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Gold Is Not a 'Side Show'

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Lenin once observed that gold should adorn the floors of latrines. Keynes labeled it a "barbarous relic," and Milton Friedman has recently been saying that for a monetary standard you may as well use pork bellies.

When President Nixon demonetized gold in 1971, Henry Reuss, chairman of the House Banking and Currency Committee, predicted that the price of gold would fall to $6 per ounce. It is true that gold remained below $40 until 1972. But it rose to $200 in 1974 as inflation engulfed the final months of the Nixon administration. After monetary policy was abruptly tightened in 1974, gold gradually declined to a low of $106 in 1976.

President Carter inaugurated his administration in 1977 with the rhetoric of austerity—pledging, among other things, to balance the federal budget. The price of gold promptly rose over $150. Mr. Carter replaced Arthur Burns with William Miller as Chairman of the Federal Reserve Board. By the autumn of 1978 the dollar was collapsing and gold was approaching $250. Then, on November 1, 1978, new policies to control the money supply and defend the dollar were announced by Chairman Miller. Gold fell to $200 within 30 days. But by the middle of 1979, gold was once again rapidly rising to $300.

In July 1979, amid much fanfare, Paul Volcker was summoned to replace Mr. Miller. Gold vaulted to $450 in September. In a crisis atmosphere, Mr. Volcker returned from the International Monetary Fund meeting at Belgrade to announce his new monetary guidelines on Oct. 6, 1979. They stressed a new method of targeting on bank reserves, and focused on the goals of a stable dollar, a slower rate of money and credit growth and an end to excessive commodity speculation in general and gold speculation in particular. Over the next few weeks, the gold price fell to $372.

Going Its Own Way

Three months later, as the gold price soared over $800, Mr. Volcker observed that gold was going its own way and that its movements had little to do with the success or failure of his Oct. 6 monetary policies. Treasury Secretary Miller allowed that the Treasury would sell no more gold during these "uncertain and uncharacteristic times," evidently meaning that gold is a good sale at prices ranging from $35 to $200 but a strong hold at $800. Fed Governor Wallich said the gold markets were no more than "a side show."

Yet on February 5, 1980, commodity future prices, following the earlier gold lead, closed at a record high, up 26% from a year earlier on the Commodity Research Bureau futures index. The market for U.S. government securities has suffered a devastating collapse. Gold closed around $665 on Feb. 15, more than 20% below the early January peak but 83% above its bottom of October 1979. It has since risen back above $700.

What caused the exponential rise and violent fluctuations of the gold price? The surging gold price, commodity prices and interest rates suggest that the so-called anti-inflationary money policy proclaimed by Paul Volcker on Oct. 6 has intensified rather than quelled speculation. The contradiction between Mr. Volcker's goals and the results achieved requires explanation.

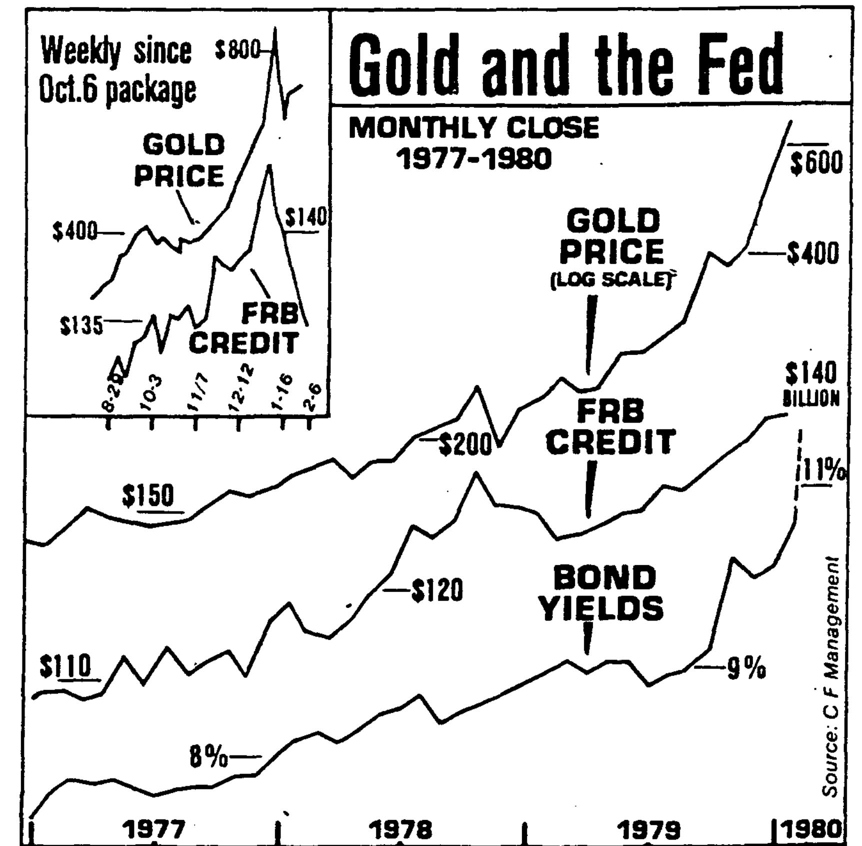
An explanation for the Volcker contradiction—and for that matter the earlier monetary problems of Arthur Burns in 1972-74 and the failure of Mr. Miller in 1978 and 1979—has to start with a determination of what policy the Fed has *actually* pursued, as opposed to its announced goals. The economists have focused our attention on monetary aggregates such as M-1. Laying aside the problem of how to define these numbers—the Fed switched definitions only last week—the fact remains that the Fed does not actually control M-1, however measured. The money stock depends partly on Fed policy and partly on events elsewhere in the economy. Consumers and producers in the market largely determine the demand for money, while the Fed influences its supply.

