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A CRITICAL LEGAL ANALYSIS OF COMMERCIAL BANK MONEY

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ABSTRACT

Because of the role that commercial banks play in today's financial and banking system, this article discusses the activity of commercial banks with regard to how money (commercial bank money) is created. By exploring the nature of the fractional reserve banking system, this article establishes that commercial banks are not mere financial intermediaries but rather exclusive money creators. A critical legal analysis of this money creation process concludes, with solid supporting arguments, that commercial bank money is riddled with legal violations and harmful socioeconomic effects, which are inevitably borne by the individual and society in the form of 'privatizing the profits of money creation' and 'socializing the losses and its outrageous financial burden'.

KEYWORDS: Commercial banks, Fractional reserve banking, Legal Analysis, Money creation

INTRODUCTION

The fact that things are scarce everywhere is, for us as humans, the most fundamental economic reality of our existence. We don't have enough resources to accomplish all of our goals. Time is limited, and so are all other available resources. This compels us to carefully and wisely choose how to use (or not use) these resources. The use of all means of action is basically governed by the law of diminishing marginal value, which stipulates that the marginal value (relative importance) of any unit of an economic good for its owner decreases with the control and acquisition of a greater overall supply of this good, and vice versa. For example, the marginal value of a sip of water (additional) is very different for a person stranded in a desert than for the same person diving and swimming in a lake. Therefore, the creation (production) of additional units of money makes money less valuable for the owners of these additional units, especially when compared to all other goods and services. Consequently, buyers of goods and services will tend to pay more in exchange for these goods and services; in turn, sellers of these goods and services will tend to demand higher money compensations. In short, money generation results in a propensity for prices to rise, even though this may occur gradually over time in a process that has a varied impact on each price.

To legally analyze the process of money creation in today's banking system, this article first explores the role of commercial banks by providing evidence pointing to the fact that commercial banks are not financial intermediaries but rather (*de facto*) private entities with an exclusive right (privilege) to create money out of thin air. The article adopts a descriptive-analytical approach to explore the nature of commercial bank money under fractional reserve banking as it builds its arguments and portrayal of the fractional reserve system on previous empirical research backed with assertions of experts and practitioners in the field of finance and banking. After that, the research paper delves into the discussion with a critical analysis of this money creation or production process from different legal perspectives. The article concludes, with irrefutable supporting arguments, that commercial bank money is blatantly harmful to the individual and society, with many legal violations at its core.

Some of the most influential and pertinent previous research on the subject came from Huerta de Soto[1] (2006) and Hulsmann[2] (2008); they both offer comprehensive analysis in their legal examination of the fractional reserve banking system, Bagus & Howden, (2010[3], 2011[4]) contributed to the subject by arguing against free banking as it is conceptualized by the likes of Selgin[5] (1988), who in turn responded to their arguments (2011) with his rebuttal[6] (article). My article builds and expands on the works mentioned above by delving, with new perspectives and arguments, deeper into the nature of this process of money creation by commercial banks to expose its inherent socio-economic and legal harms and defects that essentially constitute blatant violations of the legal framework.

What is money? And how is it created (commercial bank deposit money)?

Most attempts to define money focused on its functions. It is anything that is generally accepted by law in the fulfillment of obligations and is used as an intermediary in the exchange, as a unit of account, as a store of value, and as

1 J. Huerta de Soto, *Money, Bank Credit, and Economic Cycles,* Ludwig Von Mises Institute, Auburn, AL., 2006.

2 J. G. Hulsmann, *The Ethics of Money Production,* Ludwig Von Mises Institute, Auburn, AL., 2008.

3 P. Bagus & D. Howden, 'Fractional Reserve Free Banking: Some Quibbles.' *Quarterly Journal of Austrian Economics,* vol. 13, no. 4, 2010, pp. 29-55, <https://mpra.ub.uni-muenchen.de/79590/1/MPRA_paper_79590.pdf> [Last seen 15 December 2022].

4 P. Bagus & D. Howden, 'Unanswered Quibbles: George Selgin Still Gets It Wrong With Fractional Reserve Free Banking', *Revista Procesos de Mercado*, vol. 8, no. 2, July 2011, pp. 83-111, <http://dx.doi.org/10.52195/pm.v8i2.248>

5 G, Selgin, *The Theory of Free Banking: Money Supply under Competitive Note Issue*, Rowman and Littlefeld, New Jersey, 1988.

6 G, Selgin, 'Mere Quibbles: Bagus and Howden's Critique of The Theory of Free Banking', April 4, 2011, <http://dx.doi.org/10.2139/ssrn.1800813>

a tool for settling deferred or future payments. Scitovsky argues that money *"is a difficult concept to define, partly because it fulfills not one but three functions, each of them providing a criterion of moneyness ... those of a unit of account, a medium of exchange, and a store of value".*[7] Standard textbooks define money as any medium that is commonly considered to have the following three properties: (1) store of value, which allows money holders to conserve purchasing power over time; (2) unit of account, which serves as a reference in which the value of goods and services is measured; and (3) medium of exchange, which makes it ideal to settle transactions.[8]

For this research, I will include the definition of the form of money that this paper's discussion part will revolve around; commercial bank money (deposit money). The portion of the total money stock held by non-bank agents in the form of electronic bank deposits is what we call commercial bank money. While keeping system-wide money stocks constant, bank customers (commercial bank money holders) turn their commercial bank money into physical cash back and forth (similar to transferring funds electronically across banks). So when banks lend money (granting a loan), they create a deposit (money). Therefore, lending adds to the bank's total money stocks, while loan repayments destroy its total money stocks accordingly. In contrast, non-bank lending refers to a transfer of (already) existing legal money stocks from one economic agent to another. Hence, through a debt, one economic agent subtracts from its money holding and adds to another's.[9]

First, I must briefly tackle Fractional Reserve Banking, as it is an essential component of all today's modern economies. The practice of lending out most, but not all, of the deposits held by bankers (institutions) was first developed in Europe in the 16th century and has been followed ever since. To protect the bank in the event that many or all of its depositors demanded cash at the same time, the practice of holding a fraction in reserve was initially instituted. Fractional reserve banking allows banks to "create money" through lending, thus increasing the money supply during periods of economic expansion and growth, whether it is mandated by caution or a system of banking regulations. The majority of economics textbooks assert that banks "create" money. *"Eighty percent of the bank deposits are loaned out, but they're still considered as being 'in the bank'".*[10]

Throughout the era of gold trading, Goldsmiths observed that not everyone demanded their deposits simultaneously, which essentially opened the door for fractional banking to exist. People received promissory notes whenever they deposited their silver and gold coins at goldsmiths. Later, the notes were recognized as a valid medium of exchange, and their owners used them in commercial transactions. The goldsmiths understood that not every saver/depositor would withdraw his deposits at the same time because depositors used the notes directly in trade. Therefore, goldsmiths started issuing loans and bills with high interest rates along with the storage fee they were charging the deposits. Eventually, the goldsmiths turned from being safe-keepers of valuables to interest-paying and interest-earning banks. Later, history revealed that whenever the note-holders lost faith in the goldsmiths, they would withdraw all their deposits simultaneously, leaving the bank (goldsmith) insolvent due to the lack of reserves to support the mass withdrawals. This prompted governments to develop laws to establish a central institution (agency) to control and regulate the banking industry. In this

