Responses to recent commentary and criticism

Patrick Minford- May 2017

The purpose of this section of my webpage is to reply to selected ongoing commentary on recent work published by myself and others of Economists for Free Trade.

Nigel Driffield- letter to FT, March 22, 2017, below*

ND raises some points about my work with Edgar Miller Minford and Miller, 2017) on manufacturing prospects. Here are some answers.
First, he quotes my remark about the 'elimination' of manucfaturing. That remark concerned the 'metal-bashing' end; my point, as elaborated around it, was that manufacturing would raise productivity as it has in the past by going up the value chain and becoming more hi-tech. Given the UK's comparative advantage in such skill-intensive industry, this could well imply a substantial expansion in that part of manufacturing.
Second, ND rightly says we did not examine the effects on profits of changes in input costs; we did so for reasons of simplicity and because they do not have a big effect, especially on the short term estimates. Had we done so, it would have boosted manufacturing profits further. Our best estimate of the protection of inputs is the same as for manufacturing as a whole- viz around 20% including non-tariff barriers. This according to our trade model raises the price of all inputs by 20%. Leaving the EU for free trade would eliminate this rise. However, in the short run, the fall in sterling largely counteracts that effect, raising input costs by 15%.In the long run, with sterling the same, the input cost fall boosts profits; in the long term we assumed that EU protection would fall to 10% following past long term trends, so the gain is 10% on input costs and diminishes the necessary offsetting growth in productivity. We made some allowance for these long run effects in car manufacturing but not in manufacturing as a whole. As noted a full allowance would strengthen our conclusions.
Third, ND notes that in the short run with a 'tit-for-tat' tariff exchange with the EU there would be disruption of supply chains. We agree about this and it is one reason we argue against the UK entering into a tit-for-tat exchange. Handling the effects of the EU's solely levying (on average low) tariffs on us is fairly easy and could avoid supply-chain disruption, as we explain.

*(Nigel Driffield's letter) Sir, Patrick Minford argues that Brexit will make UK manufacturing both more productive and more profitable (FT.com, March 16). This is in contrast to his pre-referendum argument that "we would mostly eliminate manufacturing, leaving mainly industries such as design, marketing and high-tech. But this shouldn't scare us."
The assertion appears to be that sterling will have significantly depreciated, and so profits of exporters will increase. While there are companies that will undoubtedly gain as a result of this currency depreciation, this assertion ignores one crucial issue. Nearly half of what we export is imported first. Professor Minford and his colleagues point to the recent success of the UK economy, and the extent to which exporters have gained. However, as those exporters restock their warehouses, they discover that much of the price advantage that accrued from the devaluation is eaten up in price increases in imported components.
The final issue that Prof Minford and his colleagues fail to capture is any understanding of the nature of supply chains that underpin UK manufacturing, and the extent to which World Trade Organization rules affect those supply chains differently for different products. A high proportion of international trade is intra-company trade. In modern high tech manufacturing many components cross countries several times before they reach the final consumer.

This has perhaps been the biggest benefit to manufacturing of the single market. Companies are able to co-ordinate activities across many locations, taking advantage of the benefits offered by different locations, whether it be low wage costs, access to frontier technology or transport links. What we observe as final exports is simply the final stage of this process, which within Europe works relatively seamlessly.

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TPRO blog by Alan Winters **(this can be found at** https://blogs.sussex.ac.uk/uktpo/2017/04/19/will-eliminating-uk-tariffs-boost-uk-gdp-by-4-percent/ **)**

In his blog Alan Winters makes various claims about the work Edgar Miller and I recently published on behalf of Economists for Free Trade (Minford and Miller, 2017):

--that under our free trade option (1) there would be a ‘race to the bottom’ on standards

and

-- (2) we would become ‘more integrated with the EU’

-- (3) that our trade model is odd and non-standard.

--(4) that if one allowed for the effects on input prices due to the Brexit devaluation and other frictions in ‘exchange rate pass through’ manufacturers would not gain much in profit

These claims are all wrong! Here is why:

On (1) we only make price comparisons on manufactures with other OECD countries and assess the average price difference between EU and the most competitive OECD suppliers for broad product categories such as ‘electrical machinery’ and ‘transport equipment’. The price data that is averaged is of the highest quality and adjusted by national statistical offices for all the usual issues. Other OECD countries are subject to the same international standards as we are.

