

AUSTRALIAN SECURITY AND FREE TRADE WITH AMERICA

Ross Garnaut
Professor of Economics
Research School of Pacific and Asian Studies
The Australian National University

Paper presented at the Australian Business Economists meeting on *US and Australian Free Trade Agreement: National Interest or Vested Interest?*, Sydney, 27 February, 2003.

AUSTRALIAN SECURITY AND FREE TRADE WITH AMERICA

We are meeting at a time of insecurity for our country and its people, to an extent unprecedented in the lifetime of Australians born after the Second World War. It is a time when national decisions can be taken that change fundamentally Australia's opportunity and security.

This paper argues that the completion of an Australia-United States free trade agreement at this time is more likely to diminish than to expand Australian economic opportunity, and that it may weaken Australian security in important ways.

The decline in Australian economic opportunity would have two main sources. First, an Australia-United States free trade agreement would be a significant new factor in the contemporary pressures for the unravelling of the open, multilateral trading system, and the reversion globally to pre-World War Two patterns of bilateral and small-group preferential arrangements. It would increase the risks of Australia in future being left outside preferential trading arrangements that include as members its major trading partners in East Asia. Second, it would weaken domestic support for the free trade policies that have played a central role in the decisive improvement in Australian economic performance relative to other rich countries in the late twentieth and so far the early twenty first centuries.

The weakening of Australian security would also have two main sources. First, the negotiation of a free trade agreement would push contentious trade issues to the centre of the Australia-United States relationship. This has the potential to corrode Australia's important political and security relationship with the United States, at a time when it is under stress for other reasons. Second, Australia's crucial security interest in building close and productive relations with its

Asian neighbours, including its neighbours in Southeast Asia with large populations committed to the Islamic faith, would be more difficult in a world that was fractured into preferential trading arrangements, especially but not only if Australia and major East Asian neighbours were to be on different sides of the fractures.

I have made each of these points on other occasions, dating back to the first public revelation of the Australian government's intention to seek a free trade agreement with the United States in late 2000. Unfortunately, the unfolding of history has made the points more compelling now than two or one years ago.

I commence this presentation by discussing the economic case that has been made for the free trade agreement. The conclusion is that in the best of circumstances, the narrowly economic benefits of a free trade agreement would be approximately zero. This is the conclusion that can be drawn even from the study used intensively by the Government in making a case for the free trade agreement—a study constrained by conditions that are unrealistically favourable to the agreement, imposed by the Department of Foreign Affairs and Trade in commissioning the work. When account is taken of the probable feedback into the political economy of the multilateral trading system and of Australian domestic trade policy, the economic effect can be expected to be strongly negative. The general security effects compound the negatives. I then discuss briefly the two points related to economic opportunity and the two points related to security.

THE ECONOMIC CASE FOR THE FREE TRADE AGREEMENT

There was no recent internal or external study of the economic effects of a free trade agreement at the time of the Cabinet decision to seek a free trade agreement with the United States in late 2000.

Since then, there have been two major attempts to model the economic effects of a free trade agreement. In late 2001, the Department of Foreign Affairs and Trade published a report by the Centre of International Economics (CIE), (Centre of International Economics, 2001). This study is the source of the now famous “\$4 billion dollars of benefits”, to which United States as well as Australian Ministers have referred, and which was prominent in discussion of the free trade agreement in the recent Australian White Paper on Foreign Affairs and Trade (Commonwealth of Australia, 2003). I have discussed elsewhere (Garnaut, 2002) the restrictive assumptions upon which the modelling is based. In mid-2002, the Rural Industries Research and Development Corporation (RIRDC) received a draft report embodying a major modelling exercise that it had commissioned from the ACIL Tasman consulting group, on the effects of a free trade agreement on rural Australia. This report’s publication became a subject of public controversy late in 2002. Pending publication, Canberra economists know a little about its contents from evidence by Department of Foreign Affairs officials to the Senate Committee on Foreign Affairs, Defence and Trade legislation (22 November, 2002). They know more from the usual informal professional conversations with Commonwealth Government officials, prior to the time when the report became controversial.

The CIE report draws eclectically from a CIE-modified GTAP model, and from Warwick McKibbin’s APG-cubed model. The eclecticism makes it difficult at times to follow the argument, as some conclusions are drawn from one model and others from the second model. The famous \$4 billion (actually “nearly \$US2 billion”) of annual benefits by 2010 is drawn from the APG-cubed model, on the assumption of completely free bilateral trade in all goods and services between the United States and Australia. Recognising the difficulty of modelling the removal of restrictions on services trade precisely, the CIE study assumes that free trade in services raises productivity in all services industries by 0.35%. The uplift in services productivity is supported in Appendix A by reference to other studies of gains from 4 reform measures in the services

sector: the removal of limitations on foreign ownership of Telstra; the removal of restrictions on foreign ownership of Australian banks; and the removal of restrictions on foreign entry into provision of professional and distribution services. CIE makes no claim that the assumption of removal of restrictions on ownership of Telstra or of the major banks, or for that matter of complete removal of import barriers to agricultural imports in the United States, is in any way realistic. The assumptions were provided by the Department of Foreign Affairs and Trade, and the modelling simply applies those assumptions.