7 T. Scitovsky, *Money and the Balance of Payments*, 1st edn, Routledge, 1969, p. 1, <https://doi.org/10.4324/9781315438924>

8 N.G. Mankiw, *Macroeconomics,* 7th edn, Worth Publishers, New York, 2010, pp. 80-81.

9 M. Gross & C. Siebenbrunner, 'Money Creation in Fiat and Digital Currency Systems', *IMF Working Paper*, WP/19/285, December 2019, pp. 8-9, <https://doi.org/10.5089/9781513521565.001>

10 Foundation For Teaching Economics, 'Activity 6: Show Me the Money! A Fractional Reserve Banking Simulation', *fte* [website], <https://www.fte.org/teachers/teacher-resources/lesson-plans/efiahlessons/show-me-the-money-activity/> [Last seen 13 December 2022].

regard, Sweden established the first central bank in 1668, and the rest of the world followed. Central banks became in charge of regulating commercial banks, setting reserve requirements, and, more importantly, they became the lender of last resort to any commercial bank affected by banks runs.[11]

Professor Salerno testified before the U.S. house of representatives and had this to say when asked about fractional reserve banking: "*Fractional reserve banking occurs when the bank lends or invests some of its deposits payable on demand and retains only a fraction in cash reserves, hence the name "fractional reserve banking". All U.S. banks today engage in fractional reserve banking.*"[12] Similarly, Professor Cochran stated, "*Fractional reserve banks developed from two separate business activities: banks of deposit, or warehouse banking, where banks offering transaction service for a fee; and banks of circulation or financial intermediaries. Circulation banking, if clearly separated from deposit banking, reduces transaction costs and enhances the efficiency of capital markets, leading to more savings, investment, and economic growth. Fractional reserve banking combined these two types of banking institutions into one: a single institution offering both transaction services and intermediation services. With the development of fractional reserve banking, money creation--either through note issue or deposit expansion--and credit creation became institutionally linked. Banks create credit if credit is granted out of funds especially created for this purpose. As a loan is granted, the bank prints bank notes or credits the depositor on account. It is a creation of credit out of nothing. Created credit is credit granted independently of any voluntary abstinence from spending by holders of money balances*".[13]

Some economics textbooks claim that commercial banks must hold only a fraction of customer deposits as reserves and may use the rest to grant loans to borrowers. However, when awarding loans, commercial banks merely accept promissory notes in exchange for credit that they deposit (digitally) in the borrower's account. Hence, deposits to the borrower's account, as opposed to giving loans in the form of cash or currency, are part of the process banks use to create money. Because of this, whenever a bank grants a loan, it generates new money, increasing the total amount of money in circulation. For instance, when a person takes out a $100,000 mortgage loan, the bank credits the borrower's account with the appropriate amount rather than handing him currency or cash equal to the loan's value.[14]

In an attempt to defend fractional reserve banking and commercial bank money, Rendahl and Freund said: *"In recent years, some have claimed that banks create money 'ex nihilo'. This column explains that banks do not create money out of thin air. From an economic viewpoint, commercial banks create private money by transforming an illiquid asset (the borrower's future ability to repay) into a liquid one (bank deposits)".*[15] Notice how they considered 'someone's ability to repay in the future' an illiquid asset, I am not going to focus on this debatable claim but rather examine how they portrayed the granting of a loan as an exchange of a borrower's promise to pay back in the future for what they considered a liquid asset 'bank deposits'. This begs the question: where did the bank get the liquid asset? Only three possibilities are conceivable in this context; a) prior to the borrower's demand for the loan. The bank

11 Corporate finance institute team, 'Fractional Banking', *Corporatefinanceinstitute* [website], <https://corporatefinanceinstitute.com/resources/economics/fractional-banking/> [Last seen 28 December 2022].

12 J. T. Salerno, 'Fractional Reserve Banking and The Federal Reserve: The Economic Consequences of High-Powered Money', *Hearing Before The Subcommittee on Domestic Monetary Policy and Technology of The Committee on Financial Services*, U.S. House of Representatives, 112th Congress, 2nd Session, June 28, 2012, <https://www.govinfo.gov/content/pkg/CHRG-112hhrg76112/html/CHRG-112hhrg76112.htm> [Last seen 21 November 2022].

13 Ibid, J. P. Cochran.

14 Corporate finance institute team, Para. 4.

15 P. Rendahl & L. B. Freund, 'Banks do not create money out of thin air', *Centre for Economic policy research cepr* [website], 14 December 2019, <https://cepr.org/voxeu/columns/banks-do-not-create-money-out-thin-air> [Last seen 17 December 2022].

already had the money in its possession (bank's liquid money – i.e. investors/savers money deposited with the bank), b) the bank created the money demanded by the borrower 'instantly' as soon as he approached it for the loan (computer inputs into the borrower's deposit account) and c) the bank turned the borrower's promise (ability) to pay in the future into an instant liquid asset (deposit money) which is exactly similar to what Rozeff[16] tried to argue in his defense of the fractional reserve banking by claiming that when banks grant loans they create new money in the form of a purchase of the borrower's IOU in exchange of the bank's IOUs, so ultimately the money in this magical context belongs to the borrower in the first place and yet the bank loaned him 'his own future money' with an obligation of him relinquishing the same amount of money to the bank in the future (plus interest)!! So the granted loan is basically computer inputs banks add to the borrower's account. It is like 'the bank' saying *I will lend you money that I don't have (did not exist until you (the borrower) demanded it) because I have a right and privilege (by law) to create it (computer inputs) as soon as you demand it (need it). I am exchanging (trading) something that do not exist (new deposit money) for another thing that do not exist yet 'today', which is your ability (promise) to pay in the future*. How can this not be creating money out of nothing?! Moreover, they cannot explain where did they get the liquid asset (bank deposits), as their premise would only make sense if the liquid asset they were referring to came from savings/investments (i.e., saving deposits), which in reality does not.

So are commercial banks financial intermediaries? Do they create money out of thin air? Werner[17] (2014) (2014) examined the three hypotheses (theories) that are recognized in the literature. The financial intermediation theory of banking contends that banks are simply intermediaries, gathering deposits to be lent out like other non-bank financial institutions. The fractional reserve theory of banking holds that while individual banks are merely financial intermediaries and cannot create money, they do so through systemic interaction as a group. The third theory, known as the "credit creation theory of banking," holds that every single bank can create money "out of nothing" when it extends credit. Which of the theories is correct has significant ramifications for research and policy. Unexpectedly, no empirical study has, up until now, tested the theories, despite the ongoing controversy. Werner carried out an empirical test whereby a loan is taken (borrow money) from a cooperating bank while its internal records are being scrutinized and monitored to determine whether the bank transferred funds from other accounts—within or outside the bank—or if they were created from scratch when making the loan available to the borrower. For the first time using empirical evidence, Werner's study proved that banks individually create money out of thin air. The banks independently create (in his own words) the "fairy dust" that serves as the money supply. According to Werner's study, customer deposits are accounted for on the financial institution's balance sheet. The financial intermediation theory, which contends that banks are not unique and are essentially undifferentiated from non-bank financial institutions that must keep customer deposits off the balance sheet, conflicts with the empirical evidence provided by Werner's study. While non-bank financial institutions record customer deposits off their balance sheet, banks treat customer deposits very differently. Werner discovered that the bank treats customer deposits as a loan to the bank, which is why they are listed under the heading "claims by customers." This concords with the legal analysis of the demand deposit (current account) I previously conducted[18] (2022). Therefore, only

16 M. Rozeff, 'Rothbard on Fractional Reserve Banking: A Critique', *The Independent Review,* vol. 14, no. 4, 2010, p. 500, <https://www.independent.org/pdf/tir/tir_14_04_02_rozeff.pdf> [Last seen 20 September 2022].

