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REBALANCING THE DEBATE

THE BENEFITS OF TRADE LIBERALIZATION AND IMPLICATIONS FOR FUTURE POLICY

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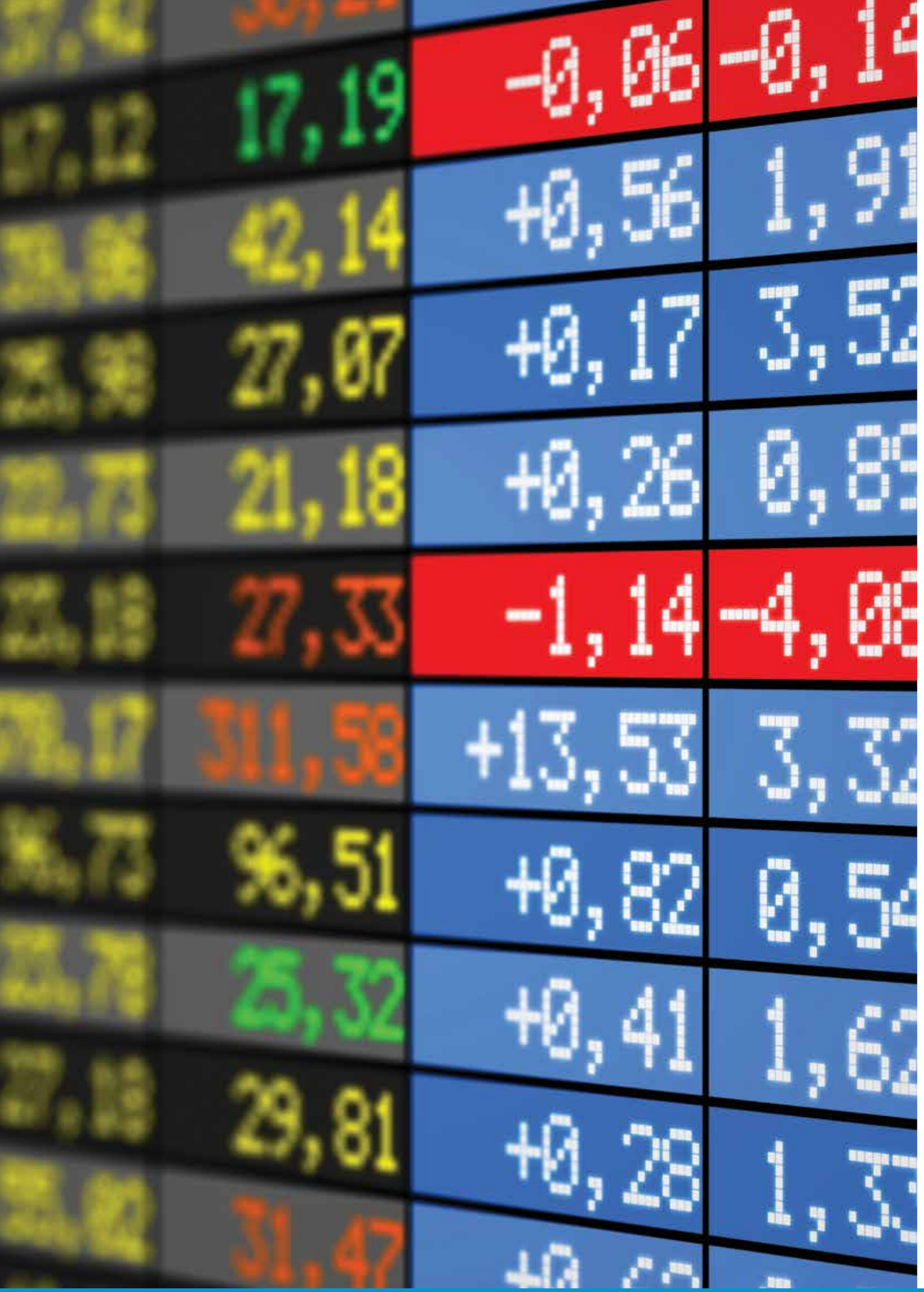


Andrei Potlogea

1

INTRODUCTION

TRADE LIBERALIZATION
BENEFITS AND COSTS

"The art of progress is to preserve order amid change and to preserve change amid order"
Alfred Whitehead

The last few decades have been characterized by a worrying economic trend: stagnating incomes and living standards for an increasing share of the population of developed nations. For instance, a quick analysis of labour market indicators across Europe reveals that in Germany real wages in 2015 were 2.4 per cent below their 2008 peak; that in the UK real wages were little changed between 2000 and 2013 and that the southern European countries most affected by the euro crisis (such as Greece, Portugal and Spain) all displayed lower median real wages in 2013 than in 2004. If anything, data for the United States makes for even bleaker reading: according to the Economic Policy Institute, median wages in the US were only 6 per cent higher in real terms in 2013 relative to 1974[1].

In turn, this development has had a number of problematic consequences. In particular, it has served gradually to erode public support for free trade, as well as for free markets in general. A 2015 YouGov analysis found that a plurality of the French (35 per cent) thought that free trade was bad for business in their country (while only 31 per cent thought it was good), while 31 per cent thought trade had a negative impact on jobs (while only 29 per cent thought trade had a positive impact on employment). Even in export powerhouse Germany, only a narrow plurality of respondents (30 per cent to 27 per cent) thought that free trade was good for business, while on the topic of jobs Germans who thought that trade had a negative effect on employment outnumbered those who thought that the opposite was true (29 per cent considered trade to have a negative impact on employment while only 22 per cent considered trade beneficial for jobs)[2].

Moreover, scepticism about international trade is now also widely shared by Americans, traditionally perceived as one of the nations most supportive of free trade. Research by the Pew Research Center revealed that in 2015, 34 per cent of Americans thought that free trade agreements slow down economic growth (as opposed to 31 per cent who believed that they accelerated growth), 46 per cent believed that they reduced wages (as opposed to 11 per cent who believed they make wages higher) while 46 per cent believed they lead to job losses (compared to 17 per cent who believed free trade agreements helped create jobs)[3].

Worse, the pace of this widespread decline in public support for a liberal trading environment appears to have accelerated during the fallout from the Great Recession.

1 The issue of US wage stagnation has been controversial, with a series of studies finding more rapid wage growth than the EPI. However, most studies agree that recent wage growth has been modest by (modern) historical standards.

2 Happily, attitudes to trade were found to be significantly more positive in Britain, Denmark, Finland and Sweden.

3 Worryingly, even these low levels of public support for free trade actually represented an improvement relative to the troughs in support recorded in 2009 and 2010, at the height of the Great Recession.

ATTITUDES TO FREE TRADE AGREEMENTS BY COUNTRY

Source: YouGov poll 2015

	'Do you think your country making free trade agreements with other countries is good or bad for businesses in your country?'			'Do you think your country making free trade agreements with other countries is good or bad for the number of jobs in your country?'		
	GOOD %	BAD %	NET %	GOOD %	BAD %	NET %
Britain	50	10	40	44	12	32
Denmark	50	13	37	43	14	29
Finland	50	17	33	46	19	27
Sweden	41	18	23	35	21	14
US	29	23	6	19	31	-12
Germany	30	27	3	22	29	-7
France	31	35	-4	29	31	-2

Faced with squeezed living standards and the perceived unfairness of the distribution of the costs of the financial crisis, voters in several rich countries have asked their elected representatives to erect trade barriers to protect them from international competition. Moreover, politicians themselves have contributed to the shift in public mood against free trade. Traditionally protectionist voices were joined by other, more opportunistic ones, in blaming foreign competition for a wide range of adverse economic outcomes, many of which were, in fact, the result of domestic policy failures.

These latter trends were perhaps most visible in the recent US presidential elections, when Donald Trump was elected on an explicitly protectionist and anti-trade platform. However, there are ample signs of similar shifts in public opinion elsewhere, including in Europe. Thus, the conducting of TTIP negotiations drew extensive public opposition and even protests in a number of European countries; the ratification of CETA was slowed down and almost scuppered by a combination of intense public and political opposition; while in the UK the government's initial reticence in protecting the local steel industry triggered a significant public outcry.

Interestingly, the recent hardening of public attitudes to trade liberalization has been accompanied by a significant shift in the balance of opinion among academic economists, who have traditionally been supportive of free trade. Starting with the early years of the last decade, a number of studies have uncovered a series of substantial economic costs associated with trade liberalization. Some of the most influential among these have focussed on the impact of increasing exposure to import competition from developing countries, particularly China, on economic outcomes in developed nations.[4]

The findings of this strand of research make for a bleak reading for proponents of trade liberalization[5]: increased exposure to import competition was associated with increased unemployment, reduced and increasingly variable earnings, an accelerated pace of factory closures and increased reliance on welfare transfers. Moreover, the negative effects of import competition were not restricted to the directly affected domestic producers, but extended to businesses both upstream and downstream of those producers, as well as to non-tradable activities. Even more worryingly, the negative effects of trade liberalization were found to be both geographically concentrated within countries and also concentrated among a narrow set of particularly vulnerable occupations and demographics.

Last but not least, the negative economic impact of import competition was found to have knock on effects in the social realm: the communities most exposed to foreign competition display significant drops in marriage and fertility rates, worse health outcomes, higher mortality rates, increases in the number of children born out of wedlock or to teens, increased crime rates and lower quality of local public services.

The ensuing change in the tone of the academic debate surrounding free trade has been stark, with support for trade liberalization increasingly lukewarm. This is perhaps unsurprising if one considers the optimistic and arguably complacent views traditionally held by economists on the issue of international trade. Classical theories of trade emphasized that trade is a win-win for all countries that participate. Freer trade, the argument went, improves consumer welfare by lowering prices and increasing the variety of available goods, while at the same time raising the productivity of economies by helping reallocate resources to the most productive sectors and firms.

In fairness, economists had long acknowledged that the benefits of trade are likely to be unevenly distributed across different segments of the population, and that the destruction and expansion of industries that accompanies trade bears its own risks and costs. Until recently, however, the economic consensus was that these transition costs were likely to be small, and the gains were large enough to compensate for the losses that some do suffer. That consensus has now evaporated in light of recent research findings.

US PERCEPTIONS ON THE EFFECTS OF FREE TRADE AGREEMENTS

Source: Pew Research Centre

Do free trade agreements make the wages of American workers higher, lower, or not make a difference?

May 12–18 2015		Nov 4–7 2010	Oct 28–Nov 8 2009	April 2008	Dec 2006
11	**Higher**	8	11	8	11
46	**Lower**	45	49	56	44
33	**Not make a difference**	34	24	22	30
1	**Mixed/Depends (VOL.)**	1	2	2	1
8	**Don't know/Refused (VOL.)**	12	15	12	14

Do free trade agreements create jobs in the US, lead to job losses, or not make a difference?

May 12–18 2015		Nov 4–7 2010	Oct 28–Nov 8 2009	April 2008	Dec 2006
17	**Create jobs**	8	13	9	12
46	**Lead to job losses**	55	53	61	48
28	**Not make a difference**	24	19	18	25
2	**Mixed/Depends (VOL.)**	1	1	2	2
7	**Don't know/Refused (VOL.)**	12	14	10	13

Do free trade agreements make the American economy grow, slow down, or does it not make a difference?

May 12–18 2015		Nov 4–7 2010	Oct 28–Nov 8 2009	April 2008	Dec 2006
31	**Make the economy grow**	19	25	19	28
34	**Slow the economy down**	43	42	50	34
25	**Not make a difference**	24	18	17	21
1	**Mixed/Depends (VOL.)**	1	1	2	2
9	**Don't know/Refused (VOL.)**	13	14	12	15

4 Studies looking at the impact of foreign competition in developing countries tend to display very similar findings. For instance see Topalova (2008, 2010), Kovak (2013), Dix-Carneiro (2014) etc.

5 A non-exhaustive list of the studies that document the findings reported in the text includes: Autor, Dorn and Hanson (2013, 2015, 2017); Autor, Dorn, Hanson and Song (2014); Acemoglu, Autor, Dorn, Hanson and Price (2016); Bernard, Bradford Jensen and Schott (2006); Pierce and Schott (2016); Feler and Zeynep Senses (2017); Krishna and Zeynep Senses (2014) etc.

The main thesis of the present paper is that the pendulum in the tone of the debate surrounding trade liberalization has now swung too far in the direction of scepticism regarding its merits. To rebalance this discussion, this paper will put forward four main arguments in support of free trade:

01. Recent findings do not undermine the fact that there are substantial aggregate gains for both developed and developing countries from maintaining a liberal trading regime and continuing trade liberalization;

02. These gains are likely to be particularly significant for developing nations, making trade liberalization a key tool for poverty alleviation;

03. Some of the short and medium run costs associated with trade liberalization might be overstated, wrongly attributed to trade liberalization or may have been incurred anyway due to other factors such as technical progress; and finally

04. Many of the short to medium run costs of trade have either been amplified by deficient domestic policies or could be partially mitigated via improved policy interventions.

