The Gold Standard: Scapegoat for the Great Depression

by Richard M. Salsman

A critique of *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939*

PREVAILING ECONOMIC FOLKLORE portrays the Great Depression as a failure of free markets, and especially of their foremost feature, the gold standard. Keynesians and monetarists alike share a revulsion for gold money and insist it played a key role in triggering and deepening the depression. Going further, Keynesians declare gold a "barbarous relic" that impedes economic growth. Monetarists belittle gold as being no different from other commodities, but too costly to serve as money. Both fully defend central banking and fiat paper money, insisting that governments can manage our affairs best when free of the golden albatross.

If the folklore about its connection to the Great Depression were true, we should never again have gold money, for it would only wreak havoc once more. But it is a myth that should be substituted with fact. Gold money is an integral part of a capitalist economy. The Great Depression was instigated by a *contravention* of sound money, by governments working actively to undermine the gold standard. Yet a recent book by Berkeley professor Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York: Oxford University Press, 1992) extends the folklore in a sophisticated form. The book combines weighty documentation with dubious interpretations; in clinging to the standard folklore, its case is unsubstantiated and contradictory. Unfortunately, the book has been praised highly by other economists and may well become a standard reference for many years. Unless this particular interpretation of gold money is challenged, the world will remain shackled to today's arbitrary systems of government paper money.

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The theme of *Golden Fetters* is that the gold standard shackled the international monetary system to an arbitrary commodity, thereby undermining financial and economic stability. As Eichengreen puts it, "the gold standard is conventionally portrayed as synonymous with financial stability," but "a central message of this book is that precisely the opposite was true. Far from being synonymous with stability, the gold standard itself was the principal threat to financial stability and economic prosperity between the wars." [4. (Numbers in brackets refer to page numbers in *Golden Fetters*.)] Eichengreen argues that gold money is an impediment to economic growth, that the supply of gold cannot keep pace with growth. A gold-based monetary system is therefore prone to price deflation and ultimately—since wages do not fall with prices—unemployment. As employment declines, so does economic output; depression results. Unless gold is abandoned in favor of government-managed fiat paper money, economic prosperity is not achievable.

Precisely how does Eichengreen argue that the gold standard caused such damage? He recounts how countries had suspended gold convertibility of their paper monies in World War I. The resulting inflation was followed by severe recession. After the war, support grew for a return to the stability of the pre-war, gold standard era. Eichengreen blames this return to gold for subsequent economic problems.

The key event, Eichengreen says, was Britain's return to gold in 1925 at the exchange rate prevailing prior to World War I, before a five-fold expansion of pound notes. With a growth in notes unrelated to a corresponding increase in the gold backing them, the number of claims on gold would exceed the supply of gold available to meet them at the old rate. To sustain gold convertibility at this artificially high exchange rate without gold losses required a painful deflation of pound notes and prices. In order to help the Bank of England return to gold and prevent its gold stock from flowing abroad, the Federal Reserve pushed down U.S. interest rates, making British rates relatively higher and encouraging Americans to hold claims to gold in pounds instead of dollars. Though the increase in foreign demand for pounds was to have offset the inflationary increase in the supply of notes, Britain ultimately suffered a contraction despite the Fed's actions. Meanwhile, lower interest rates had stoked a speculative boom in America. By 1929 the Fed's policy was reversed and rates were raised. Eventually, the U.S. contracted.

Eichengreen blames these gyrations on the gold standard. Thus, "the depression was not simply a misfortune arising in 1929 for reasons unrelated to the gold standard's operation. The prior operation of the gold standard had played a central role in the coming of the depression." [392]

According to Eichengreen, there was not enough gold in the world on which to reconstruct the post-war monetary system. The 1930s contraction was the result of "inadequate liquidity resulting from slavish adherence to the gold standard." [11] He attributes "inadequate liquidity" to gold shortages and gold "famines" plaguing the world in the 1930s. "The world supply of monetary gold is fixed at a moment in time," he asserts. Central banks had to engage in "desperate efforts to acquire gold from one another. . . . For the group as a whole, there was only so much gold to go around." [291] In the U.S. particularly, "to defend the gold standard, the Fed refrained from engaging in expansionary open market operations . . . [so] the American money supply spiraled downward." [289] In short, Eichengreen believes the gold standard caused the Great Depression by depriving the economy of much-needed fuel and shackling central banks.

