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Money, Banking and the Business Cycle (Vol. 1: Integrating Theory and Practice; Vol. 2: Remedies and Alternate Theories)

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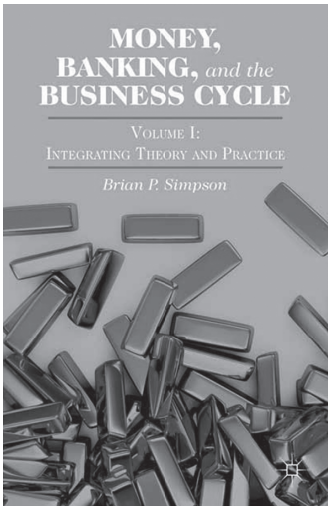


What causes recessions, depressions and financial crises? Most people (especially, it seems, influential mainstream economists and powerful central bankers) believe that the business cycle is an endemic feature and innate characteristic of today's allegedly "free-market" economy. Unrestrained capitalism, they insist, is inherently unstable. Accordingly, if not chaperoned by responsible adults – namely conventional economists and incumbent central bankers – it'll eventually run off the rails and perhaps crash. Our rulers diagnose slumps and crises as inevitable consequences of the failure of markets; hence as "cures" they prescribe constant and ever more pervasive intervention in the market – i.e., increasing doses of the state's fiscal and monetary policies, legislation and regulations.

Simpson's two volumes add to a large and growing literature that demonstrates that our anointed rulers are diametrically wrong, and that their misguided ideas and actions greatly harm their benighted subjects. Recessions, depressions and financial crises are not consequences of the market's failure, but of the government's failure. Specifically, the business cycle results from the state's debasement of money and bastardisation of banking. More specifically, and in Simpson's words, "it is the government's manipulation of the supply of money and credit through the fiat-money system and fractional reserve [banking] system that is responsible for the cycle today."

Simpson's major conclusion is correct: the Austrian business cycle theory (ABCT) explains the causes of the business cycle. Indeed, and as Simpson also rightly concludes, "the ABCT is the only theory that provides a comprehensive and logically consistent explanation of the cycle". The crux of Simpson's solution, too, is correct: the mitigation of the business cycle and the elimination of financial crises entail the abolition of the government's interference –particularly the legislation that entrenches fiat money and fractional-reserve banking. Part I of volume 1 comprises theory (the basics of money, banking and inflation; how the government causes inflation; the causes of the business cycle and an outline and defence of ABCT). Part II applies the theory to the 18th century, the business cycle in the U.S. from 1900 to 1965, the Great Depression, the recession of the early 1980s and the ups and downs since the 1990s. Part I of volume 2 refutes alternate theories of the business cycle and criticism of the ABCT, and Part II outlines Simpson's cure (namely the removal of fiat money and fractional reserve banking, of a gold standard and 100%-reserves, and the transition to a free market in money and banking).

These two volumes contain considerable strengths. Simpson's diagnosis gets most of the big things right. His prescription, like those of other studies which draw similar conclusions, would, if pursued, make the world better place. Not only would economies be more stable and generate sound growth: governments would be much smaller and weaker, and hence people would be much richer and freer. Yet Simpson's two volumes also contain significant weaknesses. He muddles several important things (like fractional reserve banking) and gets a significant number of subsidiary things wrong. Ironically, the cause of these weaknesses is his rejection of *a priori* – that is, characteristically Austrian School – reasoning. Can there be such a thing as Austrian economics and the ABCT without Austrian methods? Before I read Simpson's two volumes I doubted it; after I read them my misgivings deepened.

Simpson's definition and analysis of money exemplifies these weaknesses. Chapter 1 of volume 1 ("Money, Banking and Inflation") begins with a definition. "Money," he says (p. 9), "is an asset readily acceptable in exchange in a given geographic area and is sought for the purpose of being re-exchanged". That's a good start. "It is changes in the money supply that drive the business cycle," he continues, "so one needs to know what the money supply is composed of to understand how it changes and how it causes the business cycle". Not so fast: in order to describe clearly the composition of the supply of money, one must first reason validly from the definition of money. Although he doesn't cite him, Simpson's definition echoes the crux of Ludwig von Mises's. In *Human Action* (1949, Chapter 17, Section 1), Mises, who in the first (German-language) edition of *The Theory of Money and Credit* (1912) originated the ABCT, defined money as a "commonly used" medium of exchange. Murray Rothbard, in his 1978 essay "Austrian Definitions of the Money Supply," notably added that "money is the general medium of exchange, the thing that all other goods and services are traded for, *the final payment for such goods and services on the market* (italics added)".

