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Lessons from a Review of *Money, Banking, and the Business Cycle*

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Abstract: *Shawn Ritenour provides a review of my two-volume book titled* Money, Banking, and the Business Cycle *in the winter 2016 issue of* The Quarterly Journal of Austrian Economics. *This paper constitutes a response to some of the criticisms of the book in his review. In this response, I discuss topics such as the nature of profits, the sustainability of changes in time preference, the role of changes in prices versus changes in spending in the business cycle, the relationship between interest rates and the rate of profit, the nature of fraud, and the nature of value. I also discuss whether the structure of production can be measured using the average period of production. I address other issues raised by Ritenour as well. This discussion sheds light on Austrian business cycle theory and the nature of the business cycle.*

Keywords: Austrian business cycle theory; nature of profits; time preference; interest rates; equation of exchange; nature of value; average period of production

JEL Classification: B, B5, B53

Introduction

In the winter 2016 issue of *The Quarterly Journal of Austrian Economics*, Shawn Ritenour provides a thorough review of both volumes of my book *Money, Banking, and the Business Cycle*. I thank him for the compliments of my book that he provides. He also provides many criticisms. This article constitutes a response to some of the criticisms of the book in his review.

Before discussing the review further, let me provide a few details about the book to provide some context for the discussion of the review and my response to it. The book builds on the business cycle theory developed by Ludwig von Mises and Fried-

rich Hayek—Austrian business cycle theory (ABCT). (Mises, 1966, pp. 550-571 and Hayek, 1935) In *very* brief terms, ABCT states that when government policy leads to accelerating increases in the supply of money and credit, it temporarily reduces interest rates and increases spending, revenues, and profits in an unexpected manner in the economy. This causes businesses to expand their activities and produce more in an attempt to take advantage of the unexpectedly profitable times. Moreover, businesses often borrow at the artificially low interest rates to expand their activities. The artificially low interest rates also lead to greater investment in industries farther back in the production chain. This is the case because the low rates increase the present values of long-term investments relative to short-term investments due to the compounding effect of interest rates. This is the essence of the expansion phase of the business cycle according to ABCT.

The contraction ensues when government policy leads to decreases in the supply of money and credit or merely insufficient increases. At this point, spending, revenues, and profits fall or fail to rise sufficiently, especially relative to expectations. In response, businesses cut back on their activities and lay off workers in order to prepare for the tougher than expected financial times. Interest rates also rise due to the decrease or insufficient increase in the supply of money and credit. The rising rates reduce long-term investment relative to short-term investment due to the compounding effect of interest rates acting in reverse (i.e., higher discount rates reducing the present values of long-term investments relative to short-term investments). The result of all of this is that businesses must scrap many investments undertaken during the expansion. This is a major characteristic of the recession or depression.

For further context, here is a brief description of the four parts of the two-volume book that Ritenour reviews. Part one of volume one shows how manipulations of the supply of money and credit caused by government policy are the primary cause of the business cycle. Part one also defends ABCT from many criticisms, including the criticism that ABCT is not consistent with so-called rational expectations. Part two applies the theory to over 100 years of U.S. history to illustrate the explanatory power of the theory. Extensive amounts of data are used to show the explanatory power, including data for interest rates, the rate of profit in the economy, the money supply, the velocity of money, industrial production, gross domestic product (GDP)/gross national product (GNP), gross national revenue (a more comprehensive measure of spending and output than GDP/GNP), and more. The empirical discussion illustrates how the theory explains the Great Depression, the Great Recession, the recession of the early 1980s, and all episodes of the cycle in the U.S. since 1900. In addition, the book travels back to 18th century France and the Mississippi Bubble to demonstrate the explanatory power of ABCT.

Part one of volume two of the book critiques alternative theories of the cycle, including John Maynard Keynes's theories of depressions and fluctuations, Keynesian "sticky" price and wage theory, and real business cycle theory. Part two shows what a

free market in money and banking would look like, provides an outline to transition to a free market in money and banking, and provides a detailed explanation of why it would lead to greater stability in the monetary and banking system and raise the rate of economic progress in the economy.

Now that one has some background context, I will focus on responding to the review mentioned above. Shawn Ritenour compares my book to many other works in Austrian economics that cover the subjects I focus on in the book. I am familiar with most of the works to which he compares my book. Some, I am not. He highlights the fact that I could have done a better job comparing my work to Austrian works on the same subjects. (Ritenour, 2016, pp. 390 and 394)[1] I appreciate and accept this criticism.

