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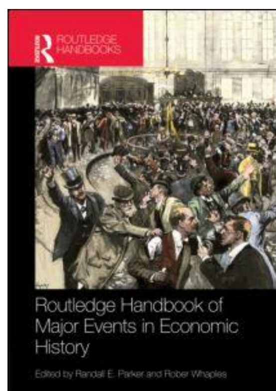


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## The Great Depression

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# 13
# THE GREAT DEPRESSION

*Randall E. Parker*

## Introduction

The interwar era from 1919–1939 was a twenty year peace that separated the hostilities of the First and Second World Wars (discussed in Eloranta's and Higgs's chapters, respectively). The period was marked by the prosperity of the 1920s (discussed in Olney's chapter) together with the long recovery period from 1933–1939 (discussed in Fishback's and Ohanian's chapters). In between the roaring twenties and the post-1933 recovery, the world economy collapsed. Figure 13.1 shows the time path of U.S. industrial production from 1919:1–1939:12.

Peaking in July of 1929, industrial output fell almost continuously with but a few upward "breathers" (March–May 1931 and August–October 1932) on its downward plunge, hitting bottom in March 1933. Assessing the damage over those 45 months shows that industrial production fell 52 percent. Given that the United States produced one half of world industrial output in 1929, this decrease in U.S. production represented a one-quarter decline in world industrial output. Unemployment statistics tell a similar story, rising from 3 percent in August 1929 to 25 percent in March 1933.

This chapter focuses on the protracted fall and trough of the Great Depression. While the economic trauma the world witnessed in 2008, and continues to endure in 2012, is similar in many ways to the Great Depression, contemporary events do not begin to match the magnitude of the economic devastation that was evident worldwide in 1933. What were the forces that produced the most severe of all business cycle downturns and why was the Great Depression as deep and widespread as it turned out to be? As we will see, the depth and ubiquity of the Depression cannot be separated, primarily, from two schools of thought: one school that stresses the importance of the intransigent adherence to the interwar gold exchange standard and its fatally flawed structure and another school that focuses on the policy mistakes of the Federal Reserve and its faulty structure.[1]

## The aftermath of World War I

In 1919, the United States and all of Europe took a look around and found their world in a smoldering heap of death and destruction. The previous four years had revealed warfare as it had never before been witnessed. Military engagements, such as the Battle of the Somme

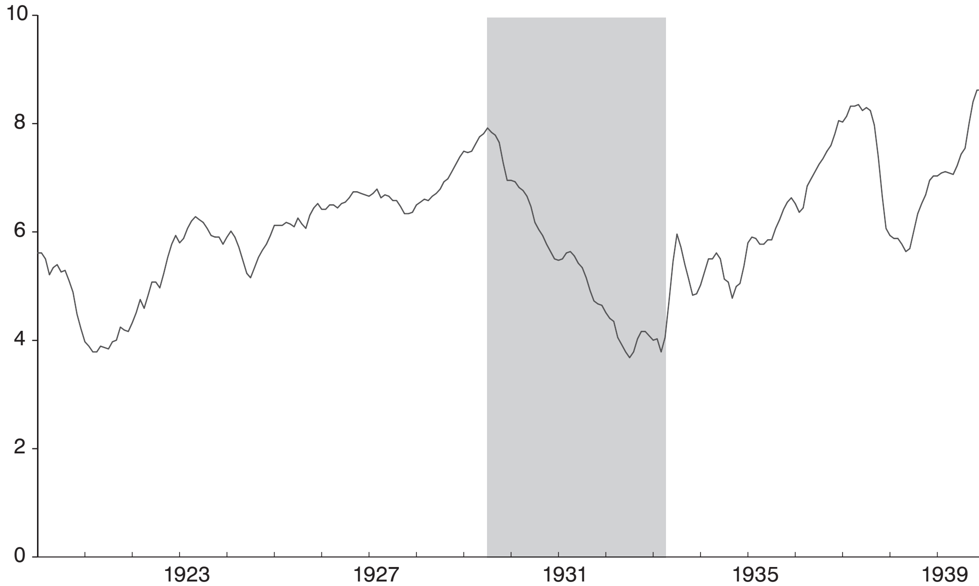


*Figure 13.1* Industrial production 1919:1–1939:12

Source: Industrial production data are from the FRED economic data source of the Federal Reserve of St. Louis, 2007 = 100.

