

INTRODUCTION

The economic analysis of juridical institutions has come to the fore in recent years and promises to become one of the most fruitful spheres of economics. Much of the work completed thus far has been strongly influenced by traditional neoclassical assumptions, namely by the concept of strict maximization in contexts of equilibrium. Still, economic analyses of law reveal the shortcomings of the traditional approach and do so perhaps better than any other branch of economics. In fact, juridical institutions are so intimately involved in daily life that it is notoriously difficult to apply the traditional assumptions of economic analysis to them. I have already attempted elsewhere to expose the dangers the neoclassical perspective brings to the analysis of juridical institutions.¹ Economic analyses of law are certainly necessary, but they call for a less restrictive methodology than has generally been used to date, one more suited to this particular field of research. The subjectivist view is a more fitting approach. Developed by the Austrian School, it is based on their concept of creative human action or entrepreneurial activity and implies a dynamic analysis of the general processes of social interaction. This perspective promises to make great contributions to the future development of the economic analysis of juridical institutions.

In addition, most studies of juridical institutions carried out so far have had exclusively *microeconomic* implications because, among other reasons, theorists have simply borrowed the traditional analytical tools of neoclassical microeconomics

¹See Jesús Huerta de Soto, "The Ongoing Methodenstreit of the Austrian School," *Journal des Économistes et des Études Humaines* 8, no. 1 (March 1998): 75–113.

and applied them to the analysis of law. This has been the case, for example, with respect to the economic analysis of contracts and civil liability, bankruptcy law, the family, and even criminal law and justice. Very few economic analyses of law have had mainly *macroeconomic* implications, and this reflects the harmful decades-long separation between these two sides of economics. However, this need not be the case. It is necessary to recognize economics as a unified whole, where macroeconomic elements are firmly rooted in their microeconomic foundations. In addition, I will attempt to demonstrate that the economic analysis of some juridical institutions yields critical implications and conclusions that are essentially macroeconomic. Or, in other words, even when the basic analysis is microeconomic, the conclusions drawn and primary outcomes resulting from it are macroeconomic. By closing the profound artificial gap between micro and macroeconomics, we arrive at a unified theoretical treatment of legal issues in the economic analysis of law.

This is my primary goal as I undertake an economic analysis of the monetary *irregular-deposit* contract, in its different facets. Furthermore, I intend my examination to cast light on one of the most obscure and complex spheres of economics: the theory of money, bank credit, and economic cycles. Now that the issue of socialism has been resolved,² at least from a theoretical standpoint, and it has been empirically illustrated to be impracticable, the main theoretical challenge facing economists at the dawn of the twenty-first century lies most likely in the field of money, credit, and financial institutions. The highly abstract nature of social relationships involving money in its various forms makes these relationships remarkably difficult to understand and the corresponding theoretical treatment of them particularly complex. In addition, in the financial and monetary spheres of western countries, a series of institutions has been developed and imposed; namely central banks, bank legislation, a monopoly on the issue of currency,

²Jesús Huerta de Soto, *Socialismo, cálculo económico y función empresarial* (Madrid: Unión Editorial, 1992, 2nd ed., 2001).

and foreign exchange controls. These institutions thoroughly regulate every country's financial sector, rendering it much more similar to the socialist system of central planning than is appropriate to a true market economy. Hence, as I will attempt to demonstrate, the arguments which establish the impracticability of socialist economic calculation are fully applicable to the financial sphere. Supporters of the Austrian school of economics originally developed these arguments when they showed it was impossible to organize society in a coordinated fashion via dictatorial commands. If my thesis is correct, the impracticability of socialism will also be established in the financial sector. Furthermore, the inevitable discoordination to which all state intervention gives rise will be vividly revealed in the cyclical phases of boom and recession which traditionally affect the mixed economies of the developed world.

Any theoretical study today which attempts to identify the causes, stages, remedies for, and chances of preventing economic cycles is guaranteed to be front-page material. As a matter of fact, as I write these lines (November 1997), a serious financial and banking crisis grips Asian markets and threatens to spread to Latin America and the rest of the western world. This crisis comes in the wake of the period of apparent economic prosperity which in turn followed the severe financial crises and economic recessions that shook the world at the beginning of the nineties and particularly the end of the seventies. Furthermore, in the eyes of ordinary people, politicians, and the majority of economic theorists themselves, an understanding has not yet been reached as to the true causes of these phenomena, the successive and recurrent appearances of which are constantly used by politicians, philosophers, and interventionist theorists alike as a pretext for rejecting a market economy and justifying an increasing level of dictatorial state intervention in the economy and society.