In truth, there are major problems with using a study based on these restrictive assumptions for drawing conclusions about the effect of a free trade agreement in practice. The assumptions related to the ownership of Telstra and of banks seem to violate subsequent policy statements of the Government on these matters. The assumption of complete free trade in agricultural products raises two fundamental questions. The first arises out of the assumption that while there are no restrictions on trade, United States subsidies, the main form of American industry assistance in agriculture, remain as they were. It is not at all clear how the obvious contradictions between the removal of barriers to trade and the retention of United States subsidies could be resolved in practice. Second, the main advocates for a free trade agreement with the United States have always agreed that the best possible outcome is nothing like free trade, but rather some improvement in access to the United States market. The "APEC Studies Centre" (2001, p.39), says that "it is very unlikely that the sector would be altogether excluded from the agreement." The recent argument to the United States Trade Commission by the Australian Ambassador to the United States is especially revealing. Ambassador Thawley (2003) argues for some improvement in access and not at any point for free trade. He explains to the Trade Commission that Australia has not been a large exporter of agricultural produce to the United States in the past and will not be a substantial exporter after a free trade agreement, and defines Australia's (and the United States') dominant interest in agricultural trade as expanding exports to Asia.

I have noted elsewhere (Garnaut, 2002) a larger problem in the assumptions applied in the modelling for the Department of Foreign Affairs and Trade: the removal by assumption of all transactions costs in trade, including transactions costs inevitably associated with application of rules of origin in a free trade agreement. This is not a criticism of this particular modelling exercise: the econometrician's art has not yet extended to analysis of these effects. Yet the increased costs of international transactions is the center of the mainstream critique of contemporary preferential trade (Bhagwati, 2002a, 2002b). The omission of transaction costs requires the modelling to be supplemented by separate analysis of these important effects in any realistic assessment of the effects in practice of a free trade agreement.

For all of these reasons, the CIE report should be regarded not as an attempt at realistic assessment of the effects of an Australia-United States Free Trade Agreement, but rather as an assessment based on assumptions that are generally favourable to a free trade agreement.

This is the context within which the results of the modelling exercise need to be interpreted. The \$4 billion by 2010 (actually a bit above \$3 billion at present exchange rates, if the published results of the study are taken literally) comes mainly from the liberalization of Australia's own imports of goods and services from the United States. The assumption of productivity growth in the services sector, deriving from Australia's own removal of restrictions on investment in services, alone would seem to contribute over half of the welfare gain. (The modelling suggests virtually no gains from United States removal of restrictions on services imports from Australia). The results of McKibbin's modelling of the gains from unilateral and multilateral trade liberalization involving Australia (McKibbin, 1998) indicate that the majority of the gains from removal of barriers on goods trade derive from Australia's own removal of restrictions from imports of goods from the United States. It follows that less

than a quarter of the “over \$3 billion” of economic benefits comes from the United States removing its restrictions on imports from Australia. The published study identifies dairy products and sugar as being the most important contributors to this small addition from United States liberalization. Separately, the study concludes that Australia’s exports, after a transition period, will have risen by 0.8%, or about a billion Australian dollars. The complete removal of United States restrictions on imports of sugar and dairy products, but retention of subsidies, causes Australia’s exports of those goods to rise by \$US442 million (\$A730 million).

Comparison of these results with the results from McKibbin’s earlier applications of the APG-cubed model (McKibbin, 1998) suggests that these additions to welfare and exports are very small compared with the gains to Australia of unilateral and multilateral liberalization. This unfavourable conclusion for the free trade agreement emerges from the published results of the modelling, despite the fact that the earlier applications of McKibbin’s model to unilateral and trade liberalization do not allow for the “DFAT uplift” in productivity in the services sector. The “DFAT uplift” would seem to contribute over half of the Australian gain in the CIE study for the Department of Foreign Affairs and Trade. Even with this difference in assumption about services sector productivity, the comparison of the CIE paper commissioned by DFAT and McKibbin’s earlier published work, suggests that the completion of unilateral liberalization in Australia, without any reciprocity from any other country, would generate over ten times the increase in Australian exports, and a substantially larger increase in GDP, than complete removal of all trade barriers between Australia and the United States.

The potential gains from an Australia-United States free trade agreement are demonstrated by the Government’s own study to be very small, even if we suspend disbelief about the United States accepting clean free trade in agriculture, even if it were possible that American agricultural subsidies would

not negate agricultural trade liberalisation in practice, and even if it were feasible for an Australian government to deliver on the removal of ownership restrictions on Telstra and the banks that in the modelling generate gains in services productivity. And yet to achieve these small gains, a major commitment of scarce political and administrative resources would be required—an allocation of resources that would have substantial opportunity cost in terms of commitment to other trade policy outcomes. A straightforward reading of the results of the CIE study for DFAT leads to the conclusion that a free trade agreement with the United States is not worth the effort.

Accepting the study commissioned by DFAT on its own terms leads to the conclusion that complete free trade in goods and services between Australia and the United States would generate welfare gains that were approximately but slightly above zero. This is interestingly similar to the results of the ACIL-Tasman study for RIRDC, that have not yet been published but which were the subject of informal discussion around Canberra by Commonwealth officials in 2002, before the study became a matter of public controversy. The ACIL-Tasman study suggested an increase in welfare of approximately but slightly below zero. It is to be hoped that the ACIL-Tasman work is soon in the intellectual market place, as comparison of assumptions used in this and the CIE modelling would illuminate both.

Before moving on from the CIE study, I should comment on the study's conclusions about trade diversion. As previously mentioned, the study draws eclectically on two models, the APG cubed and a modified GTAP. The latter is required to supplement the former because the former does not contain the commodity detail that is necessary to draw conclusions about effects on particular industries. Amongst other things, the commodity detail is necessary if conclusions are to be drawn about trade diversion.

The CIE study concludes that trade creation would exceed trade diversion in a free trade area between Australia and the United States. This conclusion has been cited frequently by advocates of the free trade agreement.

