

Economic Impact of the AUSFTA

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Introduction

[SLIDE 01]

Thank you very much for inviting me to speak at this symposium. This particular trade agreement has been a sort of hobby of mine for a number of years and I am happy to have this opportunity to comment on its economic impact.

In May of 2003, in the very early stages of this trade agreement's negotiation, I was invited by the Peterson Institute for International Economics to speak at a conference in Washington on the benefits and costs of a bilateral free trade agreement between Australia and the United States. I said then that far too many of the "WTO-Plus" features of the likely agreement were un-quantifiable by the economists and that, as a result, modelling studies were unreliable. A much better approach, I argued, would be to wait until we had a few years experience with the FTA's implementation and then try to assess its economic impact on the basis of factual evidence.

Early Forecasts, Aspirations& Criticism

Discussion in Australia of the possible economic effects of an FTA with the United States centred in 2003 on three studies, two of which produced reports in mid-2001 and were undertaken at the request of DFAT¹ and a third study that surfaced in February 2003 and which was prepared for the Australian Rural Industries Research and Development Corporation.² For ease of discussion, I will refer to these reports as the CIE study, the Monash study and the ACIL study.

The CIE study was the source for most of the positive economic claims made for an FTA by DFAT, a bilateral business lobbying group known as "AUSTA" and other proponents of an agreement with the United States. In all of the scenarios modelled by the CIE, both the

¹ "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.

² "A Bridge too Far? An Australian Agricultural Perspective on the Australia/United States Free Trade Area Idea", ACIL Consulting, February 2003.

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).

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

- 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)³; and,
- enhanced investment flows into key Australian economic sectors, such as mining and agriculture.

The Monash study predicted 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 were FTA-inspired institutional arrangements addressed to resolving problems relating to business visas, technical standards, recognition of professional qualifications and other regulatory issues.⁴

Monash researchers were right, I think, when they said that such issues, while hardly "sexy" can often be serious impediments to the conduct of business across frontiers.

The 2003 ACIL study began making the rounds just as those who criticized the FTA on its projected negative impact on Australia's regional and security interests intensified their public attacks. The ACIL study found a likely negative impact of an FTA on Australian farmers and even postulated that complete bilateral free trade by 2010 would be "slightly detrimental" to the Australian economy.

The first U.S.-based study of the potential trade and investment effects of a bilateral Australia-USA free trade agreement was John Gilbert's CGE simulation which found small welfare gains for both the United States (0.01% of GDP) and Australia (0.02% of GDP) which he ascribed to an expected improvement in both countries' terms of trade vis non-Members.⁴

Although he was critical of the FTA on a number of counts, a well-known Australian academic economist who now specializes in climate change issues made clear at the time that his main concern stemmed from his belief that governments in Australia's all-important East Asian markets would react to a bilateral agreement with the United States by reappraising their historic resistance to preferential trading arrangements. He argued that the FTA would likely

³ 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.

⁴ *Idem*, page 9.

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.

The ACIL study asserted that one reason the proposed FTA would negatively impact on Australia was “the predominance of trade diversion, especially from Asia, that such an agreement would create”. No economic modelling results were offered by ACIL to explain this statement.

Another thing that is interesting to do now is to look at what proponents of the FTA said they wanted from the agreement while it was under negotiation. In a speech delivered in late October, 2002⁵, Australia’s then 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,
- 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.

The FTA negotiation with the United States also enjoyed the strong support of the Business Council of Australia⁶, which saw 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 said it wanted 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.⁷

⁵ “Australia and the United States: Opening Markets”, Speech by Trade Minister Vaile to the launch of American Australian Business 2003.

⁶ “BCA backs free trade talks” Letter to the editor from BCA CEO Katie Lahey, the Australian Financial Review, March 24, 2003.

⁷ AUSTA Submission to the Department of Foreign Affairs and Trade, January 2003 (International Trade Strategies)

The Bilateral Economic Relationship Then and Today

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In 2004, bilateral trade in goods and services totalled A\$ 40.7 billion, of which A\$ 29.4 was trade in goods and A\$ 11.3 was trade in services. Australian merchandise exports to the USA were A\$ 9.5 billion and top export items included beef, alcoholic beverages, meat other than beef, aircraft and parts and medical instruments. Australian services exports to the USA totalled A\$ 4.8 billion in the last year before the agreement entered into force.

