Neo-Austrians between Gold Standard, 100% Reserve, and Free Banking. Notes on the occasion of reading Jesús Huerta de Soto

by Joseph Huber

Intro and summary

About a hundred years ago a main representative of the Austrian School, Ludwig von Mises, spoke out in favour of tying the money supply to Currency School principles and full reserve:

> 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 the issue of credit in form of bank balances within the legislative prohibition.' – '… it means the introduction of a new program based on the old Currency School theory, but expended in the light of the present state of knowledge to include fiduciary media issued in the form of bank deposits. The banks would be obliged at all times to maintain metallic backing for … all notes issued and bank deposits opened.[1]

Jesús Huerta de Soto, HdS for short, is a proponent of contemporary Neo-Austrians. He builds on Mises to a great extent, as well as on Hayek, one of Mises' disciples. HdS' well-read scholarly 885-page volume is unusual in form for today's habits, resembling a humanistic habilitation rather than an economics paper. In a book of so many pages the author is of course telling us many things, partly illuminating and educational with regard to details of the history of banking and monetary economics, partly somewhat redundant with regard to the message he wants to bring to us. In my understanding, there are four main components:

1) The book is an attempt to lay the theoretical foundations of a monetary and banking reform aimed at *free banking* without central banks, though subject to the requirement of a *100% reserve* on deposits or *full gold reserve,* respectively. In this respect the Neo-Austrian position appears to be an odd combination of elements of Currency School and Banking School teachings. Most readers will see this as an oxymoron—which in fact it remains in spite of the author's far-flung analyses and explanations.

2) The middle and biggest part of the book is based on the Austrian School's production model and theory of the business cycle. Such cycles are depicted in any event as harmful boom-and-bust processes. Balanced markets are not supposed to produce cycles. The main cause of cycles is seen in willful additions to the money supply, created by banks and central

[1] Ludwig von Mises 1912: Theorie des Geldes und der Umlaufsmittel, München u Leipzig: Duncker & Humblot, 419. – Ders. 1928: Geldwertstabilisierung und Konjunkturpolitik, Jena: G. Fischer.

banks extending their balance sheets out of thin air. Economic and financial cycles are considered to be unnatural and harmful phenomena, caused by banks' untethered credit and deposit (=money) creation on the basis of fractional reserve banking.

3) What enables *central banks* to do so is the abandoning of the gold standard, or any equivalent real-asset standard, in favour of pure fiat money in the form of central bank notes and reserves (i.e. credits on central bank account) imposed by legal tender laws.

4) What enables *banks* to do so is the practice of fractional reserve banking which has a long history. The Fall of Banking—so to say, its Original Sin—is fraudulent banking in the form of fractional reserve practices, in modern times backed by national central banks. This brings about unsafe and unstable money, unsound finances and recurrent crises.

Much of this sounds like New Currency Theory NCT, as championed on this website. Yet the standpoints are farther apart than it might appear at first glance.

• Neo-Austrians and NCT share the criticism of fractional reserve banking as an illegitimate privilege of the banking industry and as the root cause of overshooting money supply, inflation and asset inflation, i.e. credit and debt bubbles and recurrent crises. They think so, however, for partially different reasons.

• According to Neo-Austrians, legal-tender laws and central banks are basically evil and ought to be abolished. NCT, quite to the contrary, sees independent central banks as the best candidate to serve as a state's monetary authority in the exercise of its monetary prerogative (monopoly of currency, money issuance, and seigniorage).

• HdS relies on an understanding of fractional reserve banking which is *traditional* rather than *modern*. Part of this is the traditional textbook model of the credit or deposit multiplier, of banks on-lending customer deposits and of funding investment through savings. Such things may have been part of the now historical cash economy, but they no longer apply to modern cashless economies based on fiat money. So the Neo-Austrian ideas of monetary reform are based from the outset upon unreal ideas of the monetary system's functioning.

• To a certain degree this also holds true for a 100% reserve on deposits. This too is operationally ill-conceived and suboptimal compared to plain sovereign money as a liquid asset.[2]

• The Neo-Austrian assessment of business cycles as 'unnatural' is rather idiosyncratic. It makes more sense to see economic cycles as quite 'natural' phenomena of structural change embedded in system growth and modernization processes, such as for example industrial innovation and learning curves, in the transsecular transition from traditional to modern societies.

• Growth implies a growing money supply in adequate proportion to an economy's growth potential at full capacity. Seen like this, the envisaged return to a full gold reserve, basically with no more extending of the money supply thereafter, appears as an attempt to reverse what has for some time now become irreversible. Resorting to a 100% gold reserve or any other gold standard, rather than bringing stability and wealth, is more likely to result in a deflationary quagmire and a relapse into class warfare.