There seem to be two problems with the conclusions that are drawn about trade diversion. First, the conclusions are drawn from the model that does not contain the commodity detail that would be necessary to support them. Second, as pointed out in Garnaut (2002) some time ago, the particular test that is applied does not establish that trade creation would exceed trade diversion. The CIE study asserts that trade creation exceeds trade diversion if the total value of world trade expands. In reality, it would be possible for the total value of world trade to expand even if there were substantial trade diversion and no trade creation at all. The point can be made with a simple example. Take the case where preferential treatment of imports from Australia caused Australia to take over part of New Zealand's lamb market in the United States. Under the study's assumptions of zero trade transactions costs, New Zealand would simply take over markets in Australia and third countries previously supplied by Australia. Total world trade would have increased by the amount of the increase in New Zealand's exports to Australia and third countries, even though there had been some trade diversion and no trade creation at all.

The CIE paper also presents results from the modified GTAP model with its commodity detail that indicate substantial diversion of Australian imports away from various Western Pacific countries.(Garnaut, 2002).

Supporters of a free trade agreement with the United States have argued that benefits would be larger than the approximately zero that emerges from the CIE modelling. DFAT in its evidence to the Senate Committee referred to another study commissioned by DFAT. This was a study by the "APEC Studies Centre" at Monash University. The principal author of "APEC Studies Centre" 2001 is said to be Alan Oxley. There is no reference in the publication or in the

version posted on the DFAT website to the fact that Alan is the Director of the main business organization lobbying for the free trade agreement. The much larger benefits that are asserted for the free trade agreement in this paper are not supported by analysis. The study acknowledges “considerable assistance” from the Department of Foreign Affairs and Trade. It was not taken seriously when DFAT made reference to it in hearings in the Senate Committee on November 22. It has not been seen by independent parties as a contribution to the objective analysis of benefits and costs of a free trade agreement.

I do not suggest that the benefits of trade liberalization cannot go beyond those suggested by general equilibrium modelling. There is considerable evidence that unilateral or multilateral trade liberalization or other economic reform which clearly reduces transactions costs can generate improvements in economic performance that exceed the benefits suggested by the modelling. Indeed, this seems to have been the Australian experience following the radical trade liberalization since 1983. However, supporters of the Australia-United States free trade agreement have not been able to demonstrate the reductions in transactions costs, emerging from the free trade agreement, that are supposed to produce this result.

When it is demonstrated that a case for a free trade agreement with the United States has not been made analytically, the FTA’s most active proponents have argued that agreement would generate large benefits that cannot be captured by analysis of the effects of a free trade agreement. The argument has been made that the real objective of the current discussions is not a free trade agreement but something much larger—for example, integration of labour and capital markets (Scanlon, cited in Hartcher, 2003), or economic union (“APEC Studies Centre”, 2001, p.58). These larger arrangements are themselves amenable to economic analysis, but they are never defined with sufficient precision to allow analysis. But because they are part of the discussion of the free trade agreement, I will comment briefly on each of them.

Scanlon's expansive statements about the gains from deep integration of labour and capital markets, reported by Hartcher (2003), are made without reference to particular reform measures. However, a few points can be made in general. First, deep labour market integration would only be feasible in the context of harmonisation of immigration and broader labour market policies. Australian and United States immigration policies and labour market policies and institutions are radically different, with the differences having origins in profound differences in community preferences and values (Garnaut, 2002b). Deeper integration would be complicated and contentious and discussion of it has not yet begun. In the case of integration of capital markets, the most important steps, relating to harmonization of accounting standards, corporate law and regulation, stock exchange listing rules and corporate taxation arrangements, do not require, and in practice could be achieved with less political difficulty, outside a free trade agreement. A big step towards integration of Australian into international capital markets will be taken with Australian movement to international accounting standards by 2005, and the general community has hardly heard about it.

All that can be said of Oxley's case for the benefits of economic union is that the proposed arrangements have been defined with too little precision even for intelligent assessment of the most general kind. In one statement, Oxley argues the benefits of Economic Union by reference to the performance of states of the American Union ("APEC Studies Centre", 2001, p.58). In truth, a number of American states grew much less rapidly over the past hundred years than Tasmania, in economic terms the poorest performing of the Australian states. Membership of the American Economic Union in itself does not guarantee good economic performance. The case for a free trade agreement, has to be made by analysis and not by analogy.

Alan Oxley (“APEC Studies Centre”, 2001) has argued that there are especially large benefits for Australia in the free trade agreement, because it would link Australia to the “Information Age”. The actual mechanisms through which the closer linkage would be achieved are not clear. But even if they were clear, there are reasons for questioning the value of taking special measures, such as entering a free trade agreement with the United States, to promote the development of one important sector. The case for caution has been made most eloquently by the Governor of the Reserve Bank of Australia, Ian McFarlane. Australia has done well in recent years by mostly standing aside from the hyperbole about the information economy, and by utilizing the new technology no more and no less than individual enterprises have judged to be valuable from their individual perspectives. The Australian experience contrasts with that of Malaysia, Taiwan and Singapore, each of which introduced exceptional policies deliberately to accelerate development of the information technology sector in the 1990s, and each of which entered recession with the United States information technology industries in 2001. With the hangover from the “tech wreck” now entering its third year, there does not seem to be good reason for reconsidering Australia’s successful approach.

Sometimes a case for large benefits from an Australia-United States free trade agreement is argued by analogy with the effects of NAFTA in improving economic performance in Canada and Mexico, and in particular in raising competitiveness in third markets. The case of Canada and Mexico is not at all a close analogue of the proposed Australia-United States free trade agreement. Most importantly, the proximity of Canada and Mexico makes the United States overwhelming their dominant trading partner of these countries, whether or not they are joined by membership of a free trade agreement. So the analogy, if it were to make a positive statement about an Australia-United States free trade agreement, would have to be based on the effects of NAFTA in improving competitiveness in third markets. In fact, since the formation of NAFTA, export growth from Canada to countries outside North America has

been well below the world average, far below that of Australia, and close to the lowest in the world (Tables 1 and 2).

