The Monetary Thought-Ideology Nexus: Simons Versus Keynes

I. Tonveronachi on Simons

Having taken up the gauntlet that we have thrown down to Milton Friedman in our essay "The Chicago Monetary Growth-Rate Rule: Friedman on Simons Reconsidered" (1981), Mario Tonveronachi (1982) advances the analysis of Henry Simons's monetary economics in an important respect. In comparing Simons's theories to Keynes's as well as Friedman's, Tonveronachi highlights the fundamental ideological factor at the heart of Simons's entire approach to economics. As Tonveronachi observes, this focus "is 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" (1982, p. 182).

Tonveronachi demonstrates that Simons was more concerned with delineating the institutional aspects than the theoretical aspects of the economic system within which the values of freedom and efficiency could be enhanced. For Simons's overriding policy objective was to foster the dispersion of power throughout society as the antidote to deviations from free competition. Hence, since the orderly working of economic relations calls, according to Simons, for certainty to be evidenced in the behavior of the monetary authorities, the ideal rule to be espoused, especially for its intelligibility and clarity, is that of maintaining the stock of money constant (the fixed-quantity rule). Thus, the denial of discretionary powers to the monetary authorities is an integral part of Simons's general espousal of legally binding fixed rules that would ensure to the citizenry governmental restraint in the exercise of centralized control. For above all, Simons's aim was the thwarting of any tendency toward the discretionary use of governmental powers over private economic activity. In this vein, Simons sought to curtail concentrations of economic power within the private sector. He perceived the danger of such concentrations arising from the collusive propensity towards restrictive practices on the part of both labor unions and entrenched business firms.

We concur in Tonveronachi's argument that Simons may have had his profound reasons for being more concerned with the institutional than with the theoretical aspects of the capitalist system. In particular, we accept Tonveronachi's insistence that the monetary thought of Henry Simons was an integral part of the latter's conception of capitalism. As Tonveronachi observes, the primacy of Simons's concern with the preservation of capitalism is all the more necessary to fathom in comparing the monetary thought of Simons with that of Keynes (as well as of Friedman). Indeed we adopt this primacy aspect of Simons as our point of departure in the following exposition of what we consider to be the salient features of the relationship between monetary thought and ideology in the comparison of Simons as a new neoclassicist, and Keynes as an anti-neoclassicist. In particular, we contend that cognizance of the ideological element is no less imperative in the case of Keynes than in the case of Simons.

II. Keynes's Ideology

Among economists the range and volume of Keynes's contributions is so vast and multifarious that focusing upon his *The General Theory* as the proving ground for the role of ideology in his work is unavoidably inhibiting. Yet the fact is that it is the *General Theory* Keynes whose impact and whose policy intent are most widely and frequently explored in the assessment of Keynes's monetary thought. Certainly the perspective that Keynes, as economist, himself brought to bear on the metamorphosis of his own life-long concern with money and banking, from *Indian Currency and Finance*, to *A Tract on Monetary Reform*, through *A Treatise on Money* to *The General Theory* reflects the view that *The General Theory* was the full culmination of the evolution of his monetary ideas.

Like Marshall, Keynes made a transition from mathematics to economics through philosophy. Even more than to Marshall, to Keynes philosophy never lost its appeal. Dominating his activities as an economist throughout was his vision of a better world. Thus, even as an economic theorist, his overriding criterion was the operational content of economic models (Moggridge, 1976, p. 157). Permeating his approach to economics was his preoccupation with policy, with the active management by government of the national and international economy. And in the context of his broad intellectual horizons encompassing mathematics, philosophy, politics, the arts, and social psychology, there was manifest throughout the motive of the ameliorative reformer in pursuit of the pathway to the good society.

In light of the monumental series of publications constituting the *Collected Writings* of Keynes under the editorship of D.E. Moggridge, telling evidence is available on the ideological outlook, or *Weltanschauung*, of Keynes. In depicting this aspect of Keynes, Moggridge finds that "Keynes was, for want of a better word, a 'neoliberal', perhaps one of the earliest" (Moggridge, 1976, p. 38). Moggridge clearly demonstrates that "By his own admission, Keynes lay at the 'liberal socialist' end of the broad spectrum of political and social thought that runs to Ludwig von Mises and Hayek and successors such as Milton Friedman at the other. From the beginning, Keynes had rejected *laissez-faire* in its dogmatic form, probably more completely than had Marshall and Pigou before him. From the beginning, he emphasized the essential fragility of the economic order which others took to be natural and automatic and emphasized the need for conscious management" (Moggridge, 1976, p. 38).