After developing these points on the benefits of free trade, the paper turns to the question of how to advance the cause of trade liberalization to ensure that the prospective gains are realised. Here, it argues that the main question supporters of freer trade need to ask themselves is: "What is the least costly (i.e. the least distortionary) way to maintain and advance public consent for trade liberalization?" In truth, we do not inhabit an economy, but a political economy, and, at least in democracies, the pursuit of trade liberalization relies crucially on continued public support. It is surprising how often this point is lost on analysts focussed on narrow economic considerations and on highlighting the aggregate gains from trade.

In light of recent research, the paper suggests that proponents of free trade should consider shifting their position and message on a number of counts in order to secure public consent for trade liberalisation. First, they should embrace gradualism. As adjustment costs to the impact of trade liberalization have been shown to be significant, allowing for a phased implementation of trade liberalization measures is likely to reduce disruption and allow those negatively affected more time to adapt. This is likely to reduce their opposition to liberalization.

Second, supporters of trade liberalization should endorse activist domestic policies aimed at mitigating the short run distributional and adjustment costs of liberalization. These may include policies aimed at promoting the mobility of workers across sectors, such as job re-training programs, or policies aimed at promoting geographical mobility. Third, greater attention should be paid to public concerns regarding the unequal distribution of the gains from trade. Proponents of freer trade should therefore consider supporting [at least] limited transfer programs that ensure a more equitable distribution of these gains.

Last but not least, supporters of trade liberalisation need to improve their communication strategy with the wider public. In particular, two shifts in communication approach are likely to be particularly consequential for improving the quality of the public debate around trade. The first is to more energetically challenge and disprove the myths and misunderstandings surrounding the politically contentious issue of trade deficits. The second is to show greater willingness to discuss honestly and openly the trade-offs between national sovereignty and (deep) trade integration involved in negotiating modern trade agreements. This latter course of action may or may not enhance public support for trade liberalization, but would probably guard against some of the wild swings in support for free trade observed recently.

The rest of this paper is organized as follows. Section 2 describes the benefits of trade liberalization for developed economies. Section 3 focuses on the gains from trade liberalization for developing countries. Section 4 discusses political economy considerations and tackles the issue of how to secure public consent for continued trade liberalization. Section 5 concludes by offering a set of key lessons and policy recommendations specifically aimed at informing future trade policy debates in the European Union.

2

THE (NET) BENEFITS OF TRADE LIBERALISATION
DEVELOPED ECONOMIES

In the last few decades, developed economies have often played the role of defenders and promoters of trade liberalization. This section argues that, in spite of new difficulties generated by the changing nature of trade and the increasing competitiveness of developing nations, rich nations should maintain their commitment to free trade and continued trade liberalization. The logic of the argument is straightforward: the (net) gains from trade predicated by classical trade theory have not been disproved by recent research, are still significant and worth pursuing.

2.1 BRINGING THE BENEFITS OF TRADE LIBERALIZATION BACK INTO VIEW

Much of the recent scepticism about the merits of trade liberalization can be attributed to new evidence documenting the negative fallout from increased import competition. It is important to note, however, that while many of these studies do an excellent job at identifying the losers from foreign competition and quantifying their losses, they often only look at one side of the ledger. Once one takes a broader view, the picture surrounding trade liberalization improves considerably.

Let us begin our discussion with the supply side of the economy. Here, the weight of the evidence indicates that the benefits of trade in terms of increased (domestic) economic efficiency, promised by classical theories, have indeed materialized during past liberalization episodes. An instructive example is provided by the analysing the much politicized topic of Chinese imports in the US. While it is indeed true that increased import competition from China was associated with job losses and increased risk of closure among US manufacturing plants, Magyari (2017) points out that shifting attention to US manufacturing *firms* reveals a much more encouraging picture[6].

She finds that firms more exposed to Chinese import competition actually expanded their manufacturing employment as they reorganized towards sectors less exposed to Chinese competition and benefitted from lower costs of production due to the availability of cheaper intermediate inputs.[7] Moreover, these firms expanded employment by hiring both more production workers, to whom they paid higher salaries, and more workers engaged in complementary service activities (such as R&D, design, engineering and headquarter services). The evidence is thus broadly consistent with firms successfully responding to increased import competition by reorganizing, improving efficiency and creating higher quality jobs.

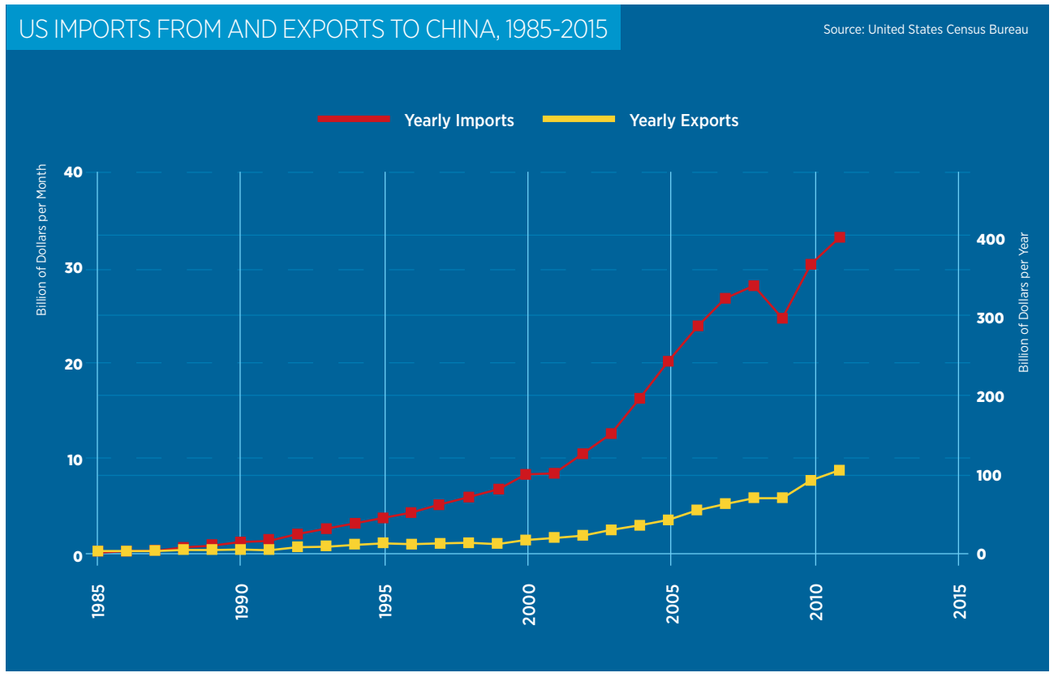
Another interesting piece of evidence supporting the productivity benefits of trade liberalization, this time from Europe, comes from a study by Nicholas Bloom, Mirko Draca and John Van Reenen. Analysing European firms following the removal of product specific quotas with the occasion of China's accession to the WTO, they find that increased Chinese competition led to both technology upgrading within firms and to the reallocation of employment towards more technologically advanced firms. The combined impact of these within and between firm effects is

6 It is perhaps easiest to think of a manufacturing firm as a collection of manufacturing plants.

7 In other words, although Chinese imports may have reduced employment within some establishments/ plants, these losses were more than offset by gains in employment within the same firms.

US IMPORTS FROM AND EXPORTS TO CHINA, 1985-2015

Source: United States Census Bureau



to cause technological upgrading in those industries most affected by Chinese imports. Moreover, these effects are large, and can account for about 12 per cent of European technology upgrading between the years 2000 and 2007.

The benefits of trade liberalisation to developed country consumers are if anything even easier to account for than the supply side benefits discussed above. Classical theories of international trade promise benefits to consumers in terms of lower prices and greater choice. Encouragingly, the empirical evidence largely backs up these predictions. For instance, Bai and Stumpner (2017) analyse detailed US barcode level price data and find that product categories facing higher import penetration from China experienced slower price inflation. The effect is found to be driven by both changes in the prices of existing goods and the entry of new goods.

Furthermore, recent research by Fajgelbaum and Khandelwal indicates that the gains from trade liberalization, both in developed and developing countries, accrue disproportionately to lower income consumers. This is largely because poorer households spend a higher fraction of their budgets on tradable goods, whose prices are typically reduced by trade liberalization. Trade liberalization benefits are likely to be even higher among the lower income consumers of rich nations, as it provides them with easier access to the cheaper varieties of consumer goods typically produced in developing nations.

Given the discussion above, it should come as no surprise that most studies that estimate the aggregate effects of trade liberalizations find significant gains. This result prevails even in studies that do their best to incorporate frictions and adjustment costs to trade liberalization[8], and when only considering the "static" or short-run effects of liberalization. Thus, the seminal study of Eaton and Kortum (2002) estimates welfare gains of moving from autarky to free trade to range between 0.2 and 10.3 per cent for 19 OECD countries; Caliendo, Dvorkin and Parro (2017) use a model embedding mobility frictions and adjustments costs find that the US actually experienced an aggregate welfare gain (albeit a relatively modest one) from the notorious "China shock"; while Hsieh and Ossa (2011) find that recent productivity growth in China provided welfare benefits for the rest of the world via trade channels.

Moreover, it is important to note that the studies mentioned above are likely to underestimate severely the merits of trade liberalization. This is because these studies ignore the longer run or "dynamic" benefits that freer trade may provide. These include, among others: increased productivity due to greater competition and improved diffusion of ideas across countries; increases in complementary flows of Foreign Direct Investment (FDI) and specialist workers (e.g. foreign firms may invest in distribution or retail units in home country, or may integrate local factories in their global value chains); learning by exporting effects etc. Studies that aim, albeit imperfectly, to estimate the gains from trade inclusive of these additional effects typically find gains from trade that are at least double, and often more than triple those that emerge from short-run studies. For instance, the seminal study of Feyrer (2009) finds that for each 1 per cent increase in a country's trade, its GDP is increased by 0.5 per cent. Applied to the trade creating effects that have been estimated for major recent trade liberalisations (NAFTA, China's WTO accession), this estimates yield the conclusion that these agreements added significantly to the output of developed and developing nations alike.

Furthermore, the changing nature of modern international trade has served to augment the benefits of trade liberalisation while raising the cost of protectionism. Much of today's trade is trade in intermediates, with parts or components crossing borders numerous times before recognisable final products are finished. This process allows the operation of highly efficient regional and global value chains, where each task is performed in the location with the greatest comparative advantage in that particular activity.

WELFARE CHANGES ACROSS POPULATION FROM FREE TRADE
Unequal Gains From Trade, Multi-Sector Case

Source: Fajgelbaum, P and Khandelwal, A, 'Measuring the Unequal Gains from Trade', *Quarterly Journal of Economics*

Country	10th Percentile	50th Percentile	Aggregate Change	90th Percentile
AUS	56%	31%	8%	5%
AUT	74%	58%	42%	37%
BEL	81%	68%	51%	46%
BGR	81%	65%	50%	45%
BRA	69%	28%	2%	2%
CAN	69%	49%	30%	25%
CHN	53%	23%	6%	5%
CYP	78%	62%	44%	39%
CZE	77%	65%	51%	47%
DEU	65%	46%	27%	22%
DNK	67%	47%	26%	21%
ESP	64%	41%	19%	14%
EST	85%	70%	51%	46%
FIN	71%	51%	30%	24%
FRA	55%	35%	16%	10%
GBR	65%	41%	16%	10%
GRC	74%	51%	27%	20%
HUN	87%	78%	68%	65%
IDN	29%	11%	4%	3%
IND	27%	12%	6%	6%
AVERAGE	70%	50%	31%	27%

Country	10th Percentile	50th Percentile	Aggregate Change	90th Percentile
IRL	72%	51%	28%	23%
ITA	63%	38%	15%	9%
JPN	60%	32%	7%	3%
KOR	64%	40%	17%	12%
LTU	91%	81%	68%	64%
LUX	72%	55%	36%	31%
LVA	79%	60%	40%	34%
MEX	75%	47%	24%	20%
MLT	87%	77%	65%	62%
NLD	70%	52%	32%	26%
POL	71%	49%	29%	24%
PRT	77%	55%	30%	23%
ROM	75%	55%	37%	32%
RUS	70%	41%	18%/	14%
SVK	86%	78%	68%	65%
SVN	82%	70%	57%	53%
SWE	63%	45%	27%	22%
TUR	67%	36%	12%	8%
TWIN	81%	64%	43%	38%
USA	82%	50%	10.7%	6%

Table reports gains from trade for the multi-sector case and uses the parameters reported in Table 3. The columns report welfare changes associated at the 10th, 50th, the representative consumer, and the 90th per centiles.

8 Admittedly the ability of current (even state of the art) trade models to embed an extensive list of adjustment costs and consider the potentially complex distributional effects of trade liberalisation is still limited.

