

**An Australia-United States Free Trade Agreement**

**By**

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## **An Australia-United States Free Trade Agreement<sup>1</sup>**

The idea of a preferential Free Trade Agreement between Australia and the United States, the two countries alone or with others, has been examined closely and left on the shelf several times in the past two decades.<sup>2</sup> It has been examined closely because Australia and the United States share many strategic and economic interests, and it is intuitively attractive to reflect these shared interests in special trading arrangements. It has been left on the shelf for several reasons, the most compelling of which is that it is hard politically for the United States to accept clean free trade with Australia except in the context of multilateral free trade. At the same time, it is hard politically and damaging economically for Australia to accept a dirty free trade arrangement that compromises such central agricultural interests as grain, meat and sugar. In addition, analysis has never revealed large enough net economic benefits to Australia, from any preferential trading arrangement that was judged to be feasible, to outweigh the cost of moving forward.

A United States-Australia Free Trade Agreement has re-appeared on the policy agenda through an Australian Cabinet decision late in 2000.<sup>3</sup> One motive for re-examination of the idea seems to have been anxiety that Australia was not having success through other means of expanding market access, and was in danger of being disadvantaged by discriminatory trading arrangements in East Asia and elsewhere.

The Australian government had, in my view correctly, placed considerable diplomatic effort behind attempts to launch a new round of multilateral trade negotiations at the Seattle Ministerial Meeting of the World Trade Organisation (WTO) in 1999. The dramatic failure at Seattle was a product of failure of political leadership in the major countries, not the least of which was associated with internal Democratic Party political maneuvering in the approach to the

U.S. 2000 election campaign. The failure, and United States and European leaders' expression of views that labour and environmental conditions should be applied to trade negotiations within the WTO, triggered widespread disillusionment with the multilateral trading system, most particularly amongst developing countries whose participation was necessary for the success of a new round.

Australia's longstanding interest in participation in the periodic Asia-Europe summits, and in the "ASEAN plus 3", (the three being Japan, the People's Republic of China and the Republic of Korea), arrangements that gained momentum from 1999, had not been reciprocated. The Australian exclusion was mainly as a result of opposition from Malaysia and (after the United Nations-sanctioned peace-keeping operations in East Timor) Indonesia. The failure at Seattle had sparked a scramble of discussions of preferential trade areas involving one or more East Asian countries. The ASEAN rejection of a preferential trade arrangement with Australia and New Zealand in 2000 appeared to the Government to signal a wider exclusion of Australia from discriminatory trade arrangements in Asia. It had a large impact, notwithstanding the inevitability of strong opposition from some ASEAN leaders at the time the issue was raised, and the reality that Australian exports to ASEAN countries were growing strongly without a preferential free trade agreement.

In these circumstances, the possibility that a United States administration would be elected in 2000 in which Australia was seen as having strong credentials generally in international affairs, and to which Australia had good access at senior levels, seemed to provide a special opportunity.

The remainder of this paper addresses six questions. First, are we doing so badly under current arrangements that we must abandon established approaches to trade policy? As part of this question, how detrimental to Australia, and how

irretrievable, is the recent weakening of support for the liberal multilateral trading system? Second, what would be involved in a Free Trade Agreement with the United States, and what would be the balance of advantages for Australia if it could be secured at no cost to other trading relationships and to the multilateral trading system? Third, what type of free trade agreement with the United States would be possible? Fourth, what are the likely effects of a Free Trade Agreement with the United States on other trading relationships, especially in Asia, and on the multilateral trading system? Fifth, what would be the wider effects of negotiating a Free Trade Agreement with the United States on the political economy of Australian trade policy and on the alliance with the United States? Sixth, now that the Australian Government has committed itself at least to discussion of negotiation of a Free Trade Agreement with the United States, what is the best way forward?

### **How Badly is Australia's Established Trade Policy Broken?**

Australia's postwar international trade policy until the mid-1980s was dominated by defence of its own exceptionally high protection for manufacturing production. Australia stood aside from the general and far-reaching liberalization of manufactured goods trade amongst high-income countries in the first 3 postwar decades, including from successive rounds of multilateral trade negotiations within the General Agreement on Tariffs and Trade (GATT). Australia's standing aside from the multilateral negotiations facilitated the GATT's acceptance that agriculture was an exception to the general desirability of open trade and the entrenchment of agricultural protection in Japan, the European Union and the United States. Australia was more active in the Tokyo Round in the late 1970s and early 1980s, although its participation was constrained by the primacy of the goal of retention of its own protection.

A new approach to trade policy was adopted by the Hawke Labor Government in 1983, and its main elements broadly continued by the Howard Coalition

Government from 1996. The late-twentieth century policy had the following elements:

- (i) Acceptance that Australian economic interests are served well by maintaining low protection, whatever other countries are doing. This led to a series of unilateral decisions on trade liberalization between 1983 and 1991, including the across-the-board reductions of protection announced in 1988 and 1991. The 1983-91 decisions caused most of what for many decades had been high Australian protection for manufactured goods to be removed by 2000. Although there were no major liberalising decisions after March 1991, further cautious steps were indicated along this path in the late 1990s by the Howard Government's legislation further to reduce protection for textiles, clothing, footwear and cars in 2005.
- (ii) Active participation in multilateral trade negotiations, with the general objective of reducing trade barriers and distortions in all including developing countries, and the particular objective of widening the scope of multilateral trade liberalisation to include agriculture, textiles (important to the wool industry and to the import capacity of East Asian trading partners), subsidies and other non-tariff measures as well as tariffs.
- (iii) Participation in regional trade discussions, particularly in APEC, with a view to reducing trade transactions costs and to encouraging trade liberalization on a most favoured nation basis, particularly in East Asia, and more broadly through concerted support for the WTO.
- (iv) Active engagement in bilateral discussions of trade liberalisation on a most favoured nation basis, focused on persuading trade partners that liberalisation of trade in sectors of importance to Australia was

in their own interest. The bilateral discussion drew upon the multilateral (GATT and later WTO) and regional (APEC) frameworks to encourage expansion of market access and sometimes to deter trade discrimination and backsliding on liberalisation.

