

ONE SYSTEM, TWO COUNTRIES
AUSTRALIA AND NEW ZEALAND IN THE INTERNATIONAL
COMMUNITY

By

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1. A CHALLENGING GEO-STRATEGIC ENVIRONMENT

As Australians prepare to celebrate the centenary of Federation, which is also the centenary of New Zealand standing aside from the political integration of the former British colonies in what was sometimes called Australasia, the two communities face a geo-strategic environment of unparalleled complexity. It is also an environment that could generate challenges to the quality of the two communities' standards of living, security and political cultures and institutions.

I take it as given that Australia and New Zealand are different in ways that will sustain two separate sovereign governments for the foreseeable future. A century ago, New Zealand was different from each of what became the Australian states, but not uniquely different. On many measures, for example, New Zealand was no more and perhaps less different than Western Australia from New South Wales. But however fortuitous the original boundaries, a century of evolution within separate nation states — a longer period of continuous democratic political evolution than in all but a few contemporary States — has emphasised and institutionalised difference and dulled similarity.

I mention the differences at the beginning because I am going to talk mainly about the interests that Australia and New Zealand share in the international community, the similarity of the challenges that they face and the advantages, indeed the necessity, of meeting these challenges together. An Australian can easily make a mistake in relation to New Zealand that is familiar to him or her from American perceptions of Australia. The mistake is to see many shared values and institutions and to assume an identity and not merely a similarity of interests. The differences are many and important, starting with the great but different challenge that each faces in relations between the descendants of early and late inhabitants of the respective territories.

Over a century of separate political evolution, the differences have sometimes included policies and implications of policies which are not obviously related to differences in the interests of the two communities. A failure of analysis and leadership in both countries saw Australia and New Zealand place huge barriers in the way of productive economic interaction between them for most of the century. The barriers made the business communities in each see each other mainly as threats and rarely as partners. Under Closer Economic Relations, that has all changed since the mid-1980s, to the considerable advantage of the people of both countries. The story is almost the opposite in security affairs. There was a presumption of near identity of interests for most of the century. This led to the military forces of the two countries fighting in the same cause in South Africa in the first years of the Australian Federation, in the Middle East and Europe in two world wars, in Korea, Malaya and Vietnam(but not the Kokoda Track). But within a couple of years of the biggest step in correction of the long failure in economic co-operation, the two countries diverged in their security orientation, with New Zealand withdrawing from the alliance that Australia continued to see as being the basis of its defence policies.

So much for the differences.

Each of Australia and New Zealand must come to grips with three profound changes in its geo-strategic environment, affecting the choices and opportunities of small, isolated communities on the Southeastern edge of Asia. However Australia might look from across the Tasman, it is disadvantaged by its small economic size and isolation. The three changes interact with each other in important ways in their effects on the two countries, so that success or failure in one will influence the outcome on others.

The first of the special challenges is a set of developments in East and particularly Southeast Asia in the aftermath of the East Asian financial crisis which, together, have had the effect of moving Australia from the centre to the

periphery of East Asian discussion of international cooperation. It is not a directly economic legacy of the financial crisis that is important for Australia and New Zealand. Growth has returned to all economies that experienced recession in 1998. In most cases, but not in Indonesia, growth rates are as high and prospects as strong as prior to the crisis. There has been no notable retreat into protectionism. The Malaysian experiment with exchange controls has not seriously qualified a relatively open approach to trade and investment, and there has been liberalisation of direct foreign investment in several economies. The problem is rather the crisis's legacy of attitudes to various matters of international economic cooperation. Regional as distinct from global approaches to international economic cooperation in East Asia have recently been accorded enhanced legitimacy, with active discussion of a number of sub-regional trade agreements, and with the ASEAN Plus Three East Asian group beginning to play a substantial role in regional affairs. There are greater doubts about heavy reliance on advice from and cooperation with the West in parts of East Asia, most particularly Southeast Asia.