I also accept his criticism of my statement that fiduciary media are backed by debt. I should have stated they are backed by loans made by banks. These loans, of course, lead to the existence of more debt in the economy. One can see this in the context of the discussion in which I stated they are backed by debt. (Simpson, 2014, vol. I, p. 21)[2] Nonetheless, the criticism is a valid one.

While there are a few criticisms with which I agree, there are many with which I disagree. A discussion of the latter will help to advance ABCT and thus help economists better understand the business cycle and business cycle theory. In what follows, I discuss topics such as the sustainability of changes in time preference, the role of changes in prices in the business cycle, the nature of fraud, and the nature of value. I also discuss whether the structure of production can be measured using the average period of production. There are a few other topics raised in Ritenour's review that I address as well.

Time Preference

The first issue in Ritenour's review to be discussed is his claim regarding time preference. One criticism in the review is the claim that the book argues that changes in time preference will not be disruptive and cause the business cycle because changes in time preference occur gradually over the long-term. Ritenour says this misses the point. He claims that the crucial point is not that changes in time preference occur gradually over the long-term, but that changes in time preference are sustainable because they do not encourage investment inconsistent with the preferences of individuals in the economy. (p. 384) Clarification is needed on this issue.

First, while it is stated in the book that changes in time preference do not provide an explanation of the business cycle because time preference does not change quickly enough to cause the cycle (vol. I, pp. 95-96), it is also stressed that there are other inconsistencies between the facts of the business cycle and changes in time preference. For example, if time preference decreased to cause interest rates to fall, which is how interest rates move during the expansion phase of the business cycle, the rate of profit

that businesses would earn on capital invested would fall as well, since there would be no overall change in spending and business revenues in the economy but there would be increased business costs due to the greater savings and resulting investment. (vol. I, pp. 95-97, 126-128, 153-156, 195-196, and 235-237) This is inconsistent with the facts of the business cycle, since, as is shown in the book, the rate of profit on capital invested rises during the expansion phase of the business cycle. (vol. I, pp. 59-73, 126-128, 153-156, 195-196, and 235-237)

Second, while it is true that changes in time preference are, as Ritenour states, "by their nature sustainable" (p. 384), it is important to understand that the reason why they are sustainable is because they occur over the long-term. If time preference throughout the economy routinely went through radical changes in the short-term, the projects undertaken by investors based on these changes would not be sustainable. If, for instance, time preference dramatically decreased for eight years, this would create a dramatic increase in savings and decrease in interest rates. If businessmen invested more and lengthened the term of their investments, such a focus would not be sustainable if time preference radically increased for two years after this period. All of the sudden, businessmen would have to scrap investment projects and reduce the term of the investment projects they are focusing on due to the sudden lack of availability of credit. Then, if after this period time preference suddenly decreased for six years again, the sudden availability of credit would move investment in the opposite direction. I grant that businessmen would be more reluctant to take on long-term projects after taking on such projects and having to scrap them with the previous changes in time preference. However, the longer that time preference decreases and the larger the decline in time preference is, the more likely businesses would be to react by investing more in total and in longer-term projects.

If time preference changed in this manner, it would create an environment in which much long-term investment would be unsustainable. In fact, there would be many similarities to the business cycle. For example, businesses that invested too heavily in long-term projects as time preference decreased would have to lay off workers as time preference increased, so unemployment would tend to increase for a short period. As investment shifted from long-term to short-term projects, workers could be hired to work on the short-term projects, however, such a shift can create temporary unemployment due to frictional and structural factors in the labor markets.

In effect, such radical changes in time preference would create a type of malinvestment. This would lead to losses (or, at least, reduced profits) on the part of some businesses during the period when time preference increases. Investment projects would have to be scrapped, assets and workers redeployed, and some capital lost altogether given that capital is heterogeneous and businesses incur costs to redeploy capital even if it can be used in other projects.

So, fortunately, changes in time preference tend to occur over the long term. If they did not, it would create much dislocation in the economy, make it harder to progress

forward economically, and create business-cycle like fluctuations. Changes in time preference are sustainable because they tend to occur over the long-term. The fact that radical changes in time preference do not generally occur over the short-term is an important point to recognize if one wants to understand *why* changes in time preference are sustainable and *why* they do not cause the business cycle. One cannot properly consider their sustainability without understanding that they occur over the long-term.

