

An Australia-US Free Trade Agreement.

Balancing of Regional and Multilateral Interests.

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Summary.

The negotiation of an Australia-US Free Trade Agreement means we will be according the United States tariff preferences over our major customer, Japan. Beyond question therefore, it has extremely important implications for our wider trade relations. At the same time however, attitudes in Asia to regional trade agreements have shifted: a myriad of RTAs already exist, or are under consideration or negotiation: Asia Pacific countries, including Japan, are increasingly becoming involved. Australia cannot greatly influence this trend, either by being in, or out, of it. So long as the obvious sensitivities are properly handled, the effects on our trade relations with third countries should be manageable and may even be beneficial. What is crucial is that our intentions are logical and clear to us as much as to others.

In my view to be “properly handled” these negotiations need to focus very specifically on Australia’s trade, investment and economic development. Trade agreements are very functional objects. It is a miscalculation for Australia in particular to use a trade agreement to try to augment existing strategic commitments or to adjust the focus of foreign policy. In part that is because Australia will need to be open to negotiating trade concessions in favour of other regional countries. The Doha Round provides a ready context to do so although another possibility would be to negotiate similar FTA arrangements with regional trading partners after concluding the deal with Washington.

Similarly it would be a mistake to imagine that we can “buy” an FTA with the US through our stance on specific international issues. That equation simply won’t work when the US Congress comes to give a tick or a cross to the agreement, and US special interests are applying intense political pressure. In any event these will be difficult and protracted negotiations, as likely to cause rancour as closeness in Australian public attitudes to the US. Because of that, the negotiations need to be very carefully managed and a few degrees of separation maintained between the trade and foreign policy elements of the Australia/US relationship.

The GATT and trade relations: the starting point.

By liberalising trade, GATT aimed to increase global prosperity and hence reduce the potential for future international conflict. At the same time its architecture endeavoured to minimise the impact of foreign relations on trade, by adopting a version of the most favoured nation principle, unconditional mfn, which requires that a trade concession extended by one country to another be automatically available to all other “members”. Regardless of which country negotiated a tariff reduction (and it was a fact of life that

countries would probably be more responsive to a demand from a major trading country like America than smaller countries like us) the likely beneficiary was the most competitive supplying country. That competitiveness will constantly alter, as will the direction of the trade flows. Judgements on the terms and conditions of market access, or judgements on the rights and wrongs of trade disputes, were and under the WTO still are, made under a rules based system that finds its most basic rationale in economic welfare, not in international political relationships. As the system embodied a “rule of law” it went at least some way to ensuring that all countries, regardless of size, conducted their trade and trade relations on the same basis. At least that was the pure theory. It was, and is, a well conceived design.

That structure was then qualified in various ways, qualifications that have grown in importance. Article XXIV, which sanctions free trade agreements and customs unions, departs from the mfn concept given that these arrangements are inherently preferential, that is to say discriminatory, in character. So too are developing country tariff preferences. The WTO still encompasses a few plurilateral Codes, such as the Government Procurement Code, that were first negotiated during the Tokyo Round and whose provisions apply between their signatories alone, not the WTO membership as a whole. Any of these measures, and others that involve discrimination of some kind or other, have the potential to generate tensions in relations between trading partners. It is a recurrent fact of international trade relations that WTO members have routinely managed and contained, notwithstanding occasional “trade wars”. In each case these arrangements can be justified because some greater good is advanced by a preferential linkage.

Trade Coverage of Regional Trade Agreements

According to the WTO in its most recent annual report the share of world trade within preferential RTAs could reach 50 percent shortly, a prediction that presumably rests on the successful completion of the negotiations for a Free Trade Agreement of the Americas and the still further enlargement of the European Union. Neither is a done deal. Even so, as things stand in excess of a third and possibly as much as half of world trade currently takes place within RTAs i.e. on a basis other than mfn. By way of comparison, last year Australia’s total exports represented 1.3% of world merchandise exports: Singapore’s export trade, excluding its entrepot trade, is equivalent to 1.6% of world merchandise exports. The WTO was notified of 19 new RTAs during the year, bringing the total number “notified and in force” to 159. (1) Other estimates put the number in existence at around 200.

The intensity of intra regional trade differs markedly between RTA’s. Approximately 60% of European Union imports and exports are intra regional, though the share of intra regional trade within EU has fallen by 3-4% over the past decade. With NAFTA 56% of merchandise exports are to other agreement countries; 40 % of imports are intra region, a disparity only explicable by the US trade deficit, now with China in particular: the respective percentages a decade earlier were 43% and 34%. In other words intra NAFTA trade has grown markedly as a share of total North American trade. Within the ASEAN (10) the share of intra regional trade is just under 25%.

RTAs, their Rationales, and Third Country Relations.

Regional trade agreements have many different rationales and to some extent the motive that drives them can be relevant to their likely affect on third countries.

