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Australia – USA Free Trade:
Benefits & Costs of an Agreement

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Introduction

In mid-March, a team of forty American negotiators arrived in Canberra for the first session of a bilateral negotiation that was originally expected to produce a free trade agreement with Australia by “sometime in 2004”¹. That same week, USTR Zoellick and business and political members of the American-Australian Free Trade Agreement Coalition celebrated the launch of the negotiations as a “win-win” venture for both countries that would not only produce important economic gains in both markets but also contribute to the two partners’ relationships with others in the Asia-Pacific region and the successful completion of the WTO Doha Round multilateral trade negotiations.² More than two hundred companies have signed on to the US-based coalition in support of the FTA. In Australia, the negotiations enjoy the strong support of an Australia United States Free Trade Agreement (“AUSTA”) business group and are seen as

¹ Lead Australian negotiator, Stephen Deady, at a 21 March 2003 press conference with Ralph Ives.

² Remarks by USTR Robert Zoellick, March 19, 2003.

central to the Commonwealth Government's objective of strengthening Australia's alliance with the United States (DFAT 2003, 86-91). Two Australian studies have suggested that an FTA could produce significant economic benefits for both Australia and the United States and both governments are actively seeking input and feedback from their private sectors in support of the negotiating effort.

The project also has important critics and detractors. In Australia, Professor Ross Garnaut of the Australian National University's Research School of Pacific and Asian Studies has taken the position that the completion of an FTA with the United States would not only diminish Australian economic opportunities but also weaken Australia's security. A February, 2003 report prepared by ACIL Consulting for the Australian Rural Industries Research and Development Corporation "low-balls" potential economic gains from an FTA and strongly suggests a negative impact of an FTA on Australian farmers (ACIL 2003). In Washington, representatives of the American dairy, sugar and beef industries have testified that free trade with Australia would do irreparable harm to these sectors of the U.S. economy, cutting farm incomes, forcing thousands of farmers out of business and endangering United States security (*Australian Financial Review*, January 22, 2003, 7)

President Bush and Prime Minister Howard have made it clear they would like to see the FTA deal done in the course of 2003 and there are rumors of a Bush visit to Australia in October. In the face of this political imperative, the negotiators on both sides have now had to accelerate an already tight timetable.

Is this likely to be a good agreement or not? How will the negotiations affect the WTO's Doha Round and other strategic Australian and American interests? In this paper, and at this early stage in the bilateral negotiations on an agreement, I propose to review the claimed benefits and costs of a free trade agreement between the United States and Australia, the core objectives of players on both sides of the Pacific, the potential trade and investment effects of an agreement and the implications of an FTA for both countries' relations with third countries.

Although I am aware of the 28 March 2003 letter to President Bush by Senator Grassley and seventeen of his Senate colleagues urging the inclusion of New Zealand in these FTA negotiations between the USA and Australia, I will not comment on that prospect in the body of this paper other than to state the obvious: including New Zealand would clearly complicate the already politically dicey agriculture side to the negotiations and it is difficult to see how the current U.S. Administration would put New Zealand on the same favourable political plane as Australia. American unhappiness with statements made by the New Zealand Prime Minister in the context of the recent war in Iraq have evidently translated into an unwillingness in Washington to include New Zealand in an FTA deal. In Appendix 1 to this paper, I briefly discuss how the Australia-New Zealand CER Agreement might need to be factored into an Australia-USA FTA and other issues relative to possible trade liberalisation between the USA and New Zealand.

Objectives of an Australia - USA FTA

Political leaders in the two governments and their private sector counterparts have already commented extensively on the objectives for a bilateral FTA. In the 2003 White Paper

on Foreign and Trade Policy, the Australian Government signals the coming FTA as an effort to make the economic relationship commensurate to the security relationship. The Australian authorities also see clear trade and other economic benefits as flowing from the FTA, provided that it offers genuine liberalisation of benefit to Australian exporters. Australians have identified priorities in a number of areas where they are globally competitive. As an example of a priority on the industrial side, Australian firms have developed a well-deserved global reputation for producing high-speed catamaran ferries and they see the FTA as an opportunity to gain an exemption from U.S. "Jones Act" limitations on their use in the American market. Priorities in agriculture include access to the highly protected sugar and dairy markets, as well as the more-open, but still protected American market for beef.

In a speech delivered in late October, 2002³, Australia's Trade Minister Mark Vaile cited as objectives *beyond those straightforwardly related to trade liberalisation*

- the attraction of additional American investment to Australia, with consequent positive effects on employment and productivity;
- greater integration of business in the two markets, enabling new synergies in areas such as research and development, materials sourcing, marketing and use of information technologies;
- using the FTA to foster "competitive liberalisation" through its demonstration effects in the WTO and other trade *fora*; and,

³ "Australia and the United States: Opening Markets", Speech by Trade Minister Vaile to the launch of American Australian Business 2003.

- engendering a broader appreciation of the bilateral alliance and the role of the two countries in underpinning stability and prosperity in East Asia and the Pacific.

More recently, Minister Vaile added that he wants to use the FTA negotiations to discipline the extent to which food aid might be used by the United States to undercut commercial Australian agricultural exports to post-war markets in Iraq and elsewhere (*Australian Financial Review*, April 8, 2003, 5)

The FTA negotiation with the United States also enjoys the strong support of the Business Council of Australia⁴, which sees it as enhancing the global competitiveness of Australian companies and the economy and the “AUSTA” business group, which set out a long list of its objectives for the FTA in a January 2003 submission to the Department of Foreign Affairs and Trade (DFAT). Among other objectives, AUSTA wants to see all barriers to trade and investment removed within ten years, a legal right to national treatment of investment, mutual recognition of professional qualifications affecting trade in services and in technical standards affecting goods trade, free movement of people and safeguards on security of access to markets.⁵

In his November 13, 2002 notification to the U.S. Congress of the President’s intention to enter into FTA negotiations with Australia, USTR Robert Zoellick provides considerable detail on United States’ objectives for the FTA. On a broad political level, and much like his

⁴ “BCA backs free trade talks” Letter to the editor from BCA CEO Katie Lahey, the *Australian Financial Review*, March 24, 2003.

