Protectionism and economic revival: the British interwar economy

MICHAEL KITSON

Department of Applied Economics, Cambridge

and

SOLOMOS SOLOMOU

Faculty of Economics, Cambridge

The right of the University of Cambridge to print and sell all manner of books was granted by Henry VIII in 1534. The University has printed and published continuously since 1584.

CAMBRIDGE UNIVERSITY PRESS

Cambridge
New York Port Chester
Melbourne Sydney

Published by the Press Syndicate of the University of Cambridge
The Pitt Building, Trumpington Street, Cambridge CB2 1RP
40 West 20th Street, New York, NY 10011, USA
10 Stamford Road, Oakleigh, Melbourne 3166, Australia

First published 1990

Printed in Malta by Interprint Limited

British Library cataloguing in publication data

Kitson, Michael
Protectionism and economic revival: the British
interwar years.
1. Great Britain. Economic growth, history
I. Title II. Solomou, Solomos
339.5'0941

Library of Congress cataloguing in publication data

Kitson, Michael, 1959–
Protectionism and economic revival: the British interwar economy
Michael Kitson and Solmos Solomou.
p. cm.
Includes bibliographical references.
ISBN 0-521-38267-X
1. Great Britain – Economic conditions – 1918–1945. 2. Tariff-
-Great Britain – History – 20th century. 3. Protectionism – Great
Britain – 20th century. 4. Great Britain – Economic
policy – 1918–1945. I. Solomou, Solomos. II. Title.
HC256.3.K58 1990
382'.73'09410904 – dc20 89-22210
CIP

ISBN 0 521 38267 X

IP

Contents

Figures

Tables

Introduction

In February 1932 Britain imposed a General Tariff of 10 per cent *ad valorem* on imports from foreign countries. This represented a *qualitative* policy shift that affected most British industries which had been exposed to severe international competition in a world economy that was increasingly protectionist since the late 1870s. This book analyses the effects of this policy change both at the macroeconomic level and at the level of the industrial structure.

Britain's economic situation after the First World War

The performance of the British economy in the 1920s was unspectacular when compared to the achievements of the world economy. Although aggregate growth indicators show an improved performance between the cycle peak to peak years 1924–9, relative to the period 1899–1924, such measures are highly deceptive when reported in isolation. In chapter 1 we argue that such growth measures need to be placed in a long-term historical perspective. Such longer-run comparisons do not show the 1920s to be a period of rapid economic growth. Moreover, the economy was burdened with high unemployment throughout 1921–9, while many other industrial countries were able to grow more rapidly at higher levels of capacity utilisation; the manufacturing sector's performance, both in terms of output and productivity growth, was significantly lower than the 1930s; exports were below the level of 1913 even at the peak of 1929, while imports were rising as a percentage of GDP and domestic absorption.

In contrast, UK economic performance was significantly improved in the 1930s. Instead of falling below the average performance of the world economy, GDP growth was over double the weighted growth rate of the world economy and much better than the performance of the other major industrial countries, including America and France. Although unemployment remained a serious problem in the 1930s it is clear that the nature of unemployment changed, weakening the links with the level of aggregate demand and economic performance (Crafts, 1987; Eichengreen and Hatton, 1988).

Of course, at this stage in the discussion we cannot assume that tariffs explain the better performance of the post-1932 era. However, there is clearly a *prima facie* case that needs to be examined in the context of other policy changes and longer-term tendencies in the economy.

The pressures for protectionism

In Britain voices were raised in favour of protection from the late 1880s onwards, most notably by Joseph Chamberlain. His main assertion was that protection could bring increased employment and would therefore be mainly to the benefit of the worker:

> The manufacturer may save himself. But it is not for him that I am chiefly concerned. It is for you – the workers – I say to you the loss of employment means more than the loss of capital to any manufacturer. You cannot live on your investments in a foreign country. You live on the labour of your hands.[1]

However, protection was not introduced until the First World War, and then limited to specific categories: by the so-called McKenna duties in 1915, which were later extended under the Safeguarding of Industries Act, 1921. The major items comprised cinema films, clocks and watches, motorcars and musical instruments, to which were added cameras, optical lenses, and a large number of scientific instruments, and various chemicals deemed essential for safety in time of war.[2]

The strength of the free trade sentiment is well illustrated by the fact that the first *Acts* of the Labour Government of 1924 (which came to power on account of Stanley Baldwin's unsuccessful bid for a specific mandate to introduce general protection) were to abolish most of these duties; the Tory Government restored them in 1925.

