

**Australia, US and China: Open Regionalism in an Era of
Bilateral FTAs**

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The Asia Pacific region has entered a new era of preferential trade. The emerging preferential arrangements have had no parallel in extent since the Imperial blocs of the 1930s, and in complexity since the international commercial order that inspired Adam Smith's *The Wealth of Nations* in the late eighteenth century.

Australian ministers last week hosted a visit of five members of the Indonesian Cabinet. On the agenda was an Indonesia-Australia FTA, to be discussed alongside Australia's recently established FTAs with the United States, Singapore and Thailand, and its prospective FTAs with China, ASEAN and Malaysia.

For Indonesia, any new arrangement with Australia sits alongside the ASEAN-China FTA, the ASEAN negotiations with New Zealand, India, Japan and Korea, and a plethora of other preferential arrangements. Each of the parties to FTA negotiations with Australia and Indonesia is itself engaged in many other discussions of preferential arrangements.

Some economists warned of the emerging dangers of proliferation of preferential trading arrangements when they became apparent from late 2000, and argued against the early and decisive steps that Australia took to hasten the Asia Pacific region down the preferential path. But that debate has come and gone. Mark Antony would have said that it was time to bury the old traditions of free trade, not to praise them. The task now is to analyse the emerging realities, and to apply the lessons to ongoing policy development.

The Problem of Preferential Trade in the Global Trading System

The multilateral trading system based on the GATT and then the WTO was built on the most favoured nation (MFN) principle. Within this principle, each

member of the GATT would treat each other as well as the most favoured nation. It is now widely accepted that the proliferation of preferential trading arrangements or FTAs over recent years, most importantly in the Asia Pacific region, has become an important threat to the multilateral system.

The extent of the threat was demonstrated in January 2005, with the release of the report, *THE FUTURE OF THE WTO*, by a group of eminent persons appointed by the Director-General of the WTO (WTO, 2004).

THE FUTURE OF THE WTO identifies the proliferation of FTAs, and the associated corrosion of the most favoured nation principle, as perhaps the most dangerous contemporary challenge to the open, multilateral trading system. It devotes its first substantive chapter, Chapter II, to “The erosion of non-discrimination”. It notes that while the principle of non-discrimination was at the heart of the GATT and the WTO, being embodied in Article 1, in recent times it has become almost the exception. “Certainly, the term might now be better defined as LFN, Least Favoured Nation treatment”. It notes the costs of diversion of trade away from comparative advantage that comes with discrimination; the distortions associated with restrictive rules of origin; and the incentives to resist multilateral liberalisation and the dissipation of administrative and political effort away from multilateral negotiations, that have been factors in the poor progress in the Doha Round.

Chapter II in *THE FUTURE OF THE WTO* concludes with a quote from a speech by economist John Maynard Keynes to the House of Lords in debate on the bills that established British membership of the GATT:

“The policies being proposed in 1945 for adoption by the United Kingdom aim, above all, at the restoration of multilateral trade...the bias of the policy before you is against bilateral barter and every kind of discriminatory practice. The separate blocs and all the friction and loss of friendship they must bring with them are expedients to which one may be driven in a hostile world where

trade has ceased over wide areas to be cooperative and peaceful and where are forgotten the healthy rules of mutual advantage and equal treatment. But it is surely crazy to prefer that.”

THE FUTURE OF THE WTO is pessimistic about halting soon the proliferation of preferential trading arrangements. Its main suggestion for reducing the cost to all countries of these unfortunate developments is to accelerate progress in multilateral negotiations towards zero tariffs in all countries, as this would remove the distorting effects of trade discrimination through FTAs. Australia could usefully provide a lead to its WTO partners in this way, whatever happens in discussion of bilateral FTAs.

The Challenges for Australia

For Australia, the problems of preferential trade interact with the challenge presented by the decline over recent years in the competitiveness of most of our export and import-competing industries. Trade policy issues intersect with the large macro-economic adjustment problems of which Australians have recently become aware, but are not at their centre. Improvements in trade policy and the trading system are, however, important to the restoration of Australia to a path of sustainable strong economic growth.