⁵ AUSTA Submission to the Department of Foreign Affairs and Trade, January 2003 (International Trade Strategies)

counterparts in Canberra, Ambassador Zoellick sees a number of objectives beyond the commercial considerations at stake in the agreement. His message makes clear that the FTA is also seen as a tool to enhance cooperation in the WTO and help achieve jointly held objectives in a shared agenda. Another cited objective of the FTA is to strengthen the foundation of the security alliance and “facilitate the building of new networks that enhance our Pacific democracies’ mutual interests, shared experiences, and promotion of common values so that we can work together more effectively with third countries”.⁶

Ambassador Zoellick’s notification letters contain nearly five single-spaced pages of detailed trade negotiating objectives for the Australian FTA. Selected examples of American objectives give a flavour of the likely approach of American negotiators. The USTR said he would seek elimination of duties and other charges affecting imports of American goods, the suppression of Australian single desk export operations for wheat, barley, sugar and rice, and strengthened cooperation between U.S. and Australian authorities with responsibilities for sanitary and phytosanitary measures. The USA will be seeking to enhance the level of Australia’s protection of intellectual property rights⁷ and, in certain areas, will seek to have Australia apply levels of protection more in line with U.S. law and practices. The USTR promised to pursue a comprehensive approach to market access in Australia for services and explicitly referenced financial services and telecommunications services. On the investment front, Zoellick’s letters target “trade-distorting barriers to U.S. investment in Australia, including

⁶ USTR Zoellick’s November 13, 2002 letters to Speaker Hastert and Senator Byrd.

⁷ In the 2003 National Trade Estimates Report on Foreign Trade Barriers, USTR expresses concern over Australian policies in respect of parallel imports (affecting CDs, books, DVDs, software and electronic games), copyright piracy issues, a general low priority assigned to IPR enforcement, and the possibility that Australia may allow “springboarding” by generic pharmaceutical makers allowing immediate marketing approvals on expiration of patents held by others.

investment screening” and establish the goal of securing for U.S. investors in Australia “important rights that would be comparable to those that would be available under U.S. legal principles and practice.”⁸

The recent issuance of the annual USTR National Trade Estimates report on barriers to American exports reiterates concerns about aspects of the Pharmaceutical Benefits Scheme and elaborates on those areas where the US believes Australia is lax in fighting infringement of intellectual property rights.

The timing of the FTA negotiations is fortuitous for “fortune tellers” aiming to predict the eventual content of a bilateral agreement. Considerable additional guidance on the core negotiating objectives of both the United States and Australia can be drawn from the free trade agreement each has recently separately concluded with Singapore. In fact, it seems that much of the discussion in the March and May negotiating sessions was devoted to focusing the attention of the bilateral negotiating groups on aspects of the Singapore texts. Evidently, the negotiators have found this to be particularly valuable in the case of the investment and services chapters of the Singapore agreements’ texts. Of course the Singapore texts are not especially instructive in respect of agriculture, one area of the U.S.-Australian negotiation where objectives of the two sides seem certain to come into conflict (at least in the near term).

It could be that the recently concluded USA -Chile FTA provides insight into how Washington will handle the demands of another country with a strong interest in exporting farm products to the American market. A review of the Chilean agreement’s provisions for market

⁸ Idem.

access in agriculture seems to have both good news and bad news for Australia's aspirations in beef, dairy and even sugar. For beef, Chile will gain unlimited access to the U.S. market at in-quota tariff rates after just four years. In dairy (cheese, milk powder, condensed milk and "other" dairy products), Chile will see quantities available to its exporters increased by around seven percent every year until limitations are fully removed in year 12. In sugar, the year-on-year increase is only five percent, but restrictions on quantities are again totally removed in year 12⁹. So the good news is that these sensitive products were on the table and trade will be liberalized. The bad news is that it will take a few years to get there – at least in dairy and sugar. Australians might also object to the side letter on sugar trade that is evidently part of the Chilean deal and may worry over Chilean and American agreement that special "snap-back" safeguards are possible in these sectors.

Both the Americans and the Australians profess publicly that everything is on the table in the negotiation and that there are no *a priori* exceptions. Both say their objective is a comprehensive negotiation. "Comprehensive" in this context has to be interpreted to mean that no area is ruled out for negotiation and that requests for policy modifications and liberalisation will be entertained and acted on even if a final outcome does not produce immediate free trade across-the-board. Politics is sure to get in the way on both sides of the Pacific. For example, to be credible Washington will need to find ways to significantly liberalize existing barriers to beef and even dairy imports from Australia. Notwithstanding industry complaints, this can likely be done without genuinely serious consequences for these sectors in the USA.

⁹ United States Trade Representative (USTR), 2003 From Website <http://www.ustr.gov>. Text of USA -Chile FTA, General Notes, Tariff Schedules of the United States,

Consider the situation in the dairy sector. Following Australia's FTA with New Zealand, the Australian dairy industry successfully undertook a series of structural adjustments, the outcome of which has been the focusing of producers and processors on responding solely to market demands. In the global context, it is a "fair trader". In addition, the industry, while efficient, is small compared to other world producers and its likely focus in the U.S. market would be on shipping increased quantities of value added dairy products (mainly cheese) not the bulk dairy commodities (milk powder and butter) increased imports of which would burden the operation of the American support program for dairy. Seen in context, the ability of the United States to accommodate Australia in dairy seems clear: Australian dairy exports to the USA in 2001 amounted to just US\$ 84.3 million and a four-fold increase in that trade (an amount Australia might reasonably be expected to achieve over the medium-term if trade were liberalized) would put total imports from Australia at just 1.4 percent of the value of American farmgate milk production in 2001.¹⁰

Sugar is another matter. U.S. sugar policy has fostered price levels so high that other industries like corn sweeteners depend upon continued high sugar prices for their own continued profitability. Actually, it is not at all clear that Australian sugar producers would benefit from enhanced access to the American market – particularly if the United States also liberalizes trade in sugar in the FTAA or USA-Mercosur contexts. The Australian sugar industry is in a real mess according to a recent report by the CIE (CIE Sugar, 2003). While Queensland was once the competitive leader in world sugar markets, according to the CIE report, Brazil is now achieving cane growing costs 30 to 40 percent below Australia's. While Australian sugar exports could

¹⁰ \$24.7 billion in 2001, using the U.S. Department of Agriculture definition of "cash receipts from marketings of milk"

benefit from enlarged quotas at high USA prices in the short term (while quotas restricted competitors' access to the American market), the Australian sugar industry would probably not gain much from USA liberalization of the market over the long term) unless it takes drastic steps to enhance its productivity.