The coincidence of an historic political transition in Indonesia with financial crisis and its traumatic economic legacy has left Indonesia struggling to find an institutional basis for stable economic policy and social order. Indonesian perceptions that Australia had suddenly changed course on the issue of Timor Independence have interacted with Indonesian feelings variously of disappointment and humiliation at the developments in Timor, and with perceptions that Australia managed its leading role in Timor with arrogance, to turn one of Australia's closest (if always complex and challenging) relationships in Asia for the time being into its most difficult at the official level. In parts of the Indonesian official system that were most unhappy about some or other part of Australia's role in Timor, principally parts of the ministry of foreign affairs and the military, there are anxieties that Australian-based groups will extend their activism for political separatism to other Eastern provinces, including Papua. This causes Australia to be seen as a threat to Indonesian security in these quarters.

The relationship retains most of the intimacy and importance that has emerged over the past couple of decades at a private level. But it is the official view that matters most between States, and Indonesia is no longer a voice arguing strongly for Australia to be seen as a full participant in regional economic and security discussion.

These developments between them create a risk that Australia and New Zealand may not be able to benefit fully from the opportunity that would otherwise be available partially to redress geographic disadvantage through linkage to economic growth in East Asia. At worst, it could lead to the exclusion of Australia and New Zealand from fora which discuss and take decisions on matters of large importance to them.

The second change in the geo-political environment is the recent developments which underline the fragility of constitutional order, and with it prospects for social and economic development, in the northern arc of islands, from Timor through Papua New Guinea to Vanuatu and Fiji, which some Australians have come to call the Arc of Instability.

Timor came to Independence in the most unpropitious of circumstances — which were probably the only circumstances in which Independence would have been a possibility. It starts its independent life with an inadequate cadre of well-trained and experienced administrators of affairs of State, no settled institutions of governance, and no democratic tradition of Government within which to build a new country. There is no system of national revenue collection, no national system of budgets or accounts. There are few well-trained people, and less after the departure of officials who were comfortable with Indonesian nationality, to maintain health, education and other community services. The chances of instability and disorder are large, and of a smooth path to successful development small. In its institutional and human resource base for Independence, Timor is weaker than that of the Melanesian island States that became independent in the

1970s, and whose poor preparation for Independence is still felt keenly a quarter of a century on.

The Eastern provinces of Indonesia, including Papua, have their own acute development problems, to the easing of which the new Indonesian government is deeply committed. The problem is not the commitment and goodwill of the government but the immense difficulty of the task, with weak institutions of State and civil society, and inadequate human resources. The new political order in Indonesia no longer sees the use of official violence as a normal means of managing social tensions, and local communities will take time to learn the alternative paths to social order. Here, as in the independent States in the Arc of Instability, successful development is a task that will take generations — a period to build and to learn to operate new institutions, and for a new generation to grow up in confident familiarity with the bases of a modern, democratic society.

Fiji and the Solomons have been dominating news in this part of the world over the past month, with constitutional democratic government having been overthrown by terrorist action in both cases. This dramatises without changing the problems of political order and development in the island states of Australia's and New Zealand's own Pacific region. The weighted average political and economic state of the region is probably no worse than a year ago, before the Morauta Government in Papua New Guinea won office and began to introduce a so far successful programme of reconstruction and development, with an initial focus on economic stabilisation. Papua New Guinea is back into building institutions rather than consuming them. But even in these more favourable circumstances, the time that it will take to sculpt a secure institutional basis for democratic social order and development has to be measured in decades rather than years.

Australia and New Zealand have an immense stake in the progress and eventual success of the island States in the northern arc, and in the Eastern provinces of Indonesia. Success can only come over a long period. Success would bring

productive relations with neighbours, and higher standing in larger communities in East Asia and the North Atlantic that are important to Australia and New Zealand in other ways. Failure would be more dramatic, and the possibility of failure of development in the near northern island region may provide more powerful impetus to policy response. Failure would mean problems at the sea borders, of crime related to immigration, arms and drugs. It would mean human destitution on an immense scale, and associated problems of refugees. It would mean periodic unscheduled demands for military intervention at large budgetary and other cost. It would mean continuing tension in relations with Indonesia and Indonesia's Southeast Asian partners. And it would mean a serious down-grading of Australia's and New Zealand's standing in the wider international community as effective developed societies.