How do we minimize the costs of preferential trade, and accelerate progress on the general trade liberalization in Australia and its partners that is widely recognized as being favourable for Australian economic growth?

The starting point is to recognize the problems clearly.

One problem derives from Australia, through the FTA with the United States, placing itself in an unusual position in world trade—a position that history demonstrates to be unsustainable. It introduces systematic discrimination in

Australian import policy in favour of one country that is a major trading partner, and against others of comparable importance. An associated problem is that several of Australia's major trading partners have recently begun to discriminate against Australia in their import policies, most importantly so far in the ASEAN-China FTA. Recognition of the potential for problems in these developments has helped to give impetus to Australian efforts to secure new FTAs in Asia.

Unfortunately, new FTAs of the conventional kind will not solve the problem of discrimination and trade diversion. There will always be exclusions at the margin, and there is no defensible rationale for favouring Chinese over Indian textiles, or Malaysian over Hong Kong computers, any more than American over Japanese cars.

The second problem with preferential trade arises from the rules of origin. The problems are more acute now than they would once have been, since goods (especially) and services are now invariably made from inputs produced in many countries. This is what globalization is all about, and it goes further every month and year. There is no completely Australian-made fashion clothing any more, or Malaysian-made laptop computers. But a lot of fashion clothing is exported from Australia, and computers from Malaysia, providing many good jobs in those countries. These exports are competitive because they draw components from the places in the world that can supply them at lowest cost.

It is simply not possible for Australian clothing or Malaysian computers to meet US-style rules of origin and to remain internationally competitive. The costs of meeting rules of origin cause virtually all Singapore exporters to pay the generally applicable tariff rather than use the FTA in exports to the United States: it is cheaper than meeting the compliance costs and the costs of restructuring to ensure that components are drawn from Singapore or the United States. The costs of the rules of origin mean that there would be

problems in a world of preferential trade, even if thousands of FTAs joined every combination of potential bilateral trading partners.

The Productivity Commission study of Closer Economic Relations between New Zealand and Australia shows that the generous rules of origin embodied in that agreement (far simpler and more liberal than in the Australia-US FTA) have become more damaging over time, as globalization has increased the benefits of drawing higher proportions of inputs from a wider range of countries.

Big countries, first of all the US and China, have much less difficulty in meeting US-style rules of origin. The US and China may gain relatively in a world of preferential trade, but nevertheless suffer costs from the constraints on efficient specialization in their trading partners.

We have now seen enough of the new preferential trading relations in the Asia Pacific region to see that they are not vehicles for significant trade liberalization. So there is a third problem with the shift into preferential trade: it is absorbing scarce political and other resources that are in principle available in support of freer trade, without producing liberalization.

The Australia-US FTA

As the American economist Viner demonstrated half a century ago, any FTA involves elements of movement towards free trade, called trade creation, and elements of movement towards protection, called trade diversion. While the Australia-United States FTA is not the most protectionist of the new preferential arrangements in the Asia Pacific region, the Government's own report on the effects of the US-Australia FTA foreshadowed that trade diversion would exceed trade creation (CIE, 2004). Philippa Dee's excellent study for the Senate Committee on Foreign Affairs and Trade showed that the

methodology of the government report underestimates trade diversion (Dee, 2004).

Last year's arguments can soon be joined by discussion of real numbers. The first month's numbers for trade under the FTA are now available. They are no more representative than the Tasmanian count on the first hour after the polls close on an election night in early summer. But like the early Tasmanian numbers, if they are decisive they can provide a pointer to subsequent results.¹

The early count is not encouraging for those who argued that there would be large Australian benefits from the US-Australia FTA. United States import demand from the world as a whole has been growing strongly in the recent past. The value of total United States imports in January 2005 was almost one fifth higher than in the corresponding month of the previous year. There was strong growth in imports across the major categories of goods and services. By contrast, the US data indicate imports from Australia fell by over one eighth in January 2005, compared with January 2004. The Australian data tell a similar but less dramatic story, with export value to the US falling by a few percent.

