The Federal Reserve's Role in the Great Contraction and the Subprime Crisis

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Milton Friedman liked to recall that his experience with the Great Depression as a young man living in New York had a major effect on his career decision to study economics. So, we can count at least one good thing that came out of that tragic, unnecessary experience.

I had about the same reaction to the Depression as Milton Friedman, as did many others who were born early enough to witness the prosperity of the 1920s and experience the inexplicable poverty of the 1930s. Several of my fellow students and I, who were lucky enough to have studied under Friedman at the University of Chicago, subsequently concentrated our professional research on monetary economics to find out just what made the monetary system tick, and especially what circumstances made it go awry. The 1929 experience was the worst, but not the only one.

Milton Friedman's and Anna Schwartz's epic account of the Great Contraction (1929–33) in their *Monetary History* tells most of what happened (Friedman and Schwartz 1963: chap. 7). It is empirical and analytic economics at its best. Anyone who followed in their footsteps has had this superb model of economic research to guide his own efforts.

Cato Journal, Vol. 28, No. 2 (Spring/Summer 2008).

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Despite the evidence in the *Monetary History*, misconceptions about the Great Contraction still abound in laymen's minds, more so in popular media accounts, and, to some extent, even among economists. Here, I summarize an important unpublicized incident of that period to emphasize the policy decision that triggered the Depression, and what the experience should have taught policymakers to do and not to do. My brief review is meant to emphasize how that Fed-provoked disaster speaks to Federal Reserve policy in the recent state of disequilibrium in financial markets.

The Gold Standard

A myth that seems to have no ending is that "the" gold standard was the behind-the-scenes villain that promoted the Great Contraction. This contention is preposterous and cannot stand even simple empirical review. Nevertheless, it serves as a convenient scapegoat for apologists who have not looked closely enough at the monetary data, and at some of other peculiar determinants of Fed policy that occurred in 1929–30.

The *operational* gold standard ended forever at the time the United States became a belligerent in World War I. After 1917, the movements of gold into and out of the United States no longer even approximately determined the economy's stock of common money. The contention that Federal Reserve policymakers were "managing" the gold standard is an oxymoron—a contradiction in terms. A "gold standard" that is being "managed" is not a gold standard. It is a standard of whoever is doing the managing. Whether gold was managed or not, the Federal Reserve Act gave the Fed Board complete statutory power to abrogate all the reserve requirement restrictions on gold that the Act specified for Federal Reserve Banks (Board of Governors 1961). If the Board had used these clearly stated powers anytime after 1929, the Fed Banks could have stopped the Contraction in its tracks, even if doing so exhausted their gold reserves entirely.

Strong's Stable Price Level Policy

As the *Monetary History* recounts, from 1922 to 1928 the Federal Reserve Bank of New York, under the aegis of Benjamin Strong, promoted what amounted to a stable price level policy for the U.S. economy. The New York Fed was in the right financial environment to implement this policy; the postwar U.S. economy after the 1920–22 recession was the right time to begin it; and Benjamin Strong was the right man to run this showcase model of central bank policy. It lasted from 1922 until late 1928, when Strong died of tuberculosis (Chandler 1958: 194–206; Friedman and Schwartz 1963: 251, 411–15).

With Strong's death, a scramble began for control of the monetary machinery. While the *Monetary History* provides much documentary evidence on the personalities vying for control on the Federal Reserve Board and in the Fed Banks, and on the critical policy decisions that occurred, the issue of who replaced Strong as the major power figure in Fed decisions is somewhat unclear. What is clear is that the successor to Strong at the New York Fed, George Harrison, lacked the commitment and the personality to continue Strong's tradition of monetary stability.

At this part of their story, Friedman and Schwartz (1963: 419) observe: "Something more than the characteristics of the specific persons or official agencies that happened to be in power is required to explain such a major event as the financial catastrophe in the United States from 1929 to 1933." My own research during the last several years has convinced me that the "something" they were looking for was the Real Bills Doctrine (RBD), the banking theory on which the Fed was founded that was supposed to rule the operations of the Fed Banks (Mints 1945: 9, 30; Humphrey 1982: 4–6). Friedman and Schwartz (1963: 191–93) critically and properly discuss the RBD in several places, but only its positive dimension as an inadequate means for providing a stable monetary policy. They do not explicitly link that doctrine, especially its dark side, to Fed policy after 1928.

The Real Bills Doctrine: Positive and Negative

The positive side of the RBD argues that the generation of money should be geared to the creation of "real bills" debt that finances the output of new goods and services. It is an appealingly simple doctrine, closely related in form and method to the operational gold standard. Just as a gold standard monetizes gold when it comes into the banking system, so the RBD would monetize real output as new enterprises created new goods and services. While harmless as a policy for *individual* commercial bank operation, the RBD is fundamentally unsound as a policy norm. It is not parallel and equal to a working gold standard, but depends on the gold standard to establish and maintain the monetary equilibrium under which the RBD would function as prescribed.