The third change in the geo-strategic environment is of a very different nature. It is the reduction in the cost of moving people, goods and especially capital, information and services that is at the roots of the phenomenon that has come to be popularly known as globalisation. At first sight, the reduction in transaction and other trade costs would seem to diminish the disadvantages of isolation and of small scale. In some ways it does. But the larger part of the expansion of trade and incomes growth in the new economy associated with globalisation comes from fine specialisation in complex goods and services, and transactions with elements of direct foreign investment. Despite the greatly increased role of electronic transactions, in which the quality of the business and physical infrastructure matters a great deal and distance in itself not much, participation in the intense trade and fine specialisation in the new areas of economic activity, and continued competitiveness with new technology in old areas of the economy, requires a high degree of knowledge and trust between the parties, supported by cultural familiarity and face to face contact and exchange amongst experts in a particular field, and suppliers of a wide range of services. The finer specialisation and global reach of successful enterprises in the new economy supports the emergence of a small number of global and regional headquarters in each line of

business. While some activities in the new economy can be undertaken without penalty at great distance from the global centres of economic activity, the highest value activities mostly cannot, unless producers in the decentralised location can establish global competitive strength, and themselves form a world centre for a particular activity. In the new economy of lower transactions and trade costs, talent as much as information has become more mobile, so that the best human resources move to the centres of initiative and excellence in which their skills can be most productively applied and have highest value, often near the great economic centres of the North Atlantic and the North Pacific. The industries based on specific resources that anchor labour and human capital to a particular location, which attracted much of the immigration to the antipodes in earlier periods of European settlement, are less important in contemporary economic activity.

It is now harder for small and isolated economies to hold their most economically productive young people. Australia and to a lesser extent New Zealand have become less isolated with the shift in the centre of gravity of the world economy towards East Asia in recent decades. But this lessening of disadvantage alone is only a partial offset to the tide generated by the new technologies and their effect in practice on the location of economic activity. An attractive physical environment can help as one element in a package to hold or attract high value employment, but it is much more influential if the superior environmental amenity is within commuting distance by a fast train from a great metropolis. Australia struggles to maintain a strong position in the knowledge-intensive industries, and to hold its most economically productive young people. New Zealand struggles against worse odds.

It is not that it is impossible for a small and isolated community to do well in the contemporary global economy. It is not impossible for small and isolated economies to develop areas of specialisation in which they are genuinely world class. The greatly improved economic performances of the reformed Australian

and New Zealand economies over the past decade or so makes the point. But success requires sustained effort and there is not much room for error in policy.

2. EAST ASIAN REGIONALISM AFTER THE FINANCIAL CRISIS

Economies trade more intensively with regional neighbours than with others. This is true in the Asia Pacific as it is elsewhere.

There are good economic reasons for regional concentration of trade and investment. Trade costs tend to be lower amongst regional neighbours than in intercontinental trade. This is obviously true for merchandise trade, where transport costs tend to be high, and where distance is related to transport costs. But transport costs are not the only or even the main trade costs affecting the country pattern of international trade. Other transactions costs are as large as transport costs in determining patterns of merchandise trade, and much more influential in the services trade that is more important in what has become known as the new economy. These include the costs of maintaining trust and good communications on matters of great complexity between people of different cultural backgrounds. These subtle components of transactions costs are more important for the fine specialisation and intra-industry trade that has contributed exceptionally to global trade expansion in recent decades. They are especially important for direct investment, and this, in turn, is an important influence on trade (Drysdale and Garnaut, 1993).

For these reasons, the natural tendency towards regional concentration of international trade is as important for the new as for the old areas of trade expansion, for services trade as much as for merchandise trade, and for the so-called new economy as much as for the old.

