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TRADE POLICY DISASTER: LESSONS FROM THE 1930s by Douglas A. Irwin, MIT Press, 2012

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At the beginning of the Great Depression, world trade dropped by an "astounding 65 per cent in gold-dollar terms". And it is estimated that about half of the decline in world trade was due to higher trade barriers. The world's trade-to-GDP ratio fell from 15 per cent to 9 per cent from 1929 to 1938.

And the world's GDP did not reach its 1929 peak until 1936. Douglas Irwin, a professor of economics at Dartmouth College, explains the reasons for the surge in protectionism in the 1930s – tariffs, quotas, exchange controls and other trade restrictions – and its consequences and lessons for the present in this small book, Trade Policy Disaster: Lessons from the 1930s.

Trade Policy Disaster is a guaranteed non-best seller because it will only appeal to economic policy wonks with a strong interest in trade history and policy. Nevertheless, Irwin has made a useful contribution by destroying many of the myths around the rise of trade protectionism in the late 1920s and early 1930s.

The essence of Irwin's argument is that it was not the pleading of special interests that drove the world into protectionism, but the fact that much of the world was on some form of gold standard, which created politically and economically unacceptable deflationary pressures in some countries.

Most countries were on fixed exchange rates because their currencies were tied to gold, but in the late 1920s and early 1930s, the US and France began to accumulate gold, which caused a loss of reserves in other countries. France increased its share of world gold reserves from "7 per cent in 1927 to 27 per cent in 1932". The loss of gold reserves in other countries caused them to tighten monetary policy, resulting in deflation.

Common lore is that the Smoot-Hawley tariff, which was signed into law in 1930, was a response to the depression and was responsible for the rise in global protectionism. In fact, the tariff was conceived in 1928 during the boom and passed by the House in 1929 before the collapse as way to help farmers who were suffering from falling prices.

Irwin does argue that the tariff and foreign response to it was harmful, accounting for about 5 per cent of the US decrease in imports, but that the depression and the monetary policy at the time accounted for a much larger share of the fall in imports.

Countries with over-valued currencies ran into balance-of-payments problems, and too many of those countries resorted to trade protectionism rather than devaluation.

Irwin states: "The primary motivation for the trade policies of the 1930s was not so much protecting domestic industries from foreign competition as protecting gold reserves from being drained away."

Furthermore, he argues "trade restrictions proved to be a poor substitute for exchange rate and monetary policy changes as a means of promoting economic recovery". This leads him to conclude: "If more countries had been willing to adjust their exchange rates in the early 1930s, the outbreak of destructive protection and the prolongation of the Great Depression could have been avoided." The reason countries were reluctant to devalue was that they feared inflation and a situation where countries got into competitive rounds of devaluation.

Protectionism is normally designed to protect certain industries from direct foreign competition, while mercantilism has the goal of reducing overall spending on foreign goods. Thus, Irwin argues that the policies of the 1930s were more mercantilist in motivation than protectionist.

Economists from the time of Hume and Smith had been critical of the mercantilists. Smith correctly accused mercantilists of confusing national wealth with precious metals and not understanding that trade was not a zero sum game. Hume had explained how mercantilist concerns with the balance of trade were misplaced because "domestic prices would adjust automatically to restore equilibrium".

This is, of course, true in theory, but not necessarily in practice, because many prices – labour for example – tend to be sticky downwards. Keynes had discussed the problem of the frictions in price adjustments and how this led to unemployment.

The global monetary system that was created at Bretton Woods in 1944 still relied on fixed exchange rates, with some ability to make adjustments in recognition of the problems Keynes had outlined, and a continued tie to gold. The abandonment of the gold standard in 1971 and the move to flexible exchange rates has reduced the pressure for trade protectionism and mercantilist policies, even during the Great Recession of 2008-2009.

Irwin argues that protectionist pressure has been reduced because of the rise of globalism and the fact that intermediate goods now make up a greater share of world trade. This change causes more business associations to oppose protectionism rather than support it.

The composition of the workforce has radically changed, and now fewer works are directly affected by international trade. In "1930 about 44 per cent of the US labour force was employed in agriculture, mining and manufacturing. Although not all of these jobs were directly affected by imports, they were in the 'tradable' sector of the economy and some of them might have benefitted from trade barriers.

