FEDERAL RESERVE FOLLIES:

WHAT REALLY STARTED THE GREAT DEPRESSION

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The Sorcerer's Apprentice

The basic error underlying the Quantity Theory of Money (QTM) is the notion that central banks can command their newly created money to flow to the commodity market, or any other market of their choice. This is the pipe-dream of the Sorcerer's Apprentice. In reality, once the newly created money is off the premises it is no longer under central bank control. It has become a plaything in the hands of speculators. Far from being guided by the wishful thinking of central bankers, speculators follow their own agenda. They are motivated by profit potential as they see it emerge in various markets. It is true that, on occasion, the commodity market is their preferred playground and mischief to prices is the result. But it could just as well be the stock, bond, or real estate market. It is also true that there is a "trickle-down" effect on the commodity market as the newly created money is spent again and again by subsequent recipients who are not speculators. But by the time money trickles down to the commodity market damage has already been done elsewhere. Whether peddled under the name "monetarism" or "neoclassical economics", the QTM is utterly inapplicable to the modern economy and cannot explain changes in the price level. The linear relationship between the stock of money and the level of commodity prices that may have held in more primitive societies up to medieval times has been replaced by a highly non-linear one modulated by speculation.

Allow me to say here that the QTM is one of those bad ideas that will probably never go away because of its intuitive appeal. It can be grasped even by the most primitive intelligence not conversant with monetary economics. People not inclined to consult the more profound works of economists who have blasted the QTM to smithereens again and again as have, for example, J. Laurence Laughlin of Chicago University, Edwin Kemmerer of Princeton, Walter E.Spahr of New York, not to mention Adam Smith, want to have something they can understand even if it will, more often than not, distort the big picture beyond recognition.

Condoning the violation of the law

This is a rejoinder to the paper of Richard H.Timberlake of the same title dated August 2005. For the sake of argument I shall adopt Timberlake's own division of the economic collapse into two distinct events: the 1929-1933 Great Contraction and the 1933-1941 Great Depression. They were preceded by the inflationary monetary regime under the domineering leadership of Benjamin Strong, Governor of the Federal Reserve Bank of New York, between 1922 and 1928. Although Timberlake characterizes it as one animated by a high-minded "stable price level policy," it was an unlawful regime continuously violating the law. Strong introduced illegal "open market operations" for the first time. He established the Open Market Investment Committee of the New York Federal Reserve Bank in 1922 under his own chairmanship. It conducted buying and selling, mostly buying, of Treasury bonds for the account of the Federal Reserve Bank of New York as well as some other Federal Reserve banks. The bonds purchased in the open market were paid for in the form of Federal Reserve notes and deposits created out of nothing for this specific purpose. The advent of open market operations of central banks has changed the landscape of world finance beyond recognition. It made official manipulation of bond and stock prices possible. It turned traditional virtues and vices upside down: thrift into vice, sharp trade practices into virtue.

The monetization of Treasury debt was illegal according to the Federal Reserve Act of 1913. It was not authorized. As a matter of fact, the use of government bonds for the purpose of backing Federal Reserve notes and deposits was explicitly ruled out. Stiff penalties were prescribed in case, and to the extent, the liabilities of a Federal Reserve bank could only be balanced through its portfolio of Treasury paper. Of course, Strong and his cohorts were aware that they were breaking the law. They argued that this policy was not official; that it was designed to meet an emergency; and it would be terminated as soon as the emergency has passed and the international gold standard was made operational once more. No doubt, this was one of those 'emergencies' that was invented to become permanent. Strong himself was instrumental in preventing the gold standard from becoming operational again by sterilizing gold that had come to the United States from European belligerents in payment for war supplies. It would be closer to the truth to say that central bankers have tasted the elixir of power, and liked it. They have become addicted to it. Never mind that it was forbidden fruit for them. They wanted to exhaust the entire cup. They knew that they could manipulate Congress to legalize retroactively the power they had illegally grabbed.

