A PRIMER ON MONEY, BANKING, AND GOLD

Peter L. Bernstein

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What is here?
Gold, yellow, glittering, precious gold?
. . . This yellow slave
Will knit and break religions; bless th' accurst;
Make the hoar leprosy adored; place thieves,
And give them title, knee, and approbation
With Senators to the bench . . .

Timon of Athens, IV, 3

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FOREWORD

Ah, for those days before globalized markets, before thousands and thousands of hedge funds, huge banking conglomerates more interested in investment banking than holding loans and attracting deposits—a world without CDOs and SIVs, mysterious "conduits," and sub-prime mortgages!

That simpler world existed just a generation ago. Peter Bernstein's little *Primer on Money, Banking, and Gold* described it all with analytic insight and with his typically lucid prose.

The details of what he described in the late 1960s may seem arcane and mostly irrelevant to the new breed of financial engineers, to traders mesmerized by their Bloomberg screens, and even to some of today's central bankers. After all, who today patiently analyzes the weekly Federal Reserve statement for clues as to the direction of monetary policy? For that matter, that statement isn't carried any longer in the financial press. All the details have been lost about Federal Reserve "float" or "currency in circulation," matters about which I, as a neophyte Fed staffer, once considered myself to be one of the world's leading experts.

Today, the Federal Reserve authorities set out their current policy objective for all to see with some precision in a written statement after every meeting of its Open Market Committee: the interest rate for Federal funds shall be "x" percent until further notice. There is a brief commentary about the reasoning behind the decision, and more often than not, speeches and statements of the Committee Chairman and members. It's all open and transparent, with the stated objective of reducing uncertainty in the marketplace and enhancing policy effectiveness.

But does it really? Those of us of a certain vintage have some doubts. We may know the intentions with respect to the Fed funds rate objective with great precision, but divining the market and economic outlook and the future of policy remains as shrouded in uncertainty as ever. We can even wonder whether, by so precisely determining a simple controllable interest rate at a particular point in time, something has not been lost. In the simpler days of the 1980s and before, we thought there was something to be learned as the tenor and force of market flows had some influence on the day-to-day or week-to-week interbank interest rate.

One thing is certain. What Bernstein, writing at the end of the 1960s perceived as "our highly developed and sophisticated financial system" has become much more complex. Given the lack of transparency of the highly sophisticated instruments and market practices, characteristic of much of the new financial system, one is forced to question whether the underlying reality has been obscured. Traditional commercial banks with a unique function at the center of the financial system described in the book have morphed into a part—sometimes subsidiary part—of much more diversified and internally conflicted institutions. The definition of money itself—and of "liquidity"—has blurred, matters that Bernstein, with his usual insight, recognized as an emerging reality decades ago.

Even more clearly, he foresaw that the role of gold as the centerpiece of the international financial system would need to give way to less rigid arrangements. Indeed, it is clear that Bernstein's purpose in writing was, in large part, to "chip away at the golden foundations" of the monetary system. In fact, that foundation soon crumbled, less by chipping away than by being overwhelmed by a financial tsunami.

But amid all those specifics, what sticks out in a reading of Bernstein's *Primer* is what has not changed—and those are matters of fundamental importance. They remain, in fact, at the center of debates about monetary policy today. Beyond the book's relevance to those of historic bent, it is those matters that make rereading the *Primer* so timely.

Bernstein deals at some length with questions of whether inflation is a great threat to the American economy, whether once entrenched at a low level it will insidiously tend to accelerate, and whether monetary policy by itself is well equipped to deal with it.

Writing from the perspective of the 1960s, Bernstein's answers are pretty clear: no, no, and no again. He counts on the enormous productivity and resiliency of the American economy to cope with, and diffuse, exceptional inflationary pressures that might arise from time to time as a result of war or other events. "When all is said and done, the productivity of the American economy is the ultimate barrier to inflation in our country."

