Sri Lanka: Capacity Building on Trade Policy Analysis
Institute of Policy Studies, Colombo, Sri Lanka

Session 1: Economics of trade liberalization: Why do countries liberalize trade? Potential costs and benefits of different approaches to liberalization.

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Based on Evenett (2010), Deardorff (2016) and ESCAP material

ARTNeT

IPS

UNITED NATIONS ESCAP
Economic and Social Commission for Asia and the Pacific

What to expect from this workshop

The purpose: to strengthen the understanding of officials and other stakeholders of:

- the types of trade barriers dominantly affecting the trade in goods and the economic analysis therefore
- options to address those barriers

The workshop emphasises the practicalities of these policy questions included offering some direction on economic analysis

➢ More comprehensive tools workshop will be offered in January 2017

Substantive topics covered

- Introduction to trade in goods and lessons from basic and more general trade theories
- Approaches to trade policy reforms
- Focus on negotiated trade policy reforms with concrete Sri Lanka experiences and a discussion on pre-, during- and post negotiation issues
- Overview of tools in impact assessment applied to trade liberalization
- A tour through a data jungle
- Private sector perspective on policymaking

Getting the most out of the workshop

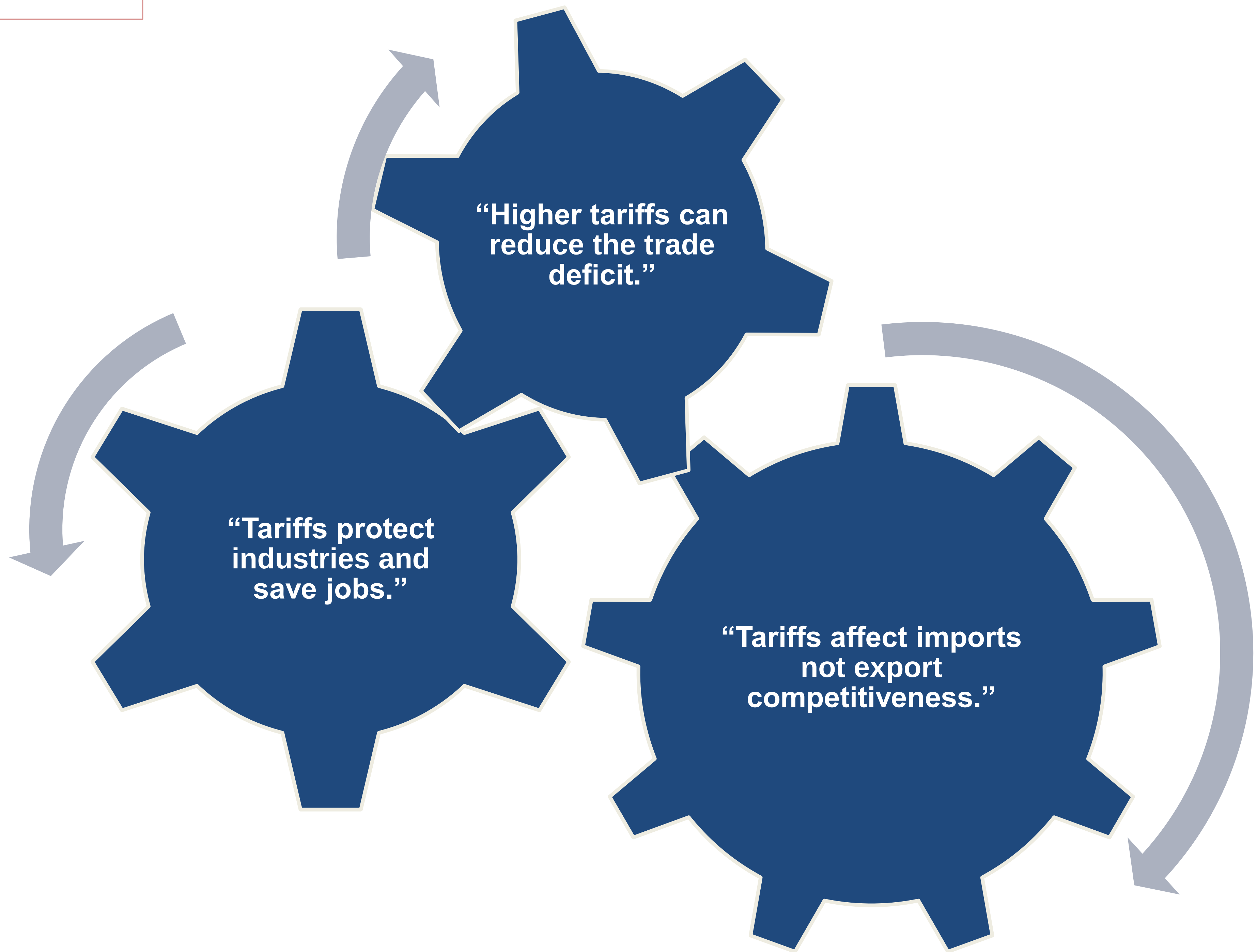
- Make sure you ask questions. If you don't understand something, most likely someone else does not too- asking questions is critical to learning
- Don't be afraid to ask what a technical word means or for an explanation to be repeated
- Engage in discussions and offer your perspective
- Tell us if we are speaking too fast
- Give a feedback

