Monetarism and Fixed Rules in H.C. Simons

1. Under the stimulus of Milton Friedman's well known article on the monetary theory and policy of Henry Simons,[1] the question of the influence of the Chicago tradition on modern monetarist theory has been the subject of intense controversies during the last fifteen years;[2] needless to say, the discussion has been fuelled by the increasing attention devoted to the 'monetarist counterrevolution'. In general, the participants in the debate are in agreement on the existence of significant differences between the theories of Simons, Keynes and Friedman, but they part company when it comes to tracking down the most significant influences on Friedman's theory. Some, for example, like Patinkin,[3] regard the Friedmanite theory as a direct evolution of Keynes' analysis; while others, such as Humphrey and Tavlas,[4] consider it to be the result of the theoretical development which took place in the United States from the 'twenties on, both at Chicago and elsewhere.

One result of the discussion has been that of overcoming Friedman's 'hesitancy', inducing him 'to accept some credit for the theoretical analysis' contained in his Restatement;[5] one of the great merits of the debate, at any rate, is that it has brought out the general ferment among American economists in the interwar period in the field of economic theory and policy. Thereby justice has also been meted out to overschematic characterizations and deep-rooted prejudices.[6]

As regards the specific positions taken up by Simons, the results of the discussion do not, however, seem satisfactory, perhaps precisely because of the 'instrumental' nature of these reassessments. The interest

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[1] M. FRIEDMAN (1967).

[2] There had previously been a first but circumscribed debate on the Chicago School between MILLER (1962), STIGLER (1962), BRONFENBRENNER (1962) and COATS (1963).

[3] D. PATINKIN (1969).

[4] HUMPHREY (1971), TAVLAS (1977).

[5] M. FRIEDMAN (1972), p. 941; the article referred to in the quotation is M. FRIEDMAN (1956).

[6] On this point see in particular DAVIS (1971).

in an overall comparison between Simons' theories and those of Friedman and Keynes has in fact resulted in confining the former to some of the issues debated in the recent controversies between the monetarist and the Keynesian schools, thereby relegating to a marginal position, or completely ignoring, certain essential features of Simons' thinking. The result has been not only to blur and distort an approach which is in many respects original, but also to impoverish the issues in the comparison which the reassessment was designed to explore.

The aim of the present article is to show that a more balanced analysis of Simons' theories can modify certain of the results obtained. In particular, this analysis makes certain differences in monetary theory less important and gives more weight to some preanalytic and some general theoretical ones. This is also helpful when it comes to rethinking a question which drives a deep gulf between modern monetarists and Keynesians — that of the choice between fixed rules and discretionary policies.[7]

2. Among economists, Simons is one of those rare examples of a scholar more concerned with carefully investigating and specifying the institutional aspects within which economic relations are situated and their interdependence, rather than the more purely analytical and formal aspects of the economic system. There were perhaps sound reasons why Simons preferred this approach. On the one hand, there was the conviction that he would be able to work within a solid body of theory, which was capable of improvement but not of far-reaching revisions; and, on the other, the danger, of which he was acutely aware, of a critical institutional change which was affecting the capitalist system and which would have led it to adopt forms which were the antithesis and the negation of the values of freedom and efficiency which had been the basis of its emergence.

Simons' philosophy may be summed up in Lord Acton's phrase: 'power always corrupts', cited by him and completed as follows: 'and not merely those who exercise it, but those subject to it and the whole society... no one may be trusted with much power — no leader, no faction, no party, no "class", no majority, no government, no church, no

[7] In the following considerations we base our analysis on the essays collected in the posthumous volume, H. SIMONS (1948); unless otherwise specified, the quotations and references are to this edition.

corporation, no trade association, no labour union,... no large organization of any kind' (H. Simons, 1948, p. 23). Given the intimate connection between political and economic liberty, the idea of democracy in which all participate calls for the maximum dispersion of power in all fields. Thus, the state must be organized with the maximum decentralization possible, with tasks which become more and more negative as one moves from the periphery to the central authority; for their part, business and labour organizations must not be in a position to create obstacles to free competition, nor have the power to impose on the state interventions designed to favour any minority.

The ideal economic structure is therefore precisely that of a theoretical system of free competition in which the market, in fixing prices, determines the best allocation of resources in relation to consumers' preferences. Even in an ideal system of free enterprise, however, there is a market — the monetary and financial one — which has different characteristics from the others. Since the orderly working of economic relations calls, in Simons' opinion, for certainty in monetary values, or, as a secondary consideration, for certainty in the behaviour of the monetary authorities, this requirement cannot be satisfied if the money market is left in private hands; this is a field in which the state must reserve for itself absolute sovereignty, to be exercised through centralized control. The defence against the abuses to which such powers can give rise and the requirement of monetary stability make it essential that this control be exercised leaving no discretionary powers to the competent authorities, and anchoring their behaviour to fixed rules, rules with legal force and felt by the citizens as deeply as a religious dogma. In the ideal economic and monetary structure, the rule to be preferred, especially for its simplicity and unambiguousness, is that of keeping the stock of money constant.

