

## THE 1866 FALSE-MONEY DEBATE IN THE *JOURNAL DES ECONOMISTES*: DÉJÀ VU FOR AUSTRIANS?

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**A**fter the 1815 Restoration, there emerged in France an influential group of economists under the inspiration of Jean-Baptiste Say advocating free trade and laissez-faire.<sup>1</sup> The movement came to fruition in the Société d'Economie Politique, which was founded in 1842. That same year the first ever scholarly journal in economics was launched, the *Journal des Economistes*.

In the first half of the nineteenth century, the French banking system was backward, undeveloped, and strictly centralized around the Bank of France, created in 1800. Government dictated interest rates, and entry into the banking industry was severely restricted (Smith 1990, pp. 28-41). The laissez-faire school was of course very critical of this system. The attack against monopolistic central banking was led by economist Jean Gustave Courcelle-Seneuil,<sup>2</sup> who advocated unrestricted freedom of banking and of note issue.<sup>3</sup>

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<sup>1</sup>For more on the French laissez-faire school, see Rothbard (1995, pp. 441ff.) and also Schumpeter (1961, pp. 490-500). The school strongly influenced such important figures as Jevons and Hearn in England, and Ferrara and Pareto in Italy. It also inspired the hard-money movement in the United States. See Rothbard (1995, p. 448 ff.) and Salerno (1988).

<sup>2</sup>Jean Gustave Courcelle-Seneuil, 1813-1892, was a journalist, businessman, and professor of political economy at the University of Santiago, Chile, in 1852-1862 (Blaug and Sturges 1983).

<sup>3</sup>Courcelle-Seneuil (1853, 1867). See also Rothbard (1995, pp. 267) and Smith (1990, p. 93-94). Courcelle-Seneuil was instrumental in turning the Chilean banking legislation to fractional reserve banking in the 1860s. Prior to that, Chile had been a haven of monetary stability with 100-percent commodity money and no central bank. The free-banking legislation of our "foreign expert" brought in an accelerating inflation, and the brave new free-banking system collapsed in less than five years. Moreover, this period led to close cooperation between banking and political elite and ultimately to the creation of a full-fledged central banking system in Chile. See Rothbard (1989) and Hirschman (1963, pp. 159-75). Selgin (1990) has defended Courcelle-Seneuil, arguing that the cause behind the crisis was government intervention, not fractional reserves.

Courcelle-Seneuil's free-banking conclusions did not convince all French liberals. Henri Cernuschi<sup>4</sup> presented a different interpretation in two tracts written in 1865. Cernuschi (1865, 1866) held that "the vital question was not one of whether the note issue should be in the hands of a few or of many banks, but whether bank notes should be issued at all."<sup>5</sup>

Victor Modeste<sup>6</sup> had already anticipated the latter view in an unpublished article written in 1864. In 1866, the *Journal des Economistes* published two of Modeste's articles which argued that all bank notes in excess of commodity reserves were inflationary and equal to plain "false money." Writing this, he not only attacked the government monopoly but maintained that the term "false money" should be used on privately issued fiduciary media as well (Modeste 1866 a,b).<sup>7</sup> This was a frontal attack against the free bankers led by Courcelle-Seneuil, and it started the heated though short-lived false-money debate of 1866 in the *Journal des Economistes*. The eminent Courcelle-Seneuil (1866) formed with Gustave du Puynode (1866a,b)<sup>8</sup> and Théodore Mannequin (1866)<sup>9</sup> the fractional reserve front against Modeste.

The earlier British banking debates had dealt with similar issues, but there was also an important difference. Both British schools, currency and banking, were inclined to opt for central banking as a solution to the problems they identified.<sup>10</sup> In the French false-money debate of 1866, the terms were different; both sides agreed that central banking was the last thing that was needed. The debate was therefore the first time that uncompromising critiques of central banking clashed on this vital question of bank note issue.<sup>11</sup>

The present paper addresses three problems. First, the 1866 debate closely resembles the present-day Austrian debate on the banking system of a free society: there was

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<sup>4</sup>Henri Cernuschi, 1821-1896, was a businessman and politician from Milan. In 1850, he went to France to become a director of the Bank of France (Columbia 2001).