From the mid-1920s on, Keynes expressely developed and articulated a social and political philosophy. Though viewing himself as an extremely bad "party man", he was willing to use political parties as vehicles for his ideas. His formal affiliation with the Liberal Party upon elevation to the House of Lords happens to approximate the contemporary connotation of British, as contrasted with Continental European, liberalism as a political movement. Correspondingly, Keynes made it plain that he harbored no desire to keep capitalism — as a system — permanently in place. Rather, he envisaged "...a reformed capitalism, despite its faults, as the best means of solving the economic problem — i.e., of carrying out sufficient accumulation so that society could then forget about encouraging it further in its morality, social customs, economic practices, and institutions.." Hence, "The purposive man, blindly accumulating wealth...would become redundant" (Moggridge, 1976, p. 168): the capitalist would in the course of capitalist development outlive his role.

In this vein, Moggridge could clearly show that Keynes, the optimistic rationalist, "...had no fear of bureaucrats and officials, provided they all had the appropriate moral outlook" (Moggridge, 1976, p. 39). For Keynes saw in the organization and management of contemporary capitalism scope for state intervention or action as a matter of pragmatic choice. And "Once the economic problem of accumulation to achieve an adequate standard of living for all had receded, then men could turn from the economic problem, to 'value ends above means and prefer the good to the useful.' Then would come the social revolution. Then free enterprise might safely go by the boards" (Moggridge, 1976, p. 133).

Thus, Keynes's view of the good society was compatible with a view of capitalism as a necessary but not immutable or pervasive evil. While rejecting the dogma of *laissez-faire* outright, as had Marshall and Pigou before him, Keynes considered capitalism as malleable by means of pragmatic reform and as capable of providing the accumulation of capital necessary to "solve" the basic economic problem without involving revolution. Moggridge's interpretation of Keynes as a "liberal socialist" is corroborated by Keynes's own expressed political outlook in 1939:

> "The question is whether we are prepared to move out of the nineteenth-century *laissez-faire* state into an era of liberal socialism, by which I mean a system where we can act as an organized community for common purposes and to promote social and economic justice, whilst respecting and protecting the individual — his freedom of choice, his faith, his mind and its expression, his enterprise and his property" (Keynes, 1939, p. 123).

Although Keynes saw in capitalism an essential fragility, he maintained that it could be ameliorated and even surmounted by conscious management via state intervention rationally organized by bureaucrats and elected officials, "provided they all held the appropriate moral outlook" (Moggridge, 1974, p. 69). Keynes himself depicted his approach as seeking "...the particular amalgam of private capitalism and State Socialism which is the only practicable recipe for present conditions." For "In contemporary conditions we need, if we are to enjoy prosperity and profits, so much more central planning than we have at present that the reform of the economic system needs as much urgent attention if we have war as if we avoid it" (Keynes, 1939, p. 121).

At the global level as well Keynes discerned scope for central planning, i.e., supernational central banking. In particular, he envisioned, as the ideal system of supernational currency management of the future, the establishment of "a Supernational Bank to which the Central Banks of the world would stand in much the same relation as their own member banks stand to them" (Keynes, 1930, vol. II, p. 399). He drew up a scheme for the founding and management of such a bank. In so doing he espoused the object "to free Central Banks from a compulsory conformity to rigid rules, the strict observance of which is neither in their own interest nor in the common interest" (Keynes, 1930, vol. II, p. 398). Hence, the Supernational Bank would have discretionary power to make advances to central banks and to engage in open-market operations as well as to issue its own "Supernational Bank-money (or S.B.M. for short)" (Keynes, 1930, vol. II, p. 399).

Keynes summarized the operational flexibility of this potentially powerful discretion-laden supernational bank in these terms: "Its methods of attaining [its] ends would be partly by means of its Bank-rate, its Discount Quota and its open-market policy, but largely by consultation and joint action with and between its adherent Central Banks, who would be expected to discuss their own credit policies at monthly meetings of the Board of the Supernational Bank and to act, so far as possible, on lines jointly agreed" (Keynes, 1930, vol. II, pp. 401-402). His willingness to entrust the appropriately staffed Supernational Bank, along with its member central banks, with a wide latitude of discretion, is attested to by his conviction that "It is plain that one can ensure nothing by the terms of a paper constitution. The desirable objectives can only be attained through the exercise of daily wisdom by the monetary authorities of the world" (Keynes, 1930, vol. II, p. 402).

Yet, with due regard to Keynes's preparedness to entrust discretionary powers to central bankers, he also stipulated "general directions" (Keynes, 1930, vol. II, p. 401), which he regarded as coterminous with general rules. In the case of the Supernational Bank these were two: "It would be the first duty of the management of the Supernational Bank to maintain, so far as possible, the stability of the value of... S.B.M.... Its second duty should be the avoidance, so far as possible, of general Profit Inflations and Deflations of an international character" (Keynes, 1930, vol. II, p. 401). Thus, Keynes combined discretion with general — but by no means vacuous — rules as his favored approach to the conduct of monetary policy.