There are also economically damaging causes of intense regional trade. It is common for regional trading relationships to be reinforced by discrimination against non-members, through tariffs and other trade barriers imposed by

Governments being higher for outsiders than for members. Trade discrimination is a central feature of the European Union and the North American Free Trade Agreement, and is present in the Association of Southeast Asian Nations and in Closer Economic Relations between Australia and New Zealand. Importantly, it is not a feature of Asia Pacific Economic Cooperation or of regional concentration of trade within Northeast Asia.

The European Union and the North American Free Trade Agreement are the dominant models of formal regional cooperation. One of the characteristics of the traditional regional trading arrangement, such as the European Union or the North American Free Trade Agreement, is the establishment of free trade amongst members while maintaining official barriers to trade with non-members. The free trade amongst members has generally expanded trade inside the area, and sometimes through this process the incomes of members. The discrimination against outsiders has diverted some established and potential trade between members of the free trade area and the rest of the world, to trade between members. This second aspect of the regional arrangements has lowered economic welfare in non-members and in the world as a whole, and has diminished the benefits of regional cooperation to members as well.

It is obvious that the traditional forms of economic cooperation intensify trade amongst member economies. It is less obvious, but no less true, that traditional, discriminatory regional trading arrangements also intensify trade amongst excluded countries. The member economies become less competitive in markets that are outside the regional arrangements. The tangle of rules of origin that is invariably associated with the old regionalism is an especially costly burden in the new economy.

Ultimately, the effects on trade and economic welfare in members and the rest of the world of the establishment of a traditional regional trading arrangement,

embodying discrimination against non-members, depends on what it does to the political economy of trade policy in member economies and in the world as a whole. Does it create momentum for more general and non-discriminatory trade liberalisation? Does it divert political focus from unilateral trade liberalisation, and the reduction of trade barriers through multilateral negotiations? These questions have no answers that apply in all circumstances. Rather, the answers need to be formed by analysis of particular circumstances.

We can say in all circumstances that regional trade liberalisation that is implemented without discrimination against third countries expands trade and increases economic welfare in members and in the world as a whole. This is the modern model of regional cooperation, called “open regionalism”, upon which APEC commitment to free and open trade and investment in the Asia Pacific region is based. ANZCERTA is close to being a clean form of “open regionalism”, since Australia and New Zealand have removed most of their trade barriers against the rest of the world alongside their bilateral free trade. “Open regionalism” is especially suited to the complex world of the new economy where production and trade is characterised by fine specialisation, worldwide sourcing of inputs and sale of products, and the need for fast transaction times.

Regional economic cooperation, whether or not it embodies discrimination against outsiders, invariably extends beyond trade liberalisation. Some measures to encourage economic integration through reduction of transaction costs have the effect of expanding trade and investment among members without damaging trade with or economic welfare within the rest of the world.

This is the background against which East Asian countries have come to consider regional trading arrangements in the aftermath of the financial crisis. The intense established economic relations in East Asia, and more generally in the Western Pacific, are mostly the result of the exceptional opportunities for

expanding incomes through trade and investment among members of the same region. They have been boosted a bit by common exclusion from the discriminatory trading arrangements within Western Europe and North America. They have been supported in significant ways by the building of confidence in open economic strategies through participation in APEC.

The huge expansion of East Asian, Western Pacific and Asia Pacific economic relations over recent decades is a triumph of market processes over political constraints. The regional arrangements that evolved in East Asia from this history were initially cautious in their ambitions, built on voluntary commitments more than binding agreements, and careful not to damage important relationships outside East Asia and the Pacific.

ASEAN and APEC emerged from these processes. By the late 1990s, each had evolved into forms that were very different from the European and the younger North American models of regional economic cooperation. Each had important achievements to its credit.