Throughout the 19th and early 20th centuries, the RBD vied with the Quantity Theory of Money (QTM) for intellectual favor among bankers and economists. Its simplicity, completeness, and practicality recommended it, especially since the gold standard was there to support it. However, from World War I on, the anchor of the gold standard was absent, as Strong recognized. He was of the reasonable opinion that a true gold standard could not function until the international financial world was stabilized with a reactivated gold system. So he used a modified QTM to guide his policies (Strong, [1930] 1983, 175).

The principal thrust of the RBD is that increases in real goods through the banking system provide optimal increases in money. However, the Great Contraction featured devastating *reductions* in money and corresponding *reductions* in real output. So how could adherence to the RBD have caused the Contraction of 1929–33?

The answer is that the RBD has a dark side. Proponents of the RBD usually emphasize its positive side as a guide for bank lending. However, many of them also unequivocally condemn long-term loans, mortgages, government bonds, and especially speculative loans that support real estate bubbles and stock market exuberances. Such loans, they argue, are unfit and dangerous as objects for commercial bank lending because they do not provide any real substance for the newly created bank money (Friedman and Schwartz 1963: 191–92, 417 n. 178; Humphrey 2001: 302–9).

The Role of Adolph C. Miller on the Federal Reserve Board

The man who assumed Strong's powerful role in the Federal Reserve System, and managed to make the dark side of the RBD the working model for Fed policy, was Adolph C. Miller, a senior member of the Board of Governors. President Wilson had appointed Miller to the Board in 1914, and President Coolidge reappointed him in 1924.

Miller was the quintessential real bills central banker. He had been a student of J. Laurence Laughlin at Cornell University, and had there received his M.A. (but not a Ph.D.) in economics. Also in the Laughlin circle was H. Parker Willis, who later received a Ph.D. in economics under Laughlin at the University of Chicago. Laughlin was a long-time opponent of the QTM, and Willis and Miller actively supported his views. (Interestingly enough, Laughlin had a Ph.D. in history from Harvard, but no formal economics training. He had absorbed some principles of economics when he was at Harvard from Charles Dunbar, America's first full-blown economist.) A fourth member of this group, who became the political spokesman for the RBD in Congress, was Carter Glass, first a congressman and then a senator from Virginia. Glass was chairman of the House Committee on Banking and Currency that drafted the Federal Reserve Act, and then chairman of the Senate Finance Committee. Willis taught economics to Glass's children at Washington and Lee about 1905, and became Glass's principal adviser in the writing of the Federal Reserve Act in 1913. During 1918–20, Miller was a member of the Federal Reserve Board, Glass was secretary of the Treasury, and, therefore, chairman of the Fed Board, and Willis was secretary of the Board (Bornemann 1940: 2–5, 27–31, 51–59).

Miller became the driving intellectual force behind Fed policy in 1929. He had publicly criticized Strong and the New York Fed on a number of occasions, but Strong had successfully countermanded Miller's sniping. With Strong gone, Miller managed to convince other members of the Board, and the presidents of several Federal Reserve Banks, including Boston and Chicago, of the righteousness of his anti-speculation ideas. The other Board members, none of whom was versed in monetary economics to any degree at all, were only too happy to coalesce on a central principle of policy that would enable them to impose their authority over the Fed Banks.

The Dark Side of the RBD in the Fed's Anti-Speculation Policy

Under Miller's influence, the Federal Reserve Board in early 1929 unleashed an evangelical crusade against stock market speculation. In keeping with the precedent Strong had initiated—a stable price-level policy, without heed to the latent gold standard—proponents of the RBD could proceed equally unconstrained by any "gold standard" (Hetzel 1985: 15). Fortunately for the record, Miller had the temerity to write an article for the *American Economic Review* in 1935, in which he lauded the Board's anti-speculation policy after 1929, and recounted his role in promoting it (Miller 1935: 442–57).

Miller (1935: 453) claimed critically that Strong's policies in the presence of stock market speculation "proved to be unequal to the situation . . . in this period of optimism gone wild and cupidity gone drunk." The Federal Reserve Board's "anxiety," he continued, "reached a point where [the Board] felt that it must assume the responsibility for intervening . . . in the speculative situation menacing the welfare of the country." Consequently, on February 2, 1929, the Board sent a letter, crafted mostly by Miller, to all the Fed Banks stating that the Board had the "duty . . . to restrain the use of Federal Reserve credit facilities in aid of the growth of speculative credit." To accomplish this end, the Board initiated "the policy of 'direct pressure' [that] restricted borrowings from the federal reserve banks by those member banks which were increasingly disposed to lend funds for speculative purposes" (p. 454).

"Direct pressure"—subjecting the borrowing bank to an inquisition on its lending policies to discourage the applicant from obtaining "credit"—added a major obstacle to member banks' borrowing over and above the cost to them of the discount rate. "It put the member bank," Miller noted approvingly, "under pressure by obliging it to show that it was entitled to accommodation. . . . It was a method of exercising discriminating control over the extension of federal reserve credit such as the purely technical and impartial method of [Fed] bank rate could not do" (Miller 1935: 455–56).

