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Control of finance as a prerequisite for successful monetary policy:  
A reinterpretation of Henry Simons's "Rules versus Authorities in  
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## Working Paper No. 713

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### **Control of Finance as a Prerequisite for Successful Monetary Policy: A Reinterpretation of Henry Simons's "Rules versus Authorities in Monetary Policy"**

by

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## **ABSTRACT**

Henry Simons's 1936 article "Rules versus Authorities in Monetary Policy" is a classical reference in the literature on central bank independence and rule-based policy. A closer reading of the article reveals a more nuanced policy prescription, with significant emphasis on the need to control short-term borrowing; bank credit is seen as highly unstable, and price level controls, in Simons's view, are not possible without limiting banks' ability to create money by extending loans. These elements of Simons's theory of money form the basis for Hyman P. Minsky's financial instability hypothesis. This should not come as a surprise, as Simons was Minsky's teacher at the University of Chicago in the late 1930s. I review the similarities between their theories of financial instability and the relevance of their work for the current discussion of macroprudential tools and the conduct of monetary policy. According to Minsky and Simons, control of finance is a prerequisite for successful monetary policy and economic stabilization.

**Keywords:** Monetary Policy; Financial Stability; Narrow Banking; Financial Regulation

**JEL Classifications:** B22, E42, E52, G28

## I. INTRODUCTION

In his 1936 article “Rules versus Authorities in Monetary Policy,” Henry Simons provides a passionate plea for a liberal political system based on clear policy rules. Such a rule-based system was particularly important within the area of monetary policy, according to Simons. The economy cannot function effectively if entrepreneurs have to second-guess the policy actions of the central banks all the time, and he noted that “we must avoid a situation where every business venture becomes largely a speculation on the future of monetary policy” (Simons 1936, p. 3).

Simons’s article has since become a classic, along with Kydland and Prescott’s famous article from 1977, “Rules Rather than Discretion: The Inconsistency of Optimal Plans.” Both articles are core references in the literature on independent central banks.

A closer reading of Simons’s article reveals a more nuanced view of the role of central banks. What is particularly striking is his rather interventionist views on the need to control short-term borrowing and speculative behavior as a precondition for the central bank’s ability to achieve monetary stability. Irving Fisher’s proposal for 100 percent money—or narrow banks—was, according to Simons, one important part of a policy package needed for government to gain control of the money supply.

Simons and his colleagues at the University of Chicago viewed volatile bank credit as an important driver of the business cycle and believed that any attempt to stabilize the economy would fail unless there was more control of the growth of private credit.

This same theme appears in Hyman Minsky’s theories of financial imbalances—the “financial instability hypothesis.” This is not surprising since Simons was Minsky’s teacher at the University of Chicago in the 1930s. As I will show below, there are other similarities between Simons’s views of the economy’s inherent unstable character (and hence the need for stabilization through explicit rules) and Minsky’s theory of endogenous financial crises. A critical review of Simons’s classic article provides us with a better basis for understanding the prerequisites for successful monetary policy, and a better understanding of Minsky’s theory of financial crises and its relevance today.

In the following, I will first describe the main features of Simons’s “Rules versus Authorities,” including three central themes in the article: (1) the proper objective of monetary policy; (2) the need to regulate private credit; and (3) how to organize the central bank. Then I

will review the similarities between Simons's and Minsky's theories, and briefly discuss how Simons's theories also provided the basis for Milton Friedman's monetary theory ("monetarism").

I conclude that Simons's article covers a wide set of issues related to unstable finance and does not provide unqualified support for the idea of an independent central bank with an inflation target. Henry Simons points in particular to the problem of stabilizing the price level without also controlling private credit. This theme has been subject to renewed discussion after the recent financial crisis in the context of the Basel III proposal for a countercyclical buffer.

