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# Gaining from trade liberalisation: some reflections on Australia's experience\*

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## Introduction

It will be 30 years next month since Australians woke up to discover that their government had initiated a 25 per cent cut in manufacturers' tariffs. This dramatic event was the opening volley in the reversal of protectionism in Australia. The path of trade liberalisation since then has been neither smooth, rapid, nor consistently downhill. However, we have ended up a long way from where we started, with limited tariffs and other import restrictions in most of our traded goods sector (and low barriers to most services trade).

Unlike most other countries, Australia undertook much of this liberalisation of its own accord, outside the formal bargaining processes of the GATT or WTO. Nevertheless, it got 'credit' for its reforms in subsequent multilateral trade negotiations and, through the non-discrimination rule, benefited from the reciprocal liberalisation of the larger trading powers.

Part way into the latest 'Doha' Round of multilateral trade negotiations, the old paradigm is shifting in significant ways. The Round itself seems to be in trouble. That is not too unusual at this stage. However, the sticking points are the same ones that have diminished the value of past rounds (including agriculture). At the same time, and partly as a consequence of the earlier Seattle debacle, there has been an acceleration in effort devoted to the negotiation of bilateral or regional preferential arrangements.

The USA has been at the forefront of this, but we are now also seeing other traditional multilateralists like Japan, and even brand-new multilateralists like China, making similar moves, as well as other countries in Asia. This 'third wave' of preferential agreements goes well beyond barriers to merchandise trade, to

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include investment and various services trade issues, as well as more contentious domestic regulation. Whether these agreements will prove to be building blocks or stumbling blocks for wider liberalisation remains hotly contested. What seems clear in the meantime, however, is that countries excluded from such agreements face considerable risks.

These developments bring obvious challenges, but also opportunities for Australia. The most significant of these relate to the current negotiation of a bilateral trade agreement with the United States, a new direction in Australia's own approach to liberalisation.

It is therefore timely to ask what lessons we can learn from the Australian liberalisation of the past that might help us plot the course ahead. What has been the effect of trade liberalisation on the Australian economy to date? Are there still benefits in proceeding unilaterally with reform? And what traps should we be aware of when negotiating trade deals, particularly bilateral or other preferential arrangements?

## **Australia's economic transformation**

The liberalisation initiatives by Australian governments over the past two decades have contributed to the transformation of the Australian economy. To illustrate just how far we have come and how important the benefits have been, let me briefly recap where we started.

### *The Jurassic Industrial Park*

As Paul Kelly observed in *The End Of Certainty*, Australia's industrial and trade policies from early last century were fashioned largely around the social compact that came to be known as the 'Australian settlement'. In essence, barriers against imports — mainly tariffs but also quotas and local content schemes etc. — were used to attract and sustain manufacturing enterprises in Australia, which in return were required to soak up immigrant labour and pay the high wages set by the Industrial Relations Commission.

Under a policy of 'made to measure' protection, successive rounds of tariff increases proved necessary to maintain the competitive position of increasingly high cost industries. This culminated in high rates of assistance for manufacturing, with particularly high assistance for TCF, cars and whitegoods. Various assistance arrangements were also introduced for sensitive parts of agriculture — such as sugar, dairy, rice and tobacco — as part of a 'protection all round' approach.

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The economic costs of this regime were masked by the performance of our broad-acre agricultural and mining industries. Until the early 1970s, Australia was still managing to ‘ride on the sheep’s back’. The terms of trade favoured our primary commodities, and we had benefited from a world-wide expansion in demand following the War. Unemployment was low and the incomes of Australians were on average still higher than in most other OECD countries.

But we were riding for a fall. During the 1970s, the prices we received for our commodity exports began a long-term decline, while the costs of imports began to rise. The resulting terms of trade decline would, in turn, expose the underlying problem of Australia’s poor productivity performance.

Productivity growth is the key determinant of a country’s ability to increase the living standards of its citizens over the long term. Even in the post-war ‘boom’ years, Australia’s productivity lagged. Between 1950 and 1973, our average annual productivity growth was 2.3 percent, compared to the OECD average of 3.6 percent.

