Avoiding 1930s-style Protectionism: Lessons for Today

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Introduction

A statement released by the G-20 leaders on 2 April 2009 emphatically noted: “We will not repeat the historic mistakes of protectionism of previous eras.” What historic mistakes of previous eras were the leaders referring to?

Almost unquestionably, the reference was to the Great Depression of the 1930s. Indeed, the world’s current economic and financial crisis - complete with plummeting stock markets, collapsing world trade, sharply rising unemployment rates, and even the threat of deflation - has prompted many comparisons to the Depression. The 1929-32 period, during which economic activity collapsed around the world, was marked by a severe outbreak of protectionism and breakdown of the world trading system. The rise in trade barriers is believed to have intensified the Depression and to have hindered the economic recovery. And the trade barriers imposed under the “emergency” conditions of the day remained in place for a period that stretched into decades, blocking the expansion of world trade even though the original justification for the barriers had long since past.

In order to avoid repeating the calamity of the 1930s, it is necessary to understand precisely what happened to the world trading system during that terrible decade. This brief paper presents an account of the deterioration in trade relations at that time and examines the similarities and dissimilarities between the situation then and today. It concludes that conditions are different enough today such that a 1930s-style resort to protectionism is unnecessary and

unlikely. However, there are other historical parallels that present a danger, such as 1970s-style conflict over subsidies that supported industries with excess capacity and had adverse spillover effects across countries.

The Trade Policy Breakdown in the 1930s

Almost everyone with a rudimentary understanding of the 1930s knows that the period was marked by greater protectionism - the infamous Smoot-Hawley tariff in the United States stands out in the public imagination - and collapsing trade. But was there any rhyme or reason to the mad scramble to block imports? Most accounts, such as Kindleberger (1986), suggest that all countries succumbed to the pressure to close markets to foreign goods. In fact, there was a logical progression to events as they unfolded in the early 1930s and there was a high degree of variation in the extent to which countries limited trade.

To understand the breakdown in the world economy, it is essential to appreciate that the international monetary system was based on the gold standard. This regime of fixed exchange rates linked countries to one another and ensured that shocks to one country would be quickly transmitted to others. In addition, the gold standard tied the hands of monetary authorities, who were obligated to maintain the value of their currency in terms of its gold parity. The loss of monetary autonomy meant that the policymakers lacked an important policy instrument (an independent monetary policy) to help adjust to any such shocks.[1]

While economic historians continue to debate the origins of the Depression, many have argued that the decision by the Federal Reserve Board to tighten credit in early 1928 was a

[1] Eichengreen (1992) is the classic study of the relationship between the gold standard

turning point.[2] By raising interest rates, the United States began to attract gold from other countries, forcing them to raise interest rates and tighten credit conditions as well. The United States, along with many other countries around the world, reached a business cycle peak in mid-1929, after which economic activity began to slow. While the U.S. stock market crash in October 1929 was a disturbing development, there was no reason to expect that the slide into the recession would necessarily lead to the Great Depression that followed.

It is commonly believed that the United States led the movement toward greater protectionism when President Herbert Hoover signed the Smoot-Hawley tariff act in June 1930. This tariff legislation, which Congress began considering in late 1928, was originally designed to insulate farmers from low agricultural prices, but was expanded to include higher duties on manufactured goods as well. The higher tariff was not a response to the Depression - the duties in the bill were largely set when the House passed the bill in May 1929, a few months before the business cycle peak - although the deteriorating economic outlook in late 1929 and early 1930 probably aided its passage in the Senate.

The Smoot-Hawley tariff raised import duties by about 20 percent, increasing the average tariff on dutiable imports from about 40 percent to 47 percent.[3] Yet the impact of the Smoot-Hawley tariff on world trade was limited. Around this time, about two thirds of U.S. imports entered the country duty free; indeed, most Latin American exports were unaffected by the duties. European manufactured goods were hit by the higher tariffs, but only six percent of

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and the Great Depression.

[2] See Hamilton (1987).

[3] The average tariff on dutiable imports subsequently rose to nearly 60 percent, but this occurred because price deflation increased the ad valorem equivalent of the many specific duties in the tariff code. This increase in duties would have happened even if the bill had not been

Europe's exports were destined for the U.S. market. Declining U.S. demand for all goods was a far greater problem for most foreign exporters.

Still, the U.S. action provoked intense bitterness and resentment abroad. Here was the world's largest creditor nation, with a substantial trade surplus, restricting the trade of other countries that were trying to pay off their World War I debts. Here was a country that failed to join the League of Nations now undermining that body's efforts to coordinate a tariff truce among countries to stop any movement toward greater protectionism.

