

THE WALL STREET JOURNAL

WSJ.com

THE SATURDAY ESSAY | OCTOBER 9, 2010

Goodbye, Free Trade?

High tariffs and currency wars cost us big in the 1930s. We can avoid making the same mistakes again.

By DOUGLAS A. IRWIN



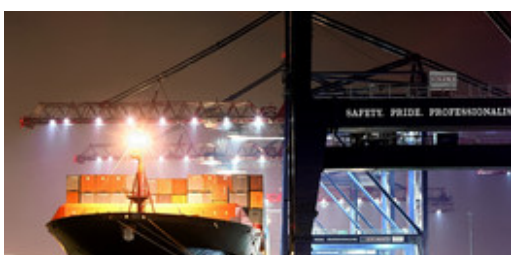
Brian Cronin

In a classic scene from the 1986 movie "Ferris Bueller's Day Off," the

actor/comedian Ben Stein portrays a boring high-school teacher who drones on to his indifferent students about a familiar history lesson:

"In 1930, the Republican-controlled House of Representatives, in an effort to alleviate the effects of the—anyone? anyone?—the Great Depression, passed the—anyone? anyone?—the tariff bill, the Hawley-Smoot Tariff Act which—anyone? raised or lowered?—raised tariffs....Did it work? Anyone? Anyone know the effects? It did not work, and the United States sank deeper into the Great Depression."

In his book on American history, the humorist Dave Barry went a step further, with an amusing riff on Smoot-Hawley as "the most terrible and destructive event in the history of Mankind."



Smoot-Hawley has become a reliable punch line because it is so regularly—and hyperbolically—invoked in the debate over international trade, a debate that has reignited recently as America's jobless recovery drags on. Late last month, the House of Representatives passed legislation aimed at imposing trade sanctions against China unless it allows its currency to appreciate,



[View Full Image](#)

Shuli Hallak

A container ship at the New York Container Terminal in Staten Island, N.Y.

Total Imports as a percentage of GDP

United States

1929: 5%

2009: 15%

China

1970: 3%

2009: 21%

Sources: Bureau of Economic Analysis, World Bank

thus diminishing its export advantage. Days later, in a speech thought to be directed at China, Japan and Brazil, Treasury Secretary Timothy Geithner warned against currency policies that might intensify "short-term distortions in favor of exports."

Indeed, by this past Thursday, the U.S. dollar had hit record lows against several currencies. The managing director of the International Monetary Fund, which holds its annual meeting in Washington this weekend, warned about the possible outbreak of competitive currency devaluations, reminiscent of the Depression era.

To exacerbate matters, American politicians of both parties, facing midterm elections in just a month, have found a useful talking point in charges of unfair trade. A newly released Wall Street Journal/NBC News poll found that 53% of the American public now believes

that free-trade agreements have hurt the U.S., up from 46% three years ago and 32% in 1999.

So is it 1929 all over again? Is America preparing to raise its economic drawbridges? Has the ghost of Smoot-Hawley returned?

It helps to start with a clear-eyed view of Smoot-Hawley itself, which was just one of many mistakes committed by Depression-era policy-makers—and not the most consequential of them. If we want to avoid the sort of destructive, beggar-thy-neighbor trade wars that contributed to bringing down the world economy in the 1930s, we have to draw the right lessons from this chapter of our history.

In his famous 1993 debate with Ross Perot over the North American Free Trade Agreement (Nafta), Vice President Al Gore claimed that Smoot-Hawley "was one of the principal causes, many economists say *the* principal cause, of the Great Depression in this country and around the world."



[View Full Image](#)

Corbis

Teamsters demonstrate against Nafta as the California highway patrol inspects trucks entering from Mexico in 1995.

