Australia's Strategies for Trade Reform

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Interest is growing in Australia in 'strategic trade policy' and in bilateral trade arrangements involving a regional free-trade area. ***Neil Vousden****, Reader in Economics at the Australian National University, assesses these proposals and concludes that the clearest gains are available from continuing unilateral trade liberalisation.*

In March 1991 the federal government committed the Australian economy to drastic cuts in protection by the end of the decade. Whereas such a commitment to freer trade deserves only praise, it is ironic that it coincides with both a worldwide resurgence of protectionist sentiment and the emergence of a highly articulate group within Australia urging a return to interventionist policies. In Australia and overseas, the new protectionists frequently deny that they are in favour of protection at all, but talk of 'outward-looking' or 'export-oriented' strategies to assist 'promising industries' to become established in world markets. The success of a number of East Asian economies is frequently cited in support of this approach. More sophisticated protectionists often appeal to new theories of so-called 'strategic trade policy'. A less overtly protectionist line is that, in the face of the emergence of world trading blocs in Europe and on the American continent, Australia should push for the formation and membership of an Asian trading bloc. All of these proposals and arguments have been given added impetus by pessimism about the outcome of the Uruguay Round of GATT negotiations.

The argument of this article is that much of this recent debate has lost sight of important well established principles of trade policy as they apply to a small country like Australia. If, as is argued, the case for strategic targeting is very weak, it is even weaker for a small country. The article concludes that our first priority should be unilateral reductions in protection, accompanied by efforts to ensure the success of multilateral reductions, particularly in agricultural protection, as part of the Uruguay Round (notwithstanding the difficulties that continue to be encountered in that round). Trading blocs and bilateral trade deals represent a less satisfactory means of securing the gains from freer trade.

The Superiority of Free Trade for a Small Country

Every undergraduate economics student should know that the best policy for a small country with competitive domestic markets is zero protection. Because a small country cannot affect the price at which it trades in world markets, the full price effect of a tariff or import quota is passed on to domestic producers and consumers. This hurts domestic consumers and unprotected producers, benefits domestic producers in the protected sector, and, in the case of a tariff, provides additional revenue to the government that can be returned to the community in one form or another. However, the losses outweigh the gains since protection imposes a net 'deadweight' cost on the community: increased production in the protected sector occurs at the expense of production (and jobs) in the more efficient unprotected sectors of the economy, and consumers are forced to reduce their consumption of protected goods in response to their higher prices. It is important to note that these net costs of protection are incurred regardless of whether foreign countries choose to impose trade distortions. Foreign trade barriers and subsidies merely serve to change the world price, but because that is beyond the small country's control, its use of protection inflicts harm only on itself: it can have no significant retaliatory role at all.

An increasingly popular line among journalists and professional lobbyists is that because of 'unfair' trade restrictions and subsidies by foreign countries, the world market is not a 'level playing field' and so we should not be playing 'fairly' either — we too should be subsidising our industries. However, this is quite misleading as a criterion for sound policy making. Trade-inhibiting policies by foreign governments **are** unfair — **to foreign consumers and/or taxpayers.** Foreign subsidies actually help our own consumers by driving down the world price of the relevant goods. Of course, in the process they can have devastating effects on our own producers, as we are currently witnessing with the agricultural subsidy war between the US and the European Community. This is a matter of extreme concern, which underlines the need for Australian governments to reduce policy-induced cost pressures on the Australian farm sector and to persist with multilateral efforts to reform agricultural trade at the world level. However, as recent experience in the wool industry attests, it is not a situation we can help by distorting our own markets, for example by subsidising wheat producers. An Australian commitment large enough to have any impact on the European or American subsidy decisions would cripple our fiscal position, even if such measures were undertaken in collusion with other countries in the Cairns group. In addition, any subsidies implemented for this purpose could become permanent and reduce our industry's future competitiveness. In short, acceptance of the unlevel playing field argument for protection would involve us, as a small country, imposing high costs on our consumers and taxpayers (including our unsubsidised efficient exporters) with no real hope of improved access to foreign markets.

There is therefore a strong case for Australia freeing up its trade regardless of what the rest of the world is doing. However, in recent years this view has come under attack from some proponents of the 'new' theories of strategic trade intervention. Although these theories have been shown to offer no basis for practical policy making (see Bates, 1990, and Vousden, 1990), they continue to influence the policy debate in Australia. It is therefore worth spending some time evaluating their merits.

