Irwin. Douglas A., Trade Policy Disaster: Lessons from the 1930s (Ohlin Lectures), the MIT Press, 2011. 216pp. ISBN 9780262016711 (hardcover)

The 2008 financial crisis has been the *worst* economic contraction since the 1930s. To boost economic activity and curb rising unemployment, governments have employed various measures from expenditure spending to quantitative easing. One bright side is that we do not observe the rampant use of protectionism as we did during the Great Depression. In *Trade Policy Disaster*, which is based on the 2010 Ohlin Lectures, Douglas Irwin gleans lessons from the 1930s and cautions policymakers today against the use of shortsighted measures like protectionist policies in combating economic crises.

In the context of economic crises, Irwin reintroduces the "open economy trilemma" idea, which claims that at any time, countries can achieve only two of three macroeconomic objectives: fixed exchange rates, independent monetary policy, and open trade.[1] However, in a financial crisis, the use of independent monetary policy to restore domestic price stability becomes a higher priority than exchange rate stability or open trade. Thus, in such a situation, countries have to choose between maintaining gold parity and imposing restrictive trade measures, or abandoning the gold standard and keeping open trade. Irwin claims this is what countries in the 1930s faced with the onset of a worldwide financial crisis and in the setting of a fixed gold standard.

Historical Examples of the Policy Trilemma

Irwin explores how countries in the 1930s approached this policy trilemma and categorizes them into three groups based on their economic responses. In choosing between fixed exchange rates and open trade, each country was greatly influenced by its own history and its position in the international market. The first group, Britain and the sterling bloc, abandoned gold parity and allowed their currencies to depreciate. The second group, Germany and the exchange control group, did not abandon the gold standard, but instead severed the convertibility of currency into gold and imposed highly restrictive trade measures. The third set of countries was France and the gold bloc, which remained on the gold standard the longest. Only when all the sterling bloc countries depreciated their currencies and put the gold bloc countries into unfavorable trading positions, did they depart from the gold parity.

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[1] The "open economy trilemma" concept was introduced by Robert Mundell and Marcus Fleming in the 1960s.

Using the members of the exchange control group as examples, Irwin explains that a country's decision to maintain the fixed exchange rate of its currency to the gold parity resulted in the imposition of severe import restrictions that did not ultimately resolve the balance of payments problem. Instead, the result was a complex web of trading regulation that broke down international trade. For example, 60% of Germany's trade in the 1930s was conducted through clearing agreements and another 20% through barter arrangements, leaving only 20% to foreign transactions" (p.78). However, once a country allowed its currency to depreciate, as the sterling sect did, economic recovery began and inefficient protectionist trade policies were no longer needed as countries regained monetary control. Nevertheless, the decision of Germany and countries in this group to remain on the gold standard is understandable because of their 1920s' experiences with monetary instability and hyperinflation. Policymakers today can take note of these lessons from history.

Empirical Analysis of Trade Policy Instruments

In the third chapter, Irwin furthers his point against the use of protectionist measures with an empirical examination of the different trade policy instruments used in the 1930s: import tariffs, import quotas, and exchange controls. First, Irwin shows that countries that stayed on the gold parity increased their tariffs more than the countries that allowed their currencies to depreciate by looking at the average tariff on imports. While acknowledging that it is subject to numerous qualifications, he notes that the average tariff is still a useful indicator of the average height of a country's tariffs.[2] The sterling bloc countries increased their tariffs the least, whereas the exchange control group and gold bloc, both of which maintained their gold parity, increased their tariffs the most. Next, Irwin looks at import quotas and discovers a similar pattern consistent with the trilemma. By plotting a relationship between the share of imports affected by import quotas in 1937 and the change in the exchange rate between 1929 and 1935, Irwin shows that countries that maintained their gold parity, such as France and Switzerland, used import quotas more extensively than the sterling group, 50-60 percent of their imports compared to only 5-10 percent.

The last trade policy Irwin examines is exchange controls, which have the potential to be more restrictive than either tariffs or quotas since they allow the government the power to determine the exact amount of spending on imports. Because there are no quantitative measures for exchange controls, Irwin uses trade data and infers their impacts. He finds that even when controlling for the change in a country's income, exchange control countries imported significantly less than other countries. This finding supports the view that exchange controls had an especially restrictive effect on imports. In sum, Irwin validates the trilemma interpretation with his conclusion that countries that allowed their currencies to depreciate did not resort to restrictive trade policies nearly as much as other countries that maintained their gold parity.

