

REQUIEM FOR ULDORAMA: A PLAIN BUT USEFUL LIFE

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*'As the great economist Jacob Viner pointed out in 1950, when asked by the Carnegie Commission to write a report on postwar commercial arrangements, free trade areas (FTAs) are not free trade. While they remove tariffs for member countries, they also increase the handicap (for any given external tariff) that nonmembers suffer vis-à-vis member-country producers in the markets of the member countries, implying therefore protection against them. So, FTAs are two-faced: they free trade and they retreat into protection, simultaneously. Of course, those who are used to sound bites and cannot think of more than two words at the same time will read "free trade areas" as "free trade"' (Jagdish Bhagwati, *Free Trade Today*, Princeton University Press, 2002 p107).*

We are gathered here today to praise, and to honour in hope, a brave new world of international trade. My small role is to reflect upon and momentarily celebrate the life of Uldorama, whose life preceded the emergence of the new order.

Uldorama was hardly known to most people. If her name arose in conversation, it was usually to remark upon her ordinary features. On occasions when her name stirred larger passions, it invariably reflected mistaken identity.

But while neither powerful nor famous, nor in any way glamorous, Uldorama had uncommon virtues, and made contributions to our lives beyond our recognition of them. So I am glad of the chance that the organisers of the Conference have given to me, humbly to provide a eulogy for a good lady whose presence greatly enriched Australians through her short and modest life.

Uldorama was born in Australia in 1965, in the year that Alf Rattigan began to exercise independent authority as Chairman of the Tariff Board and Max Corden completed his most important articles on effective protection. Her parents were earnest Australian economists. They proudly if clumsily named

their daughter for an acronym, **U**nilateral **L**iberalisation **D**omestically, **O**pen **R**egionalism in **A**sia, **M**ultilateralism **A**broad. Some friends were unkind enough to laugh at the name. “Liberalisation in Australia!!”, they would say in shock and then with laughter. “And what relevance could Asia or multilateralism or the world beyond our shores have for the life of a young Australian born two thirds of the way through the twentieth century?”.

A wise old historian colleague of Uldorama’s parents, Keith Hancock, warned that her name would add to the challenge of her family heritage. “Protection in Australia has been more than a policy: it has been a faith and a dogma”, he would say. “Its critics, during the twentieth century, dwindled into a despised and detested sect suspected of nursing an anti-national heresy. For Protection is interwoven with almost every strand of Australia’s democratic nationalism”.

When she was old enough, Uldorama took the old man’s words seriously, and read again and again Chapter V of the famous history that he had published in 1930. She reconciled herself to the reality that much of her life would be lonely.

Many children would react against such earnest parents. But not Uldorama. She absorbed the learning offered by demanding parents and at an early age began extending it. It was a highlight of her early life when at fourteen years she accompanied her parents to Washington and into the office of a young Dick Cooper, then on leave from the Economics Department at Harvard University, and serving as Assistant Secretary of State for Economic Affairs. Her parents wanted to talk to their American friends about regional cooperation amongst Asia Pacific countries, which would include the United States. “Forget about regionalism if there is any trade discrimination”, said Dick with great clarity. “America’s interests, and Australia’s and the world’s, are in removing barriers to trade amongst all the countries of the world. Trade discrimination gets in the road of all of these good things”.

Uldorama reached the voting age of 18 years in time for the 1983 election. She was most distressed at the choice on offer. Finally she closed her eyes and marked her ballot paper in favour of Mr Fraser's party, entirely on the grounds that the alternative looked worse. She was soon delighted to be proved wrong, as quantitative quotas on steel imports were abolished, the Australian dollar was floated and exchange controls removed before the year was out.

There followed the most exciting time of her life, when all that she had learned from years of study became very real. She was torn by none of the internal tensions that are common to young people everywhere. Her life's themes and passions of unilateral liberalisation for Australia, regional cooperation without trade discrimination in Asia and support for multilateralism in the whole world through the GATT and then the WTO were wonderfully comfortable alongside each other. Each strengthened the others. This internal consistency gave her coherence in discourse, and an inner serenity that attracted people. This serenity and attraction made her influential beyond her own or others' expectations. Australia was led for a while away from its protectionist history. Not a little, but comprehensively. All the economies of East Asia welcomed her presence. Australia worked with its East Asian neighbours to invent "Open Regionalism", meaning countries together liberalizing their foreign trade without any discrimination against outsiders, and together they made it operational. This became the modus operandi of a forum for regional economic cooperation that included North America as well, called Asia Pacific Economic Cooperation, or APEC. Australia and the East Asian economies worked together to build support for what became the Uruguay Round of multilateral trade negotiations and to set it on a productive path, and with APEC helped it to a successful conclusion.

Uldorama always had her detractors. Hancock had warned her about the Australian louts—the frightening people who valued ideas only as a way of

earning money and not for comprehension and a basis for good policy. “Get a life, Uldorama”, they would shout as she passed by. “Why be the only virgin in this brothel of a world”. And Hancock had warned her about all of the confused people who had not studied the wisdom of the great thinkers about economic life. Somehow the confused and the ideas-for-money people liked each other better than either liked Uldorama and her friends. They would sometimes come together as a gang and make crude threats.

Ideas carefully stated turned out to be a bigger protection from the mobs than old Hancock had feared. Her friends came from all sides of Australian politics and from all the countries that she knew. They were not ever sufficiently numerous to resist the gangs through force, but helped in mysterious ways by the aura of serenity, they turned out to be surprisingly strong.

Uldorama loved America. So many of the great thinkers that she admired were in Boston or New York or Washington. The United States was the country of Viner and Samuelson and Kindleberger, of Johnson and Krueger and Bhagwati, and a dozen others whose words in the *Quarterly Journal of Economics* and the *Journal of Political Economy* and the *American Economic Review* she had memorized. So she was delighted when at 23 she was able to spend some time in New York, and a friend took her to the 80th birthday party of Charlie Kindleberger at Columbia University. She hung on every word as an older friend and mentor of Professor Kindleberger, Professor Bob Solow, his Nobel Prize already a long time back in history, recounted many stories from the long days of struggle to make good ideas influential in American national and international economic policy. There were some shocking revelations amongst the confirmation of old truths. Solow recalled conversations in the Common Room, at the Massachusetts Institute of Technology in the Fall of 1941, when his junior colleague had talked about it being time to fight Hitler when he crossed the Mason-Dixon line!

Uldorama pushed her way into the presence of the old men when the speeches were over. “Is it really true”, she addressed Professor Kindleberger with firmness but respect, “that you once didn’t think about what was good for people anywhere outside America. And just as bad, that you thought that there could be prosperity in America and a Mad Max world outside? ”

Professor Kindleberger didn’t know about Mad Max, and obviously Solow’s stuff about leaving the South to Hitler was a joke. But it was true that there were times when he and his colleagues didn’t think about the world beyond the borders of the contiguous states. They were young then. They applied clever ideas to what would make America a better place, and sometimes thought that that was all there was to think about. They didn’t ever talk about development. But in the terrible and then exciting years that followed, all of that changed. And Solow and Kindleberger told Uldorama about the legendary Cordell Hull, Secretary for State to Presidents Roosevelt and Truman. With friends from their generation they recalled the exchanges between Cordell’s people and the Englishman Maynard Keynes. How Cordell saw so clearly that Keynes had lost perspective on the truths of international trade because he had responsibility to protect the interests of a once great Empire. How Cordell knew and argued that trade discrimination in the British Empire would not help the Empire itself, and that it would undoubtedly damage the rest of the world. Yes, the Secretary had a clear view of the system of trade that would make the whole world prosperous, and as it happens also safe for freedom. That’s why the most favoured nation clause was the first article of the GATT, and would be the first principle of a new World Trade Organisation when the work was finished in the current trade negotiations.

This was exciting but a bit confusing for Uldorama. As she tried to understand the confusing bit, her face showing the strain, she asked others in the room, “Wasn’t Keynes a great economist too?” “Most of the time”, was the response. “And on many things and at many times, when it came to putting the wisdom

of economics into a broader human frame, none greater. But he was at that time representing the interests of a once great Empire that for various reasons had become uncompetitive internationally, after an awful depression and a shocking war, and was groping for a way forward without knowing the way. Keynes made a few mistakes at that time, for his own country as much as any other. The Government for which he was working was committed to Imperial Preferences, and he would be unusual amongst servants of Governments if that had no influence on him at all. We can all be grateful that in the 1940s the United States had the leaders and the ideas that were big enough to stop the British Empire push from blocking the emergence of a multilateral trading system. We can be thankful that it was Cordell Hull and his teams that built the framework within which so many of us were to prosper for the rest of the twentieth century”.