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Strategic Trade Policy

The central case for strategic trade intervention is based on the presence of imperfect competition in product markets. The argument is that, in the presence of foreign monopoly or oligopoly, a trade policy such as a tariff or an export subsidy has a role to play in shifting rents from foreign firms to domestic firms and/or domestic taxpayers. So long as the foreign firms earn above-normal profits in a particular market, aggressive trade policy by the domestic government will increase the share of the home firm(s) in that market and shift some of the foreign firms' profits to the domestic economy. This could then be counted as a gain to be set against the standard deadweight cost of the policy (explained above). A role for the government arises if the domestic firm cannot itself act in a way that captures the rents from the foreign firm(s). For example, if the domestic firm cannot make a credible threat to expand sales, the government can then use its trade policy in a 'strategic' way to make the domestic firm's threat credible.

This idea has been seized on by a number of lobby groups and bureaucrats, none of whom appears to have read the relevant literature. The important conclusions of this literature are, first, that the markets in which the above strategic trade policy argument is applicable are rare, and second, that even in cases where the model is applicable, the nature of the optimal intervention is so sensitive to behavioural assumptions about the markets that any given policy response is likely to make things worse. It is notable that even Paul Krugman, a key proponent of strategic-trade ideas, does not believe that his theories constitute an argument for intervention in practice and cautions strongly against such intervention (Krugman, 1987).

The simplest objection to strategic trade policy is that it can work only when there are large rents to be shifted from foreign firms to the domestic economy. This immediately rules out all but a small number of highly concentrated industries such as steel, aerospace industries, shipbuilding, and possibly semiconductors. In most other industries, the more likely effect of protection is to induce entry by new firms (which compete away any rents) and to render scale economies unattainable in the more fragmented market. This has been the experience in the Australian car industry and appears to fit the experience in a number of Canadian industries. The famous simulation by Richard Harris (1984) of trade liberalisation in the Canadian economy predicted an average increase in production runs for imperfectly competitive Canadian firms of 37.2 per cent under unilateral Canadian free trade and 67.7 per cent under multilateral free trade.

Even for industries where rents are not going to be dissipated by entry, the nature of the intervention is highly dependent on how the market functions. For example, it is well known that the optimal policy may be an export subsidy or an export tax depending on whether firms compete on the basis of quantity or price (Eaton & Grossman, 1986). This means that, even if some form of intervention is warranted, there is a good chance that the wrong policy will be chosen, making matters worse than under free trade.

An important corollary of these arguments is that citing instances of successful use of strategic trade policy (and there are a few) is quite inconclusive. If there exist industries in which intervention can be beneficial, it is not surprising that occasionally governments get the policy choice right. The point is that they will often get it wrong and impose large costs on the community. In Australia, governments' record of making the right policy choice is abysmal, but there are also numerous examples of failure in East Asia (particularly the automobile industries in Taiwan, Singapore, Malaysia and the Philippines). Even in the oft-cited East Asian success stories, closer analysis reveals that in most cases either strategic targeting is not the reason for success (frequently industries have succeeded without intervention — for example, Honda in the Japanese car industry and Sony in transistors) or explanations of its success are misplaced because only some economic variables have been considered. It is common to observe the 'success' of an industry in achieving high exports without looking at the costs that accompany those exports (subsidy costs to the taxpayer, distortion of domestic consumer prices, etc.). When the full welfare calculation is made, many apparent success stories are revealed as failures. A case in point is the Japanese steel industry which, despite high value-added per worker and increased exports and market share at the expense of the US steel industry, has exhibited a very low rate of return, well below that of Japanese manufacturing as a whole and insufficient to justify the cost of the subsidies, explicit and implicit, used to target it (see Krugman, 1987).

On the other hand, those who see increased exports as an end in themselves should examine the recent performance of the US. Since 1986, the volume of US exports has grown by 90 per cent, well above the average of 25 per cent for other OECD industrialised countries. This was fuelled by a combination of a cheap dollar, high productivity and low wage growth. Strategic targeting has had no significant role to play in the American 'export miracle'.