Deposits in traditional and modern fractional reserve banking

HdS starts his treatise by examining the irregular-deposit contract. Its abuse is the starting point of HdS's criticism of fractional reserve banking. An irregular deposit is in contrast to, firstly, a regular deposit which has to be returned identically; secondly, a loan which is not a deposit but the lending of money for an agreed period of time. With an irregular-deposit contract, the depositor can at any time claim the amount of money deposited. The depositary's duty is to return on demand the entire amount of money deposited—not identically the same bullion, coins or notes as deposited, but an equivalent amount of money.

A fee is charged for the safekeeping of a deposit. On lending money, some interest is paid. If there is a deposit interest, or both a fee and interest at the same time, this indicates a confusion of contracts.

HdS never tires of pointing out that fulfillment of an irregular-deposit contract can only be taken for granted if there is a 100% reserve on any deposit. If not, in HdS's eyes, the depositary becomes guilty of fraudulent behavior. HdS discusses the history of deposit and loan contracts since ancient Greece and Rome. In their beginnings, the different types of contracts were strictly abided by, and deposit takers who did not conform to the rules were brought before court. Later on, in particular since the

[2] Cf. *100% Reserve (Chicago Plan) and Plain Sovereign Money* on this website (sovereignmoney.eu > start).

Middle Ages, the meaning of an irregular deposit came to be ever more often defined down, especially by its reinterpretation in the sense of an implicit or tacit loan contract or by relativizing the notion of availability of money with the law of big numbers, i.e. the experience that sufficiently large banks normally needed to have not more than about 10% of deposits available in order to satisfy current customer demand for money paid out. To HdS this clearly means willfully mis-interpreting the irregular-deposit contract in the interests of dishonest bankers, who made common cause with lavishly expending, debt-hungry rulers.

HdS has compiled an impressive wealth of historical findings on the matter. What he lacks, though, is an understanding of the structural changes that have occurred in the transition from traditional cash-based economies to modern cashless credit economies. HdS seems not to see that his investigation of the irregular-deposit contract only applies to the metal age of money, i.e. an economy based on bullion and cash. He fails to see that it does not apply to modern cashless economies where a deposit at source comes no longer from depositing cash, but from crediting current accounts out of authorized fiat. Rather than representing a transgression, this was a historical necessity. Industrialization could not have happened without it. Cash has now become a mere remnant of former times, and is exchanged out of and back into the basically non-cash money supply created by primary bank credit of commercial banks (demand 'deposits') and central banks (reserves).

HdS seems not to be fully aware of how fractional reserve banking on the basis of primary central-bank and bank credit actually works: 'In violation of these principles [of deposit contracts], bankers have been permitted to make self-interested use of demand deposits. Until now these effects have gone mainly unnoticed' (171). No wonder. In present-day banking, banks cannot use deposits, even if they wished to. With the idea of 'banks working with our money', HdS does not find himself alone. This is one of several widespread misrepresentations of modern money and banking, not just in the broader public, but also among economists.

Banks are said to on-lend customer deposits rather than safeguarding them, thus keeping just a fraction of the deposits entrusted to them, and using—abusing, according to HdS—the major part of deposits to multiply the amount of credit-money in circulation not backed by real-capital assets. So, tolerating and actually legalizing fractional-reserve practices is tantamount to officially advancing fraudulent banking.

From page 184 HdS replicates all of the typical mistakes of orthodox monetary economics: that banks on-lend customers' money, whereby a typical confusion occurs between payment reserves (excess reserves) and coverage reserves (reserve ratio, i.e. minimum reserve requirement). HdS reproduces the wrong multiplier textbook model which assumes an ongoing, iterative on-lending of customer deposits by *banks* to, say, 90% while keeping 10% as 'reserve ratio'. Like most economists he cannot resist couching that in those nice model formulas which are formally consistent and yet beside the point. If at all, the multiplier model in a certain sense applies to secondary on-lending of already existing deposits among *nonbanks*. This, however, may create additional loans or investments, not additional money.

In a reserve system with split interbank and public circulation, a bank is neither allowed nor technically able to use customer demand deposits. A customer deposit cannot end up on a central-bank account, and vice versa. Bank liquidity is just payment or settlement reserves in a bank's central-bank account, and, residually, cash in vault. Cash deposits have become largely irrelevant, since money at source is non-cash, and cash is now just a form of change for originally non-cash money. Sight deposits then are not 'deposited', but created at source by primary credit. Thereafter they circulate as the preferred means of payment through interbank clearing procedures.

With time deposits (including savings deposits and 'secured' deposits) the case is basically the same. A time deposit cannot be used by a bank since it is an inactivated, immobilized deposit. Banks do not obtain liquidity from time deposits. By accepting time deposits at lower deposit interest, though, they preclude deposit and account migration for a certain period of time, and are thus able to create new, additional primary credit at higher interest without running an additional liquidity risk—the liquidity risk, however, not anyway being equal to an amount involved, but just accounting for a fraction of it (about 2–11 per cent, depending on national minimum reserve requirements and specific circumstances).

