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The Eichengreen Fallacy Misleads Some "Market Monetarists," Part Two

By Ralph Benko
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As noted in my previous column, AEI's James Pethokoukis and *National Review*'s Ramesh Ponnuru — among many others — appear to have fallen victim to what I have called the "Eichengreen Fallacy." This refers to the demonstrably incorrect proposition that the gold standard caused the Great Depression.

Pethokoukis proves exactly right in observing that "Benko is a gold-standard advocate and apparently doesn't much like the words 'Hitler' or 'Nazi' to be in the same area code of any discussion of once again linking the dollar to the shiny yellow metal." "Doesn't much like" being falsely linked with Hitler? Perhaps an apology is more in order than an apologia.

My objecting to a demonstrably false implication of the (true) gold standard in the rise of Nazism does not constitute a display of ill will but rather righteous indignation. To give Pethokoukis due credit he thereupon generously devoted an AEIdea blog to reciting Peter Thiel's praise for the gold standard, praise which triggered a hysterical reaction from the *Washington Post*'s Matt O'Brien.

Pethokoukis's earlier (and repeated) vilification of gold was followed by a column in the *Washington Times* by a director of the venerable Committee for Monetary Research and Education Daniel Oliver, Jr., Liberty and wealth require sound money. In it, Oliver states:

What if liberty and riches at times diverge, though? A shibboleth of mainstream economists, repeated recently in The *National Review*, of all places, is that countries recovered from the Great Depression in the order that they abandoned the gold standard. … No doubt, money printing — the modern equivalent of leaving the gold standard — can plug the holes in banks' balance sheets when the demand deposits at the base of the credit structure are withdrawn. This is the policy recommended by National Review Senior Editor Ramesh Ponnuru and other "market monetarists" such as the American Enterprise Institute's James Pethokoukis ….

I am not in complete accord with all of Oliver's propositions therein. Ponnuru is on solid ground in contradicting Oliver's imputation of sentiments to him he does not hold and does not believe. Yet Ponnuru weakens his defense by citing, among other things, a recent summary of the history of gold standards in the United States that George Selgin wrote for the Cato Institute. It is a very gold-friendly account, but it 'concludes that the conditions that led to the gold standard's original establishment and its successful performance are unlikely to be replicated in the future.'

"Unlikely to be replicated in the future?" Prof Selgin is a brilliant economist, especially in the elite field of monetary economics. Yet as Niels Bohr reportedly once said, "Prediction is very difficult, especially about the future." This citation in no way advances Ponnuru's self-defense.

Let it be noted that Cato Institute recently announced a stunning coup in recruiting Prof. Selgin to head its impressive new Center For Monetary and Financial Alternatives. As stated in its press release, "George Selgin, a Professor Emeritus of Economics at the University of Georgia and one of the foremost authorities on banking and monetary theory and history, gave up his academic tenure to join Cato as director of the new center." Cato's recruitment, from the Mercatus Institute, of a key former House subcommittee aide, the formidable Lydia Mashburn, to serve as the Center's Manager also shows great sophistication and purpose.

Prof. Selgin hardly would give up a prestigious university post to engage in a quixotic enterprise. I, among many, expect Selgin rapidly to emerge as a potent thought leader in changing the calculus of what is, or can be made, policy-likely. Also notable are the Center's sterling Council of Economic Advisors, including such luminaries as Charles Calomiris; its Executive Advisory Council; Senior Fellows; and Adjunct Scholars. It is, as Prof. Selgin noted in a comment to the previous column, "a rather … diverse bunch."

The Center presents as an array of talent metaphorically reminiscent of the 1927 Yankees. These columns do not imply Cato to be a uniform phalanx of gold standard advocates but rather a sophisticated group of thought leaders committed to monetary and financial alternatives, of which the classical gold standard is one, respectable, offering. Prof. Selgin's own position frankly acknowledging the past efficacy of the true gold standard represents argument from the highest degree of sophistication.

Ponnuru is on the weakest possible ground in citing the "commonplace observation that countries recovered from the Great Depression in the order they left gold." This is as misleading as it is commonplace. Ponnuru, too, would do well to break free of the Eichengreen Fallacy and assimilate the crucial fact that a defective simulacrum, not the true gold standard, led to and prolonged the Great Depression.

The perverse effects of the interwar "gold" standard led to a significant rise in commodities prices … and the ensuing wreckage of a world monetary system by the, under the circumstances, atavistic definition of the dollar at $20.67/oz of gold. The breakdown of the system meticulously is documented in a narrative history by Liaquat Ahamed, *Lords of Finance: The Bankers Who Broke The World*, which received the Pulitzer Prize in history. That road to Hell tidily was summed up in a recent piece in The Economist, *Breaking the Rules*: "The short-lived interwar gold standard … was a mess." As EPPC's John Mueller recently observed, in *Forbes.com*, "the official reserve currencies which Keynes advocated fed the 1920s boom and 1930s deflationary bust in the stock market and commodity prices."

The predicament — caused by the gold-exchange standard adopted in Genoa in 1922 — required a revaluation of the dollar to $35/oz, duly if eccentrically performed by FDR under the direction of commodities price expert economist George Warren. That revaluation led to a dramatic and rapid lifting of the Great Depression. Thereafter, as Calomiris, et. al, observe in a publication by the Federal Reserve Bank of St. Louis, the Treasury sterilized gold inflows. That sterilization, together with tax hikes, most likely played a major role in leading to the double dip back into Depression.

The classical gold standard — an early casualty of the First World War — was not, indeed could not have been, the culprit. There is a subtle yet crucial distinction between the gold-exchange standard, which indeed precipitated the Great Depression, and the classical gold standard, which played no role. There is much to be said for the classical gold standard as a policy conducive to equitable prosperity. It commands respect, even by good faith opponents.

For the discourse to proceed we first must lay to rest the Eichengreen Fallacy (and all that is attendant thereon). Once having dispelled that toxic fallacy let the games begin and let the best monetary policy prescription win.