Over to you, H. Parker Willis
(GRANT'S Interest Rate Observer -9/17/10)

"What Should the Federal Reserve Do Next?" was the headline over the roundup of expert monetary opinion on the op-ed page of the Sept. 9 *Wall Street Journal*. The experts couldn't seem to agree. Buy Treasurys by the boatload, one counseled. Do nothing of the sort, urged another. Hew fast to the Taylor Rule, John B. Taylor, himself the author of the very rule, modestly proposed (i.e., fix the federal funds rate at one-and-a-half times the inflation rate plus one-half times the shortfall of GDP from potential, plus one). The half-dozen authorities shared not much common ground except to ignore the principles on which the dollar was defined in 1792 and those on which the Federal Reserve was enacted in 1913. The burden of this essay is that they thereby missed the point.

The trouble with living authorities on money and banking is the ideas they absorbed in school. For instance, that a central bank can calibrate the rate of debasement of the currency it prints by adjusting the speed of the digital press. Or that the Federal Open Market Committee can pick the interest rate that will cause the GDP to grow and payrolls to swell and prices to levitate by 2% per annum, give or take a basis point. Such things are impossible.

Say that the Fed built bridges rather than manipulated interest rates, and that, in 2008, its bridges fell down. The world would want to know why. Maybe we aren't engineers, the people would say, but we know a heap of rubble when we see it. And if an inquest determined that the Fed had built its bridges with plywood instead of reinforced concrete--a clever updating of the fusty old operations manual, some bright light on the board staff had determined--even a layman would see that "progress" is sometimes retrogression.

So it is in money and banking. With a little help from our friends, we are about to make the case that there has been no net progress in doctrine and policy since 1914, when the lights went out on the true-blue gold standard. Some will smile. The pure paper dollar, these scoffers say, is but a lighter, sleeker, more intelligent variant on the old, gold-backed model. But you could only issue so many gold-backed dollars, the supply being constrained by the scarcity of the collateral. There now being no check on the volume of issuance, dollars pile up in the vaults of America's creditors. It falls to them to say "uncle," and say it they will one day, we are certain. They will then be queueing up to exchange intrinsically worthless paper for tangible value. May the readers of *Grant's* beat them to the punch.

In the theory and practice of interest-rate manipulation, too, we have fallen off the shoulders of giants. Under classical doctrine, developed in

England and deemed best practice in this country into the administration of William Howard Taft, commercial banks existed not to "create credit" but to facilitate and liquefy the credit that two parties to a business transaction created when one said to the other, "I'll pay you in 30 days." There was an exquisite economy of motion in the old methods--no central authority deemed it necessary to buy up $1 trillion or so of public securities or to scoop up every available residential mortgage to stave off disaster in the housing market. Somehow, the economy functioned without econometricians.

Though the Fed's monetary and credit bridges collapsed two years ago, few have demanded a fundamental accounting of the ideas that undergird Chairman Bernanke's $2.2 trillion balance sheet and inform his interest-rate policy. Maybe it's as simple as the fact that the living authorities don't know, and the dead ones can't talk. Then, again, some of the ancients wrote books. Henry Parker Willis (1874-1937) is one such posthumous expert, and it's him we call on now.

Present at the monetary creation, Willis consulted for the authors of the Federal Reserve Act. He was first secretary of the Federal Reserve Board and right-hand man to Sen. Carter Glass of Virginia, the so-called father of the Fed and co-author of the Glass-Steagall Act of 1933. "The Theory and Practice of Central Banking," published in 1936 and long out of print, was his swan song. Possibly, he died of a broken heart.

The Fed--*his* Fed--had gone off the rails almost as soon as it opened its doors for business in 1914, Willis lamented. The central bank he envisioned was a kind of balance wheel in the engine of the American money market. The Reserve Banks would turn commercial IOUs into cash according to the demands of the season and the cycle, in that fashion making the currency elastic. Critically, the Fed itself would not create credit. It would, rather, liquefy the bills that a vendor would extend to his customer--the self-liquidating kind of commercial credit that allows the economic wheels to turn. In the founders' conception, the Fed would operate passively through the discount window, not actively through open-market operations. That is, it would accommodate the needs of the community, not determine what those needs should be. It would no more intervene to rescue the American residential real estate market than it would to steer the GDP or manipulate the rate of rise of the core Personal Consumption Expenditures index (as if anyone could reliably calculate it, which Willis doubted).