A prime example of this development is the rapid integration of European economies in the last three decades, as a consequence of both improved technologies and the reductions in (intra-European) trade frictions brought about by EU expansion. The result has been the creation of highly efficient European value chains, the so-called "Factory Europe", in which the more sophisticated Western European economies specialized in the design and advanced engineering stages of production, leaving processing and assembly activities to take place in developing Eastern European economies. This specialization, coupled with the increasing returns to scale that could be exploited due to the larger European market substantially increased productivity, making Europe as a whole more competitive on global markets.[9]

In the context of the development and operation of the increasingly integrated regional and global value chains described above, the unilateral introduction by a jurisdiction of even relatively modest trade protections can substantially raise overall production costs and can lead to a country being excluded from global value chains, with significant losses in terms of productivity and welfare[10].

Last but not least, let us consider the more indirect and harder to measure benefits that may accrue to developed countries from trade liberalisation, particularly when the removal of barriers involves developing nations. First among these, opening up rich country markets to developing nations aids economic development in the latter. While this may serve to relocate some sections of global value chains to poor nations (to the detriment of some rich country workers), it also serves to increase developing nations' demand for sophisticated goods and services typically produced in developed economies. Next, while negotiating trade agreements, developed countries may extract economic policy concessions in developing nations that benefit all parties: improved enforcement of property rights, governance reforms, protection of intellectual property rights[11] (which often benefits developed nation innovators), anti-corruption measures etc. Again, an example of this is provided by the process of EU enlargement, where the reforms developing Eastern European nations agreed to as part of their accession negotiations arguably played a substantial role in their subsequent growth and modernisation.

Furthermore, increased trade with developing nations can often substitute for poor-to-rich country immigration flows[12], and increased living standards in developing countries due to increased trade may reduce the incentives for migration. Giving the political and social tensions emerging in many developed nations (including the US and many EU member states) around the issue of immigration, this can be seen as an additional benefit of trade liberalization. Finally, promoting trade integration that aids poorer countries develop can help build international political goodwill. This is likely to become increasingly important in the future as the world grapples with complex global governance issues that require enhanced international cooperation.

2.2. REVISITING THE COSTS OF TRADE LIBERALISATION

The case in favour of freer trade for developed economies rests not only on the substantial benefits outlined in the previous section, but also on the fact that the costs of liberalisation are likely to be

01. overestimated,

02. mis-attributed to trade or

03. subject to mitigation by appropriate policy action.

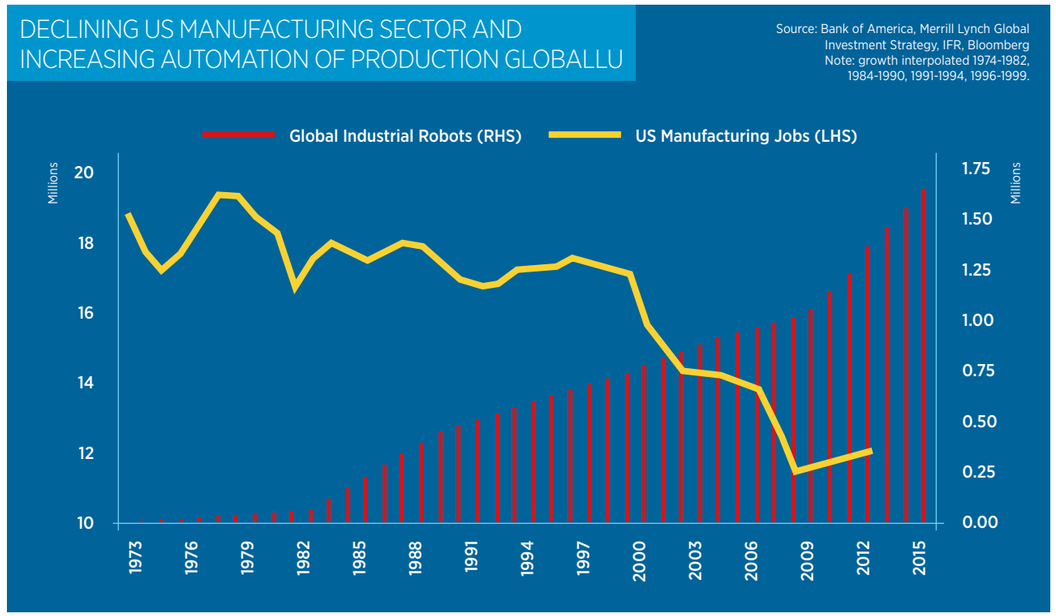
In this section I discuss the potential overestimation and mis-attribution of costs to trade liberalization, leaving the discussion of policy to the next section.

9 In fact the EU as a whole has recently been the biggest actor in world trade, being both the larger exporter and the largest importer of goods, and running a very substantial trade surplus.

10 For instance, Gawande et al. (2015) conclude that the increasing fragmentation of production across global value chains may have prevented countries from raising trade barriers and inducing protectionist measures in the follow-up of the Global Crisis of 2008.

11 In principle, offering access to rich country markets in exchange for intellectual property rights protection could enhance welfare for everyone, as ensuring that developing nations contribute to global innovation is in principle efficient. However, many commentators maintain that rich nations have often pushed the case of intellectual property protection too far, in an attempt to help their innovators extract excessive rents from developing nations.

12 In principle, one can think of trade and immigration as alternative ways to ship labour internationally. Given that immigration entails additional costs and externalities, and has faced significant political opposition in developed nations, trade may in fact often be the "cheaper" way to shift labour internationally.



The large number of high quality studies that have documented significant adjustment and distributional costs associated with trade liberalization means that these costs can no longer be ignored when discussing trade policy. However, it is important to note that there is still substantial uncertainty regarding the magnitudes and interpretation of these adverse effects found to be associated with freer trade. For instance, the seminal study of Autor et al. (2013) attributes the loss of about 1.5 million US manufacturing jobs (and 2 million total jobs) to increased competition from China in light of its WTO accession in 2001. In a recent comment however, Feenstra, Ma and Xu (2017) show that controlling for local housing conditions (a contemporaneous housing boom was affecting the localities less exposed to Chinese import competition) reduced the number of US job losses to less than half – 800,000. While it is not clear which of these two estimates can be considered more reliable, the large gap between them reveals the uncertainty inherent in attempts to assess the impact of trade on employment.

Moreover, many of the job displacements attributed to trade by recent research may in fact represent job shifts, not job losses[13]. For instance, in recent research on the effects of NAFTA, Scott (2011) attributes a net loss of 400,000 US manufacturing jobs to increased trade with Mexico. However, he also finds that roughly 300,000 of the manufacturing jobs displaced by the pattern of growing trade with Mexico are not net reductions in total US jobs but rather shifts in net jobs from manufacturing to other sectors.

Another issue to consider when assessing the costs of trade liberalization is that some adverse economic outcomes may have been mistakenly attributed to freer trade. In particular, disentangling the role of trade from that of automation in driving the sharp decline in manufacturing employment experienced by many developed economies in recent decades has proved difficult. Aside from the integration of several large developing economies into the world trading system, the last few decades have seen the sustained advance of labour saving technologies in most manufacturing sectors. This raises the possibility that some of the job losses attributed to trade might have in fact been caused by enhanced automation. Indeed, according to a recent study by the Center for Business and Economic Research at Ball State University, 85 per cent of the 5.6 million manufacturing job losses experienced by the US during the interval 2000 to

13 It is important to note that "job shifts" induced by trade are not costless. Research indicates that workers who are displaced by import competition and find work in other sectors tend to experience substantial wage losses. However, it is still true that "job shifts" are substantially less costly than "job losses" (which are associated with long term unemployment). Thus interpreting "job shifts" as "job losses" still leads to an overestimation of the costs of trade liberalization.

2010 are attributable to technological change — largely automation — rather than international trade. By contrast, Autor et al. (2015) find that import competition from China has a greater role than technological change in driving employment losses at the level of US local labour markets.

Furthermore, even in cases in which particular job losses can credibly be linked to import competition, it is difficult to assess the (marginal) effect of trade liberalisation on the employment of import competing sectors. This is because many of the jobs that are displaced by trade would have otherwise been eliminated by automation had trade not "got to them first". The activities eliminated by import competition in rich countries tend to be labour intensive, which makes them uncompetitive given the high wages prevalent in these locations.

However, had trade integration not occurred, these same activities would have also presented the strongest incentives for automation, as the scope for cost reductions involving the replacement of workers with machines would have been greatest. In this context, it makes sense to consider the (marginal) effect of trade liberalisation to be only the bringing forward of the date when some jobs and activities were eliminated from developed economies. Thinking of the effects of trade liberalisation in this way makes it almost impossible to estimate the costs of freer trade in terms of lost employment. However, as the analysis illustrates, there are theoretical reasons to believe that the (marginal) contribution of trade to job losses may be modest.

2.3. MITIGATING THE COSTS OF TRADE LIBERALISATION: THE ROLE OF POLICY

Policy can (and should) also play a role in reducing the costs and augmenting the benefits of trade liberalization for developed countries. However, in recent times, faulty economic policy in many rich countries has often achieved the exact opposite. For example, the "strong dollar" policy that has often been popular with US authorities in the last few decades has rendered many US based activities uncompetitive on international markets, arguably leading to an overshoot of "offshoring" to low wage countries. In other words, instead of cushioning the impact of import competition, US monetary policy has often served to deepen the extent of manufacturing job losses, thus raising the perceived costs of freer trade.

Moreover, many of the short run costs associated with trade liberalisation can be attributed to the existence of barriers to the reallocation of workers across sectors and locations. Workers displaced by trade often experience unemployment spells and earnings losses because finding alternative employment often requires a change in occupation or moving to a different location. In turn, these adjustments carry significant monetary and non-monetary costs. It is important to note, however, that a significant portion of the barriers affecting worker reallocation is in fact policy induced. For instance, in the United States between the 1950s and 2008 the share of employment covered by occupational regulation rose from roughly 5 per cent to nearly a third. Thus, workers displaced by import competition (or any other economic shock) today find almost a third of the labour market inaccessible to them due to these regulatory protections. Similarly, workers looking to relocate in search of work to successful cities and regions often find these locations unaffordable. This is because onerous planning regulations reduce the supply of housing in these prosperous locations and thus artificially raises its cost. An additional problem, particularly severe in parts Europe is the portability of various social benefits, such as housing benefits or social housing provision, that also artificially increase the frictions to spatial mobility.

Reversing these and other policies would go a long way towards reducing the adjustments costs associated with trade liberalization and raising public support for freer trade. But arguably policymakers should be more ambitious than to merely set out to ensure that policy does not aggravate some of the adverse effects of foreign competition. Indeed activist policies can complement trade liberalisation by further enhancing its benefits while cushioning its medium run costs. Such activist policies, including job training programs, relocation subsidies and targeted welfare support will be discussed in greater detail in Section 4.

