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## **Unleashing the Benefits of Free Trade Agreements and Regional Trade Agreements**

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# Unleashing the Benefits of FTAs and RTAs

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## Unleashing the Benefits of FTAs and RTAs

The key principle to keep in mind is the Law of Comparative Advantage

- i.e. economic activities should be consistent with a country's factor endowments
- the Law of CA means NO restraints on trade, at the border or behind the border
- NOT following the Law of CA implies economic costs
- if all countries follow this principle, all will be better off
- one of the most powerful ideas in economics (Paul Samuelson: the only “non-trivial” mathematical concept in economics)
- no exceptions; even so-called “new” trade theory
- the Law of CA should underpin all trade policy

Focusing on the Law of Comparative Advantage will ensure pro-poor growth

## Unleashing the Benefits of FTAs and RTAs

If following the Law of Comparative Advantage is the best policy, why not move to adopt policies consistent with it as soon as possible?

- therefore, policies allowing less-developed countries to “gradually” reduce restrictions on imports are not in their best interests
- such “preferential” treatment of less-developed countries only allows these countries to keep on incurring costs and operating at less than their optimal level
- maintains protection of vested (“privileged”) interests

Restricting imports means that exports have to be restricted in order to balance trade over the long term, which means the real exchange rate is higher than it would otherwise be

- exports are only useful for buying imports to expand the consumer basket; they are not of benefit in and of themselves

## The benefits of FTAs and RTAs

FTAs and RTAs allow the opportunity for unhindered free trade between the members

- can allow for easier movement of investment, technology, and ideas
- technology-lagging members can catch-up to the more advanced technology and ideas used by other members
- Most benefits will come from an investor-friendly environment fostering innovation, entrepreneurship, and productivity growth

But remember, unilateral free trade is fine (note Singapore)

## Resistance to Adoption of FTAs and RTAs

Trade reform is likely the most difficult kind of reform because the costs of adjustment are obvious and immediate and the benefits are not obvious and often well into the future (George Stigler)

- note the real exchange rate effect mentioned previously

Reform is also difficult because those hurt are often geographically and politically concentrated, while the consumers who will benefit from lower prices and costs are not concentrated and often do not presently exist

Economists are often asked to state what activities will replace those hurt by trade reform; but we have really no idea of the future

- see books being written about what will happen in the labour market following the extension of AI and robotics

- see also forecasts by experts such as Einstein, Isaac Newton, Larry Summers, Paul Krugman

## Removing Constraints on Adopting FTAs and RTAs

Given the resistance to adopting FTAs and RTAs, how best to identify and overcome the constraints and maximise the benefits from the Agreements?

Importantly, what needs to be done by government to maximise the benefits and keep the adjustment costs as low as possible

Undertaking Binding Constraints analysis (Hausmann, Rodrik, and Velasco) is a useful means of setting priorities on government activities

- see lessons learned from International Agencies' Structural Adjustment activities that did not set priorities
- study binding constraints on maximising benefits from land, labour, capital, and innovation

## Why focus on Binding Constraints to Trade Policy Reform?

Need to undertake binding constraints diagnostics to see what may be the constraints to a supply response resulting from the adoption of a FTA or RTA

At a particular time, some constraints are binding and some are not. The most binding constraint is the one with the highest shadow price or 'opportunity cost'

Removing this constraint will have the greatest impact on economic growth.

The key issue is to identify the most binding constraints and to relax these first. This process identifies a sequence or a set of priorities for the government

Binding constraints may be sector-specific or economy-wide.



## A Framework for Identifying Binding Constraints

Three major areas of possible binding constraints

### I. High Costs of Finance:

- High costs of access to domestic finance (low domestic savings, poor availability of collateral, controls over bank lending, risk of a banking crisis)
- High costs of access to international savings (high country risk, restrictions on foreign investment, regulations on the capital account)

### II. Poor Returns to Investment:

- 'Geography' (e.g. isolation from markets, topography), poor human capital, poor infrastructure, high-cost and unreliable essential services, labour market interventions, high business risks

## A Framework for Identifying Binding Constraints

### III. Difficulty in Retaining Returns to Investment:

Government failure (insecure property rights, poor contract enforcement, corruption, high taxes or inefficient tax system, high expected appropriation risks, macro-economic risks such as unsustainable fiscal and current account deficits, unsustainable public debt, unsustainable monetary policy, political instability/sovereign risk)

State-owned enterprises 'crowding-out' private sector business activity

High dependence on foreign aid; 'welfare dependency' that saps entrepreneurship in government and business

Inexperience in accessing overseas markets; may be a need to facilitate joint ventures with overseas firms with international market networks

## From theory to practice

### The search for diagnostic 'signals'

- If 'A' is a constraint, then the price/cost for 'A' should be 'too high'

Searching for price 'signals', e.g., in returns to education, interest rates, cost of transport:

- If the level of education is holding back economic growth, then the returns to skills and education will be high and the numbers of unemployed skilled people will be low
- If the shortage of savings is a constraint on investment, then deposit interest rates will be high
- If poor transport infrastructure is a constraint, then there will be transport bottlenecks and transport costs will be high
- Also, when a constraint is binding, there will be 'informal' attempts to get around it. E.g., high taxes -> large 'black' economy

## From theory to practice

‘An art, not a science’

Need for surveys of businesses, as well as examination of trends in data

Benchmarking with information from other countries

## From theory to practice (some examples)

Education: Poor education levels will inhibit structural adjustment in the form of adopting new technology and moving up or fitting into an international supply chain. The ability to adjust will be reflected in low unemployment and high economic growth (see Singapore)

Land: Insecure individual title to land will inhibit innovation and entrepreneurship and, in turn, economic growth. Lack of land collateral will restrict borrowing and also prevent a country developing a mature financial system

Investment law: Restrictions on FDI will inhibit the introduction of new technology and ideas

Infrastructure: The quality and cost of infrastructure (transport, power, water, etc) can be a binding constraint to investment (see Philippines). Cross-country cost comparisons are often useful benchmarks. See also the need for substitutes such as power generators

Innovation climate: Providing an encouraging climate for innovation and entrepreneurship is most important.