

Breaking the Trade Stalemate What Are Australia's Options?

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EXECUTIVE SUMMARY

Preferential free trade agreements between like-minded countries enjoy growing popularity. Having been rejected as a free trade partner by ASEAN, the Australian government is now debating whether to approach the US or China for a free trade agreement after these two governments previously approached us. Preferential trade agreements are becoming the fashion, as political momentum for renewed WTO negotiations has flagged. The failed Seattle ministerial meeting of the WTO signalled a lessening political commitment to economic openness in key countries, which in turn has encouraged increasing populist opposition to 'globalisation'.

The multilateral liberalisation of trade in goods and services and international capital flows has been the major engine of economic growth in rich and poor countries alike. Liberalisation must continue in one form or another, not least because this constrains the interventionist opportunism of political parties and forces rulers to protect private property rights, the rule of law and democratic participation. The fear of losing political influence is the often unadmitted reason why many oppose further liberalisation.

Preferential liberalisation may be a way to break the present stalemate in worldwide reform. This paper examines the options available to Australian policymakers if economic policy is not to fall under the spell of particular political lobbies and interest groups.

Obviously, trade deals that exclude *agricultural* products are of little interest to Australia. We should not negotiate with countries where entrenched farm lobbies continually erode free trade. In addition, any forward-looking trade arrangement must cover *services*. This area is booming, and Australians enjoy numerous and pronounced cultural, institutional and locational advantages in services. Here, too, we must be wary of foreign and domestic lobbies that represent service producers—such as banks, insurance companies and media interests. They are often protected by strict domestic regulations that constitute effective barriers to trade.

Given the growing importance of *free capital flows*, Australian negotiators should also pursue agreements which liberalise capital, and which guarantee foreigners the same status as domestic investors.

One interesting proposal is for a US-centred *free trade association* among economies with a high degree of economic freedom. A more ambitious option is to join a *customs union*, the advantage being that it imposes less paperwork on businesses and is less open to reactionary lobbying.

The main conclusion of this *Issue Analysis* is that as long as multilateral progress remains stalled, comprehensive liberalisation with the dynamic and free US economy promises by far the biggest and most sustained advantages for Australians. Such a deal could overcome the spreading myopia of unilateral regulation and populist industry policies. A deal with the Peoples' Republic of China and others seems like a non-starter. In any case, Australian politicians should not allow a narrow-minded, party-political 'US versus China' tussle to detract from pursuing the benefits of opening the economy further.

THE CHANGING ARCHITECTURE OF INTERNATIONAL TRADE AND INVESTMENT

Ever since some ASEAN governments rebuffed Australian and New Zealand participation in a prospective East Asian free trade zone, the debate has been growing over whether the Australian government should approach other countries for bilateral trade and investment deals. Two potential foreign partners are the US or China. US administrations broached the idea of a free trade arrangement with Australia when Secretary of State George Schultz met with the Hawke government in the 1980s, and again when US trade representative, Charlene Barshefsky, approached Australian Trade Minister Tim Fischer in 1998. Chinese President Jiang Zemin raised a free trade pact with Australia in 1999.

The keener interest in bilateral free trade deals is no coincidence. The momentum for the further worldwide liberalisation of trade and investment appears to have been lost. The exhausting and frustrating Uruguay Round, the failure of the OECD to bring about agreed uniform rules on foreign investment under a Multilateral Agreement on Investment (MAI), and the collapse of the ministerial WTO meeting in Seattle have encouraged noisy populist opposition against globalisation. Worldwide organisations, such as the WTO and even the OECD, have become too unwieldy to negotiate real progress. Consequently, political commitments to a truly open economy have eroded. Many government officials are therefore now attracted to the idea of more exclusive free trade clubs.

