“The monetary theory and policy” de Milton Friedman y Henry Simons

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Chapter 4

The Monetary Theory and Policy of Henry Simons

IT IS A GREAT HONOR for me to give the Henry Simons Lecture. He was my teacher and my friend—and above all, a shaper of my ideas. No man can say precisely whence his beliefs and his values come—but there is no doubt that mine would be very different than they are if I had not had the good fortune to be exposed to Henry Simons. If, in this lecture, I express much disagreement with him, that, too, bespeaks his influence. He taught us that an objective, critical examination of a man's ideas is a truer tribute than slavish repetition of his formulas.

I am especially pleased to be giving this lecture under the auspices of the Law School. One of the unique advantages of the University of Chicago for economists has always been the close co-operation and interchange between economists and lawyers. Henry Simons was for many years on the Law School faculty, and Aaron Director and Ronald Coase have continued that fine tradition. *The Journal of Law and Economics* has set the seal on a happy affair.

On re-reading Henry Simons' work in preparation for this lecture, I was struck by the contrast between my reaction to his discussion of monetary theory, on the one hand, and to his proposals for monetary reform, on the other. The monetary theory impressed me as sophisticated and correct; the proposals for

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reform as largely irrelevant and wrong. This contrast and how it can be explained are the themes of this lecture.

Though Simons nowhere set forth a consistent and comprehensive statement of his monetary theory, his views are implicit in his discussion of policy proposals, and explicit in many parenthetical remarks in his often lengthy and always penetrating footnotes.[1] I find myself, not only in full agreement with the views so revealed, but more important, enlightened by them and impressed by their sophistication.

Simons wrote on money mostly during the dozen years from 1933 to 1945. That was a period when, thanks to the Keynesian Revolution, the economics profession came to regard money—in the sense of currency, deposits, banking, and allied issues—as an unimportant and uninteresting subject. The fraction of the profession's attention devoted to this area probably reached an all time low from the late 'thirties to the early 'fifties. Since then there has been a tremendous revival of interest in this area, so that monetary theory is at the moment a dramatic growth industry. Recent developments have deepened and widened our understanding, but they have cast no doubt on Simons' basic analysis of how money enters into the economic system or of the influence it exerts. Quite the contrary. These developments have produced a return to Simons' view that the quantity of money and its behavior play a central role in affecting the course of prices and of economic activity; that monetary stability is an essential prerequisite for economic stability.

Simons' policy proposals are a very different matter. They consist of two separable elements: (1) proposals for reforming the banking and financial structure—as he put it "transition to a less preposterous structure of private money contracts" (p. 170), (2) proposals for "establishment of a simple, mechanical rule of monetary policy" (p. 170). In his role as a monetary theorist, he clearly found the second much more intriguing and interesting. Yet he regarded it as the less important. The urgent and immediate task, the essential pre-condition for the satisfactory operation of any monetary rule, was, he believed, financial reform.

In Simons' view, the "financial good society" (p. 239) required "financial reform . . . aiming at sharp differentiation between money and private obligations" (p. 79). He viewed his well-known proposal for 100 per cent reserve banking "only as the proper first step toward reconstruction of our whole financial organization. Standing by itself, as an isolated measure, it would promise little but evasion . . . and would deserve classification as merely another

1. One partial exception to the statement that Simons nowhere set forth a consistent statement of his theory is an *Appendix on Banking and Business Cycles* in an unpublished and unsigned memorandum dated November, 1933, *Banking and Currency Reform*. In a footnote, Simons describes this memorandum as having been "prepared and circulated by several Chicago economists" but, according to Aaron Director, one of the group, it was written primarily by Simons. See Henry Simons, *Economic Policy for a Free Society*, Chicago, Ill.: University of Chicago Press (1948), p. 326, note 2. All subsequent page references in the text are to this book.

crank scheme" (p. 331, n. 17).[2] In addition to 100 per cent reserve banking, "Narrow limitation of the formal borrowing powers of other corporations would obviously be necessary. . . . Further limitations might also be necessary with respect to financing via the open account (book credit) and instalment sales" (p. 171). For government, the debt structure should be drastically simplified, with all government obligations taking the form either of non-interest bearing money or very long-term securities, ideally perpetuities (consols).