Our estimates of total EU protection tally approximately with known tariff rates plus others’ estimates of non-tariff barriers.

On food we simply use the OECD’s estimate of price support to producers- which is quite standard.

(2) is not so because we assume explicitly that the EU treats us under an FTA as it does now- so no change. Under our model if they do not and levy tariffs on us, it makes no difference to the world prices we have access to and therefore causes us no national welfare losses.

(3) our world trade model is general, inclusive of all factor markets, and quite standard in terms of general competitive equilibrium. It is the models that Alan Winters embraces with their unsustainable assumptions of limited entry and widely dispersed monopoly power that cannot

match known world competitive conditions in which companies such as Blackberry and Nokia can be destroyed rapidly.

(4) if we were to allow for the effects of input costs, our estimates of manufacturing profits would be higher since we are eliminating protection on these also and this typically exceeds the devaluation effect. As for devaluation pass-through, for a 'small economy' like the UK with a supply only 3% of world output it is logical to assume that over 5 years or so it obtains world prices in dollars, implying sterling prices fully raised by the devaluation.

Let me expand on these short points.

What is strange is that Prof. Winters, an experienced applied trade economist, has so completely either misunderstood or misrepresented my work which has been around in one form or another for over ten years- see my book 'Should Britain leave the EU?-, first edition 2005, second edition 2015 (Minford et al, 2015) in which this same world trade model is both explained and used, together with the price comparison method suing detailed OECD CPI data.

The world trade model, which is also described again in my paper with Edgar Miller, traces the way that trade barriers, whether tariffs or non-tariff barriers, work their way through to consumer prices and different sectoral costs and prices, so reallocating resources between sectors of the economy. It assumes full competition and free entry in world markets for the products of these sectors- food, manufacturing and traded services. In each country there is a non-traded sector. The model solves under full general competitive equilibrium, as is standard with trade models.

It is elementary to show that, once the UK has left the EU and eliminated EU protection so that it faces world prices on both imports and exports, the EU's trade policies towards the UK are simply irrelevant to the UK. They leave world prices unchanged so that UK welfare, outputs and prices are unaltered. So Winters' remarks about 'deeper integration with the EU' are incomprehensible.

The measurement of EU protection is again standard and widely agreed, at around 20% on food and about the same on manufacturing, about three quarters of the latter being non-tariff barriers. I made this point before when the LSE group raised similar issues- see my 'Reply to LSE' Minford, 2016 c, on www.economistsforfreetrade.com. The food measure comes from the OECD. The manufactures one comes from detailed OECD consumer price comparisons and is consistent with separate measures of known tariffs and estimated non-tariff barriers. The facts of high EU protection are embarrassing to EU apologists but are a well-known fact: the EU is nearly three times as protectionist as the US in manufactures and about twice as protectionist in food. In our model we assumed that international pressure would reduce it to around half of the latest measures as indeed has been happening over a long time period.

If the UK abolishes these trade barriers would this imply a 'race to the bottom' on standards? Not at all. The non-tariff barriers are such because they use standards and anti-dumping duties in a way that acts to raise prices above going international standards used generally around the developed world. Our data is for the OECD where these standards apply. In abolishing the EU's non-tariff barriers we would simply apply these standards appropriately without an attempt to use them as an excuse to raise prices.

Winters is confused by our discussion of FTAs, suggesting that somehow we are using FTAs to create unilateral free trade. We make it perfectly clear that ‘free trade’, interpreted as our abolition of existing trade barriers put up by the EU on UK imports, can be achieved by two main routes: either unilateral abolition or abolition as part of a general negotiation of FTAs. The gains to the UK from reaching ‘free trade’ come from the abolition of these trade barriers, via an 8% fall in consumer prices and the resulting 4% rise in consumer welfare and GDP. The calculations, as well as variants where less than free trade is achieved, are set out in Appendix B of the Minford-Miller paper. As noted there and explained again above, these gains are totally unaffected by what the EU levies in the way of trade barriers against the UK.

Hence our remark that ‘no trade agreement with the EU’ whereby we institute free trade either unilaterally or by comprehensive FTAs with the rest of the world, ultimately accompanied by abolishing any barriers against the EU , is better than a ‘bad trade agreement’ with the EU which prevents us abolishing these barriers.

