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Henry Simons and the other Minsky Moment*

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This paper examines the influence of Henry Simons on Hyman Minsky. Simons' proposals for banking reform are contrasted with Minsky's alternative 'big bank' and 'big government' programme for stabilising the economy. The paper concludes by arguing that Simons' proposals for stabilising banking would have prevented a credit bubble, but would not avoid economic instability. Nevertheless, Minsky remained an admirer of 'Simons' banking' approach to the study of capitalism.

(J.E.L.: B31; E44; E58; G21)

1. Henry Simons: The other influence on Minsky

The origins of Minsky's ideas in the work of John Maynard Keynes, and Minsky's own rather idiosyncratic interpretation of Keynes are well known (Minsky 1975). But in his Ph.D. thesis, Minsky made relatively few references to Keynes, and they are mainly the predictable ones: Keynes on uncertainty, consumption, liquidity preference and the liquidity trap (Minsky 1954/2004). All of these references are to the *General Theory*, and none show the insights into Keynes' work that were to be developed in Minsky's *John Maynard Keynes* (1975). In that doctoral thesis, another later influence, the Polish business cycle theorist Michal Kalecki, has his Principle of Increasing Risk correctly cited as a theory of the size of firms. However, Kalecki's internal finance constraint on investment, which came to have a central role in Minsky's analysis after he returned in 1970 from his year in Cambridge, UK, is mistakenly attributed to the monetary business theorist Ralph Hawtrey following a citation from the econometrician Sho-Chieh Tsiang (Minsky 1954/2004:72). However, the economist who arguably directed Minsky towards the macroeconomics of financial disturbance, the Chicago liberal

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Henry Simons, is not mentioned at all in Minsky's doctoral thesis.

This is a most surprising omission. Simons had taught Minsky at Chicago. In his later memoir of his Chicago years, published in the *Banca Nazionale del Lavoro Quarterly Review* in 1986, Minsky recalled the very personal relationship that he had with Simons.

It was Simons who introduced Minsky to the idea that the financial system in the USA was structurally flawed and who explained how the banking system had contributed to the Great Depression, without resorting to tales about incorrect monetary policy, or imbalances between saving and investment. When Minsky finished his military service in 1946, he was offered a generous fellowship to return to Chicago, but turned it down for a less lucrative studentship at Harvard. His reason was that the three economists whom he most admired at Chicago were no longer there: Viner had gone to Princeton; Lange, whose socialist commitment had inspired Minsky to study economics had, to Minsky's disgust, thrown in his lot with the Polish Communists; and Simons was dead (Minsky 1988). Simons, who was prone to melancholy, had committed suicide in despair at the onset of Keynesianism. Six years before he wrote his memoir, in his Preface to his 1982 volume of essays, Minsky had mentioned Simons even ahead of Lange and Schumpeter, as an influence: "As a student, I was most influenced by Henry C. Simons, Oscar Lange, and Josef Schumpeter" (Minsky 1982: 5).

2. Simons and Banking Reform

Simons deserves consideration not only because Minsky appears so inexplicably to have omitted him from his thesis. Such consideration is further justified because many of those who have heard of him today know him from the very partial account of his work given by Milton Friedman. Hayek was later to suggest that Simons shared Hawtrey's views on the monetary business cycle (see below), and there is no doubt that Simons was a theorist of critical finance in the special sense that he argued that the real economy is vulnerable to crises emanating from the financial system (Toporowski 2005: 2-5. Due to pressure to complete my own *Theories of Financial Disturbance* Simons was, unfortunately, omitted from that book). But, whereas Hawtrey stressed the natural instability of credit as a factor in business cycles, Simons argued that the structure of the financial system was a key factor in exacerbating disequilibrium in the non-financial sector of the economy. In his classic article "Rules versus authorities in monetary policy" published in the *Journal of Political Economy* in 1936, the late-twentieth century discussion on central bank independence appears turned on its head. Simons argued that the regulation of liquidity in the financial system necessitates the absorption of central banking into the Treasury (finance ministry) function of the government.

Sensible to the financial debauchery and collapse of the first four decades of the twentieth century in the USA, Simons was a strong critic of the kind of financial entrepreneurship that Minsky later also criticised. Simons believed that such entrepreneurship was the result of liberal banking policies that encouraged excessive credit and discouraged investment by requiring business to keep liquidity tied up against a possible inability to roll over short-term loans. Simons concluded that financial intermediation needs to be subject to strict rules, and that the fiscal authorities need to have discretion over monetary policy in order to be able to regulate credit. This discretion had to be with the fiscal authorities because their open market operations determine the reserves of the banking system (Simons 1936). Simons had even argued for the abolition of central banking, because he believed that its functions are more effectively carried out by government treasuries. The elimination of central banking also followed from his adherence to the doctrine of full reserve (100% reserve) banking. If banks are obliged to hold the equivalent of all their deposits as reserves, then there is clearly no need for provision of reserves by a central bank (The discussion around this is perceptively examined by Ronnie J. Phillips in a book, *The Chicago Plan and New Deal Banking Reform*, to which Minsky wrote a Preface; Phillips 1995).

After the publication of his monetary history of the USA, Milton Friedman gave the critical reassessment of Simons referred to above. Friedman argued that Simons had failed to realise the disastrous consequences of the contraction of bank credit in 1930-3, which Friedman revealed in his history. In fact, Simons could not have been unaware of the contraction: Irving Fisher had been arguing much the same around 1933 and both Fisher and Simons were involved in the discussions around the reform of the Federal Reserve System to stabilise the faltering US banking system (Phillips 1995, ch. 3-4).