The reasons for our relatively poor productivity performance, given the policy environment just described (compounded by restrictions in capital markets and anti-competitive domestic regulation), were not hard to find:

- a fragmented, high cost manufacturing sector, focussed on the domestic market;
- indulgent, inflexible work practices, powerful unions and lack-lustre management;
- outmoded technologies, low rates of innovation and skill development; and
- bloated public utility monopolies controlling key infrastructure services like power, transport and communications.

Australia’s relatively poor productivity performance, together with the declining terms of trade, translated into an inexorable slide in our comparative living standards. Whereas Australia at Federation had been the world’s richest nation in terms of GDP per person, and was still ranked 5<sup>th</sup> in 1950, we had fallen to 9<sup>th</sup> by 1973 and to 15<sup>th</sup> by 1990. It is sobering to consider where we might be today had we kept to our prior course.

### *A more productive economy*

Instead, Australia embarked on a sustained and comprehensive program of trade liberalisation and other microeconomic reforms.

As a consequence, the effective rate of assistance for manufacturing has been lowered from almost 25 per cent in the mid-1980s to less than 5 per cent today.

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Assistance to agriculture has also declined over the last decade, and we have moved to liberalise a variety of restrictions on trade in the services sector.

As well as dismantling import barriers, Australian governments have undertaken a comprehensive program of pro-competitive reforms across the economy, including in utilities and other infrastructure, and in labour market regulation.

We have, in turn, witnessed a remarkable turnaround in the performance of the Australian economy.

For a start, Australia's exports and imports as a proportion of GDP are now one-third higher than they were in the mid-1970s. Domestic manufacturing based on import-replacement strategies has increasingly made way for export-oriented and globally-integrated production. Notwithstanding increased import penetration in manufacturing, the sector's real output has not decreased (although much employment has migrated to the services sector). Production and trade in services have also grown rapidly, as have commodity exports (at least prior to the current drought).

Over the 1990s, Australia's productivity growth accelerated to rates exceeding even the boom post-war years, with labour productivity growth almost doubling to over 3 per cent per year on average since 1993-94. Further, Australia's growth performance was maintained despite the crisis which enveloped several of our major markets in Asia in the late 1990s, and the slowing of other OECD economies. To put this in perspective, had Australia's productivity continued to grow over the past decade at its previous trend rate, annual household income would now be around \$7000 lower on average.

Australia has accordingly become the fastest growing economy in the OECD over the last few years and, by 2001 we had climbed back from 15<sup>th</sup> to 7<sup>th</sup> highest of the 22 OECD countries, in terms of GDP per person.

## **Multiple benefits of liberalisation**

While various factors, including sound macro-economic management, have played a part, research by the Commission and others suggests that the microeconomic reforms of the last two decades have been a major contributor to the strong productivity growth, and to our economy's increased flexibility in the face of economic disturbances. Trade liberalisation has been only one element in this transformation. But it has played a pivotal role, some key aspects of which are not generally recognised.

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### *Consumers gain*

First, and most obviously, tariffs are a (distorting) tax on consumption. They inflate not only the price of imports but also the price that domestic producers can charge for competing products. Reducing or removing that tax means that, over time, consumers can buy the same quantity of goods and services for less of their income, which leaves them with more to spend on other goods and services. They typically also have access to a greater variety of products

### *More competitive firms and industries also gain*

Second, lower tariffs for one industry generate benefits for businesses in other industries. One reason is that the extra consumer spending power can act to lift demand for other goods and services. But more directly, lower tariffs mean lower *input* costs for many businesses. For example, every business that uses passenger motor vehicles — from taxi owners to tourist operators to Telstra — has benefited from the significant reduction in tariffs and quotas on imported vehicles over the past two decades.

Exporters have been particular beneficiaries of lower tariffs. For example, when tariffs were lowered on farm machinery, our farmers' costs declined, making them more competitive on export markets — and better able to survive in the face of declining commodity prices. Further, high tariffs had tended to prop up the Australian dollar, which in turn pushed up the price of our wares on world markets. These are some of the reasons why economists say that “a tax on imports is a tax on exports”, and explains why export growth has broadly matched the more rapid import growth in the era of trade liberalisation.