III. The Simons Reaction to Keynes

In the British context of his time, Keynes's outlook has been identified as "neo-liberal". While regarding himself as an extremely bad "party man", he nevertheless took his seat in the House of Lords in the Liberal camp, having adhered to essentially the same political credo from the mid-1920s to his death in the mid-1940s. Permeating his outlook was an optimism about the scope for experimentation with the role of state intervention in economic affairs; always, however, to be based upon persuasion. The ultimate social objective to him was to "release men from the yoke of drudgery and privation, to allow them to enjoy the finer things of life both material and spiritual..." (Moggridge, 1974, p. 69).

On the American economic scene, whether professional or lay, rarely if ever has Keynes been identified as a socialist. At first blush, this absence of association of Keynes with socialism appears to stem from the general disposition in the United States to treat contemporary political liberalism, including espousal of the welfare state, as in the mainstream of mid-20th century democratic (if not Democratic Party) pragmatism. Indeed, insofar as there has been any ideological hostility or suspicion expressed with regard to Keynes in a scholarly context within the span of the first generation of *The General Theory*'s publication, it was to the effect that *The General Theory* may evince shades of fascism. The foremost academic exponent of the overtone of fascism as enveloping the outlook of *The General Theory* is perhaps also the leading academic exponent of *laissez-faire* in its dogmatic form, occasionally associated with the Chicago School, namely Henry C. Simons. Simons has most perceptively come to be acknowledged as "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" (Tonveronachi, 1982, p. 182).

We further concur in the assessment of Simons's intellectual stature by Breit and Ransom that "His obscurity as a public figure belied the influence which Henry Simons exerted on the shaping of economic thought in the Roosevelt era...[as] a generation of students at the University of Chicago listened to Simons's articulate defense of the *laissez-faire* philosophy and neoclassical economic theory" (Breit and Ransom, 1982, p. 208). This assessment is reinforced by Milton Friedman's frank acknowledgement that his own beliefs and values "would be different than they are if I had not had the good fortune to be exposed to Henry Simons" (Friedman, 1967, p. 1).[1]

In view of this renewed and reinvigorated appreciation of the intellectual stature of Simons on the American economic scene, his widely noted critique of *The General Theory* has been all the more influential as a reflection of Chicago School thinking on Keynes. Simons sought to repudiate *The General Theory* as a frontal attack upon traditional economic theory. Simons viewed Keynes's attack upon orthodoxy as not only misdirected but also as indiscreet. "Not content to point out the shortcomings of traditional views, Mr. Keynes proceeds to espouse the cause of an army of cranks and heretics simply on the grounds that their schemes or ideas would incidentally have involved or suggested mitigation of the deflationary tendencies in the economy" (Simons, 1936, p. 1017). Simons found this attitude of Keynes so reprehensible as to note, referring to himself as book reviewer of *The General Theory* in the American Protestant periodical, *The Christian Century*, that "The reviewer is not inclined to be more generous toward monetary orthodoxy than is Mr. Keynes. But the sophistical academic leg-pulling which he perpetrates in this volume, however delightful and entertaining in its proper place, should not be done publicly in times like these, least of all by persons of Mr. Keynes' repute" (Simons, 1936, p. 1017). So dim a view did Simons take of *The General Theory*'s policy stance that he regarded Keynes's attack upon economic orthodoxy as running the risk that Keynes "may only succeed in becoming the academic idol of our worst cranks and charlatans — not to mention the possibilities of the book as the economic bible of a fascist movement". Hence Simons was convinced that "only a kind fate can spare [Keynes] the approbation which he has invited from fools" (Simons, 1936, p. 1017).

Was fate kind to Keynes in sparing him "the approbation which he has invited from fools"? Manifestly, judging by the persistence, volume, range and variety of approbation (along with reprobation) that *The*

[1] Further support to this assessment is implied by Herbert A. Simon referring to his exposure to the University of Chicago. "While I was a student at Chicago (the 1930s) and in my later association with the Cowles Commission in the 1940s and 1950s, there was no single orthodoxy in the University's Economics Department." But he speaks of having studied with, among others, Henry A. Simon, "the closext approximation to a 'Chicago School' economist at that time" (SIMON, 1983, p. 1).

General Theory since its publication to date has evoked, not all the approbation that came Keynes's way is attributable to fools. Yet there appears to be a touch of the prophethic about Simons's prognostication of "the possibilities of the book [*The General Theory*] as the economic bible of a fascist movement." For while Simons explicitly guarded against conveying the impression of portraying Keynes himself as a fascist by noting that in *The General Theory* Keynes was "expressing decided preference for an economic system of free enterprise", other scholars have called attention to Keynes's famous (or infamous?) reference to totalitarianism in his German-language foreword to the published German translation of *The General Theory* (the foreword penned by Keynes on 7 September 1936).[2] The critical statement in question, is translatable from German as follows:

> "The theory of aggregate output, which constitutes the object of the following book, can nevertheless be much more easily adapted to the conditions of a totalitarian state than would the theory of production and distribution of a given output produced under conditions of free competition and a large measure of *laissez-faire*" (Keynes, 1936a, p. IX).