## **II. HIGHLIGHTS OF THE ARTICLE, "RULES VERSUS AUTHORITIES"**

Simons was an active participant in the economic policy debate in the 1930s. He was the co-author of several petitions and letters to President Roosevelt about the need to pursue a more active fiscal policy, and he supported the proposal for narrow banks (100 percent reserve money) by his colleague Irving Fisher from Yale.<sup>1</sup> His article, "Rules versus Authorities in Monetary Policy," was also a political manifesto burning with fervor and enthusiasm.<sup>2</sup> The opening lines reads like a mission statement:

The monetary problem stands out today as the great intellectual challenge to the liberal faith. For generations we have been developing financial practices, financial institutions, and financial structures which are incompatible with the orderly functioning of a system based on economic freedom and political liberty. (Ibid., p. 1)

For Simons, it was problematic that more and more public authorities were given discretionary powers to enforce arbitrary policy measures. He noted that discretion could be justified in some areas, such as in health care. But he argued that such arbitrariness was completely unacceptable in the area of monetary policy. There we needed stable "rules of the game" to ensure a prosperous economy based on private initiative (Ibid., p. 3).

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<sup>1</sup> The Pettingill Memorandum (Cox et al., 1932) rejected the economy's capacity for self-correction and called for an active fiscal policy; Balancing the Budget (Bane et al., 1933) called for compensatory fiscal policy over the business cycle; the Memorandum on Public Credit (1934, reprinted in Phillips 1995) urged the government to borrow when there was a need to withdraw purchasing power (i.e., when interest rates were high) and repay the loan when it was needed to inject purchasing power. In a recession, the state should also initiate public investment. Professors Simons, Vines, Knight, Mint and Douglas were among those who signed these petitions to the President and the Congress.

<sup>2</sup> According to Stigler (1974), Simons said on occasions that this article was probably his best piece of work.

Unfortunately, there was no agreement on how the monetary system should be organized to minimize or avoid “extreme industrial fluctuations” (Ibid., p. 4). In order to counter unrealistic proposals for reform, it was important for liberals to develop a constructive proposal that would ensure a sound basis for the monetary system.

### **Causes of Instability**

Variations in employment and production are due either to rigid prices or “perverse flexibility in the total turnover (quantity and velocity) of effective money” (Ibid., p. 6). It was difficult to do much with rigid prices in the short term, according to Simons. But violent fluctuations in short-term credit were bad and undermined economic stability: “The shorter the period of money contracts, the more unstable the economy will be; at worst, all money contracts would be in the form of call loans” (Ibid., p.9).

Simons noted that the claims on banks (deposit money) had gradually replaced cash, and that banks were about to get some kind of semi-official status, which would cause the government eventually to accept responsibility for these claims in the same manner as the state’s own money (cash). Eventually, the money supply would be dominated by the credit expansion of private banks.<sup>3</sup> Simons was concerned that the financial system would then become highly unstable, because “the banks will flood the economy with money-substitutes during booms and precipitate futile efforts at general liquidation afterwards” (Ibid., p. 10). This instability was exacerbated by the fact that banks generally had little equity and large exposures to unsecured loans. “Thus, a relatively small decline of security values properly raises question as to the solvency of banks and induces widespread effort to improve the quality of bank assets” (Ibid.).

Banks tend to cut their lending at the first signs of an economic slowdown, and this reinforces the downturn. The increased use of such short-term loans was therefore very unfortunate, according to Simons, not least because enterprises thus had to hold more cash and liquid assets to insure against sudden calls for repayment (“call loans”).

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<sup>3</sup> Note that Simon viewed banks as “money creators;” as they made loans, deposits were created in customers’ accounts. Simon and his colleagues were not happy with private banks taking over the issuing responsibilities of the state and the central bank.

It must be accounted one of the most unfortunate effects of modern banking that it has facilitated and encouraged the growth of short-term financing in business generally. (Ibid.)

No real stability of production and employment is possible when short-term lenders are continuously in a position to demand conversion of their investments, amounting in the aggregate to a large multiple of the total available circulating media, into such media. (Ibid., p. 9)

An economic system dominated by short-term credit would, according to Simons, only be able to function if prices and wages were extremely flexible.

