

A History of the Federal Reserve. Volume 1: 1913–1951. By *Allan H. Meltzer*. Chicago: University of Chicago Press, 2003. xiii + 800 pp. Tables, figures, references, notes, index. Cloth, \$75.00. ISBN: 0-266-51999-6.

Reviewed by Wyatt Wells

Large books often have a simple message. Allan Meltzer's *History of the Federal Reserve* invites comparison with Milton Friedman's and Anna Schwartz's *Monetary History of the United States*, which argued that "money matters." In his book, Meltzer argues that "ideas matter."

Meltzer offers a comprehensive history of monetary policy from the 1913 organization of the Federal Reserve to 1951, when an agreement with the Treasury Department effectively reestablished the Fed's autonomy, which had, as a practical matter, lapsed in the 1930s. He does not examine the Federal Reserve's other fields of activity, such as bank regulation, except when they affect monetary policy. Meltzer relies chiefly on the records of the Fed itself, particularly the detailed minutes of meetings of the Open Market Committee, the most important policymaking body, and he supplements this with the private papers of key officials, numerous secondary sources, and statistical appendices. The result is an extraordinarily thorough survey of monetary policy.

Unlike most other students of the Federal Reserve, Meltzer begins his account, not with the panic of 1907 or the National Monetary Commission's subsequent study of the banking system, but with the thinking of three economists: Henry Thornton, Walter Bagehot, and Irving Fisher. All three, he argues, provided valuable insight into central banking and useful guides for monetary policy. Unfortunately, although the leaders of the Fed were aware of at least Bagehot's and Fisher's work, they failed to make use of these economists' ideas.

The 1913 Federal Reserve Act explicitly tied monetary policy to the gold standard and the real bills doctrine. The gold standard, of course, required governments to redeem their currency on demand in gold, essentially fixing its values not only against the precious metal but also against the currencies of all other gold standard countries. The real bills doctrine limited central bank lending to the purchase of real bills—loans

secured by goods—effectively tying the issue of money to the value of goods moving through the economy. Ideally, this system would be self-regulating. The gold standard would keep international payments in balance, and the real bills doctrine would prevent the central bank from financing speculative activity while guaranteeing credit for the production and distribution of goods.

The First World War wrecked the assumptions on which the Federal Reserve Act rested. The international gold standard collapsed. At home, the Federal Reserve purchased huge quantities of Treasury obligations to help the government finance the war, so that, with the return of peace, real bills constituted only a small part of its portfolio. Much of Meltzer's history revolves around the attempts by the Fed's leaders to revive the gold standard and devise something analogous to the real bills doctrine to guide domestic policy. Both efforts proved disastrous.

Unlike many other observers, Meltzer does not consider the gold standard inherently flawed. It did, however, require symmetrical application—that is, countries with a surplus of gold must expand their currency, even as those in deficit must deflate. Such had been the case before 1914, but in the 1920s, central banks, led by the Federal Reserve, “sterilized” inflows of gold to prevent inflation. This forced deficit countries to make the entire adjustment to any payments imbalance by deflating, giving the gold standard a relentlessly deflationary bias that was ultimately economically and politically unsustainable. To make a bad situation worse, the Fed ignored the practice of other central banks before 1914, outlined by Bagehot, of ignoring the gold standard during domestic financial crises and supplying credit as needed to guarantee solvency. During 1931 and 1932, when gold reserves were falling and the American financial system was collapsing, the Fed kept credit scarce, intensifying the banking crisis and making the Depression worse. Even after 1933, when President Roosevelt abandoned gold, Fed officials hoped to restore the gold standard, but the disastrous experience of the 1920s and early 1930s meant that this project enjoyed little outside support.

The attempt to restore the real bills doctrine, under what Meltzer calls the Riefler-Burgess framework, after the economists who devised it, proved just as disastrous. After 1920, the Fed could not base policy on real bills because most of its portfolio was government obligations; the tie between real bills and the supply of money was broken.

Instead, the central bank concentrated on direct borrowing by banks from the Fed as well as “free reserves,” that is, reserves above the legal minimum necessary to cover deposits. If borrowing was high and free reserves low, monetary policy was “tight” because banks had little to lend; the reserve signified a loose policy. But as Meltzer points out, reserves might be scarce and borrowing high because banks were loaning heavily. Likewise, reserves might be plentiful and borrowing low because business was depressed and the demand for loans weak. In these cases, the Riefler-Burgess framework gave exactly the wrong signals to policymakers. Instead, the central bank should have concentrated on the quantity of money and credit available, as well as on general economic conditions. The Fed’s focus on nominal rather than real (inflation-adjusted) interest rates greatly increased the risk of mistakes—an error against which both Thornton and Fisher warned. During the early years of the Depression, for instance, the Fed reasoned that monetary policy was stimulative because reserves were high, direct borrowing low, and interest rates remained stable at around 3 percent. It failed to observe that because prices were falling sharply, real interest rates were quite high, often over 10 percent, which deterred borrowing and reinforced deflation. The Fed clung to the Riefler-Burgess framework throughout the 1930s and 1940s, often making serious miscalculations as a result.

No brief review can do justice to the depth of Meltzer’s analysis, which examines how personal temperament, political calculation, international relations, economic theory, the structure of the financial system, and the very complex organization of the Fed itself all affected policy. No doubt, some will object to Meltzer’s economic analysis. Monetary policy is a contentious subject, and Meltzer is very much a monetarist. Adherents of other schools of thought may draw different conclusions from his evidence. As a historian, however, Meltzer is hard to fault, and his work will no doubt become the definitive history of the American central bank.

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