The violation of the law as a substitute for changing it whenever its efficacy is brought into question is a serious matter in any case. But it is especially serious and pernicious when it affects the processes whereby money is created. Legal ends cannot justify illegal means under the law. If an officer of the Federal Reserve can take liberties with the law, then so can anybody else, and the bottom line is counterfeiting the currency. Timberlake passes over the blatant violation of the law in silence, presumably because of his sympathies with the hidden monetary inflation that he (in unison with Milton Friedman and Anna Schwartz) admiringly calls "the Fed's stable price-level policy". Hardly did he notice that what he admired was not monetary policy under Strong, but a mere coincidence: the knack of the speculators who for reasons of their own put the newly created money to work, not in the commodity market where inflation would have been noticed immediately, but in the real estate and the stock markets where it could remain hidden for a longer period of time. In the event the Strong-inflation could not be swept or kept under the rug for too long. It soon showed up in the shape of the Florida real estate bubble (1924) and the stock-market orgy (1929). In addition, it kept interest rates artificially low (and bond prices artificially high) with the effect that the investment-decisions of businessmen became distorted. Again, the concomitant misallocation of economic resources could not be detected immediately. But the writing was on the wall that the chickens would eventually come home to roost, as indeed they did during the Great Depression. To sing a song of praise of the Strong-inflation is not fitting to a monetary economist.

Condoning the violation of the law and blaming the consequences: the Great Contraction of 1929-1933 and the Great Depression of 1933-1941 on the Real Bills Doctrine (RBD) is, to say the least, disingenuous. This is not to suggest that the Federal Reserve Act of 1913 was a good law. Most likely it was not, and the United States could have managed, thank you very much, without a central bank in the 20th century, as it did in the 19th. But this is another issue to be investigated separately. Here I want to condemn a procedure whereby the law is violated in order to create a fait accompli, forcing the hands of lawmakers to change it so that, in the end, the violation be justified, nay, rewarded. Once the Strong-inflation induced stock-market speculation was under way, money from abroad was sucked in causing a serious deflation in Europe and elsewhere. Central bankers from around the world started making their regular pilgrimages to New York begging Strong for even more inflation. They had hoped that lower interest rates in America would bail them out. Strong was delighted to comply with their pleading. Thus the violation of the law created international complications and ultimately Congress had to amend the Federal Reserve Act of 1913 so as to legalize the practice of open market operations -- euphemism for monetizing the the public debt. The cure for the ill effects caused by an illegal monetary inflation was to be more monetary inflation, not less, making sure that this time around it was fully licensed and legalized.

Today no economist would think of open market operations as being originally conceived and introduced as an illegal practice, or would dream of suggesting that the explanation for the Great Contraction that followed it can be found in the violation of the law. I hereby take the task upon myself to make this revelation. It has to be stated in unambiguous terms that the Strong-inflation of 1922-1928 celebrated by Irving Fisher, Milton Friedman, Anna Schwartz, Richard Timberlake, and other devotees of the QTM, was illegal. I am of course aware that the grant departments of the Federal Reserve banks will never support research to explore this episode more fully to confirm my accusations. I still hope that incorruptible economists, especially the younger generation, are motivated by the truth rather than bribe money, and will rise to my challenge in doing the necessary research.

Exonerating the gold standard is not enough

Following Keynes it has been fashionable to blame "contractionist tendencies" inherent in the gold standard for the Great Depression. Timberlake, to his credit, makes a valiant effort to exonerate this venerable institution. As the German monetary economist Heinrich Rittershausen said, it was not the gold standard that failed but the people to whose care it had been entrusted. It is unfortunate that Timberlake's concept of the gold standard is faulty. He quotes Joseph Schumpeter approvingly who describes the international gold standard as an institution linking the price level in one country with that in all other countries 'on gold'.

But this is not what the gold standard does, nor is it the way it is supposed to work. The price level is too 'sticky' for adjustment through gold flows, however attractive the QTM model of price adjustment may appear. Gold flows were conspicuous only through their absence during 100 years of international gold standard ending in 1914. Furthermore, although the gold standard had a mechanism for the equalization of the discount rate between various countries, this did not mean an automatic equalization of interest rates. The two rates are conceptually very different, as are the forces governing them. They could move in the same or in opposite directions. The adjustment mechanism of the gold standard operates, not on the price level which is sluggish, but on the discount rate which is nimble. It is not gold flows but the flow of real bills, and the flow of underlying merchandise in the opposite direction, that perform the balancing act, keeping the economy on an even keel. Here is how. Suppose certain countries suffer from a natural disaster or experience crop failure, causing widespread shortages. The discount rate in these countries will rise above that prevailing abroad, making the stricken countries attractive on which to draw bills. Consumer goods are dispatched immediately to the high discount-rate countries from the low. Relief is instantaneous.