As a consequence, in a modern banking system based on fiat money, investment does not need to be funded through prior savings. Of course, channelling savings into some real-economic or financial investment can partly be done—and is done—in the form of secondary on-lending of deposits from nonbanks to nonbanks (including nonbank financial institutions such as funds). Banks, however, as creditors to nonbanks and underwriters and otherwise buyers of financial assets from nonbanks,

always create primary credit and deposits. So a modern economy does not have to rely on savings to be able to invest. Savings or own capital are still important as a bail for obtaining credit. Such collateral, however, does not of course fund the credit obtained. If banks and central banks work properly, something like a money and capital shortage does not need to occur—notwithstanding a 'natural' periodic reluctance to engage in new credit or debt in the trough of a business cycle.

The Austrian School production model and the role of credit creation in business cycles

HdS concludes his discussion of the irregular-deposit contract, and enters the middle part of his book on the Austrian production model and boom-and-bust cycles, by identifying unrestrained credit and deposit creation in a fractional-reserve regime as the root cause of such cycles. Credit creation 'out of nothing' creates 'maladjustment or discoordination in the behavior of the different economic agents' (351). This now seems to converge with the criticism of injurious effects such as inflation, asset inflation, financial bubbles and extreme business cycles created by fractional reserve banking as put forth by Currency School teachings for almost 200 years, up to the present New Currency Theory NCT and monetary reform movements in favour of sovereign money. Sovereign money, though, is the opposite of free banking. How does this fit together?

Commonalities do in fact not go very far. HdS focuses on the classical idea, which is also a central part of the Austrian School model of the production process, that investment depends on prior savings and that interest is the price for deferred consumption; or, vice versa, that savings create investment, and, going even further, that investment *has to be* based on prior savings. If, by contrast, investment is based on additional fiat-money credit created out of nothing, interest rates will fall below the 'natural' interest rate, which in turn is supposed to trigger a chain of wrong price signals, creating unrealistic 'optimism' which leads to boom-and-bust cycles. Having abundant cheap instant money to burn certainly distorts price signals. It is nevertheless a largely unreal assumption that savings finance investment and that any primary credit creation creates market discoordination, no matter what its volume in relation to growth.

HdS's analysis relies on the Austrian model of the production process in several stages, basically in terms of 'capital or investment goods versus consumer goods'—not dissimilar to Marx, though in more stages (which does not change the idea's substance). The basic idea behind is another

mainstay of 19th century economics; that is, funding of investment through savings, i.e. deferred consumption, so that consumption funds are converted into investment funds. Under conditions of modern money, however, equating 'real investment=savings from deferred consumption' has become an unreal axiom. Even under conditions of traditional fractional reserve it used to be only part of the picture. In the form of secondary on-lending of deposits among nonbanks it has become an even smaller part of the picture today.

The kernel of truth which remains is, of course, that investment upstream in a production chain, or an evolutive life cycle, takes time to materialize downstream; or, vice versa, that demand downstream takes time to materialize in corresponding upstream investment. It does not take a clumsy aggregate 'production model' to understand this, all the more so as no such model can adequately represent all of the vertical and horizontal intra- and inter-sectoral interconnections of different width and depth that exist in real industrial production or services operations and related markets.

Even though the Austrians claim to think in interdependent stages, they hardly come forth with a real-world idea of systemic chain analysis and evolutive life-cycle analysis. Had they, they would certainly go beyond mere thinking in price relations and allocation of funds. Such self-contained economic reasoning disperses technical and practical realities such as vertical and horizontal divisions of labor and societal functions in general, operative chains of production and provision of goods and services, historical life cycles of technologies and markets, innovation and modernization processes. These and other factors cannot be incorporated in purely economic models. Consequently, this is a typical source of macroeconomic failure in understanding real-world processes, even if it is about business cycles, not to mention more complex industrial cycles. No doubt, price-related market dynamics is a powerful analytical and conceptual paradigm. But many economists tend to overbid.

It fits the picture that HdS does not discuss to what extent a growing economy might need a growing money supply; as if prices and actors' attitudes and expectations were organically downward elastic any time. Accordingly, he does not concede that fractional reserve banking, besides having been a somewhat fraudulent practice, might also have been a necessity inherent to an extensively and intensively growing economy that lacks an adequate supply of bullion and silver coin.

At the same time, the Neo-Austrian model is quite 'productionist', as if in the first instance all money were used for real-economic investment purposes. Money can both be directly created and used for real-economic investment and consumption as much as for financial investment. Neo-Austrians cannot guarantee any better than others that savings first and foremost flow into real-economic investment rather than into financial speculation. The Austrian production model does not even incorporate the realities of a semi-detached financial economy (realities which HdS certainly acknowledges in other passages outside the production model).

