
In this extraordinary book, Douglas Irwin revisits one of the key lessons of the Great Depression: hard times are breeding grounds for trade protectionism. For generations, academics and policymakers have attributed the unprecedented outbreak of protectionism during the Great Depression to interest group politics. The standard explanation is that the economic downturn induced producer groups to intensify their demands for trade restrictions, causing nationally-oriented policymakers to adopt beggar-thy-neighbor strategies (e.g., the Smoot–Hawley tariff) that ultimately left all nations worse off. Irwin offers correctives to this popular view that are so profound and persuasive that this book will become the essential reference on the descent into protectionism in the 1930s.

Irwin’s first corrective is that the rise of trade protection in the 1930s was not a case special-interest politics run amok but a second-best macroeconomic adjustment policy induced by the “trilemma” of the gold standard. When the Great Depression began, most countries were on the gold standard, a fixed exchange-rate regime that restricted the ability of policymakers to ease domestic monetary policy without jeopardizing the commitment to gold. While previous research has shown that countries that remained on the gold standard tended to endure deeper and longer recessions than those that allowed their currencies to depreciate, Irwin offers a trade-policy corollary: without the flexibility to depreciate their currencies, many gold-standard nations turned to trade restrictions in hopes of boosting domestic demand, stimulating employment, strengthening the balance of payments, and protecting gold reserves.

Irwin’s second corrective is that trade protection was not universal: some countries went much further down the protectionist road than others in the 1930s. Contrary to popular perceptions, there was wide variation in the extent of protectionist measures across countries. While some countries increased tariffs significantly, others imposed tight controls on foreign exchange to reduce imports. Still others hardly restricted imports at all. Irwin argues that adherence to the gold standard explains this variation: countries that clung to the gold standard were more likely to restrict trade than those that abandoned it. He provides additional support for the argument by showing that countries were more likely to reduce tariffs once they had jettisoned the gold standard and allowed their exchange rates to depreciate. The United States, for example, broke with the gold standard in 1933 and a year later enacted the Reciprocal Trade Agreements Act, which gave the President the authority to reduce import duties in trade agreements. Likewise, once France went off gold in 1936, it also began eliminating its import restrictions.

These correctives are important because they jointly demonstrate the close connection between exchange rate policy and trade policy—policy domains that are typically analyzed separately in economics and political science. They also challenge popular understandings of the rise of trade restrictions during the 1930s. Irwin’s central point is that the gold standard and free trade were in tension in this era. In good times, he argues, the gold standard provided substantial benefits: it increased global economic integration and promoted price stability. But in bad times, the gold standard intensified deflation and balance-of-payments problems, and it promoted protectionism. This latter claim is the innovation of this book. In the context of the Great Depression, protectionism emerged where governments were reluctant to break with the gold standard and free up monetary policy as a tool of adjustment.

The main trigger that forced the choice between keeping trade free or maintaining the gold standard was not the Smoot–Hawley tariff but the financial crisis that followed the failure of Austria’s largest bank, the Credit Anstalt in 1931. Irwin focuses on three groups of countries that emerged from the wreckage of the financial crisis: Britain and the sterling bloc, which abandoned gold and largely avoided raising trade barriers; France and the gold bloc, which stayed on the gold standard but resorted to high tariffs; and Germany and the exchange control group, which imposed strict controls on foreign exchange to effectively protect their economies from imports. To show how these blocs reacted to the crisis in world trade and payments, Irwin evaluates three measures of trade policy: import tariffs, import quotas, and exchange controls.

Although no single measure proves definitively that currency depreciation and trade restrictions were policy substitutes, the combination of all three measures provides consistent and convincing evidence. Between 1928 and 1938, the average tariff rate did not change significantly for three of the four depreciating sterling-bloc nations. The important outlier was Great Britain, which abandoned the gold standard and raised tariffs (Irwin argues that Britain’s unusual combination of policies reflected domestic...
political factors; notably, the election of a coalition government headed by the protectionist Conservative party). By contrast, all four gold-bloc countries (France, Belgium, the Netherlands, and Switzerland) and three of the five exchange-control nations (Austria, Germany, and Italy) raised tariffs sharply. The two exceptions were Czechoslovakia and Hungary which imposed such strict foreign-exchange controls that they didn't need high tariffs to keep out imports.