Alan Greenspan was 10 years old the year Willis published; Ben S. Bernanke was minus 17. Still, the lineaments of the modern command-and-control approach to monetary management were all too much in evidence. The Mark I gold standard had died in World War I, and with it had gone the classical English central banking technique of discounting commercial bills.

Discretionary open-market operations--buying and selling government securities in the open market--were the new, new thing. "Central banks. . . ," wrote Willis, wagging a finger at the young fellows, "will do wisely to lay aside their inexpert ventures in half-baked monetary theory, meretricious statistical measures of trade, and hasty grinding of the axes of speculative interests with their suggestion that by so doing they are achieving some sort of vague 'stabilization' that will, in the long run, be for the greater good." It may interest Willis's ghost to learn that, although "inflation targeting" became the darling of the monetary-policy intellectuals in the years leading up to the 2008 crisis, the "stability" it thereby seemed to achieve turned out to be singularly unstable.

To the *Journal*'s timely question, "What Should the Federal Reserve Do Next?" numerous economists have proposed myriad nostrums. Among the scariest of these brain waves was one proffered last week by the chief economist of Citigroup. Writing in the *Journal*'s European edition, Willem Buiter suggested that the Fed explore techniques to impose a federal funds rate of less than zero percent. "To restore monetary policy effectiveness in a lower interest rate environment when confronted with deflationary or contractionary shocks, it is necessary to get rid of the zlb [i.e., zero lower bound, meaning a zero-percent funds rate] completely," Buiter wrote. "This can be done in three ways: abolishing currency, taxing currency and ending the fixed exchange rate between currency and bank reserves with the Fed. All three are unorthodox. The third is unorthodox and innovative. All three are conceptually simple."

Still simpler is the old doctrine that the moderns have pushed aside or never learned in the first place, and to which if the Citigroup front office had adhered, might have spared the bank the indignity of a $4 stock price. Thus, commanded the ancients: Anchor the dollar to the precious metals, raise liquidity to the top of the list of banking virtues and understand the process by which commercial credit comes into the world (hint: not by bankers' pens). The first of these rules to live by was, to Willis and his contemporaries, as clear as the law itself. Under the Constitution, the 1792 Coinage Act and the 1900 Gold Standard Act, the dollar was defined as a weight of silver and gold. The verdict of monetary history resoundingly seconded the wisdom of the lawmakers: Paper currencies unbacked by anything except the issuing politicians' good intentions invariably lost their value. Regrettably, that was not the end of the discussion. The economists were busily chipping away at the semiautomatic workings of the pre-1914 gold standard. Better, they contended, a managed system of their own devising. Willis mocked the eggheads: "The 'new era' in central banking theory," he wrote, "may thus be said to have taken form as a view that it was possible for central banks to 'manage' the level of prices and, incidentally, the business situation by issuing more or less currency (or credit). . . ." Hopefully more than analytically, Willis predicted that these demonstrably false notions were on their way out. In fact, they were on their way in.

The idea of liquidity, too, had had a hard time of it in the 1920s. A liquid asset, as Willis and his peers defined it, was a short-dated commercial IOU--a money-good industrial purchase order, for example. Banks had no business owning any asset that did not, upon its maturity, generate a cash payment. Leave bonds, mortgages and other long-lived capital instruments to the savings banks and insurance companies, Willis preached. Commercial banks were put on this earth to facilitate the exchange of goods, not to "create" credit or finance speculation. But in the Harding and Coolidge years, a new theory came to the fore. Banks need not confine themselves to the gospel of so-called real bills, the theorists held. It was not strictly necessary that a banking asset be "liquid" (as defined). All would be well if an asset were "shiftable," i.e., salable in the continually functioning, deep and liquid capital markets of the day. Willis cringed at the heresy but had the sour pleasure of seeing it exploded in the Great Depression. Though bankers and economists had endlessly debated the matter, hard experience finally told the tale: "In this case, as in so many other economic disputes, however," Willis wrote, "the test is furnished not by the usual or 'normal' experience, but is afforded by the action or experience with regard to bank portfolios during special trial or difficulty. Particularly is such a test applied in times of panic followed by depreciation when the security markets suffer most from long-period fluctuations and when unemployment and business derangements give large scope to fluctuation in volume of trade."