The Australia and New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) was explicitly preferential and although executed in 1983 by the Labor Government, was negotiated by the Fraser Coalition Government. Its reach was extended by the Hawke Labor Government in 1988. It began its life as an exception to the focus on most favoured nation liberalisation in the post-1983 policy, although the general reductions in protection from 1983 in Australia and from 1984 in New Zealand greatly reduced the agreement's discriminatory content.

Beyond the unilateral reductions in protection, the post-1983 trade policy was associated with a number of developments that expanded market access for industries that were internationally competitive in Australia. From 1997, the trade policy successes were documented elaborately and usefully in the annual publication *Australia's Trade: Outcomes and Objectives Statement* (Commonwealth of Australia, various years including 2001). Over the whole period, international trade policy developments of large importance to Australia included:

- (i) The successful conclusion of the Uruguay Round, with the establishment of an effective disputes settlement mechanism in the new World Trade Organisation, the removal of the exceptions for agriculture and textiles, and the more effective constraints on subsidies.
- (ii) The large reductions in protection in all other Western Pacific economies since the mid-1980s, supported by participation in

multilateral trade negotiations and Asia Pacific Economic Co-operation. Importantly, these gains were held after 1997 despite the pressures of the financial crisis.

- (iii) The internationalization of the Chinese economy, the rapid expansion of Chinese trade including in areas of strong Australian comparative advantage such as wool and iron ore, and the entry of China into the WTO in 2001, which, amongst much else, makes it unlikely that China will follow Western Europe, North America and Japan into high agricultural protection as incomes rise in the course of economic development.
- (iv) The use of the GATT and the WTO to constrain trade discrimination in favour of the United States in Japan and Korea, most importantly in beef and other agricultural imports, and the extension of similar constraints to Taiwan with its entry into the WTO in 2001.

The extension of the multilateral trade policy disciplines to agriculture in the Uruguay Round laid the basis for later progress, but in itself delivered gains of modest dimension pending work on issues (the “built in agenda”) left over from the Uruguay Round.

The post-1983 policy has been associated with remarkable changes in Australian trade and economic performance:

- (i) Exports grew much faster in the 1990s than in any other decade since Federation.
- (ii) As predicted by economic analysis at the beginning of the reductions in protection, growth has been most rapid for non-traditional exports,

with manufactured goods and services exceeding primary exports for the first time in Australia.

- (iii) The depreciation of the real exchange rate that has accompanied trade liberalisation, the removal of exchange controls and fiscal consolidation, together with the liberalisation of Chinese wool and Japanese and Korean beef imports, in particular, have, for the time being at least, restored prosperity to large areas of rural Australia, West of the Great Dividing Range.
- (iv) Reductions in protection and export expansion have been major factors in the decisive lifting of Australian relative economic performance, with average incomes growing at a higher rate than in the United States in the 1990s, after lagging well behind for most of the twentieth century.

The gains of the Australian new trade policy are still coming through. The substantial benefits of the entry of China and Taiwan to the WTO lie ahead. Japanese trade liberalisation including in services has caused market processes gradually to force institutional change. This, in turn, is expanding the scope for high-value exports from Australia. A basis has been laid for progress on global agricultural trade liberalisation in any new round of multilateral negotiations within the WTO. The new United States administration of George W. Bush seems to be committed to progress on multilateral trade liberalisation, and was crucial to the pressures for further multilateral trade liberalisation that emerged from the Shanghai APEC leaders' meeting and the Doha Ministerial Meeting of the WTO late in 2001. It must be recognised, however, that for some time at least, the administration will be constrained by a fractured Congress.

The growth of regional, preferential trading arrangements amongst Australia's trading partners in the 1990s has damaged Australian interests, but not enough

to undermine the generally favourable external trade policy environment. Australian trade interests have been damaged somewhat by trade diversion within the North American Free Trade Agreement, in the 1990s. Trade liberalisation in the ASEAN countries has been overwhelmingly on a most favoured nation basis despite the ASEAN Free Trade Agreement, and so has been strongly positive for Australia. Other discussion of East Asian preferential trading arrangements is unlikely to have any significant practical effect on Australian trade in the foreseeable future, although the announcement late in 2001 over China ASEAN trading arrangements warrants close analysis.

The post-1983 policy has been and continues to be successful under both Labor and Coalition Governments. Australia has not been driven into new approaches by any failure of established policy. There has been a substantial failure of domestic support for the policies — which presumably has followed some failure in the public presentation of policy.

Why has Australia done so well in its exports when it has been excluded from discriminatory trading arrangements in Europe and North America? The general reason is that there are now many open markets in the world, and particularly in Asia, which are available to Australian producers if they are competitive. Competitiveness is determined by developments in Australian domestic policy and economic structure. Foreign exchange and trade liberalisation, and the associated depreciation of the real exchange rate, have been highly favourable to improved competitiveness in international markets. A range of cost-reducing reforms, including the goods and services tax with its zero-rating of merchandise exports, have also improved competitiveness for export industries.