In the context of the time of publication of the German edition, Keynes's foregoing statement abruptly evoked his name as the object of a grapevine of an international sensationalism.[3] The rumor then making the rounds was that Keynes's foreword to his German edition might convey to its intended audience an expression of — if not outright sympathy then at least — a modicum of understanding for the Nazi economic policy then unfolding.[4] The plausibility of such a rumor was

[2] See BREIT and RANSOM, 1982, p. 209; and HAYEK, 1983, p. 41. (Note the misprint in the pagination of footnote 6 of BREIT and RANSOM, 1982, p. 209: their citation of "pp. 39-41" in the German Edition should be: p. IX. Also their transliteration "eines totalitarishen staates"in the text should read: "eines totalen Staates".)

[3] We are grateful to Henry W. Spiegel for his eye-witness account of this episode.

[4] In assessing Keynes's contribution on the occasion of the Keynes centenary, F.A. Hayek mentions Keynes's preface to the German translation of *The General Theory* and remarks that Keynes "frankly recommended his policy proposals as being more easily adapted to the conditions of a totalitarian state than those in which production is guided by free competition" (HAYEK, 1983, p. 41). Hayek also quotes an earlier (1933) statement from an essay by Keynes which Hayek vividly observes to have been "reprinted with equal enthusiasm by the Yale Review, the communist Science and Society, and the national-socialist Schmollers Jahrbuch" (HAYEK, 1983, p. 41). Keynes's 1933 statement was that "The decadent international but individualistic capitalism in the hands of which we found ourselves after the war, is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous — and it does not deliver the goods. In short, we dislike it and are beginning to despise it" (quoted by HAYEK, 1983, p. 41). Indeed, in sequel to Hayek, we may query: was Keynes in his 1933 statement implying that Soviet socialism was any less despicable even if either *would* deliver the goods? There is reason to think that the answer is negative. As we expound in the text above, the reason is provided in *The General Theory* itself.

enhanced by the closing words of Keynes's foreword. In the course of acknowledging the services of his German translator and publisher Keynes observed that "...it has now been sixteen years since [the same publisher] brought out [the German-language edition] of my *Economic Consequence of the Peace* thus having enable me to maintain contact with the German readers" (Keynes, 1936a) p. IX).

There can be no doubt that Keynes in 1936 expressed a desire to continue contact with the German audience he had first attracted with the publication of *The Economic Consequences of the Peace*, (1919), a book that undeniably conveyed understanding for the plight of Germany under the impact of the Peace Treaty of Versailles. Yet we submit that to infer, from Keynes's express recognition of the suitability of *The General Theory* to a totalitarian state, that Keynes must have favored totalitarianism would be unwarranted (as Simons himself expressly realized). In particular, in the body of *The General Theory* itself Keynes makes mention of the concept of the totalitarian state. He does so in the framework of his final chapter of *The General Theory*, Chapter 24: "Concluding Notes on the Social Philosophy towards which the General Theory might lead". Expounding his perception of the traditional advantage of individualism, Keynes maintains that "...individualism, if it can be purged of its defects and its abuses, is the best safeguard of personal liberty in the sense that, compared with any other system, it greatly widens the field for the exercise of personal choice. It is also the best safeguard of the variety of life which emerges precisely from this extended field of personal choice, and the loss of which is the greatest of all the losses of *the homogeneous or totalitarian state*. For this variety preserves the traditions which embody the most secure and successful choices of former generations; it colors the present with the diversification of its fancy, and being the handmaid of experiment as well as of tradition and of fancy, it is the most powerful instrument to better the future" (Keynes, 1936, p. 380). Certainly the reference to the totalitarian state we have here italicized bespeaks no sympathy on the part of Keynes to such a regiment within the bounds of *The General Theory*'s text, a text to which his German-language foreword neither expresses nor implies any qualification.

Thus, it is one thing (A) to view Keynes's German foreword as an open admission of the far greater adaptability to a totalitarian state that is inherent in *The General Theory*'s output theory than is inherent in neoclassical output and distribution theory under *laissez-faire*. It is quite another thing (B) to regard Keynes's German foreword as an indication of concurrence or acquiescence in a totalitarian state (of the Fascist or any other variety). (A) is a warranted interpretation; (B) is not. In particular, Keynes's expression of a desire to uphold the contact with German readers that he had established with a previously translated volume sympathetic to them, does nothing to detract from his clear-cut commitment to the avoidance of totalitarianism that the concluding chapter of *The General Theory* conveys. Thus, he was convinced "that a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment; though this need not exclude all manner of compromises and devices by which public authority will co-operate with private initiative. But beyond this no obvious case is made out for a system of State Socialism which would embrace most of the economic life of the community" (Keynes, 1936, p. 378).