17 R. A. Werner, 'Can banks individually create money out of nothing? — The theories and the empirical evidence', *International Review of Financial Analysis*, vol. 36, 2014, pp. 1-19, <http://dx.doi.org/10.1016/j.irfa.2014.07.015>

18 M. A. Benlala, 'A Scrutiny of The Demand Deposit (Cur-

the credit creation theory or the fractional reserve theory of banking can reconcile and make sense of these findings.

The following statements are some valuable quotes from past and current literature:

Schumpeter (1912): *"It is much more realistic to say that the banks 'create credit', that is, that they create deposits in their act of lending, than to say that they lend the deposits that have been entrusted to them. And the reason for insisting on this is that depositors should not be invested with the insignia of a role which they do not play. The theory to which economists clung so tenaciously makes them out to be savers when they neither save nor intend to do so; it attributes to them an influence on the 'supply of credit' which they do not have."*[19]

Keynes (1930): *"... [a bank] may itself purchase assets, i.e. add to its investments, and pay for them in the first instance at least, by establishing a claim against itself. Or the bank may create a claim against itself in favour of a borrower, in return for his promise of subsequent reimbursement; i.e. it may make loans or advances."*[20]

Minsky (1986): *"Money is unique in that it is created in the act of financing by a bank and is destroyed as the commitments on debt instruments owned by banks are fulfilled. Because money is created and destroyed in the normal course of business, the amount outstanding is responsive to the demand for financing. [.] Banking is not money lending; to lend, a money lender must have money. The fundamental banking activity is accepting, that is, guaranteeing that some party is creditworthy. [...] When a banker vouches for creditworthiness or authorizes the drawing of checks, he need not have uncommitted funds on hand. He would be a poor banker if he had idle funds on hand for any substantial time. In lieu of holding non-income-earning funds, a banker has access to funds. Banks make financing commitments because they can operate in financial markets to acquire funds as needed; to so operate, they hold assets that are negotiable in markets and hold credit lines at other banks."*[21]

Berry et al. (2007): (The Bank of England Quarterly Bulletin): *"When banks make loans, they create additional deposits for those that have borrowed the money."*[22]

Constâncio (2011): (Vice President, the European Central Bank, 2010-18): *"It is argued by some that financial institutions would be free to instantly transform their loans from the central bank into credit to the non-financial sector. This fits into the old theoretical view about the credit multiplier according to which the sequence of money creation goes from the primary liquidity created by central banks to total money supply created by banks via their credit decisions. In reality the sequence works more in the opposite direction with banks taking first their credit decisions and then looking for the necessary funding and reserves of central bank money."*[23]

King (2012): (Governor, the Bank of England, and Chairman, the Monetary Policy Committee, 2003-13): *"When banks extend loans to their customers, they create money by crediting their customers' accounts."*[24]

Turner (2013): (Chairman, Financial Services Authority, UK, 2008-13): *"Banks do not, as too many textbooks still suggest, take deposits of existing money from savers and lend it out to borrowers: they create credit and money ex nihilo – extending a loan to the borrower and si-*

rent Account) through the Lenses of Law And Islamic Jurisprudence', *Law and World*, vol. 8, no. 4, December 2022, pp. 16-33, <https://doi.org/10.36475/8.4.2>

19 J. Schumpeter, *The Theory of Economic Development,* Harvard University Press, Massachusetts, 1949, pp. 97-98.

20 J. M. Keynes, *A Treatise on Money,* Macmillan and Co., London, 1930, p. 21.

21 H. P. Minsky & H. Kaufman, *Stabilizing an unstable economy*, Vol. 1, McGraw-Hill, New York, 2008, pp. 256, 278.

22 S. Berry, R. Harrison, R. Thomas & I. Weymarn, 'Interpreting movements in broad money', *Bank of England Quarterly Bulletin Q* 3, 2007.

23 V. Constancio, 'Challenges to monetary policy in 2012', *Speech at 26th International Conference on Interest Rates,* Frankfurt am Main, 8 December 2011, p. 5, <https://www.bis.org/review/r111215b.pdf> [Last seen 28 November 2022].

24 M. King, 'Speech to the South Wales Chamber of Commerce at the Millennium Centre', Cardiff, October 23rd, 2012.

multaneously crediting the borrower's money account. That creates, for the borrower and thus for real economy agents in total, a matching liability and asset, producing, at least initially, no increase in real net worth. But because the tenor of the loan is longer than the tenor of the deposit – because there is maturity transformation – an effective increase in nominal spending power has been created."[25]

Bank of England (2014): *"One common misconception is that banks act simply as intermediaries, lending out the deposits that savers place with them... rather than banks lending out deposits that are placed with them, the act of lending creates deposits — the reverse of the sequence typically described in textbooks... Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money."*[26] So the Bank of England has come forward clearly in support of the credit creation theory.

Bundesbank (2017): *"Bank loans to non-banks are the most important money-creating transaction in terms of quantity...long-term observations have found that lending is the most significant factor propelling monetary growth."*[27]

THE LEGAL ANALYSIS

After establishing that banks are not financial intermediaries by putting forward irrefutable economic arguments and empirical evidence asserting that they do create money (out of thin air) in reality, let us delve into the interlocked socioeconomic and legal aspects of these findings. The legal doctrines that support and justify fractional reserve banking have not been founded on previously established legal precepts that gave rise to specific legal acts. Instead, they have been drafted and set *ex post facto*. It was crucial for the banks and their advocates to find sufficient legal grounds to preserve the network of vested interests that fractional-reserve banking generates "for them" overall.[28]

First, the acts of using depositors' money and/or issuing deposit receipts for a greater amount than is deposited share a common trait with all other illegal acts of misappropriation, which have always been the focus of doctrinal analysis by criminal law specialists. Because of this, the similarities between the two sets of actions are so striking that theorists could not remain unmoved by this legal inconsistency. Unsurprisingly, significant efforts have been made to justify what is utterly unjustifiable: to make it acceptable and legal from the perspective of general legal principles to misappropriate funds deposited for safekeeping and to issue 'unbacked' deposit receipts without having the corresponding deposited money in reserves. There are two main categories of doctrinal justifications for using a fractional reserve in a demand deposit (current account). The first group sought to resolve the conflict by characterizing the demand deposit as a loan; this has been extensively discussed and refuted based on Issues pertaining to the debtor-creditor relationship, the standard-form contract and the contractual discretionary power, the duplicate property titles and availability of funds, the distinguishable economic and legal purposes of the two contracts.[29] The second

25 A. Turner, 'Credit, Money and Leverage', *Conference on: Towards a Sustainable Financial System*, Stockholm School of Economics, September 12th, 2013, p. 3, <https://cdn.evbuc.com/eventlogos/67785745/turner.pdf> [Last seen 13 December 202]).

