Review of Huerta de Sotos ‘Money, Bank Credit, and Economic Cycles

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Book Review

Jesús Huerta de Soto. *Money, Bank Credit, and Economic Cycles*. Translated by Melinda A. Stroup. Auburn: Ludwig von Mises Institute, 2006.

The book under review is the first English edition of Prof. Jesús Huerta de Soto's book *Dinero, Crédito Bancario y Ciclos Económicos* which first appeared in Spain in 1998. A second edition of the book followed at the beginning of the year 2002 in the wake of worldwide economic events illustrating the great timeliness of the book and the considerable relevance of its subject matter. In the meantime previous reviewers of the book had urged the translation of the book into English[1], a task now completed as a result of the great effort of Melinda A. Stroup, who wrote the first English manuscript of the entire book, and of the determination of Lewellyn H. Rockwell, Jr., President of the Ludwig von Mises Institute.

The contribution made by the book's author cannot simply be categorized as belonging exclusively to a particular sub-discipline within economics. Most naturally it addresses macroeconomists and monetary theorists, but it can equally be considered an exploration into the now rapidly expanding field of new institutional economics, or into the Law and Economics of money and banking. Experts of the work of F. A. Hayek will recognize it as the accomplishment of a long-awaited feat: an integration of Hayek's early work on money and business cycles with his later work on legal theory, institutional economics and spontaneous order. Some commentators had started raising doubts about the compatibility and ultimate consistency between these various strands of thought in the old master's multifaceted oeuvre.[2] With Dr. Huerta de Soto's accomplishment, the various pieces of the Hayekian puzzle have been shown to consistently fit together yielding a coherently integrated picture capable of explaining a wide variety of juridical, historical and economic phenomena.

As Hayek explained, man is as much a rule-following animal as a purpose-seeking one.[3] Where economic agents' behaviour is governed by particular abstract rules of conduct, spontaneous order will emerge and social life will run its course in a well-ordered and coordinated fashion. To the contrary, whenever those rules are violated on a more or less significant scale, life in society will become dis-coordinated and a process of de-civilization will set in. With unprecedented thoroughness and clarity Prof. Huerta de

1 See in particular L. Yeager (2001, 255) and J. G. Hülsmann (2000).

2 See in particular U. Witt (1997). This author argues that Hayek's early work on the theory of the business cycle is difficult to make sense of in terms of his later work on spontaneous economic order and believes that Hayek pursued two different and basically incompatible research programs consecutively.

3 See Hayek (1973, 11).

Soto has detailed what exactly those rules of conduct are in the domain of money and banking.

One of the main these of the book is indeed that whereas the economic analysis of juridical institutions has thus far had almost exclusively microeconomic implications, the approach to the economic analysis of juridical institutions developed by the Austrian School yields critical implications and conclusions that are essentially macro-economic in nature, elucidating macro-economic phenomena like inflation, recurring boom-bust cycles and stagflation, besides their devastating consequences.

The juridical foundations are treated in the first and third chapters of the book. Chapter 1 (1-36) deals with the different legal logic inherent in the monetary irregular-deposit contract on the one hand, and the loan contract or mutuum on the other, explaining their inherent mutual incompatibility at a fundamental level. In Chapter 3 (115-165) the author considers different theoretical attempts to come up with a new contractual framework aimed at justifying banks' lending of demand-deposit funds to third parties; it is shown that these attempts at justification are riddled with an insoluble logical contradiction and are therefore doomed to failure.

Chapter 2 (37-114), which presents various historical examples of violations of the legal principles governing the monetary irregular-deposit contract by bankers and authorities in three different historical instances, by itself is worth the price of the book. If it is undeniably true that historical experience amply illustrates the relevance of the book's main theses, historians who have made important contributions to the historiography of money, credit and banking have mostly been unaware of the conclusions of the Austrian theoretical analysis and have often had recourse to somewhat inadequate theoretical tools. This chapter reviews and integrates the celebrated work of some of the most important historians from the perspective of the theoretical analysis developed in the book.[4]

[4] The three historical instances are the Greco-Roman world; the Mediterranean trading cities of the late Middle Ages and the beginning of the Renaissance; and, finally, the emergence of the first important government banks beginning in the seventeenth century. The reader is offered fascinating introductions into the work of such important historians like Raymond de Roover, Raymond Bogaert, Michael Rostovtzeff, Jean Imbert, Henri Pirenne, Abbott Payson Usher, Marjorie Grice-Hutchinson, Carlo Cipolla and Ramón Carande, among others.

Chapter 4 offers a detailed description of the credit expansion process and occupies a central place in the book because it paves the way toward a comprehension of the processes through which banking institutions and their stockholders expropriate great amounts of wealth from all of the rest of society. This chapter precedes the chapters devoted to the theoretical analysis of the business-cycle effects of credit expansion (Chapter 5, 265-395) and to a highly interesting series of additional considerations on the theory of the business cycle (Chapter 6, 397-508).

Some critics will perhaps object that the author resorts to a mono-causal explanation of such complex phenomena like business cycles and may want to point to the possible advantage of taking a more eclectic approach when analyzing the causes of business cycles. However, it can be pointed out that mainstream writers generally "sin" even more excessively in this respect since these authors do not discuss or criticize the Austrian theory – if they mention it at all – while the book under review offers a thorough criticism of rival approaches to the understanding of business cycles. The author's critical analysis and refutation of the alternative explanations for business cycle phenomena offered by the monetarist and Keynesian schools is contained in Chapter 7 (509-600).

