THE GOLD STANDARD AND ITS EFFECT ON MONETARY THOUGHT AND POLICY DURING THE GREAT DEPRESSION

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It is easy in hindsight to marvel at the inept monetary policies of the Great Depression, but much harder to explain why these policies were considered optimal at the time. Paul Kelly takes on this formidable task by giving a meticulous account of why the role of the Gold Standard was never questioned. This cautionary tale of the perils of excessive caution should be required reading for today's policy makers.

Introduction

The Great Depression began in 1929 as a normal economic recession, similar to those that preceded it in 1924 and 1927 (Friedmann and Schwartz, 1963). Its origins were not monetary in nature, but rather stemmed from the Wall Street Crash (Romer and Romer, 2013). Despite this fact, monetary policy, especially the refusal to abandon the gold standard, is commonly blamed as one of the main causes of the Great Depression. This is because, although monetary factors did not instigate the contraction, they were responsible for its depth and persistence. As Eichengreen and Temin (2000, p.195) note, what began as an "unexceptional downturn… was converted into the Great Depression by the actions of central banks and governments."

Such a result was not predestined. The gold standard alone did not force central banks to pursue such policies, rather it formed the core of the ideology which promoted them. So hegemonic was this ideology, that even as economies spiralled towards disaster, all options were framed with the implicit assumption that the standard would be maintained. As Morrison (2013: p.2) notes, "most policymakers did not know that they even 'could' leave gold- let alone that they 'should'." This essay shall examine why the gold standard worsened the Great Depression, the effect of monetary policies which tried to support it, and the monetary thought which produced such policies. In doing so, this essay shall seek to produce a fuller understanding of the effect of the gold standard on monetary thought and policy during the Great Depression.

Why did the Gold Standard Worsen the Great Depression?

The gold standard was a fixed exchange rate system that relied on Hume's Price-Specie mechanism to ensure that prices, the money supply and the current account remained consistent . If prices rose, a trade deficit ensured that gold flowed out of the country. As a result, the supply of money declined and prices eventually returned to normal, although the process was often painful.

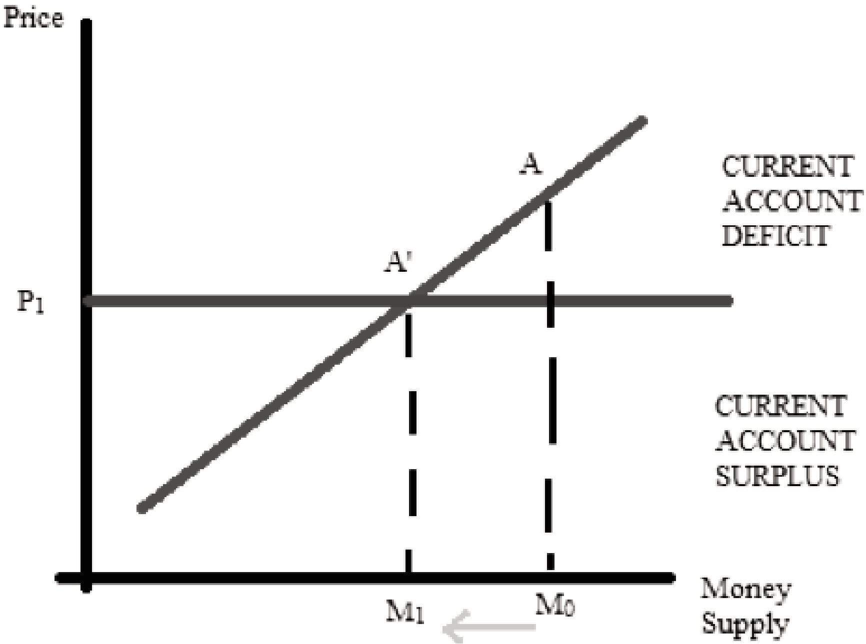

Figure 1: Hume's Price-Specie Mechanism - at A, Home is in a current ac count deficit and prices rise. As a result, money flows out until the money supply decreases to M1 and prices fall to A'. Here, trade is balanced.

