The Previous Gold Standard Explained

By James Rickards – International Finance

[FF Editorial: Jim in this short article has summed up succinctly, why any reset of the global financial system must have the Gold Standard as its anchor, and not the Gold Exchange Standard. In doing so, Jim has exploded the various myths and misrepresentations about the Gold Standard and the Great Depression. The gold standard did not cause the great depression. Period! Once you understand the true nature of Gold as the anchor of any stable financial system, it becomes elementary in our understanding as to the why and how the fiat currency system have caused and continues to cause all the booms and bursts cycles that have plagued the global economy since WWI. Jim has done us a big favour with this article, pulling the wool from our eyes and putting the central banks and their monetary policies in the spotlight.]

Some people who should know better who have their own reasons for disparaging the role of gold, and other people who don't know better they've just heard this repeated so many times that they believe it to be true without ever really studying it.

Now the thing that did contribute to the Great Depression was the fact that the UK, prior to 1914 there had been a very successful gold standard from a global standard and a national gold standard from about 1870 to 1914 with different countries joining along the way. That was disrupted by World War I. After World War I in the mid-1920s, countries were looking for a way to go back to the gold standard, but they made a couple of mistakes.

Instead of going with a pure gold standard, they went with what was called the gold exchange standard. They said international standards can be gold, but it can also be dollars, pounds sterling, or French francs at the time. This obviously was a mix or a hybrid system in which gold played a role, but so did the currencies, which meant that the system as a whole is subjected to blunders and abuses by discretionary monetary policies.

So when I look at the Great Depression, the causes of the Great Depression, it had very little to do with gold and everything to do with really poor discretionary monetary policy, particularly by the Federal Reserve Bank of New York, which eased in the late '20s when it should've tightened, and then tightened in 1929 and 1930 when it should've eased. So kind of like the Fed today getting everything wrong along the way.

Now, going specifically to the point, there were two mistakes. One was in 1925 when the UK went back to gold, they went back at the wrong price. I say they, this was Winston Churchill, Chancellor of the Exchequer at the time, picked the pre-1914 price, which was $20 an ounce. Obviously, they expressed it in pounds sterling, but the dollar equivalent was about $20 an ounce. The problem was the UK had doubled the money supply to fight World War I. They printed money to fight World War I, that's what countries do. Actually, it was John

Maynard Keynes who advised Churchill, Keynes did not really favour gold standard, but he said if you're going to go to a gold standard, you have to get the price right. Keynes favored a much higher price. He said, "If you go back to the gold standard at the old lower price, you're going to have to reduce the money supply to maintain the parody." That is contractionary and depressionary, and that blunder did contribute to the Great Depression.

Gold didn't cause the Great Depression, but getting the price of gold wrong did contribute to the Great Depression. That wasn't a problem with gold. That was a problem with the politically determined price, and again, what is really discretionary monetary policy rather than gold per say. And Keynes was right, you should've had a much higher price. A gold price of $40 an ounce instead of $20 an ounce in 1925 might have avoided the Great Depression completely. We'll never know, but that could make a very plausible case for that.

Now as far as the gold standard inhibiting or hindering the ability of the Federal Reserve to fight the Great Depression, that is completely false, and the source on that is none other than Ben Bernanke. And I spoke to Ben Bernanke about this personally. Before he became chairman of the Fed or even the Board of Governors for the Fed, he made his academic reputation mostly at Princeton University doing research on the Great Depression, following in the footsteps of Milton Freedman and Anna Schwartz and some others who were the great pioneers of studying the Depression through the lens of monetary economics.

Bernanke wrote a book on it, which I read when I was researching my book The Death of Money and the book before that Currency Wars. And what he revealed is at the time, the law allowed the money supply to be two-and-a-half times the amount of gold. So take the amount of gold that the Fed had, priced in dollars, what was that, multiply the ounces by $20 an ounce, take that number, multiply is by 2.5, and that was the upper limit on the money supply. So the money supply could not legally be greater than that.

Well in fact, the money supply during the Great Depression was never more than one times the gold. In other words, it had 100% ratio. It could've been 250%, which means that gold was never a constraint on the money supply. The Fed could have doubled the money supply in the early 1930s without having to worry about gold. So you can't blame gold for the continuation of the Great Depression. You have to blame the money supply.

In fact, the real problem was that banks didn't want to lend, and people didn't want to borrow. This, by the way, is the same problem we have today. Banks don't want to lend, people don't want to borrow. Velocity's increasing, and you can't seem to get the inflation the Fed wants, and you can't seem to get the economy moving. That was exactly the situation in 1930. And that's what Bernanke showed in his book.

So I met him recently, and had a very nice conversation with him. I said, "Mr. Chairman, I've read your book to say that gold was not a constraint on the money supply during the Great Depression. Do I understand that correctly?"

He looked at me and said, “Yes, you do.” So in other words, here’s Bernanke confirming to me face-to-face that gold did not constrain the money supply of the United States during the Great Depression. So anyone who says that is true has their facts wrong. Anyone who says that gold caused the Great Depression has his facts wrong because as I say, it was political decisions and discretionary monetary policy, not gold that caused the Great Depression.

Source, International Finance