Bernstein goes on to suggest that post–World War II experience and cool analysis alike suggest that "a little inflation"—say 1½ percent a year—will not lead to anticipatory buying or destabilizing speculative behavior. And one senses what is most important in his mind is a balancing of risks for the maker of monetary policy: there is a clear danger that tight money in an attempt to deal with inflation might feed on itself, "encouraging precautionary demands for money" almost impossible to satisfy. The potentially "catastrophic" consequences for the economy will and should outweigh concerns about accelerating inflation.

Sound familiar? With only the slightest change in language (e.g., substitute "liquidity" for "money"), it might be an op-ed piece in today's press.

Would Bernstein have been quite so emphatic, quite so confident about experience, if he were writing just a decade later, say in 1979? As he had argued, gold was gone as part of the monetary system and as an ultimate (and unduly rigid) restraint on money growth and inflation. To a threatening extent, so was confidence in the dollar as a store of value and as the centerpiece of the financial system. Our capacity to restrain an inflation that had reached double digits and to maintain strong economic growth in the midst of speculative distortions was in question.

"Our level of economic understanding and sophistication of monetary management" that Bernstein judged as "so much more advanced" in 1968 no longer seemed to provide relatively painless answers in an environment of stagflation. Nor did we avoid a serious recession when monetary policy finally was called upon to deal with an inflation that had become embedded in expectations. But severe as that recession was, the reestablishment of reasonable price stability surely helped revive the base for much more satisfactory economic performance.

In the wake of that experience, central bankers around the world have reached what seems to me a reasonable conclusion. As a matter of priority, monetary policy must be actively concerned with maintaining inflation within the small and tolerable rate that Bernstein felt acceptable and practical. For more than two decades that resolution has not been strongly tested, and there has been a remarkably benign environment for growth and productivity.

Today, that priority is again being tested amid renewed financial strain, rapid increases in commodity prices, and instability in currency values. The outcome is not certain.

But I remain sure of one thing. Peter Bernstein, over a long life in the midst of changing markets, has brought to bear a rare combination of analytic vigor, clarity of writing, and a breadth of experience. All of that is immensely valuable for those of us involved in the unending quest for understanding the shifting roles of money and financial practices as we seek to reconcile growth and stability.

—Paul A. Volcker

January 7, 2008

NEW INTRODUCTION

This book had an accidental origin. In the space of about two months early in 1963, Bob Heilbroner and I wrote a brief but passionate polemic in favor of the proposed Kennedy tax cut to stimulate the economy. We called our book *A Primer on Government Spending*. When the time came to seek out a publisher, we decided to capitalize on the fame Heilbroner had achieved from his best-selling textbook, *The Worldly Philosophers*. We took our manuscript around to four publishers and baldly asked what they could do for us.

Bennett Cerf at Random House was the most enthusiastic of the four and also offered the highest advance. So we went with Random House and were delighted with the result. Cerf attracted attention to the primer immediately upon publication when he took a full page ad in the

New York Times to reproduce the letter he had sent to all members of Congress, urging them to read our primer. *A Primer on Government Spending* was an immediate success and ended up selling over 100,000 copies.

As the sales data rolled in, Heilbroner turned to me one day and said, "A popular primer in economics seems to be a powerful idea. Why don't you write one called *A Primer on Money, Banking, and Gold*?" I thought that was a great suggestion. I had worked at two small New York commercial banks from 1947 to 1951, as a lending officer, as manager of the bond portfolios, and, in one instance, as manager of the foreign department as well. From 1940 to 1942 I had been a member of the Research Department of the Federal Reserve Bank of New York. So I was enthusiastic about the prospect of setting this hands-on experience into the larger picture of how the banking system worked, how the Federal Reserve fitted in, what role gold played, the outlook for inflation, and my view of the future of money, banking, and gold in the U.S. economy.

Three years later, the original version of this book made its appearance and followed its predecessor as a success. At that point, Random House asked me to edit a full series of primers on economics, which meant setting the titles, finding the authors, and acting as editor of each volume. We ended up with an impressive list of topics, including, among others, primers on economic history, agriculture, labor and wages, business forecasting, competition and monopoly, and economic geography.