3

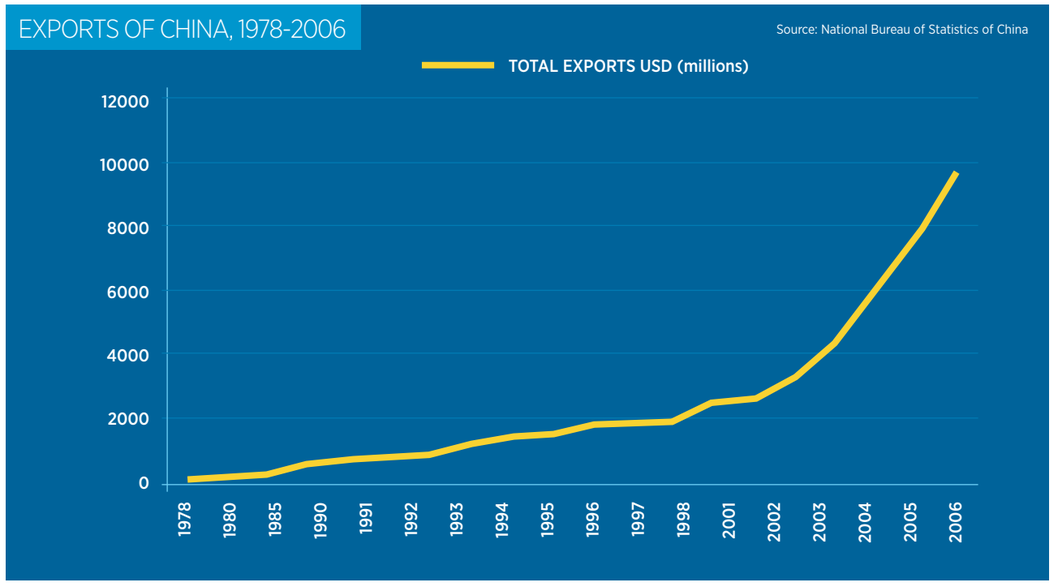
THE (NET) BENEFITS OF TRADE LIBERALISATION DEVELOPING ECONOMIES

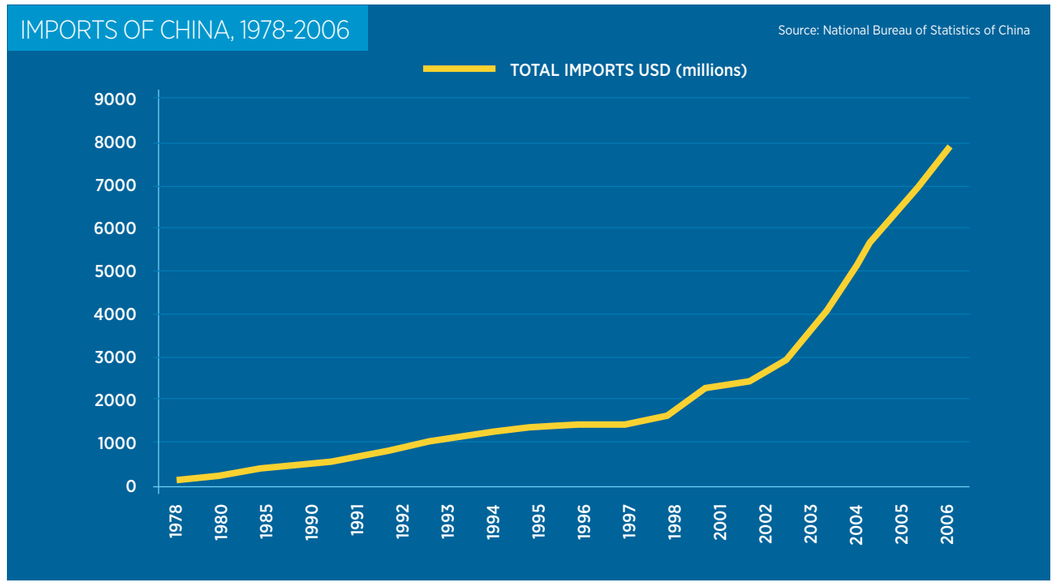
Developing countries have traditionally been sceptical of the benefits of trade liberalization. Until the early 1990s, the dominant school of thought concerning the optimal trade policy of developing countries maintained that in order to grow their economies, these emerging markets needed to protect their "infant industries" from international competition. These types of "import substituting industrialization" policies were widely applied, and even registered some success in a limited number of cases[14].

However, starting from the early 1990s, the changing nature of international trade, which shifted towards more intense trade in intermediates and the development of global value chains, brought about a significant change in the trade policies of many developing nations. Rather than attempting to develop entire vertically integrated sectors behind prohibitive trade barriers, these countries found that it was often easier to make progress by opening up to trade and allowing the sections of global value chains in which they had a comparative advantage locate in their jurisdictions. As a result, most developing economies embarked on a process of rapid trade liberalization starting from the early 1990s. In this section I argue that this development should be celebrated and further encouraged, as developing countries have even more to gain from further trade liberalisation than rich nations.[15]

14 Most notably the case of South Korea.

15 This background discussion on the evolution of the trade policy of developing nations draws on material from Richard Baldwin's recent book, "The Great Convergence".





3.1. THE GAINS FROM TRADE LIBERALISATION: THE CASE OF CHINA

Perhaps the most natural place to start a discussion highlighting the benefits of trade liberalisation for developing countries is to invoke the case of China. Its rapid integration into the world economy in the last few decades brought about one of the most remarkable economic transformations in history. As it opened up to foreign goods, capital and technology, and secured improved market access to major trading partners, China rapidly joined global value chains triggering one of the most rapid and most prolonged episodes of export-led economic growth. As a result, the face of the country has been comprehensively transformed: a formerly agricultural nation is now widely considered "the workshop of the world"; millions have been drawn from villages into China's bustling cities, particularly on its coasts, and most importantly, hundreds of millions of its citizens were lifted out of poverty.

The role of the relatively liberal global trading regime of the last few decades in fostering China's recent economic success is arguably insufficiently understood and appreciated. Indeed, the willingness of major developed economies such as the US to grant improved market access to Chinese exporters was highly consequential in driving Chinese growth, and potentially of equal import to the liberalising measures undertaken by China itself. This can perhaps most easily be seen by noting the significant improvements in the trading and overall economic performance of China around the time of its accession to the WTO in 2001.

It is precisely the episode of China's accession into the WTO that has been the focus of much of my own recent research. Alongside my co-author Wenya Cheng[16], we study how this significant trade liberalisation affected local economies and local labour markets in China. I present a summary of the findings of this research here, with a more extended and technical exposition provided in the appendix of this document. We begin our analysis by arguing that China's entry into the WTO significantly improved China's access to major foreign markets, particularly the US. This improvement in Chinese market access to the US resulted primarily from China being switched to a more favourable trading regime by US authorities as a consequence of being a WTO member. In turn this significant improvement in market access affected different locations (defined as cities) within China differently. This was because some sectors experienced more significant improvements in foreign market access than others, and because local economies varied markedly in terms of their sectoral specialisation.

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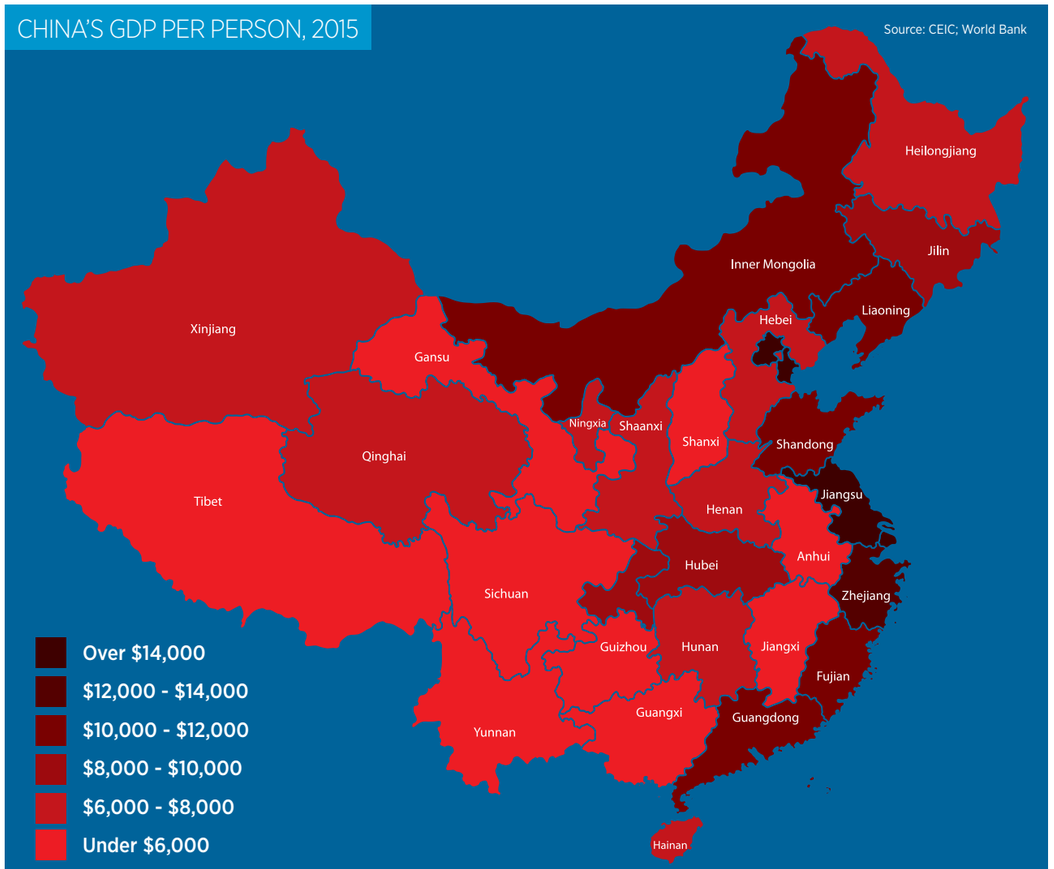
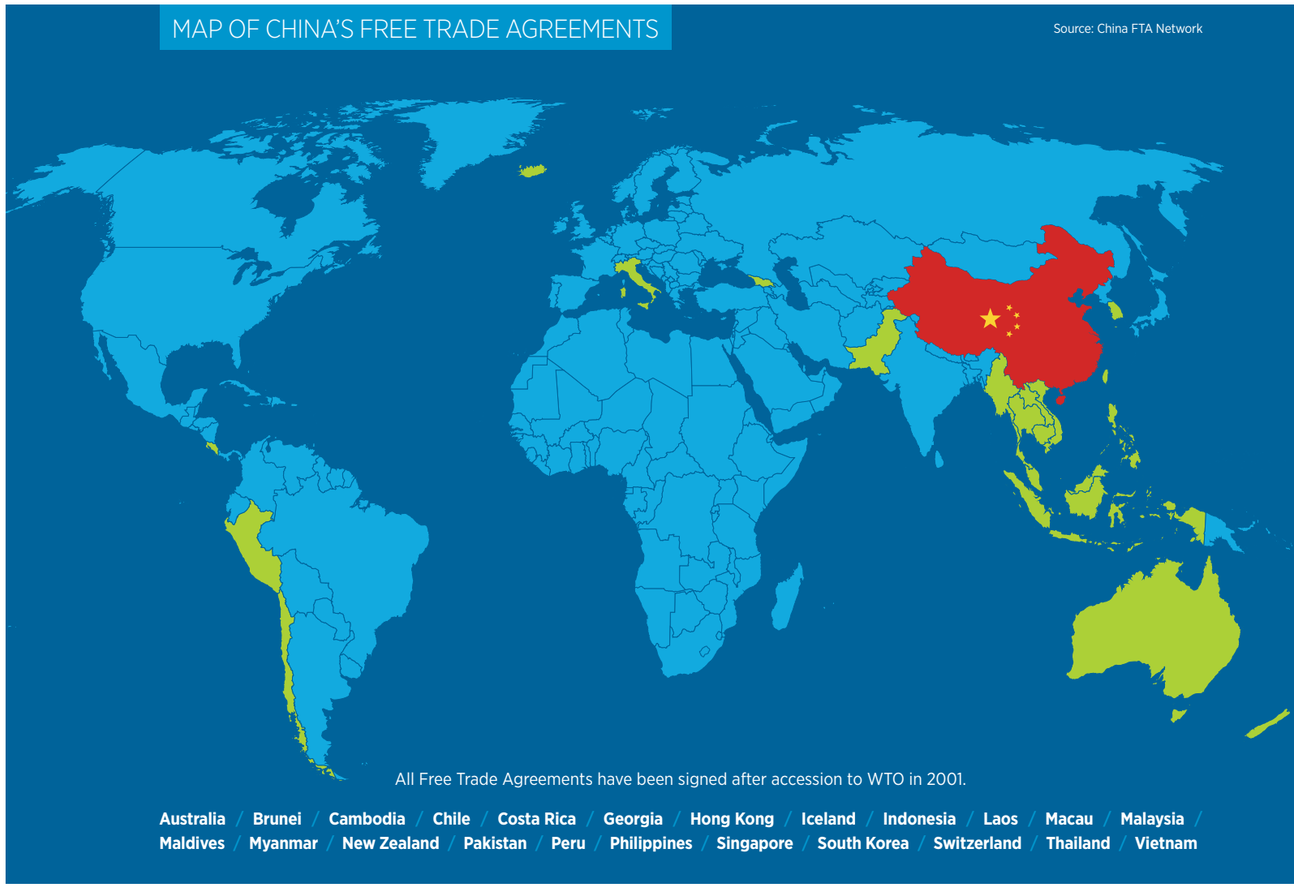
We proceed to relate the extent to which each major urban area in China was exposed to foreign market access improvements as a result of WTO accession with their subsequent economic performance after 2001 (the accession year). We find that cities that were subject to larger improvements in their international trading environment experienced much faster growth in population, employment and output following China's WTO accession. This growth seems to have been partially driven by a surge in investment, which flowed, both from domestic and overseas investors, preponderantly towards the areas with the most improved trading conditions. Moreover, the effect of trade liberalisation does not seem to be limited only to the directly affected sectors (i.e. the sectors experiencing substantial improvements in foreign market access following China's WTO accession) but spill over to other tradable and nontrable activities. Among tradable sectors, spillovers operate primarily via labour and input-output channels, whereas demand channels mediate the spillovers from tradable to nontradable activities. Indeed, these indirect effects of trade liberalisation transmitted via spillovers are often of a larger magnitude than the direct effects on the most exposed sectors.

There are perhaps two key lessons that emerge from our research. First, the gains from trade liberalisation for developing countries can be very large. This is because the direct benefits of liberalisation are amplified by complementary inflows of FDI, intersectoral links within the tradable sector as well as spillovers from the tradable sector to the nontradable sector. Second, the adjustment costs to trade liberalisation may often be lower in developing nations, which can explain the greater support for freer trade in these countries relative to the developed world. Developing countries tend to have a comparative advantage in labour intensive sectors which often means that trade liberalisation has strong job-creation effects. Moreover, at least in the case of China, worker reallocation across sectors and locations in the aftermath of trade liberalisation seems to have been rapid and caused little disruption. This may be because the lower skilled jobs that are prevalent in China are less differentiated, making re-training and adjustment easier.