<sup>5</sup>Cernuschi quoted from Smith (1990, p. 105). See also Rothbard (1995, p. 268).

<sup>6</sup>Unfortunately very little is known of the details of Victor Modeste's life and career.

<sup>7</sup>Modeste had already offered the first article to the journal in April 1864, but the editors had turned it down. The editor explains (Modeste 1866a, p. 181) that it was now given a new chance because of the very appearance of Cernuschi's works.

<sup>8</sup>Michel Gustave Partounau du Puynode, b. 1817.

<sup>9</sup>Details of the life and career of Théodore Mannequin are not well known.

<sup>10</sup>For a detailed discussion of the British money and banking debates, see for example Hayek (1991, chap. 12) and Rothbard (1995, chaps. 5-7). The centralist tendency is claimed in Rothbard (1995, p. 252), Smith (1990, pp. 71ff. and 132), and Huerta de Soto (1988b, p. 497). For this reason, the British sides are often classified as the central banking and central currency schools. The French liberals have been called the free banking (Courcelle-Seneuil et al.) and the free currency (Cernuschi et al.) schools. There was also a German currency school in the 1850s, the most notable members being Geyer (1865), Hübner (1853-1954), and Tellkamp (1867). Even they, however, were eager to adopt the central banking solution, according to Rothbard (1995, pp. 269-70).

<sup>11</sup>Huerta de Soto (1998b, p. 498) has indeed claimed that Cernuschi and Modeste were the first ones to argue pro-free banking and anti-fiduciary media. Cernuschi and Modeste did not have much support though. As the criticism of the banking system grew stronger, the Senate required in 1865-1866 that a systematic report be prepared to address the problem. The June 1866 report was strongly in favor of the Bank of France, however, most of the enthusiasm had died down by that time (Smith 1990, p. 40). Moreover, the laissez-faire school was already losing its authority, and was soon to be supplanted by socialist, historicist, and institutionalist doctrines. On the decline and later neglect of the French liberal tradition, see Rothbard (1995, pp. 470-71) and esp. Salerno (2001).

a distinct fractional-reserve side and similarly a vigorous 100-percent side. To what extent can there be found parallels between the French and the Austrian debates?<sup>12</sup> Second, we concentrate especially on the two articles by Victor Modeste. Despite his small academic output, could he be seen as a predecessor to the Austrian 100-percent school? Third, insofar as Modeste has been noticed at all, he has usually been rather one-sidedly associated with Cernuschi. As Selgin expressed it: “Mises’s support for free banking is based in part on his agreement with Cernuschi, who (along with Modeste) believed that freedom of note issue would automatically lead to 100-percent reserve banking.” But did Cernuschi and Modeste go together the whole way? If not, could Modeste perhaps be better seen as a forerunner to Murray Rothbard?<sup>13</sup>

The false-money debate of 1866 has gone largely unnoticed by historians of thought. Blaug (1997), Schumpeter (1961), and Spiegel (1991) have not studied it, and Rothbard’s treatment of it is only cursory.<sup>14</sup> We will go into the 1866 debate in more detail using the original journals. Translations from the French are mine unless otherwise noted. Also when referring to the works of Say and other French liberals of the nineteenth century, we have mainly used original editions.

### THE 1866 FALSE-MONEY DEBATE

#### *Money and Money Substitutes*

Modeste’s argument against fiduciary media was based on analytical distinctions between different types of media of exchange. He followed the reasoning of Jean-Baptiste Say (1964, p.p. 217 ff.) in order to explain how money properly originates in barter. Without money, trading is difficult and costly and can require a number of separate exchanges before the ultimate goal is reached. The remedy to this problem of a “double-coincidence of wants” was a common medium of exchange (Modeste 1866b, p. 86).<sup>15</sup> But this was only the first step, according to Modeste; a second one could also be taken. The transportation of metallic currency does, after all, generate unnecessary costs as well. Modeste noted two remedies for this problem: clearing operations and, more important, money representatives or substitutes. However, in order for the money substitutes to remain genuine money, they have to be backed by actual property—the original money commodity that emerged on the market. “Is it not true again that, in order for the paper to move and operate as a representation . . . of money, the money has to exist?”

