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# DEBT POLICY AND BANKING POLICY

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THE scheme of putting our federal debt wholly into two forms, consols and currency,<sup>1</sup> is obviously too radical for early political consideration. Its virtue is that of indicating a direction for policy which, wisely pursued, would perhaps involve numerous steps and only gradual institutional change. Much can be said for focusing attention upon the radical, ultimate objective, namely, an economy where all private property takes exclusively the forms of government demand obligations (currency or full currency equivalents), government consols (always in process of elimination, save during total war), corporate common stock, and fee interests in real assets (along with an inevitable minimum of business accounts-receivable and interpersonal debts). In its more important, converse aspect, 100 per cent reserve banking is simply 100 per cent equity financing of all incorporated enterprise. No one responsibly proposes early or sudden movement into this financial millenium. But a strong case can be made for moving ahead now in the banking field. Indeed, an approach to 100 per cent reserves now seems indispensable for sound debt policy — if only for the purpose of eliminating the enormous excess reserves which bank holdings of “governments” now actually represent.

Instead of converting all federal issues into currency and consols, we might, as a moderate, practical policy, utilize also a third debt form, namely, a completely liquid federal “bond,” continuously redeemable and callable and “on tap” but eligible only for bank ownership and required as reserve against bank deposits. (A fourth form is perhaps specified by implication, namely, a zero-rate issue for the Federal Reserve Banks.) All other issues held by banks should be convertible into such “bonds” on reasonable terms, e.g., at actual cost or at market values as of some specified date.

New reserve requirements (of, say, 60–80

<sup>1</sup> See my note, “On Debt Policy,” *Journal of Political Economy*, LII (1944), pp. 356–61.

per cent) as to these bonds might be superimposed upon existing reserve requirements; preferably they would take the form of requirements (of, say, 80–100 per cent) as to such bonds *and* deposits in the Reserve Banks, with till-money also counted toward the requirement. Clearly such requirements should apply uniformly to all commercial banks, not merely to “member banks,” and to all savings banks — although a case might be made for exempting small, genuinely mutual savings banks. A perhaps adequate expedient would be that of making the required reserves a condition of deposit guarantee by the Federal Deposit Insurance Corporation — whose charges for guarantee might then be radically reduced or eliminated.

All other federal issues should be declared ineligible for bank ownership. They should all be converted ultimately into consols or, at least, into very long maturities — if one must make concessions to political expediency. While outstanding issues should, at least temporarily, be convertible on generous terms into the consols or long maturities, all other “support” should be removed and eschewed. Indeed, sound debt management requires just the opposite of support. It should seek rather the maximum capital-gain and capital-loss leverage in open-market operations, offering capital gains to those who bet on reversal of prevailing inflationary or deflationary aberrations (declines or increases) in bond prices.

A suitable rate of interest for these special “bonds for banks” might now be  $\frac{3}{4}$  of 1 per cent, if new reserve requirements are superimposed upon existing requirements, or  $\frac{6}{10}$  of 1 per cent if a single global requirement, satisfiable entirely with such bonds, is invoked. The proper level, in any case, is merely a question of what subsidy should be paid for banking services, in the form of interest on completely riskless and perfectly liquid “bonds.”

The new reserve requirements, in either form, should be set at a level designed to freeze

present bank holdings of "governments," and with a view to subsequent adjustment of these holdings in accordance with the changes in aggregate bank money which prove requisite for price-level stabilization.<sup>2</sup>

The immediate problem is admittedly awkward. If the new reserve requirements are set at moderate levels, one minimizes difficulties with respect to particular banks whose holdings of "governments" are exceptionally small — but at the cost of leaving other banks with actual excess reserves that would enable them not only to expand their own loans but also to provide other banks with new reserves for multiple expansion. To impose severe initial requirements would doubtless be politically suicidal; and it is certainly more important to move in the right direction than to move as far as an

<sup>2</sup> To argue that price-index stabilization is a proper guiding rule of monetary-fiscal policy is *not* to recommend that an existing price level be sustained or consolidated after radical, recent change. Indeed, the strongest case can now (1945) be made for gradual, controlled deflation and for a firm, political commitment to stabilize (after recent quality deterioration is undone, after direct controls are abandoned, and after monetary-fiscal policy has again made contact with the market) at or near our 1941-42 price level. A similar recommendation evidently has been made for Sweden by the "Myrdal Commission," which proposes that "Those groups in the community which have suffered a reduction in real income during the war, owing to prices having risen more than incomes, will recover their former real standard, *not by an increase in the nominal money incomes, but by a lowering of the price level.*" (As reported in *Index*, September, 1945, p. 32.)

