



CRATE EXPECTATIONS...

Over the last 3 years of Brexit discussions, one of the few things politicians have agreed upon is the supreme importance of Free Trade Agreements (FTAs).

Those on the Leave side of the argument have talked up future opportunities for "advanced FTAs" outside the EU; those who backed Remain have highlighted the potential loss of agreements negotiated by the EU and accused Leavers of wanting to "have their cake and eat it".

So, what is all the fuss about?

An "FTA" is the blanket term for any agreement involving states or groups of states aimed at reducing barriers between them, whether for goods, services or investment.

The purpose of these agreements is ostensibly to reduce barriers to trade, so

FELIX HATHAWAY
assesses the
importance
of free trade
agreements

that free exchange according to the principle of comparative advantage can yield benefits for all sides.

This is well established in economics; however, it leads to a counterintuitive conclusion when applied to trade deals.

If a country benefits from unilaterally liberalising its trading regime (lowering tariffs, recognising foreign issued qualifications etc.),

then what is the point of an FTA?

This is the paradox of Free Trade Agreements. They promote free trade but do so from a "mercantilist" starting point.

Rather than viewing eliminating domestic trade barriers as a good in itself, this is only done as a "concession" to secure something similar from a partner.

This is why many economists are less excited by FTAs than politicians or the public. In general, FTAs represent a "second best approach" to liberalisation.

Furthermore, while signing "free trade deals" provides a great photo opportunity, many FTAs fail to meaningfully create trade.

Often this is because they preserve protections for politically important industries

or, in reality, contain far less liberalisation than headlines suggest (for both, see the EU's recent Mercosur agreement).

At the same time, these deals often entrench powerful incumbent positions by replacing regulatory competition with harmonisation that preserves or increases barriers to new entrants.

This being the case, what is the point of FTAs, and are they a dead end for a genuine free trader? The answer is: "not necessarily".

While FTAs may be a second best means of liberalising a single country's trading arrangements, there is a body of argument that they can be effective in bringing trade liberalisation to countries which might not otherwise accept it.

In reality, this works both ways, with FTAs also a tool for additional domestic liberalisation, even in countries with few or no import tariffs.

The Trans-Tasman agreement is a model example here of a "free traders' FTA", as it allows for full regulatory recognition of goods and services between Australia and New Zealand, on top of their existing liberal tariff regimes.

The second, and arguably more significant, justification for FTAs is that they "lock in" the benefits of liberalisation.

For instance, if a country unilaterally eliminates barriers to foreign investment, investors may still be reluctant to invest. This is because of the "political risk" that a new government, or a change of heart, could reverse the policy with very little warning.

In this scenario, an FTA represents an international commitment to behave in a certain manner, including when ending the agreement, and will often contain provisions for dispute settlement in areas such as investment to provide greater security.

The result is that while FTAs are important, and will be so for post-Brexit Britain, they should not be viewed as an end in themselves.

Even the best FTAs are mostly icing on the "free trade cake". However, if used correctly alongside sensible policies such as unilateral tariff liberalisation, this is one cake we can have and eat●

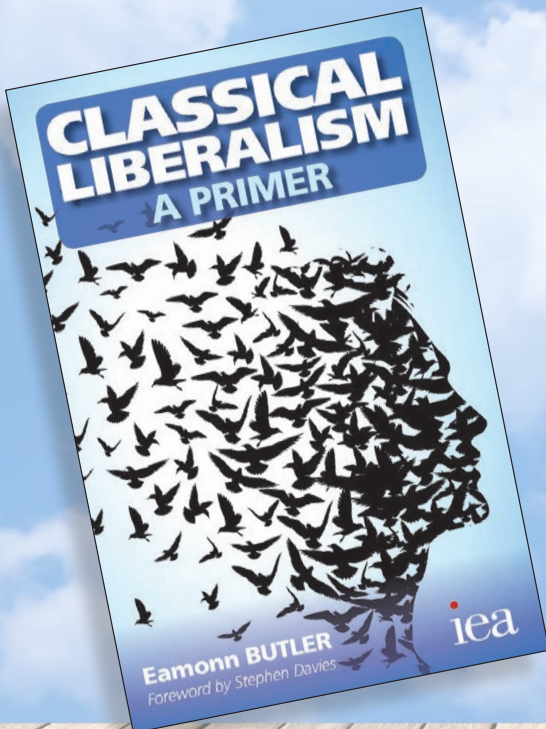
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