In fact, economists across the political spectrum reject this view. Previous tariff hikes, some even larger than Smoot-Hawley, had reduced trade and efficiency, but they didn't produce a macroeconomic catastrophe. When asked if Smoot-Hawley caused the Great Depression, the University of Chicago economist and Nobel laureate Milton Friedman replied: "No. I think the Smoot-Hawley tariff was a bad law. I think it did harm. But the Smoot-Hawley tariff by itself would not have made one-quarter of the labor force unemployed." As Mr. Friedman's own work showed, the money supply and domestic prices had fallen by a third during the Depression, largely because of a malfunctioning gold standard and inept monetary policy on the part of the

Federal Reserve. These were the fundamental causes of the economic disaster.

The Smoot-Hawley tariff did not have a huge macroeconomic impact because at the time it was enacted, unlike today, the U.S. was not very open to international trade. Total imports were just a small fraction of gross domestic product, and two-thirds of those imports were consumer goods (coffee, tea) and industrial raw materials (silk, tin) that were exempt from the tariff. In 1929, dutiable imports amounted to just 1.4% of GDP. Smoot-Hawley increased the average tax on them from 38% to 45%. A tax increase of this size on 1.4% of GDP is not enough, by itself, to generate an enormous economic contraction.

That said, the Smoot-Hawley tariff fully deserves its notoriety. It was an ill-timed and ill-judged piece of legislation that backfired spectacularly.



[View Full Image](#)

St. Louis Post-Dispatch Cartoon Collection, SHSMO

A 1939 cartoon on the effect of the Smoot-Hawley tariff on the world.

In the first place, it was completely unnecessary. When the legislation was introduced, the unemployment rate was low, and imports were hardly flooding into the U.S. The House passed the bill in May 1929 (Ben Stein was ad libbing and got the date wrong), well before the peak of the business cycle and the stock-market crash.

If Smoot-Hawley lacked any good economic rationale, what motivated Congress to embrace this protectionist measure? The answer, of course, is politics—and here the lessons for today are especially pertinent.

The tariff was originally proposed to help American farmers, who experienced a long downturn after enjoying high prices during the boom years of World War I. Low farm prices led to severe financial distress and mortgage defaults. Congress's first reaction was to pass agricultural price supports to boost farm income, but President Calvin Coolidge twice vetoed this

legislation.

In order to appear as if it were doing something to help farmers, Congress opted for higher import duties. The problem was that most farmers, particularly of wheat and cotton, exported their crops, and the world market determined the prices that they received. Higher tariffs on the trivial amount of imports they faced did nothing for them. Rep. Carroll Beedy of Maine insisted that "the inadequately protected American potato is a nationwide issue," even though imports represented just 1.4% of domestic potato consumption.

Worse, Congress failed to confine the new tariff to agricultural goods. Logrolling coalitions led to higher duties on all manner of imports. Sen. Reed Smoot of Utah even demanded an import ban on what he viewed as obscene books, such as D.H. Lawrence's "Lady Chatterley's Lover." This led to the classic newspaper headline: "Smoot Smites Smut."

For weeks on end, Congress debated such arcane matters as the precise tariff to be imposed on tomatoes, clothespins and zinc. But in their effort to please domestic interests, the lawmakers overlooked one thing: the international reaction and its impact on American exports.

Our trading partners were incensed that the world's richest country would throw roadblocks in the way of their ability to earn the dollars they needed to pay back debts and make World War I reparation payments. They struck back. Canada, America's largest export market, erected discriminatory tariffs against U.S. goods and essentially handed its market over to our British competitors. A few American jobs may have been created by blocking imports, but many more were lost as the foreign demand for our goods dried up.

Import Business

Episodes of protectionism in U.S. history:

1790



Any historical analogy can be taken too far. In this case, it would be a mistake to draw too strong a parallel between protectionist sentiment today and in the 1920s. It is highly unlikely that the U.S. will revert back to a Smoot-Hawley mindset. The country is much more integrated into the world economy than it was then, and it is widely understood that trade disruptions would be



[View Full Image](#)

Getty Images

Alexander Hamilton

The first tariffs were introduced as a means to raise revenue for the government, but Alexander Hamilton, the first Secretary of the Treasury, was an early proponent of protectionism as a matter of policy. In the 1790s, he argued that America should impose tariffs to protect its "infant industries" from foreign competition.