The most important RTA, the European Common Market now the European Union, drew on a political vision that aimed to make the recurrently warring countries of Europe so economically interdependent that a future European conflict was inconceivable because it was impractical. Hopefully it has succeeded, especially as we've had to pick up some of the bill for that endeavour.

Arguably there must be a degree of foreign policy and "political" compatibility (using that term in its broadest sense) between the members of any RTA: just how much depends on the philosophical disposition of individual countries and how much weight they put on the pursuit of "foreign policy" as against "economic policy". It also varies with the proportion of the country's total trade it embraces and the degree of "deep integration" it adopts.

True free trade with a significant trading partner implies acceptance of economic interdependence and, these days, a "deep integration" that extends beyond border measures to harmonise the underlying economic policies. That close interaction requires broad policy compatibility and a high degree of trust in the outlook and international intentions of the other country, in shorthand terms, "political" trust. It comes with an expectation of persuasive influence in what are normally regarded as the domestic affairs of the other country. Even with an effective dispute settlement procedure built in, the agreement must still operate within limits that are acceptable to each participating country. In other words you are unlikely or unwise to enter into a commercially important, close, durable, intrusive, preferential economic relationship with a country that views the world in ways that are inimical to your interests economic philosophy or democratic and legal mores.

Major powers, like the US, take this concern for compatibility a step further than would we. The US refusal to include Cuba in the Free Trade Agreement of the Americas negotiations that are currently underway, illustrates the point. It is not valid to mention New Zealand in the same breath, but reservations about NZ's policy on nuclear ships is behind Washington's indifference to New Zealand's interest in an FTA. The US negotiated free trade agreements with Israel and Jordan with an eye to its foreign policy rather than its trade policy agenda. Presumably the same applies to its proposed agreement with Morocco, which President Bush recently implied had priority over an agreement with Australia, at least in the timing of its completion. Hence foreign policy can be an extremely important motivation for RTAs. However in most instances, once the compatibility box has been ticked, it can be taken as read by both parties. For reasons that I return to later, Australia should demote foreign policy in the list of considerations that motivate our pursuit of RTA's.

A second major RTA motivation has been for "strategic" trade policy. This was the US rationale for The Canada US Trade Agreement (CUSTA). For 40 years after Bretton Woods the US eschewed regional trade agreements. Its decision to negotiate with Canada (the Canadians would claim it as their initiative) in part reflected US dissatisfaction with the EEC and Japan's approach to US demands for "a more level playing field" in

international trade, a tension that came to a head at the infamous 1982 Ministerial Meeting of the GATT. The US had reached the point where it believed that the costs of European integration, partly manifest in European indifference to then existing US economic difficulties, were unacceptably high. Japan also was opposing liberalisation of its market notwithstanding the fact it had a massive trade surplus with the US. The Americans broke the logjam with a quantum shift in their trade policy: opting to pursue FTA's both as a means of trade liberalisation and to apply pressure to the multilateral negotiations. In other words the US believed the GATT needed a hurry-along and used the Canada US Free Trade Agreement and later NAFTA to provide it. European and Japanese readiness to progress the Uruguay Round improved markedly.

In addition, the US judged that as membership of the GATT grew, and national interests increasingly diverged, it could be more productive from its perspective to establish new trade rules within a bilateral context, then incorporate the established precedents into multilateral agreements. For example international rules for services trade borrow from CUSTA.

That remains a continuing US objective. In a speech to the Australian American Leadership Dialogue that met in Washington a few weeks ago, the US Trade Representative, Bob Zoellick said that:

“...an FTA would fit well into the larger trade strategies articulated by both Australia and the United States: to press forward with regional and bilateral trade initiatives while simultaneously advancing trade globally through the WTO and the Doha agenda. By moving on multiple fronts we can create a competition in liberalisation. We can develop successful models by adapting traditional trade agreements to meet new needs, such as e-commerce. We can establish higher standards in areas such as intellectual property- for example the protection of digital products- that we can then promote in other contexts. And we can make sure the trade system adapts efficiently and safely to address new challenges, such as facilitating customs checks while inspecting for dangerous materials. (2)

The OECD has recently been examining the relationship between RTA's and the multilateral trading system. Commenting on intellectual property rights for example, it notes that:

“to the extent that RTA's include these additional aspects they are pushing harmonisation forward at a pace that is greater than is apparently possible within the framework of the WTO. Such a result is not surprising as ‘it is often possible to achieve broad consensus on standards on the basis of commonality of interests associated with regional integration while in [multilateral approaches] interests are more divergent’.” (3)

Just as important for both the US, and Canada was to improve their domestic economic efficiency and productivity by liberalising bilateral trade.

Canada also saw a need to reduce the uncertainty generated for its trade by US contingency protection and import “safeguard measures”. Not only were existing measures tough and vigorously used, but the US Congress in the mid 1980's was in a

protectionist mood, and of a mind to toughen the already tough laws. Canada wanted, and partially achieved, arrangements that limited the impact on it of these measures.