In view of the *non-totalitarian mixed-economy* component of Keynes's social philosophy, his outlook as a neo-liberal, as Tonveronachi appropriately maintains, is to be contrasted with Simons's *Weltanschauung* as an "unreconstructed, old fashioned liberal" (Simons, 1948, p. 185). Thus, while Keynes rejected the thoroughgoing espousal of *laissez-faire*, Simons embraced it. In light of this fundamental cleavage between neo-liberalism and unreconstructed, old-fashioned liberalism, we regard Tonveronachi's argument as well taken when he observes that, in an overall comparison of Simons and Keynes, Tonveronachi's own "analysis makes certain differences in monetary theory less important and gives more weight to some preanalytic and some general theoretical ones" (Tonveronachi, 1982, p. 182). Although we are not certain as to the precise meaning of "preanalytic", we nevertheless concur in Tonveronachi's judgment that "any attempt to consider (as most of his interpreters do) Simons's monetary theory in isolation from the rest of his analysis entails a substantial distortion of his ideas" (Tonveronachi, 1982, p. 189). In the same vein, we accept Tonveronachi's verdict that in previous formulations of Simons's contribution "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" (Tonveronachi, 1982, p. 182). Yet with all due regard to Tonveronachi's proof that in Simons's positive program for *laissez-faire* Simons's "analysis of the effects of monopolies is indissolubly linked to that of the monetary structure" (Tonveronachi, 1982, pp. 190-191), the reiteration of this point must not preempt or distract from a substantial similarity in

monetary analysis and in the resultant norms for monetary reform that Simons and Keynes propounded. In other words, accepting Tonveronachi's implication that one must not lose sight of the forest for the trees, we wish to suggest that one must not lose sight of some big trees for the forest.

IV. The Keynes-Simons Parallelism on Money

The thrust of Tonveronachi's interpretation of Simons is that the defense against the abuses to which the exercise of governmental powers gives rise and the requisite of monetary stability render it essential that the monetary authorities be denied discretionary powers and be subjected instead to fixed rules, rules that would be legally binding and that would be perceived by the public as fervently as a religious dogma. Simons's preferred rule in an ideal banking system is the constancy of the money stock. But within an unreformed monetary system, Simons settles on constancy of the price level as second-best. In his aiming at the attainment of the latter, the instruments of open-market operations and the rediscount rate are integral to central banking. Acknowledging that Simons rejects a monetary growth-rate rule, Tonveronachi must recognize that pursuit of the price-level guideline by the monetary authorities implies the exercise of discretion in the conduct of open-market operations and rediscounting. It turns out, therefore, that more fundamental than the issue of fixed rules versus discretionary powers in delineating Simons's monetary thought is the antecedent basic question: why central banking? It is at this basic level of the rationale for centralized monetary control that Tonveronachi, in common with other exponents of Simons's monetary analysis, may have missed the essential similarity between Simons and Keynes. The failure to recognize such essential similarity arises from the concentration upon Keynes's *The General Theory* to the neglect of his *Treatise on Money*.

Against the backdrop of Simons's social philosophy of the decentralization of political and economic power and the establishment of a *laissez-faire* economy, Simons singles out one market — the financial one — in which, in Tonveronachi's rendition — "the state must reserve for itself absolute sovereignty, to be exercised through centralized control" (Tonveronachi, 1982, p. 183). Accordingly, Simons seeks as the ultimate monetary reform to confine commercial banks to the functions of warehousing and transferring currency, denying them the capacity to lend, under the regime of a 100% réserve requirement against cash.

While not flatly seeking the termination of commercial bank-lending, Keynes in the *Treatise* propounded the proposition that the pursuit of monetary stability requires that the dividing line between demand deposits and time deposits be rigorously drawn to permit the monetary authorities the closest possible monitoring and regulation of demand deposits. So much so that if, indeed, the dividing line between demand deposits and time deposits could be sharply drawn, "...it would be justifiable from some points of view to maintain no [required] reserves at all against them..." (Keynes, 1930, Vol. II, p. 13). For in Keynes's view of the *desideratum* of monetary stability, "...a system is to be welcomed which encourages as strict a segregation as possible between savings deposits and cash deposits" (Keynes, 1930, vol. II, p. 17). In this vein, he favored, "...the stringent character of the provision which reckons all funds held at less than thirty days' notice in the demand category — an excellent provision in itself..." (Keynes, 1930, vol. II, p. 17).

Thus, it is essentially as true of Keynes as of Simons that each sought to ground central banking upon the endeavor to mark out and delineate a functional boundary between financial claims which are, and financial claims which are not, widely accepted means of payment. This is the core of the rationale for assigning absolute sovereignty over the quality, as well as the quantity, of the medium of exchange to the state, in Keynes's, as much as in Simons's, monetary thought. Simons's advocacy of 100% cash reserve requirements for commercial banks is but the attempt to draw to its logical conclusion the Keynesian *desideratum* of encouraging as strict a segregation as can be enforced between time deposits and demand deposits co-existing at commercial banks. The ideological cleavage between Simons — the *laissez-faire* exponent, and Keynes — the socialization-of-investment advocate — has left intact the attempted delineation by each of a functional boundary dividing that which is from that which is not generalized purchasing power.

