CELEBRATING 140 1879 YEARS 2019 The London Institute of Banking & Finance

Free trade: Unilateralism, the World Trade Organization and customs unions – what's the way forward?

Simon Ling-Locke looks at the history of free trade and explores how easy or difficult it will be for a post-Brexit UK to create new trade agreements, remove tariffs and trade on the WTO's 'most favoured nation' basis.

In the UK, the discussion around Brexit has seemed to be on a never-ending recorded loop filling our TV screens, smartphones, radios and newspapers with seemingly the same discussion points day after day, night after night, incessantly over the past three years – until hardly a person in the land wants to hear that word again, Brexit! There are obviously various arguments which have been espoused for and against Brexit from taking more sovereign control, removing the right of free movement for EU citizens into the UK, to being able to negotiate bilateral trade agreements freely with other countries around the world to help boost UK exports.

This article seeks to focus on an area which seems not to have been covered to the degree it should have deserved over the past three years, but which is crucial to the economic arguments for exiting – namely being able to create new trade agreements and whether removing tariffs and entering international trade on the World Trade Organization's 'most favoured nation' basis would be a sensible step for the UK. Statistical data does show that, after all, trade was not an insignificant 61.1per cent of the UK's GDP in 2018![1]

How free trade works

Since the days of Adam Smith – considered the founder of the classical school of economics with his famous work The Wealth of Nations (1776) – it has been argued that free trade and the removal of any trade barriers is beneficial to all and should be applied even if on a unilateral basis. When a country exports it might have what is called 'absolute advantage', 'comparative advantage' or indeed 'comparative disadvantage' against other countries.

Where a country has absolute advantage, it would seek to export those goods and services which are not chosen to be consumed within its home market in order to maximise the country's wealth. This could occur because the country is the only producer of a particular good but more generally because the goods can be produced for a lower price than in the other country. Often though, whilst a country's costs might be lower than in another country for say two different goods, proportionally less labour is used to make one product than the other. In this regard it makes sense for each of the two countries to specialise in the goods where they have the most comparative advantage. Thus, there is a gain from trade when countries export goods in which they have a comparative advantage, and import goods in which they have a comparative disadvantage. If this theory is applied, then there is a total gain from international trade, because the total quantity of goods available expands as a result of more efficient resource allocation.

There are though, for both political economy and practical factors, reasons why the implementation of a trade policy based on these principles of comparative advantage are invariably not applied unilaterally by countries. For instance, when import barriers are suddenly lowered it can quickly lead to adverse effects in the importing country such as:

- uncompetitive companies suddenly facing the international stage losing market share in their home market, deteriorating performance, potential bankruptcy and resultant unemployment
- the unemployed may not be able to easily move into more productive sectors (because they hold the wrong skill sets, retraining might not be effective, or there may be unwillingness to relocate from a community to find work and so on)

[1] UK Trade, December 2018, Office for National Statistics website, accessed 23 April 2019, https://www.ons.gov.uk/releases/uktradedec2018

- other manufacturing and tertiary sectors can be impacted as the primary production sectors retrench or go out of business – in the UK the contraction of various heavy industries such as coal mining and iron and steel industries, particularly in the 1980s, were examples of the damage which is caused to the wider local economies
- home-based producers might want to reduce wages to compete
- exchange rates are not static but vary so a country which has a comparative disadvantage might end up with a comparative advantage because of a devaluation in its currency against others, as such comparative advantage and disadvantage is relative and not fixed in time.

