Meltzer's *History of the Federal Reserve* and the Evolution of Central Banking

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> The only limit to a commercial bank's ability to discount is the limit to good commercial paper. . . . Such paper springs from self-clearing transactions. . . . It is the duty of the banker to discount freely for his customer in a crisis or panic. . . . The only limit . . . is the limit to good commercial paper. . . . The whole purpose of the Federal Reserve Act is to enforce this practice.
>
> —Rep. Charles Korbly (1913)

The Great Monetary Paradox

Most conventional economists are very much aware of markets. Indeed, a sound understanding of the function of markets and prices is what distinguishes economists from everyone else. Nevertheless, few economists seem to realize how far the supply of one major economic item has largely disappeared from any kind of market determination. That item is *money*, something that appears in all market exchanges with the trivial exception of goods and services bartered. To add insult to ignorance, money originated in private markets, as the Austrian economist Carl Menger showed so well, without the participation or help of any state. According to Menger ([1871] 1981: 262–63): "Money is not the invention of the state. It is not the product of a legislative act. Even the sanction of political authority is not necessary for its existence."

Yet, in spite of the undeniable fact that money was an economic innovation in private markets with no dependence on any state au-

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thority, everywhere in the world central banks and government treasuries monopolize the supply of national money stocks and closely regulate all the world's monetary systems. Nowhere is a market-determined money even tolerated much less a dominant feature. I refer to this phenomenon as the "Great Monetary Paradox."

The usual rejoinder is that the state came into the monetary picture primarily to add elements of certainty and stability to monetary systems—that its authority would somehow "gild the gold." The state's primary means for doing so, as Menger noted, was to impress upon the money already circulating the quality of legal tender so that everyone would be forced to accept it. Money in the Mengerian world was an unusual product: When common people had to accept the state's legal tender money, the quality of that money improved (Menger 1981: 262–63).[1]

All laymen and most professional economists today agree without much controversy that management of the monetary system is a "responsibility" of the government, and that a central bank is the institution of choice to do the job. Thus, what started out in all civilizations as a private-market function has become, universally, a prerogative of the state.

Central banks, if they are to be intellectually tolerable, must be at least "second-best" solutions. They must be able to argue that they have managed monetary systems rationally and systematically—that, though not "perfect," their policies have been reasonable in view of the circumstances of the times. The Big Question then to be answered is, Does the detailed history of central banking institutions and their policies justify acceptance of central banks as, possibly, a first-best solution, or indicate that central banks are at least good enough to rate as second-best in the management of money?

Allan Meltzer's *A History of the Federal Reserve, Volume I: 1913–1951* (University of Chicago Press, 2003), hereafter referred to as HFR, presents virtually all the details of institutional development and monetary policy formulation that the Federal Reserve System experienced during the first half of the 20th century. Consequently, his book provides all the evidence needed for evaluating just how well the Fed has managed the U.S. monetary system over the period covered.

[1]Twenty pages later, Menger notes that governments "have often misused their power [of legal tender]," but he does not pursue the dichotomy between what should have been and what had come to be.

The Evolution of Central Banking

Meltzer begins his work appropriately enough with a preview of what his book explores, and its scope. Chapter 2 then summarizes central banking theory and practice before the Federal Reserve Act. For this purpose, Meltzer's work would have profited if he had provided some references to the available scholarly literature on the institutional development of central banking (e.g., Hepburn 1924; Smith 1936; Goodhart 1988; Timberlake 1992, 1993). As it is, the only reference Meltzer offers is to an obscure article by G. T. Dunne (1963) entitled, "A Christmas Present for the President" (HFR: 19, n.1).

Meltzer then briefly examines the evolution of central banking, but only from the perspective of the Bank of England and the doctrinal writings of Henry Thornton and Walter Bagehot. Thornton wrote when the Bank of England had suspended gold payments for Bank of England notes. He had reason, therefore, to suggest rules for the Bank's operations, as it became a surrogate for the self-regulating specie (primarily gold) standard that had been in force until 1797. Bagehot, writing 70 years later, developed a central banking doctrine on the premise that a gold standard was again operational. Bagehot's principles, which Bank of England managers subsequently adopted, were aired in only a few Federal Reserve policy discussions in the 1920s and 1930s.[2]

Meltzer's treatment of the Bank of England covers well-known ground. But what he omits entirely is any reference to the development of central banking institutions in the United States during the 19th century. Although the United States did not then have a central bank, it had First and Second Banks of the United States, an Independent Treasury, a National Banking System, and a private clearinghouse system, all of which exercised various degrees of monetary control, and all of which contributed fundamental elements to the institutional formation of the Federal Reserve System. In spite of that rich history, Meltzer concludes, "The Federal Reserve's approach to policy originated in the Bank of England's nineteenth century practices and the partially developed theory or framework that the practices attempted to apply" (HFR: 64). By failing to take account of what is already known about U.S. monetary institutions and policies before 1913, Meltzer misses the opportunity to integrate his history of the Fed into the broader history of central banking.