In making the case for the USFTA, senior Australian foreign affairs officials had argued that the United States was the most important prospective export market for Australia (Kelly, 2003). Ironically, the first month of operation of the FTA, January 2005, saw the US market relegated to fourth place on the Australian export list (from second when the claims were being made), with third-placed Korea (after Japan and China) exceeding it by over 50 percent.

¹ If there were stronger growth in Australian trade with the US following the coming into force of the FTA, than would otherwise have been expected (especially if there were substantial additional growth in Australian exports, as trade diversion may possibly increase Australian welfare if confined to exports), it would be possible for the FTA to have increased Australian economic welfare. However, before drawing such a conclusion, we would still want to analyse the respective contributions of trade creation and trade diversion on the import and export sides. If there were no extra trade, there would be no net benefits, whatever the respective contributions of trade creation and trade diversion.

Australian exports to New Zealand, in fifth place, were within a few percent of those to the US.

US total exports increased by roughly the same proportion as those to Australia with both rising about 12 percent over the year to January 2005. US suppliers did not keep pace with the Australian import boom, and both China and ASEAN (taken as a whole) grew much more rapidly and moved ahead of the US as sources of imports.

I do not present these early data to make any definitive point about the welfare effects of the USFTA. But the data will not be surprising to people who have followed that part of the FTA discussion that was independent of Government. The FTA has removed and reduced tariffs already on many manufactured goods, and while US suppliers are able to take advantage of improved access, the restrictive rules of origin ensure that most Australian manufacturers are not. There is little reason to expect expansion in trade in services, as, with the important exception of trade in intellectual property, the FTA tends to bind rather than to change established arrangements. The change in intellectual property rights is in the direction of reducing gains from trade. For Australia, the largest potential gains from an FTA were in agriculture, but the agreement allowed little early expansion of market access. Indeed, almost any feasible outcome on agriculture in the Doha Round of multilateral trade negotiations would render redundant most of the agricultural market access provisions of the US FTA.

In its direct effects, it may be that the USFTA turns out to be sound and fury signifying nothing. But its systemic effects are substantial, and require a response.

Special Challenges of a China-Australia FTA

Sino-Australian trade has expanded strongly over the past two decades in the context of internationally-oriented reform in the two countries. Both countries (with Australia since 2000 an exception to the export growth) have expanded exports strongly in the context of a reasonably, and until recently increasingly, healthy multilateral trading system. Within this context, there has been large reduction in barriers to trade and rapid expansion of total imports in major trading partners of both countries, especially of those located in the Western Pacific region.

Neither Australia nor China showed interest in new preferential trading arrangements through the period of strong export expansion from the mid-nineteen eighties until the end of the twentieth century. Each country steadily improved its competitiveness through domestic reforms, including through the reduction of its own protection against foreign products. This allowed each to increase exports everywhere on the basis of its comparative advantage on a global basis.

One special feature of Chinese and East Asian trade expansion from the early 1990s has been the rapid expansion of trade in components. Increasingly, components used by manufacturing enterprises have been drawn from many different economies, each on the basis of the supplier's global comparative advantage. One consequence has been that the majority of the considerable expansion in East Asian and especially Southeast Asian manufactured exports for much of this period was to other East Asian economies, and comprised components.

Both China and Australia need an open global trading system to achieve their ambitions for continued export expansion and economic growth. If there is

weakness in the global trading system, it cannot be compensated by bilateral trading arrangements which take the form of conventional FTAs.

China needs an effective and open multilateral trading system, because it is far too big for its ambitions for trade expansion to be met within only part of the world economy. One feature of conventional FTAs is that they concentrate a country's exports and imports disproportionately with its FTA partners. This also concentrates the adjustment burden of one country's trade growth in its partners. For example, if China had a genuinely liberalising FTA with ASEAN and Australia, ASEAN and Australia would absorb a higher proportion of the adjustment stress to China's prodigious growth, than they would if China's growth were secured within a non-discriminatory multilateral trading system. In truth, Chinese export growth is unlikely to be sustained near the rate of recent years for long unless it is spread throughout the international economy, with all significant economies sharing the adjustment costs.