For these and other reasons, reductions in protection for particular industries can be expected to create an expansion in the production and sales of many other industries across the economy. Understanding these inter-industry ramifications has been aided in Australia by the development of economy-wide models based on input-output data. For example, the Commission's ORANI model was used in the development of the 1988 program of general reductions in protection. The modelling projected that, while there would be a contraction in some industries such as transport equipment (7 per cent), TCF (5 per cent) and chemicals (2 per cent), price reductions and resource flows would mean that most sectors would expand. Mining output was projected to expand by 5 per cent, and output across agriculture and a number of manufacturing and service industries was also projected to expand, leading to an overall increase in employment, with real GDP rising by some \$1.2 billion.

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### *Increased flexibility and 'dynamism'*

As well as these 'static' allocative benefits, there are 'dynamic' gains to an economy that opens up to import competition. The precise nature and magnitude of these gains are difficult to predict beforehand, or to model mathematically, yet Australia's experience suggests that they can be pervasive.

At one level, increased import competition puts pressure on corporate managers to examine and improve their operating efficiency, product menus and pricing, as well as exposing them to international best practice. It can also help to break down old antagonisms between management and labour within the threatened industry, providing them with greater incentives to recognise their joint interests and to work cooperatively.

At a broader level, heightened competition from imports means that firms and industry organisations that might otherwise have remained complacent about entrenched work practices, and the high cost of inputs and utility services, are no longer able to contrive to pass these costs on. This in turn can generate political pressure for reform in these other sectors of the economy. Thus the reforms to anti-competitive business regulations, government business enterprises and industrial relations, culminating in the National Competition Policy, can be seen as a logical outcome of the opening of the economy to international competition.

### *The auto industry illustrates the benefits*

The history of motor vehicle manufacturing in Australia provides a good example of these forces at work. Under the high protection regime that existed for 4 decades after World War II, this industry was an infant that just would not grow up. Every attempt to reduce tariffs — whether from 57.5 per cent or 15 per cent — was met with predictions of ruination. In reality the industry, almost despite itself, has become an advertisement for the benefits of protection reform.

While not the whole story, increasing import competition has clearly stimulated domestic vehicle assemblers and component producers to specialise, to adopt more innovative and efficient production practices, to lift quality standards, to undertake greater product innovation and to look abroad for new markets. More flexible and productive work practices have been facilitated by reforms to industrial relations regulation. And the industry has also benefited from other microeconomic reforms, including in utility services, with its adjustment facilitated by a competitive exchange rate.

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As a result, notwithstanding significant reductions in assistance and a significant rise in imports, local production is running at almost record levels, with more than 30 per cent of sales going overseas (compared with less than 10 per cent a decade ago). The industry has surprised itself with its performance, and is now more optimistic about its future than ever before. For their part, long-suffering Australian consumers now have a greatly expanded choice of cars (around 250 models, compared to just 70 in 1985) of higher quality and at much lower real prices.

### *Managers are minding their businesses*

Where the government sticks to a clear agenda of reform, such as the programs of phased reductions in tariffs that commenced in the late 1980s, there is a further benefit. It sends a signal to the business community not to expect special deals, thus releasing businesses' management and financial resources for managing rather than for lobbying. Unfortunately data on resources devoted to lobbying activities are not readily available! But casual observation of the Canberra scene over the past decade confirms a diminution and rationalisation of the lobbying armoury maintained by manufacturing firms and industries for protectionist purposes and a greater focus on seeking economy-wide reforms (in taxation, industrial relations etc.).

It is important to note that many of these gains were not achieved overnight. The reallocation of production and the introduction of new processes take time, and new investments of managerial effort as well as capital are needed. Similarly, attitudes and expectations formed in the era of government preferment take time to be redirected towards self-reliance. In the meantime, there are inevitably some dislocation and adjustment costs, particularly in more vulnerable regions, and these need to be taken into account (a point to which I return). Nevertheless, the Australian liberalisation experience has been remarkable for the smoothness of the transition.