3. Simons' concerns do not spring from the simple and obvious observation that the real system is different from the ideal one. They flow from the observation of a tendency opposite to the one desired:[8] a tendency towards centralization and an increasingly discretionary use of state powers in the economic field; towards an increase, encouraged by the state, of the concentration and powers of business and trade unions;

[8] At least as regards Simons, MILLER (1962) is wrong when he extends to the whole Chicago School the identification between the real and the ideal market.

towards a system which Simons no longer recognizes as capitalism but stamps as 'syndicalism'.[9]

If we pass over the more strictly socio-political aspects, we find that Simons' objections to 'monopolies'[10] can be summed up as the distortion caused in the allocation of resources by prices which are non-competitive and rigid downwards and by the effects that barriers to new entries have in the direction assumed by investments; as the distortion caused in consumption by the large-scale use of advertising; and as the power which they acquire of conditioning public action in favour of individual minorities. And yet, since, for Simons, competition between firms is strong enough to reassert itself, although by indirect routes, the real problem 'derives from the prospect that the state rarely will permit private monopolies to bear the consequences of their own actions. Monopolists will run to the government for protection against any threat to their unstable equilibrium, just as they always have done in the face of competition from abroad' (*op. cit.,* p. 87). Besides, as we shall see shortly, industrial monopolies manifest their negative characteristics to the full in relation to the growing power of the trade unions.

The greatest threat to the free enterprise system is identified by Simons in the excessive power characterizing strong labour organizations.[11] The aim of these organizations is seen to be that of maximizing employees' income without any regard for the interests of the unemployed and consumers.[12] The result is that wages are settled at levels higher than competitive ones and are rigid downwards in respect of variations in the demand for labour. In particular, by blocking wages at levels consistent, at best, with the productivity of skilled and highly experienced workers, trade unions restrict the possibilities of employment, and favour existing firms in their tendency

[9] It will be remembered that the time when Simons was writing — the 'thirties and the early 'forties — is the one when many economists were converted to the thesis of a centralized and discretionary interventionism; it is the time of Roosevelt and the New Deal, of the 'institutionalization' of trade union organizations as interlocutors of the government, of the Beveridge plan and hence of the first discussions on the welfare state.

[10] Simons uses the out-of-date expression of 'monopolies' or 'partial monopolies' to refer to that market structure for which the term 'oligopoly' is now used.

[11] As we shall see later on, this is due in part to the greater ease in finding answers to business monopolies; cf. p. 130.

[12] We believe that we should only take passing note (as being determined by the particular United States experience in these years) of the crude language used by Simons in referring to the trade unions who 'are essentially occupational armies, born and reared amidst violence, led by fighters, and capable of becoming peaceful only as their power becomes irresistible' (p. 152).

to erect and strengthen barriers to new entries. It is therefore in trade unions' interest to encourage non-competitive market forms which are able to ensure the firms high profits which can in time be passed on as higher wages. It follows that 'the semblance of struggle between labor and capital conceals the substantial conflict between a labor monopoly and the community; between organized workers and consumers'. (*op. cit.,* p. 143).

At this point certain considerations are in order to clarify the outlines of Simons' approach. In the first place, we must note the extreme degree of consistency in his writings between the reference to a theoretical model in which consumers' preferences constitute one of the main terms of reference, and his antimonopolistic concern dictated by the conviction that consumers are not in a position to create an organization capable of safeguarding their interests which, being of a general nature, correspond to those of the community.

In the second place, Simons adopts a concept of competition — that of free competition — which has a classical flavour, and is linked to the absence of barriers to the circulation of labour and capital, rather than the more limited concept of perfect competition, which is derived from the more stringent conditions regarding expectations, technology, etc. called for by formal 'marginalist' analysis.

In the third place, among the conclusions at which Simons arrives, it is essential to distinguish very precisely between those which are valid in a context of partial analysis and those which can be generalized to the system as a whole; the danger, otherwise, is that we may fall into those errors criticized by Keynes and imputed by him to the 'classical' theory. Simons seems to be aware of this when, for example, he writes that 'we shall be largely concerned here with principles of relative wages, since changes in average wages at relatively full employment imply changes in the general level of commodity prices, wages being the predominant element in costs'. (*op. cit.,* p. 140). Indeed, in most cases, the reference is to the advantages which more powerful categories succeed in obtaining at the expense of the weaker ones; thus, when he affirms that an increase in wages designed to erode monopolistic profits does not lead to a price increase in the sector affected, or that high sectoral wages lead to distorsions in the allocation of labour, the analysis may be accepted or refuted, but does not imply errors of composition. The case may be different when Simons attributes unemployment in general to high wages. Even if this reasoning is not very clear, he does not seem to

intend to affirm that bargaining concerns real wages;[13] he seems instead to imply a constraint on the side of nominal demand which would validate the nexus between higher wages, higher prices, and lower quantities exchanged and produced.[14] Since, as Patinkin rightly asserts,[15] Simons does not offer an analysis of the demand for money, or of its link with the rate of interest, that involves adhesion to a crude version of the quantity theory (MV = PT, with V being constant), which, however, clashes, as we shall see, with the position adopted by him in dealing with monetary problems.

However, Simons offers a second explanation of unemployment which is not subject to this type of criticism and which derives from the attention paid to relative prices; given his conviction that, in the then obtaining conditions, the investment goods sector was the one with the highest degree of labour monopoly, compared with a competitive structure, the result is a distortion of relative prices, which is reflected in high prices for investment goods, a consequent limit on their demand, and, thereby, on general employment (*op. cit.*, pp. 188-9, 194). A third explanation offered by Simons for unemployment, or rather for its persistence, ascribes to monopolistic factors a response to improved conditions of demand in terms of higher wages and prices, rather than in terms of higher employment, production and investment (*op. cit.*, pp. 115, 336 note 11). These two explanations, rather than the first one, seem to be more characteristic of Simons' position, since they are more consistent both with the explanation given by him of monetary factors and, as will become clearer in the next few sections, with his general attitude.[16]

4. The considerations just set out lead us directly to the analysis of the changes which, according to Simons, are introduced by the growing monopolistic powers of trade unions and business into the behaviour of the economic system, both during the cycle and in the long period.