Lastly with regard to time preference, it is important to note that, even though what I say above is true, I am not denying that sometimes dramatic fluctuations in time preference do occur over the short-term. However, when they do, it is the event that causes the change in time preference that has the major effect on the economy, not the change in time preference itself. For example, if a country becomes involved in a major war, this would increase time preference since much more focus would be placed on the production of consumers' goods (i.e., military hardware). The major factor influencing the economy, however, is not the change in time preference, but the war. People are merely responding with the higher time preference to this significant event that must be immediately addressed. People's normal lives—including normal investment projects—are placed on hold in order to win the war. Two more examples pertaining to this discussion are presented in the book. (vol. II, pp. 136-137)

Inflation and the Equation of Exchange

Next, it is claimed in the review that the book adopts "a simple monetarist, quantity theory of money approach to inflation" by employing the price level equation P = D / S (where P = the general price level, D = the monetary spending for goods, and S = the supply of goods). (p. 385) While this price-level equation is used in the book, this mischaracterizes the approach to inflation in the book. The price-level equation is used only to initiate the discussion of inflation in the book and demonstrate that inflation, properly understood, is not a rise in the general level of prices but an increase in the money supply at a rate more rapid than the increase in the supply of commodity money. Monetarists, like most contemporary economists, believe the essence of inflation is rising prices, although monetarists are better on the source of the rising prices than most other economists. However, as is shown in the book, that leads to many false conclusions and much ignorance concerning the nature of inflation, the business cycle, and economic activity more generally. (vol. I, pp. 22-28)

Moreover, the approach to inflation in the book does not assume that increases in the money supply lead to proportional increases in prices, something that the basic form of the quantity theory of money assumes. (vol. I, pp. 43-46) It is extensively discussed in the book how changes in the money supply can also lead to changes in the demand for money (and thus the velocity of circulation of money). Changes in the money supply can affect the expectations individuals have about the value of money

and can thus cause them to increase or decrease their demand for money. This, in turn, can cause the percentage increase or decrease in prices to be far greater than the percentage increase or decrease in the money supply.

The approach to inflation in the book also takes into account the fact that new money does not lift all prices to the same extent or at the same time. It depends on where the new money is spent first in the economy. (vol. I, pp. 72-73) This, of course, is consistent with the Austrian approach to inflation. (for an example, see Mises, 1966, pp. 412-413)

Based on the focus of inflation on increases in the money supply, many other effects of inflation, besides rising prices, are discussed in the book, including not only malinvestment, overconsumption, and the business cycle itself, but the withdrawal-of-wealth effect, the negative effect of taxes on profits, the creation of greater uncertainty in the economy, capital decumulation, and more. (vol. II, pp. 226-231) Identifying the fundamental characteristic of inflation as an increase in the money supply, relative to how much a commodity money—free-market money—would increase, and using this to demonstrate the myriad effects of inflation, goes far beyond a monetarist approach or a simple quantity theory of money approach to inflation. This treatment of inflation is consistent with Austrian economists' treatment of inflation. (for an example, see Rothbard, 2009, p. 989-994)

The review also criticizes the fact that the importance of the equation of exchange is highlighted in the book. The importance of this equation is highlighted because it focuses economists on two important variables: the money supply and the velocity of circulation of money. It can thus help economists understand the business cycle. (vol. I, p. 46) In response, it is stated in the review that, "because business cycles are the result of malinvestment which has to do with relative prices and interest rates and is *not* driven by changes in overall prices or spending, the equation of exchange tells us little to nothing about the business cycle." (p. 386, emphasis in original) There are a few problems here.

First, nowhere in the book does it say that the business cycle is driven by overall prices. The equation of exchange is important because of its focus on velocity (i.e., the demand for money) and the money supply. These affect spending and thus affect profits and the rate of profit in the economy.

In addition, while it is true that business cycles result in malinvestment and that relative changes in prices and changes in interest rates play a role in this, this is a very narrow view of both the causes and the effects of the business cycle. It fails to account for what is driving interest rates and prices and it fails to account for other effects of the business cycle. It is changes in the supply of money and credit that drive interest rates and prices, but changes in the money supply drive spending, revenues, and profits as well. (vol. I, pp. 29-32, 59-73, 126-138, 152-165, 195-199, and 235-242) Profits change in both absolute and relative terms. For example, during the expansion phase not only does the overall rate of profit increase in the economy, but the rate of profit increases

in industries farther removed from final consumption relative to industries closer to final consumption.[3] So, changes in the money supply drive interest rates, relative prices, overall profits, and relative profits, all of which result in malinvestment.

Moreover, the changes in these variables result in many other effects of the business cycle, including overconsumption, the negative effects of taxes on profits, the withdrawal-of-wealth effect, and more. These effects are not only explained by changes in the money supply, the supply of credit, relative prices, and interest rates, but by changes in overall profits and relative profits as well.[4] One must incorporate the changes in spending and profits (both relative and absolute) to have a complete explanation of *all* the facts of the business cycle. Otherwise, one will leave some facts unexplained.

