THE STATE AND CENTRAL BANKING:
AN IRRESISTABLE SYMBIOSIS

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Abstract:

This paper critically examines the notion that fractional reserve banking invariably leads to a central bank. It also looks closely at the view that the only way to prevent a central bank is to reestablish the traditional legal principles requiring banks to maintain a reserve ratio of one for demand deposits. This paper finds fault in both of these propositions. This paper concludes that fractional reserve banking cannot invariably lead to a central bank because fractional reserve banking could theoretically exist in a stateless society. The advent of a stateless society precludes the establishment of a central bank for the reason that a state is necessary its formation. Also, if a state exists, traditional legal principles will inevitably be perverted to satisfy the desires of both the bankers and state officials. This leads to the conclusion that the only way to prevent a central bank is to eliminate the state.

Introduction:

Central banking is one of the greatest manifestations of evil this world has ever known. This cartelized organization is responsible for stimulating booms and allowing them to carry on much farther than any other banking arrangement. Central banking exacerbates the problem even more so by propping up malinvestments and preventing the efficient reallocation of resources (de Soto, 2009, p. 637). A common answer to this problem is to enforce traditional legal principles of banking (de Soto, p. 638). Doing so would make the issuance of fiduciary media illegal and require all banks to maintain a reserve ratio of one. De Soto (p. 638), in one rather brilliant paragraph, describes why fractional reserve banking systems (with a government) lead to a central bank. He writes,
Although interbank clearing mechanisms and continuous public supervision would tend to limit credit expansion in a fractional-reserve free-banking system, they would be unable to prevent it completely, and bank crises and economic recessions would inevitably arise. There is no doubt that crises and recessions provide politicians and technocrats with an ideal opportunity to orchestrate central-bank intervention. Therefore it is obvious that the very existence of a fractional-reserve banking system invariably leads to the emergence of a central bank as a lender of last resort. Until traditional legal principles are reestablished, along with a 100-percent reserve requirement in banking, it will be practically inconceivable for the central bank to disappear (in other words, it will inevitably arise and endure).

The conclusion de Soto fails to draw is that the end point of a central bank is not an inevitable result of fractional-reserve banking if there is no state to institute one. Whether the banking system is fractional reserve or 100-percent reserve is immaterial in terms of preventing the establishment of a central bank. The key factor that determines whether or not a central bank will develop is the existence of a state. As history demonstrates, even when starting out with a legally enforced 100-percent reserve system, the state will corrupt it for its own purposes. The bankers willfully go along with and are a co-driving force with the state for ever increasing degrees of intervention. It is therefore the existence of a state, not whether or not fractional reserve banking is permitted that leads inevitably to a central bank. The banning of fractional reserve banking is a very important step towards a just society and property rights legal system, but if accomplished while the state persists, it will be but a fleeting glimpse of sound banking and liberty. It is wrong
for de Soto to say that if only traditional legal principles are enforced the tendency towards a central bank can be avoided.

It matters less that these principles are enforced than it does whether a state exists. If a state does exist, a central bank will inevitably arise and endure. So the state is the true starting point of the logical dynamic that ends in a central bank. Whether or not demand deposits are classified as bailments or debts only gauges how far along the road to a central bank a given statist society is. It follows that without a state, a fractional reserve banking system, could not lead to a central bank. A fractional-reserve banking system in a stateless setting would not follow the logical progression it has throughout history in the setting of various coercive governments.

De Soto (p. 638) writes succinctly, “The only way to end this vicious circle is to recognize that the origin of the entire problem lies in fractional-reserve banking”. What needs to be added to this statement is the necessity of a state for the process to be realized. The “origin of the entire problem” does not lie in fractional reserve banking. The origin lies in the very existence of a state. Fractional reserve banking is but one step, albeit a very important step, along the road of state banking perversion. Even if a 100% reserve banking system existed and was consistently enforced, the incentives (discussed in detail later on) are such that the state will invariably pervert it into a fractional reserve system. From here the transformation will be completed by the establishment of a central bank.

So far this analysis has uncovered two main issues. The first is that a 100% reserve system is, in contrast to what de Soto implies, not the sole condition for
preventing the establishment of a central bank. The second is that the starting point that necessarily finishes with the establishment of a central bank is not fractional reserve banking, but the existence of a state. It follows that if a state exists, even with a 100% reserve system, the state will pervert the banking system in favor a cheap credit, fractional reserve system and eventually a central bank. Thus, in order to prevent central banking, the institutionalized channel of violence known as the state must be abolished.