Uldorama’s delight was extended when the two lively old men introduced her to their student of 30 years before, Jagdish Bhagwati. She asked Jagdish whether there were frightening money people and confused people in America too, like there were in Australia. He told her the story of the Kodak economists, and about Ralph Nader and his friends. And he explained how even such eloquent ideas-for-money and confused people didn’t always win on policy if the arguments were explained carefully to all who showed interest. In America as much as Australia, the important thing was to show the confused people that they shared no real interests with the people who were interested in ideas only for money. Jagdish told her about his own students; and with greatest pride about the good work that had been done by young Paul Krugman. Uldorama asked about Paul Krugman’s models of oligopolistic trade, and about how they were being used as arguments for protection. Jagdish explained that the clever students often sowed some wild oats when they were young, but if they were clever and good enough they soon set about more serious contributions to making the world work better. Paul was now ready for that and would do great things.

The years that followed were rewarding beyond anything that Uldorama had been raised to hope. She felt great excitement in 1990 when Leader of the Opposition John Hewson accepted a recommendation in a Report to the Government for complete free trade in Australia by the end of the twentieth century. The excitement continued with the statement by Prime Minister Hawke in March 1991, taking Australia most but not all of the way to that goal. She was thrilled by the successful end to the Uruguay Round, bringing agriculture and textiles into the world trade disciplines. She admired the clever use of APEC by Soeharto in Indonesia, Ramos in the Philippines, and Jiang and Zhu in China to take liberalizing steps that in their own contexts were at least as large as those of Australia, and which expanded the gains of Australia's own liberalisation.

Looking back, there were moments of worry even then. Small group regionalism with discrimination against outsiders, that Cordell Hull had knocked to the ground, was raising its head again. Uldorama was reassured when the first Director-General of the WTO, Renato Ruggiero, told the first ministerial meeting of the WTO in Singapore in 1996, that the enhanced legitimacy of regionalism was a problem, but could be managed if regionalism took the form of the APEC version of open regionalism:

“I see the ensuring that national barriers are not just replaced by regional ones, but that, on the contrary, regionalism and multilateralism converge at the end of the road as the main challenge facing the multilateral system at present, one which will shape its future and help shape the world of the 21st century.

The trading system is now moving forward on two tracks—regional and multilateral...

Some of the newer regional groups (such as APEC and MERCOSUR) contain a commitment which is very important for the future of the multilateral system: this is open regionalism.

Of course, we need to be clear about what open regionalism means. Among the different possibilities, I see two basic alternatives.

The first is based on the assumption that any preferential area under consideration will be consistent with the legal requirements of the multilateral system. This would mean that such areas could at the same time be legally compatible with the WTO's rules and preferential in their nature, which means they would be an exception to the m.f.n. clause which is the basic principle of the multilateral system. The possibility of making such a legal exception to the m.f.n. principle within the rules was conceived in a completely different time and situation. Today, with the proliferation of regional groupings, the exception could become the rule, and this would risk changing completely the nature of the system.

The second interpretation of open regionalism is the one I hear from a number of governments who are members of APEC. In this scenario, the gradual elimination of internal barriers to trade within a regional grouping will be implemented at more or less the same rate and on the same timetable as the lowering of barriers towards non-members. This would mean that regional liberalisation would be generally consistent not only with the rules of the WTO but also—and this is very important—with the m.f.n. principle.

The choice between these alternatives is a critical one; they point to very different outcomes. In the first case, the point at which we would arrive in no more than 20 to 25 years would be a division of the trading world into two or three intercontinental preferential areas, each with its own rules and with free trade inside the area, but with external barriers still existing among the blocs. Is this the sort of world any of us would want?

I leave you to imagine the consequences of this vision in terms of economic and political equilibrium; the problem of those who did not fit into any of the blocs would be a serious one—and where would China and Russia be in such a world?

The second alternative, on the other hand, points towards the gradual convergence on the basis of shared rules and principles of all the major regional groups.” (Renato Ruggiero, Director-General of the World Trade Organization, first WTO Ministerial Meeting, Singapore, 1996; cited in Garnaut, 1996, p.2-4.)

Uldorama was not surprised, but nevertheless reassured, when all of the prosperity that her studies had led her to expect accompanied the new approaches to trade policy in Australia and Asia. For the first time in its

Federal history, Australia was the strongest performing economy of the developed world in the decade after the 1990-91 recession. China and other poor countries in East Asia, too, grew even faster than Uldorama's friends and mentors expected would follow their internationally-oriented reform.

Deep down, Uldorama had clung to the hope that the good results that would follow open multilateral trade would end forever the coalition between the ideas-for- money people and the confused people. But this did not happen. The truth gradually dawned on her, that whatever good Uldorama's presence had done for the world would only ever be understood by a few, and the work would have to be repeated by others again and again until the end of time.

Uldorama felt great pain when she read in the newspaper in December 2000 a report of a speech in New York by the Australian Ambassador, which said that Australia would seek to negotiate a discriminatory free trade agreement with the United States. She read in an Australian newspaper a few days later, on December 22, an article, predicting that the New York announcement would have three damaging effects. It would break the coalition of Australian economists in favour of free trade and therefore weaken support for trade liberalisation domestically. It would increase the likelihood that East Asian trading partners of Australia would break with Open Regionalism and enter free trade agreements that discriminated against Australia. And it would diminish the chances that a new round of WTO negotiations would be successful, and more generally weaken the multilateral system.

As the months went by, the consequences that had been predicted in the newspaper article came to pass. The pain welled up in her and the silence expanded. Some time earlier this year she slipped away we know not whither. It is now so long since we have heard from her that we must presume her dead.

Uldorama's Times

Trade liberalisation was far-reaching from the mid 1980s to the late 1990s in Australia and all of its neighbours in the Western Pacific—in New Zealand, Indonesia, Malaysia, Thailand, the Philippines, Vietnam, China, Taiwan, Korea and Japan. The changes were greatest in the economies that had been most inward-looking in the early 1980s. They were mainly the results of unilateral decisions in each individual country, but were influenced by the ideas and confidence provided by APEC and its doctrine of Open Regionalism, by the institutional framework of the GATT and later the World Trade Organisation, and by the fact that each country enjoyed buoyant external market conditions because each was liberalizing at the same time. Trade liberalisation, economic growth and import expansion were powerfully mutually reinforcing. All but one of the economies in the Western Pacific that were interacting substantially with the international economy grew strongly from the mid eighties until the financial crisis of 1997-8. The exception was Japan after 1991, and Japan was already rich.

The financial crisis was a heavy short-term blow to growth in most of East Asia, with China an important exception. But long-term effects of the crisis were much smaller than the Australian popular memory of them. Korea, Hong Kong and Taiwan bounced back quickly to reasonably strong growth for economies at their advanced stages of development. The longer term effects were more important in Southeast Asia, where all of the original ASEAN countries moved onto a lower, but by the standards of the rest of the world still reasonably strong, growth path.

As with growth, the pace of trade liberalisation and import expansion moderated in the years immediately following the financial crisis, but did not fall below pre-crisis levels for as long in reality as in the popular perception (Table 1 and Chart 1). Continued radical liberalisation and rapid trade

expansion in China assumed more importance as China's relative size increased. Importantly, liberalisation continued to be mainly on a most favoured nation basis throughout the region. China's entry into the WTO in 2001 placed important constraints on China following Europe, the United States, Japan and Korea into high agricultural protection as it became rich, so long as the WTO remained influential.

The international environment for Australian trade expansion, in East Asia and globally, deteriorated during and partially recovered after the financial crisis, but has been distinctly less favourable since 2000 (Chart 1). The post-2000 setbacks have several origins. Unilateral trade liberalisation lost momentum through the Western Pacific in the financial crisis. The global focus shifted to bilateral and small-group FTAs, most powerfully after the 2000 United States Presidential election and the early discussion of trans-Pacific free trade arrangements, notably with Australia. The open multilateral system was subject to more than the normal doubts everywhere after the WTO ministerial meeting in Seattle failed to reach agreement on launching new negotiations in late 1999. Global growth dipped in 2001 as the United States fell into a brief and shallow recession. The terrorist attack in the United States in September 2001 and rising tensions in the Middle East reduced confidence in international transactions, especially in the travel-related service industries. World trade contracted in 2001 and 2002 (Chart 1).