The benefit of the equation of exchange is that it focuses on two variables that affect spending: money and velocity. As is stated in the book, it can therefore help one understand what affects these variables. Placing the focus on velocity is particularly important, since the effect of that variable on spending is often ignored. Velocity provides a measurement of the demand for money, since velocity moves inversely with the demand for money. Hence, anything that affects individuals' demand for holding money moves velocity. This includes rapid changes in the supply of money. (vol. I, pp. 27-28) This is important in explaining the business cycle, since the demand for money generally decreases during the expansion and increases during the contraction. (vol. I, pp. 129-130, 160-165, 198-199, and 240-242) These changes in money demand exacerbate the changes in spending and profits due to changes in the money supply. So here we have a focus on two variables that can be used to help explain changes in relative prices, interest rates, overall profits, relative profits, and everything that results from changes in these variables (malinvestment, etc.). To deny the importance of the equation of exchange, at a minimum, makes it more difficult to see the importance of money and velocity and thus makes it harder to see everything that results from changes in these variables.

Finally, it is important to note that even though the equation of exchange focuses on aggregate variables, it does not deny that economic activity takes place at the level of the individual. It is individuals obtaining additional loans and spending the proceeds, it is individuals changing their demand for money, it is individuals responding to changes in interest rates and the rate of profit, etc. Analysis of these phenomena is a separate task. Nonetheless, highlighting these two important variables and how they affect spending is a significant contribution of the equation of exchange to understanding the business cycle and economic activity more generally.

Prices vs. Spending

In the review, exception is taken to the claim made in the exposition of ABCT in the book that the focus should be on changes in spending in the economy as the cause

of the business cycle. In the review, it is emphasized that we should be focusing on prices. It states in the review, "business cycles are the result of malinvestment which has to do with relative prices . . . ." (p. 386) In connection with profitability, it is stated in the review that, "what matters for profitability is not the volume of spending or revenues *per se*, but the gap between the price of products and the sum of the prices of factors used to produce those products. This gap can continue to be positive even if the total quantity of spending falls." (pp. 396-397, emphasis in original) Let us consider why the important variable is spending, not prices.

First, prices are not primaries. They are determined by supply and demand in the marketplace. Demand is determined by spending. For example, the greater the spending for a good, the greater the demand. Spending in the economy is determined by the supply of money. The important variable, in the context of the business cycle, driving prices is spending. This is true whether we are discussing an aggregate level of prices or the prices of individual goods. All of this is discussed in the book (vol. I, pp. 9, 22-25, 60-61, and 72-73)

Moreover, when businesses are considering whether to invest their focus is on profitability on the income statement. Profitability is determined by revenues and costs. Revenues and costs both result from spending. Revenues represent spending for the goods produced and sold by businesses. Costs are determined by the spending by businesses for factors of production. So, the focus of investors is on spending through profitability, revenues, and costs.

While it is true that revenues and costs represent, respectively, the sum of the prices obtained for the individual units of products sold and the sum of the prices paid for individual units of factors of production, the focus of businesses when determining the profitability of an investment is primarily on revenues and costs, not prices. As long as the prices of the goods sold and factors purchased have a profitable relationship to each other—and this occurs independently of the business cycle in order for industries and businesses to be viable in the long run—profitability will move with changes in spending. This is especially true given the historical nature of costs, but is true even if we ignore this aspect of costs.

Let me provide an example to address a specific scenario discussed in the review: prices remaining constant so that the gap between the prices of products sold and the prices of factors remains constant, while at the same time the money supply and spending fall. If revenue for a business is initially 100 and costs are initially 95 for profits of 5, if due to a decrease in the money supply spending falls by 10 percent and both revenues and costs for this business decrease by the same amount that spending in the economy in general falls, profits will decrease to 4.5 for this business (i.e., 90 – 85.5). Here we see that profits decrease with a change in spending and *no* change in prices and thus no change in the gap between selling and buying prices.