Outline

- Participants’ views
- Mainstream thought: Gains but yes also costs
- Which way to reform trade policy and what to expect?

Do you support these statements?

These arguments apply not just to tariffs but to other forms of protection (quotas, antidumping, etc.)



So back in “the good, old days”…

“The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend.”

John Maynard Keynes, *The Economic Consequences of the Peace*

In late 1990s and early 2000s

- Woke up by alarm of a Chinese clock,
- Got shower fitted by Italian taps,
- Made toast and coffee using German appliances
- Put on a pair of jeans from Jordan
- And shoes from Spain
- Got into a Korean car
- Stopped to get a coffee in a franchised US outlet
- Got to a work desk with a Chinese PC,
- Etc, etc… most celebrated these as virtues of globalization

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Today - ANGST from free trade (any trade?)

- In recent years witnessing strengthening and spreading of dimensions of globalization related to trade liberalization: foreign goods, foreign services, foreign workers, foreign capital, foreign knowledge (technology/IPR), ETC.
- Not all new; but stronger feelings about many aspects of globalization:
    - Jobs are shipped overseas
    - Workers income is shipped overseas (wages)
    - Capital returns are shipped overseas (MNEs not taxed, royalties, etc.)
    - Imported pollution and waste
    - Loss of national identity, culture and religion

Need to revisit trade?

First - What is economics?

Economics is the study of choices and their consequences.

Those choices need not be those associated with the exchange of goods and services.

- e.g. analyses of policy choices, marriage, divorce, abortion etc.

The consequences need not be pecuniary in nature.

- e.g. analyses of pollution.

Economic analyses examine “what is” and “what should be,” but economists are careful not to confuse the two…are you?

Economists analyse the *overall* effect of many related decisions—and this often exposes fallacies.

Source: Evenett, 2010

Why study economics in international trade?

To understand why nations trade the goods that they do and what policies governments can pursue to change current trading patterns.

- Applications to development policymaking, aid, etc.
- Concerns about competitiveness etc.

To understand who benefits and who loses from trade reforms and from imposing protection.

- Implications for the design of social safety nets.
- Implications for the design of special provisions for developing countries in the WTO.
- Applications in WTO DSU.

Source: Evenett, 2010

What are the core elements of economic analysis?

The study of choice requires:

- Statement of multiple alternatives/choices available and their relationships to outcomes.
- “Opportunity cost”
- Statement of preferences over outcomes.

Necessity of abstraction.

- We all abstract from certain factors…nobody is perfect here.

When many parties are involved consistency conditions are required, e.g. quantity supplied=quantity demanded.

We seek explanations (causal statements) as well as predictions.

Source: Evenett, 2010

So let us begin: when trade starts…

- We look at the adjustment of an economy as it moves from no or little trade to much trade
- But we need to frame the lenses we look through: we start with the basic Ricardo's model
- The role of country size in the 2-good, 2-country model is essential:

If countries are of similar size→
    Both specialize
    Both gain from trade (imports) in aftermath of complete specialization, but there are adjustment costs
If one is small and the other large→
    Small country specializes and gains
    Large country does neither (because it cannot fully specialize, , size maters)

BE AWARE: GRAPHS WILL BE USED

But what happens if there are shocks

- ❖ Internal shock leading to loss of productivity in export sector (small country can lose more than its trade gains if not entering full specialization)
- ❖ External shock – drop in world price, tougher competition; small country can lose all gains from trade, but not more

