of complicity and the coalition of interests which now traditionally exists between governments and banks commenced, explaining perfectly the relationship of intimate “comprehension” and “cooperation” which exist between both types of institutions and which, nowadays, may be observed, with slight differences of nuance, in all western countries at all

⁸With regard to the class probability (objective), which is insurable, and the single event probability, influenced and determined by human action (not insurable), see Ludwig von Mises, *Human Action: A Treatise on Economics*, 3rd rev. ed. (Chicago: Henry Regnery, 1966), pp. 106–15; and also Jesús Huerta de Soto, *Socialismo, Cálculo Económico y Función Empresarial* (Madrid: Unión Editorial, 1992), pp. 46–48.

⁹The temptation was enormous and almost irresistible, given how lucrative it was. We must remember that, in the final analysis, the system of fractional reserve banking consists of creating loans from nothing and requiring that the borrowers return them in real money and with interest, too!

¹⁰Sir James Steuart, *An Inquiry into the Principles of Political Economy: Being an Essay on the Science of Domestic Policy in Free Nations* (London: A. Millar and T. Caddell in the Strand, 1767), vol. 2, p. 301.

¹¹David Hume, “On Money,” p. 284.

¹²The Bank of Amsterdam professes to lend out no part of what is deposited with it, but for every gilder which it gives credit in its books, to keep in its repositories the value of a gilder, either in money or bullion” (Adam Smith, *The Wealth of Nations* [London: W. Strahan and T. Caddell in the Strand, 1776], vol. 2, bk. 4, chap. 3, p. 72).

levels. Furthermore, the bankers soon realized that the violation of the traditional legal principle mentioned above gave rise to financial activity which was highly lucrative for them, but which always required the existence of a last resort lender, or central bank, to provide the necessary liquidity at the difficult moments which, as experience demonstrated, always recurred.¹³

The Fractional Reserve Banking System: The Central Bank and the Theory of Economic Cycles

The inauspicious social consequences of this *privilege* granted to the bankers (but not to any other individual or entity) were not completely understood until the development, by Mises and Hayek, of the Austrian theory of economic cycles.¹⁴ In short, what the Austrian School theorists have shown is that persistence in pursuing the theoretically impossible objective—from the legal-contractual and technical-economic viewpoints—of offering a contract that simultaneously tries to combine the best features of investment funds—especially the possibility of obtaining interest on the “deposits”—with the traditional deposit contract—which, by definition, must permit withdrawal of its face value at any moment—must inexorably, sooner or later, lead to uncontrolled expansion in the monetary supply, inflation, and the generalized incorrect allocation of productive resources at a microeconomic level. In the final analysis, the result will be recession, the rectification of errors induced in the productive structure by prior credit expansion and massive unemployment.

It is necessary to realize that the privilege granted to the banks permitting them to carry on activity with a fractional

¹³It is curious to observe how the bankers used all their influence and social power (enormous, in view of the large numbers of the public who received loans from them or were their shareholders) to impede and discourage the depositors from withdrawing their deposits, in the vain hope of avoiding the crisis. Thus, State Senator Condy Raguet of Pennsylvania, concluded that the pressure was almost irresistible and that “an independent man, who was neither a stockholder nor a debtor, who would have ventured to compel the banks to do justice, would have been persecuted as an enemy of society.” Letter from Raguet to Ricardo dated April 18, 1821, published in David Ricardo, *Minor Papers on the Currency Question 1805–1823*, Jacob Hollander, ed. (Baltimore, Maryland: The Johns Hopkins University Press, 1932), pp. 199–201; quoted in Murray N. Rothbard, *The Panic of 1819: Reactions and Policies* (New York: Columbia University Press, 1962), pp. 10–11.