Creating peace through trade

I will not delve into these points to any greater extent in this article, in order to give the reader just a taste of some of the issues which arise when a country opens up to free trade. Nevertheless, free trade is a strong argument against isolationism, for wealth creation and for working with other countries. Indeed, it is often argued that if countries are trading with each other, then they will be much less likely to be going to war with each other! The International Chambers of Commerce (ICC) was actually founded in the aftermath of the First World War at a time when there was no world system of rules governing trade, investment, finance or commercial relations. The founders of the ICC did not wait for governments to fill the gap but acted on their conviction and called themselves "the merchants of peace". Despite the founders' ground-breaking efforts, the first set of trade terms were only agreed in 1936 – too late to have helped reduce the effects of the 1930s Great Depression[2] when many of the most important countries of the world enacted protectionist moves. Such protectionist steps were dramatically damaging to economic world economic growth:

World trade volume fell 16 per cent from the third quarter of 1931 to the third quarter of 1932. Between 1929 and 1932 it fell 25 per cent, and nearly half of this reduction was due to higher tariff and non-tariff barriers.[3]

The Second World War strengthened the resolve of the winning powers in the West to encourage world trade and help prevent a repeat of the Great Depression. In Germany, the resulting economic dislocation from the Great Depression triggered a rise in unemployment from around 1.5mn at the end of 1929 to over 6mn by early 1933. This was a crucial factor in Hitler and the Nazi party's ability to gain power in Germany in 1933. (Before the economic crisis, the Nazi party had gained just 2.6 per cent of the popular vote in the 1928 elections but that had increased to 18.3 per cent by the 1930 elections). Clearly without tariff and nontariff barriers being raised in that period, world trade would have been around 12 per cent higher and the adverse impact on employment and disillusionment with the economic capability of many of the more central governing political parties at the time would most likely have been lower.

The Bretton Woods Conference of 1944, as the outcome of the Second World War became more definitive, established the need for international institutions leading to the creation of the International Monetary Fund and the World Bank. However, the original intention of an 'international trade Organization' did not come into existence, as approval from the US Congress was never forthcoming. Instead trade facilitation was developed through the General Agreement of Trade and Tariffs (GATT) which was established in 1948. The GATT subsequently held a number of sets of negotiations (known as 'rounds') to try to reduce and, ideally, eliminate tariff and non-tariff barriers with a view to encouraging economic growth through world trade. The final GATT round, known as the Uruguay round, began in 1986 but was only successfully completed in 1995 – nine years later! This was also the point when the World Trade Organization (WTO) was established to take over the role of the GATT. The WTO now has 164 members representing 98 per cent of world trade as of 30 September 2018[4] with responsibility over trade in goods including agriculture, services and intellectual property. It is a "rules-based, member-driven organization – all decisions are made by the member governments, and the rules are the outcome of negotiations among members".

The challenges of cutting tariffs and barriers

The cutting of tariffs and barriers is not easy to achieve though when there are so many different countries with their own economic interests and politics to consider. Indeed, tariffs are by no means the only area to be tackled to encourage trade. Reduction, or elimination, of non-tariff barriers is also required by tackling various rules and procedures that can lead to delays, extra costs and frustration in international trade. These cover such technical questions as customs valuation, pre-shipment inspection and procedures for securing import licences. In the EU – or the European Economic Community, as established back then – all internal trade tariffs in the group had been removed by the early 1960s. But it was not until 1987 when Margaret Thatcher, UK prime minister at the

2 Kolb, Eberhard, 2005, The Weimar Republic, accessed 23 April 2019, https://alphahistory.com/weimarrepublic/great-depression/

3 League of Nations, Review of World Trade, 1931/32–38, League of Nations Secretariat, Financial Section and Economic Intelligence Service

4 About the WTO, World Trade Organization website, accessed 23 April 2019, https://www.wto.org/english/thewto_e/thewto_e.htm

time, had ensured the European Single Act came into existence that a legal basis was established to remove all remaining non-tariff trade barriers within the EU.

At the world level, multilateralism through the WTO has been less successful in eliminating remaining tariff and non-tariff barriers. The WTO launched the Doha Development Agenda in 2001 with the overarching objective to improve the integration of developing countries in the world economy. It was originally due to be completed by the end of 2004 but failed. Negotiations were suspended between July 2006 and February 2007, before being resumed as the 2008 financial crisis deepened. Despite repeated efforts it was only at the Ninth Ministerial Conference in Bali in 2013, that members agreed on a more focused trade facilitation programme aiming to reduce border delays by slashing red tape. This agreement finally came into force in February 2017 when the WTO obtained ratification from two thirds of its members. This became the first multilateral accord reached by the WTO in its 22-year history.