The European Union, itself an exclusive club of long standing, has formed preferential trading clubs (or 'association agreements') with non-member countries. The US, which has long opposed preferential trade deals, shifted position in 1983 when it liberalised bilateral trade with Canada in response to European and third world resistance to ongoing multilateral liberalisation under GATT. US trade policy moved further down the road to preferential agreements when trade with Canada and Mexico came under the umbrella of the North American Free Trade Association (NAFTA), and when a free trade agreement was concluded with Chile in 2000. Others find inspiration in South America's Mercosur, and the CER arrangement between Australia and New Zealand.

In some circles in Australia, concerns are spreading that we may 'miss out' and that this would cost economic growth, jobs, international influence and strategic clout.

The abandonment of genuine multilateralism in favour of preferential trade among a limited number of like-minded countries is a definite second best on the grounds of long-accepted, time-tested trade theory and international experience. However, the case can now be made—reluctantly—that bilateral or plurilateral liberalisation agreements are, for the time being, the only feasible way forward.

As more regional clubs emerge and as the impact of globalisation spreads within national economies, the 'new regionalism' deserves renewed critical and public scrutiny in Australia. Our common interest is in cheaper imports and more job-creating foreign investment. It must be subordinated neither to the interests of particular business groups, unions, environmentalists or social lobbies, nor to the interests of parliamentarians, political parties and bureaucrats who thrive by redistributing income and wealth.

Australia's options

The prospect for another round of multilateral trade negotiations and a multilateral investment agreement is poor. Australian international commercial policy therefore has to explore the following second-best options:

- *A bilateral free trade agreement with the United States.* US government officials have broached the idea repeatedly, and something along these lines is currently the Australian government's preferred option.
- *Seeking acceptance into an open US-led free trade area* to which countries with free economies are invited.
- *A customs union with the United States and other countries in its orbit.* Free trade associations invariably impose high compliance costs on intending traders

With the loss of momentum in multilateral liberalisation, many governments now favour preferential trade agreements.

who have to document the national origin of products to receive tariff concessions. They also invite lobbying against openness.

- *Seeking another major long-range partner* with which Australia can develop political and economic synergies. One candidate is the Peoples Republic of China, given its size, resource endowments and location. The proposal of a trade treaty between Canberra and Beijing is now being considered by the Labor Party.
- *'Integration from below'*, namely through markets: There is always the option of working within existing and new multilateral trade and investment rules, as it stands, foregoing attempts at political and diplomatic 'integration from above'. Instead, Australia could concentrate on creating favourable and attractive domestic institutions to attract profitable private foreign investment and productive knowledge, and to foment strong trading positions.

Table 1: Options and definitions

<p><i>Agreement</i></p> <ul style="list-style-type: none"> • with one country: bilateral • with many countries: plurilateral, e.g. hub-and-spoke system • with virtually all trading nations: multilateral, e.g. WTO <p><i>Coverage</i></p> <p>(a) free trade agreement: commodity trade, with or without exemptions (e.g. agriculture), with each country retaining its own tariffs vis-à-vis third countries:</p> <p>(b) customs union: commodity trade, with a common tariff and commercial policy vis-à-vis third countries:</p> <p>(c) augmented free-trade agreement: commodity trade <i>and services</i></p> <p>(d) free trade and investment agreement: commodity trade, services <i>and capital flows</i> (e.g. NAFTA)</p> <p>(e) common market: commodity trade, services <i>and the free flow of all production factors</i></p>

The benefits from free trade and investment—and the political obstacles

The growing openness to trade and investment under the multilateral GATT rules has been the major engine of worldwide economic growth over the past 50 years. The expansion of world exports and international investments has spread productive ideas through rich and poor economies alike.

Without doubt, Australians have also been major economic beneficiaries from multilateral liberalisation and the removal of many of our self-inflicted burdens of protectionism in the unilateral reforms of the 1980s and 1990s. Australian economic growth would not have accelerated in the 1990s had the traditional trade and investment controls been upheld.

