# The Great Depression and the Gold Standard

**Conor McGlynn**
*Senior Sophister*

*Have policymakers learnt from the mistakes of the Great Depression? In this essay, Conor McGlynn explores how the persistence of the gold standard prevented policymakers from engaging in expansionary monetary policies thereby prolonging the economic stagnation. The author postulates that the desire for stable monetary policy coupled with political factors were significant in explaining the reluctance to leave the gold standard.*

## Introduction

The question of what made the Great Depression so severe has been an important topic in the wake of the Financial Crisis of 2008 and the subsequent Great Recession. The key to answering this question lies in the international monetary system of the time: the gold standard. While the origin of the crisis and the mechanism through which it spread is by now well understood, there are still unanswered questions around why such a failure of policy occurred. This essay gives an overview of the Great Depression from its roots to the aftermath. It will in particular look at the question of why policy makers were so slow to react in response to deflation, and why it took so long for countries to abandon the gold standard. It draws on recent work by Adam Tooze for a potential explanation as to why there was such a persistent failure of monetary policy at the time.

## Historical Context

In order to understand the role of the gold standard in the Great Depression, it is necessary to look at the international monetary system before and during World War 1. From the mid 19th century onward, most countries in the world gradually moved onto the gold standard (Findlay and O'Rourke, 2007: 407). Other countries followed a gold exchange standard, whereby they pegged their own non-gold currencies at a fixed rate to a currency on the gold standard, such as the pound sterling. This system brought with it benefits for the participants by allowing exchange rate and balance of payments stability. This promoted trade between gold bloc countries, with estimates that trade was lifted by up to 30 per cent (López-Córdova and Meissner, 2003). This acted as driver for economic growth in the period.

Why was the gold standard so effective before the war? One answer to this question is the idea of hegemonic stability (Eichengreen, 1987). Britain was the dominant economic force at the time, and so, it is supposed, the Bank of England acted as both the leader in terms of policy for other central banks and as the international lender of last resort. This concentration of power created balance of payments and exchange rate stability within the system, a stability which lasted until the outbreak of World War 1, when this global hegemony was destroyed.

Eichengreen, however, argues against this view. He describes what he thinks are the two main elements in the success of the pre-war gold standard: credibility of central bank policy, and international cooperation between gold bloc countries (Eichengreen, 1992). Governments' commitment to the gold standard was seen as absolute, and as such investors had enough confidence to direct capital flows into countries that got into balance of payments difficulties which depleted gold reserves, because they were confident that the government would honour its commitment to gold and replenish the reserves. These capital inflows had a stabilising effect on the exchange rate and corrected the balance of payments.

International cooperation was the other element that allowed the pre-war gold standard to run smoothly. This cooperation took the form of a willingness of central banks to loan gold reserves to each other when they ran into trouble. While the Bank of England did play a key role in lending to distressed countries, the success of the gold standard came not from the actions of any one central bank, but from the strength of the international collaboration which could successfully defend the standard from shocks.

The advent of war in 1914 tore this system apart. The costs for individual countries were colossal, and most suspended gold convertibility so that they could freely print money to finance the war. This nearly bankrupted most European countries, and led them to rack up huge debts. Europe's economy was ruined, with trade and industrial production plummeting. The credibility and cooperation necessary for the successful working of the gold standard were impossible during the chaos of war.

After peace in 1918 there was a gradual attempt to return to the garden of the pre-war gold standard, with it being universal in market economies by 1929 (Bernanke, 1995). The problem, however, was that the elements that had been key to the success of the gold standard before 1914, namely credibility and cooperation, failed to resurface sufficiently after the war (Eichengreen, 1992). Having broken wholesale with gold during the war, investors no longer had so much faith in governments' commitment to preserve the link with gold. This meant that capital flows were not so quick to enter countries that ran into gold reserve difficulties, and so put strain on the system.

Initially after the war there was a high degree of cooperation between central banks. The US made loans to many European countries, and European central banks helped countries that ran into balance of payments troubles (Eichengreen, 1992: 207). However,

in 1927 the all-important link between the British and US central banks dwindled, and the cooperation necessary to sustain the system weakened. War debts and reparations also acted as barriers to closer international cooperation. This provided the setting for the subsequent financial crisis and the crash of 1929, and ultimately for the Great Depression itself.

## The Great Depression

During the 1920s the US economy was booming. Much of this growth was driven by post-war recovery. However, fears of an equity price bubble led the Federal Reserve to try to cool down the economy. In 1928, the Fed tightened its monetary policy. The effects of this monetary contraction were not limited to the US, but were transmitted around the world through the workings of the gold standard (Bernanke, 1995). The Fed raising interest rates put pressure on debtor countries by restricting foreign lending. This meant that these countries had to also tighten their monetary policy in order to continue servicing their debts. The subsequent decline in economic activity led to a fall in demand for US exports, and reinforced the downturn. The gold standard played a central role in the transmission of monetary shocks around the world.