In terms of removal of barriers, the World Economic Forum has estimated that the benefits of improved global trade facilitation far exceed those of further tariff reduction and could lead to an increase of approximately US$ 2.6 trillion (4.7per cent) in global GDP and US$ 1.6 trillion (14.5per cent) in global exports.[5]

Often, in view of the difficulty in reaching comprehensive trade agreements on a global level, it has become increasingly common to see countries move away from a multilateral approach to one of establishing bilateral agreements (trade, partnership, mutual recognition agreements) between two or more countries to reduce trade barriers between key trading partners. Indeed, the origin of the EU is such an example with the original establishment of the European Coal and Steel Community in 1952. The North American Free Trade Agreement (NAFTA) is another example. There are now approximately 300 such bilateral agreements covering some 50 per cent of world trade, with at least 119 negotiated since 2002 for just the Asia-Pacific region.

The trade choices facing the UK in 2019

The preceding paragraphs should assist the general reader in appreciating some key issues in world trade with the need:

- to encourage economic growth across the world
- for co-operation and
- to tackle the slow process in achieving the removal of tariffs and non-tariff barriers.

5 The Benefits of Trade Facilitation – A Modelling Exercise, World Economic Forum website, http://reports.weforum.org/global-enabling-trade-2013/appendix/?doing_wp_cron=1554745603.0821769237518310546875

Now, back to the emotive topic of Brexit and where the UK will have to make a fundamental choice between a number of different routes to international trade as an independent country. There are variations on the theme, but they fall broadly into three basic areas.

1) Move onto the basic WTO terms of trade and seek to establish various bilateral agreements with a number of individual countries and trading blocks.
2) Establish a bespoke agreement with the EU. Prime Minister May has so far not succeeded in obtaining parliamentary approval for her withdrawal agreement with its temporary lock-in (to deal with the need to avoid a hard border in Ireland) of continuing free trade with the EU Block pending a fundamental negotiation of bilateral trade terms with the EU. Even if May's deal had been able to pass through the Commons, negotiations on new terms of trade with the EU would likely be protracted with each EU member state having a veto over any final agreement (the EU maxim of "nothing is agreed until everything is agreed"). Whilst there is public talk of friendship and fraternity, in reality the UK would need astute, wily, tough negotiators and at the same time be prepared for significant amounts of horse-trading in order to be able to reach an agreement some years down the road. In the meantime, the UK would be locked into a temporary system where its ability to strike new deals with other countries would be highly constrained.
3) Remain in the Customs Union with the EU where the UK would become a rule taker versus its current position of a rule maker with other EU countries as a member of the EU. Under this option the UK's ability to establish bilateral trade agreements with other countries around the world would again be constrained.

The implications of the UK moving onto WTO terms of trade

Focusing on the first point of the implications of the UK moving onto WTO terms of trade we can note that currently the UK trades across the EU free from tariff and non-tariff barriers in goods, agriculture and services. In the year to September 2018 the EU accounted for a significant 49.7 per cent of UK's trade.[6] As a block, the EU has also set various external tariffs (EU's Common Customs Tariff or CCT) and has established a series of bilateral trade agreements with a number of other countries around the world.

Outside of the EU block, the UK would have to consider what levels of tariffs to set. The UK cannot, under WTO rules, just say for instance that there will be no tariffs on

6 UK Trade, December 2018, Office for National Statistics website, accessed 23 April 2019, https://www.ons.gov.uk/releases/uktradedec2018

imports from EU countries but tariffs will apply against other countries. Under WTO rules, nations cannot normally discriminate between trading partners. This is known as the 'most favoured nation' rule where each member treats all the other members equally as 'most favoured' trading partners. If a country improves the benefits that it gives to one trading partner, it has to give the same 'best' treatment to all the other WTO members so that they all remain 'most-favoured' (WTO). This rule though can be overridden when two or more countries reach a bilateral agreement between themselves rather than being governed by the multilateral agreement of the WTO.

