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 multilayered 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 expressly 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 purposeful 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., supranational central banking. In particular, he envisioned, as the ideal system of supranational currency management of the future, the establishment of "a Supranational 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 Supranational 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 "Supranational 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 supranational 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 Supranational 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 Supranational 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 Supranational Bank these were two: "It would be the first duty of the management of the Supranational 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 evoke 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” (Tonkonouaci, 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 indirect. “Not content to point out the shortcomings of traditional views, Mr. Keynes proceeds to expose 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’s 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 repudiation) that The

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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 1920s) 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. Simons, “the closest approximation to a ‘Chicago School’ economist at that time” (SMON, 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 prophetic about Simons's prognostication of "the possibilities of the book [The General Theory] as the economic bible of a fascist movement." 9 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). 10 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. 11 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. 12 The plausibility of such a rumor was 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 Consequences 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 Tonneronach's appropriately maintains, is to be contrasted with Simons's *Weltaus- schauung* as an "unconstructed, old-fashioned liberal" (Simons, 1948, p. 183). Thus, while Keynes rejected the thoroughgoing espousal of *laissez-faire*, Simons embraced it. In light of this fundamental cleavage between neo-liberalism and unconstructed, old-fashioned liberalism, we regard Tonneronach's argument as well taken when he observes that, in an overall comparison of Simons and Keynes, Tonneronach's own "analysis makes certain differences in monetary theory less important and gives more weight to some preanalytic and some general theoretical ones" (Tonneronach, 1982, p. 182). Although we are not certain as to the precise meaning of "preanalytic", we nevertheless concur in Tonneronach'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" (Tonneronach, 1982, p. 189). In the same vein, we accept Tonneronach'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" (Tonneronach, 1982, p. 182). Yet with all due regard to Tonneronach'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" (Tonneronach, 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 Tonneronach'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 Tonneronach'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, Tonneronach 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 Tonneronach, 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 Tonneronach's rendition — "the state must reserve for itself absolute sovereignty, to be exercised through centralized control" (Tonneronach, 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% reserve 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 requires 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 inestimable 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, \( n = p (k + r) \),
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 Fisherian 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). 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 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, the 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 "delibera-
tive 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).

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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 Taylas, 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) 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 constan-
cy 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 *Tract* 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 funda-
mental 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

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4 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 *Taylors and Accouchy* (1964). We might also note that the
Cambridge formulation of the demand for money was itself to become increasingly "accidental and

* The exception is 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 *Taylors* (1957) and *Aschheim and Taylas* (1979).
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, so 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 target of stabilization policy.

Hansen: What would be your criterion guiding your central bank 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 impeding 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 rate. In contrast, the Chicago quantity theorists had begun to evoke 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 Fisherian 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. Subse-
quently, 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
is pretty quickly. Hence your arguments can do nothing to avert 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).

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 Chicago-
ans. 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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Measuring Trade in Financial Services

There has always been trade in financial services.¹ Bankers have provided financial intermediation, foreign exchange market and other financial services across national boundaries. But the importance of such trade has increased greatly in the past two decades with the internationalisation of banking and the growth of international financial centres as the bases for offshore currency markets and other activities linking national capital markets. The question naturally arises how to measure the value and growth of this trade in financial services. The issues involved in this question are closely related to the difficulties that have been encountered in the treatment of financial enterprises in social accounts for national economies. It is best approached by going back to these issues.

Financial Services in Closed Economies

The crux of the problem was clearly explained in the 1947 memorandum by Richard Stone which laid the foundations for the original United Nations system of national accounts. "If we treated banks (and other financial intermediaries) like ordinary businesses, we should show as their sales proceeds simply their charges to customers and, as a consequence, a deficit rather than a surplus would appear on the other side of the operating account. In practice, this deficit would be so large that the property income generated in banking and even perhaps the whole income generated in banking would appear to be negative. This is clearly unsatisfactory,"²

¹ This paper deals with financial services other than insurance.