It is important to note that our findings are still likely to understate the benefits to China of the trade reforms associated with its WTO accession. To begin with, we mostly focus only on the benefits created by one specific change in US trade policy, and largely ignore the consequences of China's own liberalisation measures. These are likely to have brought substantial additional benefits, with a recent study by Amiti et al. (2017) suggesting that the improved availability of cheaper intermediate inputs (due to the reduction of Chinese import tariffs) may have been even more consequential than the US trade liberalisation we study in driving China's recent impressive economic performance.

Moreover, our research focuses on the production side of the economy and ignores the benefits of





freer trade on the consumer side. As with their rich nation counterparts, Chinese consumers benefitted from lower prices and improved consumer choice as a result of trade liberalisation (in particular due to the reduction of Chinese import barriers as part of the WTO accession negotiations), and also stood to benefit indirectly from China's integration into global supply chains, which raised the productivity of Chinese firms and the quality of their products. Finally, our research also omits the more indirect social and political benefits brought about by freer trade. For instance, the advance of urbanization partially caused by trade liberalisation is likely to have brought about additional benefits associated with city living: increased productivity (due to agglomeration), human capital accumulation, social modernisation etc. Moreover, the integration of China in the world economy gave its trading partners a stake in its development and gave it a stake in the existing economic and institutional order. This should in principle facilitate cooperation on a broad range of issues related to global governance.

3.2. THE GAINS FROM TRADE LIBERALISATION: OTHER DEVELOPING NATIONS

Focussing our discussion of the gains from trade for developing countries on China, arguably the most salient story of export led economic success, may lead the reader to suspect that the example was cherry-picked to produce the most positive assessment of the benefits of trade liberalization. While it is indeed the case that China has been particularly adept at leveraging the opportunities provided by freer trade in the last few decades, the bulk of the evidence indicates that most developing nations have benefitted from the trend towards trade liberalisation that started in the early 1990s.

In fact, developing nations can be broadly classified in two groups according to the way in which freer trade has benefitted them. A first set of countries has broadly followed the path of China and integrated into global manufacturing supply chains by securing improved access to foreign markets and lowering their own barriers to trade[17]. The most notable examples in this group of countries include (aside from China) Korea, India, Indonesia and Thailand. Also in this group we could include Eastern European countries that have secured EU membership in the last decade and have subsequently integrated in Europe-wide value chains (perhaps the most notable success story among this set of countries is Poland, which has achieved a high level of integration with the highly sophisticated German economy). A second group of countries benefitted more indirectly from the "commodity super-cycle" by the rapid industrialisation of the first group. The most notable members of this group include Brazil, Nigeria, Mexico and Venezuela[18].

All in all, while the gains from trade liberalisation have arguably been very uneven across developing countries (with the benefits for the second group arguably more precarious and short lived), the overall picture of the effects of the recent trend towards freer trade on developing economies is a compellingly positive one. This is perhaps most easily illustrated by the fact that this period of global trade liberalisation has coincided with a "Great Convergence" in living standards between large sections of the developing world and industrialised countries.

3.3. TWO CAUTIONARY NOTES

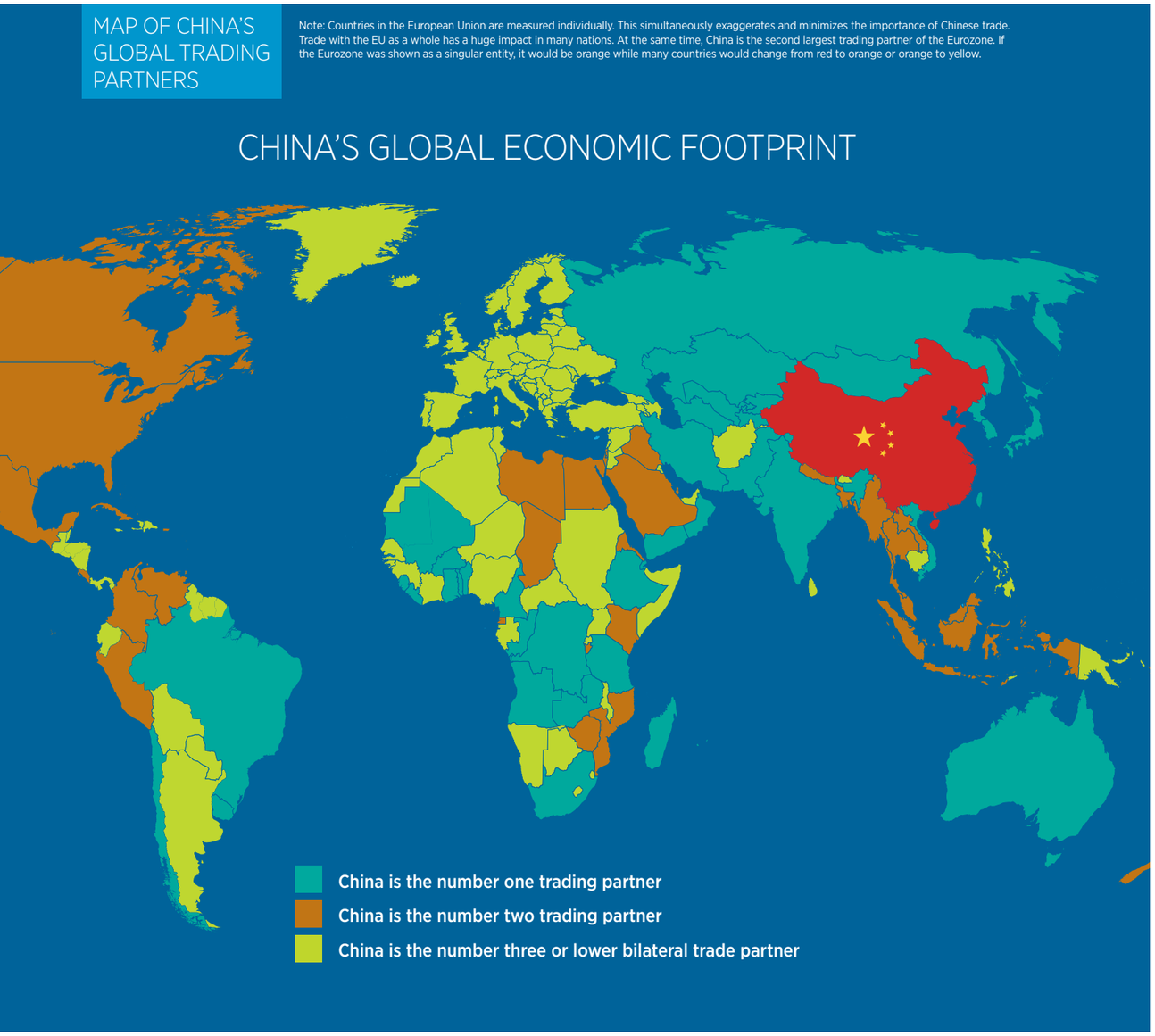
The encouraging picture of the effects of trade liberalisation for developing nations depicted in the previous section should not detract from the fact that freer trade is also likely to generate losers in these countries, at least in the short run. The adjustments

17 Richard Baldwin argues compellingly in his recent book, "The Great Convergence", that improving communication technologies also played an important role in integrating developing countries in global supply chains, and thus in accounting for the convergence in economic performance between rich and poor countries observed recently.

18 Australia is also an important member of this group of countries to benefit from the "commodity supercycle", but is not a developing country.

MAP OF CHINA'S GLOBAL TRADING PARTNERS

Note: Countries in the European Union are measured individually. This simultaneously exaggerates and minimizes the importance of Chinese trade. Trade with the EU as a whole has a huge impact in many nations. At the same time, China is the second largest trading partner of the Eurozone. If the Eurozone was shown as a singular entity, it would be orange while many countries would change from red to orange or orange to yellow.



costs to opening up to foreign competition may be lower than in rich countries, but they are likely to remain significant. In this context, as for developed countries, the role of complementary policy interventions that serve to cushion the short run costs and amplify the longer run benefits of trade liberalisation is crucial. Some of these policies will be discussed in greater detail in the next section.

Another frequent pitfall in discussions surrounding trade liberalisation in developing countries is the tendency in some quarters to over-hype its benefits, particularly in the short to medium run. In turn, when these benefits are slow to materialise or smaller in magnitude than promised, the credibility of pro-trade voices is called into question. While freer trade and the integration into global value chains can produce substantial benefits for developing nations, they do not represent a silver bullet. If unaccompanied by additional (and complementary) pro-development policies such as encouraging the acquisition of skills and the adoption of new technologies, providing secure property rights, reducing burdensome regulation or corruption, the effects of freer trade alone on the economic performance of these countries is likely to be modest.

4

TACKLING THE POLITICAL ECONOMY OF TRADE LIBERALISATION

Our discussion so far has revealed that while trade liberalisation has the potential to bring about substantial economic benefits to developed and developing nations alike, it often carries short run costs that make it unpopular with electorates, particularly in rich countries. In this context, an important question for supporters of freer trade to answer is how to secure the consent of sceptical electorates for continued trade liberalisation such that the potential gains from trade are realized.

In this section I argue that the key to alleviating public concerns about the effects of trade liberalisation is to promote policies that mitigate the short run distributional and adjustment costs entailed by freer trade. Moreover, I suggest that depending on the particular sectors and circumstances involved, a combination of the following three policy "instruments" should be used to put forward liberalisation programmes that are palatable to the public:

01. **gradualism** – trade liberalisation programmes should be implemented gradually to allow sufficient time for the reallocation of resources (particularly workers) in the economy to occur, with minimum disruption;

02. **complementary macroeconomic and microeconomic policies** that reduce the barriers to intersectoral and geographic mobility should be implemented, and any policies that raise artificially such barriers should be eliminated;

03. **public employment, risk sharing and welfare policies** should be implemented to ensure a wider distribution of the gains from trade across broad segments of society.

Given that all these policies also carry costs, the objective of the policy mix should be to secure public consent for continued trade liberalisation while minimizing policy induced distortions to individuals' decision to work, save and invest.

To these policy recommendations I also add two suggestions regarding the approach proponents of freer trade may want to take when communicating about liberalisation with the wider public. The first is to prioritise educating the public about the often misunderstood and over-politicised issue of trade deficits. The second and perhaps more important one is to show greater willingness to discuss openly and honestly the sacrifices in terms of policy and regulatory discretion (and arguably sovereignty) that are required to pursue the "deep" trade liberalisations of the future. This may or may not secure greater support for freer trade, but should prevent the wild swings in public support for trade liberalisation observed in recent years.

In what follows I develop the logic behind the policy proposals mentioned above, and where appropriate I illustrate their applicability with the example of the recent controversy in the UK surrounding the protection of the domestic steel industry (and in particular the iconic plant at Port Talbot) in the face of intense Chinese competition. I use the example of the UK as this country is likely to soon engage in a significant reconfiguration of its international trade arrangements. However, the main lessons and policy recommendations outlined here applicable more widely, including in Europe and the US.

4.1. MANAGING THE SHORT RUN COSTS OF LIBERALISATION: GRADUALISM

Given that much of the short run costs of trade liberalisation are due to the sluggishness with which workers reallocate across sectors, one straightforward policy response would be to seek trade agreements

in which liberalisation measures are phased in slowly (over say a period of 5 years or more). Alternatively, effective protection can be maintained via targeted subsidies.

These measures could in principle allow workers in uncompetitive sectors more time to re-train and seek alternative employment, thus cushioning any short-run adverse effects and lowering political opposition to freer trade. For instance, in the case of UK steel, Britain could sign trade agreements in which import tariffs for steel are gradually reduced from a relatively high rate over a period of time.

Gradualism is of course not costless, as it entails foregoing some of the gains from trade for a period of time. Its desirability therefore depends on a number of factors: the position of the protected sector in input-output relationships, its geographic location(s) and whether the conditions making the sector uncompetitive are likely to be temporary or permanent. Thus, holding other things equal, protection is more costly for sectors that provide inputs for many other activities in the economy (as it raises the cost of these activities), more beneficial when applied to sectors that are concentrated in less developed areas with little alternative employment (adjustment costs are likely to be high in this case), and easier to justify in situations in which the sectors are uncompetitive due to temporary circumstances.

Applying this type of analysis to the case of the UK steel sector reveals the complications involved in devising trade policies that preserve most of the gains from trade while limiting short-run disruption. On the one hand, protecting steel from foreign competition is likely to prove costly as it is an input in the production of many other products. On the other hand, the steel sector is concentrated in relatively poor parts of the UK where alternative employment is limited, while some of the conditions making the sector uncompetitive, such as competition from heavily subsidised Chinese steel are likely to be temporary. In this context, a short period of tariff protection followed by a period of state support via subsidies may be warranted. Crucially, the period of tariff protection needs to be kept short to ensure the competitiveness of downstream sectors, which are more important to the UK economy in terms of both employment and value added.