Principal amongst the APEC achievements were a number of practical steps in trade and investment facilitation to reduce transaction costs; the strengthening of confidence in each Asia Pacific economy that continued open policies in others provided a secure basis for deeper integration into the international economy; the support that the APEC goal of free and open trade in the Asia Pacific region gave to unilateral trade liberalisation in Indonesia, the Philippines and China in particular but also in Australia, New Zealand and elsewhere; the framework that it established for resisting retreat into protectionism in the financial crisis; and the opportunity it provided for high-level consultation amongst Asia Pacific governments, including on the marshalling of financial support and technical assistance on monetary matters for countries damaged seriously in the crisis. APEC has provided consistent support for the WTO, and its predecessor the GATT, and on a number of

occasions an APEC consensus has been highly influential in developments that have strengthened the global trading system.

From the earliest days of discussions of Asia Pacific Economic Cooperation, the Southeast Asian countries worked within ASEAN and APEC to ensure that the roles were complementary. The ASEAN Free Trade Agreement (AFTA) was nominally discriminatory, but in practice, as with ANZCERTA, movement towards the goal of free trade within ASEAN was principally through non-discriminatory liberalisation and strongly supportive of the APEC goal of free and open trade in the Asia Pacific region. Most AFTA members are committed to multilateralisation of ASEAN free trade within a time frame that supports the APEC goal of free and open trade and investment by 2020 (Garnaut, 1996).

Developments in recent years have raised questions about whether the established regional (ASEAN and especially APEC) and global (the WTO and the IMF) institutions are meeting East Asian requirements for a framework for international economic cooperation. The difficulties in securing membership for China and Chinese Taipei weakened the WTO. The back-loading of textile trade liberalisation in Europe and the United States in the Uruguay Round settlement encouraged cynicism. The apparent capitulation in Seattle to populist forces seen as opposing export expansion from developing countries raised doubts about the continued relevance of the WTO. APEC's legitimacy was weakened by the perception that it had played an inadequate role in response to the financial crisis, and by the disappointment on Early Voluntary Sectoral Liberalisation at Kuala Lumpur in 1998. Recurrent political tensions between the United States and some East Asian countries, especially China, provided encouragement for people who favoured new, exclusive East Asian cooperation. The IMF was seen in some countries as having mis-judged the policy response to the financial crisis, and as having represented United States interests in its advice and conditions on funding.

There has been a plethora of proposals for sub-regional trade arrangements that would see important APEC members shift trade policy priority to negotiation of “free trade” arrangements of a potentially discriminatory nature. The discussions between Japan and Korea are desirable for the Asia Pacific region if they reduce historic distrust between two major countries, but have the potential to do great damage to the open regional and global trading systems if they settle into the mould of a traditional discriminatory free trade area. Potentially but not necessarily discriminatory arrangements have been proposed, amongst others, for Japan-Korea-Taiwan; AFTA-CER; Japan-Mexico; Korea-Chile; AFTA-Chile; Singapore-Japan; Singapore-New Zealand; United States-New Zealand; and United States-CER.

This is a time for major efforts in leadership in support of an open trading system. This leadership was not provided by the US in Seattle. Japan could once have been relied upon to point out the potential danger in these developments, but not at this time. A former WTO Director-General, at the Singapore Ministerial Meeting four years ago, noted that the WTO could be rendered largely irrelevant if there were undisciplined proliferation of regional trading arrangements (Ruggiero, cited in Garnaut, 1996). He called for commitment to the APEC concept of Open Regionalism as a means of harnessing the enhanced legitimacy of regionalism to the strengthening of an open global trading system. Earlier this month, at the time of the APEC Trade Ministers’ meeting in Darwin, the current Director-General endorsed APEC open regionalism as a means of ensuring that regional arrangements were supportive of the WTO. However, unlike his predecessor, he seemed to endorse discriminatory arrangements so long as they met the inadequate tests of not creating new trade barriers or becoming hostile blocks.