¹⁴A brief explanation of the Austrian theory of economic cycles, together with the most significant bibliography on the topic, may be found in my article “The Austrian Theory of Economic Cycles,” originally published in *Moneda y Crédito*, no. 152 (Madrid, March 1980), and republished in volume 1 of my *Lecturas de Economía Política* (Madrid:Unión Editorial, 1986), pp. 241–56.

reserve, implies an evident attack against a correct definition and defense of the property rights of the depositors by the governmental authorities. This inevitably generates, as is always the case when property rights are not appropriately defined, the typical effect of “tragedy of the commons,” by virtue of which the banks are inclined to try to get ahead and expand their corresponding credit base before, and more than, their competitors. Therefore, a banking system based on a fractional reserve will always tend towards a more or less uncontrolled expansion, even if it is controlled by a central bank which, in contrast to what has normally been the case, is seriously concerned about controlling it and establishing limits. In this respect, Anna J. Schwartz reaches the conclusion that many modern theorists of the free banking system do not completely understand: that the system of interbank clearing houses which they propose does not act as a brake on credit expansion if all the banks decide to expand their credit simultaneously, to a greater or lesser extent.¹⁵ This phenomenon, which had already been set out by Ludwig von Mises in his brilliant explanation of the free banking system,¹⁶ drove us to seek its explanation in the typical process of the “tragedy of the commons”: the entire expansive process originates, as we have seen, from a *privilege* that contravenes property rights. Each bank internalizes all the profits obtained from expanding its credit, making the corresponding costs fall, dilutedly, upon the entire banking system. For this reason, it is easy to understand that a mechanism of inter-bank compensation or clearing houses may put a stop to individual, isolated expansion initiatives in a free banking system with fractional reserves, but is useless if all the banks, to a greater or lesser extent, are carried away by “optimism” in the granting of credits.

The proposal to establish a banking system with a one hundred percent reserve was already included in the first edition of *The Theory of Money and Credit* published by Mises in 1912, in which the author reached the conclusion that “it is obvious that the only way of eliminating human influence on the credit system is to suppress all further issue of fiduciary media. The basic conception of Peel’s Act ought to be restated and more completely implemented than it was in the England of his time by including

¹⁵See her article “The Theory of Free Banking,” presented at the regional meeting of the Mont Pèlerin Society in Rio de Janeiro from September 1993, especially page 5.

¹⁶Mises, *Human Action*, pp. 648–88.

the issue of credit in the form of bank balances within the legislative prohibition.¹⁷ Subsequently, Mises again dealt with the matter even more explicitly in 1928¹⁸ and especially in the appendix on *Monetary Reconstruction* which he incorporated into the English edition of *The Theory of Money and Credit* in 1953, where he expressly states that “the main thing is that the government should no longer be in a position to increase the quantity of money in circulation and the amount of checkbook money not fully—that is, one hundred percent—covered by deposits paid in by the public.”¹⁹ Hayek already referred to this proposal in 1937²⁰ and it is evident that Hayek, like Mises, proposes the free choice of currency and banking system as a means to achieve, in the final analysis, a banking system based on a one-hundred-percent-cash-ratio.²¹ After Mises, the writer who has, in modern times, defended the elimination of the banking system as we know it today with the greatest determination and brilliance is, without doubt, Murray N. Rothbard.²²

Also in modern times, Maurice Allais has defended the principle of the one hundred percent reserve, although it is true that he defends it as a means to facilitate the monetary policies of governments, preventing their elastic and distortive expansion through the fractional reserve banking system.²³ Maurice Allais, in this respect, merely follows the now abandoned Chicago School tradition in favor of the one-hundred-percent-cash-ratio in order to make the monetary policies of the governments more

¹⁷Ludwig von Mises, *The Theory of Money and Credit* (Indianapolis, Ind.: Liberty Press, 1980), p. 447.

¹⁸Ludwig von Mises, “Monetary Stabilization and Cyclical Policy,” in *On the Manipulation of Money and Credit* (Irvington-on-Hudson, N.Y.: Free Market Books, 1978), pp. 167–68.

¹⁹Mises, *The Theory of Money and Credit*, p. 481.

²⁰F. A. Hayek, *Monetary Nationalism and International Stability* (New York: Augustus M. Kelley, 1971), pp. 81–84.

²¹F. A. Hayek, *Denationalization of Money*, pp. 119–20.