from July 1, 1916–November 18, 1916 which caused over one million casualties, were of an entirely new and unknown magnitude that shocked the human senses. The world powers longed to remake the world into something better than what had been endured for those dreadful four years from July 1914–November 1918.[2] So, naturally enough, they looked at a happier time in world history and reached back for what they had known prior to the war. They wanted to recreate what they had before 1914 when everyone agreed it was a better world. One of the key ingredients that fostered economic stability and made the pre-1914 period worthy of emulation was the gold standard. When viewed through the lens of history, the gold standard and prosperity appeared to be a package deal and were considered synonymous. The gold standard fixed exchange rates, and linked markets and the transfer of resources and value internationally. Certainly the empirical record from the late nineteenth and early twentieth centuries gave contemporary observers great faith and belief that the mingling of the gold standard and stable macroeconomic performance was not just a relation that emerged from historical coincidence but rather emanated from meaningful economic causality. Indeed, adherence to and maintenance of the gold standard was considered to be an unmistakable sign and coveted affirmation of a country's passage into economic adulthood and financial rectitude (Bordo and Rockoff 1996).

However, it was the reintroduction of the gold standard into a post-World War I world that had very much changed that set the stage for the Great Depression. The world of 1925 had little resemblance to the world of 1913. The world powers may have longed to recreate what they had before the war, the *status quo ante*. But the morphing of labor markets, unions, wage rigidity, the evolution of the social contract in many European countries and flaws in the structure of the gold standard insured that the efforts toward that recreation would fail. The functioning of the interwar gold standard would be entirely different…and the results devastating.



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## Re-establishing the gold standard

As discussed in the chapter by Olney and also by Field (2011), the decade from 1920–1929 was a period of economic progress and technological innovation. But it was also a time of financial turmoil as the world powers, particularly the U.S., Great Britain, France and Germany struggled to return to the gold standard.[3] Traditionally, countries suspended the gold standard when hostilities broke out. During the time of war, inflation in the general price level accompanied the expansion of government debt and the gearing up of the economy for wartime production. When the war was over, a country that was previously on the gold standard would re-establish the gold standard at the parity that existed before the war commenced. This was done by Great Britain after the Napoleonic Wars and by the United States after the Civil War, and each required deflation in the general level of prices to reset the dollar or pound sterling to its antebellum fixed price. (See the chapter by Burdekin and Siklos for a discussion of gold resumption and the deflation of the 1870s.) To not do so at the antebellum price was considered by the public to be a betrayal by the government and a confiscation of the wealth of government bond holders since re-establishment at a higher price would imply the erosion of purchasing power of the underlying value of bond holders' assets. Indeed, the dollar price of an ounce of gold had been established at $20.67 beginning in 1837 and it was to that price it was going to return after World War I.[4] While there was some argument regarding when and how the British would return to the gold standard, re-establishment at the price of £1 = $4.86 was not seriously questioned by either Prime Minister Baldwin or Montagu Norman, Governor of the Bank of England.[5] They ultimately brought the Chancellor of the Exchequer, Winston Churchill, over to their way of thinking, against the pleadings of John Maynard Keynes.[6]

The post-war deflation experience was different across countries. The Federal Reserve, in exercising its newly created independent monetary powers (in the sense of not having to accommodate wartime finance concerns), was able to engineer a sharp and short deflation which produced only a mild economic downturn that was quickly reversed. The United States went back on the gold standard in April of 1919, well before any of the countries in Europe. Although initially the recession of 1920–21 that followed the sharp deflation was thought to be a major economic disruption, subsequent scholarship has revealed its mild characteristics for the real economy (Romer 1988). The Federal Reserve faced its first independent test of its monetary powers and was perceived to have passed it convincingly (Friedman and Schwartz 1963, Eichengreen 1992). But the lessons that the Federal Reserve took away from this episode would prove to be very costly later in the decade.

The British did not fare as well as the U.S. in deflating and re-establishing the gold standard. With the re-establishment of the gold standard at prewar parity being the only option under serious consideration, deflation and falling wages were the avenues of adjustment, not devaluation. In maintaining the gold standard, internal balance of the domestic economy is subordinated to external balance and the preservation of the exchange rate and gold price of the domestic currency. Falling prices and wages (and higher interest rates) are the equilibrating mechanism. Indeed this is one of the main factors that led to the demise of the gold standard in the UK in September 1931 as Britain could no longer sustain the loss of gold reserves nor tolerate the deflation that was the necessary and only response to defend and preserve the exchange value of the pound (discussed in Kitson's chapter). After World War I, falling prices were needed to re-establish the exchange rate at £1 = $4.86. Since labor was the largest part of production costs, falling prices meant falling wages. However, the Britain known before World War I was not the Britain after World War I. Wage flexibility had