*The Inevitable, Logical Transition to a Central Bank*

Whenever a state exists, there is a logical dynamic set in motion which inevitably leads to a central bank. Take the hypothetical scenario of a society with a 100% reserve banking system which a government enforces. The dynamic is then first put into motion by a government legally permitting fractional reserve banking (if it is not already common practice) (Rothbard, 1995). The end point of this shift in banking is a fiat currency and central bank.¹ The dynamic itself proceeds from the initial stage of a hard money, fractional reserve banking system as follows:

1. The additional profit that can be earned from pushing the reserve ratio lower and lower prompts bankers to do so.
2. Understanding that more loans and lower reserve ratios are profitable but risky, the bankers come together to find a way to insure against bank runs.
   a. This is first done by pooling reserves. With this arrangement there is the problem of moral hazard in that if a bank knows it will be not be in trouble if it lowers its reserve ratio, it will do so. As the banks lower their reserve

¹ One can imagine an even further endpoint of a currency that is not only fiat in nature, but also purely electronic. Such a currency would then be easily tracked by the state. This would severely stifle black markets, especially if legal tender laws are strictly enforced.
ratios, the pool of available funds shrinks, and it becomes more difficult to cover each bank failure. When the pool becomes too small the solution is to socialize it and create a lender of last resort.

3. In comes the central bank. It permits the private banks to use its paper money as reserves while centralizing specie at its branch institutions.

4. Since these notes can be produced \textit{ex nihilo}, banks have no problem in issuing as many un-backed loans as they desire because any failure on their part is followed by a bailout.

   a. Rothbard ([1982] 2008, p. 135) points out that “through its centralization of gold, and especially through its monopoly of note issue, the central bank can see to it that all banks in the country can inflate harmoniously and uniformly together.”

The result of this process is a dramatic incarnation of the dreaded boom-bust cycle. This is because the central bank allows the boom period to carry on for a much longer time than would otherwise be possible (de Soto, 2009, p. 665). Due to the inevitable nature of this dynamic, some believe that to prevent a central bank, fractional reserve banking must be legally outlawed. This would make demand deposits bailments instead of debts. In other words, the person who deposits money into a demand deposit must remain full owner of the money. This means that if the bank issues more than one receipt for the specie, they are issuing two claims to the same property. Such an act is fraud.

Another conclusion that can just as readily be drawn, however, is that in the absence of a state (by which is meant an entity with a monopoly on force for a
fractional reserve banking will not lead to a central bank and fiat currency. Fractional reserve banking would remain far less inflationary without state intervention. With developments in technology such as internet phones, the emptying of fractional reserve banks could be immediate upon the surfacing of even the slightest doubt concerning a bank’s solvency (de Soto, 2009, p. 640). Under these conditions, a fractional reserve system absent state intervention could, theoretically, result in a 100% reserve, hard money system. This is, however, not necessarily the case. If banks adopted a single note of issue and all agreed to redeem it, they could issue a limitless amount of fiduciary media (Mises, [1912] 2009, p. 325). This could also be accomplished by means of having only one bank issue money substitutes. Their issue of fiduciary media would only be limited by the confidence of their customers. Such an arrangement could result in the same credit expansion as a government-sponsored central bank, but only if the consumers haplessly went along with it. One might object that the only reason the current systems of fractional reserve banking and fiat money endure is that people just go along with it. This is true to an extent but the force behind legal tender laws entrenches the state-sponsored central banks in a far greater way than is possible in the state’s absence.

The type of banking arrangement that can arise in the absence of state coercion differs from a state-sponsored central bank in that it is much more transient. It may be able to generate a boom and bust cycle of a great magnitude, but will inevitably fall to pieces. If there exists a multiplicity of banks, all issuing the same notes, it will be very difficult for the cartel arrangement to remain intact after the boom bust cycle. With a state in control of the banking system, banks are forced to stay in the cartel through legal tender laws and the necessity of using federal reserve notes as reserves. This arrangement
has a far greater degree of longevity than anything possible in the state’s absence.
Without the state, entrepreneurs will be free to advertise superior currencies and banking practices. This will be especially attractive to consumers in the bust phase of the business cycle when they discover the money they have claims to is actually not present at all. If there is only a single bank that issues notes, and decreases its reserve ratio very low, it is sowing the seeds of its own demise in the same way a cartel does. In an anarchic setting these institutions have no way of preserving their existence once their insolvency is made apparent. The above analysis leads to the conclusion that even if banking in a stateless society begins create the ill effects central banking does, the permanence of today’s government instituted central banks could not be achieved. This isn’t to suggest that the Federal Reserve can go on inflating the money supply indefinitely. If it continues, at some point the dollar will be useless as money. It can, however, preserve its existence much longer with state privileges than it could without.