Australia's competitiveness in wider international markets has also been improved to some extent by its not having to carry the burden of trade diversion from membership of a major preferential trading bloc. Membership

of a preferential area through replacement of lower cost imports by supplies from within the preferential area, has the potential to increase costs and reduce competitiveness in third markets. Trade diversion in the European Union and to a lesser extent the North American Free Trade Area, had some negative effect on members' competitiveness relative to Australia in third markets.

### **The Benefits of an Ideal United States-Australia Free Trade Agreement**

A traditional free trade area such as that proposed by Australia for the United States is not free trade even if the partners remove virtually all barriers to trade between themselves. It is preferential trade, removing barriers to imports from member countries but retaining barriers against outsiders.

Economic analysis tells us that there is no presumption that the establishment of a preferential trade area between a limited set of countries will be economically advantageous even for the member countries themselves. It is less likely to be beneficial for the world as a whole. This is the inspiration for the Theory of the Second Best, (see the application in Lipsey, 1960). In a world in which it is not possible to remove all trade distortions, it may not be second best to remove barriers amongst some countries.

Whether or not a traditional free trade area, is second best to global free trade is an empirical matter. It is more likely to be second best the wider the range of goods and services within which one or other of the member economies has global comparative advantage. It is more likely the lower the transport and transactions costs amongst member economies, and therefore the more the members are "natural" trading partners. This introduces a tendency towards larger net gains from integration between neighbouring economies. More generally, it is more likely to be second best if the members of the area would, in the absence of preferential trade, represent a high proportion of each other's trade.

The gains for Australia from a clean free trade area with the United States would come mainly from two sources of trade creation. Trade could be created by the replacement of some higher-cost United States production by imports from Australia. The replacement of some American sugar by imports from Australia would be an example.

Trade would also be created by replacement of some higher cost domestic production in Australia by imports from the United States. The replacement of some Australian television content by imports from America would be an example.

The most important potential gains from trade creation would derive from United States reduction in protection against Australia in the agricultural sector, and Australian reduction in protection against the United States in the services sector.

The costs of a clean free trade area that had no adverse political effects at home or abroad would come from two sources: trade diversion; and transactions costs associated with rules of origin.

Trade diversion would occur when higher-cost supplies from a member country replaced established imports from outside the free trade area. The higher costs might result from higher production costs, or from higher transport and transactions costs in the new pattern of trade. The replacement of some Australian imports of motor vehicles and components from Japan and Korea by higher-cost imports from the United States would be an example. The replacement of some United States imports of New Zealand meat by higher-cost imports from Australia would be another.

Trade diversion is more likely to be important and costly when protection against imports from third countries is high.

Trade diversion was costly for the United Kingdom's standard of living and competitiveness outside the European Union when it replaced agricultural imports from the world's lowest cost suppliers (often in Australia) by high-cost imports from Europe. (In the case of the United Kingdom's membership of the European Union, the common external protection led to *higher* barriers to imports from third countries, and additional costs from replacement of imports by high-cost domestic production.)

Trade diversion has imposed costs on the United States when it has replaced imports of textiles from East Asia with higher-cost imports from Mexico and Canada. It is a remarkable fact that, since the establishment of NAFTA, Mexico and Canada have become the first and second suppliers of textiles and clothing to the United States, ahead of any of the East Asian economies that are the world's lowest cost suppliers of comparable products.

A free trade area that allows free entry for goods from some but not all countries requires "rules of origin" to define what proportion of the value to the product must be added in the partner country for it to be granted preferred access.

The increased transactions costs associated with rules of origin are recognized as being increasingly important in a world of proliferating preferential arrangements. Within a Free Trade Area with the United States, Australian officials would need to inspect imports from the United States to ensure that there was no more than a specified proportion of non-U.S. value-added in the products. This is difficult, intrusive and costly in a world of globalised production.

The costs to Australia of trade diversion and rules of origin could be removed by a single initiative in domestic policy: the removal of all protection. If

Australia moved to a free trade position in relation to all suppliers, there would be no diversion of imports to the United States, and no transactions costs of rules of origin. There are precedents for such an approach. Singapore has been able to enter free trade agreements at low cost to itself because it maintains free trade with the world as a whole. Australia is now close enough to free trade with the world as a whole with tariffs remaining above 5 per cent only for passenger motor vehicles, textiles, clothing and footwear, for this approach to be politically feasible for a Government that is persuaded of its merits.

Incidentally, it is a common argument of trade negotiators in Australia and elsewhere, that unilateral trade liberalisation gives up “bargaining coin” in bilateral, regional and multilateral trade negotiations. The argument is hard to sustain alongside the recent progress of Singapore, with virtually complete free trade in goods on a most favoured nation basis, in negotiating preferential trade agreements with New Zealand, Japan and Australia.

The United States does not represent a high proportion of Australian current or potential trade. About 10 per cent of Australia’s exports go to the United States, less than one fifth of the proportion going to East Asia (Table 1). The proportion going to the United States would not be significantly higher, and might be lower, with global free trade. In this, Australia is quite different from Canada and Mexico, for whom the United States represents the overwhelming bulk of export trade, and would continue to do so in the absence of preferential access to the United States market.

