# FREE BANKING – POSSIBLE SOLUTION TO THE RECENT CRISIS?

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## Abstract

The free banking system, as a possible solution to alleviate the difficulties made by the recent financial crisis and to avoid such situations in the future, require the absence of central monetary authority and allow the establishment of private banks in conditions of freedom. The purpose of this article is to highlight the opinions pros and cons of adopting a free banking system and the ways in which it could provide a more stable financial system. In literature can be found proposals in the application of a free banking system based on fractional reserve or reserve 100%. Analyzing these issues, we conclude that in the economic systems will be supporters of both solutions, but the application of only one system which can ensure the general welfare must be experimented.

**Keywords:** free banking, fractional reserve, 100% reserve, reform.

**JEL classification:** F40, F41, G21.

## Introduction

Unlike the central bank which is an institution endowed with power and able to take series of macroeconomic measures, free banking defines a more decentralized market which is found in the absence of any central monetary authority. Despite this undeniable fact, the notion of free-banking refers to monetary market issues and the issuance of currency by private banks. Free banking does not amount in full with the idea of liberalizing the banking regulations and, therefore, rejected the idea that free banking is one of the causes of recent international crisis. In the crisis context, confusion has been created between the lack of regulation of the system and its degree of freedom, many believing that the crisis is due to excessive liberalism in the banking system (Milne, Wood, 2008, p. 517). The idea is based on the fractional reserve which can be interpreted as a too much freedom of the commercial banks in the lending provided by the central bank.

In order to remedy the situation caused by the crisis, there have been discussions on implementation of a reform based on **free banking** (Păun, 2010, p. 67). The proposed reform has gathered both supporters and opponents. Furthermore, proposals are discussions in adopting a system based on the fractional reserve or reserves 100% in a free banking system that constitutes solution to the recent crisis and can ensure monetary, financial and economic stability. The main criticism in application of a fractional reserve system consists in the inflationary effects, but supporters of 100% reserves (Soto and representatives of the Austrian School) believe that the necessary elements that the financial and monetary system requires in order to become more stable are: complete freedom in the choice of currency; free-banking system and eliminating the central bank and subjecting all agents involved in the system of free banking to the rules and traditional principles of law, the principle that no one should enjoy the privilege to lend something entrusted to deposit sight. In short, it is necessary that the banking system to maintain at any moment 100% reserve. Partisans of this concept allowed the freedom of establishment as many private banks in terms of complete freedom, both in terms of social order and legal form.

The article is structured as follows: part two presents literature about the concept of free banking and discussions conducted on this concept in the context of the crisis and the third part present the contradictory opinions in applying a free banking system with fractional-reserve or 100% reserve. The article ends with conclusions.

## Literature Review

The concise definition of free banking is that once the requirements imposed by state law are satisfied, any person or group of people is allowed to open a bank. Banks, after their creation by submitting a minimum capital can create money that is characterized by free movement, but with the obligation to hold a security deposit to the monetary authorities. Free banking refers directly to the banking laws so that the application of such a system is characterized by a lack of regulations and the fact that banks and other institutions, be they non-financial, should be guided by the same law (Dwyer Jr., 1996, p.78). Free banking implies the absence of a banking authority so that

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reserve rates are not set by law but are required in each bank to ensure a degree of prudence and safety (Sechrest, 2008, p.13).

The recent international financial crisis has manifested itself in the entire economy, but financial institutions play an essential role in the production, transmission and resolution thereof. Banks as financial intermediaries that make the transfer of funds from agents with excess to those with deficit have contributed to the expansion of economic instability.

The causes of recent international crisis were many, highlighting the failures of banking regulation and supervision plan. In the literature it is argued that one legal system consistent and robust and an appropriate supervision represent the essential elements to a stable banking system. According to Rochet (2008, p. 320), a banking system is more functional if possess a considerable volume of cash or the investments retains in a liquid form resources that to ensure reimbursement of depositors requests. This phenomenon, massive withdrawal of deposits at a bank caused its bankruptcy and led to the recital of the fragility of the banking system. To avoid the propagation this phenomenon have been designed a series of mechanisms such as the creation of an institution to act as lender of last resort, security system, public investment through capital injections or supervision rules (Rochet, 2008, p. 320).