By 2008, with four full years of the FTA in operation, total bilateral trade had grown to A\$ 49.7 billion – or an increase of 22 percent over four years. Bilateral goods trade increased by 19 percent and bilateral services trade increased by 31 percent. Australia's overall merchandise exports to the USA grew by 12 percent to A\$ 10.6 billion and services exports to America were 22 percent greater at A\$ 5.9 billion. While you might not be too impressed by these numbers, it is important to know that for the four year period immediately preceding AUSFTA (2000 to 2004), Australia's merchandise exports to the USA actually fell in value by 1.2 percent and overall exports of goods and services to the USA in the period fell by seven tenths of one percent.

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How much of the turnaround can be ascribed to the AUSFTA is probably impossible for anyone to tell; however, the increase in bilateral trade and the increase in Australian exports of both goods and services to the U.S. market took place against a situation in which the change in the exchange rate whacked Australian exporters with a 27 percent deterioration in their price competitiveness between 2004 and 2008 – and a 55 percent deterioration when the 2008 exchange rate average is matched against the situation in 2003!

In fact, given the exchange rate situation, it is surprising that a number of key Australian exports to the U.S. market showed important sectoral gains in the 2004 to 2008 period: Exports of medical instruments, for example, grew by 131 percent, aircraft and parts exports grew by 17 percent and exports of meat, other than beef, grew by 3.4 percent.

Notwithstanding continuing restrictions in the sector, the value of Australia dairy exports to the US market rose from A\$ 75.4 million in 2004 to A\$ 112.2 million in 2006 before falling back to A\$ 91 million in 2007. The value of alcoholic beverage exports to America fell by nearly 16 percent since AUSFTA entered into force, but again, we need to take into account the 27 percent deterioration in the exchange rate between 2004 and 2008 in what is obviously a highly price-competitive segment of the market.

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Those who are familiar with international trade in beef, will know that in 2005, the first full year of the FTA, Australian beef exports to the USA were up by A\$ 116 million – almost 9 percent – over the previous year. Beef exports to the USA dropped to considerably lower levels in 2006 and 2007. This important fall off in beef exports to the USA is mainly accounted for by the rise in Australian beef exports to Korea over the period. Following a BSE outbreak in the USA, Korea banned imports of American beef and Australian suppliers diverted their exports away from the American toward the Korean market to take advantage of the opportunity to sell their product in a higher-priced market. Between 2005 and 2006, Australian beef shipments to the

USA fell in value by A\$ 288 million, while the value of shipments to Korea grew by A\$ 212 million.

If Australian exports to the USA were able to increase since the introduction of the FTA notwithstanding the exchange rate situation, American exports to Australia show a growth in value (26 percent) that can be almost entirely explained by the 27 percent change in the exchange rate. In addition, the fact that Australian imports of American goods and services grew at a much greater rate than did Australian exports can be explained in part by the very important fact that the Australian economy was growing at a greater rate than the American economy in 2005, 2006, 2007 and 2008. In fact, in 2007, real GDP growth in Australia was more than double that of the American economy (4.4 percent v. 2.0 percent).

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Last year, I served on Minister Crean's FTA Expert Group which worked with David Mortimer on his Review of Export Policies and Programs. In one small aspect of our work on FTAs, we looked at changes in trade intensity in the pre- and post-implementation periods for Australian FTAs with Singapore, Thailand and the United States. In the case of Australia's trade with the United States, there has been no meaningful change in the intensity of the bilateral trading relationship since the entry into force of the FTA⁸. This is probably because we have not seen the kind of trade diversion predicted in 2003 – but I will come back to the question of trade diversion in a couple of minutes.

Although they again cannot be readily ascribed to the existence of the AUSFTA, there are other measures we can look at to see how well Australia is doing in the post- as opposed to pre-AUSFTA period. The country's share of trade in GDP averaged 19.7 percent in 2002-2004 and rose to an average of 21 percent in 2005-2007. Annual growth in productivity, measured by the OECD as GDP per hours worked, was 0.9 in 2004 and 1.6 in 2007. For the years 2001 to 2004, average unemployment in Australia was 6.3 percent; in the 2005 to 2008 period, the unemployment rate averaged 4.7 percent.