26 Bank of England, 'Money creation in the modern economy', *Quarterly Bulletin*, Q1, 2014, <https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2014/money-creation-in-the-modern-economy.pdf> [Last seen 13 December 2022].

27 Bundesbank, 'The role of banks, non-banks and the central bank in the money creation process', Monthly Report 2017, <https://www.bundesbank.de/resource/blob/654284/df66c4444d065a7f519e2ab0c476df58/mL/2017-04-money-creation-process-data.pdf> [Last seen 13 December 2022].

28 Huerta de Soto, p 115.

29 For more on this particular issue, you can see M.A. Benlala, 'The Characterization of the Demand Deposit as a Loan under Fractional Reserve Banking: A Critical Legal Analysis,' *Perspectives of Law and Public Administration*, vol. 11, no. 4, December 2022, pp. 638-649, <https://www.adjuris.ro/revista/articole/An11nr4/16. M.A. Benlala.pdf> [Last seen 03 January 2023].

group of theorists recognize the fundamental distinctions between the loan and demand deposit contracts but concentrate their focus on their newly developed legal concept of "availability" and maintain that this notion must be interpreted "in a loose manner," which means that bankers should only be required to make their investments "in a prudent manner" and to always comply with regulations and bank legislation. The notion of availability being redefined is irrelevant and a mere leap into the unknown.[30] First, banks continue to treat deposits like loans and invest them in private business deals accordingly, while depositors continue to make deposits with the primary goal of transferring custody and safekeeping of their money while maintaining its full availability. In other words, the forced attempt to redefine the idea of availability did not make the legal logic's inconsistency any less apparent. Moreover, from the point of view of private law, the general guideline of "prudent" use of resources combined with the "calculation of probabilities" is far from sufficient to guarantee that fractional reserve banks will always be able to honor all repayment requests. Au contraire, it carelessly starts a process that, at least once every few years, inevitably leads to a loss of trust in banks and a massive, unforeseen withdrawal of deposits.[31] Availability has also been depicted as the compliance of the private banks with the entire structure of government banking legislation. However, this is another blatantly artificial requirement that aims to shift the unsolved problem with regards to legally defining the fractional-reserve bank deposit contract from the field of private law (where the demand deposit cannot be a loan) to the field of public law; namely the administrative law with its pure voluntarism by which the authorities can legalize any institution, no matter how legally outrageous and immoral it may be. So the fact that fractional-reserve banking has not been able to survive without a government-created central bank, which would impose legal-tender regulations and force the acceptance of paper money with the aim to produce out of thin air the liquidity needed in emergencies, serves as conclusive evidence for everything stated above. Only an organization that complies with general legal principles can endure in the marketplace without the recourse to privileges and government support and funding, but only by virtue of individuals' voluntary use of its services.[32]

We can understand why, in his critique of the history of the government's management of money, Hayek points to the fact that today's banking structure may appear sustainable despite its juridical and legal inconsistency. This is because of the support it presently obtains from the government and an official central banking institution that produces the liquidity necessary to bail out banks in need (in return for their adherence to an intricate web of administrative law made up of countless, enigmatic, and ad hoc directives).[33]

At the end of the day, there has never been a formal justification for fractional reserve banking concerning demand deposits. This explains the constant ambiguity in doctrines regarding this type of bank contract, the vain attempts to avoid transparency and accountability in how it is handled, the general lack of accountability, and, more importantly, the support and backing it has received from a central bank that implements the rules and provides the liquidity required at all times to prevent the collapse of the entire system (since on its own, fractional reserve banking would perish and cannot possibly survive economically).[34] This blatant vulnerability of the entire banking system was the main underlying reason for the creation of central banks (with the principal role of providing the system with "liquidity" in times of need and distress). However, the central bank's "liquidity pool" only works for a while. After a while, commercial banks get used to the easy supply of money in dire situations and start losing

30 Huerta de Soto, p 117.

31 Ibid, p. 151.

32 Ibid, p. 152.

33 F. A. Hayek, *The Fatal Conceit: The Errors of Socialism,* 1st edn, Routledge, 1990, pp. 103-104.

34 Huerta de Soto, p 118.

the fear of such situations. Consequently, they start issuing "unbacked" titles on an even larger scale. Obviously, this does not solve the problems of fractional reserve banking, it rather creates moral hazard and inflates those problems.[35] Even if bankers maintain a sufficiently high reserve ratio, a banking system based on the demand deposit with a fractional reserve causes bankers to go bankrupt and unable to uphold their commitment to return deposits on demand. History revealed[36] that this is precisely the reason the vast majority of private banks that did not fully abide by the safekeeping obligation (full reserve banking) ultimately failed. This situation prevailed up until bankers demanded the establishment of a central bank.[37] Bankers use demand deposits to create bank deposits (money) and in turn, loans (purchasing power transferred to borrowers, whether businessmen or consumers) from nothing. The problem is that these deposits/loans do not result from any real increase in voluntary saving by non-bank agents (individuals in the society).

My previous research about the characterization of the demand deposit as a loan concords with Werner's empirical study, in which he discovered that the bank treats customer deposits as a loan to the bank, this act is legally unfounded. Ignoring the rule of *contra proferentem* and the fact that the demand deposit contract is a standard-form contract (contract of adhesion) when explaining the depositor-banker (bank-customer) relationship, the radically distinct and different purposes of the two contracts, the conundrums of duplicate property titles and the continuous full availability of the deposited sum of money to the depositary all point to the refutation of the loan theory.[38]

As a result, there are always inevitable negative social consequences when traditional property rights principles are violated. For instance, although the return of deposits might be thus "guaranteed," at least theoretically (even when using a fractional reserve ratio if we assume that the central bank continuously lends its support), what cannot be guaranteed is that there won't be a significant change in the monetary units' purchasing power relative to the initial deposit. In fact, since the development of modern monetary systems, we have experienced severe chronic inflation that has significantly reduced the purchasing power of the monetary units returned to depositors, with only minor variations in severity from year to year. Furthermore, we have recurrently experienced the cyclical, successive phases of artificial booms and economic recessions marked by high unemployment rates that are inherently detrimental to our societies' orderly, steady growth. This proves the validity of Hayek's seminal theory that whenever a traditional rule of conduct is broken, whether through direct government compulsion, the granting of special governmental privileges to certain people/organizations, or a combination of both (as is the case with the monetary demand deposit under a fractional reserve), sooner or later harmful, unintended consequences follow, which essentially damage and disrupt the spontaneous social processes of cooperation. The 'traditional' legal rule of conduct broken in banking is that in the demand deposit contract, custody, safekeeping, and continuous availability and access to funds can only take the form of a continuous 100% reserve requirement. Therefore, any use of this money, especially to make loans (whether directly under the fractional reserve theory or indirectly under the money/credit creation theory), constitutes a breach of this principle and an act of misappropriation. What seems obvious now is that bankers and authorities realized that by sacrificing and ditching traditional legal principles in the demand deposit, they could reap the benefits of a highly lucrative

35 J. G. Hulsmann, 'Banks Cannot Create Money', *The Independent Review,* vol. 5, no 1, summer 2000, p. 105, <https://www.independent.org/pdf/tir/tir_05_1_hulsman.pdf> [Last seen 17 December 2022].