[13] See the passage cited in note 14; however, Simons adds immediately afterwards that the presence of strong trade unions makes the manoeuvre aiming at reducing real wages through increases in prices the cause of an unending inflationary spiral.

[14] 'We might assure reasonably full employment at any level of money wages by sufficient injections of money and raising of the price level' (p. 159).

[15] PATINKIN (1969), pp. 52-3.

[16] The proof of this is, *inter alia*, Simons' criticism of Hansen and the Keynesian approach on account of their neglect of the price structure in their analysis of the depression (p. 187); and it is also significant that, in the same context, Simons refers to Pigou (1935) *à propos* of the consequences of price rigidities.

On this latter point, Simons firmly denies any validity whatever to theories which, like that of Hansen, link the phenomenon of stagnation to the maturity of a capitalist economy, that is, to the gradual exhaustion of opportunities to invest. He is of the opinion that the curve of the marginal efficiency is substantially flat [17] and that 'a maturing syndicalism is the mature economy of our monetary and fiscal extremists' (*op. cit.*, p. 154). Whereas in a competitive economy there is no problem of opportunities to invest, in a system with strong trade unions, business must bear the burden of all the uncertainties and risks connected with investment in a free market, with the additional prospect that the workers' organizations will appropriate a large part, if not all, of the profits which would otherwise flow to them in favourable circumstances: 'The prospect for losses is as good as ever; the prospect of profits is, in the main, profoundly impaired' (*op. cit.*, p. 146). This drives firms and investors into a defensive position and leads them to divert their capital from production in favour of government securities; 'ultimately this means the disappearance of all opportunities for remunerative enterprise and investment, governmental or private, via excessive costs, actual and prospective ... [Such a system] is inherently unstable and unmanageable. It may be kept going, at income levels far short of our potentialities, by sufficiently large fiscal and monetary stimulation' (*op. cit.*, p. 154).

This means that, for Simons, Keynesian policies of constant support of aggregate demand constitute only palliatives, a sub-optimal solution which does not go to the root of the problems posed by monopolistic powers. In addition, the public attempt to keep unemployment under control would in these circumstances involve a continuous expansion of the socialized sector which, being supported by taxes and the national debt, does not need to be seriously worried about the relations between wages and productivity. 'Thus, movements of administered wage rates would determine, not movements of the price level, but merely the rate of socialization, that is, the life-expectancy of free enterprise!' (*op. cit.*, pp. 203-4).[18]

[17] 'Holding fast to CASSEL notions [1903], I believe that the productivity curve for new capital is extremely flat; that investment, proceeding at the maximum rate consistent with high thrift, would have little effect for the significant future, even failing large accretions of innovations, on yields in this sense' (p. 192).

[18] When DAVIS (1968) and PATINKIN (1979) rightly attribute the Chicago School's aversion to Keynes' *General Theory* (1936) to the implications drawn by that School as regards the need of a chronic support of demand, they fail to add that, for Simons, that does not mean the inexistence of the phenomenon (stagnation), but a different explanation thereof, and hence a different therapy. It should be added that, according to Simons, there was not in the 'thirties a real recovery of activity

Another factor responsible for the loss of dynamism of the system is the gigantic size of companies. Simons distinguishes between a) those economies linked to the size of the individual industrial plant, which represent a general advantage and usually lead to medium-sized firms, and b) those 'artificial' economies of scale, derived for the greater part from the vertical and horizontal integration between different productive units, which represent diseconomies of scale from the social point of view. These diseconomies stem from the control on demand exercised through advertising and large chain stores and from differential access to technical knowledge and fresh capital; they therefore result in the erection of barriers to free competition (*op. cit.*, pp. 34-5, 59, 95, 246-8). The giant companies 'become essentially political bodies, run by lawyers, bankers, and specialized politicians, and persisting mainly to preserve the power of control groups and to reward unnaturally an admittedly rare talent for holding together enterprise aggregations which ought to collapse from excessive size... In a short-sighted view, they are instruments of progress; but they lack the creative powers of a multiplicity of competitive smaller units ... The only substantial assurance of long-term efficiency lies in persistent ... competition' (*op. cit.*, pp. 14, 246).[19]

5. On the importance of the monopolistic elements for the behaviour of an economy during the cycle, the starting point is the recognition of the problems posed by the continuous changes (in technology, in relative costs and in consumers' preferences) to which the economic system is subjected (*op. cit.*, p. 144).

The virtue of a competitive system, with its flexibility, even if not perfect, in relative prices, consists in ensuring that the consequent readjustments take place without giving rise to substantial discontinuities in production and employment; for Simons, this system is not, however, capable of preventing those variations which influence the

despite strong injections of liquidity and low interest rates because of the adverse 'socio-political atmosphere' produced by the 'legislative measures, whereby the government and its supporting minorities practically defied people to invest privately or to behave enterprisingly' (p. 193).

[19] Putting the rate of profit as the main determinant of growth, the latter is slowed down by the negative influence which the trade unions and giant companies exercise on the former; that implies that Simons sees wages only as costs, or that he considers the cost aspect prevailing over the demand aspect. It is interesting to recall that, in these very years, another Chicago economist, Paul Douglas, attributed part of the responsibility for the Great Depression of the 'thirties to the excessively low real wages experienced in the 'twenties; cf. ASCHHEIM and TAVLAS (1979).

price level from being trasformed into cumulative movements of the value of money and then of production, unless the state fulfils its function of guarantor of monetary stability (*op. cit.*, pp. 108-9). As was pointed out at the beginning, Simons regards the market for money and credit as being different from the others, one in which the rules of competitive optimality are not valid; it is therefore necessary to make a departure from the principle of the decentralization of power in order to safeguard the aim of monetary stability, an interest which, although like that of consumers, not represented in the political process, is equally important for the regular functioning of an economy founded on free enterprise (*op. cit.*, p. 112).