<sup>12</sup>On the present-day fractional-reserve side see, for example, Dowd (1993), Selgin (1988, 1996), White (1989, 1999), and Selgin and White (1996). One-hundred-percent-reserve arguments are more recently developed in Block (1988), Hoppe (1994), Hoppe et al. (1998), Hülsmann (1996), and Huerta de Soto (1995; 1998a,b).

<sup>13</sup>Selgin (1988, p. 62). His view is based on Smith (1990, p. 105), who indeed only notes that the “same attitude [as Cernuschi’s] towards the bank notes was taken up by Modeste.” Neither does Huerta de Soto (1998b, p. 498) differentiate between the two. Only Rothbard (1995, pp. 268–69) presents a brief analysis of Modeste’s policy conclusions. On Rothbard’s views, see Rothbard (1983, 1990, and 1991).

<sup>14</sup>Rothbard does not really comment on the debate but on the French *laissez-faire* banking views in general (1995, p. 266–69). Interestingly, Rothbard does refer to the 1866 debate in his bibliographical essay (p. 491), but he only describes it as a “fascinating debate among the French *laissez-faire* thinkers on how to apply libertarian principles to the vexed question of banking.”

<sup>15</sup>Frédéric Bastiat (1979, p. 123) also explained this very clearly in 1850.

### *Real Money and False Money*

Different metallic commodities are not of similar value, however. This makes it possible to counterfeit money, for example, debasement of gold coins by mixing gold with copper or some other less valuable metal, yet representing them as genuine gold coins. These belong to the category of *false money*.

Modeste (1866a, p. 182; emphasis in original) used an interesting definition in distinguishing between real and false money: “*Real money is the one whose value as commodity is equal to its value as money.*” He pointed to the fact that the basis of the value of money is the value of the money commodity. In fact, the very name of the French monetary unit, *franc*, was originally a measure of weight, 3447.74 francs equaling a fine kilogram of gold. False money, on the other hand, is different: “What is *false money*?—*It is money whose commodity value is smaller than its monetary value*” (p. 184; emphasis in original).

What are the effects of false money? Obviously, and most important, the counterfeiter of the false-money benefits. He has transformed something less valuable into something more valuable, if others mistakenly accept it as money (p. 185). This money, however, increases the quantity of money in the economy and ultimately leads to increased prices and a decreased value of money. As money (in a broader sense) thus becomes undervalued, part of the real money is exported outside the country, where it still has a higher value (p. 186).<sup>16</sup> This process, described by Gresham’s Law, requires that false money be accepted at par with real money.<sup>17</sup>

The concept of false money can be found earlier in Frédéric Bastiat, Michel Chevalier,<sup>18</sup> and Gustave de Molinari.<sup>19</sup> Bastiat called the “draft on the Bank of Exchange” a “deceitful substitute,” and described paper money as “fictitious money.” He concluded that “all the reasoning which can be made in favor of paper money has been made in favor of legal false-coined money.”<sup>20</sup>

### *Bank Notes and Fiduciary Media*

If for most French liberals the main enemy had been the government monopoly in banking, Modeste wanted to take the case even further. The point was that bank notes without reserve backing were always false money—they were fraudulent *irrespective* of whether there was a government monopoly or not.

Modeste approached this argument by first discussing different types of banking activity, following the typology developed by J.B. Say (1964, pp. 268-72). He was especially interested in a type called bank of issue (*banque d’émission*), or fractional

<sup>16</sup>Modeste, however, used the common nineteenth-century French definition of money as a “measure of value.” Mises (1981, p. 51) refutes this concept, saying that “to speak of money as a measure of value . . . is entirely fallacious.”

<sup>17</sup>Free bankers today argue for option clauses as a solution to the contractual problems of fiduciary media. This would however make them trade at discount to money certificates if they circulated at all. On option clauses, see for example, Shah (1997).