One virtue of the 1941-42 level is that, as an announced, accepted goal, it might enable us to sustain the present value of our money! Merely holding the line, now as in 1931-1932, is a nearly impossible task. Besides, we should somewhat reverse the recent expropriation of bondholders, annuitants, and wartime money-hoarders, if only to minimize perversity in monetary expectations during future inflation dangers or wars. This achievement would be worth some cost in larger transitional unemployment; but no such cost is likely to be incurred — unless one assumes (absurdly) that strategic wage-rates will go their own way regardless of monetary policy or monetary expectations. If our commodity-price level now is high relative to wage rates, adjustment should be made largely in the price level; and labor should be encouraged to demand and expect increases in real wages rather than in money-wage rates during the next years. Monetary stabilization will probably remain a forlorn hope unless and until we are prepared, not only to accept it firmly as a rule or principle of policy but also to establish in fiscal practice a basis for expectations that inflationary (and deflationary) aberrations, if not prevented, will afterwards be reversed. The wise beginning would be deliberate, gradual reversal of our recent wartime inflation. At the least, we should make now an advance commitment to reverse any further decline in the value of money if such decline does occur.

extremist would wish. The most feasible scheme would perhaps set a global requirement not above 75 per cent, with provisions for gradual increase at intervals. And it should err on the side of generosity, in special interim provision for banks with unusually small reserves of "governments," e.g., with interim arrangement for impounding of other assets as temporary substitutes for the "required" bonds.

Note now the urgent current difficulties which these measures would resolve:

1. They would be uniquely effective in preventing bank-financed inflation of securities and real estate.
2. They would eliminate the vast excess reserves which bankheld "governments" now represent — and, Federal Reserve policy apart, which bankheld short-term "governments" will otherwise continue to represent. As things stand, the banking system has an ominous inflation potential. Banks may obtain the reserves necessary for multiple expansion of commercial, security, and real-estate loans, not only from the Reserve Banks directly but also from the Treasury via the Reserve Banks, by not replacing federal obligations as they mature.
3. They would leave the Treasury free to follow, if and as necessary, a suitable inflation-checking policy of borrowing from the public at interest rates (yields) as high as necessary to the mopping up of excess liquidity. The notion that suitable increase of interest rates<sup>3</sup> on consols or long maturities involves a threat to bank solvency is probably

<sup>3</sup> Whether the increase involved in conversion to longer maturities and reduction of liquidity features should be regarded as more than nominal change of interest rates, is a neglected question of definition. In any case, to raise yields on federal obligations, by making them less nearly equivalent to currency, is not, in any significant sense or measure, to raise the cost of capital for long-term private investment — save possibly for great corporations which, within narrow limits, may rival governments in the liquidity they can offer. Most current talk about fixing or controlling interest rates has, for me, simply no meaning, save as talk about varying the "moneyness" of governmental obligations. Surely our government could reduce its interest *payments* to zero, by monetizing its whole debt. Does anyone hold that such action now would lower the cost of capital funds for private firms? Low rates deriving from liquidity that only government with issue powers can give to securities may stimulate *governmental* investment, by making it seem irresistibly cheap in terms of quite misleading interest-burden calculations. How they promote private investment, save by creating expectations of inflation, I cannot see. Incidentally, one virtue of leaving a large amount of unsupported consols outstanding is that we might then discover empirically whether, panics apart, their yields could be lowered by increasing liquidity. In the financial good-society, open-market purchase of consols would, by announcement effects, tend to lower their prices rather than to raise them.

illusory; but, if so, the illusion is widely entertained and affords a powerful inhibition and political argument against necessary measures for combating inflation through debt policy. If borrowing from banks were sharply dissociated from other borrowing, we might expect better practices at both levels and better understanding of both tax and debt problems.

4. They would also bring elegantly under control the awkward problem of inordinate bank earnings — and thus eliminate an argument against increase of interest rates that is more substantial than the supposed threat to bank solvency.
5. They would largely dispose of the vexed problem of inadequate bank capital or thin residual equities — and, incidentally, of a plausible, spurious apology for excessive bank earnings. If deposits were supported largely or wholly by completely liquid “governments,” there would be little need for much cushion of stockholder equity — save as banks chose to operate also as investment trusts with respect to their own capital.
6. They would offer a long-term prospect of retiring our interest-bearing debt at a more rapid rate, and within a shorter period, than otherwise would be possible. Suppose that we shall need, for stability at a proper postwar price level, only 100 billion dollars of money and deposits, and that, with rising real income, this amount must be increased secularly at 3 per cent per annum to sustain the price level. It thus appears that (save for nominal “interest” paid as subsidy for banking services) we might retire our present interest-bearing debt in 30–40 years merely by extrabudgetary measures, i.e., without having any net excess of tax revenues over expenditures during that period.<sup>4</sup> Our debt being what it is, the government clearly should reappropriate its prerogative of issuing the country’s money.