4.2. MANAGING THE SHORT RUN COSTS OF LIBERALISATION: COMPLEMENTARY POLICIES

Aside from allowing enough time for the necessary adjustments to take place, the policy mix accompanying trade liberalisation needs to take active steps to lower the cost (and increase the speed) of these adjustments. Policymakers have two broad classes of instruments at their disposal to achieve this goal: macroeconomic tools and microeconomic interventions.

Focussing on macroeconomic policy first, it is advisable that the completion of major trade agreements is accompanied by a period of expansionary fiscal and monetary policies. These policies should aim to keep labour markets strong and unemployment low, such that the workers displaced by trade liberalisation have the best possible prospects to find alternative employment.

Targeted microeconomic interventions are also likely to be an important part of the optimal policy mix. Such interventions should promote the reallocation of workers most likely to be negatively affected by freer trade and should include re-training programs and re-location support. For instance, in the case of the UK steel industry, to complement the measures discussed in the previous section, the government should consider running large retraining programs in the regions most affected by the decline of the steel sector, as well as offer subsidies to encourage workers to re-locate to more prosperous parts of the country. Needless to say, any policies that artificially raise the costs of necessary adjustments, such as onerous occupational licensing rules or restrictive planning policies in prosperous regions should be revised or eliminated.

4.3. MANAGING THE SHORT RUN COSTS OF LIBERALISATION: RISK SHARING, PUBLIC EMPLOYMENT AND WELFARE TRANSFERS

Sometimes ensuring the gradual implementation of trade liberalisation and taking policy action to assist the required adjustments will not be sufficient to gain wide-spread public support for freer trade. In these situations additional measures may be required to reassure the public that the gains from trade will be widely shared.

Perhaps the first among these is ensuring adequate risk sharing among local communities within each country. It is crucial that (central) governments do not allow the quality of public services (in particular education and healthcare) in areas most adversely affected by foreign competition to deteriorate. This is a particularly important point to keep in mind given the recent drive towards greater decentralisation in many countries. While decentralisation does indeed bring many benefits, if vital public services are funded solely from local revenue with little risk sharing across communities, this can lead funding gaps and inadequate provision in areas experiencing adverse impacts from trade liberalisation.

Moreover, unlike the effects of import competition which are likely to be short-lived, substandard schooling for instance can have long run detrimental effects. The best way to guard against these effects (and the opposition to trade they are likely to trigger), is for central governments to provide funding top-ups to local authorities particularly adversely affected by foreign competition[19].

A second set of additional measures to cushion the short run costs of trade liberalisation involve the expansion of public employment or other forms of public procurement. While this of course raises the risk of wasteful projects, given the inadequate provision of infrastructure, education, health and social care in many developed countries, there should be enough scope for an expansion of public services that adds real value to citizens. Such an expansion in public services would serve to absorb some of the workers displaced by import competition and other adverse economic shocks.

Lastly, governments should also consider a limited expansion of social insurance and welfare transfer programmes. While these programmes are likely to be the costliest and provide the smallest benefits[20] among the ones discussed in this section, it is nevertheless the case that they can play a role in mitigating the effects trade induced job displacement for those least able to adjust to the new economic

19 Note that the same logic applies to other economic shocks, such as technological displacement.

20 The benefits are likely to be limited even for recipients, as the welfare effects of social transfers are likely to be smaller than those of employment.

conditions. Moreover, at least anecdotal evidence indicates that opposition to freer trade is strongest in the countries with the most limited welfare transfer programmes, which would seem to indicate that these programmes can play an important role in securing public consent for freer trade. It is important thus to note that these type of welfare programme expansions are likely to be more appropriate in countries where welfare support is modest (such as the US) and less likely to be useful in locations where welfare provision may already be excessive or mis-targeted (arguably the case in a number of European countries).

4.4. IMPROVING COMMUNICATION: TRADE DEFICITS AND SOVEREIGNTY

Aside from shifting some of their policy positions to reflect recent research and placate some of the concerns of the general public, proponents of freer trade also need to improve their communication strategies. In particular, two changes in communication approach could prove particularly useful in improving the quality of debate around trade liberalisation: a strong focus of proponents of freer trade to dispelling some of the myths surrounding the notion of trade deficits; and an increased availability on their part to talk openly and honestly about the costs in terms of sovereignty of modern, "deep" trade agreements.

Trade deficits are undoubtedly one of the most misunderstood concepts in international economics. Many people (including the incumbent US president) see the trade balance as a way of "keeping score" regarding a country's international trade activities, and trade deficits as an indication that the country is "losing", or being taken advantage of by its trading partners. However, this logic is misguided. Trade deficits are merely the counterpart of borrowing from abroad, and tend to emerge in countries characterised by low domestic saving rates. It is not at all clear, however, that the ability to borrow resources from other countries with excess savings is detrimental to a nation's welfare. Admittedly, holding everything else equal, larger trade deficits may be associated with larger short run adjustment costs to trade liberalisation. But the solution to this problem (and to lowering trade deficits should this be considered desirable) is not to impede trade but to enact macroeconomic policies that encourage domestic savings and reduce reliance on borrowing from abroad. Clarifying these points should remove an important source of public scepticism to trade liberalisation.

Another misunderstanding that proponents of freer trade need to fight against concerns the nature of remaining trade costs and the nature of modern trade agreements. We now live in a world in which remaining tariffs and quotas are no longer the worst barriers to international trade. Instead, non-tariff barriers are currently the biggest impediment to international trade, and any meaningful future trade liberalisation will have to find ways to significantly lower them. The problem, however, is that many of these barriers emerge from differences in rules and regulations across jurisdictions, such that goods need to be subjected to costly inspections to assess their suitability to be sold in each particular market. As a result, lowering these non-tariff barriers involves seeking greater homogeneity in rules and regulations across countries, which in turn implies lowering the policymaking discretion of each jurisdiction. This gives rise to an important trade-off between national sovereignty and further trade liberalisation (or market integration), which should be recognised fully by the proponents of freer trade[21]. This issue has particularly come to the fore in the EU, where the very deep integration of the economies of member states, alongside a rapid pace of regulatory harmonisation and an expanding role for EU institutions, has led to disquiet in some quarters about loss of national sovereignty. Similar issues have also emerged during the process of negotiating so called deep trade agreements, such as TTIP, TPP or CETA. Discussing this issue openly may or may not increase public support for freer trade, but it should ensure that whatever support is ultimately won is on sounder footing and thus reduce the chance of costly trade liberalisation reversals in the future.

21 Perhaps the most compelling characterisation of the trade-off between sovereignty and deep trade integration is offered by Dani Rodrik, in his description of the "Political Trilemma of the Global Economy".

5

CONCLUSION

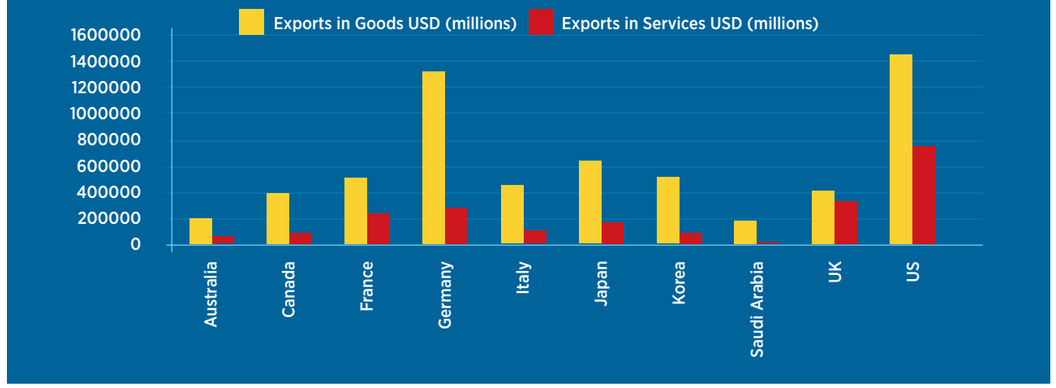
This paper aims to re-balance the current academic and public debate about the impact of trade liberalisation. While recent research has conclusively shown that trade liberalisation can bring about adjustment and distributional costs in the short run, it remains the case that the longer run benefits of freer trade are substantial for developed and developing economies alike. There is, therefore, a strong case for the current (relatively) liberal international trade regime not only to continue, but to be extended and augmented by further liberalisation.

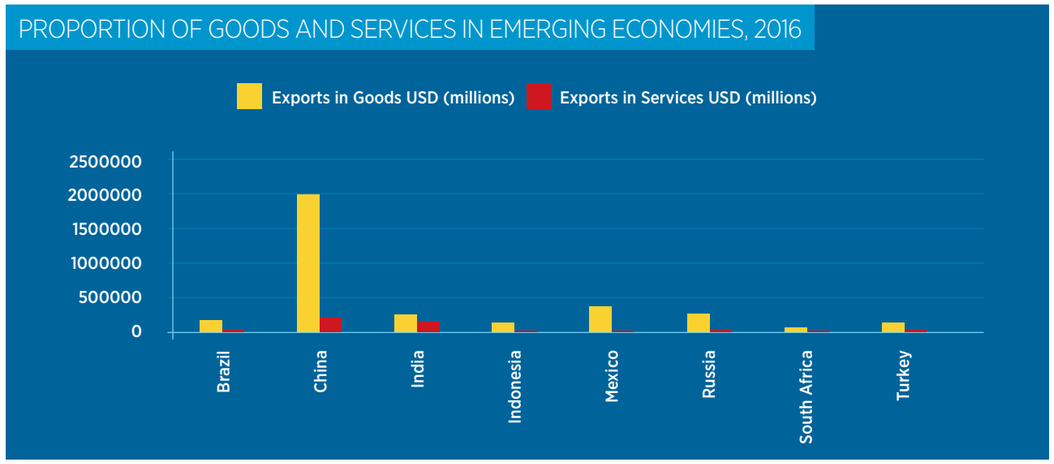
However, the findings of recent research which identifies difficulties in the short-run adjustment to trade liberalisation should not simply be ignored, and proponents of freer trade need to adjust their policy positions if they want to see the significant potential gains of freer trade realised. In particular, I argue that they need to embrace gradualism and the activist use of complementary policies that can cushion the short run adverse effects of trade liberalisation for some groups. These policies are likely to not only enhance the overall gains from any trade liberalisation but also make liberalisation more likely by addressing some of the voting public's concerns about freer trade.

Supporters of freer trade should also change the way they communicate about trade liberalisation. I emphasize two shifts in communication strategy that are likely to be particularly beneficial for the quality of the public debate around the issue of trade: a focus on dispelling some of the most misleading myths about freer trade, particularly surrounding the issue of trade deficits; and a willingness to openly discuss and debate the trade-off between national sovereignty and trade integration that is likely to become more visible in the future, as countries begin to contemplate modern "deep" trade agreements.

