The Chicago Tradition Revisited: Some Neglected Monetary Contributions: Senator Paul Douglas (1892-1976)

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INTRODUCTION

In his 1956 "Restatement" of the quantity theory, Milton Friedman presented his analytic and pragmatic framework as one that "conveys the flavor" of the Chicago quantity-theory tradition of Simons, Mints, Knight, and Viner [15, p. 4]. As a result of Friedman's attempt to bridge his contemporary quantity theory to that of his mentors, there has been an increased interest in the doctrinal historical character of the Chicago School of the 1930s. Important contributions have included (a) Patinkin's study [20] concerning the theoretical nature of the earlier Chicagoans and his conclusion that, contrary to modern quantity theorists, these economists placed primary reliance on sharp fluctuations in the velocity of circulation (with the money stock responding passively) in interpreting changes in the level of economic activity; and (b) Davis's survey [1] of the policy orientation of the members of the Chicago School during the early 1930s and his surprising finding that these Chicagoans advocated the use of public works and deficit budgets as means of combating depression.

The culmination of this doctrinal historical research has been the recent exchange between Friedman [15] and Patinkin [21]. Friedman now seems to accept the validity of Patinkin's criticisms concerning the difference in conceptual frameworks between earlier and contemporary quantity theorists and thus no longer claims theoretical lineage to the former Chicagoans. Yet following Davis, he notes, "so far

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as policy was concerned, Keynes had nothing to offer those of us who had sat at the feet of Simons, Mints, Knight, and Viner" [15, p. 937]. Though the doctrines of the aforementioned Chicagoans are undoubtedly of importance in contributing to the monetary economics that Friedman now teaches, even more relevant to the theme of the anticipatory nature of the earlier Chicago School are the neglected contributions of Paul Howard Douglas.[1]

Douglas, who was born March 26, 1892, in Salem, Massachusetts, joined the faculty at the University of Chicago to teach economics in 1920 (the following year he was awarded his Ph.D. at Columbia University). Douglas taught at Chicago until 1942, when he enlisted in the Marines. He returned to Chicago in 1946 and remained there for two more years—until his election to the U.S. Senate. During his eighteen years as a senator, Douglas established a reputation as a champion of liberal causes. He died on September 24, 1976.

MONETARY CONTRIBUTIONS DURING THE 1920s AND 1930s

As a minimum statement, Douglas was the first Chicagoan to advocate the use of public works and deficit budgets to combat depression, doing so originally in a 1927 article [8]. This fact has been overlooked by latter-day commentators. Moreover, he continued to argue for budget deficits throughout the early 1930s [3, 9, 12] financed preferably by printing money, as tax-financed and bond-financed deficits had offsetting effects [8, p. 42; 9, p. 80; 4, pp. 136-38]. In accordance with the views of his Chicago colleagues (see [1]), Douglas had originally called for the balancing of the budget over the course of the cycle [3, p. 14; 12, p. 149]. But by the time of his *Controlling Depressions* in 1935, he recognized that chronic deficits would have to be expected [4, p. 185]. The following year, Simons joined Douglas in foreseeing the need for chronic deficits [22, p. 333]. Thus if credit is to be given to the other Chicagoans "for developing relevant policy prescriptions" [15, p. 3] some acknowledgment seems due to Paul Douglas.

Yet even more pertinent to contemporary Chicago are Douglas's theoretical views on money. Using as his analytic framework the Fisherine equation of exchange, $P = (MV + M'V')/T$, he was careful to note: "The various terms are not, however, as some of the more naïve quantity theorists have believed, independent of each other. On the contrary, they are inter-related in a somewhat organic fashion" [11, p. 26].[2]

[1] Davis [2] does refer to Douglas's 1935 work [4]. Davis, however, is not concerned with Douglas's monetary economics, but rather with his advocacy of fiscal measures as cures for depression. He also describes how Douglas's views were influenced by Keynes and Wicksell and led to Douglas's adoption of a saving-investment analysis. But Davis is in error when he states that: "Douglas pointed to the saving-investment nexus as the major culprit in depression making. The sperm of a depression was an excess of saving over investment" [2, pp. 48-49]. As this paper will demonstrate, this was not how Douglas interpreted the initiating cause of depressions.

[2] That Douglas's monetary writings are representative of the Chicago tradition is evidenced by the fact that when Patinkin refers to a similar interpretation of the quantity equation, as described in Lloyd Mints's lecture notes, he observes: "[this] has always represented to me 'the flavor of the Chicago tradition'" [20, p. 55].