Australia, for its part, needs an effective and open multilateral trading system first of all because it is still a major exporter of agricultural products, international markets for which are more restricted and distorted than for other goods and services. Substantial liberalisation of international agricultural markets is feasible only in a multilateral context. Australia also needs an effective multilateral trading system because its considerable manufactured exports—which grew strongly from the mid-nineteen eighties to the turn of the century but have stagnated since 2000—depend on drawing many components from the economies from which they are supplied most competitively. The standard, US-style rules of origin tend to exclude manufactured goods from countries which are naturally suited to large-scale use of components from multiple sources. Australia needs a smoothly functioning multilateral trading system as well because that is essential to growth in its East Asian neighbours, the continuing prosperity of which determines the prospects for the resources

industries which are expected to provide a high proportion of Australian export growth for the foreseeable future.

These are all reasons for China and Australia to have modest expectations about realisation of important trade policy objectives through a preferential bilateral agreement.

To the extent that bilateral negotiations may encourage the further proliferation of bilateral FTAs, or further divert effort from the strengthening of the multilateral trading system, they are reasons for caution.

But even if China and Australia recognise that the proliferation of FTAs is unfortunate for the multilateral system and their own trade interests, there may still be an argument for their seeking a bilateral agreement. Contemporary policy has to take into account the contemporary reality, described so clearly in *THE FUTURE OF THE WTO*.

Within the contemporary reality, Australia, most importantly in the USFTA, now systematically discriminates against supplies from China, its most rapidly growing trading partner, and in January 2005 its largest merchandise trading partner and second largest export market. China since January 1 2004 has systematically discriminated against Australian agricultural products, within the “early harvest” of the China-ASEAN FTA. This is a factor in the poor recent performance of Australian exports of fruit, vegetables and fish to what had been a large and well established (Southeast Asia) and its most rapidly growing market (China) for these products. The imminent completion of the China-ASEAN FTA is set soon to expand discrimination against Australia across the whole range of agricultural and manufactured products.

It can be expected that the persistence of this discrimination on both sides of the relationship would gradually corrode the current excellent trade relations between China and Australia.

A standard FTA between Australia and China, if it were comprehensive in coverage and liberalised market access as much or as little as the two countries' other bilateral agreements, would end the discrimination that each country has introduced against the other in recent FTAs, and with it the costs of trade diversion away from Sino-Australian trade. If it had liberal and uniform rules of origin like the ASEAN and Australia-New Zealand FTAs, it would contain the losses—especially to Australia—of denying the use of the lowest cost components from third countries.

Such a Sino-Australian FTA would also introduce some economic gains from trade creation. I have not yet seen the results of the studies prepared for the Australian and Chinese Governments on the potential gains from an FTA, but, presuming identical assumptions and sound method (as, for example, in Dee 2004), would expect these to be larger than in the US-Australia FTA, because of the larger differences in cost structures in the two economies in industries which are protected by relatively high trade barriers. (The exclusions, safeguards and long transition periods greatly diminished the gains from trade creation from the AUSFTA in the agricultural sector, in which the potential for gains was greatest). There would be gains to both countries from Australia's acceptance of China as a market economy, with associated constraints on protectionist applications of anti-dumping rules.

We would be wise not to repeat the error of early advocates for the AUSFTA, and assume that the benefits from a China-Australia FTA would coincide with those that would follow comprehensive bilateral liberalisation. The pressure from the Australian side to have long transitions and incomplete liberalisation for some manufactures, and from the Chinese side for agriculture, are unlikely

to be entirely in vain in the current political environment of trade policy-making. And current hopes that the FTA will lead to major services liberalisation are likely to be dashed on the realisation that a bilateral FTA is a poor vehicle for the reform of regulatory structures that is crucial to nationally rewarding expansion of services trade.