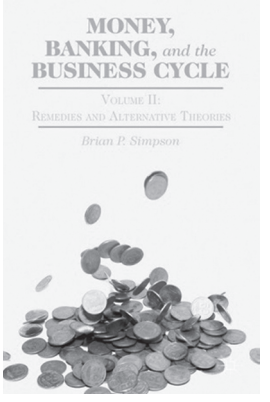
"The first purpose of scientific terminology," said Mises in *Human Action*, "is to facilitate … analysis …" In this respect Simpson stumbles badly. The problem is that he (unlike strict *a priorists* such as Mises, Rothbard and Hans-Hermann Hoppe) doesn't deduce from this and other key definitions. As a result, he wanders repeatedly into needless complexity and outright error. In the first paragraph of page 11 (vol. 1), for example, he states that money market deposit accounts (MMDAs) and money market mutual funds (MMMFs) – neither of which he defines – "are a part of the money supply". And on page 17 he adds: "Also, it should be clear that traveler's cheques are a part of the money supply since they are used as a medium of exchange. One does not need to first convert them into anything before they can be used to purchase goods and services". In the second paragraph of page 11, however, he retreats:

> [MMDAs] are part of the money supply, with some qualifications. They are a part of the money supply to the extent that depositors use them as a medium of exchange. It is generally believed that MMMFs are used more often as a medium of exchange than MMDAs … Estimates [which Simpson neither provides nor cites] have been made for the portion of MMMFs that have cheque-writing capabilities on them. I use this to estimate the portion of MMMFs that should be included in the money supply … What portion of MMDAs to include in a measure of the money supply remains open to debate…

Got that? Alas, on page 14 things become even more opaque:

> It is difficult to say exactly what portion of MMDAs and MMMFs are used as a medium of exchange. … Perhaps the best estimate of what portion of MMDAs are held as savings deposits are those MMDAs for which cheques (or debit cards) are never ordered. One could say the same for MMMFs. However, such data cannot be obtained. Given the data that exist, the most accurate statement I can make is that the money supply is closest to M1 plus MMMFs on which cheques can be written, the portion of "commercial" sweep accounts not swept into MMMFs, and "retail" sweep accounts.

Having likely bewildered the general reader, Simpson then capitulates: "As one can see, establishing a measure of the supply of money is not easy". It's difficult for Simpson because he doesn't reason from his definitions. If he did, he'd realise that units of MMMFs are securities, securities are not money and therefore that units of MMMFs are not part of the money supply. An MMMF is a managed investment vehicle that issues units of ownership in exchange for money. It then invests this money in (that is, exchanges it for) short-term credit instruments such as bank bills. An increased quantity of units doesn't – because it can't – increase the supply of money: the investor in an MMMF purchases units with money and redeems them for money; as a result of both transactions, the supply of money remains unchanged.



Some MMMFs allow their investors to write cheques. Yet there's a key difference – which escapes Simpson – between a cheque drawn on a bank and a cheque drawn on an MMMF: the former instructs a bank to transfer money from the cheque-writer's demand deposit account to the recipient's demand deposit account; the latter instructs an MMMF to reduce the cheque-writer's quantity of units and to increase by a corresponding amount the balance in the MMMF's demand deposit account. Unless the MMMF's portfolio contains sufficient money for this purpose, it must sell (say) bank bills for money. This money – the medium of exchange – then makes the payment that the cheque-writer has requested. The cheque drawn on an MMMF account obscures the fact that its

units are not means of final exchange; but this subtlety doesn't alter the reality that securities such as an MMMF's units are not money.[200]

Why are securities not money? Bearing Mises and Rothbard in mind, they're not a generally-accepted means of final exchange. Convince yourself by going to your local Coles supermarket, place (say) $288 worth of groceries into your trolley and proceed to the checkout. Then say to the checkout chick: "as payment, I propose to transfer to Coles the ownership of 288 units of an MMMF, each of whose units has a market value of $1". The probability is 0.99999 that the chick won't have the slightest idea what you're saying. She'll likely summon her supervisor – who also won't have the slightest idea what you're saying. One thing, however, will be perfectly clear: Coles won't accept your units as payment for the groceries. It's true that they'll take your cheque drawn on an MMMF – not because the units constitute money, but because the aforementioned indirect process of payment will ensue.

