

Richard Timberlake

Richard Timberlake has one of the longest-spanning careers of any economist. His first article was published in 1957, when he was 35 and earning his Ph.D. at the University of Chicago. His latest book, a history of the most important Supreme Court decisions affecting money, was published in 2013, when he was 90. After teaching at the University of Georgia for 26 years, Timberlake has been retired for a nearly equal length of time — he retired, he says, so he could get some work done.

Timberlake is widely regarded as one of the world's foremost experts on monetary history. The intriguing thing about money, he says, is that its existence since ancient times proves that people can use it whether or not they understand how it works or what gives it value.

His work has often taken an anthropological perspective, exploring the influences over key policymakers and lawmakers who have shaped U.S. monetary policy — in many cases, he argues, to its detriment. In *Constitutional Money*, he argues that key court cases weakened the monetary clauses of the Constitution, making way for the era of fiat money that has prevailed almost since the Fed was created.

He was one the first economists to show, in 1984, that private clearinghouses were quite successful at resolving bank panics long before the Fed came into existence. Timberlake is perhaps best known as a staunch supporter of monetary rules, like a gold standard, that remove the discretion from monetary policy to keep policy insulated from political pressures and human fallibility.

Timberlake is also the author of *They Never Saw Me Then*, a memoir of his experiences as a bomber co-pilot during World War II, for which he earned three Purple Hearts, and he was a Richmond Fed visiting scholar in the early 1970s. Renee Haltom interviewed Timberlake at his home in Bogart, Ga., in February 2014.



EF: Let's start with a unifying theme of your work: Your support of a gold standard. Several great neoclassical monetary theorists — Marshall, Walras, Wicksell, Fisher, and Keynes — argued that a rules-based fiat money could outperform a gold standard. Why do you disagree?

Timberlake: Let me say first of all that I am not a “gold bug.” Nonetheless, the fact is that an operational gold standard works to promote a free society, and no other monetary policy seems able to do so.

The key word in your question is “could.” But the policymakers won't allow it to. The reason they won't is found in public choice economics, which argues that the policymakers, like all other human beings, have a stronger motive to further their own self-interest than to promote sound public policy — not only at the Fed, but everywhere. Until maybe 10 or 20 years ago, economists who studied money felt that they could prescribe some logical policy for the Federal Reserve, and ultimately the Fed would see the light and follow it. That proved illusory. A central bank is essentially a government agency, no matter who “owns” it. The Fed's titular owners are the member banks, but the national government has all the controls over the Fed's policies and profits. And as with all government agencies, the Fed is subject to

public choice pressures and motives.

The gold standard, by contrast, constrains the quantity of money because gold itself is a limited substance in the crust of the earth and is recognizable for what it is everywhere. It is amazingly constant in value relative to other commodities, over not only centuries but millennia. In ancient Egypt, the value of silver to gold was about 3 or 4 silver to 1 gold. By the end of the 19th century it was 30 to 1. By the end of the last century it was 80 to 1. Recently it has been closer to 50 to 1, which seems more or less right. But its value relative to all goods and services, so far as that can be determined, has hardly changed at all.

EF: What inspired you to write *Constitutional Money*?

Timberlake: Primarily, it was the observation that Supreme Court decisions had never been discussed analytically in terms of monetary economics. In U.S. history there have been about 10 important monetary rulings. I found that these decisions very much impacted both beliefs and policies and significantly influenced monetary affairs. I also found an important trend during the period I studied: Those court decisions rendered the constraint of the gold standard less and less forceful.

The culminating decisions were the last ones I examined — the Gold Clause decisions of 1935, which took place after Congress significantly devalued the dollar in terms of gold in 1933-1934. The U.S. Treasury then was authorized to call in all the gold and melt it down so it was unusable as money, while government ownership and legislated devaluation gave the government a windfall profit of \$2.8 billion. This profit almost equaled the federal government's total revenue for that year. To prevent a similar windfall that would benefit private holders of contracts redeemable in gold, Congress banned gold payments for contractual debts. The constitutionality of this decision then became a court case.