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been reduced as the early 1920s saw the emergence of union power, proposals for minimum wages and calls for the provision of state-provided family allowances or "living wages".[7] For the workers who fought and suffered during World War I, this adjustment of falling wages had gone too far. They bore the burden of the fight and now wanted to be treated as equals in the social contract, not simply to be dictated to by the government and firm owners. Although the UK went back on the gold standard in May of 1925, workers were not ready to just give in and capitulate. A general strike occurred from May 4, 1926 until May 13, 1926 that essentially shut the UK economy down. It ended when unions were told they could be held liable for losses during the strike and have their assets seized by the ownership of the firms they worked for. The labor movement lost this fight, but the future had been foretold.

Countries had to live with the exchange rate they chose when they went back on the gold standard. And for Britain, it is thought that the exchange rate they returned to was overvalued by about 10 percent. The combination of an overvalued pound with persistent deflation and labor unrest would make Britain's adherence to the gold standard untenable when the heat of the Great Depression was applied.

Given France's dreadful experience of 300 percent inflation during World War I (Beaudry and Portier 2002: 74) and the continued inflationary aftermath from 1921–1926 (see Eichengreen 1986), France was in no mood or position to deflate back to their pre-war parity of 25 francs per pound sterling in re-establishing the gold standard. When Raymond Poncaré was restored to power in 1926 he put in place a stabilization program that ended the deficits the French government had been running, stopped excessive money growth and successfully reduced expectations of inflation. The steady devaluation of the franc during the 1920s was also halted during this stabilization and the franc was back on the gold standard officially in June 1928 at one-fifth its 1913 exchange rate.[8] It is thought that the franc, based on purchasing power, was re-established at an exchange rate that was undervalued by 25 percent.[9] As indicated above, the parity at which a country returned to the gold standard was chosen unilaterally. Once chosen however, that was the rate that must be defended and would persist. The French were going to rejoin the international financial community at a severely undervalued currency, and French inflation would have been the necessary response to the forthcoming gold inflows the French were to experience. Inflation would have been the avenue to a sustainable equilibrium given this misalignment of exchange rates. But inflation was a non-starter for the French. This is one of the many flaws in the international gold exchange standard, and the stage for the Great Depression was now set.

## The Midas touch

The interwar gold exchange standard that the world had wedded itself to was now in place and ready to operate. As long as the rules of the game were observed there was every reason to hope for a happy outcome for the international financial community's contribution to the recreation of the better world that had been known prior to 1914. That is, as long as the law of one price held, as long as countries that gained gold would inflate and countries that lost gold would deflate to observe the proper functioning of the price–specie–flow mechanism, as long as economic adjustments would be borne by prices and not quantities, as long as countries would trade internal imbalance (unemployment, falling wages, lost output) for external balance, and as long as countries would accept deflation in whatever dose was necessary to defend the gold price and exchange value of the national currency and never breathe a word or have a thought about devaluation, the gold standard would be operational. Any chink in the armor of the above list and the sanctity of the gold standard would begin to

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wobble. Check enough of the above items off the "ready-to-perform" list and the sanctity of the gold standard would crumble.