The gold standard also prolonged the contraction, Eichengreen argues, because it limited the powers of government to respond to the Great Depression by printing money. "The dilemma was whether to sacrifice the gold standard in order to reflate, an option most policymakers continued to oppose, or to forswear all measures that might stabilize the economy in order to defend the gold standard." [16–17] Officials had insufficient power to contain bank runs by injecting liquidity into the banking system, he contends. [18–19] Policymakers could not avoid disaster because they clung to ancient notions favoring gold-based money.

Eichengreen further contends that only defaults on the gold standard made economic recovery possible. "Currency depreciation was the key to economic growth" because "it stimulated economic recovery. . . . Output, employment, investment and exports rose more quickly than in countries that clung to gold." [21–22] In 1933, he argues, "the U.S. devaluation ignited a successful economic recovery." [384] Yet the gold standard was abandoned first by Britain in 1931 and the book's title, *Golden Fetters*, echoes the words of Keynes, who wrote at the time:

> The great advantages to British trade and industry of our ceasing artificial efforts to maintain our currency above its real value were quickly realized. *There are few Englishmen who do not rejoice at the breaking of our gold fetters.* We feel that we have at last a free hand to do what is sensible. The romantic phase is over, and we can begin to discuss realistically what policy is for the best. . . .
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> The competitive disadvantage will be concentrated on those few countries which remain on the gold standard. On these will fall the curse of Midas."[1]

Eichengreen, along with Keynes, believes in "the curse of Midas," in the evils of gold money. Even after gold was officially abandoned, it played an insidious role in the minds of men, Eichengreen argues. He blames policymakers at the time who questioned the efficacy of devaluation and stubbornly refused to inflate paper currencies, even though the "golden fetters" were removed. Instead, anxious at the prospect of resurrecting the inflations of the 1920s, they clung to gold as a symbol of financial stability. [288] Eichengreen casts aside the reasons why gold had a favorable reputation, maintaining that "recovery required discarding not just the gold standard statutes but also the gold standard ethos." [393] The gold standard haunted us even from its grave, its fetters and chains clanking about us, as in a nightmare.

Despite its superficial plausibility, Eichengreen's indictment of the gold standard is unsubstantiated. To understand why, one must first understand how a genuine gold standard operates and what political-legal context it requires. In essence, the gold standard is a monetary system in which gold is money, while private currency and checking deposits are convertible into a fixed weight of gold. This fixed weight is a unit of account, called a dollar (or some other name). The standard is similar to a yardstick, whose units of measurement neither expand nor contract. Just as, over time, people settled on a yard of three feet as a fixed standard of length, so they came to accept a certain weight of gold, the dollar, as a unit of account. Over the centuries people freely converged on gold money and adopted the gold standard by choice. They recognized that money facilitates economic activity, much as yardsticks facilitate the construction of buildings. If such standards were arbitrary or prone to fluctuation, economic activity (like buildings) would be undermined.

In light of the preceding, it is clear that a well-functioning gold standard is not maintained by some predetermined supply of gold, any more than the integrity of a yardstick is determined by the supply of yardsticks. The money supply adjusts automatically to its demand, which is determined by the level of economic activity. Claims about there being "too little gold" are irrelevant. And under a strict gold standard, there is no need for a central bank. A gold standard requires only that government protect private property and uphold monetary contracts in accordance with a system of weights and measures, a role strictly provided for in the U.S. Constitution. More generally, the gold standard requires a context of laissez-faire capitalism in order to operate effectively.

