Federal Reserve Follies: What Really Started The Great Depression

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The basic error underlying the [real bills] doctrine is the notion that there is such a thing as a well-defined supply of "real bills," the value of which does not depend on the actual quantity of money in existence, so that the latter quantity might be adequately limited by "gearing" it to the outstanding stock of real bills. In fact, the outstanding stock of "real" bills--which are, after all, financial assets--is necessarily measured in money units, and that stock will increase or decline as monetary policy becomes easier or tighter . . . Consequently, to "gear" the money stock to the quantity of real bills in the hope that doing so will rule out inflation or deflation is rather like trying to keep a boat from going adrift by mooring it to a dinghy . . .For gold bugs to endorse [real bills] is particularly bizarre—yet not uncommon—for if the doctrine were in fact sound there would be no reason for wishing to see the stock of money linked to the stock of gold. Only one monetary "anchor" is necessary.

George Selgin, 2005

1. Why All The **Fuss About '**The **Great Depression'?**

The Great Depression, 1929-1941, properly defined, was two distinct events in U.S. economic history. First, came The Great Contraction, 1929-1933, during which time prices fell 8 percent per year, the stock market 'crashed' declining much more than prices, the economy's stock of money fell 25 percent, national income fell by 30 percent, unemployment increased to a high of 25 percent of the work force, and everyone's frame of mind and confidence fell to almost zero. No one knew what had happened. Most people then, and even today, think that some kind of fatal weakness in the free private enterprise market economy suddenly manifested itself and had to run its course. Their key indicator was the horrendous decline in the stock market, a variable that is right out in plain sight for all would-be economists to use. In all the decades since it happened, no agreeable consensus has pieced together the causal chain of policies and events that ended in this catastrophic and unprecedented decline in the U.S. economy.

Since most of the collapse in the economy's vitals occurred during the Administration of President Herbert Hoover, his Administration and the Republican congresses of that period have received everlasting popular condemnation for the debacle. While the policies of Hoover and his Administration certainly did not help

matters—did not alleviate and probably aggravated the developing crisis, neither did they have anything to do with the fundamental cause of the collapse, or its persistence.

The ensuing Great Depression, 1933-1941, which would not have happened had The Great Contraction not occurred first, coincided with the election and Administration of Franklin Delano Roosevelt. Since the economy was already bottoming out when he took office in 1933, FDR's subsequent policies could not have caused The Great Contraction either. Indeed, Roosevelt was in an enviable position: Everything and anything he did after the initial four-year collapse could only evoke admiration and praise, because the economy had nowhere to go but 'up.' After many decades of more rigorous economic and political analysis, however, several reliable studies have documented the great harm that resulted from his anti-market and unconstitutional New Deal policies (see, Jim Powell, Robert Higgs, etc.). To be fair, the economy's collapse might well have provoked the same kind of political, economic, and social folly from any other "leader." A special—even a unique—personality was not that important.

The fundamental cause of The Great Contraction, the only event I discuss here, was the evolving monetary policy of the Federal Reserve Board and Federal Reserve Banks. Most interestingly, it was One Big Idea—a dogmatic belief guiding Fed policymakers—that caused the economic downturn in 1929, and continued the deflationary pressure for four long years. That policy dogma, and not a gold standard, nor any brand of political activism, nor the stock market collapse, nor foreign terrorists, nor any other popular scapegoat, such as "big" corporations, labor unions, foreigners, international Jewish bankers, or "economic royalists," was the root cause of what happened. The Big Idea I refer to was a policy norm that monetary economists label, The Real Bills Doctrine. It is a theory of banking and banking policy that has been around for as long as fractional reserve, commercial banks—say, 300 years. As a principle for a commercial bank's lending operations, it is harmless; but as a theory for central bank monetary policy, it is disastrous. Unfortunately, in 1928 The Real Bills Doctrine became the dominant and unconstrained principle of Federal Reserve policy.

2. The **Gold Standard and** The **Real Bills Doctrine in** The **Federal Reserve Act**

First, let's see what a **real** gold standard is, and how it provides money to an economy.

A functioning gold currency starts with the mints, either private or public, that monetize gold on the terms fixed by a gold standard law. Such a law typically describes a gold coin of some convenient denomination containing a weight of gold of specific fineness. The monetization of gold then proceeds on these fixed terms no matter what the season, the state of business, the needs of the government, the direction of international trade, or any other real life variables. After a gold standard law is passed and a legal tender gold coin defined—say, a ten-dollar gold Eagle, 0.900 fine, as in the United States, no one ever has to describe 'real gold,' or decide which 'real gold' is 'eligible' to be monetized.

Banks now hold gold as reserves, on the basis of which they unintentionally create bank money (checkbook deposits) by making loans to needy borrowers. Bankers are unaware that they create money, and, indeed, it is not important to them or to the operation of their banks as commercial enterprises that they do. Their creation of bank money is simply a conventional by-product of their lending operations as fractional reserve institutions.