These monetary shocks acted on the real economy through two main channels: deflation and increased real wages above market clearing level (Bernanke, 1995). As the economy slowed from 1929, policymakers allowed money supply to fall further. This monetary contraction led to debt deflation. This deflation was crippling for the economy, and was a main contributor to the severity of the depression. The other channel through which monetary contraction affected the real economy was through nominal wages failing to adjust. This meant the labour market failed to clear, and led to unemployment and further economic decline.

Why did policymakers permit the money supply to fall so much, thus prolonging and worsening the downturn? Again, the gold standard is central to the story here. Because of fears of gold outflows, world central banks were unwilling to engage in any expansionary policies. This meant that they were unwilling to act as lender of last resort to troubled banks as it would threaten gold convertibility. This led to bank failures and worsened the financial crisis. The link to gold tied policymakers' hands. A strong multilateral push by countries to engage in monetary expansion could have been possible within the constraints of the gold standard. However, the level of international cooperation necessary for such a push, while it might have been possible before the war, was unable to be achieved in the 1930s (Eichengreen, 1992).

Ultimately, countries began to leave the gold standard. From 1932 onwards, major market economies began abandoning gold. This allowed them to reflate their price levels and money supplies, and engage in expansionary policies to rescue their economies. The countries that abandoned the gold standard sooner subsequently experienced a faster

economic recovering (Bernanke, 1995: 5). By leaving the gold standard, countries removed what Eichengreen calls the "golden fetters" which restrained monetary policy and prevented a quick economic recovery.

The question that remains to be answered, however, is why countries were so slow to abandon the gold standard in the face of such grave economic circumstances? Why was there such a pronounced failure of policy around the globe at the time? There were a number of factors that contributed to this. For many countries, one of the main reasons they were unwilling to break with gold was a fear of inflation. During the 1920s many countries experienced severe and crippling levels of inflation. It was the desire for stable monetary policy that restrained inflation which led many countries to go back on the gold standard after World War 1 (Crabbe, 1989: 423).

This explanation, however, does not account for why countries that didn't experience very extreme inflation, such as Sweden and Britain, were so slow to leave the gold standard. An alternative account of why major countries tried to preserve the link to gold for so long is given in a recent work by Adam Tooze (2014). Tooze emphasises the importance of political factors in the wake of World War 1, and how these political factors influenced the aims and actions of policymakers around the world.

Tooze's thesis is that World War 1 represents a watershed in world history; in the words of Lloyd George it was "the deluge" that would completely reshape the world's political order. It created as an overwhelming aim for politicians the avoidance of any further conflict between advanced nations that would result in such destruction and loss of life. It was recognised that the only way that this could be achieved was through global cooperation and a new transnational world order.

Under this system, policymakers' bull-headed commitment to the gold standard in the face of worsening economic crisis can be seen as their protection of the supranational monetary order. This monetary accord represented a key part of the global political order, and in order to prevent a return to the separatism and nationalism that produced World War 1 governments would go to extreme lengths to protect it.

Tooze gives an explanation of why policymakers tried so hard to defend the gold standard during the crisis. It is extremely important to get an understanding of why policymakers did what they did during the Great Depression. According to Eichengreen (2015), an incomplete understanding of the mistakes of policymakers, coupled with the belief that such mistakes could not happen again, led to similar flaws in policy before and during the recent financial crisis and Great Recession. While policymakers learned the lessons of the Great Depression with regard to avoiding deflation and bank failures, in other areas they did not. This has led to a lack of systemic reform, and leaves us open to making the same mistakes in the future. An appreciation of the forces at work in policymaking during the Great Depression may help us to avoid this fate.

## Conclusion

Ben Bernanke says of the Great Depression that it "gives birth to macroeconomics as a distinct field of study" (1995: 1). An understanding of its causes and of the causes of its severity is therefore crucial for the discipline of macroeconomics. While we have a strong understanding today of the mechanics of the crisis, it is still important to try to gain insights into the decision making process of policymakers at the time. Only by doing so in a comprehensive way can we hope to avoid their mistakes in the future.

**References**

Bernanke, B. 1995. 'The Macroeconomics of the Great Depression'.

Crabbe, L. 1989. 'The International Gold Standard and U.S. Monetary Policy from World War I to the New Deal'. Federal Reserve Bulletin June 1989.

Eichengreen, B. 1987. 'Hegemonic Stability Theories of the International Monetary System'. NBER Working Paper No. 2193.

Eichengreen, B. 1992. Golden Fetters: The Gold Standard and the Great Depression. Oxford University Press: New York.

Eichengreen, B. 2015. Hall of Mirrors. Oxford University Press.

Ernesto López-Córdova, J. and Christopher M. Meissner. 2003. 'Exchange-Rate Regimes and International Trade: Evidence from the Classical Gold Standard Era.' American Economic Review, 93(1): 344-53.

Findlay, R. and O'Rourke, K. H. 2007. Power and Plenty. Princeton University Press: Princeton.

Tooze, A. 2014. The Deluge. Penguin: New York.