<sup>18</sup>Michel Chevalier, 1806-1879, was a liberal economist and a professor at the Collège de France, 1840-1879 (Blaug and Sturges 1983).

<sup>19</sup>Gustave de Molinari, 1819-1912, was a Belgian-born journalist, leader of the French *laissez-faire* school and editor of the *Journal des Economistes*, 1881-1909 (Hart 1981).

<sup>20</sup>This was in Bastiat’s article “Maudit Argent” ([1849] 1877, pp. 175, 188 and 206), originally published in the *Journal des Economistes* in April 1849. On Chevalier, see his entry “Monnaie” in the *Dictionnaire de l’Économie Politique*. Molinari’s concept of false money as governmental counterfeiting appears in Molinari (1849). I would like to thank Antoine Gentier and Philippe Nataf for bringing these to my attention.

reserve banking.<sup>21</sup> This should be clearly distinguished from loan banking (*banque d'escompte*) and deposit banking (*banque de dépôt*). Modeste (1866a, p. 181) explained that insofar as a bank issues notes but maintains a corresponding reserve of metallic money in its vaults, it is a genuine deposit bank. It becomes a bank of issue when it issues notes without reserve backing.

The concept of false money and the analysis of different banking activities were both common for the French liberals.<sup>22</sup> Modeste only integrated these two elements. He was bound to somewhat contradict his own definition of real money, since according to it, only the money commodity should be called real money. This may have confused his opponents, but what he came up with was an important discovery and the core of his attack on fiduciary media.

Exchange can be done with money representatives, that is, titles to money proper; however, not all bank notes represent real money. Modeste (1866a, p. 186) thus distinguished between what present-day Austrians would call money certificates and fiduciary media—bank notes with or without specie backing respectively.<sup>23</sup> He concluded that money certificates are real-money substitutes. Issuing this type of bank notes does not bring about additional money to the economy; the note only represents the actual money in the bank. Fiduciary media, on the other hand, are not money substitutes at all according to Modeste (1866a, p. 188; emphasis in original): “Is the note real money?—Let us remember that *real money is the one whose value as commodity equals to its value as money.*—The answer is given.”

In the legal terminology of the time, money referred to the metallic money proper. Modeste, however, realized that the economic use of certain goods does not depend on the language of jurisprudence. He strongly concluded: “The bank note of issue is used as money.—It is not a value *sui generis* [by itself].—It is money—it is false money—it has all the characteristics and all the economic effects of false money” (p. 207).

#### *Fractional-Reserve Free-Bankers' Reply*

Modeste's claim that fiduciary bank notes were inherently fraudulent was an open attack on the free-banking doctrine of Courcelle-Seneuil. The idea of Courcelle-Seneuil (1853, p. 322) was simple. In an earlier article on paper money, he openly acknowledged the negative consequences of unrestricted government note issue. He argued, however, that there would be no problem whatsoever if all restrictions on banking were abolished. The modern defenders of free banking with fractional reserves present very similar claims, often comparing historical statistics of banking crises in “free” versus “unfree” banking systems (White 1984, esp. p. 48; Selgin 1966, pp. 196-67).

Replying to Modeste's article in the *Journal des Economistes*, du Puynode and Courcelle-Seneuil argued that bank notes are not really money at all. This was the core of their defense.<sup>24</sup> Courcelle-Seneuil (1866, p. 342) did not agree with the distinction

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<sup>21</sup>The definition of *banque d'émission* (bank of issue) corresponds to what contemporary Austrians would call fractional reserve banking. Similarly, the concept of *le billet des banques d'émission* (bank note of issue) corresponds to the concept of fiduciary media. On these and other conceptual distinctions in present-day Misesian literature, see for example, Rothbard (1993, pp. 700-03).

<sup>22</sup>The typology and analysis of banking can also be found in Coquelin's entry on “Banque” in the *Dictionnaire de l'Economie Politique* (1852-53, pp. 107-45), as well as in Courcelle-Seneuil (1867).

<sup>23</sup>On the Austrian definitions, see esp. Mises (1998, pp. 429-31).