HdS criticizes certain aspects of Monetarism and Keynesianism for 'mechanical' thinking—for example, the equation of exchange (MV = PT). In HdS's view such equations imply 'simultaneous production and consumption' which would not allow for analyses over time, as his production model would. I do not want to defend Keynesianism and Monetarism against HdS's critique, as I won't dwell in detail on the Austrian production model. Simply, monetary and financial affairs cannot be understood on real-economic 'productive' grounds alone. A more substantial criticism of MV = PT would have been to call for disaggregating the equation of exchange into a real-economic and a financial hemisphere, as has been proposed by Werner, Hudson and myself.[3]

By not taking into account such aspects, HdS fails to consider the undesirable effects of banks' discretionary credit creation on ownership of financial assets and distribution of income. Such aspects have always been a sort of non-issue to Austrian School scholars, and this is particularly rigid in Hayek who refused to discuss distributional justice. Income distribution is seen as a market result which has more wisdom to it than we are supposed to understand. As if market results were a judgment of God. This is—like the 'invisible hand' of markets; that is, God's manus gubernatoris—just another element of medieval theological scholastics in classical and neoclassical economics. In this regard, the Austrian School is any different. If there is market failure, it must surely be the devil's work, i.e. government and central bank interference. It seems to be outside the neoclassical as well as the Austrian School's horizon that banks *are* the money market and that their discretionary allocation of primary credit directly results in distribution of financial assets and financial income, and

[3] Michael Hudson 2006: Saving, Asset-Price Inflation, and Debt-Induced Deflation, in L. Randall Wray / Forstater, Matthew (eds) 2006: Money, Financial Instability and Stabilization Policy, Cheltenham: Edward Elgar, 104–124. – Richard A. Werner 2005: New Paradigm in Macroeconomics, New York: Palgrave/Macmillan, 185. – Joseph Huber 1998: Vollgeld, Berlin: Duncker & Humblot, 224.

actually at the expense of earned income if the money supply grows in disproportion to GDP.

Having said this, it can be seen that despite all such divergences there is a convergence between Neo-Austrians and New Currency Theory with regard to the damaging effects of boom-and-bust cycles based on banks' overshooting credit and deposit (money) creation. The models and explanations behind it are different, but the factual finding is similar: Unrestrained overshooting of money supply pre-empts any sort of 'market equilibrium'. It distorts adequate interest rates and price signals and induces inflation, asset inflation, financial bubbles, and overinvestment and overindebtedness of any kind, discharging in wreckful crises.

To Austrians, however, any willful primary credit creation, as well as the ups and downs of economic cycles, is evil per se. To New Currency Theory, by contrast, such cycles fulfill a necessary role of structural change and readaptation in ongoing modernization processes (quite in the tradition of Schumpeter, who, by the way, was Austrian, but not of the Austrian School, even though Böhm-Bawerk was his and Mises' academic teacher). Growing insertion of fiat money into a growing economy is enabling and benign as long as this keeps within the limits of the economy's productive potential so that cycles do not go wild.

The question then is how to keep control of the money supply. Both Neo-Austrian and NCT scholars disbelieve in self-adjustment of money and capital markets under conditions of unrestrained primary credit and deposit creation in a fractional-reserve regime. Neo-Austrians, however, resort to some fixed real-capital standard, such as gold or productive capital. To contemporary currency scholars, a return to a gold coverage of money is definitely lagging behind the times. Real-economic capital, moreover, is almost impossible to reliably objectivize in all its tangible and intangible forms, such as developed land, available raw materials, infrastructure, production sites, human capital, property rights on technological know-how, registered trademarks and company names, not to mention the ambivalent notion of monetary value of natural capital. NCT therefore prefer to follow the concept of productive potential and a related potential-oriented monetary policy, based on an array of well-established empirical indicators regarding stocks and flows in the real and financial economy alike.

The role of central banks

In HdS's analysis, the development of fractional reserve banking owes much to the century-old interplay between creditor bankers and debt-hungry rulers. There is no doubt about that connection, right up to the present day. The bankers-rulers tandem has been supported since the late 1600s by central banks, in particular those of Sweden and England. The oldest, the bank of Amsterdam of 1609, is said to have observed a 100% reserve policy for more than one hundred and fifty years. From around the mid-1700s, however, the previously honest money merchants secretly started to grant illegal blank credit on a fractional reserve base to the Dutch East-India Company.

HdS's idea of central banks is rather one-sided from the beginning. He just sees them as patronisers of oversized accumulation of credit and debt. But he either disregards or finds fault with central banks' development from privileged private commercial banks to national monetary authorities, with ever more of them owned and run as state agencies. Neo-Austrians have no more regard for money as a constitutional state prerogative than Hayek had.