This revised edition of 1968 follows the same structure as the original edition of 1965, although I brought the empirical material up-to-date and added three chapters on postwar economic and monetary history. The first half of the book is largely explanatory. In language as simple and homely as possible, I describe how the commercial banking system operates—why and how banks lend and invest, where money comes from, how it moves from hand-to-hand, and what kinds of information interest rates convey.

We then turn to the Federal Reserve System, which controls the money-creation feature of commercial banking, and, through that function, influences interest rates as well. The book explores the consequences of these activities for the economy as a whole as well as the role of gold and the foreign exchange value of the dollar.

Many readers will be either amused or bemused by the need for an appendix on reading the Federal Reserve statement. No one pays any attention to these data today, as the Fed now focuses on short–term interest rates as the primary tool for carrying out its twin mission of controlling inflation and encouraging economic growth. In the 1960s, in contrast, the Fed executed the goals of monetary policy by focusing on the volume of commercial bank reserves—the cash balances held by member banks at the Federal Reserve Banks. Changes in the Fed's weekly financial position provided the only reliable information about Federal Reserve actions in the financial markets and reflected its intentions in terms of policy, to the extent one could make sense of what they were doing. In their verbal statements, the Federal Reserve authorities set a record of double-talk that makes today's authorities look like rank amateurs at the practice. Transparency was neither a goal nor even under consideration. The irresistible and highly competitive game of Fed-watching, therefore, developed into a weekly search for the footprints in the miasma of the statement. The readers of this book in the 1960s would have been shortchanged without this appendix.

The flavor of the book begins to change when we reach Part Four on gold and then proceed to a description of how everything described up to that point in generalities evolved in practice over the years from 1938 to 1966. The explanatory process continues, but now there are questions about what all of this might mean for the future of the U.S. monetary system, the dollar, inflation, and the stability of the economic system as a whole.

The concluding chapter, "Money and Gold in the Future," raises questions that are pertinent in our own time, especially relating to inflation. Some of the answers to those questions look quaint today, to put it mildly, in view of how events unfolded. But the errors are worth considering, because they reflect on the times, they reveal the heavy-handed influence of memory on the forecasting process, and they demonstrate the courage involved in breaking with patterns of the past.

During the late 1950s and the first half of the 1960s, people began to worry about inflation as they experienced a prosperity no one could have dreamed of in the early days after World War II, or surely during the 1930s. For many people, the inflation of World War II, with its associated price controls and rationing, remained a vivid memory. Its repetition under conditions of high prosperity seemed a logical development. I was not so sure about that. The great prosperity of the 1920s had been accompanied by a gently *falling* price level. Except for wartime, inflation in U.S. history all the way back to the early nineteenth century had never amounted to anything—until the late 1960s rolled around, just about the time the revised edition of the book was published.

From the business cycle peak of 1957 to 1965, the cost of living had risen at an annual rate of only 1.9 percent, not such a surprise as unemployment averaged 5.7 percent during those years. But beginning with 1966, in large part due to an expansion of 60 percent in government spending for the war in Vietnam, the unemployment rate began a steep decline, reaching 3.5 percent at the end of 1969—a level not seen since the Korean War in the early 1950s. The impact on the cost of living was significant, as inflation more than doubled to an annual average of 4.3 percent over this period, reaching 6 percent at the end of 1969.

In retrospect, I was much too calm about these developments. The final chapter makes that error clear enough. My memory bank played an unfortunate trick on me. Throughout history, people's memories seem to be more influenced by the disasters of an era than by any positive changes that may have occurred. As a child of the depression, I continued to worry much more about too little output and employment in the 1960s than I worried about too much prosperity and inflation. On page 211, I wrote, "[W]e have no basis for believing that stable prices are essential for economic growth and full employment, nor can we necessarily argue that, in the difficult business of matching demand to supply, we would do better to err on the side of too little demand than on the side of too much."