On monetary policy, Simons vacillated between favoring a rule expressed in terms of the quantity of money—for example, that the quantity of money be kept constant—and a rule expressed in terms of a price index—for example, that the authorities be instructed to keep the wholesale price index stable. His final position was, roughly, that the price-index rule was the only feasible rule pending a closer approximation to the "financial good society," but that the quantity of money rule was much preferable, when and if the "financial good society" was attained.

I would myself be inclined precisely to reverse Simons' priorities—and so, I believe, would most other modern students of money, even those of us who share most completely Simons' basic objectives of social policy. Financial reform along his lines seems not only unnecessary but in the wrong direction.[3] Why should we not have variety and diversity in the market for borrowing and lending as in other markets? Is it not desirable that borrowers tailor their obligations to the demands of lenders? Is it not a sign of the ingenuity and efficiency of the free market that financial intermediaries develop which reconcile the needs of borrowers and lenders—providing funds on terms desired by borrowers and borrowing on terms desired by lenders? This simultaneously lowers the cost of capital to borrowers and raises the effective return on capital to lenders—thereby fostering a higher level of capital formation than would otherwise occur.

I agree with Simons on the desirability of 100 per cent reserve banking—but I regard it as less important and basic than he did and favor it in some ways for almost the opposite reasons. He viewed it as a step toward simplifying the structure of financial claims, as a step toward making effective the legislative limitations he favored on the terms on which people could borrow and lend. I view it as a step toward reducing government interference with lending and borrowing in order to permit a greater degree of freedom and variety in the arrangements for borrowing and lending.

2. His proposal involved separating existing commercial banks into two sets of institutions. One would be essentially a warehouse for money. It would accept demand deposits transferable by check but be required to keep a reserve in cash (or deposits at the Federal Reserve) of 100 per cent of such deposits, and would get its income from service charges paid by depositors. The other would be an investment trust which would take over the lending activities of commercial banks, getting its capital by issuing securities to the public.

3. Emphasis on this type of reform has almost disappeared from the literature. Its only counterpart was a temporary flurry of interest in non-bank financial intermediaries a few years ago.

Even on monetary policy, where the passage of time has only strengthened my belief in the lesson he taught me—that rules are greatly to be preferred to authorities, I am inclined to reverse his emphasis. A rule in terms of the quantity of money seems to me far superior, for both the short and the long-run, than a rule in terms of price-level stabilization.

What explains this contrast? How is it that I can admire so greatly Simons' grasp of monetary theory and disagree so completely with his proposals for reform? We have all of us in our personal lives had the experience of coming on a fact that suddenly illuminated an issue in a flash, showing us how wrong we had been and leading us to a fresh and very different opinion. It is something of an oversimplification, but only a slight one, I believe, to say that that is the explanation of the contrast I have been stressing. A few facts, which we now know and he did not, have made all the difference.

The facts have to do primarily with the Great Depression of 1929–1933. Were I to interpret that episode as Simons did, I would agree with his recommendations. Had he interpreted that episode as I do, he would not have made the policy recommendations he did. And our difference of interpretation is not simply a difference of personality or taste: It reflects—or so I would like to believe—the accumulation of evidence through scientific study.

Needless to say, Simons' interpretation was not unique to him. On the contrary, it was widely shared by his contemporaries. In particular, I have been struck that the statements I have been making about Simons apply almost verbatim to John Maynard Keynes. He, too, was led to make policy recommendations that seem wrong now—and in his case that differed drastically from his own earlier views—because he accepted the same interpretation of 1929–1933 as did Henry Simons. In his case, too, I find his monetary theory sophisticated and modern, yet his policy recommendations unacceptable. As we shall see later, though some of his policy recommendations parallel Simons', in other respects they differ drastically. But they differ not because of a difference in monetary theory or a different interpretation of 1929–1933 but because of a different basic attitude toward social policy—Keynes was a reformer, Simons, a radical.

