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Response to Chris Leithner's review of Money, Banking, and the Business Cycle

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In his review of my book *Money, Banking, and the Business Cycle*, Chris Leithner states that my major conclusions are sound but my methods are not.[177] He spends much of his review illustrating the differences between my epistemological methods and those of the Austrian school of economics. I agree with him that there are major epistemological differences between the Austrian school and me. However, his review doesn't illustrate my errors—as he thinks—it reveals the errors of the Austrian school.

Before discussing the more fundamental errors, I must reveal Leithner's factual errors regarding the claims he makes about the content of my book. For example, he claims that I don't define money market mutual fund (MMMF) and money market deposit account (MMDA). However, in the same paragraph from which he quotes a statement that I make about MMDAs and MMMFs being a part of the money supply (volume 1, page 11), I define those terms. I provide further explanatory matter on the nature of MMMFs on page 18.

The second error occurs when Leithner says I neither provide nor cite estimates for the portion of MMMFs that have check-writing capabilities on them. He says this while quoting me from page 11. On page 13, in the discussion where

177 Chris Leithner, 'Book Review – Money, Banking and the Business Cycle' (2014) 3 *Journal of Peace, Prosperity and Freedom.*

I provide estimates for different measures of the money supply, are the very estimates Leithner claims I don't provide. Note 6 on that page directs the reader to the citation (on page 247).

The last error of this kind occurs when he says that I retreat from my claim that MMMFs and MMDAs are a part of the money supply, after I had already claimed that they were. He says this because on page 11 I say they "are a part of the money supply, with some qualifications." However, there was no retreat. Apparently Leithner missed the statement on page 10—where I first introduce MMMFs and MMDAs and mention they are a part of the money supply—that says "I discuss qualifications . . . below".

There are more significant errors that Leithner commits that do not pertain to his reading comprehension abilities. These errors pertain to the methodology of the Austrian school.

The difference in methodology between the Austrian school and me begins to be revealed when Leithner states that my identification of the monetary components in the economy is not validly reasoned from the definition of money. Leither's implicit view here appears to be: define the concept first and then see what referents are subsumed by the definition. However, this has it backwards. Valid definitions are based on the essential characteristic(s) of a concept: the one(s) that make it the kind of thing it is and best distinguishes it from other concepts. We identify these characteristic(s) through observation.

How does one arrive at a proper definition without reference to the characteristics of the referents of that concept? What facts are used to ground the definition and concept in reality? Is one supposed to define the concept arbitrarily? If so, then money could be defined as a recreational vehicle with four wheels. If one applied this method consistently, one could define concepts in any manner whatsoever. This would lead to intellectual chaos.

Based on his description of what is to be done, one could not establish a valid definition. The fact that Austrians have established some valid definitions is because, at least implicitly, they are using the proper method of defining concepts that I mention here.

Where I share common ground with Leithner is on the issue of applying the definition to identify new referents that are subsumed by the concept. This is done after one has defined the concept by identifying its essential characteristics. This is how one determines the components of the money supply, and this is precisely what I do.

Leithner also thinks I have difficulty establishing a measure of money because I don't reason validly from the definition of money. However, it's not difficult for

me to establish a measure of money because I'm not properly applying the definition. It's difficult because sometimes it's not easy to determine how many people use certain accounts as money (i.e., to write checks on) and how many do not. Furthermore, sometimes the data are not reported. Therefore, it's difficult to obtain the data one needs to measure the money supply. It's made more difficult in a heavily regulated, fractional-reserve checking system in which the lines are blurred between accounts used as money and accounts used for saving and investing. However, even in a free market data on money may be difficult to obtain to the extent the data aren't widely collected and reported.

Leithner's complaint about my inability to provide a precise measure of the money supply is essentially a complaint that it's sometimes difficult to collect data and measure accurate values. This isn't a legitimate complaint. It's easier to collect data if one has a massive budget to do so, which is what government data collection agencies have. So if one is using standard data in one's research that is collected by the government, it's more likely that one will be able to obtain accurate data. However, if one wants to use non-standard data and has a budget of zero (like me), it's much more difficult to obtain precise measures.

Leithner also rejects the claim that MMMFs are money. In his analysis of why MMMFs are not money, he becomes confused by the use of the term "securities" to categorize MMMFs and by the belief of some Austrian economists that money can only include the means of "final payment" for goods. Because MMMFs are securities that provide a claim to ownership in short-term credit instruments, he thinks they are not money. Nonetheless, as I state in the book (volume 1, page 18), there is no fundamental difference (in terms of their influence on the money supply) between shares of ownership in short-term credit instruments and being a creditor to a bank where the majority of the account at the bank to which the creditor has a claim is backed by credit instruments (i.e., is a fractional-reserve checking account).

When the MMMF manager receives money, he purchases short-term credit instruments and maintains a checking account at a bank to transfer funds. When one deposits money in a checking account at a bank, the bank will use some of the reserves to make loans and purchase short-term credit instruments. The result is essentially the same: one has an account on which one can write checks that is only partially backed by reserves. In both cases, ultimately, credit instruments are turned into reserves to pay recipients of checks.