Many countries protested the enactment of the Smoot-Hawley tariff, and some even retaliated by imposing restrictions on U.S. exports. Certainly other countries saw the America's move as an excuse to raise their own tariffs. As the League of Nations (193, 193) put it at the time: "The Hawley-Smoot tariff in the United States was the signal for an outburst of tariff-making activity in other countries, partly least by way of reprisals. Extensive increases in duties were made almost immediately by Canada, Cuba, Mexico, France, Italy, [and] Spain." The tariff had the biggest impact on Canada, America's largest trading partner. The tariff led to the electoral defeat of the pro-American Liberal government in July 1930 and the election of the pro-British Conservative party. The Conservatives retaliated by imposing higher duties against U.S. goods and began thinking about a preferential trade agreement with Britain.[4]

Still, if one were to ask, did the Smoot-Hawley tariff lead to the collapse of the world trading system by the end of 1930 or early 1931, the answer would have to be "no." While trade relations deteriorated and the League's efforts at a "tariff truce" came to naught, the system of world trade was disrupted but not destroyed.

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enacted. See Irwin (1998).

The series of events that really began to undermine the trading system started with the failure of Creditanstalt, Austria's largest bank, in June 1931. This failure contributed to a financial panic that spread to neighboring countries and around the world. In particular, the failure led to a financial crisis in Germany as depositors began massive withdrawals of funds and demanding gold in exchange for marks. This prompted Germany to impose strict controls on foreign exchange transactions that impeded trade and capital flows alike. Just days after Germany imposed exchange controls, Hungary and Chile followed suit as well to stem the loss of gold and foreign exchange reserves.

Financial pressure quickly spread to Britain. After attempts to support the pound on foreign exchange markets, Britain relented to the financial pressure. Unlike Germany, Britain did not opt for exchange controls. Rather, Britain abandoned the gold standard in September 1931 and allowed the pound to depreciate against other currencies on the foreign exchange market. Other countries whose currency was tied to the pound sterling, including Denmark, Finland, India, Norway, and Sweden, also allowed their currencies to depreciate relative to gold. Japan followed in December 1931.

While there were sound domestic economic reasons for Britain's action, it led to the breakdown of international trade relations. The British action triggered a defensive response by countries that remained on the gold standard. A month after the British devaluation, France imposed a 15 percent surcharge on British goods to offset the depreciation of sterling and began to impose restrictive import quotas. In early 1932, the Netherlands, which traditionally had a policy of free trade, increased duties by 25 percent, partly to offset the competitive advantage

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[4] See McDonald, O'Brien, and Callahan (1997).

gained by sterling area producers.

The British move also put other countries under financial pressure and forced them to impose exchange controls. In September-October 1931, the following countries implemented exchange controls: Uruguay, Colombia, Greece, Czechoslovakia, Iceland, Boliva, Yugoslavia, Austria, Argentina, Belgium, Norway, and Denmark (Gordon 1941, 54-55). Exchange controls – which restricted the use of foreign exchange, not only to prevent capital flight but to reduce spending on imports as well – were among the most restrictive trade practices of the early 1930s.[5]

Britain followed the depreciation of the pound by enacting higher tariffs. In November 1931, Britain enacted the Abnormal Importation Duties Act which gave authorities the discretion to impose higher duties on selected goods. In February 1932, parliament passed the Import Duties Act which imposed a 10 percent across-the-board tariff along with additional restrictions on selected imports, although goods from the Empire were exempt. The British adoption of protectionist policies marked a great retreat for a country that historically had been a staunch free-trade country at the center of the world economy. It was also somewhat paradoxical because John Maynard Keynes and other economists had argued that devaluation and protection were substitutes rather than complements.[6]

The economic crisis of mid- to late-1931, as well as the change in Britain's trade policies, was much more responsible for the deterioration in trade policy around the world than the

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[5] Wei and Zhang (2007) show that exchange controls today inflict substantial collateral damage on trade.

[6] Keynes advocated import restrictions on the assumption that the gold standard was inviolably. Once Britain went off the gold standard, Keynes disavowed the use of protectionism, clearly viewing import tariffs and devaluation as substitutes. See Eichengreen (1984).

Smoot-Hawley tariff had been. In its World Economic Survey 1931/32, the League of Nations (1932, 289) said that:

> "It is impossible in any brief summary to make anything like a complete statement of all the various devices brought into use to restrict trade. Especially after the abandonment of the gold standard by Great Britain in September 1931, there has been a veritable panic, which has piled new tariffs on old, turned licensing systems into prohibitions, monopolies and contingents; denounced existing commercial agreements; created more and more rigid exchange controls issuing in debt moratoria and paralysing trade; and substituted a slight and temporary framework of clearing agreements for previous existing treaties . . . .There has never before been such a wholesale and widespread retreat from international economic co-operation."