Taking into account the historical nature of costs, costs will decrease less than revenues and profits will change even more than 10 percent. This occurs because,

while costs on account of variable inputs (such as materials and labor) will decrease along with revenue, costs on account of fixed inputs (such as plant and equipment) will remain constant if no fixed inputs are completely used up during the period under consideration, no new fixed inputs are purchased, and straight-line depreciation is used. Assuming that variable costs and fixed costs are initially equal, this implies that, instead of a profit, the firm incurs a loss of 0.25 after spending decreases (i.e., 90 – [42.75 + 47.5] = -0.25). Note that variable costs decrease here from 47.5 to 42.75 and fixed costs remain constant at 47.5. So, profits not only decrease by more than 10 percent but actually turn to losses. Again, all of this occurs with *no* change in prices and thus no change in the gap between selling and buying prices. Changes in profit in these examples occur due to changes in the number of units of the good sold. The same would be true, mutatis mutandis, with increases in spending. For the details of how this all occurs, see the relevant discussion in the book. (vol. I, pp. 33-34 and 61-72)

Given the change in overall spending and the changes in the profitability of individual industries and firms that will result, malinvestment can result with no changes in prices. Add to this the effects from changes in interest rates and the malinvestment will be that much worse. Even so, all of this can still occur with no change in the gap between selling and buying prices. The key is that one needs changes in spending and interest rates, not changes in prices (whether relative or otherwise), to get the business cycle. All of this is discussed in the book. (vol. I, pp. 71-72, 75-76, and 98) Of course, changes in relative prices do typically occur and provide additional forces driving the cycle. This is also discussed in the book. (vol. I, p. 72)

Keynesian Fallacies

It is claimed in the review that as long as prices are flexible in the downward direction, a recession will not occur. To quote from the review: "he [Simpson] . . . identifies the cause of recession as 'a decline, less rapid increase, or less rapid acceleration in spending' (II. p. 17). This is not correct, as long as prices are flexible downward . . . ." (p. 392) In making this statement, the Keynesian fallacy that recessions are caused by "sticky" prices and wages is embraced in the review.

It is shown in the book that even if prices and wages fully adjust to changes in aggregate demand or spending, both expansions and recessions will still occur. This is due in part, as discussed above, to the amplified changes in the rate of profit caused by the historical nature of costs. This causes the rate of profit to move more than prices. Moreover, the cycle occurs because prices adjusting fully does not eliminate the incentive to expand or contract provided by changes in interest rates and the ability to pay off debt. For example, focusing on a recession, since this is the episode specifically referred to in the review, when interest rates rise (as they generally do in a

contraction), this raises the cost of borrowing (in real terms), which makes it harder to maintain one's business activity at its current level. Also, decreased revenues during the contraction make debts taken on in the past, when spending and revenue were higher, harder to pay off because there is less revenue available to make one's debt payments. The same is true, mutatis mutandis, for expansions. This is all discussed in the book. (vol. I, pp. 54, 70-71, 126-128, 153-156, 195-196, and 235-237)

Moreover, it is claimed in the review that "he [Simpson] mistakenly indicates that Keynes and the Keynesians' solution for recession is to boost consumption spending . . . ." (p 386) This is no mistake. It is common knowledge that Keynes and Keynesians prefer consumption as the solution to recessions (and to promote alleged economic health, in general). Their advocacy of consumption is seen in their desire for increased government spending to "stimulate" the economy during a recession. As is shown in the book, the government is a giant consumer. (vol. I, pp. 40-42) Their preference for consumption is also seen in the "Keynesian Multiplier." Through the use of this "multiplier," they discourage saving because saving is seen as a "leakage" from the economy. They encourage consumption spending because, according to the "Keynesian Multiplier," consumption leads to even greater increases in spending, relative to the initial increase in spending, through the so-called marginal propensity to consume. Keynes himself promoted consumption as the best means to lift an economy out of a depression. He considered this the best way because, according to Keynes, it does not put downward pressure on the marginal efficiency of capital (i.e., the rate of profit on new investment), as additional investment spending allegedly does. The book provides ample evidence of Keynes's preference for consumption over saving and investment through extensive quotations of Keynes. It also provides a thorough refutation of both the "Keynesian multiplier" and Keynes's ideas related to the business cycle. (vol. I, pp. 46-56 and vol. II, pp. 17-43)

The Average Period of Production

The review also raises an objection to the use in the book of the average period of production to represent the structure of production. Austrian economists have generally rejected the use of the average period of production because a satisfactory method of measuring it has not been provided. However, George Reisman has supplied us with a means of measuring the average period of production. This makes it possible to use it to assess the capital intensiveness of the structure of production. Reisman states that "[o]ne can express the concept of the average period of production or the length of the structure of production in terms of how many years must elapse before some given percentage of the capital goods and labor in existence in a base year will have ended up directly or indirectly serving in the production of consumers' goods." (Reisman, 1996, p. 822)