It must be stressed that the need to assign to the state the task of guaranteeing monetary stability flows, in Simons' view, from the recognition of the fact that a *real* competitive system is far removed from the ideal instantaneous adjustment of prices and quantities; in that system, the readjustment implies a process which *per se* gives rise to cyclical fluctuations, whose size would however be moderate if it were not disproportionately increased by the absence of a control, whether direct or indirect, of the general price level. The above specification, which sees in the divergence from ideal competitive conditions the root of the system's instability (and hence the growth in the power of business and trade unions is a factor making for an increase and not a diminution in instability), and which regards monetary factors as an aggravating factor and not a primary one of instability, is of fundamental importance for a correct understanding of Simons' thought and of the order of priority assigned by him to the aims of reform.

There is then a trade-off between the degree of competitiveness of the system and the need for an optimal structure of monetary institutions: if, in an ideal system of competition, any monetary structure is optimal (for the simple reason that in it money is only a veil), as monopoly factors grow, so does the need for a set of monetary institutions and rules with the specific aim of ensuring price stability. As will be seen more clearly below, any attempt to consider (as most of his interpreters do) Simons' monetary theory in isolation from the rest of his analysis entails a substantial distortion of his ideas.

For Simons, the destabilizing effect introduced by monetary factors during the cycle depends essentially on the procyclical variations in the velocity of circulation of money. In an institutional structure in which the banking system is allowed to create and destroy, largely at its discretion, monetary substitutes (near-moneys), the banks' action ac-

commodates and amplifies variations in the cash balances held by the public; 'banks will flood the economy with monetary substitutes during booms and precipitate futile efforts at general liquidation afterward' (*op. cit.*, p. 167). Simons' attention is directed in particular to the liquidation forced by the banks against business once the recession has started, a practice which makes depressions longer and more ruinous; this behaviour is the result of a distortion inherent in the nature of banking, that of lending at short- term, i.e. in liquid form, amounts larger than the total available circulating media.

Simons' theory is quantitative in the proper sense of the term, since it is the volume of money and of its substitutes (corrected for the variations in the velocity of circulation) which is related to the level of activity; he does not analyze the demand for money, its links with the rate of interest, or any connections between the rate of interest and nominal magnitudes.[20] Historically speaking, Simons' position seems isolated from the major contributions already well established at his time in the field of monetary theory, even if he has in common with them an interest in the 'transition period'. We need only think of the Swedish school, Wicksell in particular, the Cambridge school, especially the Keynes of the *Treatise on Money* (1930), and Irving Fisher's contributions, based on the distinction between the monetary and the real rate of interest.[21] In other respects, Simons' theory diverges from the rigid versions of the quantitative theory, as it follows, intentionally or not, the slant given by Wicksell to the problem of 'monetary disequilibrium': the prime mover of disequilibrium is the variations in the real data of the system. These disequilibrium movements are then amplified by the non-neutral behaviour of the credit system.

6. We now come to the characteristics which, according to Simons, 'a positive program for *laissez-faire*' should possess. In keeping with the image of Simons as a monetarist, there is a general tendency to concentrate on the normative aspects solely in the monetary field, and to dwell, after a few references to the proposals for institutional reforms, on anti-depression therapies. The fact is that, as we have tried to illustrate in the preceding sections, Simons'analysis of the effects of

[20] This applies at least to his works in the 'thirties; as we noted above, in note 18, Simons in his 1942 essay on Hansen, attributes to an adverse socio-political atmosphere the lack of recovery in the 'thirties, despite strong injections of liquidity and low rates of interest. It is not, however, clear whether Simons means only to show the inadequacy of the reasoning which he is contesting.

[21] On these questions see PATINKIN (1972, 1973) and TONVERONACHI (1980).

monopolies is indissolubly linked to that of the monetary structure; in addition, he shows scant interest in the simple management of what exists because in the long run that only helps to facilitate the move away from the free enterprise system.

In this perspective, the decentralization of the state's powers, the reform of industrial and financial companies, the decentralization of the stock exchange, the reform of the freedom of association in the economic field and the reform of banking institutions form parts of a single design in which, however, there is a specific scale of reform priorities which is the product of the causal links analysed above.

Setting aside the problem of the decentralization of the state's powers, the criteria for which have already been discussed and which can be regarded as related to the other measures of reform, the main problem, that of trade union powers, also represents for Simons the one which can least easily be directly attacked; a trade union power 'which democracy cannot endure, cannot control without destroying, and perhaps cannot destroy without destroying itself' (*op. cit.*, p. 193). The only hope is in the mobilization of public opinion once the decentralization of power has been carried out in the other fields (*op. cit.*, pp. 238, 255-6).

