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## INTELLECTUAL TYRANNY OF THE STATUS QUO FOLLOW UP



### Reply to Hortlund's "Defense of the Real Bills Doctrine"

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IN A CRITIQUE OF MY PAPER ON "GOLD STANDARDS AND THE Real Bills Doctrine in U.S. Monetary Policy" that appeared in *Econ Journal Watch* (August 2005), Per Hortlund has raised several interesting issues about the Real Bills Doctrine (RBD). As Hortlund observes, my article had two major themes, first, the innocence of the gold standard for the monetary infelicities that caused the Great Contraction of 1929-1933, and, second, the culpability of the RBD for the debacle. Hortlund accepts my defense of the gold standard. However, he finds some arguments to support a case for the RBD, and he raises an important issue concerning the substance of the RBD and its implementation as policy during 1929-1933, part of which I thoroughly accept.

Hortlund states that the RBD "may be a useful rule of thumb that can improve the workings of a central banking system on the gold standard" (74). No one would deny this assertion. The more fundamental question is, however, would the RBD by itself—without a gold standard to protect it—have the necessary operational constraints to prevent dynamic instability in the monetary system? I do not find Hortlund's affirmative arguments on this particular question convincing. His next sentence noting that the RBD prohibits the monetization of government debt is correct and

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attractive even though the idea may have come about because of the real billers' hostility to the quantity theory of money.

Hortlund argues, I think mistakenly, that the RBD can be made as rigorous as a gold standard:

Note that the real bills criterion in this sense is a purely formal, legal one—similar for example to the criterion of monetization of gold on fixed terms. Nothing says that a loan bill of a certain nominal amount could not represent “real value” or “real wealth”. Timberlake's (2005, 206) discussion about the distinction between monetization on gold and on real bills I therefore believe to be somewhat off the mark. (Hortlund 2005, 76)

But how does his “loan bill of a certain nominal value” come to represent real wealth? The valuation of real bills always requires human discretion by bankers or central bankers. At times, bankers' judgments may be stabilizing, and at times destabilizing.<sup>1</sup> By way of contrast, the monetization of gold under a gold standard can never be dynamically unstable. Gold standard laws regulate the monetization of gold in a way that laws describing and governing real bills can never achieve.

I realized after writing “Gold Standards and the Real Bills Doctrine in U.S. Monetary Policy” that I had neglected to emphasize sufficiently the negative features of the RBD; Hortlund's “Defense” provides this proper amendment.

Virtually all of the arguments on the workability of the RBD focus positively on monetization of the financial assets that qualify as real bills. However, in 1929 the Fed Board instituted its hysterical crusade against “speculation,” which was very much a negative policy. Other negative types of lending that the RBD considered unsuitable were long-term investments and real estate, and, as Hortlund emphasizes, government bonds.

I wrote in a short sequel to “Gold Standards . . .,”

The Fed Board's anti-speculative compulsion crowded out legitimate lending to needy banks that actually had ‘real bills’ to discount, thereby causing the very condition that the Federal Reserve System was supposed to prevent. (Timberlake, unpublished)

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<sup>1</sup> For an analysis of the conditions for both, see Girton (1974).

Hortlund takes the matter further.

The true real-bills central bank discounts *if and only if* real bills (eligible paper) is presented to it for discount. That is, the real-bills central bank acts according to these two rules:

Rule #1: Do not discount non-real bills (ineligible paper) presented for discount.

Rule #2: *Do* discount all real bills (eligible paper) presented for discount.

A central bank that does not follow *both* of these rules cannot be said to follow the RBD. For the RBD adherent, the real bills criterion provides a rule that renders monetary policy more or less automatic. 'The volume of real bills corresponds by itself in a desired manner with the 'needs of trade', wherefore no discretionary evaluation or prudence on the part of the central bank is needed. The central banker's only task is to check whether the instruments presented for discount is on the list of eligible paper or not. Did the Fed follow the rules? (Hortlund 2006, 82).

The obvious answer, of course, is "No." However, the Fed's failure to discount real bills at this time, due to the anti-speculative bogeyman it had fabricated, does not confirm that it had abandoned real bills precepts. Indeed, "speculation" is a major sin in real bills circles. It is just as much a part of the RBD as are the positive principles for lending. Consequently, one cannot separate the anti-speculative proscriptions that the Fed pursued during 1929-1933 from the RBD's proper prescriptions. Both together make up the total package. That being the case, the disaster of 1929-1932 still ranks as the result of the RBD\* (with an asterisk signifying that the negative side of the Doctrine was dominant).

One cannot argue that the contraction never would have occurred if Fed policymakers had just discounted real bills. It is a counterfactual impossibility. They did not do so because their real bills precepts required them to eliminate speculative 'credit' first. Fed policy expanded Hortlund's

Rule #1 of not discounting non-real bills to an active negative policy of killing speculative ‘credit’ no matter what the cost.

Incidentally, if I could set the rules for a central bank, in addition to Hortlund’s two rules, I would add a third rule.

Rule #3: Do not pay any heed to any particular market, such as the stock market, the real estate market, the agricultural market, the foreign exchange market, or any special asset or capital problems, or any goal or target at all, except stability in the value of the money unit. Use your absolute control over the quantity of money to achieve this goal, and with zero tolerance.

The crux of this Rule is that the mechanics of contemporary central banking give that institution control over one, and only one, Big Variable—the quantity of money. Given this one control, the central bank can maintain stability of the money unit. However, in doing so, since it cannot aim at multiple targets at the same time, it must eschew all other considerations—no matter how much its governors discuss them or wring their hands about them. In short, both the necessary and sufficient condition for managing a central bank in today’s world is the quantity theory of money.

Benjamin Strong understood this principle and acted accordingly. Indeed, his appreciation of the Fed’s power, as a part of the government, to control the quantity of money and the price level is what prompted him to reject a stable price level mandate for Fed policy. He wanted permanent control of money ruled by a gold standard, with the central bank limited to providing some currency ‘elasticity’ in a crisis. The best we can hope for from the present-day Fed is something akin to Strong’s policies.

## REFERENCES

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