[2]For an excellent analysis of the bullionist and anti-bullionist arguments, see Humphrey (1993: 12–31, 77–95).

When the bill creating the Federal Reserve System was going through Congress, its Democratic sponsors denounced and denied the idea that it might be a central bank. It had to be a regional system of reserve-holding banks with no political connections and no money controlling powers. It was to be an institution *limited to helping the self-regulating gold standard work more smoothly.* It should be accommodative to banks and act as a lender of last resort, but not take an active role in anticipating or preventing monetary and financial disequilibria. The congressional debates emphasized the principle that the proposed Federal Reserve System would be an institution geared to the specific banking conditions of the United States, with little or no similarities to the Bank of England (Timberlake: 1993, 214–34).

The largely passive role that the new law prescribed for Fed policy was no accident. It was there because the self-regulating gold standard of the time was universally recognized and accepted. The Federal Reserve Act itself confirmed: "Nothing in this act . . . shall be considered to repeal the parity provisions contained in an act approved March 14, 1900 [the Gold Standard Act]" (*Congressional Record*, 63d Cong. 2d sess.: 5100–6).

Federal Reserve Policy in the 1920s and the Real Bills Doctrine

In Chapter 4, Meltzer thoroughly documents how the accommodative role of the Fed changed in its first few years, at the same time that it was under the thumb of the Secretary of the Treasury during World War I. Once the war was over, Federal Reserve Banks and the Federal Reserve Board could resume their bureaucratic encroachment and turf struggles for power. By 1929, Meltzer writes, the Fed had "a new activist policy [that] was supposed to achieve three ends: mitigate business fluctuations, prevent inflation, and restore the international gold standard. . . . The apparent success of postwar policies in achieving the three main objectives and preventing financial panics increased the credibility of policies and the belief that a new more stable era had begun" (HFR: 261).

It surely did, and it also meant that Federal Reserve managers were now controlling the gold standard. Through much of the 1920s, the Fed sterilized gold inflows resulting from the post-World War I adjustments in Europe, and formulated other policies to prevent the U.S. banking system from using all the gold available. Their efforts

prevented domestic prices from rising and retarded Britain's efforts to restore the prewar parity of the pound sterling (HFR: 165–81).[3]

This experience gave Fed policymakers the awareness that they could—and should, by their lights—manage the "gold standard" so that it would provide the "correct" results.[4] Their substitute for a gold standard was the *real bills doctrine*. Meltzer's account shows how this transformation set the stage for the sharp decrease in the money supply—the "Great Contraction"—during the 1929–33 period (HFR: 263–66).

The working rules for a gold standard specify the terms for the monetization of gold into various denominational coins. These terms are fixed. As additional gold enters the monetary system, it tends to raise money prices. Offsetting the potential price increases are the increasing flows of goods, services, and capital currently produced. Much of the new production is accompanied by bank loans, that is, "real bills." If the dollar value of new monetary gold and additional bank money matches the money value of the increased production of goods and services, the average level of money prices remains reasonably stable. Alternatively, increased production of goods and services, from, say, new technologies, may initiate a money-goods price adjustment. In either case, successive approximations of goods production and money production under an operational gold standard generate an ongoing monetary equilibrium.

The *commodity theory of money* was solidly fixed in the minds of bankers and politicians, both when the Federal Reserve Act was going through Congress and during the 1920s (Timberlake 1993: 193–95, 259). The real bills doctrine was an important feature of that theory. While leading monetary theorists of the day (such as Knut Wicksell, Irving Fisher, and Lloyd Mints) had repudiated the real bills doctrine, many other mainstream economists (such as J. Lawrence Laughlin, Benjamin Anderson, and H. Parker Willis) endorsed it.