In order of importance, there follows the restoration of competitive conditions in the business sector. The priority allotted to this reform over monetary reform flows from the analysis discussed earlier: monetary factors are not ultimately responsible for the loss of dynamism and for the basic instability of the system. This priority is repeatedly reaffirmed by Simons, for example, when he writes that 'no monetary system, however perfectly conceived and administered, can make a free-enterprise system function effectively in the absence of reasonable flexibility in the price structure — that is, in the absence of effective price competition among enterprises and among owners of productive services' (*op. cit.*, p. 65).[22]

The logic of industrial decentralization consists 'in the maximum dispersion of property compatible with effective production' (*op. cit.*,

[22] See also pp. 116, 120 and 170. From which, moreover, it follows 'a) that *no* concessions can be made as regards the restoration of highly competitive conditions, and b) that *few* concessions can be made in the effort to remodel our permissible financial practices' (p. 173, italics added). It should also be noted that, although Simons affirms that 'all proposals to sacrifice freedom on behalf of other ends (notably, security) be examined under a presumption of error' (p. 3), he has no doubts that 'protection of the public interest demands limitation of the right of association where the association is of people as suppliers of particular commodities or services' (p. 153).

p. 27);[23] hence, the changes to be pursued 'have to do mainly with ownership units and control devices, not with operation. There would be a breaking-down of enormous integrations into more specialized firms, with ownership separation among phases of production which are now largely separate in place and in management. For horizontal combinations, the policy would require ownership separation among operating units which are now connected by little more than common advertising and selling organizations' (*op. cit.*, p. 82). The firm, confined to a single operating unit, must thus be forbidden to own direct or indirect shareholdings in other firms; these single operating units must be limited in size in accordance with criteria of competitiveness proper to every branch of production.

Specific proposals are advanced for trade organizations and for the role to be assigned to the state as regards research (*op. cit.*, pp. 85-6, 247-8). The restoration of competitive conditions therefore calls for radical changes and cannot at all be substituted for by measures designed to restrain or control monopolies: '[We] ought to concern [ourselves] about maintaining effective competition, not about hammering monopoly prices down to competitive levels with grand juries' (*op. cit.*, p. 102).[24] All the same, Simons is well aware that the competition obtainable by this reform is not the ideal one, but only a degree of competition sufficient to maintain a certain flexibility of prices.

And he does need such a flexibility as he goes on to outline his monetary reform. Without that flexibility, as we have seen, no institutional arrangement in the field of money is in a position to make a free enterprise system work effectively.

The logic of the plans for reform put forward by Simons lies in eliminating that part of the variability in the velocity of circulation of money which can be attributed to banks' action, by reducing it to the sole result of the variations in the cash balances held by the public, which no reform can influence directly.[25] The ideal monetary structure, therefore, ought to ban contracts fixed in money terms, with property held solely in common-stock form, i.e. in a form with residual

[23] As we have already seen in section 4, for Simons, economies of scale which do not involve external diseconomies stop at a medium-size dimension of the firm.

[24] In these circumstances, recourse to tribunals again raises the problem of discretionality: to this must be added that Simons did not think highly of the legal profession in the economic field: 'Where lawyers try to draw a line between lawful and unlawful restraint of trade, they invariably end up with something that looks like the silhouette of a roller-coaster' (p. 101).

[25] On this point and on what follows, see pp. 165-72.

yields. Firms would thus be freed both from the risk of forced liquidation by the repayment of capital and from the variations in the real burden of debt due to interest fixed in money terms. In a decreasing scale of optimality, we then have a system which admits of contracts fixed in money, but of unlimited duration; a system with long-term contracts, and, at the bottom of the ladder, a system with short-term contracts.[26]

In terms of feasible reforms, Simons aims at the maximum reduction in short-term borrowing by a modification of the banking structure. The banks ought to confine themselves to the functions of warehousing and transferring of actual currency,[27] leaving the lending functions to appropriate investment trusts which would convert their deposits solely into long-term securities and shares. These companies would be forbidden to possess any voting power or control over firms, in accordance with the antimonopolistic logic discussed earlier.[28] The radical nature of this reform, therefore, consists in the disappearance of short-term loans by banks to firms, who ought thus to draw on their own risk capital to finance working capital and inventories. Simons realizes that banking is a phenomenon which transcends the banks, and is therefore aware that decisions must be left to experience as regards the detail of the legislative measures needed to ban short-term contracts effectively.

The next step consists in defining the behaviour to be adopted by the state in the monetary and fiscal field, in the different hypotheses as regards the monetary structure. We have already explained the reasons why Simons prefers fixed rules to discretionary powers; the problem is now to see whether, and, if so, what rules are consistent both with the objectives chosen (mainly monetary stability) and with the structure

[26] In reality, the scale adopted by Simons is longer, since it includes, at the bottom, a system with assets convertible into a commodity (such as gold) whose availability constitutes only a fraction of potential demand.

[27] It is in this context that we should consider his proposal for 100% reserve requirements.

[28] In these investment trusts, of moderate dimension and closely linked with single local communities, Simons sees a way of decentralizing the capital market and of rendering it less subject to the actions of wavering investors, since it would be aided by the loyalty of the community whose savings it mobilizes. With this reform, Simons associates the possibility of finding a non-traumatic solution for the trade union problem as well: 'If such local investment trusts really served, as they should, to mobilize mass, small savings in their communities, even our labor problems might be brought toward good solution. In such circumstances community pressure might inhibit wage demands that would threaten the relative prosperity of local industry, that is, impair its competitive position vis-à-vis other communities. On the other hand, such pressure would also be exerted against needlessly low wage rates that impaired a firm's ability to attract or maintain good-quality labor' (p. 238).

envisaged. In principle, the rule preferred by Simons is to keep the volume of money constant; but that rule is unambiguous, and does not leave any margin for discretionary powers, solely in a reformed monetary structure from which are absent those monetary substitutes which make it impossible to give practical significance to the conception of quantity. Leaving banking functions unaltered, the adoption of this rule would produce both a perverse variability in the quantity of such substitutes and their wider circulation, which would frustrate such a policy (p. 164). This rule, like the reform needed in order to implement it, therefore constitutes in Simons' view an objective at which to aim in the long run. [29] In an unreformed monetary system, the rule to be preferred is that of the price-level constancy; this rule should be carried out through variations in the quantity of money correcting the variations in the velocity of circulation, and such as to stabilize the general purchasing power. The price-index rule thus implies strong discretionary powers in the hands of the public authorities, both as regards the choice of the price-index and the choice and combination of anti-cyclical monetary and fiscal policies (*op. cit.*, pp. 175 and 331). It should be noted, *inter alia*, that, while the fixed-quantity rule implies a continuous balancing of the budget, the price-index rule may entail deficits during recessions and surpluses in periods of expansion, with an eventual balancing out over the average of the cycle.[30]