In the situation where a state does exist, bankers can appeal to the state for various interventions with the intention of generating additional revenue by decreasing their reserve ratios beyond what could happen in the absence of the intervention. The specific interventions are state-sponsored cartelization in the form of a central bank, so called “deposit insurance,” fiat money, legal tender laws, and suspension of specie redemption.

*Intervention: State-Sponsored Cartelization.*

Perhaps the most important stage in the degradation of the banking system in a statist society is the government backed cartelization of a central bank. Rothbard states that, “in short, the Central Bank functions as a government cartelizing device to
coordinate the banks so that they can evade the restrictions of free markets and free banking and inflate uniformly together” (2009, p. 135). The ability to inflate uniformly allows the banks to extend more loans than they otherwise would be able to. Mises (2009, p. 326) writes that for banks to extend their issue of fiduciary media, they would have to do so “according to uniform principles.” If banks achieve this uniformity absent the aid of the state, they have entered into a most volatile relationship and will soon split up. So even if the banks make this arrangement, it will naturally correct itself in a much more pain-free manner than any attempt to repair a banking system backed by the state.

The key here is that the government does the cartelizing. Just as any cartel in a free market will naturally break up, so too will a banking cartel. Rothbard (1965, p. 651) writes, “a cartel is an inherently unstable form of operation”. In a fractional reserve free banking cartel arrangement, some banks will be content maintaining a higher reserve ratio. All the while they will likely be contributing the same or a proportional amount into the cartel’s pool of reserves. They will realize the cartel serves them no purpose and helps the banks who make ill-advised and risky loans disproportionately. These more risk-averse banks will leave the cartel out of self-interest when the reserves are drawn upon by other, riskier banks. These are also the banks which are less likely to draw from the pool of reserves. The more stable banks leaving paired the moral hazard many other banks face will cause any cartel held together in a voluntary manner to fall apart quickly. Also, as the reserve ratios drop lower and lower and the malinvestments increase, the more risk-averse banks will leave the cartel out of self-interest. Rothbard (2008, p. 123) writes that banking cartels on the free market have “every economic incentive working against their success.” On the free market, the more inflationary banks will lose gold while the
less inflationary will gain it (Rothbard, 2008, p. 123). By leaving the cartel then, the sounder banks can easily beat their competition and increase their market share. As inflation increases in a private cartel, the sounder banks will have an even larger incentive to break out and call for redemption on the other banks.

Not only will competition from within work against the private cartel, but also competition from without. A 100% reserve bank could easily start up. It would advertise its noninflationary operations, and be content to earn money as a financial intermediary and through deposit fees. This new competing bank would break “their competitors by calling on them to redeem their inflated notes and deposits” (Rothbard, 2008, 123). For this reason the force inherent in government is a necessary feature of holding a banking cartel together, especially after the bust. The cartel plays a vital role in lowering reserve ratios. The lowering of reserve ratios is the result of the banker’s desire to extend more loans to generate more revenue. The extending of more loans made possible by the cartelizing government intervention is the credit expansion which causes a boom, followed inevitably by a bust.

De Soto (2009, p. 636) points out that a proposition for a central bank in a 100% reserve banking system would be irrelevant. This makes a 100% reserve legal requirement highly desirable in order that economic crises may be avoided. What could also be said here is that the proposition of a central bank in a stateless society would be irrelevant. Thus, a stateless society seems like a viable way to prevent the degradation of the banking system into one with a central bank (and to more rapidly do away with one if it arises). Without a connection to the state and its coercive power that forces tax payers
to be the lenders of last resort, a central bank would amount to nothing more than a private cartel. As such, it would fall apart just as easily as those do.

*Historical Example: Cartelization*

The national banking system in the United States, as well as the Federal Reserve system provide excellent examples of government sponsored cartelization. Rothbard (2002, p. 186) writes that, “In a typical cartelization, national banks were compelled by law to accept each other’s notes and demand deposits at par.” This had the adverse effect of preventing the “process by which the free market had previously been discounting the notes and deposits of shaky and inflationary banks” (2002, p. 186). In this type of intervention, the government eliminated a crucial check on solvency that existed in the relatively freer market. This is the check of day to day note redemption by non-client banks.

This degree of cartelization was not enough for the big banks who desired an ever increasing ability to expand credit (Rothbard, 2002, p. 187). What they wanted was “a federal governmental Santa Claus who would always stand ready to bail out banks in trouble” (Rothbard, 2008, p. 230). They, which is to say the state and the bankers, wanted the ability to expand the money supply, particularly in the event of panics and recessions (p. 231). The bankers and the state were unhappy with this “halfway house between free banking and government central banking” (2002, p. 186).

