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Much has been said in the past year about global free trade and the impact that it has on different members of society. President Trump ran on a platform suggesting that free trade with many countries really means unfair trade practices that harm American workers. While the rhetoric has been toned down since his inauguration, negotiations have begun on changes to the North American Free Trade Agreement (NAFTA) with Canada and Mexico and less formal discussions are underway elsewhere.

Meanwhile, Britain is preparing to leave the European Union, and this will mean new trade agreements both between the EU and Britain and also between Britain and other countries. China has been working on leading trade discussions within Asia, possibly excluding the United States in the process. It is reasonable to say that global free trade is likely to see changes as a result of all this renegotiating. Since those who ignore history may be doomed to repeat it, I think it is worth looking at how trade policy has changed in different eras and what the impact has been on history.

The Great Depression is an excellent place to begin in looking at the impact of trade policy. While free trade has had its ups and downs over the centuries, the Depression stands as one of the most significant episodes in recent history. We begin with the October 1929 crash of the stock market, which marked the start of the economic downturn of failing businesses and lost jobs – at this point, still just a recession.

In 1928, President Herbert Hoover had campaigned in favor of helping farmers by increasing import tariffs to reduce competition for farmers dealing with the problem of lower farm prices and crop surpluses. These were largely the result of increased productivity as America electrified and improved transportation with cars, trucks and tractors. Senator Reed Smoot and Representative Willis Hawley sponsored the bill to increase tariffs by as much as 50%, and this passed Congress in May of 1930.

President Hoover signed the bill despite a signed statement from 1,028 members of the American Economic Association warning of the dangers of increased tariffs. The economists felt that it would hurt farmers rather than help them, that it would increase the cost of living for people already stretched by the downturn, and would result in retaliation by other countries. The Dow Jones Industrial Average dropped 23% in the first two weeks of June 1930, anticipating the impact of the bill even before Hoover signed it on June 16th. Tariffs now were nearly at the highest levels America had seen in 100 years.

The result was devastating. Farm exports fell by about two-thirds over the next four years, causing farmland prices to drop. Since many farmers borrowed money to finance their farming costs using land as collateral, the rural banks that lent the money began to fail. Other exporting industries felt the impact as well, including mining, automobile and steel makers. The money supply, which normally grows at a modest rate each year declined 29% during this period. As predicted, many countries that traded with the U.S. increased their import tariffs in retaliation, and global trade declined. American unemployment went from 3% to 25%, and 40% of all U.S. banks closed permanently. The decline in trade made it more difficult for countries like Germany to get dollars so they could pay off war debt to U.S. banks, making matters even worse. Our recession turned into the Great Depression.

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While Smoot-Hawley was not the only policy error during the Depression, it was a big one. By contrast, the period following World War II saw the U.S. develop a much more open trade policy. The economies of Europe and Japan were nearly destroyed by the war, and needed help in rebuilding. In 1944 at the Bretton Woods conference to establish a postwar economic order, the U.S. acted to replace the British pound with the U.S. dollar as the global reserve currency. Since world trade would now largely be conducted in U.S. dollars, countries that exported to the U.S. would accumulate dollars, and these dollars would help finance trade with other countries as well.

A coffee grower in Brazil, for example, might be selling beans to a coffee roaster in Malaysia, and would not want to be paid in Malaysian ringgit unless the grower planned to buy Malaysian goods with the money. Instead, the Malaysian coffee roaster pays the Brazilian grower in U.S. dollars, and the bean grower can use the money to buy things from any other country that trades using dollars – for example, a tractor from Germany. This results in increased trade.

Countries such as Japan, Germany and China have grown by focusing on exports during the post-World War II era. This model, known as the Japan Model, relies on restricting consumption inside their countries, freeing up savings to be invested in industrial growth. The profits made from the exports are financing the growth of the economy, essentially by using money that could have been paid to workers to finance consumption. Germany and China are the largest net exporters in the world today.

The U.S., as the source of the world's reserve currency cannot follow this model, as there must be at least one country that imports more than they export. The U.S. serves as the importer of last resort, and the trade deficit serves as a source of international investment funds for the U.S. economy. Our trade partners use the profits to invest in businesses here, including such things as factories to build their products inside the U.S. In addition to private investment, these funds support our government spending when our own taxes can't cover the bill. If our government spending was in balance with tax revenue, the imported funds would provide even more private capital and help our economy grow.

The U.S. plays other roles in assuring global free trade, and one of the most important is providing access to the most liquid and predictable financial markets in the world. Foreign exchange trading is one of the most important parts of our markets, supporting the financing of trade. We also lead the world in policy matters, such as in the World Trade Organization and the North Atlantic Treaty Organization. Our Navy provides security for the shipping lanes to reduce the risks of piracy and war.

The rise of populist sentiment in the U.S. suggests that we no longer want to follow this model, and that the costs to our economy in increased inequality are more than we wish to bear. Laid-off factory workers who see dim prospects of better jobs are gaining more attention as they suffer from the impact of less expensive imported goods. At the same time, no other country is prepared to take on the role the U.S. has played since World War II. Should we abandon our role, we can perhaps expect a messier world as other countries – for good or ill – attempt to fill the vacuum we leave behind.

This month's commentary was in part sparked by a series of very fine reports written by Bill O'Grady of Confluence Investment Management in St. Louis, MO. I encourage anyone who would like to explore this topic further to read his Weekly Geopolitical Reports from May 1st to 22nd of 2017. You can access these at www.confluenceinvestment.com

Sources

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William O'Grady, Weekly Geopolitical Reports May 1 – 22nd Confluence Investment Management www.confluenceinvestment.com

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