→ Bottom line: small countries do gain but are also **more vulnerable to shocks and volatility** ("all eggs in one basket")

More 'realistic' models – economies of scale

EOS and competition grow, variety increases bringing gains in particular to those small markets

- But to benefit, they have to **specialize so vulnerability the same as with no EOS plus no market power**

Delivering BASIC gains from free trade

- Efficient structural adjustment: the country uses its resources in the most productive way when it specializes in the areas in which it has comparative advantages
- Firms are able to source the most cost-effective inputs
- Consumers are able to purchase imports at the lowest price

→ NOTE: **“free trade” and “free trade area” are not the same thing.**

and DYNAMIC gains

Dynamic effects: more important but difficult to quantify

- Economies of scale: the average cost
  - -The “average” cost reduction effect
  - - More competitive not only at home but also in foreign markets
- Technology transfer and FDI
  - - Long-term, risk-sharing investment flows
  - - MNCs provide a channel to reach the global market
  - - Technology transfer from MNCs
- Stimulating competition
- Structural policy change and reform
  - - Pressure to embrace “best practices”, to reform law and regulations, policy harmonization.

In summary, that is how globalization works

Reduced barriers to trade (reduced costs!)

Fragmentation

Extension of trade to markets other than goods might need further clarification, in particular for financial services

Policy options (highways)

- UNILATERAL (non-negotiated, non-reciprocal)
- MULTILATERAL (WTO)
    - **PLURILATERAL**
- REGIONAL (subregional blocs eg SAFTA)
- BILATERAL

Negotiated (reciprocal) liberalization- is it a better option?

Political economy of liberalization

- Ethier (2004, 2007)
- Governments reluctant to liberalize trade unilaterally
- Reciprocity is the solution
- If foreign governments do liberalize their trade, export-oriented sector will gain, thus shifting the balance of political support in favour of trade liberalization
- Also a support for gradual liberalization

Why FTAs? Many reasons; never a single reason

- Economic motives:
- Minimizing beggar-thy-neighbour
- Gaining credibility
- Market access
- Other reasons
  - increasing policy predictability
  - signalling openness to investors
  - foreign policy …

Why do WTO members still need FTAs?

- Easier than WTO to address deeper integration in a shorter period of time
- A requirement of “substantially all trade” in GATT/WTO.
- A group of like-minded countries
- Training ground for all – negotiators, legislators, producers, consumers
- Increased bargaining power in WTO, though trade interests of all members may not be the same

Is discrimination allowed in Multilateral trading system?

- GATT (1947) → WTO (1995)
- Both based on **MOST-FAVOURED NATION (MFN)** principle: non-discrimination — treating virtually everyone equally
- The mutual exchange of trade concessions through instrument of "preferential trade agreements (PTAs)" is allowed:

Article XXIV of GA TT 1994 provides the rules governing free trade in goods.

Article V of the General Agreement on Trade in Services (GATS) gives the corresponding rules for free trade in services.

The WTO and FTAs: Requirements

Trade barriers against non-members “must not be raised”

The FTA must be formed “within a reasonable length of time”

The FTA must eliminate trade barriers on “substantially all the trade” among the members

With regard to services, the General Agreement on Trade in Services (GATS) requires that the FTA or CU involve “substantial sectoral coverage”

Potential cost and benefit of a FTA (Viner Theorem)

Exports from FTA-partner countries will replace inefficient domestic production

It is called “Trade creation”

Exports from FTA-partner countries will displace exports from efficient non-partner countries