The solution to their woes was found in a more complete cartelization. They would give a central bank a monopoly over note issue and reserve requirements which would “insure a multilayered pyramiding on top of its notes” (2008, p. 233). Rothbard
continues this concise description of the central bank by function of bailing out banks in trouble, and inflating “the currency in a smooth, controlled, and uniform manner throughout the nation.” Since banks could no longer issue their own notes, they were forced to inflate uniformly as the central bank printed as it pleased and regulated their reserve ratios. The problem of competition both from within and from without was then solved and the cartel could be held together. National banks were forced to become members of the Federal Reserve System making it the single entity at the base of monetary pyramid (Rothbard, 2008, p. 236). Even the state banks, while not forced to be part of the system, were under its control. In order to get cash for their clients they had to open up an account with the Fed (Rothbard, 2008, p. 236). Thus, the Fed from conception was a cartel backed by government force that both the state and the bankers have a strong incentive to desire.

**Intervention: Deposit Insurance**

So called “deposit insurance” is a key intervention into the banking industry which fosters riskier behavior than would otherwise occur. Since bank runs are dependent on the free choices of individuals, they are a problem of uncertainty, not risk. Risk refers to situations with a class probability that can be quantified. This means there exists some known probability density function that is empirically relevant. This allows the possibility of insuring against risk. Mises ([1949] 2008, p. 107) specifies that knowledge of the probability density function does not shrink the risk but merely reveals it. With deposit insurance, however, there is no risk to be revealed. Whether or not a bank run occurs or the bank managers mismanage the time structures of their loans is not dependent on risk but uncertainty. The deposit insurance is attempting to insure
something entirely dependent on specific cases of human behavior and is not in any true sense of the term, insurance. Therefore, with banking deposits there is no class of events to be statistically analyzed.

The safety net of deposit insurance promotes credit expansion and riskier banking practices. De Soto (2009, p. 635) points out that that deposit insurance “has played a major role in fostering perverse behavior among bankers and in facilitating and aggravating bank crises.” The other effect of socialized deposit insurance is that it works to prevent bank runs, a powerful check on credit expansion (Rothbard, 2008, p. 147). Rothbard explains that this type of insurance puts “the unlimited taxing and counterfeiting power of the federal government behind every bank deposit.” He goes on to explain that even though banks are now safer, they have lost a powerful check of their ability to inflate (Rothbard, 2008, p. 147). Deposit insurance is consequently one of the interventions commonly used by governments in the maintenance of the interventionist banking system.

*Intervention: Fiat Money*

Fiat money is money that is not backed by any commodity. Money of this sort has an exchange value that far exceeds its commodity value. When this is the case, bankers can always earn money by extending additional credit. This happens until the commodity and exchange values equilibrate and the currency is destroyed. Rothbard (2004, p. 36) writes that “almost every government in the world” has utilized fiat money. With fiat money it is easier to save banks from insolvency because an unlimited quantity of it can be printed (Rothbard 2009, p. 1014). Rothbard (2009, p. 1017) writes that as long as the
currency is in any way tied to gold, “the central bank and the banking system must worry about an external drain of specie should the inflation become too great.” Fiat money is the virtual end state in the evolution of banking intervention and removes all limits on inflation (Rothbard, 2009, p. 1017). The only situation with fewer limitations on credit expansion is the existence of world state.

**Intervention: Legal Tender Laws**

Legal tender laws are yet another intervention mutually beneficial to banks and the state. By forcing individuals to accept government currency for the payment of debt, the government can make any purchases it desires, inflate the currency to pay for them, and then force the seller to take the money. In doing so, cheap credit becomes even more valuable to the government. Without such legislation, the ability to debase the currency wouldn’t have much significance for a state. If people were free to use whatever money they prefer, they could just opt out of the state’s currency and live merrily. Rothbard (2008, p. 133) describes legal tender laws as an important feature in “propping up the Central Bank and its associated commercial banks.” This “monopoly on note issue” is how governments have generally begun to establish central banks (Rothbard, 2009, p. 1015). Legal tender laws are therefore an integral feature of the transition from hard money backed fractional reserve banking or 100% reserve banking to central banking and a fiat currency.