36 For details see Huerta de Soto, p 69.

37 M. N. Rothbard, *The Case Against the Fed,* Ludwig Von Mises Institute, Auburn, AL., 2007, pp. 90-106.

38 For further extensive analysis see M. A. Benlala, 'A Scrutiny of The Demand Deposit (Current Account) through the Lenses of Law And Islamic Jurisprudence', *Law and World*, vol. 8, no. 4, December 2022, pp. 23-29, <https://doi.org/10.36475/8.4.2>

financial activity, even though a lender of last resort, or a central bank, was needed to provide the necessary liquidity in times of difficulty (history and experience showed that sooner or later, these times always returned). However, until the theory of money and capital theory made enough advancements in economics and was able to explain the cyclical emergence of economic cycles, the damaging social effects of this privilege granted only to bankers were not fully understood.[39] From a legal 'contractual' and economic perspective, the Austrian School, in particular, has taught us that the contradictory goal of providing a contract made up of essentially incompatible elements and intended to combine the benefits of loans with those of the conventional monetary 'demand' deposit, which entails the withdrawal of funds at any time, is bound to result in unavoidable spontaneous adjustments sooner or later. The first signs of these adjustments are increases in the money supply (due to the creation of loans that do not correspond to actual increases in voluntary saving), inflation, a generalized misallocation of the limited productive resources available to society at the microeconomic level, and in the prolonged run recession, the correction of errors and flaws in the productive system brought on by credit expansion, and endemic unemployment.[40]

Going back in history, when the formulation of the theory of money first emerged, theorists only acknowledged the immorality of creating unbacked banknotes and the significant harm it results in. They initially failed to recognize or acknowledge the exact same effects of the massive creation of loans backed by deposits created from nothing. This explains why the Peel Act of July 19, 1844, which served as the basis for all modern banking systems and forbade the issuance of unbacked bills, utterly failed to achieve its goals of monetary stability and a sufficient definition and defense of citizens' property rights with regards to banking. It failed because lawmakers could not grasp that bank deposits with a fractional reserve have the same effects (from an economic standpoint) and nature as unbacked banknotes. The long-standing practice of issuing unbacked "secondary" deposits was thus permitted to continue because the Act did not outlaw fractional reserve banking. The issuing of secondary deposits preceded the fiduciary issue of banknotes. However, only the latter was "very tardily" made illegal because the former was inherently ambiguous and complex. Although it has the same economic characteristics (nature) and adverse effects as the issuance of unbacked banknotes outlawed in 1844 by the Peel Act, the monetary bank 'demand' deposit contract with a fractional reserve is still legal in today's all societies.[41] Moreover, in the UK, for instance, the 'Client Money Rules' of the FCA, which are regarded as the cradle of financial regulations and modern banking, require all firms that hold client money (under CASS 7.4 Segregation of client money) to segregate such funds from the firm's assets and liabilities by holding them in accounts that maintain their separation.

"Depositing client money CASS 7.4.1 R

A firm, on receiving any client money, must promptly place this money into one or more accounts opened with any of the following:

(1) a central bank;

(2) a CRD credit institution;

(3) a bank authorised in a third country;

(4) a qualifying money market fund".[42]

Therefore, customer deposits must be held in segregated accounts at banks or money market funds of unlicensed entities. In other words, the firm's client assets, including those of non-bank financial intermediaries, continue to be an off-balance sheet, and the depositor continues to be the actual legal owner. However, with a banking license, things are entirely different. Under the section "Depositaries" 1.4.6 Rule stipulates that the above-mentioned client money chapter does not apply to a depositary acting

39 Huerta de Soto, pp. 153-154.

40 Ibid, 154-155.

41 Ibid, pp. 252-253.

42 Financial Conduct Authority, Client asset sourcebook (CASS), FCA PRA handbook, 2013, <http://fshandbook.info/FS/html/FCA/> [Last seen 27 December 2022].

as such. This is further explained in chapter 7:

"Chapter 7 Client Money Rules

Credit Institutions and Approved Banks

7.1.8 R The client money rules do not apply to a CRD credit institution in relation to deposits within the meaning of the CRD held by that institution.

7.1.9. G If a credit institution that holds money as a deposit with itself is subject to the requirement to disclose information before providing services, it should, in compliance with that obligation, notify the client that: (1) money held for that client in an account with the credit institution will be held by the firm as banker and not as trustee (or in Scotland as agent); and (2) as a result, the money will not be held in accordance with the client money rules".[43]

Therefore, this exemption of banks from the client money rule allows them to create credit and thus money. They can continue keeping customer deposits on their balance sheet because of this exemption. In other words, once a depositor places money in a bank, he is no longer the actual owner of that money. Instead, he is considered one of the many banks' creditors to whom it owes money. Additionally, it can create a new "customer deposit" that wasn't actually paid in but was instead reclassified as an account payable liability of the bank resulting from a loan contract.[44] The legal question that arises here is whether the Client Money Rules were intended for this use and whether this reclassification of general "accounts payable" items as specific liabilities designated as "customer deposits," without any actual depositing on the part of the customer "borrower" is a lawful and legitimate act.

Moreover, one must be baffled by the misconception that money titles and an increase in these titles are the same as money and an increase in money. The reality is that, unlike an increase in the amount of money (i.e., gold) or an increase in the number of titles to money backed by a corresponding increase in the amount of money, any increase in the volume of money titles without a corresponding increase in the amount of money entails simultaneous possession of the same amount of money by multiple people (holders of both types of titles –backed with money and unbacked), which is physically impossible. Every redemption of a fiduciary title, whether it is into money or another form of real property, involves an act of illicit appropriation because the amount of money is unchanged, and all money currently in existence must be owned by someone (at that given moment). For the same reasons and in the same way that titles to cars are 'and should be' backed by cars, titles to money are 'and should be' backed by money. This is merely in accordance with the nature of property and property titles. Hence, a title to money backed by assets other than money is, in essence, a contradiction in terms. Its issuance and use represent an objective misrepresentation, just like the issuance of a title to a car backed by assets other than a car (a bicycle, for instance). Deposit 'receipts' contracts cannot be made into debt, and fractional reserve agreements are ethically unacceptable because they go against (deny) the very nature of things. Therefore, any such contract is –a priori – invalid. More importantly, contracts acknowledge and transfer existing property rather than creating a new property. The theory of property must therefore come first before discussing contracts, just like in Rothbard's ethical framework. Property and property theories are prerequisites for contracts and contract theory constraints, respectively. In other words, rather than the other way around, the range of possible (valid) contracts is constrained and limited by the quantity (stock) of existing property and the nature of things.[45] A startling lack of understanding exists that a fractional reserve banking agreement implies no less of an impos-