Simons is of the opinion that the instruments at the disposal of the central bank (open market operations and the discount rate) are generally insufficient for a stabilization policy; hence it is for the Treasury to act as the promoter of anti-cyclical policies through the control of the budget. The approach preferred is that of changes in taxation which involves both less discretionality and advantages in

[29] It is perhaps advisable to recall the differences between the fixed-quantity rule and the constant-rate of growth rule. If the latter is presently associated with the name of Friedman, one of its first advocates was Paul Douglas, who arrived at it as a result of his researches on the long-period trend of production. While a fixed quantity of money may call for a continuous deflation of prices in presence of a positive real growth, the constancy of its rate of growth is equivalent to the aim of constant prices. The constant-rate of growth rule, however, leaves the authorities discretionary powers to fix and to revise the reference real rate of growth of production. See FRIEDMAN (1967), TAVLAS (1977) and TAVLAS and ASCHHEIM (1981).

[30] The abandonment of the policy of balancing the budget on an annual basis in favour of a balancing over the average of the cycle was put forward in the 'thirties by a group of Chicago economists, including Simons, led by Paul Douglas. Simons, however, showed himself lukewarm as regards this type of proposal, which in his opinion does not tackle problems at their root. In addition to the studies cited in the preceding note, see DAVIS (1971, 1979) and TAVLAS (1976, 1979).

terms of distributive justice.[31] In particular, he affirms that injections of money operated through the central bank can in fact not help production, ending up in accumulations of liquidity with the banks; on the contrary, changes in the deficit imply direct variations in the purchasing power of the community.[32]

The position of monetarists, old and new, is generally contrasted with that of Keynesians on the ground that, according to the former, fiscal measures are a way of implementing monetary policy; in other words, those measures are effective only in so far as they produce variations in the quantity of money.[33] At least in Simons' case, this reasoning does not appear to grasp the full significance of his adhesion to the Fisher equation. First of all, attention should be given to the argument just set out that an increase in the quantity of money can prove ineffective if it produces an equivalent decrease in the velocity of circulation; hence, the general purchasing power (MV) remains constant. When Simons speaks of monetary policy and monetary stabilization, we must not be misled by the meaning which these expressions have assumed in post-Keynesian practice; he means a policy and a stabilization designed to control aggregate demand in monetary terms, not different from the Keynesian positions on demand control. In current terms, Simons asserts that, if the stabilization of aggregate demand is carried out with the instruments of monetary policy, it may prove ineffective, especially to get out of a depression; if carried out by means of fiscal policy, it proves effective. When Simons affirms that monetary policy should be entrusted to the Treasury, he means to say that 'by proper variations in its spending and, especially, in its tax levies, it can inject and withdraw purchasing power as monetary stabilization may require' (*op. cit.*, p. 111). A stabilization policy is therefore effective if it does produce variations, not in M but in MV, that is, if it succeeds in controlling aggregate demand.

7. Let us now try to isolate the salient characteristics of Simons' thought. As against an unfortunate absence of theoretical depth which would have given greater solidity to his theses, Simons offers a very

[31] See pp. 212, 265, and 273. It is interesting to note that Simons sees in the progressive taxation of income a way of inducing automatic anticyclical variations in expenditure; see p. 265.

[32] PATINKIN (1969) is of a different opinion. According to him, for Simons, "it is 'inconceivable' that a sufficiently vigorous policy of (say) expanding M in a period of depression would not ultimately affect aggregate spending in the required manner" (p. 51).

[33] See for example TAVLAS (1967, 1977 and 1979).

broad and interconnected set of problems and especially a clear general vision which confers coherence on the individual parts. If we wish to fit Simons into some line of thought, we are confronted with an explicit affiliation to liberal thought, and in particular to that fringe which interprets in positive (and not only negative) terms the role of the state in a free enterprise system. The ideal society is the one in which the state, conceived as the rule of law and not of reason, prevents the loss of those social and economic liberties which alone can guarantee the full development of human capacities in a context of economic efficiency. Hence his reformist radicalism directed against business and trade union monopolies, and against the bureaucrats' state, which is an expression both of a concentration of power and of its discretionary use.

It seems to us an open question in what sense, within this framework, Simons belongs to the sub-species of the monetarists. [34] Going back to the old distinction between banking school and monetary school, Simons can be aligned with the second one, although in that radical fringe which denies that a control on banking activity is sufficient. The reform proposed by Simons tends to eliminate that 'classical' function which is the hallmark of modern banking — short-term loans.

One characteristic which generally serves to measure adherence to the monetarist school is the exogeneity of the money supply. We have seen that, for Simons, the functions of money are performed not only by cash, which is directly controlled by the state, but also by substitutes which are created by the banking system. Simons believes that, without a far-reaching reform, control over the exogenous part has the sole effect of increasing the importance and the perverse variability of monetary substitutes. The limit of the existing monetary arrangements lies therefore precisely in the non-exogeneity of the supply of money, which can be attained only by the desired reforms.