In its decision upholding the abrogation of gold clauses, the Supreme Court reaffirmed, without re-argument, its decisions in 1871 and 1884 that gave Congress full control over the monetary system, including the issue of full legal tender paper money called "greenbacks." Those decisions were politically motivated and patently anti-gold standard, as well as invalid. I say "invalid" in the sense that the decisions were contrary to all constitutional precepts, but also in the sense that there was a dichotomy between what the Supreme Court decided in 1871 and 1884 and the monetary principles the public universally believed and acted on. Subsequently, the Fed was created in 1913 with no presumption at all that it had complete control over the monetary system. But neither that fact nor the absence of any other common evidence supporting the court's conclusion ever became part of the argument in the Gold Clause cases. Passage of the Gold Standard Act in March 1900, for example, would have been

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superfluous and trivial if Congress had actually had such constitutional powers.

With the Banking Act of 1935, Congress formally granted the Fed complete discretionary power over the monetary system that was implied by the 1935 Gold Clause

decisions, even though almost nobody knew how unfettered monetary policy would work. Such an understanding requires knowledge of how the central bank creates money, how the commercial banking system creates money, and how an individual bank creates money, as well as an understanding of the behavior of money and what the limits are to monetary manipulation. No one in the government then knew or cared about such principles. Fed policies from 1935 to 1952 were all politically determined by the Treasury Department.

EF: So how does monetary policy since the 1930s argue for a gold standard, in your view?

Timberlake: After the Depression ended in about 1941, the Treasury simply put the central bank in tow, especially during World War II. When the Fed finally broke loose with the Fed-Treasury Accord of 1951, Fed policymakers still had to be politically correct. Nevertheless, Fed policy was reasonably good under Chairman William McChesney Martin, and I would say also reasonably good under Alan Greenspan. However, with a gold standard in place, no personality decides monetary policy. No one throws stock markets into a panic with comments about "irrational exuberance." A simple constitutional law is in place that everyone understands: The quantity of gold in banks and the rest of the market system is strictly limited and determines the quantity of common money. No government agency can manufacture gold to bail out any big banks or corporations, or raise or lower interest rates. There is no QE (quantitative easing) 1, 2, 3, and so on.

A gold standard provides a stable monetary system because it operates under the principle of spontaneous order. After Congress specifies the amount of gold in the unit of account — the dollar, in the United States — millions of people making tens of millions of decisions in thousands of markets determine prices, wages, and the patterns of production. It's easy to understand, even if a person doesn't know exactly how the gold standard works. Under a gold standard, governments can rarely initiate spending orgies. Only with a war developing can mortal legislators overrule the gold standard's strictures.

At the present time, the Fed, with its monetary facilities, enables the U.S. Treasury to extend its fiscal base for creating a seemingly limitless national debt. The worst possible scenario is one in which the front door of the Treasury is also the back door of the central bank. With such an institutional nightmare in place, the Treasury sells the securities and the Fed immediately buys them, thereby creating more money,

which then goes out of the Fed's front door. Currently, much of that new money is in the form of commercial bank reserves. The Fed has successfully neutralized their monetary impact by initiating interest payments on them so that bankers will not use the new bank reserves to expand credits and deposits. However, that policy cannot last forever. If the economy starts recovering, interest rates will begin to increase and the Fed will have to raise the near-zero interest rates it now pays banks not to use those excess reserves. Increasing market rates of interest will provoke political demands that the Fed "lower interest rates" — something it will not then be able to do.

Currently, it is difficult to imagine what a constrained monetary system, or a constrained government of any kind, might look like. Expansive monetary policy finances the government's unstable welfare system, unending foreign wars, and all the rest of the government's limitless tax-and-spend policies. I cannot see any kind of market equilibrium with this kind of unstable institutional environment.