### **Unilateral reform has been the main source of benefit**

Australia of course has not been alone in reducing barriers to imports. For example, average tariff levels for manufactured goods in industrialised countries have fallen from over 40 percent after World War II to 4 percent today. However, unlike the liberalisation efforts of the Europeans and North Americans, most of Australia's liberalisation has been *unilateral*, undertaken voluntarily rather than in return for reciprocal 'concessions' from other countries.

This is partly because Australia was essentially precluded from being a conventional participant in multilateral trade negotiations. For many years our main

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export interest, agriculture, was off-limits in the GATT, providing little scope for trade bargaining, so we were forced to think about the domestic implications of reducing our own trade barriers (and we pioneered tools of analysis, such as the ‘effective rate of assistance’, to help us with that).

This turned out to be an important advantage, as we were among the first countries to act on the recognition that a country gains most of all from reducing its own trade barriers, *regardless of what other countries do*.

Contrary to mercantilist notions, the main benefits of trade for a country come not from maximising export income *per se*, but rather from the improvements in domestic productivity, resource allocation and consumption that import competition brings. A country’s own barriers to trade generally have a more distorting effect on the allocation of its resources and on incentives to be productive and innovative than the trade barriers of other countries.

Thus, for example, when McKibbin modelled the economic benefits of the APEC Bogor agreement he found that the projected gains to Australia from meeting its own liberalisation commitments would account for almost 90 per cent of the gains which it would accrue if *all* APEC countries (including the USA) met their commitments.

Unfortunately, the time-honoured rituals of trade negotiation are predicated on the opposite presumption — that any domestic ‘concessions’ are costly and can only be countenanced as the price for gaining greater access to foreign markets. This can often lead to tortuous tactical manoeuvres that are largely self-defeating.

#### *Foreign liberalisation can bring additional gains*

This is not to argue that reductions in foreign barriers to Australia’s exports cannot be an additional source of benefit. In the case of agriculture, the Commission has estimated that complete liberalisation of the protection regimes in North America, Japan and Europe would yield welfare gains to Australia of over \$US 1 billion, largely through higher prices on world markets (improved terms of trade).

Moreover, it is obviously also true that the lower a country’s trade barriers become, the larger the relative gains from foreign liberalisation.

This point was reflected in modelling conducted by the CIE for the Commission’s recent inquiry on the automotive industry. In the automotive sector where Australia’s tariffs are still relatively high, the CIE found that, of the gains that Australia would enjoy were all APEC countries to reduce their automotive tariffs to 5 per cent, Australia could accrue 90 per cent of this gain by reducing its own tariffs



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unilaterally. However, when considering the case of reductions in all manufacturing tariffs (most of which are already at 5 per cent in Australia), the CIE found that the main gains to Australia come from ‘terms of trade’ effects associated mainly with foreign liberalisation, rather than domestic resource allocation effects.

This is germane to the current debate about the AUSFTA. Putting the tricky services-related issues to one side for the moment, the scope for Australia to derive further gains from liberalising its own merchandise trade barriers will have been considerably reduced once the final protection peak (TCF) has been dealt with. On the other side of the ledger, US barriers to Australian exports, particularly agriculture, are significant and their reduction might be expected to yield significant gains. (That said, it is also the case that much US agricultural assistance is in the form of domestic subsidies and price supports, which could not be changed to provide any preferential advantage to Australia.)

*Non-discriminatory liberalisation has been advantageous*

A further consideration, much discussed, is that moving from traditional unilateral liberalisation to a bilateral agreement opens up the possibility that domestic gains from our own liberalisation may be eroded by imports being diverted to a higher cost source. Australia’s traditional non-discriminatory approach to protection and its (unilateral) liberalisation has to date largely ensured that we used the lowest cost sources of imports — as well as having the benefits of administrative simplicity and avoidance of international frictions.

Recent research by Commission staff suggests that, in practice, trade diversion may have been a more dominant consequence of many PTAs than previously thought. How significant it might be in a particular agreement will depend on the preferential margin at stake and the competitiveness of the partner. For the merchandise trade component at least, Australia’s tariffs are becoming relatively low and the United States is a pretty competitive supplier of many products.

