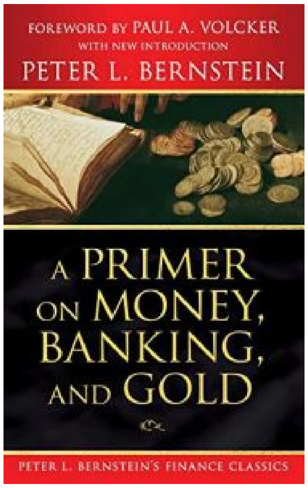

Book A Primer on Money, Banking, and Gold

Peter L. Bernstein
Wiley, 2008
First Edition:1964
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Recommendation

Peter L. Bernstein's classic, originally published in the mid-1960s, provides a learned, generally accessible explanation of the workings of the American monetary system. Of course, some of the information is quite out-of-date, but you'll understand that as you read. For example, the author speaks extensively about the importance of gold in international finance – yet gold has not really mattered since 1971. Moreover, the book came out before history taught the lessons of the 1970s, 1980s and 1990s, not to mention the financial crisis that began in 2008. Former Fed Chair Paul Volcker's foreword and Bernstein's new introduction acknowledge these time lags. The last quarter of the 20th century saw a very extensive reshaping of the financial system, including the creation of new financial entities and even new forms of money, so this primer is less useful and informative than it may have been when new. Nonetheless, *BooksInShort* finds that Bernstein's explanation of the fundamental workings of the Federal Reserve and of the role of commercial banks in the monetary system remains lucid and well worth reading.

Take-Aways

- Currency accounts for only a very small fraction of the money supply.
- Banks create money by making entries on their books.
- The U.S. Federal Reserve can influence the money supply by buying or selling securities, changing interest rates or changing reserve requirements.
- Although banks and the Fed have the power to influence the money supply, it depends on individual, business and government decisions to spend or to save.
- Gold flows had an important impact on the money supply and the business cycle.
- The U.S. government created new money to finance World War II, and avoided inflation by implementing rationing and controlling prices.
- The 1966 crisis made clear that expectations matter more than the authorities had recognized.
- It showed that overreliance on monetary policy is risky and that the public is astute about money and quick to take advantage of opportunities.
- Inflation has not historically been a problem in the U.S. because of its productivity.
- Neither gold nor money has intrinsic value – their value depends on their purchasing power.

Summary

Why Money Matters

Money means that you do not have to negotiate a barter exchange whenever you want to make a purchase. Money was a fixture of even very rudimentary societies. However, in today's complex society, money is no longer a matter of feathers, beads or even coins, but of accounting entries by bankers. Money is abstract. Oddly, there is also something abstract or symbolic about gold. Even though gold is physical, hard to find and impressive to look at, it has no intrinsic or inherent value. People decide upon its monetary value, as they decide upon the value of money. In some cases, those people make incorrect value decisions. They may allow money supply reserves and prices to fall so much that producing goods seems pointless. Alternatively, they may let the money supply expand so rapidly that it drives up prices, leaving the financially conservative and the poor in the lurch.

Paying for What We Buy

People work for money to buy things. Take a family that lives on $60,000 a year. If inflation occurs, they may need $66,000 to keep living the same way. The income earner may be able to press for a raise or draw down savings, or may find that he or she cannot get the extra $6000 and has to cut expenses. When enough people cut expenses, manufacturers stop making products and cut their payrolls. Thus, the money supply affects the real economy. Regulators are supposed to make sure that enough money is in circulation to match production. Too little money, prices fall; too much, prices inflate. So, who determines how much money people really need? Ordinary folks do – as they choose what to spend or save, and whether to spend money as soon as they get it, or put it aside for another day.

Everything Has a Price – Even Money

Most people keep some money in no-interest checking accounts to cover day-to-day cash requirements. However, if they have more money than they need right away, they can lend it to earn interest, for example, by opening savings accounts or buying bonds. How much they keep in cash or lend depends on the price, that is, the interest rate. It must be attractive enough to compensate for the inconvenience and risk of lending. People's demand for cash, or liquidity, has caused economic crises. In the Great Depression, people were not willing to lend because the risk of never being repaid was too high.