The Department of Foreign Affairs and Trade released in June, 2001, a paper that it had commissioned, presenting estimates of the economic effects of removing official barriers to trade between Australia and the United States, without either country removing barriers against the rest of the world (Vaile, 2001: Centre for International Economics, 2001).

The paper commissioned by the Australian Department of Foreign Affairs and Trade reports results from two separate modeling exercises. One exercise uses Warwick McKibbin's APG-Cubed model, and the other the well-known GTAP (Global Trade Analysis Project) model as modified by the Centre for International Economics.

Both modeling exercises were undertaken under specific assumptions determined by the Department of Foreign Affairs and Trade. It is assumed that all tariffs are reduced to zero, without exceptions. Quota restrictions on imports are "in the main" converted to tariff equivalents and assumed to be reduced to zero. Additional cases were examined, in which all tariffs and tariff-equivalents were reduced across-the-board by one quarter and one-half, but none for the more realistic case where trade barriers were reduced to zero for many products but not at all for politically difficult sectors (like sugar in the United States).

It is assumed that the movement towards bilateral free trade take place without affecting other aspects of trade policy abroad or at home.

The modeling assumes that subsidies (for example on production and exports of many agricultural products in the United States) are retained at current levels. The paper does not address the important issue of how it is possible to retain large export subsidies for some United States agricultural products while allowing free entry for similar products from Australia.

Many of what would be the most contentious issues in real-world negotiations on an Australia-United States Free Trade Agreement are removed by assumption. It is assumed that there is no change in quarantine arrangements, although reform of Australian approaches to quarantine would be a central objective of American agricultural trading interests. It is assumed that there is no change in approach to intellectual property, although parallel imports of

compact discs and the Australian government's Pharmaceutical Benefits Scheme, at least, would be priority targets of United States negotiations. It is assumed that the Australian Wheat Board monopoly on wheat exports would be retained, although its removal is likely to be a condition of Congressional support for bilateral free trade.

Perhaps the most important of the limiting assumptions imposed on the modeling are that there are no restrictive rules of origin, thus removing one of the main sources of costs from discriminatory trade. Further, it is assumed that there are no transport and transactions costs of international trade, allowing costless re-arrangement of the global pattern of bilateral trade in response to trade discrimination. For example, within the model, trade discrimination in an Australia-United States free trade area diverts United States imports of lamb from New Zealand to Australia. New Zealand exports to Australia the lamb that would otherwise go to the United States. There are no additional transport or transactional costs associated with this new pattern of trade.

The APG-Cubed model is a fully dynamic model that integrates financial and goods markets. The model is highly suitable for assessing macro-economic effects. The paper concludes that in an Australia-United States free trade area with the assumed characteristics, Australian household consumption would rise 0.5 per cent by 2020.

Comparison of these results with other publications applying the same model and methodology makes two points. First, these gains are small compared with gains from unilaterally removing the remaining Australian protection (real consumption rises by 1.08 per cent by 2020 (McKibbin, 1998, p.208)), without any reciprocation from the United States. Second, the great majority of the gains to Australia from bilateral and reciprocal free trade with The United States would come from Australia's own removal of protection against American products (McKibbin, 1998). As it happens, the small net gains that

would come from United States preferential reciprocation of Australia's removal of barriers to imports from the United States would accrue mainly through a small number of farm products, most importantly sugar and dairy products (see the results from the GTAP model in Centre for International Economics, 2001).

The paper commissioned by the Department of Foreign Affairs and trade purports to use the results from the APG-Cubed model to demonstrate that, within an Australia-United States Free Trade Area, trade creation would exceed trade diversion. In fact, the test applied for this purpose — an increase in the total value of world trade — does not establish the point. Within the framework of the model, it would be possible for the total volume of world trade to increase, even if there were no trade creation at all, and there were some trade diversion. More generally, the high degree of sectoral aggregation of the model (just one agricultural and one manufacturing industry) makes it unsuitable for detailed assessments of the importance of trade diversion and its impact on particular third countries.

The greater commodity detail in the GTAP model was the reasons for its use alongside APG-Cubed. The GTAP model suggests a moderately lower positive impact on Australian output. It indicates significant negative effects on Australian imports from its East Asian trading partners (Centre for International Economics, 2001).

### **Is Clean Free Preferential Trade Possible?**

In 1989 at the Institute of International Economics in Washington DC, in conversation with former Special Trade Representative Bill Brock, I noted that United States restrictions on imports tended to be most severe on Australia's major potential exports to the United States: sugar, wool, meat, grain (with import restrictions supporting the subsidy regime), steel and others.

Ambassador Brock acknowledged that the United States system of protection was especially onerous on products in which Australian interests were strongest. He observed that it just happens to be a fact that United States domestic political pressures are most acute in the areas of Australian interest.

Fred Bergsten, Director of the Institute of International Economics in Washington D.C., noted in conversation in April 2001 that Brazil finds itself in much the same position as Australia in relation to the protectionist neuralgic points of United States trade policy. As a result, United States participation in any regional free trade arrangement in the Americas would be highly qualified in ways that were disadvantageous to Brazil. That reality reduces Brazil's enthusiasm for free trade in the Americas.

The political pressures for protection against Australian products come together in the United States Congress, the approval of which is required for bilateral as well as multilateral trade liberalisation.

It is a bad time for open trade in the Congress. The previous Clinton administration concluded a free trade agreement with Jordan, with the labour and environment clauses favoured by the Congressional Democrats. The agreement is seen as having high strategic value and virtually no economic effects. Even so, it has so far failed to win Congressional approval because of Republican opposition to the attachment of "sanctions" to the labor and environment clauses.