To illustrate how to measure the average period of production, he uses an example with a simplified economy in which the capital goods and consumers' goods available at the beginning of the year are consumed entirely in that year and each stage of production is equal to one year in length. In addition, the goods produced in the economy all require the same proportions of capital goods and labor to produce them. Given these assumptions, and the further assumptions that the capital goods and labor are used each year to exactly replace the capital goods consumed each year and produce equal values of consumers' goods and capital goods (i.e., production consists of 50 percent capital goods and 50 percent consumers' goods), the average period of production for 90 percent of the capital goods available in a base year to directly or indirectly serve in the production of consumers' goods is between three and four years. This is the case because 50 percent of the capital goods available in the base year (call it Year 1) directly serve in the production of the consumers' goods produced in that year. In addition, 25 percent of the capital goods available in Year 1 produced the half of the capital goods available in Year 2 that produced the consumers' goods of that year. Continuing with the example, 12.5 percent of the capital goods available in Year 1 produced 25 percent of the capital goods in Year 2, which, in turn, were used to produce the half of the capital goods that produced the consumers' goods for Year 3. This means, in three years, 87.5 percent of the capital goods and labor available in Year 1 were used directly or indirectly to produce consumers' goods. Following the same procedure, 6.25 percent of the capital goods available in Year 1 indirectly produced the consumers' goods available in Year 4. Hence, in four years 93.75 percent of the capital goods and labor available in Year 1 directly or indirectly served to produce consumers' goods. So, the average period of production or the length of the structure of production is between three and four years.

With a more capital-intensive economy, the average period of production or the length of the structure of production increases. To represent a more capital-intensive economy, Reisman uses an example in which the capital goods and labor existing at the beginning of each year are used to produce a value of capital goods each year that is 50 percent greater than the value of consumers' goods. Hence, the value of what is produced comprises 60 percent capital goods and 40 percent consumers' goods each year. In this case, the average period of production is lengthened to between four and five years. (Reisman, 1996, pp. 820-824)

The above procedure applies under some very limiting simplifying assumptions. As a result, Reisman also provides an alternative method for measuring the average period of production under more realistic conditions. The description of the alternative method is too lengthy for this paper. However, one gets an idea of how the average period of production or structure of production can be measured from the simplified example. Here I merely direct the reader to the relevant discussion on the alternative method. (Reisman, 1996, pp. 639-641, 647, and 843-854)

Value

Issue is also taken in the review with the claim in the book that gold has objective, not subjective, value. It is stated in the review that the discussion in the book on this topic is imprecise, misleading, and confusing. (p. 397) No mention of why is provided. Nonetheless, Ritenour and I have a fundamental disagreement on the nature of value because he believes value is subjective, not objective. (p. 396) This is probably the reason for the criticisms in the review.

It is discussed in brief terms at a couple of points in the book why gold money has objective value. (vol. II, pp. 159-160 and 232-233) Why values, in general, are objective and not subjective can only be understood as an implication of the discussion of gold as objectively valuable. Discussing the objectivity of value would have taken the book away from its central purpose: to understand the causes and cures of the business cycle. So, I will elaborate here in brief terms why values are objective.

There are three theories of value: the subjective, intrinsic, and objective. The subjective theory of value says that the value of something is determined by the subject—the person doing the valuing—independently of the object being evaluated. For example, according to the subjective theory of value, an object is of value merely because someone feels it is of value or wants it to be of value. Based on this theory, if a person feels that snorting cocaine is of value, then it is of value. The effect that the object has on a person's life and well-being does not matter.

Obviously, something is wrong here. Just because someone might feel something is beneficial to his life will not make that thing of value if, in fact, the object—the item being evaluated—is destructive to his life. One cannot wish reality into existence. So, cocaine is not a value even if one feels it is. It is not of value because of the effects it has on human life, which we can identify through an assessment of the facts based on a rational standard, including the requirements of human life.

Nothing changes if we substitute a group for the individual. That is, social subjectivism is false as well. For example, a group of people—even an entire nation—may want socialism to be of value to human beings. However, their wishing does not change the nature of socialism. Regardless of how many people think socialism is good, it is destructive to human life, and we can identify why it is destructive through a logical analysis of the facts pertaining to socialism and the nature of human life.[5]

The intrinsic theory of value says that the value of something is determined by the object being evaluated independently of the person doing the valuing. This means, for example, that an object is of value by the mere fact of its existence. One variant of this theory—the labor theory of value—says the value of a good is determined by the amount of labor required to produce it. Based on this theory, square wheels are as valuable as round wheels if the labor required to produce them is the same. As with the subjective theory of value, this theory ignores the effects of the object being evaluated on the valuer. It ignores the relationship between the object being evaluated and

the person performing the evaluation. Using rational standards, including the benefit of means of transportation to human life and the requirements of those means of transportation, we can determine that square wheels have no value and round wheels have substantial value.