By way of contrast, real bills—no, not those things that come at the end of the month, as one lady friend suggested to me—are debt instruments, that is, loans, that banks make to borrowers who need credit to finance their prospective productions of goods and services. Borrowers and banks agree that these forthcoming productions serve as collateral for the dollar value of the loans.

From such conventional and unexciting beginnings, bankers and some other observers of monetary affairs take the next step. They argue that if bankers extend bank credit and create bank money *only* on the basis of these loans—that is, on the value of real bills—the dollar value of the new credit and bank deposits will exactly equal the dollar value of the new goods and services. This twist is what makes ordinary harmless real bills into the Real Bills Doctrine—an advised policy for gearing the creation of new money to the money value of new goods and services. What could be cooler?

However, bank monetization of real bills, unlike the monetization of gold (or silver), cannot be done on *fixed dollar* terms. A bank loan to a borrower must always include the banker's estimate of the dollar value of the real goods or services that the

borrower offers as collateral to secure the loan, as well as the likelihood of repayment. The interest rate the bank charges reflects this judgment. If bankers are too optimistic, they overextend credit, thereby oversupplying deposits. New loans and deposits exceed the market value of the goods and services that the borrowers can generate, and monetary inflation results. If bankers are overly pessimistic, creation of bank money is insufficient to maintain prices at their current level, and deflation follows. These rising or falling prices raise and lower the dollar value of the real collateral that constitutes the basis for the creation or destruction of bank money, so that the system when put into motion does not move toward equilibrium. Several economists have emphasized this dynamic instability (Mints, Humphrey, Girton. See also the epigraph on p.1).

Fortunately, a genuine gold standard, *if* it is in good working order and *if* it is the dominant monetary institution, will not allow banks to generate too much or too little money for very long, no matter how much credence bankers attach to the real bills doctrine. The stock and rate of increase of monetary gold determine the stock of common money, the price level, and the trends in both. If real bills tend to generate too little money relative to what the gold standard demands, bankers' reserves continue to be excessive, and banker pessimism moderates. If bankers allow too much bank credit, gold flows out of the monetary system, depleting bank reserves and bringing bank lending up short. The important principle here is that no matter how invalid the real bills doctrine is as a basis for creating the 'right' quantity of money, the system's higher ranking commitment to an operational gold standard completely overrides any weaknesses in that doctrine (Schumpeter, 1954, 721-722; A.Piatt Andrew, 1905, 114-115).

Now, let's see how a central bank, such as the Federal Reserve System comes into the money-creating picture.

A central bank is also an institution that supplies an economy with money. The Federal Reserve System (the Fed) is the central bank of the United States. It came into the monetary picture in 1912-1913. Like the Bank of England and the earlier Banks of the United States, however, the Fed was *not* designed to be a central bank. To the newly elected Democratic Congress and President in 1912, a central bank was politically unacceptable. Bad enough that it was a bank, a *central bank* was also monolithic and monopolistic, and would operate only to further the interests of bankers. Instead, the

ruling Democratic majority devised a system that complemented the regional structure of national banking. This new Federal Reserve System consisted of twelve super-banks that would hold the gold and other reserves of the national and qualified “member” commercial banks in their regions.

This new System was to serve as a self-regulating adjunct to the self-regulating gold standard. Fed Banks were to be Gold Standard Reserve Banks that would hold the gold reserves of their ‘members’ and occasionally provide additional bank credit and bank deposits in step with seasonal peaks and troughs in the productions of goods and services. Acting as lenders-of-last-resort, they would also supply extra reserves to banks whenever depositors for any reason became alarmed and wanted to redeem abnormal amounts of their bank notes and check-book balances into gold.

Congressmen who sponsored and passed the Federal Reserve Act in 1913, however, believed that commercial banks’ and, especially, Federal Reserve Banks’ faithful adherence to the real bills doctrine would make the monetary system self-regulating, with or without a gold standard. To function properly, a Reserve Bank was supposed to discount for its member banks only ‘eligible paper.’ The Federal Reserve Act defined this paper as, “notes, drafts, and bills of exchange arising out of actual commercial transactions, . . . issued or drawn for agricultural, industrial, or commercial purposes (1961, 43).” ‘Eligible’ also meant short-term and self-liquidating. “The only limit to a commercial bank’s ability to discount,” Charles Korbly, a congressman from Indiana stated during the congressional debates in 1913, “is the limit to good commercial paper [real bills]. Such paper springs from self-clearing transactions”. Although supporters of the Federal Reserve Act who subscribed to the real bills doctrine did not acknowledge it, their stated beliefs, such as Korbly’s cited here, made the gold standard appear superfluous.