It was not a flow of gold but that of real bills on London, maturing into gold in less than 91 days, that financed world trade prior to World War I. Gold hardly ever left the vaults of the Bank of England. Its relatively small gold reserve could finance a world trade several times as large. Without real bills world trade could have never expanded the way it did during this Golden Age. By 1913 it reached a record high that could not be surpassed for the next 75 years. Timberlake commiserates that the gold standard was in 'remission' during the years following World War I. It is true that the garrison states that emerged after the signing of the peace treaties were pursuing highly protectionist policies. The efficiency of gold in financing world trade has fallen from the high level reached during the years prior to World War I. Lip service was still being paid to gold thereafter, but the garrison states embraced mercantilist ideas and they were determined to wean their subjects from the gold coin. They foolishly concentrated gold in official coffers rather than putting it to work in reconstruction and in refinancing world trade. They sterilized gold by letting their central bankers sit on it. The United States was no exception. Why should Governor Strong put excess gold reserves into circulation in the form of gold coins? He knew that the outcome would be losing his cherished dictatorial powers. Open market operations and gold coin circulations are incompatible.

Gold inflation is a red herring

Of course, Strong argued that putting gold coins into circulation would be 'inflationary'. Timberlake agrees. They are wrong. Even if all the world's monetary gold had descended upon the United States and were put into circulation, there would have been no price increases. The (natural) discount rate would go to zero. As a consequence vendors could do their 'vending' with zero capital (i.e., they could sell first, and pay for the merchandise out of the proceeds). Marginal merchandise would be displayed on sidewalks, public squares offering shoppers a previously unheard-of variety of goods. The abundance of gold coins would call out an equal abundance of consumer goods. Circulating capital would expand, matching the increase in gold coin circulation to finance trade in marginal merchandise. Automatically and immediately. The maxim that 'more money chasing fewer goods brings higher prices' does not apply, provided that the color of the money is yellow and it has the right ring to it when plunked down on the counter. The collapsing discount rate will see to it that a sufficient abundance and variety of goods is always available. Prices need not rise on account of a greater abundance of gold coins in circulation. 'Gold inflation' is a red herring.

Conversely, there would have been no deflation when European countries recovered after the war and started repatriating their gold. The contraction of the pool of circulating gold coins would make the (natural) discount rate rise in the United States. Vendors of marginal merchandise would fold tent. Circulating capital financing trade in marginal merchandise would shrink, matching the decrease in gold coin circulation. The variety of goods available to consumers would be reduced accordingly. Prices need not fall on account of a reduced abundance of gold coins.

Discounting is not lending

It is not enough to exonerate the gold standard which cannot be fully understood without a proper understanding of the RBD. This Timberlake clearly does not have. In real bills he sees a 'false anchor' competing with gold in the balance sheet of the central bank. In his view the central bank monetizes real bills. The bill is merely a collateral securing the loan and could be replaced by bonds that could also be used for the same purpose. In reality they could not. Banks do not acquire real bills in consequence of a passive maneuver such as securing a loan. Just the opposite is the case: discounting (rediscounting) real bills is an active bank maneuver. The bank (central bank) takes the initiative and goes out to acquire an earning asset. The bill is not a collateral security for a bank loan, neither is the merchandise underlying it. The real bill is an earning asset that is second to none in liquidity (it is second to gold but gold is not considered an earning asset). For a commercial bank, asset liquidity is a primary concern because in a squeeze, or to meet a run on the bank, these assets may have to be mobilized and thrown on the market simultaneously and indiscriminately. Even government bonds cannot come close to real bills as far as their liquidity is concerned. If mobilized and thrown on the secondary market in a panic (as it happened after World War I in 1921), bond prices would collapse and interest rates would shoot up. Yes, even for government bonds. By contrast, real bills are always in demand as long as the underlying goods are. One-ninetieth of the portfolio of bills of every commercial bank matures on every single day of the year. To maintain revenues the bank has to replace them. If one bank has to sell, it will always find another that wants to buy. Even if the taste of consumers has changed, the short maturity of the bills, 91 days (or 13 weeks, or 3 months, or one quarter) makes it certain that bills in disfavor will expire and disappear quickly, long before they could cause mischief. In the worst-scenario case, the drawer of the bill would pay it at maturity even if he had to take a loss. He would do it lest he lose his discounting privileges for good.