This standard was distinctly rigid and was not conducive to monetary experimentation. Deviations from the fixed exchange rate were rare and only occurred in emergencies. Afterwards, parity was always restored (Morrison, 2013). World War 1 abruptly changed this system. In 1914, the gold standard was suspended in all major economies as countries printed money to finance the war. After it, countries attempted to, as before, return to their pre-war parities. By now, however, every currency was vastly overvalued, to a degree never seen before. The solution prescribed for this was deflation, as this would allow prices to fall and would ensure that enough gold remained to keep the fixed exchange rate. This was believed to be essential for the maintenance of international stability. Without it, policymakers believed that "violent fluctuations in the exchanges" would force trade to cease (Strong, 1925, quoted in Eichengreen and Temmin, 2000, p.188).

But such deflationary policies were no longer appropriate for these economies, as wages had become sticky, preventing lower prices. The increasing power of trade unions meant that increased unemployment no longer produced lower wages, cheaper exports and a return to equilibrium. As Eichengreen and Temin (2000, p.184) have noted "the gold standard adjustment mechanism no longer operated as before". This problem was accentuated by the fact that gold no longer provided a suitable nominal anchor for the world's money supply. As mining became increasingly unpredictable and gold in ever shorter supply, it provided a direct barrier to economic growth. In addition to this, with France and the USA now controlling a combined 72 per cent of the world's gold reserves, gold had become a "managed currency" (Bernanke and James, 1991; Keynes, 1923, p.167). Its rarity no longer dictated its price, but rather the actions of central banks did, leaving it open to speculative attacks. With this emphasis on deflation and its inability to provide a suitable nominal anchor, the gold standard ceased to be an appropriate monetary system.

Indeed, it was only when countries began to abandon gold that growth began to recover. Between 1932 and 1935, economic growth was 7 per cent higher for countries that had left the gold standard than for those who remained (Bernanke and James, 1991). Such a result, however, was not necessarily inevitable. Although the gold standard worsened the economies of many countries, it could have survived, and the worst of the depression been avoided, had the correct monetary policies been in place. However, the failure to use such monetary policies was intimately connected with the ideology the gold standard was embedded into. In the words of Friedman and Schwartz (1963, p407) "the monetary system collapsed, but it clearly need not have done so."

Monetary Policy: Mismanagement of the Gold Standard

Like all fixed exchange rate systems, the gold standard required a degree of cooperation in order for it to succeed. To assist the price-specie flow mechanism, surplus countries needed to increase domestic money supply, while deficit countries needed to decrease it. In the interwar period, however, such cooperation was rare. Although previously, the system had been led by the Bank of England, during the Great Depression there was no such leader (Giovannini, 1988). The USA and France, the two main surplus countries, instead of increasing their money supply, drastically contracted it and instead of allowing gold to flow freely, sterilised it. This insured that deflation was exported worldwide, forcing deficit countries to increase interest rates still further in order to avoid losing all their reserves (Bernanke and James, 1991). In the words of a contemporary business magazine, this gave rise to "worldwide reckless deflation" (Business Week, quoted in Romer and Romer, 2013: p.6).

This competitive gold hoarding had drastic domestic implications. As central banks continued to increase their interest rates, commercial "banks failed by the thousands" (Calomirs and Wheelick, 1998, p.25). Although commercial nominal interest rates remained low throughout this period, thus encouraging central banks in their deflationary policies, given expected deflation, real interest rates were actually high. This increased the burden of existing debt, forcing many banks to collapse, inspiring panic and bank runs, which forced still more to fail. This financial collapse produced decreased investment, output, and employment. As a result, further deflation followed. Between 1929 and 1931, prices fell by 31.4 per cent in the USA alone (Romer and Romer, 2013).