<sup>24</sup>Puynode (1866a,b) entitled his articles “The Bank Note Is Neither Money Nor False Money.”

between fractional reserve banking and genuine deposit banking. He stressed that bank notes are always merely promises to pay a certain amount of money proper:

Is this note money? No. It is a promise to pay in real money a given sum. Thus, in so far as the contract is executed, the note cannot by itself serve as a measure of values even if it is accepted as such. The measure is the metallic money. (Puynode 1866b, p. 262)

If fiduciary media are not money, what exactly are they? According to Courcelle-Seneuil and du Puynode, they are simply *credit*. As du Puynode put it, “the bank note, issued on top of reserves or not, is a pure engagement, a simple promise, like the check, . . . like the bill of exchange.”<sup>25</sup> Courcelle-Seneuil (1866, p. 348) maintained that in this function, they are very important for industry, and issuing them is neither dangerous nor dishonest.

Present-day free bankers similarly criticize the distinction between time liabilities and demand deposits. According to Selgin (1988, p. 62): “Holders of demand liabilities are granters of credit just as are holders of time liabilities.” They therefore hold that “the common definition . . . of a ‘bank deposit’ is . . . that of a *debt claim* against the bank and not a warehouse receipt.” To be sure, Selgin (1988, p. 62) and White (1996, pp. 88-89) do not deny the money-nature of fiduciary media because they follow the subjectivist definition of money.<sup>26</sup> Courcelle-Seneuil, on the other hand, adopted a definition according to which money is simply metallic money.

#### *Redeemability of Bank Notes*

Let us then think that bank notes are essentially promises to pay in metallic money on par and on demand. How could this be possible under fractional reserve banking? How could all notes be redeemed, should the note holders happen to demand the redemption at the same time?

Courcelle-Seneuil (1866, p. 192) replied by saying simply that this is not a problem because banks never have to redeem their notes at the same time. Present-day fractional-reserve free bankers also downplay this problem, arguing that “a free banking system would . . . be relatively immune to systemic crises” (Selgin 1996, p. 9).<sup>27</sup> Modeste (1866a, p. 192), however, wittily noted the circularity of Courcelle-Seneuil’s reasoning: “What a curious convertibility that exists only insofar as no conversion is demanded!”

#### *Resource-Cost Savings*

Another fractional-reserve free banker, Théodore Mannequin (1866, pp. 403-04), joined the debate and brought in the Smith-Ricardian argument that fiduciary media would render possible the nonmonetary use of part of the money commodity. Modern advocates of fractional reserves similarly use this argument of resource cost savings.<sup>28</sup> Mannequin (p. 404 n), however, added interestingly that, under the present system of privileged banks, this advantage would only benefit the owners of the banks, not their customers.

<sup>25</sup>On the classification of the bill of exchange as a credit instrument, see for example Rothbard (1993, pp. 723-24).

<sup>26</sup>On the subjectivist definition and identification of money, see esp. White (1989, chap. 11).

<sup>27</sup>On the other hand, they implicitly admit the problem by advocating “option clauses” as “a potentially important form of protection for banks that have redeemable liabilities and operate on a fractional reserve” (Dowd 1993, pp. 41 ff.).

<sup>28</sup>See, for example, Selgin and White (1996, pp. 98-99).

Modeste (1866b, p. 81) pointed out that simply creating false property titles could not possibly increase the actual property. He argued that the advocates of fiduciary media ultimately wanted to substitute a paper money for metallic money, but their attempts were contradictory. On the one hand, they wanted to suppress the value of the money commodity by substituting mere paper for it. On the other hand, they wanted the commodity to maintain its value so that it could be used as the basis of the value of paper notes.<sup>29</sup>

Michel Chevalier had earlier attacked the fiat money doctrines and government paper-money dreams in his 1853 article in the *Dictionnaire de l'Économie Politique*. He pointed out that much of the reasoning is based on the curious yet prevalent idea that money is only a sign representing wealth (*signe représentatif*) and not wealth in itself. If money indeed is not real wealth, why not simply go all the way and use mere paper tickets instead of valuable metals (Chevalier 1853, pp. 201-02)?