The Independent (http://www.independent.co.uk/news/business/news/brexiteers-economists-for-brexit-patrick-minford-study-doubly-misleading-eu-uk-trade-deal-tariff-a7691271.html) lauds the Winters analysis as debunking the ‘one study supporting the Brexit WTO strategy’. It does no such thing, as the Independent could easily have established had it not rushed into print about this muddled blog. The disgraceful truth is the opposite: our study is the ONLY one that analyses the WTO option under the free trade assumption. As Winters well knows and as the Independent ought to be aware, all the other studies that purported to examine this option were fraudulent in that they assumed no elimination of the EU’s protection: thus they calculated the outcome under continued UK protection against the world at large, including against the EU (Minford, 2016b). Some ‘WTO free trade option’ that! Furthermore most of them used the notorious ‘gravity’ model under which attempts to trade further afield than our neighbours in the EU is supposedly most handicapped by increasing costs of distance; this model hugely underestimates the gains from global free trade and is at variance with the far-flung nature of UK trade (thus our biggest country export market by a mile is the US, nearly three times as large as Germany, yet hugely more distant). Yet interestingly even this model produces some small gains from the WTO free trade option, as exemplified by an exercise of the LSE group: based on their calculations of the effect of a 3% tariff cut by the UK one reaches a gain of 1% of GDP from levying the full 10% assumed trade barrier and 2% from levying the current 20% barrier.

It is time for the Independent and other Remain supporters in the media and academia to use standard trade models as we have to evaluate the policy of HMG to Brexit free trade. While gravity models are all the rage among trade academics at present they are essentially untested- they have merely been ‘calibrated’ to reproduce trade regressions-, and their assumptions of limited entry and competition in world markets violate the known facts of world trade competition. Furthermore the pretence that the UK cannot pursue free trade policies under the WTO should be abandoned now that it is government policy to do so.

Finally, a word about manufacturing prospects. In the Minford-Miller paper we showed that near-term profits are likely to be much higher due to the Brexit devaluation, giving the sector a long time window in which to raise productivity over the long term to face the greater competition under free trade. The sector has shown itself highly competent in the past in ‘going up the value chain’, raising productivity annually by nearly 3% by increasingly hi-tech operation. It needs only a fraction of this growth to rise to the challenge of world competition outside the EU. While no doubt we can further refine these detailed calculations, this basic productivity calculation is clear enough: in the long term, say the next ten years, competition will lower prices by 10%, so productivity must rise to compensate, and this is much facilitated by the enlarged profits the sector will enjoy while sterling remains depressed over the short to medium term.

UK government policy today is pro-free trade and pro-competition, which benefit consumers and the economy. Economists like Winters should applaud this and stop being apologists for busted Remain prejudices.

Ambrose Evans-Pritchard in the Telegraph, below*

A E-P reports on the views of John van Reenen and in particular quotes his estimate that the WTO option would reduce UK GDP by 2.5% via trade, plus an effect of reduced foreign investment and so productivity effects, bringing the total reduction to 8.5%.

In effect van Reenen's position is like Winters' and that of the Treasury's Project Fear, to which he was an adviser. In the response to Winters above I have explained once again why this approach is wrong and gives the opposite of correct answers. Also I and others set out a comprehensive critique of the Treasury's approach and results during the referendum, to be downloaded from www.economistsforfreetrade.com (Minford, 2016 a, Blake 2016 and Dowd 2016). Similarly I responded at length to van Reenen and the LSE critique of my work in 'Reply to LSE', available in the same place (Minford, 2016 c). For those wishing to see more recent debate my oral evidence to the International Trade Committee, in discussion with the LSE's Swati Dhingra and the TPRO's Jim Rollo is available from the Committee's website (Economists for Brexit, 2016).

In a nutshell the Treasury made its trade calculation assuming continued UK protection in the same gravity model which in turn calculates the effect of EU membership on trade via trade gravity regressions for many countries: the coefficient is therefore an average of many countries' experience on joining the EU. It is not in any way linked to detailed tariff and non-tariff barriers and it reflected many factors affecting events at the time of joining. Hence there is no way of deducing from these what the effect would be of the unique event of the UK leaving and changing its trade barriers v the EU.

Furthermore on the FDI relationships these are the usual regressions of productivity by industry on FDI plus another set of regressions relating FDI to trade among other things. The problem about such regressions is their interpretation because these relationships come from underlying policies (such as controls, taxes and trade barriers) and business opportunities at the time: FDI and trade are both aspects responding to these other factors (they are 'endogenous variables') and again one cannot read off these the 'effects' of trade or of FDI.

