

A HISTORY OF THE FEDERAL RESERVE, VOLUME I:
1913-51. BY ALLAN H. MELTZER. CHICAGO:
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If Allan Meltzer were a screenwriter one might wonder if his portrait of the Federal Reserve System is meant to serve as a comedy or a farce. From one episode to the next the picture of the U.S. central bank that emerges resembles more the bumbling Wizard of Oz than omniscient Delphic Oracle. Consider two examples from Dr. Meltzer's 800-page history, which was written with the Fed's cooperation.

First, the Fed is shown more than once to be an institution prone to *political* influence, not the independent central bank proclaimed by its court intellectuals. Meltzer concluded that the Fed's creation in 1913 represented a political compromise by Democratic President Woodrow Wilson—"a politically appointed Federal Reserve Board in Washington and regional banks in principal centers, run by bankers, with no clear division of authority between the two" (p. 67). Meltzer also showed that President Franklin Roosevelt "knew how to keep the Federal Reserve under his control" (p. 438). When FDR wasn't meddling with the price of gold (p. 453) he was demanding the Fed inflate. The Fed's feeble response? A New York director voiced the sentiment of many. "He was opposed to directives from the government. If there was to be a policy of inflation, it should be a consistent policy, not one that changed every week" (p. 438).

A "most unusual breach of independence" occurred in January 1951 when the entire open market committee met in President Harry S. Truman's office (p. 7).

Second, Meltzer showed that Fed policies were an important contributing factor to the three most severe economic contractions in the period: 1920-21, 1929-33 (the Great Depression), and 1937-38.

The Fed contributed to the post-World War I recession in 1920-21 (p. 90). Virtually every statistical indicator shows the recession as a sharp decline (p. 109). The recession was the first test of the policy conception implicit in the Federal Reserve Act (p. 119). Yet this policy failed. The recession was long and deep; two years after the NBER peak, real GDP was 8.4 percent below its peak value (p. 120).

The Great Depression was mainly a monetary event (p. 389). Its depth and severity were the consequence of a series of shocks that the Fed failed to offset (p. 390). Most Fed governors failed to function as lender of last resort, and to distinguish between nominal and real interest rates (p. 411). The national banking holiday in March 1933 revealed the Fed as "indecisive and incompetent as the banking problem became a crisis" (p. 421).

Monetary factors also contributed to the 1937–38 recession (p. 521). At its peak, the unemployment rate reached 20 percent, not much below the 25 percent maximum in 1932 (Zarnowitz and Moore 1986). Real GNP fell 18 percent and industrial production 32 percent in the 13 months beginning June 1937 (p. 522). The Fed did little to correct the mistakes that contributed to the recession (p. 529). As in 1920–21 and 1929–33, the Fed took no responsibility for the recession, denied that higher reserve requirements had contributed, and took no expansive actions until late in the recession (p. 573).

Surveying the Fed's history in its first 37 years, Dr. Meltzer concludes:

Looking back from 1951, few would conclude that the Federal Reserve had achieved the hopes of its founders and early proponents. The Great Depression, though at the time not considered a failure of monetary policy, was the deepest and longest in United States history. The Federal Reserve had not prevented thousands of bank failures, the collapse of the financial system, and the devaluation of the dollar. (p. 727)

These sentiments will not surprise Austrians who have long been critical of the Fed. Yet Meltzer is working within the paradigm of the Chicago School and his mission is not to consider it as the source of the boom-bust cycle, or to argue that the market should perform its functions. Instead, Meltzer attacks an economic theory—*real bills*—and argues the doctrine contributed to the comedy of monetary policy errors that resulted in the Great Depression. Chairman Alan Greenspan takes note of this line of attack in the Foreword to the book:

In Meltzer's view, the System's adherence to the real bills doctrine, combined with a belief that the purging of speculative excess was necessary to set the stage for price stability, led to the failure of monetary policy to lessen the decline.

Meltzer's book is a monetarist history of the Federal Reserve. He explains (p. xiii) his history of the early Fed builds on Friedman and Schwartz (1963):

[I]n the physical sciences, replication of experiments is the norm. No one appreciates their work more than I, but its quality and importance should encourage, not deter, replication. There are additional good reasons for revisiting the early years. First, I had unlimited access to material that they did not have. To the extent that I reach the same conclusions, as I often do, my work strengthens theirs. Where I find differences, as I sometimes do, my work supplements theirs by giving a more complete or more accurate account.

Meltzer reaches the same conclusion as Friedman and Schwartz: the Fed failed in its monetary policy response to the Great Depression. The book's major contribution is Meltzer's voluminous research arguing the Fed erred greatly by adhering to the *real bills doctrine*, which holds that central bank credit should finance self-liquidating commercial loans. Government paper, stock market loans, and real estate mortgages were "speculative" investments that had no place on a central bank's balance sheet. Since speculative loans were not self-liquidating, they were considered inflationary finance (p. 400). The Real bills doctrine was so widely accepted it was actually written into the Federal Reserve Act of 1913.