The commodity theory of money recognizes both gold and real bills as the basis of bank-issued money—that is, bank deposits and, in the 19th century, bank notes. Proponents of the real bills doctrine did not seem to realize that the real bills base for money creation is critically

[3]For more on this point, see Friedman and Schwartz (1963: 283–84).

[4]When referring to the gold standard, one should recognize the many forms that the gold standard took (Friedman 1961: 66–79). The gold standard of the 1920s was a Fed gold-exchange standard; the one from 1879 to World War I was a Treasury gold standard. From 1862 to 1879, the U.S. had a gold-standard-in-abeyance. During much of the first 60 years of the 19th century, the country had a constitutional gold standard. Needless to say, all of these gold standards have different parameters and function in critically different ways.

different from the gold base: real bills are not monetized on fixed dollar terms. A banker's loan to a borrower always includes an implicit estimate of the dollar value of the goods or services that the borrower offers as collateral to secure the loan. If bankers are too optimistic, they will overextend credit (i.e., oversupply deposits or bank-issued money). Loans will exceed the value of the goods and services borrowers can generate and monetary inflation results. If banks are overly pessimistic, creation of bank money is insufficient to maintain prices at their current level and deflation follows (Mints 1945: 30–38).

Instability of prices and output would seem to be inherent in this model of monetary determination. Stability is secured, however, by the monetary system's allegiance to the gold standard, which will not permit too little or too much money from banks for very long, no matter how much credence bankers attach to the real bills doctrine. Thus, under a gold standard, the real bills doctrine is a useless "fifth wheel" in the determination of money and prices. The stock and rate of increase of monetary gold dominate the process and establish the price level and its trend. If real bills tend to generate too little money, bankers' reserves continue to be excessive, and banker pessimism moderates—or perhaps new bankers, not so pessimistic are more accommodative to borrowers. If bankers allow too much bank credit, gold flows out of the monetary system, which depletes bank reserves and brings bank lending up short. The important lesson here is that no matter how invalid the real bills doctrine is in its role as a "neutral" creator of bank-issued money, the monetary system's commitment to an ongoing and viable gold standard completely overrides any weakness in that doctrine.

To understand the Great Contraction, the observer must first understand the deliberate metamorphosis of the Fed from a central bank accommodating banking under a dominant gold standard to an institution controlling monetary and credit policies on the basis of the real bills doctrine. Throughout the 1920s, the Fed's managers worked toward this end. By the late 1920s, they had largely succeeded. From this time on, the U.S. monetary system was under the "guidance of human wisdom," and the "wisdom" was the real bills doctrine. Only a token "gold standard" remained (Friedman and Schwartz 1963: 191–93; Timberlake 1993: 254–73).

Fed Policy and the Great Contraction (1929–33)

In Chapter 5, "Why Did Monetary Policy Fail?," Meltzer reviews the chain of events and Fed policy responses through the four years of the Great Contraction. The primary concern of Fed officials and

many politicians, as the recession-depression began, was the quality of current bank loans. In their view, the current credit fabric was not real-billsish enough—there was too much speculative stock-market credit outstanding, as well as too many long-term real estate loans, and too much government debt. None of those forms of credit was short-term, self-liquidating, and created to aid the production and marketing of current output. As Meltzer explains, bank lending for such purposes, and central bank support of such a debt structure, were widely touted as "inflationary" and "speculative" (HFR: 398–400). Yet, "No one discussed what the System should do if the two signals [from the gold standard and the real bills doctrine] gave conflicting commands. . . . The Federal Reserve had abandoned strict adherence to the gold standard in World War I and in the 1920s. It [now] followed the real bills guide. Policy was deflationary in 1930 when adherence to gold standard rules called for expansion" (HFR: 401–2). Had the gold standard remained dominant, the inflows of gold that occurred would have increased the quantity of money by the "right" amount. The Great Contraction would have been avoided and the recession would not have turned into the Great Depression.

Another possibility, one that many economists share today, is that, in place of the real bills doctrine, the Fed could have adopted a monetary policy based on *the quantity theory of money* to complement the existing gold standard. As Thomas H. Humphrey, a leading monetary historian, points out, "The quantity theory framework by the mid-1920s [had] progressed to the point where, statistically and analytically, it was state of the art in policy analysis. . . . Yet the Fed refused to have anything to do with this framework and its components" (Humphrey 2001: 286). The reason for the Fed's rejection of the quantity theory as a policy guide, Humphrey explains, "was that the quantity theory framework was incompatible with the type of institution created by the Federal Reserve Act of 1913." That central bank was supposed to "accommodate commerce and business," not stabilize the monetary system.