The best historical example of a genuine gold standard was the 19th-century classical gold standard. Not coincidentally, this was also the century that most closely approximated capitalism. Eichengreen's harsh judgment about the effects of gold money after World War I clashes with his applause for the classical gold standard: "For more than a quarter of a century before World War I, the gold standard had been a remarkably efficient mechanism for organizing financial affairs. No global crisis comparable to the one that began in 1929 had dis-

rupted the operation of the financial markets. No economic slump comparable to that of the 1930s had so depressed output and employment." [3] "The hallmark of the prewar gold standard was precisely its ability to accommodate disturbances to financial markets without causing severe business cycle fluctuations." [29]

This ringing endorsement of the classical gold standard is shared by historians of other persuasions. According to a monetarist, "the period from 1880 to 1914, known as the heyday of the gold standard, was a remarkable period in world economic history. It was characterized by rapid economic growth, the free flow of labor and capital across political borders, virtually free trade and, in general, world peace. . . . In several respects, economic performance in the U.S. and the U.K. was superior under the classical gold standard to that of subsequent periods of managed fiduciary money. In particular, both the price level and real economic activity were more stable in the pre-World War I gold standard era than in the subsequent six-and-one-half decades."[2] The predominantly laissez-faire context of the 19th century, so integral to the success of the classical gold standard, is largely ignored by Eichengreen.

Before World War I, most gold was held as coin in private hands, currencies were fully convertible into gold, and central banks refrained from active intervention. But during and after the war, gold came under the control of governments, which deliberately shrunk gold's role in the monetary system. Convertibility was suspended. Gold coin was taken from private hands, melted into bullion to discourage demand, and then replaced with paper money. Governments withdrew gold from circulation and then immobilized it by setting minimum gold reserve requirements for central bank currency. Central banks then used each other's currency in place of gold as reserves, creating a pyramid of paper claims upon other paper claims. This was called the *gold exchange standard*, even though gold played a far lesser role in its operation than did foreign exchange.

This system is the context for interpreting Eichengreen's charge that free market money caused the Great Depression. The gold exchange standard was not a product of free markets, but a deliberate policy to maximize government's power to inflate money and finance the growing deficits that accompanied higher spending. Eichengreen himself recounts how the independence of central bankers became compromised. [xi] In Europe at the turn of the century, "unable to balance government budgets, politicians enlisted the central bank's monetary printing presses to finance their deficits . . . resulting in episodes of inflationary chaos and economic turmoil. . . . Issues that had previously remained outside the political sphere, such as the determination of the level of wages and employment, suddenly became politicized" and "doubt was cast over the credibility of the commitment [to gold convertibility]." [9] In better days, "convertibility provided a visible signal that a government's financial house was in order, and the gold standard inspired confidence on the part of domestic savers and foreign investors." But after the war, "in an effort to maintain confidence, governments sought to disguise the extent of currency depreciation. They maintained convertibility de jure even when suspending it de facto." [230] In other words, governments pursued a contradictory policy of maintaining confidence by cheating. The gold exchange standard subordinated gold to statist goals. In the end, it was statism that sabotaged the classical gold standard.

Nevertheless, Eichengreen does not oppose statism, nor the welfare state, nor governments that break rules and violate monetary standards. Indeed, he believes government must take an active role in correcting chronic market "excesses." He opposes monetary rules and standards as such. He credits central banks for delivering sound money before the war, even though gold played a greater role, and then blames gold for ruining things after the war, even though gold played a diminished role. The post-war gold exchange standard was destabilizing, he says, not because it involved larger doses of government intervention, but because it retained minor vestiges of gold. That system was doomed, he insists, not because government was incapable of planning, but because its planning was tethered to gold. Government was fettered, its monetary powers too narrow. Only a fiat paper money scheme is manageable. These contradictions stem from Eichengreen's failure to identify the essential nature of the gold standard.

Other aspects of Eichengreen's main theme break down on closer examination. The disruptive interest rate manipulations of the Fed on behalf of the Bank of England certainly did not reflect free markets. They were an attempt by governments to maintain an artificial link between their excessive paper money issuance and gold. Instead of permitting gold to operate freely, governments withdrew it from circulation, printed paper money in its place, and then devalued their currencies. The results were clearly disastrous, but hardly the fault of gold. If a ship crashes in a storm because its crew fails to secure its position by dropping anchor, one cannot in justice blame the anchor.