3. The **Fed’s Stable Price Level Policy After World War I, 1922-1928**

Virtually all of the Fed’s Democratic supporters in Congress swore during the debates in 1913 that it would be non-political, but federal government fiscal policy during World War I denied this hope. The temper of Congress, and the government’s wartime fiscal needs, forced the Fed Banks to adjust their policies to the dictates of the Treasury. Since the Secretary of the Treasury and the Comptroller of the Currency—the second

officer in the Treasury Department—were Chairman and Vice-Chairman of the Federal Reserve Board, the Treasury's fiscal needs always received top priority. The *Annual Report* of the Board for 1918 began by stating: "The discount policy of the Board has necessarily been coordinated . . . with Treasury requirements and policies, which in turn have been governed by demands made on the Treasury for war purposes."

The Board's *Annual Report* for 1920, however, blamed the post-war inflation, not on the dominance of the Treasury and its inflationary pressures on Fed Banks, but on "an *unprecedented* orgy of extravagance, . . .overextended business, and general demoralization of the agencies of production and distribution." To end this "orgy," Fed Banks tightened up credit, provoking the sharp post-war recession of 1921-1922.

Fed policy in the years after 1922 operated independently of Treasury pressures, but also without the constraints of a gold standard. The original Act had stated that Fed Banks were "to furnish an elastic currency," which meant that they would rediscount commercial paper of member banks who wanted to convert deposits into gold, or other legal tender such as greenbacks, in order to prevent undesirable changes in the total quantity of money. This task was also complementary to the function in everyone's mind of Fed Banks serving as lenders of last resort for solvent but illiquid banks in a financial crisis, in order to maintain the existing level of bank credit and deposits (Timberlake, 1993, 111). In accordance with these principles, Fed Banks were to keep their rediscount rates higher than general market rates, so that they would become financially active only in a liquidity pinch, i.e., as lenders of last resort (Hepburn, 1924, 531-534).

The policies and reports of the Fed Banks and the Board of Governors during the 1920s, however, reflect anything but such a defensive role. Starting in 1922, the New York Fed, the largest and most important Bank in the System, formed an Open Market Investment Committee (OMIC) with some of the other Reserve Banks to coordinate purchases and sales of government securities in New York's financial market. By this means, the Fed as a loosely organized central bank came into decisive control over the economy's stock of money.

The purpose of the OMIC was to make money 'tight' or 'easy' depending on what the OMIC managers thought the financial and productive sectors of the economy needed. Their unofficial indicator for stability was the general level of prices, which they wanted

to keep constant. They also insisted that this policy was not official and would be terminated when political authorities in the trading world could re-establish a functioning international gold standard.

Fed Banks at this time, particularly the Fed Bank of New York, were inundated with gold reserves, which is why gold was not a constraint on their operations. Indeed, to prevent current gold monetization and gold inflation—yes, there is such a thing—and a subsequent deflation when the gold returned to European banking systems, Fed policymakers "sterilized" the gold that had come into the U.S. as a result of WW I financing. Instead of letting the additional gold become reserves for new money creation, Fed Banks sold off their holdings of government securities and the loans they had made to commercial member banks, and were thus able to sequester the 'redundant' gold without monetizing it. Had they not done so, the additional gold would have significantly inflated U.S. prices. As it was, U.S. prices were remarkably stable between 1922 and 1928, and gold did not flow back to Europe. Consequently, the Reserve Banks had a huge volume of 'excess' gold reserves—more than double the amount that the Federal Reserve Act required of them—backing outstanding Federal Reserve notes and the deposits of their Member banks.

Table 2. Money Stock, M1 and Selected Items in All Federal Reserve Banks, 1920-1933, with Gold Reserve Ratios. ($ Billions, except ratios)

Year (June 30)	M1	Total Mon. Liab.	Gold and OTher Total	Reserves Exc.	Net Mon. Liab.	Change in Net Mon.Lia.	Bills Bought	Gold Res. Ratio
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1922	21.6	4.03	**3.14**	**1.62**	0.89	-2.10	0.98	**77.8**
1924	23.2	3.93	**3.25**	**1.78**	0.68	-0.21	0.86	**82.5**
1926	26.1	3.94	**2.98**	**1.51**	0.96	0.28	1.00	**75.4**
1929	26.2	4.04	**3.10**	**1.51**	0.94	-0.02	0.82	**74.5**
1931	23.9	4.14	**3.50**	**1.96**	0.64	-0.30	0.62	**84.3**
1932	20.5	4.80	**2.80**	**0.99**	2.00	1.36	0.25	**58.4**

March 1933	19.1	6.14	**3.15**	**0.80**	2.99	0.99	0.12	**51.3**

Sources: Board of Governors of the Federal Reserve System. *Banking and Monetary Statistics, 1943,* table 93, 347-349, and Friedman and Schwartz, 1963, tables B-3 and A-1, 801-804 and 709-714.

[Note: Bill: Should we eliminate this table?]