Going back to a more constrained system, such as a legitimate gold standard, couldn't be done overnight. It requires a public consensus, an ethos for a constrained government as well as a disciplined monetary system. Public choice theory suggests that government agencies would drag their feet to prevent it, because getting back on a gold standard would take monetary powers away from government control. So returning to any truly constitutional government will be a long, hard haul.

EF: Do you think there are viable rules-based alternatives to a gold standard that would be better than the fiat system we have?

Timberlake: Since any central bank unequivocally controls the quantity of money, two rules are possible that would suitably restrain the government's monetary excesses. The first would be a rule mandating that the Fed, by means of its full control over the quantity of money, stabilize a price index of commonly used goods and services, without any excuses or exceptions. Many economists favor this rule. While an acceptable rule, it would not be foolproof.

The second possibility — which the late Milton Friedman finally decided on after studying the lagged effect of monetary policy on prices, and after it became apparent that the Fed would not bind itself to a price index policy — is a fixed rate of increase in the quantity of money. Such a policy would be simpler than an indexed price level policy because the

Richard Timberlake

► Present Position

Professor of Economics, Retired

► Other Positions Held

Florida State University (1958-1963);
University of Georgia (1964-1990)

► Education

Ph.D., University of Chicago (1959)
M.A. Columbia University (1950)
B.A., Kenyon College (1946)

► Selected Publications

Author of the books *Constitutional Money: A Review of the Supreme Court's Monetary Decisions* (2013), *Monetary Policy in the United States: An Intellectual and Institutional History* (1993), and others. Articles have appeared in journals such as the *Quarterly Journal of Economics*, *Journal of Economic History*, *Journal of Political Economy*, and *Journal of Monetary Economics*

Fed has unquestionable day-to-day (or week-to-week) control over the quantity of money, even though Fed spokesmen have not always liked to talk about it.

I was visiting at the Richmond Fed in the summer of 1970, and I wrote an article for the Richmond Fed's *Monthly Review* to acquaint the layman with the mechanics of money creation. (See "The Supply of Money in the United States," *Monthly Review*, January and February 1971.) I constructed a basic diagram that showed the Fed's control over the quantity of money. But the editor of the *Review* had to run it by the Federal Reserve Board in Washington, and they almost squelched it because it explicitly discussed the Fed's control over the quantity of money. (*Editor's Note: The Board no longer approves the publications of the Reserve Banks.*) The Board did not want the Fed to be controlling the quantity of money.

That operation is too simple. Policymakers want the Fed to do other things that are more "important," such as fiddle around with interest rates, so that the Fed organization continues to have an unquestionable reason for existing. However, even with a stable price level rule in place, all the Fed's parts and pieces could stay in place to ensure that this policy, no matter how simple, was being perfected.

Friedman recommended a steadily increasing quantity of money — that is, bank checking deposits and currency — between 2 and 5 percent per year. Prices might rise or fall a little, but everybody would know that things were going to get better or be restrained simply because the Fed had to follow a quantity-of-money rule. I wrote him a letter at the time and remarked, "I agree with your idea of a stable rate of increase in the quantity of money, and I suggest a rate of 3.65 percent per year, and 3.66 percent for leap years — 1/100 of 1 percent per day." He responded dryly, "Your percentage is very ingenious."

EF: Some economists argue that the Fed should target nominal GDP (NGDP), essentially stabilizing prices in the long run and perhaps reducing unemployment in the short run. What do you think of this proposal?