The contemporary discussion of East Asian regional cooperation also includes consideration of the “ASEAN Plus 3” grouping, covering ASEAN, China,

Japan and Korea, evolving from its current status as a focus for high-level consultation (now at Heads of Government level) into a more formal institution. Its first practical agreements relate to monetary cooperation, but there is some talk of sub-regional free trade.

The new legitimacy of sub-regional arrangements has positive as well as negative origins. The challenge is to channel its potential for change in ways that strengthen wider regional and global mechanisms for international cooperation. The response to the challenge must begin with clear-headed recognition of the dangers.

The WTO can be damaged in two ways by regional trading arrangements. One is by diversion of the political will and effort and administrative capacity of member governments away from the strengthening of WTO mechanisms and from a new round of multilateral trade negotiations. The second is through the proliferation of discriminatory regional arrangements, which can render the first Article of the WTO, the most favoured nation principle, irrelevant, whether or not they are legal under Article 24 of the WTO. The WTO alone can develop the rules-based system that is necessary for the international community to take full advantage of the potential gains from global free trade, enhanced as they have been by the new information technology.

New regional, sub-regional and bilateral trading arrangements may be able to generate gains through cooperation to reduce transaction costs in trade and investment amongst members. They may be able to take some areas of cooperation further in sub-groups than in what is now the huge and diverse membership of APEC. But if they went further than this, to the negotiation of binding agreements for discriminatory free trade, they would be very likely further to reduce the coherence and effectiveness of APEC, and to corrode the WTO.

The APEC concept of open regionalism provides the means for reconciling the building of new regional arrangements with the requirements of a strong WTO.

Once the dangers have been identified, how do we channel the energy in contemporary sub-regionalism into strengthening the open trade system? There are gains and few risks if the primary focus is on technical assistance and on a wide range of co-operative activities to reduce transactions costs among regional neighbours, without seeking to negotiate special arrangements on market access. If the political dynamics of sub-regional cooperation generate pressure for improved market access, as they may do, for example, between Japan and Korea, a primary commitment to open regionalism is the discipline that is necessary to ensure that the new arrangements are supportive and not destructive of APEC and the WTO.

In the absence of leadership on these issues from the major developed economies, it is particularly important that Australia and New Zealand take a clear-headed view of their own and the region's interests into their discussion of sub-regional arrangements. They need to recognise, however, that this is a time when their role in shaping the regional agenda has been diminished for a while by the legacy of the financial crisis and Timor. The dangers of marginalisation in important regional developments in East Asia make it important that Australia and New Zealand seek positive outcomes from current discussion of a link between CER and AFTA, and make it clear that they would welcome unconditionally an invitation to participate in the ASEAN Plus Three discussions, which would become ASEAN Plus Five.

Australia and New Zealand would increase the chances of positive outcomes from the current discussion of sub-regional economic cooperation by doing two things. The first is to complete the transition to complete free trade in goods in each of their own countries by the APEC deadline of 2010, making ANZCERTA a clean example of open regionalism, and making it possible to

enter other free trade arrangements in the Western Pacific without discriminating against other trading partners. The second is to do what we can, within a realistic assessment of our influence, to ensure that any market access liberalisation that emerges from discussion of the AFTA-CER links and ASEAN Plus Five be within the framework of open regionalism.

3. DEVELOPMENT IN THE ARC OF INSTABILITY

The management of relations with Australia's immediate neighborhood, is the country's most demanding foreign policy problem. It could hardly be different for New Zealand, given the prominence of the South Pacific in the country's external orientation.

The special features of the challenge include the analytic difficulties in settling upon an approach that is likely to be successful, the immense fiscal demands of the necessary programmes for development, the long-term nature of the task, and the intricate complexity of the diplomacy required to steer a steady course over long periods. They include as well the reality that in this region, or at least in that part of the region East of the Papua New Guinea border with Indonesia, the international community expects Australia and New Zealand to take the lead, and mostly to carry the load alone.