Similar monetary failures were abundant throughout the Great Depression. Widespread banking panics, for example, could have been averted had the proper monetary policies been in place. This can be seen in Bordo et al's (1999) empirical analysis of USA monetary policy. They found that if $1 billion of expansionary open market operations had been conducted between October 1930 and February 1931 and between September 1931 and January 1932, such panics could have been averted without endangering the gold standard.

A failure to follow such policies was due to the Federal Reserve's inability to calculate when they were necessary. The Federal Reserve believed, in the words of one contemporary economist, that "member banks are in general reluctant to borrow from the Reserve Banks, (and) when they do borrow they are in most cases motivated by necessity rather than profit" (Riefler, 1930, quoted in Wheelock, 1990, p411). Due to this belief, the Federal Reserve calculated when monetary expansion was necessary based on whether banks were borrowing. When banks borrowed heavily, monetary expansion was utilised. Such a policy was inherently flawed however, given that banks were less likely to borrow during the Great Depression due to uncertainty and the fact that the recession had decreased the amount of loans and investments they made. As a result, "The Fed actually contributed to economic instability by exacerbating pro-cyclical swings in the money supply" (Wheelock, 1990, p.412). Although, Friedman and Schwartz (1963, p 411) have argued that such policies were due to the death of New York Bank Governor Benjamin Strong and the resultant "shift of power within the system and the lack of understanding and experience of the individuals to whom the power shifted", this misunderstands how the Federal Reserve operated. As Wheelock (1990) has shown, these pro-cyclical policies were in place even during Strong's lifetime. The reason they did not provoke depression earlier was that the 1924 and 1927 recessions had not hurt bank borrowing and, as such, had led to an expansionary monetary policy.

In contrast, the Great Depression abruptly halted bank borrowing leading policymakers to believe "that the decline in borrowed reserves following the stock market crash implied that money and credit were plentiful" (Wheelock, 1990, p.423).

Similar policy failures were endemic elsewhere. In Germany, as in much of central Europe, deflation was pursued as policymakers recovered from the shock of hyperinflation. In Great Britain, in what has been described as a "landmark policy mistake", deflation was also used to return to the pre-war parity (Baldwin and Wyplosz, 2012, p.382). In the UK, this pursuit was largely due to a mistaken belief that the gap between pre and post-war prices was only 2-3 per cent when, in reality, the gap was five times greater. Whilst policymakers had measured prices using wholesale index numbers, which were mainly affected by international prices, they should have instead used internal prices and measurements of the cost of living (Keynes, 1925). Similarly, policymakers severally underestimated the difficulty of deflation. As Keynes (1925, p.11) eloquently described it, policymakers "dwelt in the imaginary academic world… where the necessary adjustments follow 'automatically' from a 'sound' policy by the bank of England". The net result was that policymakers across Europe and the USA deliberately tried to create unemployment, in the hope of decreasing wages and lowering prices back to their pre-war parities (Keynes, 1923). Here, it is most clear how the ideology of the gold standard became so inextricably intertwined with that of a deflationary mind-set and a mismanagement of the very standard they sought to protect. In the words of Eichengreen and Temin (2010, p.13) "policies were perverse because they were formulated to preserve the gold standard, not to stabilise output and employment".

Monetary Thought: a Fixation on Gold

Monetary thought throughout the Great Depression supported such perverse policies, as it was believed that they would preserve the gold standard. As a contemporary economist, Basil Blackett makes clear: "The gold standard has become a religion for some of the boards of central banks in Continental Europe, believed in with an emotional fervour which makes them incapable of an unprejudiced and objective examination of possible alternatives" (Eichengreen and Temin, 2000, p.207). Such a fixation on gold was not without foundation. For decades, gold had provided the international system with stability and encouraged both saving and investment by removing the risk of government interference in the value of money. So great were the benefits of this that by 1914, one third of UK savings were invested abroad (Edelstein, 1982). The alternative to such stability, it was believed, was Germany's hyperinflation. Indeed, the fear of such hyperinflation cannot be underestimated in the minds of policymakers. Even as deflation gripped the USA, officials continued to preach that expansionary monetary policy would produce uncontrollable inflation. The same beliefs held true elsewhere. In Britain, few believed "that it was possible to let the pound float without suffering political and economic collapse" (Morrison, 2013, p.9). In Continental Europe, central banks were legally banned from making open market purchases (Bemanke and James, 1991).