43 Ibid.

44 R. A. Werner, 'How do banks create money, and why can other firms not do the same? An explanation for the coexistence of lending and deposit-taking', *International Review of Financial Analysis*, vol. 36, December 2014, p. 75, <https://doi.org/10.1016/j.irfa.2014.10.013>

45 H. Hoppe, J. G. Hulsmann & W. Block, 'Against Fiduciary Media', *Quarterly Journal of Austrian Economics*, vol. 1, no. 1, 1998, p. 23, <https://cdn.mises.org/qjae1_1_2.pdf> [Last seen 27 December 2022].

sibility and fraud than, for instance, the trade of squared circles. Fractional reserve banking involves an even greater degree of impossibility. A necessary and categorical conclusion is that fractional reserve banking contracts are impossible. That is to say, it is implausible (praxeologically impossible) for a bank and its customer to decide to convert money substitutes (banknotes, demand deposit accounts-claims to present –available – money in his account) into debts. Of course, they could assert or certify that they are debts, just as someone could argue that triangles are squares. But their claims would be demonstrably false. Money substitutes (titles to present money) would continue to be distinct from debt claims (titles to future goods 'not yet existing') and equity claims (titles to existing property other than money), just as triangles would continue to be triangles and differ from squares. Any other claim would be an objective misrepresentation of reality rather than a change of it.[46]

The following illustration will clarify the legal misconduct and infringements involved in this process:

When depositing his money, instead of receiving a debt or equity title from bank **B**, money depositor **A** receives a claim to current 'available' funds. That is to say, **A** does not relinquish ownership of the money he deposited (as would have been the case with a debt or equity claim received from **B**). Now, while **B** treats **A's** money deposit as a loan rather than a bailment (a demand deposit) and records it as an asset on its balance sheet (which is offset by an equivalent amount of outstanding demand liabilities), **A** retains ownership and title to the money deposit (the sum of the money deposited). At first glance, this might seem like a meaningless accounting trick, but it actually involves lying and misrepresenting the real state of affairs. The financial accounts of both **A** and **B** count the same quantity of money simultaneously among their own assets, making them financial impostors. And despite being fraudulent, it would not be as significant if the legal misconduct stopped here. Because The moment **B** behaves as though the situation is exactly as it appears on his balance sheet—that is, as though the bank owns the money deposited and is only required to redeem outstanding (inherently larger than its reserves) money deposit receipts upon demand—then what was merely a misrepresentation becomes a misappropriation. Accordingly, If **B**, lends money in the form of issuing additional 'unbacked' money deposit receipts and lends these to some third party **C** (who is expected to repay principal and interest in the future), the bank commits unjustified appropriation because what **B** lends out to **C**—whether money or titles to money—is not its (**B's**) own property but that of someone else (**A's**). Fractional reserve banking is inherently fraudulent because the title that was transferred from **B** to **C** concerns a property that **B** does not own in the first place. Contrary to mainstream belief, fraud or a breach of contract does not only occur when **B**, the fractional reserve bank, is unable to accommodate all redemption requests as they come in. Instead, each time **B** fulfills its obligations related to redemption, fraud is also committed. Because whenever **B** converts a fractionally covered banknote into money or when a note holder takes possession of the property, it does so with money that belongs to someone else. For example, if **B** redeems **C's** note into money, it does so with money that belongs to **A**, and if **A** wants his money too, **B** pays him with money that belongs to **D** ... and it goes on and on. Therefore, proponents of fiduciary media and fractional reserve banking would have to contend that there is no breach of contract if **B** can fulfil its obligations using another party's property (money). According to Rothbard's contract theory, people can only enter into agreements involving transferring their property. Eventually, even when it is successfully implemented, fractional reserve banking involves contracts involving the transfer of other people's property by its very nature. In light of this, the title-transfer contract theory is fundamentally (inherently) incompatible with the issue of fidu-

46 Ibid, p. 26.

ciary media.[47]

Murray Rothbard regarded fractional reserve banking as a fraud based on his thorough study of property rights theory and ethics over a long time. A number of fundamental misconceptions and issues plague proponents of money creation under fractional reserve banking, including confusion about the difference between property and property titles, the impossibility of something (property) having multiple owners at once, the logical precedence of property and property theory over contract and contract theory, and the requirement of fulfilling contractual obligations with owned property and not with someone else's property. Voluntary agreements do not define nor make for a valid contract. Legally valid contracts are agreements about the transfer of real property; As a result, the range of legal contracts is restricted first and foremost by the nature of things and property and only then by agreement. Hoppe eloquently explained: "*Freedom of contract does not imply that every mutually advantageous contract should be permitted.... Freedom of contract means Instead that A and B (B and C in the above example) should be allowed to make any contract whatsoever regarding their own properties, yet fractional reserve banking involves the making of contracts regarding the property of third parties.*"[48]

Treating money, which is property, and money substitutes (banknotes and commercial bank deposit money), which is property titles, as the same thing is illogic because changes in the supply or demand of one have different consequences to the other. Proponents of money creation in the form of bank deposit money under fractional reserve banking argue that fiduciary titles to money (titles backed by assets other than money) are money, so following the same logic (as an illustration), they should say that fiduciary titles to cars (titles backed by assets other than cars) are cars!! For the sake of argument (example), we are willing to dismiss the previous illogic. I want to discuss the impact of how changes in the supply or demand for cars differ from changes brought about by changes in the supply or demand for titles to non-existing (unchanged) quantities of cars on car owners' wealth position. In the first scenario, if the price of cars decreases due to a greater supply, all current car owners continue to possess the same amount of property (cars) without any changes. Nobody's physical property is reduced. Likewise, the physical quantity of cars owned by any current owner is unaffected if the price drops due to buyers offering only smaller amounts of other goods in exchange for cars. In stark contrast, in the second scenario, there is a quantitative reduction of some current owners' physical property due to the issuance and sale of additional titles to an unchanged number or quantity of cars. It does more than just affect the value: the purchasing power of car titles will drop. In the process, the issuer and seller of fiduciary car titles misappropriate other people's cars. So it does have a tangible physical impact. In exchange for an empty property title, the issuer/seller of fiduciary titles takes possession of other people's property without giving up any of his own.[49] In short, banks can only transfer or redistribute existing property from one person to another when they issue fiduciary notes because no contract can increase the amount of existing property. That is why every time they purchase a piece of existing property in exchange for the titles to a piece of non-existing property, the bank and its client (borrower) are committing an act of fraudulent appropriation because they have agreed to falsely represent themselves as the owners of a quantity of property that neither of them owns and does not exist.

Thus, the conclusion is the same; issuing fiduciary media in fractional reserve banking is ethically unjustified whether we look at it through the lens of the title transfer theory of contract or the principle of freedom of contract.

From a socioeconomic perspective, the na-

47 Ibid, p. 27.

48 H. Hoppe, 'How is Fiat Money Possible? – or, The Devolution of Money and Credit', *Review of Austrian Economics*, vol. 7, no. 2, 1994, p. 70.