Alongside these gains, a standard FTA would impose costs on the Chinese and Australian economies. The liberal rules of origin would not entirely eliminate the distortions in use of components—and following the precedent of the AUSFTA, there will be pressures for much more restrictive and distorting rules.

While such an FTA could end Australia's discrimination against China and China's against Australia, it would increase Australia's and China's discrimination against countries with which they did not have FTAs. This would introduce new economic costs of trade diversion, and new political costs as well.

Overcoming Problems of Preferential Trade

The costs that Australia imposes on itself in entering FTAs, through discrimination against important trading partners, and from introducing rules of origin into its import trade, could be removed by one policy step. Australia could allow all of its trading (and investment) partners the same terms of access that it grants to its FTA partners. It would be necessary to generalize the most liberal terms allowed in each sector, since the arrangements differ greatly across agreements. The terms for New Zealand would be the most favourable, with zero barriers to entry of all goods that meet the rules of origin, and for a wide range of services.

There is much to be said for this response. It would yield immediate and large benefits for Australian economic performance, as attested by a 2001 Productivity Commission report. It would contribute directly and quickly to improvement in the competitiveness of industries in which Australian comparative advantage is strong. This is especially helpful now, with problems of competitiveness emerging in recent years across most export industries. This approach would also encourage multilateral approaches to trade liberalization elsewhere, including in WTO negotiations.

There are two limitations with this straightforward and attractive approach. First, it runs counter to increasingly protectionist thinking in Australian trade policy-making in recent years, manifested in the opposition to domestic liberalization that is not matched by “concessions” in trading partners. One of the costs of the new era of preferential trade has been the increase in legitimacy of demands for specific reciprocity for any reductions in domestic protection. But let us not forget that it was once possible to liberalise trade unilaterally in Australia, and the further steps required are much smaller than those introduced following decisions announced between 1983 and 1991.

Second, it would not directly reduce the costs to Australia from the increasing tendency for FTAs of its major trading partners to discriminate against Australia.

This is not as big an economic issue as is presumed in much popular discussion, as other countries’ competitiveness in global markets falls when they enter trade-diverting FTAs. For example, Australian exporters gained from the dramatic decline in Canadian exporters’ shares in East Asian markets after the formation of the North American Free Trade Area (NAFTA). But the offsets would be smaller and the damage larger when the discrimination against Australia involved major Australian trading partners in its own region, as it

does with China-ASEAN, and would do with China-ASEAN, Japan-ASEAN and ASEAN—China—Korea—Japan.

Pursuing New FTAs Within An Open Trading Arrangement

I see the remedy to the problem of others' discrimination against Australia being addressed most effectively through the development of an Open Trading Arrangement (OTA). The OTA could be built into the current Australian discussions of an FTA with China, Indonesia or ASEAN.

To establish the basis for the OTA, the new Asian-Australian FTAs would embody the simplest and most liberal of the rules of origin amongst established Asia Pacific FTAs. The ASEAN FTA would be the best model, with its across-the-board requirement for 40 percent of value to be generated within the FTA.

The current quality of the Australia-Indonesia relationship, and the interests and capacities of the personalities involved, may make Australia-Indonesia a good locus for the early development of the OTA. But whichever bilateral relationship were the initial focus of exploration of the idea, the imperatives of the Australia-China and Australia-ASEAN relationships would be kept in mind.

It would be sensible for New Zealand to be closely involved in the development of the OTA, and to join the new arrangements soon after their establishment. It would be an objective of the initial discussions to achieve early membership of OTA by Japan, Korea, India, and the separate WTO customs areas of Hong Kong and Taiwan. The US would be welcome, and should be encouraged to join, although its own political economy constraints may make its acceptance of membership difficult in the early years.

Membership of OTA would be available to any country that agreed to meet the arrangement's rules.

Each member of OTA would agree to extend to its partners terms of market access at least as liberal in each sector as it had made available to any other country in a preferential trading agreement. Thus if the first of the new Australian FTAs were with China, Australia would extend to China the New Zealand CER conditions on market access. China would provide access for Australia at least as liberal as to ASEAN or New Zealand under FTAs currently under negotiation.