The next year, the League of Nations (1933, 16-17) elaborated on this point:

> "The multiplicity and variety of these emergence restrictions [on international trade] after September 1931 is difficult to summarise in a few words . . . In the sixteen months after September 1st, 1931, general tariff increases had been imposed in twenty-three countries, in three of them twice during the period - with only once case of a general tariff reduction. Customs duties had been increased on individual items or groups of commodities by fifty countries, in most cases by a success of enactments which, in several countries, numbers over twenty tariff changes in the sixteen months. Import quotas, prohibitions, licensing systems and similar quantitative restrictions, with even more frequent changes in several important cases, had been imposed by thirty-two countries. Import monopolies, for the most part of grains, were in existence in twelve countries; milling or mixing regulations in sixteen others. Export premiums were being paid in nine, while export duties or prohibitions had been imposed in seventeen. This bare list is utterly inadequate to portray the harassing complexity of the emergency restrictions that were superimposed upon an already fettered world trade after the period of exchange instability was inaugurated by the abandonment of the gold standard by the United Kingdom in September 1931. By the middle of 1932, it was obvious that the international trading mechanism was in real danger of being smashed as completely as the international monetary system had been."

Thus, by 1932, a wide range of controls and restrictions - higher tariffs, new import quotas, controls on foreign exchange transactions - had been imposed on world trade around the world. The volume of world trade fell 26 percent between 1929 and 1932, as figure 1 shows. According to Madsen's (2001) calculations, about 45 percent of this decline was due to lower income and about 55 percent due to an increase in tariff and non-tariff barriers to trade. In

addition, countries began forming preferential trading areas, most notably the Imperial Preferences of the British Empire. This balkanized trade in exclusive trade blocs and complemented bilateral clearing arrangements as the multilateral pattern of trade and payments was in shambles.

Eventually, all countries left the gold standard. The United States delinked the dollar from gold in April 1933 and allowed the dollar to depreciate. The remaining gold bloc countries - France, the Netherlands, Belgium, and Switzerland - clung to gold but eventually abandoned the standard in 1936 (1935 in the case of Belgium). The timing of a country's recovery during the Depression is intimately linked to when it abandoned the gold standard because it allowed countries to reduce interest rates and expand the money supply, relieving financial distress and promoting recovery. Britain and the sterling area, which left gold in 1931, experienced a relatively mild recession, whereas the gold bloc countries, which did not leave until 1936, suffered a prolonged economic downturn.[7]

This suggests that the best strategy to have combated the Depression would have been a suspension of the gold standard or a coordinated change in the gold parities such that all countries could have pursued monetary reflation even with fixed exchange rates. Instead, there was no international coordination, countries left the gold standard in a haphazard fashion, and those that did intensified the economic problems faced by those remaining tied to gold.[8] Unfortunately, the world trading system was a casualty of this process.

Understanding the 1930s Breakdown

[7] See Eichengreen and Sachs (1985) and Campo (1990).

How should the breakdown in world trade relations in the early 1930s be interpreted?

Eichengreen and Irwin (2009) argue that the move toward protectionism was intimately related to the real or perceived constraints on macroeconomic policy instruments. Countries that clung to the gold standard were unable to use monetary policy to prevent the slide from recession to Depression. In addition, fiscal policy was constrained by the prevailing economic orthodoxy that governments should run balanced budgets even in bad times; hence, there should be fiscal retrenchment in an economic downturn, not a fiscal expansion. Therefore, since many countries ruled out the use of monetary or fiscal policy to address to Depression, the turn to protectionism was simply an alternative (albeit inferior) way of reducing capital outflows and the loss of gold and foreign exchange reserves.

In this sense, devaluation, exchange controls, and trade restrictions were substitute policy instruments.[9] Countries that chose to devalue did not need exchange controls or trade protection. Alternatively, countries that could not or would not devalue almost invariably imposed exchange controls or adopted protectionist trade measures. As Eichengreen and Irwin (2009) show, this general pattern holds. Countries that abandoned the gold standard relatively early in the Depression, notably Britain and others in 1931, did not increase tariffs very much (Britain notwithstanding). Other countries, such as Germany, were constrained from using devaluation as a policy option. Under the terms of the reparations set after World War I, Germany could not abandon the gold standard. Furthermore, having experienced a massive hyperinflation less than

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[8] Eichengreen (1990) explores the reasons for the lack of policy coordination.

