Response to a Review of Money, Banking, and the Business Cycle

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ABSTRACT: Shawn Ritenour provides a review of my two-volume book Money, Banking, and the Business Cycle in the Winter 2016 issue of this journal. In his review, he provides a number of criticisms of the book and offers some compliments of the book as well. While I appreciate the compliments, most of the criticisms are not valid. In this response, I explain why it is that more money in the economy leads to more profits. I also show the difference between making a distinction between the rate of profit and the interest rate and saying they are independent of each other. Furthermore, I discuss the effect of changes in interest rates versus changes in the rate of profits. I discuss criticisms of Objectivist philosophy as well.

KEYWORDS: Austrian school, business cycle, net consumption-net investment theory of profits, profit, interest, Objectivism

JEL CLASSIFICATION: E14, E32

INTRODUCTION

I thank Shawn Ritenour (Ritenour, 2016) for his thorough review and compliments of both volumes of my book Money, Banking,
PROFITS AND THE MONEY SUPPLY

Ritenour states that a problem with my analysis is my claim that more money in the economy leads to more profits in the economy. He is fine with my claim that more money leads to more spending and revenue, but not with the connection between money and profits. He states, “Certainly more money leads to more spending and revenue. However, it is not clear at all that such spending necessarily leads to more profits. Profits are the difference between revenue and costs. If costs increase along with revenues... profits do not increase.” (Ritenour, 2016, p. 385 [emphasis in original])

Here he fails to address the extensive discussion I provide to show how it is that more money leads to more spending, revenue, and profits. (Simpson, vol. I, pp. 33–34 and 61–72) More money leads to more profits mainly because of the historical nature of costs. Costs reflect spending from the past and thus tend to adjust in a slower fashion to changes in the money supply and spending in the economy. Because of the historical nature of costs, when the money supply increases and causes spending and revenues to increase, costs do not increase as rapidly as revenues.

My discussion of how increased money and spending cause increased profits is based on George Reisman’s Net Consumption-Net Investment Theory of profits. (Reisman, 1996, pp. 228–229 and 719–774) Reisman provides significant accounting evidence and other forms of evidence to show the validity of this theory. His theoretical evidence is corroborated by the empirical evidence provided on the rate of change of the money supply and the change in the rate of profit in my book. (vol. I, pp. 126–129, 153–160, 195–198, and 235–240)

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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 Rothbard identifies the same phenomenon, although with Rothbard it is an idea in its infancy. (Rothbard, 2009, pp. 993–994) Reisman puts forward a fully developed theory.
Reisman and I provide a mountain of theoretical and empirical evidence regarding how profits change in the same direction as the money supply. Ritenour ignores this evidence. He merely asserts without proof that profits will not change with changes in the money supply. If he is going to claim that Reisman and I are wrong, he must show logically and factually why we are wrong. He fails to do this.

Note also that nothing I say above regarding the movement in aggregate profits in the economy denies or contradicts the changes in the structure of production that occur during the business cycle. As Mises has stated, new money is not spent uniformly throughout the economy. (Mises, 1966 [1949], pp. 412–413) The money can show up sooner in some areas of the economy and some areas of the economy may experience larger changes in spending and profits than others during the cycle. My empirical evidence indicates that capital goods industries and industries in general that are farther removed from final consumption experience larger changes in spending and profits than consumers’ goods industries and industries in general that are closer to final consumption. (vol. I, pp. 115–120, 144–146, 189–190, 221–223, and 225–230) This is consistent with the greater expansion and contraction of capital goods industries and industries farther removed from final consumption during the cycle that are predicted by Austrian business cycle theory (ABCT).

In addition, none of what I say is inconsistent with the profitability of individual entrepreneurs being based on their ability to have better foresight and be more innovative. Ritenour seems to think there is an inconsistency between aggregate profits being determined by the amount of spending in the economy and the profits earned by individual firms being based on entrepreneurial foresight. He states, “What matters [for profitability] is entrepreneurial foresight and not whether spending increases or decreases.” (p. 397) In fact, both matter.

