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POLICY BRIEF

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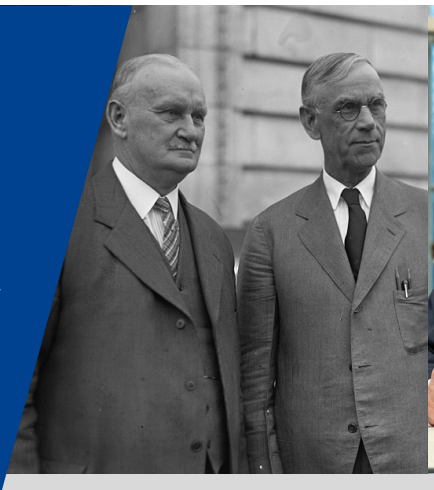
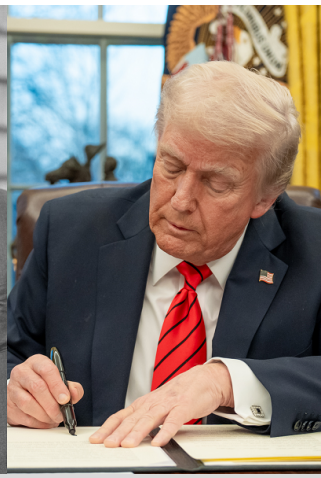
Trade Wars and Currency Wars – Lessons from History





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Overview

- In the 1930s countries responded with widespread retaliation to the protectionist measures implemented in the U.S. with the Smoot-Hawley Tariff.
- Retaliation led to a reduction in bilateral trade flows: U.S. exports to retaliators decreased by about one third. This drop was especially pronounced for America's top exports by value, signaling that the strategic retaliation by US trade partners proved effective.
- Trade further fell in the face of the global currency war. More than 70 countries also took a "me first" approach to exchange rates and devalued their currencies relative to gold between 1929 and 1936.

Keywords: US trade policy, tariff policy, Trump administration, historic trade wars, US national debt

- In den 1930er Jahren reagierten US-Handelspartner mit weitreichenden Vergeltungsmaßnahmen auf die protektionistischen Zölle, die in den USA mit dem Smoot-Hawley-Tariff eingeführt wurden.
- Die Vergeltungsmaßnahmen führten zu einem Rückgang der bilateralen Handelsströme: Die Ausfuhren der USA in Länder, die Vergeltungsmaßnahmen ergriffen, gingen um etwa ein Drittel zurück. Dieser Rückgang war bei den wertmäßig wichtigsten amerikanischen Exporten besonders ausgeprägt, was darauf hindeutet, dass die strategischen Vergeltungsmaßnahmen der US-Handelspartner Wirkung zeigten.
- Angesichts des weltweiten Währungskriegs fiel der internationale Handel weiter. Mehr als 70 Länder gingen in Bezug auf die Wechselkurse ebenfalls einen Alleingang und werteten ihre Währungen zwischen 1929 und 1936 gegenüber Gold ab.

Schlüsselwörter: US-Handelspolitik, Zollpolitik, Trump-Administration, historische Handelskriege, US-Staatsschulden

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Trade Wars and Currency Wars – Lessons from History

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1 Summary

Explaining President Trump's "Liberation-day" tariffs on April 2nd, 2025, Stephen Miran, President Trump's chairman of the council of economic advisors suggested that countries accept the U.S. tariffs without retaliation to come to a fair "burden sharing"(Miran: 2025). History shows that this assumption is wrong: using a detailed data set of bilateral trade flows constructed for the interwar period, this column shows that in fact the US faced substantial and widespread retaliation from trade partners in response to the U.S. Tariff Act of 1930 (i.e., the Smoot-Hawley Tariff). U.S. exports to retaliating countries fell by as much as 33%, with U.S. trade partners specifically targeting high-end, branded consumer products, such as U.S. autos. The drop in trade contributed to the Great Depression, which in turn triggered a large currency war: between 1929 and 1936, 70 countries devalued their currencies relative to gold. We show that trade was further reduced by more than 21% following devaluation. The currency war destroyed the trade-enhancing benefits of the global monetary standard, ending regime coordination and increasing trade costs. The 1930s are a potent reminder of what can happen when international policy coordination breaks down and countries go it alone when negotiating trade and exchange-rate policies.

