Should We Fear Another Smoot Hawley?

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With more than a whiff of depression in the air, is a Smoot-Hawley-like backlash against trade about to follow? It was the collapse of GNP in 1929-30 that led the U.S. Congress to impose the tariff that caused the unraveling of world trade. Might the same happen again?

The danger exists. If the last months have taught us one thing, it is that anything is possible. Other economic aspects of the 1930s that many of us thought we would never again see in our lifetimes have reared their ugly heads. Google News listed fully 181 articles mentioning “Smoot Hawley” in the week ending December 29th.

Some of these fears relate to the protectionist rhetoric of Barak Obama during the Ohio primary and his opposition to the Colombian and Korean free trade agreements. Then there is the bailout for GM and Chrysler. A subsidy for domestic auto producers is functionally equivalent to a tax on the U.S. sales of foreign producers. Finally there is the fear that the U.S. fiscal stimulus package about to be adopted will be rendered less effective if the increased demand is allowed to leak out in the form of increased imports. U.S. politicians will be quick to react with protectionist measures if they see that today’s spending programs, which create a debt burden for future generations, fail to stimulate the American economy and only benefit other countries.

Fortunately there are reasons for thinking that this danger is overdrawn. First, the growth of multinational production and global supply chains has altered the political economy. Protecting U.S. auto producers no longer automatically benefits U.S. parts suppliers when the Big Three source many of their parts in Canada. Foreign companies with an interest in the maintenance of free and open trade are better represented in the political process than they were in the 1930s. We saw this in the debate over the auto bailout when the “Senator from Honda,” Richard Shelby, argued against the provision of federal funds.

Second, in 1930 the Congress resorted to Smoot-Hawley out of desperation over its lack of alternatives. It was not that the Congress then, as some suggest might be the case now, resorted to a tariff to maximize the employment-creating impact from expansionary fiscal policies. Rather the tariff was imposed instead of expansionary fiscal policies, there as yet being no understanding of the case for fiscal stimulus. The danger of a tariff as a convoluted employment-creating policy is now less precisely because we understand that there are direct ways for the government to stimulate demand, namely by cutting taxes and raising public spending.

Finally, if fiscal stimulus and the Fed’s zero-interest-rate policy mainly suck in imports, then the dollar will decline in response to the widening current account deficit. This will shift demand back toward domestic goods, venting the pressure for a protectionist response. This is no mere hypothetical: we have already seen the dollar falling in anticipation of just these
developments. This is fundamentally different from 1930, when the U.S. and other countries were on the gold standard and there was no scope for the exchange rate to adjust.

This suggests that a better analogy than Smoot-Hawley is the British General Tariff of 1932, imposed after the UK abandoned the gold standard. Sterling had already depreciated substantially, raising the prices of imports relative to British goods and rendering the tariff redundant. With sterling floating, the decline in imports induced by the tariff just put upward pressure on the exchange rate, neutralizing most of the change in relative prices. As a result, the employment-creating effects of the tariff were somewhere between minimal and nonexistent. This has been well known since a Yale University dissertation was written on this particular series of events 30 years ago. (No bonus points for guessing the identity of the author.)

If the General Tariff had been rendered redundant, then why was it imposed? The simple answer is that, with unemployment rates of 20 per cent, British politicians were desperate to do something, and they had few other instruments at their disposal. To be sure, there was "cheap money," the 1930s equivalent of today’s zero-interest-rate policy. But there was no certainty that this would work, just as there are questions today about whether, with banks reluctant to lend, the Fed is simply pushing on a string. And, as already noted, there was no understanding of the role for fiscal policy.

Today, in contrast to the 1930s, our politicians have no shortage of policy levers. They just need to pull the right ones.

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