In exploring this thesis further, I shall outline Simons' interpretation of the 1930's and similar episodes, show how his policy recommendations follow from that interpretation, and contrast his policy recommendations with Keynes'. I shall then indicate what our current interpretation of this episode is and suggest what policy views derive from that interpretation.

I. SIMONS' INTERPRETATION OF BUSINESS CYCLES IN GENERAL AND THE GREAT DEPRESSION IN PARTICULAR

"The problem of synchronous industrial . . . fluctuations," wrote Simons, "is a problem (*a*) of rigidities in crucial areas of the price structure . . . and (*b*) of perverse flexibility in the total turnover (quantity and velocity) of effective money" (p. 165).

The perverse flexibility in "total turnover"—Keynes' aggregate demand—was reinforced, Simons thought, but not essentially produced, by changes in the quantity of money. It reflected rather changes in "the speculative temper of the community."[4] Such changes, he argued, produce changes in velocity that can develop into "catastrophic disturbances as soon as short-term borrowing develops on a large scale. . . . Short-term obligations provide abundant money substitutes during booms, thus releasing money from cash reserves [that is, raising velocity]; and they precipitate hopeless efforts at liquidation during depressions [that is, lowering velocity]" (p. 166).

These "cumulative maladjustments are likely to be peculiarly severe" "in an economy where most of the effective money is provided by private banks" because "the quantity of effective money, as well as its velocity, responds promptly and markedly to changes in business earnings."[5]

Widespread borrowing on short-term in order to finance long-term obligations is the key to instability because, in Simons' view, it makes the economy vulnerable to changes in confidence and hence in the desire for liquidity. Each individual separately may be in a position to convert his assets into cash but the economy as a whole is not. There is "shiftability" but not "liquidity." The commercial banking system makes this problem more serious not primarily as a creator of money, but because it fosters more widespread and extensive borrowing on demand and lending on time.

This vision undoubtedly was derived largely from the 1929–33 crash. Hence, Simons put special emphasis on the potentialities in such a system for deflation. ". . . [W]e evolved a fantastic financial structure and collections of enterprises for money-bootlegging, whose sanctimonious respectability and marble solidity only concealed a mass of current obligations and a shoestring of equity that would have been scandalous in any other type of business. . . . [W]e evaded long term deflation by continuously courting deflation catastrophe" (pp. 198–99).

Or again, "once a crisis has developed, and once earnings have begun to decline, the process is even more chaotic. Each bank seeks to contract its loans; but none augments its reserves unless it contracts more rapidly than the rest. Every reduction in bank loans means reduction in the community's effective money; and this in turn means lower prices, smaller volume of business, and still lower earnings. . . .

"It is more than an incidental aggravation that practically all the banks of necessity become insolvent in the process, and that large numbers are actually forced to close."[6]

4. Appendix to *Banking and Currency Reform*, p. 2 (see note 1 above).

5. See *ibid.*, p. 3.

6. See *ibid.*, p. 5.

For our purposes, the key feature of this interpretation is that the channel of influence runs from changes in business confidence to changes in velocity to changes in the quantity of money. For the depression, it is the collapse of confidence (Keynes' collapse of the marginal efficiency of investment) that sets off a demand for liquidity. This demand cannot be met but the attempt to meet it forces widespread liquidation, including the liquidation of bank loans with a resultant decline in the quantity of money and runs on banks.

Simons implicitly regarded the Great Depression as occurring despite, not because of, governmental monetary policy. Though he made no explicit statement to this effect, Simons' quite clearly accepted the official apologia of the Federal Reserve System—it had done its best, but was powerless to stop the collapse, once private confidence was sapped, as it was by the stock-market crash. "Reflect casually," says Simons, "on what the thirties might have been if only we had not permitted the stock-market crash to initiate a long and precipitous deflation in the United States. . . ." (p. 272).

II. SIMONS' THEORY OF CYCLES AND HIS POLICY PROPOSALS

It is clear how Simons' policy proposals derive from his interpretation of the Great Depression. It is the rigidity of prices that converts fluctuations in aggregate demand into fluctuations in output and employment. Hence, greater flexibility of prices is highly desirable, whatever else is done. This is the link between Simons' views on money, on the one hand, and on monopoly in industry and labor and government price-fixing, on the other. The way to make prices less rigid was by measures that are desirable in any event in order to make the economy more competitive. Hence, in his monetary writings, he only stated the objective of price flexibility, without a bill of particulars.