Recasting the Keynes-Simons uniqueness-of-money hypothesis in terms of the American contemporary deregulation of the financial sector, we can restate the shared moral of their parallel monetary teachings as a timely proposition. The convergence of commercial

banks and financial intermediaries of all types is anathema to both Keynes and Simons. Maintaining the separate identity of the medium of exchange from all other financial claims is the irreducible and ineffable imperative that both Keynes and Simons sought to establish as the cornerstone of central banking. To this end, they were opposed to any blurring of the distinction between commercial banks and other financial enterprises. In turn, the release of commercial banking from the boundary conditions that would preserve its separate identity was in their view tantamount to the abdication of the role of government in providing the framework for economic activity. The preservation of monetary stability as safeguarding the quest for avoidance of inflations and deflations was for both Keynes and Simons synonymous with the institutional circumscription of commercial banks under the aegis of the monetary authority.

V. The Monetarism-Fiscalism Conundrum

The revolution in economic thought to which *The General Theory* gave birth was rejected at the University of Chicago. We have previously delineated the implications of the Chicago School's rejection of the Keynesian revolution with regard to the re-emergence of monetarism in association with a right-wing ideological bent (Aschheim and Tavlas, 1979). Yet at the core of the Chicago resistance to the Keynesian virus lay a reaffirmation of the usefulness of the quantity-theory approach to monetary analysis and the applicability of the quantity theory to policy-related issues. In terms of the monetary thought-ideology nexus, Simons, as well as his Chicago colleagues who shared an interest in the area of macroeconomics, rejected the Keynesian onslaught on the basis of monetary-theoretic considerations. In the heat of the battle during the early years of the Keynesian versus monetarist debate, ideology occupied a subordinate position.

In order to highlight the role of monetary thought in underpinning the Chicago School resistance to *The General Theory,* consider the transformation of Keynes's own thinking on monetary economics beginning with the *Tract on Monetary Reform.* Keynes of the *Tract* was a quantity theorist very much in the Cambridge tradition of Marshall and Pigou. Keynes stated: "This theory is fundamental. Its correspondence with fact is not open to question" (Keynes, 1923, p. 61). He formulated the quantity theory in terms of the demand for money, n = p (k + rk'), where n is the amount of cash in circulation, p is the price level, k is the number of consumption units which the public decides to hold in cash, r is the banks' ratio for checking accounts, and k' is the number of consumption units which the public decides to hold in checking accounts. Pigou, in a 1917 article on *The Value of Money* (Pigou, 1917, p. 74) had referred to the Fisherine transactions-velocity approach to the quantity theory as "something that seems at first sight accidental and arbitrary." Similarly, Keynes argued that his formulation of the quantity theory "seems less artificial than Professor Fisher's [version]" (Keynes, 1923, p. 63).[5] Specifically, by approaching the quantity theory in terms of the demand function for money, Pigou and Keynes imparted a choice-theoretic content to that theory.

In the *Tract* Keynes used his cash-balance version of the quantity equation to articulate a theory in which the business cycle was initiated by shifts in the demand for money. Thus:

> Cyclical fluctuations are characterised, not primarily by changes in n or r, but by changes in k and k'. It follows that they can only be cured if we are ready deliberately to increase and decrease n and r, when symptoms of movement are showing in the values of k and k' (Keynes, 1923, p. 69).

Moreover, once set in motion by changes in k or k', the cycle would be exacerbated by changing expectations with respect to the price level:

> There is a further aggravation of the case, in that an expectation about the course of prices tends, if it is widely held, to be cumulative in its results up to a certain point. If prices are expected to rise and the business world acts upon this expectation, that very fact causes them to rise for a time and, by verifying the expectation, reinforces it; and similarly, if it expects them to fall (Keynes, 1923, p. 34).

Accordingly, Keynes opted for a stabilization policy based on "deliberate decision" and aimed at "controlling the standard of value" by varying the money supply in such a manner so as to offset changes in the demand for money (Keynes, 1923, pp. 35-36).

[5] Fisher is generally considered the progenitor of contemporary monetarism as it has developed in the United States. In a forthcoming paper, however, we provide evidence demonstrating that Fisher's work was anticipated by the neglected nineteenth century quantity theorist, Alexander Del Mar. See TAVLAS and ASCHHEIM (1984). We might also note that the Cambridge formulation of the demand for money was itself to become increasingly "accidental and arbitrary" following the publication of *The General Theory*. See TAVLAS (1981).