The volume of Australian exports stagnated and then fell from the December quarter of 2000, after one and a half decades of mostly strong export expansion. The fall appears to be accelerating through 2003. The cumulative fall in export volumes so far is the greatest since the Second World War (ABS, National Accounts). In constant United States dollar terms, exports fell but by a smaller amount in 2001 and 2002 (Chart 1): by this measure, the slump in exports was cushioned by the fall in the international purchasing power of the United States dollar.

Many Australians have some appreciation of the link between the generally strong export expansion and economic growth since the recession of 1990-91, but the relationship has been the subject of little detailed discussion, even amongst economists. In my own view, rapid export expansion has been crucially important to sustaining economic growth through three main channels. It has contributed directly to demand for Australian goods and services, importantly at times of weak domestic demand. It has been associated with strong expansion in investment, which supported growth by augmenting demand and also enhanced labour productivity growth as a result of capital deepening. And the deeper exposure of the economy to competitive international markets was an important influence on the growth in total factor productivity. The withdrawal of these contributions since late 2000, should it continue, would be a serious threat to the continuation of the high growth that has been sustained since 1991.

The Recent Troubles of Unilateral Trade Liberalisation in Australia

The period of sustained unilateral liberalisation that caused Australia at the end of the twentieth century to be a relatively open economy was relatively short. Nearly all of the important decisions were made between 1983 and 1991. The exception was the Whitlam Government's 25% tariff cut in 1973, the effects of which were negated for the most highly protected industries by the subsequent imposition of quantitative restrictions on imports. The March 1991 decisions on what turned out to be the final set of across-the-board reductions in protection were phased in over the subsequent 5 years for most goods, and 9 years for textiles clothing, footwear and cars. What was left of protection by 2000 was small by Australian historical standards, but still more than trivial in its economic effects. By 2000, there were no exchange controls or quantitative import restrictions; there were still tariffs of 15% for cars, 15 to 25 % for textiles, clothing and footwear, and up to 5% for a range of other goods; and

contingent protection (mostly anti-dumping) was of considerable and increasing importance.

There were no new decisions to reduce protection by the Labor Government from 1991 to 1996. The Howard Coalition Government took decisions for further reductions in tariffs for the highly protected industries, mostly by 5 percentage points, to take effect in 2005. The Howard Government rejected advice from the Productivity Commission to go further with tariff reductions in the most highly protected industries and to remove tariffs for all goods on which the tariff rate was 5% or less. It has recently facilitated increases in protection through anti-dumping measures, and threatens to take this further under legislation currently before the Senate.

While the systematic removal of most protection began only in 1983, it followed over a decade of intense national intellectual debate, which created a strong (but by no means unanimous) climate of leadership opinion in favour of fundamental reform. The final and decisive steps announced by the Hawke Labor Government in 1991, in the difficult political circumstances of deep recession, were supported by the Hewson-led Coalition Opposition (see Hyde, 2002 and Garnaut, 1993 and 2002, for accounts of the historical background to reform).

Trade liberalisation in Australia is widely recognised as having been centrally important to the lift in the performance of the Australian economy relative to other advanced economies in the 12 years since the 1990-91 recession.

While the majority of the potential benefits from removal of protection have already been harvested, there are significant further gains to be had from completing the liberalisation. I argued in a letter to the Productivity Commission in 2000 that the gains per unit of trade liberalisation would be greatest of all from removing the last bits of protection, because of effects on

international transactions costs and on perceptions of policy irreversibility. The static resource allocation gains and competitive spurs to efficiency from removing the remaining protection are also worth having. Further reduction of the real exchange rate from completing the trade liberalisation will be of special interest as Australians begin to focus on the consequences of the stalling of export growth since late 2000.

Support for an open economy was weakened significantly by the Keating Government's protectionist rhetoric in the by-election for the electorate of Wills in 1992, and in the 1993 General Election. The Government opposed the then Opposition's proposals to remove remaining protection by the end of the twentieth century.

The weakening has gone further as narrow conceptions of "reciprocity" with trading partners have become prominent in recent Australian discussion of policy. The weakness was compounded by the policy-making processes that led to the decision to seek an FTA with the United States. The Australian Cabinet decision of December 2000 was made without any paper on the economic effects even from the public service, let alone a paper based on independent and transparent analysis. Justification of the decision after the event relied on highly constrained consultancies.

There is little prospect of reversing the deterioration in the climate of opinion about trade liberalisation in Australia and in its trading partners without challenging the recently enhanced legitimacy of conceptions of narrowly defined reciprocity, and re-establishing the role of independent, transparent policy analysis. This was the theme of Bill Carmichael's and my open letter earlier this year to the Prime Minister and the Leader of the Opposition. The positive responses to that letter give us hope that Australia might be able to return to more productive approaches to trade policy. (The Carmichael-

Garnaut letter and the Prime Minister's recent response are appended to this paper).

The Decline of the Open Multilateral System

The open multilateral trading system supported the sustained rapid growth of much of East Asia and Australia in the second half of the twentieth century. It was greatly strengthened through the 1990s. The collapse of the Soviet Union, and with it COMECON, ended the division of the world into two *blocs* with relatively little trade between them. The Uruguay Round improved the institutional base of the multilateral system with the formation of the World Trade Organisation (WTO), the strengthening of the disputes settlement mechanism, and the extension of the WTO's disciplines to two major areas of goods trade that had previously been treated as exceptions (agriculture and textiles), and to a much wider range of services. The admission of the 3 Chinese economies to the WTO at the Doha ministerial meeting in late 2001 covered what had been a large and increasingly important gap in the organization. A new round of multilateral trade negotiations was launched at Doha with a strong mandate to deal with some longstanding weaknesses, most importantly relating to agriculture, and in the process dissipated (as it turned out, only temporarily) the pessimism about the future of the system that had accompanied the failure of the ministerial meeting at Seattle two years before.

There are three main grounds for the resumption of pessimism about the multilateral system.

First there has been a large recent increase in the use of contingent protection, most importantly anti-dumping actions, and most damagingly in relation to exports from Asian developing countries, first of all China

Second, there has been an explosion in interest and negotiation of bilateral and small-group discriminatory free trade areas, greatly increasing in intensity over the past two years. The most important developments have been the post-NAFTA proliferation of discriminatory arrangements involving North American economies (especially Mexico and increasingly the United States), the heightened United States interest in free trade areas after the election of the Bush administration in late 2000, and the more recent (post-2000) threat of discriminatory arrangements in the Western Pacific. The Australia-United States FTA promises to be the first intercontinental FTA involving two substantial economies. The disciplines of Article 24 of the GATT and Article 5 of the GATS are being interpreted so loosely as to provide no constraint. Little progress is being made in Doha Round discussions on reforming the Free Trade Area provisions of the WTO.

Third, the Doha negotiations on the crucial and difficult agricultural issues have lost momentum and have missed an important March 31 deadline. Countries in the Western Pacific region, whose unilateral liberalisation had been the world's main source of dynamism in intercontinental trade through the 1990s, and which contributed a great deal of energy to the Uruguay Round in its early stages, have committed their limited trade policy-making and negotiating capacity overwhelmingly to exploration of small-group FTAs. Australia and Japan are the leading examples of the general phenomenon. Much the same can be said of the North American countries: so far since the launch of the Doha Round, United States leadership has been missing. The problems of the multilateral system have been crowded out of the diaries of political leaders and officials by international security issues and the discussions of free trade areas. For several years after the WTO Director-General's eloquent statement to the 1996 ministerial meeting, cited above, there were few high-level words of caution about marginalizing Article I of the GATT, although the current Director-General has returned to the issue (Supachai, 2002). The press conference following the Australian Prime

Minister's meetings with the United States President in Texas in May 2003 gave high profile to the proposed bilateral free trade agreement, but absolutely none to the interests that the United States and Australia share in a successful multilateral system and outcome of the Doha Round.

The Decline of Open Regionalism in Asia

In the mid-1990s, the participants in Asia Pacific Economic Cooperation committed themselves to free and open trade in the Asia Pacific within the concept of "Open Regionalism". Because trade liberalisation was to be on a most favoured nation basis, it did not require the formal negotiations and binding agreements of a Free Trade Area established under Article 24 of the GATT and Article 5 of the GATS. Considerable progress on trade liberalisation throughout the Western Pacific was achieved within this approach to policy, before as well as after the commitment to Asia Pacific free and open trade and investment at Bogor in 1994.

