Trade Policy Disaster: Lessons from the 1930s

Douglas A. Irwin

The MIT Press
Cambridge, Massachusetts
London, England

The Ohlin Lectures

1. Jagdish Bhagwati, Protectionism (1988)
2. Richard N. Cooper, Economic Stabilization and Debt (1993)
3. Assar Lindbeck, Unemployment and Macroeconomics (1993)
4. Anne O. Krueger, Political Economy of Policy Reform in Developing Countries (1993)
5. Ronald Findlay, Factor Proportions, Trade, and Growth (1995)
6. Paul Krugman, Development, Geography, and Economic Theory (1995)
7. Deepak K. Lal, Unintended Consequences: The Impact of Factor Endowments, Culture, and Politics on Long-Run Economic Performance (1998)
8. Ronald W. Jones, Globalization and the Theory of Input Trade (2000)
9. W. Max Corden, Too Sensational: On the Choice of Exchange Rate Regime (2002)
10. Jeffrey G. Williamson, Globalization and the Poor Periphery before the Modern Era (2006).
11. Robert E. Baldwin, Development and Testing of the Heckscher-Ohlin Trade Models (2008)
12. Robert C. Feenstra, Offshoring in the Global Economy (2010)
13. Edward E. Leamer, The Past and Future of the Heckscher-Ohlin Framework (2011)
14. Douglas A. Irwin, Trade Policy Disaster: Lessons from the 1930s (2012)

Contents

Preface

More than eighty years ago, the world experienced a deep and prolonged economic contraction that left disastrous political and social consequences in its wake. Today, the Great Depression of the 1930s remains a fascinating subject of general and scholarly interest, one that has left a permanent imprint on modern economics. As Ben Bernanke (1995) once remarked:

> "To understand the Great Depression is the Holy Grail of macroeconomics. Not only did the Depression give birth to macroeconomics as a distinct field of study, but also -- to an extent that is not always fully appreciated -- the experience of the 1930s continues to influence macroeconomists' beliefs, policy recommendations, and research agendas."

The same is true for trade policy. This period of extreme duress saw an unprecedented outbreak of protectionism. The proliferation of higher tariffs, import quotas, and foreign exchange controls all contributed to the collapse of international trade. These import restrictions, combined with preferential trade blocs, destroyed the open, non-discriminatory world trading system. Once imposed, the trade barriers took root and proved difficult to remove, stifling world trade and hindering economic recovery for years to come. In fact, it took decades of negotiations after World War II, through the General Agreement on Tariffs and Trade (GATT), before these barriers were fully unraveled.

The trade policy experience of the 1930s continues to influence the beliefs and policy recommendations of international trade economists. The worst nightmare of every trade specialist is that, in the midst of an economic crisis, policymakers might be tempted to return to the autarkic, beggar-my-neighbor protectionism of the Great Depression. Such a move, it is feared, could easily spin out of control, with countries retaliating against one another in race to close their markets to foreign goods. This would not only destroy trade and make the crisis even worse, but, if history is any guide, reversing the policies and undoing the damage would be very difficult.

Consequently, economists frequently warn of the dangers of protectionism and criticize the use of trade policy interventions as costly and counterproductive, often by invoking the 1930s experience as an example. But they have done so without fully understanding why policymakers felt it necessary to adopt such policies at that time. For example, economists usually attribute protectionist measures to domestic producers who pressure the government for relief from foreign competition, but this was not the main story in the 1930s. Import penetration began declining for most countries when the Great Depression hit because trade fell much faster than production. Pressures from foreign competition were easing, not intensifying, for most domestic producers, although they were still struggling to cope with falling prices and contracting demand.

Hence, the standard explanation for the existence of trade restrictions – special interest politics – does not help us understand the trade policy developments of the 1930s very well. This is problematic. If economists lack a clear understanding of why countries so easily slid into protectionism in the past, it will be difficult to recognize situations in which protectionist policies might be enacted in the future.

This book examines the trade policy disaster of the 1930s in the hopes of understanding the logic behind the policy response. Once we uncover the reasons that countries resorted to protectionism, once we recover the historical context in which policymakers were willing to sacrifice open trade for other policy objectives, we will be in a better position to draw lessons that can help us avoid making similar mistakes in the future. Such insights are all the more relevant today because of the fears that another financial crisis could produce a similar outbreak of trade-destructive policies.