Australian access to the U.S. market for fast ferries is also problematic, both because of the general political difficulty in dealing with maritime questions and (significantly) because of the peculiar way in which the "Jones Act" restrictions are sheltered in the WTO.¹¹ That said, the Jones Act might not be as serious a barrier as one would think. Australian firms have reportedly negotiated special joint venture construction and leasing arrangements that get around the Jones Act to some extent. In addition, the Jones Act only applies to cabotage trade so Australian fast ferries can still be sold to Americans for use in transport between U.S. and non-American destinations.

In the same vein, Australia will certainly resist anticipated U.S. demands for radical changes in single desk export operations, restrictions in audiovisual services and the pharmaceutical benefits scheme. But as with the anticipated situation in U.S. agriculture, Canberra's resistance to radical change does not mean that it would nonetheless be possible to meaningfully address specific problem areas raised by the USA. Canberra might even want to use the FTA negotiation as an excuse to change in areas like single desk (which has been criticized inside Australia as anti-competitive and which was singled out as a problem for the sugar industry in the CIE report referred to above).

¹¹ See paragraph 3 of General Agreement on Tariffs and Trade 1994.

Notwithstanding the obviously warm bilateral relations of the post-Iraq war period, it seems clear that neither the United States nor Australia could be expected to be satisfied with a “trophy” agreement without a credible free trade outcome. This might not be an agreement to completely free trade overnight¹², but both governments share the core objective of making the coverage of this FTA as comprehensive as possible.

Potential Trade and Investment Effects of an FTA¹³

For the United States, an Australia – USA FTA clearly does not have an economic significance in the same league as (NAFTA) or the current FTAA exercise in the Western Hemisphere. The impact of an agreement will be proportionately much more important for Australia. Considerably less than two percent of total American exports are destined for Australia, compared to roughly 11 percent of total Australian exports destined for the United States. Still, the numbers are large enough to make the negotiation interesting for both sides. Two-way merchandise trade exceeded US\$ 20.8 billion in 2002 (Australia recorded a deficit in goods trade of US\$ 7 billion for the year).¹⁴ It is very hard to come by up-to-date data on services trade that has sufficient detail to be significant for this exercise. Against this background, in 1999/00, bilateral services trade reached nearly US\$ 6.6 billion, with annual growth in Australia’s services exports to America rising much faster than imports of services from the USA.¹⁵ Clearly, there is already a certain amount of economic integration of the two markets. Sales of services in Australia by majority U.S.-owned affiliates totalled US\$15.1

¹² In part due to their federal nature, neither the American nor the Australian internal markets could be said to be completely free of barriers to trade. Whether we are concerned with insurance regulation, product standards, labeling requirements or professional qualifications, substantial barriers prevail inside of both countries.

¹³ In this paper, certain statistics emanate from U.S. sources and others from Australian sources. For consistency, all values are shown in US\$. The exchange rate used is that for late April, 2003 reported as A\$ 1.66 = US \$ 1.00.

¹⁴ Australian Bureau of Statistics Report 5422 (December Quarter, 2002)

¹⁵ Department of Foreign Affairs and Trade (DFAT).

billion in 2000, while sales of services in the United States by majority Australian-owned firms totalled US\$8.7 billion. Total sales (goods, services and investment income) of U.S. affiliates in Australia amounted to US\$ 56.6 billion in 2000, with Australian affiliates in the U.S. recording total sales of US\$31.9 billion.¹⁶ The United States is the largest recipient of Australian investment at US\$ 70.4 billion and Australia's largest source of investment at US\$ 141.5 billion (DFAT 2003, 89)

Discussion in Australia of the possible economic effects of an FTA with the United States centres on three studies, two of which produced reports in mid-2001 and were undertaken at the request of DFAT¹⁷ and a third study that surfaced in February 2003 and which was prepared for the Australian Rural Industries Research and Development Corporation.¹⁸ For ease of discussion, I will refer to these reports as the CIE study/report, the Monash study/report and the ACIL study/report. In addition to the reports themselves, the CIE in March 2003 issued a reaction to the ACIL report.¹⁹

The original CIE study is the source for most of the positive economic claims made for an FTA by DFAT, AUSTA and other proponents of an agreement with the United States. In their modelling of possible outcomes, CIE researchers made use of both the APG-Cubed model and the GTAP model. The CIE explains that both models were used in order to exploit the advantages of each, with the APG-Cubed model providing greater information on financial

¹⁶ U.S. Department of Commerce, Survey of Current Business, December 2002.

¹⁷ "Economic Impacts of an Australia – United States Free Trade Area", Centre for International Economics, June 2001 and "An Australia – USA Free Trade Agreement: Issues and Implications", Australian APEC Study Centre, Monash University, August 2001.

¹⁸ "A Bridge too Far? An Australian Agricultural Perspective on the Australia/United States Free Trade Area Idea", ACIL Consulting, February 2003.

¹⁹ "Australia – United States Free Trade Agreement: Comments on the ACIL Report, Centre for International Economics, March 2003.

flows, the timing of effects and the macro economy and the GTAP model providing greater sector²⁰ and country detail. The CIE, in its study, assumed complete removal of all identified barriers to trade between the United States and Australia. Calculations were also done on the basis of a fifty percent removal of barriers and a 25 percent removal of barriers, with the models yielding roughly proportional results in economic benefit to the participants. In all of the scenarios studied by the CIE, both the United States and Australia gained through the negotiation and implementation of an FTA. The CIE also concluded that the FTA would create more trade than it would divert and that there would be a positive economic impact on third countries (particularly for New Zealand).