Unlike his Chicago colleagues, who interpreted depressions as due to independent movements in velocity,[3] Douglas argued that depressions were caused by the failure of the money supply to increase as rapidly as the annual trend rise in production [8, pp. 31–41; 11; 4, p. 77]. The annual rise in production was attributed to improvements in technical efficiency and increased savings. The failure of the money supply to keep pace with increases in production would result in an induced fall in the general price level in order to clear the market of the excess supply of goods. Because present product prices have embodied within them relatively higher costs that have been paid out previously, profit margins would shrink, and curtailed output would ensue. Much in line with Friedman's recent criticism of the London School of Economics tradition of the 1930s [15, pp. 936–41], Douglas observed: "The orthodox economists of the English classical tradition, whose reasoning tends to be permeated with the assumptions of a pre-capitalistic and barter economy, see few or no evil consequences in a fall in prices. But the results may be serious in the money and credit economy of today, where business enterprises produce for a profit. For production takes time, and raw material and labor purchased at one period of time will not be fully combined into finished products and sold until some time later" [10, pp. 112–13].

Douglas applied his analysis directly to the Great Depression. He cited the failure of the money supply to increase proportionately with the annual rise in production "as an important reason I believe for the great depression which began in 1929"[4] [11, p. 161]. This is precisely the conclusion reached by Friedman and Schwartz [17] in their reinterpretation of the 1929 depression. In addition, another distinctive feature of Douglas's work was the emphasis he placed on empirical verification of his theoretical framework [4, 8, 10]. This, too, serves to link him more directly to the methodology of contemporary Chicago than do the nonempirical approaches of Simons, Knight, or Viner.

To prevent depressions, Douglas argued that primary reliance should be placed on two key indicators; either a general price index could be kept relatively stable or the unemployment rate prevented from rising above a maximum level of 4 or 5 percent [8, p. 42; 4, p. 195]. Attainment of either of these two goals could in turn be achieved "if the quantity of purchasing power were to be increased at the rate of 3 to 4 percent a year, or the long-time rate of production" [4, p. 185]. This is re-

[3] The other Chicagoans did not really express strong interest in the factors that might initiate a depression. In this context, Knight stated that, "Too much attention has been given to this problem of the cause of the collapse" [18, p. 214]. A similar opinion is expressed by Mints in [19, p. 60].

[4] Douglas's monetary economics and his interpretation of depression as being due to a failure of the money supply to increase proportionately with production were greatly influenced by the joint writings of the American economists William Foster and Waddill Catchings. I have discussed the monetary doctrines of Foster and Catchings elsewhere [23]. The point to be emphasized is that Douglas did not ascribe the initiating cause of depression to the "saving-investment nexus" as claimed by Davis [2] and as referred to in note 1. Indeed, he argued throughout the late 1920s and early 1930s that an excess of saving relative to investment was a cumulative cause of depression. Thus, after crediting Wicksell and Keynes for their saving-investment analyses, Douglas notes: "They are [however] describing characteristics and accelerating causes of the up and down swings rather than the initiating causes themselves" [4, p. 42].

markably similar to the growth-rate rule that is the hallmark of contemporary quantity-theory policy. Douglas advocated the monetary growth-rate rule as early as 1927, when he stated: "The primary need is for stability in the price level of those goods manufactured under the present technique of mass production and this can be secured by a general and proportionate increase in the supply of monetary purchasing power" [8, p. 40]. Douglas stated the growth-rate rule on numerous occasions during the late 1920s and early 1930s[5] but was the only Chicagoan to do so. It is *not* to be found in the published writings of Simons, Mints, Knight, or Viner during the early 1930s.

Entirely consistent with the aforementioned doctrines are the views contained in a neglected 1931 work, *The Problem of Unemployment,* which Douglas coauthored with Aaron Director (then in his first year on the Chicago faculty). The analysis of depressions in this volume—as due to the failure of the supply of monetary purchasing power to increase as rapidly as production—follows closely the reasoning that Douglas had been expounding since 1927 [14, p. 181]. Douglas and Director argued that depressions could best be combated through the use of public works and deficit budgets, "particularly where fresh monetary purchasing power is created to finance the construction work" [14, pp. 210–11]. Moreover, curtailment of economic activity could be avoided "if the supply of money and credit were to increase commensurately with the increase in production" [14, p. 183].