The UK government has already announced in their March 2019 communication that, in case of a no-deal Brexit scenario, tariffs would be imposed on 13 per cent of the country's imports, particularly on agricultural produce but also on fully finished cars, tins of tuna etc. Unilateral removal of all tariffs will not happen since any political economy of bargaining power in negotiations with other countries – for reciprocation on the removal of tariff barriers on imports from the UK – would be lost, as well as because a number of domestic industries in the UK would face sudden changes in the competitive environment.

Not as easy as expected

It would appear that the UK government had originally assumed it would be a relatively easy task to roll-over the around 40 EU bilateral free trade agreements with over 70 countries on a comparable basis. However, one has to ask – especially when the UK economy has more to lose from the introduction of tariffs – why would another country want to accept the same terms agreed with an economic power house of a block of 27 countries against just one when the opportunity exists to reopen negotiations and seek better terms? It is also not so easy in practice due to the legal technicalities of ensuring such agreements are drafted so as not to trigger WTO rules around 'most favoured nation'!

The Department for International Trade has published a paper stating these free trade deals cover around 12 per cent of the UK's total trade currently. As such, if the UK came out of the EU with no deal, approximately 62 per cent of all UK trade would be affected as preferential trade terms and the Customs Union with the EU would fall away. As a comparator, none of the current top 20 EU trading partners trade purely on WTO rules. They all have some form of bilateral agreement and/or free trade deal.[7] Such magnitude of potential transformation clearly chimes with a comment made by Carolyn Fairburn, Director General of the CBI during a BBC Radio 4 *Today* programme: "What we are hearing is the biggest change in terms of trade this country has faced since the mid-19th century".

7 EU bilateral agreements (or 'side deals'), Institute for Government website, accessed 23 April 2019, https://www.instituteforgovernment.org.uk/explainers/bilateral-agreements

It would therefore appear – as has often been stated by many economists, financial commentators and some politicians – that a sudden hard Brexit would result in a fundamental impact on UK trade with seemingly little preparation to date by the government for such an eventuality.

As of 31 March 2019 the UK had signed bilateral agreements and mutual recognition agreements with a handful of countries, only two of which are within the top ten of the UK trading partners – the USA with 14.6 per cent and Switzerland 2.6 per cent.[8] The remaining countries mostly account for relatively insignificant amounts of trade. In the case of the USA, a comprehensive free trade agreement has not yet been established with the EU and as such it was relatively easy for the UK and US to agree on mutual recognition. But when it eventually comes to seeking a more comprehensive bilateral agreement with the USA, one can be sure that negotiations will be tough. In particular, the USA will be looking for the UK to open up its agricultural market to USA produce and the emotive, genetically modified foods produced in quantity in the USA. Of the other top ten trading partners of the UK, seven are member countries of the EU with just China at number five being the exception.

How quickly might bilateral agreements be concluded if needed?

It is obviously a very difficult question to ask, just like asking how long is a piece of string! However, we can gain some insight from research undertaken by the Peterson Institute for International Economics on how long it took the USA to agree 20 bilateral trade deals.[9] From launch to implementation, it has varied from a minimum of 18 months (for Jordan) to 102 months (for Panama) with an average length of nearly four years.