The fact that real bills are the most liquid earning asset a bank can have, combined with the fact that the real bill 'matures' into gold coins released by the consumer in buying the underlying good, makes these instruments very special. In the asset pyramid they come right after the monetary metals. It is wrong to look at real bills as competition for gold. Real bills are supplementing gold in financing circulating capital, not competing with it. No prior saving is necessary. It is sufficient that the underlying merchandise be in urgent demand. On the other hand, real bills cannot and will not finance fixed capital. To do that you must have savings in the form of gold. People who insist that prior savings is also a prerequisite for the financing of circulating capital are myopic. There is no way society could save enough to finance the entire circulating capital of a modern economy, in addition to financing its fixed capital. A simple back-of-the-envelope calculation can convince any open-minded observer of that. Real bills, and only them, can make it possible that gold is not tied up unnecessarily in moving merchandise in urgent demand to the consumer expeditiously. Gold, thus released, can then be used to form new fixed capital in financing more roundabout processes of production. The great improvements in the productivity of capital in the 19th century would not have been possible without this division of labor between gold and real bills.

When a bank discounts a real bill, it is not making a loan (even though pro forma the transaction may be dressed up as such). Rather, the bank acquires a self-liquidating paper which at maturity is paid out of the proceeds of the sale of merchandise described on the face of the bill. The gold coin released by the ultimate consumer liquidates the bill. Other loans that the bank may make are not self-liquidating. In more details, at maturity the borrower has to invade the pool of circulating gold coins and withdraw the necessary amount. Should too many loans of this type wait in line to be liquidated simultaneously, there would be a problem. Unless banks could make snap loans to credit-worthy customers, there would develop a squeeze on the money supply. Innocent third parties would find it difficult or impossible to discharge their obligations. Defaults could cascade. This is the stuff out of which depressions are made. This was the core problem after the stock-market collapse in 1929 which revealed that businessmen had been misled by artificially low interest rates. There were no profitable investments on the horizon. There were no credit-worthy borrowers to take the loans the banks were so desperate to make. As a result, the stock of money collapsed as a pricked balloon, replicating the collapse of the stock market.

The case is different with self-liquidating loans. As long as people want to be fed, clad, and sheltered in warm homes in winter, there will always be an adequate supply of real bills, and banks may compete for them. Nobody is squeezed and there is no threat of cascading defaults. As I have said it is wrong to assume that the banks take the real bill, or its underlying merchandise, as a collateral for loan. It is wrong to say that the bank monetizes real bills. It is the market that in fact does the monetization. Discounting bills is not a lending funcion of the bank, but a clearing function. This was known to Adam Smith already well over two centuries ago. He said that real bills could circulate on their own wings and under their own steam. What the banker does is this: he goes out and buys them as the most eligible prime earning asset he can have, one that can always be liquidated in an emergency without fear of a loss, regardless of the vagaries of the interest rate and the economy.

