1 Introduction

The Great Depression of the 1930s is well known today not only as a period of extreme economic hardship in the United States, but perhaps more strikingly for its global nature. Recent research has shown that the severity of the economic repercussions felt around the world was largely attributable to the kind of exchange rate regime in place. More specifically, as Temin (1993) argues, countries adhering to the gold standard - a system of fixed exchange rates - were vulnerable to negative demand shocks from other countries. On the other hand, evidence from Bernanke (1995) suggests that countries that either abandoned the gold standard early on or who adhered to a system of floating exchange rates not only experienced less severe economic repercussions, but also recovered faster from the Depression.

2 Fixed Exchange Rates: The Gold Standard

By adhering to a gold standard, a country pegs their currency to the official international reserve asset, gold. It is a form of a fixed exchange rate because each country fixes the price of their currency relative to gold. Central banks exchange domestic currency for gold to maintain this price. That is, balance of payments settlements are ultimately satisfied through exchanges in gold. Under expansionary monetary policy, for example, downward pressure on interest rates, ceteris paribus, makes foreign currency assets more desirable. If there were
a floating exchange rate regime, the domestic currency would simply depreciate against the foreign currency, counteracting this effect and re-establishing interest rate parity. Under fixed rates, and more specifically, following an international gold standard, the currency is fixed to the price of gold and central banks are forced to buy domestic currency from the public in exchange for gold to maintain the price of domestic currency. The public can then “sell the gold to other central banks for their currencies, and use these currencies to purchase deposits that offer interest rates higher than the interest rate” on domestic assets.\(^1\) In this way, the domestic country experiences a private capital outflow which, in turn, implies a capital inflow for foreign countries. In other words, the central bank in the domestic country in the preceding example is losing foreign reserves and this reduces the money supply until interest parity is once again restored.

The functioning of the gold standard system of exchange rates suggest that countries that are running balance of payments deficits are necessarily exporting gold while those who are running surpluses are importing gold. Furthermore, as argued by Temin (1993), countries with balance of payments deficits adhering to the gold standard - that is, countries exporting gold - would choose deflation over devaluation as a mechanism for adjustment. In this way, a reduction in domestic prices would discourage imports and boost exports. Temin (1993) argues that this approach to macroeconomic balance was the most important factor in the international transmission of the Great Depression.

After being established in 1870, the gold standard system of exchange rates was abolished with the beginning of World War I, but was reconstructed following the war. By 1929 most market economies had returned to the gold standard (Spain being an exception) - the four major countries being the United States, the United Kingdom, France, Germany, as well as some small open economies like the Netherlands, Belgium, Italy, and Poland. Eichengreen (1992) argues that the groundwork for the Depression of the 1930s was laid out by the gold standard of the 1920s. In response to speculation in the New York stock market, the Federal

\(^1\)Krugman and Obstfeld, 2000, p. 514.
Reserve favoured a contractionary policy in the late 1920s. Unfortunately, as Eichengreen (1992) points out in referring to this policy stance:

[it] coincided with a massive flow of gold to France, where monetary policy was tight for independent reasons. Thus, gold and financial capital were drained by the United States and France from other parts of the world. Superimposed on already weak foreign balances of payments, these events provoked a greatly magnified monetary contraction abroad. In addition they caused a tightening of fiscal policies in parts of Europe and much of Latin America.2

This quotation highlights the global nature of the shift towards contractionary policies in response to a relatively minor shift in American policy, and it also shows the gold standard as the force driving the shift.

The contraction of American, British, French and German economies depressed other economies through the mechanism of the gold standard. As Temin (1993) points out, the economies in these countries not only showed falling industrial production, but also declining prices. That is, Temin (1993) argues that “the fixed exchange rates of the gold standard led to uniform changes in prices even though other factors affected the change in production”.3 While expansionary fiscal policy could have countered the negative shocks on the U.S. economy (or other countries using the gold standard), this would have pushed the balance of payments into deficit, thereby threatening the gold standard. In other words, some countries experienced prices through falling aggregate demand, while others were forced to drive prices down to maintain the fixed exchange rate.

3 Floating Exchange Rate Experience

It is important to draw attention to the evidence that shows that the magnitude of the transmission of the Great Depression to countries depended on the exchange regime countries followed. In their study of small open economies in Europe, Choudhri and Kochin (1980) contend that there were three different currency experiences during the Great Depression –

3Temin, 1993, p. 90
those of the “Gold Bloc” lead by France (i.e. the Netherlands, Belgium, Italy, and Poland),
that of Scandinavian countries that were initially on the gold standard but then allowed
their currency to adjust during the Depression, and that of Spain which followed a floating
exchange rate. Choudhri and Kochin (1980) highlight the fact that Spain was the only coun-
try operating under a floating exchange rate at the onset of the Depression. Furthermore,
Spain had relatively stable monetary conditions during the Depression as well. Choudhri and
Kochin (1980) show that the Spanish output and prices remained largely unaffected com-
pared to countries following the gold standard during the Depression; the authors attribute
this to the flexibility of the exchange rate.

Scandinavian countries such as Denmark, Finland and Norway allowed their currency to
float in 1931. As pointed out by Choudhri and Kochin (1980):

The Scandinavian experience can be viewed as representing a mixed exchange
rate regime that falls somewhere in between the pure flexible and pure fixed
exchange rate systems of Spain and the gold countries.4

The authors show that deflation was more significant in Scandinavian countries than Spain
(floating rates), but smaller than that of countries under the gold standard (fixed rates).
With regards to output, Choudhri and Kochin (1980) show that negative output effects
were more severe in gold standard countries than in Scandinavian countries. More inter-
estingly, the authors find that output changes were not significantly different from those
of Spain. Overall, Choudhri and Kochin (1980) find that Scandinavian countries benefited
from greater independence from the depression of gold standard economies once they allowed
their exchange rate to float.

4 Conclusion: Exchange Rate Regimes and Recovery

The preceding discussion implies that countries that abandoned the gold standard re-
covered from the Depression more quickly, and the evidence suggests that this is the case.

Bernanke (1995) points out that many countries left the gold standard in 1931 in response
to several financial crises in that year (such as in Germany). The U.S. went off gold in 1933
and France stayed on gold until “the final collapse of the system in late 1936”. Leaving the
gold standard severed the link between balance of payments and macroeconomic policy. As
Eichengreen (1992) argues:

Depreciation was the key to economic growth... Prices were stabilized in countries
that went off gold. Output, employment, investment, and exports rose more
quickly than in countries that clung to their gold parities... No longer was it
necessary to restrict domestic credit to defend convertibility. No longer was it
necessary to cut public spending in countries where expenditure was already in
a tailspin.⁶

As Bernanke (1995) points out, the common factor linking countries that experienced
monetary contractions was the international gold standard. Indeed, the gold standard served
to transmit negative price and output effects being felt in the United States and the world
over. However, the magnitude to which the Depression was felt around the world was largely
attributable to the differing exchange rate regimes in place at the time. Countries who
abandoned the gold standard early on were able to insulate themselves from the outreaching
impacts of the depressed gold standard economies, while countries such as Spain avoided
much of these negative impacts by having a floating rate. In the end, getting off the gold
standard (i.e. devaluing their currencies) allowed countries to enter the recovery phase of the
Depression. The broad lesson from the Great Depression seems to be that by fixing a price
(that of their currency), countries forego the role it can play in macroeconomic adjustment
to shocks, so that the burden of adjustment has to be borne by other variables output and
the price level.

⁵Bernanke, 1995, p.11.
⁶Eichengreen, 1992, p. 21
5 References


