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Did the Gold Standard Cause the Great Depression?*

by Richard M. Salsman

Prevailing economic folklore has it that the Great Depression was a failure of free markets, especially its foremost feature, the gold standard. Keynesians and monetarists alike share a distaste for gold money and say it played a key role in triggering and deepening the depression. While Keynesians declare gold a "barbarous relic" that impedes economic growth, monetarists say it is like any other commodity, but too costly and cumbersome to serve as money. Both defend central banking and insist that governments can manage our affairs best when free of the golden albatross.

If this notion is correct, we should never again have gold money or free markets, for they will only wreak havoc yet again. If it is myth, however, it should be exposed as such. 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), helps us decide which is the case. The book analyzes the connection between the gold standard and our worst economic contraction. Laden with data and charts, *Golden Fetters* contains penetrating and scholarly insight. The work has received high praise from those who pay close attention to the Great Depression and may become a standard reference for years to come.[1] At root, Eichengreen sides with the prevailing folklore. However, the facts he presents tend to exonerate the gold standard.

The Gold Standard's Shortcomings

The overriding theme of *Golden Fetters* is that the gold standard shackled the international monetary system to an arbitrary commodity, thereby undermining 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] Eichengreen argues that gold money is an impediment to economic growth, that its supply cannot keep pace with the overall growth in output. A gold-based monetary system thus is prone to price deflation and ultimately, unemployment, since wages do not fall with prices. As employment declines, so does economic output, and depression results.

Eichengreen also derides the gold standard for shackling government policy makers who would otherwise be free to manage money and ensure full employment. He endorses central banking and fiat paper money, because they permit governments to break free of these golden fetters. The book's dust-jacket is most succinct on this point: "The gold standard fundamentally constrained the economic policies that government pursued. It was largely responsible for creating an unstable economic environment. The gold standard of the 1920s set the stage for the depression by heightening the fragility of the international financial system and was the mechanism transmitting destabilizing impulses from the U.S. to the rest of the world. It was the constraint preventing policy makers from averting the failure of banks and containing the spread of financial panic. Recovery proved possible, for these same reasons, only after abandoning the gold standard."

The Gold Standard's Role in the Great Depression

Precisely how did the gold standard bring on the contraction of the 1930s? Eichengreen's chronology begins in 1919, when most countries were issuing inconvertible paper monies, as they had begun to do during World War I. In the 35 years prior to the war, 45 countries had been on the gold standard. The sharp recession of 1920-21 convinced many to seek a return to the prewar stability that had prevailed under the gold standard. That was the conclusion of an international monetary conference in Genoa in 1922.

But Eichengreen regards this eagerness to return to gold-convertible currencies as a main source of the contraction in the 1930s. The key event, he argues, was Britain's return to the gold standard in 1925 at the exchange rate that prevailed before World War I, before the fivefold expansion of pound notes to finance the war effort. By returning the pound to gold at an artificially high exchange rate, Britain set the stage for a deflation. Either pound notes and prices had to decline, or gold would be lost and convertibility threatened. Thus, Eichengreen states "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]

Meanwhile, a boom-bust scenario was playing out in the United States, which Eichengreen also attributes to the gold standard. To help Britain return to gold at the pre-World War I exchange rate, the Federal Reserve pushed down interest rates in 1924 and 1927. The goal was to preserve the Bank of England's gold stock and prevent it from flowing to the United States. But the Fed's artificially low interest rates set off a speculative boom. By 1929, the Fed was reversing its policy, raising interest rates to check the boom and rebuild its gold reserves. Britain al-

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* This article is a review of *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939*, by Barry Eichengreen (New York: Oxford University Press, 1992). Numbers in brackets refer to pages in the book.