Over the years of the decline in support for unilateral liberalisation in Australia, and dramatically over the past 2 years, the Western Pacific has abandoned its commitment to Open Regionalism and embarked on a scramble of negotiations for bilateral and small-group free trade areas. Not much has yet actually happened to distort trade, but the trajectory of change is towards arrangements that will fundamentally restructure the regional trading system. Such is the relative size and the influence of the Western Pacific in the contemporary world economy that this is likely to have a strong influence on global trading arrangements. After a couple of years of dalliance, there is now considerable momentum building for the establishment of free trade agreements joining ASEAN and major Northeast Asian economies, and linking Japan, Korea and China in various combinations.

The lurch into trade discrimination in the Western Pacific seems to have been driven by a series of developments, none of which was thought to be of large importance in isolation. One country's movement created momentum for more change, until the breakdown of open trade in the region was as strongly mutually reinforcing as concerted unilateral liberalisation had been in the decade leading up to the financial crisis. Over the past year, fear in each country that it will be left out of others' discriminatory *blocs* has become the main motive for new initiatives—most importantly, involving Japan and China in East Asia.

The significance of the agreements and discussions so far is in establishing a new climate of opinion about trade discrimination in the Western Pacific that, while it persists, renders trade liberalisation unlikely from unilateral decisions and through multilateral processes. Already, however, the minor agreements that have been reached have increased bureaucratic oversight of trade transactions in the region, with negative implications for efficiency. For example, the rules of origin on the Singapore-United States free trade agreement require both Governments to monitor the third country content of goods and services exported by Singapore to the United States, and even the proportion of Singapore producers' imports from Indonesia that derive from adjacent rather than more distant regions of Indonesia. Rules of origin in an Australia-United States free trade agreement would require the United States and Australian Governments, and therefore Australian companies, to monitor the New Zealand and Asian content of Australian products. No longer would Australian companies be able to take decisions on inputs simply on the basis of the most cost-effective source.

The “spaghetti bowl” of overlapping bilateral trading arrangements and rules of origin that has been so damaging to European trade relations (Bhagwati, 2002), is in the process of being repeated and perhaps surpassed in the Asia Pacific

region. As Bhagwati described the problem in evidence to the United States Senate on the free trade agreement with Jordan:

“The result is a maze of criss-crossing preferences. With different rules of origin applied to different sectors in different countries in different bilaterals, with the same commodity on different schedules of tariff abolition, so that the name of the game becomes defining which product comes from where—a matter that can make being a customs official a lucrative business aside from creating huge headaches for planning production location and product decisions.” (Bhagwati, March 20, 2001.)

Australia will be damaged directly and indirectly by the increasing importance of trade discrimination in East Asia. There will be a cost to competitiveness in the diversion of management effort into negotiation of bilateral agreements and administering rules of origin. There is likely to be slower and less internationally-oriented growth in East Asia, the region that absorbs the majority of Australia’s exports. And there is likely to be trade discrimination against Australia in the East Asian economies that include Australia’s largest and most rapidly growing export markets.

The most remarkable feature of the current Australian official discussion of the international trading system is the lack of concern for emerging discriminatory trading arrangements in East Asia. Trade Minister Vaile in a recent speech in Sydney held out the example that an Australia-United States Free Trade Agreement would set for East Asia as one of its merits. By contrast, former Secretary of the Department of Foreign Affairs and Trade, Michael Costello, recently argued in *The Australian* (May 23) that the potential damage from East Asian discrimination against Australia in agricultural trade was large.

Is Costello right to urge caution on this matter? Or is Vaile right to welcome and encourage trade discrimination in East Asia?

Table 2 presents data relevant to the resolution of these conflicting views. The data speak eloquently for the Costello and against the Vaile case.

The risks of trade discrimination in East Asia are by no means confined to agriculture. They are similarly large in relation to the materials processing industries that have been a major source of growth in Australian exports since the mid-1980s, and in which rules of origin can generate high effective rates of protection from moderate tariff rates. They are important in large-scale minerals and energy projects, and in the manufactures and services trade.

To be complacent about the effects on Australia of a retreat from East Asian commitment to multilateral trade is to err on an historic scale.

A Trans-Pacific Oasis?

If we take the deterioration in the multilateral and Asia Pacific trading systems as given, might it not be better for Australia to join in the new game, first of all with the United States FTA? And perhaps with major East Asian trading partners?

There will continue to be large and expanding opportunities for exports from flexible and competitive economies even in the fractured trade environment that is emerging. The most important determinant of Australian success in this environment will be the efficiency of the Australian economy. Would an FTA with the United States help to promote efficiency-raising reform in Australia?

Free trade helps to promote reform more generally. But protectionist elements are as prominent as the free trade features of an FTA, and create vested interests in resistance to general liberalisation (Findlay, 2003). Much is made of ambitions to remove barriers to labour and capital flows in an Australia-United States FTA. It is possible that this could contribute to economic growth if there were genuine liberalisation, but less than if the liberalisation were

multilateral, given the bureaucratic interventions required to enforce bilateral arrangements. And a free trade agreement is not necessary for liberalisation in those areas. Indeed, politically contentious “free trade area” elements are likely to complicate and delay reform in other areas if they are tied together in one package. Further, it is unlikely that trade, capital or labour liberalisation would be easier politically if its elements were seen as “concessions” granted in an agreement with the United States, than if they emerged from Australian discussion of measures that had merit in the interest of improving Australian economic performance.

The Australian Trade Minister, Mark Vaile, recently argued that Australia would gain from the FTA “turning heads” of American business towards Australia. There is an analytic basis for Minister’s “head turning” concept which, when applied rigorously, weakens rather than strengthens the case for an FTA.

Humans and human institutions take economic decisions on the basis of inevitably imperfect information. The order in which businesspeople search potential opportunities for transactions is affected by what Vaile might call “head turning” events. A study of Australian trade with various economies in the years when imperial preferences affected Southeast Asia, revealed that such biases in decision-making processes were as powerful as tariff preferences in determining trade patterns (Garnaut, 1972).

Negotiation of a free trade agreement between Australia and the United States turns three sets of heads. It turns some American heads away from third country opportunities towards Australia. This was the turning of heads that was mentioned by the Trade Minister. In addition, it turns some Australian heads away from third country opportunities towards America. It turns some East Asian and other third country heads away from United States and Australian towards other third country opportunities.

The “head turning” phenomenon can be observed in Canada following the formation of NAFTA. Canada’s trade outside North America, especially exports to East Asia, has many features in common with Australian trade. Table 3 shows that over the seven years from 1995 to 2002, immediately following the beginnings of NAFTA trading arrangements, Canadian exports to North America in constant United States dollars rose by 24 per cent. Over the same years, exports to East Asia *fell* by 33 per cent, to the European Union by 15 per cent, and to the Rest of the World by 30 per cent. The turning of Canadian heads away from other countries, and heads in East Asia, the European Union and the Rest of the World away from Canada, seems to have been of considerable importance in the collapse of Canadian exports to these regions, since conventional trade diversion can have accounted for only a small part of the slump.

By contrast, over the same years, Australian exports *rose* to East Asia, the European Union, and the Rest of the World. Australia’s share of the imports of each of these regions remained steady, while Canada’s share fell sharply.

Was the turning of heads towards intra-American and away from intercontinental Canadian opportunities advantageous for Canada? Despite the large percentage falls in exports to countries beyond North America, one cannot immediately dismiss the possibility over these particular years. Total Canadian exports grew more (15 per cent) than Australian (6 per cent) over the early NAFTA years (1995 to 2002), despite the fact that Canada lost market share in all four regions defined in Table 3, and Australia held or increased market share in all four regions. The different outcomes emerged because North America accounted for a large majority of Canadian trade even prior to the introduction of trade discrimination, and in the years of the “tech boom” and the strong United States dollar, North American imports rose more rapidly than those to other regions. What can be said with some confidence is that a

similar turning of heads from other trading relationships to the United States would be much more damaging for Australia than for Canada, even in a period of rapid growth in North American imports, because only a small proportion of established exports are to the United States. Even in Canada, such a turning of heads would be much less likely to confer net benefits outside the exceptional and temporary conditions that generated the United States import boom of the late 1990s.

The dominance of the United States in Canadian trade does not depend on discriminatory free trade. In this sense, Canada and the United States are “natural trading partners”, for which bilateral free trade is more likely to lead to a preponderance of welfare-increasing trade creation over welfare-reducing trade diversion (Krugman, 1991). There can be no presumption that the intensification of focus on bilateral opportunities at the expense of others, the head turning effect, will increase economic welfare even for natural trading partners: that outcome depends on the presence of uneconomic under-investment on search for bilateral opportunities in the absence of a free trade area. In the case of Australian economic transactions with the United States, the low proportion of each country’s trade that would be conducted with the other in a free trade world makes it likely that the artificial diversion of effort towards bilateral transactions would reduce economic welfare.

