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First things first: start with a trade strategy

Michael Gasiorek

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Briefing Paper 1

Key points

- There is increasing acceptance and legitimacy of government policy intervention across a range of spheres, which includes trade policy. Government policy involves making trade-offs between efficiency, equity and security.
- A sensible trade strategy should be one that seeks to support and contribute to domestic policy objectives, and thus these need to be clearly articulated as well as the extent of the contribution of trade policy to those objectives.
- A key feature of trade policy is that it directly impacts the economic relations between countries, and therefore it almost always involves negotiation between countries as opposed to being unilaterally determined.
- Given the gains from international trade it is tempting to see the desire to sign free trade agreements as a step in the right direction. However, this risks: focusing overly on efficiency, a lack of coherence across agreements, and pays too little attention to what can be achieved plurilaterally or multilaterally.
- Trade and investment are closely linked, and in turn are important for long-run economic growth, leading to technical progress and increases in productivity, but which, in turn, requires clarity, certainty and stability in policy.
- Trade policy is not just about free trade agreements but also working with and through the multilateral institutions and plurilateral initiatives which help to underpin the rules-based international economic environment.
- Unilateral trade policy measures should be taken based on evidence, with transparency and consultation otherwise they are open to capture by interest groups, as well as political interference.
- Trade liberalisation, including signing free trade agreements, needs to be done selectively, coherently and consistently across agreements. In order to achieve this, there should be greater clarity regarding the UK's objectives across the wide range of issues increasingly included in free trade agreements.

Introduction

In a recent blog, following another change of UK prime minister, and Secretary of State for International Trade, I commented: '<u>Ask not which free trade agreements to sign but why you want them in the first place</u>'. The message was that it is important to first have a clear trade strategy and then to consider the different ways in which free trade agreements may contribute to that trade strategy. For the UK this has particular resonance and importance because having left the EU, the UK is now in a position to create an independent trade policy.

The 2019 Conservative Party manifesto lacked substance in this regard other than freeports, and the desire for striking new trade deals, aiming for 80% of UK trade to be covered by free trade agreements by December 2022 (the current figure is just over 62%). More recently, in November 2021, the Government published its "<u>Export Strategy: Made in the UK, Sold to the World</u>" which perceives trade strategy to be focused almost entirely on exports and the desire to open up opportunities for UK businesses. The Labour Party also published its approach to trade policy in September 2021 which identified the objectives of a worker-centred trade policy. Neither pays much attention to wider domestic policy objectives, the range of domestic constituents, nor the wide range of issues increasingly covered in modern trade agreements.

Two elements of contextualisation are worth mentioning here. The first is that in the UK, the Brexit referendum and subsequent debate have been often rancorous with polarised views, not just concerning the UK relationship with the EU, but more broadly with regard to international trade and trade policy. Sometimes it has felt like listening to a fairy story – with twists and turns, unicorns, magical outcomes and of course villains. This has made it more difficult to have a clear and rational debate about a UK trade strategy.

The second is that it is clear that many countries around the world are becoming more interventionist with regard to what can be loosely described as industrial policy and trade policy. This has been justified in part by geopolitical concerns notably with regard to China, but also as a response to two major shocks - Covid-19, and the Russian invasion of Ukraine - which have required government action and intervention, and in the process of doing so have given increased legitimacy to intervention.

This Briefing Paper sets out some key considerations in the making of a trade strategy and a framework for considering the elements of policy that contribute to achieving that strategy. Possibly the most important point to make here is that a trade strategy, and thus policy to achieve that strategy does not exist independently of other policies. Trade policy is primarily about domestic outcomes and, therefore, also domestic politics, and thus has to be thought of in the context of the government's wider economic and social policy objectives. A government's trade strategy then becomes about how to support those objectives through trade policy with other countries. This is why you need to ask why you want trade agreements in the first place.