Since ~~the inherent~~ instability of the financial structure is the source of cumulative maladjustments, the *sine qua non* of stability in a free market economy is an improved financial structure. The "approximately ideal condition" would be one in which "there were no fixed money contracts at all—if all property were held in a residual-equity or common-stock form. With such a financial structure, no one would be in a position either to create effective money substitutes (whether for circulation or for hoarding) or to force enterprises into wholesale efforts at liquidation. Hoarding and dishoarding (changes in velocity) would, to be sure, still occur; but the dangers of cumulative maladjustment would be minimized" (p. 165).

In the absence of such financial reform, "The obvious weakness of fixed quantity [of money], as a sole rule of monetary policy, lies in the danger of sharp changes on the velocity side. . . . The fixing of the quantity of circulating media might merely serve to increase the perverse variability in the amounts of 'near moneys' and in the degree of their general acceptability. . . ." (p. 164).

Hence, pending such financial reform, the theoretically attractive quantity of money criterion had to be relegated to the "more distant future" (p. 183) despite its unique advantage of providing an objective rule and minimizing the role of discretion by monetary authorities. "For the present, we obviously must rely on a large measure of discretionary money management. . . ." (p. 170). But this discretion should be guided by some definite policy objective, not be ". . . merely the composite of the uncertain daily actions of an indefinite number of agencies, governmental and private" (p. 174). Simons was led by this route to endorse reluctantly the stabilization of a price index as the only feasible means of ". . . bringing the totality of monetary measures under the discipline of some rule. . . ." (pp. 174–75). "If price-level stabilization is a poor system," he wrote, "it is still, from a liberal viewpoint, infinitely better than no system at all. And it seems now highly questionable whether any better system is feasible or possible at all within the significant future" (p. 174).

Finally, if, in the existing financial structure, the fluctuations in aggregate demand originate in the private sector and in turn affect the commercial banking system, and if a major problem is the ease with which non-banks can create and destroy near-moneys, then the banking authorities, strictly interpreted, operate on too narrow a base to be able to control the price level. "Banking," Simons said, "is a pervasive phenomenon, not something to be dealt with merely by legislation directed at what we call banks" (p. 172). Hence, "The task [of stabilizing the price level] is certainly not one to be intrusted to banking authorities, with their limited powers and restricted techniques, as should be abundantly evident from recent experience. Ultimate control over the value of money lies in fiscal practices—in the spending, taxing, and borrowing operations of the central government" (p. 175).

III. SIMONS AND KEYNES

There is clearly great similarity between the views expressed by Simons and by Keynes—as to the causes of the Great Depression, the impotence of monetary policy, and the need to rely extensively on fiscal policy. Both men placed great emphasis on the state of business expectations and assigned a critical role to the desire for liquidity. Indeed, in many ways, the key novelty of Keynes' *General Theory* was the role he assigned to "absolute" liquidity preference under conditions of deep depression. It was this, in his view, that made it impossible for the monetary authorities to influence interest rates. It was this that meant that changes in the quantity of money produced by the monetary authorities would simply be reflected in opposite movements in velocity and have no effect on income or employment.

Keynes had earlier been a strong champion of relying primarily on orthodox monetary policy to promote economic stability. He abandoned this position when he concluded that liquidity preference could frustrate central bank attempts to alter long-term interest rates. Like Simons, he turned instead to fiscal policy

—changes in government expenditures and taxes—as his primary reliance.[7]

Despite the similarity between the views held by Simons and Keynes, Simons, as best I can determine, arrived at his views independently. My earlier quotation from Simons that "ultimate control over the value of money lies in fiscal practices" comes from an article published in February, 1936, or at roughly the same time as Keynes' *General Theory*. (The preface is dated December, 1935, and the book bears the publication date of 1936.) More important yet, Simons' basic ideas on both theory and policy are all contained in an unpublished mimeographed memorandum dated November, 1933. Already in that memorandum, Simons had written "at the present time, increase of expenditures or reduction of taxes would be far more immediately effective toward raising prices than conversion of the federal debt into the non-interest bearing form."[8] Indeed, I have always thought that it was because such ideas as these, and the earlier ones I have summarized, were in the air at the University of Chicago in the early and mid-1930's that the Chicago students were so much less susceptible to the Keynesian virus than their contemporaries in London, England, and Cambridge, Massachusetts, who were taught that the Great Depression was a necessary and ultimately healthy purgative.