2 US Tariff Policy Today

U.S. President Donald Trump has recently upended global trade policy, announcing wide-ranging tariffs on April 2nd, 2025, affecting all its trade partners. President Trump's "Liberation Day" pivot consists of two main parts: a 10% tariff layered on top of existing product-level tariff rates that went into effect on April 5th and that affects all countries except Canada and Mexico (which were already impacted by earlier "fentanyl tariffs") as well as "reciprocal" tariffs for 57 U.S. trade partners to go into effect April 9th. The "reciprocal" tariffs, which were calculated as the country's (2024) bilateral trade deficit with the US divided by (2024) U.S. merchandise imports and then multiplied by 1/2, were expected to put a heavy burden on some of the U.S. major trade partners, including China, Japan, Germany, India, South Korea, Taiwan and Vietnam. These changes come on top of several other changes and previously announced tariffs, including a 25% tariff on parts and assembled autos

that went into effect on April 3rd and a March tariff on steel and aluminum of 25%.

Fallout in the financial markets from these tariffs was immediate, with stock markets wildly gyrating across the globe. In the U.S., the VIX reached five-year highs, trillions in wealth were pared from market valuations, and some indices moved into bear territory for the year. U.S. trade partners responded with tariffs on U.S. goods. For example, China, the third largest export market for U.S. goods, met Liberation Day by matching the U.S.'s reciprocal 34% tariff with one of its own, leading President Trump to further increase the tax on Chinese goods to 145%. Beijing responded with an additional increase in tariffs on American goods to 125% on April 11. Newly appointed Prime Minister Mark Carney of Canada introduced a 25% tariff on cars and trucks in retaliation for the new U.S. auto tariffs (with Canada already retaliating to the March tariffs). And U.S. aluminum and steel tariffs led to a plan by the European Union to retaliate with tariffs on bourbon, whiskey, motorcycles, and jeans on April 1, and to threaten additional tariffs of about $18B in mid-April. For now, both tariff responses have been paused for 90 days. Similarly, other U.S. trade partners have taken a more measured approach, especially in light of President's Trump pause of the "reciprocal tariff" component for 90 days to permit further negotiation – an ex-post pivot in the administration's initial position.

If fully enacted, these policy changes will raise the average tariff rate for goods entering the United States from around 2–3% to more than 20%, well above any rate seen in the U.S. since the 1930s. The response by U.S. trade partners suggests that the trade war is burgeoning!

3 What motivates President Trump?

The Trump administration has stated at least three goals to justify this trade shift:

1. New tax revenue: according to Trump the tariffs will generate "trillions and trillions of dollars" to be "paid by foreigners" with multiple objectives, including lowering other domestic taxes.
2. Boosting domestic manufacturing production and bringing jobs back to the U.S.
3. Engaging in a "tit for tat" reduction in tariffs to reduce trade barriers.

These goals are not entirely consistent with each other (raising revenue or bringing back manufacturing jobs require tariffs to remain in place, which would mean it would be impossible to reduce tariffs through negotiation) and reflect a warped understanding of the principles of international trade

and the power of the United States in bilateral tariff negotiations.

First, since the introduction of the federal income tax in 1913, tariffs have not been a major revenue source for the US government and currently stand at less than 2% of total government revenue (CEA: 2024). Projections expect the liberation day tariffs to raise $1.4 trillion over the next decade (Yale Budget Lab: 2025), meaning it will still be far less than what is collected through the income tax. Even the best-case estimates would not offset the Trump administrations proposed tax cut of more than $4.6 trillion over the next decade. Moreover, the estimated budgetary impact of tariffs is likely far too optimistic as it ignores dynamic effects, such as changes in trade patterns and the cost of retaliation. It also assumes that the cost of the tariffs is entirely borne by foreigners, but recent evidence from President Trump's more limited first-term trade war suggests that the cost will be passed on to the American consumers in the form of higher prices.