Meltzer agrees that a truly functional gold standard or a standard based on the quantity theory would have provided sufficient increases in the supply of money to prevent monetary disequilibrium from cascading into the Great Contraction. But Fed decisionmakers were manipulating the gold standard, and had emphatically rejected the quantity theory of money as a working doctrine for policy. Many economists, Meltzer notes, shared the views of the Fed managers. Generally, the belief was that only a resurgence of production in the real sector could induce the proper amount of new money from the banking sector. Fed policymakers could not understand that their normative

and positive passive-money doctrines no longer fit a regime in which the central bank could and did actively manipulate the quantity of money. They still held the view that any contrived issue of money by the Fed, such as the quantity theory proposed, would have been "redundant" and "inflationary" (HFR: 411–13).[5]

In early 1933, as the banking and monetary system deteriorated, several last-ditch options were still available. Meltzer refers briefly to proposals for the issue of clearinghouse certificates that the private banking system had developed in countering the bank panics of 1893 and 1907 (HFR: 380–85). However, the Federal Reserve Banks had taken over all the clearing functions as well as the effective lender-of-last-resort role that the clearinghouses had performed so well. Consequently, the response of Fed officialdom was typically negative. Clearinghouse certificates, noted the Fed Board, present "a number of complications from the standpoint of practical operation" (HFR: 384). Yet, the private clearinghouse associations, which had a self-interested stake in maintaining the integrity of the commercial banking system, had readily overcome such "complications" and had effectively neutralized the earlier panics (Timberlake 1993: 198–213).

Another possibility for preventing the final paralysis that occurred in 1933 was for the Fed to suspend the gold reserve requirement, which was 40 percent against Federal Reserve notes and 35 percent against Fed Bank deposit accounts. In fact, the Federal Reserve Banks taken as a whole were still surfeited with gold reserves.

Meltzer reports that the Federal Reserve Board did suspend the gold requirement for the Federal Reserve Bank of New York on March 3, 1933, but the bank remained open and the gold drain continued. To stop the drain, notes Meltzer, the Fed could "declare a bank holiday, suspend specie payments [for all the Reserve Banks], or suspend reserve requirements for the entire System" (HFR: 386–87). The fatal decision was to close all banks nationwide. As such, the Fed failed to act as a lender-of-last-resort, even though it still had approximately 4,900 tons of gold in its vaults.

Rather than admitting that the theoretical foundations of monetary policy and the policy itself had been grossly wrong, Fed officials blamed the disaster on "natural" factors in the private economy. They convincingly promoted the idea that no monetary policy could have

[5]Lloyd Mints's remark appropriate to this situation was, "If in a depression the volume of bills were less than the quantity of money . . . then the consequences would be most unfortunate. This untoward effect, however, would be much more marked if the currency were inconvertible [as Fed policy made it at this time] than if it were convertible" (Mints 1945: 38).

averted the sharp decline in money and prices, and, therefore, that Fed policy was not responsible for the Great Depression (HFR: 464). Popular opinion continues to nurture that belief, much to the detriment of the truths about monetary policy, market economics, and the principles of constitutional government.

Fed Policy and the Continuing Depression of the 1930s

The banking crises of the early 1930s, the depreciation of capital wealth, the growth of unemployment, and the destructive ongoing fall of prices seemed like a nightmare that would never end. The Great Depression not only discredited monetary policy, it left Fed officials incoherent and largely powerless. Consequently, politicians turned to the activist potential of other government agencies, especially the Treasury Department. The Treasury thereupon became the acknowledged leader in financial policy, while the Fed was reduced to the role of an obsequious yes man for whatever the Treasury demanded (HFR: 574; Timberlake 1993: 272–87). It did not demand much: Just keep interest rates "low" so that the federal government through the Treasury can float government debt on favorable terms to pay for the new government programs.

Three major monetary developments took place during the 1930s. First, Congress passed the Banking Act of 1935, which reconstituted the Fed as a *central bank*—the label Congress had originally denied the Fed in 1913. Thereafter, the Fed became a Washington-based institution close to the citadels of political power. With its restructured Federal Open Market Committee (FOMC), the Fed now had complete control over the banking and monetary system, but still lacked any specific goals, rules, or procedures to guide it.