For any real understanding, we must remember that the Federal Reserve is above all a bank, though a bank with the monopoly powers to issue legal tender currency and to regulate the banking system. It is not a magical government agency, nor should it be confused with the Yale Economics Department or a classroom at the University of Chicago. To study the policies of a bank, you study its balance sheet, to see what its officers are actually doing. The only things its managers control, within limits, are the volume and composition of its assets and liabilities. The Fed's balance sheet will show the amount of credit it is extending to the commercial banking system.

The Fed's credit operations are revealed in the balance sheet item called Total Federal Reserve Bank Credit. FRB credit is the Fed's financial assets—the amount of government securities, acceptances, advances, float and so on. Changes in FRB credit reflect the net operations of the Fed's open-market desk, foreign-exchange desk and discount window—the various ways the Fed influences the expansion and contraction of credit in the economy.

To achieve its announced Oct. 6 goal of restraining the growth of credit, the Fed would have to restrain the growth of FRB credit. But as the accompanying chart shows, total FRB credit growth *accelerated* between Oct. 6 and year-end. And *so did the price of gold.*

Let us go back to 1977 and look at recent history. Both FRB credit and the gold price were relatively calm in 1977, but in the second half of 1977 FRB credit rose toward $120 billion and gold toward $175. As expected FRB credit peaked seasonally at



The price of gold in dollars, total federal reserve bank credit in billions, and the yield on long-term U.S. Treasury Bonds.

year-end; the gold price topped out two months later. By October of 1978, FRB credit had expanded above $130 billion, while the gold price rushed to $250.

FRB credit peaked after the Miller monetary changes of Nov. 1, 1978, and so did the price of gold. FRB credit declined and stabilized through the winter of 1978-1979, and so did the price of gold, which remained below $250 through the winter.

Beginning in April of 1979, total FRB credit advanced rapidly from $125 billion, reaching $143.5 billion during the week ending January 2, 1980. During this period FRB credit did stabilize for six weeks, starting with the week of Oct. 3, reflecting the Volcker Oct. 6 moves. But it started to rise again by Nov. 14, about the time of the Iranian deposit freeze. From Nov. 14 to Jan. 2, total FRB credit startled most Fed watchers by rising from $135 billion to nearly $144 billion.

In parallel, the gold price took off from $250 in the spring of 1979, and topped out at $450 with the Oct. 6 Volcker moves. Promptly the gold price declined to under $450 and steadied along with FRB credit, which remained steady in October and early November. Gold then vaulted to $850 on Jan. 15, peaking just two weeks after FRB credit. FRB credit declined from its high of $143.5 billion on Jan. 2 to $134.5 billion during the week ending Feb. 6. By Feb. 15, the gold price fell to $665.

The lagged correlation between the rise and fall of FRB credit and the rise and fall of gold is not perfect, but there is a compelling association between the two. Indeed, even taking into account seasonality, almost every reacceleration of FRB credit between January 1977 and January 1980 tends to be accompanied, after a varying but short lag, with an acceleration in price of gold.

The relationship is logarithmic; a rise in FRB credit causes an exponential rise in the gold price. This relationship reflects the impact of expectations, well known to classical economists. Market participants are increasingly sensitive to information that suggests the Fed is expanding credit rather than, as the Fed chairman says, contracting or stabilizing credit. In response to each new injection of Fed credit, individuals and businesses move ever more decisively to protect themselves against inflation.

It is essential to point out that the price of gold seems to respond directly to the monetary policies *actually pursued* by real people at the Federal Reserve open market desk. But the gold market does ignore what the Chairman says or others think the Fed will do. In a word the rise of the price of gold is just one more reflection of excessive credit growth, as shown by the Fed's own balance sheet. If war-scares, oil-price hikes and Iranian asset freezes did not exist but the same expansionary credit policies prevailed, Fed apologists would find other plausible political events with which to rationalize the advance in the price of gold.

The Fed managers do not deceive us intentionally. Instead they deceive themselves. They believe they can achieve what is not within their power to achieve—namely, a certain quantity of money. Thus they create uncertainty and disorder in the financial markets.

The Fundamental Problem

The fundamental problem of Federal Reserve monetary policy can be stated quite simply. Because the quantity of money cannot be controlled effectively by the Fed, the goal of the Fed's monetary policy must *not* be to control it. The Fed simply cannot determine *precisely* either the demand for money in the market or its supply. Nor does the Fed possess the information, the operating techniques or the perfect foresight to bring about a certain rate of growth of money and credit, especially through its chosen technique, open market operations. As history shows, open-market operations succeed only in destabilizing interest rates and the money markets.

It is not the gold price which is unstable. On the contrary, it is the Fed's volatile monetary policies which are unstable. Steady monetary policies would produce different effects. It follows that the price level, like the gold price, can be brought down. The government bond market can be stabilized. But the monetary authorities must actually pursue the stabilizing policy which they proclaim—for more than a few weeks.

Ultimately, achieving the goal of price stability will require comprehensive reform of the monetary system. But for now, in their efforts to sustain a managed currency, Fed policymakers often misunderstand market data and the effects of their own hyperinterventionist open-market operations. They even have difficulty insuring that announced policies of the Fed governors are actually implemented by the staff at the open-market desk. Still, in the absence of comprehensive reform, it would help if the men at the Fed and Treasury stopped belittling the importance of the gold price. Their policies since Oct. 6 would have been better if they had recognized that it is no "side show," but a highly sensitive scoreboard for the main event.

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