Pressures for the extension of protection developed throughout the period and originated from varied sources. One of the most cogent arguments came from Keynes who in his evidence to the Macmillan Committee and as Chairman of the Economic Advisory Council Committee of Economists advocated import duties as one method of increasing employment. Keynes argued that the inflexibility of real wages was the main source of unemployment. Given the rigidity of money wages, he contended that a tariff was one method of raising prices relative to money wages.[3] A second element of Keynes' argument was that a tariff, by improving the current account of the balance of payments, would increase British foreign investment and thus raise the foreign demand for domestic products.[4]

It would be wrong to consider that the debate on protection was solely conducted by academic economists. Apart from discussion in Government there was growing pressure from business groups and other interested parties. The case for tariffs put forward by the National Union of Manufacturers was instrumental in the introduction of the Safeguarding of Industries Act (Capie, 1980). From 1924 onwards the Empire Industries Association (EIA) pressed for increased tariff protection and had considerable influence amongst backbench MPs. It wanted not only increased protection for domestic industry but also the extension of Empire preference. The arguments of the EIA were closely allied to those of the iron and steel industry. Iron and steel was the industry most forceful in its advocacy of protection due to its rapidly declining share of the domestic market.

The pressure for increased protection was therefore an amalgam of sectional interests and various arguments concerning the impact of a tariff on general economic conditions. Britain's deteriorating external account finally swung the balance towards protection. In 1931 the current account balance moved into deficit, partly due to the expectation of a general tariff (Capie, 1983) and partly due to the declining invisible earnings. At the same time the depression activated fiscal stabilisers that increased the budget deficit undermining confidence in sterling. Under such conditions the argument in favour of tariffs became more *expedient;* such a policy would not only generate revenue for the Government and help the budget but it would also help correct the trade balance.

The financial crisis was heightened by the suspension of the gold standard in September 1931. Many believed this reduced the need for a tariff as exchange rate adjustment would ensure balance of payments equilibrium. Others believed that the exchange rate was incapable of achieving external balance and a large depreciation would not only undermine confidence in the economy but reduce the value of Britain's external assets as well as being inflationary. It was the latter arguments which were eventually accepted by the majority of the Cabinet and led to the emergency Abnormal Importations Act in November 1931 and the Import Duties Act in February 1932. This provided a base rate on newly protected manufactured imports of 10 per cent, but which could be raised subsequently on the recommendation of the newly established Import Duties Advisory Committee. This Committee soon recommended that most rates should be raised to 20 per cent and for a more limited category of commodities (which included steel and chemicals) it should be 30 per cent. These rates were further increased as a result of subsequent recommendations in 1934 and 1935.

The international context of protectionism

To fully appreciate the nature of Britain's trade policy change in 1932 we need to place it in the context of protectionism in the world economy during the period. As can be seen from table 1 Britain was the only major country to pursue a free trade policy in the pre-1913 era. Even by 1925 the limited extent of protectionism meant that the average tariff level on manufactured goods in the UK was only 5 per cent *ad valorem*, while the average for

Table 1 *Average tariff levels of European countries 1913, 1927 and 1931* (%)

	1913	1927	1931
Germany	16.7	20.4	40.7
France	23.6	23.0	38.0
Italy	24.8	27.8	48.3
Belgium	14.2	11.0	17.4
Switzerland	10.5	16.8	26.4
Sweden	27.6	20.0	26.8
Finland	35.0	31.8	48.2
Spain	37.0	49.0	68.5
Austria	22.8	17.5	36.0
Czechoslovakia	22.8	31.3	50.0
Hungary	22.8	30.0	45.0
Bulgaria	22.8	67.5	96.5
Poland	—	53.5	67.5
Romania	30.3	42.3	63.0
Yugoslavia	—	32.0	46.0

Source: Liepmann (1938), p. 415.