*Effects of Fiduciary Media: Illusion and Error*

If fiduciary media are akin to false money, they have the effects of false money: they benefit the issuer of the false money and depreciate the value of real money. Yet what are the broader effects of fiduciary media on the economy?

According to Courcelle-Seneuil, bank notes are not money after all; they are promises, or credit. Thus, they do not affect the value of money but only increase the amount of available credit in the economy. Courcelle-Seneuil admitted that it is the banks that profit from issuing fiduciary notes, but this would be for the benefit of the whole economy “because the banks do not borrow in order to consume but to save.” He argued that the additional banking profits would stimulate the economy and ultimately benefit the consumers as well (Courcelle-Seneuil 1866, p. 346). Present-day defenders of fractional reserves argue on surprisingly similar lines:

Benefits accrue to bank depositors and noteholders, who receive interest and services paid for by the extra bank revenue generated from lending out a portion of its liabilities. Benefits accrue . . . to everyone who works with the economy's consequently larger stock of capital equipment. (Selgin and White 1996, p. 94)<sup>30</sup>

Modeste well understood that the issuing of fiduciary media created a boom in the economy. He argued, however, that the prosperity brought by fiduciary media was only illusory and would inevitably collapse in a crisis. Bank notes cannot create new capital. The “prosperity” does not rest on anything real, but is simply created out of thin air, or, in other words, it is “riches fallen from the sky” (Modeste 1866a, p. 198). In his brief discussion on business cycles, Modeste followed the money-based analysis set forth earlier by Richard Cantillon<sup>31</sup> and Say, stressing that issuing fiduciary media brings about an illusion in the economy (pp. 199-205).<sup>32</sup>

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<sup>29</sup>To be sure, this sort of paper-money dream was very different from that of the twentieth-century fiat-money advocates such as Milton Friedman (1953). They explicitly reject the need for gold or any other commodity to function as the basis of the value of money.

<sup>30</sup>Selgin (1990, p. 5) has in fact argued in favor of the 1866-1874 period of free banking in Chile on these grounds. According to him, it was an “era of remarkable growth and progress” during which “Chile’s railroad and telegraph systems were developed, the port of Valparaiso was enlarged and improved, and fiscal reserves increased by one-quarter.” However, Huerta de Soto (1998b, p. 549n) has replied that all of this is not evidence of increased real wealth but rather of an illusory boom induced by fiduciary media.

<sup>31</sup>Richard Cantillon, 1680-1734, born in Ireland, made an influential career as a banker and economist in France (Blaug and Sturges 1983).

<sup>32</sup>On Cantillon’s business cycle theory, see (Cantillon 1959) and the summary in Hülsmann

The cycle starts when the expansion of fiduciary media creates an illusive sense of prosperity. Spending increases and anticipations about the future become highly optimistic (p. 200). Increased spending raises prices and depreciates the value of money. This may be ignored at first, but the prices will keep on climbing. The error eventually begins to manifest itself: people have spent in excess of their sustainable capability. Businesses search in vain for additional credit, but nobody offers it (pp. 203-04).

As domestic prices rise, imports go up and money is increasingly exported from the country. This forces the banks to redeem their notes. But will they be able to do so? Soon all banks come under suspicion; panic arises and generates a run on banks. Now the fraud becomes apparent. Bank notes must be liquidated, the supply of money falls rapidly, and the value of money rises again. The illusion ends and the economy is forced to return to reality (p. 204).<sup>33</sup>

#### *Positivist vs. Essentialist Methodology*

An interesting topic of the debate was the question of proper methodology. Although the writers addressed this subject only briefly, it became apparent that they represented two opposite methodological extremes. The free bankers, du Puynode especially, stressed the importance of experience and believed that economics must be based on the experimental method of physical sciences. Du Puynode seemed quite frankly to despise all kinds of essentialist-analytical reasoning, and therefore argued primarily on grounds that the very existence of fractional reserve banks proved their superiority. Falling into the positivist *post-hoc-ergo-propter-hoc* fallacy, du Puynode maintained that fractional reserve banking has developed hand in hand with the development of industry, and that there could not be rich and industrialized countries without the expansion of fiduciary media (Puynode 1866b, p. 264). He took his position so far as to claim that analyzing the nature of different forms of money and of banking was nothing but meaningless and misleading casuistry (p. 265).