And that is what happened. The gold standard failed, as it was structured in 1928, because it was afflicted with six dysfunctional flaws.[10] First, and most damning, the gold standard was (and still is if it were to be adopted again) an engine for deflation anytime there was an increase in the relative price of gold. Given that the price of gold is fixed in dollar terms, *anything* that increases the relative price of gold compared to any other commodity must by necessity reduce the price of the other goods in terms of dollars, that is, impose deflation. Second, there was an asymmetry between gold-gaining countries and gold-losing countries. Countries that lost gold reserves *had* to deflate and reduce their money supplies while countries that gained gold *were not compelled* to inflate and increase their money supplies. If a country (or countries) that was attracting gold also decided to go down a contractionary economic path, it would continue to drain gold from other countries, export deflation and force further declines in the supplies of money in other countries. The Genoa Conference of 1922 that established guidelines for the return to gold did not contain any enforcement provision to compel countries to follow the rules of the gold standard (Irwin 2012). This would prove to be a pivotal cause of the spread of the Depression internationally. Third, countries that did not have reserve currencies could hold their minimum reserve balances in the form of gold and convertible foreign currencies, which is known as reserve pyramiding. As long as no threat of devaluation existed the system was stable. But any risk of devaluation sent countries fleeing from holding reserve currencies into gold, rather like the contractionary effects of the public switching from bank deposits to cash holdings. The result was a further contraction of the world money supply and further deflation. Moreover, France had little use for foreign exchange holdings and converted virtually all of their reserves into gold. Fourth, some central banks were restricted in their powers and indeed the Bank of France was prohibited from conducting open market operations (Eichengreen 1986). Thus, as France was amassing gold reserves, it was prevented from adhering to the rules of the gold standard and continued its export of deflation that consumed the world's economy. Fifth, when the gold standard was in jeopardy, the policy options available to improve the situation in fact exacerbated the conditions of the economy. Gold reserve losses promoted deflation and deflation was the only choice to preserve the exchange rate. If market participants questioned a country's commitment to gold, the relative price of gold would rise, more deflation would follow and interest rates would need to rise to stop gold outflow. This cycle of gold loss, deflation, higher interest rates, and unemployment ultimately is what led to Britain leaving the gold standard September 21, 1931. They no longer were able to, nor desired to, resist devaluing the pound. Finally, the sixth and last dysfunctional flaw has been discussed above. The misalignment of exchange rates provided a failure scenario for the world economy with the UK being overvalued by 10 percent and France undervalued by 25 percent, when all countries were officially back on the gold standard and the fact that these exchange rates were the ones that had to be lived with come what may.

## The U.S. and France

In 1926 France held 7 percent of the world's gold reserves. By 1932 it held 27 percent of the world's gold reserves. "By 1932, France held nearly as much gold as the United States, though its economy was only about a fourth the size of the United States. Together, the United States and France held more than sixty percent of the world's gold stock in 1932"

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(Irwin 2012). And that is the biggest piece of the puzzle needed to construct the narrative of the relation between the gold standard and the Great Depression.

In January 1928, a law was suspended that prohibited the export of capital from France so that securities of all national origin could come and go without restriction for the first time since 1918 (Hamilton 1987: 146). Once the process of officially stabilizing the franc was started in August 1926, at an undervalued exchange, money and gold came pouring into France from all corners of the globe. French gold holdings increased 76 percent between December 1926 and December 1928 of which gold flows from the United States alone represented the equivalent of 4 percent of the total stock of high-powered money in the U.S. during 1928 (Hamilton 1987: 147). In addition, Federal Reserve Bank of New York Governor Benjamin Strong had convinced Fed officials in 1927 of the need to assist the Bank of England in attempting to revive the British economy, especially after the traumatic general strike the year before. Knowing that unilateral action under the gold standard was futile, Montagu Norman asked for help and Strong complied. Monetary policy eased in the U.S. in 1927. By January 1928 , many in the Federal Reserve were convinced that speculative credit was driving the stock market surge and that this was Strong's fault[11] (see Meltzer's interview in Parker 2007). The monetary stimulus of 1927 was a mistake that needed to be unwound. In the real bills doctrine mind set of the time, credit creation was only to be countenanced in support of production. Self-liquidating loans made to support production and output were fine. Money creation for speculative purposes was anathema and supported the monetization of non-productive credit which would ultimately be inflationary. Further, in the belief system of the time, deflation was the inevitable result of inflation and inflation the result of speculative excess. Together with the loss of gold to France and the desire to address the rise in the stock market, the Federal Reserve became highly contractionary in January 1928 (Hamilton 1987).[12] The Fed had deflated quickly and with little consequence to the real economy in 1920–21 and it proceeded to repeat that episode. However, the Fed in 1928 did not appreciate the extent to which the successes of 1920–21 were a product of the unique circumstances that prevailed at that time. Europe was devastated after the war and export demand was strong for the U.S. Other countries were not on the gold standard yet in 1920–21 so that U.S. deflation was not matched by European deflation. Yet the Fed thought it could deflate again in 1928–29 with little consequence to the business cycle. However, the gold standard was now operational and was an engine for the international transmission of deflation (Eichengreen 1992, Parker 2007).