1. Government policy is about trade-offs

The aim of government policy is to maximise welfare. This includes both specific economic concerns (output, GDP) as well as non-economic concerns, such as inclusiveness, which often need to be balanced against each other. Inevitably, therefore, policymakers, face trade-offs in the policy choices that they make. A key element in good policymaking is to understand those trade-offs, and to be frank about them.

Conceptually, the typical trade-off which economists consider, and which appears in many an undergraduate textbook is that between "efficiency" and "equity". Increasingly, however, there is a third aspect which needs to be considered: "security".

Let me use import tariffs to illustrate the point: It is not difficult to show that from the perspective of economic efficiency (and under certain conditions), removing import tariffs is the most ***efficient*** trade policy for an economy. Efficient here means the policy that maximises real income. Take tariffs on food and agriculture as an example. While importing agricultural goods more cheaply may lead to a more efficient allocation of resources and benefit consumers, and firms buying intermediate inputs, it may also entail the contraction of some of the agricultural industry and the decline of some producers that may have been protected by the tariffs. Hence, the reduction in tariffs results in winners and losers and thus has ***equity*** implications

Note that typically equity may have a broader remit than simply jobs and income. There may be a legitimate public policy preference for maintaining a given domestic sector – food production and agriculture, fishing, cultural goods are frequently cited in this regard. For example, the government may care about the availability of food supplies and the domestic capacity to provide food for its population, or there may be preferences regarding the regional distribution of economic activity across a country.

Closely related to the preceding is the justification for government intervention (policy) where there may be, what economists call 'market failure'. Market failure may occur when the actions of private agents and the market lead to spill-over effects onto others, which have not been taken into account. These spill-overs may be negative – for example concerning the environment; or they could be positive, for example, with regard to

Research and Development (R&D). Market failure may also occur where there are information asymmetries. For example, where potential exporting firms do not have sufficient information regarding the policies and procedures in an export market. Where there is market failure, and a public policy preference for addressing that failure, such as minimising negative environmental impacts, or facilitating beneficial exports then government policy may be needed.

Simply because there may be equity concerns does not necessarily mean that the policy should not be introduced. It might, for example, mean that there need to be further policies to mitigate the negative consequences, or to attain those broader equity concerns. To stay with the example of agricultural trade, there may be a need for policies to support agricultural producers from the loss in income, or encourage diversification, or facilitate re-training. But equally, it may be that the broader public policy concerns dominate and/or it is hard to implement the flanking policies, such that the policy is not introduced.

There is however a third element in these trade-offs which is increasingly on the minds of policymakers, and which is concerned with ***security***. Where efficiency is concerned with the best way of economically achieving a given outcome, equity is concerned with the impact on a particular section of society or on a particular outcome, security is concerned more with systemic risk which may impact across a range of outcomes and sections of society. As with efficiency and equity, security has a number of possible dimensions. The key dimensions are to do with national security and economic security. It is clear, that in recent years there have been growing concerns with national security related to military and ICT technologies, and economic security be this food security, energy security, or supply chain resilience in perceived 'critical' sectors.

Such security issues and the related geopolitical concerns have led to the emergence of policies with a more explicit assertive geopolitical focus ranging from the Inflation Reduction Act in the US, the EU's Open Strategic Autonomy initiative, China's dual circulation strategy, as well as the various initiatives in many countries to promote a domestic semi-conductor industry. These issues have also led to the emergence of new fora and dialogues such as the Trade and Technology Council between the US and the EU, or the Trilateral Initiative between the US, Japan and the EU.

Note that just because there may be equity or security objectives does not obviate the need for efficiency considerations. Suppose policymakers want output in a certain sector to be higher on equity or security grounds. This might well be achievable through protectionist tariffs, but it is unlikely that this is the most efficient way of achieving that outcome. Generally, policy is more efficient the more it is targeted at the problem / distortion it is trying to address. Hence a tariff may well increase production - and so addresses the problem of production being too low – but at the same time tariffs raise the prices paid by consumers - introducing its own distortion - which is inefficient. Hence, it is important to find *efficient* ways of achieving equity or security objectives.