²²See particularly Murray N. Rothbard’s books *The Case for a One Hundred Percent Gold Dollar*, 2nd ed. (Auburn, Ala.: Ludwig von Mises Institute, 1991) and *The Mystery of Banking* (New York: Richardson & Synder, 1983); and his articles “The Myth of Free Banking in Scotland,” *Review of Austrian Economics* 2 (1988): 229–45 and “Aurophobia: or, Free Banking on What Standard?” *Review of Austrian Economics* 6, no. 1 (1992): 99–108.

²³Maurice Allais, “Le retour à L’État du privilège exclusif de la creation monétaire” in *L’impôt sur le capital et la réforme monétaire* (Paris: Hermann Editeurs, 1985), pp. 200–10, and also his most recent article “Les conditions monétaires d’une économie de marchés: des enseignements du passé aux réformes de demain,” *Revue d’économie politique*, 3 (May/June 1993): 319–67.

effective and predictable.²⁴ Although monetary policy would be more predictable with a one-hundred-percent-cash-ratio, all the Chicago theorists are ingenuous if they think that the government can and will want to carry out a stable monetary policy. This ingenuousness is parallel and similar to that shown by the modern fractional reserve free banking theorists, when they trust that spontaneous clearing house mechanisms can put a brake on a simultaneous and agreed upon expansion by a majority of banks. *The only correct solution for a society free of privileges and economic cycles is, therefore, banking which is free but subject to the law, i.e., with a reserve ratio of one hundred percent.*

The Monetary and Banking System in a Free Society

In short, the main defect of the majority of the theorists who defend free banking is their failure to realize that the demand for a one hundred percent reserve requirement is theoretically inseparable from their proposal. Specifically, they have not appreciated that all the defects which advocates of the central bank see in the free banking system lose their potential and completely disappear if it is put into practice on the basis of traditional legal principles. Or, to put it another way, using Mises's words, the issue is to subject the banks to the traditional principles of civil and mercantile law, according to which each individual and each enterprise must meet its obligations in strict accordance with what is literally established in each contract.²⁵

This error is very generalized and affects, in particular, the interesting and broad literature which has been developed as a result of the great echo arising from the publication of Hayek's book on the *Denationalization of Money*, together with the important economic and financial crisis which took place at the end of the 1970s. The most important comment I have on all this literature

²⁴This tradition was initiated by an anonymous 26-page pamphlet on "Banking and Currency Reform," circulated in 1933 by Henry C. Simons, Aaron Director, Frank H. Knight, Henry Schultz, Paul H. Douglas, A. G. Hart and others and subsequently articulated by Henry C. Simons, "Rules versus Authorities in Monetary Policy," *Journal of Political Economy* XLIV, no. 1 (February 1936): 1-30; Albert G. Hart "The 'Chicago Plan' of Banking Reform," *Review of Economic Studies* 2 (1935): 104-16; and Irving Fisher *100 Percent Money* (New York: Aldelphi, 1936) culminating in 1959 with the publication of Milton Friedman's book *A Program for Monetary Stability* (New York: Fordham University Press, 1960).

²⁵Mises, *Human Action*, p. 443. In short, according to Mises, it is a question of replacing the current tangle of administrative banking legislation by clear and simple articles in the commercial and criminal codes.

is that, apart from a few exceptions, it uses the defense of a free banking system to put forward whims typical of the old "banking school," the erroneous principles of which were demonstrated long ago. Moreover, all this literature, which is headed by the works of White, Selgin and Dowd,²⁶ among others, forgets that, as we have argued, the only way of getting rid of the central bank and its excesses is by eliminating the fractional reserve privilege which private bankers currently exploit.

If one wishes to defend a truly stable financial and monetary system for the next century, one which immunizes our economies against crises and recessions as much as is humanly possible, it will be necessary to establish three conditions: (1) complete freedom of choice of currency; (2) a free banking system; and (3) most importantly, all the agents involved in the free banking system are subject to and follow, in general, traditional legal rules and principles. In particular, the principle according to which nobody, not even the bankers, should enjoy the privilege of lending something which has been deposited with him as a demand deposit (i.e., to maintain a banking system with a reserve of one hundred percent).