The lesson for Australia should be clear. Strategic trade policy is a very unpredictable tool that has its greatest chance of success in highly concentrated capital-intensive industries with substantial economies of scale — industries in which Australia does not have a comparative advantage. The inevitable lack of government information about the nature of competition in the market will, as often as not, yield an incorrect policy choice. In addition, in the Australian case, any gains that could potentially be realised from such a policy are likely to be dissipated in higher payments to scarce specific factors such as skilled labour (see Dixit & Grossman, 1986) and upward pressure on costs from powerful unions. Certainly the strategic-trade arguments offer no convincing reason why Australia should depart from its present course of unilateral reductions in protection.

An Asia-Pacific Trading Bloc?

The desirability of unilateral trade liberalisation for Australia seems incontestable. Nevertheless, some problems remain. In particular, given the emerging segmentation of the world economy into trading blocs and the disappointing progress in recent GATT negotiations, should Australia not also consider how it can guarantee its exporters access to other markets? Should we not also aim for a range of **bilateral** trade deals with some of our trading partners and/or participation in a regional free-trade area or trading bloc? On the surface these seem desirable objectives. Indeed, a famous proposition of international economics (Kemp & Wan, 1976) states that formation of a customs union among a group of countries always improves the group's welfare provided the imports entering the group from outside are not reduced when the customs union is formed. Moreover, the Australia-New Zealand Closer Economic Relations (CER) deal appears to be working well and could be thought of as a good first step in building a more extensive free-trade area involving Australia (see Thakur, 1991, and Mapp, 1991, on aspects of CER and the Canada-US Free Trade Area).

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Unfortunately, political pressures within countries frequently lead the partners in a customs union or free-trade area to erect higher barriers against trade with the rest of the world to compensate their producers for greater import competition from union partners. This phenomenon has already occurred in the European Community. Increasing the external barriers would divert imports away from the external suppliers to a higher-cost internal source — the so-called **trade diversion effect** of a customs union. This effect involves a welfare loss for the union that must be set against any gains from freer intra-union trade. If the losses due to trade diversion are large enough, the formation of the union will make the countries of the union worse off. It is therefore important that any trade deal that Australia might enter into does not involve increased discrimination against outside countries. Unfortunately, because many of the countries in the region (including Australia) currently have very high levels of protection in their import-competing sectors, the size of the internal adjustment associated with formation of, say, a free-trade area would almost certainly yield irresistible demands for a significant raising of the group's external trade barriers, resulting in extensive and costly trade diversion. Admittedly, such trade diversion would be more of a problem in a smaller free-trade area (such as one involving just the ASEAN countries). For larger free-trade areas, trade diversion is less of a problem (simply because so much efficient production would occur within the group) but there is increased pressure for certain goods and industries to be exempted from the deal. It is not hard to see that a full Pacific Free Trade Area involving the US and Japan and accounting for something like 40 per cent of world trade would, by virtue of its size, be plagued by similar difficulties to multilateral trade liberalisation at the world level. Given present national attitudes, such a free-trade area could come into being only if it were encumbered by a large number of important exceptions. The likelihood of both costly trade diversion and a proliferation of exceptions is reason to be cautious of efforts to form a regional trading bloc. It is perhaps not accidental that East Asian countries have enjoyed much faster growth in trade and living standards without a major regional trade agreement than Africa and Latin America have experienced in the presence of such agreements.

In the case of a small country like Australia, there is another important issue to be considered. It is commonly supposed that joining a free-trade area is superior to unilateral liberalisation because, as well as yielding the standard gains from removing trade restrictions at home, it also yields 'reciprocal' gains from increased sales to other markets that have reduced their trade restrictions under the deals. However, these reciprocal gains are not guaranteed. Domestic export industries that are small in world markets can sell as much as they want to at the going world price. For these industries the real issue is the world price itself, something which, for small countries, is more likely to be affected by reform at the multilateral level (for example, getting rid of US and European agricultural subsidies). In the absence of reciprocal gains from membership of a free-trade area, all significant gains can be realised by unilateral reform without taking on board the other restrictions that often accompany membership of a trading bloc.