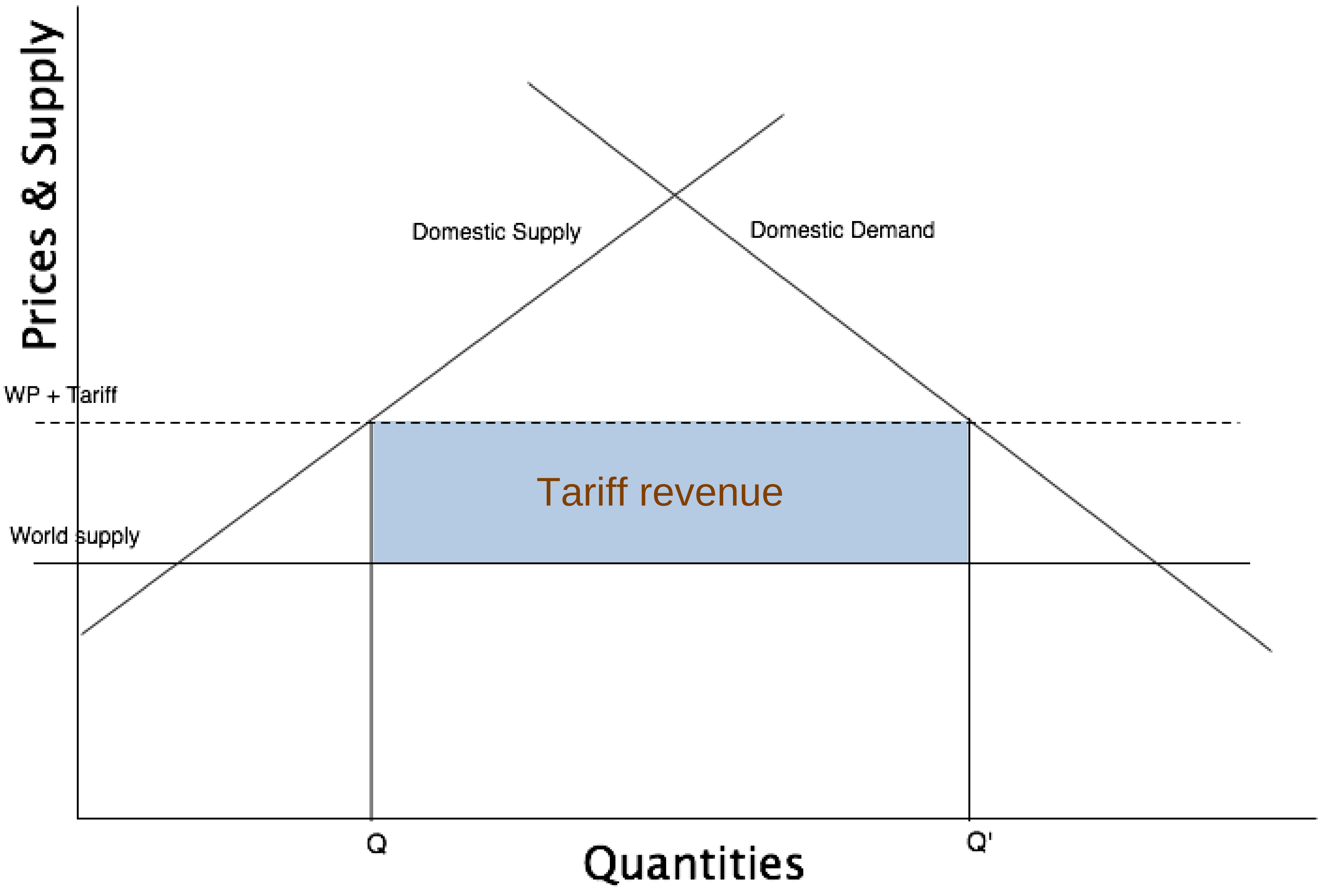
It is called “Trade diversion”