HdS assumes that central banks 'emerged as the inevitable consequence of a fractional-reserve private banking system' (602). According to HdS, and in line with NCT, fractional reserve banking is the basic structural defect of the money and banking system. Strangely enough, however, this defect is not blamed on the banking industry, even though HdS incessantly calls it fraudulent. What is allegedly really to be blamed is state interference in general and central bank interference in particular.

Central banks not only tolerate but actively advance fractional reserve banking and thus promote 'intertemporal discoordination' in the economy (that is, more precisely, in the Austrian-School production model). Central banks are to be blamed in any case, in their role as 'bank of the state' as much as in their role as 'bank of banks'. Even if in some places HdS considers central banks a creature of the banks on grounds of their collective interest in having a lender of last resort, he never sees them as offenders; rather, he considers them weak-principled victims of government and central bank who lure banks into practicing fractional reserve and becoming over-exposed to government and other customer debt, encouraged by central banks' promise to always stand by as a source of reserves and reliable lender of last resort. HdS even pretends 'that the privilege which allows banks to operate with a fractional reserve represents an obvious **attack by government authorities** on the correct

definition and defense of depositors' private-property rights' (810, emphasis added). So, government and central bank are an attack on the banking industry? What are we to think of this kind of interpretive art? What becomes ever more clear, however, through to the end of the book, is HdS's one-eyed attack on central banks, which he wants to abolish.

No doubt central banks are partly a creature of banks, as is most apparent in the American history of central banks and the Federal Reserve (to which HdS, curiously enough, does not refer in more detail). And HdS certainly has a point in saying that if banks can rely on always being re-financed by central banks, this causes moral hazard with regard to risk-taking and sound, honest banking in general.

HdS, however, as Hayek, before him, is misguided in pretending that in a system of free banking—i.e. a world without legal tender laws, central banks, supervisory authorities and banking regulation—market competition among banks would be the general solution to all those problems. HdS pities currency scholars for their 'naivety' regarding central banks. He might pity himself, together with his forefather Hayek's plan of *Denationalisation of Money,* for much the same with regard to free banking. As if banking today were not the business of huge multinational oligopolies, in fact, private corporate planning bureaucracies, distorting and bending markets according to their private business advantage; as if the interplay between banks and customers, including government, would be any different from today's, including overexpansion of balance sheets (the informed and 'spontaneous customers' vigilance' (665) being another fictitious figure in this plot); as if currency and interest-rate speculation in private bank currencies would be any different from today's in national currencies.

When it relates to central banks and free banking, HdS's argumentation assumes an ideological character. Central banks are accused of being 'paternalistic', 'coercive' for imposing legal tender and implementing 'financial central planning'—something which is evil by definition, according to the Austrian 'theorem of the impossibility of socialism' and Hayek's thesis of 'pretension of knowledge'. As always with ideologies, there is a kernel of truth. But this surely applies to corporate banking bureaucracies and private bankers of old in much the same way. As if they knew better. What they actually have is early insider knowledge, which they tend to exploit at anybody else's expense. Would one reproach large capitalist corporations for practising 'socialism'? It is no less beside the point to project this onto central banks. It remains HdS's secret why he

adds his voice to this, despite his characterisation of central banks as backers of capitalist private banking corporations operating on a small fractional reserve.

A contemporary central bank is far from being 'a central planning agency in the field of money and banking' (808). Asserting that the present situation is a 'system strictly controlled and regulated by the central bank' (789) is a grotesque misrepresentation. It fits the myth of central-bank governors as big wheels, moving financial markets at will through setting base rates and applying monetary-policy instruments. False pretences. Central banks today determine neither the money supply nor the structure and level of interest rates. The degree to which they may 'influence' these variables is rather modest. The cash and reserve base they provide, without pro-actively determining it, and thus also the base rate they determine, refers to just about 2–11 percent of demand deposits. Beyond that they have no say in anything of relevance. And of course, they have no command line into the banking industry. What they actually do is re-act to the facts that banks have pro-actively created, by residually re-financing the banks to any extent demanded. Far from being the quasi-socialist central-planning state agency the Neo-Austrians pretend it to be (e.g. 652), today's two-tier banking system is much closer to Hayek's brave new private banking world than his followers want to see.

Even if central banks would actually do their job of being 'currency protectors' and having control over the money supply (which is next to impossible under fractional reserve banking), they still were not 'financial planners' but just 'monetary planners', perpetually assessing and readjusting an adequate money supply, without however directly interfering in banks' loan and investment business and financial markets beyond, and without getting mingled in fiscal responsibilities of parliament and government.

The blind spots of the Neo-Austrian position have to do with their unreal idea of money as something that emerges 'spontaneously' and 'endogenously' on markets, with markets in turn equally supposed to have emerged 'spontaneously' without further preconditions such as, for example, the extended households of secular and religious sovereigns and the legal frameworks they developed for production and trade in general, and for accounting and coining tender in particular. While desperately believing in spontaneous market money on ideological grounds, Neo-Austrians block out the constitutive realities of state money past and present.