In a deteriorating international trading environment, would not increased access for some products to one market be a good thing in itself? At this stage of the discussion we are assuming that other countries’ trade policies are not affected at all by Australian policy decisions, including the FTA. The formal modeling suggests that the market access gains from an FTA of the kind contemplated would be small. There would be inevitable offsetting losses to exports through the interference in business decisions associated with rules of origin. There would be some loss of competitiveness in third markets as the cost level in the

FTA rose relative to the rest of the world. Even in the narrow terms of this argument, the net increase in exports is likely to be very small indeed.

Would the outcomes be better if Australia sought free trade agreements with Asian trading partners, alongside a United States FTA? The much larger exports to East Asia, than to the United States, and the much more rapid growth in opportunities at present and for the foreseeable future, suggest this approach to someone who accepts the logic of FTAs. In fact, Australia has negotiated an economically unimportant free trade agreement with Singapore. It recognised the impracticality of negotiating FTAs with ASEAN, Japan, Korea and China in the current cool state of Australian political relations in Southeast Asia, and given sensitivities over agriculture in Northeast Asia. For highly practical reasons, it is likely that Economic Agreements with several East Asian countries will promote closer economic interaction without in any sense being FTAs. Because they do not involve trade discrimination, these will do no harm, and may very well lead to helpful reductions in transactions costs.

If it later turned out to be feasible to negotiate free trade agreements in East Asia, an arrangement with the region as a whole is likely to have substantially larger net benefits than with the United States. However, the large, systemic reasons for not being a party to proliferation of trade discrimination would be just as strong as with the United States. That is why I have never advocated an Australian FTA with East Asia.

The second most remarkable element in the Australian discussion of the FTA, after the relaxed approach to the prospect of trade discrimination in East Asia, is the argument by proponents that the FTA would improve the prospects of good trade policy multilaterally and in the Asia Pacific region. The proposed Australia-United States FTA has been held out as a “model” for other countries (Vaile, 2003), when the discussions have accepted the likelihood of maintenance of American agricultural production subsidies in the FTA. The

awful reality is that this would make the agreement “WTO minus” in the area of the WTO rules that is probably more important than any other to Australian economic welfare.

The issues, addressed in this paper suggest that Australia would have better prospects for sustaining strong economic performance as a multilaterally free trading economy, strongly focused on removing impediments to domestic economic efficiency, than by contributing to the scramble for FTAs, even in an increasingly fractured international trade environment.

Preserving Uldorama’s Legacy

How do we preserve some of Uldorama’s legacy?

My starting point would be the rebuilding of the role of transparent, independent analysis of the effects of alternative policies, as a basis for public education and discussion. Bill Carmichael and I are encouraged by the responses the Prime Minister and Leader of the Opposition have made to our Open Letter of 10 March, 2003, to think that this might be part of a productive way forward. The Prime Minister holds a different view from that presented in this paper on the merits of a United States FTA. The Prime Minister’s view, and our own, can be tested through independent, transparent analysis and public discussion.

Our letter to the Prime Minister and the Leader of the Opposition explained why progress in opening world markets through international trade negotiations has stalled. It is because:

- tit-for-tat trade negotiations are preoccupied with market access;
- this has undermined understanding that all the gains—including the market gains—available to countries liberalising through trade negotiations (whether

in a multilateral, regional or bilateral context) depend on the decisions each makes at home—about its own barriers;

- the influences that are stalling progress in trade negotiations originate at home, in the domestic policy environments of participating countries;
- the existing processes involved in negotiating and implementing market access agreements abstract entirely from those influences.

We are not alone in concluding that progress now depends on winning the argument at home, where the crucial decisions about reducing the barriers protecting domestic industries are made. Leon Brittan, then Vice President of the European Union, observed that the greatest challenge facing the EU and Australia is:

to pursue...multilateral liberalisation in the face of domestic pressures in the opposite direction. I think we have to recognise that support for trade liberalisation is not automatic in Australia or Europe. We need to make the case. And it needs to be made again, again and again. (The Australian, 24 June, 98)

The GATT Secretariat drew attention to the issue as early as 1983, before the Uruguay Round. In its annual assessment of developments in world trade for that year it observed that:

It was the original purpose of the GATT—and of the broader concepts of multilateralism, or international cooperation—to strengthen governments against the particularist pressures emanating from national economies. This purpose has almost been lost; a new joint initiative is needed to retrieve it. (International Trade 1982-83, Geneva)

And Clayton Yeutter, the US Trade Representative during the Uruguay Round and subsequently Secretary for Agriculture in the Bush (senior) Administration, has described the approach proposed in our letter as essential to trade policy decision-making in all countries in personal communications with Bill Carmichael.

These views come from people who have actually experienced the difficulties of implementing trade liberalisation at home. They reflect an emerging realisation that international commitments are not providing a persuasive domestic reason for lowering trade barriers ; that it is the positive or negative perceptions at home about the domestic consequences of liberalising that determine how much liberalisation takes place; that it becomes politically realistic to reduce domestic barriers through international negotiations only when pressure from domestic groups who see liberalisation as detrimental to their interests is balanced by a wide domestic awareness of the overall domestic benefits of adjusting to the changes involved.

In his response to our letter, Prime Minister Howard has affirmed that Australia will argue—in the WTO and other international trade forums—for the introduction of domestic processes that expose the economy-wide consequences of trade liberalisation. Given the government's commitment to press on with negotiation of a bilateral agreement with the United States, the challenge for our negotiators now is to establish an operational basis for the agreement that reflects the Prime Minister's undertaking on domestic transparency arrangements.

The efforts being made by Australia and the Cairns Group to publicise the domestic costs of US farm support may, or may not, help in the negotiating process. Like similar efforts made in the Uruguay Round to publicise the domestic costs of farm support in the EU, however, they are unlikely to have any lasting influence on the day to day conduct of US trade policy. Progress

needs to be underpinned by procedures **within** the US that focus the attention of decision-makers, and their domestic constituents, on the national gains at issue in opening domestic markets. Recent US actions taken in breach of, or outside, WTO rules confirms that we cannot rely on an agreement itself to do that.

Introducing into US advice and decision-making the **national** gains from liberalising, and the domestic costs of continuing to subsidise domestic production, will make it easier for US governments to resist pressure from domestic producers seeking to avoid the consequences (for them) of opening domestic markets to Australian competition. And it will make it more obvious when they succumb to such pressure. It would thus force the US to face squarely the domestic influences that are eating away its credibility as a world leader in trade reform.

Obviously the Australian Government can only seek United States agreement on independent and transparent analysis of the effects of the draft FTA that emerges from negotiations. It is, however, in control of the process of consideration of a draft FTA in Australia.

The Productivity Commission should be asked to report on the costs and benefits to Australia of a free trade agreement with the United States on the terms which emerge from the current negotiations, under two different assumptions about trade with third countries. One assumption would embody the maintenance of trade barriers against imports from third countries exactly as they are under current law and announced Australian policy. The second assumption would provide for the bilateral free trade agreement to be implemented simultaneously with the completion of the removal of the remaining Australian protection against all countries.

At this late hour in the negotiation of a free trade agreement with the United States, the timing of such a step presents some challenges. But these are not insuperable.

After completion of the current confidential intergovernmental negotiations, it will be necessary for the terms to be approved by the United States Congress, and there is a reasonable expectation that approval will be sought from the Australian Parliament. The negotiation of these approvals will take time. If the negotiated draft agreements have any substance at all (and we must wait and see on this matter), it will not be a simple matter to obtain approval from the two legislatures. In Australia, the Senate can be expected to hold up politically contentious elements of the FTA, if there are community doubts to be exploited. The Australian polity's caution on these matters can be diminished if credible independent analysis and transparent public discussion suggests favourable outcomes in the public interest.

The considerable time during which the United States Congress would deliberate upon a draft agreement would allow simultaneous completion and public discussion of a Productivity Commission report. The analytic issues are familiar, and if the Commission were alerted to the fact that a reference was coming its way, it could begin its work before the intergovernmental negotiations had produced a draft agreement.

Consistently with the Prime Minister's response to the Carmichael-Garnaut letter, we would suggest that the Government follow a similar process for assessing any future trade policy initiatives with large implications for the welfare of Australians, and seeks the commitment of partners to similar course in future bilateral, regional and multilateral negotiations.