The principal driving force behind Fed policy at this time was Benjamin Strong, Governor of the New York Fed. Strong was instrumental in forming the OMIC; he was its Chairman, and he particularly favored price level stabilization. Besides his practical experience as a banker who had witnessed the private clearinghouse operations that stabilized the financial markets during the Panic of 1907, Strong had the counsel of Professor Irving Fisher and some other economists who recommended price stabilization through control over the quantity of money. Strong once stated, "[N] o influence upon prices is so great in the long run as is the influence of [significant] changes in the quantity of money" (Burgess, 1930, 175). At the same time, he felt that a *law* requiring price level stabilization was inappropriate—that the gold standard was the only lawful institution to control the quantity of money, and that it was the proper means of preventing the government from assuming undesirable control over monetary policy.

However much Strong's policies were in lieu of a gold standard, they anticipated the restoration of an operational gold standard when the current period of instability had ended.[1] Moreover, Strong and his associates at the Fed Bank of New York pointedly and emphatically rejected all aspects of the real bills doctrine as either a guide to or a norm for effective policy. Strong's disavowal of that doctrine, however, did not speak for the opinions of the Fed Board and many of the Fed Bank Governors.

4. The **Shift in Policy from Price Level Stability to Real Bills**

[1] Strong's policy philosophy is thoroughly summarized in the paper he delivered to graduate students at the Harvard Graduate School of Business on November 28, 1922: "Control of Credit Through the Reserve System" (Burgess, 1930, 173-197). In this paper Strong discussed his specific principles and methods for policy. He noted his experience as a banker during the panics of 1893 and 1907, and how the clearinghouse banks, in one of which he was an officer, had provided positive monetary relief. This experience obviously influenced significantly his role as Governor of the Fed Bank of New York, and his acknowledged leadership of the Fed System. His speeches in the years 1919-1928 confirm that he would never have abided nor overseen the Great Contraction that began in 1929.

By 1928, three operating methods and supporting arguments had appeared in Federal Reserve policy: the gold standard, in remission throughout the world since 1914, but still the ultimate norm in official discourse; price level stabilization by quantitative control of bank reserves through open-market operations; and the real bills doctrine that argued for 'credit control' under the discretion of the Board of Governors and the Reserve Banks, using the Fed Banks' discount rate as the controlling mechanism. When Strong died (of tuberculosis) in October 1928, real bills policymakers within the System moved to take charge of the policy machinery. Unfortunately, they succeeded.

Both the administrations of the 12 Reserve Banks and the Federal Reserve Board, which was based in the U.S. Treasury Building in Washington, had policymaking powers. The Board operated as a supervisory-and-review body, and had a veto power over discount rates set by individual Reserve Banks. It also made the final determination of the "character of paper eligible for discount," and could set other regulations and limitations on discounting (*Federal Reserve Act,* Board of Governors, 1961*,* 44-48).

Besides its proscriptive powers over Fed Bank discount rates and the eligibility of commercial paper, the Board also had extensive emergency powers that it could use actively in a crisis. First, on the affirmative vote of five members, it could "require Federal reserve banks to rediscount the discounted paper of other Federal reserve banks at rates of interest to be fixed by the Board of Governors." With this power, the Board could move gold from one Fed Bank to another whenever the gold-needy Bank required and requested such help. More importantly, the Board could order the suspension of "*any* [gold] reserve requirements specified in this Act" for a period of thirty days, and it could renew such suspensions every fifteen days thereafter for an indefinite period (Board of Governors, 1961, 34-35. Emphasis added). This reasonable provision gave the Board the power to let the Reserve Banks use *all* of their gold, if need be, to maintain gold payments for their paper currency as long as they had any gold. It emphasized the fact that the Fed was supposed to be a Gold Standard Central Bank.

The Fed Board in Washington, however, had no tradition of active policy, and most of the other Reserve Banks were mainly concerned with local affairs. Most important was the theory under which both Board and Banks operated: With the

exception of the New York Fed, all of them were steeped in the Real Bills Doctrine—as the Federal Reserve Act suggested they should be.

An especially prominent member of the Board, who had served on it from the date of its establishment, was Adolph C. Miller, an economist, who, along with another prominent economist of the time, H. Parker Willis, was instrumental in writing real bills norms into the Fed Act when it was passed. Both Miller and Willis had been students of J. Laurence Laughlin, a Professor of Economics at the University of Chicago, and the most influential and dogmatic real bills proponent in the economics profession.[2] During Congress's *Stabilization Hearings* of 1926-1928, Miller was the quintessential real bills advocate. He was also instrumental in writing the Board's *Tenth Annual Report* in 1923, which is virtually a handbook for real bills policy. As his final observation in the *Stabilization Hearings* of 1928, Miller stated flatly, "The total volume of money in circulation is determined by the [productive activity of the] community. The Federal reserve system has no appreciable control over that and no disposition to interfere with it." Miller was particularly opposed to the price-level stabilization policies of Governor Strong, and was almost indiscreet in implying that Strong was one of those "amateur economists" who "constitute one of [the System's] dangerous elements." Other Board members shared this view.