The Fed's new chairman was Marriner Eccles, a successful banker from Utah. Eccles was a fiscalist who believed in lots of government deficit spending and a central bank that would support the new debt that accompanied such a policy. He was everything that an activist secretary of the Treasury could wish for. He did not know or care much about the real bills doctrine, but his belief in deficit spending and in his own ability to formulate the "right" monetary policies left no room for real bills anyway (HFR: 463–70).

The second big event of the 1930s was the gold that kept coming into the country, and thence into the U.S. Treasury, because of the new law prohibiting private ownership of gold or its use for monetary

purposes. The country was now on an imaginary gold standard. The Treasury received the gold, and the Fed treated the gold as an asset—recording the dollar value of the gold as "Gold Certificates" on its balance sheet. The inflows of gold resulted from the new higher price of gold that the Roosevelt administration and Congress had determined, and from the political upheaval in Europe as a result of the German aggressions. By 1940, the U.S. Treasury held approximately 18,000 tons of gold, which would require a convoy of 1,800 ten-ton trucks 34 miles long to transport.

The third major monetary event of the era was the Fed's decision to double reserve requirements between August 1936 and May 1937. Since 1932, reserve accounts at Federal Reserve Banks had become "excess," that is, commercial banks held more reserves than the law required. After Congress passed the Banking Act of 1935, the Fed had the authority to set applicable reserve requirements. By June 30, 1935, bank reserves were almost double the legally required reserves, and they continued to increase. At the same time, nominal short-term interest rates were close to zero. That combination proclaimed to virtually everyone—in the Fed, Treasury, academia, and the financial community—that monetary policy was "easy." Therefore, the excess reserves were both "redundant" and potentially "inflationary" (HFR: 495–96). Consequently, a large majority of policymakers in the Fed and Treasury agreed that excess reserves should be largely eliminated by the simple expedient of increasing reserve requirements. At the same time, Secretary Morgenthau decreed that the new gold coming into the Treasury *not* be monetized, and that Gold Certificates *not* be issued to Federal Reserve Banks. To implement this plan, he had the Treasury sell government securities in financial markets, which, in effect, paid for the gold so it would not become money.

The Treasury's gold sterilization policy in the 1936–38 period was virtually identical to the Fed's sterilization policy in the 1920s. Both policies emphasized the fact that "the gold standard" was no longer a gold standard, but a façade for Treasury-central bank management of the monetary system. The combined Fed-Treasury policies—doubling legal reserve requirements and gold sterilization—were extremely deflationary.

Meltzer claims correctly that the Fed greatly overestimated the "inflationary" monetary growth that might result from expansion of excess reserves and underestimated banker reaction to the higher requirements (HFR: 496). Political factors were abundant in the discussions and decisions (HFR: 502–3). He also notes that no observers at that time or later criticized the reserve requirement policy or blamed the ensuing recession of 1937–38 on monetary policy. His

Chart 6.4 shows how growth in the adjusted monetary base and M1 fell precipitously after the initial increases (HFR: 525).

In my book *Monetary Policy in the United States* (Timberlake 1993: 291–96), I treated both the potential monetary expansion and consequent inflation that might have resulted from the commercial banks' reserve totals at that time. I also conjectured what the increase in reserve requirements did to banker behavior. Using the existing 1936 ratio of bank deposits to required reserves and the quantity theory of money, I calculated the expansion of bank credit and deposits that would take place if the banks used their excess reserves to the maximum. I found that, before to the first reserve requirement increase in August 1936, bank credit expansion would have increased the price level by 5.6 percent above its 1929 level. After the first increase, no inflation above the "full employment" price level of 1929 was likely. In fact, the economy would still have been about 10 percent below capacity.[6] After the last two increases in March and May 1937, no expansion at all was plausible.

To bankers, these "excess" reserves were fundamentally necessary, no matter their formal label. After surviving the financial debacles of the early 1930s, bankers had been conditioned not to expect any lender-of-last-resort help from the Fed. The result was that their desired reserves had become significantly greater than their legally required reserves (Timberlake 1993: 295; Friedman and Schwartz 1963: 348, 510–42). By doubling required reserves, a momentous change at any time, the Fed ruined the cushion that bankers wanted and had so carefully built up.[7]

Legal reserve requirements had developed as a result of experience. They were, nonetheless, seat-of-the-pants estimates. In normal times they were greater than bankers thought necessary, notwithstanding the possibility that the actual ratios that bankers wanted to maintain could be much higher. More important, the very act of setting a legal reserve requirement increases the desired ratios that bankers would maintain if left to their own devices. Legal reserve requirements turn the cushion of reserves into a barrier below which reserves dare not fall. When reserves do fall below the required

[6]Any such estimate must also assume some value for the velocity of money. I assumed it to be constant because it was, is, and always will be a sluggish variable responding only slowly to changes in the quantity of money and spending. Time, circumstance, and measurement support this view.