We do not yet understand well enough the requirements for sustaining a constitutional democratic order and development in the island communities. Part of what must be done therefore involves research. Part of the requirement is long-term assistance to human resource development and institution-building. Part will involve the commitment of Australian and New Zealand human as well as financial resources directly to the protection of constitutional order when, as they will sometimes do, the local mechanisms break down. The effort must include a large, sustained diplomatic effort within the region, most importantly through the South Pacific Forum, to provide a supportive framework for sustained interaction of great intensity; and beyond the region

to build understanding and support for the region to manage its affairs in this way.

The domestic and international political difficulties for Australia and New Zealand are immense. It is a challenge beyond the normal capacities of our political systems, with their short time horizons and demand for concrete and immediate outcomes from policy initiative. The effort will suffer from being politically, and for the individuals who will be called upon to do the work, personally and professionally, a thankless task.

Progress will be slow, at times to the point of imperceptibility. There will be setbacks, and periods when the effort will seem to have been fruitless. Worst of all, at best it will be several decades before success will be realised.

Why bother?

Because there is no realistic alternative. No matter how bad things are now, with the breakdown in constitutional order in Fiji and the Solomons, they will get much worse without concerted action from the region, led by Australia and New Zealand.

In Timor, it is better for everyone if Australia and New Zealand are strong supporters of a development programme in which Indonesia and the European Union also play leading roles. I fear, however, that the European interest will recede to issues closer to home, and that international leadership of continuing support to Timor will fall to cooperation between Australia with support from New Zealand, and Indonesia — placing another load on an Australia-Indonesia relationship that is already under strain.

We have taken some important steps together over the past year. For all its unfortunate implications for Indonesia-Australia relations, Australia-New

Zealand cooperation in developing the coalition of the willing on East Timor around the Auckland APEC Summit led to successful humanitarian intervention. At the same Auckland Summit, the New Zealand hosts were instrumental in organising a first meeting of Friends of Papua New Guinea, with Australia in the Chair, in support of the new Morauta Government's commitment to economic stabilisation and political and economic reform. This has to be just the beginning.

4. ONE SYSTEM, TWO COUNTRIES

More effective integration of the perspectives, policies and economies of Australia and New Zealand, around the concept of open regionalism, can reduce the risks of marginalisation of the two countries from developments in East Asia. More effective cooperation can also increase the chances of success for the two countries' contributions to political stability and economic development in the small island countries in their neighborhood. In these ways, they could *indirectly* support the two countries in meeting the special challenges to small isolated economies in the world of falling trade and transactions costs and "globalisation".

Many of the *direct* benefits in meeting the challenge of globalisation in small, isolated economies through Closer Economic Relations have already been realised. But unrealised gains from completing the unfinished agenda of CER are not negligibly small, especially for New Zealand.

In *Australia and the Northeast Asian Ascendancy*, I drew attention to the high costs of maintaining a world class analytic and diplomatic effort in relation to East Asia, and suggested that Australia's disadvantage of small scale would be helped a bit through an integrated effort with New Zealand. Some of the potential gains to which I drew attention eleven years ago are still available.

Trans-Tasman integration in several of the service sectors has lost momentum, amongst other things weakening Closer Economic Relations as a model for regional economic cooperation.

The recent New Zealand proposal for monetary integration has extended the bilateral agenda. It has merit.

A recent book by Grimes and Holmes (2000), *An ANZAC Dollar* has drawn attention to the volatility of the New Zealand dollar since the float in 1985, and the tendency for it to respond more strongly to domestic than external shocks. The Australian dollar has fluctuated more sympathetically than the New Zealand currency with New Zealand's as well as with Australia's external terms of trade. The larger currency area would be a bit more stable in response to fluctuations in sentiment in international markets than the Australian dollar alone, and substantially more stable than the New Zealand dollar alone. Grimes-Holmes correctly draw attention as well to the significant reductions in New Zealand's international transactions costs from a common currency, although this source of gain would be small for Australia.

Former Australian Deputy Prime Minister, Tim Fischer, has supported a joint currency and suggested that it be called the ZAC.