[9] As Keynes pointed out at the time, a devaluation is equivalent to an import tariff plus an export subsidy. But it is more than that because it allows monetary policy to be used to reduce interest rates and increase domestic demand.

a decade before, the German government did not want to risk monetary stability.[10] This explains their resort to exchange controls. France and the gold bloc clung to the gold standard because they had difficulty establishing monetary stability after World War I. These countries imposed higher tariffs and import quotas to a much greater extent than others with the onset of the Depression.

Under fixed exchange rates, there is an intellectual case for protectionist policies to provide a macroeconomic stimulus in lieu of a devaluation. Yet, like the optimal tariff argument, trade restrictions are a “beggar thy neighbor” policy that only brings a stimulus if implemented unilaterally and without foreign retaliation. When every country adopts such a policy it destroys trade and with it any potential stimulus: the benefits to one country from reducing its imports is offset by a loss in its exports. As the League of Nations (1932, 158) noted:

> “The currency disruptions and trade restrictions which have complicated the course of trade since the latter part of 1931 may serve in some cases to improve or prejudice the relative trading position of individual countries, but their cumulative and combined effect has been greatly to diminish the total value of world trade. Even for those countries whose competitive position has been improved by a lowering of export relative to import prices, there is little consolation in securing a somewhat larger share of a constantly diminishing total.”[11]

Furthermore, many of the trade controls adopted in the early 1930s were not removed until well after World War II.[12]

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[10] See James (1986).

[11] Similarly, Foreman-Peck, Hughes-Hallett and Ma (2007) conclude: “For all their damage to trade, trade policy instruments were not a powerful means of achieving national targets. Monetary and fiscal policies were far more effective. . . . The other two instruments – the discount rate and government expenditure – were clearly more potent and more appropriate to the three targets – output, prices and the current balance – than trade controls.”

[12] See Irwin, Mavoridis, and Sykes (2008) for a study of how the GATT grew out of the interwar trade policy experience.

Similarities and Dissimilarities to Today

Without doubt, there will be an increase in protectionist measures during the current economic recession. Many such measures are WTO-legal. The use of antidumping duties is very countercyclical and inevitably rises as economic growth falters. In addition, for most developing countries, bound tariffs are much higher than applied tariffs. If they wanted to do so, these countries could increase their duties on imports without violating WTO commitments. Finally, in areas where WTO agreements are weak, such as government procurement, the temptation to impose buy-local requirements (such as the Buy America provision in the stimulus bill) may prove irresistible.

But is there a risk of a 1930s-style increase in protectionism? Fortunately, the world economy in the 2000s is very different from the world economy in the 1930s. Most of the differences augur well for preventing another outbreak of protectionism.

First, countries today have many more policy instruments for dealing with the current severe recession. Governments are significantly less constrained in terms of using monetary and fiscal policy to address the economic crisis. In the 1930s, governments took no responsible for propping up financial institutions and were unable to pursue reflationary monetary policies because of the gold standard. Today, expansionary monetary and fiscal policy measures have been used in the United States, the European Union, and elsewhere to offset the recession. While governments may be under political pressure to protect certain producer interests, policymakers are not under the illusion that protectionism can provide a macroeconomic stimulus on par with monetary and fiscal policy.

Second, in the early 1930s, countries imposed higher trade barriers unilaterally without

violating any international agreements or anticipating much foreign reaction. Today, WTO agreements restrict the use of such discretionary trade policy. Countries that are tempted to violated WTO agreements can have no illusion that they will avoid swift foreign retaliation if they choose to do so. When a country is certain that its exports will face new impediments abroad if it chooses to impose WTO-inconsistent import restrictions, that country will think twice about restricting imports.

Third, the share of the workforce in sectors directly affected by international trade - mainly agriculture and manufacturing - is much lower today than in the 1930s. In the case of the United States, for example, about 44 percent of the labor force was in agriculture, mining, and manufacturing in 1930 and hence might benefit from import restrictions. Today that share is about 14 percent. The service sector of the economy is much more insulated from foreign competition, which means the scope for beneficial expenditure-switching policies is that much lower.

Fourth, unlike the early 1930s, foreign investment has transformed the world economy. Leading firms around the world have become so multinational in their production operations and supply chains that they have a vested interest in resisting protectionism. Many industries that faced import competition in the past, such as televisions and automobiles and semiconductors, have found that international diversification or joint ventures with foreign partners are a more profitable way of coping with global competition than simply stopping goods at the border. Many domestic industries no longer have much of an incentive to ask for import restrictions because foreign rivals now produce in the domestic market, eliminating the benefits of trade barriers for domestic firms. For example, unlike the early 1980s, U.S. automakers are not asking

for trade protection because it would not solve any of their problems; they are diversified into other markets with equity stakes in foreign producers, and other foreign firms operate large production facilities in the United States.