As a result, they refuse to recognize that the entire problematique is not only about private contracts and efficient markets. Important as both of these are, the entire problematique is also, and more fundamentally, about principles of state constitution, separation of powers, in particular, the fundamental currency principle of separating money and banking. It is about public law, integrity of a nation's monetary prerogative in analogy to its prerogatives of legislation, public administration, jurisdiction and monopoly of taxation or of force. It is about national monetary unity and sovereignty. This is of course a highly sensitive political issue, as it is a question of transactive efficiency. To discredit national monetary integrity and sovereignty as 'financial nationalism' comes close to playing the 'useful idiot' for banking mega corporations who certainly would love to finally become the 'masters of the universe'.

Not least, the problematique is about controlling the issuance of fiat money, since other money, real-asset money, has now become obsolete as it would be dysfunctional. Finally, it is about making sure that the 'free lunch' of creating additions to the stock of money, i.e. seigniorage, benefits public coffers or citizens' purses rather than being creamed off by the commercial banking industry which enjoys the illegitimate privilege of just fractional funding of all the transactions they can add to their balance sheet as an asset. HdS too is very critical about this privilege. What he again refuses to recognize, however, is the real need for a growing money supply in a growing economy.

Once more: Currency versus Banking

HdS reports scholarly dispute and litigation throughout the centuries on the question of how to handle deposits. He sees this as an expression of a more fundamental, political contraposition which found its further developed form in the currency-vs-banking controversy in the first half of the 19th century. And yet his legal standpoint remains one of private (banking) compacts, ignoring a state's monetary prerogative as a question of constitutional importance. In this respect, HdS reproduces the typical stance of neoclassical as well as Austrian economics of claiming a quasi-extraterritorial status for markets, entrepreneurs and bankers.

Given HdS's criticism of fractional reserve banking, he consequently criticizes the historical Banking School as 'fundamentally unsound' (624). His historical references also elucidate how deeply the currency-vs-banking issue is rooted in the development of money and banking over the centuries. He however does not want to be a supporter of the historical

Currency School either. He reproaches them with allegedly not having understood that banknotes have the same credit base as deposits and therefore what applies to banknotes equally applies to deposits. That reproach is not quite right. HdS erroneously quotes Thornton, who was fully aware of the banknotes-deposits issue, as witness for the Banking School position, while Thornton in fact turned to the Currency School for he was ever more disappointed with his banker fellows and was a supporter of central banking anyway. It might be an interesting subject for an academic thesis to find out whether 'forgetting' about deposits in Peel's Act was the fault of Currency Theory or of politics and banking lobbyism.

HdS also faults the Currency School for not having integrated monetary theory with a capital theory. The Banking School hasn't either—it's just a peculiar Neo-Austrian preoccupation. HdS finally blames the Currency School for not having foreseen that central banks, in the decades to come, became ever more 'bank of the banks' rather than 'bank of the state', serving fractional reserve banking rather than the state's or central bank's control of the money supply. As noted before, it is not so clear whether this was a conceptual weakness or interest-driven politics.

Because of his own idea of combining 100% reserve with free banking, HdS understandably encounters some difficulty in coming to terms with his positioning within the field of currency vs banking. His description of the currency-vs-banking problematique starts from a definition by A.J. Schwartz according to which the controversy is about whether banking ought to be governed by rules or by discretion. This is relevant, but misses the point, especially in a cashless economy based on fiat currencies. Both central banks and banks are subject to legal and factual rules, and both have high degrees of freedom, i.e. discretion in monetary and business policies.

The real question is who has the prerogative of determining the currency, of issuing and controlling the money supply and of benefitting from the seigniorage—the state or the banking sector (with third parties hypothetically being possible, though not occurring in practice); and in whose interest monetary policy is carried out—in the state's or national interest, to the benefit of the public purse, or in the interest of banks' privileged status and extra private banking profits. The role of central banks in this field of conflict has been highly ambiguous from the beginning.

The oxymoron of combining 100% reserve, thereafter a gold standard, with free banking

In the end, the reader is confronted with a strange combination of elements of Currency School and Banking School teachings. On the one hand, and in accordance with Banking teachings, HdS wants banks to be free, i.e. not subject to legal-tender laws and not dependent on central banks or government, maybe even issuing their own currency, as in Hayek's plan of denationalization of money. On the other hand, and in accordance with older currency teachings, banks should strictly observe a 100% reserve on demand deposits.