Globalisation has raised living standards and life opportunities, notably also for many of the poor. Real incomes have gone up across all income brackets, and Australians now live longer, healthier, securer and richer lives than they ever had under protection. Of course, all change demands adjustments, but it is simply untrue that there is a systemic rise in uncertainty. Many new jobs are part-time and casual, but this is a welcome choice for many, in particular women with children. Since the 1960s, some 250 million industrial workers have learnt to do industrial jobs that now produce for world markets. It is therefore not surprising that low-skilled workers in Australia and other affluent countries have to compete increasingly with low-skilled workers in the third world who are prepared to work for less. The solution is more education and training so that first world workers can justify their high incomes in the global marketplace and fully exploit the productivity advantages they enjoy. More competition-friendly institutions, including flexible labour markets, would help workers in Australia to compete successfully in growing world markets.

Without the external discipline of growing openness, it seems unlikely that Australian political parties could maintain sufficient political commitment to implementing much-needed domestic reforms. Free market reforms are rarely

Open trade and investment discipline particular interest groups and political parties, and empower citizens.

implemented out of the high-minded commitment of political leaders to the common good. Normally, political opportunism and populist-interventionist instincts are overcome only by traumatic experiences such as capital flight and unsustainable external deficits.

The economic interests of Australian suppliers and buyers are not served by a narrow free trade pact covering only manufactures. Any trade agreement must cover agricultural products, where we have strong competitive advantages, and should be augmented to cover services, where demand and technical opportunities are growing enormously. Australian producers enjoy institutional strengths in service exports, thanks to their familiarity with the English language and international laws and standards, location in a rapidly growing region, and competitive human capital.

Open trade in all goods and services will challenge established and part-protected Australian suppliers. It will also meet resistance from entrenched farm, service and industry lobbies in those countries with which we might conclude free trade arrangements. Some observers with protectionist convictions consider the resistance of overseas farm lobbies against the liberalisation of agricultural trade as unalterable. They derive from this the argument that Australia too should go the mercantilist-protectionist route. But it is the task of Australian trade policy to continually test the influence of protectionist lobbies in the US, the EU and Japan.

Australian trade negotiators will have to insist on credible and binding guarantees of access. They must remain wary of potential partners where farm or service lobbies pose insurmountable obstacles to genuine competition, for example in Japan and the European Union in agriculture. In most Southeast Asian countries, protected service providers and politicians form close alliances that would impede competition from Australian suppliers. More generally, countries with heavily controlled economies make poor partners in a free trade pact.

Gains from trade

What matters increasingly is not just static economic gains from specialisation, but the dynamic stimulation of innovation by international competitors. Openness does not only lead to a better allocation of given resources, but stimulates the discovery and development of new resources, in particular knowledge. In this dynamic discovery game, trade is often less important than the exchange of specific knowledge and specialised skills, which is often tied to direct international investments. Therefore, every economy in the world now appears to be taken over by foreigners; jobs increasingly depend on demand in other countries and the decisions of foreign governments and firms. This erodes the 'sovereignty' of national parliaments to regulate and control citizens. New capital mobility has therefore promoted domestic economic, civic and political liberties, not least in the new industrial countries, many of which have become new democracies. All this points to the desirability of comprehensive liberalisation of both trade and capital flows.¹

Despite the obvious national benefits, vested interests strongly resist the further opening of national borders to trade and investment. National governments, and the lobbies that try to manipulate them, lose much of their influence in an open

¹ For traditional organisational reasons, trade in goods and services and international investments are typically administered by different branches of the bureaucracy, in Australia by the Department of Foreign Affairs and Trade and Treasury. The globalised economy, however, now requires that the rules governing these two aspects of openness are tackled jointly. This relates to the legitimate role of public policy in international activity, namely the setting of rules for private trade and investment transactions and the control of harmful foreign political opportunism.