U.S. manufacturing will face massive disruptions in supply chains and rising intermediate goods prices, making U.S. exports less competitive. Onshoring will not be cost neutral but rather increase domestic prices further. It is also uncertain to result in the 'good' manufacturing jobs that President Trump has promised to his supporters and certainly will not be achieved in the short term.

President Trump and his policy advisors are also wrong to think that tariffs reduce trade deficits. Bilateral surpluses and deficits reflect differences arising from comparative advantage and specialization. Currently the U.S. spends more than it produces (trade deficit 3.1% of GDP). If goal were to reduce the overall trade deficit, the U.S. would have to reduce its spending (e.g., lower the budget deficit and generate a recession) or compress investment. Perhaps rising uncertainty over the stability of the dollar generated by trade policy uncertainty would cause foreign investment in the U.S. to fall, but this reduces the productivity-enhancing effects of those investment flows. Compressing the overall trade deficit through a decline in investment or a recession is neither good in the short run or long run. President Trump may get his resolution of the trade deficit, but not in the way he intended.

4 Cost of the Tariff Policies

Until trade policy stabilizes after this massive policy shift, investment spending will decline in the short run due to increased uncertainty. In the medium run, adjustments are likely to occur through exchange rates. And, to the extent there is not a massive reversal in Liberation Day tariffs, the future

portends a reorganization of the international trading system.

All of this seems to suggest that it may not be the case, as President Trump asserts, that "trade wars are good and easy to win". In fact, a longer-run perspective shows otherwise. We have conducted extensive research on the mother of all trade wars – the one instigated by the U.S. in 1930 when it passed the infamous Smoot-Hawley tariff. Things did not end well, either for the incumbent president (Herbert Hoover) or the American economy. And, it proved harmful for all economies, not just the United States.

In the 1930s, the trade conflict created by Congress when it passed the 1930 Tariff Act (aka Smoot-Hawley) made economic depressions worse by reducing trade flows – just when countries needed more income, not less. On the domestic front, tariffs led to the closing of the largest markets for America's most important manufacturing and agricultural exports. The world abandoned global agreements and retreated into an era of protectionism and other "me first" policies (such as controls on financial capital across borders) that compounded the self-inflicted wounds of Smoot-Hawley and only served to shrink global trade further and delay economic recovery. Trade requires collective management, and when countries chose to prioritize domestic policies, the gains from trade shrank dramatically.

The 1930 Tariff Act started with the narrow aim of helping distressed farmers and then mushroomed into a wholesale rewriting of the U.S. tariff code, provoking anger and outrage from trade partners around the world.

America's major trade partners responded to those aggressive tariffs with their own targeted tariffs, quotas, and boycotts on American goods:

- Trade partners like Italy, Switzerland, Uruguay, and Argentina called for patriotic boycotts on key exports, such as American cars, sewing machines, and motion pictures.
- European countries employed reprisals that targeted highly visible U.S.-branded goods (e.g., France changed its tariffs on autos from value to weight-based, effectively closing off its market to medium-priced but far heavier American-made cars.)
- And the nearest neighbors, Canada and Mexico, retaliated by imposing duties on American farm and livestock products, including wheat, oats, potatoes, and fresh meat. Ironically, trade legislation aimed at helping farmers ended up shrinking their export markets.

That retaliation hurt the U.S.'s ability to export to countries it needed to buy its goods. In our research with Kevin O'Rourke (Mitchener, O'Rourke, and Wandschneider: 2022), we have identified countries' responses to Smoot-Hawley by classifying countries into three groups: retaliators, threateners and non-responders. Retaliators are countries that imposed tariffs, quotas, or other trade barriers versus the U.S. in response to Smoot-Hawley (Mann: 1930 and Jones: 1936). Threateners are countries that filed official complaints with congress in response to Smoot-Hawley, threatening that they would retaliate, but for which we could not identify concrete measures. Non-responders are countries that neither retaliated or threatened to retaliate.

We then construct a new, quarterly panel dataset of bilateral trade flows between 1925 and 1938, for 99 countries, colonies, and country groupings. The dataset contains 108,722 raw observations, and accounts for most of the world's trade (89% of global imports in 1928). These high frequency data then allow us to exploit the differential timing of retaliatory measures when estimating the impact of retaliation.