Being within a customs union helps preserve industrial value chains – two important sectors being autos and aerospace where UK industry is deeply integrated with those in the EU. It does not though ensure frictionless trade. Other factors, such as regulatory harmonisation, are needed to ensure there is limited or no paperwork at borders. Without an agreement with the EU, export-import paperwork and checking at borders will be required even if tariffs are at zero. This is of course again the reason why

8 UK Trade in Numbers February 2019, Department for International Trade and Government Publishing Service, accessed 23 April 2019,
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/791972/190402_UK_Trade_in_Numbers_full_web_version.pdf

9 Freund, C and McDaniel, C, (21 July 2016), How Long Does It Take to Conclude a Trade Agreement With the US? Peterson Institute for International Economics, accessed 23 April 2019,
https://piie.com/blogs/trade-investment-policy-watch/how-long-does-it-take-conclude-trade-agreement-us

late in the day the UK government realised there would be a bottle neck at Dover, a key trading point between UK and EU accounting for 17 per cent of trade in physical goods.

The Port of Dover management provided data which enabled impact assessments to be carried out for the UK government.[10] This impact assessment showed that just a two-minute delay to processing times for freight vehicles in the event of a hard Brexit would lead to a 17-mile queue of lorries on the M20. (As Dover is a flow-through port, it lacks the capacity to store goods or park trucks and thus it is essential to minimise delays). As long as Britain is a member of the EU, trucks can carry intra-EU trade to roll on and off ferries at Dover and other ports without delay. However, outside of a customs union, paperwork for exporting and importing will be needed. As of 5 April, HMRC has stated that only 77,000 out of an estimated 240,000 businesses have so far acquired an 'economic operator registration and identification' number which is needed to fast-track goods through customs[11]. Even if the UK government instructed customs to waive through all imports without checking, there would undoubtedly be delays because paperwork would be necessary to speed the process on the continental side. And clearly delays would be far more than two minutes! The lack of preparation by government – together with the lack of preparation and willingness to spend money for an uncertain eventuality by businesses – could lead to the M20 becoming a very long lorry park indeed. Perhaps a taster of the mayhem which could ensue were the events back in the summer of 2015 when industrial action in Calais led to lorries being parked on the M20 for 21 days.

10 Port of Dover, (2017), Annual Report and Accounts, accessed 23 April 2019 https://www.doverport.co.uk/administrator/tinymce/source/Annual%20Reports/Annual%20Report%20and%20Accounts%202017_Web.pdf

11 Hughes, L, 10 April 2019, Financial Times, accessed 23 April 2019, (paywall) https://www.ft.com/content/9ae4a036-5b77-11e9-9dde-7aedca0a081a

Conclusion

Brexit is, I would say, the most highly charged, emotive and politically tumultuous disruptor the UK has experienced since at least the Suez crisis. People hold different opinions for various reasons, some more coherent than others. A decision on which route the UK will take has to be decided. This phoney situation of being in suspended animation with nothing agreed will come to an end and, potentially, quite abruptly.

Economic theory suggests that free trade is good for wealth creation, but this is not necessarily equally applied across the board and for some could be very detrimental indeed. Trade liberalisation on an international scale is slow and difficult. This has encouraged more and more regional and bilateral agreements to be signed between countries in order to boost trade. Even these deals though take years to complete. Much trade is regional and there is logic to the creation of trading blocks whether it be focused on basic removal of tariff barriers or more comprehensive steps, such as those taken by the EU.

The UK is woefully underprepared for a hard Brexit with too little infrastructure in place and too little preparation by industry to cope with moving onto WTO terms. (And this has not even considered the ramifications for the UK's trading partners). Moving straight onto WTO would be a wholly untried and untested process for a major country such as the UK. The politics of setting an arbitrary time limit for exit has little synchronisation to the needs of international trading. Shock of changing systems can create new dynamisms but could equally cause untold damage. Some businesses and expertise once lost might never be recoverable. The original arguments for and against were polarised and in many respects negative in tone. Parliamentarians would do well during their continuing deliberations to focus more intensely on the longer timeframes needed to cope with the complexities of disentanglement and preparation for new trading arrangements.

Simon Ling-Locke has three decades of banking experience at Barclays, Tokai and UFJ banks working in international markets including syndicated loans, risk management, and heading European leverage finance and corporate banking teams at UFJ bank. He also led training activities at the Loan Market Association.