Concerns to improve economic efficiency, and to pursue trade liberalisation beyond that on offer from the multilateral system, motivated one earlier FTA. Australia's Closer Economic Relationship with New Zealand was small as a share of global trade but architecturally it was very significant. Many of the concepts it pioneered were picked up and replicated in other FTA agreements, including CUSTA. Beyond question, the experience and conditioning that CER provided ensured that both business sectors were better equipped to tackle the profound trade liberalising economic reforms they separately pursued over the next two decades.

The motive that underpins any particular FTA can be very important in determining its effect on third countries. If an agreement does not preclude expansion of membership, if it does not inhibit trade liberalisation with other countries, if the main aim is to improve economic efficiency, enhance deep integration and business confidence, if it aims to add momentum for trade generated policy change, a regional trade agreement can be a stepping stone to wider economic liberalisation. There can be beneficial multiplier effects. However if an agreement has an overriding aim of generating political closeness then the interests of third countries tend to be discounted. For example EU policies up until the 1980's frequently had a strong protectionist tint as its members tried to link Europe at all costs. These days there is less evidence of that, though constant vigilance is required.

To put the RTA process in a less positive light, a defensive motivation is also applies. Arguably with an increasing amount of trade subject to FTAs, countries outside such agreements are vulnerable even if border protection levels are low or zero. MFN suppliers do not have the same certainty of access, particularly if temporary import restrictions or other safeguard measures are ever adopted. It is very hard to quantify the economic effects of such uncertainty but its impact, especially on the direction of investment over the longer term, is likely to be considerable. Again the effects of this process may be incremental rather than abrupt. Countries outside RTA's have to consider whether to enter into equivalent arrangements to avoid being at a disadvantage.

For Australia to justify a free trade agreement with the US or any other country on "political" or "foreign policy" grounds would be unwise. Australia should base its judgement on whether any agreement we've struck advances our trade and economic interests. In the event we may decide it doesn't, and not ratify it. So may the US.

For many reasons it is important to avoid as inextricably link the trade and wider strategic relationship with the US. Beyond question foreign policy and strategic compatibility will be important for the US, a precondition for any FTA negotiation to commence. However in no sense will the approach we adopt on individual foreign policy issues "buy" the agreement of the US Congress to the outcome: for individual Congressmen that judgement will likely be made for parochial special interest and economic reasons.

From Australia's perspective the more foreign policy and "political" considerations motivate the negotiations, in other words the less the extent that trade and trading opportunities are central, the less national flexibility we will have to settle similar deals with other major trading partners. We will need that flexibility given we have a wide spread of other important trade relationships. In that respect Australia differs from a

country like Canada, whose trade with the US dwarfs its trade with other countries. If the Australia US negotiations don't get off the ground, or if they don't reach a successful conclusion, we do not want that to cause irreparable damage the wider bilateral relationship, a risk that increases the more the negotiations are presented as being crucial for strategic or similar reasons.

Regional Agreements and the WTO.

The spread of RTA's is pressuring the multilateral trading system. The WTO concludes that "the global trading system looks more and more multitiered, with a variety of less than global trade initiatives engaged in preferential trade liberalisation and policy negotiations, in parallel to the efforts pursued within the MFN framework... The regional option has become an attractive tool for virtually all WTO members managing their trade policies alongside multilateral trade negotiations." (4)

Any RTA generates a valid concern about the balance of trade creation versus trade diversion that results from it. The WTO's way of exercising quality control over RTA's is to set criteria that require them to eventually cover "substantially all" of the bilateral trade between the two countries, a formulation that leaves considerable scope for debate. Also required is transparency as to their measures (eg rules of origin) and neutrality between non parties' trade.

Any newly established RTA is examined by a WTO panel. In the words of the WTO this process "has enjoyed no success so far in assessing the consistency of the more than 100 RTAs notified to the WTO due to various political and legal difficulties". (5)

Nevertheless as these agreements spread it is extremely important that they involve genuine liberalisation and the domestic economic adjustments that flow from that. Amongst the proposals for reform, and as a way to improve the compatibility of RTAs with the multilateral system, Australia has proposed empirically determining whether any RFA meets the key criteria of encompassing substantially all trade: it does so by requiring a set percentage of tariff lines to be covered by any agreement. It is typical of Australia that we should be simultaneously seeking to negotiate FTAs, and to tighten the international rules that apply to them. Australia has not yet proposed what the percentage of tariff lines should be, possibly waiting for the conclusion of our FTA negotiations before filling in the blanks, a mixture of principle and pragmatism.

The bottom line for Australia is that there is such a strong current running for RTAs. We will not significantly influence that whether we opt in or opt out of negotiating such agreements. You could mount an argument that if there is to be a tightening of the multilateral rules governing RTA's, and a harmonisation of the concepts and provisions they use, we may have marginally more influence by being within "the group" than being outside.