[7]In explaining bankers' preference for reserves and reluctance to extend credit, Friedman and Schwartz (1963) point out, first, that only conservative bankers survived the earlier banking crises, and, second, that the experience had made the survivors even more conservative.

amount, banks have to pay penalties in money, prestige, and the confidence of their depositors. In short, required reserves set up the conditions for a stigma that banks can ill afford to suffer. The inability of Fed and Treasury policymakers to understand this logic in their policy of "mopping up" reserves in 1936–37 stopped the recovery in its tracks and extended the Great Depression by two or three years.

Monetary Policies during World War II and the Postwar Years

By the time one has read this far in Meltzer's *History*, one is benumbed by the details of political machinations that constantly shaped monetary policies from the beginning of the Fed's existence. Political thralldom to the Treasury became even more pronounced during World War II and the late 1940s, as one would expect. Wars require money; the central bank controls the quantity of money that it and commercial banks can create; the Treasury must, therefore, control the central bank. In the United States the Treasury had already established its dominance over the Fed; World War II simply gave it more excuses to continue its authority (HFR: 719).

Nor did things change much after the war. As Meltzer shows, the Treasury could always find some further excuse for keeping the Fed in tow. The Treasury's continuing compulsion was for low interest rates. No one in the Fed wanted to argue this point or to face the Treasury in a showdown. So Fed policy continued to support the government securities market while arguing for other means to control the incipient inflation. Continued wage-and-price controls, consumer credit controls, secondary reserves for banks, and margin requirements in the stock market, were all on the Fed's list and everyone else's (HFR: 643–51). Nor had Fed monetary theory changed: "Vestiges of the real bills doctrine remained" (HFR: 636).

The Fed kept trying to extricate itself from the Treasury's shackles, but the Treasury had the ear and support of both Roosevelt and Truman. By way of contrast, the Fed had to maintain a discreet distance because it was supposed to be politically "independent." When, the Korean War began, government securities again had top priority. However, the economy was not mired in depression, so the Fed realized it had to break loose from the Treasury to prevent inflation. By enlisting support of several key congressmen, especially Senator Paul Douglas, chairman of the Subcommittee on the Joint Economic Report, the Fed succeeded in restoring some of its long-missing "independence" (HFR: 684–85; Timberlake 1993: 320–27).

The Secretary of the Treasury, John Snyder, and the rest of the Truman administration put up strong resistance to letting the Fed get away, not excluding lies as well as other strong-arm tactics (HFR: 699–712). However, reason prevailed, and the famous "Accord" between the Treasury and the Fed was signed on March 4, 1951. Henceforth, Douglas's subcommittee declared that both fiscal and monetary policies were to be guided "by their effects on employment, production, purchasing power, and price levels . . . consistent with . . . the purpose of the Employment Act of 1946" (Timberlake 1993: 314). For the first time, Congress had given the Fed some kind of guidelines for policy (HFR: 690, 742). Even so, Meltzer notes, "The System's founders would not have liked or even recognized the Federal Reserve that existed in 1951. . . . A small, mostly passive institution had become the most important central bank in the world" (HFR: 726).

Assessment of *A History of the Federal Reserve*

Meltzer's Chapter 8, "Conclusion: The First Thirty-Seven Years," provides a useful summary of the Fed's institutional development. At the time Congress passed the Federal Reserve Act in 1913, and throughout the 1920s, central bankers, economists, and everyone else "regarded the gold standard as essential for monetary stability. . . . The Federal Reserve and other central bankers considered restoration of a type of gold standard one of the major achievements of the 1920s" (HFR: 727). However, according to Meltzer, even though "central bankers and governments wanted the gold standard restored, several were reluctant to accept its implications. . . . In retrospect, the breakdown of the gold standard seems inevitable; at the time [1929–33] it seemed calamitous" (HFR: 728).

In conducting monetary policy, the Fed was primarily concerned with preventing inflation and "relied on the real bills doctrine—the belief that credit extended for common stocks, real estate, government securities, or commodity speculation created inflation because the additional credit did not give rise to additional output" (HFR: 728). A few lines later Meltzer observes: "There is no single cause of the Great Depression."