Some of the figures regularly quoted by the Commonwealth Government and attributed to the CIE study are:

- net economic welfare gains over 20 years of about US\$ 20.1 billion, shared evenly between the two countries;
- a 4 percent (about US\$ 2 billion) increase in Australian GDP by 2010, with a cumulative benefit over 20 years of about US\$ 15.5 billion;
- a 0.8 percent overall rise in Australian exports by 2006 (with a potential 350%+ increase in dairy exports)²¹; and,

²⁰ Appendix 2 provides partial summary tables drawn from the CIE GTAP modelling where Australian and American export sectors registered gains of more than 5 percent.

²¹ In its discussion of the sectoral changes found in the modelling, the CIE is careful to point out that certain very large percentage gains (for example, dairy and sugar for Australia) are off of very low bases.

- enhanced investment flows into key Australian economic sectors, such as mining and agriculture. (DFAT, 2003, 91)

Central to a large proportion of the economic gains found in the CIE report are researchers' assumptions with respect to the impact of services trade liberalisation. With such a large percentage of the two countries' economies now accounted for by services, it seems reasonable to assume that the removal of barriers to trade in services through the FTA would produce cost reductions contributing to economic welfare. In its study, the CIE notes the many difficulties associated with quantifying the impact of services liberalization. Research in the area to date is fairly slim and the CIE relied primarily on estimates of the costs of trade barriers produced by staff members in various studies done at the Australian Productivity Commission. For example, these studies estimated the cost (in terms of price impact) of barriers in the Australian banking sector at 9.3 percent, and at 0.57 percent in the Australian retailing and wholesale sector. Estimates of the price impact on professional engineering services in the USA were 3.6 percent and 2.26 percent for the American retail and wholesale sector. Overall, the CIE researchers appear to have applied a conservative approach, for example, by limiting Australia's impact on the U.S. services market to one-twentieth of what could be the potential effect of Australia's entry (because Australia's GDP is only about 1/20th of the US GDP). Globally, (for the FTA) CIE seems to have been conservative as well, estimating the cost reduction to the economy as a result of assumed full liberalization of services trade at only 0.35 percent (CIE, 2001, 58 -68)..

ACIL takes a different approach and ANU's Professor Garnaut argues that the "uplift" in services productivity (the 0.35%) found by the CIE should be discounted because it arises out of

an unrealistic assumption that all barriers to services trade would be removed by an FTA²². How services trade is treated is therefore very important, but nobody who has looked at the potential FTA so far seems to have a firm grip on what would realistically happen to trade patterns and efficiency gains in particular services sectors. This important gap in the research is a problem for the analysis of the Australia -USA FTA..

As noted earlier, the CIE modelling was done on the basis of the total removal of all identified trade barriers. Under these assumptions, it is not surprising that the sectors shown by CIE as deriving the greatest benefits from the FTA are dairy and sugar. Other sectors forecast as likely to benefit from reasonably large increases in exports to the United States include ferrous metal products and motor vehicles and parts. For the United States, CIE sees the biggest potential gains in exports of motor vehicles and parts and metal products, with smaller gains for beverages and wood and paper products (CIE, 2001, Tables 4.5 and 4.6)

The 2001 Monash study takes a far less quantitative approach to examining the possible benefits to Australia of an FTA and, in fact, cites liberally from the slightly earlier CIE study's findings on quantifiable economic benefits. The Monash study devotes most of its commentary to the anticipated qualitative benefits to the Australian economy over the longer term as a result of its integration with the much larger American economy. For example, the study expects that an FTA would foster greater competitiveness in the Australian economy through its influence on business adaptation to new information and communication technologies, business culture and encouragement of best practices in key aspects of economic activity.

²² Garnaut notes in his paper that, at the very least, it is hardly likely that Canberra would anytime soon remove ownership restrictions affecting Telstra and major Australian banks.

The Monash study also predicts important positive inward investment effects for Australia as a result of the FTA's contribution to improved conditions for investors and endorsement of Australia's long-term prospects as a place for American firms to do business. Among the important qualitative benefits to Australia identified by the Monash study are FTA-inspired institutional arrangements addressed to resolving problems relating to business visas, technical standards, recognition of professional qualifications and other regulatory issues (Monash, 2001, xii) Monash researchers are right, I think, when they say that such issues, while hardly "sexy" can often be serious impediments to the conduct of business across frontiers.

Coincidentally, the 2003 ACIL study began making the rounds just as those who criticize the FTA on its projected negative impact on Australia's regional and security intensified their public attacks. The ACIL report criticizes the "robustness" of the CIE study, finds a likely negative impact of an FTA on Australian farmers and even postulates that complete bilateral free trade by 2010 would be "slightly detrimental" to the Australian economy. The ACIL analysis completely discounts CIE's services sector benefits analysis and assumes that the conclusion of an FTA with the USA "could undermine Australia's participation in the WTO and its multilateral negotiations" and "have a deleterious effect on the prospects for advancing other forms of trade liberalisation" (ACIL, 2003, vi) ACIL states that its GTAP-type modelling was "arguably more standard" than that employed in 2001 by the CIE. (ACIL, 2003, 39)

The ACIL report and its criticism of the CIE's approach has drawn a rapid and strongly argued reaction from the CIE, which calls ACIL's analysis flawed and points out that ACIL's

conclusions contradict its own analysis. Apart from taking issue with ACIL's misrepresentations of the CIE's earlier work and discussing the errors in ACIL's treatment of trade diversion effects, the CIE criticizes ACIL for its use in the modelling of parameters for the elasticity of Australian export demand that are unresponsive to changes in sales. The CIE points out that the "Armington elasticities" (the degree of substitutability between locally sourced and imported products) used by ACIL in its modelling were too low and should have been doubled (as was the case for the CIE study and as is recommended by GTAP model developers). The CIE argues that if ACIL had "corrected" the elasticities used, its analysis of the FTA's economic impact would have approximated the findings of the CIE study. (CIE Comments, 2003, 5)

In the context of this FTA, I think ACIL might be faulted for its presumption that free trade with the United States would lead to no productivity increases in Australia's services sector (ACIL suggests such increases are a matter of opinion). ACIL also seems to start with a strong bias in its report. In a statement that seems to reveal much about ACIL's going-in mindset, the report categorically concludes that

"...bilateral free trade cannot on first principles be given a clean bill of health. The merits of a bilateral deal are difficult to estimate with confidence, but they will always hurt some trading partners and benefit others..." (ACIL, 2003, 48)

The ACIL study is likely to be relied upon by those who are naturally critical of the FTA for other reasons and who seek to bolster their claims with studies of economic effects that support their own position, however, it is unlikely to displace the CIE study as the more generally accepted basis on which to judge the probable economic effects of a bilateral FTA.