A striking aspect of the foregoing views is their basic similarity with the macroeconomics of the Chicago School of the 1930s. Thus, as we have shown elsewhere (Aschheim and Tavlas, 1979), the earlier Chicago economists argued that business cycles were caused by variations in the velocity of circulation or the demand for money (i.e. hoarding),[6] that the cycle was exacerbated by changing price expectations, and that, accordingly, the cure for the cycle consisted of offsetting changes in velocity by varying the money supply in order to achieve price-level stabilization. Said Chicagoan Frank Knight: "An approximate constancy in general prices... can in the nature of the case be achieved by deliberate action, based on constant attention, correcting or offsetting incipient tendencies to expansion or contraction" (Knight, 1941, p. 224). Moreover, compare Keynes's statement on the role of price expectations with the following remark by Chicagoan Paul Douglas:

> ...during a depression, the velocity of circulation of both money and credit is appreciably reduced... Consumers hold dollars in their pockets longer because they expect prices to fall still further and their money will consequently be worth more... Such is the so-called 'hoarding' at the present time. The effect is to decrease the quantity of money offered for goods and hence again to cause prices to decrease (Douglas, 1932, p. 79).

By the time of the publication of the *Treatise* and Keynes's participation in the University of Chicago's Harris Foundation Lectures in 1931, his theoretical thinking had undergone a marked change as Table 1 illustrates. The demand-for-money approach to the quantity theory had been replaced by the controversial and short-lived fundamental equations. The cash-balance mechanics of the *Tract*, where a change in the stock of money exerts its initial impact on the goods market, had been replaced by the income-expenditure approach of the *Treatise*, in which a change in the money stock initially affects the short-term rate of interest via portfolio substitution in the bond market. Keynes appended this transmission mechanism with a theory of the term structure of interest rates whereby the initial change in the short-term rate would lead to a change in the long-term rate and thereby influence profits and the level of investment.

In order to highlight the transformation in Keynes's thought, consider his discussion at the Harris Lectures. The business cycle, he

[6] The exception in Paul Douglas, who thought that depressions are caused by a failure of the money supply to increase in proportion to the secular advance in production. For discussion of Douglas's views, see TAVLAS (1977) and ASCHHEIM and TAVLAS (1979).

TABLE 1

KEYNES VERSUS CHICAGO VERSUS KEYNES

	Keines: Tract	Chicago School (circa, 1930-36)	Keynes: Treatise
Quantity Theory Formulation	Cambridge Equation (Demand for Money, K)	Fisherine Equation of Exchange (Velocity and/or Demand for Money)	Fundamental Equation
Transmission Mechanism	Cash-Balance Mechanics (stock-flow)	Cash-Balance Mechanics (stock-flow)	Wicksellian Income-Expenditure Mechanics (Crude Portfolio Adjustment)
Monetary-Impulse Market	Goods Market	Goods Market	Bond Market
Cycle Theory	Unstable K	Unstable K or V	Unstable Investment
Expectations Variable in Cycle	Price Level	Price Level	Profits
Policy Target Variable	Price-level Stabilization	Price-level Stabilization	Investment Stabilization
Policy Tool	Vary Money Supply	Vary Money Supply	Change Long-Term Interest Rate
Implementation of Policy	Use Traditional Monetary Policy (Vary Short-Term Interest Rate)	Traditional Monetary Policy Weak. Use Budget Deficits to Change Money Supply	Use Traditional Monetary Policy to Change Short-Term Interest Rate and (via Term Structure) Longer-Term Rate

argued, "is a function of costs of production moving at a different rate from prices" (N.W. Harris, 1931, p. 73). So far this sounds like the diagnosis of business cycles developed in the *Tract*, as well as that formulated by the Chicago School of the 1930s. But to Keynes of the *Tract*, as well as to the Chicagoans, changes in the level of output during the cycle were thought to be caused by the failure of costs to move as quickly as prices due to the rigid nature of the cost, or wage, structure. By the time of the Harris Lectures, however, Keynes argued that the disparity between costs and prices was due to "a failure of the rate of interest to be as sensitive as it ought to be to changes in the minds of the business community" (N.W. Harris, 1931, p. 74). Accordingly, Keynes abandoned his earlier persuasion as to the desirability of price-level stabilization and opted instead for stabilization of the level of investment, to be achieved through manipulation of the interest rate. He stated: "What we ought to get rid of are the wastes of the credit (i.e., business) cycle, and *that is not primarily a price problem, it is primarily a rate of interest problem*" (emphasis added) (N.W. Harris, 1931, p. 74). One of those present at the Harris meetings was Alvin Hansen, then of the University of Minnesota, who pressed Keynes on the issue of the proper target of stabilization policy.

> Hansen: What would be your criterion guiding your central banks in their rate of interest? Would it be the movement of the price level? (N.W. Harris, 1931, p. 93).
>
> Keynes: I think as much as anything the volume of impending construction (i.e., investment) is a symptom. I should look at it more than I should look at the price index (N.W. Harris, 1931, pp. 93-94).