For this reason, from the point of view of liberal doctrine, it is of great theoretical interest to scientifically analyze the origin of economic cycles, and in particular, to determine the ideal model for the financial system of a truly free society. Libertarian theorists themselves still disagree in this area, and

there are great differences of opinion as to whether it is necessary to maintain the central bank or whether it would be better to exchange it for a system of free banking, and in the latter case, as to what concrete rules economic agents participating in a completely free financial system should have to follow. The central bank originally appeared as the result of a series of dictatorial government interventions, though these were mainly urged by various agents of the financial sector (specifically by private banks themselves), who on many occasions have considered it necessary to demand state support to guarantee the stability of their business activities during stages of economic crisis. Does this mean the central bank is an inevitable evolutionary outcome of a free-market economy? Or rather, that the way private bankers have characteristically done business, which at a certain point became corrupt from a legal point of view, has brought about financial practices unsustainable without backing from a lender of last resort? These and other issues are of utmost theoretical interest and should be the object of the most careful analysis. In short, my main objective is to develop a research plan to determine which financial and banking system is appropriate for a free society.

I intend this research to be multidisciplinary. It will have to rest not only on the study of juridical science and the history of law, but also on economic theory and specifically on the theory of money, capital, and economic cycles. Furthermore, my analysis will shed new light on some historical economic events related to the financial realm, and will better illustrate the evolution of certain trends in the history of economic thought itself, as well as the development of various accounting and banking techniques. A proper understanding of finance requires the integration of various disciplines and branches of knowledge, and we will consider these from the three perspectives I deem necessary to correctly comprehend any social phenomenon: historical-evolutionary, theoretical, and ethical.³

³I have presented the theory of the three-tiered approach to studying social issues in Jesús Huerta de Soto, "Conjectural History and Beyond," *Humane Studies Review* 6, no. 2 (Winter 1988–1989): 10.

This book comprises nine chapters. In the first I describe the legal essence of the monetary irregular-deposit contract, paying special attention to the main characteristics distinguishing it from a loan contract, or *mutuum*. In addition, Chapter 1 deals with the different legal logic inherent in these two institutions, their mutual incompatibility at a fundamental level, and how the unique ways each is regulated embody traditional, universal legal principles identified and developed from the time of Roman classical law.

Chapter 2 is a historical study of economic events. There I examine ways in which the traditional legal principle governing the irregular-deposit contract has been corrupted over time, mainly due to the temptation felt by the first bankers to use their depositors' money to their own benefit. The intervention of the political establishment has also played an important role in this process. Always eager to secure new financial resources, political authorities have turned to bankers entrusted with others' deposits and have attempted to exploit these funds, granting the bankers all sorts of privileges, chiefly authorization to use their depositors' money for their own benefit (of course on condition that a significant part of such funds be loaned to the politicians themselves). This chapter offers three different examples (classical Greece and Rome, the resurgence of banking in medieval Italian cities, and the revival of banking in modern times) to illustrate the process by which the traditional legal principles governing the monetary irregular-deposit bank contract have become corrupted and to outline the resulting economic effects.

In Chapter 3 I adopt a legal viewpoint to consider different theoretical attempts to come up with a new contractual framework in which to classify the monetary bank-deposit contract. Such attempts are aimed at justifying banks' lending of demand-deposit funds to third parties. I intend to show that these attempts at justification are riddled with an insoluble logical contradiction and therefore doomed to failure. I will also explain how the effects of privileged banking practices (see Chapter 2) expose profound contradictions and weaknesses in the formulation of a new legal, theoretical basis for the monetary irregular-deposit contract. The attempt to

establish such a foundation dates back to the Middle Ages and has continued until practically the present day. We will take a detailed look at different efforts to formulate an unorthodox legal principle capable of governing present-day monetary bank deposits in a logical, coherent manner. I conclude that such attempts could not possibly have been successful, because current banking practices are based precisely on the violation of traditional principles inherent in property rights, which cannot be violated without serious harmful effects on the processes of social interaction.