The major differences between Keynes and Simons on policy reflected their difference in temperament. To both, the financial structure threatened instability. To Keynes the reformer, with his emphasis on short-run problems—it was he, after all, who said, "in the long-run we are all dead," with his confidence in civil servants to control and regulate—he was himself, after all, in and out of the civil service, with his belief that we had seen 'the end of laissez-faire,' as he entitled a famous article, the solution was to substitute government intervention

7. In a letter commenting on this lecture, Friedrich A. Hayek writes: "I believe you are wrong in suggesting that the common element in the doctrines of Simons and Keynes was the influence of the Great Depression. We all held similar ideas in the 1920's. They had been most fully elaborated by R. G. Hawtrey who was all the time talking about the 'inherent instability of credit' but he was by no means the only one. . . . It seems to me that all the elements of the theories which were applied to the Great Depression had been developed during that great enthusiasm for 'business cycle theory' which preceded it."

No doubt the elements of the theories were all present and Hayek may be right that the Great Depression did not have the effect on Keynes' views that I attributed to it. However, the Great Depression surely produced a different emphasis. More important, my impression is that the Great Depression also produced an important difference in substance. Hawtrey and others emphasized the inherent instability of banking credit proper; their stress was on the forces that Simons described as explaining why these "cumulative maladjustments are likely to be peculiarly severe," "in an economy where most of the effective money is provided by private banks," not on the earlier effects to which Simons attributed the cumulative maladjustments themselves. The Great Depression led, I believe, Keynes and Simons to emphasize the inherent instability of the financial structure more generally—the effect of near-moneys rather than of money itself. Unfortunately, I have not had the opportunity to investigate this point at all fully, so this reaction to Hayek's comment is a tentative impression, not a documented conclusion.

8. Appendix to *Banking and Currency Reform*, p. 13.

for market adjustment, to replace where necessary private investment by government spending. To Simons the radical, who always took the long view, who had the Midwesterner's suspicion of the bureaucrats in Washington, who regarded a large measure of laissez-faire as an essential requisite for the preservation of political liberty, the solution was to go to the root of the problem by reforming drastically the financial structure.

IV. THE KEY FACTS AS WE NOW KNOW THEM

The keystone of Simons' interpretation of 1929–1933 was that the trouble originated with business earnings and the shock to business confidence, documented or perhaps initiated by the stock-market crash. The subsequent widespread pressure for liquidation, on his interpretation, left the monetary authorities, narrowly defined, largely powerless. Once the scramble for liquidity was on, there was no way they could prevent a decline in the value of private claims and debts, which in turn rendered banks insolvent, and induced their depositors to try to withdraw deposits.

We now know that the critical relations ran precisely the other way. Beginning in mid-1928, the Federal Reserve System, concerned about stock-market speculation, adopted a monetary policy of nearly continuous restraint, despite its desire to foster business expansion. The result was a policy that was ". . . not restrictive enough to halt the bull market yet too restrictive to foster vigorous business expansion."[9] The stock of money failed to rise and even fell slightly during most of the cyclical expansion from November, 1927 to August, 1929—a phenomenon not matched in any prior or subsequent cyclical expansion.

Cyclical contraction began in August, 1929, well before the stock-market crash in October, 1929. That crash no doubt did shake business confidence and may well have produced a rise in liquidity preference (that is, a decline in velocity). But there is no sign that it produced any panicky pressure for liquidation, any tendency for bankers to call loans, any concern about the safety of banks, or any widespread deterioration in the value of bank assets—on the contrary, the prices of the kinds of bonds banks held initially went up rather than down.

