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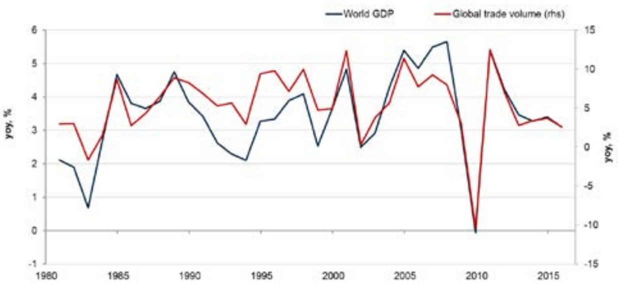
info@ethenea.com | ethenea.com

Deal or No Deal?

As growth has been lacklustre in the wake of the Global Financial Crisis, trade agreements are of great importance. However, protectionism is resurging on both sides of the Atlantic.

According to economic theory there is no doubt about the benefits from trade. Growth and trade have evolved hand in hand in the last decades (Graph 1). It might be surprising at first sight that both US presidential candidates, namely Hillary Clinton and Donald Trump, show restraint to outright aversion regarding trade agreements. The fact that Hillary Clinton, a former advocate of the Transatlantic Trade and Investment Partnership (TTIP), is now turning her back on the deal is however not an individual case. Sigmar Gabriel, German Minister for Economic Affairs and initially a strong supporter of the trade agreement, has also lowered his voice on the ongoing negotiations as public protest increased.



Source: Bloomberg, ETHENEA
Current state: 12/8/2016

Graph 1: Growth and trade evolve hand in hand

The rising public criticism and the declining political support do not come by chance, however. But as it is often the case with interest group lobbying and politicians looking for popularity with their voters, the discussion fails to address the core issues or to result in solution-oriented proposals. With this text we try to provide a more balanced view on the good and the bad sides of trade agreements and we will argue for liberal economics and trade accompanied by targeted social measures.

Benefits from trade

In economic theory, the benefits from trade are linked to the fundamental idea of *comparative advantage.* According to this concept some countries as well as individuals are more efficient in the production of one type of goods or services than they are at others. This advantage may be related to the availability of natural resources, climate conditions, technology or other less obvious factors. Trade allows a country to specialize in the production of those goods and services where it has a comparative advantage, so that it can produce what it does best and can deploy its resources to the highest possible return.

A world of free trade works like division of labour. Rather than producing everything everywhere, countries engage in trade and specialize in the field where they are the most efficient while still being able to cover all needs through trade. This concept of trade based on the *comparative advantage* was first described by David Ricardo in 1817 and focuses on the producer's benefits from trade. Meanwhile, trade also benefits consumers, as the competition between global producers results in more choice and better quality for a given price.

Based on these arguments, it has been undisputed in economics ever since Adam Smith, that free trade results in higher welfare and that it is in every economy's interest. One can also turn around the argument as did Henry George, an American economist and an advocate of free trade, who compared barriers to trade with trade embargos in the context of war. Embargos intend to hurt the enemy, so why would a country inflict them on itself by creating barriers to trade via tariffs or quotas?

History tells a different story, though. In fact, there have been only very few moments in time when a country was truly open to global trade, while tariffs have been the norm. Governments have often levied trade tax as a major source of government financing. At the end of the day, it is no different from consumption tax, as producers pass on the cost of import taxes by charging them to the end customer.

After the introduction and spread of direct income or profit tax as the main source of government financing, trade tariffs have decreased significantly in developed countries, reaching an average of 1.7 % in 2012 for OECD countries compared to 5 % in 1990 according to World Bank statistics. However, they did not disappear completely and for certain products they remain high – as for agricultural products – especially in developing countries. Tariffs, a unilateral policy that limits the inflow of foreign products, are held in place for example to protect an infant industry from international competition, to maintain a minimum level of local production in some *strategic* industries, or to counter unfair competition by foreign state-subsidized products. Regardless of their motivation, tariffs result in higher prices and less consumption, protecting domestic uncompetitive producers while harming consumers (keep this in mind when politicians flirt with higher import tariffs).

TTIP - Transatlantic Trade and Investment Partnership

The negotiations on the Transatlantic Trade and Investment Partnership (TTIP) have started in 2013 and if they succeed, the trade area will cover 40 % of the world economy, creating thus the biggest global economic area. Negotiators have strong incentive to close the deal before the end of President Obama's term, but the most delicate issues have been left out till the end of the negotiations. Political support has recently decreased on both sides of the Atlantic, while Brexit could be a game changer, as 25 % of the American exports to Europe go to the United Kingdom.

Trade agreements, whose number has risen as tariffs were declining, are intended to foster the benefits from trade by limiting the risk of unfair trade practices on the part of large economies using their international market power. This is exactly what the two main principles of the World Trade Organization (WTO) - reciprocity and non-discrimination - aim at. They create a level playing field in trade for all economies, regardless their size. Trade agreements further limit dumping and subsidies and help to reduce the pressure of lobbyists or interest groups on governments.

Side effects

Fair enough, but the reader surely remains sceptical about the argument of unconditional benefit from trade, as the theoretical benefit often applies on a broad scale and in the medium to long term, neither taking into account the distribution of gains nor any transitory effect. It is a genuine flaw in economic theory that, while looking at the aggregate picture, the principles of efficiency do not say anything about distribution or fairness. Of course, trade theory predicts that if an economy opens to trade and competition from products that might be less costly to produce in different places of the world, it forces some producers out of business.