**Historical Example: Legal Tender**

A great example of legal tender laws in action is 17th century Massachusetts. Here the government printed bank notes to pay the wages of discontented soldiers (Rothbard,
They couldn’t resist the urge to print more, and enacted legal tender laws in an attempt to keep the purchasing power up. They made depreciation illegal and the punishments for failure to accept the paper at par were fines, imprisonment, and total confiscation of property (Rothbard, 2002, p. 53). After a military expedition against the French, Massachusetts engaged in yet another round of inflation. From 1690 to 1748 the price of silver had risen from six shillings an ounce to 60 shillings an ounce (p. 53). At the end of this period, Great Britain “prohibited all further issues of legal tender paper in New England” (p. 54). The existing notes were to be redeemed in specie and a gradual retirement of the outstanding notes ensued. Even though the legal tender laws forced creditors to accept paper notes at par, specie wasn’t outlawed as money and persisted remarkably throughout this turbulent period (Rothbard, 2002, p. 56). Unlike then, using specie as money is not currently a viable option. As a result, there is greater demand for the state’s phony money. This in turn allows the bankers to reap higher returns and makes the escape hatch of hard money all the more elusive.

**Intervention: Suspension of Redemption**

One of the first stops on the road to a central bank is for the state to allow banks the special privilege of reneging on their contracts to pay out specie to note holders. A state would undertake this type of intervention if they needed to borrow a large amount of money, say for a war. Without the intervention the banks would not be able to extend the amount of loans the government demanded at the interest rates they wanted without lowering their reserve ratio. As the bank’s reserve ratio lowers, they are less and less able to fulfill their contractual obligation to pay out specie on demand to their note-holding
customers. In a stateless society, a bank unable to fulfill its contractual obligations would simply have to shut down and liquidate its assets.

In the statist scenario, however, the state has a keen interest in keeping the bank afloat so that it can obtain additional loans for its operations. To keep the bank afloat, the state infringes on the property rights of all the note holders and allows the bank to deny redemption for specie. This is a clear case of the state giving banks a special privilege that flies in the face of property rights and how all other businesses are treated. The additional credit expansion allowed under these circumstances contributes to a boom, or is simply wasted by the state on temporary war time goods. Either way the higher order capital goods must sooner or later be reallocated.

*Historical Example: Suspension of Redemption*

A great example of the suspension of redemption intervention in action occurred in the aftermath of the war of 1812. First, the government encouraged the formation of “recklessly inflationary banks” (Rothbard, 2002, p. 73). These banks then proceeded to print huge amounts of notes to purchase government bonds. This is another way the government participates directly in the inflationary process that goes on in state sponsored free banking.

During this same time period the New England states where the government was much less involved had reserve ratios of 1.96 to 1 in Massachusetts, 2.7-to-1 in New Hampshire, and 2.42-to-1 in Rhode Island, as contrasted to 19.2-to-1 in Pennsylvania, 18.46-to-1 in South Carolina, and 18.73-to-1 in Virginia where the government was more involved (Rothbard, 2002, p. 74). The government was using the more inflated notes
from the banks outside the New England states to purchase goods from them. When the New England banks called upon redemption from the other banks, the government stepped in to save the failing banks that faced insolvency upon the redemption (Rothbard, 2002, p. 74). In 1814 the government allowed the failing banks to suspend specie payment. Rothbard (2002, p. 74) calls this “one of the most flagrant violations of property rights in American history.” Rothbard (pp. 74-75) goes on to describe the consequence of this government intervention or “carte blanche,” as he calls it, to be rapid credit expansion. The banks were allowed to continue suspension of redemption for two years after the war ended.

The government intervention that resulted in suspension of redemption set a precedent and whenever banks were in trouble, the government let them default on their contracts and carry on making loans and forces debtors to pay up. All the while they themselves were refusing to pay up with all the force of government behind them. Thus, it became clear to banks that in times of general banking crisis they would not be obligated to fulfill their contracts (Rothbard, 2002, p. 76). Rothbard (2008, p. 230) informs, “in each of the banking panics after the Civil War, 1873, 1884, 1893, and 1907, there was a general suspension of specie payments.”

In a related form of intervention, some enacted laws restricting the activity of money brokers. Money brokers would collect depreciated notes and then travel to their bank of origin and redeem them all at once. In an attempt to protect the banks of its state, Maryland required a $500 a year license to be a money broker in addition to the $20,000 bond to start the business (Rothbard, 2002, p. 80). Likewise, Kentucky, Tennessee, and Missouri passed laws requiring creditors to accept inconvertible, depreciated notes. This
invoked a quasi-legal tender status to the paper (Rothbard, 2002, p. 81). The result is that banks were protected from being held accountable to the contracts they made with clients.

The point here is that in a stateless society where free banking is prevalent, the private defenders of property rights would never let this type of blatant contract fraud go unpunished. If they did, their clients would simply switch protection service providers so that their rights could be adequately protected. In the stateless society, therefore, inflation and credit expansion would be greatly diminished, thus avoiding to a great extent (although not fully) the boom and bust cycle.