Perhaps not. But as Meltzer's book documents so thoroughly, the real bills doctrine was the most important reason that what started out as an ordinary recession turned into the Great Depression. Fed officials thought that "the proper response was to purge the system of its excesses—excesses made more serious by credit expansion unrelated to real bills. . . . On the real bills interpretation, [Fed purchases of

government securities would have] prevented the inevitable adjustment and purge of previous excesses" (HFR: 728). Even in the winter of 1933, Meltzer continues, "The Federal Reserve, following the real bills doctrine, saw no reason to expand" (HFR: 729).

"Ideas were important too. The original Federal Reserve Act wrote the real bills doctrine into law. At the Federal Reserve Board, and at several reserve banks, officials followed this doctrine. They considered real bills—commercial credit—to be the only correct foundation for credit expansion. . . . This policy gives rise to procyclical policy action: credit and money expand when output expands and contract when output contracts. The gold standard, too, makes policy action procyclical" (HFR: 729). A few pages later, Meltzer restates these points: "The Federal Reserve Act used the gold standard and the real bills doctrine as guiding principles. Faith in the gold standard and belief in its stabilizing power constituted a cornerstone of the orthodoxy of the time" (HFR: 731).

Meltzer's analysis of the real bills doctrine is sound and in accord with received knowledge (Humphrey 2001: 310–11; Timberlake 1993: 249–60). His book contains exhaustive detail on the stubbornness of Fed officials in holding to this dogma. However, Meltzer does not properly connect this belief to "the" gold standard and the implications that follow. He does not allow for the fact that gold standards have existed in many guises. The automatic self-regulating gold standard of the 19th century, even though it had variants, was a gold standard that worked. It worked when the Federal Reserve Act was passed, and it always prevented the real bills doctrine from doing any long-run harm.

However, the "success" of Federal Reserve policymakers in subordinating the workable gold standard to the real bills doctrine in the 1920s upset the apple cart. "The" gold standard that was in place by 1929 was not an operational self-regulating system. It was part of a managed international gold-exchange standard. It had become a means to excuse the Fed's errors in monetary policy. To be fair, many economists, financial analysts, and bankers hewed to the same line. Even so, the real bills doctrine would have been innocuous had Federal Reserve officials not codified it into policy, thereby gutting the self-regulating properties of the pre-1914 gold standard.

Meltzer's belief that "the gold standard, too, makes policy actions procyclical" implies that he has not distinguished among gold standards. An operational gold standard of the 19th century variety was obviously anti-cyclical, or it would not have lasted 100 years.[8]

[8]Meltzer seems to rely far more than is justified on Eichengreen's *Golden Fetters*

Even with its real bills bias, the Fed's failure to remedy the Great Contraction in time to prevent the Great Depression is difficult to understand or excuse. Fed officials could have relied on the quantity theory of money and could have justified some kind of lender-of-last-resort policy, as Meltzer suggests, to alleviate the banking crises of the early 1930s. If nothing else, they could have followed the lead of their clearinghouse predecessors in 1893 and 1907.

A History of the Federal Reserve tells us just about everything we could want to know about the evolution of the Federal Reserve up to 1951. What it does not do very well is to show how the Fed evolved from previous institutions. Meltzer puts far too much emphasis on the influence of Thornton and Bagehot, who were only mentioned occasionally in congressional and Federal Reserve circles. He also has missed some other major works that bear on this subject. A researcher cannot cover all the bases, but he has a responsibility to recognize the foundations from which his study emerges more profoundly then he has done.

Finally, one can ask, Where does the Federal Reserve of this era rank as a means for managing the monetary system? Was it a first-best or second-best option, or was it something less good than the somewhat ponderous gold standard it replaced?

When Congress gave power to the Fed, it hoped to streamline gold policy adjustments that occurred through the banking system, and that is all. Once institutionalized, however, the Fed successfully shook off its "golden fetters" and in their place shackled itself with "real bills fetters." The results were calamitous. Subsequently, Congress and the President put the Fed under the yoke of the Treasury. From that point on (1933–35), Fed policies became politically inspired and politically controlled, with virtually no heed to conventional economic alternatives. Meltzer's book confirms that politicization. Surely the judgment must be that the Fed was a ghastly failure through the era that Meltzer has chronicled.

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