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NO NEED TO QUEUE

The benefits of free trade without trade agreements

Patrick Minford
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About the author

Patrick Minford has been the Professor of Economics at Cardiff Business School, Cardiff University from October 1997. Between 1967 and 1976 he held economic positions in: the Ministry of Finance, Malawi; Directors' staff, Courtaulds Limited; HM Treasury; HM Treasury's Delegation to Washington, DC; Manchester University; and the National Institute for Economic and Social Research. From 1976-1997, he was a Professor of economics at Liverpool University. Patrick Minford was also a member of the Monopolies and Mergers Commission between 1990 and 1996 and one of HM Treasury's Panel of Forecasters (the 'Six Wise Men') between January 1993 and December 1996. He was awarded a CBE for services to economics in 1996 and is the author of: books, articles and journalism on exchange rates, unemployment, housing and macroeconomics. Patrick Minford currently directs the Julian Hodge Institute of Applied Macroeconomics at Cardiff University Business School.

Summary

- It is widely believed that trade agreements are necessary to enable the UK to prosper in world markets. In reality, unilateral free trade is possible and offers many benefits.
- The UK's exports of services to the EU owe little to the Single Market as national barriers to trade in services still dominate in Europe.
- Trade agreements typically involve substantial trade diversion as domestic interests exert pressure on governments to protect particular producers.
- In world terms, the UK benefits from the 'importance of unimportance'. If any country or group of countries decides to erect trade barriers against us it cannot influence world prices and we can trade elsewhere.
- When the general equilibrium consequences are properly understood, trade agreements by small countries are seen to reallocate output, but do not alter world prices in the long run.

Introduction

The expansion of international trade boosts output and raises worldwide living standards. Countries such as China and India have demonstrated over the last three decades the huge gains to be made by opening up economies to world markets. Many people think that in order to reap these benefits there needs to be an expansion in trade agreements, either regionally or, through the World Trade Organization, globally. And fear of being cut off from the European Union and related trade agreements provides a large part of the case against the UK leaving the EU: President Obama recently warned the UK that Brexit would send us ‘to the back of the queue’ for a preferential trade deal

But China’s rapid growth, for example, owes little to trade agreements: it was not even a member of the WTO until 2001. Equally, Britain’s rapid growth in the nineteenth century was largely the product of unilateral free trade rather than the result of complicated bilateral or multilateral trade deals. More recently, New Zealand struck out as a unilateral free trader in the 1980s and proved able to build a successful export position fully integrated into the world economy.

So does the UK need trade agreements in order to prosper from being a part of the international economy? I would argue not.

World trade, B2B and the WTO

To analyse the question we require a clear theory of how trade works. For this I adopt a standard textbook trade model. In such a model the UK produces traded goods in a competitive world market, where prices for these goods are set by world supply and demand. It is also assumed to be a relatively small supplier in any particular world market, since the UK has around 3 per cent of world GDP; as a result it is a 'price-taker', that is whatever it sells or buys on the world market has no effect on the world price. This world market can be thought of as a business-to-business (B2B) market for goods and services at the border or ex-factory. For example a laptop computer of a certain power and with a bundle of typical characteristics would be priced in this market at a certain value, set so that world demand equals world supply; if the UK produces such a machine it would get the same price for it as one produced by, say, South Korea.

Notice that this B2B market is not really familiar at all to ordinary people who think in terms of shops or online markets where they buy products that have been made into marketed, branded objects that they see in advertisements, on supermarket shelves or on the internet. For a 'product-making' business this is the result of a whole distribution effort, usually made by specialist firms to whom they sell the product they make.

We need also to think about service products, whether shipping, tourism, banking, or currency trading. Here again we need to distinguish the B2B general unbranded product- whether it be a container ship or a transportation outfit or a currency hedging team- from what the retail customer is sold - such as a parcel service, a package holiday, or a currency transfer service for family abroad.

In much of this B2B market government is barely involved. Often a whole series of B2B product operations- e.g. down a supply chain- are done

within a single multinational company. Usually trade barriers can be avoided by careful siting of parts of the supply chain so that only untaxed products get sold on. Trade agreements are often not involved at all. For example there has been an explosion in supply chains around East Asia and yet few East Asian countries have comprehensive trade agreements with each other.