Meltzer identifies a specific version of this doctrine developed in the 1920s by Fed economists Winfield Riefler and W. Randolph Burgess, which failed to distinguish between real and nominal interest rates, as a major source of later monetary policy errors:

Federal Reserve records suggest that the real bills or Riefler-Burgess doctrine is the main reason for the Federal Reserve's response, or lack of response, to the depression. With few exceptions, the Federal Reserve governors accepted this framework as a guide to decisions. They believed that a low level of member bank borrowing and low nominal interest rates suggested there was no reason to make additional purchases. (p. 398)

The strength of Meltzer's book is his use of internal Fed documents to explain policy debates within the central bank, and the intellectual limitations of its officials. The dominant personality in the early days was Benjamin Strong, first governor of the Federal Reserve Bank of New York. Strong's prewar policies can be described succinctly as an attempt to recreate Lombard Street on Wall Street, with the Fed, especially the New York bank, playing the Bank of England's role (pp. 75-76). The Riefler-Burgess doctrine, with its emphasis on open market operations and quantitative control, could be called the Strong-Riefler-Burgess doctrine, to recognize Strong's role in developing a policy framework based on observation and experience (p. 193). Meltzer notes that many of the principals responsible for policy in the 1920s, and during 1929 to 1933, were "weak men with little knowledge of central banking and not much interest in developing their knowledge" (p. 196).

For example, there is no doubt officials knew of Walter Bagehot's central banking work since references to *Lombard Street* appeared in Open Market Policy Committee minutes (p. 282). Yet they ignored Bagehot's advice that a central bank should publicly state that it would serve as lender of last resort. Minutes also show officials did not understand the Great Depression's severe deflation had increased real rates (p. 321). The minutes, statements by Fed officials and outside commentary by economists did not distinguish between real and nominal interest rates. Even Irving Fisher did not insist on this distinction (pp. 412-13). "So certain was the System about the correctness of its actions and its lack of responsibility for the collapse," Meltzer writes, "that I have found no evidence the Board undertook an official study of the reasons for the policy failure" (p. 413).

A minor criticism of Meltzer is that he does not use Fed member bank reviews to buttress his case that Fed officials had little knowledge of central banking. Text references to economists and monetary theorists were rare in these reviews in the period examined by Meltzer. The first reference to Bagehot did not appear until February 1950 in the Philadelphia reserve bank's *Business Review*.

Meltzer also should have provided context to the political developments that led to the Fed's creation. There are no references to the political forces that sought a central bank such as Teddy Roosevelt and the Progressives, or the Socialist Party whose federal vote total peaked in the 1912 election. One is left with the impression Woodrow Wilson awoke in 1913 and—voilà!—decided it was time to establish a Fed. By contrast, Rothbard (1999) provides useful background on the political and financial intrigues that aggressively fought to establish the Fed.

The broad array of sources assembled by Meltzer notwithstanding there are critical aspects of his book that Austrians will contest. The book appears to suggest the central bank can repeal the business cycle by expanding the monetary base to prevent contraction. "Failure to act during the Great Depression was the Federal Reserve's largest error," Meltzer writes, "but far from its only one. Failure to expand can be explained as the result of prevailing beliefs about the inevitability of a downturn following the stock market boom" (pp. 728-29). According to Fed officials, bank failures "were the inevitable consequence of bad decisions and speculative excesses that had

to be purged before stability could return” (p. 731). Meltzer describes the Great Depression’s impact on the views of Fed Governor Marriner S. Eccles:

The prevailing belief was that the depression was purgative. Business leaders argued that “a depression was a scientific operation of economic laws” and could not be interfered with. The 1920s had been a profligate era. The price of profligacy was (eventual) depression—the inevitable consequence of prior events. (p. 464)

The suggestion that a central bank can repeal the business cycle was echoed by Chairman Greenspan in a January 2000 speech in New York:

Regrettably, we at the Federal Reserve do not have the luxury of awaiting a better set of insights into this process. Indeed, our goal, in responding to the complexity of current economic forces, is to *extend the expansion by containing its imbalances and avoiding the very recession that would complete a business cycle.* (emphasis added)

This Fed operation described by Greenspan failed when the economy contracted in 2001. A recession occurred between March and November 2001, according to the National Bureau of Economic Research.

Austrians have demonstrated that recessions—and depressions—are the inevitable result of central bank intervention in the economy. Perhaps Meltzer would like to dismiss this conclusion, but even he is forced to admit that the Fed was a contributing factor to the 1920–21, 1929–33, and 1937–38 recessions. One looks forward to Volume II, and what role, if any, he will ascribe to the Fed as a factor in recessions that occurred in 1953–54, 1957–58, 1960–61, 1969–70, 1973–75, 1980, 1981–82, 1990–91, and 2001, including credit-induced booms in the 1960s and 1990s.

The book’s greatest weakness is its inference that all economists critical of the 1920s credit structure were somehow real-bills ideologues. Meltzer might have dispelled this notion by stating, “One need not embrace the real-bills doctrine to accept that excessive *credit growth* in 1927–29 contributed to monetary policy failures and contraction.” Instead, he argues in a footnote (p. 250), “The idea of “absorption and diversion of credit” lacks analytic content except, perhaps, in a real bills framework.” There is, of course, another framework—the Austrian School tradition—that distinguishes between genuine (sustainable) economic growth and artificial (unsustainable) booms. The unsustainability of credit-driven booms is the essence of the Austrian theory of the business cycle set forth by Ludwig von Mises early in the twentieth century and developed by F.A. Hayek in the 1920s and 1930s. Austrians reject the real bills doctrine (Garrison 1999), and were critical of credit-induced speculation in the 1920s, a period described as one of the Fed’s few policy successes by Meltzer in this manner: “The relatively stable price level and stable interest rates from 1922 to 1929 lay behind acceptance of the Federal Reserve and its increased congressional support” (p. 733).

There are honest policy disagreements between Austrians and monetarists. Austrians would surely disagree with Meltzer’s argument that the Fed could have prevented the Great Depression if there had been a congressional mandate for price stability. Ultimately, disagreements between the two schools might be summarized as follows: monetarists seek to tinker with the policies of the Fed, a quasi-government institution, while Austrians gaze fondly at another institution known as the market.

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