Some writers, such as Keynes, have attributed this fixation to the fact that elites who held contracts valued at the pre-war parity benefited most from deflation. But with the cost of credit spiralling upwards, such elites, who typically invested heavily abroad, hardly benefited from the end results. Indeed, as Morrison (2013, p.35) makes clear, the attachment to gold was not an elite phenomenon: "Virtually all of Britain- from the Prime Minister who sacrificed his political future, to the labourers and the unemployed who swallowed the 10-15 per cent cuts in income with minimal resistance – wanted desperately to save the gold standard". This was due to the hegemony of the gold standard as an idea. The idea that gold was intrinsically valuable was clung to by policymakers and publics alike who searched in vain for stability in a world economy that was crumbling. With this at the fore, few other options were considered. Policy debate centred on the choice between deflation and devaluation (Keynes, 1923). Whether the gold standard should be abandoned or not did not even reach the agenda. And given that deflation strengthened the gold standard, whilst devaluation, would weaken it, deflation and its consequences, were what was prescribed. The hegemony of the gold standard can be clearly seen in the fact that even when countries abandoned it, such actions were viewed as failure. Britain's withdrawal in 1931 was described as "a catastrophe of the first order of magnitude" by a contemporary economist (Robbins, 1934, p.117). Likewise, the USA's withdrawal was seen as due to "inflationist sentiment" (Robbins, 1934, p.122). The American Institute of Banking even argued that abandoning gold had not been necessary, given that "at the time… its international economic position was so strong and its own gold holdings so large" (Robbins, 1934: p.122). The idea that the gold standard could be doing internal economic damage was not even considered.

Similarly, anything but the gold standard was blamed for the Great Depression. The public and the media blamed central banks for failing to expand, resulting in "the creeping paralysis of deflation" (Business Week, quoted in Romer and Romer, 2013: p.6). Central Banks, in turn, blamed commercial banks, arguing that money was neutral and that bank failures were due to the mismanagement of individual banks (Friedman and Schwartz, 1963). Professional economists blamed politicians, World War 1 and protectionism (Robbins, 1934). Politicians blamed trade unions for failing to allow wages to fall. Although all of these factors clearly impacted the Great Depression, none were as influential as the gold standard, which was rarely mentioned. This, above all, was hailed as the only bastion of stability in the world, while German hyperinflation was consistently used as a lesson for its necessity.

Conclusion

In conclusion, it is clear that the gold standard drastically impacted monetary thought and policy during the Great Depression. As we have seen, it was hugely harmful to the world economy as it was no longer suitable as a nominal anchor and encouraged deflation. Despite this, through the sterilisation of gold inflows and the hiking of interest rates, contractionary monetary policies were formulated to preserve it. This led to a further undermining of not just the world economy, but the conditions under which the gold standard could function as an appropriate monetary system. However, even as this occurred, monetary thought, despite some notable exceptions, consistently called for its protection due to the hegemony the ideology had over other alternatives. Such alternatives existed, as can be seen in Keynes' A Tract on Monetary Reform (1923), but they were never allowed reach the policy agenda. This led to a vicious circle, where monetary thought produced monetary policies which harmed the global economy, further endangering the gold standard, resulting in policymakers advocating ever more drastic measures to save it. Indeed, in the USA and in much of continental Europe, it was only when such policymakers were removed from office that the gold standard was abandoned (Eichengreen and Temin, 2000). In the UK, gold was only abandoned after a financial crisis forced what was intended to be a brief floatation of sterling. It was only when this failed to result in hyperinflation that policymakers at last began to consider a floating rate as a permanent solution (Morrison, 2013). Clearly, although the gold standard harmed the global economy, its effect on monetary thought and policy was unparalleled.

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