That the Fed should, under the circumstances, have slipped into a do-nothing policy after Strong's death in 1928 should cause no surprise. Few if any of the Fed's official family agreed with Strong's active policy of price level stabilization, and none had any interest in prolonging it. Fed officials now in charge of monetary affairs completely accepted the real bills doctrine as the guide to policy. They believed that active control of the quantity of money was improper—that a return to "legitimate" lending alone would establish the correct amount of "credit" and money (Friedman and Schwartz, 1963, 417, n.178; Humphrey, 2001, 302-309).

This shift in control was decisive—and fatal. In accordance with the precedent Strong had unwittingly set in promoting a stable price level policy without heed to any

[2] Both Miller and H.Parker Willis were associated throughout their professional lives with Laughlin. They, in turn, were close associates and advisers of Carter Glass who was Chairman of the House Banking and Currency Committee that fashioned the Federal Reserve Act in 1913. Laughlin was a long-time opponent of the Quantity Theory of Money, and Miller and Willis actively assisted and supported his views. In Congress, Glass promoted their ideas into law.

golden fetters, real bills proponents could proceed equally unconstrained in implementing their policy ideal. System policy in 1928-29 consequently shifted from active price level stabilization to passive real bills. "The" gold standard remained where it had been—nothing but formal window dressing waiting for an opportune time to reappear. Observers who wish to understand correctly The Great Contraction and The Great Depression that followed must be aware of this metamorphosis of Fed policy—from active price level stabilization to passive real bills.

5. The **Real Bills Central Bank in Operation, 1929-1933**

When the first signs of serious trouble appeared in financial markets in 1929, the concerns of Reserve Bank authorities centered on the *quality* of bank loans. In their view, the supply of credit included far too many speculative loans based on stock shares, real estate loans, and government securities. None of these forms of credit was consistent with the real bills doctrine. The Fed, therefore, was content to allow the supply of credit—and, along with it, the money stock—to shrink. As Professor Allan Meltzer has noted recently, "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" (Meltzer, 2003, 401-2).

Fed authorities could have continued the stable price level approach that Strong had followed. But as monetary historian Thomas Humphrey has pointed out, Fed policymakers "refused to have anything to do with this framework . . . [because price level stabilization] was incompatible with the type of institution created by the Federal Reserve Act." (Humphrey, 2001: 286). That institution was supposed to "accommodate commerce and business," not control the price level.

True. But the Federal Reserve System as originally envisioned was also supposed to be subsidiary to an operational gold standard. Since that gold standard was missing, Fed policymakers were adamant that an independent resurgence of production in the real sector of the economy was the only proper basis for growth in money and credit. They expected such growth to manifest itself in applications for new business loans from banks, but they were first determined to see the monetary system purged of "speculative" and long-term "credit." Consequently, during 1929-1933, Fed Banks virtually stopped

rediscounting. Another monetary historian, Clark Warburton, writing some years later, emphasized the intensity with which the Fed Board insisted that Fed Banks deny discounts to member banks by 'direct pressure' tactics.[3] In the early 1930s, Warburton wrote, the Fed Banks

> . . . virtually stopped rediscounting or otherwise acquiring "eligible" paper. This [policy] was not due to any lack of eligible paper . . .Nor was this virtual stoppage . . . due to any forces outside the Federal Reserve System. It was due to "direct pressure" [from the Federal Reserve Board] so strong as to amount to virtual prohibition of rediscounting for banks which were making loans for security speculation, and a hard-boiled attitude towards banks in special need of rediscounts because of deposit withdrawals . . .Federal Reserve authorities had discouraged discounting almost to the point of prohibition (Warburton, 1966, 339-40.)

At the same time that the Banks and Board refused to provide member banks' requests for loans and discounts, Fed Banks were also piling up gold. Fed gold (and other) reserves peaked at $3.50 billion in 1931 (from $3.10 billion in 1929), an amount that was 81 percent of outstanding Fed demand liabilities, and much more than double the gold reserves required by the Federal Reserve Act. (See Table 2 and Timberlake, 1993, 270.) Fed-held gold was almost 40 percent of the world's monetary gold stocks.

With the bank credit contraction in full swing, Fed policymakers in late 1931 to the summer of 1932 undertook a policy of open market purchases and bank credit expansion in a half-hearted attempt to provide some sort of monetary relief. However, this policy ground to a halt when the Fed's excess, or "free," gold reserves[4] were still $1.02 billion, and its overall gold reserves more than 58 percent of its demand obligations (Friedman and Schwartz, 1963, 346; Timberlake, 1993, 271). Even in March 1933, Fed Banks had almost $1 billion of excess gold reserves, which could have been accounted even higher by simple bookkeeping adjustments. As Friedman and Schwartz state: "The conclusion seems inescapable that a shortage of free gold did not in fact seriously limit the alternatives open to the System. The amount was ample at all times to support large

[3] "Direct pressure," meant to "jawbone" negatively banks that applied for loans. Besides the discount rate a Fed Bank charged a borrowing bank, the bank also had to endure a severe cross-examination meant to discourage its application for assistance, especially if Fed authorities thought the new "credit" might be used for speculative purposes.

