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PHILOSOPHY, HISTORY, AND METHODOLOGY OF ECONOMICS

Money, Bank Credit, and Economic Cycles

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For those who are not schooled in finance or who do not work in the financial industry, the business of money, credit, and banking can be somewhat of a mystery. Most people know that a sound currency and a reliable banking system are indispensable for the workings of modern free-market economies. People are also generally aware of the converse—that a crisis in confidence in a currency or a lack of liquidity in one or more banks is often the precursor to some form of wider economic downturn. Beyond these parameters, however, knowledge of the history and nature of modern banking—both commercial and central banking—is more elusive for the vast majority of people, including many with significant investments in banks and financial institutions or whose ability to survive financially is highly dependent on the interest-rates set by central banks.

This lack of knowledge is at least partly due to the manner in which finance and banking are taught in many universities and business schools. Leaving aside the tendency to study these subjects in a historical context that excludes all but the most recent economic history, much instruction in banking and finance is conducted in the language of econometrics and mathematics. This also accounts for the relative dearth of serious instruction on the moral reasoning that ought to guide the business of banking. Too often, ethical reflection on the workings of finance and banking is reduced to insisting that morality's requirements can be satisfied by minimal compliance with the law and regular donations to politically correct causes.

These factors make all the more refreshing the effort of Jesús Huerta de Soto in the first English translation of his magisterial *Money, Bank Credit, and Economic Cycles* to (1) outline the history of the development of finance and banking in a manner accessible to nonspecialists; (2) offer a moral and economic critique of its contemporary workings; and (3) present an alternative to the financial systems currently dominant in the West. To describe de Soto's coverage of his subject as comprehensive is an understatement. As de Soto explains in his introduction, this 876-page book is multidisciplinary in nature. It embraces the study of ethics, law, legal history, and economic theory. Everything in the book, de Soto stresses, is examined from the three perspectives that he deems "necessary to correctly comprehend any social phenomenon: historical-evolutionary, theoretical, and ethical" (xxiv). This combination of insights from positive and normative sciences allows Huerta de Soto to do full justice to his topic as an economic, historical, and moral reality. It also permits his subject to come alive in a manner normally absent from most other texts addressing similar questions.

Why, some might ask, would anyone invest such intellectual energy in exploring the workings of money and credit and their impact upon economic growth and decline? De Soto's answer is simple. In light of socialism's discrediting as a serious economic alternative, "the main theoretical challenge facing economists at the dawn of the twentieth century lies most likely in the field of money, credit, and financial institutions" (xxii). The irony, de Soto stresses, is that many features of the banking systems existing in the West today—such as the power exerted by central banks, the practice of fractional reserve banking, foreign-exchange controls, and the existence of currency monopolies—are far more compatible with the workings of a centrally planned socialist economy than true market economies. His point is that "the arguments that establish the impracticability of socialist economic calculation are fully applicable to the financial sphere" (xxiii). The implication is that unless the business of money, credit, and banking is conducted according to market principles rather than socialist ideology, societies will not escape the boom-bust, inflation-deflation-stagnation cycles that continue to bedevil economic life in developed and developing countries alike.

De Soto's text consists of nine chapters. He begins with a detailed study of the legal nature of the monetary irregular-deposit contract and how it differs from a loan contract. This distinction is central to De Soto's book, as many of the subsequent chapters involve analysis of what happens when monetary irregular-deposit contracts are violated by being treated as if they were loan contracts. De Soto presents a compelling historical case to suggest that such practices, which De Soto believes to be derived from the moral error of using people's monetary deposits in ways not previously approved by the depositors, have steadily undermined the legal principles that traditionally governed irregular-deposit contracts. The same error has also, he suggests, facilitated many governments' subsequent gradual erection of legal privileges for banks in the form of protections not accorded to other enterprises. Anxious to secure capital to advance particular political objectives via a variety of state interventions in economic life, many governments have proved willing to legitimize a range of financial practices by banks that De Soto considers morally problematic on multiple levels and that do not accord with market principles.

Chapters 2–7 are extensive and worth careful reading. De Soto demonstrates a formidable command of the sources of the relevant legal and economic history. His analysis of Roman law's treatment of irregular deposits is especially masterful and deserves careful attention. De Soto also takes the opportunity to apply Austrian economic insights to the effects of the development of fractional-reserve banking. To this end, De Soto develops a strong moral, legal, and economic case for holding banks to a 100 percent reserve position. It is from this standpoint that De Soto presents his own Austrian-based theory of economic cycles, which he contrasts with Keynesian and monetarist explanations. Throughout these sections, De Soto uses econometrics and mathematics sparingly but effectively.

In chapter 8, De Soto turns his attention to the practice of central banking. Those accustomed to the contemporary caricature of financial markets as the domain of "savage capitalism" would do well to read this chapter, not least because of De Soto's demonstration of the extent to which the form and amounts of money and credit in most contemporary financial systems are based upon government monopolies of the key decisions concerning these subjects. De Soto's suggestion is that the very practice of central banking is naturally subject to the same problems of economic calculation that plagued and ultimately undermined socialist economies. Central banking continues to be a fiercely debated subject, even among market-inclined intellectuals and economists. Those who dispute De Soto's conclusions on this topic will find themselves confronting a powerful theoretical edifice, and compelled to develop very sophisticated arguments if they wish to restate their own positions in ways that can coherently answer De Soto's critique.

In his final chapter, De Soto provides a detailed outline of his alternative to contemporary monetary arrangements and banking systems. It amounts to a case for truly free banking in a free market economy. The cornerstone of De Soto's system is a return to the legal requirement of a 100 percent fractional reserve in banking. As well as examining possible objections and providing responses (here, De Soto's style will remind some readers of the traditional Scholastic method of intellectual inquiry), De Soto takes the time to apply his theory to practical policy issues, such as the erection of a new European monetary system.

The sheer length of this text will demand much time and concentration of readers wishing to fully absorb its insights. Certainly there is an element of repetition at different points. This tends, however, to reflect De Soto's determination to demonstrate that the moral, legal, and economic dimensions of money, credit, and banking cannot be artificially separated from each other without risking the loss of a sound understanding of the subject. One wishes that more authors were willing to avoid the extreme specialization that characterizes much contemporary university life. The Ludwig von Mises Institute is to be commended for having the foresight and commitment to have De Soto's powerful work of synthesis made available to English-speaking audiences.

—Samuel Gregg
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