These reforms to the domestic policy-making process in Australia, and efforts to extend them to other countries, could be usefully supported by two other

initiatives in the international system, one directed to the multilateral system, and the other to Asia Pacific Economic Cooperation.

Australia would be better placed to play a positive role in changing the unhappy trajectory of Asia Pacific and multilateral trade policy if it chose to complete its own trade liberalisation generally. Amongst other things, the elimination of remaining protection would remove the need to discriminate against other partners in the context of free trade with the United States, which would reduce the risks of the FTA contributing to systemic decline and trade discrimination against Australia. This would not remove all distortionary effects of the FTA, however, as the problems of enforcing rules of origin in exports to the United States would remain. In any case, Australia would be in a stronger position to perform well economically in the difficult years ahead if it were to press on with removing the remainder of its own protection.

The Doha Round is in trouble, but is not dead. Australia currently has substantial, possibly unprecedented access to high-level policy-making processes in the United States. If Australia applies this leverage to raise the priority of success in the Doha Round in United States international policy priorities, it is likely to be influential. It is worth testing the influence.

Within the Western Pacific, the momentum behind proliferation of discriminatory free trade areas is now strong. It will not now be easily stopped. Any resumption of focus on multilateral trade liberalisation would help, and it is desirable for APEC to be encouraged at its next Trade Ministers' and Economic Leaders' meetings to provide the greatest possible support to a successful outcome. In reality, the best prospects for making progress along this line would come from the Western Pacific, with China's strong growth and recognition that its trading interests are global giving it an important leadership role.

There is one way of linking APEC's contributions to restoration of momentum in the Doha Round to dealing with the growing problem of trade discrimination in the Pacific. APEC Leaders could recommit themselves to the Bogor objective of free trade by 2010 (developed countries) and 2020 (developing). They could then offer to make these objectives operational by committing to multilateralise all preferential liberalisation by these dates, in the context of a successful outcome of the Doha Round. This seems an unlikely outcome at this stage—but rather less unlikely than the reductions of protection the 1990s in Indonesia, the Philippines and China appeared at the beginning of the last decade. As Director-General Ruggiero said in Singapore, this is the one way in which the growth of free trade areas can be reconciled with an effective multilateral system. At least there is no danger that it could contribute to confirmation of the unhappy outcomes for the trading system that are now in train. Uldorama would think it worth the effort.

Table 1
East Asian, North American and World Merchandise Imports, Total
and from Australia
(\$US billions 1995 constant prices)

	1985	1995	2000	2002
East Asian imports	344	1,063	1,033	1,061
North American imports	551	976	1,340	1,259
World imports	2,530	4,987	5,479	5,254
Australian exports to East Asia	13.6	29.4	28.9	29.6
Australian exports to North America	3.5	4.3	6.5	6.6
Australian exports to World	30.8	50.6	55.4	53.8

Note: East Asia includes Japan, Korea, China, Taiwan, Hong Kong, Thailand, Malaysia, Philippines, Indonesia, Singapore and Vietnam.
North America includes the United States, Mexico and Canada.

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

Table 2
East Asian Imports of Rural Products from Australia and ASEAN, 1985 and 2000
(\$US millions)

<u>Rural Product</u>	<u>1985</u>			<u>2000</u>		
	East Asian Imports from ASEAN	East Asian Imports from Australia	<u>of which:</u> Northeast Asian Imports from Australia	East Asian Imports from ASEAN	East Asian Imports from Australia	<u>of which:</u> Northeast Asian Imports from Australia
Meat and live animals	119	468	425	679	1,831	1,476
Fish	818	219	210	4,411	834	786
Fruit and vegetables	682	98	32	1,706	411	233
Sugar	318	271	150	646	587	358
Animal feed	103	23	17	431	347	299
Rural fats and oils	1,044	56	46	1,663	441	418
Other Rural Products	5,603	2,503	2,095	13,520	5,311	3,329
Total Rural Products	8,687	3,638	2,975	23,056	9,762	6,899

Source: International Economic Data Bank, The Australian National University.

Table 3
The Head-Turning Effect of Canada's Entry to NAFTA:
Merchandise Exports to Country Groups
(\$US billions in constant 1995 prices and per cent of Country Groups' of Imports)

	<u>North America</u>		<u>East Asia</u>		<u>European Union</u>		<u>Rest of the World</u>	
	1995	2002	1995	2002	1995	2002	1995	2002
Canadian exports to Country Group	153.7	199.1	15.8	10.6	11.6	9.9	9.7	5.5
Percentage of Country Group's imports	15.8	15.2	1.5	1.0	0.6	0.5	0.8	0.6

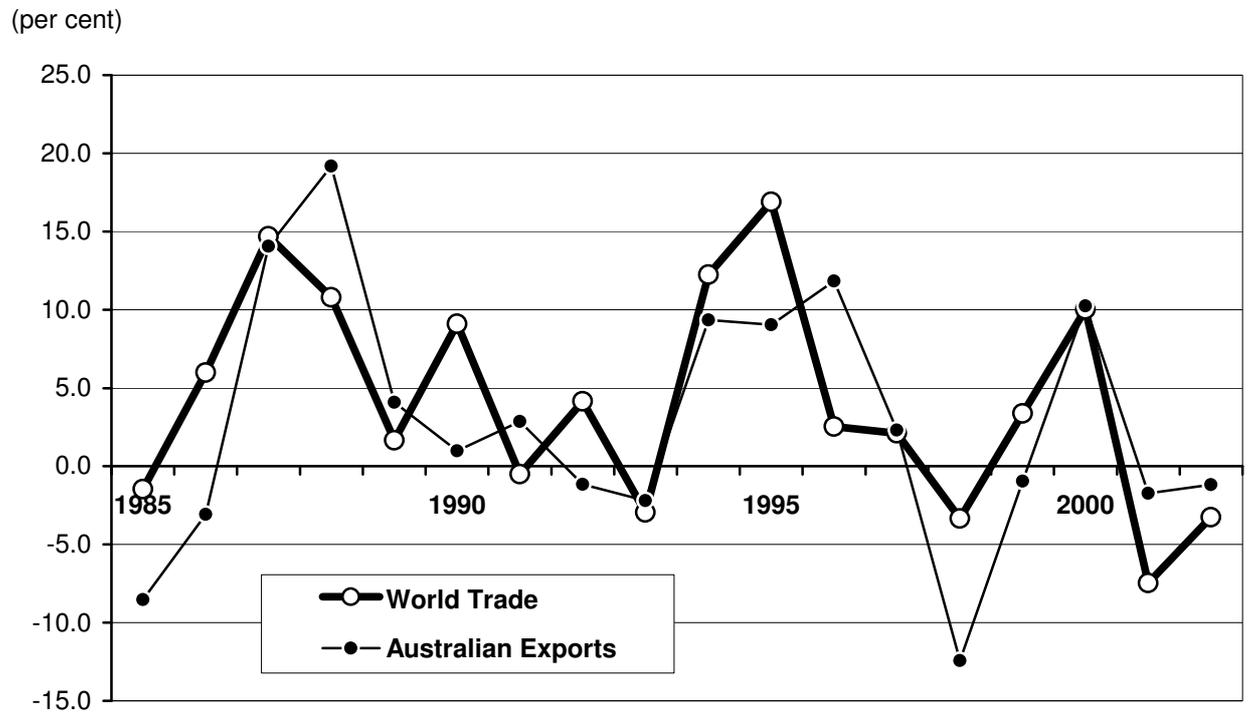
Notes: Normalised by US GDP deflator. East Asia includes Japan, Korea, China, Taiwan, Hong Kong, Thailand, Malaysia, Philippines, Indonesia, Singapore and Vietnam.

North America includes the United States, Canada and Mexico.

EU 15 stands for European Union 15 member economies.

Source: International Economic Data Bank, Australian National University, Canberra.

Chart 1 Growth Rates of World Trade and Australian Exports, 1985 – 2002
(at Constant 1995 US dollars)



Source: International Economic Data Bank, Australian National University
 (Compiled from IMF, *International Financial Statistics, Direction of Trade*, and
World Economic Outlook, various issues)

Note: Raw data are normalised by US GDP deflator (1995 = 100)



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10 March 2003

Mr John Howard
Prime Minister
Parliament House
Canberra ACT 2600

Mr Simon Crean
Leader of the Opposition
Parliament House
Canberra ACT 2600

Dear Mr Howard and Mr Crean,

We are writing as two Australians who helped build support for the trade liberalisation that has made ours a relatively open economy. It is one lesson of our experience that Australia's trade liberalisation emerged from Australians recognising that it was in our interest to reduce our own trade barriers, with almost no contribution being made by tit-for-tat negotiations with other countries. Another lesson is that disinterested analysis and wide dissemination of information about the costs of protection was a critical element in persuading Australians that reducing our barriers was in our own interest.