There is some argument with the going-in assumptions given to the CIE (in particular, whether these are realistic), but overall the CIE's study appears well-reasoned and documented and the CIE criticism of the ACIL methodology seems justifiable..

The first U.S.-based study of the potential trade and investment effects of a bilateral Australia-USA free trade agreement seems to be John Gilbert's CGE simulation of US Bilateral Free Trade Agreements prepared for this IIE conference²³. The United States International Trade Commission (USITC) also has a study underway of the potential impact of the FTA on United States interests, but the USITC report is due to be a confidential document available only to American negotiators.

Gilbert's study does not include an analysis of the impact of trade in services liberalisation and it is addressed only to liberalisation through removal of tariffs affecting trade in goods. Even on this basis, Gilbert finds small welfare gains for both the United States (0.01% of GDP) and Australia (0.02% of GDP) which he ascribes to an expected improvement in both countries' terms of trade vis non-Members.²⁴

Implications of an FTA for Trade (and Other) Relations with Third Countries

There are really three issues worth discussing in this section of the paper: (1) would the negotiation of an FTA undermine the prospects for a successful WTO "Doha Round"?; (2) should we expect the proposed FTA to produce important trade diversion effects?; and, (3) what

²³ CGE Simulation of US Bilateral Free Trade Agreements, John Gilbert, Department of Economics, Utah State University.

²⁴ Idem, page 9.

could be the impact of the FTA on Australian (and to a lesser extent USA) political, security and trade interests with East Asian countries?

Relations with Third Countries:

In Australia, by far the greatest heat has been generated by the debate on the third of the issues raised above. Early architects of Australian policy in respect of East Asia have argued that the negotiation of a FTA between Australia and the United States would be a disaster on a number of fronts. Probably the most vocal spokesman for this viewpoint is Professor Ross Garnaut, who has stated categorically that he is opposed to 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”.²⁵ Most recently, Garnaut’s criticism of the FTA has focused on what he believes will be the very damaging effects on trade of the American approach to rules of origin in preferential trading arrangements. As noted above, Professor Garnaut also doubts that there would be real benefit to Australia from an FTA not because he disagrees with the CIE’s economic analysis but because he challenges the DFAT assumptions on which the CIE was obliged to base its analysis.

Although he is critical of the FTA on a number of counts, Professor Garnaut’s main concern seems to stem from the belief that governments in Australia’s all-important East Asian markets will react to a bilateral agreement with the United States by reappraising their historic resistance to preferential trading arrangements. Having argued successfully in favour of

²⁵ “Australian Security and Free Trade with America”, paper presented by Professor Garnaut at the Australian Business Economists meeting on US and Australian Free Trade Agreement: National Interest or Vested Interest, Sydney, 27 February 2003.

multilateralism in trade relations and against regionalism, Australia has so far been able to avoid a situation where these East Asian markets see it as in their interest to create their own preferential arrangement that could exclude Australia. Professor Garnaut acknowledges that China and the ASEAN countries announced in 2002 that they would seek to enter a free trade agreement, but argues that negotiation of such an agreement

“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 increase the probability of it happening”.²⁶

Professor Garnaut believes the FTA would likely create significant trade diversion, that preference margins post-FTA would disadvantage East Asian exporters and that the global significance of the Australia-USA agreement would (probably) be enough to move East Asia to create its own regional framework at the expense of Australia..

In fairness, Professor Garnaut opposes the FTA on other counts as well, including on the theory that it would actually *worsen* relationships with the United States. First, as noted earlier, he takes issue with the assumptions underlying the economic analysis of the CIE and expresses doubt there would be real benefit to Australia from the deal. Second, he is among those who believe that the negotiation of an FTA will distract Canberra and Washington from the important WTO work in Geneva and decrease the prospects for a successful Doha Round. Third, he sees this as a dangerous time to risk souring the bilateral U.S.-Australia alliance by placing

²⁶ Garnaut “Australian Security and Free Trade with America”, page 16

contentious trade issues on the table. Professor Garnaut's views are echoed by other commentators at the ANU.

Not surprisingly, Garnaut is on a more or less permanent collision course with Alan Oxley, a principal author of the Monash Study, head of the AUSTA business group supporting an FTA, and Australia's former Ambassador to the GATT in Geneva. Oxley's Monash Study accepts and endorses the CIE findings in respect of trade diversion from an FTA²⁷ and stakes out a position (already in 2001) in opposition to Garnaut's view on the East Asian dynamic:

“If the suggestion is that Australia needs to consider any proposal for strengthening its relationship with the United States, such as negotiating an FTA, in the light of its possible impact on relations with countries in East Asia, that is an altogether different proposition. Other countries in the region do not feel so constrained (Singapore is negotiating an FTA with the United States and South Korea is studying the idea.) And given that the strengthening of the relationship with the US is important to Australia's economic and political interests, to suggest that actions to strengthen ties should not be pursued for their own merit must surely be to subsume Australia's national interest to that of another country's.” (Monash, 2001, 90)

In its recent submission to the Australian Senate, the AUSTA business group (headed by Alan Oxley) continues this line of reasoning. The group states that “there is no evidence China considers an Australian/US Free Trade Agreement will chill Australian-China economic

²⁷ The CIE found there would be some trade diversion but that it would be outweighed by global trade creation due to the FTA.

relations”²⁸. Not everyone gets the same impression, however. A March 26 article appearing in *The Australian* newspaper cited “apparent concerns in China that the free trade agreement being negotiated between Australia and the US is a signal that Canberra is placing less emphasis on its Asian trading partners” (*The Australian*, March 26, 2003, 12). These “apparent concerns” were reportedly recounted by Labour’s shadow minister for trade, Craig Emerson, after his return from a recent visit to China. Mr. Emerson and his staff declined to elaborate when I contacted his office for comment.