Trade Diversion and the AUSFTA

Recall that in 2003, ACIL asserted that the AUSFTA would negatively impact on Australia due to the predominance of trade diversion, especially from Asia, and at least one prominent academic economist argued that the AUSFTA would disadvantage Asian exporters and would probably be enough to move East Asia to create its own regional preferential network at the expense of Australia – which he thought might be excluded from this network.

Before we look at trade patterns and whether there might appear to be any significant post-AUSFTA trade diversion, let's consider what's happened with regional preferential agreements since 2003 and where Australia stands in the region's architecture. ASEAN has now more or less completed its network or so-called "ASEAN Plus One" agreements with all of its significant partners in the Asia-Pacific region, including Australia which – with New Zealand – is a party to the relatively recent AANZFTA. In this region, Australia also has bilateral FTAs in place with New Zealand, Singapore, and Thailand, and is actively negotiating FTAs with China, Japan and Korea, as well as studying the potential for liberalization agreements with Indonesia and India.

⁸ "Winning in World Markets: Meeting the competitive challenge of the new global economy", Department of Foreign Affairs and Trade, Canberra, 2008, pp. 96-97.

Through its participation in the East Asian Summit, Australia is also involved in projects like the mooted Comprehensive Economic Partnership for East Asia (or CEPEA) that would regionally link ASEAN with China, Korea, Japan, Australia, New Zealand and India. It does not appear to me that East Asia has decided due to the AUSFTA to leave Australia out in the cold when it develops its regional trade architecture.

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What about trade diversion and Australia's trade with key East Asian partners? Since the entry into force of the AUSFTA, Australia's trade in goods and services with ASEAN, Korea, Japan and China has exploded and has grown much faster than trade with the United States. And this explosion in trade has almost nothing to do with the existence of preferential trade agreements that would mitigate the preference margins resulting from the AUSFTA. Between 2004 and 2008, total bilateral trade in goods and services is up by 125 percent (to A\$64 billion) in the case of China; by 84 percent (to A\$81 billion) in the case of ASEAN; by 53 percent (to A\$ 22.8 billion) in the case of Korea; and, by 45 percent (to A\$ 59.6 billion) in the case of Japan.

These increases compare to an increase of just 22 percent over the same period in bilateral trade with the United States – and there are no preferential agreements in place between Australia and any of these East Asian partners, with the exceptions of Singapore and Thailand.

The statistics do not give much credence to the validity of the trade diversion argument – at least in the case of the AUSFTA and East Asia. Of course, once again there are a number of factors at work here and the real world of global commerce is far more complicated than that of the economist's textbook. For starters, there seem to be greater complementarities between the economies of Australia and its East Asian trading partners than there is with the United States.

But even if this were not the case, I have always maintained that the potential of AUSFTA to create trade diversion was far smaller than the academic economists would have you believe. Why?

Because AUSFTA was never very much about tariffs. In 2004, in the United States, the average MFN tariff stood at just 5.4 percent and more than 30 percent of MFN tariff rates were duty-free. The situation in Australia was not much different: prior to the AUSFTA, the average Australian applied MFN tariff was 4.3 percent and almost half of all tariff lines (48.2 percent) were duty-free for MFN trade. Only about 15 percent of all Australian tariffs qualified for the designation "tariff peaks".

From the start, the large number of tariff lines allowing for duty-free trade between Australia and the United States (and into the two countries from third countries) reduced the significance of potential problems relating to complexities in rules of origin and the generally low levels of tariff protection significantly reduced the incentive for welfare-diminishing trade diversion.

Investment Impact of the AUSFTA

As I indicated earlier, both Americans and Australians said that they hoped that the AUSFTA would lead to an increase in flows of foreign direct investment. Although Australia retained the ability to screen American investment proposals in areas like urban land, telecommunications

and defence-related businesses at existing thresholds, the threshold for screening all other American investment proposals in non-sensitive sectors was increased to A\$ 800 million. This threshold is indexed and currently stands at around A\$ 1 billion. Has the AUSFTA lived up to its potential in terms of impacting investment flows?

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According to Australian statistics, in 2004, before the agreement entered into force, the level of American foreign direct investment in Australia was A\$ 145.2 billion and Australian investment in the United States stood at A\$ 129.8 billion. In 2005, there was a dramatic fall in the level of American FDI in Australia, which dropped by 48 percent to A\$ 75.6 billion. Australian levels of FDI in the USA also dropped that year, declining by 12 percent to A\$ 114.8 billion.