Against the background of HdS's investigation into the irregular-deposit contract and his criticism of fractional reserve banking, the requirement of a 100% reserve is an obvious consequence: '… we must conclude that the only effective way to rid society of special privileges and economic cycles is to establish a free-banking system governed by legal principles; that is, a 100-percent reserve requirement' (735). This is in accordance with Mises' point of view, as indicated earlier. HdS points out that also Hayek's private-money banks 'would have to practice a kind of '100 percent banking', and keep a full reserve against all their obligations payable on demand' (725).

How so? Can 100% reserve and free banking really go together? What is 'a kind of' 100%, and what is the respective reserve, and where does it come from? Well, the mountain labors, it labors for more than 700 pages and keeps the reader on tenterhooks, and then brings forth a mouse—which is gold. HdS sees gold as the ultimate anchor to tie the money supply to, for he sees gold as the only monetary factor of long and proven standing supposed to be independent of various political pressures and interferences (739).

HdS does not hesitate to reinterpret Hayek in a similar way. Hayek, after all, dubbed his favored free-banking currency the *ducat*, reminiscent of the gold coin of the same name which existed from around 1300, originating in Venice and spreading across the continent until the mid-1800s. Rothbard, another known Neo-Austrian, also made the *Case for a 100-Percent Gold Dollar* in 1962.[4]

The backward-looking belief in gold can and must be challenged. Production and management of gold is not at all, and never was, independent from pressures and interferences. Control of gold and silver,

[4] Murray N. Rothbard 1962: The Case for a 100-Percent Gold Dollar, in: Leland B. Yeager (ed), In Search of a Monetary Constitution, Cambridge, Mass.: Harvard University Press, 94–136.

including the entire chain from mining and melting to minting, awaked the powerful's greed no less than does free creation of fiat money. More importantly, silver and gold have had a long monetary history, but the metal age of money in archaic and traditional societies is over now. There were strong historical reasons for taking national currencies finally off the gold standard, in particular industrial growth and the development of modern fiat money which is not a commodity itself and can be provided in any required quantity. In this regard gold was nothing but a 'barbarous relic' indeed, in the apposite words of Keynes.[5]

Furthermore, digging for gold in order to obtain real-asset coverage of circulating means of payment is sheer ecological nonsense. In order to obtain a value base for money, a sort of master meter of monetary value, it doesn't make sense either. The value of money is neither in other monetary tokens, nor in real assets valued themselves in terms of that money. The value of money is transactive, not productive, and expresses itself in its purchasing power which is directly derived from current national and international product and productivity; which can be, but is not necessarily and must not only be understood in terms of GDP .

If there were a return to gold as a material value base, and a much too scarce one, then one of two things, or both, would happen. On the one hand, the gold standard would have to be watered down under pressure from economic and social realities, as was the case in the 19th and 20th century (from 1:1 to 1:3 to 1:7, or similar). That is, the gold standard will dwindle away. On the other hand, economy and society would get stuck in a deflationary mud.

The Neo-Austrian production and money program is taken from an ideal model world where people's expectations and preferences are flexible in any direction and all prices and wages have unimpaired downward elasticity, readapting to all market conditions, whereby markets are supposed to be open to new entries, competition is supposed to be perfect, and participants are on an equal standing with regard to information, financial clout etc. Growing wealth would then not be expressed in growing income, which allows for buying more or better things at stable or higher prices. It would express itself in stable or declining income which allow for buying things and services at even lower prices. Something like that, however, is not of this world. In a certain sense it may partly apply to development and then take-off stages of learning

[5] John Maynard Keynes 1923: A Tract on Monetary Reform, London: Macmillan, 172.

curves of single products and markets, but not in general and on the aggregate. In the real word, downward flexibility is involuntary and resisted, and power to resist is unequally distributed.

One may raise the question of whether the scenario would not come with a zero or negative interest rate. If the idea of a 'natural rate' of interest or unemployment is more than just an idée fixe, these must be floating rates, and obviously no one ever knows what level those 'natural' rates are at in a given situation. What would a zero or negative interest rate do to 'deferred consumption', i.e. saving for investment, in the sense of the Neo-Austrian model of production and finance? Money holders would be better off than debtors. Because of the rising real costs of incurring debt, there would be no great number of debtors and real investors. Thus there would not be too many happy creditors either. If earning is flat or down, and lending is flat or down, everything else will be flat or down—prices certainly yes, but what is the point of lower prices if investment, employment and mass purchasing power is down too? Middling and lower earners would suffer most from wage cuts and unemployment. The better off would struggle to keep their standards. Only the rich would be happy, as usual.

Neither full reserve nor gold will deliver on promises because they reflect a cash economy which no longer exists

Maybe wanting to avoid old and endless discussions on deflation or inflation, maybe wanting not to be seen as too rigid, HdS's plan allows for a transition process from fractional central-bank reserve to a gold standard:

> Our proposal is based on privatizing money in its current form by replacing it with its metallic equivalent in gold and allowing the market to resume its free development from the time of the transition, either by conforming gold as the generally accepted form of money , or by permitting the spontaneous and gradual entrance of other monetary standards (739).