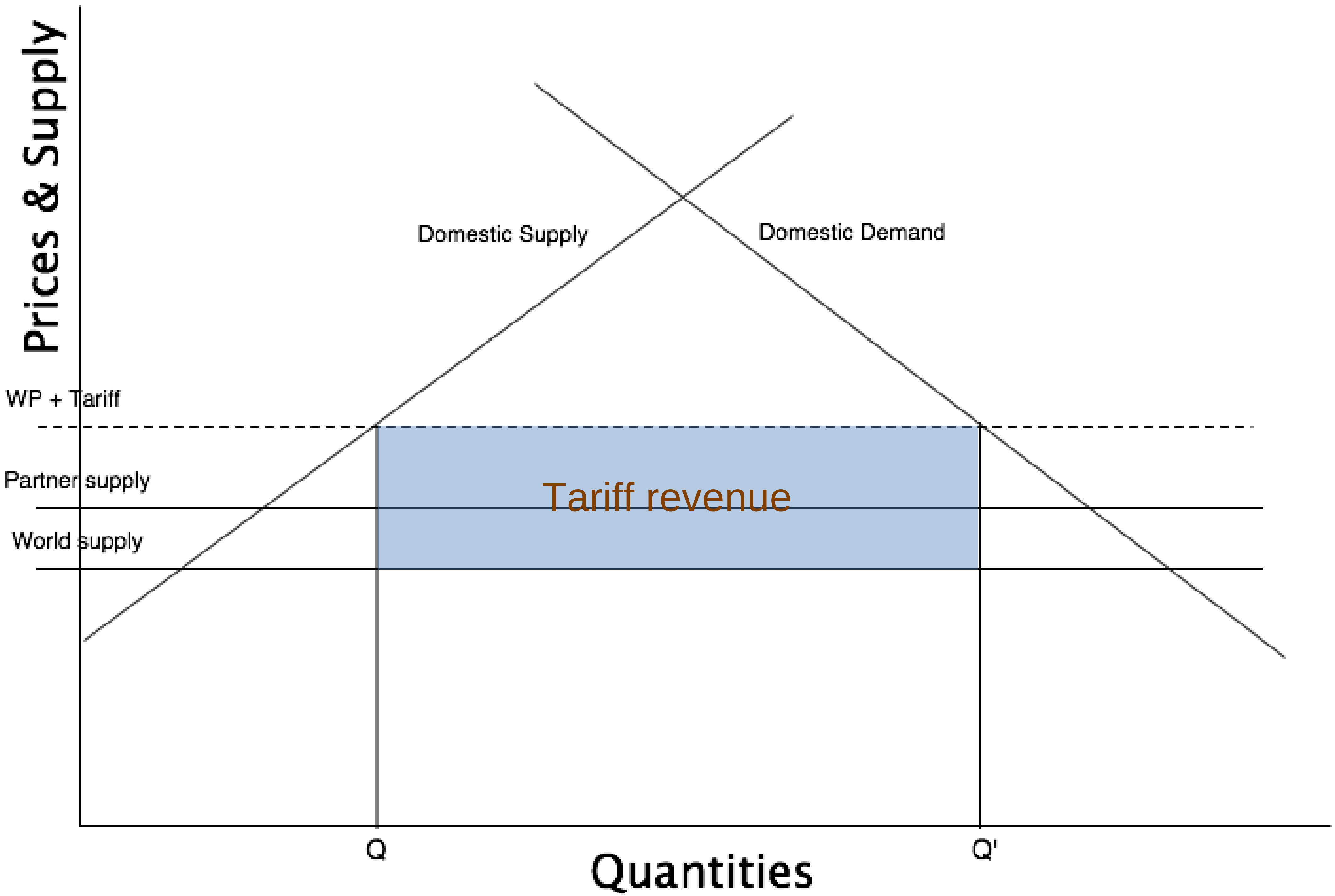
What would happen to efficiency?

What would happen to tariff revenue?