*Historical example: 100% Morphs into Fractional Reserve*

The last attempt at banking under the traditional legal requirements was the Bank of Amsterdam. Although the Bank of Amsterdam maintained a nearly 100% cash reserve for over one hundred and fifty years, it did not endure forever (de Soto, 2009, p. 99). This bank earned money by charging fees for safe keeping, exchanging money, and stamping gold bars (de Soto, 2009, p. 101). During the 1780’s the Bank of Amsterdam began to “systematically violate the legal principles on which it had been founded” (de Soto, 2009, p. 106). A question of crucial importance is why they began to violate the 100% reserve legal principle at that particular moment in time. De Soto explains that this departure from 100% reserve banking began at the time of the fourth Anglo-Dutch war. The bank went from 100% cash reserve to 25% in this period (de Soto, 2009, p.106). De Soto (2009, p. 106) writes, “The reserve ratio decreased drastically because the city of Amsterdam demanded the bank loan it a large portion of its deposits to cover growing
public expenditures.” Thus, blame for the perversion of the last bank founded on “general legal principles” can be placed squarely on the government. The temptation to rob the bank was too great for state officials to resist and far easier than taxing people.

De Soto (209, p.61) refers to Abbott Payson Usher who shows that it was not until the 13th century that bankers began to engage in fractional reserve banking. Usher also believed that this was the most impactful development in the whole history of banking. Referring to 16th century Catalonia, de Soto (2009, p. 63) cites Usher when he “highlights the failure of public officials at different levels to enforce sound banking practices, particularly a 100-percent reserve requirement on demand deposits.” He goes on to report that the government granted banks the privilege to operate with a fractional reserve. The government Usher refers too, like nearly all governments, couldn’t resist and intervened in the banking industry to give itself easier access to funding. De Soto (2009, p. 63) states that government rulers were the first to take advantage of the cheaper credit. He also describes the unspoken agreement between bankers and government officials that most of credit expansion be loans to the government. Since the state officials were the first to receive the newly created money, they had the advantage of spending it before prices adjusted to the new quantity of money. In this way the state took advantage of Cantillon effects.

In his discussion of medieval banking, de Soto describes the mutual interest bankers and rulers have in violating traditional banking legal principles. He (p. 68) writes that the erosion of these principles came about because of “bankers’ greed and rulers’ complicity”. De Soto (p. 77) also points out how bank crises in the fourteenth century Barcelona led to more government control over banking through a municipal government
bank. This new government bank, the *Taula de Canvi*, was created for the express purpose of lending to the government. De Soto (p. 77) describes this bank as highly representative of virtually all other government created banks in that the public officials sought to take “direct advantage of the dishonest profits in banking.” He also describes how this bank employed the typical methods governments use to gain advantage of the banking industry such as suspension of redemption. The historical examples of government intervention into the banking industry for its own and the bankers advantage are too numerous to further elaborate on in this paper.

*The State’s Incentive for Intervention in the Banking Industry:*

States, like most individuals and associations, want to increase their revenue and influence. The difference with a state is that it can do so by exercising force over individuals in a given geographic region. Mises (2008, p. 439), explains that states think “the foremost task of the banks [is] to lend money to the treasury”. Obtaining funds by borrowing money from banks is one way state officials can increase their power and influence. Mises (2008, p. 438) cites the true motivation guiding government intervention into the banking industry as a “lust for inflation and credit expansion”. Inflation and cheap credit are the most politically expedient ways a government can increase its revenue. Mises goes on to explain that even free banking, and much less 100-percent reserve, is never considered by rulers because of the restrictions it places on credit expansion. Briefly, credit expansion in a free market is limited by the trust of the public and merchants, bank runs, and the most effective, the redemption of notes by non-clients (Rothbard, 2008, pp. 114-119).
The way to effectively prevent credit expansion, Mises (2008, 440) writes, is to treat banks the same as any other business, and to demand they fulfill all contractual obligations. But is this possible when a state exists? States have very strong incentives to seize the opportunity presented to them and corrupt the banking system. They will borrow money from the bank and devise interventions to make their borrowing cheaper (the specifics of the interventions are discussed above). So to really prevent credit expansion and the boom bust cycle in a free banking system, there must be no state. Sometimes states implement a policy of only lifting limits on fiduciary issue in times of emergency. Mises (2008, p. 440) identifies this scheme as no solution at all. Whenever the rulers want to increase spending without jeopardizing their popularity through higher taxes, they can easily declare an emergency.