The gold standard and the RBD in the Federal Reserve Act of 1913

Timberlake states that the idea of a central bank was anathema to the newly elected Democratic Congress and president in 1912. The presumption was that a central bank is monolithic and monopolistic. It would not serve the public. Rather, it would further the interest of the bankers. We may be well-advised to take this view of Woodrow Wilson and his Congress with a grain of salt. True, they may not have suffered the expanded power of the banking establishment gladly as it existed then. But this did not mean that they would not embrace unlimited power to monetize government debt, given the opportunity to do so. In particular, Secretary of State William Jennings Bryan was a dyed-in-the-wool inflationist. There is a painting on display in the Treasury Building on Pennsylvania Avenue depicting him as he gleefully signs the very first Federal Reserve notes ready to be rushed into circulation on Christmas Eve, 1913. This Santa Claus of the century has given the world the Federal Reserve, the income tax, no-sweat financing of wars (declared or undeclared), in one word: unlimited power concentrated in the Washington establishment, epitomized by the unlimited power to monetize public debt. This power was grabbed unconstitutionally through the unlawful introduction of open market operations less than ten years later. Even before that, the Federal Reserve was a tool in the hands of trigger-happy politicians who faced a country with no stomach for getting entangled in a fratricidal war on another continent an ocean apart. The warmongers were determined to get a piece of the action by hook or crook. For starters they were eager to finance the trade in war material, especially as it was being dispatched to the Entente powers in violation of the Neutrality Act. Needless to say, financing foreign wars fought by foreigners on foreign soil for foreign interests was not the purpose for which the Federal Reserve System had been established. But let us not make a shortcut in relating events as they unfolded.

It is true that Congressmen who sponsored and passed the Federal Reserve Act of 1913 sincerely believed that the commercial banks' and the Federal Reserve banks' faithful adherence to the RBD would make the monetary system self-regulating, so that the involvement of the Federal Reserve as a central bank could be kept at a bare minimum. Five years of diligent research, after the panic or 1907, had gone into the preparation of the legislation. As mentioned by Timberlake, prominent economists such as H. Parker Willis and Adolph C. Miller, both former students of J.Laurence Laughlin of the University of Chicago, played a crucial role in this research. Not mentioned by him was Paul Warburg, an immigrant from Germany with connections to banking circles there, who brought with him the experience and expertise of the Reichsbank, established a few decades earlier, after a careful study of banking principles with characteristic German thoroughness. The law governing the operation of the Reichsbank was animated by the RBD. Most of its provisions were also written into the Federal Reserve Act of 1913. Carter Glass was the Chairman of the House Banking and Currency Committee nursing the Bill that was to become the Federal Reserve Act. As Timberlake observes, Laughlin was a long-time opponent of the QTM. Miller, together with Willis, supported his criticism of this simplistic theory. In Congress, Carter Glass promoted the pro-RBD and anti-QTM ideas into law.

Hijacking of the Federal Reserve by warmongers

The Federal Reserve Act of 1913 was not a perfect document. In many ways it was rather imperfect. It did not close loopholes whereby real bills could be made to do overtime and consequently become stale in the portfolio of Federal Reserve banks, that would be a drag on the system. The distinction between real bills and accommodation or anticipation bills was not made watertight. Above all, the very idea that the country's gold must be entrusted to 'reserve' banks, rather than to the people themselves by putting it into circulation, is a monstrosity. Be that as it may, the Act had the attributes of a reasonable legislation to prevent inflationary and deflationary adventures of an activist central bank. The idea of linking the emergence of new currency to the emergence of goods and services in urgent demand (and the retirement of currency at the time of the sale of merchandise or completion of service) was sound. Resisting the temptation to organize the public debt into currency was admirable. Under a more favorable constellation of the stars the experiment of founding a central bank of the people, for the people, by the people, may have succeeded.

Unfortunately, constellation was anything but propitious. The fledgling institution had no chance to succeed in its mission. The Guns of August shot the gold standard, and the bill trading supplementing it, to pieces. Enemies of private enterprise, free trade, and the ideal that the individual knows best what is good for him, together with collectivists of all spots and stripes, saw a great opportunity coming their way presented by the fratricidal war overseas. The socialist minorities sitting in European parliaments, without exception, voted all the war credits governments asked for and then some, in effect throwing out the gold standard as useless baggage inappropriate to carry along in wartime. In reality, the retention of the gold standard would have greatly shortened the war. As taxes to pay for the prolongation of war had had to be increased, the pressure on belligerent governments to make peace would have intensified.