An altogether different government role is direct involvement in specific business transactions simply because they cross national borders. Specialised bureaucracies in the former USSR and China dealt with foreign trade and investment, and AUSTRADE too is directly involved in specific private business deals. In a market economy, such involvement is not legitimate. AUSTRADE should therefore be privatised so that market forces can determine whether its mediation, entertainment and information services justify the expense, and so that hidden subsidies to selected and favoured Australian firms and individuals are eliminated.

economy. This realisation has played an important part in the recent retreat into populist protectionism by Australia's major political parties. After the Keating government declared a 'tea break' in liberalisation, the Howard administration shifted to populist case-by-case interventionism. It overturned the pre-announced elimination of still disproportionately high car tariffs and has been offering discriminatory subsidies to selected car and textile producers. Petty import levies and residual 'nuisance tariffs' are retained even though they inflict high transaction costs on importers and disadvantage exporters.

It is the role of an open economic order to inhibit the narrow and myopic unilateralism of politicians. The GATT and the WTO have been effective multilateral constraints on unilateral national policies that harm other economies and destroy opportunities for world economic growth. If progress on that front is no longer possible for lack of political interest, bilateral liberalisation can still work as a control of unilateral myopia.

Out of the liberalisation stalemate

After the Seattle debacle, it is important to revive political interest in liberalising worldwide trade and investments. Comprehensive liberalisation demands unanimity at the global level. Recalcitrant foot-draggers out to extract concessions are using a *de facto* veto and hold up progress among like-minded trading nations.

Such a stalemate is broken when free trade nations demonstrate the advantages of further advances in liberalisation by forming associations with more ambitious cooperation. If these clubs are open, the foot-draggers can change their minds and join once they observe the growth and other advantages of freer exchanges. The reformers thus regain the initiative, and the protectionists lose their veto.

It behoves Australia to assist in bringing about such an improvement in the global liberalisation climate, and to do so without reservations as a committed free trader and supporter of free capital movements.

A free trade association

Joining one or two big economies in a comprehensive agreement to free up trade and investment can be done bilaterally, as is now commonly the case. But this may lead to distortions and incompatible tariff structures. An interesting variant is the proposal aired by the Heritage Foundation and *The Wall Street Journal*, namely

Bilateral liberalisation would inject new momentum into domestic economic reform.

Table 2: Membership in a Free Trade Association

Qualifying Candidates	Next in Line	
	Selected Candidates	Obstacle to Membership
Chile	Australia	Regulation
Czech Republic	Austria	Regulation
Denmark	Belgium	Regulation
Estonia	Canada	Foreign Investment
Hong Kong	El Salvador	Property Rights
Ireland	Germany	Regulation
Luxembourg	Hungary	Regulation
New Zealand	Israel	Regulation
Singapore	Italy	Regulation
United Kingdom	Japan	Foreign investment
United States	Netherlands	Regulation
	Poland	Regulation
	Switzerland	Regulation
	Taiwan	Foreign Investment
	Thailand	Regulation

Source and complete list of possible candidates: G. P O'Driscoll, K.R. Holmes, and M. Kirkpartrick, *2001 Index of Economic Freedom*, (Washington-New York, The Heritage Foundation-*The Wall Street Journal*, 2000), 34.

There is much merit in joining a US-led Free Trade Association of the world's freest economies.

to form a free trade association (FTA) among relatively free economies. A plurilateral initiative promises to overcome the current liberalisation stalemate more rapidly than an accumulation of bilateral agreements would.

The fundamental idea behind this FTA proposal is that a number of free economies retain such low barriers to trade and investment that they could easily group around the United States to open their economic borders almost completely. If one accepts the evaluation of economic freedom by the Economic Freedom Report, the US and ten other countries would qualify, and some two dozen other countries—including Australia—would nearly qualify for FTA membership (see excerpt from the list of candidates in Table 2 on the previous page). The main obstacle to an Australian FTA candidature is regulation, which the Heritage Foundation calls 'cumbersome, especially those affecting labour, occupational safety and health standards, and the environment'.