I would like to conclude by outlining some of the key lessons of this piece that I consider to be relevant for future trade policy debates in the European Union. While the EU is currently the world's most deeply integrated trading bloc and also the largest actor in world trade, there are several aspects of its trade policy environment in which very substantial scope for improvement remains. This is true both in the area of intra-EU trade (i.e. trade among EU member states) and (perhaps even more so) in the area of the bloc's economic relationships with the rest of the world. Addressing some of these shortcomings would serve not only to enhance the continent's economic

PROPORTION OF GOODS AND SERVICES IN DEVELOPED ECONOMIES, 2016





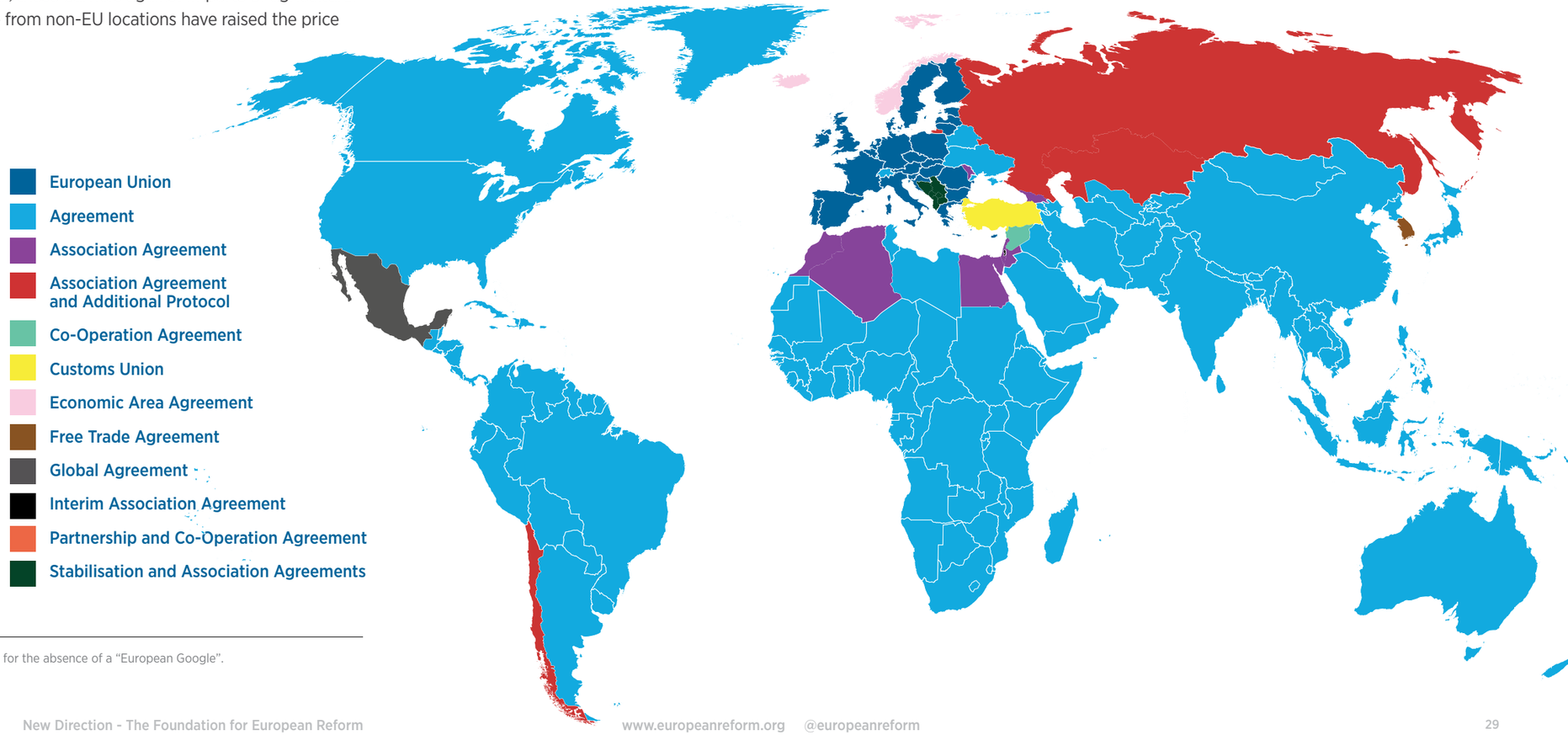
performance, but would also advance some of its other goals, such as tackling the migration crisis and promoting peace and prosperity in its immediate geographic neighbourhood.

Perhaps the biggest missed opportunity of the EU's current trading arrangements is that its otherwise impressive single market remains incomplete. In particular, it does not adequately cover significant areas of the services sector and the digital economy. This state of affairs is problematic for at least three reasons. First, as an increasing share of modern economies is represented by services, more and more valuable trading opportunities are likely to remain unrealised under the current arrangements, at significant cost to both European producers and consumers of services. Second, many of the fastest growing activities in advanced economies are service sector or digital economy activities subject to increasing returns to scale. As a result, the current fragmentation of the European market for services is likely to hamper productivity growth in these sectors and the wider economy, as increasing returns to scale remain unrealised and major product innovations take place elsewhere[22]. Third, the failure to complete the European market for services has led and is likely to continue to lead to tensions among EU member states. This is because countries that have a comparative advantage in these activities may feel like they benefit substantially less from the single market than other member states more involved in sectors well covered by the rules of the internal market.

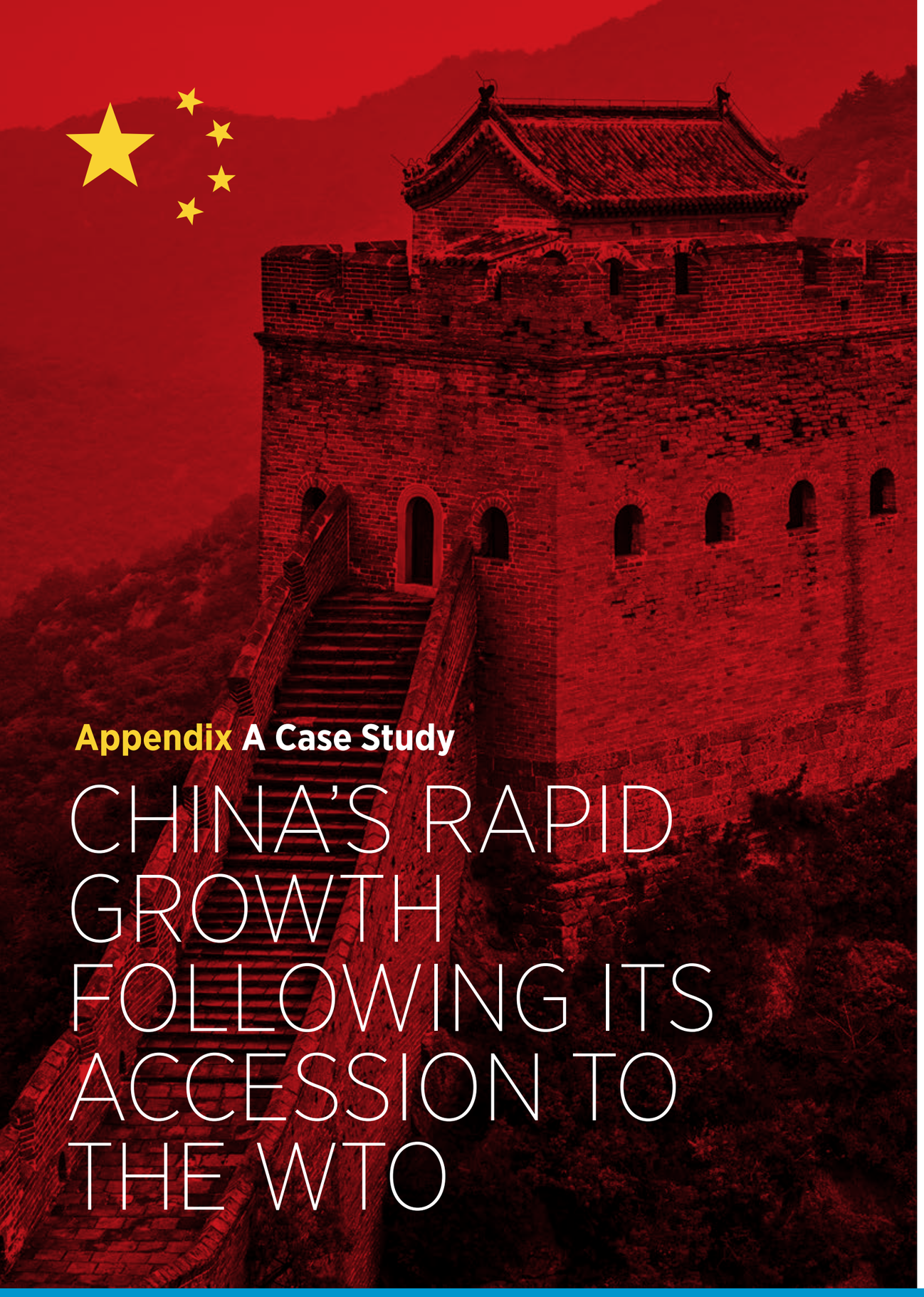
The second major shortcoming of the EU's current trading arrangements pertains to its relationship to the rest of the world. While operating a highly integrated internal market, the EU has often been known to be markedly protectionist relative to third countries, particularly when it comes to the agricultural sector. This stance has proved very costly, not only to cost-effective farmers in a host of developed and developing nations, but also to EU citizens themselves. In particular, these barriers against imports of agricultural produce from non-EU locations have raised the price of food faced by EU consumers, hurting vulnerable households the most. In this context, the gradual elimination of these restrictions is justified not only on efficiency but also on equity grounds. As suggested in section 4, the optimal politically implementable policy on an issue such as this is likely to involve the gradual elimination of trade barriers coupled with policy interventions aimed at helping European farmers and rural communities to adapt to the new trading conditions (i.e. subsiding farmers to undertake environmental protection and conservation activities, retraining programmes etc.).

Furthermore, aside from benefitting European consumers, opening the continent's markets, particularly to neighbouring developing nations, can help advance some of the EU's other goals. In particular, a heavier emphasis on the trade component of the "trade and aid" approach of contributing to the growth of developing countries, is likely to prove more effective in lifting living standards in these nations. As a result of increased economic prosperity and the political stability that it often brings, this may result in reduced immigrant and refugee flows to Europe and thus alleviate some of the political convulsions that they have caused. Moreover, increased trade flows may serve to enhance the goodwill and influence that the EU enjoys around the world. This may be particularly useful for the case countries such as Russia, where the cycle of rapidly deteriorating economic and political relations should be broken as soon as possible.

Last but not least, aside from addressing these long-standing shortcomings of the continent's trading arrangements, EU policymakers will also need to face the challenge of redefining the bloc's relationship with the United Kingdom, in light of the latter's decision to leave the EU. While the political and legal complexities of this episode are significant, any economic analysis needs to recognise that the UK is a large and sophisticated economy that plays a substantial role in continental value chains. In this context, from the perspective of the EU, the optimal parameters of any (politically implementable) new relationship with the UK are likely to involve maximising mutual market access conditional on preserving the integrity of the European single market.



22 In fact, the fragmentation of European markets is likely to be one of the major explanations for the absence of a "European Google".



Appendix A Case Study

CHINA'S RAPID GROWTH FOLLOWING ITS ACCESSION TO THE WTO

In this section I aim to illustrate the benefits of freer trade for developing economies with a case study, that of China. In particular, I focus attention on the episode of China's admission into the World Trade Organization (WTO) in 2001, which has been widely analysed in the economics literature and is considered one of the most consequential trade liberalizations in the last few decades. I build my discussion around this episode for two main reasons:

01. China is perhaps the prime example of rapid export-led growth, and understanding the role of trade liberalisation in this story of Chinese economic success if of first order importance; and

02. analysing the impact of WTO membership from the perspective of China serves to rebalance the treatment of this topic in the literature, which has focused disproportionately on the adverse impact of Chinese import competition on developed nations.

China's entry into the WTO in 2001 was the result of a complex negotiation process started in the mid 1980s. As part of this process China implemented a set of significant policy changes including a reduction of import tariffs, a relaxation of export licensing rules and a reduction in barriers to foreign investment. Interestingly though, China's accession to the WTO did not bring about a significant reduction in tariffs faced by Chinese exporters, as these were already low even before 2001. In this context, a casual analyst may conclude that WTO membership only brought a modest improvement in foreign market access for Chinese exporters.

However, such a conclusion would be misguided. While it did not bring tariff reductions by major trading partners, China's entry into the WTO triggered a significant reduction in uncertainty concerning the future tariff policy of a major export market for Chinese firms: the United States. Before 2001, Chinese exporters already benefited from low, Most Favoured Nation (MFN) tariff levels when accessing the US market. However, their continued access to these favourable tariffs critically depended on China's MFN status being renewed every year by the US Congress. In the eventuality of China's MFN status not being renewed, Chinese firms would have faced much less favourable tariff schedule represented by the so called Smoot-Hawley tariffs. This represented a significant source of uncertainty for firms looking to access the US market. After 2001, as a result of its newly acquired WTO membership, the US grants China permanent MFN status. This removes any uncertainty regarding US tariff policy relative to China, guaranteeing Chinese exporters permanent access to the favourable MFN tariff schedule. In effect, the award of permanent MFN status was equivalent to a substantial trade liberalisation on the part of the US, resulting in significantly improved access to US markets for Chinese exporters.[23]

It is this shift in US trade policy triggered by China's WTO accession that Wenya Cheng and I exploit in recent research that aims to assess the role of improved foreign market access in driving growth in China. We combine the fact that the reduction in US tariff uncertainty varied widely across different product categories[24], with the fact that different Chinese cities specialized in different sectors, to construct a city-level measure of exposure to US trade liberalization[25]. We then relate this measure of exposure to US trade liberalisation to the economic performance of Chinese cities in the period following China's WTO accession.