The orders of magnitude for UK trade are as follows: 43 per cent of our trade is in services where the European Union has essentially no commercial policy (i.e. there are no tariffs, nor any rules for trade, simply national regulations), and about 50 per cent of our goods trade is outside the EU. All this services trade and non-EU trade is conducted under WTO rules, whether for services where there is the GATS (General Agreement on Trade in Services; see chapter 7 of Minford et al, 2015) or for goods where there is the Most Favoured Nation (MFN) rule preventing a country from applying a discriminatory tariff on any country. This implies that over 70 per cent of UK trade (ie 43%+[0.50x57%] =71.5%) is already conducted under general WTO rules without any involvement of the EU. It is worth noting, too, that all those trade agreements the EU has signed on our behalf cover hardly any of our non-EU trade (see below); mostly they are simply continuations of old colonial agreements.

The EU has made some efforts since 2009 to open up a Single Market in services across the EU. However, UK services trade has mainly bypassed the EU because the long-standing national barriers have not been removed; even these Single Market efforts have had little effect because exemptions are freely permitted on the grounds of public interest - a reason that is easily invoked for services provided by nationals. The City of London provides expert financial services to EU nationals and firms that wish to issue financial assets here and also provides insurance and other services. However, much of this does not require trade agreements as such. These transactions are often offshore, just like issues of dollar bonds. Alternatively, UK companies often establish subsidiaries in EU countries and provide services from the UK to those subsidiaries – this is especially true in insurance, for example. What would happen if the UK left the European Union? It would of course be possible for the EU to forbid its nationals from using UK markets. But this would trample on free capital movements between EU countries and all other ones, which is a guiding principle of the Maastricht Treaty.

What this means is that services are traded under standard WTO rules wherever there are opportunities in the world. The UK, remember, is 'small' in world trade terms. It is an effective supplier of many financial and other services to many different countries' firms and citizens. If anyone or any one group of them decides to stop trading with the UK there are many others with whom the UK can do business. So far the UK has managed to do good service business around the world without any help from the EU.

To fill out the picture, distributive businesses (consisting of wholesaler-retailer-marketer firms in a country) buy a product (good or service) and then put it on sale to consumers. These businesses specialise in the intricate processes of getting products and services to market. These processes include getting government permits, paying tariffs and taxes, advertising locally, finding the right retail outlets and so on. Once in this shopping market a UK product will become a distinct product with some branding attached. Its retail price will equal the world price at border plus the competitive distribution margin including local taxes plus any tariff-equivalent charged by the country. Its sales in the country will rise or fall, in competition with other locally branded goods of similar type, with changing prices; there will be some elasticity of demand in response to these price changes, depending on the closeness of this competition.

To this set-up I now add two final assumptions: that UK products are produced within competitive UK industries and that the output of any UK product is small relative to the size of the world market for that product. Since our economy is around 3 per cent of world GDP, the last assumption must be generally accurate. As for internal competition, we have an active Competition and Markets Authority dedicated to ensuring it; industries that fail to be competitive are regularly referred to this office and action taken to make them competitive if they are not.

The case of a single small country setting a tariff or giving a trade preference

These assumptions – which seem a reasonable approximate description of reality - give rise to what is known in trade theory as ‘the importance of being unimportant’ (Kindleberger 1968). Thus any small country levying a tariff on our products cannot influence their world price. Consider how this happens; we will make the usual assumption that the tariff revenue is handed back to taxpayers in some way, so their income remains the same, and they buy as much in total as before.

First, the retail price of our product would go up in that country - call it Ruritania - and so less would be sold there. Other competing countries would sell more, replacing our sales. Our UK industry would then seek to sell its unsold output elsewhere. It would find that its competitors’ sales elsewhere have fallen and so it supplies more to those other markets. The extra amount in each market is small and so virtually no change in retail price is required for the extra sales. What we notice is that neither the world supply nor the world demand for this product has changed and so nor has the world price: the only change is in the distribution of products. UK output is diverted from the tariff-levying country elsewhere, and vice versa for other countries’ output.