This leads to the broader question of the potential economic gains to Australia and the USA of preferential access to each others’ markets. While the magnitude of the potential gains to Australia is not entirely clear, but could be significant if agriculture were fully liberalised, the potential gains to the USA are likely to be miniscule (given that we account for only 1 per cent of their trade and are a relatively open market already). Much larger gains are potentially available to the United States from its *own* liberalisation, again especially in the case of agriculture.

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## **Attention to adjustment has been important**

While trade liberalisation can generate a range of benefits across the economy, its most immediate and obvious effect is to put pressure on local, previously-protected industries. As we have seen, many businesses will be able to respond by cutting costs, innovating, lifting productivity or entering new markets. Inevitably though, some businesses will need to cut-back production or even cease operations. Such rationalisation is occurring in the TCF industry at present, where Australia's large labour cost disadvantage means that many local firms producing standardised clothing and footwear will not survive almost regardless of the tariff regime.

However, the way in which governments unfold liberalisation can affect the extent of the risks. Governments can also help to ameliorate the adverse effects on people when change occurs. And this can affect community support for liberalisation.

In retrospect, I have come to the view that a prime example of what *not* to do was the one-off 25 percent tariff cut of July 1973. That this cold shower descended on an unsuspecting, out-of-shape manufacturing sector, just as Australia was about to enter a recession anyway, did not help. While the tariff cut ameliorated some of the economic problems emerging at the time, it exacerbated others. Most significantly, in the recession that followed, quotas were reintroduced for some particularly hard-hit and uncompetitive industries, and further serious reform was effectively put on ice for the next 15 years.

### *Incremental liberalisation has facilitated adjustment*

In contrast, the programs of phased reductions in assistance that ran from 1988 to 1996 brought more gradual and predictable change. Their announcement in advance gave businesses and their workforces time to plan their responses, and the phasing of tariff reductions resulted in incentives for continuous improvement within a more manageable rate of change. The across-the-board approach to reform also meant that businesses that came under increasing competitive pressure in their output markets were assisted by lower costs on their inputs. And, in contrast to earlier piecemeal approaches to reform, across-the-board reductions also made it more difficult for individual industries to argue for exemption.

Two industries that nevertheless achieved (or maintained) special status were PMV and TCF. Following particularly adversarial review processes in 1997–98, those industries were granted a pause or freeze in tariffs for five years until 2005, when stepped reductions were legislated for in advance. In its recent inquiries, the Commission has seen value in extending this innovation through further stepped

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reductions culminating in tariffs of 5 per cent, with clothing having five years longer than PMV to get there, given its higher starting point.

While tariffs have been declining, governments have provided other forms of assistance to industry, partly to facilitate adjustment. These have included retraining subsidies or redundancy packages for workers in some industries, and a range of budgetary measures tied to production, investment and R&D. As I mentioned earlier, micro-economic reforms in other sectors have also been introduced in part to assist businesses to remain competitive against imports.

Adjustment programs that effectively facilitate rather than hinder efficient adjustment are notoriously difficult to design and implement. Their efficacy is also difficult to assess. Nevertheless in its PMV and TCF reports the Commission saw value in extending for a limited period the respective subsidy programs, conditional on achieving further reductions in tariffs. In the case of PMV this was no doubt central to the industry's acceptance of further tariff reform (the government providing larger subsidies than the Commission had envisaged).

### **An informed public debate helps achieve durable reform**

Australia has not been the only country to liberalise its trade unilaterally. But it has been one of a few to do so from such an entrenched protectionist base, without pressure from the IMF or World Bank, or in response to economic crisis. Moreover, unlike New Zealand, it has done so within a bicameral parliamentary system, which raises the hurdle for radical policy change.

So how did this come about? The short answer is 'with a lot of effort'! A satisfying explanation would require more time and space than I have available here. However, at the risk of over-simplification, a number of factors seem to stand out. First, I have already noted that the fact that our principal export interests were 'off limits' in the GATT negotiations was (perversely) helpful, because it meant that we were not distracted from focussing on the domestic costs of our own policies.