We believe that these lessons now hold the key to mutually beneficial trade liberalisation with Australia's trading partners, and that there is scope (and a need) to introduce them into the WTO system. The current bilateral discussions with the US provide an opportunity to develop a joint initiative aimed at doing that. Australia's experience, including establishing a widely respected institutional basis for independent advice about the costs of maintaining our own protection, provides a sound basis on which to develop such an initiative. The resulting benefits for both countries, from WTO negotiations and from a bilateral agreement, would greatly exceed any that might result from tit-for-tat market access negotiations between them.

Trade Minister Vaile has placed the estimated annual gains for Australia from a bilateral agreement with the US (one that completely removed all barriers to trade in goods and services between the two countries) at nearly \$4 billion, and has foreshadowed much greater gains from the present WTO Round. Government studies show that most of the estimated gains from the US agreement would come from Australia's own removal of its import restrictions against American goods and services.

The estimates Minister Vaile has used measure only potential gains. Whether they eventuate will depend on the decisions governments make at home, about their own barriers, when preparing for negotiations and subsequently in meeting their commitments arising from the

agreements struck. The crucial decisions about opening or closing domestic markets are made at home, in the domestic policy environments of participating countries, not at the negotiating table.

The influence of protected domestic producers over these decisions is illustrated by recent developments in the US, the country regarded as crucial to successful global liberalisation. The power of the US farm lobby, for instance, was demonstrated by Trade Representative Zoellick's explanation that the extension of farm subsidies, although a backward step, was necessary in order to secure authority to negotiate. The US Ambassador to Australia said at the time (on Australian TV) that the Farm Bill was the price for the United States agreeing to enter negotiations for a free trade agreement. How many more such backward steps will it take before US negotiators are able to open agricultural markets? Under these constraints we are not likely to see anything resembling free trade in farm products from an agreement with the US or from multilateral negotiations in the WTO. The problem, however, is not limited to agriculture.

This power of protected producers over decision-making on protection (trade barriers) has been institutionalised in the major industrial countries—the EU, Japan and the US. For instance, US procedures and criteria for providing relief from import competition actually increase the difficulties US governments face in dealing with pressure for protection from domestic producers. In formulating its advice the US International Trade Commission is required to use narrow legal rules to determine whether a particular industry is being 'injured' by import competition. The positive domestic effects of liberalising domestic markets --for other domestic producers, for consumers and for the US economy as a whole--are not brought into account. The President and his advisers are left to work out for themselves the answer to the broader, more important, question-- whether it is in the national interest to provide relief from import competition. Thus the usual roles of advice and decision-making are reversed in existing US procedures. The objective behind trade liberalisation-- to secure the national gains at issue-- is turned on its head as US governments succumb to pressure from protected producers seeking to avoid the adjustment involved (for them) in liberalising domestic markets.

The same influences and institutional arrangements dominate advice and decision-making in Japan and the European Union—the countries initially responsible for corrupting world agricultural markets. Until a way is found to deal with them the gains for Australia from a free trade agreement with the US, and from the present WTO Round, will fall well short of those foreshadowed by Trade Minister Vaile. The estimated gains he has used raise expectations about outcomes that international negotiations and agreements alone cannot deliver.

While trade liberalisation is pursued through the WTO as an external issue--involving international negotiations, agreements and rules--the influences working against better WTO outcomes operate in the domestic policy environments of participating countries. The external processes on which the WTO depends abstract entirely from those influences. They do not address the issue primarily responsible for holding back progress in the WTO —pressure at home from domestic producers seeking to avoid the (nationally rewarding) adjustment involved for them in liberalising domestic markets. The influences that gave rise to the recent market closing actions in the US, for instance, originated in the domestic political arena and exercised power over domestic decision-making. Those influences explain why governments in the major industrial countries are under constant pressure to minimise their market-opening commitments during negotiations and subsequently to avoid the commitments arising from

WTO agreements-- by replacing the forms of protection negotiated away with other, less visible, forms. The growing power of these influences in the domestic policy environment of those countries was confirmed in Australia's recent Foreign and Trade Policy White Paper, which observed that 'protectionist forces in major developed countries have become more active, and opposition to liberalisation...is growing'. That is why governments now need help to counter these negative influences over domestic decision-making, and why the present system of international rules cannot provide the help needed to win the argument for trade liberalisation at home.

An additional process is needed to underpin trade negotiations—bilaterally, regionally and in the WTO system--one that focuses on the positive (domestic) reasons for liberalising, rather than continuing to rely solely on what are increasingly perceived as negative (external) reasons for doing so. The additional process is needed for two reasons:

- ◆ to help participating countries improve their *own* outcomes from international trade negotiations; and
- ◆ to renew the ability of the WTO to deliver the gains available from liberalising in a multilateral context.

Ownership of this process must reside where responsibility for future progress in liberalising world trade now rests—in the domestic policy environments of individual countries.

The case for strengthening the WTO system in this way is compelling. It is as follows:

1. The major gains available to individual countries liberalising through the WTO system come from reducing their own barriers. These are the gains each can make by liberalising unilaterally, and do not depend on international negotiations or the WTO system. The preoccupation with market access in international negotiations has undermined understanding that the major gains from multilateral liberalisation depend on what each country does about its own barriers.

2. The additional gains available from liberalising through the WTO—those resulting from access to other countries' markets—also depend on what each does about its own barriers. The barrier reductions each country must make to enable the WTO system to deliver these additional gains are the same as those required to secure the gains from liberalising unilaterally. In both cases it involves lowering the barriers protecting their less competitive industries. That is proving to be an intractable problem for existing WTO processes, where the only incentive to do so is to meet international commitments. Would we have undertaken our program of protection reform, and accepted the adjustment involved for our less competitive industries, simply to meet external commitments? It has proved to be less of a problem, however, when countries have liberalised unilaterally. This was demonstrated by our own experience. Australia did not reduce the barriers protecting our less competitive industries in the Tokyo or Uruguay Rounds. We did so unilaterally after the Tokyo Round and before completion of the Uruguay Round—to raise Australian living standards and to reduce the burden placed on the rest of the economy. We were able to reduce those barriers when the cost of maintaining them was the issue, but not in order to meet external commitments.

3. All the gains available from liberalising through the WTO therefore depend on the decisions governments make at home-- about their own barriers. The gains they collectively take away from the negotiating table depend on what each takes to it.

4. In early Rounds of multilateral negotiations tariffs were the principal form of protection being negotiated. The simple decision rules involved in negotiating tariff reductions were responsible for the very substantial liberalisation that took place in North Atlantic countries in early Rounds. But the forms of protection in use have changed. Pressure from protected domestic producers has caused governments, particularly those in industrial countries, to introduce less visible forms of protection to replace the tariffs negotiated away. While the level of industrial tariffs in OECD countries is now only 4 per cent, non-tariff barriers affect a major part of world trade. This new protection is often in non-border forms and is seen (by governments introducing it) as part of domestic policy, beyond the reach of international agreements and rules. That is the case, for instance, with the recent US action to extend its farm subsidies. Moreover, the scope for replacing traditional forms of border protection with less visible, non-border forms is endless. The simple decision rules that produced nationally rewarding outcomes when tariffs were being negotiated away are therefore no longer available or relevant. The domestic decisions governments must now make to secure the rewards available from liberalising through the WTO are more complex. In the case of major industrial countries—particularly the EU, Japan and the US-- they involve decisions about forms of protection that are arguably outside the remit of WTO negotiations.

5. Countries liberalising through the WTO system therefore have an incentive—and a need--to invest in the effort now required to work through those more complex decisions at home, and to counter the negative influences in their domestic policy environment that increase the difficulties of doing so. There is nothing in existing WTO procedures to help them do that.

It follows that any initiative to strengthen the WTO system must satisfy two requirements. First, it must include procedures and criteria—operating within participating countries-- that focus advice and decision-making on the national (economy-wide) benefits of liberalising domestic markets. Those domestic producers who felt they would be adversely affected by barrier reductions that are widely perceived to be nationally beneficial would then find it more difficult to get public support for resisting market opening commitments. Second, it must ensure that WTO procedures begin with domestic decisions that resolve the domestic (unilateral) issues involved in liberalising through the WTO and culminate in international negotiations and agreements to reduce protection-- rather than the other way around. The domestic commitment to accept the adjustment involved can then result from decisions based on what is nationally rewarding, rather than emerge as the accidental outcome of a balancing act---in the international arena--- between the market-opening requests of foreigners and the market-closing demands of protected domestic producers.