To macroeconomists these are all old familiar points as is the spuriousness of the empirical tests claimed by these and other trade economists- there is no 'test' involved in fixing up the parameters of a trade model so as to yield the results of gravity equations. It is as if these economists have simply failed to understand the significance of the revolutions in macroeconomics in the past few decades. Unfortunately this incomprehension carries a policy cost as this ad hoc approach based on gravity and related regressions is hostile to free trade and fails to give a proper account of comparative advantage. In this theory such as it is one trades as one does because one is close and for no particular other reason other than sheer size: hence policy should simply build up what is, in an echo of the infant industry argument for protection. The fact that policy such as that of the EU is protectionist can under this theory be good as it fosters more of what you have.

Yet how come then at the UK is heavily specialised in financial and other services which are sold all over the world? It is plain enough that this is so because the UK has a large supply of skilled people who can provide these services effectively and it has withdrawn barriers to entry (e.g. via Big Bang in 1986 in the City). What this highlights is that to understand trade patterns you must bring in the economy's supply side, especially factors of production available in the country. Also, to make sense of the widespread penetration by the UK of many countries' markets you must assume free entry into the world market together with implied high levels of competition. All this is typically denied in gravity models. However even under imperfect competition free trade remains the welfare-dominant policy except in most unusual circumstances and free entry pushes this world close to that of full competition where free trade is unquestionably the welfare-dominant strategy.

In short van Reenen et al are espousing a neo-protectionist agenda based on a model in which there is little real competition. It is no wonder that they attack free trade with the world as a whole, preferring EU protectionism. But for the UK government this has rightly come to be seen as a position quite harmful to the UK's long term interests which manifestly lie with global free trade as quantified in the classical model of trade with worldwide free entry and competition and comparative advantage based on supply-side factors.

* Britain needs fighting 'Plan B' for trade as EU turns screws on Brexit

AMBROSE EVANS-PRITCHARD

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The European Union is hardening its terms on Brexit. There is a new hint of hostility in the language. The tone is peremptory.

Those of us who hoped that Germany would push quietly for an amicable settlement can no longer be so confident. We now learn from Handelsblatt that the German finance ministry insisted on some of the most unfriendly changes to the EU's latest working documents.

Berlin stipulated that Britain must honour "all obligations" (Verpflichtungen) for divorce payments, a tougher wording than the earlier, gentler talk of legal and budgetary "duties" (Pflichten).

It demanded that Britain desist from tax dumping and financial deregulation that would "jeopardize the stability of the union". This demand is almost insulting. British regulators have led efforts to recapitalize banks. It is the eurozone and Germany that have dragged their feet on tougher capital rules.

There is no longer any attempt at diplomatic tact. The document states that the European Commission will "determine" when the UK has made "sufficient progress" as it jumps through the hoops, the way it handles accession talks for supplicants hoping to join. It reads like an imperial curia discussing a colony.

The French too have stepped up their demands, insisting that financial services be excluded from the trade deal. The City of London must respect the "regulatory and supervisory standards regime" of the EU in any future arrangement, suggesting that Britain will have to accept the sway of the European Court.

Some argue that France will soften its line under a President Emmanuel Macron. His economic strategist is the anglophile Jean Pisani-Ferry, co-author of a Breugel paper proposing a 'continental partnership' between Britain and the EU that preserves very close ties.

Sadly, Mr Pisani-Ferry has made no headway with this idea. I have met Mr Macron enough times - or have seen him at EU venues behind closed doors - to detect a messianic fervour for the European project. He is a crusader by political religion, the EU's latterday Bernard de Clairvaux.

But it is the hardening mood in Germany that is most ominous. The reason for the sudden change is unquestionably Theresa May's snap election. While we think that the Prime Minister's motive is - in part - to build a buffer against Brexit ultras in her own party, that is not the view in Berlin. Germans see her gambit as anti-EU sabre-rattling and a breach of good faith.

"The EU wants to counter Theresa May's rhetoric and kill the idea that a bigger conservative majority will make any difference to their negotiating position," said John Springfield from the Centre for European Reform.

The German press has likened Mrs May's demarche to the defiant posturing of Alexis Tsipras in Greece. They almost take it as a given that her Brexit plan will fail and that she too will be forced to capitulate, grovelling for mercy. One wonders where the briefings are coming from in Berlin.