Monetary historian Clark Warburton, writing some years later, recounted the viciousness of "direct pressure." In the early 1930s, he noted, the Fed Banks

> virtually stopped rediscounting or otherwise acquiring "eligible" paper. This [hiatus] was not due to any lack of eligible paper. . . . It was due to "direct pressure" so strong as to amount to virtual prohibition of rediscounting for banks which were making loans for security speculation. . . . Federal Reserve authorities had discouraged discounting almost to the point of prohibition [Warburton 1966: 339–40].

Direct pressure tended to make the formal discount rate almost meaningless. A bank not able to pass the "direct-pressure test" could not borrow from a Federal Reserve Bank at any rate, no matter how much "good" paper it had or how badly it needed "credit" to meet deposit withdrawals. To such a client bank, discretion by authority substituted for the Fed discount rate to ration Federal Reserve "credit." Ironically, the policy was completely contrary to the positive prescriptions for Fed Bank discounting set forth in the Federal Reserve Act.

Miller made no bones about who was responsible for the new restrictive policy. "It is not without significance," he noted proudly,

> that . . . the five members [out of nine] of the Board who took the responsibility of formulating the policy and attitude of the federal reserve system were opposed by a minority [four] of their own membership, including the Secretary of the Treasury, the governor and vice-governor of the Board, by the [presidents of] the twelve federal reserve banks, the Federal Advisory Council, and by many of the largest member banks. . . . Nonetheless, the Board adhered to its position [Miller 1935: 456].

Fed Gold Stocks

At the same time that Fed policymakers refused to provide relief to member banks, gold in Fed Banks was piling up. By August 1931, Fed gold had reached $3.5 billion (from $3.1 billion in 1929), an amount that was 81 percent of outstanding Fed monetary obligations and more than double the reserves required by the Federal Reserve Act. Even in March 1933 at the nadir of the monetary contraction, Federal Reserve Banks had more than $1 billion of excess gold reserves (Timberlake 1993: 270–72). Whether Fed Banks had excess gold reserves or not, *all* of the Fed Banks' gold holdings were expendable in a crisis. The Federal Reserve Board had statutory authority to suspend all gold reserve requirements for Fed Banks for an indefinite period. Of course, no such loss of gold would have occurred. A Fed Bank expansion of "credit" would have initiated a spending dynamic that would have restored all the monetary vitals both in the United States and the rest of the world. In no way were gold stocks inadequate to maintain a full employment economy, and neither did gold have anything to do with the policy that Miller invented. Far from being "inept," however, the Fed's contractionary policy was deliberate, contrived, man-made, disastrous beyond measure, and deadly contagious to the rest of the trading world.

The Fed's Role as a Central Bank

What should the Fed have done in 1929? The answer is simple: It should have continued the policy that Benjamin Strong had implemented through the offices of the New York Fed during the 1920s—that is, it should have maintained stability in the value of the dollar, until the international gold standard could be reinstituted under amended parameters.

But what about stock market speculation? The stock market is one market out of hundreds—or even thousands—that function through dollar exchanges for goods, services, and capital. Many markets include speculation and hedging between present and future prices. Such activities are fundamental to a market system. Some of the speculative activity may seem or even be excessive, but that is the burden or the fortune of speculators. If they are successful, they become rich. If unsuccessful, they go bankrupt. In any market disequilibrium that has come to a head, everyone's goal is to expeditiously make the necessary adjustments.

Specific market prices and participants' wealth positions may require serious adjustments, but such effects will not spread to other markets as long as the general monetary framework is sound. As Fed Chairman Ben Bernanke (2007) recently testified before the House Committee on Financial Services, "Markets do tend to self-correct." They surely do, because most market participants' self-interest is enhanced by correction of the disequilibrium. However, a particular market instability can be contained only if Federal Reserve policy maintains monetary equilibrium, the principle it abandoned in 1929.

All markets in which dollars circulate make up the true "money market." The Fed, having complete control over the quantity of dollars, controls the money market. It can and must use that control for just one goal: stability in the price level and the value of the dollar. It cannot concern itself with speculation, real estate bubbles, foreign exchange values, interest rate fluctuations, employment problems, or any other real variables. True, its policies often have short-term repercussions on real factors, which may be important to politicians, but its singular control over the nominal quantity of money precludes it from targeting any of these variables if it properly determines to keep constant the value of the dollar. Friedman and Schwartz (1963: 291) note that both the attempt to stop stock market speculation and the gold sterilization policy of the period "exemplify the difficulties raised by seeking to make [monetary] policy serve two masters."

Since the epic disaster of the Great Contraction, similar sector instabilities have occasionally appeared. The most recent example is the subprime mortgage crisis and the real estate slump. The Federal Open Market Committee's response to these events shows that Fed policy is too ready to take the politically easy route by accommodating "important" markets that get themselves into trouble. Every time it does so, it generates moral hazard in the protected sector, thereby making more difficult the one task that it, and only it, can accomplish—internal price level stability, which means a dollar of constant purchasing power.

Finally, the FOMC must advertise the priority of price level stability so that everyone understands what it is doing and why. Only then will it achieve the level of respect and finality that the true gold standard imposed on market economies.

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