POSTWAR VIEWS

During Douglas's first senatorial term, he was appointed chairman of the Subcommittee on Monetary, Credit, and Fiscal Policies. In this capacity he presided over a series of hearings having to do with the Federal Reserve-Treasury conflict of the late 1940s and early 1950s. Throughout these hearings, Douglas continued to express his adherence to the quantity theory of money and to recognize the importance of monetary policy in the Chicago tradition.

The conflict between the Fed and the Treasury was a consequence of the Treasury's desire to peg interest rates on government debt. This required that the Federal Reserve lose its control over the money supply. Douglas viewed the conflict as particularly acute during periods of inflation or threatening inflation, when the Fed favored higher interest rates and the Treasury continued in its adherence for low interest rates [26, p. 533]. A subsequently published report of the Subcommittee on Monetary, Credit, and Fiscal Policies dealt directly with this issue. The report recommended that the primary responsibility for regulating the supply, availability, and cost of credit should be lodged with the Fed and that "Treasury actions in the Federal debt shall be made consistent with the policies of the Federal Reserve"

[5] Elsewhere he stated: "Since the long-time advance in production tends to be somewhere between 3 and 4 percent a year . . . it follows that the monetary purchasing power in the hands of consumers must normally be increased in approximately that rate" [3, p. 19]. See also [13, p. 32; 6, p. 190; 11, pp. 160–61; 7, p. 332]. The development of the growth-rate rule traces back to the early nineteenth century English economic literature. See [24].

[27, p. 2]. In addition, the report rejected the notion that fiscal policy could be very effective if monetary policy were neutral and stated that "a conflicting monetary policy could lessen still further the effectiveness of fiscal policy." Douglas's Subcommittee also criticized the contractionary policies pursued by the Fed during the first few years of the 1930s depression and suggested that the severity of that depression might have been substantially lessened had more expansionary policies been followed [27, pp. 18–19].

On February 22, 1951, Douglas took the floor of the Senate and delivered a lecture on his interpretation of the key issues regarding the Fed-Treasury conflict. "No one desires a high interest rate in and of itself," he stated. "However, I do not think that this states accurately the real issue before us. The real issue is inflation" [25, p. 1470]. Douglas proceeded to give his senate colleagues a verbal description of the equation of exchange. He argued that the rise in the general price level that had taken place since June 1950 was a consequence of prior increases in the supply of money made possible by the expansion of reserves by the Fed. But the blame does not lie with the Federal Reserve, for "over the shoulder of the Federal Reserve System has stood the Treasury, making threatening passes and gestures and from time to time cracking its whip. . . . Under this pressure the Federal Reserve System has gone along. The real responsibility has been that of the Treasury. The Treasury has pulled the strings, and the Federal Reserve has danced to its music" [25, p. 1473].

Douglas noted that he did not believe high interest rates would have much effect in halting inflation. But that was not the issue. Inflation could best be controlled not by raising the price of credit but "by helping to shut off the supply" [25, p. 1478]. Accordingly, he proposed that the Fed give primary emphasis to controlling the supply of money while continuing its policy of maintaining orderly conditions in the money market. Having completed his speech, Douglas presented his senate colleagues with a signed document that he had received from seven University of Chicago economists–including Milton Friedman and Lloyd Mints[6]–on "The Failure of the Present Monetary Policy." He noted that the analysis of inflation contained in the document, as well as the proposed inflation remedies, were entirely in accord with his own. Shortly after Douglas's speech–and a direct consequence of his persistent efforts in that direction–the Treasury and the Fed issued a joint statement acknowledging that they had reached "a full accord" (on March 2, 1951).[7]

CONCLUDING REMARKS

Paul Douglas is notably remembered today for his pioneering studies on the relative effects of labor and capital upon production. Yet at one time he remarked that

[6]Other signers of the document were: Lloyd A. Metzler, Frederick H. Harbison, D. Gale Johnson, Theodore W. Schultz, and H. G. Lewis. See [25, pp. 1481–82].

[7]Some twenty years later, Douglas reflected upon the Fed's actions prior to the accord as "a vindication of the quantity theory of money, supposedly known to every student of elementary economics" [7, p. 332].

he considered his contributions to monetary economics at least as important as his work on production functions [5, p. 507]. This note has sketched some of these contributions that have been overlooked and that serve to link him directly with the contemporary quantity theory. Combined with the innovations of his Chicago colleagues during the 1930s, Douglas's monetary economics serves to reinforce Milton Friedman's exegesis of a Chicago tradition where "money matters" and where the quantity theory "became a flexible and sensitive tool for interpreting movements in aggregate economic activity and for developing relevant policy prescriptions" [15, p. 3].

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