THE HENRY SIMONS LECTURE

Comments on The Monetary Theory and Policy of Henry Simons by
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This paper by Professor Friedman really joins the issue between the Keynesian and the non-Keynesian economists. Friedman correctly sees that the critical element in choosing between monetary and fiscal policies is whether financial crises, instability, tremors, or whatever label you choose to apply are inherent in capitalism. In Friedman's view, they are the result of a perverse policy, with respect to the quantity of money: He makes his ~~cuse~~ case by citing the experience of 1929 - 33. Even though he argues that changes in the supply of money were the essential determinants of the financial crisis, he recognizes that the key element in making fiscal policy the core of economic policy is the situation that exists after the financial crisis.

A gross logical weaknesses in his argument is that even if we accept that perverse monetary policy ~~was~~ is the cause of the breakdown of the financial system, which ~~is what~~ he argues ~~occurred during~~ is [illegible] the great depression, it does not follow that appropriate policy after such a human-error generated financial crisis ~~was~~ is the establishment of monetary stability in his sense. That is after a financial crisis monetary stability need not efficiently lead to the elimination of the big depression reaction, even if monetary instability was the cause. Friedman can be granted the correctness of his diagnosis without simultaneously giving him anything as the aptness of his corrective prescriptions.

Thus the propositions that (1) there exists financial structures such that in these appropriate contexts ~~that~~ a non-unusual event will imply a financial crisis, and that (2) these financial structures can result from the evolution of an enterprise economy are critical in choosing between Keynesian and non-Keynesian interpretations of system behavior. Obviously, the material in my "Commission on Money and Credit" paper as well as papers such as "Can It Happen Again," and "Linear Models of Cyclical Growth," together with the work on "Economics and Euphoria" are really very relevant.

When Friedman talks about money, he writes "in the sense of currency, deposits, banking and allied issues." If money as a subject of study is defined as Friedman does, then it is heroic to assume that all of the monetary supply and demand problems can be subsumed under demand plus time deposits at commercial banks plus currency. I would argue that even as he sees it, money is really what I call finance, and finance is central to the study of an enterprise economy.

If monetary stability is an essential prerequisite for economic stability and money is defined as above, the question arises is monetary stability attainable. Simons' good financial society required monetary reform because Simons always was worried and concerned about the old pervasiveness of money and monetary phenomena. It is perhaps a liquidity attribute of money that he has in mind. It may be that he, too, used money in a vague way. The <u>gutsey</u> question is how much of the 1929-1933 development was an inevitable tremor and how much was due to human error that led to the amplification of the perhaps minor initial distrubance. The earthquake of 1929-33 is hoepfully not inherent in capitalism. It is a tremor of let us say a shakeout of a bull market, or the impact of a profit squeeze on liquidity positions of non-financial business firms, or the feed back from rising interest rates upon the solvency and liquidity of savings intermediaries that is inevitable. These liquidity tremors are an inevitable part of finance Capitalism. Aggressive central banking can prevent these tremors from generating the earthquakes of a thorough-going tremor.

It is really a Mitchell-type view that the stresses and strains of the expansion--boom are first felt and later amplified in the financial system. That the boom is going to generate stresses and strains is, of course, no more than 'the nonsustainable growth' proposition that I have been talking about from time to time. The worst consequences of the business cycle follow in part from the disruption in financial channels that is an essential result of the tremor mechanism. Any business firm which has its normal financing technique disrupted by problems of ~~that~~ the financial institutions he normally deals with ~~faces~~, suffers a capital loss. These imposed capital losses, reflections imposed, additional difficulties and costs of doing business are very much a part of how a boom is broken in a complex capitalist society.

On page 5 of his talk Friedman's mystical belief in the all-powerful ability of a free market to solve problems is expressed. Financial reform is not only unnecessary but the thrust of Simons' suggestions were in the wrong direction. The thrusts of Simons' suggestions were to eliminate or constrain the type of financial instruments that were to be available. The menu was to be an ulcer or a gall-bladder menu. The rich set of alternatives, which are available to a healthy person, were not to be available. In particular, Simons objected to borrowing short to finance long positions, especially by financial intermediaries, ~~and~~ I would also say that also the tight cash-flow positin that I have discussed were notlooked upon with favor. Friedman, on the other hand, views variety and diversity in the markets for borrowing and lending as testing the ingenuity and efficiency of the free market and, therefore, should be allowed the fullest rank. Friedman views financial innovation as being inherently neutral. He must have an argument in mind to the effect that nominal money, if the quantity is sustained, will sustain asset prices, regardless of the complexity and the thrust of losses that might be forced upon asset holders by way of market disruptions. Freidman states that "I view a hundred per cent money as a step toward reducing government interference with the lending and borrowing in order to permit a greater degree of freedom in variety and arrangements for borrowing and lending."

