

THE PECULIAR POST-GREAT DEPRESSION PROTECTIONISM

ROLF LÜDERS AND GERT WAGNER*

1. INTRODUCTION

That the early 1930's brought profound changes in Chile's commercial strategy, is part of "conventional wisdom". Economic historians generally accept that after the Great Depression the economic policy of the country shifted from its up to then "outward" oriented development strategy, into an "inward looking", anti trade policy, which extended over the next four decades.

Judging from trade data, to identify the Great Depression as the dividing line between the mentioned out and inward looking experiences of Chile seems plausible. Total exports reached in 1933 only 38 per cent of its 1926 level. Compared to the exceptional 1928-29 years, the fall is even more pronounced, down to 28 per cent (see Table 1). Recovery during the 1930's was slow, remaining during the whole decade well below the 1929 peak.¹

Given such a drastic fall in overall exports, the economy required, no doubt, a profound increase in the relative price of traded goods. What characterized Chilean trade policy from then on and until the mid 1970's, was not the relative price change, but the particular policy decisions through which this change was achieved. Raising tariffs was one technique, as can be seen in Table 1, but more complex and discretionary devices, such as quotas, maximum prices, multiple exchange rates, etc., were also used. It is the combined presence of all these instruments which determined trade and price policy in the following decades. In this field, more than in most other, the initial reactions to events of the early 1930's can be seen as having a profound imprint on later developments. It is difficult to imagine the in the 1950's and 1960's existing trade institutions, were it not for the peculiar and, of course, highly inefficient way the above mentioned relative price change was tackled initially.

After this brief Chilean trade policy overview and based on Lüders and Wagner (2003) the following section describes the pre depression trade regime and offers a hypothesis aiming at an explanation of the underlying institutional

* Department of Economics and Finance, Diego Portales University.
Email: rolf.luders@udp.cl, and Gert Wagner, Department of Economics, Pontifical Catholic University of Chile. Email: gwagner@facepuc.cl, respectively.

¹ However, as discussed in "Early 1930's: A Unique Period in Fiscal Evolution?" Lüders and Wagner (2003) the asymmetry between the behavior of exports of different products was very important during those years. While nitrate exports were heavy and negatively influenced by the long-run evolution of both, the world market for nitrates and Chilean public policy, copper exports, which also declined sharply with the depression, had almost completely recovered by the end of the decade.

equilibrium. The complexity of objectives behind post depression protectionism is then described. Later on the origin and stability of the new policy instruments brought about by the depression are discussed. In the last section we come back to the institutional hypothesis for understanding pre 1930 protectionism, exploring if its underlying assumptions survive in the post depression period.

TABLE 1
CHILE: GDP, EXPORTS AND TARIFFS, 1928-1940
(1926=100)

	GDP	Total Exports	Nitrate	Copper	$\bar{\tau}$
1928-1929	124	134	136	187	117
1930	106	93	96	122	136
1931	84	69	40	80	140
1932	71	26	17	33	80
1933	87	38	15	57	137
1934	105	63	22	95	176
1935	111	60	32	91	179
1936	117	71	32	106	177
1937	133	112	36	223	162
1938-1940	138	89	42	176	154

Source: based on Díaz, Lüders, Wagner (2003).

The columns “nitrate” and “copper” refer to value of production indices, that is, production times price indices. Almost all production of both these products was being exported. The last column represents the average import tariff.

2. THE PRE GREAT DEPRESSION TRADE REGIME

Chile’s commercial policy at the outbreak of the Great Depression was based exclusively on custom duties, as it had been during the previous 120 years.² In 1925 and at a two digit level of industrial classification, the average tariff was 15.8 per cent, ranging from a high of 37 per cent, to a low of 0.07 per cent. (Figures

² The so called “outward looking development strategy”, which ended according to conventional wisdom with the Great Depression, got somehow mixed up with the idea of *free* trade. The former expression is used in the oral tradition, rather than in the rigorous professional literature, as a rhetorical device to underscore the trade policy change of the 1930s. The confusion of an “outward looking development strategy” with free trade seems is, however, quite common, as witnessed by the surprise expressed by Coatsworth and Williamson (2002) when discovering tariff levels existing in Latin America before the Great Depression. Chile is no exception and pre Great Depression tariff levels were not only relatively high, they also represented a considerable fraction of GDP. In the 1920’s, import duties still constituted about a quarter of total fiscal revenues.

are based on largest import sectors, in a sample covering 74 per cent of total imports). The overall average import tariff, that is total revenues from this source over total imports, reached 19.2 per cent for 1921-1930 and their standard deviation was a relatively low 4.64 per cent. These revenues represented 3.13 per cent of average GDP, financing about 27 per cent of total fiscal expenditures.