The Bush Administration seems to want the United States to take a leading position in a new round of multilateral trade negotiations, and to work towards of a Free Trade Agreement for the Americas (FTAA). For these it judges that it requires "fast track authority" from the Congress, to avoid line-by-line Congressional negotiations. Congressional leaders have said that the granting "fast track" would be conditional on there being a meeting of minds on labor

and the environment. In December 2001, the House of Representatives has passed fast track authority, leaving the Senate to adjudicate on its fate. The House of Representatives vote was accompanied by a highly protective Administration decision on steel imports, and by support for a new Forum Bill that would greatly increase subsidies to United States agriculture.

On 23 May, 2001, Senator Max Baucus (Democrat, Montana), Chairman of the Senate Finance Committee, called for the addition of Australia, New Zealand and Korea to the list of countries with which the United States should seek to negotiate bilateral free trade agreements. Baucus argued that the United States should give priority to countries like Australia that might enter free trade agreements with binding labour and environmental conditions above a new round of multilateral negotiations. The opposition of many other countries to such conditions mean that binding labour and environmental conditions would be an important obstacle in new multilateral trade negotiations. The inclusion of binding labor and environmental clauses, and the downgrading of WTO negotiations, are contrary to established Australian trade policy, as well as to Bush Administration trade policy.

The established trade policy agenda before the Congress was challenging before any mention of Australia (see the floor statement of Senator Max Baucus, May 3, 2001). Once Jordan is out of the way, the multilateral round and FTAA are the priorities. Both are politically difficult.

Where does a free trade agreement with Australia fit? Congressional deal-makers have not thought much about content. When asked, they say that trade in meat, sugar, dairy products and some other agricultural goods would have to be excluded. There is no mechanism for maintaining free trade in grain with Australia alongside United States subsidies, so there is a presumption that free trade in grain would not even be discussed.

It would be much easier politically for the United States to enter a preferential Free Trade Agreement with Australia that excluded or greatly qualified free trade in the main agricultural commodities. There are three problems with this approach. First, it would be illegal under the WTO, and neither Australia nor the United States has an interest in undermining the WTO in this way. Second, it would make it harder for the United States and Australia to secure their agricultural trade interests in a new round of multilateral negotiations, if they had conceded in a bilateral trade agreement the European Union and Japanese position that agriculture should run on different rules. These two points were made strongly by Senator Baucus in a speech to the Commodity Club on June 12, 2001. Third, as we have seen, the main potential benefits to Australia of United States trade liberalisation within a free trade agreement are in agricultural trade.

There is invariably one end point of a discussion of a free trade agreement with Australia with thoughtful trade policy analysts or practitioners in Washington. Would it not be better as well as easier for the United States and Australia to work together in getting the right outcome from a new WTO round?

The best practicable bilateral free trade agreement would have much less trade creation than a clean free trade agreement. And it would be likely to have the same trade diversion and transactions costs for Australia. It would be unlikely to deliver positive net benefits to Australia.

Discussion of a free trade agreement would inevitably lead beyond trade. Some interests in each side would press for convergence on labour, environmental, tax and securities policies. Some of these matters, particularly in relation to taxation and securities laws, would have value on their own merits. Progress on these issues would not require a “free trade agreement” involving preferential trade. Indeed, it is hard to see how progress on any of these issues would be advanced more productively in the context of an

inevitably tense negotiation over trade policy, than on their own merits in other fora. Progress would be most likely if there were a major focus now on securing progress on these matters within an Economic Agreement or a new Trade and Investment Liberalisation and Facilitation Agreement, that did not encompass preferential trade, and which therefore avoided the costs and difficulties of a bilateral free trade agreement.

### **Effects on Other Trading Relationships**

It is important to weigh the effects of attempts (whether or not ultimately successful) to negotiate a bilateral free trade agreement on 3 sets of relationships: the established bilateral relationship with the United States itself; the Australian trade relationships with Asia; and the multilateral trading system.

In each case, we need to consider the opportunity cost of negotiating a bilateral free trade agreement. Both Australia and the United States have limited official negotiating time, and even less abundant high-level political, executive and parliamentary decision-making capacity. Even a politically simple arrangement, such as that proposed for Jordan and the United States, absorbs scarce leadership resources, and free trade with Australia would be politically demanding on both sides. Time spent untying knots in the negotiations on a free trade agreement with the United States is time not spent on more specific bilateral issues, on other bilateral and regional trading relationships, and on building the multilateral system. The expected net gains from bilateral preferential trade would need to be large to outweigh the opportunity cost.

At a time when Australia faces large problems in the traditional bilateral trade policy agenda, the opportunity cost is particularly high. An Australian Prime Minister or Foreign Minister or Trade Minister is allocated a limited amount of a counterpart's time. More time on a Free Trade Agreement means less progress in case-by-case presentation of Australian interests.

Australia has suffered major setbacks late in 2001 on United States steel trade and the Farm Bill, and has seen the beef quota become restrictive of Australian imports. These issues together are of larger consequence than any possible net gains from a bilateral free trade agreement. Australia's position might have been stronger if these matters had been given higher priority in the bilateral trade policy agenda.

There is much goodwill towards Australia in the United States, and a great deal in the current Administration. There is a willingness to do things that are important for Australia if they are not politically costly to the United States government. The art of diplomacy involves identification of issues that meet these tests, arguing them persuasively at all levels of Government, and pushing the willingness to be helpful as far as possible into the politically difficult territory.