Modeste (1866b, p. 85) had a different idea of empirical research. He argued that empirical research should deal not with particular historical events but with the essence of the objects concerned. He replied that du Puynode's claims regarding economic history confused fundamental facts. No one contested the utility of loan banking and of deposit banking, but the third case was different. Fiduciary media created a sense of prosperity, and the key question was whether this ended up in economic crises or not (p. 80).

#### *Ethics of Banking*

Just as the two sides relied on opposite methodological approaches, they similarly founded their positions on opposite ethics. The ultimate question of the debate was whether fractional reserve banking was a legitimate form of business. For the French free-bankers, the choice was between freedom and nonfreedom. Du Puynode (1866b, p. 265) maintained that free banking was similar to free trade: a sacred right that should not be questioned. This is also the heart of the modern case for fractional-reserve free banking. Fractional reserves must be beneficial because "depositors continue to patronize these banks, demonstrating their preference for them." After all, "fractional-reserve banking has never been compulsory." Selgin and White (1966, pp.

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(2001, p. 701-02). See also Say (1852, pp. 471-79). This idea is further developed in a recent interpretation of the Austrian theory, which maintains that business cycles are essentially cycles of error, caused by an illusion of increased prosperity that fiduciary media generate. See esp. Hülsmann (1998).

<sup>33</sup>Courcelle-Seneuil did not follow this theory but was instead "heavily influenced by James Wilson's circulation into fixed capital analysis of the boom" (Rothbard 1995, p. 267).



95, 97, and 105) conclude that freedom to use fiduciary media “is preferable . . . to a system . . . where the law restricts money-users from holding any or some types of fiduciary media.”

Modeste, on the other hand, did not begin with laissez-faire as such. What mattered was the nature and morality of the actions concerned. Freedom correctly understood did not mean the right to lie or to deceive. “The question is to know whether what is accepted is economic value; whether the engagement . . . is economically solid, its promise economically realizable.” Thus we return to analyzing the characters and abilities of fiduciary media, and the answer is clear (Modeste 1866b, p. 84).

To be sure, Modeste was not an apologist for the central banking system. But instead of grounding his political philosophy on the vague idea of freedom, he advocated the principle of *self-government*. He was particularly clear on the nature of the State: “What we call the State, it is the master, the hindrance, the obstacle, the enemy” (Modeste 1866b, p. 76).<sup>34</sup>

#### *Solution to the Note-Issue Problem*

We have noted earlier that Henri Cernuschi is known as one of the first thinkers to propose unrestricted freedom of banking as a solution to the problem of fiduciary media. To be sure, he advocated free banking for exactly the opposite reasons that Courcelle-Seneuil did. Cernuschi believed that free note issue would result in fiduciary media losing their credibility: “I believe that what is called freedom of banking would result in a total suppression of bank notes in France. I want to give everybody the right to issue bank notes so that nobody should take any bank notes any longer” (Cernuschi 1866, p. 55, quoted in Mises 1998, p. 443). This idea is essentially the same as in Mises: “Freedom in the issuance of bank notes would have narrowed down the use of bank notes considerably if it had not entirely suppressed it” (Mises 1998, p. 446).

Did Modeste agree with this conclusion? It appears that he did not. Modeste (1866b, p. 75) was, to the contrary, highly skeptical of bankers and of the likely results of such schemes.<sup>35</sup> Moreover, if fractional reserve banking was fraudulent business, why should it be allowed at all? Modeste argued that the right to issue fiduciary media was a special legal privilege in the first place: “To depreciate, . . . to falsify . . . the money . . . [are] privileges of banks. This *privilege* is sold to them by the government” (Modeste 1866a, p. 211).<sup>36</sup>

Modeste came up with a different proposal. He realized that we do not have to choose between the free-fractional reserve banking system and the 100-percent central banking system. Fiduciary media were false money. Fractional reserve banking was a

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<sup>34</sup>Modeste was not alone with his anti-statism to be sure. The *Dictionnaire de l'Économie Politique* (Guillaumin 1853, p. 324) expressed similar sentiments in Charles Renouard's entry on “Parasites.”