We estimate a theoretically well-founded gravity model looking at the impact of threatening and retaliating in response to Smoot-Hawley. Threatening and retaliating are captured by dummy variables that turn to one in the quarter when the country or colony concerned filed a protest or retaliated. As is standard, we include exporter-time, importer-time, and bilateral pair fixed effects, and we control for a variety of potential confounders, including joint membership in various blocs (the sterling bloc, Reichsmark bloc, gold bloc, or British Imperial Preference system; see Jacks and Novy: 2020), the Anglo-Irish trade war, trade treaties with the US signed as a result of the 1934 Reciprocal Trade Agreements Act, and simultaneous financial crises. Including importer-time fixed effects especially controls for the aggregate decline in the imports of threatening and retaliating countries – any impact of responding that we uncover captures the differential decline suffered by US exporters to responders.

We estimate our gravity models using both OLS and PPML and find a large impact of retaliation. Ceteris paribus, US exports to countries regarded by Mann and Jones as having retaliated fell by between 28% and 33%. US exports to threateners even fell by between 15% and 22%, suggesting that de facto retaliation may have extended beyond those countries traditionally regarded as having retaliated.

In a second step we collected data on U.S. exports in 104 product categories to 59 trade partners. The use of product-level data allows us to see which products were particularly affected by retaliation.

We identified the top 10 US exports to each destination in our dataset, and found that, controlling for aggregate US exports to each economy, exports of these top 10 products to retaliators fell by an additional 33% (exports to threateners fell by an additional 20%). The evidence is consistent with responders targeting particularly important US exports. Exports of American cars were especially badly affected, consistent with the historical evidence that automobile exports were in many cases singled out for retaliation.

To be sure, Smoot-Hawley did not cause the Great Depression. The contraction was already underway when it was passed, and trade was too small a share of the U.S. economy to be the driver of the worst economic calamity of the 20th century. But misguided trade policies, which began with Smoot Hawley and then exploded into a trade war, certainly reduced the welfare of all combatants, including the U.S. Global trade collapsed in the early 1930s, falling alongside production and incomes.

5 Effects on Exchange Rates

In the 1930s, countries responded to the Great Depression by abandoning the global currency system (the international gold standard) through devaluation and/or the introduction of exchange controls (Mitchener and Wandschneider: 2015). Early movers who abandoned the fixed exchange rate to gold initially benefited, with exports becoming cheaper in foreign markets and imports becoming more expensive, but only in so far as their major trade partners did not respond in kind. Once they did, and perhaps even more aggressively, the first-mover trade benefits evaporated.

Between 1929 and 1936, more than 70 countries left the gold standard. The collapse of the international monetary system and lack of regime coordination represented a huge uncertainty shock, and one that more than likely required considerable adjustments by exporters and importers on a number of margins – leading to higher trade costs and potentially depressing trade flows.

What were the currency war's effects on trade flows? In a new working paper (Mitchener and Wandschneider: 2024), we show that the uncoordinated devaluations following the breakup of the interwar gold standard served up a second source of uncertainty that escalated into a global currency war and further damaged trade flows. We use newly compiled, high- frequency bilateral trade data and gravity models that account for when and whether trade partners had devalued to identify the effects of the currency war on global trade. We include a full set of exporter-time and importer-time fixed effects to account for both the general decline in trade in the 1930s (e.g., that driven by

falling aggregate demand) as well as domestic policies that were enacted to offset the effects of that decline, such as across-the-board increases in tariff and non-tariff barriers to trade. We find that a country's trade was reduced by more than 21% following devaluation. Countries were caught trying to anticipate whether their trade partners were about to devalue and whether they should do so. Our results provide an additional reason why trade flows fell precipitously in the 1930s relative to the period before the Great Depression – the world's largest currency war put an end to the international monetary system. Indeed, policymakers seem to have carried that "lesson" with them when they finally returned to negotiating tables after the conclusion of World War II. The disruption to trade that the currency war unleashed was to be avoided, and served as inspiration for the framework of the next international system that emerged, Bretton Woods.