49 H. Hoppe, J. G. Hulsmann & W. Block, p. 30.

ture of fiduciary media (as titles to non-existing quantities of money property or titles to money covered by things other than money) can only result in ongoing income and wealth redistribution. Real wealth (property) is transferred and redistributed in favor of the issuing bank and the initial and early recipients and sellers of this 'fiduciary' money, and at the expense of its late or never receivers and sellers, as the unbacked money substitutes circulate from the issuing bank and its borrower clientele outward through the economy and in so doing inevitably raise the price of gradually more and more goods. Rothbard explains that the new money's initial recipients profit the most, the subsequent recipients profit slightly less, etc., until the halfway point, at which each receiver loses more as he waits for the new money. For the first individuals, selling prices soar while buying prices remain the same (to a great extent); however, after a while, buying prices increase while selling prices remain unchanged.[50]

Furthermore, this money creation process inherently contradicts Say's law: No one can demand something without supplying something else, and no one can demand or supply more of one thing (good) without reducing their demand or supply of another good. All goods (any property) are acquired and bought with other goods. This does not apply to the supply and demand of fiduciary notes. The increased demand for money is met without the demander requesting less of anything else or the supplier providing less of anything else. Wishes, not actual demand, are satisfied through the issuance and sale of fiduciary media. Consequently, the property is appropriated (demanded and satisfied) without supplying other property in exchange. As a result, what is happening here is an act of wrongful appropriation rather than a market exchange (which is governed by Say's law). This is why, following the lead of Rothbard, Hoppe criticized the Keynesian view regarding the relationship between the demand for money and savings (actual loanable funds) by pointing out that:

"*Not-spending money is to purchase neither consumer goods nor investment goods.... Individuals may employ their monetary assets in one of three ways: they can spend them on consumer goods; they can spend them on investment or they can keep them in the form of cash. There are no other alternatives.... The consumption and investment proportion, that Is, the decision of how much to spend on consumption and how much on investment, is determined by a person's time preference, that is, the degree to which he prefers present consumption over future consumption. On the other hand, the source of his demand for cash is the utility attached to money, that is, the personal satisfaction derived from money in allowing him immediate purchases of directly or indirectly serviceable consumer or producer goods at uncertain future dates. Accordingly, if the demand for money increases while the social stock of money is given, this additional demand can only be satisfied by bidding down the money prices of non-money goods. The purchasing power of money will increase. The real value of individual cash balances will be raised, and at a higher purchasing power per unit money, the demand for and the supply of money will once again be equilibrated. The relative price of money versus non-money will have changed. But unless time preference is assumed to have changed at the same time, rear consumption and real investment will remain the same as before: the additional money demand is satisfied by reducing nominal consumption and investment spending in accordance with the same preexisting consumption and investment proportion, driving the money prices of both consumer as well as producer goods down, and leaving real consumption and investment at precisely their old levels*".[51]

Simply put, Hoppe's analysis proves that accommodating an increased demand for money by issuing fiduciary credit (bank deposit money) is unjustifiable.

The other burdensome effect that this nefarious activity inflict on the individual and society is inflation. The debasement was the common

50 M. N. Rothbard, *Man, Economy, and State,* Ludwig Von Mises Institute, Auburn, AL., 1993, p. 851.

51 H. Hoppe, pp. 72-73.

type of inflation before the advent of banking; it is a unique method of modifying precious metal coins. When a coin is debased, one of two things can happen: (a) the fine metal content is decreased without the imprint changing, or (b) a higher nominal value is imprinted on the coin. Its absence in more recent times can only be explained by the fact that modern debasement perpetrators could rely on the significantly more effective inflationary techniques of fractional-reserve banking and paper money.[52] Now if titles to money (unbacked by real money), which are false money certificates, were the same as real money, there would be no need for governments to 'legalize' them by declaring these fractional reserve banknotes (debased coins) to be a means of payment that must be legally accepted at par by every creditor.[53] These money certificates (and created bank deposit money) are subject to legal tender laws, which establish a legal equivalence between the certificates and the underlying money and a requirement that creditors accept the certificates up to their full nominal value. As a result, legal tender laws frequently lead to social unrest and economic inequality. So, the combination of legalizing false money certificates and granting exclusive monopolistic privileges (of creating money out of thin air) to fractional reserve banks is essentially enforced, reinforced, and protected by legal tender laws.[54] This Legal-tender protection for fractional-reserve banking results in a downward spiral. Every banker has a reason (incentive) to minimize his reserves while maximizing (inflating) the number of notes he issues. Now the technical superiority of this form of fiat inflation has led governments to stop debasing their currency and start working with fractional-reserve banks. It made it possible for governments to raise additional funds that they were unable to get through taxation of their citizens while also keeping their other sources of revenue intact and their creditors happy, and without getting their countries in trouble with the international division of labor or having to eliminate competition in the banking industry. From the government's perspective, these were remarkable benefits. The situation appeared somewhat less appealing from the standpoint of the average citizen. The result is too many resources were sucked from the rest of the economy by the inflation of banknotes, just like it would have been the case with debasement, if not more. Additionally, it established a long-term alliance between governments and banks. Fractional reserve banking greatly exacerbates the inflationary effects of legal tender laws. Legal tender regulations, on the other hand, are a blessing (advantageous) for fractional-reserve banking. It has to be noted that the same argument goes for both money creation theories discussed in the previous section of this article (Werner's empirical study findings); fractional reserve theory and credit creation theory. Therefore, similar considerations come into play when legal tender privileges are granted to credit money with its inherent default risk. When market participants accept it by law in lieu of natural money, the operation of the market process is perverted, and a race to the bottom sets in. Like all forms of inflation, fractional-reserve banking and credit money supported by legal-tender privileges result in unlawful income redistribution. Since it produces significantly more inflation than any other institutional setup, the quantitative impact can be huge. Inflation-profiting fractional reserve banks have a strong economic incentive to extend their note issues, which increases the likelihood of redemption failure. Even if a banker is generally prudent, the competition from other bankers forces him to increase the number of notes he is issuing to avoid losing market share to these rivals. Thus, the situation arises where the amount of money needed for redemption exceeds the amount of money in the bank vaults. These demands are beyond the bank's capacity. It declares bankruptcy. Due to the numerous connections between banks and other companies, the failure of one bank would

52 J. G. Hulsmann, *The Ethics of Money Production,* pp. 89-90.

53 Ibid, p. 109.

54 Ibid. p. 131-132.

probably result in the collapse of the entire fractional-reserve banking sector. Throughout the history of fractional-reserve banking, this has frequently been the case.[55] The problem is when fractional reserve banks make their banknotes and credit money available through the credit market**,** credit-seeking entrepreneurs are unaware that inflation, not additional savings, is the source of the additional credit they are taking, and this, in turn, makes the interest rate likely to be lower than it would be in an equilibrium market**.** And since the interest rate is a key factor in determining the prospects of business projects, there are suddenly a lot more investment projects that appear to be profitable even though they are not (in reality). Consequently, when entrepreneurs and business owners begin making large-scale investments in these projects, a crisis is pre-programmed and bound to occur. The completion of these projects would require resources that are simply nonexistent. These required resources exist only in the minds of business owners and entrepreneurs who have mistaken more credit for more savings. Additionally, a sizable portion of the resources that are actually available are actually being wasted on unachievable projects. There are not only transitory short-term production interruptions when the crisis first sets in. Instead, a lot of projects must be completely abandoned, and the resources and time invested in them are most likely lost forever.[56]