2. The making of trade policy

The three concerns of policy identified above – efficiency, equity and security – of course apply to all areas of government policy. They are not specific to trade policy. However, there is a central feature of trade policy which distinguishes it from other areas of government policy which is that trade policy directly impacts the economic relations between countries, by affecting the degree of market access countries give to each other and thus also third countries. In turn, that means that trade policy (almost always) involves negotiation between countries, in a way that is not the case for many other areas of government policy. This also frequently, therefore, means agreeing to forgo elements of sovereignty in return for increased market access. It also means that trade policy also often overlaps with foreign policy in complex ways.

A second feature worth noting is that with trade policy, we typically start from a position where there are various policy barriers in place to start with: tariffs and non-tariff measures, and other areas of government policy. Hence, the debate about trade policy over the last 70 years or more has typically been about how and why governments should liberalise trade by removing barriers to closer integration to improve market access.

There are strong arguments and empirical evidence to suggest that reducing barriers to trade and investment between countries, leads to more trade and economic gains through higher levels of GDP, and may also lead to higher growth in GDP. This occurs because of the gains from specialisation according to comparative advantage; increased competition between firms leading to lower mark-ups, the exit of less efficient firms and the entry of more efficient firms; more variety, choice and quality for consumers and firms purchasing intermediate inputs; positive technological or managerial spill-over effects; and the stimulus to investment, research and development and technological progress.

It is important to highlight that many of these gains derive from the ability to increase imports from partner countries, though there may also be additional gains from exporting arising from diversification, economies of scale, extending product life cycles, spill-over effects and technology transfer. Trade policy ought to recognise the value of importing and not just be focused on increasing exports.

Given there are gains from importing and exporting and if there are barriers to firms importing and exporting, then it seems logical that governments should do something about reducing those barriers. In turn that entails clarity on the types of barriers that exist. These range from tariffs and quotas to procedural barriers; discriminatory government policies for example with regard to government procurement; the fixed costs of entering markets (knowledge of the institutional framework, demand, language and cultural differences); as well as barriers to trade and investment, be this foreign investment limits, joint venture rules or regulatory restrictions and requirements.

One policy approach, therefore, is that in order reap all these benefits government policy should aim to reduce these barriers as much as possible, one route towards which may be to sign (as many as possible) free trade agreements (FTAs) with countries. This appears to be the main approach that has been taken by the UK.

There are three problems with this approach. First, it focuses overly on the efficiency objective and pays too little attention to the broader public policy issues of equity and security. In so doing it may, for example, result in negative effects on groups in society without adequate consultation or mitigation, or it may result in changes in production which undermine security objectives. Secondly, differences in what is agreed across agreements on specific issues (think of rules of origin or digital provisions) may lead to a lack of coherence and consistency that may, in turn, impact UK firms as well as what can be agreed in future agreements. Thirdly it tends to focus overly on FTAs as instruments of trade policy and risks paying too little attention to what can be achieved plurilaterally, or multilaterally via international organisations such as the World Trade Organisation. In the UK, these three factors are compounded by the lack of public dialogue over the broader objectives of economic policy and the role of trade in supporting that policy, and by the lack of parliamentary scrutiny. This gets even more complicated when it comes to non-tariff regulatory measures which may be in place for non-trade reasons yet which have a trade effect; and by extension where policy may be made by regulatory bodies as opposed to national governments

The starting point of framing a trade strategy should, therefore, be first to identify the key domestic policy objectives and determine whether and what forms of policy intervention are desirable. These objectives will inevitably involve trade-offs, and so the second stage should be to prioritise those objectives and to establish the sorts of trade-offs policymakers and the public may be prepared to accept. The third stage is then to ask which elements of trade policy offer the most efficient approach to those objectives. All this needs to be done taking into account the key emerging economic and geopolitical developments. This makes it sound easy. It is not, and there is no simple rubric but without attempting to articulate the key objectives, and the possible choices / trade-offs it is hard to have a coherent trade strategy and to know what one would like from trading partners.