What about the impact of the Australia – USA FTA on APEC? It seems doubtful there would be much impact either positively or negatively as APEC seems to have lost Australian policy-makers attention as a forum for trade liberalization. Most APEC trade-related discussion these days seems related either to backstopping work in the WTO (i.e., APEC TEL workshops on WTO telecommunications services negotiations) or are focused on regional issues like how to deal with the need for enhanced security requirements for containers, etc.

Trade Diversion:

The CIE study found a number of cases where an FTA between the United States and Australia could be expected to produce trade diversion, but also concluded that trade creation for Australia, the United States and the world as a whole would outweigh the trade diversion. For example, CIE found increased American automotive exports to Australia displacing a considerable value of auto exports from Japan and Europe and increased Australian sugar and dairy exports to the USA displacing Latin American and European product. But the modelling also shows the FTA leading to considerable increases in the regions’ exports of other goods to

²⁸ AUSTA submission to the Australian Senate, March, 2003.

the United States. In terms of net trade creation, the CIE estimated an increase in net imports to Australia of US\$675 million and an increase in net USA imports of US\$ 1.1 billion. (CIE, 2001, 42-44)

It should be pointed out that Professor Garnaut does not accept the CIE conclusions in respect of trade creation and trade diversion. He argues that “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”.²⁹

In marked contrast to the CIE Study, the ACIL study asserts that one reason the proposed FTA would negatively impact on Australia is “the predominance of trade diversion, especially from Asia, that such an agreement would create”(ACIL, 2003, 37) As the CIE points out in its reaction to the ACIL report, no economic modelling results are offered by ACIL to explain this statement. In fact, the only basis for ACIL to hold such a position seems to be its acceptance of the likelihood of trade diversion as articulated separately by Professor Garnaut.(ACIL, 2003, 35) The CIE reaction to ACIL’s position on trade diversion makes for good reading in a step-by-step tutorial on why ACIL’s focus on potential effects in Australian export markets is misplaced.(CIE Comments, 2003, 10-11)

In general, I have found little reason to criticize the CIE study, however, the modelling results in respect of trade diversion produce some results that seem either counter-intuitive or at odds with other CIE studies. For example, Australia is forecast to greatly expand sugar exports to the USA largely at the expense of Latin American sugar exporters, yet in its own separate

²⁹ Garnaut “Australian Security and Free Trade with America”, page 9.

study of the sugar sector in Australia, the CIE notes the huge cost advantage now enjoyed by Brazil (also negotiating with the USA on an FTA). Similarly, it is hard to believe that USA exports to Australia of automotive vehicles and parts would actually rise by over US\$ 500 million at the expense of Japanese and European manufacturers.

WTO Negotiations and Impact on the Doha Round:

Free Trade Agreements are not popular among certain “multilateralists” in the trade community. The Director-General of the WTO, Supachai Panitchpakdi and many academics have pointed out that the worrying tendency to negotiate FTAs has accelerated importantly in recent years and Dr. Supachai has been critical of FTAs as undercutting the Doha Round in public remarks he has made since taking office. A frequently-voiced criticism is that FTA negotiations distract trade officials from the more important job at hand – the negotiation of multilateral trade liberalisation. This view enjoys considerable support in some Australian circles.

ACIL’s report strongly supports the multilateral negotiations underway in Geneva in the context of the WTO Doha Round. (Who in this debate does not?) ACIL’s modelling, not surprisingly, finds full multilateral trade liberalization creating significantly greater economic benefits for Australia than a bilateral FTA or unilateral Australian liberalization. ACIL goes on from here to strongly criticize the planned FTA on grounds that it would be a distraction of officials’ time and government interest. Worse still (and this is really curious), ACIL suggests that “The US, for example, might feel it had done enough if it had moved somewhat to meet Australia’s demands in the FTA context and might be less interested in meeting those demands

in the WTO context.”(ACIL, 2003, vii) ACIL also sees the FTA as potentially undermining the credibility of Australia’s position on agriculture in the WTO if it agreed to pursue an FT A with the United States that excluded agriculture.

These are not credible concerns in my opinion and in fact, fly in the face of recent Australian Government policy statements. DFAT’s recent White Paper makes explicit that agriculture has to be dealt with in the FT A with the USA. That same document makes clear that the Commonwealth sees the WTO Round as its best hope for major trade gains and that liberalization of agricultural markets is a priority for the country in the multilateral negotiation. (DFAT, 2003,53)

In everything they have said publicly on the subject, the Government of Australia, like the United States Government, clearly sees the negotiation of an FTA as a complement to the multilateral negotiations of the WTO. Both Washington and Canberra have used the term “competitive liberalisation” to explain how the demonstration effect of an FTA could help achieve objectives in the WTO. On this point, I cannot help but note that one of the largest FTAs, NAFTA, was concluded at a critical stage of the Uruguay Round negotiations and many commentators have credited the NAFTA negotiation with helping to push the Uruguay Round toward a successful conclusion.

Conclusions

This negotiation has only just started. It’s going to be an interesting exercise, particularly in the light of the political -level decision to accelerate the timetable for conclusion of the talks.

Chief negotiators Ralph Ives and Stephen Deady and their teams have their work cut out for them. Notwithstanding the extremely friendly atmosphere that characterized the start of negotiations in Canberra in March, there are certain to be more difficult negotiations in the months to come.

Costs to Australia's Regional Relationships :

\ Is Australia likely to do irreparable harm to its important political and economic relations with East Asia if it concludes an FTA with the United States? That seems very doubtful. For starters, there are probably only a very limited number of goods and services where U.S. and East Asian exporters are likely to be competing head-to-head in the Australian market, so the introduction by Australia of preferences favouring U.S. suppliers is unlikely to divert importers away from Asian and toward American suppliers. The CIE study identified autos as an area where Japan could lose out to the Americans in a post-FTA world, but my observation is that there are many incentives for Japanese firms to both produce in, and export to, the Australian market. At the same time, the incentive to Ford, and GM to ship large numbers of U.S.-produced right hand drive vehicles to Australia is not that clear, given their important existing investments in Australian manufacturing operations which have now been integrated into their global production plans. The new Pontiac GTO is a re-branded Holden Monaro, produced in Australia for world-wide markets.