The use of FTA's to cover new trade issues and to develop new disciplines is less worrisome than the implications for traditional merchandise trade. Arguably the US has always sought, and generally succeeded, in moulding the international rules of trade to meet its particular needs. It succeeded directly with the original design of the GATT, and specifically with the concept of unconditional mfn. In those days Australia too was able to sneak the odd provision into the GATT text that met our requirements, for example in

relation to international commodity agreements. That has become harder with time. As mentioned, one US response was the move in the Tokyo Round to plurilateral codes, discriminatory to the extent that their membership was limited: the use of the FTA process is the latest technique and arguably one that in some areas could suit Australia. The designs developed in one FTA are frequently adopted by others, and at times by the multilateral system. The US at times borrowed from CER when developing CUSTA. We are more likely to be able to influence international trade concepts and architecture in one on one negotiations, than we are to get our way multilaterally: and there can be a dividend from being both architect and builder.

Asia-Pacific and Regional attitudes to RTA's.

Asian countries have been the least inclined of any to enter into RTAs generally able to rely on sheer competitiveness and mfn liberalisation. Less positively, many regional countries have been reluctant to give internationally binding trade commitments on any basis, mfn included. With the exception of Singapore, ASEAN countries even though longstanding members of the WTO, have fewer mfn bound industrial tariffs than, say, equivalent South American nations. Even absent East Timor sensitivities, Australia's attempt to embark on exploratory discussions with ASEAN would have almost certainly run into difficulties given reservations about binding commitments with developed countries.

Attitudes in Asia toward RTA's are now changing. As a trade policy initiative, an Australia US Free Trade Agreement may have been epoch making if we had embarked on it eighteen or so years ago when the idea was first mooted: not today. The WTO Annual Report for 2002 notes that:

“In Asia-Pacific, 2001 was a threshold year with respect to RTA activity, both among countries in the region and between them and other parts of the world; some countries clearly shifted their longstanding policy of mfn only trade liberalisation to actively consider the regional option. Japan finalised RTA negotiations with Singapore, launched negotiations with Mexico, and formed a study group to consider the feasibility of an RTA with the Republic of Korea. Likewise, the Republic of Korea started negotiations with Chile and has been exploring the possibility of negotiations with Mexico, while conducting feasibility studies on RTAs with Japan Thailand and New Zealand. The members of ASEAN moved toward their objective of achieving a free trade area by 2005; most tariffs will be cut to 0-5% by 2002. Singapore is forging links with a number of its trading partners: in 2001, it concluded an RTA with New Zealand (in force since January 2001) and it held negotiations on RTAs with Australia Canada, EFTA States, Japan Mexico, and the United States. Similarly Thailand, another member of ASEAN, has been exploring prospects for negotiating bilateral RTAs with Australia, Croatia the Czech Republic and the Republic of Korea. New Zealand has agreed to launch negotiations with Hong Kong, (China); New Zealand's CER partner Australia is considering RTA negotiations with the United States. The most notable development in the region, however, has been the agreement between ASEAN members and China, to initiate RTA negotiations. Japan and the Republic of Korea are also exploring the possibility of similar negotiations with ASEAN.” (6)

Certain of the developments cited by the WTO are less than fact. For example the idea of an agreement between Japan and Mexico is still at the assessment stage. However a recent joint study, staffed on the Japanese side by METI, Finance and Gaimusho officials at the “decision making” level, recommended that::

“the members of the Joint Study Group shared the view that Japan and Mexico should proceed with liberalisation in such areas as trade in goods, investment, trade in services and government procurement, as an effective measure for strengthening bilateral economic relations. As to specific steps for liberalisation members of the Joint Study Group reaffirmed the importance of trade liberalisation in the WTO for both Japan and Mexico, but further concurred in recognising that an early conclusion of an FTA is the desirable and effective instrument to advance such liberalisation. Given that the current situation in the said areas requires prompt solutions, an FTA will enable both countries to put the mutually complementary characteristics of their economies into full play in a prompt way while taking into consideration the domestic interests and sensitivities of each other. Further the members concurrently recognised that, considering the urgent need to solve some of the existing problems, it is desirable to consider the adoption of individual liberalisation measures as soon as possible.” (7) (8)

AFTA’s progress toward further liberalisation is uncertain and chafing against national sensitivities, most notably Malaysia’s determination to develop a motor vehicle industry behind solid levels of protection. One should also assume that many of the foreshadowed negotiations will run into the sand. Japan and the US for example have mused about the possibility of a bilateral FTA, then consigned it too the too hard basket largely because of the difficulties over agriculture, an issue that will bedevil Japan’s attempts to negotiate technically credible FTA’s, even more than it weighs on their authority in the WTO. All of that acknowledged, the readiness of regional countries to pursue RTAs is obvious.