The main cost to Australian-Asian economic relations of seeking to negotiate a free trade agreement with the United States, is that it enhances perceptions in Asia that Australia sees its interests mainly outside the region. This point was made explicitly by a good friend of Australia, former Indonesian ambassador Wiryono, in a paper to a conference at the Centre for Strategic and International Studies in Jakarta in March 2001.

There is no moral point at issue here. In the scramble over possible preferential arrangements in East Asia at present, there is discussion of agreements that would exclude Australia. The point is simply that it would be better to be inside than outside East Asian discussions of trade and strategic matters that affect Australian interests, and we are more likely to be left outside if we are perceived to be strongly oriented towards North America rather than East Asia in our international policy. Our alliance with the United States is known and understood, but other countries' perceptions must be managed closely if it the

alliance is not to impose unnecessary costs on East Asian relationships. The management problem would become more difficult if we were seen to discriminate in favour of the United States and against East Asian partners in trade policy.

The modeling exercise for the Department of Foreign Affairs and trade, to which reference has already been made, highlights two effects among many that are bound to generate negative reactions in Asia to an Australia-United States Free Trade Agreement. First, there would be a noticeable amount of diversion of imports from East Asia to the United States in commodities in which Australia still has substantial protection. Significant amounts of Australian imports of motor vehicles and components that are currently drawn from Japan and Korea would be diverted to suppliers in the United States (Centre for International Economics, 2001, pp.39, 41 and 44). Significant amounts of Australian imports of textiles, clothing and footwear that are currently drawn from China would be diverted to suppliers in the United States (Centre for International Economics, p.44). Second, total Australian imports would fall from Asia as a whole and for every Asian economy and group of economies for which data are presented separately in the study for the Australian Department of Foreign Affairs and Trade: China; Japan; Korea; Singapore; “other ASEAN” and “Rest of Asia”, (Centre for International Economics, 2001, p.43). Third, the effects of an Australia-United States free trade agreement on overall expected return to capital is negative for Asia as a whole and for all but two Asian economies and groups of economies for which data are presented separately in the study for the Australian Department of Foreign Affairs and Trade: China; Korea; Singapore and Other ASEAN. For Japan and “Rest of Asia”, the changes are but too small to be significant (zero to second decimal place) (Centre for International economics, 2001, p.42).

It would be naive in the extreme to think that systematic trade discrimination against economies accounting for a majority of Australia’s export trade,

leading to reductions in Australian imports from and overall rates of return on investment in these economies, would have no negative effects on imports of Australian goods and services. Two examples of what is at stake can make the point. Trade diversion would put at risk the fruits of nearly two decades of careful trade diplomacy directed at securing open access for Australian wool to China, which has led to the Chinese share of Australian wool exports rising from a few per cent to one third of the total. Trade diversion would put at risk the fruits of two decades of careful trade diplomacy directed at securing open and non-discriminatory access to the Korean and Japanese beef markets, and at unwinding past trade discrimination in favour of the United States. In each of these cases, Australia's recourse would be to the WTO, at a time when its own actions were weakening the WTO. The increase in the value of Australian wool exports to China plus beef exports to Korea and Japan between the early 1980s and 2001, alone, substantially exceeds the *total* increase in Australian exports of all goods and services to the United States anticipated as a result of movement to comprehensive clean bilateral free trade between Australia and the United States (Australian Bureau of Statistics, various years, and Centre for International economics, 2001, p.43).

Reactions to Australian trade discrimination against Asian trading partners would be the greater because it would follow a period in which Australia, in its own interests, made non-discrimination a central feature of its trade diplomacy. For example, in 1992, former Prime Minister Paul Keating assured a Japanese Prime Minister that Australia would never join a trade agreement that discriminated against Japan (Capling, 2001, p.185). It may be a worthwhile debating point, but not a protection against negative trade policy reactions, that Japan, Korea and some of the ASEAN economies have been prepared to discuss (but not yet to enter) new preferential trade arrangements that would discriminate against Australia.

In these circumstances, good arithmetic is a necessary component of assessment of Australian interests. In discriminating against imports from East Asia, Australia would be balancing the risk of small gains in 10 per cent of its export trade (directed to the United States), against the risk of losses to more than half of its exports (directed to Asia). (See Table 1.)

There is a way of avoiding the costs of discrimination against East Asia. Australia would avoid these costs if it unilaterally removed its protection against imports from all countries on the same timetable as it implemented any bilateral free trade agreement with the United States.

The third set of effects to be considered relate to the multilateral trading system. The WTO has been greatly damaged by the chaotic discussion of bilateral and regional preferential trading arrangements since the fiasco in Seattle in 1999. It is not that there has been much new preferential trade: the real economic effects of free trade between Singapore and New Zealand matter not a whisper in their immediate economic effects on the countries themselves or the rest of the world. It is rather that the perception of proliferation of preferential arrangements is undermining confidence in and support for the multilateral trading system.

This is an additional impediment to the successful conclusion of the new round of multilateral WTO trade liberalisation negotiations. Each country cites others' interest in preferential arrangements as cause for its own reduced commitment to the multilateral mechanisms. Australia and its interest in free trade with the United States is not a primary cause of this weakness in the multilateral system. It is simply part of the mess, reinforcing others' perceptions that the multilateral system has had its day.