The immediate problem, to repeat, is that of preventing banks from feeding inflation in the

<sup>4</sup> Empirical evidence as to secular increase in the demand for money or liquidity is, however, a precarious basis for long-term policy. Trends in such demands cannot confidently be extrapolated from periods of extreme monetary instability and uncertainty into a long future of (proposed) highly stable money value. Rising mass incomes should increase somewhat demands for liquid reserves; but monetary stabilization, if achieved and sustained, would tend steadily to reduce such demands. The prospect of monetizing gradually our whole federal debt over a generation may thus be illusory, or anomalously dependent on the sustaining of much monetary instability and uncertainty. If so, the greater tax cost of bond retirement will be handsomely compensated by the greater monetary security that a smaller (increase in) money quantity will involve. The long-term possibility of monetizing bonds is, if real, a mixed blessing: it mitigates tax problems while aggravating monetary problems. The smaller the amount of money required in the future for monetary stabilization, the more adequate and powerful will be the proper, simple devices of fiscal stabili-

zation. Certainly it is desirable that small changes in mass income taxes should suffice to produce large and prompt monetary effects. Indeed, the desirable public confidence in monetary stabilization is ultimately the prime instrument of stabilization; and every increase in such confidence would, *ceteris paribus*, be reflected in a lower demand for liquidity. On balance, therefore, one may hope that monetary stabilization and debt retirement will require a secular excess of revenues over expenditures.

stock market, in real estate, and in inventories. More broadly, it is that of preventing general banking inflation on the basis of liquid “governments” as virtual excess reserves. Still more broadly, it is that of removing obstacles, real and illusory, to an anti-inflationary debt policy of borrowing from the public at the substantial interest cost that long maturities or consols would involve, i.e., of funding our debt into illiquid, unsupported, and firmly held bonds or, if you please, of paying interest on real debt instead of paying merely hoarding premiums on money in the nominal form of bonds.

These immediate problems are urgent and critical, for we probably shall have, in the near future, no substantial protection against inflation save that which debt policy affords. Even if one accepts the Keynesian dictum that inflation should instead be stopped largely or wholly by taxation, there is now really little or no hope of securing increases in federal tax rates, save possibly after high interest rates are shown to be the alternative. We shall be lucky to hold present taxes against the insistent political pressure for reduction. Even the quixotic bureaucrats who proposed to stop wartime inflation with their bare hands, i.e., with direct controls amidst fiscal insanity, have now few illusions about their future potentialities, even for creating illusions.

To be sure, we may ride through without disaster in spite of policy. Inflation may simply not take hold in the dangerous near future. But it is folly to lay all bets on that possibility. We should be prepared for any eventuality, and for accelerated and explosive inflation among others. Strong anti-inflation measures in debt policy (e.g., large reduction in bank deposits) may prove unnecessary; but we certainly should be prepared to take them, and to take them promptly if the need becomes still more acute. This means getting on with a funding program and cleaning up the mess that war-time debt policies or practices have left behind.

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This much done, by the measures here proposed, there would remain interesting long-term questions, notably, the question of whether federal subsidy for banking services should be continued indefinitely or gradually withdrawn.

I can make out no substantial reasons for permanent subsidy, i.e., no reason why the services of warehousing and transferring private funds should not be paid for like any other economic services, i.e., by appropriate service charges. Interest should not be paid on money, or on any money contracts that one may purchase without sacrifice of liquidity; and this proposition is certainly as valid for interest paid in banking services (to demand-depositors) as for interest paid in cash (to savings-depositors). It is anomalous that banking services should be free only to persons with large balances, and that customers should be left without financial incentive to economize their use of such services.

Subsidy may be defended only as a transition expedient — as a device for facilitating transition to reserve requirements of 90–100 per cent, and as a means for avoiding abrupt change in an established but anomalous institution. In the process of change, it would be a great advance merely to create arrangements under which interest payments on bank-held “governments” would be recognized for the subsidies they are, and thus distinguished clearly from interest payments to the public on real debt (consols). The subsidy issue might then be faced squarely and dealt with on its merits. The government need not pay private institutions to create money; it need not pay anyone to hold money equivalents instead of money; but it must and should pay people to sacrifice liquidity and really to forego the available (expected) returns on real investment (assets and equities).<sup>5</sup>

Given subsidy as even a temporary or transitional expedient, a nice question arises of what kind of services shall command subsidy. Shall it be available regardless of the level of service

<sup>5</sup> Besides an average expectancy of “real” return (net real productivity), assets and equities, by contrast with consols, offer an inflation hedge which, in view of the asymmetry of political inflation-deflation expectations, people must be paid to forego — unless property in assets and equities, and especially in “sunk” investment, is in turn becoming so differentially insecure and exploitable as to render our institutional system unworkable. This latter proviso perhaps suggests the distinctive reason for the recently low levels both of private investment and of interest rates.

charges, or regardless of the minimum balances required for free services? If banks were mere service agencies, one might rely on competition to assure reasonable charges, whatever the actual subsidy; while they remain “financial department stores,” and while national charters remain subject to rationing, competitive determination of charges is, at least, not a wholly satisfactory prospect.