3. Domestic objectives and Trade Policy

With regard to domestic policy objectives, some fairly obvious ones come to mind - and the list is not intended to be exhaustive nor in any order of importance: higher economic growth; more inclusive economic growth across a range of dimensions; national security and economic security; increased environmental sustainability, minimise the impact of climate change; improved working conditions, digital competitiveness and digital security.

Of course, each of these needs more detailed analysis and discussion. For example, it is not enough to simply state a desire for higher economic growth. Almost anybody would want this as an objective. It is important to state how this is to be achieved, be this via incentives for investment and R&D, training and skill upgrading, worker mobility both national and international; the structure and access to finance; the physical, institutional and ICT infrastructure in the country and across the regions of the country; the extent and quality of investment in people be this through health care, education provision, or protection of workers' rights.

As indicated earlier there is an increase in the acceptance and desire among policymakers for policy intervention. This appears to have gained ground with concerns about, what is often loosely referred to as, supply chain resilience, which is in turn linked closely to the earlier discussions regarding both national and economic security. This does not necessarily imply a desire for self-sufficiency, but it does mean reducing reliance on certain suppliers and countries. Those issues of 'supply chain resilience' are typically discussed in terms of their direct and immediate impacts, such as access to grain, energy, or semi-conductor chips. But they are, and should also be, related to longer-run concerns and objectives about the evolution and future structure of the economy, and how trade policy and what sort of trade policy can help in this regard. Policymakers should be concerned about that longer-run perspective and how policy can be used to facilitate longer-run objectives and to nudge the economy in given directions. Arguably this may be more important in a country, such as the UK, where firms typically have a shorter investment time horizon than appears to be the case in other countries such as Germany, Korea or Japan.

All this suggests that what is needed is a coherent industrial strategy, and then a clear understanding of how trade policy and the trade agreements that are signed contribute to that strategy. Two notes of caution here. First, the articulation of an industrial strategy does not necessarily entail a highly interventionist approach, nor does it entail picking winners. It entails the need for government to be clear about the medium and long-run objectives of the economy and the evolving structure of economic activity, and how policy is designed to help achieve this. This has many dimensions. In part, for example, this is concerned with the distribution of activity across sectors. In the UK economic activity is increasingly heavily dominated by services (which comprises over 80% of GDP), and manufacturing tends to be concentrated in capital-intensive, R&D-intensive and high-skill industries. We have also seen a rise in the use of services, and delivery of services by manufacturing. In part, for example, this is concerned with who is engaged in that economic activity be this by firm size, worker composition, or across the regions and devolved administrations. Trade can then become part of that broader strategy as opposed to a, hoped-for helpful, add-on. It is perhaps telling to note that the last UK industrial strategy document was published in 2017, four Prime Ministers ago.

Secondly, while trade may be an important share of GDP (in the UK the value of exports plus imports as a share of GDP is a bit over 60%), there may be a limited amount that trade policy itself can do with regard to both overall levels of economic activity, but also with regard to some of the wider policy issues such as inclusivity, environment, or sustainability, and we should never expect too much of any given free trade agreement. In simple economic terms, the UK Government's own estimates of the gain in GDP arising from any of the agreements with Australia and New Zealand, or the proposed accession to the CPPP are less than 0.1% of UK GDP.

4. What can / should the UK do:

Whatever one's views are regarding the political merits or demerits of leaving the EU, it is very hard to provide a convincing case that economically this is or will be beneficial to the UK. Almost universally all the empirical evidence both prior to the exit of the UK from the EU, and since its exit point to the negative economic consequences. Broadly speaking this is for three reasons:

1. The direct effects of the increase in barriers to trade in goods and services, investment, and labour mobility.
2. The increase in uncertainty regarding policy and outcome in the UK leading to an impact on investment.
3. Concerns regarding the reliability of the UK as an international partner given its perceived willingness to undermine its undertakings under the Northern Ireland Protocol.