## Depression

So in 1928–29 both the U.S. and France decided to take the path to falling prices, and the deflationary vortex that consumed most of the rest of the world had begun (Hamilton 1987, Bernanke and James 1991).[13] The structural dysfunctions of the gold standard and the gold standard's *mentalité* took it from there.[14] As gold flowed in, gold-gaining countries like France sterilized these inflows and compelled their trading partners to deflate and raise interest rates to stop the gold outflow. Preservation of the gold standard required deflation and it would be adhered to since the gold standard was the ideology and belief system that drove the actions of policy makers of that day. Consideration of actions outside the framework of the gold standard was unthinkable. Maintaining the orthodoxy of the gold standard would eventually restore order, if only there was the political will to persevere. This was the thinking of Benjamin Strong, U.S. president Herbert Hoover, Governor of the Federal Reserve System Eugene Meyer, Treasury Secretary Ogden Mills, Montagu Norman and Émile Moreau,

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Governor of the Bank of France, to name some of the most important policy makers. And they stuck to it until they could not maintain it any longer (Britain) or there was a regime change (U.S.) and the unthinkable became thinkable. Or in the words of Eichengreen and Temin (2003: 212) only "until after an unprecedented crisis had rendered the respectable unrespectable and vice versa." Britain left gold on September 21, 1931 after a summer of bad financial news in Europe and a series of speculative attacks on the pound. They could no longer stomach interest rate increases and further deflation with a 20 percent unemployment rate. Moreover, their gold reserves had been drained to the point that they no longer found participation in the gold standard viable. After Britain departed, the U.S. continued to defend gold and this delivered "the knockout punch to the U.S. economy" (Hamilton 1988: 72). Uncertainty regarding the maintenance of the gold standard led to an increase in the relative price of gold and gold outflow. The gold standard prescription for this situation was higher interest rates and more deflation … and an intensified tumble to the bottom that finally came in March 1933. Leaving the gold standard was an executive decision and Hoover was going to stick with gold to the bitter end. And he did. It was only when Franklin Roosevelt took office in March 1933 that the gold standard was suspended and the allure of the Midas touch finally rejected. It was only after 25 percent unemployment, a massive wave of bank failures, a run on the dollar and the Federal Reserve of New York being reduced to a gold cover ratio of 24 percent that the gold standard and its orthodoxy were jettisoned.[15] Once this was done, recovery began almost immediately. In fact one of the strongest macroeconomic relations that economic research has identified is the empirical link between when a country left the gold standard and when recovery commenced. Brown (1940), Choudhri and Kochin (1980), Eichengreen and Sachs (1985), and Campa (1990) all overwhelmingly confirm that leaving the gold standard was a precondition for recovery. Regime change, as discussed by Temin (1989), finally freed the U.S. from the grip of the vertiginous downward deflation and depression cycle of August 1929–March 1933.

## The monetary hypothesis

The hypothesis that the Great Depression was caused by a massive decline in the money supply is neatly summarized by the title of the seventh chapter, "The Great Contraction, 1929–1933," in the monumental work of Friedman and Schwartz (1963). A look at Figure 13.2 quickly reveals what Friedman and Schwartz had in mind. Note the dramatic fall in M2 from a high in August 1929 of $46.28 billion to a low of $29.75 billion in April 1933, a decline of 36 percent.

Great Contractions in the supply of money cause Great Depressions. Figure 13.2 also contains the answer to whom Friedman and Schwartz attribute the responsibility for this unfortunate economic record. By definition, the supply of money is the product of the monetary base multiplied by the money multiplier. Figure 13.2 shows that with a falling M2 and a constant monetary base, a crashing money multiplier is the culprit behind the falling money supply. The proper response from the monetary authorities should have been to accelerate the growth rate of the monetary base to counteract the falling multiplier and prevent the money supply from falling. Figure 13.2 demonstrates the monetary base had little to no movement during the protracted downward phase of the Depression. Its time path is virtually horizontal when the Depression was at its worst. The monetary base is certainly the one monetary variable that the Federal Reserve most closely controls and yet it did nothing to combat the epic fall in the money supply.[16] Looking at the equation of exchange where the money supply multiplied by the velocity of money equals nominal GDP, $M \times V = NGDP$,

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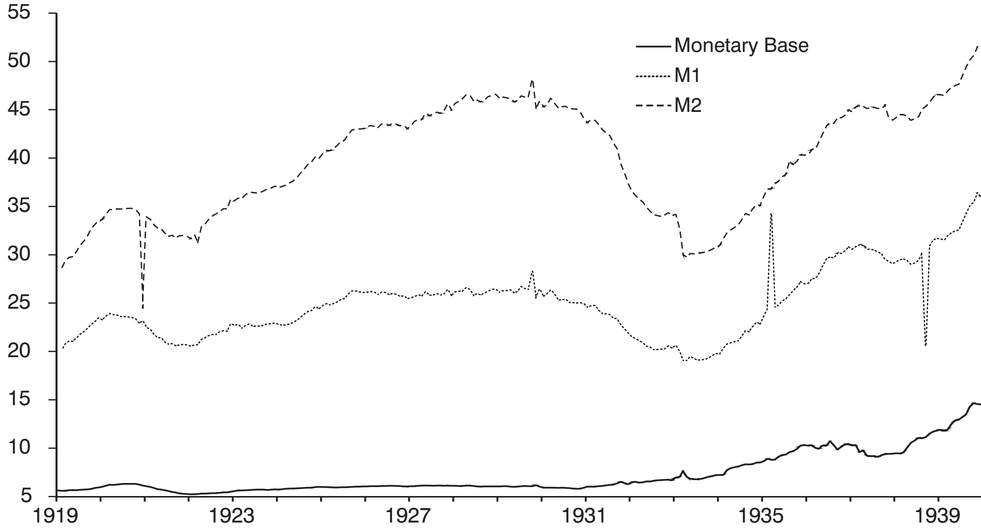