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[1] See Richard N. Cooper, "Fettered to Gold? Economic Policy in the Interwar Period," *Journal of Economic Literature*, December 1992, pp. 2120-2128 and Ben S. Bernanke, "The World on a Cross of Gold: A Review of 'Golden Fetters: The Gold Standard and the Great Depression, 1919-1939,'" *Journal of Monetary Economics*, April 1993, pp. 251-267.

ready had suffered economic contraction and unemployment, regardless of the Fed's help. The United States was about to experience the same. Soon the whole world was contracting.

Why? According to Eichengreen, because it was clinging to the ancient notion that money should be tied to gold. "The problem was the inadequate liquidity resulting from slavish adherence to the gold standard."[11] In short, Eichengreen tells us the gold standard deprived the economy of fuel, enslaved central banks, and thereby brought on the contraction.

Surprisingly, Eichengreen barely mentions other factors known to have contributed to the Great Depression. In the United States, the protectionist Smoot-Hawley Act of 1930 set off retaliatory measures worldwide, and income tax rates were *doubled* between 1932 and 1936. In the few times Eichengreen does refer to these burdens on commerce, he attributes them to the gold standard. Why? Protectionism aimed at a buildup of net exports and gold reserves and higher taxes were imposed to prevent government budget deficits and central bank monetization, which threatened the gold standard. Without the gold standard, neither policy would have been tried. Other factors may have contributed to the contraction, but they all relate somehow to the gold standard.

Prosperity to Those Who Abandoned Gold

Eichengreen also blames the gold standard for prolonging the contraction. Paralyzed by a dilemma, "Governments were slow to respond to the Great Depression." "The dilemma was whether to sacrifice the gold standard in order to reflate, an option most policy makers continued to oppose, or to forswear all measures that might stabilize the economy in order to defend the gold standard."[16-17] "Why didn't policy makers intervene to head off the collapse?" he asks. "Because the gold standard posed an insurmountable obstacle.... Containing bank runs required policy makers to inject liquidity into the banking system, but this was inconsistent with the gold standard rules." In short, "far from being a bulwark of financial stability, the gold standard was the main impediment to its maintenance."[18-19]

Eichengreen believes this "dilemma" was effectively resolved by defaulting on the gold standard. Countries that abandoned gold earliest, he says, also recovered earliest. As he puts it, "depreciation was the key to economic growth.... Currency depreciation stimulated economic recovery. Prices were stabilized in countries that went off gold. Output, employment, investment and exports rose more quickly than in countries that clung to gold.... Only when principles of orthodox finance were abandoned did recovery follow."[21] "In the absence of gold standard restraints, international cooperation was no longer essential ... permitting more expansionary monetary and fiscal policies all around."[22] The gold standard was abandoned first by Britain in 1931 and the 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 Englishman 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.... The competitive disadvantage will be concentrated on those few countries which remain on the gold standard. On these will fall the curse of Midas.[2]

Haunted by the "Ethos" of Gold

Although Eichengreen believes "the U.S. devaluation ignited a successful economic recovery,"[384] his evidence is sketchy. Industrial production actually was starting to turn up in the United States in 1932, a year before devaluation, and in 1937-38 it suffered another, though milder depression. Eichengreen himself recounts how U.S. industrial production fell 12 percent at the time.[387] The unemployment rate was 19 percent in 1938, higher than it had been in 1931. In fact, most of world remained mired in recession until after World War II. Contrary to Keynes's optimism, Britain *never* regained its prewar economic stature. None of this was alleviated by resorting to inconvertible paper money, as Eichengreen suggests.

Policymakers who questioned the efficacy of devaluation, says Eichengreen, were mired in the "ethos" of the gold standard. They stubbornly refused to inflate their paper currencies, even though the golden fetters were removed. "Policy makers feared that abandoning the gold standard courted a replay" of inflations in the 1920s, he notes, because "the gold standard was a symbol of financial stability."[288] But instead of crediting gold for its favorable reputation, he says it is undeserved. "Recovery required discarding not just the gold standard statutes but also the gold standard ethos," he contends.[393] Eichengreen, with Keynes, apparently believes in "the curse of Midas." He tells us, in effect, that the gold standard haunted us even from the grave.