One of the scenarios that caused the crisis is blamed on **liberalization measures in the banking systems** which were not accepted as an appropriate means of surveillance. The initial image is of an oligopolistic banking system, protected from competition of foreign banks and non-bank financial intermediaries. At the beginning of the liberalization process newcomers subjected to lax regulations will provide services at discounted prices because of reduced capital costs. The balance sheets of the existing banks in the market will deteriorate, banks decapitalisation being affected by asset immobilization with low interest, loss of major customers and the emergence of other financing costs (Dornbusch and Giavazzi, 2001, p.445).

In the process of discovering the causes of the recent financial crisis and of finding solutions for remedying arose one of the most controversial ideas supported by Austrian School economists: the renunciation of the monopoly of central banks (monopoly over issuing currency) and invoking competition between the coins of banks (public and private) and depriving the government of issuing money over the needs of the economy. It recounted the fact that in the case of a fractional reserve banking system is violated the traditional rule according to which in a deposit agreement the traditional obligation of custody requires that all time be kept a reserve 100% of the among of fungible money receive into deposit.

Lately, a new trend has developed in free-banking, borrowing and banking school elements. The trend is called **Neobanking School or Fractional-Reserve Free Banking School**. Among the representatives of this trend include: Lawrence White (1992), George Selgin (1993), Kevin Dowd (2003), David Glasner (2005). They believe that the spontaneous mechanism of clearing houses can hold simultaneous and concerted expansion of a majority of banks. Selgin (1987, p. 439-57) argues that a free banking system with fractional reserve could rectify the fiat money creation at the public demand for such instruments in the most efficient way compared with other systems. He believes that high demand of money may cause a reduction in demand for the replacement of fiat money from bank reserves resources. This will cause an increase in the reserves, and banks in search of higher profits will grow credit supply and thus the issue of banknotes (fiat money), resulting in an adaptation of the cash changeover to public demand. This latter objective can be achieved in the reverse situation when the reduction of the demand for its currency will lead to the replacement of its reserves at the bank, the bank will notice that they can go into default and credit supply will decrease and thus the currency.

Also, Bagus and Howden (2011, p.11) are proponents of the idea that you can maintain a balance in the monetary system by practicing a free banking system with fractional reserve and those reserves are a way of protection against credit expansion generated by this system. They were shown three ways that the practice a free banking system with fractional reserve can lead to credit expansion in the absence of prior increases in the real economy. This demonstrates that the fractional reserve system, even in a free system is ultimately causing instability and requires a call to the central bank to achieve stability. Janson (1998, p.20) argues that banking activity based on fractional reserve banking is not fraudulent and is against those free banks that choose to work under the obligation of constituting a 100% reserve. She is skeptical of predictions made on this system with 100% reserves and cannot explain the way that it fractional reserve system would not achieve the same results without violating the rights.

One of those coming against the fractional reserve system is Jesus Huerta de Soto (1998, p.679) who states that credit expansion may lead to banking crisis and recession which will inevitably lead the public to seek government intervention to solve the problems. Similarly, the bankers will be forced to accept the existence of a lender of last resort to reduce their risk of insolvency, provided that call for reunification liquidity. In the author's view, the practice of free banking with fractional reserves strengthens the need for a central bank and believes that a correct solution to a free society privileges is a free banking activity, but subject to the law, which means 100% reserve (Soto, 2010, p.657).

## Free banking – fractional reserve or 100% reserve?

The recent economic and financial crisis has reopened the debate about the state intervention in economy and the free market. Discussions on this subject are designed to clarify the real causes of the crisis and the devastating effects they propagate the general welfare. In the plan of these discussions are concerned regulatory elements of banking and financial systems, of introduction of new controls and supervising in the financial markets, the use of new financial instruments and of the role of bank and non-bank operators in these markets. Once understood why the system is not functioning properly and how possible interventions can fix this issue would avoid such situations in the future. The starting point for re-discussion of reforms implemented in the financial and banking systems should be "money" (Marimon, Nicolini, Teles, 2012, p. 11).