So, value is not determined by the person doing the valuing independently of the object being evaluated and it is not determined by the object being evaluated independently of the person doing the valuing. Value is determined by an assessment of the relationship of the object being evaluated to the person doing the evaluating. That is, value is objective. It is important to understand here that the relationship of the object to the subject must be rationally assessed. It is also important to understand that a rational evaluation does not consist of, "I feel this object is of value." One has to look at the nature of the object being evaluated and determine whether the effect it has on the person doing the evaluating is beneficial or harmful. Furthermore, what is beneficial and harmful must be determined based on rational standards. What is beneficial and harmful to human life is not arbitrary. Human life has a certain nature and thus has certain requirements. To determine objectively whether something is of value one must evaluate the relationship of the subject to the object based on a logical analysis of the facts. This is what it means to use rational standards.

This discussion provides an indication of the objective nature of values. The nature of value is an enormous subject and cannot be discussed in detail in this paper. There are many aspects of this subject to understand. For instance, why are both universal and optional values objective (for example, both food and specific types of food, such as liver and onions, are objectively of value)? What, specifically, does objective thinking consist of? What is the status of pseudo-values (what Carl Menger called imaginary goods [Menger, 1994 [1871], pp. 53-54])? Why are prices objective measures of value? All of these questions, and many, many more, cannot be answered here. One must turn to other works for a more detailed exposition of the objective nature of values. (such as Peikoff, 1991, pp. 241-249 and Rand, 1967, pp. 21-28)

Miscellanous Issues

There are a few other issues in the review of *Money, Banking, and the Business Cycle* worth addressing. First, exception is taken in the review to the second-best policy discussed in the book whereby, in response to the cycle, the government makes sure the money supply does not shrink. In the review it states, "It is especially hard to make sense of his [Simpson's] call to not let the money supply fall, as if it is the job of the central bank to maintain an optimal . . . money supply." (p. 390) However, it is easy to make sense of this policy suggestion given that it is a *second*-best solution. The discussion in the book on this topic is set within the context of the best policy—achieving a laissez-faire capitalist society in the U.S.—not being a possibility, given

the U.S. government's desire today to interfere in the economy. Given this context, what is the best policy we could expect the U.S. government to engage in? That policy is to maintain the money supply and deregulate the economy. (vol. I, pp. 136-137) It is as if the desire being expressed in the review is to have the best solution not only as the first option, but as the second-best option as well. That, certainly, does not make any sense.

It is also claimed in the review that there is a contradiction in the book regarding protecting the right of banks to engage in fractional-reserve banking. It is claimed in the review, in essence, that the viewpoint expressed in the book is that fractional-reserve banking is both fraudulent and not fraudulent. (p. 395) This is claimed in the review because it is stated in the book that fractional-reserve banking is not inherently fraudulent. It can be engaged in openly, with full knowledge of all the parties involved. (vol. II, pp. 126-130) However, a quotation from the book is also provided in the review that states that banking is one of the easiest industries to commit fraud in because it is easy for bankers to secretly lend reserves they are contractually obligated to keep on hand. If the next sentence from the book had also been quoted, after the sentence from the book that was quoted in the review, one would see that it is also stated in the book that, "If governments had protected individual rights (and in many cases not been an accomplice in the fraud), this practice would have been stopped . . . ." (vol. II, p. 216) Just because it may be easy to commit fraud in an industry does not mean that everyone in the industry is engaging in fraud. Wanting to impose 100-percent reserves on the banking industry because there is the *potential* for bankers to commit fraud is, in essence, the same argument that statists use to justify regulation. They claim we must regulate to, for instance, prevent people from harming others by building unsafe products. Statists also seek to outlaw the ownership of guns because guns could *potentially* be used to commit murder. This argument, whether with regard to banking or regulation in general, assumes people are guilty until proven innocent and is a slippery slope toward a police state. To protect rights, one must have evidence that specific individuals are engaging in fraud before preventing them from engaging in an activity. The mere potential of fraud is not an appropriate justification to outlaw the activity.