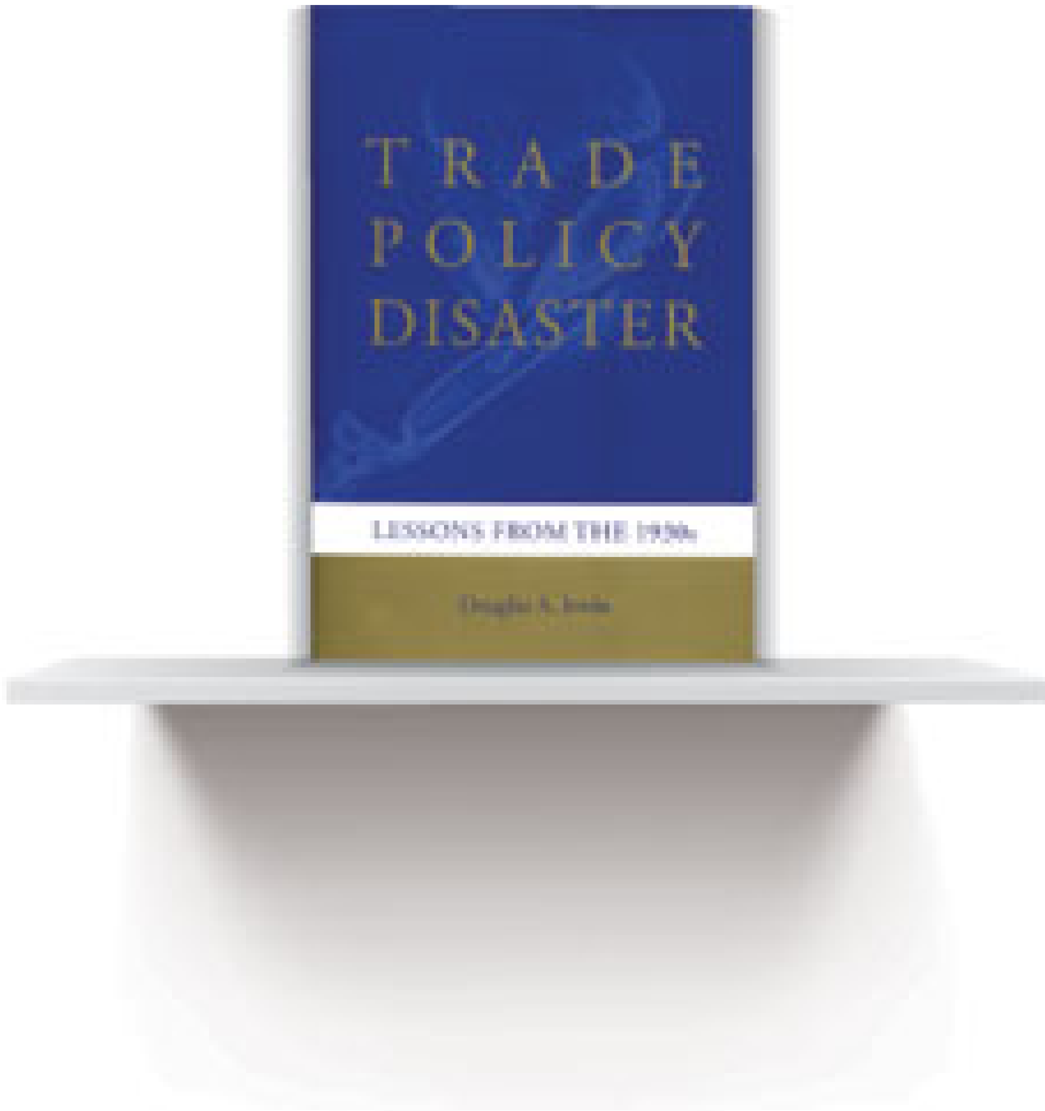
Today that number has dropped to 14 per cent; most workers are in the service sector of the economy, which tends to be much more insulated from foreign competition." Governments have also been able to resist trade interventions in recent years because of the rules of the World Trade Organization, which did not exist in the 1930s, and to which most big countries have signed.

It has been widely recognised by policy makers, business people, the media and even the public at large that the current financial crisis was not the result of a failure with the world trade in goods and

services, but with the monetary and financial systems. As a result, few have proposed restricting trade, when it clearly is not the problem – and that is good news.

Trade Policy Disaster is a useful book for policy makers and others interested in the history and consequences of trade policies from the late 1920s onward.

Readers may notice some data inconsistencies, which Irwin acknowledges, that are due to the problems with the data rather than the author. The book would be even more useful if it had been better organised and more tightly edited – but that said, it is still a nice little reference book.



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