Ritenour fails to see that both matter because he fails to distinguish between what determines the profits earned by an individual firm versus what determines the level of aggregate profits. As I have discussed, aggregate profits are determined by the aggregate spending in the economy. However, any individual entrepreneur can earn a larger portion of those profits by possessing
better foresight and being more innovative. So, individual entrepreneurs or business owners who are particularly innovative can earn much larger profits than the average entrepreneur or business owner in the economy. Alternatively, entrepreneurs and business owners who are not very talented might actually incur losses. These individual profits and losses will sum up to the aggregate level of profits in the economy. This is all made clear in Reisman’s discussion of his Net Consumption–Net Investment Theory of profits, which I refer to in my book.

CHANGES IN INTEREST RATES VERSUS CHANGES IN THE RATE OF PROFIT

Ritenour’s strongest objection pertains to my positive presentation of ABCT. He objects to my claim that slow and steady increases in the money supply will not generate the cycle because they can be incorporated into entrepreneurs’ plans. He also states that I argue “almost exclusively that it [the business cycle] is due to an increased rate of profit due to increasing the money supply above what is expected.” He goes on to say that “Malinvestments do not occur merely after entrepreneurs allegedly see profits increase due to increased spending....” He states that, as F.A. Hayek argues in Prices and Production, “the process begins with the increased spending of entrepreneurs due to monetary inflation via credit expansion.” (p. 386 [emphasis in original])

The first point to make pertains to Ritenour’s objection to my view that if increases in the money supply are slow and steady, they will be incorporated into entrepreneurs’ expectations and not provide a stimulating effect. He claims that this is more monetarist than Misesian. (p. 386) However, Mises did, in fact, recognize that an increasing money supply provides no stimulating effect once it is incorporated into the expectations of economic actors. (Mises, 1966 [1949], pp. 776–777 and 792–793) I also show as a part of my defense of ABCT from the criticism based on so-called rational expectations that a slow and steady increase in the money supply will not generate the business cycle because businessmen can incorporate such an increase into their expectations and make the appropriate adjustments. (vol. I, pp. 104–105) Ritenour states in another part of his review that he considers this to be an “excellent
defense” of ABCT, (p. 384) so I am not sure why in this portion of his review he takes exception to the claim that slow and steady increases in the money supply will not create the business cycle. This phenomenon is consistent with ABCT.

One point I agree with Ritenour on is that malinvestment begins with the spending created by credit expansion. I acknowledge this in my discussion of credit expansion and interest rates. I also acknowledge that the effect of changes in spending on the rate of profit takes time to occur, since the new money must be spent and re-spent throughout the economy. (vol. I, pp. 33, 35, and 73–74) However, I do use much more space in the book discussing how spending affects the rate of profit because that phenomenon is not well understood by most economists. The process of credit expansion and the creation of malinvestment is much better understood (at least by Austrian economists). That might be why he thinks it appears that I “almost exclusively” argue that the business cycle is due to changes in spending and profit when, in fact, I do not.

The belief that I almost exclusively argue that the business cycle is due to changes in spending and profit might also come from the fact that I do place greater importance on changes in the rate of profit, relative to interest rates, in causing changes in investment than Austrian economists generally do. While some Austrian economists do emphasize the role that inflated profits play in the business cycle (for examples, see Mises, 1966 [1949], p. 549 and Salerno, 2012, pp. 5, 17, 20, and 28), as with Ritenour, they place much more emphasis on the role of interest rates.

Ritenour states that I seem unaware that the originator of ABCT, Ludwig von Mises, emphasized the importance of artificially low interest rates in causing the cycle. (p. 387) I am not unaware. But that is what makes the emphasis on the rate of profit, as I state in the book, “an advance in ABCT.” (vol. I, p. 74) I provide ample evidence of the significance of changes in the rate of profit to the business cycle and yet the rate of profit has not received the attention it warrants from Austrian theorists, including its originator.

This is really a minor debate about ABCT. I am not arguing that increases in the money supply do not cause the cycle through a process of credit expansion (i.e., I am not arguing that ABCT is invalid). I am not even arguing that increases in the money supply
cause the business cycle solely through changes in the rate of profit. I am merely arguing that more emphasis should be placed on changes in the rate of profit than on changes in interest rates. Hence, Ritenour’s claim that this is the most troubling weakness of the book (p. 386) is not justified. His claim here is based on a failure to see what causes changes in the rate of profit and the effects of those changes in the economy. In addition, his claim makes it appear that I am proposing radical changes to ABCT. However, my argument requires only minor changes to ABCT.