UNRAVELLING OF MULTILATERAL TRADE: THE THEORY OF THE UNIMPORTANT COUNTRY

While the potential gains from a free trade agreement with the United States are at best small, the potential losses are very large. The most important relate to the momentum that an Australia-United States free trade agreement would add to the growth of bilateral and small-group free trade agreements globally and in particular in the Asia Pacific region, and the associated weakening of a rules-based multilateral trading system.

It is obvious to this audience that Australia has a large interest in the preservation of a rules-based multilateral trading system, and in the avoidance of substantial retreat by the international community into small-group preferential trading areas. The interest is greater for Australia than for larger economies that can hold more reliable expectations of achieving national objectives through the exercise of power. The interest is greatest for Australia in avoiding the retreat of its major trading partners in its most important trading region, East Asia, into preferential arrangements that exclude Australia.

It will therefore have come as a shock to you, as it has to me, that some Australian officials have been relaxed about, even enthusiastically welcoming of, the recently enhanced legitimacy of preferential trading arrangements globally and in the Western Pacific region (Commonwealth of Australia, 2003).

It is foolish for an Australian to be relaxed about these developments. In the haunting words used by an Australian political leader on another issue half a century ago, for an Australian enthusiastically to welcome them is the “very ecstasy of suicide” (Menzies, 1947 cited in Garnaut, 2001, p.27). The emergence of preferential trading blocs as major elements in the arrangements

governing trade of East Asian countries would be seriously damaging to Australian interests in several ways. Such developments would inhibit growth in East Asia, which continues at a rate well in excess of the global average since the financial crisis of 1997-98, and which depends on fine specialisation in regional and global markets. At this time in history, Australia is very likely to be excluded from major preferential trading arrangements in East Asia. Amongst much else, exclusion would mean that Southeast Asian suppliers of agricultural products would be preferred over established suppliers from Australia in the rapidly expanding Northeast Asian markets for food and raw materials. Australia would also be damaged by the exclusion from preferential arrangements in East Asia of newly important trading partners in South Asia, the development prospects of which would be diminished.

These arguments are acknowledged by serious policy analysts in the upper echelons of the economic departments of state in Canberra. Some senior Canberra officials, who recognise the dangers but nevertheless argue for the government's position on the free trade area with the United States, defend their position with what has become known in Canberra as The Theory of the Unimportant Country.

The Theory of the Unimportant Country is based on the premise that the disintegration of the international trading system into small-group preferential trading areas is happening independently of anything Australia might do. Australia is an unimportant country, which has little or no influence over the shape of the international trading system. Australia has to make do as best it can in the international system as it is shaped and defined by greater powers. Since the trading system is breaking down into small-group preferential areas, Australia's interests are served best by joining in, and finding the best place it can for itself in one or more preferential areas.

There are several flaws in the Theory of the Unimportant Country. First, it does not explain why Australia now is an Unimportant Country, when at times in the past it has been able to influence in significant ways the international trading system within which it must secure its interests. Second, it accepts that the multilateral trading system has broken down already, when the reality is that the recently enhanced legitimacy of preferential trade has not yet had much real effect, beyond the now well-established arrangements within the European Union and NAFTA, on Australia's relations with its major trading partners. Third, it asserts without establishing through analysis that in a world in which preferential trading areas have become much more important, Australia would be better off to join a free trade agreement with the United States, rather than to establish a position outside the emerging trading blocs as a country of free trade with the whole world.

On the first weakness in the Theory of the Unimportant Country, one need only refer to the role played by Australia in the 1960s in building acceptance for the developing country preferences as an exception to the general rule of non-discrimination; in the late 1980s and early 1990s in the building of eventually effective coalitions to include textiles and agriculture within the range of issues covered by multi-lateral negotiations; and in the early 1990s in discouraging the United States from pursuing its trading interests through bilateral and small-group preferential arrangements. . It is always a challenge for a country of Australia's modest size to influence the international trading rules. But it is a lesson of experience that an Australian Government that has identified its essential interests and pursued them consistently can have substantial influence on the shape of the international trading system.

Australia's influence is negative as well as positive. The search of various Asian Pacific countries including Australia for small-group preferential partners since 2000 has been a major factor in persuading the Chinese leadership that, despite their strong emphasis on and success with multilateral

trade in the era of reform, China should itself seek free trade arrangements in East Asia, for fear of being left out of a general retreat into preferential trade. (Private communications with Long Yongtu, Chinese Vice Minister for Foreign Trade and Technical Co-operation, with ministerial responsibility for responsible for trade negotiations, Canberra, 2002). This is the immediate background to the 2002 announcement by heads of government that China and the ASEAN countries would seek to enter a free trade agreement.

Australia's entering into a free trade agreement with the United States would be a major development in the international system. It would be by far the most substantial success so far of the current United States administration's active pursuit of bilateral and small-group free trade agreements. It would be the first free trade agreement among substantial economies that joined distant countries rather than members of the same geographic region.

The negotiation of a free trade agreement between China and ASEAN or China-Japan-Korea and ASEAN will not be a straightforward matter. The presence of trade diversion in an Australia-United States free trade agreement against East Asian countries would generate reactions that increased the probability of it happening.

On the second weakness in the Theory of the Unimportant Country, there has not yet been a single important small-group preferential trading arrangement negotiated since a number of Western Pacific economies including Australia and the North American countries began a frenzied search for new preferential arrangements at the end of the twentieth century. Despite commitments in principle to small-group free trade agreements, East Asian countries have found the practical difficulties considerable. Even the United States in the period of explicit commitment to preferential trade, with Bob Zoellick, as Special Trade Representative since early 2001, energetically seeking his place in history, has made little progress so far with the high priority Free Trade

Agreement of the Americas. Political and economic developments in Brazil and Argentina made early success in negotiations unlikely. The arrangements that have been concluded between Singapore and a few countries including Australia, and between the United States and Jordan, are distinguished by their genuine unimportance.