That domestic focus was in turn aided by theoretical and modelling developments in assessing the economy-wide impacts of trade restrictions (many of which were pioneered by Australian economists, Prof. Max Corden being the pre-eminent example) and by institutional vehicles which enabled an economy-wide perspective to be brought to bear on industry assistance decision-making. Perhaps the most durable and systematic of these were the predecessors to the Productivity Commission, which in having a mandate to provide information on the wider costs of protection, were able to alert those industries who would bear the burden and act as a public interest counterweight to the pressure from import-competing industries.

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A third important ingredient was the political leadership needed to translate reformist ideas into actions, and sell them to the Australian community. This came together under the Hawke-Keating Labor Government of the mid-1980s, facilitated by the support of the Liberal Opposition.

The upshot has been a more open and well-informed debate on industry assistance issues in Australia than is evident in most other OECD countries. And, while one cannot expect *consensus*, it is apparent that most industries have come to accept that their protection was not sustainable. The relatively muted public response to the Commission's reports advocating 5 per cent tariff rates for PMV and TCF, compared to the more hostile and defensive reactions in the past, is the most recent illustration of this. Such public acceptance has no doubt been aided by accumulating evidence of the economic dividends from reform.

### **Trade liberalisation shouldn't mean 'open slather'**

Trade liberalisation should involve policy actions which, in facilitating trade and investment flows, yield gains in national welfare. Trade liberalisation is not an end in itself. There can be valid rationales for certain measures that restrict trade in some cases and these should not be automatically surrendered under the banner of 'free trade'.

Free markets can be powerful mechanisms for promoting economic efficiency. But well-targeted government regulations or other interventions can improve on market outcomes in some cases. What needs to be demonstrated is that some form of 'market failure', or 'inequity' exists that can be addressed most efficiently by the intervention.

In the case of restrictions on merchandise trade, such rationales are hard to find. Sometimes regulations that can have the effect of restricting trade, such as technical standards and product design rules, may be warranted on safety or environmental grounds. But even in these cases, it is usually possible to achieve the underlying social or environmental objective through standards that do not discriminate between domestic and imported goods.

#### *Some restrictions have sound rationales*

However, the issues are more complicated in relation to negotiations on certain services and various 'trade-related' matters. Prominent examples include the PBS scheme, our quarantine laws, broadcasting content and ownership regulations, and the Foreign Investment Review Board. All these government interventions directly or indirectly restrict inward trade or investment flows; or, in the case of the PBS

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scheme, reduce the profits foreign companies can make by exporting pharmaceuticals to Australia. Some of these interventions have been raised as potential targets by US trade negotiators. Yet at least some of them appear to have defensible objectives, with discrimination against imports a requirement for their successful operation.

In such cases, there is a need to assess carefully the domestic benefits and costs of the interventions before offering to ‘surrender’ them as part of any trade deal, whether it be a bilateral deal with the United States or other countries, or as part of multilateral negotiations in the WTO.

In some cases, it may be that the underlying objective is either not warranted or does not require the particular restriction. For example, the Commission’s 2000 inquiry into *Broadcasting* found that sector-specific restrictions on foreign ownership of media outlets were not warranted on either economic or cultural grounds. Similarly, in a number of reviews the Commission has concluded that the benefits of Statutory Marketing Arrangements are likely to be outweighed by the costs. This is because of the limited scope for Australia to influence world prices, and also because many of the potential benefits don’t necessitate a regulated monopoly.

On the other hand, the Commission’s *Broadcasting* inquiry was more ambivalent about local content requirements, concluding that they should be retained pending a more systematic evaluation in the new context of the digital era. Similarly, in recent reports on pharmaceutical prices and assistance arrangements to the pharmaceutical industry, the Commission found that prices for drugs under the PBS are considerably lower than would otherwise prevail, partly reflecting (countervailing) buying power, yet this did not have sufficient adverse effects on the local pharmaceutical industry to warrant compensatory assistance for manufacturers.