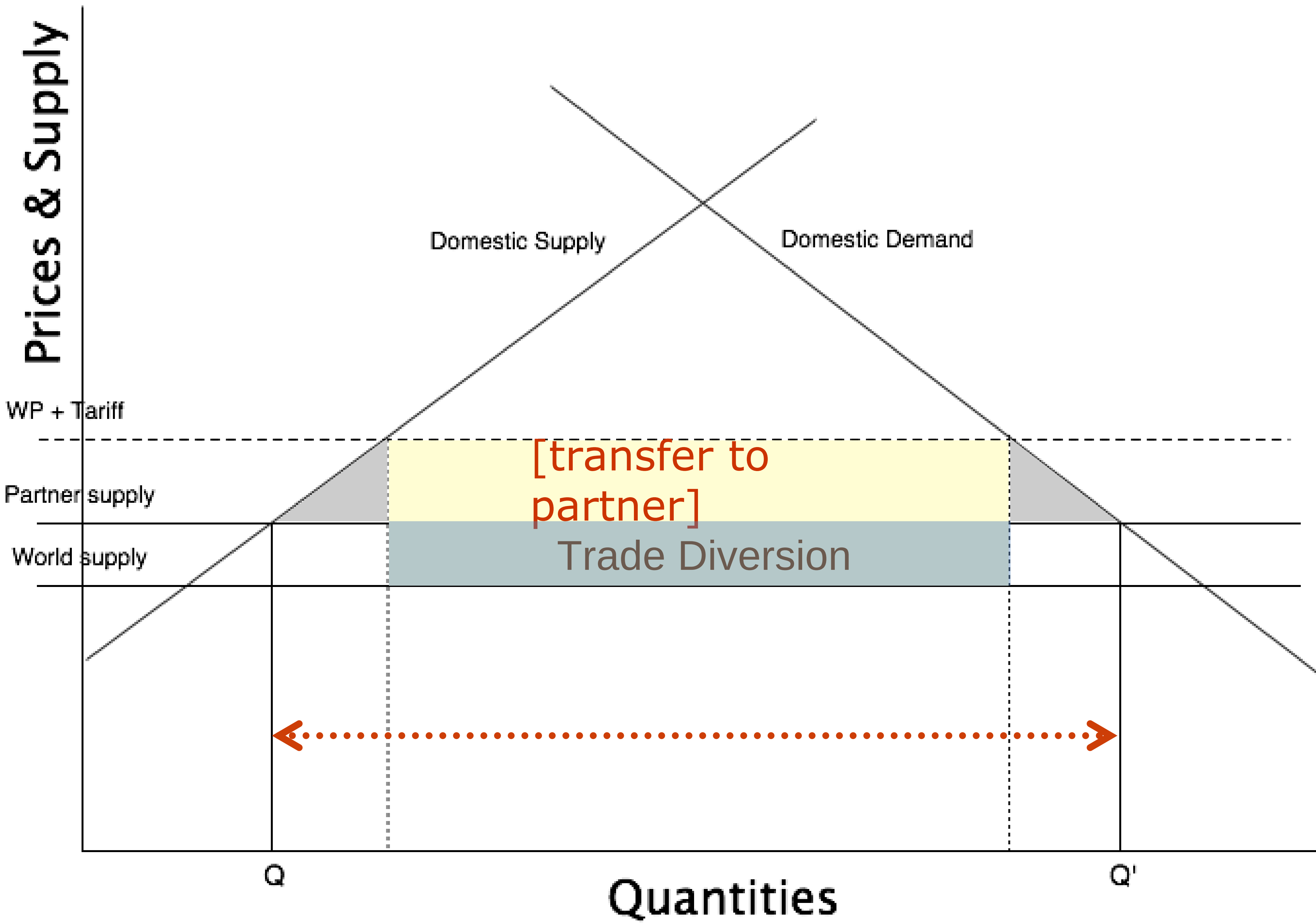
Is there any better option?