1895



[View Full Image](#)

Hulton Archive/Getty Images

Theodore Roosevelt

During the late 19th and early 20th centuries, Republicans and Democrats continued to argue over the benefits of free trade. In 1895, Theodore Roosevelt said, "Thank God I am not a free-trader. In this country pernicious indulgence in the doctrine of free trade seems inevitably to produce fatty degeneration of the moral fiber."

1828



[View Full Image](#)

Gehl Company/Corbis

A farmer employs a horse-drawn potato-digger to bring in the crop, circa 1914.

Protectionism hit its peak with passage of the Tariff of 1828, which imposed high levies (including 45% on wool products) to benefit

much more costly. We seem to have learned some lessons from history.

In the first place, import restrictions seldom achieve their intended goals. Smoot-Hawley actually ended up hurting American farmers. Though some still claim that trade sanctions on China would create jobs in the U.S., the more likely effect would be to send those jobs to other developing countries with low wages. The Obama administration's punitive tariff on cheap tires from China, imposed late last year, has had no impact on domestic tire production and employment. The chief beneficiaries have been tire producers in Thailand and South Korea, whose exports to the U.S. have surged to replace those from China.

More important, we have learned to take into account the possibility of foreign retaliation against U.S. exporters. China is a rising power whose Marxist ideology has given way to an increasingly assertive nationalism. It will not sit quietly if it is directly targeted by trade restrictions. Indeed, recently imposed Chinese duties on American poultry are widely thought to be payback for the Obama administration's tire tariff. This makes using trade sanctions against China a risky strategy.

The Smoot-Hawley episode remains an important cautionary tale. But there are other, more subtle lessons to draw from the mistakes of the Great Depression, and they are even more relevant to the problems we face today.

The defining moment for trade policy in the Depression era was not when President Herbert Hoover signed the ill-conceived tariff in June 1930, but when several countries abandoned the gold standard and others did not in September 1931. That divergence triggered a trade war, as countries that remained on the gold standard began restricting imports from countries that allowed their currencies to depreciate.

In research that I've done with Barry Eichengreen of the University of California, Berkeley, we found that, during the 1930s, countries used expansionary monetary policy and trade protectionism as substitutes for one another. Countries that clung to the gold standard were forced to maintain tight monetary policies. Because they could not print money to counteract the deflationary forces that had taken hold of the world economy, they imposed higher tariffs, import quotas and exchange controls to restrict imports. These import barriers were an utter failure in jump-starting their economies. As a result, these countries suffered a protracted depression.

northern industries. Consumers and farmers in the South called it the Tariff of Abominations because it brought about higher prices and reduced export markets when other countries retaliated.

1922



[View Full Image](#)

Getty Images

A worker at the Shelton Looms factory in the 1920s takes a closer look at newly manufactured cloth fabric.

World War I spurred isolationist tendencies in the U.S. In 1922, Congress passed the Fordney-McCumber Tariff, which Republican Rep. Joseph W. Fordney believed would help American farmers and provide more jobs for returning American servicemen. Eight years later, the controversial Smoot-Hawley act boosted tariffs further.

1890



[View Full Image](#)

Granger Collection

The blast furnaces of Pittsburgh, Pa.

In October 1890, just before midterm elections, the McKinley Tariff went into effect. Pushed through by Republicans, it was an effort to aid steel producers and other industries. Tariff rates rose to some 50% for many manufactured goods. Voters saw it as a boon to wealthy industrialists, and House Republicans lost 93 seats in the election.