All members of OTA would accept value-added within any OTA member as regional value added for rules of origin purposes.

In recognition of the reality that improved market access has little meaning if members apply subsidies for exports or production, all members would agree to constraints on trade-distorting subsidies. This would not be a significant barrier to entry of East Asian or Southwest Pacific economies or of India.

Each of the members would be encouraged to provide OTA partners with liberal market access. The chances for subsequent success in attracting new members would be greater the more liberal the terms offered for access to the Chinese, Japanese, Korean and Australian markets. However, the first objective within OTA would be to reduce the practice and the costs of trade discrimination. For this objective, ease of entry for new members is more important than liberalization at the point of entry.

The entry of subsequent members would not be the subject of demanding case-by-case negotiations. Apart from acceptance of the OTA's rules of origin, the extension to other members of the most favoured preferential arrangements that it had offered to others, and the commitment to accept new members on these

terms, each member would need only to offer market access to the extent necessary to meet the requirements of Article 24 of the GATT and Article 5 of the GATS.

Now that the Australia-US FTA, with its major exceptions for agriculture, has been accepted as being consistent with WTO requirements, OTA membership by the Northeast Asian economies with highly protected agricultural sectors (Japan, Taiwan and Korea) would not be problematic. Membership would require, however, extension to all countries of the modest “concessions” on agriculture that Japan and Korea have negotiated in bilateral discussions with Mexico.

In practice and in general, bilateral FTAs have been unproductive as vehicles for liberalisation of agriculture. The OTA would be moderately liberalising, because of the generalisation of the China-ASEAN agricultural arrangements. The main challenge of global agricultural protection is in Northeast Asia, the European Union and the United States, and this can only be addressed in multilateral negotiations under the auspices of the WTO.

It would be possible to introduce two other elements into the OTA that would generate some tendency for liberalisation over time.

First, each member could agree to establish an institution for transparent, independent analysis of the effects of trade policy choices along the lines of Australia’s Productivity Commission. This would not in itself involve new commitments to trade liberalization, but would lay the basis for liberalization over time. Bill Carmichael and I have developed and advocated a model for the domestic transparency institution.

Second, each member would commit itself to cooperation within OTA to achieve a liberal outcome from WTO negotiations. OTA members would work

through the WTO to achieve free and open global trade and investment by a definite date. The definite date would be consistent with the revised end dates for free and open trade in the Asia Pacific region that are due to be discussed at the APEC mid-term review of the 1994 Bogor Declaration, scheduled for 2005.

Would membership of OTA be attractive? For all members, it would reduce, and, if and when OTA's membership had expanded to encompass China, Japan, Korea and ASEAN, remove, the important cost of exclusion from components trade that has accompanied the shift to preferential trade in East Asia. Developing countries with significant Asia Pacific trading interests would find membership relatively straightforward.

While the domestic political economy constraints may postpone US interest in membership for some time, the OTA would not threaten essential US interests, beyond the threat already present in the current proliferation of bilateral FTAs in Asia. There would be some large pluses for the US. OTA would be a useful partner of the US in global and Asia Pacific trade liberalization discussions.

There would be economic advantages, as well as gains to external political relationships, if Australia, and any other country that chose to do so, extended OTA terms of market access to all trading partners. To achieve this desirable outcome, Australia could announce a programme for removal of the last of its barriers to imports as part of the formation of OTA.

I do not pretend that the genuinely liberalising dimensions of the OTA would be as easy to implement politically in Australia as the protectionist FTAs that have been negotiated recently. The political resistance is best challenged by a return to independent, authoritative and transparent analysis of trade policy options as a basis for public education and discussion. This is the approach that facilitated trade liberalization in the 1980s and 1990s. The Government would be wise to provide a reference to the Productivity Commission, to report on the

costs and benefits to Australia of alternative trade strategy options, including the alternatives presented in this paper.

Informed public discussion of the effects of trade policy choice has in the past changed the constellation of public policy possibilities. There is no reason why it would not do so again.