At least in Europe where nationalistic fervor could reach fever pitch the blind sentiment to continue the war to total victory or death was understandable. But in the United States the European war did not make sense to ordinary people. Their ancestors came to this continent to escape the arbitrary war-making power of kings. No pet wars for presidents here, they had thought. The country stayed neutral for the first three years of the conflict, in spite of ongoing political intrigues to take the plunge. The Constitution had assigned the power to declare war to the House of Representatives, and congressmen would not antagonize their pacifist constituents by war-mongering. It was in the president's official family where warmongers found a niche and could prepare the ground for the United States' entry to the conflagration, through provocation if need be.

We shall never know what would have happened if two momentous events: the eruption of war in Europe, and the Federal Reserve banks' opening their doors for business, had not coincided in the fateful year of 1914. One thing is certain: the world would be quite different from what it is now.

The Great Contraction

Strong died while in office in October, 1928. The removal of this tyrant gave a chance to his enemies to crawl out of the woodwork. They did not delay making the system conform to RBD guidelines as required by the Federal Reserve Act -- a most unfortunate development in the view of Timberlake. Here is another interesting historical coincidence. Two events: the bursting of the stock market bubble fed by the Strong-inflation, and the death of Strong were separated by just one year. We shall never know what would have happened if Strong had lived to continue his open market operations in the 1930's. Timberlake says that the Great Contraction would have been avoided. Strong would have pumped even more money into the system, anticipating Greenspan's response to the "irrational exuberance" of the stock market. We may agree, for the sake of argument, that this could have postponed the crisis. Yet it is certain that the crisis caused by a growing amount of central bank money in circulation could not be put off forever. Timberlake's assumption is tantamount to assuming that damage caused by inflation can be cured by more inflation ad infinitum. However, in our more sober moments we should admit that inflation cannot survive as a permanent monetary policy. The Fed combats falling prices by open market purchases of bonds, and it combats rising interest rates -- you have guessed it -- by more open market purchases of bonds. The cure is always the monetization of more government debt, regardless whether you are combating inflation or deflation. Just print more money, rain or shine. We know from history how inflationary adventures inevitably end. There could be nuances of difference, but deflation that follows inflation as night follows day cannot be avoided, no matter how much government debt is monetized by the central bank.

The Federal Reserve Board minus Strong had the unenviable task to rein in the unbridled Federal Reserve credit that was feeding the stock market orgy. They tried to do this as gingerly as they could. Credit contraction is always painful. The pain that goes with contracting an unprecedented credit expansion is no less unprecedented. Timberlake is right in assuming that the Great Contraction has run its course by 1932 and there were signs of recovery in early 1933. Why did then the Great Depression follow so hard on the heels of the Great Contraction? Here the use the RBD as whipping boy that can be conveniently blamed for deflation comes handy. Timberlake does not pretend that his thesis is original. Indeed, it is not. You could have become a Nobel Prize laurate in economics for suggesting it first. But even a dozen Nobel prizes cannot overtake truth.

Why the Great Depression?

Although the Great Contraction in the wake of the Strong-inflation was unavoidable, the Great Depression was not. The world was sucked into it not because of the RBD but in spite of it. If Timberlake does not see it that way, it is due to his faulty understanding of the RBD, which is inseparable from the gold standard. Real bills must mature into gold coins. Otherwise the RBD makes no sense. Why can't a real bill mature in Federal Reserve notes? If it could, it would not have come into existence in the first place. An omniscient and omnipotent Fed could helicopter-drop just the right amount of Federal Reserve notes, when needed, where needed, for the smooth functioning of the economy. They tried that approach in Bolshevist Russia, with results only too well-known. The experiment was discontinued in Russia's 'Evil Empire' in 1990. Now they try it again in the U.S. and its very own Evil Empire. As Benjamin Franklin has said, experience runs an expensive school, but fools will learn in no other.