[4] Fed Banks were required to keep gold reserves of at least 35 percent of their member bank deposit liabilities, and 40 percent of outstanding Federal Reserve notes. Any gold reserves they held in excess of this minimum were labeled "free gold reserves."

open market purchases . . .The problem of free gold was largely an ex post justification for policies followed, not an ex ante reason for them" (Friedman and Schwartz, 1963, 406).

Neither were the Fed's legally required reserves—never mind the excess—a line in the sand. As explained above, the Fed Board had the absolute power to suspend gold reserve requirements entirely, so that the Fed Banks could use their gold—all of it if necessary—by lending to member banks, thereby providing the gold liquidity that the situation demanded. Instead, the Fed Banks and Board sat on the gold, including the "excess," while the economy disintegrated. In contrast to the U.S. Treasury Gold Standard operation of 1893-96 that witnessed Treasury gold reserves declining by 60 percent while the Treasury Department maintained gold redemption of Treasury currencies, the Federal Reserve Real Bills Central Bank of 1929-1933 accumulated gold throughout the period. It had more gold in early 1933 than it had in the fall of 1929! Had Fed authorities allowed "their" gold reserves to run down, not only would the monetary contraction have been halted, but the rest of the world's monetary systems would also have been able to expand as their central banks received the Fed's outgoing gold flows through trade and capital movements (Friedman and Schwartz, 1963, 412; Timberlake, 1993, 272).

The reason Fed policy was so disastrous was neither technical nor legal. It had nothing to do with "the" gold standard, if for no other reason than the fact that "the" gold standard throughout this period was nothing more than a plan for the future that was not currently operational. Fed managers were making policy on a real bills basis without reference to gold. They had sterilized gold inflows during the 1920s and were now sterilizing gold outflows. To their way of thinking gold flows were superfluous in governing money growth anyway, except to the extent that they happened to do so in a manner consistent with a real-bills rule (Meltzer, 2003, 411-413). However, the Fed Board continued to explain "economic decline and then banking failures as occurring despite its own actions, and as the product of forces over which it had no control" (Friedman and Schwartz, 1963, 419).[5]

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[5] Failure to recognize the pro-cyclical effects of the real bills doctrine on Fed policy during the Great Contraction and after may have resulted from the common practice of using only that doctrine's

6. General Misunderstanding and Innocence of The Gold Standard

To say that neither the general public, nor government officials, nor economists, nor soothsayers understood what had happened to the monetary system, and then to the economy, is an understatement. The whole country, including federal and state governments, and the financial system, were shocked and paralyzed. Everyone had a favorite scapegoat and whipping boy. No one, however, blamed Federal Reserve managers and their operational emphasis on the real bills doctrine.

The Fed was a complex and mysterious institution, somewhat akin to a Tibetan monastery in its opaqueness. (It is rumored that when the Fed Board met in their secret tabernacle, one could hear the far-off chant of choirboys and detect an occasional whiff of incense.) Only a scattered handful of economists and Fed officials knew how its machinery functioned; none of them realized how adherence to the real bills principle had propagated the current disaster; and all Fed officials had an obvious vested interest in blaming other factors. "The" gold standard that was not functioning was one such factor; "speculation" was another; and a popular notion that "you can pull with a string [monetary policy] but you can't push with it," became a favorite slogan. (See, Higgs, *Crisis and Leviathan*, and, Powell, *FDR's Folly*, for the wholesale misconceptions that appeared, and the great leap forward to collectivist policies and institutions that characterized the 1930s and after.)

Since the nightmare of the 1930s, some progress toward a proper understanding of the event has occurred. First, most present-day economists agree, first, that the Great Contraction was largely a failure of monetary policy and of institutional arrangements that allowed monetary policy to provoke such a disaster; and, second, that the Great Contraction initiated the Great Depression. In a negative sense, economists also deny that a capitalist free-market economy in any way caused these catastrophes. Given these agreements, however, economists still record some major differences on just how monetary policy went awry, and just what was the crux of the problem. Somehow, the data omissions on gold stocks and the untreated role of the real bills doctrine have gone unnoticed, or at least unstressed. The profession is, therefore, working with some

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inflationary potential, e.g., the German hyperinflation of 1923, to emphasize its instability. The doctrine's unstable deflationary dynamic became empirical reality in the United States during 1929-1933.

fundamentally flawed historical analysis, and the general public is still misinformed and bewildered.

"The" gold standard should be formally exonerated forever from having any part in the disaster. Official Fed spokesmen have through the decades used this innocent institution to cover up for their real bills errors. And since the general public can intuitively appreciate a 'gold standard,' but has no idea at all what a 'real bills doctrine' is, Fed apologists have been successful. Their case reminds one of the ditty:

Last night I saw upon the stair,
A little man [gold standard] who wasn't there.
He wasn't there again today;
Oh how I wish he'd go away.

