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HIGH & LOW FINANCE

Bernanke: Greenback's New Father

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Six months after the financial world seemed to be coming to an end, the world's economies appear to be recovering. Banks that seemed to be on the brink of failure less than a year ago are now able to pay back investments made by the Treasury.

It is too early to declare victory, but the world looks much safer than it did only a few months ago. Credit markets are recovering, to the point that the junk bond market will have its best year ever if it manages not to lose any money over the rest of 2009. The stock market has just finished its best six months since 1938.

If victory is to be had, it will owe a lot to the willingness of American policy makers to set aside cherished policies and simply create money. And that is one reason it is appropriate to pause and celebrate an unheralded bicentennial: The father of the greenback, Elbridge Gerry Spaulding, who was born 200 years ago, in 1809.

Spaulding was that rarest of creatures, a man who succeeded in both business and politics; a congressman who saw a problem coming and had a solution ready. It was he who, at the end of 1861, figured out that the American government simply needed to print money to pay for the Civil War. It was economic heresy then, but without it this country might not have survived.

Such an idea was then dismissed by some as "fiat money," money that is money not because it is backed by gold or silver, but because some government says it is money.

That such currencies can fail to work is obvious, as those who lived in Weimar Germany or present-day Zimbabwe have found out. But notwithstanding those examples, the last 20 years deserve to be remembered as the age of fiat money. For much of that time, central bankers were revered as heroes for engineering long booms and short, shallow recessions.

Ben S. Bernanke, the current chairman of the Federal Reserve, sometimes does not seem to understand that this reputation has taken a hit. After he warned that "a perceived loss of monetary-policy independence" could lead to "reduced economic and financial stability," he drew a taunting comment from Dean Baker, an economist with the Center for Economic Policy and Research in Washington.

"Maybe Mr. Bernanke missed it," wrote Mr. Baker, "but his independent Fed gave us the largest financial and economic crisis since the Great Depression. Does anyone really think that things would have been worse if the Fed had been more accountable?"

Mr. Bernanke did not miss it, of course. He may have been slow to realize how critical the situation was, but when he did, he acted decisively. Like Spaulding almost 150 years ago, he showed a willingness to abandon the wisdom of an earlier time. The government lent money it did not have to financial institutions, and bought stock in them.

The Federal Reserve expanded its balance sheet to an unprecedented extent, and seemed to be guaranteeing almost everything in sight. Given how closely the Fed worked with the Bush and Obama administrations, it may not have reinforced its reputation for independence, but it was certainly a pioneer in innovation.

Today Spaulding is largely forgotten. Civil war generals are remembered with monuments and even colleges; Spaulding has a dormitory named for him at the University of Buffalo.

But some deem him a hero. “If Wall Street had saints, then the college of financial cardinals would surely canonize Elbridge G. Spaulding,” wrote T. J. Stiles in his insightful new biography of Cornelius Vanderbilt, “The First Tycoon.”

Spaulding, wrote Mr. Stiles, “performed a true miracle: he conjured money out of nothing, and so contributed more toward the Union victory (and the future of New York’s financial sector) than any single battlefield victory.”

How did he do that? A congressman from Buffalo, and a banker before and after he was a politician, he was chairman of a House Ways and Means subcommittee when the government was in danger of running out of money to pay for the Civil War. He wrote a law that allowed the government to print money and declare it had to be accepted as legal tender.

Until then, the only circulating paper money was notes issued by banks. Those notes were supposed to be convertible into gold, although the banks had been forced to suspend such conversions at the end of 1861. There was no central bank.

To opponents, Spaulding’s plan was simply immoral. “It will infinitely damage the national credit,” warned Representative Justin S. Morrill of Vermont, adding that it was “a breach of the public faith” that would lead to rampant inflation.

“This fair fabric of our untarnished faith and unbounded wealth and credit ought not to be destroyed,” added Representative Valentine B. Horton of Ohio. “It will,” forecast Representative Roscoe Conkling of New York, “proclaim throughout the country a saturnalia of fraud, a carnival for rogues.”

The bill passed Congress not because anyone thought it was good policy absent a crisis, but because most thought it was necessary. Something very similar can be said about the government’s multiple bailouts during this crisis.

In the end, Spaulding was proved right. “It was at once a loan to the government without interest and a national currency, which was so much needed for disbursement in small sums during the pressing exigencies of the war,” he wrote years later in his book, “History of the Legal Tender Paper Money.”

He even created a floating currency. Gold dollars still existed, and were the only dollars that could be used for international trade. When the war appeared to be going badly for the North, the value of the greenback sank. Someone with first knowledge of a Union victory could gain a quick profit by selling gold for greenbacks.

Contrary to the expectations of Representative Morrill, paper money did not set off sharp inflation over time, and when the paper money eventually was made convertible into gold, there were no lines of people wanting to trade in paper for bullion.

Mr. Bernanke's eventual reputation is likely to be determined by how well he succeeds in his vow to right the economy without prompting a major devaluation of the dollar.

Some doubt he can do it. "The Fed, which saw none of this coming, now asks us to believe that it will see clearly enough into the future to remove this massive monetary stimulus before it becomes harmful," said James Grant, the editor of Grant's Interest Rate Observer.

If Mr. Bernanke does manage to accomplish that, he, like Elbridge Spaulding, will have earned financial canonization.