Success of the Classical Gold Standard

Eichengreen's harsh judgment about the effects of the gold standard after World War I contrasts sharply with his praise of the prewar classical gold standard: "There can be no question that the development of the international gold standard in the second half of the 19th century and the enormous growth of international trade and investment which took place are no mere coincidences." "The hallmark of the prewar gold standard was precisely its ability to accommodate disturbances to financial markets without causing severe business cycle fluctuations."[29] "For more than a quarter of a century before WWI, the gold standard provided the framework for domestic and international monetary relations. Currencies were convertible into gold on demand and linked internationally at fixed exchange rates. Gold shipments were the ultimate means of balance of payments settlement. 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 disrupted the operation of the financial markets. No economic slump comparable to that of the 1930s had so depressed output and employment."[3]

This ringing endorsement of the classical gold standard is shared by historians of other persuasions. According to Michael Bordo, 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."[3]

Eichengreen fails to name some important reasons for this success. The classical gold standard was a product of market choice, not government command. As money evolved over 25 centuries, it became defined as a certain weight in gold and other precious metals. Gold coins circulated alongside private bank currency, which held its value because it was con-

[2] John Maynard Keynes, "The End of the Gold Standard," September 27, 1931, reprinted in *Essays in Persuasion* (New York: Harcourt Brace and Company, 1932), p. 288, 292.

[3] Michael David Bordo, "The Classical Gold Standard: Some Lessons for Today," Federal Reserve Bank of St. Louis, *Review*, May 1981, pp. 2-17.

vertible. For more than a century in the United States, Canada, and Australia, the gold standard operated smoothly without central banks. Elsewhere in the world, central banks mostly kept hands off the gold standard.[4] This private, gold-based monetary system was certainly no impediment to the unprecedented economic growth of the 19th century.

The laissez-faire context of the 19th century also contributed to the success of the classical gold standard. Eichengreen ignores this key point, but others have not. Economist Leland Yeager has written that "by and large, people in countries that happened to be on the gold standard were freer from government control than in any age before or since — freer to transact business, freer to make investments, to transfer funds, to travel.... The civility and internationality prevalent during the age of the (classical) gold standard have such a charm for us nowadays that it seems almost sacrilege to ask whether these benefits resulted from the gold standard, or instead, coexisted with it by mere coincidence."[5] In fact, the classical gold standard was an integral part of the free market environment prevailing at the time.

If Eichengreen is correct that the gold standard caused the ills of the 1920s and 1930s, how does he explain why it worked so well before World War I? He credits central banks for its prewar success. "The stability of the prewar gold standard," he writes, was the result of central bank credibility, "the confidence invested by the public in the government's commitment to a policy." "In the prewar period there was little doubt that the authorities ultimately would take whatever steps were required to defend the central bank's reserves and maintain the convertibility of the currency into gold."[5] These steps included lending to one another when there were gold losses, adjusting interest rates to accommodate each other in times of stress. In effect, central bank actions were geared to assisting the gold standard instead of overriding it. Importantly, "rather than advocating active monetary management to stabilize the economy, the majority of observers advised a passive and therefore more predictable monetary stance."[6] Had central banks not cooperated, Eichengreen says, the gold standard would have broken down. When international cooperation broke down during the war, that is precisely what happened. But the classical gold standard, epitome of a laissez-faire age, could not survive without central bank nurturing. So Eichengreen tells us.

What is a Gold Standard?

This seeming conflict in Eichengreen's account stems from his lack of a clear definition of the gold standard, a major shortcoming in a book that credits it with such disastrous consequences. Only by understanding the fundamental characteristics of the gold standard can one accurately interpret its role in economic history.