The advantage of the FTA proposal is that it would exert pressure on countries such as Australia to eliminate residual offending tariffs and domestic regulations. Relapses into national regulatory fervour would be penalised by the loss of free trade status. The prospect of such a trade initiative might help to overcome the current 'reform fatigue' and job protectionism in the ALP, and counter the populist-dirigiste inclinations of the Howard administration. Without opening the economy further there is little prospect that the Australian economy will become fully 'globalisation fit', as Australia's lobby-ridden parliament will hardly be moved to adopt overdue reforms in industrial relations and public administration.

Belonging to a club of the world's relatively freest economies and having preferential ties with the US economy could bring economic advantages if the coverage is comprehensive (free trade in goods, including agriculture, and services, free investment flows). There would also be political advantages. Our influence in Washington would be strengthened, in particular in predictable conflicts with the US farm-protection lobby, if we offered free access to American traders and investors. In addition, Australia's political standing in the wider East Asian neighbourhood would be enhanced by belonging to an elite club of free economies together with Singapore, Hong Kong and New Zealand, apart from the US.

The FTA proposal is, however, not without problems. The Index of Economic Freedom, which would determine the candidature for membership of a 'free economies club', does not seem to be sufficiently 'load-bearing' as a basis for policy. The weighting and estimation of the Index underrate obstacles in agricultural trade. If these are properly taken into account, EU countries, such as the UK, Ireland and Denmark, can hardly be classed as free, and Switzerland does not seem to qualify. US agricultural protectionism also conflicts with economic freedom. Numerous non-tariff barriers do not seem to have been properly taken into account in the preparation of the Index. These are technical matters that would have to be sorted out.

Another problem is that the proposed free trade association would be a hub-and-spoke system centred on the US, similar to NAFTA, as the US Trade Act in its present form only allows bilateral free trade arrangements. This leads to inconsistencies in trade arrangements among FTA members other than the US, as is now the case in NAFTA, for example diverting US imports trade from Korea to Mexico. The FTA would divert some buying from the cheapest and most efficient suppliers in the world to members of the FTA. Nevertheless, an FTA would create additional wealth and hence new trading opportunities.

Towards a customs union

Free trade agreements inflict high compliance costs on traders who have to prove the origin of a product and its components when they want to gain tariff concessions, thus imposing much paperwork on businesses. Much is therefore gained from opting instead for a customs union with a common external tariff. If Australia wanted to establish a common tariff with the US and other free economies, the rates for most product categories should be easy to unify because tariff rates are generally low. However, there would be problems in agriculture and textiles, garments and footwear.

The adoption of common external tariff rates limits national sovereignty. This may look like a bad thing to political power brokers and rent-seeking interest groups, but it is a boon for the common economic good and the average citizen. In critical cases, exemptions can be negotiated. However, it has to be recognised that people cannot understand and remember more than a few exemptions to the free trade rule. Exemptions would also open the door to self-seeking lobbying for further exemptions. Australian negotiators should therefore make a bid to negotiate an outright customs union.

US versus China?

The debate about trade and investment liberalisation has recently been complicated by party-political disagreement about whether to seek a free trade link with the Peoples Republic of China or the US. The choice need not be mutually exclusive. Australia can demonstrate its sovereignty by trying to establish mutual liberalisation treaties with both these important countries. Such a tactic would indeed reveal whether there are hidden political motives to limit our scope for independent political action behind either the US or the Chinese approaches.

If, however, a political choice were to be envisaged, the decisive question is: in which association will future generations of Australians learn the most advanced knowledge, the most competitive skills and the most future-oriented technology? From the standpoint of static comparative advantage and geographic location, an argument can admittedly be made for a China link, with Australia supplying raw materials to a country with low labour cost. In reasonably open trade conditions, the benefits of such complementarity occur anyway. Yet the Australian concentration on raw material exports has been weakening. Over the past decade, innovative Australian manufacturers and service providers have been discovering numerous profitable niche markets based on knowhow, human capital and Australia's institutional strengths. Care must be taken not to lock our economy into past specialisation patterns, and hence declining terms of trade for primary products. Nor must commercial policy exclude Australians from markets with leading-edge standards of technical and managerial excellence and innovation.