Another reason to doubt the potential East Asian backlash predicted by some is the East Asian history of choosing deals with clear economic benefits when faced with a choice of concluding either a politically or economically-motivated trade deal. China recently faced such a

choice in concluding a long-term gas supply contract. A political choice favouring regionalism would have given the prize to Indonesia, but China chose Australia as its partner because the economics outweighed the politics.

Finally, the negotiation of an FTA with the United States is no more a sign of Australia disengaging from East Asia than it is of Australia abandoning multilateralism for bilateralism. Australia has negotiated an FTA with Singapore and is in the process of cutting a deal with Thailand. A bilateral dialogue with Japan on closer economic relations has been underway for some time and Canberra and Beijing are in the early stages of a similar discussion.

I just don't see the big risk.

Costs to the Multilateral Trade Negotiations:

What about the impact of the FTA negotiations on the WTO process? Well, where are the Doha Round negotiations at this point in time? Anyone reasonably familiar with the Geneva negotiations and their prospects and would say that there is currently no risk that the FTA negotiations are going to get in the way of progress in Geneva. The Geneva negotiations have slowed on their own merits. Quite predictably, the talks are stalled, awaiting one of those periodic political crises in the GATT/WTO that inspire everyone with the need to compromise and move on. Through periodic surveys of experts, the Institute for International Business, Economics and Law has been collecting some fairly reliable information on attitudes to the WTO talks in Geneva and in key capitals. What the polls have shown is that (a) everyone continues to

support the WTO talks as the biggest game in town, (b) almost nobody thinks the Doha Round will finish on schedule and (c) most trained observers of the WTO are relaxed by this scenario because it is “normal” for a multilateral trade negotiation. In the words of a good friend, “we’ve all seen this movie before”. The professionals understand that, like the war in Iraq, the Doha Round will take as long as it takes.

The Round will finish eventually and it will finish successfully because finishing successfully is important to all of the WTO’s Members. There is no substitute for the global system and it will take a long time before the trend toward regional trade agreements takes (most of) us away from the belief in the primacy of the multilateral system. If for no other reason, only the WTO talks can credibly address the need to reform global trade in agriculture. This is important for the USA, Australia and the Cairns Group. It is also, and perhaps more significantly, an objective that represents the only hope for many Least Developed Countries to trade their way out of poverty.

WTO Director-General Supachai Panitchpakdi and his Deputies will make speeches about the threat to the WTO posed by regionalism while USTR Zoellick and Trade Minister Vaile speak of their “competitive liberalisation” efforts in the FTAs they are negotiating. Conventional wisdom in Geneva ties progress in the GATT/WTO multilateral sphere to successive EC enlargements. It seems to me that it’s just as easy to accept that the “competitive liberalization” of non-EC preferential agreements could also contribute positively to the multilateral negotiating dynamic.

Economic Benefits of a Free Trade Agreement :

This paper has looked briefly at the studies done in Australia concerned with potential economic benefits of an FTA and I think there are clearly more reasons to side with the CIE analysis than the ACIL report. DFAT might have given the CIE some unrealistic assumptions to work from but those assumptions are not impossible. For its part, ACIL clearly started with a big chip on the shoulder against any FTA and that probably poisoned the outcome. Gilbert's study might not see big gains for either side (although he does not treat services which figured so importantly in the CIE study) but it also does not find the FTA impacting negatively on either country.

Leaving aside the studies, it is clear that the majority of the business community in both countries is strongly supportive of an FTA. Companies know there are gains to be made in enhanced movement of personnel, elimination of duplicate product testing, labelling and a more secure environment for investment and movement of capital. Also FTAs are valuable for their implementation through ongoing institutional mechanisms that can be important tools for resolution of business problems or discussion of additional trade liberalisation. There is also a good chance that difficult problems and barriers will be significantly modified if not eliminated. On the economic side, there really do not appear to be any important down-sides to this agreement, given that the two countries are already relatively open to each other in most key sectors.

Australia asked for this negotiation. In fact, Australia started asking for this negotiation quite some time back. Ambassador Zoellick has long believed that it is in the interests of both

countries to conclude an FTA. The recent war in Iraq complicated public debate on the issue, at least in Australia. Some commentators openly expressed the view that Australia would be given economic benefits through the FTA as a dividend of the country's participation in the coalition. I have sought to dissuade people from perpetuating this point of view. I have made the point that even if the Administration wanted to reward Australia in this way, that won't carry much water with those facing a loss of protection in their market and a consequent reduction in profitability. Sensitive political issues will come up on Capitol Hill and Members of Congress are only going to support an FTA if they believe it's a good deal for the United States. Of course, Canberra is also committed to the negotiation of a good deal.

There are plenty of indications that the Australian – USA FTA can be a successfully-negotiated, economically meaningful agreement of benefit to both countries. The two governments are committed to pursuing a “large” agreement in a relatively short time frame. Reliable economic studies support the prospect of mutual gains. And in both countries, the mainstream business community appears strongly supportive of the FTA and eager to get on with an integration process. In Australia, early scepticism over the benefits of a FTA seems to be changing in favour of broader support. Reportedly, fifty-six percent of respondents to a recent poll now say they would support an FTA, against only 22 percent opposed to a deal.³⁰

Of course, that's not all there is to the story. In this case, there will be considerable opposition to a “full-scope” FTA from vested interests in both countries and some will continue to argue against an FTA on more political grounds. All of this will keep it interesting for the

³⁰ UMR Research poll carried out (March 28 -30, 2003) for political lobbyists Hawker Britton and reported in the Australian Financial Review on 8 April 2003b”Vaile wants food aid in FTA terms”.

negotiators and the newspapers. As of the date of this paper's drafting, the question is not whether a good deal can be done, but rather whether it can be done by the end of 2003.

APPENDIX 1

Australia – New Zealand Closer Economic Relations (CER) ³¹ And Issues Relative to New Zealand in an FTA with the USA

At the outset of this paper, I noted that I believed the chances for a New Zealand – USA FTA were relatively remote and therefore planned to concentrate on a strictly bilateral Australia-USA FTA (which was in any event the topic assigned for this IIE conference). That said, there are some issues worth reviewing, if only briefly.