Holders of frozen assets in the long, hard financial winter of 2008-09 will warm to the words that followed: "[D]uring the depression following the panic of 1929, banks have lost relatively little through the 'freezing' of their bona-fide commercial paper, while they have suffered heavily through inability to dispose of their long-term capital obligations or from deterioration of such obligations when sold at a sacrifice," Willis recorded. "In a word, recent experience is positively against the acceptance of the doctrine of shiftability in place of that of liquidity as a canon of banking soundness." Reading Willis, one is led to wonder how often the same lesson must be absorbed. Evidently, once a generation.

And, in a panic, what duty did a central bank owe to the institutions that chose shiftability over liquidity? "There is no more reason for violating the canons of conduct of central banking in a time of 'panic' than there is at any other time," Willis answered. "No central bank can, by the mere exercise of its credit-granting power, make something out of nothing, or save other banks from the disastrous consequences of their past policy. When a central bank does so it merely tends to make a bad matter worse."

The story of the evolution of American finance since the publication of "The Theory and Practice of Central Banking" has been the comprehensive rejection of every theory and practice Willis advocated. Commercial banks have seemed to apply themselves to the pursuit of illiquidity while the Federal Reserve has devoted itself to the black arts of central planning. As for the dollar, it is a claim on nothing except the competence of the public servants who somehow failed to anticipate--having so signally helped to cause--the greatest credit calamity of the past 70 years.

"What Should the Federal Reserve Do Next?" Less, we say. Withdraw from the business of macroeconomic management. Acknowledge the essential error of the doctrine of interest-rate manipulation. Confess to the obvious flaws in the paper-currency system. Renounce debasement under the pseudo-scientific name of "quantitative easing."

"What Should We the People Do Next?" is another question. Inflation usually proceeds by stealth--in the 1950s and 1960s, "creeping inflation" was the phrase. There is, however, nothing stealthy about Chairman Bernanke. He could not be more forthright. Inflation is his policy, and money printing, a.k.a. quantitative easing, is his method. Gold is one refuge from this design, though there is safe harbor in cheap stocks and undervalued real estate, too. As for bonds, they are promises to pay dollars, the definition of which the bondholder entrusts to the man who intends to cheapen them.

David A. Stockman, paid-up subscriber and former director of the Office of Management and Budget, points out that Willis's name does not even appear in the index of Bernanke's "Essays on the Great Depression." Monetarists like the late Milton Friedman brushed aside Willis's quaint (to them) attachment to the doctrine that credit has its origins not with a bank loan officer, but with the businesspeople who anticipate each other's cash in the process of production.

"The ironic point," Stockman observes, "is that H. Parker Willis and the English banking tradition did not believe in macro-management of the aggregate economy. They thought that the free market would take care of itself as long as trade bills were not artificially and precipitously liquidated in a money panic. Stated differently, they thought that the job of the central bank was to liquefy the commercial banking system, not to levitate the GDP. So in embracing the quantity theory of money, Mr. Capitalism and Freedom ["Capitalism and Freedom" was a Friedman best seller] laid the planking for central planning by the Fed. Yes, Friedman said that such macro-management of the aggregate economy should proceed not from discretionary tinkering by the Open Market Committee, but based on a fixed rule. As we can see, his wayward disciple, Professor Bernanke, has done just that. He is running the U.S. economy based on *his* rule."

United States House of Representatives
Committee on Financial Services

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