The average tariff of 1931-1940 was 28 per cent, about 50% above the average of the previous ten years, a dramatic change, and quite consistent with the idea of a landmark.³ However, in the following decades, the 1940's, 1950's and 1960's, all of which conventional wisdom incorporates into the "inward looking years", the average tariff fell back to its pre Great Depression level of the 1920's. Why then the talk about protectionism? Do tariffs charged by customs really explain the changed character of Chilean trade policy after the Great Depression? If not, what then stands for it? The answer to these questions starts with the identification of what we consider essential features of the pre Great Depression commercial policy decision process. The next step underlines the changes experienced in the early 1930's in this field, in particular the introduction of a new set of policy instruments, and then goes on exploring how these innovations affected the above decision process.

Two institutional factors which characterized the pre-depression commercial policy making process changed during the 1930s. In the first 120 years or so of republican life, tariff changes were the outcome of a public choice process in which Parliament and the executive branch of government had to reach an agreement. This is of course a normal procedure in democratic organizations, but it has to be stressed that these agreements imply political transaction costs; that is, tariff *changes* are expensive under such circumstances. If one accepts this price as a restrictive device, the pre Great Depression commercial policy stability in Chile can then be explained. Moreover, the tariff approval procedure also helps to explain the relatively low dispersion of tariffs for different groups of products. Given the importance of tariff revenues in fiscal accounts - in 1925 tariff revenues represented a quarter of total fiscal revenues, down from even higher shares in the previous 100 or so years- significant tariff revenues losses had to be compensated. Therefore, any bids in favor of prohibitive tariffs on, or exemptions in favor of, imports of certain goods which were heavily represented in the country's imports, were not easily approved, because they would require compensatory taxation.

Another feature characterizing the "old" way of doing commercial policy was that the executive branch of government, although interested in charging tariffs, prevented these to be excessively high or too dispersed. This was also a consequence of the mentioned high relative weight of tariff revenues in total fiscal revenues, which induced the Executive to "maximize" or at least not dilapidate, such revenue source. Any tariff innovation was therefore carefully evaluated by

³ The country did not switch at one point in time from completely free trade to a high level of protectionism, nor did protectionism begin at any one moment during the Great Depression. In particular the new tariff law of 1928 already had amplified governments capacity for discretionary commercial policy changes.

the Executive with respect to its fiscal consequences. In particular and as any monopolist knows, “high” surcharges may be far from the optimum, while zero or very low rates do not generate much income. Therefore the relatively low tariff dispersion found in Chile before the Great Depression.⁴

In synthesis the pre Great Depression political decision scenario can be characterised by the following:

- (i) tariff is the only policy instrument.
- (ii) maximum to average tariff levels are below or within the range of two or three.
- (iii) tariff structure is relatively stable; changes require laws, and they are expensive

This context would change dramatically as a consequence, we argue, of policy options opened up by the change in monetary regime: the loss of gold’s anchor which comes with the depression. The next section present the mix of policy objectives which describe the complex protectionism arriving with the Great Depression and the following centers on the stability of the policy instruments which came with the depression.

3. RESTRICTIVE TRADE POLICIES AS PART OF A COMPLEX PUBLIC POLICY MIX

The so called “inward looking development strategy” is a public policy program which in Chile was initiated in the early years of the Great Depression, which consisted of a peculiar mix of commercial, price and industrial policies. Often also identified simply as “protectionism”⁵, the experience lasted for more then four decades. (Wagner 2003)

But “protectionism”, understood as a set of public policies aiming to achieve a specific structure of production and a defined factor income relationship, obtained through trade restricting devices, only partially covers the mix of regulations implicit in Chile’s “inward looking development strategy”. Direct price management of

⁴ Some deviation from the described model took already place in the late 1920’s, when the new tariff code of 1928 conferred special discretionary powers to the President of the Republic to change tariffs in certain cases without further consultation to Parliament. This of course lowered the “price” of tariff changes, as argued above. This procedural change was probably the consequence of the growing feeling that potential market failures existed everywhere and that the State and in particular its Executive, had to be given more power to regulate and intervene the economy. At the same time, the relative importance of tariff revenue in fiscal income was diminishing, so that this stabilizing factor was also weakening. The Great Depression had a powerful impact on the set of factors commented upon in this section, but it should not forgotten that this occurred in a dynamic context, where changes of the “old” model were already taking place.