It is also claimed in the review that I contradict my argument that fractional-reserve banking is not inherently fraudulent when I state that it is an attempt to cheat reality because it is an attempt by people to have their money and lend it at the same time. While the review claims that cheating reality "could allude to philosophical inconsistency," it also states that "cheating implies fraud." (pp. 395-396) But the term "cheating reality" is obviously being used metaphorically in the context in which it is used in the book. It means that one is attempting to get away with a contradiction. To commit fraud, one must not attempt to "cheat reality." One must cheat another person. The review equivocates between the metaphorical meaning of "cheat" and the literal meaning. There is no contradiction in the two claims made in the book that the review refers to here.

In addition, it is stated in the review that a naïve suggestion is made in the book in the call for restrictions to be included in the U.S. Constitution on what the government can do in connection with the monetary and banking system. It is claimed this is naïve because the U.S. Constitution does not currently provide the U.S. Congress with the power to charter banks, but this has not stopped it from chartering banks and interfering in the monetary and banking system in other ways. (p. 394) However, there is a major difference between placing explicit restrictions in the Constitution on what the U.S. government can do and the Constitution remaining silent on what the U.S. government can do. If the U.S. Constitution remains silent in a particular area, statists can use provisions in the Constitution that endorse government interference more generally, such as the Commerce Clause in Article I, Section 8 (which gives the government the power to regulate commerce), to justify government interference in that area. In the area of money and banking, unfortunately, the U.S. Constitution is not silent. The Coinage Clause, also in Article I, Section 8, gives the government the power to coin money and regulate the value thereof. Explicitly restricting what the U.S. government can do with regard to money and banking (and, as a part of this, repealing provisions of the Constitution that allow the U.S. government to interfere in the monetary and banking system, such as the Coinage Clause) would provide much stronger protection of a free market in the monetary and banking system in the U.S. There is nothing naïve about that.

Finally, an objection is raised in the review to the claim in the book that a decrease in the money supply caused the downturn in 1938 in the U.S. It is stated in the review that, "His [Simpson's] only stumble is his unfortunate buying into the monetarist notion that a decrease in the money supply in 1936-1937 led to the recession in 1938 . . . ." (p. 391) This is a bizarre claim considering the fact that one of the main claims throughout the book is that *all* recessions and depressions are due to manipulations of the supply of money. It is stated in the book that expansions are caused by accelerating increases in the supply of money and credit and this leads to recessions and depressions when the supply of money and credit are either not increased at a great enough rate or they are actually decreased. In every empirical chapter pertaining to the U.S., a graph of the changes in the money supply is included in the section on the causes of the cycle. There was no objection in the review to this claim in connection with all the other recessions and depressions discussed in the book. How is the contraction that occurred in 1938 fundamentally different than any of the other contractions in the U.S. from 1900 to 2010? I will grant that there were various regulations imposed by the administration of President Franklin D. Roosevelt that made this downturn worse than it otherwise would have been (as it is also argued in the case of the Great Depression).[6] However, the fundamental cause, as in all recessions and depressions, was a change in the money supply caused by government policy.

Conclusion

In the review of *Money, Banking, and the Business Cycle* analyzed in this paper, there are many errors and a number of inaccurate claims made about the content of the book. For example, the discussion in the book on time preference and its relation to the business cycle is mischaracterized. The view of inflation in the book is mischaracterized and there is a failure on the part of the reviewer to understand the significance and importance of the equation of exchange. A lack of understanding of the relationship between spending and prices, especially their causal roles in the business cycle, is also demonstrated. In addition, a Keynesian fallacy is embraced in the review. There is a failure to understand many of the arguments made in the book. It is important to make sure one understands the arguments in a book one is reviewing before one writes the review. It is also important to make sure one accurately deals with those arguments in one's review of the book. This did not occur in this case.

There are many other errors in the review. The analysis here and in an earlier paper (Simpson, 2017) of the errors in the review provide a good understanding of the errors in the review and enable the reader to learn a great deal from those errors.[7] I encourage people not to ignore or dismiss the arguments in the book simply because they might be different from the arguments that have been made by other economists. If one does not merely dismiss the arguments because they are different, one will see that the ideas in the book improve our understanding of the business cycle and economics more generally.

NOTES

[1] For subsequent references to Ritenour's review, I will only refer to the page number.

[2] For subsequent references to my book, I will only refer to the volume and page number.

[3] For an indication of this relative effect, see vol. I, pp. 115-120, 122-126, 143-146, 148-152, 188-190, 192-195, and 221-234.

[4] For the link between the inflation of the money supply and these effects, see vol. II, pp. 226-231.

[5] On the destructive nature of socialism, see Simpson, 2005, pp. 5-23.

[6] On some of the government interference during the Great Depression, see vol. I, pp. 202-218.

[7] The earlier paper analyzes errors separate from the errors analyzed in this paper.

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