Basically, the gold standard is a system in which gold is money and 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 the yard evolved over time to specify three feet, the dollar evolved as a specific weight of gold. Over the centuries, after dispensing with other forms of money, people converged on gold money and adopted the gold standard by choice. They did so because such a monetary standard facilitated economic activity, much as a yardstick facilitates the construction of buildings. If the standard instead were arbitrary or prone to fluctuation, economic activity (and buildings) would be undermined.

A well-functioning gold standard is not maintained by some predetermined supply of gold, any more than the integrity of the yard as a unit of measure is determined by the supply of yardsticks. The supply of gold-based money adjusts automatically to the demand for it, which is determined by the level of economic activity. As one writer has described it, "a gold standard doesn't limit the money supply any more than a yardstick standard limits the number of yardsticks. The argument that there is 'too little gold' is irrelevant."[6] A gold standard also requires no government management or intervention. As Bordo has written, "under a strict gold standard, there is no need for a central bank."[7] At most, it requires only that government uphold contracts in accordance with a market-generated system of weights and measures. Such a role is provided for in the U.S. Constitution.

The Interwar Gold Exchange Standard

Knowing the main characteristics of the gold standard helps explain the breakdown of the monetary system between the two world wars. While *Golden Fetters* focuses on this period, it does so while mistaking the system for a genuine gold standard. Gold's place in the monetary system changed drastically during and after World War I. Before the war, most gold was held as coin in private hands, currencies were fully convertible into gold, and the central banks that did exist refrained from active intervention. During and after the war, gold came under the control of governments. Convertibility was suspended. Gold coin was removed from private hands, turned into bullion to discourage demand, and replaced with paper money.

As Eichengreen tells it, "a gold reserve was necessary to maintain confidence in the financial system, the authorities believed, more so where the confidence-inspiring gold standard statutes had been suspended for the duration of the war. Appealing to patriotism, governments urged citizens to deposit any gold they possessed with the authorities. Of wartime experience, contemporaries said more gold was mined out of the pockets of the people than out of the mines of the earth."[86] Governments hoarded gold and immobilized it by establishing minimum gold reserve requirements for central bank currency. Central banks used foreign exchange in place of gold as an active reserve. They monetized government debts and devalued currencies. In the United States, a new central bank was established and did many of these same things.

Eichengreen attributes these drastic changes to the exigencies of war. Convertibility was suspended to prevent adversaries from gaining a financial advantage. Gold was removed from private hands and hoarded as a show of financial strength. Unwilling to have taxpayers finance war efforts, governments resorted to deficit spending, and had no one but central banks to monetize their debt. That is, they instructed central banks to print money without regard to their gold holdings. During and after the war, "the preeminent concern of government officials was debt management," Eichengreen explains. "So long as problems of debt management remained unresolved, governments were hesitant to restore to central banks the independence they had traditionally enjoyed. Central banks were pressured to keep discount rates low to minimize debt service costs and facilitate the placement of treasury issues."[105]

When central banks held each other's currencies as reserves, they created a pyramid of paper claims upon other paper claims. This system is called the *gold exchange standard*, even though gold played a far lesser role in its operation than did

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[4] Arthur Bloomfield, *Monetary Policy Under the International Gold Standard* (New York: Federal Reserve Bank of New York, 1959).

[5] Leland Yeager, "The Image of the Gold Standard," in *A Retrospective on the Classical Gold Standard, 1821-1931*, Michael D. Bordo and Anna J. Schwartz (Chicago: University of Chicago Press, 1984, p. 663).

[6] Jude Wanniski, "A Supply-side Case for a Gold Standard," *Business Week*, December 7, 1981, p. 23.