1981



By contrast, countries that went off the gold standard and allowed their currencies to depreciate did not have to resort to protectionist trade measures. They used monetary policy to end the crippling price deflation and restore economic growth. Moreover, unlike trade restrictions, currency depreciation was not a beggar-thy-neighbor policy. Because the underlying monetary expansion boosted growth, it actually helped neighboring countries. Imports by countries with depreciated currencies grew much faster than imports by countries that maintained their gold parity.

It is here that we find the crucial link to our current situation, with the looming possibility of a trade war over currency values. If all major central banks were to intervene on foreign exchange markets to drive down the value of their own currencies, none would succeed in changing nominal exchange rates, but it would be equivalent to a world-wide easing of monetary policy. A more relaxed monetary stance was critical to ending the Depression in the 1930s. Had it been coordinated so that exchange rates did not change abruptly, protectionism could have been kept at bay.

On the other hand, if some countries intervene unilaterally—as China is rightly accused of doing, with other countries appearing to follow suit—nominal exchange rates are affected; goods priced in Chinese yuan become cheaper when purchased with dollars or euros. The experience of the 1930s shows that this sort of situation breeds trade disputes and can trigger a protectionist response.

So what can be done to discourage the U.S. from retaliating against countries that push down the value of their own currencies? The most important tool for resisting protectionist sentiment in the 1930s was a monetary policy that promoted economic growth. Such policies worked during that era, when prices were falling and unemployment was unusually high, and the situation is similar today, if not as extreme. If fears of deflation were to subside and employment were to expand more rapidly, the pressure for a protectionist response from Washington would dissipate. When the economy is performing well, currency disputes become background noise.

The great concern is that an expansionary monetary policy will lead to uncontrolled inflation, destroying faith in the dollar. Similar sentiments were expressed in the 1930s by advocates of "sound money" who opposed going off the gold standard. Such fears may be justified in ordinary times of full employment, but when there is



[View Full Image](#)

Jim West

Auto workers picket a Toyota dealer, waving American flags to protest Japanese imports.

As Detroit fell on hard economic times, Japan agreed to "voluntary export restraints" on car shipments to the U.S., initially set at 1.68 million vehicles a year. In response, Japanese car makers built their own American factories. By 1990, 1.7 million cars built in Japan were sold in the U.S., well below the then-2.3 million cap.

considerable slack in the economy and unemployment remains high, monetary policy can help to raise output before it leads to higher prices.

Today, American policy makers should focus their attention not on China but on our own Federal Reserve. There has been a very public debate recently among the presidents of the Federal Reserve banks over the future course of policy and whether additional steps to ease monetary policy are warranted. Sentiment now seems to be in favor of a new round of "quantitative easing"—that is, of increasing the money supply. As Charles Evans, the president of the Chicago Fed told the Journal this week, the grim economic outlook makes him favor "much more [monetary] accommodation than we've put

in place." At a time of enormous excess capacity in the economy and nonexistent consumer-price inflation, additional measures by the Fed to stimulate growth should be condoned, not condemned.

I suspect that even Milton Friedman would have approved. In the 1990s, Japan was in a situation similar to the one now faced by the U.S.: no inflation (or deflation in the case of Japan) and lackluster growth after the bursting of a real estate bubble. Writing about Japan in 1997, Mr. Friedman observed: "The surest road to a healthy economic recovery is to increase the rate of monetary growth, to shift from tight money to easier money, to a rate of monetary growth closer to that which prevailed in the golden 1980s but without again overdoing it."

Right now, Congress is geared up to blame other countries for our jobless recovery. If the Fed were to act more decisively, it would not only help the economy, but also help to fend off protectionist measures that could do lasting economic damage.

—Douglas A. Irwin, a professor of economics at Dartmouth College, is the author of "Peddling Protectionism: Smoot-Hawley and the Great Depression," to be published in February, and "Trade Policy Disaster: Lessons from the 1930s," to be published next fall.

Printed in The Wall Street Journal, page C1

Copyright 2009 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com