Australia has much at stake in the strength of the WTO and in progress in the new multilateral negotiations that were set in train in the Ministerial meeting in

Doha in late 2001 — rather more than larger countries which are better able to secure their interests through the exercise of power.

It is a matter of importance to Australia that the new Bush administration is committed to multilateral free trade, and to agricultural trade liberalisation having high priority in a new round of WTO negotiations. This stands alongside the modification of the proposed Farm Bill as one of Australia's two most important interests in contemporary trade policy in the United States. The importance of the issues at stake argues for the subordination of the pursuit of bilateral preferential trade with the United States to the larger interest in United States leadership of a new round of WTO negotiations.

In truth, Australia is much more likely to move close to free trade with the United States in the context of a WTO round than through negotiation of a bilateral agreement. Substantially expanded access to United States agricultural markets is only going to be feasible in the context of multilateral negotiations. Only in this context will Congressional representatives of agricultural regions be able to present reductions of Japanese and European agriculture protection as a reasonable *quid pro quo* for liberalisation of the American agricultural economy.

### **Wider Political Economy Effects**

The negotiation of a free trade agreement between Australia and the United States would touch neuralgic points in both polities. This would have potentially important effects on the political economy of internationally-oriented economic reform in both countries, and especially in Australia. It would also have important effects on the wider United States-Australia political relationship, including on strategic matters. These wider political effects are likely to be more important than the direct economic effects of a free trade agreement.

The Australian political discussion of trade policy has deteriorated into populism in recent years, to the point where the large gains from a successful late-twentieth century trade policy count for little, so that the policy itself is at risk.

We know from the experience with NAFTA that support for a liberal trade policy can be compromised by debate on preferential trade, even in a large, secure and prosperous polity, like the United States in the 1990s. The political economy problem is that the gains from a limited free trade area are limited, but the responses from protected interests facing the possibility of import competition, and from groups with ideological objections to market exchange and capitalism, are as strong as with more broadly based liberalisation. The whole range of interests that have organized against so-called globalisation in recent years could be expected to come out in force against an Australia-United States free trade agreement.

Export interests have less at stake in bilateral than in multilateral free trade, and provide less support. The intellectual case is weaker or non-existent for a bilateral free trade agreement, and is therefore less effective in support. The opposition is as strong and the support weaker with bilateral free trade, so there is greater danger that the opponents of market exchange will be effective, with damaging implications for the political economy of trade policy more generally.

There is a special problem in the politics of contemporary trade policy in Australia. Leaders of the mainstream political parties are under challenge in rural and provincial areas from a populism that opposes market allocation of resources and open trade, and favours high subsidies for local production. The inevitable failure of bilateral negotiations to secure free access to United States markets for grain, meat, sugar and some other agricultural products would provide fertile ground for criticisms of open trade. Agreement that provided

free entry into the United States of the goods and services produced in the cities, but not for farm produce, would underline rural and provincial Australian feelings of political and economic exclusion.

The history of Australia-United States relations since the 1950s suggests an additional matter for concern, at least for the large majority of Australians who favour close and productive relations with the United States. On several occasions over the past half century, bitter disputes over trade issues, especially on agricultural trade, have intruded into the important political and strategic relationship. The danger is that attempts to negotiate a bilateral free trade agreement would again place the most difficult issues at the centre of the relationship. The inevitable disappointment of Australian hopes for free access to American agricultural markets would generate disillusionment with the relationship more generally. The economic interests at stake even in clean free trade with the United States are too small to warrant any compromise or controversy in the wider political and strategic relationship.

### **The Balance of Advantages**

Australia's established trade policy has been delivering large benefits which can be expected to expand in the period ahead. Taking everything into account, would these large gains be significantly enhanced, or would they be put at risk, by bilateral free trade between Australia and the United States?

It is worth recalling that even if Australia and the United States negotiated a clean and comprehensive free trade agreement, like Australia and New Zealand, it would produce only modest economic gains — substantially less than Australia deciding unilaterally to remove all of its remaining protection.

There has been no serious attempt by any supporter of a bilateral free trade agreement to argue against the proposition put forward in this paper, that any free trade agreement with the United States would be compromised in several

important areas of agricultural trade. Such compromise would remove the main sources of potential gains to Australia, other than those that derive from Australia removing its own barriers to imports. As a result, a bilateral free trade agreement would break the formal rules of the World Trade Organisation, encourage Japanese and European supporters of agricultural protection, and weaken the prospects of securing Australian and United States interests in a new round of multilateral trade negotiations.

All that is politically feasible is a heavily compromised bilateral free trade agreement. There is an associated risk that the United States-Australia political relationship and Australian domestic support for liberal trade policies would be damaged in the course of failed negotiation.

The Australian government has already made strong representations to Washington in support of a free trade agreement. It is not realistic to expect the matter to go away quickly. The issue now is how to contain the potential damage to Australian interests as we move forward. In the circumstances, the following four points are suggested, to minimize the risks of damage to Australia, and to increase the probability and potential scale of benefits in the discussions that have been foreshadowed by the Australian Government:

- (i) Make it clear to the United States government that Australia shares its view that the first objective of trade policy is the strengthening of the multilateral system and the successful completion of a new round of negotiations within the WTO. Discussion of a bilateral free trade agreement would be folded into the multilateral negotiations if and when the latter shows promise of success.
- (ii) Restore momentum in unilateral trade liberalisation. This would have four large benefits in the context of bilateral free trade with the United States. First, on the evidence of the model employed by the

Department of Foreign Affairs and Trade, it would deliver substantially larger economic benefits than perfect success in negotiating comprehensive bilateral free trade with the United States. Any increased market access to the United States would be a bonus. Second, it would remove the large but commonly overlooked (including in the studies for the Department of Foreign Affairs and Trade) transactions costs associated with limited free trade agreements and their rules of origin. Third, it would avoid any trade discrimination against Asia in Australian imports, and so remove risks of negative trade policy responses. Fourth, it would make pursuit of a bilateral free trade agreement with the United States consistent with Australia remaining a positive force for non-discriminatory trade liberalisation within APEC and the WTO.