### **Measures to Reduce Instability**

Simons argued that the problem of “booms and depressions” must be addressed by creating more flexible prices and wages, but also by measures that provide a more stable monetary and financial system. He noted that “with adequate price flexibility, we could get along under almost any financial system” (Ibid., p. 14). But since monopolies and unions dominate the economy, it is important to design a monetary policy that takes these features into account:

Such a policy, however, must be guided by a more fundamental strategy and by the need for early abandonment of temporizing expedients; otherwise, political control must degenerate into endless concessions to organized minorities, with gradual undermining of the "constitutional structure" under which free-enterprise economy and representative government can function. (Ibid., p. 15)<sup>4</sup>

### **Clear Rules for Monetary Policy**

#### *Objectives of the Money Supply*

Simons searched for a “simple, mechanical rule of monetary policy” (Ibid., p. 16). His “favorite” was a rule that determines the money supply. Such a rule would:

- Reduce the need for discretionary policy measures
- Lead to a general reduction in prices as a result of increased productivity
- Be easy to understand for all economic actors, and
- Be so simple that it could form the basis for a new “religion of money” (Ibid., p. 5)

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<sup>4</sup> The quote is part of a broader discussion by Simon on the relationship between the central bank and various organized groups (such as trade unions and monopolies) and policy measures that can be implemented to avoid nominal demands resulting in an inflation spiral.

But such a simple rule would, unfortunately, have several weaknesses. Simons noted that it could well stimulate the use of new means of payments that would not be subject to tight regulation, so called “near-moneys” (Ibid.). It would then be difficult to “define money in such a manner as to give practical significance to the conception of quantity [of money]” (Ibid., p. 16). The prevalence of “near-moneys” or “shadow banking”<sup>5</sup> could thus lead to a shift in the velocity of money that will make it hard to conduct monetary policy based on a fixed target for the ‘money supply.’<sup>6</sup>

### *Goals for the Price Level*

Another rule would be to stabilize the price level. Simons discusses in detail the various price indices that could be stabilized.<sup>7</sup> He favored the domestic prices level, since other indices would be influenced by factors outside the control of the central bank.

Despite his preferences for rule-based monetary policy, Simons had reservations about a system with a price level target, since it would give the central bank considerable discretion in determining the policy tools. This would require “much intelligence and judgment in their administration” (Ibid., p. 12).

But he still preferred this rule to the money supply rule, since the former was better able to accommodate changes in the circulation of money. So he concluded that one form of “price-index rule is eminently preferable for the immediate future”—at least until prices and wages have become more flexible and the use of short-term credits is reduced significantly (Ibid., p. 18, footnote 16).

If price-level stabilization is a poor system, 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. (Ibid., p. 21)

Still, changes in the financial structure would be required, irrespective of whether you choose a money supply rule or a price level target.

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<sup>5</sup> Simons does not use the term “shadow banks,” but he deals with exactly the same issues, e.g., the growth of non-regulated credit, especially in a boom. A much earlier discussion of the same phenomena can be found in Henry Thornton’s 1802 book, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*.

<sup>6</sup> Simons was criticizing the monetarist position that his student, Milton Friedman, would later develop (see Simons 1936, p. 5, 16).

<sup>7</sup> See Simons (1936), p. 12, especially footnote 10.



The existence of a large volume of privately created money-substitutes, with alternate expansion and contraction, might tax seriously the powers of a monetary authority seeking to prevent price-level changes. (Ibid., p. 28)

To gain monetary stability, the government would therefore need to gain control of the growth of “near-moneys.”

### *The Need to Regulate Private Credit*

In the past, governments have grossly neglected their positive responsibility of controlling the currency; private initiative has been allowed too much freedom in determining the character of our financial structure and in directing changes in the quantity of money and money-substitutes. (Ibid.)

Simons’s proposal to control private credit was influenced by his negative views of short-term credit and the bank’s role as “money makers:” by extending loans, banks create deposits. In his ideal system there would hardly be a loan; the financial system would only be based on equity and cash. But Simons recognized that this ideal would be hard to realize: “To propose abolition of all borrowing, or even of all borrowing at short term, is merely to dream” (Ibid., p. 16).

But a gradual reduction in the extent of short-term credit would, according to Simons, be both possible and desirable. The Chicago proposal to re-establish banks with a requirement of 100 percent reserves (“narrow banking”) would be a step in the right direction.<sup>8</sup> But in itself, the proposal would be inadequate, according to Simons, because it would encourage credit extension outside the regulated system: “Standing by itself, it would promise little but evasion, and would deserve classification as merely another crank scheme” (Ibid., p. 17, footnote 17).