Chapters 4, 5, 6, and 7 comprise the heart of my economic analysis of the bank-deposit contract as it has developed over time; that is, using a fractional-reserve ratio in violation of traditional legal principles. I will explain why Hayek's insightful rule rings true in the banking field as well. This rule states that whenever a traditional legal principle is violated, sooner or later there are serious harmful effects on society. From a theoretical viewpoint, I will analyze the effects the current banking practice of disregarding traditional legal principles in the monetary-deposit contract has on the creation of money, intra- and intertemporal market coordination, entrepreneurship, and economic cycles. My conclusion is that the successive stages of boom, crisis, and economic recession recurring in the market result from the violation of the traditional legal principle on which the monetary bank-deposit contract should be based. They stem from the privilege bankers have come to enjoy and have been granted in the past by governments for reasons of mutual interest. We will study the theory of economic cycles in depth and critically analyze the alternative explanations offered by the monetarist and Keynesian schools for this type of phenomena.

Chapter 8 focuses on the central bank as a lender of last resort. The creation of this institution resulted inevitably from certain events. When the principles which should govern the irregular-deposit contract are violated, such acute and inescapable effects appear that private bankers soon realized they needed to turn to the government for an institution to act on their behalf as lender of last resort and provide support during stages of crisis, which experience demonstrated to be a

recurrent phenomenon. I will endeavor to show that the central bank did not emerge spontaneously as the result of market institutions, but was forcibly imposed by the government and responds to the demands of powerful pressure groups. I will also examine the current financial system, which is based on a central bank, and apply to it the analytical economic theory of the impracticability of socialism. Indeed, the current financial system rests on a monopoly one government agency holds on the chief decisions regarding the type and quantity of money and credit to be created and injected into the economic system. Thus it constitutes a financial market system of "central planning" and therefore involves a high level of intervention and is to a great extent "socialist." Sooner or later the system will inevitably run up against the impossibility of socialist economic calculation, the theorem of which maintains it is impossible to coordinate any sphere of society, especially the financial sphere, via dictatorial mandates, given that the governing body (in this case the central bank) is incapable of obtaining the necessary and relevant information required to do so. The chapter concludes with a review of the recent central-banking/free-banking controversy. We will see that most current free-banking theorists have failed to realize that their plan loses much of its potential and theoretical weight if not accompanied by a call to return to traditional legal principles; that is, to banking with a 100-percent reserve requirement. Freedom must go hand-in-hand with responsibility and strict observance of traditional legal principles.

The ninth and last chapter presents an ideal, coherent model for a financial system which respects traditional legal principles and is thus based on the adoption of a 100-percent reserve requirement in banking. Also considered are the different arguments made against my proposal. I criticize them and explain how the transition from the current system to the proposed ideal system could be carried out with a minimum of tension. A summary of main conclusions wraps up the book, along with some additional considerations on the advantages of the proposed financial system. The principles studied here are also applied to certain urgent practical issues, such as the construction of a new European monetary system

and of a modern financial system in the former socialist economies.

A summarized version of this book's essential thesis was first presented in a paper before the Mont Pèlerin Society in Rio de Janeiro in September 1993 and received the support of James M. Buchanan, to whom I am very grateful. A written, Spanish version has been partially published in the "Introducción Crítica" of the first Spanish edition of Vera C. Smith's book, *The Rationale of Central Banking and the Free Banking Alternative*.⁴ It was later published in French as an article entitled "Banque centrale ou banque libre: le débat théorique sur les réserves fractionnaires."⁵

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⁴Vera C. Smith, *Fundamentos de la banca central y de la libertad bancaria* (Madrid: Unión Editorial/Ediciones Aosta, 1993), pp. 27–42. (*The Rationale of Central Banking and the Free Banking Alternative* [Indianapolis: Liberty Press, 1990].)

⁵Jesús Huerta de Soto, "Banque centrale ou banque libre: le débat théorique sur les réserves fractionnaires," in the *Journal des Économistes et des Études Humaines* 5, no. 2/3 (June-September 1994): 379–91. This paper later appeared in Spanish with the title "La teoría del banco central y de la banca libre" in my book, *Estudios de economía política*, chap. 11, pp. 129–43. Two other versions of this article were also later published: one in English, entitled "A Critical Analysis of Central Banks and Fractional Reserve Free Banking from the Austrian School Perspective," in *The Review of Austrian Economics* 8, no. 2 (1995): 117–30; the other in Romanian, thanks to Octavian Vasilescu, "Banci centrale si sistemul de free-banking cu rezerve fractionare: o analiză critică din perspectiva Scolii Austriece," *Polis: Revista de stiinte politice* 4, no. 1 (Bucharest 1997): 145–57.

Introduction

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Angel
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