<sup>35</sup>Historically there seems to be reason for such skepticism: the inherent insolvency of fractional reserve banking does not necessarily lead to full reserves but rather encourages mutual deals between bankers and politicians. The common privilege of suspending specie payment in times of crisis is only a first step on the way to more systematic inflationary cooperation. On this progression of events, see esp. Hülsmann (1997, pp. 88-90) and Huerta de Soto (1998a, pp. 39-40 and 46).

<sup>36</sup>Huerta de Soto (1998a, p. 42) has argued that this indeed is the historical case: “The legally-invalid (i.e., criminal) historical origin of fractional-reserve banking seems to me to be unquestionable. . . . Once the bankers obtained from the government the privilege of acting on the basis of fractional reserves, their criminal status disappeared.” For more documentation on the history of banking from a legal point of view, see esp. Huerta de Soto (1998b, chaps. 1-3).

fraud against the depositor. Modeste concluded that the proper solution was to deal with it just like with any form of thievery or fraud, and prohibit it under criminal law:

What I wish is that the law would recognize that not to be able to deliver is equivalent to theft; that to falsify the title, the weight, the value, the time-value . . . is equivalent to theft; that theft in all its forms is theft and everywhere deserves its penalties. . . . [These] are criminal acts and should be relieved under the criminal law. (Modeste 1866b, p. 77)

It is here that Modeste's similarity with Rothbard is difficult to overstate. Writes Rothbard:

Yet the free market does not mean freedom to commit fraud or any other form of theft. Quite the contrary. The criticism may be obviated by imposing a 100%-reserve requirement, not as an arbitrary administrative fiat of the government, but as part of the general legal defense of property against fraud. (Rothbard 1993, p. 709)<sup>37</sup>

### CONCLUSION

The false-money debate of 1866 in the *Journal des Economistes* was the first time that uncompromising laissez-faire advocates clashed on the question of fiduciary media. The defenders of free banking with fractional reserves—Courcelle-Seneuil, du Puynode, and Mannequin—were mainly in line with their present counterparts. They maintained that banks with fractional reserves are relatively stable because they seldom have to redeem all their notes at the same time. They claimed that issues of fiduciary media increase the available credit and benefit the entire economy. The legitimacy of fractional reserves rested—then just as now—on freedom of contract, and the remedy to all banking problems was to abolish all government interventions. Courcelle-Seneuil and du Puynode differed somewhat from their present followers in their argument that fiduciary media, being mere promises to pay in money on demand, are not money at all.

Victor Modeste was with Henri Cernuschi a forerunner of the present-day advocates of free banking with 100 percent reserves. By integrating vital concepts developed by earlier laissez-faire economists in nineteenth century France, Modeste put forth a systematic argument against fiduciary media. He distinguished between money and money representatives, and argued that bank notes are either real money representing the money in reserves, or they are fiduciary media that do not represent anything but thin air. He argued that fiduciary media—whether publicly or privately issued—are a specific type of money: false money. He also defended the theory that business cycles are based on the illusion and error created by fiduciary media.

Modeste was not simply following Cernuschi but was important in his own right. Just as Cernuschi anticipated Mises with his policy conclusions, Modeste was essentially Rothbard's forerunner. To him the key question was about honest business against robbery and fraud. Modeste argued that fractional reserve banking was a form of fraud and theft and that it should be abolished not by central banking but by prohibiting fiduciary media under criminal law.

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<sup>37</sup>This idea is not as radical as it may seem. As Huerta de Soto (1995, p. 29) has informed us: "In the continental juridical tradition, there is a long-established principle that dates back to the old Roman Law according to which custody, in irregular deposits, consists precisely of the obligation to always have an amount equal to that received at the depositor's disposal." For more elaboration on the history and philosophy of law from the viewpoint of banking, see Huerta de Soto (1998b, chap. 1).

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