De Soto (2009, p.647) points out that central banks are the outcome of a purposeful government intervention into the banking industry. He goes on to characterize the institution of the central bank as “rooted in the failure of public authorities to adequately define and defend depositors’ property rights” (2009, p.647). This is true, but it shouldn’t be surprising to any degree. The “public authorities” in question only exist because of society’s failure to define and defend property rights. The miss-defined and unenforced property rights of depositors that allow fractional reserve banking are to be expected. As it turns out, fractional reserve banking is much more profitable for the bankers. Credit expansion has the immense consequence of creating the boom bust cycle, generating mal-investment and recessions. Wisdom dictates that only 100-percent reserve banking should be permitted by whatever entity is in charge of enforcing property rights. History and a general understanding of property rights indicate that a state cannot be
depended on for this protection. De Soto (2009, p. 647) explains that “governments have been the first to take advantage of the banking business”. This is a completely predictable outcome when precondition of the state’s existence is satisfied.

It is unreasonable to expect that a state, which is by nature an aggressor against property rights, would, for any length of time, defend property rights to the extent required for the establishment of a 100% reserve requirement. Rothbard (1998, p. 166) writes that the state “which subsists on taxation, is a vast criminal organization.” He also describes how important it is to the state that it controls the monetary system. He writes, “control of the money supply is a way to assure the State an easy and rapid revenue” (p. 162). The incentive a state has for allowing fractional reserve banking and all further interventions is enormous. Cheap and politically expedient funding, as well as making some powerful banking friends along the way is simply too much to pass up. Especially for an institution that already violates property rights on a massive scale. Rothbard (1998, p. 170) explains that the state’s true nature is to “habitually violate the generally accepted injunctions against robbery and murder”. For the state, allowing fractional reserve banking is easier and more expedient than the method by which they primarily fund themselves – the direct expropriation of resources from rightful owners. It is much easier for a state to tinker with banking law than to force someone to pay up at the point of a gun. This task is made even easier by the fact that the special interest group with a stake in the matter, the bankers, also have an incentive for the legislative tinkering.

The state always wants easier money. This is predictable because the state has a monopoly on coercive force and the ability to tax. It therefore has no incentive to economize and operate within the bounds dictated by its revenue as do private
companies. Since the state acquires its revenue by force and not demonstrated preference, it has a tendency to think there will always be more for it to take. This leads to financial carelessness (de Soto, 2009, p. 647). The only limit on how much they can take rests on the desire to remain relatively popular and avoid revolt. Politicians find it much more expedient to simply take out loans. To make this endeavor less expensive, they just tinkered with the banking laws to allow for lower interest rates and greater availability of credit through the issuance of fiduciary media (de Soto, 2009, p. 647). Given the delayed nature of the negative effects of debt-financing, politicians dole out benefits to voters and are out of office by the time the bust hits or the debt must be paid off. The incentive states have to pervert the laws governing the banking industry are so strong, even the presence of the state, however minimal, is enough to begin the feedback loop of intervention. The result is economic crises, ever increasing statism, and war. Even if 100-percent reserve banking was the sole condition necessary to avoid central banking, it seems unlikely that in the existence of a state, fractional reserve banking could be banned. The average man on the street knows and cares little about the intricacies of banking and the state has every incentive to keep it that way.

Another aspect of the state’s motivation to intervene in the banking industry comes from its need to satiate the pleas of the masses. Once fractional reserve banking is inevitably allowed in a statist society and booms and busts inherent to credit expansion occur, the masses will desire government action. Mises (2008, p. 441) writes that “public opinion has become convinced that such happenings are inevitable in the unhampered market economy.” This presents a power force which only builds ever increasing momentum towards intervention with each boom and bust.
Additionally, as the state appeases the public’s demand for intervention, the booms and busts increase in severity. Unless wiser minds prevail, this feedback loop will end in the destruction of the currency. Further emphasizing the importance of public opinion is Mises (1953, p. 397) when he writes that governments have been able to transform the banking industry because “public opinion gave them the moral right to do so.” Shortsighted politicians concerned with reelection are eager to intervene. Those who lost money (or a house) in the bust will look to the government to prop up their mal-investments. Instead of liquidation, the bad loans will be propped up and a perpetuation of the downturn will ensue. Even more people will be struggling and will again cry out to the state for more intervention. The momentum for intervention builds and a central bank is hailed as the economic savior.