[7] Bordo, *op. cit.*, p. 5.

foreign exchange. The gold exchange standard was not a product of the free market. Eichengreen admits that "the special structure of the inter-war gold standard heightened the vulnerability of national financial systems. Central banks were authorized to hold, in addition to gold, a portion of the backing for domestic liabilities in the form of convertible foreign exchange," and "by the late 1920s the share of foreign exchange in international reserves was at least 50% above prewar levels." The trouble was, "as exchange reserves grew large relative to monetary gold, the capacity of the reserve countries to maintain gold convertibility (U.S., France, Britain) was cast into doubt."[20]

Doubts were hardly removed when central banks blocked gold exports and devalued currencies whenever it proved expedient. Central banks "intervened systematically in the relationship between specie reserves and credit conditions,"[34] Eichengreen says, and "although licensing or prohibiting gold exports was inconsistent with laissez-faire principles, the war had taught officials to view such matters in a more pragmatic light."[103] In the parlance of the day, the gold exchange standard was adopted to "economize" on limited supplies of gold. But gold was "limited" only in the sense that the wartime inflation had created an excess of government debt and paper money claims at prewar exchange rates. The gold exchange standard did not serve as a "fetter" — it subordinated gold to the insatiable financial needs of rapidly expanding governments.

There was ample evidence at the time that expedience and intervention would prove destabilizing. According to Eichengreen, "central bankers ... were well aware that market interest rates exceeded official discount rates, providing banks an incentive to rediscount paper at the central banks and to expand the supply of credit."[111] For example, "the excessively accommodating policies of the Federal Reserve System around the middle of the decade" created "liberal supplies of credit" and "fueled speculation in financial markets...."[301] Could this be blamed on the gold standard? Eichengreen concedes that "the gold standard also existed in the 19th century, of course, without exercising such debilitating effects. The explanation for the contrast lies in the disintegration during and after WWI of the political and economic foundations of the pre-war gold standard system.... During and after WWI, disputes over income distribution and the proper role for the state became increasingly contentious ... quarrels over war debts and reparations soured the prospects for cooperation. Economics and politics combined to challenge and ultimately compromise the independence of central bankers...."[xi] Eichengreen finds that "credibility and cooperation were central to the smooth operation of the classical gold standard" and that "the scope of both declined abruptly with the intervention of World War I."[12] "The inter-war gold standard, despite resembling its prewar predecessor, shared few of these virtues" and "led a short and brutish life of barely six years (1925-1931)."[29] Yet *Golden Fetters* insists on blaming gold for the interwar breakdown.

In Eichengreen's view, the postwar gold exchange standard was destabilizing not because it involved larger doses of government intervention, but because it retained minor vestiges of gold. The problem was not government-managed money, but that gold was the money governments sought to manage. The gold exchange standard was doomed, not because government was incapable of central planning, but because the planning was tethered to gold. Government was fettered, its monetary planning partial instead of total. Only fiat paper money could prove beneficial.

The "Shortage" of Gold

Eichengreen refers repeatedly to gold shortages and gold "famines" that plagued the world in the 1930s and blames the deflation of the Great Depression on the gold standard. Why? "The world supply of monetary gold is fixed at a moment in time," he writes, and 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 United States 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 fact, there was no shortage of gold in purely physical terms. For decades the total stock of gold in the world had grown incrementally with new production, about 1-2 percent per year, even during World War I. Evidence in *Golden Fetters* itself confirms this point, although its author never explains it. One chart shows how the annual production of gold was many millions of ounces every year, adding a steady increment to the world's stock, even during the contraction years.[199] Considering the stock of gold alone, there was certainly neither deflation nor inflation to speak of. So where was the problem? Were central banks running short of gold? No, the gold reserves of central banks actually increased by more than 40 percent from 1927 to 1935, as another chart in the book clearly shows.[192] How can gold be held responsible for the dollar deflation that occurred?