In the longer term, Simons envisaged a financial system without traditional banks, where the (new) 100 percent banks would primarily be engaged in payment services. Short-term borrowing by regular business firms would have to be limited to prevent circumvention. In the future, we would then have a financial system where “the volume of short-term borrowing would be minimized, and in which only the government would be able to create (and destroy) either effective circulating media or obligations generally acceptable as hoards-media” (Ibid., p.

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<sup>8</sup> In a long footnote (19) on page 21, Simon provides a motivation for the 100 percent proposal that is not so well-known. He notes that many contemporary economists were worried that all the banks would be taken over by the state, and their proposal was thus motivated as a way to avoid the full socialization of the banking sector and thus also the end of private financing of long-term investments.

17). This would limit the problem of extensive liquidations during recessions, as companies increasingly would be long-term funded and therefore would not be liquidated to repay short-term loans in a crisis.

Such extensive interference with individual rights under contract law must, according to Simons, be weighed against the benefits resulting from limiting the scope of short-term credit: “If such reforms seem fantastic, it may be pointed out that, in practice, they would require merely drastic limitation upon the powers of corporations (which is eminently desirable on other, and equally important, grounds as well)” (Ibid.). Simons acknowledges that his proposals might seem radical, but he still argues forcefully for change based on a broad popular support for a stable monetary system based on liberal values.<sup>9</sup>

#### *The Central Bank’s Organization*

Simons wanted to reduce the number of “authorities” involved in policymaking and gradually concentrate the authority for monetary policy in a central authority based on a price-index rule. But Simons was skeptical of putting this responsibility within the central bank “with their limited powers and restricted techniques” (Ibid., p. 22).<sup>10</sup>

Ultimate control over the value of money lies in fiscal practices—in the spending, taxing, and borrowing operations of the central government. Thus, in an adequate scheme for price-level stabilization, the Treasury would be the primary administrative agency; and all the fiscal powers of Congress would be placed behind (and their exercise religiously limited by) the monetary rule. (Ibid.)

Simons was thus not an advocate of an independent central bank. In his view, it was the Ministry of Finance who, by their decisions over government revenues and expenditures, affected the flow of funds available for payments, and therefore had to be responsible for monetary policy. Fiscal policy, together with the government's debt policy, would thus be the main policy tools to keep the price level (or money supply) constant:

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<sup>9</sup> “The requisite measures, radical in the money field and more radical elsewhere, will become possible politically only with the revival or development of a real religion of freedom, of a strong middle-class movement, and of values (and revulsions) of a rather intense sort” (Ibid., p. 18).

<sup>10</sup> Note that Simon’s article was written in 1936, at a time when the Federal Reserve had not exactly excelled in the conduct of monetary policy.

The powers of the monetary authority should have to do primarily or exclusively with fiscal arrangements with the issue and retirement of paper money (open-market operations in government securities) and perhaps with the relation between government revenues and expenditures; in other words, the monetary rules should be implemented entirely by, and in turn should largely determine, fiscal policy. (Ibid., p. 29-30)

Simons also highlights the fact that the authorities in his policy regime will have to constantly run budget deficits to provide sufficient means of payments to keep the price level constant (Ibid., p. 23, footnote 20). At the same time, such a fixed price level rule would also provide an implicit rule for the budget balance. Beyond this, there was no need for a complicated government debt policy; a combination of cash and long-term debt (“lawful money and console or perpetuities”) would be sufficient.<sup>11</sup>

### **III. SIMILARITIES BETWEEN SIMONS AND MINSKY**

In the preface to his classic book, *Stabilizing an Unstable Economy* (1986), Minsky paid homage to his former teachers, Oscar Lange and Henry Simons at the University of Chicago and Joseph Schumpeter of Harvard. He refers in particular to Simons’s theories when he emphasizes that his book is an attempt to “reform our malfunctioning economy.” He notes approvingly of Simons’s deep knowledge of the actual working of the financial system, which needs to be combined with a “passionate, even irrational commitment to democratic ideals” (Minsky 1986, p. 10, n. 7). In Minsky’s view, the substance of Simons’s proposals is still worth considering “in spite of the passage of fifty years” (Ibid.).