Monetarism is also characterized with reference to the neutrality of money. It is now generally held that no serious scholar has affirmed, at least after Marshall, Fisher and Wicksell, the existence of such a neutrality in the short run, that is, for the 'transition period' or 'monetary disequilibrium'.[35] There thus remains the long-period neutrality, but what that means is not at all clear. If by long period we mean a stationary state or one of steady growth, Keynes himself must be placed among those who deny any influence whatever, in these conditions, of monetary variables (if we can continue to talk of them) on real magnitudes.[36] If, instead, by long period reference is meant to the forces responsible for accumulation processes, a theoretical division becomes possible between those who recognize and those who deny any lasting influence on those processes by monetary factors.

[34] It is not thereby intended to affirm that monetarism is necessarily a result of liberal thought. According to Aschheim and Tavlas (1979), the 'thirties in Chicago saw the coexistence of a rightwing monetarism (Knight-Simons) and a leftwing one (Douglas). The former was free-enterprise and anti-trade-union, while the latter was interventionist. Such an ideological contraposition is not satisfactory, since, if we may paraphrase SIMONS (p. 169), it ought to be based mainly on differences in ends and not in means.

Mention has already been made of Simons' opposition to Hansen's views on the tendency of a mature economy to stagnate — a tendency strengthened by high rates of interest. Since Simons thinks that there are no 'technical' reasons for the curve of expected yields on investments to be diminishing, the rate of interest cannot limit their volume. Even when he imputes to the trade unions the responsibility for the loss of dynamism of the system, he seems to be thinking of a downward shift of the curve of expected yields, without any influence on its flatness. Such a formulation, however, fails to explain the factors which determine a *finite* volume of investments; Simons does not appear to be aware of this, and, even when he criticizes the Kaleckian theory of increasing risks, he offers no alternative explanation.[37] When he then affirms that, because of trade union action, investors switch to government securities, there is no calculation of relative advantages in this choice, but only a defence against risk and uncertainty. In Simons, therefore, there is no trace of the Keynesian 'design' according to which the link between uncertainty and investment goods characterizes a monetary economy in which accumulation may be slowed down by high relative yields (discounted for the elements of risk and liquidity) attributed to goods with a low elasticity of production within the productive system.

There is obviously a — rather trivial — sense in which Simons' analysis, and perhaps also that of modern monetarists, can lead to the long-term non-neutrality of money; for, if a chronic policy of monetary scarcity is pursued, with a velocity of restriction higher than any resulting increase in the velocity of circulation, non-transitory effects on

[35] See PATINKIN (1972).

[36] Nevertheless there can be a difference in the theoretical importance attributed to the stationary state.

[37] The link between profits and investments hypothesized by Simons could explain a limited volume of investments in terms of constraints in internal and external finance; these questions, however, are not discussed in his work.

accumulation become inevitable; however, it remains to be seen whether such a situation does not in the long run induce the private system to switch to a different monetary standard.

With reference to the two characteristics just discussed, neutrality and non-exogeneity of money, Simons' theory is a quantitative one, but not a monetarist one, at least in the present sense of the term.[38] Beyond these doctrinal distinctions, Simons has the great but unacknowledged merit of having shown the close connection between institutional structure and behaviour of monetary variables, that is, the relativity of the theory to specific institutional arrangements. This is a connection which, although investigated, has in fact been rejected by the new monetarism, which affirms the stability of monetary relations, even when there are institutional changes, and which indeed bases the strength of its own theory on this stability.[39]

The debate on the old and new Chicago school, referred to at the beginning, has brought out a series of differences between Simons' theories and those of Friedman and Keynes. As regards Friedman, Simons: a) considers as intrinsically unstable both the system of real relations and that of monetary relations (Patinkin, 1969); b) uses a quantitative analysis and not a theory founded on portfolio choice (*ibid.*); c) is diffident about empirical tests effected by means of statistical techniques, to the point at which, in the event of a divergence between theory and empirical correlations, he remains true to the former (Humphrey 1971, 1973; Tavlas and Aschheim, 1981); d) prefers the price-index rule compared with the fixed-quantity rule (*ibid.*); and e) regards as effective anticyclical fiscal policies (Davis, 1968). On point c), it may be added that this difference is crucial, given Friedman's firm conviction that, from among the infinite number of possible theories, we must choose the one which proves superior in the statistical-empirical verification. [40] On point d), as has already been observed, Simons' preference is for the fixed-quantity rule, but he is also clear that its adoption presupposes a profound reform of the monetary system; the price-index rule is to be preferred in the case of a non-reformed system. On point e) it must be made clear what precisely is meant by effectiveness; if, for Simons, a discretionary fiscal policy is in a position to lift the economy out of the depression, it runs the risk, in the long

[38] See in this connection the debate between KALDOR (1970) and FRIEDMAN (1970).
[39] See FRIEDMAN and SCHWARTZ (1963).
[40] FRIEDMAN (1953).

run, and especially if carried out by variations in expenditure, of upsetting the rules of a free-enterprise economy.[41]

It must also be added that, if Simons and Friedman both deny the possibility of stagnation in a competitive economy, their explanations are different. For Simons, the curve of expected yields from investments is flat, while, for Friedman, the wealth effect operates.[42] In addition, there is a point in Simons which Friedman has vigorously taken up and on which he has built part of his fortune as a forecaster; in the early 'forties, Simons asserts that certain institutional changes which had taken place in the field of banking and the fresh attention paid to unemployment make liquidity crises (which precipitate the advent of a depression) less important for the future and, in a monopolistic economy, inflationary pressures more important. If we remove the reference to monopolies, this is a position which has long been sustained by Friedman.[43]