Likewise, no evidence exists for Eichengreen's claim that there was not enough gold in the world to support economic activity. As previously noted, supply is irrelevant to the issue of maintaining a standard, given the minimum needed for a general medium of exchange to exist. Ever since men converged on gold as money twenty-five centuries ago, gold supplies have been sufficient for this purpose. In this century, the world stock of gold has grown about 1–2% per year with new production, even during the disruptions of World War I and the Great Depression. Statistics in *Golden Fetters* itself confirm the point. One chart shows the annual output of gold as many millions of ounces, a steady increment to the world stock. [199] So neither inflation nor deflation can properly be attributed to gold. Nor were central banks short of gold; they were

removing it from private hands. Their reserves increased by more than 40% from 1927 to 1935, as another chart in the book plainly shows. [192] Given these basic facts, Eichengreen is in no position to blame gold for the dollar deflation.

Since World War I, the world had suffered not from a shortage of gold but from a glut of paper money from governments that promised to pay gold. Many more claims to gold were printed than could be satisfied. Gold flowed from countries that inflated their currencies most (Germany and Britain) to those that inflated least (the U.S. and France). But the U.S. went further and accumulated gold. The Fed's gold reserve ratio was nearly twice the 40% minimum requirement in the midst of the U.S. deflation. Not only had the Fed taken gold from the private sector, but it then immobilized nearly 80% of it.[3] When default came and the gold content of the dollar was reduced 41% in March of 1933, the Federal Reserve was sitting atop a massive gold stockpile.[4]

Eichengreen's charge that the Great Depression was prolonged by those clinging to the "ethos" of gold is also unsupported. The book recounts, for example, how from the time FDR was elected he created uncertainty by threatening to devalue the dollar. His aim was to abandon gold, not cling to it. Threats to lower the dollar's gold content only encouraged people to abandon dollars for gold, triggering a dollar deflation. As former U.S. Treasury Secretary Ogden Mills remarked in1935, "it was not the maintenance of the gold standard that caused the banking panic of 1933 and the outflow of gold, it was the definite and growing fear that the new administration meant to do what they ultimately did—that is, abandon the gold standard." [327] Even Eichengreen concedes that in March 1933, "fears that Roosevelt might devalue the dollar induced depositors to withdraw their balances even from U.S. banks that were fundamentally strong in order to redeem their Federal Reserve notes." [326] And he admits that after Roosevelt's devaluation of the dollar in mid-April 1933, conditions worsened. [331] Yet Eichengreen insists that "there was no reason for the dollar to decline," since "the gold standard had not been abolished" but only suspended as a "transitory expedient." [329] He fails to recognize that political expediency is incompatible with sound money.

Finally, what of Eichengreen's claim that countries which abandoned gold and inflated their currencies prospered soonest? As can be gleaned from the book, industrial production was rising in the U.S. in 1932, a year before abandoning gold. Yet in 1937–38, by then fully on a paper standard, the U.S. suffered another depression, with production falling 12%. [387] The unemployment rate was 19% in 1938, higher even than in 1931. In fact, most of world remained mired in recession for most of the 1930s. Britain never did regain its prewar economic stature. Eichengreen says "the failure to pursue more expansionary policies, and not currency depreciation itself, was responsible for the sluggishness of the recovery." [22] But the resort to inconvertible paper money was not the panacea Eichengreen makes of it. Prosperity cannot be printed.

The eventual economic recovery had nothing to do with devaluing money. Markets function best under money which holds a relatively constant purchasing power; that is the reason gold first became the money of choice. Government currencies, in contrast, have been prone to inflation and deflation. The German hyperinflation of 1922–23 and the U.S. deflation of 1930–34 are only extreme examples of this tendency. When governments force unstable money on people, markets suffer. When their intervention ceases, markets tend to improve. Historically, sustained economic recovery was achieved only when gold was reintroduced in the international monetary system, albeit in diluted form, under the Bretton Woods agreement of 1944. The market's need of credible monetary stability only reinforces the case for gold-based private money.