Minsky notes that his understanding of financial instability is derived from Keynes’ *The General Theory* of 1936, Fisher’s description of debt deflation from 1933, and the work of Henry Simons (Minsky 1986, p. 192). Their works were all influenced by the depression and the policy efforts to combat unemployment.

In his earlier book, “Can ‘It’ Happen Again?” (1982), Minsky also refers to Simons’s theories and he notes that Simons “recognizes the endogenous nature of money and the impossibility of managing money by trying to control the quantity of some specific set of debts,

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<sup>11</sup> Footnote 21, p. 24 gives an extensive discussion of the need for policy rules for fiscal policy, before Simon concludes that: “Sound fiscal policies are impossible (cannot even be defined) without precise and firmly established rules of monetary policy” (Simons 1936, p. 24).

especially in an economy in which the lure of potential profit induces innovation in financial practices” (Minsky 1982, p. 71). According to Minsky, there are quite distinct similarities between Simons and Keynes:

The economics of Simons of Chicago and Keynes of Cambridge have much in common, but this is not surprising. Both Keynes’s *General Theory* and Simons’s *Rules versus Authorities* were responses to the same real world situation. However, Simons never broke with inherited theory, whereas Keynes saw that one aspect of the crisis of his time was that the inherited theory was incapable of explaining what was happening. (Minsky 1982, p. 87)

Minsky also noted that Simons’s “Rules versus Authority” was written with the same empathy as Keynes’s great book, and that both authors were keen to understand “the fundamental rules of behavior of a capitalist economy” in order to save it (Minsky 1982, p. 87, n. 1).

Others have since pointed out the similarities between Simons and Minsky. Whalen (1988) highlights the similarities between Minsky and Simons in their explanations of the business cycle, and in particular the importance of (unstable) credit in propagating the cycle. Phillips (1989) draws the line further back from Minsky via Simons to Thorstein Veblen (1904) and notes that Veblen in his *Theory of Business Enterprise* had an understanding of the banks’ role in the cycle that is very similar to Simons’s. Toporowski (2010) highlights Simons’s understanding of the financial sector’s importance for the inherent instability of the economy as one of several similarities with Minsky. And he adds that it was Minsky (1982) who drew attention to Simons’s radical restructuring of the financial sector as a prerequisite for “a depression-proof good financial society,” while for Milton Friedman a money supply rule was sufficient (Toporowski 2010, p. 366).

#### **IV. SIMONS THEORY AS THE BASIS OF MODERN MONETARISM**

It is interesting to note that despite the similarities between the theories of Henry Simons and his student Hyman Minsky, Simons’s theories also formed the basis for the monetary theory that one of his other students, Milton Friedman, would later develop—which then formed the basis of modern monetarism. This part of Simons’s theory can be illustrated by the following quote from “Rules versus Authorities,” which ends with a call for further research:

A monetary rule of maintaining the constancy of some price index, preferably an index of prices of competitively produced commodities, appears to afford the only promising escape from present monetary chaos and uncertainties. A rule calling for outright fixing of the total quantity of money, however, definitely merits consideration as a perhaps preferable solution in the more distant future. At least, it may provide a point of departure for fruitful academic discussion. (Simons 1936, p. 30)

Friedman preferred a money growth rule, despite Simons's warning that the variations in the velocity of money would render such a rule ineffective. But other aspects of Friedman's first version of "monetarism" were more in line with Simons's theories when he launched his ideas in the 1948 article, "A Monetary and Fiscal Framework for Economic Stability." He then favored restrictions on banks' short-term lending and argued that open market operations would not be an effective way to control the money supply. Fiscal policy should be the main policy tool for achieving a fixed growth in the money supply:

[This is] a reform of the monetary and banking system to eliminate both the private creation or destruction of money and discretionary control of the quantity of money by central bank authority. The private creation of money can perhaps best be eliminated by adopting the 100 per cent reserve proposal, thereby separating the depositary from the lending function of the banking system. The adoption of 100 per cent reserves would also reduce the discretionary powers of the reserve system by eliminating rediscounting and existing powers over reserve requirements. To complete the elimination of the major weapons of discretionary authority, the existing powers to engage in open market operations and the existing direct controls over stock market and consumer credit should be abolished. (Friedman 1948, p. 247)