Timberlake: Providing a hard rule for policymakers is always going to get the discretion out of policy, so virtually any rule is better than unlimited discretion. An NGDP target is better than what we're seeing now, which is unfettered money creation and stimulus spending. However, this policy has a major drawback: The Fed can affect only one side of the market, the quantity-of-money side. The other side is

the real sector, where goods and services are produced. The Fed cannot do anything about that side, as current monetary excesses have confirmed. But it can keep the monetary side in order. That was the principle that Milton Friedman emphasized. With a central government generating so much uncertainty and counterproductive policies for the real sector, an NGDP policy might well see nothing but price level increases. The real sector would be stuck on a zero or declining rate of increase due to anti-market incentives, such as those currently in place — excessive taxes, with huge dead weight losses; a plethora of counterproductive regulations; anti-enterprise government propaganda; and stifling controls of all kinds, such as minimum wage laws and legislation costly to the financial sector, such as the Dodd-Frank Act.

Current Fed policy is to promote an inflation *rate* of 2 percent per year married to a minimum *level* of unemployment. That is an absurd confusion of monetary and employment policies. First of all, an annual rate of increase of 2 percent in the price level will not achieve anything that a zero rate of increase would not do, and also has other associated pitfalls. In fact, there is a very good case for a monetary policy that would allow the price level to fall at the rate of increase in the production of real goods and services. In any case, most economists know that price level increases have no effect on production, that a stable price level is as good in the longer run as any inflationary policy so far as real production is concerned. Friedman also argued that an optimal price level policy would reduce the price level 2 to 5 percent a year. He had very good theoretical arguments to back this proposal.

The problem with an advertised falling price level is that it is politically unacceptable. But a stable price level policy, which is plenty good enough, is acceptable and plausible. Like a gold standard, everyone understands what it means. Just as everyone understood that more gold meant more money, everyone would understand that average prices would be constant, even though people might argue about which specific prices and weights to include in the policy index.

EF: When, if ever, has the Fed followed a good rules-based policy, in your view?

Timberlake: The first — and only — stable price level policy followed by the Fed was initiated by Benjamin Strong, president of the New York Fed in 1922, who showed how it would work. He initiated this policy as a temporary action until international agreements could re-establish the gold standard. The policy ended in 1929 due to his death the previous October.

The New York Fed was the largest Reserve Bank by far and was in the center of the financial district. Strong realized that the Fed System could promote financial stability because of his banking experiences in the panic of 1907, when privately owned and operated commercial bank clearinghouses extended their credit facilities to fulfill the extraordinary demand for money that had developed

in financial markets. Strong thought he could promote a stable price level and then reconstitute the gold standard when prospects seemed favorable. During that period, 1922 through 1929, the price level (CPI) rose a total of 2.3 percent, and the wholesale price index actually fell. Prices were essentially stable and enterprise flourished.

After Strong died in late 1928, activists on the Fed Board in Washington took over. The Board member most influential at that time was Adolph C. Miller, a “real bills” proponent who was also a fanatic about speculation. He managed to prevail on the Board to crusade against this evil practice no matter what that policy did to the banking system. The result was disastrous, absolutely calamitous. The anti-speculation policy “cured” the patient by killing it.

Incidentally, some economists’ papers printed in the *American Economic Review* in 1925 discussed Strong’s price level policy. The gist of what several said was that Strong’s policy was legally questionable and about as far as the Fed could go under constitutional law, and only acceptable until the gold standard could be resumed. Nonetheless, Strong’s policy showed unquestionably that a central bank can maintain a stable price level even in the presence of the carping criticism of the real billsers.

EF: That’s a good setup for my next question: What is the real bills doctrine, and how did it lead the Fed astray during the Great Depression? And why didn’t the Fed realize it at the time?

Timberlake: The Fed was founded on the basis of the real bills doctrine, which simply meant that the money and “credit” it created were supposed to be backed by short-term loans that bankers made for the marketing of real goods and services. The idea is that the banker creates credit and new money for the entrepreneur, who uses the money to make goods and services, and then sells those goods and services to pay off the bank loan, 30, 60, or 90 days hence. The newly created bank credit was supposed to be of short-term duration and self-liquidating.