The downward pressure on velocity produced by the reaction to the stock-market crash was strongly reinforced by the behavior of the quantity of money, which fell by 2.6 per cent from August, 1929, to October, 1930. This may seem like a small decline—and it is, compared to the total decline of over 30 per cent that occurred before the depression was over. But the decline should be interpreted in the light of prior and subsequent experience. Because of the long-term growth in the quantity of money, there are only four earlier cyclical contractions

9. M. Friedman and A. Schwartz, *A Monetary History of the United States, 1867–1960*, Princeton, N.J.: Princeton University Press for the National Bureau of Economic Research (1963), p. 298.

and no later ones in which the quantity of money declined as much—and all of these earlier exceptions were also unusually severe contractions.

For our purposes, the source of the decline in the quantity of money is even more important than its magnitude. It was produced entirely by a decline in Federal Reserve credit outstanding. No part whatever was played by weakness in the banking structure, attempted liquidation of loans by banks, or an attempt by depositors to convert deposits to currency. On the contrary, the banks' willingness to reduce reserves and the public's willingness to hold more deposits relative to currency offset half of the decline in Federal Reserve credit. The monetary authorities, not the private economy, were the major source of deflationary pressure.

The character of the contraction changed drastically in December, 1930, when a series of scattered bank failures culminated in the dramatic failure of the Bank of the United States in New York—the largest single bank failure in the United States up to that time. For the first time, there was widespread distrust of banks and runs on banks. But again the sequence was the opposite of that which Simons postulated. The runs on banks produced pressure on banks to liquidate. This did lower the market value of their assets and so gave substance to the initially unfounded fears about the safety of the banks. But their position was not weakened by declines in the value of their assets originating in the rest of the financial structure.

A major objective in establishing the Federal Reserve System in 1913 was to meet precisely this kind of situation—to serve as a "lender of last resort" in order to enable banks to meet the demands of depositors without having to dump assets. In the immediate month of December, 1930, the Reserve System behaved to some extent as initially intended. But no sooner was the immediate crisis over than it retreated back to its earlier position and renewed its deflationary pressure on the money supply.

When a second banking crisis began in March, 1931, the Reserve System did not even temporarily step in to ease the situation. The only relief came from gold imports. The Reserve System renounced its heritage and treated the banking crisis as something outside its sphere of competence.

But worse was yet to come. When Britain left gold in September, 1931, the Reserve System embarked on an active deflationary policy—taking the most extreme deflationary measures in its history before or since. The result was to turn a crisis into a catastrophe. The quantity of money had fallen at an annual rate of 13 per cent from March, 1931, to August, 1931. It fell at the incredible annual rate of 31 per cent in the five months from August, 1931, to January, 1932.

One fact during this episode highlights the error in Simons' interpretation. The chief problem confronting banks was not the collectibility of their commercial loans but the decline in the prices of the bonds they held in their portfolios. Among the prices that declined was the price of U.S. government bonds, which fell by 10 per cent. This price decline clearly did not reflect a scramble for liquidity on the part of the community at large or the decline in earnings of business enterprises or a fear about the safety of the bonds. Like the accompanying decline of 20 per cent in the price of high grade corporate bonds, it reflected the inevitable effect of the dumping of bonds by banks which was enforced by the failure of the Federal Reserve System to provide sufficient liquidity to enable banks to meet the demands of their customers.

In our *Monetary History*, Anna Schwartz and I summarized the role of the Reserve System in the great contraction from 1929–1933 as follows:

"The System pleaded impotence, arguing explicitly that the non-monetary forces making for contraction were so strong and violent that it was powerless to stem the tide, and implicitly that the depth of the decline in the money stock was due to the depth of the decline in business activity, rather than . . . the reverse. Many others, recognizing the good intentions of the monetary authorities and the ability of many individuals in the System, while independently holding a wide variety of views about the role of money in economic affairs, accepted the System's plea"—as we have seen, Simons and Keynes were of this company.