Later, Friedman would modify his 1948 views about the role of short-term credit and central banks. In his presidential address in 1968, he thus favored an independent central bank with responsibility for monetary policy, while private banks could "govern themselves"—i.e., a more or less "free banking" position. This view of financial markets was very different from Simons's earlier theories and also Minsky's financial instability hypothesis. In a comment on a 1963 article by Friedman and Schwartz, Minsky noted that he was not convinced that changes in money supply alone could explain the cyclical fluctuations in money and credit aggregates. It would be better to explain these fluctuations with regard to commercial banks' role as "money creators" when they make loans, thus the resulting correlation between money and credit (Minsky 1963). Such an explanation, based on an understanding of the workings of the banking

sector, would according to Minsky be a much better explanatory model. And we may add, it would also be more consistent with the view of the financial sector that both Simons and Minsky shared.

## **V. CONCLUSION**

Simons's article, "Rules versus Authorities," outlines the basis for a monetary policy based on a clear rule for either a fixed money supply or a stable price level. This part of Simons's article is well-known and has been part of the theoretical basis for the establishment of independent central banks with inflation targets. The article lists, however, a number of assumptions that, according to Simons, must be met if such a rule-based monetary system is to result in more stable economic development. He was particularly concerned about limiting short-term lending, thus limiting the ability of commercial banks to create money. Without control of the private component of the money supply, any attempt at stabilization of the economy would be futile. These elements of Simons's article have not been much discussed before, but have now become more relevant after the global financial crisis.

A rapidly growing shadow banking system pushed the financial system over the brink during the recent crisis. But strong growth in shadow-type financial structures both before and during financial crises is also a prominent feature in the theories of Simons and Minsky. Simons was particularly concerned about the uncontrolled growth in the "near-moneys," particularly during a boom. He therefore supported the proposal by his colleague Irving Fisher for narrow banks, but only as a first step toward a system where the government would regain control of the (growth of) society's money supply.

The appropriate money supply to support the goal of a fixed money supply or a fixed price level would be achieved by regulating the government's revenues and expenditures, in combination with a sensible debt management policy. The central bank would have a relatively limited role in this system, primarily as a fiscal agent of the State, but also with a prime responsibility for the payment system.

Simons's article is still relevant for our discussion of how monetary policy should be conducted and its relationship to financial stability. Simons outlined several conditions for the central bank to achieve its goal of price stability; especially a strict limitation of short-term loans

and bank loans in particular. For Simons, Fisher, and the other supporters of narrow banks in the 1930s, the free lending by private banks was an anachronism that contributed heavily to the cyclical nature of credit and the difficulties in bringing the economy back to full employment. They also noted that this system was highly procyclical and very sensitive to shifts in investors' expectations. Their solution was to limit banks' abilities to provide credit.

Today's discussion centers on limiting banks' proprietary trading. But so far there have been few suggestions for limiting the strong credit growth in the unregulated "shadow" credit markets. Simons had a vision for a better and more stable financial system, if somewhat unrealistic. But at least he directed us to the critical importance of controlling "near-monies," especially in an upswing, and he provided some interesting ideas about what to do with the problem.

We have a lot to learn from a reinterpretation of Henry Simons's classic article "Rules versus Authorities in Monetary Policy." There is also much to be learned in the works of Hyman Minsky, who took the key insights from Simons and developed them further in his financial instability theory. They both viewed the capitalist economy as inherently unstable and the banking sector as an important source of this instability. But while Minsky believed that the economy could be stabilized by an active lender of last resort policy by the central bank in combination with an active fiscal policy, Simons suggested that only radical changes in the financial sector's structure could prevent future crises.<sup>12</sup> A mixture of their policy proposals is probably required to avoid another global financial crisis.

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<sup>12</sup> Minsky would also advocate financial sector reform, especially after a financial crisis, but his proposals were not as radical as Simons's.

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