The main reason that governments resorted to import restrictions in the 1930s was that they had relatively few policy instruments with which to respond to the Great Depression. Most countries were on the gold standard and could not ease domestic monetary conditions without jeopardizing the fixed gold parity; this eliminated a monetary policy response. The economic orthodoxy of the day held that governments should respond to a downturn with austerity measures - cutting expenditures and raising taxes - to keep the budget in balance; this ruled out a fiscal policy response. Without monetary or fiscal policy as options, governments turned to trade restrictions. These measures not only failed to promote economic recovery, they made matters worse by choking off international trade.

Yet this explanation for the protectionism of the 1930s is also incomplete. A closer look at the period reveals that not all countries adopted protectionist policies to the same degree. The key to understanding which countries imposed the most protectionist measures, it turns out, is their exchange rate policy. When the Great Depression began, most countries had fixed exchange rates under the gold standard. The onset of deflation and the loss of gold reserves was the initial shock that triggered a policy response. Countries had very few ways of adjusting to this adverse development: wage and price deflation, exchange rate depreciation, or import restrictions and foreign exchange controls. Policymakers initially believed that wage and price deflation would restore equilibrium, but they gradually learned that it was failing to do so and, even worse, that it was only intensifying the contraction.

In the face of continuing deflation and loss of gold reserves, therefore, countries faced a choice between abandoning the gold standard (exchange rate depreciation) or abandoning open trade policies (protectionism). The countries that chose to remain on the gold standard and keep their exchange rate fixed still could not use monetary policy as a palliative; this pushed them toward embracing protectionism as a potential remedy. The countries that chose to abandon the gold standard and allow their exchange rate to depreciate were freed from concerns about the balance of payments. They were able to use monetary policy to end the deflation and start the economic recovery, and they did not find it as necessary to employ trade restrictions. Thus, the choices that countries made about their exchange rate shaped their policy response to the Great Depression. In short, the exchange rate system under the gold standard, and the constraints it imposed on policy, was intimately linked to the outbreak of protectionism in the early 1930s and destruction of the world trading system.

Chapter 1 describes the origin and spread of protectionism in the early 1930s, focusing primarily on Europe. The turning point that marked the beginning of the protectionist avalanche was not the U.S. Smoot-Hawley tariff of 1930, as is often suggested, but the world financial crisis that struck in mid-1931. The financial crisis led many countries to experience balance of payments problems associated with gold outflows, forcing a policy response. At this point, some countries imposed exchange controls or import restrictions, both of which limited trade, to relieve pressure from the balance of payments. Other countries allowed their currencies to depreciate, which also relieved pressure on the balance of payments without the need to fall back upon protectionist measures.

These events can be explained with reference to the open economy trilemma. The trilemma limits countries to choosing just two of three objectives: a fixed exchange rate, an independent monetary policy, and open trade policies. While all three objectives may be desirable, they are incompatible and only two can be attained. Most countries wanted to have some monetary policy independence to fight deflation, but many also refused to consider any change to their gold parity. In trying to make a fixed exchange rate compatible with an independent monetary policy, these countries adopted protectionist trade measures. These countries essentially sacrificed open trade policies on the altar of the fixed exchange rate. Meanwhile, countries that allowed their currencies to depreciate generally found that they no longer had balance of payments problems that needed to be addressed through trade restrictions.

Chapter 2 examines how different countries resolved the trilemma. Some, such as Germany, maintained the gold parity but imposed exchange controls that severely limited trade and capital flows alike. Others, such as Britain, were forced off the gold standard and allowed their currencies to depreciate. Still others, such as France, remained on the gold standard and used import restrictions to compensate for their increasingly overvalued currencies. What determined which path a country followed? As the chapter will explain, a country's historical experience with inflation in the 1920s played a crucial role in determining the policy choices that were made with respect to the exchange rate. Specifically, countries with a history of high inflation resisted any change to their gold parity in the belief that this would assure monetary stability, whereas countries that did not experience high inflation over the previous decade were less concerned about the inflationary consequences of a depreciation of their currency.

Chapter 3 begins by considering how these trade restrictions contributed to the collapse of world trade. Between 1929 and 1932, the volume of world trade fell an astounding 25 percent, about half of which has been attributed to higher trade barriers. The chapter also examines empirical measures of trade policy to see if the pattern of their use is consistent with the trilemma framework. The existing data on import tariffs, import quotas, and exchange controls generally support the conclusion that countries allowing their currencies to depreciate were less likely to impose trade restrictions than those maintaining their gold parity. This finding is broadly consistent with the notion, suggested by the trilemma, that trade restrictions and exchange rate adjustments were substitutes for one another. Furthermore, these policy choices had enormous consequences for macroeconomic performance and international trade flows. When a country delinked its currency from the gold parity, it is also able to pursue a more expansionary monetary policy. At a time when unemployment was abnormally high and a great deal of productive capacity was unused, such policies stimulated economic growth and enabled neighboring countries to export much more to the depreciating country than would otherwise have been the case.