Who would even dare to write such a thing today? But I was far from alone. As late as October 1978, when inflation was roaring ahead in the U.S. economy and in many nations around the world, Congress passed the Humphey-Hawkins Full Employment Law, which explicitly specified that fighting inflation was not to take priority over the effort to reduce unemployment. In addition, James Tobin, the leading Keynesian Nobel Prize winner at the time, wrote in 1980 that, ". . . demand management cannot stabilize the [inflationary] price trend without chronic sacrifice of output and employment unless assisted, occasionally or permanently, by direct incomes policies of some kind."* Although Milton Friedman had

* Tobin, James, "Stabilization Policy Ten Years After," *Brookings Papers on Economic Activity*, no. 1, pp. 19–71.

uttered his famous dictum that "inflation is always and everywhere a monetary phenomenon" as far back as 1963, concerns about unemployment clearly remained dominant even after fifteen years of gathering evidence to support the validity of Friedman's dictum.

Making this point today does not let me off the hook for having ignored Friedman in this primer. His monumental study with Anna Schwarz, *A Monetary History of the United States, 1867–1960*, had appeared in 1963 (I did not even peek into that fabulous book until 1984), and it was here that Friedman had originally laid out his theory of the supply of money as the dominant economic variable in the system.* Even though I have vacillated over time in my view of this thesis, no one can diminish the impact Friedman's views—and his extraordinary scholarship—have had on economic policy and economic theory. Indeed, as I emphasize just below, control of the money supply was the primary motivation of Paul Volcker's herculean battle against inflation in the late 1970s and early 1980s.

Another interesting passage in this book appears on page 207, where I wrote, with the italics in the original, "*When all is said and done, the productivity of the American economy is the ultimate barrier to runaway inflation in our*

* See Milton Friedman and Anna Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton: National Bureau of Economic Research, 1963).

country." I would still stand by that observation, and the extraordinary decade of the 1990s demonstrated its validity. Today, however, I would have to add an important qualifier, namely, "as long as monetary policy does not finance an inflationary spiral at levels approximating full employment."

As Americans in 1969 were soon to learn, the Federal Reserve's weak-kneed response to political pressures from President Nixon led the Fed to do precisely what it should not have done right through the 1970s. Once the genie was out of the bottle, only newly-installed Fed Chairman Paul Volcker's blunt, painful, sustained, and courageous effort to bring the money supply under control during the turbulent years from August 1979 to August 1987 would manage to convince people inflation had to be licked and that no consideration for unemployment would be allowed to interfere with this overriding obligation. Volcker also broke away from long-standing traditions of purposely obfuscated Federal Reserve policy statements by making his intentions loud, clear, simple, and unqualified. He would bring the money supply under control, let short-term rates go where they would under the circumstances, and he would not let go until the job was done.

The alternative would have been a United States transformed into a banana republic. Talk about the influence of memories! That experience still hangs like a shadow over the Federal Reserve authorities and still influences every decision they make.

The ambivalent position taken on gold in the final pages of the book is also controversial in view of the history that followed publication of this primer in 1968 – Richard Nixon's decision in 1971 to abolish the convertibility of dollars into gold by foreign central banks.* The result was the revolutionary shift to a floating rather than a fixed foreign exchange rate for the dollar, an arrangement that persists to this day and is common among most major currencies. At the same time, a free market for gold developed among private investors, banks, and corporations. The price in this market hung around $40 an ounce for a while but then, as the inflation of the 1970s developed, gold took off on a huge bull move that topped out over $800 an ounce in 1981. In 1995, I wrote a book attacking the passion for gold over the ages with all the passion I could muster, a far more decisive view than I took here.†

But the big change in monetary policy since I wrote this book is only in part the emphasis on inflation as opposed to unemployment. Instead of focusing on what has transpired in the past, policymakers have elevated expectations of the future as the core element in the execution of policy. It is worth noting that the word "expectations" is conspicuous

* I confess to having predicted on page 213 of this primer that, "the practical and political difficulties in the way of abandoning gold seem insurmountable."

† *The Power of Gold: The History of an Obsession* (New York: John Wiley & Sons, 1998).