Completion of a free trade agreement with Australia would be by far the largest of America's free trade agreements of the recent (post-NAFTA) era. It would give substance to and confirm the recent United States policy shift towards preferential trade.

The world trading system has not yet moved far towards disintegration into small-group free trade areas, even with Australia's weight having been placed solidly behind this development. If Australia's influence were applied as firmly against preferential trading arrangements, and especially if the new tendency towards preferential trade in the United States were contested by Australia, the tide of history may no longer run towards preferential trade.

The Australian government continues to recognise that Australia has a far greater interest in a successful outcome of the Doha Round of multilateral trade negotiations than in bilateral free trade arrangements (Commonwealth of Australia, 2003). However, it does not face up to the reality, to which the WTO's Director General drew attention on a visit to Sydney last year, that the contemporary enthusiasm for bilateral free trade agreements is inhibiting progress on the Doha Round (see also Drake-Brockman, 2002).

The third weakness in the Theory of the Unimportant Country is centrally important to Australian policy.

There are many and rapidly expanding opportunities for profitable Australian trade, even following the formation of discriminatory trading arrangements

involving major trading partners in Europe and North America. There are no signs that this will cease to be the case in future. The range of available opportunities would be enhanced by unalloyed focus by Australia and others on the strengthening of the multilateral trading system, even in the contemporary world of enhanced legitimacy for preferential arrangements.

To focus on one set of expanding opportunities, the multilateral trading system has been greatly enhanced by the entry of China and Taiwan into the WTO in 2001. The increase in Chinese imports from Australia over the past decade exceeds by over 5 times the whole of the anticipated increase in annual exports to the United States by 2010 as a result of a perfectly successful free trade agreement (Centre for International Economics, 2001 and Australian Bureau of Statistics, various years).

The new round of multilateral trade negotiations launched in 2001 at Doha has a good agenda from an Australian perspective. It has reasonable prospects for large success if enthusiasm for preferential arrangements in the United States does not deny it priority in the allocation of political resources.

It is Australia's own competitiveness, and not preferred access in some markets, that holds the key to making good use of the substantial export opportunities that will continue to be available. All of the economic analysis demonstrates that the benefits to Australia from completion of its own trade liberalization, and from further steps in productivity-raising reform, greatly exceed any possible benefits even from widespread liberalization in the rest of the world.

Australia's competitiveness in the general run of international markets generally is actually enhanced by some countries entering free trade agreements with each other (Garnaut, 1998). Trade diversion within a free trade agreement reduces the members' competitiveness in third markets, which

increases opportunities for third countries to trade profitably with each other. This result emerges from general equilibrium theory. It is apparent empirically in the weak performance of Canadian exports to non-NAFTA economies after formation of NAFTA. The shares of countries that are not members of NAFTA in the markets of other “excluded” countries have risen strongly over the years of implementing NAFTA (Tables 1, 2).

Australia can do well as a productive free trading country, even in a world in which preferential trading arrangements are much more important than they are today. It will do better still if it is successful in contributing to a strong international trading system, including through working towards a successful outcome to the Doha Round, and in persuading the United States that its own interests as well as Australia’s are served better by a successful multilateral trading system than by the proliferation of preferential arrangements.

THE POLITICAL ECONOMY OF FREE TRADE IN AUSTRALIA

The prominence of bilateral free trade areas in Australian discussion of trade policy in recent years has been accompanied by loss of interest in completion of the unilateral trade liberalization, the earlier substantial progress on which had been the most important single cause of the greatly improved economic performance in the 1990s.

After 8 years in which a series of decisions was taken to reduce Australian protection to a small fraction of the level in the early nineteen eighties, no decision by Government since 1991 has yet reduced protection in Australia below the levels announced in March 1991. The Keating Government took no decisions to reduce protection, and the modest steps by the Howard government in relation to textiles, clothing and cars will have their first effects in 2005. The gains from completing the liberalisation process, on unfavourable assumptions, are much larger than perfect success in the negotiations with the United States on the most generous of assumptions.

The loss of momentum in Australia's own trade liberalization has several causes. Perhaps the most important was that responses to the 1990-91 recession, and the Keating Government's opportunistic criticism of the then Opposition's advocacy of free trade by 2000, broke what had been for a while bipartisan support for trade liberalisation.

One obstacle in the way of Australia returning to trade liberalization and productivity raising reform is the recent reversion of the culture of trade policy –making to practices that gave Australia eight decades of high protection and, by the standards of other countries which are now rich, poor economic performance (Garnaut, 2002). The clearest example of reversion to old ways, with strong influence of vested interests in policy-making and weak and non-transparent analysis of alternative trade policies, is the free trade agreement with the United States.

The successful Australian trade liberalization of the past two decades began with disinterested analysis of the costs of protection and publication of results by the Productivity Commission and by independent economists. Vested interests played a role in public discussion of trade policy, as is inevitable in a democracy. But the transparency of the policy-making process placed limits on vested interests' capacity to assert sectional over national interests.

It is disturbing that transparent and disinterested analysis has played such a small role, and business vested interests such a large one, in policy-making so far on the free trade agreement. The debate suffers from the absence of a report from the Productivity Commission, attempting to measure objectively and independently the extent and distribution of benefits. The papers commissioned and published by DFAT came after the policy decision to seek a free trade agreement, and the professional study that was commissioned was constrained

to an undesirable degree by the assumptions imposed on it by Government officials.

