Free trade and Europe

The **Governor**[1] *stresses the importance of sustaining the global momentum towards free trade—the foundation of post-war prosperity in the industrialised world. The benefits of protectionist trade barriers to individual sectors, he argues, must inevitably be outweighed in the long term by the damage caused by discouraging competition and the resulting misallocation of resources. In this context, the* **Governor** *highlights the need for the industrial world to retain its common purpose and to ensure a successful conclusion to the GATT talks. Failure, he warns, would risk reversing the trend towards free trade, which in turn would risk setting back economic prospects for the developing world and Central and Eastern Europe.*

It has become a commonplace but remains an understatement to say that we are living through an historic phase of international economic relations. The combination of events in Europe is indeed startling. Most dramatically, of course, the Soviet empire has crumbled and the system of centralised planning has been thoroughly discredited. In its place should emerge a system based on market forces and international openness.

Here in western Europe, meanwhile, we are little more than a year away from the target date for completing the arrangements for a Single Market. The details and negotiations are, as everyone here knows, often prolonged and even tedious. But so long as the end objective of the 1992 Programme is kept in mind, the struggle is more than worthwhile, because by the beginning of 1993, if things go according to plan, we will have dismantled an enormous number of the remaining barriers to the free movement of goods and services, labour and capital, among the member states of the European Community. This will be a remarkable achievement.

This will be a major step towards free trade in Europe, and that, a lot of rhetoric aside, is what the *Economic* Community must be about. The growth of trade within the EC has been accompanied by higher living standards and greater political cohesion. And, if I may draw on our shared history in Europe, it is clear enough that those who trade are less likely to fight. The Community's commitment to free trade is not inward looking, however, as is amply evidenced in the agreement just reached with our neighbours in EFTA to create a free trade zone covering all *eighteen* nations of western Europe.

And this growing acceptance of the virtues of free trade reaches well beyond Europe. The United States and Canada have already created a free trade zone in North America, and the chances of its soon being extended to Mexico are good. In Latin America, countries in both the southern cone and the Andean region are dismantling trade barriers, and promoting regional free trade. Across the Pacific, the possibility of an East Asian economic grouping is being explored; and moving west again, the Arab Maghreb Union is now two years' old; whilst in sub-Saharan Africa a number of countries are pursuing more liberal trading policies as part of their adjustment programmes.

How different all this is from the position—and outlook—prevailing only five or six years ago. Then there was no end in sight to the suppression of political liberty by the totalitarian political regimes of central and eastern Europe, with their centrally planned economic systems exerting a deadening influence on prosperity and enterprise. But, albeit less dramatically, western Europe too seemed to have lost its optimism and dynamism, with progress on economic liberalisation stalled and growing talk of 'eurosclerosis'.

There are probably some lessons in this. Most obviously, it would be unwise to take for granted the prospects for continuing trade liberalisation. We will always face challenges in resisting the forces of protectionism and economic nationalism. This is why it is so important to maintain the forward momentum in trade negotiations; not only dismantling barriers to *intra*-regional trade, but also making genuine progress towards greater *inter*-regional free trade. The current Uruguay round is therefore of immense importance. It has already been underway for some five years, and is approaching a critical point: some of the differences which have so far stood in the way of agreement have to be addressed. Today, if you will permit me, I would like to dwell a little on the importance of these trade talks to all of us involved in business and in economic and financial policy-making.

The forces for protectionism

Why should free trade be so difficult to achieve in practice, when its benefits are so generally acknowledged by economists? This is a matter worth pondering, because only if we understand the forces for protectionism can we effectively counter them. It takes us, inevitably, into questions of political economy.

(1) In a speech to the Paris Chamber of Commerce and Industry and the Franco-British Chamber of Commerce and Industry on 18 November 1991.

One obvious observation is that although the immediate benefits of trade liberalisation are many, they are usually widely-dispersed; those who profit from restrictions on trade, though typically far fewer, tend by contrast to be concentrated, and trade liberalisation may require them to make radical and disagreeable changes to their lives. It is therefore relatively easy for those favouring continued protection to band together to form interest groups capable of exerting pressure on the political process. This places a responsibility on those who understand the dangers of protectionism to lend their weight to those urging freer trade.