CER entered into force in 1983 and has been hugely successful in integrating the economies of Australia and New Zealand. Through three general reviews of CER's operation, it was progressively widened and deepened. Apart from the elimination of tariffs and quantitative restrictions on trade in goods and extensive liberalisation of trade in services, CER replaced the use of antidumping action with competition policy instruments and has moved far into "domestic" policy measures in other areas as well. CER embodies agreements on industry assistance, technical barriers to trade and harmonisation of regulatory barriers to trade, such as the setting of food safety standards. CER has by all accounts been a huge success that has linked the two partners so closely that it is not unusual in 2003 to read serious talk of monetary union.

The extent to which New Zealand exporters might benefit directly (through CER) from an Australian – USA Free Trade Area is hard to assess in the absence of knowing what rules of

³¹ Background information on the CER is summarized from *Closer Economic Relations: Background Guide to the Australia-New Zealand Economic Relationship*, Australian Department of Foreign Affairs and Trade, February 1997.

origin would apply in the new FTA. CER origin rules specify that in order for merchandise trade to qualify for free movement, the last process of manufacturing and at least fifty percent of the value of the product should be in expenditure associated with materials, labour and factory overheads or inner containers originating in the area. In the case of the USA FTA with Singapore, origin rules go on for pages and appear complex. However, the United States seems to have settled basically on an approach which requires either that the good be “wholly obtained or produced entirely in the territory” of Singapore or undergoes such additional processing in Singapore as to bring about a “change in tariff classification” of the product in question.³² On the face of it, the application by the USA to Australia of Singapore FTA origin rules could complicate the operation of CER given the integration of the Trans-Tasman economies. It would seem that about the only New Zealand origin goods that would make it to the USA under the FTA would be those further processed enough in Australia to undergo a change in tariff classification. Many products would likely fail the 90 percent plus content test of the Singapore-USA deal. Whether Australian industries and the negotiators in Canberra would be happy with such a scenario is not known, but it is likely to be an interesting and complicated aspect of the negotiations, given the CER context.

In the main paper preceding this Appendix, it was briefly noted that the CIE study had found indirect benefits to New Zealand of an FTA between Australia and the United States. This is partly because as the Australian economy expands as a result of the positive impact of the FTA, New Zealand benefits from increased demand in the Australian market. To the extent that the Australia-USA FTA liberalised dairy trade, New Zealand would gain there as well, mainly

³² United States Trade Representative (USTR) From Website <http://www.ustr.gov>. Draft U.S.-Singapore Free Trade Agreement Text, Chapter 3. To be considered wholly obtained or produced entirely in Singapore, less than ten percent of the adjusted value of the good must be from non-Singapore sources.

because it would pick up dairy sales in Japan and elsewhere as Australian dairy exporters diverted some portion of exports to a more profitable American market (CIE, 2001, 26).. It should be noted that John Gilbert's study finds a welfare loss for New Zealand in the case of a USA-Australia FTA due to a deterioration in New Zealand's terms of trade.³³

Notwithstanding the letter from Senator Grassley and his colleagues, it is unlikely that the United States will soon enter into free trade agreement negotiations with New Zealand or that Washington would negotiate a CER-wide FTA with both Canberra and Wellington simultaneously. I am assuming that New Zealand's continued policy with respect to nuclear ship visits and the Clark government's statements made during the war in Iraq will stand in the way of the American Administration's willingness to put trade relations with New Zealand on the same footing as those with Australia. This may be good news for Australia, not only because its exporters will not have to compete directly in the U.S. market with New Zealanders, but also because it could be more difficult for the United States to liberalize certain agricultural restrictions if it had to contend with imports from both countries as well. New Zealand is not an issue for sugar but New Zealand is an important exporter of both beef and dairy products. Over the longer term, an inevitably sequenced approach might actually work to New Zealand's benefit if, through a good experience with increased imports from Australia, American agriculture comes to believe it could also live with more beef and cheese from New Zealand.

³³ CGE Simulation of US Bilateral Free Trade Agreements, John Gilbert for IIE Conference.

APPENDIX 2

Partial Summary of Australian and United States Sectoral Changes³⁴ (Export Gains of More than 5 Percent)

AUSTRALIAN SECTORAL CHANGES

Sector	Price of Aus Exports to USA Percent	Aus Exports To USA Percent	Total Export Volume Percent
Other Crops	-0.65	5.36	-0.26
Meat Products	-1.95	7.77	1.69
Other Food Products	-1.50	6.60	0.60
Dairy	-18.53	354.30	6.21
Sugar	-38.11	2550.81	14.84
Beverages and Tobacco	-1.47	9.24	1.94
Textiles, Clothing & Footwear	-7.92	75.48	10.40
Chemicals, Rubber and Plastics	-2.13	8.26	2.55
Other mineral and metal products	-1.83	10.52	1.04
Ferrous metal products	-2.60	15.41	1.96
Motor vehicles and parts	-1.92	10.33	3.77
Other transport equipment	-1.10	5.69	1.90
Electronic equipment	-1.21	6.75	1.15
Other manufacturing	-1.16	6.48	1.98

UNITED STATES SECTORAL CHANGES

Sector	Price of US Exports to Aus Percent	US Exports To Aus Percent	Total Export Volume Percent
Other food products	-2.21	9.21	0.11
Dairy	-3.26	38.13	1.94
Sugar	-0.87	72.07	16.91
Beverages and Tobacco	-4.60	28.42	0.06
Textiles, Clothing and Footwear	-10.48	104.50	0.83
Wood and paper products, publishing	-4.65	19.48	0.21
Chemicals, rubber and plastics	-2.65	8.62	0.08
Other mineral and metal products	-4.31	25.14	0.08
Ferrous metal products	-4.24	25.24	0.05
Motor vehicles and parts	-8.53	46.60	0.78
Other manufacturing	-2.93	13.30	0.07

³⁴ From CIE Study, Tables 4.5 and 4.6. Reproduced with the permission of the Centre for International Economic

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