In the case of quarantine, there are long-standing provisions within the WTO for restrictions that have a legitimate scientific basis and all countries have arrangements in place. Australia’s quarantine regulation and administration has drawn flak for being more restrictive than some judge necessary. This is a view apparently shared by the United States and the European Union. Clearly for a country like Australia, which still depends on agriculture and has much unique flora and fauna, an effective quarantine administration is particularly important. And, as some recent scares and potential threats illustrate (eg. foot and mouth, fireblight, wheat virus etc.) some degree of risk aversion would seem justified. Whether any changes to existing arrangements may nevertheless be domestically beneficial as well as trade liberalising would require careful assessment.

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## Looking forward

Australia has derived substantial economic benefits from the trade liberalisation which eventually followed that ‘opening volley’ of 30 years ago. In this period, we could demonstrate that our high import barriers imposed large costs on our domestic economy and community — and that this was so regardless of what other countries chose to do. The gains from unilateral liberalisation accordingly dominated external trade policy considerations. Moreover, apart from agriculture, our external interests were effectively secured anyway through (mostly) non-discriminatory treatment and multilateralised liberalisation by our trading partners.

At the start of this new century, while economically fortified by our past reforms, we find ourselves in a more complicated trade policy environment. Most of our own barriers to trade in goods and services are relatively low, or soon will be, whereas overseas barriers to our agricultural, services and some manufactured exports, and in some markets to investment, remain high. At the same time, there has been a shift to ‘regional’ or bilateral trade agreements by our trading partners, which seem to be generating more liberalisation of trade and investment in those countries than the more inclusive but unwieldy processes of the WTO. However, unlike multilateral initiatives, these preferential arrangements pose obvious risks for Australia: by excluding us, they serve to depress our exports and terms of trade and thus our national income.

While this new environment presents new challenges and requires some new approaches, I believe that Australia’s past experience in reaping gains from liberalisation continues to provide guidance for the future.

### *Push on with domestic reform*

In particular, it would be counterproductive for Australia to hold back from further beneficial reforms simply to provide it with negotiating chips in trade negotiations. The gains from domestic reform are gains that we can plan for and can count on benefiting from, if we implement them well, whereas those contingent on the actions of other countries are much less certain. In any case, Australia’s domestic market and its remaining barriers are unlikely to be large enough to exert much negotiating leverage on our major export markets. Finally, and of particular importance in the current environment, the lower are our barriers to trade and investment generally, the less scope there is for ‘diversion costs’ associated with any bilateral or regional agreements that we do decide to join.

Thus it is a positive development for Australia that the Government has committed itself to further reductions in automotive assistance. And it is important that we also

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proceed to complete tariff reform in the TCF sector. The Commission's preferred option in its inquiry position paper provides a balanced plan for achieving this, on which public hearings are currently taking place.

*Bilateral negotiations may be a useful 'motivator'*

A question remains, however, as to whether trade negotiations can nevertheless provide a useful motivator for Australia to undertake further, nationally beneficial reforms. For reasons already noted, the GATT/WTO had only a limited role in this respect. However the more concentrated pressure of bilateral negotiations may serve to expose issues which otherwise could not easily have been addressed.

For example, among issues identified in the context of the AUSFTA, I see no reason why we should not provide an undertaking to review our current arrangements for quarantine, government procurement, statutory marketing, anti-dumping, foreign investment and even the PBS. Indeed, I would be surprised if there were no ways in which we could make these arrangements work better for the benefit of the Australian community, apart from the external implications. I hasten to repeat that (most of) these are complex issues requiring careful analysis and public consultation before we could be confident about what changes may be required. Any such decisions should not be made lightly or quickly, or simply as a trade-off for potentially improved access to the US market or even to foster "deep integration" between our economies. However, if any nationally beneficial reforms we identify could also help to secure us improved access overseas, so much the better.

It is worth noting that any reforms in most such areas would in any case need to be implemented in a non-discriminatory way. (This is most obvious in the case of quarantine regulations.) To that extent, there is a built-in safeguard against one potential source of loss in the context of an FTA.

While we clearly need to do our homework on any domestic reform initiatives we may undertake, we obviously also need to assess very carefully the national implications of offers made by the USA.