Chapter 4 draws on the lessons from the trade policy experience of the 1930s to look at three issues: the relationship between the exchange rate regime and trade policy, the distinction between protectionism and mercantilism, and the reasons protectionism was not as pronounced during the recent financial crisis and recession as it was during the Great Depression.

One lesson from the 1930s is that there is a close connection between the exchange rate regime and trade policy. In particular, fixed exchange rates prevent a discretionary monetary policy response to an economic downturn; governments are required to adjust their macroeconomic policies to maintain the exchange rate rather than to assure domestic economic stability. In addition, fixed exchange rates force governments to pay close attention to the country's balance of payments and monitor the level of the central bank's reserves to ensure that it is able to keep the exchange rate fixed. These features of the regime push policymakers toward using protectionist measures as an adjustment mechanism in lieu of an exchange rate change. For example, import surcharges were frequently used to help address balance of payments problems in the 1960s under the Bretton Woods system because exchange rate changes were discouraged.

Because of the balance of payments constraint that existed under the gold standard, trade policy in the 1930s was driven more by mercantilism - in the sense of limiting spending on imports to reduce the outflow of gold - than by protectionism - in the sense of sheltering import-competing producers from foreign competition. This mercantilism was not based on the erroneous confusion of gold with wealth, as Adam Smith accused earlier writers of doing, but on a simple recognition that the costs of losing gold reserves and pursuing contractionary monetary policies were extraordinarily severe. Compared to the usual description of trade policy in the 1930s, this is a very different way of viewing the developments of the period.

Finally, during the recent economic and financial crisis, the world economy has largely avoided the proliferation of trade barriers that so plagued the Great Depression. There are several reasons for this difference, but an important one is that much of the world operates under a flexible rather than a fixed exchange rate regime. Flexible exchange rates allow countries to have a monetary policy response that is unconstrained by balance of payments considerations and can be employed differentially across countries, depending on local conditions. Such a response should receive a great deal of credit, not just for making the recession shorter than it otherwise would have been, but also for keeping protectionist pressures at bay.

***

This book is based on the Ohlin Lectures that I delivered at the Stockholm School of Economics on September 7-8, 2010. I am grateful to Mats Lundahl for inviting me to participate in this prestigious lecture series that has included so many distinguished international economists. It was a privilege to pay tribute to Bertil Ohlin, who helped reshape the field of international economics. Ohlin lived through the perilous times discussed in this book and made many important contributions to the economic policy debate that raged throughout the decade

(Ohlin 1931, Carlson and Jonung 2002). As will be seen later, he had many keen insights about the relationship between exchange rate policy and trade policy that are largely consistent with the perspective presented in this book.

The invitation to give the Ohlin Lectures was particularly gratifying to me on a personal level. When I was in graduate school, I was fortunate enough to work as a research assistant for Professor Jagdish Bhagwati when he was invited to give the first Ohlin Lectures in 1987. He inaugurated the series and turned his lectures into the marvelous book *Protectionism*, published in 1988. It was a great honor to be asked to deliver the Ohlin Lectures myself twenty three years later. The invitation also reminded me of how fortunate I was to have studied at Columbia University when it had an exceptionally strong lineup in international economics, including Jagdish Bhagwati, Ronald Findlay, and Robert Feenstra in trade, and Maurice Obstfeld, Guillermo Calvo, and Robert Mundell in finance. This book explores the connections between these two branches of international economics that are usually considered to be separate and distinct.

I would particularly like to thank Jagdish Bhagwati and Ronald Findlay for their support and encouragement over the years. I am especially indebted to Barry Eichengreen for allowing me to draw on our joint collaboration in what follows. Two of our papers – one on the role of trade and currency blocs in altering the pattern of interwar trade (Eichengreen and Irwin 1995) and another on the reasons for protectionist trade policies during the Great Depression (Eichengreen and Irwin 2010) – deeply inform the analysis in this book. More importantly, he has been a role model for me and many others who have undertaken research at the intersection of international economics and economic history.