To widen the geographic net from East Asia to the Asia –Pacific as a whole, the US has FTA’s with Canada, Mexico, Israel and Jordan. As President Bush made clear when signing the Trade Promotion Authority into law a few weeks ago, Washington’s priority is to:

“move quickly to build free trade relationships with individual countries such as Chile, Singapore and Morocco. We’ll explore free trade relationships with others, such as Australia. The United States will negotiate a Free Trade Area of the Americas and pursue regional agreements with the nations of Central America and the Southern Africa Customs Union.”

The exact status of the 34 country FTAA negotiation is difficult to judge. Economic and political developments in Latin America suggest it is unlikely to be completed within the scheduled timeframe (2005). However it will remain a longer term aim of Washington. If the comprehensive FTAA agreement is not negotiable, US may well try to enter into bilateral agreements or negotiate with smaller Latin American groupings. President Bush puts particular store in this region, and this objective.

Canada, Chile and New Zealand are basically on offer to negotiate FTA’s with any country that may be interested and is prepared to liberalise. Canada has basically run an “open book” and stands ready to negotiate FTA’s with other trading partners if they are

interested. It has long suggested the possibility of a bilateral agreement with Australia. While the negotiations would be difficult, there would be advantages to negotiating with Canada in parallel to negotiating with the US. Mexico has concluded FTA's with countries that in total account for 60% of the world's GDP including the US and Canada under NAFTA, the EU, EFTA, Israel, and some Latin American countries.

Australian Trade with the Asia Pacific region.

Asia remains by far the most important destination for Australian merchandise exports, taking some 53% in 1999-2000. That figure is up from a decade earlier, but down over the past five years as Australia has redirected exports away from Asia after the Asian economic crisis. In 1999-2000 North-East Asia accounted for 40% of total merchandise exports, ASEAN (7) for 13%.

Over the last decade the most dramatic shift in the direction of our merchandise exports has occurred within the Asian region. Japan's share of total Australian exports fell from 26% to 19% between 1989-90 and 1999-2000. Over the same period, China's importance rose. (9) Looked at from the other direction Australia's (and New Zealand's) combined share of Japan's merchandise imports fell from 5.8% to 4.5 % between 1993 and 2000 (10) The adjective usually used to describe Australia-Japan trade, "interdependence", is becoming less apposite.

The United States took 11% of Australian exports in 1989-90: 10% in 1999-2000. Over the past five years Australia's merchandise exports to NAFTA countries have grown at an average of almost 15% per annum; to ASEAN at 1.8% per annum and for North-East Asia as a whole 4.3% per annum. The United States is by far the largest single supplier of merchandise imports to Australia accounting for 21% of our total imports, down 3% on a decade earlier.

Again the most dramatic shift affecting our import trade is the relative decline in Japan's position as a supplier of the Australian market. Over the decade, its share was down from 19% to 13%. ASEAN and China's position as suppliers grew (up from 6% to 14% in the case of ASEAN and 2.4% to 6.8% with China). Australia's strongest flow of private investment is with the US.

Australia consistently runs sizeable trade surpluses with Japan and Korea and a massive trade deficit with the United States. The latter situation has applied for decades even though the US itself has incurred massive global merchandise trade deficits, some \$US 430 billion this past 12 months alone.

Australia's services exports and imports were roughly in balance, totalling \$57.9 billion in 1999-2000. The United States was the largest importer and exporter of services to Australia taking 16 percent of our exports and providing 21% of our imports. Japan, the EU, and ASEAN are all important markets.

Over the decade 1990-2000 merchandise exports from North America to all destinations grew on average by 7% per annum; those of Asia by 8% per annum with Japan's exports only growing at an average rate of 3% per annum. With imports, North America's average rate of growth was 8.5% per annum for the decade; Asia's 7.5%. Again the Asian figures are averaged down by Japan, whose growth for imports was 5.5% over the

decade. (11) With global services trade the growth both Asian and North American trade trends have been similar: exports and imports growing at around 7-8% per annum on average. Again the subplot within Asia is extremely low rates of growth for Japan, extremely high rates of growth for China. (12)

Between 1993 and 2000 North America's (US and Canada's) share of world exports rose marginally (from 16.8% to 17.1%). For Asia as a whole, the share of exports also edged up (from 26.3% to 26.7%) but again with a marked drop in Japan's share (from 10% to 7.7%) and an increase for China. Asia's share of world imports fell while North American imports rose from 19.8% to 23.2% courtesy of the American consumer. Australia therefore remains heavily dependent on Asian markets for our exports.

Regional reactions.