The Australian Treasurer has commented that if New Zealand wishes to base its currency on the New Zealand dollar, it is welcome to do so. New Zealand and Australia would each realise most of the potential economic gains from integration if New Zealand took this step unilaterally, perhaps through a currency board system.

The Australian Treasurer did not hold out much encouragement for going further, and working towards a joint currency, although there are advantages in doing so. To have any chance of being politically acceptable in Australia, the

respective roles of Australia and New Zealand in setting the rules, and maintaining a joint currency, including through appointments to the Board of the Central Bank, would need to reflect the relative sizes of the two economies.

While most of the prosaic economic gains from integration could be achieved through a unilateral decision by New Zealand to peg its own currency to the Australian dollar, I see three advantages in taking the extra step to a joint currency.

First, while both Australia and New Zealand have successfully developed perceptions and reality of central bank independence in recent years, a central bank established by international agreement, with, say, one member of a 6-person Board nominated by the second government, would be more obviously and indissolubly independent. The extension of the talent pool to New Zealand would make it a bit easier to find the required complement of qualified independent Board members without conflicting interests.

Second, a joint currency would be politically more palatable in New Zealand than a currency board based on the Australian dollar. Of course, this would only be a net gain if the joint currency came to have political support in Australia.

Third, a new joint currency would provide a sound base — probably a bit more attractive to the island States than the Australian dollar alone — for the currency board systems that would provide the necessary monetary stability for long-term development in the South Pacific island economies. This would be an important development, since badly managed independent currencies have been an important problem for development.

I was asked in Christchurch in early July, 2000, whether, given the gains so far, the potential gains from completing the unfinished agenda, and the imperative

of working together on wider regional issues, it was inevitable that there would be continued progress on Closer Economic Relations.

Regrettably, it is not inevitable.

The incremental gains to Australia from completing the unfinished agenda are not so large that they seem obviously worth the effort, if there are irritants in the broader Australia-New Zealand relationship that raise the Australia political costs of further steps in cooperation. In this context, the divergence in approaches to defence — on defence expenditure and its orientation, and especially on the United States alliance — is more than a small irritant. I note that last week's Australian Defence Discussion Paper (Commonwealth of Australia, 2000) barely mentions New Zealand in its treatment of alliances. A soon-to-be-released book by American and Australian foreign policy and defence analysts on Asia Pacific security issues, edited by Blackwill and Dobb (2000), barely mentions New Zealand. In a rare reference Dobb says that "Canberra will increasingly" come to see New Zealand as more of a liability than a useful ally.

The recognition in both Australia and New Zealand, following recent developments in Timor, Fiji and the Solomons, that relations with countries in the Arc of Instability will require stronger defence capacities can provide a basis for a new and more productive discussion on defence cooperation.

I hope that it does. Australia and New Zealand face immense strategic challenges in the period ahead. Deeper integration of policies and economies would increase the chances of success with these strategic challenges, even for Australia, larger but still small in a contemporary international context. Australians and New Zealanders should need no other reason to make the effort.

But there are other reasons. Our commitment together to open regionalism can make a significant contribution to peace and prosperity in East Asia and the Asia Pacific. Our commitment together to a long-term programme of constitutional stabilisation and institutional and economic development in the South Pacific island economies, would seem to be a necessary condition for those countries' eventual success.

In China, a unique set of historical circumstances has made it important to maintain separate economic systems in China, Hong Kong and Taiwan, while holding up some symbol of national unity. Ye Yuanjing and Deng Xiaoping used the term "One Country Two Systems" to describe their version of arrangements to meet these conditions.

In Australia and New Zealand, a century of separate political sovereignty, and a different unique set of historical circumstances, have made it important at this time in history to maintain symbols of separate sovereignty. At the same time, the similarity of interests in a wide range of economic and international affairs argues for deep integration and closely complementary policies. If Australia and New Zealand get it right in each of their own interests, "One System, Two Countries" would be an appropriate description of their relationship to each other.

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