Impact of Protectionism on World Trade in the 1930s

Irwin also investigates the impact of protectionism on world trade in the 1930s. Between 1929 and 1932, the volume of world trade shrank by 25 percent. Irwin examines how much trade

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[2] See Irwin (2010) for alternative tariff measures for the United States.

barriers account for this trade reduction. Citing Madsen (2001), whose work decomposed the change in the volume of world trade during the period from 1929 to 1937, Irwin explains that more than half of the decline in trade between 1929 and 1932, about 55 percent, can be attributed to higher trade barriers. Next, he questions whether the destruction of trade due to protectionist trade barriers intensified the Great Depression by leading to an additional fall in national income. Although according to simple theory, an equal reduction in exports and imports should not affect GDP, trade can increase real income through increased consumption or investment. Frankel and Romer (1999), by isolating the non-income, geographically determined component of trade, found that more trade is systematically related to higher real income.

Exchange Controls vs. Devaluation

More significantly, Irwin examines the macroeconomic ramifications of the exchange rate choices made. Comparing the impact of import controls to that of devaluation, Irwin argues that a depreciation of one's currency should have a greater stimulating effect on an underemployed economy than import restrictions because it gives a boost to exports. He describes the benefits of currency depreciation clearly: it frees monetary policy from an exchange rate target and allows policymakers to employ an expansionary monetary policy, which can end deflation and reduce interest rates. Depreciation, as a result, stimulates investment. Irwin calls the combination of devaluation and an expansionary monetary policy, expenditure switching and expenditure increasing. In contrast, trade restrictions, such as import controls, are only expenditure switching because they reduce the demand for other countries' exports. Hence, Irwin concludes that the sterling-bloc's depreciation did not exert deflationary pressure on other countries. Rather, opting for an exchange rate adjustment not only avoided the destruction of trade that came with protectionism, it also had macroeconomic benefits in freeing up monetary policy and allowing the process of economic recovery to begin. Irwin ends the chapter with his conviction that if more countries had been willing to adjust their exchange rates in the early 1930s, the outbreak of destructive protectionism and the prolongation of the Great Depression could have been avoided.

Conclusion

In the conclusion, Irwin explores the differences between the 2008-09 recession and the Great Depression and explains why the former did not lead to a trade policy disaster like that of the 1930s. In both instances, world trade fell sharply, but the causes were different. In 2009, the world trade volume fell 12 percent; during 1929-1932, it declined 25 percent. One reason world trade declined much more in the early 1930s is because of the greater decrease in world GDP, which declined 13 percent during the Great Depression, whereas it was less than 1 percent in 2009 (and even increased in 2010). The most important difference, however, is that the 1930s were marked by rampant protectionism. While about half of the decline in world trade in the early 1930s can be attributed to higher trade barriers, only 2 percent of the recent (2008-2009) decline in world trade has been blamed on higher trade barriers.

Irwin explains why there is less protectionism today than in the 1930s. First, we do not have fixed exchange rates, but floating exchange rates that allow countries to use monetary policy. Governments also have more policy instruments on hand to address financial crises and

recessions, both monetary and fiscal. The world economy has also changed, with increased foreign investment and international sourcing. Additionally, the share of the workforce in the trade-sensitive sector, mainly agriculture and manufacturing, has decreased considerably. Accordingly, the benefits of protectionist policies have become more limited. Moreover, by signing agreements and joining institutions, such as the World Trade Organization (WTO) and the European Union (EU), that restrict the use of trade interventions, governments have been able to resist protectionist pressures better than before. As a final remark, Irwin explains that the current structure of our international monetary system, flexible exchange rates and expanded world trade, allowed us to avoid another trade policy disaster. Irwin warns against trade interventions, especially during severe recessions, which give the illusion of improving short-run economic prospects but risk adverse consequences in the long run.

Trade Policy Disaster by Douglas Irwin is a great introduction to the basics of trade policy and the application of such economic properties to real world problems. Irwin makes complicated structures of economic policy-making decision look simple and easy: all you need to understand is the open economy trilemma. Using this concept, he successfully links international trade with international finance. Moreover, Irwin's ability to pick out crucial factors that led to our disastrous financial crisis in the 1930s is what makes this book attractive and what enables us to take away valuable lessons. This book is a must-read for anybody concerned with macroeconomic, trade, and exchange rate policy. Policymakers can draw lessons from history and avoid making similar mistakes. Students struggling to understand macroeconomics can learn piece together the big picture from this book.

References

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