In the 1930s, far from a gold famine, the world was suffering from a paper money glut, and from a shortage of credibility in ever more powerful central banks. They had printed many more claims to gold during and after the war. There was a maldistribution of gold stock among central banks. Gold flowed to more financially stable countries, such as the United States and France, away from Germany and Britain. Those that inflated their currencies most lost the most gold. Those that inflated least gained gold. But the United States and France not only obtained gold due to financial prudence, they hoarded it in amounts far in excess of what the gold exchange standard required. For example, just when the U.S. economy was undergoing a massive deflation, the Fed's gold reserve ratio was nearly twice the 40 percent minimum requirement. Not only did the Fed systematically transfer gold from the private sector, it then immobilized nearly 80 percent of it while the private sector was dying of thirst.[8] When the gold content of the dollar was reduced 41 percent in March of 1933, the Federal Reserve was sitting atop a massive hoard of the "barbarous relic." Ogden Mills, who had been Hoover's Secretary of the Treasury, remarked that "for a great central banking system to stand by with a 70% gold reserve without taking any active steps in such a situation was almost inconceivable and almost unforgivable. The resources of the System should be put to work on a scale commensurate with the existing emergency."[9]

For government finances to undermine the private sector was nothing new. A similar situation had occurred in the decades after the Civil War, when private banks were forced to back their currency with Federal debt. As that debt was retired and the demand for private currency grew with the expansion of trade, currency shortages developed. After World War I, private banks found themselves stripped of gold reserves, forced to rely instead on government paper money, which was unreliable despite the Fed's gold hoard. In both cases, government policy fostered the currency instability, while the private sector took the blame. When the financial system was relatively free of intervention, it survived

[8] 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.

[9] Quoted in Milton Friedman and Anna Schwartz, *A Monetary History of the U.S., 1867-1960* (Princeton: Princeton University Press, 1963), p. 385.

the government's policies. During the Civil War government issued fiat paper "greenbacks" that depreciated greatly in purchasing power, but with no central bank at the time, private banks were not forced to use them as reserves. They survived on a foundation of gold. That alternative became illegal after World War I.

Breaking the Rules

The smooth operation of the classical gold standard embraced the customs, standards, and rules that markets had generated over the centuries. These rules were widely respected, fostered credibility, and lent stability to the monetary system. Such arrangements crumbled with the advent of central banking and government intervention in money, especially at the turn of the century. In 1925, John Maynard Keynes derisively referred to the market's long-standing "rules of the game,"[10] a phrase that subsequently evolved to refer to the various ways in which *central banks* should "manage" the gold standard.

As it turned out, of course, central banks actively interfered with gold flows, turned coin into bullion, discouraged convertibility, hoarded gold, then added to the confusion by raising and lowering interest rates at will, above and below market rates, to manipulate trade flows and the domestic business cycle. In short, they broke all the rules. Eichengreen seems aware of this. For example, he discusses Ragnar Nurske's famous study of the 1922-1938 period, which shows how much the central banks of the world interfered with the gold exchange standard. In effect, they sabotaged it.

Eichengreen also observes how "issues that had previously remained outside the political sphere, such as the determination of the level of wages and employment, suddenly became politicized" and how "doubt was cast over the credibility of the commitment [to gold convertibility]. No longer did capital necessarily flow in stabilizing directions."[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."[231] In other words, governments pursued a contradictory policy of maintaining confidence by cheating. Nevertheless, Eichengreen does not criticize central banks for breaking the rules and violating standards. He argues against monetary rules and standards as such.

Did Devaluation Actually Foster Recovery?

As mentioned, Eichengreen's claim that economic recovery came quickest to those countries that abandoned gold-based money soonest lacks supporting evidence. There is a good reason for this. When Britain abandoned the gold standard in 1931, the pound still was a reserve currency for most of the world's other central banks. As the foreign exchange value of the pound plummeted, other central banks that held pounds suffered reserve losses and initiated further contractions of their own currencies. That development was unrelated to gold. Rather, it was the inevitable result of pyramiding paper upon paper. Markets valued gold more than pounds, and later, more than dollars. By early 1933, George Harrison, head of the Federal Reserve Bank of New York, witnessed an accelerating demand for gold coin from his bank and observed that "this movement represents something more than a hoarding of currency, which reflects a distrust of banks; it represents in addition a distrust of the currency itself and it is inspired by the talk of devaluation of the dollar and inflation of the currency."[11] Instead of inspiring confidence in the Federal Reserve dollar, Harrison tried to discourage gold coin conversions and urged banks not to provide storage facilities for customers.