A second long-term issue concerns the future of banks as sources of capital funds for private business. A 100 per cent reserve requirement would leave banks free to provide such funds out of their own capital. It would not preclude combination of the business of providing safe-keeping and checking facilities with the proper business of investment trusts. Such combination, of course, while requiring great increase in bank capital for large survival of conventional banking business, would facilitate best use of existing enterprises and their established staffs. But it seems uneconomical to sustain this combination of such widely different kinds of business. Services to depositors surely could be rendered more cheaply by specialized enterprises, housed in modest premises, investing mainly in accounting machines, and officered by skillful accountants rather than by credit analysts, bond specialists, business forecasters, and political-financial leaders.

Even greater advantages of enterprise specialization are apparent when one looks at the other part of the present combination. If banks as lender-investors were dissociated from banks as depositary-clearing agencies, the lender-investor enterprises might then focus upon a vital and essential function of providing long-term capital and, at best, of providing it in an equity form. There is now little need for the old type of bank lending or the short-term commercial loan. Established enterprises no longer need place their working capital precariously on call; they can finance out of withheld earnings, by issuing stock-rights or by outright sale of shares (or bonds); and seasonal variations in working-capital needs can be minimized directly or met by trenching temporarily upon ample liquid reserves. New or ill-established businesses need long-term funds, and equity capital above all. Trading on a shoestring of equity, and under a mass of current liabilities, is largely a thing of

the past, and should be for banks as well as for their corporate customers.

If existing banks were suddenly excluded from lending or investing activities, their executives might simply be driven to effect a most salutary institutional reconstruction, namely, to establish thousands of localized investment trusts. Such institutions might attract a mass of equity capital for purposes of equity participation in worthy, smaller, local enterprises. Big metropolitan banks probably would reorganize, without much change of their staffs and facilities, into big investment trusts, specializing in equities (listed stocks) of great firms that need no such institutional assistance. But smaller banks, whose executives really know something about local or community enterprises, might be converted into highly useful institutions, mobilizing local funds for local investment, much as building-and-loan associations once did but on an equity basis. In other words, the change in question might release a lot of useful, competent people to perform functions which their present institutional connections preclude their performing adequately or in a proper way.<sup>6</sup>

It is easy to become dithyrambic if, as a libertarian, one contemplates the possibilities of radical decentralization of our capital markets via such localized investment trusts. It might eventually undo, and even reverse, the present artificial economies of inordinate enterprise size, in differential access to capital funds. While giant enterprise aggregations were plagued by a volatile New York Stock Exchange, and supported only by the most inconstant investors, small and moderate-size firms might enjoy the steady loyalty of their communities, acting through local investment trusts, and also a salutary close scrutiny of management by interested local shareholders,

<sup>6</sup> One reason for the persistence of banking is our lamentable failure to develop proper institutions for mobilizing the savings of middle-income families. If legislatures and econ-

indeed, by the whole community as a functioning social group.

If such local investment trusts really served, as they should, to mobilize mass, small savings in their communities, even our labor problems might be brought toward good solution. In such circumstances, community pressure might inhibit wage demands that would threaten the relative prosperity of local industry, i.e., impair its competitive position vis-a-vis other communities. On the other hand, such pressure would also be exerted against needlessly low wage rates that impaired a firm's ability to attract or maintain good-quality labor, or impaired the community's ability to hold or recruit good worker-citizens. But this is rhapsody!

The urgent first-step, to repeat, is to replace bank-held "governments" with a new low-rate issue, eligible only for bank ownership, guaranteed against any depreciation, available, redeemable, and callable continuously at par, and required as bank reserves to roughly the amount of "governments" now held by banks. We should then fund our remaining federal debt into consols or very long maturities. In this process, it might prove necessary, in avoiding imminent inflation, to use such consols to reduce the amount of bank-held "governments." Over 40 years, however, it might well be feasible, and necessary in avoiding deflation, gradually to convert all consols into money and (or) the low-rate issue for banks. Over such a period, if not sooner, the rate on this latter issue might well be reduced gradually to zero. Thus we might arrive at or approach an economy where all private property consisted in pure assets, pure money, and nothing else. This, along with fiscal stabilization of the value of money, is the financial good-society.

omists were more concerned about giving us good, small investment trusts, and less concerned about making bank accounts and life insurance safe and salable, we might get a better structure of financial organization.