However, Friedman drew a conclusion that was directly contrary to that of Simons. In Friedman's view, consistently argued since 1948, the monetary authorities, rather than banks, had to be bound by rules on credit expansion because, according to Friedman, the relationship between reserves and credit is essentially stable (Friedman: 1967). It goes almost without saying that, in the monetarist analysis, the relationship between financial intermediation and the real economy is essentially benign and speculation results from loose monetary policy rather than loose banking. Friedman's claim, that these doctrines were part of the "oral tradition" of Chicago, had already drawn Patinkin's famous defence of a broader tradition at Chicago (Patinkin 1961).

Simons was therefore the missing link between Hawtrey and Minsky. Hayek hinted at this in criticising Friedman's suggestion that the Great Depression predisposed both Keynes and Simons to fiscal activism. Simons' fiscal schemes were explicitly designed to regulate the liquidity of the financial system, rather than regulating aggregate demand (Simons 1942). Hayek wrote to Friedman: "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 1920s. 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..." (Friedman 1967: 88).

Minsky, like Patinkin, objected to Friedman's narrow interpretation of the Chicago tradition. In a 1969 paper in the *Journal of Finance Minsky* contrasted Simons' view that the "...depression-proof good financial society requires the radical restructuring of the financial system..." with Friedman's view that "the establishment of the good financial society requires only the adoption of a stable money growth rule by the Federal Reserve System, given that the reform represented by the introduction of deposit insurance had already taken place... Simons had a financial system rather than a narrow monetary view of the "Banking's problem" (Minsky 1982: 279/289).

3. Minsky, Simons and the Stability of Capitalism

An essential difference between Simons and Minsky arises over the question of the inherent stability of capitalism. Simons believed that the capitalist market system was stable and self-adjusting, at least in the sense that a "largely competitive, free market, free-enterprise system" could be stabilised providing that the government was able to manage the reserves of the banking system and provide sufficient purchasing power in those capitalist markets. In particular, in an article published in 1944, Simons argued that competitive markets were inherently stable. "...General and acute instability is, on any soundly reasoned analysis, primarily attributable to faulty monetary institutions and, in the broadest sense, to unfortunate fiscal policy". (Simons 1944: 107-8). This is the fundamental premise of economic and monetary policy in the U.S. and U.K. following the crisis of 2007-2008.

The Minsky view was much more radical. Capitalism is unstable not just because of "faulty monetary institutions" and inappropriate government policy (see Vercelli 2001). From the 1970s onwards Minsky attributed instability explicitly to the cyclical shifts in non-financial business investment. Firms indebt themselves in order to finance their investment, and, in rather approximate accordance with Kalecki's theory of profits, investment is necessary to generate the revenues necessary to service debts. The failure of investment to rise sufficiently to provide the financial surpluses necessary to service growing corporate debt gives rise to the financial crisis of which Minsky wrote. His "financial" crises were therefore industrial crises precipitated by rising indebtedness, rather than bank illiquidity (Minsky 1978). (In this regard, Minsky overlooked the monetary implication of Kalecki's theory, namely that investment above the level of household saving leads to the accumulation of credit balances on the accounts of nonfinancial enterprises. See Steindl 1982 and Toporowski 2008).

This has radical implications for economic policy. Stabilising a banking system without stabilising the industrial and commercial system which those banks serve, leaves the economy still vulnerable to non-financial business fluctuations. Non-financial instability in turn renders financial regulation vulnerable to arguments from bankers and economists to the effect that if only the regulations were made lighter, or even removed altogether, the credit system would automatically alleviate those imbalances, and bring the economy-back to equilibrium. And only the ignorant could dismiss such a plea, since we all teach our students that the credit system functions to accommodate economic imbalances and has done so quite effectively for decades with only recent disastrous results. The radical conclusion of Minsky's work ("big bank and big government", Minsky 1986) is based on a fundamental insight of business cycle theory, rather than just banking economics, namely that without stabilising the economy at large, banking stabilisation is unlikely to hold. This is an implicit criticism of Minsky's teacher, Simons, for whom the free market in exchange with a stabilised banking system is a guarantee of equilibrium.

Nevertheless, Minsky retained an admiration for Simons and his teacher's belief that the destabilising influence in capitalism is banking rather than, as Chicago later convinced itself, government policy. In his most important and developed exposition of his theory, Minsky declared the writings of Simons, along with Keynes's *General Theory* and Fisher's debt deflation analysis, as providing "the fundamentals of a theory of financial instability" (Minsky 1986: 172). He commended Simons' "serious conservative program of institutional reform and policy operation that remains a model of political economy" and concluded: "In spite of the passage of fifty years, the substance of Simons' proposals are still worth considering" (Minsky 1986: 9). Even though Simons' ferocious opposition to Keynesianism repelled Minsky, he still admired the brio with which Simons put forward his critique of the American Keynesian Alvin Hansen (Simons 1942). This critique, Minsky wrote, "can be read with pleasure for both its rather unfair attacking style and as a sophisticated attack on the interventionist economy." (Minsky 1986: 122). The seriousness and sophistication that Minsky found in Simons quite evidently arose because he recognised that Simons had integrated banking and credit into his economic analysis and was prepared to treat it critically, instead of just taking it for granted. For this reason Minsky was prepared to give Simons the critical attention that he gave also to Keynes and Fisher, but which he would not give to Samuelson, Tobin, Hicks or Milton Friedman.

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