Irwin’s data on import quotas and exchange controls paints a similar picture: after depreciating their currencies, the sterling-bloc countries did not rely on these protectionist measures nearly as much as the gold-bloc and exchange-control groups that maintained gold parity. One of the novel findings of the book is how important exchange controls were to the collapse of world trade in the 1930s. Irwin calculates that exchange-control nations, which squeezed imports by rationing the amount of foreign exchange allocated to the purchase of foreign goods, reduced imports 23 percent more on average than countries without exchange controls, controlling for the change in their real GDP. Irwin concludes that exchange controls were “among the most trade-destructive forms of government policy.”

Why were some countries reluctant to break with gold during the wreckage of the Great Depression? This question is crucial since abandonment of the gold standard would ease the path to economic recovery and help maintain open trade policies while staying on gold was bad for both recovery and free trade.

Irwin emphasizes two national idiosyncrasies that made countries more reluctant to abandon the gold standard: previous experience with high inflation and international financial center status. For Germany and the exchange-control bloc, attachment to the gold standard was based on memories of the hyperinflations of the 1920s. In these countries, the gold standard was viewed as a bulwark against inflation, which made even draconian exchange controls look like a reasonable trade-off. For gold-bloc members such as France and Switzerland, the main argument against devaluation was that it would harm their status as international financial centers: bankers and policymakers feared that a break with monetary orthodoxy would erode confidence in monetary probity.

While Irwin considers a variety of influences on the choice between free trade and the gold standard, his insights suggest that political economy factors played a decisive role. For example, partisan politics are prominent in his explanation of Britain’s decision to raise tariffs in the aftermath of the 1931 devaluation. Likewise, money-center bankers hold pride of place as the special interest group behind the gold-bloc’s preference for tariffs over exchange controls. While more research into these political mechanisms is certainly needed, Irwin’s rendering of the basic policy trade-off – domestic monetary independence, gold standard parity, or free trade – lays the groundwork for such analyses. Standard models of trade protectionism that emphasize lobbying by import-competing producers will be of limited use in this open economy macroeconomic context.

What lessons about protectionism can we draw from the 1930s? Irwin’s conclusions are very different from those of analysts and policymakers that draw parallels between the Great Depression and the Great Recession and fear a new slide into protectionism. The key difference is that, unlike the 1930s, most nations today do not have fixed exchange rates that they are desperate to defend. With today’s flexible exchange rates, governments have more policy tools at their disposal to boost domestic demand, so the incentive to resort to trade protection has diminished (indeed, there has not been a wholesale outbreak of protectionism). Back then, by contrast, monetary stimulus was ruled out by the gold standard and fiscal stimulus was constrained by balanced budget orthodoxy. Lacking these essential tools of macroeconomic management, governments turned to tariffs and non-tariff trade barriers to address the downturn, which only made matters worse.

Why capitalism? by Allan Meltzer

Actually, this recent short book by Professor Meltzer was quite a surprise. Even as short as it is, there is much more in it than the cogent defense of capitalism.

First, the book could easily have been titled, “What is Capitalism?”—and just as important, what it is not. The crony version that has been such a disaster—and is still very much with us—deserves all the criticism leveled by others, even when they don’t realize that it is only the crony version that has failed to sustain prosperity.

Professor Meltzer draws clear lines between the real thing and the crony mutation of capitalism, but he also stresses that even the best forms of capitalism are far from perfect and will always be less than ideal simply because we humans are flawed creatures. Capitalism requires clear rules and institutional constraints on individual behavior. From the preface to the conclusion, Meltzer frequently reminds readers of Prussian philosopher Emmanuel Kant’s critique of human nature.

No doubt James Madison’s lament, “If men were angels, no government would be necessary,” was influenced by Kant as well as by Scottish philosophers, Adam Ferguson, David Hume and Adam Smith. Without these shoulders to stand on, where would Madison have acquired the wisdom to seek to establish a country of limited government, institutionalized checks and balances,