By eliminating financial instability or financial crunches from the realm of what is possible, Friedman sees no cost from diversity and complexity. It is only when financial instability is taken as a real consequence or possibility that either broad-guage central banking or a financial constitution such as Simons advocated becomes necessary. As I see it, the difference between Minsky and Simons is that Minsky believes in the lender-of-last-resort, central-banking function as the essential stabilizing instrument in a capitalist society, whereas Simons, feeling that even the Crunch could be avoided, believes that a good financial society was all that had to be achieved.

The paragraph on page 14 where Milton indicates the major difference between Keynes and Simons as he sees it is where I leave off from Friedman's interpretation. I see Keynes holding the perhaps unstated view that a financial tremor is as inherent result of a boom taking place in the context of a complex and evolving financial system that is necessary for a sophistocated capitalism. Simons' explicit view is that there exists a set of financial institutions and public-policy rules that can be legislated and with eternal vigilance maintained, which is consistent with financial stability. I believe that we have to distinguish in the "rules vs. authorities" argument between whether a rule for the behavior of the financial system, central bank, when things are going normally has to be combined with a discretionary authority as a lender of last resort when the crisis ~~or~~ whether one rule holds at all times. It may be that almost always it is wise to follow a rule, and that it is only on rare occasions, the one time out of every 30 years, that we need the discretionary authority.

In earlier writings I contemplated the existence of balanced growth, in which both the real and financial sectors grew in lock step. This view did not place valuation under uncertainty in the correct perspective. For it is the changes in the weight attached to uncertainty and the meaning to the alternatives that are possible that is the major disrupting factor. Changes an uncertainty, in particular the attenuation of the discounts due to uncertainty, is an inherent reaction of the system when it is functioning well. Such new-era psychology, such attenuation of uncertainty, will lead to the investment buldge and the willingness to elaborate financial patterns that is the major and endogenous disrupting factor.

Essentially, as I see it, the tremor is inevitable. A scenario of 1929-1933 without Federal Reserve 'perversity' might be very useful indeed. However, regardless to whether or not the tremor is inevitable, the earthquakes such as occurred in 1933 are not inevitable. Appropriate Central-Bank policy could have stopped the debt-deflation process at any step. [Note that Irving Fisher's debt-deflation theory of business cycles is relevant, as well as his more-extended writings on the same topic; should look into this.]

Therefore, from my point of view there are two kinds of business cycles: Those which depend upon the accumulation and decumulation of inventories and perhaps stop-go behavior by government. These cycles occur within a stable monetary environment, where money is passive in the sense that velocity will adjust to changes in demand: the fine tuning occurs by velocity reactions. In these situations money really doesn't matter. Recalling a conversation with Duesenbery, it is perhaps true that the period in which the data was brought together, and for which the econometrician discovered the behavioral relations that go into things like the Brookings-SEC model was a unique period in which money mattered very little, if at all. But this was due to the peculiar way in which capitalism behaved in that particular historical circumstance. Capitalism does not always behave in the same manner. Once capitalism really takes off, then, in addition to the business cycles which are not accompanied by any important financial consequence, there are cycles which are associated with significant financial shakeups. These latter cycles are deeper and longer.

The start of a financial shakeup is inherent in a capitalism with a complex financial system. It is necessary at all times to impress upon the Board of Governors that a potential for financial crisis, which it has to power to abort, exists. It is this forward-looking to a liquidity crunch that is the essential element in the reporting scheme that has to be thought out.

To summarize Friedman's lecture falls down in that he retreats to his well-known view that the supply of money always calls the tune and that under no circumstances will there be many a slip twixt cup and lip.

It is amazing how simplistic are the final results from ~~in~~ this very, very sophistocated mind. I believe it is clear that Simons had a very subtle mind, who always considered more possible system states than Friedman does in the heat of presentation. The essence of the Keynesian system remains the shifting liquidity preference function, and this in another language is central to Simons.*

*The difference between Keynes and Simons is that to Keynes the 'shifting liquidity preference' was tied into very subtle arguments about expectations, rational belief in a world of ignorance, and the nature of uncertainty, whereas in Simons the views about the perverse unwinding of complex financial structures rested on simple observation and intuition. Keynes' greater power rested on the "General Theory" being and offshoot of the "Treatise on Probability."

It is by magic of transforming the history of the system into a positioning of the liquidity preference function that Keynes can get straight-forward propositions about system behavior without engaging in a great deal of detailed dynamic analysis. It really comes to the fact that we have to summarize some uncertainty which cannot readily be handled by formal mathematical analysis. What we have to contain in our summary view of the world is the position that firm, hard, unchallengable financial positions are highly desired commodities. However, from time to time, due to the erratic history of the system, the definition of what is a firm, hard, unchallengable financial position changes radically. In particular dire consequences will follow if what was considered a position of great solidity yesterday is considered a position of great vulnerability today.

All in all, Milton sees a good deal of the truth. All in all, he repeats himself again and again. It is this tired repetitive response to a most perceptive statement of the problem which is most to be regretted.

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