⁵ Much of empirical and analytical work related to this development strategy was developed by researchers specializing in the field of international economics, exploring and quantifying its quite evident trade restricting and resource allocating distorting features.

specific goods, at some times with the apparent objective of putting a brake on inflation but at others with the more precise idea of benefiting consumers, especially when referred to classical “wage goods”, intermingles constantly with the more direct and traditional notion of protectionism⁶.

Moreover, state interventions into the country’s investment structure were added. This was done through two channels, investment in public enterprises and credit management. Through the latter governments induced the centrally planned private investment composition. By the end of the 1930’s the Chilean development corporation, CORFO, came into existence and much of capital accumulation in manufacturing and public utilities –aimed directly or indirectly at import substituting activities- was either done or influenced by this agency. Imported goods required by public accumulation and the foreign inputs into the production process this capital helped to demand, in many occasions imposed discriminatory treatments in their favour, introducing additional complexity into the commercial policy.

All these policy measures could, of course, be considered simply as random interferences with the free market resource allocation mechanism. However, the distinction among different objectives and policies is necessary to understand this complex public policy program. If this is done, the peculiar mix which was adopted between 1930 and the early 1970’s, more than the result of a single, integral and balanced planning effort, and beyond the outcome of pure constructivism, may be seen as a complex and mutating set of regulations and interventions accumulating through time, stemming from public agencies many times quite independent one from another, and often inspired by apparently unrelated objectives. Complex time dependency paths developed, influenced by unexpected or undesired consequences of previously adopted policies, which then triggered new interventions.

4. COMMERCIAL POLICY FROM THE GREAT DEPRESSION ONWARDS : INSTRUMENTS AND STABILITY

Early during the Great Depression, once the sharp export reduction and severe financial restriction became evident, Chile abandoned the gold standard and increased import tariffs. As a result, decisions were taken away from the market and transferred to the executive branch of government.⁷ Chile had been off

⁶ The rhetorical distinction between real and monetary phenomena might be considered somewhat outmoded, but for the sake of illustrating the peculiar policy mix developed by Chile we could say it constitutes a case where money is no longer a pure veil and commercial and industrial objectives of government interplay with goals expressed in terms of money prices of specific goods.

⁷ The new constitution of 1925 curtails Congress’ powers. Among others it took away the legislative approval of money emissions (authorizations) transferring it to Central Bank. In the beginning its directors came also from Congress but thru time the executive acquired more and more decision power.

gold for over five decades, except for a three year period late in the XIXth Century and in 1925-1931. Therefore, were it not for the following two new elements, Chile's decision to abandon the gold standard would not have implied a really new scenario. However, the breakdown of the international monetary and trading systems generated a new environment for Chile's public policy makers, in which benefits to be derived from gold's anonymous discipline lost appeal in relation to "visible hand" type interventions. In addition, of course, the non discretionary gold anchor was lost for monetary policy purposes.

Benefits to be obtained from a network good like the adherence to a money standard, are positively related to the number of consumers. That is, the generalized repeal of gold may be understood as a loss of weight by defendants of monetary discipline in Chilean public discussions. As a result, traditional restrictions on money's expansion were weakened or simply disappeared, but the emerging scenario also facilitated new and formerly unknown management opportunities of foreign exchange. Whatever the reason, the fact is that soon authorities found out that the new paper standard provided fresh opportunities for trade regulation through multiple exchange rates and direct exchange managements. These instruments opened up the door for interfering in new ways with relative price formation; they also provided new channels for export taxation and eventually for generating fiscal revenue.⁸ These institutional innovations, accompanied by new actors in the decision scenario, opened up the road for new outcomes in trade regulation.⁹

Initially the depression was faced by a combination of (i) a substantial increase in tariffs charged by customs; (ii) adoption of multiple exchange rates and (iii) direct exchange allocation to specific imports. Only the first instrument required explicit approval by Parliament; the other two were administered by the executive with little or none legal instruction for specific action, besides the objective of aggregate equilibrium of foreign accounts. Taking tariffs as given, the executive could now determine the level and structure of protection, and also the time span over which a given set prevails. Innovations could be imposed any time.

The underlying dynamics of protection turned out to be a complex interrelation of different forces. One, government objectives might change through time, conditioning in this way the specific use of policy instruments. Two, inflation, in itself a phenomena exacerbated by institutional changes triggered by the Great

⁸ It is easily appreciated that all these instruments and new regulations can be seen as different aspects of the same overall system of trade reduction.