The modern free banking theorists erroneously consider (due, among other things, to their lack of a juridical background), that the one hundred percent reserve requirement would be an inadmissible *administrative* interference with individual freedom. They do not realize that, far from implying systematic administrative coercion by the government, as we have seen, this precept is merely the application of the traditional principle of *property rights*. In other words, they do not realize that the famous anonymous phrase of an American quoted by Tooke, according to which "free banking is equivalent to free swindling"²⁷ is applicable to free banking not subject to law (and which, therefore has, fractional reserves). In the final analysis, the defense of free banking must be made, not as a means to exploit the lucrative possibilities of credit expansion, but as an *indirect* means to get closer to the

²⁶Thus, for example, see the works of Lawrence H. White, *Free Banking in Britain: Theory, Experience and Debate, 1800-1845* (Cambridge: Cambridge University Press, 1984) and *Competition and Currency: Essays on Free Banking and Money* (New York: New York University Press, 1989); those of George A. Selgin, *The Theory of Free Banking: Money Supply under Competitive Note Issue* (Totowa, N. J.: Rowman and Littlefield, 1988) and *The Experience of Free Banking*, George A. Selgin and Kevin Dowd, eds. (London: Routledge, 1992); and those of Kevin Dowd, *The State and the Monetary System* (New York: St. Martin's Press, 1989) and *Laissez Faire Banking* (London: Routledge, 1993).

²⁷Quoted by Mises in *Human Action*, p. 446.

ideal model of free banking with a one hundred percent reserve requirement which, additionally, must be *directly* pursued by all the legal means available in each historical circumstance.²⁸

Although the foregoing economic policy recommendations may appear *utopian* and very distant from the practical problems we have to deal with, especially with regard to the design and management of a European monetary system, they indicate, at all times, at least the appropriate direction which reform should take and dangers that must be avoided. Thus, it seems clear that we should reject both a system of monopolistic national currencies which compete among themselves in a chaotic environment of flexible exchange rates, as well as the move towards the creation of a central European bank.

This proposed central European bank would prevent the competition among currencies over a wide economic area, would not confront the challenges of banking reform, would not guarantee a monetary stability which is at least as great as that of the most stable national currency at each moment and would set up, in short, a definitive obstacle to making subsequent reforms in the right direction.

Perhaps the most practicable and appropriate model in the short and medium terms is, therefore, to introduce throughout Europe the complete freedom of choice of public and private currencies inside and outside the Community, linking the national currencies which, for reasons of historical tradition continue in use, to a system of fixed exchange rates. These rates would discipline the monetary policy of each country in accordance with the policy of that country which, at each historical moment, is carrying out the most solvent and stable monetary policy. In this way, at least the door would remain open for some nation-state of the EEC to have the possibility of advancing along the three lines of monetary and banking reform indicated above,²⁹ forcing its partners in the Community to follow its monetary leadership along the right lines. (This, and

²⁸Only in the sense of indirectly getting closer to the ideal should we understand Cernuschi's position, mentioned by Mises (in *Human Action*, p. 446), when in 1865, he said, "I believe that what is called freedom of banking would result in a total suppression of banknotes in France. I want to give everybody the right to issue banknotes so that nobody should take banknotes any longer."

²⁹The practical problems posed by the *transition* from the current monetary and banking system to a system in which, at last, the creation of money and the banking business were completely separated from the State have been theoretically analyzed and solved by, among others, Murray N. Rothbard in his *Mystery of Banking*, pp. 249-69.

nothing else, appears to have been the essence of the project defended by Margaret Thatcher and the incorrectly named group of "Euro-sceptics" who follow her, among whom this author is included, for the monetary future of the EEC.)

It is evident that the definitive work on monetary and banking theory, in the light of the historic controversy taking place between those who favor free banking and those who support a central bank, has not yet been written. Therefore, we are afraid that it is not unrealistic to think that the world will continue to suffer recurrently, very dangerous economic recessions as long as the central banks maintain their monopoly on currency issue, while the privilege granted to the bankers by the governments is not abolished. And, in the same way as we began this article, we would dare to say that, after the historic, theoretical and actual fall of socialism, the main theoretical challenge faced by both professional economists and lovers of freedom well into the next century will consist of fighting with all their strength against both the institution of central banking and the maintenance of the privilege currently enjoyed by those who practice private banking activities.