*Modelling has limitations*

The oft-quoted estimated gains from a AUSFTA are based on certain presumptions about the nature and extent of US actions. Modelling can only tell us so much — and, as the recent battle between the CIE and ACIL exercises reveals, is critically influenced by the choice of parameters. It would nevertheless be useful to model the implications of different scenarios as they emerge.

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GE models typically understate the gains from liberalisation because they are unable to capture adequately the dynamic benefits. However, in the case of preferential arrangements they can also partly *overstate* the gains, because they cannot model the detailed rules of origin and contingent trade remedies which may in practice impede effective market access. This is one reason why recent econometric research by Commission staff, based on actual trade and investment flows following the formation of PTAs, found much less (net) trade creation than *ex ante* CGE-type models had predicted.

### *The devil is in the detail*

As is well known, the United States has devised quite detailed (and lengthy) rules of origin in its various bilateral agreements. Apart from their complexity, they have varying restrictiveness, depending in part on the domestic ‘sensitivity’ of the imports. For example, at one extreme, under the ‘triple transformation’ rule for TCF in NAFTA, duty free access is permitted only if clothing is sewn in a NAFTA country from fabric made in a NAFTA country from yarn spun in a NAFTA country. This can serve to distort the partner’s input sourcing decisions in favour of higher cost NAFTA suppliers, such as the USA. (This diversionary effect can occur even if the country’s own import barriers are negligible.)

Similarly, unlike Australia, the US has traditionally employed narrowly-based ‘safeguard’ provisions in the administration of its trade agreements, potentially enabling restrictions to be re-imposed where a local industry suffers injury. For example, this has bedevilled Canada’s attempts to export timber to the United States.

Clearly, Australia will need to ensure that rules of origin and contingent protection provisions are truly consistent with further opening markets. One avenue for ‘deep integration’ that could usefully be pursued, therefore, would be to align rules of origin and safeguard provisions in both countries with those of the most liberal partner. At the very least, we should seek to modify the arrangements used in previous FTAs by the USA, to minimise their protectionist potential.

As one ‘spoke’ on the USA’s ‘hub’, Australia cannot overcome through an AUSFTA the perils of bilateral and regional arrangements among our other trading partners and competitors — including other countries attached to the US hub. At the same time, some of our suppliers, like New Zealand and China, will see their exports eroded to some extent and this may adversely affect our trade relations with them.



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*Multilateral progress is needed*

It therefore seems clear that we must redouble our efforts to ensure progress in multilateral liberalisation within the WTO and APEC and, as mentioned previously, we should push ahead in lowering our barriers generally, wherever this yields domestic gains. The alternative of seeking to do a succession of bilateral deals, is fraught with difficulty (apart from the transaction costs) and may see us entering arrangements which favour particular Australian industries at the expense of others.

One avenue within the WTO for Australia to advance its interests, as well as the interests of global trade and development, is to seek to tighten the rules relating to FTAs, in order to reduce their potential to harm third parties. Stronger and clearer provisions relating to the need for elimination of barriers to ‘substantially all trade’ among the members of such an agreement would seem a good starting point. And, as has been argued previously, if such deals are truly to be ‘building blocks’ rather than ‘stumbling blocks’ for multilateral liberalisation, it would also be desirable to require that any such arrangements are eventually made open to other WTO members on the same terms.

*The nub: understanding the domestic gains*

The biggest problem that we face in any shift from our traditional ‘unilateral-multilateral’ approach to liberalisation to a ‘regionally’ negotiated one, is that most countries (including the United States) understand their national interest through trade policy primarily in terms of the concessions they can wrest from other countries, rather than their own liberalisation. As a relatively small market, with few ‘prizes’ to offer, we are at an obvious disadvantage in such a world. This has always been so, but previously we got to share the spoils of larger countries’ battles through MFN treatment under the GATT/WTO. These spillovers are not available under preferential agreements.

How do we resolve this fundamental dilemma? The answers are not obvious, but the question deserves far more attention than it has been receiving. The task is to find ways through which the gains from domestic reform by our trading partners can be better recognised in their policy formulation. While each country needs to come to terms with this in its own way, Australia’s beneficial experience with trade liberalisation may provide a useful role model.