Comstock Partners, Inc.

An Early Stage Of A Return To Smoot-Hawley Environment?

October 02, 2003

This comment will attempt to show how protectionism and tariffs led to the deflation and intensity of the depression of the 1930s. We explain how devastating the Smoot-Hawley Act was to world trade back then and how we seem to be going down the same path currently in order to “protect” the developed world's farmers and troubled industries. We first show the ramifications of the steel tariffs instituted in the first quarter of 2002 by President Bush. We then show how the world trade talks just recently broke down without the developing countries having any idea of the repercussions that could come from the inaction.

While on the surface protectionism seems logical, the imbalances and retaliations that result from these policies always come back to haunt the initiator of tariffs. We have tried to illustrate this process in the “cycle of deflation” chart, which has become almost a symbol of Comstock on this webpage, and is shown again at the end of this comment. If this process continues, as we expect, deflation will be the inevitable result of the combination of excess debt, excess capacity, and the decline in worldwide trade as a consequence of protectionism.

The Smoot-Hawley Tariff Act was passed in the U.S. Congress in 1930. This Act brought U.S. tariffs to the highest protective level in U.S. history. President Hoover desired a limited upward revision of tariff rates with general increases on farm products and adjustments of a few industrial rates. However, after the Senate and House debated the issue, with each trying to outdo one another, the bill arrived on the President’s desk with the high tariffs the Senate wanted on farm products, as well as the increased tariffs that the House insisted on to protect manufacturers. The bill was signed by Hoover in June of 1930 and effectively raised the rate of tariffs in the U.S. by almost 50% by 1932. This provoked retaliatory tariff acts from 25 foreign countries. Within two years following the Smoot-Hawley Act, U.S. exports decreased by nearly two-thirds.

Last year the United States initiated tariffs of up to 30% on steel imports, threatening a damaging trade dispute. The Bush Administration said that it was justified in acting to protect the ailing U.S. steel industry since 31 American steel firms went bankrupt over the past five years. The industry blamed the decline on the unchecked influx of cheap foreign steel. European Union leaders vowed swift retaliation and gave warning that the global economy would suffer. Japan, Brazil, Australia, South Korea, and Russia joined the E.U. in filing protests with the World Trade Organization (WTO). So far, the tariffs remain in place and there are estimates that these tariffs are costing the U.S. over 200,000 jobs from the industries that use steel. This estimate is much larger than the jobs that were saved in the steel industry by the tariffs. We have also experienced retaliation from many of our trading partners such as the E.U. with farm products, and Japan (specifically with beef imports).

In July of this year the WTO panel found the hefty tariffs imposed on steel imports into the U.S. violated global trading rules. After the WTO ruling was announced, E.U. Trade Commissioner Pascal Lamy said that unless the tariffs were withdrawn, Brussels would slap sanctions worth $2.2 billion on U.S. imports. The U.S. appealed this finding which now gives the initiated steel tariffs life until at least mid 2004, and delays such retaliatory actions as Brussels threatened. Other countries recently threatening retaliation were China, Norway, Switzerland, Australia, New Zealand, and Taiwan.

Just this past Monday top U.S. companies urged Bush to quickly lift tariffs on imported steel to avoid retaliation on up to $3.8 billion worth of U.S. exports. Heading into next year's presidential election, Bush faces pressure on both sides of the issue. “An early decision by Bush to withdraw the tariffs would allow him to declare victory in helping steel companies get back on their feet, while sending a positive signal to trading partners after the recent collapse of WTO talks”, stated Mr. Cohen, president of the Emergency Committee for American Trade.

Tom Friedman recently wrote an editorial in the N.Y. Times tying the failure of the developed nations to cooperate at last week’s world trade talks to the possible fostering of terrorism. He made the connection that if we don’t allow the poorest emerging countries to compete in agriculture and textiles (because of the developed countries subsidies and tariffs), we will find that these countries will be the new breeding grounds for terrorists.

We believe Mr. Friedman made a good point. However, we also believe that he didn’t follow-up on the economic consequences when the developed countries, such as the U.S., the E.U. and Japan, refuse to give up the lavish subsidies they bestow on their farmers and troubled industries. The economic ramifications could be even more devastating than potential terrorism. These subsidies make the prices of agriculture and troubled industries (such as steel and textiles) so cheap that developing nations can’t compete. The Economist magazine quoted a World Bank study that said, “A Cancun agreement, reducing tariffs and agriculture subsidies, could have raised global income by $500 billion a year by 2015—over 60 percent of which would go to poor countries and pull 144 million people out of poverty”.

As you can see from the “cycle of deflation” chart (attached) the devaluations and competitive devaluations that are continuing to take place are being followed just like a bee to honey by protectionism and tariffs-- and the chart speaks for itself as to what follows protectionism.

- Cycle Of Deflation

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