Preferential trade, like all restrictions on trade, creates both winners and losers. Many winners have a vested interest in maintaining preferences, and therefore in partner countries maintaining protection against third countries. Inevitably, some potential supporters of general trade liberalization are converted by their vested interests into opponents of free trade. This effect would compound the other adverse political economy effects of a free trade agreement on Australia's prospects for completing its trade liberalization.

EFFECTS ON THE UNITED STATES ALLIANCE AND POLITICAL RELATIONS WITH EAST ASIA

The United States alliance remains fundamentally important to Australian security (Garnaut, 2001b). As my colleague Paul Dibb has said recently, the alliance is currently under exceptional challenge in Australian public opinion.

Capling (2002) has observed that there is good reason behind the longstanding Australian policy of separating the trade from the security relationship with the United States. The good reason is that the trade relationship is inevitably a difficult one, arising out of United States protectionist interests being especially powerful politically in sectors in which Australian export interests are strong. Security policy is run by the executive, but there is a large Congressional role in trade policy-making. With the best will in the world towards Australia, a United States Government cannot be relied upon to deliver trade policy decisions sought by Australia.

The inevitable tensions over trade matters would inevitably spill over into the more important security relationship if the two areas of policy were allowed to affect each other. It follows that separation is the more reliable approach to preservation of the alliance.

This is a particularly dangerous time to put contentious trade issues at the centre of the relationship. The Australian interest in the alliance is broadly recognized in the community. But conditions can arise in which opposition to the alliance is temporarily popular. The danger is that at such times, the relationship could be changed permanently by political responses to tensions between Australia and the United States.

The circumstances in which New Zealand withdrew from the alliance in 1984 are instructive. I was the only other person present in the first meeting between Prime Ministers Bob Hawke and David Lange, at which the risks of disintegration of the original ANZUS alliance became apparent. As a result, I am more aware than most supporters of the alliance of the risks that are present in the currents and eddies of popular debate on these matters. It is now often said that New Zealand's security interests and orientation were different from Australia's in ways that led to the different approaches to ANZUS. This is the wisdom of hindsight. The difference between New Zealand and Australia in 1984 was in the attitudes to the alliance of leaders in the two countries. The New Zealand leadership saw a political advantage in challenging the alliance, and took it. The political popularity of this step deterred the Conservative successor government from reversing it

Contemporary supporters of the Australia-United States alliance have a strong interest in ensuring that tensions over trade issues do not add to divisions over an unpopular war. This is especially important following recent inept partisan diplomatic interventions in Washington and Canberra.

Alongside the alliance with the United States, close and productive relations with East Asia are an important element of Australian security. The recent prominence of terrorism in security concerns increases the importance of these relationships. Australia's discriminating against neighbouring countries, in

favour of imports from the United States, as it would do in a free trade agreement, would be an additional barrier to close and productive relations with East Asia. Any eventual evolution of the Asia Pacific region into two trading blocs, discriminating against each other, and with Australia and the United States in one bloc and most of East Asia in the other, would corrode Australia's prospects for intimate cooperation on terrorism over the long period over which close cooperation may be required. The fact that several of Australia's Southeast Asian neighbours have large Moslem populations adds to what is at stake in this issue.

MISTAKES AND MISREPRESENTATION BY ALAN OXLEY

In conclusion, it is my melancholy duty to point out some errors and worse in Alan Oxley's presentation of my own position in a paper that he placed last year on the website of the business lobby group for an Australia-United States free trade area. Oxley is Director of the business lobby group. The paper is entitled "Free Trade Agreements in the Era of Globalisation" (Oxley, 2002). The paper is dated July 2002 and may have been on the website for a long time, but I have been aware of its existence only since opening the website a week ago in preparation for this occasion.

Oxley says that free market economists fret when they see threats to the international trading system from free trade agreements. It is true enough that free market economists recognise the dangers of preferential trade, but "to fret" is a strange choice of verb to describe the confident analysis of a distinguished economist like Bhagwati. He cites a paper by Bhagwati and others and says that these economists have Australian counterparts, "traditionally Rattigan and Carmichael, and most recently Garnaut". I am happy for my views on trade policy to be associated with Bhagwati, Rattigan and Carmichael. For myself, far from being a recent addition to the club of economists "fretting" about preferential trade, I have advocated non-discrimination in trade for as long as I have advocated free trade, in published papers going back 23 years (see the

collections of papers on these themes published as Garnaut 1996 and Garnaut 2001).

Oxley says that “Given Garnaut’s own history, it is surprising he would dismiss the benefits to Australia of committing to reduce its own barriers in an FTA”. Presumably Alan is referring to my long advocacy of free trade for Australia, and the role that I played in the reduction in protection in Australia in the 1980s and 1990s. The truth is that I have consistently opposed Australia entering discriminatory arrangements for as long and with as much rigour as I have argued the case for free trade. I oppose the free trade agreement with the United States, amongst other things, because it is not free trade, and because it would be antithetic to continued progress towards free trade.

Oxley associates me with Stephen Fitzgerald’s views in his 1997 book about the inter-relationship between a free trade agreement with the United States and relations with Asia (Fitzgerald, 1997). Stephen is a distinguished commentator on and contributor to Australia’s relations with Asia. So far as I recall, Stephen does not discuss the free trade agreement with the United States in the work cited. His views on Australia’s relations with the United States as expressed in the book are distinctively different from my own, as presented in many published papers over a decade and a half. Oxley’s has abused academic citation to misrepresent my views on Australia’s relations with the United States.