*The Banker’s Incentive for Inviting Intervention*

Bankers are quick to jump on board with the state scheme for the sake of their own self-interest. The bankers are quite aware of the frequent panics and crises that occur whenever they try to increase their profits and interest by issuing fiduciary media. According to de Soto (2009, p. 647), private bankers are always the first to request the establishment of a central bank. They desire this lender of last resort to guarantee their survival through the bust phase of the business cycle. The result is that “the interests of private bankers [come] to coincide with those of the state and its central bank, and a symbiosis form[s] between the two” (p. 648). When these two groups come together with a central bank, the state is able to obtain inexpensive loans at no initial cost to the citizens. The debt can be put off seemingly indefinitely, and if it goes on long enough, will only be paid off by debasing the currency. All the while the private bankers gleefully
go along with any rules or regulations of the state. They know that without their state-sponsored cartel, they wouldn’t be able continue at their current level of returns and would either have to increase their reserve ratio or face the inevitable and liquidate when the bust hits.

De Soto (2009, p. 757) describes another of the benefits that accrue to both bankers and the state when fiduciary media is permitted. Each of these two parties gains from the debasement of the currency. De Soto calls this process “hidden expropriation citizens’ wealth.” On the same page he refers to the state and bankers as “two ‘accomplices’ in the socially detrimental credit-expansion process.” Much like the common thieves this cabal resembles, they must negotiate who gets what share of loot. The inflation tax, as it is commonly referred to, is too strong a temptation for states to resist. It turns out that banking is an industry quick to turn to the dark side. This is easily explained first by the mutual advantages, and difficulty with which the average Joe has in detecting the relationship between the state and the bankers. Secondly, the social detriments of this relationship are heavily lagged. The bust doesn’t come until after a lengthy boom. Many fail to even see the connection between the credit expansion and the economic crisis that necessarily follows.

*Fractional Reserve Banking, the State, and the Rise of a Central Bank*

De Soto (p. 648) writes that he accepts the hypothesis of Professor Charles Goodhart that the emergence of a central bank is the “necessary consequence of the shift from a system of commodity money to a system of fiduciary money”. He goes on to write that “the central-bank system is simply the logical and unavoidable consequence of
private bankers’ gradual and surreptitious introduction (in historical complicity with governments) of the fractional-reserve banking system”. What these statements ignore, or mislead about, is that the central bank is not a necessary consequence of the shift to fiduciary money. It there were no state, bankers who got themselves into trouble would be wholly unable to establish a central bank like those that exist today. As elucidated above, the same problems that plague every cartel on the free market would likewise prevent establishment a central bank with anywhere near the distortionary capabilities of the state central bank. Even in the event of the majority of banks getting together and expanding their deposits and bills simultaneously, de Soto (2009, p. 637) informs, “the spontaneous processes identified by the theory of economic cycles soon gather momentum and tend to reverse the initial expansionary effects and bankrupt marginally less solvent banks.” It is only a central bank, and the force of the state behind it, that makes it possible to prolong the process of credit expansion beyond the bust, resulting in a much more destructive economic cycle than could otherwise exist without it. So if fractional reserve banking can’t establish a central bank without a state (which de Soto agrees with when he writes in the above quotation “historical complicity with governments”) then the central bank is not simply “the logical and unavoidable consequence” of fractional reserve banking as de Soto writes. A central bank is really the logical and unavoidable consequence of the existence of a state. As was seen in the Bank of Amsterdam example above, even when a bank dedicates itself to the traditional legal principles of 100-percent reserve banking, the state will be there to eventually corrupt it.

De Soto writes brilliantly of the “community of interests that have generally united governments and bankers”, but neglects spell out the full conclusions of his work.
The full conclusion is that banking, even 100-percent reserve banking, will always be corrupted by the state as a source of cheap credit for public expenditures. It follows that a central bank is an unavoidable eventuality when a state exists. De Soto (2009, p. 649) writes that the perversion of banking by the state is “evident in all western countries and in almost all situations”. This is strong evidence for the inevitability of a central bank in societies which accept the legitimacy of a state.

Concluding Remarks:

The state sees the banking industry as a source of politically expedient funding. Whenever a state exists, it will, as history demonstrates, pervert the traditional legal principles of 100-percent reserve banking for its own purposes. Bankers have just as strong an incentive to pervert the laws as well and are happy to go along with the state’s scheme. The result of these complimentary forces of mutual advantage is the establishment of a central bank. The central bank, with the force of the government behind it, cartelizes the banking industry and uniformly inflates the currency while lowering reserve requirements. The result is a boom-bust cycle of vastly increased severity. Since both the bankers and the state are necessary for the creation of a central bank, it follows that one must be eliminated. Given banking performs activities beneficial to social welfare, and the state is by definition parasitical, the choice is clear. To remedy the fated establishment of a central bank, the state must be abolished.
References


