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ECONOMIC INSIGHTS

Protectionism: A Potential Peril for the U.S. Economy

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Popular sentiment appears to be rising for increased restrictions on U.S. trade. Do the names "Smoot" and "Hawley" ring a bell?

In Brief

- Protectionist sentiment is growing in many developed economies, fueled by concerns about income inequality and economic stagnation.
- This has already resulted in some dramatic developments for global trade, including the "Brexit" vote in the United Kingdom.
- In addition, both major U.S. presidential candidates have spoken out against the Trans-Pacific Partnership trade accord. For his part, Donald Trump has advocated tariffs on goods from China and Mexico, according to press reports.
- But if history is any guide, any new round of protectionist measures would not end well. The Smoot-Hawley Tariff Act of 1930 (see below) was followed by a tremendous worldwide economic slump.
- *The key takeaway*—The best U.S. response to the resurgence in protectionist sentiment may be a renewed focus on economic growth, job creation, and worker retraining.

A growing global populist movement toward protectionism could have damaging consequences for world growth. Driven by concerns about income inequality and stagnant economic growth, protectionist sentiment in the United Kingdom, the European Union, and now in the United States is changing the political landscape.

We already have seen these concerns produce policy responses and referendums in various countries aimed at protecting jobs. In the United States, for example, with both major presidential candidates expressing variations of the "our jobs are being stolen, exported, or taken by immigrants" refrain, the willingness to build economic or physical barriers to preserve industries and jobs is gaining popularity. The environment is eerily similar to that surrounding America's last foray into protectionism, the Smoot-Hawley Tariff Act of 1930 (Smoot-Hawley).* The outcome of that legislation suggests that a similar path of beggar-thy-neighbor protectionism may not end well for any of us.

Immigration Concerns

The UK vote for "Brexit," the rise of political parties, such as the Eurosceptics in Italy and Marine Le Pen's National Front in France, and the popularity of free-trade opponents, such as Bernie Sanders and Donald Trump in the United States, represent a groundswell of populist support. The populist movement seems unified in demanding protections to guard against job loss due to immigration, currency manipulation, predatory pricing, or cheaper emerging market labor. Those protections generally take the form of immigration reform or trade tariffs.

Both those proposed solutions seem to reverse the trend toward, and the cost reduction benefits of, globalization. The UK's version of immigration reform was to stop the free flow of immigrants by removing itself from the European Union. In our view, Trump's threat of building a wall along the U.S. border with Mexico—America's third largest trading partner—is just as dramatic as the UK's solution, and as isolationist.

Those in favor of ending immigration would be wise to study Japan's experience. Japan's declining population and restrictive immigration policies have combined to contribute to years of lost economic growth. The populist backlash against immigration in the European Union and in the United States could create economic hurdles similar to those that have existed in Japan, with similar consequences to economic growth.

Trade Winds

The second form of protectionism comes in the form of trade restrictions. Both major U.S. presidential candidates have promised to back out of the Trans-Pacific Partnership (TPP) trade agreement. The TPP, encompassing 12 Pacific Rim nations, including the United States, cuts more than 18,000 tariffs and eliminates almost all tariffs on U.S. manufactured goods and farm products in other TPP economies. It would be the largest free-trade agreement for the United States, according to the Congressional Research Service.

Signed by President Obama in February 2016, but not yet ratified by Congress, the TPP is expected to have modest long-term economic benefits, according to projections by the World Bank, the U.S. International Trade Commission, and the Peterson Institute. Imports and exports are both projected to increase, as are wages, but benefits are likely to accrue more to skilled than unskilled labor. The U.S. International Trade Commission projects that increases in the income of skilled labor would account for about 41% of U.S. gross domestic product growth attributable to TPP, while increases in income of unskilled labor would account for about 25%, with the remaining 34%, of course, going to business owners.

Beyond the populist concerns of the economic inequality resulting from the TPP, the biggest fear, of course, is loss of jobs. The balance between preserving employment for some and broader economic benefits for others has been a knotty issue in trade policy since the early days of the United States. The first secretary of the U.S. Treasury, Alexander Hamilton, favored tariffs to protect and promote jobs, while Thomas Jefferson argued that higher tariffs would hurt consumers. Throughout our history the balance has alternately tilted toward and away from import duties, but rarely to the point of dramatic economic consequence.

Smoot Points

Along the lines of a more dramatic shift, Trump has adopted a more aggressive approach to protectionism than just opposing the TPP. Among other initiatives, he has threatened to unwind the North American Free Trade Agreement and impose tariffs of 35% on imports from Mexico and 45% on those from China, according to reports from CNN and other sources. Pursuit of such protectionist measures could be costly.

The last major effort to invoke substantial tariffs to protect American jobs was the previously mentioned Smoot-Hawley Tariff Act. Passed in the Senate by a narrow margin of 44-42 and signed by President Hoover in 1930, despite a petition from 1,028 economists urging his veto, Smoot-Hawley raised, to record levels, import duties on more than 20,000 agricultural and industrial goods. Foreign governments retaliated, and U.S. exports to Europe fell by two-thirds between 1929 and 1932. American farm exports were particularly hurt, contributing to agricultural bankruptcies as well as failures among banks that specialized in agricultural loans. The difficulties were echoed among exporters of manufactured products and the banks that supported those industries.

The impact of Smoot-Hawley on the U.S. economy occurred within an environment in which exports accounted for 5% of gross national product (an earlier measure of the output of the U.S. economy), compared with about 13% of gross domestic product today. Between 1929 and 1934, world trade fell by 66%, according to the U.S. Department of State. Today's more tightly integrated global economy could imply dramatic economic consequences if aggressive protectionist trade measures produce spiraling retaliatory responses.

Another Solution?

While higher tariffs were not the only factor influencing the economic free-fall and rising unemployment during the 1930s, former U.S. Federal Reserve chairman Ben Bernanke put the now-infamous protectionist legislation into perspective: "Economists still agree that Smoot-Hawley and the ensuing tariff wars were highly counterproductive and contributed to the depth and length of the global depression."

Regardless of the outcome of the U.S. elections, let's hope that lawmakers in Washington include students of history who understand the bitter lesson of protectionism: In the short run, it may indeed reduce imports and preserve jobs, but the inevitable retaliation of other countries could produce longer-term consequences that overwhelm any short-lived benefits. The political process should be capable of developing a more effective solution to the causes of protectionist sentiment in the United States through the promotion of economic growth, job creation, and worker retraining.

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*Smoot-Hawley Tariff Act, formally the United States Tariff Act of 1930, also called Hawley-Smoot Tariff Act, was a piece of U.S. legislation (signed into law June 17, 1930) that raised import duties to protect American businesses and farmers, adding considerable strain to the international economic climate of the Great Depression.

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