Moreover, the balance of benefits over costs from economic liberalisation is usually rather less clear in the short run than over a longer period. Increased international competition can mean short-term loss of jobs and profits in previously protected sectors; and those adversely affected often see no immediate prospect of alternative employment. In the longer term, however, the benefits of continued increases in efficiency come to outweigh by far the initial transitional costs of transferring labour and capital to new uses.

I believe strongly that we should not simply ignore those adversely affected by economic change. In my judgement, modern societies have a clear obligation to ensure that people whose jobs disappear as a result of changing patterns of trade are adequately equipped to take advantage of opportunities in other sectors. And transitional hardships need to be sympathetically treated. But it is nevertheless essential not to let the transitional difficulties of adjustment stand in the way of the long term welfare of all.

A further obstacle to greater trade liberalisation lies in the negotiating process itself. The removal of restrictions, even if it creates both winners and losers domestically, is unambiguously beneficial for a country's trading partners. In consequence, negotiators inevitably—and sadly invariably—treat existing restrictions as something to 'sell'. If they cannot reach what they consider to be a 'fair' bargain, they may be inclined to retain their wares for sale at a future date. The fact that trade negotiations are a positive-sum game can easily get forgotten at the negotiating table.

It is, then, possible to see why protectionist measures continue to have a superficial appeal, and why the removal of restrictions is often resisted. But the damage inflicted by protection is out of all proportion to the sectional advantages conferred. I should say why; and I apologise in advance if I am covering familiar ground.

The damage inflicted by protectionism

The most obvious problem with protectionism is in some ways perhaps the least important. It leads to what economists refer to as a *static* misallocation of resources; 'static' because even if technology and productivity remain constant, there is an obvious economic cost to producing in one country what could be more efficiently made elsewhere. This has been well known since David Ricardo enunciated the principle of comparative advantage. Nevertheless, to take just two examples, Saudi Arabia grows wheat, and Sweden grows tomatoes.

Much more important, to my mind, though are the *dynamic* inefficiencies created. By 'dynamic', I mean that they may be small to begin with, but grow over time. We all recognise in our domestic economies the benefits of competition as a spur to productivity and best practice. (We also know that businessmen do not always favour unrestricted competition, which is one reason we have anti-monopoly and anti-restrictive practice laws.) Internationally, competition is provided by allowing foreign producers access to domestic markets. Speaking from UK experience, this international competition spur has been almost entirely beneficial in stimulating British industry to improved productivity. Indeed, in some cases the spur to efficiency has been so great that the removal of restrictions on *imports* has actually led to higher net *exports*. It is no accident that, in modern times, the countries with the most rapid growth in trade have also been those which have enjoyed the fastest increase in their standard of living.

Agriculture and the CAP

I have touched on agriculture, and you would hardly expect me to talk about trade liberalisation without doing so. My perspective on agriculture is of course that of a central banker, but it is also that of a European and, last but not least, that of a farmer.

Put rather baldly, agriculture is the sector where interference with market forces has been at its most acute. We in Europe are particularly aware of the Common Agricultural Policy which, if I may say so, has raised the art of creating economic inefficiencies to a very high plane. But we are far from alone. In Japan, as I am sure you are aware, rice production is so heavily subsidised that domestic production is profitable for farmers even though costs are five or six times international levels. In the United States, too, major distortions arise from subsidised water pricing, below-cost grazing rights and so on. And even in Canada, certainly an efficient producer by any standards and loud in its arguments against agricultural protection, there are numerous price-distorting regulations.

It is sometimes argued that these sources of misallocation, though regrettable, are of relatively minor significance, generating costs which are well within the capacity of advanced industrial nations.