Oxley attributes to me the view that Asian countries would retaliate against Australia’s entering a free trade agreement with the United States by systematic discrimination against non-Asian (I presume non-Asian; the words in the paper actually say Asian) economies. Retaliation suggests a deliberate and direct response. My argument has always been that Australia’s entry into a free trade agreement with the United States would strengthen the legitimacy of preferential trade and the forces encouraging development of preferential

arrangements in East Asian countries. The difference from retaliation may be subtle, but it is important to understanding the position that I have presented consistently since the beginning of the current debate, and which is supported by the evidence of reactions to the discussion of new free trade agreements that has already taken place.

Finally and most egregiously, in a paper that focuses heavily on my own critique of the proposal for a free trade agreement with the United States, Oxley says that “It is notable that a chorus of concern about bilateral and regional agreements only arose in public debate in Australia when the proposal to negotiate with the US was floated.” Oxley says that the “Australian academics”, unnamed at this point but clearly from the context including me as the prime example of the genre, have accepted with favour the ASEAN Free Trade Area as an example of “open regionalism”. The implication of Oxley’s remark is that there is an imbalance in the positions that I have taken in relation to preferential trading arrangements involving the United States on the one hand and Asia on the other.

This allegation misrepresents my position. In the large extent of my published work on free trade, preferential trade, “open regionalism”, Australian relations with the United States and Australia’s relations with Asia you will find not a single word of even the faintest praise for preferential trade with Asia. My advocacy of free trade in Australia and elsewhere has always been of non-discriminatory free trade. My 1989 Report, to the Australian Prime Minister and Foreign Minister, *Australia and the Northeast Asian Ascendancy*, which is widely seen as providing a framework for the development of Australian relations with Asia for a considerable period after its publication, describes the maintenance of non-discriminatory trade as one of the prime objectives in East Asian trade diplomacy. Oxley’s misrepresentation fails to contend with my history as a longstanding and public supporter of close and productive relations with the United States and of the United States alliance.

Indeed, my concern for the health of relations with the United States and the longevity of the alliance are amongst my motives for accepting invitations to participate in gatherings like this today, to explain the risks to Australia of entering a free trade agreement with the United States.

References

- “APEC Studies Centre”, 2001 “An Australia-US Free Trade Agreement: Issues and Implications”, A Report for the Department of Foreign Affairs and Trade, Canberra.
- Bhagwati, J, (ed) 2002, *Going Alone*, “Australia: A Case Study of Unilateral Trade Liberalization”, MIT Press, Massachusetts.
- Bhagwati, J. 2002b, *Free Trade Today*, Massachusetts Institute of Technology Press, Cambridge.
- Capling, A., 2002, “September 11 and the Global Trade System”, Speech for the Brisbane Institute, Queensland.
- Capling, A., 2003, “Clayton’s FTA likely to produce a few trade gains”, in *Australian Financial Review*, 8 January.
- Centre of International Economics, “Economic Impacts of an Australian-United States Free Trade Area”, prepared for and published by Department of Foreign Affairs and Trade, Canberra.
- Commonwealth of Australia, 2003, *Advancing the National Interest*, National Capital Printing, Canberra.
- Drake-Brockman, J., 2002
- Drysdale, P. and D. Vines, 1998, *Europe, East Asia and APEC, A Shared Global Agenda?*, Cambridge University Press, Cambridge.
- Fitzgerald, S., 1997, *Is Australia an Asian Country*, Allen and Unwin, St Leonards.
- Garnaut, R., 1998, “Europe and Asia Pacific economic cooperation”, Chapter 12 in *Europe, East Asia and APEC, A Shared Global Agenda?* Cambridge University Press, Cambridge.
- Garnaut, R., 1996, *Open Regionalism & Trade Liberalization*, Institute of Southeast Asian Studies, Singapore.
- Garnaut, R., 2001, *Social Democracy in Australia’s Asian Future*, Asia Pacific Press at the Australian National University.
- Garnaut, R., 2001b, “ANZUS and Australia’s Security in Asia”, Chapter 4, in *The United States-Australia Alliance in an East Asian Context*, (H. Albinski and Rowan Dalrymple, eds).

- Garnaut, R., 2002 “An Australia-United States free trade agreement”, in *Australian Journal of International Affairs*, Vol. 56, No. 1.
- Garnaut, R., 2002b, “Immigration: Who wins and who loses” in *Migration: Benefiting Australia*, Department of Immigration and Multicultural and Indigenous Affairs.
- Hartcher, P., 2003, *Australian Financial Review*, January.
- McKibbin, W., 1998, “Regional and multilateral trade liberalisation: the effects on trade, investment and welfare, Chapter 8 in *Europe, East Asia and APEC, A Shared Global Agenda?* Cambridge University Press, Cambridge.
- Thawley, M., 2003, Evidence to the United States Trade Commission, Washington DC, February 6.

Table 1 Exports of East Asia, North America and European Union, 1985-2001, US\$ billion, current prices

Importer/ Exporter	East Asia				EU 15				Nth America			
	1985	1992	1995	2001	1985	1992	1995	2001	1985	1992	1995	2001
Australia	10.2	20.3	29.4	31.5	3.2	5.4	5.9	7.0	2.7	4.2	4.3	7.3
New Zealand	1.4	3.2	4.7	4.7	1.2	1.4	1.9	1.9	1.0	1.4	1.7	2.5
East Asia	115.4	336.6	591.3	660.7	44.4	134.2	191.9	224.0	127.1	210.9	317.4	380.1
Japan	37.7	112.4	158.5	159.3	23.3	67.1	70.4	64.5	72.2	107.4	131.4	133.4
Korea	7.6	31.2	54.7	67.0	3.6	9.8	16.3	19.7	12.0	20.7	27.1	35.5
China	16.0	56.6	80.9	121.9	2.5	8.0	19.3	41.0	2.6	9.4	26.5	59.5
ASEAN 6	34.3	89.5	156.1	187.8	8.1	30.2	45.3	57.6	14.4	38.7	62.7	75.0
EU 15	29.4	92.8	146.3	150.2	422.4	1,043.6	1,259.7	1,406.9	81.3	121.5	154.5	248.0
Nth America	51.7	123.8	172.8	188.9	61.3	113.8	138.3	175.9	143.2	263.8	394.5	639.1
USA	43.3	110.9	155.2	175.1	51.9	100.5	123.6	159.4	60.9	122.1	172.3	265.2
Canada	6.5	11.7	15.8	11.1	5.4	9.9	11.3	11.4	68.6	103.5	153.7	230.5
Mexico	1.9	1.2	1.8	2.2	4.1	3.4	3.4	5.0	13.7	38.3	68.5	143.4
Rest of World	50.5	82.4	118.4	194.4	170.6	242.7	308.0	411.3	58.7	84.6	103.3	185.4
World	258.6	659.1	1,062.8	1,230.4	703.1	1,541.0	1,905.7	2,227.0	414.0	686.4	975.6	1,462.4