Who could expect economic recovery amidst such uncertainty? Others correctly saw devaluation as the problem, not the solution. French Prime Minister Edouard Daladier asked "How are we to restore the circulation of goods if the measure of value continues to depend on hazard or chance?" The French Foreign Minister, Georges Bonnet, asked "Who would be prepared to lend with the fear of being repaid in depreciating currency always before his eyes?"[335] Former U.S. Treasury Secretary Ogden Mills remarked in 1935 that "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 Keynes admitted that arguments such as Eichengreen's "are not arguments against the gold standard as such.... They are arguments against having restored gold under conditions which required a substantial readjustment of all our money values."[12]

Eichengreen denies that currency devaluation prolonged depression by spreading uncertainty. "The failure to pursue more expansionary policies, and not currency depreciation itself, was responsible for the sluggishness of the recovery."[22] Yet he concedes that "a public that fears that abandoning the gold standard will provoke an inflationary crisis is likely to sell its financial assets if that event occurs, rendering such fears self-fulfilling."[26] He recounts how in March 1933 confidence plummeted when "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 when "FDR finally opted for a devaluation in mid-April 1933 ... the situation deteriorated abruptly."[331] Yet Eichengreen is unsure why things got worse. He claims "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] Instead of seeing a devaluation of government money as an impediment to the private sector that had been forced to use it, Eichengreen insists the problem was government money tied to gold "as an albatross around the necks of American and British policy makers."[335]

The scant evidence Eichengreen does offer for economic recovery in the 1930s has nothing to do with currency devaluations. History shows that markets function best under stable money, a medium of exchange that holds a relatively constant purchasing power. That is precisely why people converged on gold money over the years. Government currencies have been another matter entirely. Generally they have not met the market's need for stability. They have been prone to inflation or deflation. The German hyperinflation of 1922-23 and the worldwide deflation of 1932-33 were only extreme examples of a broader pattern. When governments issue unstable money, the market's demand for gold and other "hard" currencies intensifies. Once major inflations and deflations cease, markets generally improve. Rather than marking any "success" of fiat paper money, it is simply this latter phenomenon that Eichengreen observes.

Guardians of the Gold Standard — or Saboteurs?

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,

[10] John Maynard Keynes, "The Economic Consequences of Mr. Churchill," 1925, reprinted in *Essays in Persuasion* (New York: Harcourt Brace, 1932), p. 259.

[11] Friedman and Schwartz, *op. cit.*, p. 350, n. 60.

[12] Keynes, *op. cit.*, p. 248.

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 that "the arrival of the Fed on the international scene was a significant departure from the prewar era," that "the new institution was unpredictable,"[12] and that "the establishment of a central bank with discretionary powers contributed to the politicization of monetary policymaking in the U.S."[9] In Europe at the turn of the century, "the decisions of central bankers, long regarded as obscure, became grist for the political mill ... 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..."[9] Are *unpredictability, politicization, inflation*, and *turmoil* compatible with the smooth operation of a gold standard? Eichengreen suggests they are. History says otherwise.

How is it that central banks can be seen as guardians of the gold standard and responsible for its smooth operation in the *prewar* era, while the breakdown of the *postwar* era is blamed on gold? The contradiction is never reconciled, for Eichengreen does not question the legitimacy of central banking. He believes its "discretionary powers" are remedial, not harmful. But far from being the "guardians" of the gold standard, central banks have been the proverbial foxes guarding the hen houses. Even Eichengreen 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]

Nationalism and the Gold Standard are Incompatible

While Eichengreen's account of the interwar period is illuminating, it does not support his main thesis. The gold standard cannot be held accountable for the Great Depression. A more likely culprit was the strain of government interventionism that was running rampant at the turn of the century, and has not diminished much since. As the late Melchior Palyi once wrote in his own account of the "twilight of gold," the problem was "an age of monetary and commercial nationalism, with the central banks at the mercy of political forces," and "the welfare state's determination to bypass 'automatism,'" which "resulted in making the gold standard nearly unworkable."[13] Palyi's book remains the definitive account of the connection between the gold standard and the Great Depression.