This signals much confidence in markets voting for gold. It actually might appear more realistic to bet on the contrary, i.e. modern banking and markets driving gold out again, as they did in the modern past. Having currencies finally taken off the gold standard did not occur for monetary despotism from the side of government or central bank. Quite to the contrary: if any, than in fact gold was the 'despotic' factor, and the banking industry and the markets strived to get rid of the gold standard since its enaction in 1844 through to its end in 1931/71.

HdS's transition plan (791) is rather irritating in that the first decisive step leads to 100% banking under independent central-bank control and the

next and final step from there to a full gold reserve to be held by the banks, while central banks would be abolished.

As to the first step, HdS does not express himself clearly on whether the full reserve is based on legal-tender fiat money issued by the treasury or the central bank, or already based on gold. The answer seems to be legal-tender fiat money, for he is fully taking up the original Chicago plan of the 1930s (not, however, referring to Fisher's 100%-money, presumably due to dislike of Fisher's 'mechanical monetarism', even though Simon's and Friedman's monetarism was even more 'mechanical'). In any case, HdS's program includes the nowadays mostly forgotten but actually most important part of separate banking—which is separating money and payment services from commercial credit and investment banking. This is fully in line with the early Chicago School, Irving Fisher, Maurice Allais, and other 100% reserve reformers. All of them wanted to set up money and payment services as a money trust, or money warehouse, or mutual fund, separate from the banks' lending and investment businesses. The idea has of late been carried to extremes by Kotlikoff, who wants to break up the entire banking industry into a greater number of mutual funds.[6]

The last stage of HdS's plan leads from 100% reserve within a two-tier banking system to free banking on a pure gold standard and without central banks. This is supposed to rest on an international agreement on a 100% gold reserve, the abolition of central banks, 'a single, worldwide monetary standard (equivalent to fixed exchange rates)' and 'no more credit expansion', instead, 'slight, continuous 'deflation'' (793). If this is meant to be a real-world program, HdS does not explain in more detail how to bring to pass that transition from 100% central-bank reserve to a free-banking gold standard.

Because of HdS putting into play 100% reserve together with gold reserve, and be this just transitionally, it is not clear to what extent his conviction is based on overcoming fractional reserve, and to what extent on introducing a 100% gold reserve rather than 100% central-bank reserves. Almost all of the advantages he lists are identical to those in corresponding lists put forth by monetary reformers in favour of 100% central-bank reserves, as well by those in favour of plain sovereign money (pp.743)—safe money, stable finances, putting an end to inflation, preventing boom-and-bust cycles based on credit and debt bubbles, and wiping out public debt. What is the point of replacing a 100% fiat central-bank reserve with a 100% gold

[6] Laurence J. Kotlikoff 2010: Jimmy Stewart is Dead. Ending the World's Ongoing Plague with Limited Purpose Banking, Hoboken, NJ: Wiley.

standard, if the first would achieve what the latter claims to achieve as well? Or to put it in a less 'convinced' way: what is the point of replacing 100% central-bank reserves with a full gold standard, if neither can deliver what its promoters promise?

Notwithstanding the misled return to gold, a 100% reserve requirement on deposits is misleading too, no matter what the reserve is. As explained earlier, a 100% deposit reserve made sense in a cash-based economy where deposits could actually be used for funding something else. In a non-cash monetary system with split circulation—one of reserves in interbank circulation, the other one of demand deposits in public circulation—the idea of a 100% reserve has become obsolete. Deposits do not, and need not, help finance bank expenditures. Neither do savings in bank accounts (M2/partly M3) help finance investment. Savings deposits are inactivated demand deposits, and all deposits are originally not 'deposited' but credited into existence. If customer deposits are on-lent as secondary credits to nonbanks, this can be for real-economic as much as for purely financial purposes.

After primary credit and deposit creation, outstanding credit claims sit as assets on the balance sheet of the creditor banks while deposit liabilities flow off to the balance sheets of other banks. Coverage requirements thus fall on banks differently from those who have initially credited a current account. A *coverage reserve* on deposits, i.e. liabilities, is different from *payment reserves* (excess reserves), i.e. liquid assets. Deposit reserves are calculated ex post on the liability side and do not preempt deposit creation ex ante on the asset side. Central banks will feel just as obliged to accommodate banks' demand for both payment and coverage reserves as ever before. Maintaining a coverage reserve not too far below 100% of deposits will just add to costs on top of idle M2/M3 deposits, augmenting the profit of the reserve supplier, and driving up costs charged to customers.

HdS repeatedly laments a lack of understanding of monetary and banking affairs among the broader public and economists alike. But his upright defence of 'traditional legal principles to banking' (730) is a defence of cash-based banking of former times and reveals itself as a project of veritable quixotic character.