In theory, factors of production - human as well as capital resources - should then move to competitive industries or service providers. But as so often, reality teaches another lesson. There is mounting evidence that this adjustment process is more difficult in reality than in theory, what has been shown by a recent publication by Autor et. al[1]. In the real world, retraining workers and changing industry or location takes time. Furthermore, losing one's job can be disruptive to a person's life in a way that cannot be captured by economic models. Moreover, economic trade theory also predicts some permanent negative effects on employees. When economies open to trade, production factors that were scarcer in a domestic market than in the world – in developed countries this typically applies to low-skilled workers – face a decrease in pay, as producers come across a larger offer. Vice versa, production factors which are scarcer in the world than they are on their domestic market – typically technology or high-skilled workers – meanwhile benefit from an increase in returns. This adjustment, described by the Stolper-Samuelson theorem[2], implies that trade directly contributes to increases in income inequality. Income inequality in the US today has never been so high since the Second World War. This puts trade in quite a bad light and explains the rising resistance to trade agreements. While these negative effects and incurred costs cannot be denied, the current political discussions do not really help.

First of all, even without trade, the demand for low-skilled, manual labour would have been adversely affected by the rise of new technologies. The wage premium for skilled workers would have increased as well, leaving others worse off than before. In both cases, as long as the aggregate benefit from engaging in trade or technological progress is bigger than the associated cost, which is reasonable to assume, the real question is about distribution. When gains and costs occur at different places in society or at different moments in time, it is a government's responsibility to help those that are put at a disadvantage. Unfortunately, there are flaws in many countries concerning such transfer schemes, while certain government policies even amplified the losses from trade.

Inadequate bridging pushes people into other social security schemes, like disability insurance, and they thus leave the workforce. This has given ground to the feeling that trade leaves people worse off, what calls for more protectionism and was quickly picked up by populist politicians. It is however questionable to what extent people's standard of living would actually increase due to

[1] Source : http://www.ddorn.net/papers/AADHP-GreatSag.pdf

[2] The Stolper-Samuelson theorem „describes the relationship between relative prices of output and relative factor rewards – specifically, real wages and real returns to capital." Source: https://en.wikipedia.org/wiki/Stolper%E2%80%93Samuelson_theorem

an import tax on Chinese products of 45 %, as suggested by Donald Trump. It is above all the poor that profit disproportionately more from cheap imports as they spend a bigger share of their income on consumption. And while some of the lost jobs might return, many have become redundant amid technological progress. The *China shock*[3] has already happened and the US is unlikely to re-emerge as an exporter of manual labour-intensive goods. It would also be naive to think that lobby groups from certain industries ask for tariffs or quotas for the better of society rather than in their own interest. Raising import taxes will not rewind the economic development of the last two decades. It would rather make imports more expensive, hurt middle income consumers as well as economic growth.

Today's discussion

It is likely that the concentration of costs from trade borne by specific groups or regions was underestimated in earlier economic studies. These costs cannot and should not be denied. Nevertheless, the benefits from trade, namely higher productivity, more choice and lower prices outweigh the costs, are however more difficult to grasp as they occur (only) over time and are geographically spread. We should not forget though that the trade agreements under negotiation today are not in the same category as the North American Free Trade Agreement (NAFTA) in the 1990s, including Mexico, or China joining the WTO in 2000. The present negotiations concern tariffs only to a small degree. They rather focus on intellectual property, liberalization of trade in services and set certain labour and environmental standards that also emerging economies would be requested to adhere to. This holds true for the Transpacific Partnership (TPP) as well as for TTIP. This focus on regulations may scare some people and make them worry that such agreements could result in a *downward harmonization* of environmental and labour standards and limit a government's ability to adjust or create new regulations going forward. This is an especially sensitive issue with regard to the provisions on Investor-State Dispute Settlement (ISDS) that allow companies to sue governments if new regulations hurt their business.

We certainly do not want to dismiss that there are some elements in these agreements that are highly important and require a thorough debate. The current public debate on trade agreements seems however much more influenced by foreign policy than by economic principles and thereby misses the important points. We agree that TTIP will result in benefits to participating nations. The TTIP trade area would cover 40 % of the world economy and would impose regulations based on Western values. It is thus the chance to set global standards before emerging economies do so. Unfortunately this argument is often drowned out by discussions about specific details like chlorinated chicken. A reduction of non-tariff barriers between the US and Europe by means of an agreement on regulations and standards such as the colour of turn signals for cars bears great potential for producers and consumers on both sides of the Atlantic.

TPP - Transpacific Partnership
RCEP - Regional Comprehensive Partnership

The Transpacific Partnership (TPP) was signed in February 2016 and is currently awaiting ratification to enter into force in member states including big Pacific countries like Australia, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the US … but not China.

China itself is in negotiations for the Regional Comprehensive Partnership (RCEP) which would expand China's current agreement with the ASEAN (Association of Southeast Asian Nations) to Australia, India, Japan, New Zealand and South Korea. This would include half the world population, a third of the global economy and 30 % of global trade.

Of course, where some producers may gain, others may lose. There is definitely need for a better acknowledgement of adverse effects of trade and more transparency about the ongoing negotiations. There needs to be as well an in-depth and effective discussion on how governments can channel some of the gains from trade to those that bear its negative effects. So far, the debate has rather been focused on details with limited implications in order to cater interest groups and gain the support of voters. However, closing the agreement in time and creating a bigger market for consumers and producers under unified standards brings about a substantial gain.

Yves Longchamp, CFA

Head of Research
ETHENEA Independent Investors (Schweiz) AG

[3] Source: http://dspace.mit.edu/openaccess-disseminate/1721.1/101757