

NOTES AND REPLIES

## On the Optimal Performance of Fiduciary Media: Response to Kristoffer Mousten Hansen

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In his article “Are Free Market Fiduciary Media Possible? On the Nature of Money, Banking, and Money Production in the Free Market Order,” Kristoffer Mousten Hansen (2021) reframes the long-running debate between free bankers and 100 percent reservists and attempts a novel application of Misesian monetary analysis to refute the viability of fiduciary media in a free market economy.

We take issue with the main thrust of Mousten Hansen’s article; namely, the claims that users of fiduciary media are committing entrepreneurial error and that the use of such forms of money will be eliminated through the market process. Before outlining our critique, however, we will acknowledge an important point of agreement.

Mousten Hansen (2021, 291–93) does an able job outlining the controversies over free banking, labeling the parties to the debate the “free banking school” and the “full-reserve school” (287). He dispenses with the argument, common among the Rothbardian camp of the full-reserve school, that fractional-reserve banking is inherently fraudulent. Mousten Hansen admits that there’s nothing immoral about the essential act of deposit banking: “Although borrowing money at call and investing it in longer-term loans and securities might be seen as an extreme case of maturity mismatching, this practice is not in itself illicit. On the contrary, there seems to be nothing in this practice at odds with respect for property rights and freedom of contract” (293). We agree completely, and we appreciate Mousten Hansen’s moving beyond an argument that is self-evidently false on libertarian ethics grounds.

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Having conceded this important point to the free banking school, Mousten Hansen moves on to the major contention of his article, the argument that issuance of fiduciary media, whether in the form of “unbacked”<sup>1</sup> banknotes or demand deposits, constitutes a fundamental “entrepreneurial error” and as such would be swiftly eliminated within a free market. Mousten Hansen states his argument succinctly in this passage:

It is fundamentally erroneous to consider a mere unbacked claim on a person or an institution as equivalent to money. The error consists in mistaking a future good, or a claim to a future good, for a present good, and in mistaking an unsafe asset for the comparatively safest good, viz., money. As all other errors in the free market, the error of mistaking fiduciary media for fully backed money certificates will tend to be corrected in the process of entrepreneurial profit and loss, leading to the virtual elimination of all fiduciary media from the market economy. (288)

This is a bold claim indeed, and no less than an indictment of the entire modern monetary and payments system in use in all advanced economies. Any person or business with a checking account<sup>2</sup> is regularly using fiduciary media in the form of bank deposits<sup>3</sup> to make and receive payments. Mousten Hansen’s hypothesis is also testable: Are fiduciary media on their way to elimination through the working out of a corrective market process, or is the use of fiduciary media commonplace and possibly becoming a more widely accepted means of payment over time? We will first address the illogic of Mousten Hansen’s thesis and then briefly examine the available evidence.

Mousten Hansen’s entrepreneurial error argument hinges on a particular aspect of the definition of fiduciary media. Drawing on Ludwig von Mises, Mousten Hansen repeatedly insists that fiduciary media must be perfectly reliable—that is, that these claims must carry zero risk of nonredemption or nonpayment in units of the ultimate money:

*Money in the broader sense* is perfectly secure and instantly redeemable claims to money in the narrow sense. . . . *Fully secure* [emphasis added] and present claims to money will be deemed equivalent to money in the narrow sense. (289)

1 The idea of any firm’s liabilities being “unbacked” is categorically false; any business’ liabilities are completely backed by its assets. One may call into question the quality of a firm’s assets, in terms of value, liquidity, etc., and determine that the firm’s equity is overstated or indeed negative (i.e., assets < liabilities), but it is spurious to state that liabilities are “unbacked,” regardless of the nature of the firm’s business dealings.

2 An FDIC (2024) study found that 96 percent of American households had access to a bank or credit union account in 2023.

3 Although he focuses on banknotes, Mousten Hansen (290) acknowledges that demand deposits are “nowadays the prime example” of fiduciary media.

So long as claims to money are considered *perfectly secure* [emphasis added] and instantly redeemable, they can perform all functions of money in the narrow sense. (297)

A claim's character as a money substitute depends on there *never being any doubt as to its safety* [emphasis added] and to the ability of the issuing institution to redeem it in full without delay. (297)

Only if the public thinks the bank's money substitutes are *fully secure* [emphasis added] will they accept them at par with money, and only thus can they gain any circulation at all. . . . As soon as the *slightest doubt* [emphasis added] arises as to the issuer's ability to redeem them in full and without delay—as soon as he loses the goodwill of the public—all his circulating notes will lose the character of money substitutes, trade at a discount to money, and return to the issuer. (298)