Then as today, retaliatory devaluations have the potential to provoke a widespread currency war, which could increase trade costs and reduce trade flows. Given that the size (number of combatants) and scope (the tools used to alter currency values) are unknown at a currency war's outset, domestic policymakers could underestimate the potential costs from unilateral devaluations. These could include disruptions in domestic trade due to exchange-rate policy uncertainty and exchange-rate volatility as well as a reduced scope for responding to global economic downturns through policy coordination, such as a coordinated expansion of monetary policy or a coordinated devaluation.

President Trump has stated publicly that he considers the U.S. dollar overvalued and has accused other countries, especially China, of deliberately undervaluing their currencies to gain a competitive advantage. Moreover, the Trump administration has suggested a new "Mar-a-Lago Accord" that would strategically weaken the U.S. dollar, perhaps even more than the decline that has occurred since Liberation Day. So, it would not be unfathomable to see countries turning to strategic depreciations today if the trade war worsens and if global economic output were to begin to decline. Trade policy frictions can take many forms, and the trade war could quickly escalate to include non-tariff barriers and monetary warfare. In other words, currency wars and trade wars can go hand-in-hand.

6 Global Leadership

But beyond the direct effect on bilateral trade flows, the 1930s offer additional cautionary lessons. Trade wars often distort goods and services away from their most efficient producers, redirecting them to politically preferred partners. In the 1930s, the UK, its dominions, and colonies walled off their trade through a system of Imperial Preferences – trade agreements that favored products from these

economies. For consumers, this can result in higher-priced or lower-quality imports. But the interwar example also highlights that often the 'trade blocs' that emerge share some geopolitical alignment. For example, Germany used a clearing system and bilateral trading agreements to strengthen trade with neighboring central and south-eastern European nations, securing German access to raw materials. Today countries are exploring new alliances in response to the US trade policy: One example is the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) which links countries across the Pacific Rim, such as Australia, Canada, Chile, Japan, and Mexico. Likewise, Europe is accelerating trade with Canada, Japan, Singapore and Vietnam.

The current US trade policy clearly signals a break from the 80 years of U.S. leadership in the post WWII era. With this tariff policy, President Trump has abdicated stewardship of the global trading system. The U.S. tariffs clearly violate the principle of non-discrimination, one of the cornerstones of global trade policy, and effectively signal the decline of the World Trade Organization's role in facilitating and regulating global trade.

Who will fill this vacuum? The period between the world wars was characterized by the end of British hegemony, and a reticent U.S., not quite ready to become the "global conductor of the international orchestra". Researchers have argued that this lack of leadership had devastating consequences, further destabilizing economic ties and worsening the Great Depression (Kindleberger: 1986). Today, some of the newly emerging alliances offer the opportunity for more prominent European leadership if the EU is prepared to step into this role. However, the restructuring of the new international order could also play into the hands of China and Russia.

The erratic U.S. trade policies described above, the concern about the value of the U.S. dollar, and the volatility in global financial markets have been interpreted as signs that America's "exorbitant privilege" may come to an end in the near future. To date, the U.S. dollar has fallen by about 9% and is trading near a three-year low. Rising 10-year treasury yields, which have moved 45 bps after the tariff announcement, suggest that traders may now be pricing some sovereign risk into U.S. Treasurys, reducing the advantages the U.S. receives for a trading and financial system where the dollar is at the center. Just as in the 1920s, when the British Pound began its slow retreat as the dominant international reserve currency under the gold standard and eventually yielded to the US dollar (Eichengreen and Flandreau: 2009), now the U.S. may lose its advantage of being the world's reserve currency. This may further weaken the economic and fiscal prospects for the U.S.

Turmoil in the U.S. debt market can generate a flight to other safe assets, but the relative size of the U.S. financial markets raises the question where funds will ultimately land. China, as a pioneer in the development and introduction of digital central bank money, is aggressively promoting the renminbi as international trading, credit, and reserve currency. Again, this raises the stakes for Europe. Europe needs to send a strong signal to the world – that the Euro is stable and a safe haven for investors and that Europe is ready to face the challenges unleashed by President Trumps trade war. To avoid repeating the mistakes of the 1930s, Europe needs to step up and fill the global leadership vacuum opened by the U.S.

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