Central banking is nothing but central planning applied to money and banking. It is no part of a genuine capitalist system. Indeed, central banking is inimical to gold money and capitalism. Yet despite pages of evidence to the contrary, Eichengreen speaks of central banks as "the traditional guardians of the gold standard." [xi] He credits "the stability of the prewar gold standard" to "effective management by its leading member, the Bank of England." [4] Without evidence, he asserts that "one rationale for creating the Federal Reserve System in December 1913 was to manage the American gold standard more effectively." [31] But he admits the newly-created Fed behaved unpredictably [12] and politicized American monetary policy. [9] Eichengreen implies that politicized money is compatible with the smooth operation of a gold standard. He concedes that "what was inadequately appreciated was that by creating a central bank the U.S. government might exacerbate the cyclical instability of the domestic economy." [64] But despite these concessions, he never questions the legitimacy of central banking and instead urges still wider powers for it. Eichengreen endorses the very institution that contributed most to the Great Depression. He is fettered by anti-capitalist folklore.

The wider culprit behind the Great Depression was statism, which had grown more pronounced at the turn of the century. As the late economist Melchior Palyi argues, it was "an age of monetary and commercial nationalism, with the central banks at the mercy of political forces. The welfare state's determination to bypass the automatic workings of the gold standard resulted in making the gold standard nearly unworkable."[5] Nationalism meant a vast expansion of government into hitherto private economic affairs, a trend shaped by intellectuals like John Maynard Keynes, whose work inspired Eichengreen to write *Golden Fetters*. "The mercantilists were under no illusions as to the nationalistic character of their policies," Keynes once wrote, "but intellectually their realism is much preferable to the confused thinking of contemporary advocates of an international fixed gold standard and laissez-faire, who believe that it is

precisely these policies which will best promote peace."[6]

Economic and monetary nationalism did not solve the depression, as Eichengreen claims, but made it possible. Indeed, nationalism and the gold standard are incompatible. Gold is worldwide, international money, objectively valued, and accepted by all. Government paper money is arbitrary and imposed on markets by force. Far from being the "guardians" of the gold standard, central banks have been the government tool used to sabotage it. Certainly there were other statist measures that contributed to the Great Depression, such as the protectionism imposed by the Smoot-Hawley Act of 1930, the maintenance of artificially high wage rates, and the near doubling of income tax rates in the U.S. But the displacement of gold by government money early in this century and increased political manipulation of the currency since World War I account for the bulk of the monetary instabilities Eichengreen writes about—and of those we still suffer from today.

Golden Fetters perpetuates a long-held myth about the gold standard in a seemingly scholarly manner. That is its main danger. So long as the gold standard is obscured and made a scapegoat for the failures of interventionism, sound money will never be adopted. At bottom, *Golden Fetters* is directed not against monetary "slavery" (the alleged fetters imposed by the gold standard), but against virtually any limits to government. Eichengreen is in no position to warn us against repeating the financial and economic disasters of history, for these are but symptoms of interventionism, central banking, and inflation, all of which he fully endorses.

REFERENCES

[1] John Maynard Keynes, "The End of the Gold Standard," September 27, 1931, reprinted in *Essays in Persuasion* (New York: Harcourt Brace and Company, 1932), pp. 288, 292. [2] Michael David Bordo, "The Classical Gold Standard: Some Lessons for Today," Federal Reserve Bank of St. Louis, *Review*, May 1981, pp. 2–17. [3] For a detailed account of this irresponsible policy, see Richard H. Timberlake, *Monetary Policy in the United States: An Intellectual and Institutional History* (Chicago: University of Chicago Press, 1993), pp. 269–273. [4] Quoted in Milton Friedman and Anna Schwartz, *A Monetary History of the U.S., 1867–1960* (Princeton University Press, 1963), p. 385. [5] Melchior Palyi, *The Twilight of Gold, 1914–1936, Myths and Realities* (Chicago: Henry Regnery, 1972), pp. 159–160, 104. This book remains the definitive account of the links between central banking, the gold standard and the Great Depression. [6] See Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace and Company, 1936), p. 348.