What does “perfectly secure” mean in practice? It can't mean there is absolutely zero risk (prospectively), or zero actual incidence, of banks' nonpayment of their demand liabilities. Many of us have personally encountered at least a temporary inability to access bank funds, whether due to an ATM outage, an accounting error, a deposit hold, or something similar. Fiduciary media necessarily will always carry *some* risk of nonpayment or delayed payment, even in today's world of deposit insurance and 24/7 electronic networks.<sup>4</sup> This should come as no surprise to any astute economist, as nothing in the realm of human action under uncertainty is perfectly safe or predictable (Mises [1949] 1998, 105). One wonders if Moustén Hansen insists on such Platonic perfection for other businesses whose profitability hinges on promises to provide certain goods. Does occasional failure under rare, extreme circumstances negate the business's value proposition? A grocery store might occasionally stock out of milk, bread, or eggs due to improper forecasting of temporary demand surges. An airline overbooks a flight, requiring an auction process to compensate those passengers most willing to accept a breach of contract and settle for a travel delay. A contractor misses an appointment to repair your house due to unforeseen hang-ups on other projects. These eventualities are, fortunately, rare in a competitive market economy precisely on account of the market discipline of profit and loss—the very factor Moustén Hansen presumes will

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<sup>4</sup> Indeed, when one considers innovations in technology and improvements in convenience—such as extended banking hours, the prevalence of 24-hour/365-day availability of ATMs, the proliferation of online payment apps, and so on—it appears that the ability of banks to make good on the payment of their fiduciary obligations has only increased over time. We thank Jasper Miller for bringing this point to our attention.

eventually squash fiduciary media. But there is no world in which even the best-functioning, idealized market process can eliminate all uncertainty, risk, or error, from whatever source it might stem.

Indeed, as Mises, Friedrich Hayek, Israel Kirzner, and other “market process” economists routinely point out, the market economy is a mechanism for continually adapting and adjusting production and delivery of goods to minimize the inconvenience brought about by uncertainty and error, with the result of generating the best possible conditions for consumers’ pursuit of wealth. When it comes to businesses making promises to deliver goods, utter perfection is out of the question, but good enough is good enough—as judged by the revealed preferences of consumers, which are the ultimate determinant of entrepreneurs’ success in business (Mises [1949] 1998, 308–11). The prevalence of fiduciary media, in note or deposit form, throughout historical monetary systems is *prima facie* evidence that the benefits of such monetary arrangements outweigh the costs. The functionality and reliability of a free market system of deposit and note issuance has, of course, been the core subject of free banking scholarship extending over the last forty or fifty years. This body of research has found that, under the right institutional and regulatory conditions, free banking has historically proven to function in a reliable fashion with respect to banks’ payment of their deposit liabilities (Rolnick and Weber 1983; White 1984; Selgin 1988, 135; Sechrest 2008).

In addition to requiring impossibly high standards of reliability from banks, Mousten Hansen (2021, 301) condemns all who hold or use fiduciary media as perennially guilty of entrepreneurial error:

Consequently, a man who, wanting to add to his cash balance, increases his holding of fiduciary media, is fundamentally in error: he wants to reduce the uncertainty of his investments by increasing his cash balance, but fiduciary media are precisely *not* the most certain investment option; they are claims on other people, whether individuals or institutions such as banks. As such, they are always liable to the risk of default and nonpayment. Wanting to increase his certainty by increasing his holding of fiduciary media, the individual in fact renders himself liable to lose all if the issuing institution suspends redemption.

Mousten Hansen is correct that fiduciary media are claims issued by banks and that there is some risk of nonpayment. But for Mousten Hansen to state that the individual who prefers to hold bank deposits rather than “money in the narrow sense” is somehow in error is mere assertion and a substitution of Mousten Hansen’s judgment for that person’s own assessment of risk and reward. There are costs and benefits to holding money in any form. Bank notes and deposits, especially in a pure free banking system without

deposit insurance or bond collateral, carry the cost of a small risk of potential default and at least partial loss of one's funds. They also carry the substantial benefit of being readily and instantly transferable to other individuals and businesses at very low cost through today's ubiquitous electronic payment system, a fact Mousten Hansen neglects to acknowledge. Mousten Hansen suggests that it is only "correct" for a person desiring to increase his cash balance to hold physical units of the fundamental money, which in the United States today would be Federal Reserve Notes (FRNs). However, while holding such physical currency carries the benefit of minimizing potential loss or delayed availability of funds, it carries its own costs of security (theft or loss) and illiquidity risks, as some businesses are not equipped to handle cash transactions, and it is difficult to transfer such funds to distant parties without great cost.<sup>5</sup>

Mousten Hansen's preferred "banking" system, in which banks are merely secure storage facilities for depositors' funds, would be able to effectuate payments via a ledger or clearinghouse network. But such banks would not be able to invest these funds in loans or other earning assets, meaning the costs of these storage and accounting services would fall fully on the customers in the form of fees. Under free banking (fractional reserves), in contrast, banks can provide security and payments services at zero fee and, of course, pay interest on certain forms of deposits because all operating costs—storage, overhead, salaries, and so forth—are covered by the earnings on their investments. The glaring absence of such a "money storage" (100 percent-reserve banking) business model in modern history—both before and after the ascent of central bank fiat money monopolies—indicates that this business model is not what most of us are looking for when we shop for banking services. Comparing the benefits of liquidity, payments access, and interest earnings against the risk of potential loss of their funds, consumers' revealed preferences have been overwhelmingly in favor of fractional-reserve deposit banking. Indeed, the competitive advantages of this arrangement have led to the extinction of any full-reserve alternative that might have existed.