Despite the changes that occurred in Keynes's monetary thought, there was one notable similarity between the *Tract* and the *Treatise* which is of fundamental importance in assessing the Chicago School's resistance to the Keynesian revolution. Thus, Keynes in both the *Tract* and the *Treatise* argued that stabilization policy should be implemented through the banking system via the operation of traditional monetary measures, particularly, through manipulation of the bank rate. In contrast, the Chicago quantity theorists had begun to evince a lack of faith in traditional monetary policy by the early 1930s. Such measures were considered: (1) time-consuming; (2) subject to the offsetting influence of confidence which induced banks not to want to lend, nor business to borrow; (3) further subject to the unstable character of fractional-reserve banking which made expansion by a small number of banks self-defeating.[7] Accordingly, the Chicagoans opted for budget deficits in order to attain the necessary variations in the money supply. But they were careful to note that such deficits were entirely consistent within their short-run version of the Fisherine framework. In particular, to the Chicagoans, public works were a means of conducting monetary policy (Aschheim, 1975, pp. 7-8).

Actually, by the time of the Harris Lectures, Keynes, too, had begun to display some reservations concerning the efficacy of traditional banking tools. For example, he noted that attempts to expand the money supply might well be thwarted if the banking system chose to hold additional reserves rather than lend them out to business (N.W. Harris, 1931, p. 449). Nevertheless, he did not regard this as a sufficient qualification to reject the use of traditional monetary measures. Subsequently, he began to share the Chicago view that banking measures were insufficient for dealing with the 1930s depression. Moreover — and in accord with the Chicagoans — Keynes increasingly opted for budget deficits to combat the depression. Where he departed from the Chicagoans, however, was in his denial of the compatibility of budget deficits with the analytic framework of the quantity theory. Instead, Keynes elected to construct a new theoretical structure to support his practical recommendations of public works projects.

As evidence in support of the foregoing argument, consider a most revealing exchange which occurred between D.H. Robertson and Keynes in 1933. Robertson never did become a convert to *The General Theory*, and this exchange explains, in part, why he — as well as the Chicagoans — refused to partake of the Keynesian offensive. The point at issue was how best to justify public works theoretically. Said Robertson in a letter dated April 1, 1933:

> I know I shall never reconvert you to the old K and V (i.e., quantity theory) method; but I can't refrain from suggesting how much stronger they make the *prima facie* case for public works. For on your and (R.F.) Kahn's short period method, all new money becomes completely inert in the end, and most of it pretty quickly. Hence your arguments can do nothing to allay the objections of those who argue that the budgets *of future years* will be burdened by the interest charges on the loan. But surely *prima facie* money once effectively introduced into circulation may be expected to stay there, and to circulate (thus affecting prices or employment as the case may be) with a velocity approximating to that of existing money, unless and until it is withdrawn by taxation, deflation, etc. (original italics) (Keynes, 1979, p. 17).

[7] For documentation, see TAVLAS (1977a).

To which Keynes retorted in a May 3, 1933 letter:

> I doubt that either version of the Cambridge equation is of any serious utility, and I can't remember that I have ever come across a case of anyone ever using either of them for *practical purposes of interpretation... All the versions of the quantity theory*, which make no distinction between swaps and intermediate transactions and genuine production-consumption transactions, *seem to me to tell one nothing* (emphasis added) (Keynes, 1979, p. 18).

Robertson's point regarding the financing aspect of budget deficits was to become a distinguishing feature of the Chicago School. For example, such Chicagoans as Simons (1942), and more recently, Friedman (1972), have argued that debt-financed deficits are contractionary because they fail to operate on the supply of money. In contrast, to Keynesians the financing aspect of deficits was, until recently, of secondary importance.

The important issue, however, concerns the development of Keynes's monetary views and their relation to those of Simons. As Table 1 highlights, the one constant underlying the development of Keynes's monetary thought from the *Tract* to the *Treatise* and the Harris Foundation Lectures was his continued espousal of traditional monetary measures. In contrast, Simons, as well as his Chicago colleagues, argued for the manipulation of fiscal deficits to attain monetary creation. Hence, it was Keynes's continued espousal of traditional monetary measures which initially distinguished him from the Chicagoans. But there is an additional aspect to the story. Specifically, Keynes's monetary theory in the *Tract* stressing direct stock-flow monetary mechanics and its associated emphasis on price expectations and price-level stabilization ran along similar lines to the monetary views characterizing the 1930s Chicago School. The transformation of Keynes's thought in the *Treatise*, accordingly, served to set him apart along *theoretical* lines from the Chicagoans — a transformation which became accentuated with the appearance of *The General Theory*. But by that time it had become clear that the Chicagoans had accepted the compatibility of the quantity theory with a policy of deficit budgets, while Keynes, rejecting that notion, had chosen to set off in another direction. The results of the ensuing monetary-theoretic split were to include a conflict over ideology, the ramifications of which have not been settled to this day.

Washington

J. ASCHHEIM - G.S. TAVLAS

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