Elements considered to be aggravating global crisis include: capital account liberalization, speculative investment flows, transactions in currency markets, monetary policy expansion that changes the price level and structure, fractional reserve and deposits on term with the possibility of retirement before maturity. In the crisis were created confusions between the lack of regulation of the system and its degree of freedom, many authors believing that the crisis is due to excessive liberalism in the banking system. The idea is based on the fractional reserve and which can be interpreted as a greater freedom of the commercial banks to lending.

Furthermore, it came to discussions on establishing a reform based on **free banking** which gathered both supporters and opponents. Glasner (2005, p.344) specify that the goals of such reforms based on free banking can create a dilemma. On the one hand, the free market can generate greater efficiency and lower transaction costs, but on the other hand, a pure free money market cannot protect all market participants to cost of price-uncertainty level. A free money market would minimize the cost of holding money, but will not necessarily reduce the uncertainty and cost of the overall price. These costs will be reflected in employees, borrowers, to all those involved in future activities involving the exchange of value in nominal terms.

Pascal (1998, p. 61) affirms that, in a perfectly free system, all must be willing to provide all existing money and attract customers for their services. In turn, customers should be free to choose money and payment system. A possible way by which creators of substitute money can make people to pay the cost of holding gold is practicing only the fractional reserve system. This gain will be proportional to the length of time that people have the money and the time value of money they receive fractional interest detainees, namely those who have loans and not gold as their counterpart in the balance. In a free banking system, various creators of currency must coexist in the market. The same author argues that the definition of free banking = free competition between different creators of currency is not compatible with the idea of holding the banks of a 100% reserve system. In his opinion there are two ways that you can select one or a combination of systems of reserves (reserves 100% and fractional reserve): once, through regulations imposed by the state, in which case it will apply 100% reserves and thus have eliminated the idea of free banking; on the other hand suggests that the monetary system is chosen by market, namely the creators and users of coins.

The preference for one system or another cannot be given. Therefore, there may be people who prefer 100% reserve system just as there may be people who prefer fractional reserve banking, which should be experimented. Just as specify Hülsmann (1996, p. 3-53) and Pascal (1998, p. 61) the existence of both systems at the same time can define a perfect free banking system. It is worth noting that there is a contradiction in his Hülsmann view namely that support 100% reserve system apparently does not represents the mandatory existence of another system if the fractional reserve would be banned by the state. Although the superiority of reserve of 100% cannot be established, and as well as Pascal, we can use the history items related to this. The first coins were covered with reserves of 100%, but the fractional reserve system has progressively evolved there is a time in which the two systems become competitive.

Fractional system was selected not as a result of the follow state regulations prohibiting reserves 100%, but because it made possible a more convenient intersection need of creators and holders of currency. It is also true that during the transition from one system to another will be a major currencies creative with effects in inflation, excessive credit, more investment, and so on, these effects are accompanied by costs. Under the free banking system with fractional reserve individual decisions will prevail, which will not favor limiting the volume of coins substituents. This causes Hülsmann to say that fractional reserve will not ensure the optimal level of quantity of coins and appropriate quality of them.

Characteristics of free banking do not allow us to accept the idea that fractional reserve is ineffective and is creating systemic risk through the effects of contagion because, under such a system, banks will interact with other institutions that will help them to avoid the systemic risk.

The arguments were made in favor of fractional-reserve banking and were generalized due to members of **Banking School**, forming a group of theorists around this idea. Among its members are also the following: Parnell, Wilson, MacLeod, Tooke, Fullarton, etc.. They militate around three fundamental theses of banking School namely: a) fractional reserve banking who is theoretically justified and legal is very beneficial for economic development, b) the ideal monetary system that facilitates the expansion of the money supply as required population growth and economic activity; c) the banking system with fractional reserve allows, through the expansion of credit and the issuance of paper money not covered by commodity money, the increasing of money supply according to the needs of trade, without inflationary effects or distortions in the production structure.

Banking School doctrines were contradicted by the followers of the Monetary School who pointed out three of their most serious mistakes. On one side, accused them of misunderstanding the fact that bank deposits have a role similar to banknotes issued without precious metal coating and they treated in a superficial way the manner in which the credit expansion can affect different stages of capital goods in the production structure of a country. Also, were accused of granting to an official central bank the monopoly privilege of banknote issue in order to end the inflationary excesses, without realizing that such an institution will complete by accelerating credit expansion in the form of deposits and banknotes in circulation. As supporters of the Monetary School, Modeste, Cernuschi, Hubner and Michaelis, followed by Ludwig von Mises understood that recommendations of Banking School in favor of central bank were erroneous and supported the establishment of a free banking with 100% reserve.