Experience tells us that the motivation for opening domestic markets cannot come from outsiders. The information published by Australia and the Cairns Group on the cost to the US economy of maintaining its high level of farm support may, or may not, help the negotiating position of the Cairns Group in the present Round. Like similar efforts in the Uruguay Round, however, it is unlikely to have any lasting effect on the day to day conduct of US trade policy. The information about the domestic costs of protection needs to be generated domestically, as a routine input to policy advice and decision-making. Introducing this approach into the WTO system, and into the bilateral agreement with the US, would automatically bring the actual gains from international trade agreements closer to the potential gains foreshadowed by Trade Minister Vaile. The alternative is to leave outcomes from these agreements to be driven by process, not objective.

Australia is well placed to sponsor this approach in the WTO-- so long as it re-commits itself to independent, public advice as an important element of the trade policy-making process. Its

public inquiry procedures and economy-wide criteria for advice and decision-making, introduced in the early 1970's, provide a widely recognised and relevant model for doing so.

The strength of the approach in renewing the WTO system is that it:

- ◆ recognises that governments will always be under pressure to avoid the domestic adjustment involved in meeting international commitments to reduce trade barriers until those they represent are persuaded that the national benefits this makes possible outweigh the adjustment costs;
- ◆ operates at home, in the domestic policy environment of WTO member countries, where the positive or negative perceptions about the domestic consequences of liberalising hold sway and where decisions about protection are made;
- ◆ leaves governments in full control of domestic policy, and more accountable domestically for WTO outcomes;
- ◆ involves public participation in the process through which advice on protection is formulated, thus increasing the likelihood of a more comprehensive domestic commitment to liberalise;
- ◆ raises public awareness of the larger national rewards from reducing domestic barriers, thereby arming governments against pressure from protected domestic producers seeking to avoid the adjustment involved for them.

Australia unlike the EU or the US, lacks the bargaining strength to insist on changes to WTO processes. On this issue, however, we have an opportunity to influence events by the relevance of the approach we offer to deal with it. The need to find a solution is not of marginal, or even second order, importance. It is now a pre-condition for progress in liberalising through international negotiations. At issue for Australia is the opportunity to secure a more hospitable market environment for our world competitive industries—our reason for liberalising in a multilateral context.

While we have dealt in this letter with the problem posed for the WTO system, it applies to all trade liberalising initiatives depending on international negotiations and agreements—including the proposed free trade agreement with the United States. Australia and the US have both committed to using bilateral agreements to strengthen support for the objectives of the WTO system. That is the basis for our suggestion that the present bilateral discussions with the US should focus on developing a joint approach to this important issue—for inclusion in any bilateral agreement between Australia and the US, and subsequently as an initiative in the current WTO Round.

To be credible in proposing this innovation, Australia will itself need to demonstrate that it still accepts the value of disinterested analysis and advice about the economy-wide effects of trade policy changes under consideration. This would require a renewal of Australian Governments' commitment to seek public and independent advice from the Productivity Commission as a basis for public discussion of the economy-wide effects of major trade policy initiatives in prospect. To be effective in Australia, that commitment would require the support of the Opposition.

The challenge, for both government and opposition, is to choose between two quite different paths for Australian trade policy: one that sees trade liberalisation primarily as an external issue, involving tit-for-tat negotiations and relying on international rules to enforce domestic compliance with the agreements struck ; and one that gives priority (in domestic preparations for international negotiations) to the economy-wide consequences of liberalising its own barriers. Which is more likely to engender trust and confidence in the WTO system, and to

deliver nationally rewarding outcomes for participating countries? Which leaves governments in full control of domestic policy, and more accountable domestically for WTO outcomes?

Yours sincerely,

Bill Carmichael
Formerly Chairman
Industries Commission 1985-88
CEO Tariff Board and
Successors 1974-85

Ross Garnaut
Professor of Economics
The Australian National University



**PRIME MINISTER
CANBERRA**

29 MAY 2003

Professor Ross Garnaut
Professor of Economics
The Australian National University
CANBERRA ACT 0200

Dear Professor Garnaut

Thank you for your letter of 10 March 2003, co-signed by Mr Bill Carmichael, regarding Australia's trade policy approach. I apologise for the delay in replying.

I share many of your perspectives, including that:

- countries liberalising trade barriers gain from unilateral action, as Australia has done;
- unilateral action is less frequent in other countries than it should be because the costs of misguided trade barriers are less well understood by foreign citizens; and
- more transparency as to the costs of protection in other countries would help to redress the imbalance between the diffuse interests of consumers who each individually lose a little from protection, but collectively lose more than the concentrated and individually large gains of the few who are protected.

The dynamic supporting trade liberalisation in democracies will only succeed if communities in each country believe that it is in their interests to liberalise. In the Australian context, the work of the Productivity Commission and its predecessors (including in important periods under Mr Carmichael's chairmanship) has been fundamental to building and maintaining Australian public understanding of the benefits of greater openness to international competition.

This has been an important factor underpinning the Australian public's acceptance of reductions in protection over recent decades which, in turn, led to the upsurge in Australian trade-to-GDP ratios that came with our greater economic engagement with world markets and our participation in East Asian growth.

More broadly, this approach to the "supply" side of the economy has been an important factor in the above trend growth in productivity and in Australia's strong overall economic performance.

The government will of course continue to look to the Productivity Commission as an important source of independent advice. We also recognise the role it can play in stimulating informed public discussion of the economy-wide effects of major trade initiatives.

Because of the government's belief in the robustness and transparency of the Australian institutional framework, we have regularly advocated the Productivity Commission as a model for other countries to adopt. If other countries could adopt similar transparent institutional responses, public opinion would be better informed on the cost of trade barriers, and support would be built for good-policies in broader areas of industry protection.

The government sees broader virtues in improved international transparency than in the important area of trade barriers that your letter addresses. In the government's strategic and analytical response to the Asian crisis (the 1998 Report of the Task Force on International Financial Reform), in our work in APEC, the OECD, the international financial institutions and the Financial Stability Forum, we have sought consistently to build international transparency and so to spread the application of best practice - often Australian practices - to other countries.

Your letter touches at several points on the parallel paths of bilateral, WTO-consistent trade liberalisation and multilateral liberalisation through the Doha Round.

Australia has an ambitious free trade agenda - both multilateral and bilateral negotiations offer the prospect of real gains for Australia. The Doha round has the potential to deliver the greatest benefits but it will be held back until the European Union commits to real reforms in agriculture. Slow progress in the round is not the result of the proliferation of free trade agreements (FTAs). Strong advocates of free trade are working for an ambitious outcome for the round as well as seeking to harvest the benefits of free trade in a shorter timeframe through FTAs. Bilateral agreements can support multilateral negotiations by setting a high benchmark for liberalisation and stimulating multilateral negotiations. This is why we are pursuing the most comprehensive and ambitious outcomes from FTAs.

In addition to market access improvements, FTAs offer an unparalleled opportunity for closer economic integration with our key trading partners. This will be critical to help Australians do business internationally, given the growing role of services and investment in our economy and in world economic growth.

A FTA with the United States is a great opportunity to further integrate Australia with the biggest, most advanced economy in the world - stimulating investment, improving business links and driving innovation. Our negotiation with the United States however is not at the expense of enhanced economic and trade relations with the region. The government has already concluded a FTA with Singapore and is working to deepen economic integration with our region through trade and economic negotiations with Thailand, Japan, China and ASEAN. Indeed, many of these countries are themselves seeking to negotiate FTAs, including with the United States. We are also driving closer regional and trans-Pacific economic integration through APEC.

However, I agree that the multilateral or bilateral approach can not be wholly successful if our negotiating partners have a misinformed view that their existing protection is in their overall national benefit, and that lowering their trade barriers will advantage us and disadvantage them. Both multilateral and bilateral negotiations offer the opportunity to explain to our trading partners the benefits of transparency and to underscore the costs of protection to domestic communities.

You can be assured that Australia will continue to argue, in the WTO and other forums, for the virtues of full transparency and the benefits of domestic processes which expose the economy-wide consequences of trade liberalisation.

Thank you for raising your concerns with me. I have written to Mr Carmichael in similar terms.

Yours sincerely,

John Howard