An important case in which significant reciprocal gains **can** arise has been identified by Wonnacott and Wonnacott (1981). Suppose two small countries, A and B, are about to enter into a bilateral trade deal. Suppose further that, prior to the deal, A exports to both B and to C ('the rest of the world') where C is large and determines the world price of A's exports. Suppose finally that either C imposes high tariffs on imports from A or the cost of shipping to C is much higher than the cost of shipping to B. Then, before the deal, it may still pay A to export to C (because it gets a better price than selling exclusively to B), but once B removes its tariffs under the trade deal, A gets a better price from B and so sells exclusively to it. In this case, the bilateral deal between A and B yields an additional terms-of-trade gain for A (and possibly for B also) that could not be realised from a unilateral tariff reduction. Thus, if a deal offers a country the prospect of switching a large proportion of its trade from a distant or highly protectionist country to a close neighbour, there may be substantial additional terms-of-trade gains. Certainly this case would appear to have some relevance to Australia's trade deals with countries in its immediate region where country C is interpreted as being a more distant market such as Europe or the US.

But it would be advisable to be cautious. In recent years, about 57 per cent of Australia's exports have been directed to countries in Asia (70 per cent to Asia plus the US), a share that has grown steadily without trade deals (it was 31 per cent in 1965). This low resistance to trade within our immediate region, combined with steadily falling real freight costs, suggests that the share of exports that would be profitably 'reassigned' to partner countries under a trade deal may not be all that large.

On the other hand, in the event that the world becomes segmented into large trading blocs, Australia's exclusion from an Asian or Asia-Pacific trading bloc would have serious implications for its terms of trade. Its export prices would be effectively determined by a highly protectionist world market, whereas if it were a member of a trading bloc, its export prices would be determined within the free-trade environment of the bloc and so would be significantly higher. Once again, the message seems to be that membership of any regional trading bloc should be approached with due caution, but we should keep one eye on developments in the world economy so that we do not become a residual country in a world dominated by trading blocs.

One reason why Australia may gain from joining a regional free-trade area is that the resulting greater access to foreign markets would make it easier for certain industries to exploit economies of scale. In the Australian case, such industries tend to be characterised by low profits and easy entry, so no 'strategic' (or rent-shifting) gain is involved. Instead, the formation of a free-trade area would lead to the demise of some firms as efficient domestic exporters seized opportunities to increase their sales to the partner countries in the free-trade area, thus reaping economies of scale with resulting lower prices for domestic consumers. This would be a worthwhile additional gain from any such deal, but it remains to be seen how significant it would be in the Australian case, given our strong comparative advantage in primary products.

Finally, most proponents of a trade bloc point to the increased bargaining power a small country like Australia would have by joining a larger regional trade grouping. This is true to some extent, but we should remember that largeness can be a two-edged sword: a group that is large enough to exert influence in trade can also be the subject of harmful retaliation. More important, any Asian bloc that is large enough to matter would have to include Japan and would therefore probably also have to include the US. Such a bloc would be so unwieldy and riddled with exceptions that

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it would offer little that cannot be achieved better via the existing GATT machinery. It would also divert our bureaucratic resources away from the important task in promoting multilateral reform. Of course, if a powerful Asia-Pacific free-trade area proves inevitable, we should make sure we are in at the outset to avoid being cut off from markets. This is clearly a delicate balancing act: it is not really in our interests to encourage the formation of an Asian trade bloc, but we cannot afford to be left out if some other countries decide to form one.

Conclusions

Australia stands to gain dramatically if the impetus of truly global multilateral reform can be sustained. This would not only yield immediate benefits by freeing up world agricultural trade and by promoting growth in our immediate region, but would also offer us a great opportunity to benefit from the entry into world trade of the emerging new market economies of Eastern Europe and Asia. So long as there is hope of a successful outcome to the Uruguay Round, Australia's allocation of lobbying resources to the support of GATT reforms represents a sound investment in our future. Provided these efforts for multilateral reform continue to be backed by a firm commitment to unilateral reform at home (including removal of major domestic distortions that serve to reduce the competitiveness of our exporters), there is every reason to be optimistic about our trading future. The primary ground for pessimism is that we may be tempted to follow an interventionist path by advocates of the new protectionism, resorting to policies that have no sound foundation, theoretical or empirical. Such a course would ensure that our national standard of living continues to fall.

Although many observers have advocated an Asia-Pacific trade bloc as a panacea to our current problems, there is every chance that such a bloc could make matters worse, given the likely exemption of a range of important industries and strong political pressures for increased protection against countries outside the bloc. But if an Asia-Pacific free trade area appears inevitable, we may have no alternative but to join it and attempt to use it as a force for trade liberalisation at the world level.

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