What would be the likely reaction of regional countries if Australia and the US were to negotiate an FTA? Ross Garnaut in a paper published earlier this year argues that:

“the main cost to Australian-Asian economic relations of seeking to negotiate a free trade agreement with the United States, is that it enhances perceptions in Asia that Australia sees its interests mainly outside the region.... In the scramble over possible preferential arrangements in East Asia at present, there is discussion of agreements that would exclude Australia. The point is simply that it would be better to be inside than outside East Asian discussions of trade and strategic matters that effect Australian interests, and we are more likely to be left outside if we are perceived to be strongly oriented towards North America rather than East Asia in our international policy. Our alliance with the United States is known and understood, but other countries perceptions must be managed closely if the alliance is not to impose unnecessary costs on East Asian relationships. The management problem would become more difficult if we were seen to discriminate in favour of the United States and against East Asian partners in trade policy.” (13)

As already outlined, the trade policy climate in the region is such that these days another bilateral FTA negotiation is not excessively newsworthy. The possibility of an Australia US FTA has been mooted for close to two decades. It scarcely comes as news to any country in the Asia Pacific region that Australia and the US see themselves as politically close, an alignment that applies regardless of which political party is in government in Canberra or Washington. Nor as a straight trade policy assessment, would it seem other than logical for us to advance our interests in the US market and seek more secure access. The existence of NAFTA already mandates that, as does the expectation of early US agreements with Chile and Singapore and the possibility of an FTAA. Again relevant is that other regional countries are themselves negotiating FTAs.

At a more abstract level there are two competing designs for the Asia-Pacific region. The Australia's preferred concept, embodied in APEC, is that the interests of the region are best served by involving the two sides of the Pacific, the Americas and East Asia, in common pursuit of economic growth and strategic stability. That concept explicitly projects Australia's view of the desirable economic and strategic balance. APEC retains its Bogor objective of achieving free trade in the region by 2010/2020 but progress in that direction is at best tenuous and is not been driven by the internal dynamics of APEC but

rather by positive national initiatives: China's membership of the WTO is the most significant. Australia's close interaction with the US is totally in keeping with that regional design.

To some extent the Australian approach is competing against a concept, most regularly put by Malaysia, which asserts pan-Asian nationalism and which wants to see Asia alone taking control of its future. There are very good grounds for all regional countries having reservations about this approach and the narrowness it promotes.

Quite aside from that Australia's perspective is affected by our inability to secure a presence in arrangements with this philosophical underpinning, notwithstanding the best endeavours of countries like Japan. Respect for consensus decision making, especially within ASEAN adds to our difficulty, as does the attitude of individual countries on specific issues; Indonesia's coolness post East Timor and ongoing Malaysian hostility being factors.

Hence the region has kept Australia at arms length from some of its important, though not necessarily prudent, policy initiatives. Exactly what ASEAN Plus 3 for example means in either the international financial or the trade fields is unclear. What is clear is that the starting point is regionally narrow and that there is no consensus in favour of Australian participation.

A valid response to this situation is to 'create our own weather' and pursue beneficial agreements where we can, with the US for example. If the circumstances fit we should follow suit with individual countries in the region. Thus the importance of the agreement with Singapore, quite aside for the important commercial objective of seeking liberalisation of the Singaporean services market. It is crucial that we be prepared to engage in sequential trade liberalisation with regional countries subsequent to the conclusion of an Australia-US agreement. The more we make effective bilateral progress, particularly in Asia but not necessarily limited to it, the more other countries will want to interact.

As a "recovering" diplomat, I am extremely wary of concrete policy actions being taken or avoided so as to address international perceptions. Trying to calibrate policies according to whether they will beneficially influence others "perceptions" is akin to trying to shovel smoke. Policies need to address concrete decisions in the national interest. Clearly Japan does not see regional perceptions as crucial to whether or not it strikes a deal with Mexico. What affects perceptions is our economic performance, our ability to logically define our national interests from a long term not a transient or party political viewpoint, and to explain them persuasively in Australia and abroad. The latter brings into play the effectiveness of our diplomacy. (That said, it would be very adverse for regional perceptions for us to embark on a negotiation with the US, and fail). Australia can't be seriously accused of turning its back on the region. APEC and innumerable specific purpose bilateral relations are one aspect of that. Australia explored the possibility of FTAs with ASEAN countries and was rebuffed.

If any regional country has a problem with Australia negotiating an FTA with the US it has been very quiet about it in public, (and as far as I can gauge in private as well). Not surprising given the situation described. Implicitly there is no concern on China's part that Australia may fail to take due account of the region. It has just signed up for a \$23 billion

natural gas contract clearly knowing Australia's thinking on a possible FTA with the US, at least as well as any of us here.

Retaliate or negotiate?

Beyond question a FTA with the US does create the possibility of generating sensitivities for our important regional trading relations. In essence it will give the US preferences in the Australian market, of variable commercial significance, over our number one customer, Japan. Potentially we might face the equivalent situation in Japan (depending on the specific provisions) if a Japanese-Mexican agreement sees the light of day. We have to have a clear and coherent strategy for handling both possibilities. The sensitivities can be managed.

The WTO obviously provides a logical starting point. Certainly the Doha Round gives Japan, China, Korea, whoever, a ready made context to negotiate on any perceived disadvantage that may arise from an Australia-US FTA.