Evaluating the claim of impotence, we concluded that "At all times throughout the 1929–33 contraction, alternative policies were available to the System by which it could have kept the stock of money from falling, and indeed could have increased it at almost any desired rate. These policies did not involve radical innovations. They involved measures of a kind the System had taken in earlier years, of a kind explicitly contemplated by the founders of the System to meet precisely the kind of banking crisis that developed in late 1930 and persisted thereafter. They involved measures that were actually proposed and very likely would have been adopted under a slightly different bureaucratic structure or distribution of power, or even if the men in power had had somewhat different personalities. Until late 1931—and we believe not even then—the alternative policies involved no conflict with the maintenance of the gold standard. Until September, 1931, the problem that recurrently troubled the System was how to keep the gold inflows under control, not the reverse."[10]

I have stressed the Great Depression because this climactic episode clearly played a key role in leading Simons—and also Keynes—to believe that the orthodox powers of the monetary authorities were too weak to cope with disorders arising in the private financial markets. In fact, as I have emphasized, the private financial markets displayed extraordinary resilience and stability—but not enough to cope with the disorders arising from the actions—and inaction—of the monetary authorities.

Since Simons wrote, an enormous amount of evidence has accumulated that bears not only on these few years but also on a far wider range of economic history. This evidence, too, contradicts Simons' interpretation of the source of instability. It turns out that the rate of growth of the quantity of money has systematically tapered off well before the economy in general slows down, and

10. Ibid., pp. 691, 693.

has speeded up well before the economy speeds up. The movements in velocity —which Simons took as an independent source of instability—come later than the movements in the quantity of money and are mild when the movements in the quantity of money are mild. They have been sharp only when there have been sharp movements in the quantity of money. There is no evidence to support Simons' fear that a fixed quantity of money might involve "the danger of sharp changes on the velocity side." On the contrary, the evidence is precisely the reverse—that it would lessen the danger of sharp changes in velocity.

V. POLICY IMPLICATIONS

Had Simons known the facts as we now know them, he would, I believe, have been confirmed in "his earlier persuasion as to the merits of the rule of a fixed quantity of money. . . ." (p. 170)[11] rather than have accepted, albeit with great reluctance, stabilization of a price level as at least a temporary objective pending the establishment of the "financial good society." He would not have felt constrained to denigrate monetary powers narrowly conceived and to elevate fiscal powers to the forefront as the major weapon of monetary policy.

In short, as it happens, a correct view of the facts would have strengthened his basic intuitions, would have reinforced his confidence in policies fully consistent with his central belief in laissez-faire for the private economy and the rule of law for governmental bodies.

Instead, because of a misconception of the facts, he was led to compromise for the short run and to propose radical reform for the long-run.

Is it just a happy accident that a fuller study of the facts would have led Henry Simons to compromise less with his basic intuitions, would have supported the conclusions to which he was drawn by his economic theorizing? I believe not. Those intuitions, those conclusions were derived from a sophisticated body of economic theory that had developed over centuries. Such a body of theory has implicit in it a set of empirical judgments about the character of the world. It

11. To avoid misunderstanding, I should note explicitly that Simons' rule is not identical with the rule I have come to favor. Simons proposed that the quantity of money be held constant in amount. I propose that it grow at a fixed rate year after year, the rate of growth being designed to produce roughly stable final-product prices.

Simons explicitly rejected the rule of a constant rate of growth. He recognized that his rule of a constant money supply involved a secular decline in final product prices. His basic reason for favoring it nonetheless was that the sticky and inflexible prices were factor prices, especially wages, and that a constant quantity of money would (aside from growth of population, which he thought would decline and might disappear, and aside from secular changes in velocity, which he ignored) mean stability in these prices and hence would minimize the necessity for changes in the sticky prices. Supplementary reasons were the greater ease of public understanding of a constant quantity of money than of a necessarily arbitrary rate of growth and the greater pressure for fiscal discipline it would impose on legislators.

survives if and only if those implicit judgments are vindicated by experience. It may go into temporary eclipse when casual empiricism seems to run counter to it. That is what happened during the 'thirties. But the sign that it is a good theory is that it will revive and be restored to grace as emerging evidence vindicates it. That is what has been happening in the past decade. That is why Simons' keen theoretical understanding has proved more permanent than his empirical compromises.