Superficially, it may seem possible to make a political judgement as to whether or not the price is worth paying, although I am one who believes that economic realities do in the end prevail, even in the political arena. And the question is at what cost in the meantime. But I wonder whether the voters who are ultimately called upon to make these judgments are actually aware of what the costs really are. The OECD estimates that the total costs (to OECD countries) of consumer and taxpayer transfers to agriculture in the latest year for which statistics are available (1990) were some $300 billion. The Common Agricultural Policy alone is estimated to impose additional costs on EC consumers and taxpayers of $130 billion, which is equivalent to $380 per capita.

Moreover, it would be quite wrong to suppose that the costs of agricultural protection are internal to the countries or regions providing protection to their farmers. For one thing those countries or regions typically deny free access to their markets to the agricultural output of countries outside. Perhaps even worse, they tend to dump surplus produce from their own farmers at very low prices outside their region. These anti-social practices do severe damage to the agricultural sectors of countries outside the protected area.

Agriculture is certainly not the only protected industry, though it is perhaps the most heavily protected. A wide range of industrial products is also subject to trade restrictions. The most pernicious are not tariffs, which are visible and, in most cases, no longer particularly high. Much more insidious are the non-tariff barriers, such as quotas and so-called 'orderly marketing arrangements' and 'voluntary export agreements'. These generally fall outside the ambit of international rules under the GATT. They are dangerous because they are based on an implied threat of protectionist retaliation, and they generally reinforce bilateralism in international economic relations.

The Uruguay round

Mr Chairman, everything I have said so far will be very familiar to you. Why, you may ask is a central banker labouring these points? Surely the current round of GATT negotiations will eventually come to a satisfactory conclusion, just as its predecessors did? And even if it does not, does it really matter? International trade is pretty free already, and we can surely concentrate on making progress in regional trade liberalisation, as we are in fact doing in Europe.

I believe the stakes are higher than that. For perhaps the first time since the war, there is a global consensus that reliance on market forces offers the best prospect, not only of continued prosperity in rich countries, but of sustained development in the rest of the world. As I indicated in my opening remarks, it is not only the formerly centrally-planned economies which have undergone a change in their economic thinking. Throughout the developing countries, and in countries such as Australia and New Zealand, there has been a turning away from the philosophy of economic development based on protection of domestic industry. The focus is turning toward competition and international trade as engines of growth.

This is a profoundly encouraging trend. But it has to be maintained and nurtured. The developing countries need our markets to make their new found strategies work. And if our markets are closed to them, it will be more than just a setback to their trade prospects. It risks undermining their faith in market economies more generally, promoting cynicism about the motives of the richer industrialised countries.

But the Uruguay round is important not only for the future welfare of developing countries. It is necessary to sustain the momentum of liberalisation which has been the foundation of postwar economic prosperity in the industrial world, and nowhere more than in Europe. The present trade round is the eighth time the members of the GATT have come together to negotiate a multilateral set of trade-liberalising measures. It nevertheless represents something of a turning point. No longer is the focus exclusively on the reduction of tariffs on manufactured goods, where so much has already been achieved: they have mostly now been reduced to the point where they are no longer a significant deterrent to international trade.

Instead, the focus is on new areas of trade, such as agriculture, services and intellectual property; and on different kinds of trade distortions, such as non-tariff barriers and domestic production subsidies. As I have already suggested, agreement in these areas poses a new set of technical and political issues. If they are not dealt with, there is a real danger that the trend towards freer trade at the global level will be thrown into reverse.

Two factors increase this danger at the present time. The first is, paradoxically, the collapse of the Soviet empire. With the external security threat removed, one of the impulses to co-operation and cohesion among western industrial countries is eased. The second is the growing strength of regional trading arrangements. Such arrangements, and I think especially of the European single market, promise enormous benefits for their members. The risk to be guarded against is that regional free trade does not sap the political will for global liberalisation and, especially, that it does not lead to additional de facto protection.