While these important differences suggest that a protectionist trade war need not break out like the 1930s, there are other historical episodes that might provide a closer parallel to today. In the early 1970s, however, a series of macroeconomic shocks coincided with an intensification of trade competition due to the rise of Asian producers in Japan, Korea, and Taiwan. These changes required structural changes in several the U.S. and Western European industries, such as steel, chemicals, automobiles, and footwear. In particular, there was worldwide excess capacity that required some rationalization. That downsizing process was difficult and costly, requiring plant closings and layoffs, and many governments resisted this trend by using subsidies to prop up domestic producers and maintain the capacity at home. The trade problems caused by the reluctance of countries to reduce capacity allowed trade frictions to grow and trade barriers to proliferate in the 1970s and 1980s.[13] The subsidy code of the Tokyo Round agreement was a response to the problems of that period, but was largely ineffectual.

Today, with government intervention on behalf of automakers and support for banking and financial services firms, countries may be tempted to resist the need for restructuring. If one country tries to prop up its own firms, thereby imposing costs on similar firms in other countries, the subsidies may lead to counter-subsidies and trade restrictions.

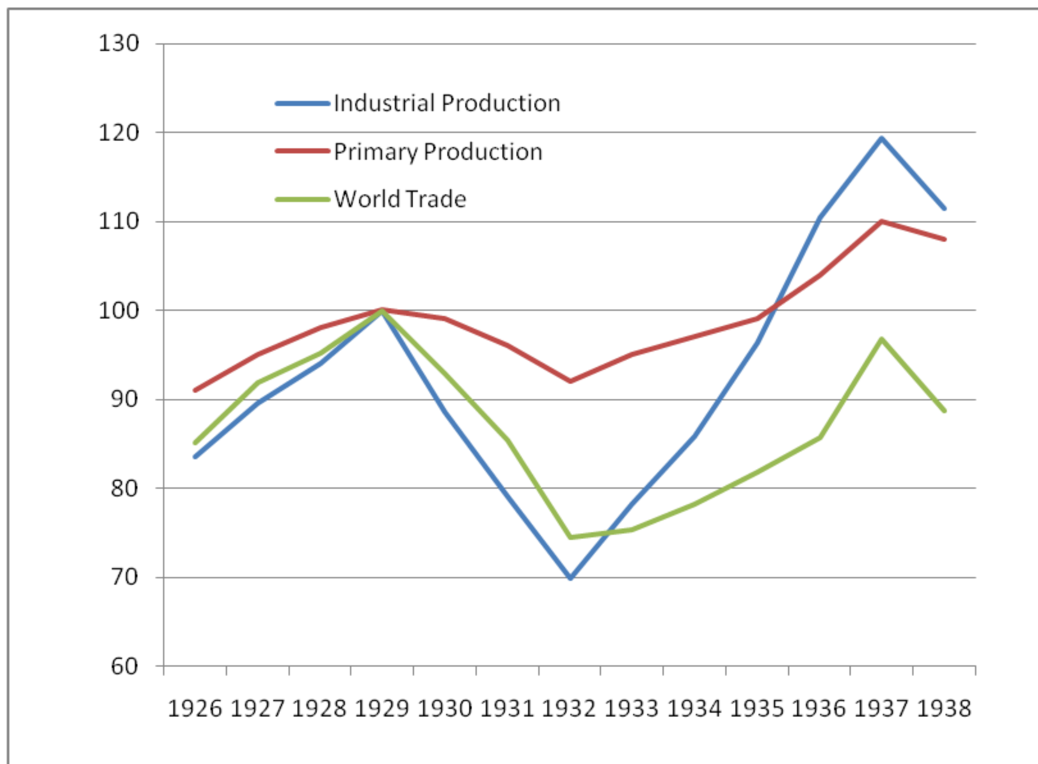
Concluding Remarks

[13] See Strange and Tooze (1981).

This paper explains the greater protectionism in the 1930s as the consequence of the lack of macroeconomic tools to address the Great Depression and halt the deterioration in a country's balance of payments. With more economic policy instruments in play today, the need to resort to trade restrictions should be less of a problem. Yet severe recessions are always a dangerous periods for trade policy, and policymakers should remain on guard against measures that have external ramifications and might lead to countervailing policies in other countries.

Figure 1: World Trade and World Production, 1926-1938

Source: League of Nations.



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