Mousten Hansen (2021, 302) further insists that demand for money constitutes demand for present goods, and that holding financial assets such as fiduciary media is incompatible with actual demand for money. We grant that money in the form of fiduciary media is essentially a financial asset, but we reject Mousten Hansen's contention that this fact makes fiduciary media unqualified to serve as money. Granted, one's demand to hold cash itself is largely based on uncertainty and the desire for the flexibility and liquidity that cash (FRNs) itself provides, although this aspect of physical cash has declined in importance as more merchants and even individuals can reliably take payments through automated clearing house (ACH) payment

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<sup>5</sup> The risks and costs of physical cash apply equally to gold or silver coins as to central bank-issued fiat currencies.

networks and payment providers such as Venmo, Zelle, PayPal, and the like. One's demand for money in a broader sense—money substitutes or fiduciary media—stems additionally from the convenience they allow for making routine payments. Regardless of the exact composition of one's demand for money, it is not an entrepreneurial “error” to demand or hold money other than the ultimate redemption medium—FRNs or other base money. Rather, holding of fiduciary media represents a prudential judgment, an optimization strategy based on comparing the marginal cost and benefit of physical cash versus bank deposits.

Mousten Hansen closes his article with this statement: “Mises wrote that ‘the development of the fiduciary medium must necessarily lead to its breakdown.’ We hope here to have shown that on a free market, with no privileged banking system, this breakdown will come quickly, before the fiduciary medium has gained widespread currency” (311). Monetary history appears to have falsified this claim, unless Mises and Mousten Hansen are thinking along geological time scales, and “quickly” means a thousand years. Fiduciary media took off and became commonplace long before central banks came to dominate nations' monetary systems. In the more recent past, under the not-so-benign influence of central banks, fiduciary media persist. The system seems to be working relatively well, regulatory strictures and inflationary instabilities notwithstanding. It's distressing to see a scholar make sweeping critical claims about a well-established financial system without offering a scintilla of either qualitative or quantitative evidence to support such dire pronouncements.

On a final note, let us take a brief look at the substantial empirical record of some of the best-known free banking (or quasi free banking) episodes and empirically assess Mousten Hansen's hypothesis regarding the instability and inevitable disappearance of fiduciary media. Lawrence White, who pioneered free banking scholarship with extensive analysis of the Scottish free banking experience, notes that “the Scottish free-banking system of 1716 to 1845 combined remarkable stability with competitive performance” (White 2015b). Scotland's system featured “many competing banks, [and] most of them were well capitalized. . . . None were disproportionately large, all but a few were extensively branched [and] all offered a narrow spread between deposit and discount rates of interest” (White 2015a, 195). Although free banking in Great Britain was suppressed by Peel's Act in 1844, interestingly some Scottish banks still retain the authority to issue banknotes that circulate alongside Bank of England currency (White 2014).

Arthur Rolnick and Warren Weber (1983), in their extensive analysis of the American “free banking” era,<sup>6</sup> evaluate the losses borne specifically by noteholders of failed banks. They find that these losses varied drastically by state, ranging from noticeable to vanishingly small, depending on the quality of regulation and the degree of competition each state provided. Their overall conclusion is that “free bank notes were relatively safe, although the degree of safety varied over states and over time within a state. New York bank notes were the safest; the expected value of a randomly selected New York bank note never fell below 99 cents on the dollar, and for many years this expected value was one dollar” (1087). Ignacio Briones and Hugh Rockoff (2005, 304) compare the success and stability of Canada’s robust free banking system against the post–Civil War National Banking System in the United States:

The contrast between the stability of the Canadian system and the instability of the U.S. system, however, was present long before the Great Depression. By 1900 American reformers were drawing attention to the difference in stability and calling for reforms of the American system to make it more like the Canadian system. Canada’s private system did so well that a central bank was not established until 1935. . . . The Canadian system, like the Scottish system and parts of the American system, was clearly a successful case of lightly regulated banking.

Reality points to a conclusion opposite Moustén Hansen’s doomsaying: the fiduciary media payment system, though today built upon a shaky foundation of central bank fiat money, is nonetheless ready and reliable. It is not going away anytime soon—indeed, ongoing fintech innovations, such as payment apps and the advent of stablecoins, only make it stronger and more valuable by extending participation in a robust payments system to the unbanked and to foreign users of US dollars.

Moustén Hansen invokes Ludwig von Mises to disclaim the viability of free banking. Much as we respect, admire, and indeed build upon the immense body of work of this eminent economist, history has proven Mises’s doubts about the survivability and prevalence of fiduciary media to be mistaken. As long as contracts are enforced by a reasonably just and efficient legal system, fiduciary media will thrive, as they offer a form of money which is convenient, optimally reliable, and adequately safe. In short, fiduciary media have passed the market test, and they are here to stay.

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<sup>6</sup> It should be noted that there were significant restrictions on US banks during the so-called free banking era; namely, universal restrictions on branching and state government requirements that bank capital consist partially of state bonds or other securities of dubious value. See Sechrest (2008, 95–97) for details.



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