The real bills doctrine can be destabilizing because the monetization of bank assets depends on the variable discretion of the banker, whereas the monetization of gold has no discretion connected to it at all. Any amount of gold can be turned into money at a fixed rate. Its monetization is a rule of law, with no one’s discretion applicable. However, when operating as a subsidiary policy to the gold standard, the real bills doctrine is harmless; the gold standard dominates the creation of money, no matter how many real bills appear.

So it wasn’t the real bills doctrine, as such, that led the Fed astray in the Great Contraction of 1929–1933. It was the sub-policy of anti-speculation that did all the damage. Anti-speculation was politically appealing at that time because the stock market seemed to be going wild. It also sounded so virtuous. It especially appealed to those speculators who had lost money.

Many Fed policymakers, and most economists, believed

in the real bills doctrine. Since the gold standard was no longer operational — in fact, had not been since 1914 — real bills proponents in the Fed had the chance to bring it in as a policy and put it into practice. The Board's anti-speculation regulations were initiated in February 1929. From then on, Reserve Bank loans were denied to all banks that had any taint of speculation to them. That started a cumulative process of contraction. The monetary and banking data show this decline without any question, and the policy went on and on until the speculation was cured, by which time the patient was dead.

EF: So do you agree with Milton Friedman and Irving Fisher that if Benjamin Strong hadn't died in 1928, the United States and the world would have avoided the Great Depression?

Timberlake: Miller was always at odds with Strong. He said out loud that Strong was one of those “dangerous economists” who had weird ideas about the banking system. But in the early '20s, Strong had the power. His was a dominant personality. He was president of the Fed bank of New York, so he had as much power over the system as Janet Yellen or Ben Bernanke or Alan Greenspan have or had in modern times. He knew what he was doing. A lot of the others didn't know because they refused to acknowledge how the system worked quantitatively. They were still real billsers. To answer your question: Yes, undoubtedly. (See “Taking Charge,” page 4.)

EF: What should the Fed do about asset bubbles?

Timberlake: The Fed shouldn't pay any heed at all to asset bubbles. If it followed rigorously a constrained price level, or quantity-of-money rule, I don't think there would be bubbles. Markets would anticipate stability. Markets today, however, anticipate, with good reason, all the government interventions that lead to bubbles. If we had a stable price level policy and everybody understood it and believed it would continue, there wouldn't be any serious bubbles. We don't even know whether the 1929 “bubble” was even a bubble, because after the Fed's unwitting destruction of bank credit, no one could distinguish in the rubble what was sound from what might have been unsound.

EF: Walter Bagehot, the 19th century British economist, is often credited with having written the playbook — literally, in his 1873 book *Lombard Street* — for what a central bank should do in a crisis. Economists have different interpretations of what he was prescribing, however. What is your interpretation of Bagehot?

Timberlake: Bagehot discussed the operations of the Bank of England, which was at the time a budding central bank but also a commercial bank. It was a sort of super commercial bank. He did not argue that the Bank of England should try to counter the actions of the gold standard. He was

analyzing the role of a commercial bank that was also the government's bank but constrained by the gold standard for which it was a shock absorber.

Bagehot said there were five principles to central bank credit intervention to allay a panic. The first two most often cited are that it lend freely at high interest rates. He also added that it should lend only on “paper” that financial markets recognized traditionally as good bills — assets that everybody knew were sound. The fourth principle was to preannounce this policy, and the fifth was to continue it boldly until the now-central bank was out of gold. The bank then would have done all that was possible, and the gold standard would take over.

EF: Did the Fed follow Bagehot's prescriptions during the 2007-2008 financial crisis?

Timberlake: No, not at all. The Fed was never a lender of last resort, and it wasn't this time either. The Fed should never point its finger at a particular sector and construct a policy that might help that sector, such as agriculture or employment, and say, “We're going to act until this particular problem is corrected.” That goes back to the fact that the Fed has no rights, responsibilities, or abilities to do anything at all about the real sector. It has to deal with the monetary sector alone and not try to extend itself into the real sector. But when it's called upon to counteract “bubbles,” it is being given a role that it cannot fulfill. If it tries, it ruins any price level stabilization policies it might have.