CONFLATING INTEREST RATES AND THE RATE OF PROFIT

One of the serious errors committed by Ritenour is his conflation of interest rates and the rate of profit. He also makes a number of inaccurate statements regarding what I say about interest rates and the rate of profit based on this conflation. Understanding these errors will help improve one’s understanding of these important variables and thus improve one’s ability to explain the causes of the business cycle.

In my book, I make a distinction between interest rates and the rate of profit. These are two separate rates of return. The rate of profit is the return on capital invested in a business enterprise to produce a good. The interest rate is the return on funds loaned to others. (vol. I, p. 30) It is clear that these two rates of return exist in the real world. Most people have paid or received interest on money borrowed or loaned to others. That is different than the profits earned by businesses that appear as net income on their income statements. Using these profits, it is easy to calculate a rate of profit on capital invested. Return on assets and return on equity are two examples of a rate of profit.

Ritenour takes exception to what I call the rate of profit and claims that the rate of profit is actually the rate of profit I refer to minus the interest rate. He cites Rothbard (Rothbard, 2009, pp. 509–516) to help make his case. While it is true that Rothbard does refer to a rate of profit equal to the rate of profit I refer to minus the interest rate, Rothbard refers to this as “pure profits” or “entrepreneurial profits.” This is the profit earned for risk taking or the uncertainty an entrepreneur faces. (Rothbard, 2009, pp. 354
and 529) However, Rothbard also refers to the rate of return that businesses earn, which is equal to the rate of pure profit plus the interest rate. (Rothbard, 2009, pp. 354 and 513–514) What I refer to as the rate of profit is this rate of return. Hence, the rate of profit I refer to is consistent with Rothbard’s treatment of the subject.

It is important to distinguish between the rate of profit that businesses earn on capital invested and the interest rate because, for one thing, they both exist and identifying them can help us understand the world in a better fashion and, for another, they both play a role in the business cycle. If one conflates these rates of return, as Ritenour does, one’s understanding will not be complete. For instance, one will not be able to see all the influences a change in the supply of money and credit has on the economy.

In addition, it is important to understand that businesses do not look at entrepreneurial profits to determine their return on an investment. They look at the entire return. It may be helpful for economists to use entrepreneurial profits as a conceptual tool to better understand economics. However, that is not the financial incentive motivating entrepreneurs and businessmen. I have never seen any type of financial statement analysis that subtracts costs from revenues, divides the result by the capital invested, and subtracts the interest rate from this quotient to get the rate of return that investors think they will earn.

Furthermore, in connection with this topic, Ritenour claims that I fail to recognize that a decrease in interest rates increases the rate of profit. (p. 386) This is a false statement. I recognize in the book that a decrease in interest rates can increase the rate of profit (as I use the term) by decreasing interest costs. (vol. I, p. 73) I also recognize how decreased interest rates can increase profitability by decreasing discount rates. This, of course, increases profitability by increasing the present values of investment projects. (vol. I, pp. 76–77) This effect on profitability is separate from the effect that decreased interest rates have on the rate of profit by lowering the costs of businesses.

Ritenour also claims that I treat the rate of profit and the interest rate as “completely independent” of each other. (p. 387) It should be clear that this claim is false. Part of the dependence between the interest rate and rate of profit that I demonstrate exists is discussed above. I also discuss in the book that, because the interest rate and rate of profit are competing rates of return, they influence
each other when they move too far apart. For instance, if the rate of profit increases relative to interest rates, businesses will tend to decrease their lending and increase their borrowing to finance their own investment projects, which now appear more profitable than lending money. This puts downward pressure on the rate of profit and upward pressure on interest rates, creating a tendency to reverse the initial changes. (vol. I, pp. 34–35) Clearly, there is no independence, and I never make the claim in the book that the two rates of return are independent of each other.

After inaccurately claiming that I fail to recognize how decreases in interest rates can increase the rate of profit and also making the inaccurate claim that I treat interest rates and the rate of profit as completely independent of each other, Ritenour goes on to allege that I refute my claim that interest rates and the rate of profit are independent of each other when I explain how interest rates reduce borrowing costs and thus raise profitability. (p. 388) Ritenour builds one inaccurate claim upon another and, at the same time, contradicts his claim that I fail to recognize how decreases in interest rates can increase the rate of profit.