Thus, was developed a complex debate between supporters of free banking and supporters of the central bank. The latter argue that a free banking system would be subjected to isolated banking crisis who might affect the holders of notes and deposits, and that in such circumstances it is necessary to have an official central bank invested with power to intervene in order to protect the holders of notes and deposits in a crisis. Moreover, they argue that a free banking system controlled by the central bank can causing less economic crisis than a free-banking system, and in the circumstances of recent international crisis, it was argued that such a bank is the most conducive to creating the necessary liquidity. It was concluded that the existence of fractional reserve banking system inevitably lead to the establishment of a central bank acting as lender of last resort.

Historical studies support the idea that a free banking system would immunize the economies front of the cycles of boom economies and depression due to the mechanism of "monetary equilibrium". Soto (2010, p.350) believes that the studies pursued in this regard instead to investigate whether free-banking system has avoided the credit expansion, artificial boom and economic recession were limited to study whether banking panics and crises were more or less frequent and severe than a central bank system. Even though historical studies indicate that free banking systems have created less panics and banking crisis than a systems with central bank, this not mean that a free banking system is completely devoid of such events. In support of the assertion of Soto (2010, p.676) comes Selgin (1993, p. 347), which relies on three acute banking crises that ravaged the free-banking systems: Scotland - 1797 Canada - 1837 Australia - 1893.

According to the above affirmations, we can distinguish two radically different systems that can be applied in banking activity. On a side, a free banking system subject to traditional principles of law (compliance rate of 100% reserve), in which the operations with fractional reserve are illegal and contrary to social order and, on the other hand, a system that allows the application of the fractional reserve and which inevitably lead to the establishment of a central bank as a central element of the financial system and as lender of last resort. The first economist who supports the establishment of a banking system with a 100% reserve for deposits is Ludwig von Mises, in the first edition of his book on the theory of money and of fiduciary media, published in 1912, which joins economists such as Cernuschi, Modeste, Geyer,Tellkampf, Michaelis, Hayek, Friedman, Tobin and Allais.

Soto and the representatives of the Austrian School are among the supporters of such a system and, in the context of international economic and financial crisis, they propose a banking reform that is based on free banking system. They propose, on the one hand, subjecting financial market institutions to traditional principles of law and, on the other hand, the elimination of state organisms devoted so far to control and steer the financial system. They believe that the necessary elements that financial and monetary system become more stable are: complete freedom in the choice of currency, a free-banking system, eliminate the central bank and subjecting all agents involved in the system to rules and traditional principles of law, the principle that no one should enjoy the privilege to lend something entrusted like deposits. In short, it is necessary that in any moment in the banking system to keep 100% reserve. Partisans of this concept allowed the freedom of establishment as many private banks in terms of complete freedom, both in terms of social order and legal form.

This reform would allow the establishment of specific banking institutions of a market economy, facilitating better invested capital accumulation and economic development so as to avoid imbalances and crises that produce the current system which is subject to interventions and intense centralization (Reinhart, Rogoff, 2008). One of the advantages achieved by the application of this system would **be avoid crises** resulting from lack of liquidity of banks, by simply applying the legal principles of bankruptcy. This type of "banking crisis" has nothing in common with qualitative or quantitative traditional crisis which continued to affect the banks which began to act the operations with fractional reserve. Another advantage of applying this system would avoid **cyclical economic crises;** since there is not an artificial credit expansion without previously have been a parallel increase in voluntary saving and real society. Defenders of the system argue that it is the best private property **rights and fueling economic growth stable and sustained minimize transaction costs, especially those related to union negotiations.**

A monetary system based on the gold standard and 100% reserve and assuming annual increase productivity by 3%, this pattern of growth would lead to a gradual and steady decline in prices of consumer goods and services. This decrease would provide economic development and ensure the benefits of growth, increasing constantly purchasing power of monetary units that citizens possess. Another advantage of this system would be that this **will end financial speculation and its harmful effects, will provide greater compatibility with the democratic system and supports harmonious and peaceful cooperation among nations.** The same authors consider that the main error of the majority theorists which defense the free banking system is the assumption that the bank reserve requirement of 100% reserve would be unacceptable administrative interference in individual liberty and not see it as an application of traditional principle property rights (Soto, 1998).