Let us go over this again carefully, asking whether if the world price remains the same everything I have claimed will happen:

a) At this (same) price UK suppliers' total supply will be the same. Hence as it supplies less to Ruritania it must sell more product to other countries.
b) In these countries non-UK suppliers will find a decrease in demand for their product because UK supply has risen. They then divert their unused supply to Ruritania. Consequently Ruritanian customers for the product have their demands satisfied by extra supply from non-UK producers.
c) Hence supplies to all countries remain the same. So do supplies from all countries.
d) Demands from all countries for the product also remain the same.
e) Hence there is no need for the world price to change.

What one can see from the explanation is that the tariff has not affected the UK in any fundamental way; it has merely redistributed the product it makes between demanding countries. Similarly for other supplying countries, which see a redistribution of their product.

Why is this important to the UK? It means that no country has any incentive to levy tariffs on UK products, since they do not affect the world price they pay for them. A major reason for tariffs is to force down the prices paid for them.

Another reason for tariffs is to increase the sales of your domestic industry. But again if that industry could have sold its output at the world price, then any extra sales it makes will be at the expense of sales abroad. So it will sell no more in total.

Now if we apply this model to a trade agreement between the UK and a tariff-levying country, what we find is that too makes no difference to UK welfare, since by the same argument when the tariff is taken off, the UK simply sells more into that country and less elsewhere.

So this model implies that, as a 'small' world supplier, we have no national interest in trade agreements with any particular country

Of course this is pure theory. No doubt there will be numerous ways in which actual markets differ in detailed effects. However the point of the theory is to explain how ‘zero effect’ can occur. Even if there are some detailed differences in practice they are likely to be of second order. The force of the point lies in looking at ‘general equilibrium’ (i.e. all markets when all effects have worked out), rather than at one market on its own, ‘partial equilibrium’, where the effects may be strong but quite misleading for the overall effect. Unfortunately many policy commentators are ignorant of this general equilibrium analysis.

Some will argue that competition is not so intense as assumed in this theory. But there are two points about this. First, in the long run, which is relevant here for a long-term change in trade policy, competition does tend to be intense as pockets of inefficiency and imperfection are discovered over time by new or old competitors. Second, even under imperfect competition much the same sort of effect goes through in general equilibrium: a country’s firms may benefit from the trade preference but they are limited in their capacity to supply and hence their higher supplies to the preferential market allow other suppliers to replace it in other markets. Overall, the main effects are of product displacement. Consumers in all markets are little affected since they have access to substitute product from other suppliers.

The essential point to take away from this analysis is that trade agreements are, from the national point of view, of limited relevance. At most they are of second order importance. Nevertheless particular firms will not see matters like this; for a particular firm a market may be crucial to it as its main selling area and hence it will lobby intensely for a trade agreement in that market. But an implication of the analysis is that we should not confuse corporate interests and lobbying with the national interest.

This point only fails if we are dealing with a national monopoly in the world market or where there is considerable market power. In this case the firm and its country have the power to alter world prices. Two large countries with substantial monopoly power on each side will then be engaged in an effort to widen world trade in the interests of their domestic consumers and they will each try to gain overall in terms of the world prices they charge and pay for. But as noted at the start, this is not the case for a small country without monopoly power such as the UK. The UK enjoys ‘the importance of being unimportant’. It is from this that the essential irrelevance of trade agreements for its national interest arises.

The case of a large country or bloc offering preferential trade that absorbs whole industries' output

However, I now turn to the rather different situation where the UK - a 'small' country - is dealing with a large country such as the USA or China or a large country-like bloc such as the European Union. Here the offer of a preferential agreement may require different analysis.

Suppose a large country, the USA say, offers a tariff elimination on a UK product, a specialised form of widget. This country being large it is quite possible that the UK industry's supply could be wholly demanded in this country's market. If the country's market is still too small for this, then the analysis of a) above still applies. And indeed even large countries or blocs will usually not have large enough markets to totally absorb another country's supply. It is important to realise that even the largest market will not absorb the whole of one country's product in practice - usually because there will be limitations on the suitability of the UK product for the market, so that only a part of the industry is involved. If this is so then the only effect of the trade agreement is the across-country displacement analysed earlier.

