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Don’t blame the Depression on the gold standard – but don’t expect it back either

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TWO of America’s Republican candidates – Newt Gingrich and Ron Paul – have dared to toy with the idea of bringing back the gold standard. Their remarks have in turn triggered a fusillade of indignant replies, from pundits and professional economists alike, the general theme of which is that no one fit to be America’s Commander-in-Chief can possibly have a good word to say about gold.

Of all the reasons usually given for condemning the gold standard, perhaps the most common is the claim that it was to blame for the Great Depression. What responsible politician, gold’s critics ask rhetorically, wants to relive the 1930s?

But the criticism misses its mark. Fans of the gold standard are no more anxious to repeat the 1930s than their critics are. Their nostalgia is instead for the interval of exceptional international monetary stability that prevailed from the mid-1870s until World War I. That was the era of the classical gold standard – a standard policed by the citizens of participating countries, all of whom were able to convert their nations’ paper money into gold.

This classical gold standard can have played no part in the Great Depression for the simple reason that it vanished during World War I, when most participating central banks suspended gold payments. (The US, which entered the war late, settled for a temporary embargo on gold exports.) Having cut their gold anchors, the belligerent nations’ central banks proceeded to run away, so that by the war’s end money stocks and price levels had risen substantially, if not dramatically, throughout the old gold standard zone.

Postwar sentiments ran strongly in favour of restoring gold payments. Countries that had inflated, therefore, faced a stark choice. To make their gold reserves adequate to the task, they could either permanently devalue their currencies relative to gold and start new gold standards on that basis, or they could try to restore their currencies’ pre-war gold values, though doing so would require severe deflation. France and several other countries decided to devalue. America and Great Britain chose the second path.

The decision taken by Winston Churchill, then Britain's chancellor of the exchequer, to immediately restore the pre-war pound, prompted John Maynard Keynes to ask, "Why did he do such a silly thing?" The answer was two-fold: first, Churchill's advisers considered a restored pound London's best hope for regaining its former status – then already all but lost to New York – as the world's financial capital.

Second, Britain had other cards to play, aimed at making its limited gold holdings go further than usual. Primarily, it would convince other countries to take part in a gold-exchange standard, by using claims against either the Bank of England or the Federal Reserve in place of gold in international settlements. It would also ask the Fed to help improve Great Britain's trade balance by pursuing an easy monetary policy.

The hitch was that the gold-exchange standard was extremely fragile: if any major participant defected, the British-built house of cards would come tumbling down, turning the world financial system into one big smouldering ruin.

In the event, the fatal huffing and puffing came then, as it has come several times since, from France, which decided in 1927 to cash in its then large pile of sterling chips. The Fed, in turn, decided that pulling back the reins on a runaway stock market was more important than propping-up the pound. Soon other central banks joined what became a mad scramble for gold, in which Britain was the principal loser. At long last, in September of 1931, the pound was devalued. But by then it was too late: the Great Depression, with its self-reinforcing rondos of failure and panic, was well under way.

So the gold standard that failed so catastrophically in the 1930s wasn't the gold standard that some Republicans admire: it was the cut-rate gold standard that Great Britain managed to cobble together in the 20s – a gold standard designed not to follow the rules of the classical gold standard but to allow Great Britain to break the old rules and get away with it.

So does this mean that those Republican candidates are right to pin America's hopes on a return to gold? Alas, it doesn't: the collapse of the gold-exchange standard forever undermined the public's confidence in governments' monetary promises; and absent such confidence there can be no question of a credible, government-sponsored gold standard, classical or otherwise. Sometimes with monetary systems, as with life, you can't go home again.

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Gold standard fans are not nostalgic for the 1930s but earlier, exceptional stability