Part of the problem is that Ritenour conflates making a distinction between interest rates and the rate of profit with saying they are completely independent of each other. The conflation can be seen explicitly when he states, “Simpson makes a hard distinction between the interest rate and the rate of profit and treats them as completely independent of one another....” (p. 387) However, there is a difference between making a distinction between two things and arguing that they are completely independent of each other. For example, a mother and a two-month old baby are two distinct living beings, but they are not independent of each other. The baby is dependent on the mother for all its needs, and there are other dependencies as well. As another example, Rothbard distinguishes between entrepreneurial profit, actual returns, and interest, but recognizes the dependencies between them. The case is the same for my treatment of the rate of profit and interest rates.

OBJECTIVISM

Ritenour also commits the error of claiming that Objectivism—what he calls Randianism—is based on faith. (p. 388) This could
not be farther from the truth. The highest virtue in Objectivist philosophy is rationality. This means going by facts and logic. It means observing the world and using reason to reach conclusions based on a logical analysis of the facts one observes.

Faith means basing one’s beliefs not on a logical analysis of the facts—not on rational evidence—but believing in something without evidence or, in fact, believing in something that stands in contradiction to the evidence. This has disastrous effects on one’s ability to gain knowledge. Anything goes if one bases one’s beliefs on faith.

Faith, of course, is also the method of belief employed by religion. It is well known that Objectivism stands in opposition to religion. In attempting to associate Objectivism with faith, Ritenour is attempting to throw a lifeline to faith. In essence, he is saying, “See, fellow Christians, it is okay to go by faith because the intellectual opponents of religion embrace faith, too.” But the attempt to save faith is not only futile, it is cognitively harmful.

Ritenour takes a number of other jabs at Objectivism. For instance, he claims that Objectivism is quirky and strange. (pp. 384 and 395) Notice that these are not actually arguments against Objectivism; they do not logically or factually refute any aspect of Objectivism. If one is going to show that an idea or philosophical system is invalid, one cannot merely offer intellectually empty accusations as the means of doing so. Such accusations reveal nothing about whether the ideas they are directed at are invalid.

Ritenour also makes a number of related accusations, such as that the Objectivist arguments I make are unnecessary and unhelpful. (pp. 390–391) However, the Objectivist arguments I make are necessary and helpful in integrating economic ideas with more fundamental philosophical ideas, including ethical and epistemological ideas. This integration provides a much more comprehensive understanding of the world and thus a much more powerful argument for the free-market ideas defended in the book.

For instance, one issue discussed in my book and the relevant sources I cite is how statist policies that call for government interference in the marketplace—government violations of individual rights—are based on the altruist code of morality (i.e., the morality of self-sacrifice). I also discuss how laissez-faire capitalist policies
are based on the morality of rational self-interest. (vol. I, pp. 101–102, 134–135, 203, and 210–211) The links shown between these ideas help one see that free-market economics is not only practical, it is moral. Likewise, they show that statist politics and economics are not only destructive from an economic standpoint, they are immoral as well. This completely disarms the statists morally and gives the moral high ground to the advocates of capitalism.

Ritenour questions whether altruism provides the moral basis for statist policies, but when he does so, he, again, does not provide any arguments to refute my claim. (pp. 390–391) This is a pattern throughout his review. He asserts without proof and questions or rejects ideas put forward without confronting the evidence provided for those ideas. If he disagrees with an idea, his method is to dismiss it without consideration, regardless of the evidence put forth to support the idea. This is not a proper method of thinking.

CONCLUSION

Ritenour commits many errors and makes a number of inaccurate claims about the content of my book. His most egregious error is making repeated arbitrary assertions—assertions without proof or evidence. If one is going to make a claim that something is true, he must present evidence to back up his claim. Likewise, if one is going to claim that a person’s position is false, he cannot simply ignore the evidence presented for that position. He must show logically and factually why the person’s position is false.

There are many other errors committed by Ritenour—in fact, I have identified eleven other errors. Unfortunately, space does not allow them to be analyzed in this article. Nonetheless, even based on this condensed response, one gets a good idea of the kinds of errors he commits. Many of Ritenour’s objections appear to be based on my arguments being different from the arguments of other Austrian business cycle theorists. I encourage people not to ignore or dismiss the arguments in the book simply because they are different. If one does not do this, one will see that the ideas in the book advance ABCT and improve our understanding of the business cycle.
REFERENCES