But suppose that it is indeed large enough to absorb the whole UK widget industry's supply. Let us assume that the UK supplies its output to the US at a price which is now higher because there is no tariff and so the UK suppliers can sell at the ex-tariff price. Because of the extra UK output and so the extra competition the US price of the product falls a little. But plainly the UK industry gains, selling its output now at this higher price than it could obtain before.

If this were all that happened we could say that this improved the prices the UK enjoys. Effectively on this one product the UK enjoys a higher export price and this can continue indefinitely. We say the UK's terms of trade have improved. As far as the UK is concerned this product's price now joins the relevant set of available trading prices.

However such an offer is rare to the point of non-existence. The reason is that the US's domestic widget suppliers will complain vigorously to its government about the damage they will suffer from the lower prices induced by extra UK competition. They will wish to be compensated, and trade negotiations become a general balancing act by governments to assure industrial support for the trade agreement. The 'balance' to the gain offered to the UK in better prices on this product will tend to come in the form of the UK offering a preference to US industries on other products. To do this the UK must first, have a MFN tariff on these products for other countries and second, give US producers a zero, preferential, tariff on them. Compared with no trade agreement for the UK and a zero tariff on all its imports, this is likely to be costly. Its consumers and firms will now pay higher prices for certain products in which the US wants an agreement, and this will be a cost to set against the gain to its industry that acquires US trade preference.

To take a recent example of this, in the Trans-Pacific Partnership (TPP) negotiated recently, Vietnam stands to gain from preferential access to the US market for its textiles. However it must also source its imports of a variety of products from other TPP partners in return, at possibly higher than world prices, and for this it will have to place tariffs on its normal world import sources.

Effectively these trade agreements with large countries are similar to customs unions. A network of tariffs is set up on third parties while the signing partners agree to zero tariffs for each other. This is not necessarily a good agreement for the joining country as it may divert trade to a greater extent than it creates it, a recent example being the Australia-United States agreement (Armstrong 2015). For the world as a whole it is damaging because it restricts global free trade.

The rule of thumb for a country joining a customs union is that it will only gain if it sells quite a lot more than it buys from the union partners. For the large country offering the agreement, there is only a potential national gain if it involves another large country. Then again it can only gain if on

all the products with all the other countries it sells more to them at higher prices (due to the preference) than it buys from them at higher prices. Yet from a world viewpoint these agreements are damaging compared with general free trade.

As an aside, should by chance a large country such as the USA offer the UK a higher price for some products via tariff reductions at a low cost that makes the deal attractive, then what is the relative likelihood of the UK getting such a deal if it is in the European Union compared with if it is outside the EU? The usual view is that there is more chance inside the EU. However as the endless struggle over the Transatlantic Trade and Investment Partnership (TTIP) illustrates, the EU is so large and complex that concessions to it can be seen as highly expensive by the US. The UK on its own however is far less threatening; an agreement might be much easier. We see this already in the numerous ways in which UK service industries, such as banking, finance and law, are closely integrated into the US market and vice versa. But this is without any help from trade agreements: these links have arisen organically through the B2B markets in services, where firms have found that they can usefully link their businesses to provide a US-UK service- for example in advising on takeovers, where US-UK deals are commonplace.

What we see in this discussion of trade agreements between a small country and a large country or bloc is that they are not necessarily beneficial.

Conclusion

In discussions about new trade agreements, and in the even more contentious case of a possible UK withdrawal from the European Union, many commentators have failed to grasp the advantages of unilateral free trade when you are a ‘small’ economy – which, in the sense of being a relatively small player, most countries are. When the general equilibrium consequences are properly understood, trade agreements by small countries are seen to reallocate output, but do not alter world prices in the long run.

Even if there are in some (much less frequent than is supposed) cases potential advantages to a country from preferential treatment accorded by a large country or trade bloc, such arrangements come with strings attached. Favourable market access for some of a country’s producers is likely to be offset by higher prices faced by consumers as reciprocal privileges are awarded to partners’ producers.

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The Institute of Economic Affairs
2 Lord North Street
London SW1P 3LB
Tel 020 7799 8900
email iea@iea.org.uk