Neither units of MMMFs nor travelers' cheques are money; accordingly, neither can be components of the money supply. One such mistake should be forgiven; a number of them strewn throughout both volumes, however, becomes irksome – and a symptom of a deeper shortcoming. Significant numbers of Simpson's assertions are demonstrably wrong; they're wrong because he doesn't establish them deductively (if he tried, he'd find, as our example shows, that they're false); and he doesn't try to do so because he isn't an "a priorist" like Hoppe, Mises and Rothbard. Simpson's subject matter is characteristically Austrian, but his methods certainly aren't. Quite the contrary: he's an "anti-a priorist." On page 4 of volume 1 he tells us so:

> It is important to understand that what I describe … as necessary to develop business cycle theory is not rationalism [by which Simpson seems to mean *a priorism*]. Some people have a tendency to confuse deduction with rationalism. Deduction is the process of applying validated generalisations to make conclusions about other concrete phenomena and is an appropriate method of logic. The generalisations used in deductive reasoning are based on the

200 For similar reasons, Simpson is wrong about traveler's cheques. It's true, as he states, that they're commonly regarded (albeit by few Austrians) as an integral part of narrowly-defined money (M1). And (depending upon the country) some banks, hotels, etc., but certainly not all, will accept them; hence they're hardly a universal means of exchange. Further, as with units of an MMMF, so too with travelers' cheques: they're a claim upon the issuer's investment portfolio; hence they're not a final means of payment. The means of final payment – and hence the actual underlying money – is the demand deposit account of the traveler's cheque's issuer.

> facts, either directly or indirectly through inductive reasoning. Rationalism is an invalid form of deductive reasoning. It involves the attempt to explain phenomena using ideas not grounded in the facts of reality. … While induction is not the primary method used in developing business cycle theory, it is still used in understanding the nature of the business cycle and validating business cycle theory. … In the end, induction cannot be escaped since any valid conclusions must ultimately be based on observations.

According to Simpson, economic science is a collection of inductively-derived "facts"; according to Austrians, it's a set of principles deduced from indisputable first principles. As Mises devised it and Rothbard and others have extended and elaborated it, the ABCT follows *a priori* from the axiom of human action (plus a few corollaries). "A priori" means knowledge that comes before, and is true irrespective of, fallible sensory experience. Like the laws in Deuteronomy, which our Creator has written into our hearts, the axiom of human action has been inscribed into our minds. The study of human action (which Mises dubbed "praxeology") is thus a matter of self-examination and deduction rather than external observation and induction.

The axiom of human action is obviously and self-evidently true for all people, everywhere and at all times, and cannot possibly be untrue. We cannot, in other words, conceive of a world where man exists but does not act. Human action is self-evident in the sense that nobody can deny the truth of the axiom of human action. Why not? Any "denial" is itself an example of human action – and thereby affirms rather than contradicts the axiom! The laws of economics (including derivations such as the ABCT) are thus as necessarily true as the laws of geometry. Just as it's absurd to attempt to falsify the laws of geometry with data, and just as any attempt to do so belies a fundamental misconception of mathematics, it's also ludicrous to "test" empirically the laws of economics. Historical and statistical analyses can, of course, help to illustrate these laws, and thereby help us to understand them better: but they can neither establish nor disprove them.

Money, Banking and the Business Cycle possesses significant strengths and notable weaknesses. Simpson's application of the ABCT to decades since the 1980s is interesting, his refutation of its critics is very useful, and his proposals to cure the plague of boom and bust (to the extent, which is considerable, that they echo Hoppe's, Mises's and Rothbard's) deserve support. Embrace his major conclusions, doubt significant numbers of his subsidiary assertions and reject his methods.