While regional developments are very obviously to be welcomed for the way in which they harness co-operative traditions among neighbouring states and reinforce natural trade linkages, there is an important proviso. Such arrangements *must* be open to the outside world and not exclusive. When the 1992 programme was first established, there were fears, particularly in the United States, that it would be a step towards 'Fortress Europe'. These fears should by now have been largely allayed. The European Community has generally been successful in ensuring that the removal of *internal* restrictions has not been accompanied by any increase in *external* barriers. It must succeed in doing so again.

Financial services

Mr Chairman, I have managed to get most of the way through my remarks without making more than a passing reference to the financial sector. This is not, I assure you, defensiveness on my part. Those of us in the financial sector who advocate the principle of freer trade—in other words, virtually everybody—have a special obligation to make sure we practice in our own field what we preach for everyone else.

In the City of London we have a history of welcoming foreign participation in our markets. We do so out of conviction. But it has not escaped our notice that it is also good for business! Over the past decade or so, we have re-examined more or less every aspect of our domestic markets, with the aim of enhancing competition and innovation. We have not sought to impose a particular vision on the structure of the financial sector; we believe it is the job of market forces to show the way. And an important part of this process has been the energy and competitive instincts brought to the London markets by financial institutions from around the world.

I am particularly glad that the Single Market directives in the financial area will underpin our commitment to a liberal and outward-looking financial system. It is less certain, perhaps, whether as much can be achieved in the Uruguay round. I hope it can; and that we can use the introduction of financial services into the current round as a vehicle to facilitate, and not retard, an overall agreement.

One condition is paramount, however. Nothing must be done to dilute the prudential standards we use to protect the integrity of our financial systems. Consider the implications for the functioning of the economy at large if confidence in the integrity of financial institutions and markets were called into question. The financial sector cannot be viewed in isolation; it is an integral part of the process of production and distribution. The problem is to devise appropriate standards of prudential supervision, with sufficient harmonisation of minimum standards to promote competitive equality, but enough differentiation to respect differing market traditions and provide adequate access for new-comers, regardless of where they come from. We have made considerable progress with this objective in Europe, and must now seek to do the same at the global level.

Eastern Europe and the former Soviet Union

Mr Chairman, I began my remarks with a reference to the collapse of the Soviet empire. Allow me to end with some reflections on the role of trade in moulding the economic and political future of its successor states.

The collapse of the communist Soviet Union sprang, I submit, from the failure of its economic system. This, no doubt, had several causes, but one of the most potent was its systematic inability to take advantage of trade—the voluntary exchange of goods, based on the principle of comparative advantage, and facilitated by a recognised and stable medium of exchange.

This is not to say that goods did not move, and specialisation in production did not occur. They did, often too much so. The levels of inter-republic trade in the former Soviet Union were significantly greater than in, say, Western Europe. The trouble was that goods moved according to the dictates of planners, not the principle of comparative advantage, guided by the 'hidden hand' of the market. Prices were not allowed to play their essential function of allocating scarce resources.

Now, thankfully, the nations of central and eastern Europe have discovered the values of the market system. It has so far been a painful discovery; the removal of pre-existing price distortions has resulted in sharp reductions in output. But it will not be long before eastern European enterprise starts producing to meet market demand.

Western Europe has a special responsibility and a special opportunity. It is to our markets that our fellow-Europeans in the east will look first for outlets for their nascent industries. In particular, given the shortcomings of their industrial output, they are likely to seek markets for agricultural produce. As I have suggested, if they find our markets closed to them, not only will their economic recovery be hampered, their faith in economic liberalism will be severely dented. Disillusion could set in, with incalculable political consequences. I trust future historians will not have to say we were responsible for that.

I said that trade with Eastern Europe offered us an opportunity as well as a responsibility. Our eastern neighbours do not simply want to export to us. They want to import our high-value-added products, and they want to attract our direct investment. It is sobering to remember that almost as many Europeans live east of the old Iron Curtain as west of it. They are generally well-educated and anxious to raise their standard of living. If we help them realise their economic aspirations, I venture to suggest that we will strengthen immeasurably our own economic prospects. At the same time we would make a major contribution to safeguarding the political future of our Continent for generations to come.