In the longer-run these negative economic consequences may be substantial, and it is worth noting that economic history suggests that adjustment to large shocks for workers and regions can take a long time because of strong elements of path dependency leading to spirals of decline. In addition, and together with other countries the UK, has been hit by Covid-19, and by the disruptions caused by the Russian invasion of Ukraine. Nevertheless, even taking these factors into account we can see the negative impacts on trade and GDP from leaving the EU.

The challenges for the UK are therefore substantial and trade policy and the UK's economic relations with partner countries are an important part of the solution. Some of the issues will be mitigated by firms themselves, increasing productivity, finding other markets etc. But some of the mitigation will have to be done by other instruments of government policy: industrial policy, regional policy, adjustment assistance, human capital investment, public sector investment and… trade policy. It is therefore important to have a clear articulation of that trade policy.

Key recommendations

With regard to the latter here are some broad parameters leading towards a sensible trade policy:

1. Articulate clearly what the domestic policy objectives are and how trade and trade policy can contribute to those objectives.

2. Trade and investment are closely linked, and in turn, are important for long-run economic growth, leading to technical progress and increases in productivity. Investment requires stability, clarity and certainty. Therefore, it is important that trade and investment policy is made in such an environment, with a clear sense of the objectives and priorities of domestic policy. Increasing levels and rates of economic growth are likely to make it easier to achieve public policy equity and security objectives

3. The making of good policy also requires good institutions, evidence-based policymaking, transparent processes with consultations with stakeholders such as producers and consumers, UK regions / nations, assessments and an ex-post review process, appropriate parliamentary scrutiny, and the input of the devolved administrations.

4. Work with and through the multilateral institutions which help to underpin the rules based international economic environment (World Trade Organization, International Monetary Fund, Organisation for Economic Co-operation and Development, World Bank). Consider also the role of plurilateral initiatives which may further the rules-based system (for example with regard to digital trade, climate change, or supply chain resilience), enhance trust and cooperation between countries and manage geopolitical economic tensions.

5. There are areas of unilateral trade policy which do not, prima facie, require negotiation and agreement with a partner, though in some cases, this may well be desirable. Notably, this concerns each countrys' Most

Favoured Nation (MFN) tariff schedule, trade remedies, and relatedly policies in response to the actions of others be these subsidies, anti-coercion instruments or border carbon adjustments. Actions in these areas should be taken based on evidence, with transparency and consultation otherwise they are open to capture by interest groups, as well as political interference.

6. Free trade agreements should be seen as a part of the Government's trade strategy, as opposed to being the strategy. Trade liberalisation under FTAs needs to be done coherently and consistently across agreements, and without the need for the speedy conclusion of negotiations for immediate political gain. This is so that we do not end up with a 'spaghetti bowl' of policies crisscrossing the different agreements. What you agree in one agreement may impact another agreement (Most Favoured Nation clauses, regulations) and this requires explicit consideration. In the absence of a clear overall strategy and policy objectives on specific issues, you risk ending up with a mess.

7. There should be clear articulation of what the UK's objectives are across the range of issues increasingly included in free trade agreements. This includes: market access barriers in goods and services and their relationship to the current and future economic structure of the UK economy; regulatory policies – be this equivalence, mutual recognition and conformity assessment, and the role of the precautionary principle; trade defence; environmental, labour, and social concerns; climate change (listed separately because of its importance); the digital economy and digital trade; labour mobility and the mutual recognition of professional qualifications. This is not intended as a definitive list, but serves to illustrate the range of policy areas encompassed by a trade strategy.

8. Given the preceding, and based on the available empirical evidence, selectively liberalise trade in goods, services and people with countries we trade with a lot; countries with whom firms have closely integrated supply chains, that are geographically closer, those growing more rapidly, where there is greater scope for reductions in barriers, and/or where geopolitical relationships may be important. It should be obvious to most readers therefore that improving relations with the EU, should be at the top of this agenda. While the impact of other agreements will be considerably smaller and those agreements will not compensate for the loss of access to the EU market, this does not mean that they should not be pursued, nor that their cumulative long-run impact will be negligible.

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