Further if Australia can conclude a deal with the US, we should be open to negotiating FTA's with regional countries so long as they are able to accept equivalent, comprehensive, liberalisation and engagement. The effect of the second generation of FTA's, ie those pursued post NAFTA, has been to give a multiplier effect to sequential liberalisation over and above the outcome of multilateral processes. We should regard that as an inevitable consequence of initiating negotiations with the US. That is one reason that a negotiation with the US shouldn't be pursued for non-economic reasons: once concluded, its supposed uniqueness will likely be eroded by the reciprocal negotiation of additional concessions with other trading and investing partners, a step that both Australia and the US are likely to follow and should accept.

There has been speculation that countries like Japan will retaliate against Australia. Their reaction is far more likely to negotiate with Australia than to retaliate. The evidence on this is consistent. There has been no evidence of retaliation against Canada (and we were probably the country that had a score to settle) post Nafta. Both the European Community and, possibly, Japan have been moved to negotiate FTA's with the likes of Mexico after the latter concluded NAFTA. Singapore has been wooed by half a dozen other countries wanting, and concluding, FTAs, their agreement with one country triggering requests from others. Singapore's experience is similar to that of Chile and Canada.

A similar observation on the dynamics of trade negotiations applies to APEC. APEC's great contribution to liberalisation so far has been its effect on the dynamics of the Uruguay Round. The commitment of APEC countries themselves to the Geneva outcome was one aspect of that. Importantly, the establishment of APEC also disconcerted the European Union, causing it to get serious about concluding the Round negotiations. To some extent the beneficial effect rubbed off once the EU established that APEC's focus was MFN not preferential based trade liberalisation, but its uncertainty lasted long enough for APEC to earn its keep.

Japan, like China and Korea, will always have an eye to maintaining diversity of supply for industrial raw materials. It is highly improbable that Japan will take umbrage at an

Australia/US agreement if only because the starting point for Japan is that most alternative suppliers to Australia are either in, or negotiating to be in, similar RTAs. In some respects existing bilateral treaty arrangements give Japan means of redress, at least as relates to the non trade elements, narrowly defined, of an FTA. They do the same for Australia if Japan enters into FTA's. This most specifically applies to investment. The Basic Treaty for example provides for mutual de facto mfn treatment for investment, and while the lawyers would no doubt quibble, FTA provisions relating to investment would not be an exemption from that commitment.

Also in the main Australian tariff levels are now low and still coming down. Most regional countries enjoy tariff preferences by virtue of the GSP. In industries where Australian tariff peaks apply, for example on motor vehicles, it is difficult to gauge where either the US or Japan would stand, their attitude to the arrangements traditionally being ambiguous, influenced by investment considerations as much by trade per se. Australia has not chosen to react to AFTA, nor to our exclusion from the Europe-Asia talks. If Japan and Mexico do strike a deal we will have to assess how it affects our interests.

Retaliation is a very slippery slope: you make life very difficult for yourself if you try to make life difficult for others. Japan is far more likely to negotiate...or to invest.

On one specific commodity it has been argued that:

“trade diversion would put at risk the fruits of nearly two decades of careful trade diplomacy directed at securing open and non discriminatory access to the Korean and Japanese beef markets, and unwinding past trade discrimination in favour of the United States.” (14)

It's worth examining the beef issue, simply as a test case. Beef was a target of Japanese discrimination in favour of the US in the mid 1970's to mid 1980's. True, the US pushed for discriminatory quotas in the Japanese beef market in the early 1970's to our disadvantage...and succeeded. However later the US had a change of heart. Both we, and they, pushed Japan to comprehensively liberalise its beef import trade in the late 1980s on an mfn basis. To our surprise, and rather to their own, the US kept to that. (15)

For Japan to discriminate against Australian beef in the event of an Australia-US FTA would see it moving against one FTA partner in favour of another. That's very unlikely. With an FTA, Australia would be much better placed to pressure the US not to accept discrimination to our disadvantage than we would otherwise be. Virtually any alternative source of beef, the European Community (probably out on health grounds in the short term) or Latin America will be following an equivalent trade policy equation to Australia. In short there is no logic in Japan pursuing discrimination against Australian beef. About the only circumstance in which it is conceivable, is if Japan and the US negotiated an FTA, and Australia was outside any similar configuration.

Australia-US relations: some cautionary comments.

Slightly outside the ambit of this session but negotiating an FTA runs its own risks for Australia-US bilateral relations. Trade disputes, most notably in the mid 1980's, have seriously strained and caused rancour in public attitudes to the bilateral relationship. Most Australian's still recall what EEP stands for. There will be issues under negotiation

that will receive a very bad press from many Australians. This is one reason for maintaining a few degrees of separation between our foreign and defence relations and our trade relations. It would be a mistake to imagine that we can “buy” an FTA with the US through our stance on international issues.

Hence it is important to regard these negotiations as economic negotiations, distinct and separate. The political compatibility box was ticked long ago: the trade compatibility box remains to be filled. Ironically the very magnitude of the trade imbalance between Australia and the US, in the latter’s favour, reduces the apparent benefit in the eyes of Congress of having an agreement.