Illustration

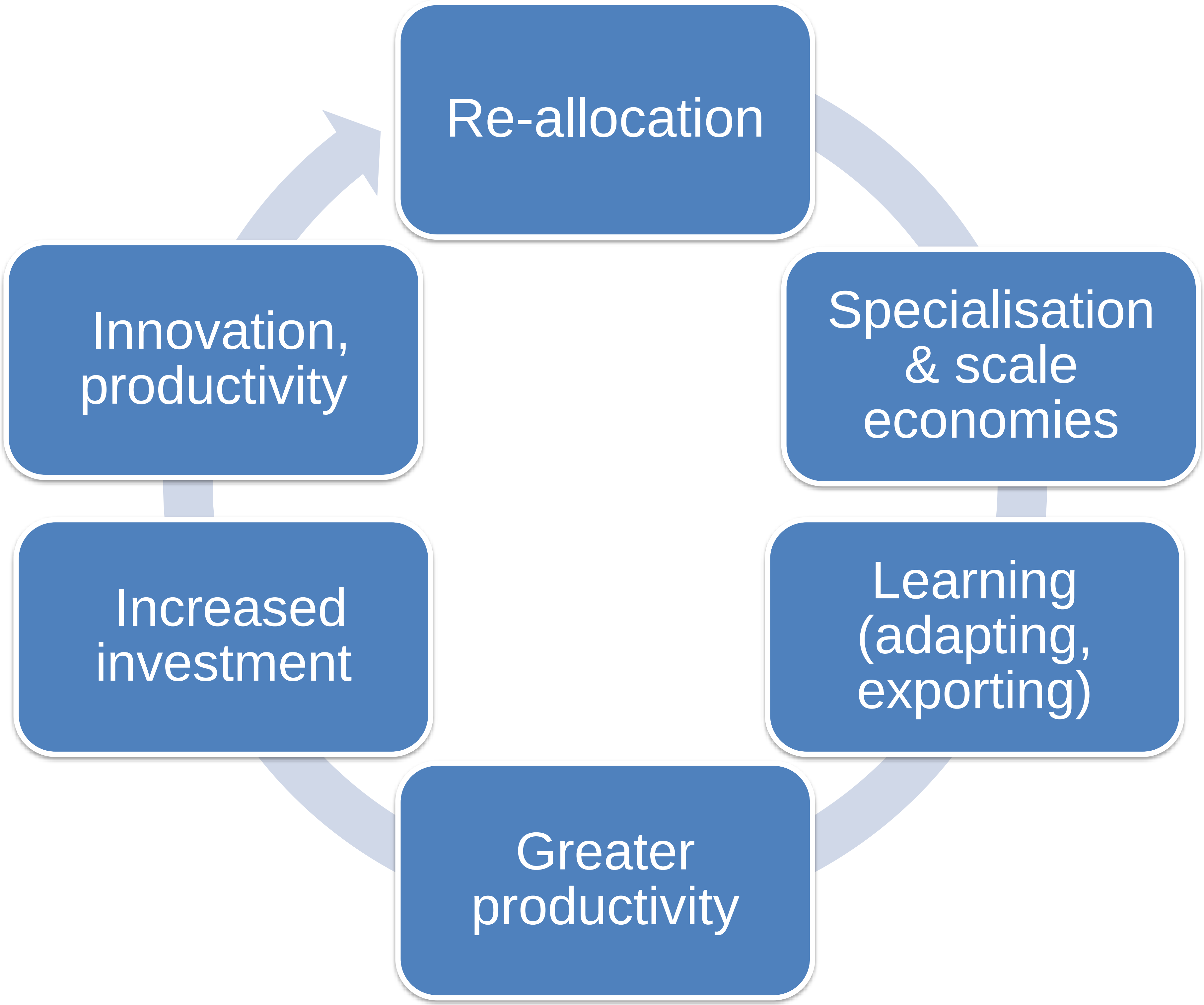



Prices & Supply
Domestic Supply
Domestic Demand
WP + Tariff
Partner supply
World supply
Tariff revenue
Q
Q'
Quantities

Summary: *the net trade effect depends on whether the loss of efficiency due to diversion (green rectangle) is greater or less than the gains in efficiency (grey triangles).*



Stylized dynamics



Effects of overlapping FTAs

Four main effects

- **Trade creation**: Import from partner what was previously produced at home
- **Trade diversion**: Import from partner what was previously imported from 3^{rd} country
- **Preference erosion**: Loss of a preference when a previous partner forms FTA with a 3^{rd} country
- **Trade reversion**: Import from new partner what had been diverted to a partner in prior FTA (Deardorff, 2014)

Burden of the noodle bowls

- Overlapping and uncoordinated rules
- The complex rules and variable tariffs increase transaction costs
- Deter the use of FTA preference , particularly by small- and medium-sized enterprises (SMEs)
- One way to solve the problem is having an over-arching set of free-trade principles.

Conclusion

Principle 1:
A tax on imports is a tax on exports

Resources have to be used to produce exports and import-competing goods.

When an economy is at or near full employment then expansions of one sector necessarily require contractions of another sector; with labor and capital market prices adjusting to signal how each sector adjusts.

A tariff (artificially) stimulates the import-competing sector, which draws resources away from other sectors—including the export sector.

An across the board tariff increase will damage non-importing sectors: imports and exports will fall together.

Principle 1 is known as Lerner Symmetry.

Principle 2:
Businesses are consumers too.

It is well known that personal consumers gain from reductions in tariffs on the goods they import.

What is less well appreciated is that firms import lots of goods too.

The prices firms pay for imports directly affects their costs and competitiveness.

International production networks.

Incentives created for firms to lobby.

Structure of protection: tariff escalation.

Principle 3: Trade imbalances reflect capital flows (1)

Balance of payments (BOP) is defined as the sum of current account, Capital account, and some small balancing terms.

BOP accounts measure the flow of funds into and out of a country and the associated changes in asset holdings.

Each transaction involves a debit and credit of the same size in the BOP.

Hence the BOP always equals zero.

Principle 3:
Trade imbalances reflect capital flows (2)

Recall that, essentially:

BOP = Capital Account + Current Account.

Since BOP≡0

Current Account = - Capital Account.

In gross terms capital account transactions are much larger than current account transactions.
So capital account changes drive the current account.
What then determines capital flows and the capital account?
Perceived differences in returns on financial assets--which in turn is heavily influenced by perceptions of risk and expectations of future changes in asset values.

Thank you

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