*Figure 13.2* M1, M2 and the monetary base 1919:1–1939:12

Sources: M1 and M2 are from Friedman and Schwartz (1963) in billions of dollars. The monetary base is from the FRED economic data source of the Federal Reserve of St. Louis

with both the velocity of money and the money supply falling sharply, unless prices were perfectly flexible in the downward direction the inevitable result was depression. Yet, the Federal Reserve sat back and watched while the economy burned. In the monetary view, the culpability for the meltdown of the financial system, deflation, high real interest rates, and Depression can be laid squarely at the feet of the Federal Reserve and their series of policy errors.[17] In the words of Friedman and Schwartz (1963: 693):

> At all times throughout the 1929–33 contraction, alternative policies were available to the System by which it could have kept the stock of money from falling, and indeed could have increased it at almost any desired rate. Those policies did not involve radical innovations. They involved measures of a kind the System had taken in earlier years, of a kind explicitly contemplated by the founders of the System to meet precisely the kind of banking crisis that developed in late 1930 and persisted thereafter. They involved measures that were actually proposed and very likely would have been adopted under a slightly different bureaucratic structure or distribution of power, or even if the men in power had had somewhat different personalities. Until late 1931 – and we believe not even then – the alternative policies involved no conflict with the maintenance of the gold standard. Until September 1931, the problem that recurrently troubled the System was how to keep gold inflows under control, not the reverse.

So, inept monetary policy caused the Depression and it need not have turned out as it did. Different policies or different people would have produced different history.

The real question then becomes *why* did the people who ran the Federal Reserve act, or not act, as they did? It is not enough to just say it was a mistake and move on. The task of economic research and the key to a greater understanding of economic history is to discern what compelled the policy makers during the Depression to make the decisions they

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did in fact make. On these matters pertaining to the Federal Reserve, the chapter by James Butkiewicz provides an excellent discussion that will not be repeated here. For the purposes of this chapter, suffice it to say that during the 1929–33 period the leaders of the Federal Reserve had a list of beliefs, and might we say with the clarity of history, shortcomings, that molded the way they saw the world. This is not unique to those individuals as everyone else throughout history views events through their own experiences and their own theories of how the world works. However, taken together, at one time or another across a wide group of important people, these nine items were the largest part of the concatenation of forces that gave the world the Great Depression. Meltzer, in his interview in Parker (2007), spells out the items on this list:

1. The inability to distinguish between nominal and real interest rates.
2. The use of interest rates as an indicator of monetary tightness or ease.
3. Reliance and belief in the real bills doctrine which rendered monetary policy endogenous and completely passive with respect to the business cycle.
4. The use of borrowing volume as a measure of monetary tightness or ease. The thinking was if no one borrows then money must be plentiful.
5. The failure to act as lender of last resort.[18]
6. The belief that speculative excesses would be inflationary and must be purged.
7. Ignoring the rules of the gold standard.
8. Flawed institutional structure in both the Federal Reserve and the Bank of France.
9. As discussed at length above, the strict adherence to the gold standard orthodoxy as being the key to long-run prosperity.

Any one of these would probably not have generated the severity of the downturn that was experienced. The combination of all of them gave us the history contained in Figures 13.1 and 13.2.[19] But it need not have been as it turned out. Meltzer (2003) argues that if countries simply would have followed the rules of the gold standard, the Depression would not have happened. Moreover, McCallum (1990), Fackler and Parker (1994) and Bordo, Choudhri and Schwartz (1995) all demonstrate that if the Federal Reserve would have kept the money supply growing along its 1920s trend, the Great Depression would have been averted.