Economists such as Irving Fisher, Milton Friedman, James Tobin, John Kay, Martin Wolf and Sir Mervyn King believe that 100% reserve system can be a possible solution to the present international economic crisis and identify its benefits, including: greater control over the sources of fluctuations in the cycles of business, eliminating bank failures, reducing public debt and monetary creation, monitoring risks and costs and reducing inflation. Similarly, in the Submission to the Independent Commission on Banking was listed benefits of implementing such a system, including achieving economic stability and reduce systemic risks posed by the fiscal position of the government, banking competition that would eliminate restrictions on the banking activity, security of depositors, the possibility to establish interest rates in the market, etc. (Dyson, Greenham, Collins, Werner, 2011, p. 347). White (1992, p.517) affirms that the fractional reserve system it is not unstable if the banking system is deprived of fulfillment of banking restrictions, and without privileges. He considers that an advantage of the application of this system is to gain the coins of banks granting the loan from the funds held. The most vehement critics in implementation of the system to the fractional reserve relate to the inflationary effects caused; the supporters of this idea are Selgin, Rothbard or Tenebrarum.

## Conclusions

Free banking defines a more decentralized market which is found in the absence of any central monetary authority. In order to remedy the situation caused by the crisis, it was discussions on implementation of a reform based on **free banking**, around which gathered both supporters and opponents. Furthermore, proposals are discussions in adopting a system based on the fractional reserve or reserves 100% in a free banking system that constitutes solution to the recent crisis and can ensure monetary stability, financial and economic.

Selgin (1987, p. 83) argues that a free banking system with fractional reserve could rectify the fiat money creation at public demand for such instruments in a more efficient way compared to other systems. Janson (1998, p.45) argues that banking activity based on fractional reserve banking it is not fraudulent and is against to those free banks that choose to work under the obligation to constitute a 100% reserve. She is skeptical of predictions made on this system with 100% reserves and cannot explain the way that it fractional reserve system would not achieve the same results without violating the rights. One of those coming against the fractional reserve system is Jesus Huerta de Soto (1998, p.78), which states that the practice of free banking with fractional reserves strengthens the need for a central bank and believes that a correct solution to a free society privileges is a free banking activity, but subject to the law, which means 100% reserve. The main criticism in the application of a fractional reserve system is the inflationary effects, but supporters of 100% reserves consider that the necessary elements that financial and monetary system to become more stable are: complete freedom in the choice of currency; free-banking system and eliminate the central bank and subjecting all agents involved in the system of free banking to the rules and traditional principles of law, the principle that no one should enjoy the privilege to lend something entrusted to deposit sight. In short, it is necessary that at any moment in the banking system to keep 100% reserve. Partisans of this concept allowed the freedom of establishment as many private banks in terms of complete freedom, both in terms of social order and legal form

In literature, we found that the goals of such reforms based on free banking can create a dilemma. On the one hand, the free market can generate greater efficiency and lower transaction costs, but on the other hand, a pure free money market cannot protect all market participants to cost of price-uncertainty level. A free money market would minimize the cost of holding money, but will not necessarily reduce the uncertainty and cost of the overall price. These costs will be reflected in employees, borrowers, to all those involved in future activities involving the exchange of value in nominal terms.

A preference for one system or another cannot be established. Therefore, there may be people who prefer 100% reserve system just as there may be people who prefer fractional reserve banking, which should be experimented. Just as specify Hülsmann (1996, p.3) and Pascal (1998, p.61) the existence of both systems at the same time can define a perfect free banking system.

The article is a theoretical work on what is means free banking and if the appeal to one free banking system could be a solution in resolving the recent financial crisis. The literature determine us to affirm that the appeal to a free banking system based on fractional reserve or 100% reserve must be experimented and that there will always be supporters of both types of solutions. The article determine reactions for new directions for research such as studying the effects that the application of such a system can have on the economy, empirical studies on the subject or comparing the effectiveness of free banking solutions with other solutions utilized in order to remedy the situation caused by the crisis.

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