EF: What do you mean by “the Fed was never a lender of last resort”?

Timberlake: The Fed was created solely to be a lender of last resort under the law of the gold standard. It was supposed to be similar to the Bank of England.

Soon after the Federal Reserve Act was passed in 1913, the U.S. government was embroiled in World War I, and the Fed became a subsidiary of the Treasury Department. In fact, it was housed in the Treasury Building in Washington until about 1937. Wartime Treasury policies determined Fed policy for the next several years. For three years after the war ended, from 1918-1921, the Fed was still a lackey of the Treasury. It finally broke loose and squeezed out the bubbles that had developed, so that by 1922 it was back to where it was supposed to be. By the time that the gold standard might have been reintroduced in late 1929 or early 1930, Miller and the real-bills Fed Board upset the apple cart and promoted the disaster that was the Great Contraction and then the Great Depression. Then the Banking Act of 1935 gave the Fed complete control over the monetary system. Thus, the lender of last resort label never fit the reality of the Fed as an institution.

EF: Then does the financial system inherently require a lender of last resort at all?

Timberlake: No, I don't think it does. Private institutions will always furnish lender of last resort services if markets are free to operate and if there are no government policies in place that cause destabilization. In the last half of the 19th century, the private clearinghouse system was a lender of last resort that worked perfectly. Its activities demonstrated that private markets handle the lender of last resort function better than any government-sponsored institution.

EF: I want to ask about your experience at Chicago in the 1950s, because that was a period in which Chicago was really becoming the Chicago we think of it as today. Who were some of your key influences there?

Timberlake: My two mentors there were Earl J. Hamilton and Milton Friedman. Hamilton was an economic historian — an economist first, a historian second — and of course everyone knows who Milton Friedman was.

Milton Friedman was a triple star player in economics — runs batted in, total hits, and percentages, he had it all. He could communicate with the public, he was good at theory, and he was an excellent empiricist. What more can you be?

I recall the time when I presented a potential Ph.D. thesis proposal at Chicago to the economics department. The audience included professors and many able graduate students. I could feel that my presentation was not going over very well. After the ordeal was over, Friedman said to me, "Come back up to my office." When we were there, he said, "The committee and the department think that your thesis proposal has less than a 0.5 probability of acceptance." I knew that was coming, and I despondently replied that I had had a very frustrating time "finding a thesis." My words suggested that a thesis was a bauble that one found in a des-

ert of intellect that no one else had discovered. It was then that Milton Friedman turned me around and started me on the road to being an economist. "Dick," he said, "theses are formed, not found." It was the single most important event in my professional life. I finally could grasp what economic research was supposed to be.

Other excellent economists who were my teachers included Lloyd Mints, who specialized in monetary theory and policy. He retired in 1953. I found him a very inspirational teacher because he was right on the button. His most noteworthy work was *A History of Banking Theory*, in which the real bills doctrine was a centerpiece.

I had other very good professors there — Gregg Lewis, George Tolley, and of course Frank Knight. I remember some of the things he said, such as, "All civilization is capital," in answer to a question about capital values.

I never studied under George Stigler, but I knew him a bit, and I was always impressed with his work. *Production and Distribution Theories* is a great book. If you're just a beginning graduate student in economics and you read that book, you'll understand what economics is all about. He well deserved the Nobel Prize.

Incidentally, the fact that Anna Schwartz never got the Nobel is criminal. The Nobel Committee's disregard of her contributions says more about the committee than it does about her. She was an excellent economist. Very kind, too. I would put her as one of my teachers, even though I never had a formal course under her guidance.

I sometimes say that I was Milton Friedman's worst student, because I was surrounded by geniuses who knew much more economics than I. Nonetheless, I have enjoyed my professional role as an economist, and I have never regretted making it a life's work. **EF**

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