The fact is that the interwar "gold standard" was not a gold standard. It was an entirely different system than the pre-1914 gold standard that had existed for 100 years.[6] Furthermore, if "the" gold standard was such a disaster in the 1920s and 1930s, why was it tolerated and even venerated through some very turbulent financial episodes of the nineteenth century? How could such a simple rule-based system be so pernicious? And, finally, if it was such a disaster for the world in 1929 and after, why did its faults not manifest themselves sooner?

The "gold standard" of the 1920s was a pseudo-gold standard. The real gold (or bimetallic) standard had worked very well for the better part of a century as a rule-based system supplying the world with money. As monetary histories confirm, bank panics and suspensions in the nineteenth century resulted from governmental over-issues of legal tender paper money, and were corrected by the working gold standards of the times. What the 1929-1933 disaster demonstrated was how a non-gold standard central bank, dominated by the real bills doctrine, could mismanage the monetary system and the economy into a worldwide tragedy.

The conclusive datum that should have urged the anti-gold standard proponents to look for other answers is that both France and the United States all through the early

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[6] Friedman and Schwartz make a similar observation. "The Federal Reserve System [following World War I] for the first time felt itself a free agent, relieved alike from the pressures of Treasury needs and of internal liquidity . . . It had to face explicitly the need to develop criteria and standards of monetary policy to replace the automatic operation of the gold standard" (1963, 240).

1930s and after had enormous amounts of gold reserves that were never set in motion. In 1933, the United States had 5,900 *tons* of gold in Treasury vaults, and the Bank of France had about half this much.[7]

Given the huge amount of gold that the Fed controlled, even a seat-of-the-pants understanding of the situation in 1931-1933 should have convinced Fed Banks to carry out some degree of monetary expansion. Data from Friedman and Schwartz's *Monetary History* indicate that as of August 1932 the M2 money stock was $34.0 billion and the monetary base $7.85 billion, giving a money supply multiplier of 4.33 (Friedman and Schwartz, 1963, table A-1, 713). At the same time, the Fed Banks-and-Treasury held $2.91 billion gold (Board of Governors, 1943, table 93, 347-349). If Fed Banks and Board had spent all of this gold discounting paper for member banks, so that the monetary base had increased by this amount ($2.91 billion), it would have expanded M2 to $46.6 billion, which was the level value for M2 in July 1929, and a corresponding amount of spending. Of course, Fed expansion never would have had to go that far, for an expansion dynamic would have set in and restored all the major monetary vitals long before the Fed's gold had dissipated. Moreover, if expansion had occurred earlier before the banking crises and the great increase in the real demand for currency,[8] the money supply multiplier would have been very much greater, and the Fed's expansion procedure would have been much easier and more effective.

7. The **Real Culprit:** The **Real Bills Doctrine**

Looking closely at the history of the Federal Reserve from the Fed's beginnings in 1914, it is clear that an operational gold standard, either in its pure form or in the mode intended by the Federal Reserve Act, virtually never constrained Fed policies. During WW I, Treasury compulsions ruled the Fed's actions. In the 1920s, Strong's price level stabilization policies were dominant. After Strong's death, with Real Bills Central Bankers in charge, the Great Contraction devastated both the monetary and economic systems. As the Great Contraction ended, Roosevelt became President, and the wild

[7] How much gold is 5,900 tons? If this gold were loaded into a convoy of 590 ten-ton trucks for transport, allowing 100 feet for each truck, the convoy would stretch over 11 miles.

[8] See, Timberlake, 1993, Table 2, 267, for the disaggregation of money stocks and a comparison of real growth in their components between 1929 and 1933. This table shows how the increase in the demand for real currency and the corresponding increase in the currency-deposit ratio provoked the banking crises and significantly reduced money supply multipliers.

swings of the New Deal took center stage. Gold became a political football; Congress hyper-devalued the gold dollar; the Supreme Court allowed contracts in gold to be abrogated; and the Banking Act of 1935 left gold as a useless adornment on Treasury and Federal Reserve balance sheets. Today, the U.S. Treasury has 8,125 *tons* of gold (15.4 miles of 10-ton trucks, or one *ton* of gold for every word in this article) sequestered in heavily guarded vaults. This gold has no relationship at all to the U.S. monetary system, and no other function except to furnish jobs for its government custodians.

The negotiations and machinations of the world's central bankers trying to provide a human design to the world's monetary systems did not work. Their blueprint retained only the outward and visible sign from the working gold standard of a previous era; it abandoned the inward and spiritual grace of that system. It neglected the fact that an authentic gold standard functioned on the principles of Spontaneous Order—set up simple rules and let human operatives make their own arrangements within that framework. Managing gold to fulfill real bills criteria, as the central bankers did, proved to be a disaster. The gold standard did not succeed; neither did it fail. The issue was not even moot, because the gold standard was not functional. What failed was the theory—the Real Bills Doctrine—that U.S. central bankers used to guide monetary policy into the monetary disequilibrium that never ended.