What Banks Actually Do

Most cash is not in the form of physical coins and notes. It is in the form of entries on banks' books indicating how much money is in which accounts. The government does not actually create money – banks do. Even the government depends on bank accounts. Banks take money from depositors and lend it to borrowers. Their profit is the difference between the interest they pay depositors and the interest they charge borrowers. Good bankers need a fairly clear idea of their institutions' rates of deposits and withdrawals. A bank that does not have enough cash to satisfy people who want to withdraw money fails. So banks keep cash reserves on hand. They also invest money in interest-bearing securities that are highly liquid – that is, the bank can convert them into cash quickly if needed. Banks lend or invest the rest. The banker's job is to strike the optimum balance among the amount of noninterest earning cash, the amount invested at relatively low rates in very liquid securities and the amount lent for longer terms at more profitable interest rates.

> "The objective of the entire game played by the Federal Reserve has nothing to do with the level of bank reserves."

Banks create money simply by making entries on their books indicating that a person or company has money. When you get a loan from a bank, you have money that you didn't have previously. The bank created that money by giving you a loan, but it didn't take the money from someone else. Your account increases, but no one's account decreases. The banks extend more money in loans than they receive in deposits. They actually have to maintain only a small percentage of their deposits in reserves to cover demand from people who want to withdraw money from their accounts. Every deposit connected with your loan lets the banks create more money by making more loans. The creation of money is an accidental, but very powerful, side effect of their lending activity. For any single bank to lend money, depositors have to put some money in accounts there. However, the banking system – the aggregate of all commercial banks – does not need to have more money deposited in it before it can create money. The circulation of loans and deposits among banks within the system creates money.

What Is the Federal Reserve?

Congress established the Federal Reserve System, a distinctively American institution, in 1913 to prevent a repeat of the 1907 banking crisis. The U.S. has 12 Federal Reserve Districts, each with a Federal Reserve Bank. Each bank has a Board of Directors composed of bankers and nonbankers, some elected and some appointed. The president appoints the seven members of the Fed's overall Board of Governors, who serve 14 years. Fewer than half of U.S. banks are members of the Federal Reserve, but they hold most of the country's deposits. The Fed regulates the money supply by influencing member banks' lending. The member banks have accounts at and borrow from Federal Reserve Banks, which are, in essence, banks for banks. They also act as the bankers for the U.S. Treasury. The Fed has three ways to control the money supply:

1. **Buying or selling securities** – This increases or decreases liquidity in the banking system, and increases or decreases bank reserves. The Fed's buying or selling of securities is called its "open-market operations."
2. **Lending to banks** – The Fed lends only to Federal Reserve System members and it uses an interest rate called the "discount rate." A low discount rate encourages banks to borrow. Since banks are in business to lend, they prefer to lend more and increase the money supply. To cut the money supply, the Fed raises the discount rate.
3. **Reserve requirements** – The Fed can require banks to carry a stipulated level of reserves, and it can raise or lower that level. It does not change reserve requirements often, because such changes affect banks across the board, no matter what their reserve positions may be. Yet, the more a bank has to carry in reserves, the less it can lend; and the less it has to carry in reserves, the more it can lend. Because lending creates money, changes in reserve requirements change the money supply.

Domestic and Foreign Gold

For much of the 20th century, legislation tied the U.S. money supply to gold held in Fort Knox. When the government bought gold, it could create more money. Conversely, when gold flowed out of the U.S. to foreign countries, the money supply had to fall. The U.S. eventually stopped tying its money supply to gold because gold outflows became too great. What would have happened in the mid-1960s if foreign governments had lost confidence in the U.S. and demanded gold for their dollars? The U.S. had a positive trade balance, but it had a balance of payments deficit, and foreign banks held large dollar accounts. Some risk existed that those banks might have wanted to convert their dollars into gold, requiring more than the U.S. had, and triggering "a run on...gold." In such an instance, the U.S. might have had to halt the conversion of dollars into gold. Even if chaos had followed such a decision, the markets probably would have soon adjusted the dollar's value to a level fairly close to its exchange rate at the time.

Cash and Currency

Sometimes people withdraw money and, instead of redepositing it, they keep it in cash. During World War II, such withdrawals totaled $18 billion. When people stop trusting banks, as they did during the Great Depression, they may try to withdraw so much money that the banks do not have enough reserves to cover withdrawals. The system must hold enough currency to cover the public's demand for cash. The Fed helps to ensure the availability of cash by lending at its "discount window." Where does the cash come from? A printing press at the U.S. Mint. With a "floating" foreign exchange rate unanchored to gold since 1971, nothing "backs" the Fed's paper money except public confidence.