- (iii) Initiate negotiations on an Economic Agreement, perhaps a new Trade and Investment Facilitation Agreement, with the United States, that is directed at reductions of transactions costs in trade and investment. Examples of matters to be covered could include a new double taxation agreement, and convergence of securities law. Such an agreement could include some commitment to trade liberalisation on a most favoured nation basis in areas of substantial importance to one or other country where there was limited political resistance in the United States. This would channel goodwill towards Australia in the United States to areas where progress faces less difficult political obstacles, more certain positive outcomes and with large potential for Australian benefits.
- (iv) Listen carefully to the messages from Capitol Hill, and desist from strong advocacy of a preferential trade agreement if they continue to be discouraging. In particular, end the pursuit of a bilateral free trade

agreement if and when it has become clear that any free trade agreement would need to exclude grain, sugar, dairy products or other major agricultural commodities.

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**Table 1 Australian Merchandise Exports**  
**(\\$A billion and percentage increase, constant 1995 dollars)**

	1989-90	2000	Increase	Percentage increase
Japan	15.8	20.0	4.2	27
China	1.5	5.5	3.0	275
Hong Kong	1.1	3.3	2.1	184
Taiwan	2.3	5.1	2.7	125
Korea	3.3	8.2	4.9	149
Total Northeast Asia	23.9	42.0	18.1	76
ASEAN	6.2	13.9	7.7	125
Total East Asia (incl. ASEAN)	30.1	55.8	25.8	86
European Union (15)	8.8	11.5	2.7	30
USA	6.6	10.0	3.4	52
World	60.4	100.9	40.5	67
Northeast Asian share of increase in exports:				45%
Total East Asian share of increase in exports:				64%

*Source: International Economic Data Base, The Australian National University, Canberra.*

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<sup>1</sup> This paper was prepared for presentation at The Australian Institute of International Affairs, Panel Discussion on Australia-US Free Trade Agreement, 19 April, 2001. This paper has been updated to include reference to later official and political statements in Australia and the United States. I am grateful to Peter Drysdale and Anne Capling for comments on the April version of the paper, and to Warwick McKibbin for discussions on the Centre for International Economics paper commissioned by the Australian Department of Foreign Affairs and Trade, *Economic Impacts of the Australia-United States Free Trade Area*.

<sup>2</sup> On the first of those occasions, in 1985, I was working as Prime Minister Hawke's economic advisor, and received a message via the Australian Department of Trade from United States Deputy Special Trade Representative Mike Smith that the United States might be interested in a bilateral free trade agreement with Australia. The office of STR would take it further if Australia were interested. The matter was discussed within the Australian government, and a paper commissioned from Professor Richard Snape at Monash University (Snape, 1986). The conclusion from the work and discussion was that Australia's interests would not be served by pursuing bilateral negotiations. Mike Smith and I agreed that the central interests of both Australia and the United States would be served better by co-operating in securing a wide agenda and success in what became the Uruguay Round.

On the second occasion, George Bush senior, in a 1992 campaign speech announced that, if he were elected President, he would pursue bilateral free trade agreements with a number of countries including Australia. There was a strong response from private Australians who follow trade policy issues that the "hub and spoke" system of free trade agreements, centred on the United States, was less advantageous to Australia than the pursuit of multilateral trade liberalisation. The discussion prompted a statement in Tokyo on a visit to Japan by Australian Prime Minister Paul Keating that Australia would never enter a trade agreement that discriminated against Japan. Bush senior in office pushed ahead with the Uruguay Round and the North American Free Trade Area (NAFTA), but not with the bilateral free trade agreements. Bob Zoellick, now Special Trade Representative for George W. Bush, then on the staff of Bush senior, had written the material on bilateral free trade areas into the campaign speech. This was obviously in his mind when he responded to the recent Australian interest in a free trade agreement with the United States by saying that he would only consider the matter if there were bipartisan support in Australia for such an agreement. The Shadow Minister for Trade in the Australian Labor Party, Peter Cook, has since indicated that the ALP's support would depend on any bilateral agreement emerging from a transparent process of public discussion, covering agriculture, being supportive of the multilateral trading system, and not damaging Australian trade interests in Asia. These are all sensible conditions, which are shared by thoughtful members of the Government. They helped to ensure that there was no rush into arrangements that were permanently detrimental to Australia's central trade interests in the lead-up to the Australian general election in November 2001.

<sup>3</sup> There was no public statement on the decision at the time. Michael Thawley, Ambassador to the United States, referred to the matter in a speech in New York in December 2000. *Australia's Trade* (Commonwealth of Australia, 2001) says that "Australia has expressed interest in the possibility of an Australia-United States free trade agreement to the new US administration. Before there was a decision to commence negotiations, the Government would need to be sure there was genuine economic benefits to Australia, as well as a commitment by the United States to address areas of critical interest to Australia."