Just as the world economy was making its first tentative steps to recovery in 1933, the international gold standard -- and together with it the bill market -- were mortally wounded by saboteurs. The newly elected Democratic President, no less strong a man than Governor Strong, took the law, and the Constitution, into his hands in March, just a few days after inauguration. Under the threat of heavy fines and prison terms he called in all gold coins and gold certificates by issuing a Presidential Proclamation. Next, he cried down the value of the Federal Reserve notes in terms of gold, the very same notes that had been paid out 'in compensation' to holders of gold. In other words, the president used the strong arm of government to pauperize the citizenry. Pity poor Henry VIII. He was being mocked as "Old Coppernose". Yet the vilest thing he ever did to the coin of the realm was to give it a gold wash. When the wash rubbed off after a few years of wear and tear, the copper nose on his effigy became plainly visible. Ownership of solid gold coins was not made illegal. People who could see through the cheap trick were not harmed. Those who were, could at least have a good laugh for their money whenever they looked at the coin counterfeited by their sovereign. But what this president did amounted to raping an entire nation. People were deprived of their gold coin they needed to validate their demand for consumer goods. Thereafter producers of goods and services would not take orders directly from the consumer bereft of his gold coin. Instead, they would take orders from the issuers of purchasing media, the bankers. They were the ones to call the shots, and to pay the piper. The consumer must take it or leave it.

Timberlake does not see this. He insists that the 'gnomes' of the Federal Reserve have smuggled real bills back into circulation for doctrinaire reasons. Their plot could not possibly work. Production has stopped (or nearly so) and the flow of real bills dried up, making the economy come to a screeching halt for lack of purchasing media. Meanwhile gold was piling up in the vaults of the Federal Reserve Bank of New York well in excess of reserve requirements, doing nothing. Surely, a strong leader such as Strong would have issued Federal Reserve credit against this gold, and the Great Contraction as well as the Great Depression would have been avoided, according to Timberlake. This betrays his incomplete understanding of the RBD, which makes the availability of gold coins to the consumer an absolute prerequisite.

Here is what would have happened, had the dictatorial-minded president not confiscated gold. The RBD would have been allowed to operate. As foreign gold flowed to the country, it would be monetized, and the discount rate would be driven lower, perhaps all the way to zero. The United States would have become the clearing house for real bills originating from all over the world. The movement of goods in international trade would have been financed by real bills drawn on New York, just as prior to World War I world trade had been financed by real bills drawn on London. The low discount rate would have revived the export industry of the United States. Recovery of production for the domestic market could have proceeded apace. The appalling unemployment would have never happened. The Great Depression would have been avoided.

None of this was going to occur because the boat of the international gold standard has been torpedoed and real bills, being tied to the mother ship, went down with it.

Lionizing saboteurs

Timberlake is blaming the victim of a disaster for the disaster caused by sabotage. The RBD could have been the savior had it not perished along with the gold standard at the hand of collectivist assassins. Real bills could have revitalized world trade and revived the world economy. But the lion's share of world gold had been sequestered and made unavailable for any purpose whatever by a megalomaniac. Bereft of its gold, the world had no choice but go through the meat-grinder. It was no coincidence that the beginning of the Great Depression coincided with the incarceration of gold.

Timberlake should refrain from lionizing lesser saboteurs such as Strong. It appears that his hero is the Latter-Day Strong alias Alan Greenspan. Unfortunately, he says, Greenspan may have come too late and may have left too early. The task of enforcing the "stable price-level norms of Benjamin Strong" has remained unfinished. I quote: "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 hyperinflation] of 1923 will be only too applicable."

Is this not exactly what Governor Strong, not having a constitution 'made of titanium steel', had done and would have continued doing had he not succumbed to tuberculosis in 1928? Can the policy of curing the ill effects of inflation with more inflation have any other ending?

Abstract

"Federal Reserve policies were one hundred percent responsible for the Great Contraction and the 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 incursions in the economy, and in a vast expansion of powers that no Supreme Court could stop. Worse still, the common misconception 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."

My agreement with this assessment of Timberlake is complete. Our difference is centered on the question whether the follies of the Federal Reserve consisted of its abiding by the law, or violating it. This article makes the case that violation of the law, regardless whether you consider it good or bad, creates far greater problems than those it may hope to solve. It also points out that gold coin circulation is a sine qua non of the RBD. Timberlake ignores the implications of the fact that the newly inaugurated president confiscated the gold coins of the people on March 4, 1933. The coincidence of that day, which will 'live in infamy', with the beginning of the Great Depression was no coincidence.

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