The negotiating process will be both protracted and difficult. Agriculture will be only one of the tough areas. To the extent that one can read between the lines, the proposals the US has tabled on agricultural reform in the WTO suggest that the sensitive areas it has been unwilling to liberalise in the past, remain just that. Because of that, the negotiations need to be very carefully managed.

The US will probably intertwine its negotiation with Australia with those involving the FTAA countries, as there will be competing bids for market access in a situation where total liberalisation is unlikely. Both countries are then likely to replicate or extend concessions agreed in the FTA bilaterally or in other contexts. We will need to be looking over our shoulder at the implications for our domestic policy prerogatives, for our position in the WTO negotiations and for our trade relations with third countries.

An FTA will beneficially focus US business attention on the possibilities of investing in Australia. Arguably the greatest single benefit from an FTA for Australia is if firms invest here to produce products and services for the US market. To date Australian firms with good products and good skills, balk at the magnitude and the risk inherent in gearing up production to meet US market requirements. Even with very low border protection, investment diversion remains likely if one country is subject to the full impact (arguably the magnified impact) of US import safeguard measures while another is exempt. Removing that disadvantage will be a major benefit to Australia.

Anyone imaging an FTA will lead to general public awareness in the US about Australia is in for disappointment. Canada and the US live cheek by jowl. The bilateral trade flow is \$A3 billion a day: the biggest bilateral trade flow in the world by a considerable margin. Two way investment is massive. Yet as someone who has recently spent four years in Canada, and travelled extensively in the US during that time, I was constantly pulled up short by the US lack of knowledge about, or interest in, matters Canadian. The Canadian elections were underway as I travelled across the US en route to Ottawa in 1997. Until the day before the election the sum total of all the coverage in the major US dailies was three column inches. My personal polling suggests that few residents of northern New England States, a few hours drive from Ottawa, know the capital of Canada.

Canadians themselves are expert in matters American, knowledgeable about the complexities of the US political system. They bring detachment and hard nosed experience to their bilateral dealings: for example they don’t feel a need to identify with the US on each and every foreign policy issue. If anything they incline to the opposite, except when the game really gets serious, such as the Gulf War. Australians likewise,

will become far more knowledgeable about what makes the US tick and the nefarious mechanisms of power in Washington. We will probably become more litigious. Peter Lloyd noted (16) that Australia and NZ have never taken each other to the WTO over a bilateral trade dispute. Canada and the US routinely do so, and use the dispute settlement processes of NAFTA as well. A few months ago the Canadian Cabinet allocated \$C20 million, simply so Canada could try to publicise its side of a dispute over softwood lumber in the US. All this is there to look forward to.

Footnotes.

(1) World Trade Organisation Annual Report for 2002. Page 112.

(2) A Pacific Partnership: Australia and America in a Globalising World. Robert B Zoellick. US Trade Representative. Washington DC July 10 2002.

(3) OECD Trade Committee Working Party. "The Relationship between Regional Trade Agreements and the Multilateral trading System: Intellectual Property Rights". OECD Document TD/TC/WP(2002) 28/FINAL

(4) See WTO Annual Report 2002 Page 114.

(5) ditto

(6) ditto page 113.

(7) Japan-Mexico Joint Study Group on the Strengthening of Bilateral Economic Relations. July 2002.

(8) A sense of the rationale for the recommendation comes through from the following extract.

“The Joint Study [Mexico Japan] Group concurred in recognizing that there is an urgent need for both countries to improve the following situations restricting the development of Japan Mexico bilateral trade and investment.:

1) Japanese enterprises are placed in a disadvantageous position with regard to tariffs, compared to their US/European counterparts as a result of Mexico’s conclusion of NAFTA in 1994 and the Mexico-EU FTA in 2000. At the same time, Mexican government extends preferential treatment to the countries with which it has concluded FTA’s in the area of trade in services, investment and government procurement.

2) the further opening up of their respective markets will contribute to the economic growth, and job creation in both countries and, especially for Mexico, to the diversification of exports.

3) ...”

(9) See Department of Foreign Affairs and Trade: Direction of Trade Time Series 1979-1980 to 1999-2000.)

(10) See WTO World Trade Statistics 2001

(11) WTO World trade Statistics 2001 Table 1.2.

(12) ditto Table 1.4

(13) R. Garnaut. An Australia-US Free Trade Agreement. Australian Journal of International Affairs Vol 56 No1 pp123-141 2002

(14) ditto

(15) At the conclusion of the beef negotiations with Japan I had an exchange with the then US Secretary of Agriculture, Dick Lyng, who I had been consistently lobbying with ill disguised concern that the US may accept, or push Japan to revert to, discrimination in its favour. He commented to me “we surprised you didn’t we”: I replied “you surprised yourselves”. He laughed, tacitly acknowledging the point.

(16) P. J. Lloyd. An Australian-US Free Trade Agreement-Opportunities and Challenges: CER Lessons. Canberra 21 June 2001.

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