	Rest of World				World			
	1985	1992	1995	2001	1985	1992	1995	2001
Australia	7.1	8.2	11.0	14.9	23.1	38.1	50.6	60.6
New Zealand	2.4	3.3	5.0	4.0	5.9	9.3	13.3	13.2
East Asia	80.1	114.5	178.9	198.1	367.0	796.2	1,279.5	1,463.0
Japan	44.6	52.5	54.0	22.1	177.9	339.5	414.3	379.3
Korea	8.2	14.7	29.3	22.4	31.4	76.4	127.5	144.6
China	6.2	10.9	19.3	38.8	27.3	84.9	145.9	261.2
ASEAN 6	12.7	25.3	45.5	49.2	69.5	183.6	309.6	369.5
EU 15	198.2	320.1	444.8	479.8	731.3	1,577.9	2,005.3	2,284.9
Nth America	74.3	97.6	127.2	127.9	330.6	599.0	832.7	1,131.8
USA	57.7	87.3	113.2	113.2	213.7	420.8	564.3	712.9
Canada	13.9	7.0	8.2	7.6	94.4	132.1	189.0	260.7
Mexico	2.7	3.3	5.8	7.8	22.5	46.2	79.5	158.3
Rest of World	162.5	162.1	276.0	298.4	442.3	571.7	805.6	1,089.4
World	524.6	705.7	1,042.9	1,123.1	1,900.3	3,592.3	4,987.0	6,042.9

Table 2 Exports: GDP ratios for selected economies by export destination, 1965-2001, per cent

Importer/ Exporter	East Asia				EU 15				Nth America				Rest of World				World			
	1985	1992	1995	2001	1985	1992	1995	2001	1985	1992	1995	2001	1985	1992	1995	2001	1985	1992	1995	2001
Australia	5.9	6.5	7.8	8.4	1.9	1.7	1.6	1.9	1.5	1.4	1.1	1.9	4.1	2.6	2.9	4.0	13.4	12.2	13.5	16.2
New Zealand	6.2	8.0	7.9	10.4	5.2	3.6	3.2	4.2	4.3	3.6	2.8	5.5	10.8	8.2	8.3	8.9	26.5	23.3	22.1	29.0
East Asia	5.7	6.7	8.1	8.6	2.2	2.7	2.6	2.9	6.3	4.2	4.4	5.0	4.0	2.3	2.5	2.6	18.1	15.7	17.6	19.1
Japan	2.8	3.0	3.0	3.1	1.7	1.8	1.3	1.2	5.3	2.8	2.5	2.6	3.3	1.4	1.0	0.4	13.0	8.9	7.8	7.3
Korea	8.2	9.9	11.2	13.0	3.8	3.1	3.3	3.8	12.9	6.6	5.5	6.9	8.7	4.7	6.0	4.4	33.6	24.3	26.1	28.1
China	5.3	13.5	11.6	10.4	0.8	1.9	2.8	3.5	0.8	2.3	3.8	5.1	2.0	2.6	2.7	3.3	9.0	20.3	20.8	22.2
ASEAN 6	15.2	21.2	24.5	31.3	3.6	7.2	7.1	9.6	6.4	9.2	9.8	12.5	5.6	6.0	7.1	8.2	30.9	43.6	48.6	61.7
EU 15	1.0	1.2	1.7	2.1	14.6	13.4	14.6	19.5	2.8	1.6	1.8	3.4	6.8	4.1	5.2	6.6	25.2	20.2	23.3	31.6
Nth America	1.1	1.7	2.1	1.6	1.3	1.6	1.7	1.5	3.0	3.7	4.8	5.4	1.6	1.4	1.6	1.1	7.0	8.3	10.2	9.5
USA	1.0	1.8	2.1	1.7	1.2	1.6	1.7	1.5	1.5	1.9	2.3	2.5	1.4	1.4	1.5	1.1	5.1	6.7	7.7	6.8
Canada	1.9	2.1	2.7	1.5	1.5	1.7	1.9	1.5	19.6	18.2	26.5	30.9	4.0	1.2	1.4	1.0	27.0	23.2	32.6	35.0
Mexico	1.0	0.3	0.6	0.3	2.2	0.9	1.2	0.7	7.4	10.5	23.9	20.8	1.5	0.9	2.0	1.1	12.2	12.7	27.8	23.0
Rest of World	2.6	2.2	2.6	3.9	8.7	6.6	6.7	8.2	3.0	2.3	2.3	3.7	8.3	4.4	6.0	6.0	22.6	15.5	17.7	21.8
World	2.2	2.7	3.7	3.8	6.0	6.4	6.6	6.9	3.5	2.8	3.4	4.5	4.5	2.9	3.6	3.5	16.1	14.9	17.2	18.8

Notes: 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.