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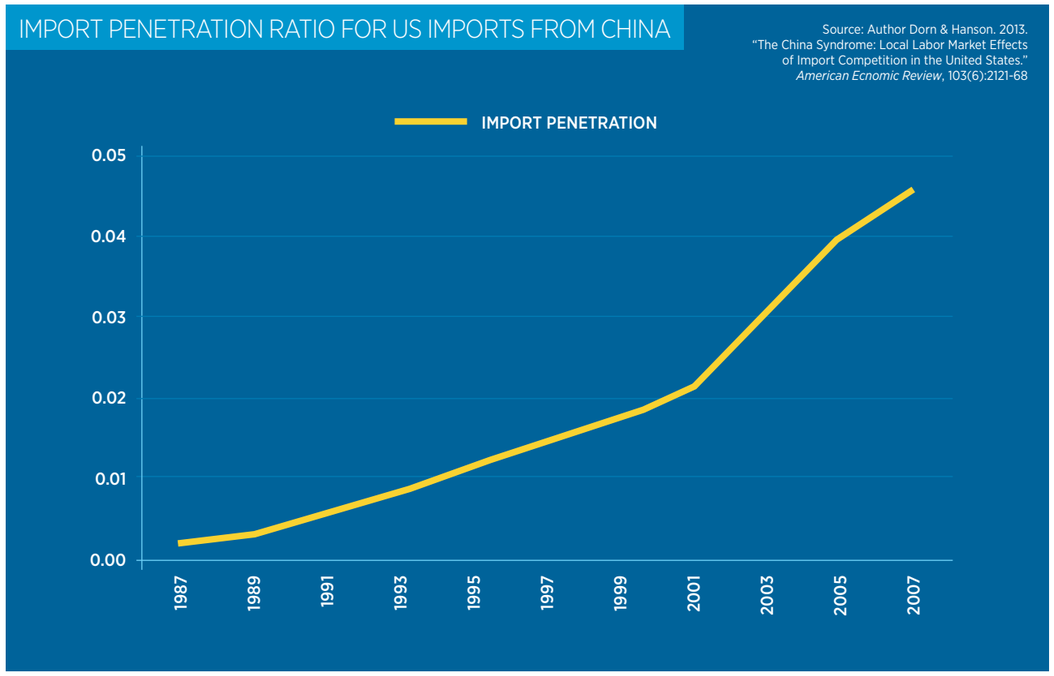
23 The importance of this change in US trade policy triggered by China's accession to the WTO was first pointed out by Pierce and Schott (2016) and Handley and Limao (2017).

24 Some of the sectors most affected by US tariff uncertainty were made-up textiles (which risked a tariff increase of 58.8 per cent if MFN status was lost), games and toys (risked a tariff increase of 58.4 per cent), other textiles (risked a tariff increase of 57.7 per cent), knitted and crocheted fabric and articles (risked a tariff increase of 56.1 per cent), furniture (risked a tariff increase of 41.7 per cent), and luggage and hand bags (risked a tariff increase of 37.5 per cent). At the opposite extreme were malt liquors and malt (risked tariff increase 5.3 per cent) and prepared animal feed (risked tariff increase 12 per cent). As predicted by theory, the sectors which faced higher tariff threats grew faster after the removal of the threat. For instance, furniture employment grew by 129 per cent while luggage & handbag employment by 104 per cent during our period of analysis. By contrast malt liquors and malt employment actually contracted, while animal feed employment expanded by a much more modest 27 per cent.

25 We define US tariff policy uncertainty at the product level as the difference between the (typically high) non- MFN tariffs that would have applied to each product had China's MFN status not been renewed and the (typically low) MFN tariffs that are granted by the US to WTO members. We then perform a two-step aggregation procedure. We first compute sector level tariff uncertainty by taking the average over all the products pertaining to each sector. Second, we compute US tariff policy uncertainty at the city level as the weighted average of the US tariff policy uncertainty of each sector of the city, with the weights represented by local employment shares. This city level exposure to US tariff policy uncertainty exhibits wide variation: Quanzhou and Xiamen in Fujian province were subject to tariff threats of 17.5 per cent and 16.3 per cent respectively, while locations such as Shuangyashan and Daqing in Heilongjiang province were barely affected by US tariff policy uncertainty (tariff threats of 1.3 per cent and 1.4 per cent respectively).



Our findings are unsurprising on some level and surprising on another. As expected we find that greater exposure US trade liberalisation is associated with improved economic performance: cities that stood to benefit more from the reduction in US tariff policy uncertainty grew faster in terms of population, employment and output after 2001. More surprising was the very large magnitude of the effects we find. For instance cities such as Xiamen in Fujian province and Shaoguan in Guangdong province had experienced elevated levels of US tariff policy uncertainty (risked tariff increases of 16.3 per cent and 15 per cent respectively) and grew rapidly after China's WTO accession (employment growth of 51.9 per cent for Xiamen and 65.7 per cent for Shaoguan in the period 2001 to 2007). By contrast cities like Shuangyashan and Daqing in Heilongjiang province had experienced much less US trade policy uncertainty (risked tariff increases of 1.3 per cent and 1.4 per cent respectively) and grew much more modestly after 2001 (employment growth rates over the period 2001 to 2007 of 0.05 per cent and 0.3 per cent respectively). More generally, each per centage point reduction in US tariff uncertainty facing a city's output was associated with 1.6 per cent more rapid population growth, 1.7 per cent faster output growth and more than 3 per cent faster employment growth at the city level over the period 1998 to 2007. Taken at face value, our results indicate that this one US trade policy reform was responsible for about half of the population growth and about three quarters of the manufacturing employment growth experienced by the average Chinese city during our period of analysis (1998 to 2007).

We further investigate the mechanism through which US trade liberalisation benefits Chinese local economies. We find that cities more exposed to US trade liberalisation experienced rapid growth in exports and investment after 2001. Moreover, we find that a substantial portion of the rise in investment in these locations is driven by foreign direct investment (FDI). The evidence is thus consistent with multinationals operating in the sectors previously held back by US market access uncertainty investing to integrate China in their global value chains, and as a result improving the economic conditions in the locations that house these sectors.

US trade liberalisation also brought about significant structural transformation of Chinese local economies: manufacturing and services experienced rapid growth in the cities most exposed to US trade liberalization, while agriculture experienced relative decline. The growth of local services following trade liberalisation is particularly interesting to note, as it presents us with evidence of strong links between the local tradable and nontradable sectors. Given the non-tradability of most services the most straightforward interpretation of our findings is that as manufacturing grows in the cities most exposed to trade liberalisation and draws in workers from surrounding area, local spending increases and provides an indirect boost to all local activities, tradable or nontradable.

Intrigued by the magnitude of our headline findings (and by the results on the nontradable sector discussed above), we proceed to a more detailed analysis of local intersectoral links. In "econospeak", we set out to estimate the strength of "local spillovers" between sectors by asking ourselves the following question: "does a local industry stand to benefit when other industries located in the same city grow as a result of trade liberalisation?". We aim to address this question in two steps. In the first step we focus on identifying spillovers within the broader manufacturing sector, and check whether the trade induced growth of one local manufacturing industry (say the automotive sector) tends to foster the growth of other local manufacturing activities (say electronics). In the second step we analyse spillovers from the broader manufacturing sector to services by breaking down the service sector into its component sub-sectors to identify which activities stand to benefit most from trade liberalisation.

In both steps we find emphatic support for the presence of large local spillovers between sectors. Within manufacturing, the exposure to trade liberalisation of sectors located in the same city as a particular local industry is at least an important in determining the performance of that local industry after 2001 as that industry's own exposure to US trade liberalisation. Moreover, we find that the benefits of trade liberalisation spill over between local sectors primary via labour channels. In other words, a local industry stands to benefit indirectly from trade liberalisation if the neighbouring local economy (the industries in the same city) experiences a deep liberalisation, with the benefits being particularly great if the neighbouring local economy also employs similar types of workers as the industry in question.

From manufacturing to services our findings are perhaps less interesting but still important: all activities within the services sector (including construction, finance, sales and catering etc.) are found to benefit substantially from the US trade liberalisation.

There are several lessons that emerge from our research. First, the gains from trade liberalisation for developing countries can be very large. This is because the direct benefits of liberalisation are amplified by complementary inflows of FDI, intersectoral links within the tradable sector as well as spillovers from the tradable sector to the nontradable sector. Second, the adjustment costs to trade liberalisation may often be lower in developing nations, which can explain the greater support for freer trade in these countries relative to the developed world. Developing countries tend to have a comparative advantage in labour intensive sectors which often means that trade liberalisation has strong job-creation effects. Moreover, at least in the case of China, worker reallocation across sectors and locations in the aftermath of trade liberalisation seems to have been rapid and caused little disruption. This may be because the lower skilled jobs that are prevalent in China are less differentiated, making re-training and adjustment easier.

Last but not least, our analysis reveals the importance of trade policy uncertainty as a barrier to international trade. Even if applied tariffs are low, if uncertainty regarding future trade policy is substantial this can severely reduce trade flows and hence the gains from trade. A corollary to this finding is that there is still significant scope for trade agreements to bring about substantial benefits by enhancing countries' commitment to freer trade, providing dispute resolution mechanisms and improving the predictability of future trade policy.

However, the "deep" trade agreements that can yield the benefits outlined above often come at the cost of reduced domestic policy discretion, which can in turn raise concerns regarding national sovereignty.

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GLOSSARY

CETA Comprehensive Economic and Trade Agreement

EPI Economic Policy Institute

FDI Foreign Direct Investment

GDP Gross Domestic Product

MFN Most Favoured Nation

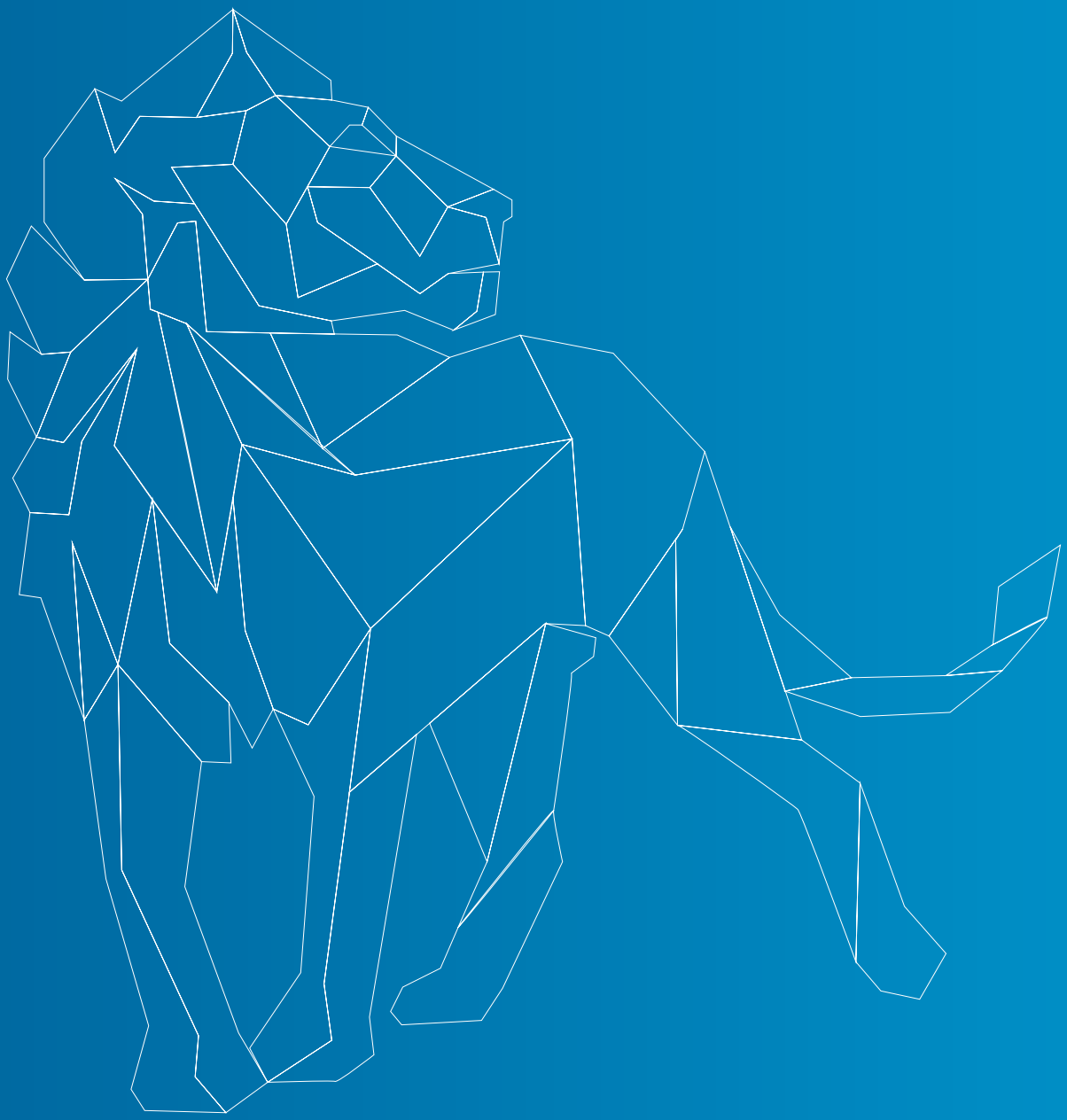
NAFTA North American Free Trade Agreement

OECD The Organisation for Economic Co-operation and Development

TPP Trans Pacific Partnership

TTIP Transatlantic Trade and Investment Partnership

WTO World Trade Organisation



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