⁹ These instruments were probably perceived as practical solutions to tough public policy challenges but, was Chile prepared for recognizing the implicit cost of their potential long run incidence? Answering this we are not prepared for, but the possibility that social capital pertaining to their rationality should have been scarce cannot be dismissed, and the bureaucracy in charge of administering at the executive branch of government might not have had the perception, experience and knowledge of traditional gold experts. The new policy instruments may be seen as negative technological innovations, were consequences to be appreciated in the long run were not present at the decision process in the early 30's when adopted. Alternatively actors may have thought that getting rid of them once the depression had finished is an easy task.

Depression, depreciates the real price of imported goods and their substitutes, for any given structure of nominal exchange rates. In practice and for a long period, the range between the maximum and minimum fixed exchange rates increased, mainly due to maintenance of its lowest level and to increases, in variable proportions, of higher rates. But, three, also tariffs charged by customs experienced frequent changes; on the one hand, tariff increases were legislated, and on the other effective tariffs were reduced through different channels starting with exemptions decreed by the President of the Republic, be it for stimulating production of certain goods -reductions of tariffs on intermediate imports- or for the sake of price controls of politically sensible items. Four, bilateral agreements, quite frequent in those years, were in general agreements for discriminatory tariff reductions. In addition, five, new domestic legislation created a variety of "special trade regimes", lowering taxes and tariffs for imports into extreme regions and for certain industries.

In synthesis, starting with the Great Depression commercial policy was implemented using a set of highly unstable instruments to ration imports. In other words, a set of tools which and for different reasons, required constant management and adaptation by the authorities, was used to implement that policy. But it is important to notice that this inherent instability in the use of the instruments did not translate into chaotic investment and disinvestment in different industries. This turned out to be so, because one of the important aims of commercial policy was to maintain and even enhance domestic production of goods, producers could expect that the system would make sure that they at least survived. Once production of a given good started, producer were almost assured that the process would go on forever.

But this did not mean that, for example, new technology could easily be introduced or quality improved, if those activities somehow fell outside regulators -planners- concept of the "correct" production function. The capacity of the commercial system for permitting adaptation to new circumstances at industry level was therefore quite limited.

Before going on with the discussion of how these new instruments changed the decision scenario in matters of commercial policy, some evidence on the intensity of their utilization is presented. Obtaining such measures required considerable effort for authors and are the first attempts for translating the complex set of commercial regulations into a synthetic implicit tariff are estimations disposable for the early 1960's. The average implicit tariff generated by these calculations are roughly in the range of three times the average tariff collected by customs. In other words, about 75% of the average protectionism was generated by non traditional means, that is non revenue raising tariffs.¹⁰ Our best guess is that this proportion also accounts for the 1950's and 1940's; but it is possible that during the 1930's this proportion could have been somewhat lower, mainly because tariffs were higher.

¹⁰ For some sub period in the 1930's and 1940's differences made in exchange transactions were explicitly registered in fiscal accounts; but in most cases those differences translate directly into some sort of subsidy or direct investment.

This magnitude is important for two reasons. First, it provides the necessary evidence for the existence of an intense type of protectionism. It is precisely these new post 1930 policy instruments which account for the real difference between pre and post Great Depression protectionism, representing the quantitative dimension behind the intuitive distinction among “inward looking” and “outward looking” development strategies. But also, this proportion between new and old instruments reveals significant changes in commercial policy options after 1930.

5. GOVERNMENTS INTEREST IN COMPLEX PROTECTIONISM

The Great Depression introduced huge changes into the commercial policy public choice process. Does this mean that the underlying model we visualize for the pre-depression decades –the executive government branch maximizes fiscal income subject to parliament approval– completely disappears with the phenomena? We argue that even if conditions and the relative power of actors changed, the underlying assumptions sustaining the model are maintained. Moreover, it is the same model that facilitates the understanding of post depression protectionism.

Assume that the direct political objective is public action, where action stands for expenditure but also for other types of interventions, be they of the regulatory kind or providing some sort of redistribution. Also assume that tariffs and taxes in itself do not add nothing positive to governments popularity, but action in itself does. The point is that in the pre Great Depression context the only way for government to obtain political benefits from commercial policy changes, required raising revenue through tariffs and in this way getting access to fiscal expenditure, more or less the only possible accepted action.

The new policy instruments introduced with the Great Depression implied that political benefits for the executive may now be obtained directly through the assignment of specific exchange rates to particular imports, distribution of quotas, tariff exemptions, access to special exchange rates, etc. Moreover, formerly expenditures needed to be approved by both the executive and parliament, meanwhile direct action based on some of these new instruments does not require such a transaction¹¹.