The parallel with Greece is on one level absurd. Syriza caved after the European Central Bank cut off liquidity and shut down the banking system. Britain is not in the euro or vulnerable to such coercion, and the strategic contours are entirely different.

Yet the Greek saga is instructive. The lesson is that you do not bluff with the EU power structure. If Theresa May still thinks that "no deal is better than a bad deal", she had better have a credible Plan B, and she must be willing to activate it.

Falling back to the minimalist option of the World Trade Organisation and hoping to craft global trade deals smacks of defeat. It would leave Britain in limbo, pleading with the US, Japan, China, India, and other countries to embark on talks when they have larger matters at hand.

So it is time to think in revolutionary terms. Parliament's Exiting the EU Committee called earlier this month for a detailed study of what it would mean if the UK left the EU without a deal.
Downing Street should answer this legitimate request, and the menu should include the nuclear option of unilateral free trade.

This is a heady Cobdenite manifesto, a turbo-charged version of the Repeal of the Corn Laws in 1846. No developed country has ever attempted such a thing, though New Zealand comes closest, leaving aside the special cases of Hong Kong and Singapore.

All tariffs would be cut to zero. There would be no restrictions on imports besides obvious safeguards, such as policing child labour or environmental abuses, or for national security reasons.

It needs no reciprocation, working from the premise of Adam Smith that if any other country wishes to impose or maintain barriers that is their own folly. They suffer the welfare loss. The currency would adjust to the new equilibrium, keeping the current account close to balance over time.

Adam Posen, head of the Peterson Institute in Washington, said Britain would face a rough time with no EU trade deal but at least such a plan has creative allure. "It is far more credible than other options," he said.

The current dismal narrative on Brexit would be transformed overnight. Britain would suddenly be seen by the rest of the world as pioneering nation at the forefront of globalism, reasserting Thatcherite audacity, rather than a crabby islanders in decline. "People's jaws would drop," says Professor Patrick Minford from Cardiff University.

Pure free trade cuts through the Gordian Knot, eliminating the need for an army of technocrat negotiators and for yet more of those supra-national tribunals that so proliferate, eviscerating democracies and sapping consent for globalism.

Prof Minford says the hide-bound political class has yet to give such clear blue sky proposals a serious airing. "It is so unfamiliar. It takes a mental somersault to break free of mercantilist thinking," he said.

Economists for Brexit - now Economists for Free Trade - certainly got off on the wrong foot last year by suggesting that the UK would be positively richer under such a model. This invited a blizzard of criticism.

My own view has always been that there will be a negative shock from Brexit and withdrawal from the single market, with effects on GDP at best neutral by 2030 with the right policies.

Professor John Van Reenen, a trade expert at MIT and a vocal critic of the Minford plan, says retreat to the WTO would cost roughly 2.5pc of GDP compared to remaining in the EU, with losses rising over time to 8.5pc due to productivity effects.

He agrees that unilateral elimination of barriers is the best WTO variant since it at least mitigates damage to supply-chains entering Britain from the EU. "It offsets some losses but the politics of all this would be very hard," he said.

Clearly there would have to be income support for farmers and the rural way life - as a cultural choice - and temporary measures to shield the car industry and key sectors from sudden trauma.

Prof Van Reenen said that if Britain wishes to take this leap into the dark, it should at least try to use the allure of zero-tariffs to generate goodwill and secure at least some concession on market access for goods and services. Smithians disagree: reciprocity is not strictly necessary, and should not become the obsessive focus of talks.

As for models used by trade economists, these cannot reliably predict what would happen in an overthrow of the existing economic order. The variables are too big. Nobody knows how investors would react, or what other countries would do. We are in the realm of psychology.

Brussels might try to portray the move inaccurately as 'dumping' but the EU would be in the odd position of erecting barriers where none existed before, in effect retreating into unilateral protection vis-a-vis an open Britain.

The claim that the EU had to do this to defend the sacred acquis and the integrity of the Union would in such circumstances be humbug, inviting a good intellectual trashing.

Such a trade plan is certainly a high-risk venture. It might lead to a sterling crisis and a deeper break-down in confidence. But it might equally be a powerful catalyst for renewal. It deserves proper study.

What is clear is that if the final document presented to Britain looks anything like the EU papers circulating this week, no sovereign state can accept it. We will need a Plan B. It should be crystal clear, on the table, fully-loaded, with the trigger cocked.

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