Chapter 8 (601-714) offers a fascinating overview of past as well as more recent controversies relating to the role of a central bank as well as a brilliant refutation of the rationale for both central banking and fractional-reserve free banking.

On the critical side, advocates of a system of fractional-reserve free banking will likely remain unconvinced by the way the author portrays the internal dynamics of a fractional-reserve free banking system, contained in the section devoted to the analysis of such a banking system (664 ff.), in particular as regards the author's suggestion that fractional-reserve free banking will inevitably evolve towards a system of central banking. The main issue can be summarized as follows.

In Table VIII-2 on page 667 of the book the author conceives of the interaction pattern between banks in a fractional-reserve free banking system as a classic prisoner's dilemma, a conceptualization which is here intended to elucidate the typical "tragedy of the commons" effect which will appear under fractional-reserve free banking: bankers face the almost irresistible temptation to be the first to initiate a policy of expansion, particularly if they expect all other banks to follow suit to one degree or another. In the prisoner's dilemma configuration comprising two banks, if either bank expands credit alone, its viability and solvency will be endangered by interbank clearing mechanisms, which will rapidly shift its reserves to the other bank if the first fails to suspend its credit expansion policy in time. Furthermore, the situation in which both banks simultaneously initiate credit expansion – a strategy which yields the same large profits to both – represents the mutually cooperative outcome, while the situation in which neither of the banks expands and both maintain a prudent policy of loan concession represents the outcome of mutual defection. Prof. Huerta de Soto concludes that it follows from this interaction configuration that the two banks will face a strong temptation to arrive at an agreement and, to avoid the adverse consequences of acting independently, initiate a joint policy of credit expansion, and particularly, to urge authorities to create a central bank.

However, and even if the author's conclusion remains fully relevant in view of the historical evidence presented in the book, the aforementioned argument, as it stands, clearly presents a theoretical gap. Without a more detailed description of how, in the absence of extra-market devices and interventions such as those of a central bank, the two banks will actually coordinate their courses of action upon the mutually cooperative outcome (in-concert expansion), the argument is not entirely tight. Indeed according to the logic of the prisoner's dilemma game all players will end up defecting so that no over-expansion will ensue.[5] This is the conclusion Prof. L. White (1995, 16) seems to have had in mind when he wrote:

"Concerted expansion by a multiplicity of independent banks is implausible for the same well-known reasons that the attempt to build a stable cartel arrangement among many firms is unlikely to be successful in any industry in the absence of a legal mechanism enforcing cartelisation. Any firm not abiding by the cartel agreement could capture whatever benefits the agreement is supposed to bring the industry to a greater extent than a firm adhering to the agreement."

This does not mean that the argument is wrong or useless. In fact the conclusion is well supported by historical evidence. It does seem to mean, however, that the conclusion refers only to one theoretically possible scenario – the one which historical events have

[5] In the prisoner's dilemma setting players cannot reach the mutually cooperative outcome because they cannot get together to make a binding agreement to expand together. That is why the prisoner's dilemma is characterized as a non-cooperative game.

actually taken – and not to the only possible scenario. Indeed, there are reasons to believe that economic forces would tend to limit the practice of fractional-reserve free banking even in the hypothesis that fractional-reserve banking were considered fully legitimate from the ethico-juridical perspective.[6]

A relatively underexplored topic in the literature concerning proposals for banking reform in general and concerning the theory of a 100-percent reserve requirement in particular relates to the unavoidably complex issues surrounding the transition towards a genuine gold standard. Such questions relate to the "economics of transition" in the field of money and banking and constitute a legitimate topic of research in themselves. Partly taking inspiration from earlier proposals, and partly going beyond these, the book contains an original proposal in this respect which can be expected to fuel future debate in the relevant literature.

In the final chapter of the book (715-812) the author thus details five basic stages of the process of reform and transition toward the preferred monetary and banking system (788 ff.). In this process which would culminate in complete banking freedom subject to legal principles and in a single, worldwide monetary standard, today's private bankers would be converted into mere managers of mutual funds, to which banks would transfer all of their assets and claims (except for the portion corresponding to their net worth). The shareholders of these mutual funds would consist of two groups, on the one hand the holders of current demand deposits who have opted for replacing these deposits with mutual-fund shares, on the other hand – and here resides the originality of the book's proposal – the holders of treasury bonds who would receive, in exchange for them, the remaining shares in the mutual funds to be established with the assets of the banking system.

In conclusion, it should be stressed that the book under review has put the multidisciplinary method and approach into practice with great effectiveness. It is no exaggeration to assert that the strongest argument in support of the author's case ultimately derives from the fact that the results of the historical-evolutionary, the theoretical (or economic) and the juridico-ethical analyses converge on a similar overall conclusion.

[6] See my (Winter 2006).

Obviously if the analytical results reached from the perspective of such various angles all converge and point in the direction of the same overall conclusion, one is likely to have hit upon some important truth.

Even if it may be difficult at this time to gauge in any precise manner the effect the book will have on the economics profession at large, there can be no doubt the book is destined to become a classic, both by virtue of the subject matters that are treated and in virtue of the manner in which they are treated: thoroughly and authoritatively.

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