Redemption is one more fundamental problem related to bank deposit money creation. The issuer will be unable to comply if enough customers choose to demand redemption at the same time. He declares bankruptcy. From the viewpoint of a bankrupt person and his business partners, it is understandable to consider bankruptcy a negative occurrence that should be prevented if possible. However, from a larger social viewpoint, bankruptcy is beneficial as it fulfills a crucial social necessity for preserving the available capital stock. From my previous analysis and discussion, banks' bankruptcy might result from fraud, insolvency, or illiquidity. In each scenario, bankruptcy is justified and beneficial from a socio-legal and economic perspective. **A)** Fraud: The distinguishing trait of a fraudulent company is that it never intended to generate income or revenue from actual products or production. It was only interested in channeling the money from lured investors (and the public/society) into its own pockets. The investors and the public have suffered harm. However, because such fraud depletes capital without replenishing it, it also has a negative social impact by dwindling the productivity of human labor and future wages. A prime example of this is fraudulent fractional reserve banking. Its natural death is bankruptcy, which should be followed by criminal prosecution of the banker. **B)** Insolvency: An insolvent company unintentionally uses more resources than it generates. Even though it benefits some stakeholders of the insolvent company in the short term, such as employees and suppliers, it also impoverishes society. An insolvent company can only continue to operate for any time if it has access to another entity's capital. This person is typically the owner, though he may also be the creditor occasionally. The insolvent company comes to a halt when these people refuse to contribute more money to it. The machines and other capital goods are sold to other firms for less than their initial actual book value, and the fired employees go on to work for other companies at lower pay rates. This is bankruptcy. It eliminates wasteful, and consequently socially undesirable, firms and forces their stakeholders—laborers, and investors—to allocate their financial and material resources to other businesses that offer lower rewards but greater output. **C)** Illiquidity: unlike an insolvent company, an illiquid company does not experience a fundamental mismatch between sales proceeds and cost expenditure. A temporary financial mismanagement issue is "just" the issue. Legalized fractional reserve banking is a prime example. A temporary mismatch between payments and receipts is what banks put forward when faced with large-scale redemp-

55 Ibid, p. 138-140.

56 Ibid, p. 141.

tion demands (for example, during a run). If given time (days, weeks, months), they could sell their assets for cash, thus complying with the redemption demands. First of all, it is typically impossible for fractional-reserve banks to sell their assets at book value in a reasonable amount of time, especially if the run doesn't just affect their bank but also spreads to other banks. The money prices of all assets plummet more or less sharply below their book values during an economy-wide run, which historically has been a common phenomenon. Then, no bank can sell its assets for book value. As a result, the whole (artificial) distinction between insolvency and illiquidity disappears. And even if we assume for the sake of the argument that the bank's assets could be sold in a relatively reasonable amount of time at or above book value, the economic case for the strict application of bankruptcy law is still valid. Therefore, at the very least, the banker must be viewed as a bad manager of his clients' funds, and the purpose of bankruptcy would be to remove him from a position of authority for which he is unqualified. So rather than encouraging and promoting qualified bankers and banking, exempting fractional reserve banking from bankruptcy law does the opposite. Worse than that, legislators have frequently allowed fractional reserve banks to suspend payments. However, "suspended payments" is a rather blatant euphemism, as is the case so frequently in politics. Although it seems kind and open-handed, the truth is very different. In reality, the government no longer enforces payments promised to creditors by the privileged banks, but it still does so for payments that these banks collect from their debtors. In one breath, the bank that halts payments takes the incongruous position of insisting on receiving payments in fulfillment of its contractual rights while simultaneously rejecting the same principle by refusing to make payments in fulfillment of its contractual obligations. A moral hazard is evident if a bank can rely on the government to approve the suspension of payments. There is less need for the bank to exercise caution and maintain high reserves. Customers of the bank will be encouraged to borrow money from a bank because they will know that the bank has the government's approval and blessing. More bankruptcies occur as a result.[57]

Since fractional reserve banks can create additional bank credit at very little cost (to no cost), they can offer credit at lower interest rates than those that would have otherwise been the norm. This, in turn, encourages the entrepreneurs to resort to created bank money (not theirs or the money from real savings) to finance through debts some ventures and projects that they otherwise would have funded with their own money or that they would not have begun at all. Business is more reliant on banks as a result of fiat inflation. Compared to a free market, credit creation inflation establishes a higher hierarchy and more centralized power. An entrepreneur is no longer considered an entrepreneur if they operate with 90% debt and 10% equity. In reality, this makes the bankers, who are the entrepreneur's creditors, the real (true) entrepreneurs because they are the ones who make all crucial decisions. Therefore, the entrepreneur becomes merely a manager or more or less a well-paid executive. The presence of central banks and paper money bailouts make debt-based financial strategies more attractive than strategies based on prior savings. Thus, fiat and credit creation inflation are detrimental to genuine prosperity because it reduces the number of genuine entrepreneurs (independent individuals who run their businesses using their funds). There are still a startlingly large number of these individuals, they can continue to exist and prosper thanks to their superior talents that match the subpar financial conditions they must contend with. Compared to their rivals, they must be more inventive and diligent. They are willing to pay whatever it takes to maintain their independence. Unlike their competitors (bankers' puppets), they typically have a stronger sense of loyalty to the family business and much more concern and

57 Ibid, p. 153-157.

care for their employees.[58] Let me just stress that money hoarding has no detrimental macroeconomic effects. Without a doubt, it does not discourage commercial investment. Hoarding makes money more valuable, increasing the "weight" of the currency units still in use. With these remaining units, any purchases of goods and services and any financially sound investments can be made. Fundamentally, there are no new resources created by inflation. It simply changes how the existing resources (already available) are distributed and allocated. They deprive companies run by entrepreneurs who operate with their own money from these resources to grant them to business executives who run companies financed with credit. This is why banks can act (grant credit) as financial intermediaries only in a natural system of money production. This means that they would only be able to lend out those sums of money that they had either saved themselves or had been saved by people and lent to them.

CONCLUSION

Nowadays, it has been established, without any shadow of a doubt, that commercial banks do, in fact, create money "out of nothing" when they extend credit and grant loans. This research backed its arguments with Werner's empirical test that confirmed the veracity of 'the credit creation theory of banking', which states that banks individually create money out of thin air. This article exposes the inherent legal violation of traditional legal principles governing property rights due to the confusion about the difference between property and property titles (acts of misappropriation), the incompatibility of the money creation process with the title-transfer theory of contract, the impossibility of something (property) having multiple owners at once, the logical precedence of property and property theory over contract and contract theory and the requirement of fulfilling contractual obligations with owned property and not with someone else's property, and socioeconomic issues related to money debasement and inflation (legal tender and deposit money laws). Therefore, this research paper provides an extensive critical analysis of the numerous legal violations and harmful socioeconomic effects that are inevitably (and ultimately) borne by the individual and society in the form of 'privatizing the profits of money creation' and 'socializing the losses and its outrageous financial burden'.

58 Ibid, p. 180-181.

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