## Current (and perhaps perpetual) debate and further readings

Perhaps the greatest remaining debate regarding the economics of the Great Depression concerns the extent to which the Federal Reserve was free to follow an independent monetary policy as long as it was functioning within a gold standard regime. Friedman and Schwartz (1963), Bordo, Choudhri and Schwartz (2002) and Hsieh and Romer (2006) conclude the Federal Reserve could have and should have done much more to avert the Depression and it was within its powers to have done so. Temin (1989), Eichengreen (1992) and Eichengreen and Temin (2000) argue that as long as the United States and other countries were locked into obedience to the gold standard, they were forced to choose deflation over devaluation. Monetary policies were crucially important, but they "were made in a particular institutional setting and global context."[20] And that of course was the gold standard and the constraints it placed upon policy makers. As long as the gold standard orthodoxy was followed, deflation and depression would result. Only a change of regime would break the cycle.

That is where the literature stands, as of 2012, and where it will probably remain. Perhaps the most measured reading of the debate is the work of Bernanke and Mihov (2000: 111)

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who conclude "the causes of world monetary contraction might be that damage resulted from 'self-inflicted wounds' prior to the financial crises of 1931, and 'forces beyond our control' between 1931 and 1933." Or said differently, there was room for monetary authorities to independently offset monetary contraction prior to the summer of 1931. But after the realities of massive bank failure in Europe and the U.S., and the British exit from the gold standard in September 1931, the gold standard and a country's commitment to its preservation called the tune until remaining on the gold standard was no longer viable and regime change came about.

The reader is referred to Parker (2011) for a comprehensive three-volume reference on the major pieces of research that have done the most to advance our understanding of the Great Depression. In particular, the seminal works of Bernanke (1983), Choudhri and Kochin (1980) and Eichengreen and Sachs (1985) deserve special mention. While Bernanke (1983) built upon the work of Friedman and Schwartz (1963), it furthered the ideas of Fisher (1933) and analyzed the role of information loss due to bank failures to help explain the protracted non-neutrality of money during the Depression. But more than this, the work of Bernanke energized a moribund literature and spurred a twenty-five-year burst of research on the interwar era that continues today. Further, the literature on the gold standard and the Great Depression had been virtually silent since Brown's classic work of 1940. Choudhri and Kochin (1980) brought the importance of the gold standard back to the discussion, and Eichengreen and Sachs (1985) laid the groundwork for the flurry of research on the gold standard in the late 1980s and beyond that has done so much to sharpen what we know about the interwar era.[21]

## Conclusion

In a must-read new book titled *Why Nations Fail*, Daron Acemoglu and James Robinson make the convincing case that it is manmade economic and political institutions, how they are structured and the responsibility and accountability they provide to the people they serve that determine wealth and poverty, famine and plenty among nations. Leaving out the richness of the case made by Acemoglu and Robinson (2012) and putting it simply, nations fail because of flawed institutions.

This can also be the lesson to take away from the Great Depression. World economies fail because of flawed institutions and faulty international arrangements. At the top of this list for the interwar period of the flawed and faulty should be any institution that would permit the money supply to fall by 35 percent. The story told by Friedman and Schwartz (1963) of the lack of meaningful institutional decision-making structure at the Federal Reserve and the absence of corrective monetary policy action when it was at their disposal to implement makes the mantra "there will be no more 1930s" something the current leaders of the Federal Reserve are correctly chanting.

Also at the top of this list for the interwar period of the flawed and faulty should be the interwar gold standard. Men and nations executed some very severe policies to slavishly maintain this international financial system, until they could no longer take the pain. For some the pain lasted shorter periods of time (Japan, Sweden, UK, Canada, Norway, Australia and New Zealand, all left the gold standard by December 1931). For others it was much longer (the U.S. left in 1933 and France, Poland, Italy, and the Netherlands not until 1936). But in the end, relief only came once the gold standard was put back in the history books. The gold standard and the Great Depression are forever linked by the historical experience and empirical evidence of the interwar era.

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Let us hope it is in the history books that the gold standard remains. Since the financial crisis of 2008, the voices advocating for a return to the gold standard have gotten louder and louder.[22] These quixotic longings are dangerous and must be resisted with all possible intellectual vigor. To praise the gold standard, long for its reemergence and advocate for its return ignores history. Yet, the gold standard is like a phoenix that rises from the ashes when the economy seems to be burning. Let us hope that the interwar gold exchange standard will be viewed as the pernicious anachronism that it is, and returned to the ash heap of history every time it rises.

