
Trade policy in 2008: Great Depression redux?

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The global crisis raises the appeal of protectionism but a 1930s-like scenario is highly unlikely. Policy makers today don't have to rely on protection to promote unemployment and WTO disciplines limit protectionist backlash at least in rich nations. Nonetheless, world leaders must remain vigilant against a slide toward protectionism.

The world's current economic and financial crisis – complete with plummeting stock markets, sharply rising unemployment rates, and the threat of deflation – has prompted many comparisons to the Great Depression of the 1930s.

Fortunately, today's policy makers seem determined to avoid the mistakes of the past. Not only have they responded to the downturn with aggressive macroeconomic policies and financial market interventions, political leaders have pledged to avoid imposing new restrictions on international trade. 'We underscore the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty,' the G20 leaders declared in mid-November. They also agreed to 'refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organisation inconsistent measures to stimulate exports.'

Unfortunately, such pledges alone may not be enough to stop the spread of protectionism in the face of an enormous economic crisis.

World leaders' pledge in 1929: No new protection

World leaders in the 1930s were not blind to the costly protectionism that then enveloped the world. In September 1929, the League of Nations recommended that member countries agree to a 'tariff truce' in which tariff levels would not increase for two to three years. A conference was convened five months later for this purpose, but it broke down as central and eastern European countries embraced intensive agricultural protectionism in the face of a sharp decline in commodity prices. A few countries ratified the tariff-truce pledge, but it had little effect on subsequent policy.

Instead, as the collapse intensified in 1931 and 1932, countries resorted to ever higher trade barriers in a desperate attempt to prop up their economies and promote domestic employment. These futile responses became known as a 'beggar thy neighbour' policy because trade restrictions were used by countries seeking to prop up their own economy at the expense of others. But this backfired. Blocking imports to expand domestic employment failed because one country's imports are another's exports. The combined effect of this inward turn of policy was simply a collapse of world trade and a deepening of the global economic slump.

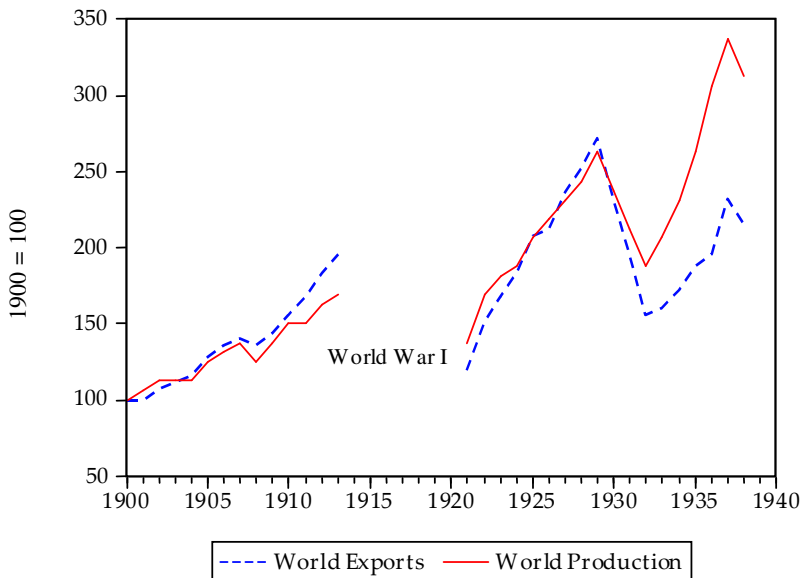
The US bore some responsibility for this turn of events. The US was not a member of the League of Nations and exercised no international leadership as the crisis

unfolded.

What started out in 1929 as a legislative attempt to protect farmers from falling agricultural prices led to the enactment of higher import duties across the board in 1930. The Hawley-Smoot tariff of that year pushed already high protective tariffs much higher, undermined the possibility of a tariff truce and provided an excuse for other countries to act similarly. As the League of Nations noted at the time, ‘the Hawley-Smoot tariff in the US was the signal for an outburst of tariff-making activity in other countries, partly at least by way of reprisals.’

The spread of protectionism in the 1930s

The spread of trade barriers around the world in the early 1930s intensified the economic downturn. The volume of world trade fell by nearly one half. By one calculation, the imposition of discretionary trade barriers was nearly as important as the decline in national income in accounting for the sharp decline of world trade from 1929-1932.



The trade barriers that accumulated during the early 1930s did not disappear once the recovery began. Instead, the trade barriers hampered the economic recovery. As the chart shows, while world output recovered in the second half of the 1930s, world trade lagged, failing even to reach its 1929 peak by the end of the decade. It took the GATT decades of work to undo the damage to world trade from the accumulated trade barriers of the interwar era.

Why today may be different

For these reasons, the G20 pledge to resist protectionism is welcome. Yet even though talk is cheap, it should be pointed out that today's environment is very different from the early 1930s. These differences augur well for preventing another outbreak of protectionism.

- Countries today have many more policy instruments now for addressing economic crises.

Governments then took no responsibility for propping up financial institutions and were unable to pursue reflationary monetary policies because of fixed exchange rates under the gold standard. In fact, those countries that remained longest on the gold standard also imposed the most draconian import restrictions (tariffs, quotas, and foreign exchange restrictions). They did so in an effort to reflate their economy and discourage imports from countries with depreciated currencies.

Restrictive trade policies were at most a third-best or fourth-best policy for addressing economy-wide problems, but countries resorted to them because they lacked other macroeconomic policy instruments, mainly monetary policy, to stabilise the financial system and improve economic conditions.

- 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 by WTO members. And countries that are tempted to violate WTO agreements can have no illusion that they will avoid swift foreign retaliation if they choose to do so. If a country is certain that its exports will face new impediments abroad if it chooses to impose WTO-inconsistent import restrictions, it will think twice about restricting imports. However, this threat applies with the greatest force to developed nation WTO members, since the developing nation members have either not bound their tariffs or bound them at levels that are often far above the actual tariffs applied. As such, developing nations have plenty of room to raise protection without violating WTO commitments.

- 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, 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.

Moreover, 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 in the early 1980s, US 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 US.

- Unlike the early 1930s, the US accepts its international responsibilities and is prepared to exercise its leadership to prevent an outbreak of protectionism.

The strong economic team of president-elect Barack Obama is likely to prevent the administration from imposing new trade barriers.

These key factors distinguish the present era from the past. They have sustained political support for an open trading system and have prevented the outbreak of a globalisation backlash.

The need for vigilance

Despite the welcome pledge by the G20 leaders, world leaders must remain vigilant

against any the temptation to slide toward protectionism. For example, the pledge has already been broken by Russia. In addition, the pledge presumably does not include antidumping duties, which are a non-discretionary, WTO-legal form of administrative protectionism.

Still, there is ample reason to hope that the current economic crisis, unlike the Great Depression, will not be marked by an outbreak of economically-damaging protectionism.

About the author

*Douglas Irwin is the Robert E. Maxwell Professor of Arts and Sciences in the Department of Economics at Dartmouth College. He is author of *Free Trade under Fire* (third edition, Princeton University Press, 2009), *The Genesis of the GATT* (Cambridge University Press, 2008, co-authored with Petros Mavroidis and Alan Sykes), and *Against the Tide: An Intellectual History of Free Trade* (Princeton University Press, 1996), and many articles on the history of U.S. trade policy in professional journals. He is a Research Associate of the National Bureau of Economic Research and the editor of the *World Trade Review*. He has also served on the staff of the President's Council of Economic Advisers and the Board of Governors of the Federal Reserve System.*