Continental Europe was 24.9 per cent (Liepmann, 1938) and for the United States 37 per cent (Bairoch, 1986).

Moreover, the early 1930s saw a sharp rise in tariff levels and quotas. This wave of rising protectionism was induced by falling product prices in 1928–9 which encouraged many European countries to raise the level of agricultural protection. Under the Smoot-Hawley tariff in 1930 the level of American tariff protection reached an unprecedented height, especially for manufactured goods with an average duty of 45 to 50 per cent. Before the end of 1931, partly as a reprisal, twenty-five countries had raised their duties on American products. The 1930s also saw a rise in quota restrictions, particularly in France and Switzerland.

Such trends suggest that the relevant question that needs to be addressed is whether Britain pursued an appropriate *second best* trade policy in 1931–2. A first best policy of free trade was simply not viable in the circumstances of the unco-ordinated world economy of the 1930s.

The theoretical analysis of the impact of protection

The use of commercial policy as an instrument for economic revival remains a controversial issue. The theoretical aspects of this area have undergone rapid change during the past decade. There now exists a large body of literature on international trade theory arguing that protectionism may have beneficial effects on real variables. It is now widely recognised that the classical argument for free trade is based on assumptions that are historically invalid. Protectionism may be a 'second best' policy to ease the adjustment problems of under-utilised economies.

However, if other trading partners engage in retaliation, the so-called 'beggar-thy-neighbour' policy response, some trading partners may suffer and indeed *all* economies may end up worse off. In order to think about the nature of the gainers and losers from protectionism in this period we need to consider the following effects:

The 'initial conditions' effect

The 'initial growth conditions' of economies may affect their response to protectionism. Thus, economies that failed to reconstruct successfully in the 1920s, burdened with slow economic growth and uncompetitiveness, may have responded differently from the more successful economies. The argument can also be extended and adapted by emphasising the initial conditions of the sectoral structure of each economy. Thus, if the sectors protected in the 1930s were facing adverse competitive conditions in the 1920s (as in the case of Britain) economic growth may have been stimulated by protecting these sectors, giving them time to adjust.

The 'beggar-thy-neighbour' effect

Any initial benefits of a change in trade policy may be negated by the impact of retaliation and the decline in world trade. What proportion of the decline in world trade can be attributed to protectionism? The development of 'trading blocs' in the 1930s complicates the analysis of this question significantly.[5] The size of an economy may also be relevant in that it may influence the magnitude of retaliation from trading partners.

Qualitative policy shifts

Britain was basically a free trade economy until the interwar period. Thus, the policy shift of 1932 can be viewed as a *qualitative* shift for most industries and its effects would be expected to be different from the policy adjustment of other economies which simply involved raising tariff levels.

The Lewis effect

Lewis (1949, pp. 59–61) suggests that the spread of protectionism may have had beneficial effects in reducing the amplitude of the downswing but negative effects during the upswing. He argues that if one country cuts its imports then trading partners whose exports have fallen must cut their imports to maintain trade balance. To achieve balance with the protectionist country without recourse to trade policy their overall level of imports will have to fall by some multiple of their imbalance with the protectionist country. That is, they will have to deflate. The introduction of a tariff allows trade flows to be adjusted directly, arresting the necessity of internal deflation. However, if the country maintains protection during the recovery period this may hinder the strength of recovery by preventing the expansion of trade.

The overall policy regime of the 1930s

The effect of tariff policy cannot be analysed in isolation. The 1930s saw a number of important changes due to other policies and 'natural' cyclical influences. Sterling was devalued in September 1931 which gave Britain a major competitive advantage between 1932 and 1933. The devaluation also meant that the government could pursue a 'cheap money' policy between 1932 and 1939, as it did not now have to use monetary policy to sustain the exchange rate. Many studies have also pointed to the 'natural' influences favouring recovery in the 1930s, such as the favourable terms of trade between 1929 and 1933 and diffusion of new demand patterns. Many of these issues are discussed in chapter 6 but the reader should bear them in mind when evaluating the empirical results reported throughout this book.