In the period since 2005, businesses in both countries have increased their levels of foreign direct investment in the other market, although total levels of FDI remain lower than they were in 2004. Curiously, at A\$ 121 billion, Australians now have a higher level of FDI in the USA than Americans have in Australia (A\$ 95.4 billion).

Qualitative Economic Impact of the AUSFTA

I want to switch gears now and take up what I call the “qualitative economic impact of the AUSFTA”. This agreement affects far more than tariffs and other border measures and is changing many important behind the border measures that affect the bilateral business environment. The agreement is having a progressive positive economic impact in many areas that cannot be quantifiably measured – but this does not mean they are not important.

A very significant “living agreement” aspect of the AUSFTA is its Working Group on Professional Services that was established to facilitate profession-led initiatives aimed at developing mutually acceptable standards and criteria for the licensing and certification of professional services suppliers. Since the entry into force of the AUSFTA, the Working Group has focussed on initiatives affecting accounting, engineering and law – with good results in each of the professions.

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In the accounting sector, mutual recognition agreements (MRAs) have been negotiated between Australian and American professional associations that recognize Australian CPAs and chartered accountants as eligible to sit for the international version of the U.S. national CPA exam.

In the engineering profession, an MRA between Engineers Australia and the Texas Board of Professional Engineers will provide Australian engineers with a three-year renewable license to practice in Texas and the recognition of Texas-licensed engineers for registration and Chartered Professional Engineer status in Australia. Similar arrangements are under consideration in other American states.

Under the Australia-United States Legal Services Initiative, created under the FTA Working Group, important progress has been made in increasing market access for Australian legal practitioners in the United States. The state of Delaware introduced a new Foreign Legal Consultant (FLC) rule in late 2007 that allows Australian lawyers to practice Australian and foreign law in its jurisdiction. Given that nearly all large American corporations are registered in

Delaware, this is an important new opportunity directly attributable to the AUSFTA. The states of Georgia and California are actively considering changing their FLC rules to ease market access for Australian lawyers. At the national level, the American Conference of Chief Justices has passed resolutions urging U.S. states and territories to consider recognizing Australian law degrees for the purpose of being admitted to practice in the United States.

These professional services initiatives are significant – especially when seen as a complement to the Australia-specific E-3 visa arrangements which were enacted by the U.S. Congress following the negotiation of the AUSFTA.

As a former trade negotiator, I know how important it is to work with business to ensure that they benefit from the opportunities opened up by a trade agreement. Austrade has worked hard with Australian companies to help them to benefit from the AUSFTA and has collected a series of success stories. Many of these success stories concern Australian firms' newly created access to the huge American government procurement market.

Some Tentative Conclusions

Probably the slightly more than four years' experience we have had so far with the AUSFTA is not enough time to allow us to reach any definitive conclusions about the Agreement's economic impact.

This is particularly the case because a number of extraneous factors have impacted the bilateral economic relationship in this period – in particular the exchange rate and more recently the global economic crisis. The first really serious evaluation of the economic impact of the North American Free Trade Agreement, NAFTA, was only conducted after a full ten years of implementation. Still, some tentative conclusions are possible.

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- Since the entry into force of the AUSFTA, Australian exports to the United States grew by twelve percent notwithstanding a very large deterioration in the price competitiveness of Australian goods due to exchange rate movements. In the four years before AUSFTA, Australian exports to the United States actually fell in value.
- Australian imports from the United States grew by more than Australian exports, but this is hardly surprising given higher economic growth in Australia and the exchange rate impact.
- Overall bilateral trade has grown by 22 percent in four years, but there has been no real change in the trade intensity of the relationship.
- The growth in bilateral trade certainly did not come at the expense of Australia's trading relationships with its main Asian partners where trade volumes have exploded in recent years. It is certainly not apparent to me that AUSFTA has led to trade diversion in the Asia-Pacific.
- Two-way foreign direct investment has grown since experiencing a big fall-off in 2005 and, curiously, Australian investment in the USA now exceeds the value of American investment here.
- Important progress is being made toward greater economic integration through the Working Group on Professional Services and there are a number of success stories where Australian exporters have directly benefited from the AUSFTA.

Is the overall economic impact of the AUSFTA positive? I don't think we can say for sure, but I certainly don't see any evidence of the AUSFTA negatively impacting Australia.

Thank you very much for your attention.