## Notes

1 There are some additional emerging avenues of research such as Ohanian (2009) and McGrattan (2010) that take a fresh look at wage policy and fiscal policy during the Depression, respectively. However, the "monetary hypothesis" and the "gold standard hypothesis" are the two major competing interpretations of the causes of the Great Depression.
2 For additional detail and insight see Temin (1989) and Eichengreen and Temin (2000).
3 See Ferguson and Temin (2003) and Ritschl (2003) for further discussion of the German experience during this period.
4 This was certainly the opinion of both Montagu Norman and Benjamin Strong. See Temin (1989: 14) for an expression of these sentiments in a memorandum written by Strong and sent to Norman on January 11, 1925.
5 Officially, doing the math, an ounce of gold was worth $20.67 in the United States and £3 17s 10½d in Great Britain. Therefore, the exchange rate works out to be $4.86 per pound. Note also that the value of money on the gold standard is backed up by some physical commodity, namely, gold. Thus the gold standard is referred to as a "commodity standard", as opposed to today's fiat standard, and also has the appellation of being a "hard money" monetary system.
6 See Keynes (1925) for reaction to the re-establishment of the pre-war parity. Also see Irwin (2011) for a discussion of the prescience of Gustav Cassel in predicting the demise of the gold standard as early as 1920.
7 See Eichengreen and Temin (2000: 191–92) for greater detail.
8 In January 1913 the French franc exchanged for 19.35 cents. In June 1928 the French franc traded for 3.93 cents. Remembering that the £1 = $4.86, the French franc went for 25 francs = £1 in 1913 to 125 francs = £1 in 1928.
9 See Hamilton (1987: 146).
10 Not to mention dysfunctional flaw seven where the world's money supply is held hostage in the long run to the discoveries of new gold deposits that can be mined and added to gold reserves. See Friedman and Schwartz (1963) for a discussion of the importance to the world economy of gold strikes in South Africa and Canada in the 1890s.
11 Adolf Miller, a founding Governor of the Federal Reserve System, certainly said so in testimony for the Banking Act of 1935.
12 Note, it really is irrelevant whether or not there was a speculative bubble in stocks at the time or if they were fairly priced. The Federal Reserve's perception was that there was a bubble and that is what it acted on.
13 Not all countries got caught up in the worldwide deflation. Spain was never on the gold standard at this time and missed the Great Depression completely. The Chinese were on a silver standard and missed the Depression too, although they had much else to be concerned with as Imperial Japan invaded Chinese Manchuria two days before Britain left the gold standard.
14 See Temin (1989). The French word *mentalité* translated into English, according to the Merriam-Webster online dictionary, means a set of thought processes, values and beliefs shared by members of a community. This definition could not be more fitting.
15 The statutory minimum cover ratio was 40 percent so there were not sufficient gold reserves to cover the currency that had been issued by the Federal Reserve of New York. See Meltzer (2003) and Wigmore (1987) for more extensive discussion of March 1933. Looking at the data for bank failures, it seems clear that the worst waves of bank failures centered around the episodes where the commitment to gold was most in question, the Summer of 1931 and March 1933.

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16 See McMillin's chapter on recent monetary policy for insightful observations regarding the Federal Reserve's actions during the crisis of 2008 and how completely different they were compared to 1929–33.
17 See Hsieh and Romer (2006) for a more recent affirmation of these conclusions.
18 See Richardson and Troost (2009) for an important discussion and unique empirical approach showing how greater lending by the Fed would have moderated the financial crises and severity of the Depression. Also see Bordo and Wheelock (2011) for reasons why the Federal Reserve failed to live up to its role as lender of last resort during the Depression.
19 Certainly economic research and history will come up with a similar list for the financial crisis of 2008. Perhaps Gorton's chapter can be viewed as a starting point in this endeavor.
20 The quote is from Eichengreen in Parker (2007: 154).
21 Credit also goes to Kindleberger (1973) and Temin (1976) for introducing international considerations into the inquiry of the causes of the Great Depression, It should be noted that Abramovitz (1977) was the first to look at the international angle in the modern literature on the Great Depression. Unfortunately this paper was never published and copies of it are scattered to the winds of history.
22 Statements such as: "We need a currency that is as good as gold." "The gold standard was never really properly executed during the Depression so that evidence is irrelevant to today." "The gold standard worked fine during the Depression. It was the people that corrupted it." "The Federal Reserve cannot be trusted so we need an ironclad rule that would eliminate the Fed." The public policy pronouncements of Congressman Ron Paul are the most cited comments that contain these sentiments. He is not the only one who feels this way.

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