As regards Keynes, it is asserted that Simons: a) attributes economic instability to the variations in the velocity of circulation of money and not to variations in investments (Patinkin, 1979); b) uses a quantitative approach and not a theory founded on portfolio choices (Patinkin, 1969); c) opposes the Keynesian theory of the chronic deficiency of aggregate demand (Davis, 1968); d) considers fiscal policy as only one way of implementing monetary policy (Tavlas, 1976). As regards point a), that disctinction, if interpreted literally, appears insufficient, since the instability in the velocity of circulation appears to Simons to be the product of the real instability which also includes the variability of investments; it is perhaps more correct to assert that, while Simons stops at the instability of general purchasing power, Keynes, following Wicksell and Robertson, goes back to the investment component as the primary cause of fluctuations in aggregate demand; the real distinction is therefore between the quantitative approach and the portfolio-choice approach (point b). As to point c), it should be made clear that the denial of chronic deficiencies in demand does not concern the real system, with its tendencies to the strengthening of monopoly powers, but a sufficiently competitive system; the basic difference therefore is on the question of the importance to be attached to market forms in characterizing the functioning of an economy, not only

[41] SIMONS (1948), p. 170.
[42] FRIEDMAN (1948).
[43] FRIEDMAN (1954).

in the long period, but also during the cycle. On point d), we have already seen that that difference reflects differences of language and not of substance.

From the picture traced so far, it emerges that if, from the point of view of the analytic instruments employed, the differences between Simons and Keynes are greater than those between Keynes and Friedman, if we consider the method adopted and the vision of the functioning of the system, it would seem that it is Friedman who is isolated. The most significant differences between Simons and Keynes seem to be two: one of a theoretical nature, the other of a preanalytical order. The most significant theoretical difference does not, in our view, concern monetary theory, but the importance of market forms in influencing the behaviour of the economy as regards cyclical phenomena and accumulation.[44] The preanalytical difference covers, at least in part, the same issue. Keynes seems to regard its evolution towards forms of oligopolistic competition as inherent in capitalism, and hence as not being reversible, with the appearance of the trade unions as bearers of values and interests not satisfied by nineteenth century liberalism. Deriving from this picture a preference for the flexibility characteristic of the rule of reason, Keynes arrives at the view that his theory is independent of the specific market form introduced into the analysis.[45] Simons, on the contrary, attributes to the state the responsibility for the problem of business and labour monopolies, and to the state *and* to these monopolies the responsibility for all modern ills. Even if difficult to carry out, the radical reforms put forward by him are regarded as possible, while the position of those who seem to consider as impossible the reversal of the trend is deemed to be defeatist. Strong in this belief, Simons does not in the slightest deviate from the canons of pure liberalism which sees the ideal society as a result of the maximum dispersion of power.

These considerations also offer grounds for re-examining the division between modern monetarists and Keynesians as regards the choice between fixed rules and discretionary policies. As is well known,

[44] In this context, it is perhaps not paradoxical to affirm that there are fewer general differences between PIGOU (1933), Simons and the trend of the stagnationists *à la* STEINDL (1952) than between Simons and Friedman, whose overall work reflects the attribution of socio-political importance, but not of economic significance to oligopolies and trade unions. According to M.W. REDER (1982), the irrilevance of non-competitive market forms to the allocation of resources is a distinguishing feature of the modern Chicago School.

[45] KEYNES (1939).

fixed rules, like the fixed-quantity rule, depend, for their effectiveness, on the extent and rapidity of action of the re-equilibrating mechanisms inherent in a given institutional structure. If these automatic mechanisms act qualitatively and quantitatively in the sense desired, there are no problems of choice: the fixed rule is clearly superior to any discretionary interventions, which are burdened by different and significant types of delays and the possibly imperfect understanding of the phenomena taking place.[46] The problem arises when the *existing* automatic mechanisms, though acting in the sense desired, do not do so with the rapidity and intensity needed to keep disturbances in real variables down to the minimum; while the tendency in the modern debate is towards the comparative measurement of the net advantages offered by each method, Simons and Keynes thought in terms of economic engineering, suggesting institutional modifications capable of creating automatic mechanisms with greater efficacy.

Any Keynesian going back to the Master ought to remember that he wrote that 'organized public works... may be the right cure for a chronic tendency to a deficiency of effective demand. But they are not capable of sufficiently rapid organization (and above all they cannot be reversed or undone at a later date) to be the most serviceable instrument for the prevention of the trade cycle. Buffer stock controls to deal with the epidemic of intermittent effective demand are therefore the perfect complement of development organisations... to offset a deficiency of effective demand which seems to be endemic'.[47] For Simons, as we have seen, the adoption of the fixed-quantity rule is subordinated to the profound reforms required to make prices sufficiently flexible and to eliminate money substitutes. In both authors, with regard to cyclical instability, it is not a question of a better management of the existing structure, but of thinking of possible changes in order to improve its automatic response. By proposing to use discretionary policies as anticyclical measures, the Keynesians do not seem to have fully understood that the alternative in this field between Keynes and Simons is not between fixed rules and discretionary policies, but between institutional reforms of a different design because they flow from the different outlooks outlined above. On the other hand, the modern mo-

[46] The limits to discretionary interventions are mercilessly analyzed in FRIEDMAN (1948, 1951).

[47] KEYNES (1942), p. 122; but these same doubts about the efficacy of public works as an anticyclical policy and this very proposal for the creation of buffer stocks had, it must be said, been already advanced by D. ROBERTSON (1926), pp. 96-9.

netarists, the declared continuators of Simons' tradition, ought to reflect on the meaning of the adoption of the fixed-quantity rule in the absence of the institutional conditions which Simons regarded as indispensable.

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