In this interpretation, the underlying motivation of government is the same as before, but it is the new instruments and circumstances which changed procedures and outcomes. They broadened the range of possible public actions, which means that there were now more products capable of generating benefits for government, while the political price to be paid by the executive was reduced. The price to government was lower after 1930, not only because transaction costs with parliament could now be avoided, but also due the fact that the new instruments,

¹¹ Of course, this should be understood as a movement in a scale of grays since the need for political compromise cannot be dismissed as easily. But for the sake of the presentation we rest here with our argument.

contrary to taxes, generated negative effects which were not easily perceived by the public.

Additionally and as discussed in a previous section, many of these new instruments not only do require, but also permit frequent revision. Employment of a particular instrument in a given sector or industry in, say one particular year, does not preclude its employment next year in the same or other industry.

Let us also mention that tariff dispersion was not penalized after 1930, while it was before that date. A very high *implicit* overall protection rate, and extremes rates in fact exceeded 700%, might have produced benefits for government, even so it did not generate any fiscal income at all.

Benefits for government stemming from what we here call commercial policy induced public action, were directly derived from benefits obtained through these devices by private agents. These benefits may be seen as the distribution of private goods to selected persons. If this is the case, who is paying for the product, and why is it that these payments do not enter negatively into the governments benefit function? The underlying assumption is that private benefits are heavily concentrated and perceived only by few actors. Payments which make these benefits for a few possible, are instead broadly distributed over the whole society and tend to be more or less impossible to perceive by any particular individual. That such policies do have a welfare cost is more or less obvious for economic thinking today, but the discussion of this aspect exceeds our present goal.

6. FINAL REMARKS

Protectionism, understood simply as tariffs on trade, dates back to the beginnings of the Chilean Republic in the early XIXth Century, but with the Great Depression a completely new variety of protectionism was born in the country, where non conventional instruments made most of the difference with past experience. This aggressive type of protectionism was made possible by the breakdown of the gold standard, the emergence of a wide variety of money standards around the world, and the granting to the Central Bank of broad and discretionary issuing powers. It is this close relation between relative price decisions and their implementation using instruments provided by the emerging monetary system, which confers the post Great Depression protectionism its peculiar characteristic. It is in this realm where the defining moment hypothesis pertaining to the Great Depression's incidence on Chilean development can be considered fully accountable, throwing also new light on the historical importance of gold's collapse.

In the early 1950's, once the long lasting depression of world trade initiated in the early 1930s and continued by the effects of World War II, ended, the strongly protectionist Chilean economic system, and its pillars, survived, in spite of the fact that a rapidly growing international trade volumen presumably must have offered

interesting trade opportunities for Chilean business. Institutions and organizations characterizing this system, as well as interests associated to the peculiar resource allocation it engendered, had become healthy and strong enough to resist any change. Moreover, its peculiar instruments not only inhibited any change, but their complex nature clouded the perception of their efficiency costs, thereby reducing or eliminating pressures to get rid of them. A radical change only came about in the early 1970s, as a result of a mayor economic, social and political crisis, to which the messy system here described no doubt contributed to.

What sustained Chile's "inward looking development policies? The obvious candidate and the one getting most attention in the literature is of course "interest groups", that is owners of specific factors which without such a policy might have suffered significant capital losses. But it is our contention that we have added a second and permanently interested actor: Government itself, who also wants to avoid change.

It is therefore not surprising to find that protectionism, as implemented in Chile in 1930-1974, only began to fall apart once the whole economic, social and political system broke completely down at the end of that period.

REFERENCES

- Coatsworth, J. H. and J. G. Williamson (2002), "The Roads of Latinamerican Protectionism: Looking before the Great Depression". NBER Working Paper N° 8999, June.
- Díaz, J.; R. Lüders and G. Wagner (2003), "La República en Cifras: 1810-2000". Manuscript presented to the Editorial Committee Series Análisis y Políticas Económicas, Central Bank of Chile.
- Lüders, R.; G. Wagner (2003), "The Changing Character of Protectionism. Chile a Case in Latinamerica 1820-2000". Preliminar version presented at the January 2003 Seminar of the Faculty of Economics and Business Administration, P. Catholic University of Chile.
- Wagner, G. (2003), "El Proteccionismo Post Gran Depresión" in José Díaz and Gert Wagner *Política Comercial Chilena: Siglos XIX y XX*. Documento de Trabajo N° 223, Instituto de Economía, Pontificia Universidad Católica de Chile.