[13] Melchior Palyi, *The Twilight of Gold, 1914-1936, Myths and Realities* (Chicago: Henry Regnery, 1972), pp. 159-160, 104.

Not only did nationalism manifest itself in war, but also in the vast expansion of government into hitherto private economic affairs. The spread of mercantilist and protectionist trade policies, progressive taxation, and central banking at the turn of the century were all part of the nationalist wave that broke over the international free market economy that had evolved up until that time. All of these developments were stoked by intellectuals such as John Maynard Keynes. "The mercantilists were under no illusions as to the nationalistic character of their policies," he 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."[14] Keynes sided with the nationalists and gave them ammunition. Such ideas, far from "saving" capitalism and the gold standard, undermined them both. Far from offering a remedy for the contraction, as Eichengreen claims, the economic and monetary nationalism of Keynes and others made it possible.

The Cost of Misinterpreting History

Just as history helps us formulate theories, theory shapes the way we look at history. False theories must render false histories. Eichengreen's underlying theory is that free markets fail while governments fix them. In *Golden Fetters*, he blurs the distinction between free markets and government intervention. While examining many problems that arise, in fact, from intervention, he blames them on free markets. The world is only recently learning the error of this approach.

The empirical record cited in *Golden Fetters* is the same one that indicts central banking and fiat paper money, the same one that exonerates free banking and the gold standard. By clinging to myths such as the inherent instability of capitalism, the slavery of the gold standard, and the benign influence of deficit spending and central banking, Eichengreen is unable to read the record straight. He ignores not only the context within which his drama plays but also the contrary evidence that resides outside of this brief episode in monetary history. Any interpretation of the 1919-39 period should be consistent with what is known to have occurred before and after. The interwar period was a mixture of laissez-faire and interventionism. Before World War I, governments and central banks were relatively limited, major countries had no central banks, the gold standard worked well, and economies prospered. In the decades since 1939, central banks have grown more beholden to governments that have grown more interventionist. Economic instability, inflation, financial crises, and currency protectionism are commonplace today. While the superiority of the results of the pre-World War I era to those of the post-World War II era seems quite clear, Eichengreen's theme suggests that the opposite should have maintained.

[14] See Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace and Company, 1936), p. 348.

If Eichengreen's account in *Golden Fetters* gains credence, it will be unfortunate. Prevailing views of history often directly influence policy. So long as our understanding of the gold standard is obscured and gold is made a scapegoat for governments that brought us the Great Depression, as in this book, a gold standard is not likely to be adopted. Indeed, this current view contributed in part to the failure of the U.S. Gold Commission in 1982 to recommend a reintroduction of gold into the U.S. monetary system. And the recent breakdown of the European Currency Mechanism, instead of being blamed on government fiat currency, has been blamed on pale vestiges of the gold standard.[15] The inspiration for this bizarre notion reportedly was none other than *Golden Fetters*.

At bottom, this book is directed not against monetary "slavery" (the alleged fetters imposed by the gold standard), but against virtually any limits to government. It is a book that favors unmitigated power for the central banks that finance it. As such, it is a dangerous guide to future policy. *Golden Fetters* cannot warn us against repeating the financial and economic disasters of history, for these are but symptoms of government intervention and central banking, both of which its author endorses warmly.

[15] See "The Gold Standard Revisited," *The Economist*, March 6, 1993, p. 79.

PRICE OF GOLD

	1992	*1993*	*— 1994 —*	
	Apr. 2	*Apr. 1*	*Mar. 24*	*Mar. 31*
Final fixing in London	$340.50	$336.35	$390.40	$389.80

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