The indirect process used by MMMFs to transfer funds does not deny that they are money. In other words, it doesn't matter that the MMMF is not the final

means of payment. Being a final means of payment is not an essential characteristic of money. As proof of this, note that checking deposit funds are not the final means of payment when the payee is an MMMF account holder. They must be converted to the asset the MMMF account holder receives as payment.

In another attempt to prove that MMMFs aren't money, Leithner uses the fact that at a grocery store, for instance, units of an MMMF wouldn't be accepted in payment without the use of a check drawn on the MMMF. However, units of a checking deposit would not be accepted either. I challenge Leithner to pay for groceries with checking account funds without writing a check.

MMMFs become a part of the money supply through the pyramiding of reserves. The pyramiding of reserves occurs when gold reserves are held by the central bank to back paper-money reserves at commercial banks in excess of the gold. The commercial banks then create checking deposits that exceed the paper-money reserves. Reserves of rural banks may also be held at city banks and used to back checking deposits at the rural banks that exceed the reserves at the city banks. Since they have checking deposits at banks, MMMFs are essentially in the same position as the rural banks.

Toward the end of his review, the fundamental philosophical disagreements between the Austrian school and my own epistemological views are made sharper. Leithner says I am an "anti-a priorist." He is right to say this. There is no knowledge independent of experience. Where does this knowledge come from? Leithner states that the fundamental knowledge is inscribed in our minds. He makes reference to the Bible and says it is like knowledge being written into our hearts by our Creator.

When one makes reference to the Bible and mystical beings in an attempt to prove his case in matters regarding the nature of the world, it's a sure sign of intellectual bankruptcy. The Bible *was* used at one time in such matters. It was the standard "scientific" reference manual—to be referred to as the ultimate arbiter in "scientific" disputes—during the medieval period. It's no accident that this period isn't known for the advancement of science and knowledge. Fortunately, Austrian economists don't generally make reference to mysticism when making their arguments. However, such references are consistent with "a priorism".

The mystical analogy used by Leithner is apropos because it highlights the essence of what an a priori belief in knowledge leads to: the arbitrary. If one believes "knowledge" is gained apart from observation, then anything goes. We can believe in mystical beings even though there is no evidence for such beliefs and despite the fact that such beliefs contradict the evidence.

In a positive sense, I'm an Objectivist. This means I recognize the validity of the philosophy of Ayn Rand. This philosophy demonstrates that all knowledge must be grounded in the facts of reality. That is, induction is the primary method to gain knowledge.

Nonetheless, induction is not the only method that can be used to gain knowledge. For example, economic analysis primarily involves the deductive application of fundamental principles, which I discuss briefly in the book as it pertains to business cycle theory (see volume 1, pages 4-5). But note that the fundamental principles are not known *a priori*. If they are not grounded in the facts, they are just mere arbitrary assertions: assertions without evidence. What makes them "indisputable first principles," to use Leithner's words, is that they are based in the facts of reality, not merely asserted arbitrarily.

Even the axiom of human action is grounded in the facts of reality. For example, valid concepts (which include the concept "human action") are formed through integrations of perceptual data and thus are grounded in the facts. Also, we understand human nature (a part of the facts of reality) through observation, both through introspection and observations of others. Human nature, of course, includes the need to act to further our lives and well-being. In addition, we refer to the facts to determine the effects our actions have on the world. While axioms are self-evident, and thus require no proof to validate them, this doesn't mean they aren't grounded in the facts of reality.

One major error that contributes to Leithner's acceptance of invalid views about how knowledge is acquired is his belief that the senses are fallible. This isn't true. The senses give us the raw data about existence. They are the base of all knowledge and the precondition of all proofs. It's our conceptual interpretation of sensory data that can be in error. One of the classic examples of the alleged fallibility of the senses is that of the stick that appears to be bent when placed partially in water. The senses merely respond to stimuli; they don't interpret their own reactions. It's up to the perceiver to determine at the conceptual level that the stick is not, in fact, bent but only looks so because of the different speeds at which light travels in different mediums.

Even sensory data from the eyes of a color-blind man are valid. There is no contradiction between the observation by a color-blind man that something is gray and a man who perceives the same object as red. They are both observing an aspect of reality. The type of sensory mechanism one possesses (or the capabilities of a given sensory mechanism) changes the form of the data one obtains, but it's still data about reality. Again, it's up to the perceiver to determine what the data mean.

That the senses are necessarily valid is an inescapable truth. One has to accept their validity in any attempt to deny it. If one is going to show that they are not valid, how else will one do it except by reference to evidence provided by the senses? On these and the other fundamental issues I have discussed, see Leonard Peikoff, *Objectivism: The Philosophy of Ayn Rand*, chapters 1-5 and his essay "The Analytic-Synthetic Dichotomy" in the second edition of Ayn Rand's *Introduction to Objectivist Epistemology*.

Lastly, Leithner asks whether Austrian business cycle theory (ABCT) can exist without Austrian methodology. This is the wrong question to ask. It implies that the validity of ABCT hinges on the method that is used to validate it, regardless of whether ABCT agrees with the facts of reality and can explain some aspect of the world. The proper question to ask is: Is ABCT valid? That is, does it make sense logically and explain and thus help us understand the world? The answer is: yes. It is a theory that is proved through deduction *and* is grounded in the facts of reality, as I state in the book (volume 1, pages 4-5). All valid Austrian economic ideas—and valid ideas in any other field—must be grounded in the facts.