The choice of a long-term economic strategy must also evaluate how a preferential Beijing-Canberra link would affect Australian trading opportunities in Taipei, Osaka, Jakarta or Bombay. What political imponderables would Australian traders and investors have to face if an emerging China challenges its East or South Asian neighbours? In addition, where would Australia's interest lie in the predictable stand-offs between the established superpower, the US, and the world's most populous rising economy, China? It is unwise to plan a strategy that risks such diplomatic and political nightmares.

Since 1980, the Peoples Republic of China has certainly developed its economy through its open door policies, but it still ranks low on the Economic Freedom Index (classed 'mostly unfree' and ranked 100th out of 161 countries). More importantly, the Chinese leadership has been reluctant to match economic reforms with complementary political liberalisation. Economic freedom can only be kept compatible with political repression for a limited time. A country's institutional structure is only stable and efficient in the long term if all aspects of freedom—political, civic and economic—support each other. Only then is economic prosperity sustainable over the long run.

A China link would no doubt have advantages for those Australian politicians who want to preserve some political and union influence. Beijing governments will be less insistent on genuine free trade rules, and Chinese investors will not be as mobile and critical of Australian conditions as private American investors. Observers who put much stake in collective action can therefore be expected to sympathise with the China option.

Another problem would be civil rights. Should the Chinese authorities again crack down on domestic freedom as they did in Tiananmen Square, or resort to religious persecution as they now do in Tibet, Xinjiang and with regard to the Falun Gong sect, Australians will be placed in a most difficult position, never a good basis for stable and effective strategy. Cultural and political factors—cultural

Betting on the 'China card' is politically risky. The 'America option' promises more growth, but demands more honest reform efforts.

affinities, shared values and mutually respected institutions—are important foundations for stable economic cooperation and mutual trust.

In the short term, an FTA tie with the US might produce some adverse diplomatic noises from some Asian capitals. Joining a US-led FTA with top economic freedom credentials would mitigate this fallout. The long-term consequences will not be adverse as long as preferential agreements are kept open. Membership in a free trade club of jurisdictions with ‘first-best’ institutions would demonstrate our economic confidence to leaders and the upwardly mobile elites of Asia. This, along with being part of a wider Western political, economic and knowledge network, will make us more interesting and worthier of respect, even in China.

Whatever the exact nature of evolving US and China connections, it is most important that narrow party-political tussles do not divert from the first order task of opening the Australian economy further to outside competition.

Conclusion: ‘Integration from below’

Economic strategists in high office seldom contemplate the option of letting things sort themselves out spontaneously. They rarely accept that small countries cannot influence the institutions of international trade and investment, and have to adjust to them as best they can. However, economic successes have been built on such benign neglect. Switzerland and Taiwan, for example, have not pursued an activist trade and investment diplomacy. They have instead done much to ensure domestic producers are highly flexible and competitive and to make domestic investment conditions highly attractive to foreigners.

This strategy relies on the fundamental insight that virtually all international trade and investment is private and that all beneficial international integration grows from the bottom up. It is a myth that international integration depends on high-level agreements. Diplomacy can at best remove political obstacles. ‘Integration from the top down’ must therefore never be treated as a substitute for market integration, competitiveness in trade and attractiveness to foreign knowledge, capital and enterprise.

In the Australian case, a ‘Swiss or Taiwan strategy’ would require a renewed energetic and comprehensive effort to improve our own institutions, including some innovative and unconventional reforms. In the immediate future, Australian parliamentarians seem disinclined to overcome their populist-interventionist instincts. Implementing first-best domestic reforms would only cause their parties problems with client and support groups. This is why the discipline of free trade and investment, in whichever form, is urgently needed.

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