The Economy: 1938 to 1945

Prior to WWII, Europeans seeking a safe haven fled to the dollar and gold flowed into Fort Knox. Commercial bank reserves doubled from 1937 to 1940. However, interest rates were low and good borrowers were scarce, so banks did not lend proportionately to the increase in their reserves. Monetary policy did not spur spending. The U.S. had idle capacity and a mountain of gold, so it could finance and conduct WWII. Drafting of soldiers did not come at the industry's expense, and the nation did not have to pay the war's entire cost by raising taxes. The Treasury borrowed roughly $210 billion, $70 billion of it from commercial banks. That is, the banks created new money. Despite a fivefold expansion in government debt, interest rates remained low. The government addressed the risk of inflation by rationing and controlling prices.

The Economy: 1945 to 1963

After 1945, the government ended price controls and rationing. Pent-up demand drove consumer prices up 33% and wholesale prices up 51%. Investors wanted better returns than government securities offered. The Fed bought government securities from banks that were trying to sell them, but its ability to act was limited. The Fed could not commit to buy at fixed prices whatever open-ended volume of securities its member banks wanted to sell. The 1951 Treasury-Federal Reserve "Accord" relieved the Fed of this obligation.

> "These are only tools to execute policy changes that will shape expectations as to the future of inflation and production."

After that, the market would determine prices. In the late 1950s, the Fed restricted the money supply by reducing open-market operations and requiring member banks to borrow at its discount window if they chose to increase reserves. It became difficult for businesses to borrow from member banks, and interest rates rose. In 1961, the Fed increased the ceiling rate that banks could pay on interest-bearing accounts. The public reduced its holdings in checking accounts, and increased savings and time deposits. Banks had to hold only 4 cents on the dollar in reserves against these accounts. In comparison: regulators demanded that they reserve 20 cents on the dollar against demand deposits (checking accounts).

The Extraordinary Events of 1966

In 1966, the U. S. entered a monetary crisis. The country had nearly full employment, and manufacturers were running at 90% of capacity. National spending on the Vietnam War was going up. Regulations limited the interest rates the government could pay on longer-term bonds, so it borrowed short-term funds, driving up short-term rates. Meanwhile, in a "subterfuge," the government tried to raise money by selling securities in the Federal National Mortgage Association and the Export-Import Bank. Because these assets were unfamiliar, investors demanded higher rates of interest. Corporate borrowing boomed under expansionary Fed policy. Then, suddenly, in April 1966, the Fed signaled that it would restrict the money supply. Businesses and individuals rushed to borrow, but the banks limited credit. Interest rates flew upward. Depositors pulled money out of banks to invest at the higher interest rates. Three steps help defuse this crisis:

- The government changed its borrowing policy, stepping away from the subterfuge of selling Federal agency assets, thereby taking pressure off interest rates.
- The president proposed a tax increase so the U.S. did not need to borrow as much.
- The Federal Reserve signaled an easing in its restriction of the money supply.

> "Recognize with the poet Robert Burns, how 'the best-laid plans of man and beast gang oft agley' by an impending future of which we had no sense at the moment we articulated that logic."

The crisis taught policymakers that money demand depends as much on expectations as on current requirements for money. It also taught them to balance monetary policy with fiscal policy, and to recognize that the public is quite astute and responsive to investment opportunities that offer a better risk-return trade-off than traditional bank intermediaries.

> "On that point, I rest my defense of the positions taken in this book over 40 years ago."

Inflation has not historically been a problem in the U.S. because of its productivity. Mild inflation is no great risk. The country does not need to anchor the dollar to gold to defend it on the international stage. In fact, gold puts an arbitrary, inflexible limit on economic activity. Thus, the U.S. "should continue to chip away at the Golden foundations on which our domestic and international financial relationships have been built."

About the Author

Peter L. Bernstein is founder and president of Peter L. Bernstein, Inc., established in 1973 as publishers of *Economics & Portfolio Strategy* and as consultants to institutional investors around the world. He also is the author of 10 books.