Federal Reserve policies were one hundred percent responsible for The Great Contraction and subsequent Great Depression. The damage done both materially and ideologically was and is inestimable. Ignorant governmental reactions to the debacle resulted in vast expansions of governmental activity and powers that no Supreme Court could stop. Even worse, the common misperception of a market system that had "failed," resulted in a popular *ethos* of anti-free market regulation and governmental interventions that have increased exponentially with no end, or even equilibrium, in sight.

The present-day Federal Reserve System has no relationship to the Real Bills Central Bank of the early 1930s. It has, under Alan Greenspan's chairmanship, come back to the stable price level norms of Benjamin Strong. However, it may be too late. The huge unfunded liabilities of the federal government, as they come due in coming decades, are going to require the U.S. Treasury to pay them. The Treasury will have to "get the money" to do so. It will "ask" the Fed for "help" in keeping interest rates "down."

Whereupon the Fed, unless it has a Chairman made of titanium steel, will buy those Treasury securities in the open market—yes, holding interest rates "down" temporarily, but thereby creating new money and initiating an ongoing central bank inflation. The German model of 1923 will be only too applicable.

The authentic gold standard within the greater context of a relatively free market system had provided long-term stability both to the United States and the world not matched by any other monetary system before or since. Joseph Schumpeter stated the case most elegantly: "An 'automatic' gold currency," he wrote, "is . . .

> part and parcel of a laissez-faire and free-trade economy. It links every nation's money rates and price levels with the money-rates and price levels of all the other nations that are 'on gold.' It is extremely sensitive to government expenditure and even to attitudes or policies that do not involve expenditure directly, for example, to foreign policy, to certain policies of taxation, and, in general, to precisely all those policies that violate the principles of [classical] liberalism. *This* is the reason why gold is so unpopular now [1950] and also why it was so popular in a bourgeois era. It imposes restrictions upon governments or bureaucracies that are much more powerful than is parliamentary criticism. It is both the badge and the guarantee of bourgeois freedom—of freedom not simply of the bourgeois *interest*, but of freedom in the bourgeois *sense*. From this standpoint a man may quite rationally fight for it, even if fully convinced of the validity of all that has ever been urged against it on economic grounds. From the standpoint of *etatisme* and planning, a man may not less rationally condemn it, even if fully convinced of the validity of all that has ever been urged for it on economic grounds (Schumpeter, 1954, 405-406.His italics.).

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Abstract

This paper provides a reassessment and a restatement of the essential qualities of gold standards. Second, it emphasizes the role of the Real Bills Doctrine in Federal Reserve policy as the primary cause of the Great Contraction of 1929-1933. It takes issue with recent articles and books that have assigned major fault to "the" gold standard for the disastrous decline of employment, prices, production, income, and welfare that characterized the Great Contraction and the ensuing Great Depression.

The Real Bills Doctrine was the guiding principle for passage of The Federal Reserve Act. It proposed that the creation of money would be geared automatically to the output of real goods and services if banks and the central bank adhered to a policy of providing credit only on short-term, self-liquidating loans for legitimate business purposes. The gold standard was to continue as the fundamental determinant of the economy's stock of money, but real bills principles would take care of seasonal and cyclical variations in the demand for money.

The new system, however, never operated under a true gold standard. U.S. gold stocks burgeoned after World War I, allowing the quantity-theoretic policies of the New York Fed under Benjamin Strong to fashion a stable price level policy for the monetary system until an authentic gold standard could be become operational. After Strong's death in 1928, real bills advocates on the Fed Board and in some Fed Banks controlled Fed policies. Their avowed purpose was to oversee no monetary expansion until the real economy provided the proper impetus for monetary rejuvenation.

In recent decades studies analyzing the Great Contraction have overlooked, first, the fundamental properties of a true gold standard, second, the quantity of gold stocks available for credit expansion by Federal Reserve policies in the early 1930s, third, the statutory power of the Federal Reserve Board to nullify for an indefinite period the gold reserve requirements facing the Federal Reserve Banks, and, fourth, the dominating influence that the Real Bills Doctrine had over both monetary beliefs and monetary policy in that era. This paper attempts to correct these omissions, and to demonstrate that the Real Bills Doctrine, not "the" gold standard, was the intellectual and operational basis for the disastrous Fed policy of 1929-1933.

Allow me to say here that the "RBD" is one of those bad ideas that probably will never go away. The doctrine is just intuitively appealing enough to be a favorite of persons with little training in monetary economics, who aren't inclined to consult any of the works that have blasted it to smithereens again and again. Among these I particularly recommend Thornton's *Paper Credit*, Wicksell's *Interest and Prices*, and Lloyd Mints's *History of Banking Theories.* Von Mises--no enemy of the gold standard--also understood it to be a fallacy, and a very dangerous one.