



Worth Noting

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Worth Noting is the fortnightly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.

On the face of it a proposed free-trade agreement 'sometime in 2004' with the U.S. seems compelling. The U.S. is the U.S. The country is the most powerful economic force in the world, global markets rise and fall depending on what happens in the U.S. and it would seem better to work with them rather than against them.

More particularly, the U.S. is our second biggest trading partner, our largest single market for traded services, our single largest foreign investor, and an important partner for new technologies and intellectual property.

In addition, the path toward a free-trade agreement has already been laid. The Australia-U.S. relationship is already underpinned in economic and commercial terms by an existing Trade and Investment Framework Agreement (TIFA). TIFA provides for consultations between trade ministers between the two countries on multilateral, regional and bilateral issues in trade, commerce and investment.

This all seems good doesn't it? Australia and the U.S. forging closer and more advantageous trade agreements, better access to a huge market for our exporters, and perhaps even a more attentive ear for us to whisper to when we do have problems or issues with economic actions by the U.S.

Why then has there not been overwhelming enthusiasm for a free-trade agreement with the U.S.? In this edition of *Worth Noting*, we consider what FTAs and this particular AAFTA might mean (or conversely what the AAFTA does not mean) and issue a few reasons why the mere announcement of an intention to form an AAFTA should not automatically mean better times ahead.

What Does an AAFTA mean?

In the 2003 White Paper on Foreign and Trade Policy, the Australian Government signals the AAFTA as an effort to make the economic relationship comparable to the security relationship with America. The underlying method of doing so: *trade liberalisation*.

In a speech delivered in October 2002, Australian Trade Minister Mark Vaile cited the straightforward objectives related to trade liberalisation:

- The attraction of additional American investment to Australia, with consequent positive effects on employment and productivity.
- Greater integration of business in the two markets, enabling new synergies in areas such as research and development, materials sourcing, marketing and the use of IT.
- Using the AAFTA to foster “competitive liberalism” though its demonstrating effects in the World Trade Organisation (WTO) and other trade fora.
- Engendering a broader appreciation of the bilateral alliance and the role of the two countries in underpinning stability and prosperity in East Asia and the Pacific.

A few things are worth noting about this. First, the ‘T’ word – ‘tariffs’ – was not mentioned at all even though this is what many people associate with any FTA. Second, the AAFTA is not just about having the unfettered right to sell our products to the American market; it is largely about creating synergies between the two economies. Third, any FTA is about entrenching the liberal view of international economics – state borders should not be an automatic defining barrier to doing business. Nor should state borders be an excuse to stifle genuine competition. And finally, any AAFTA is complementary to WTO priorities, not in lieu of them.

All these objectives are very general ones. In themselves, they do not tell us very much. They are necessarily general for a number of reasons:

- (a) No details have really been agreed upon yet.
- (b) FTA might sound like broad sweeping agreements on principle but they hardly ever are. They are usually messy, complicated agreements on bits and pieces of the economy that subscribe only to arbitrary time frames and ad hoc principles. Hence, objectives of FTAs tend to be phrased very generally so they can cover all kinds of eventual specific agreements.
- (c) Politically powerful lobby groups on behalf of certain industries will always be influential. Neither government really wants to get into

political trouble by promising specific measures before the political fallout is assessed. Hence, the propounding of general objectives.

Like most things, then, the meaning (or perhaps the devil) is to be found in the detail. Both countries have signaled a desire to undertake a 'comprehensive' review of trade relations.

'Comprehensive' here does not mean that all industries in all sectors will be covered in the final agreement. What it means simply is that there are no sectors or industries that are off limits for discussion. It does not mean there will be agreements across all sectors and industries. For example, the Business Council of Australia has gone on record in their submission to DFAT that they want to see ALL barriers to trade and investment removed within ten years, mutual recognition of professional qualifications affecting trade in services and in technical standards concerning goods trade, and free movement of people and safeguards on security of access to markets. We can confidently bet that this is much more than what will eventually happen.

Many economists, bureaucrats and business leaders have forecast what they believe will make up the detail of any AAFTA. We do not have the time to go into this. Besides, this would be not much more than guesswork that will at best ask more questions than give answers and at worse mislead.

Before we continue, let us quickly cast doubt on some of the claims of an AAFTA by the Government such as:

- Net economic welfare gains over 20 years of about US\$20.1 billion, shared evenly between the two countries.
- A four percent (about US\$2 billion) increase in Australian GDP by 2010, with a cumulative benefit over 20 years of about US\$15.5 billion.
- A 0.8% overall rise in Australian exports by 2006.

These claims are largely based on a CIE Report¹ and are quoted freely by the Government. The problem is that besides using statistical and economic modeling assumptions that are far from widely accepted, the report basically takes on the highly unrealistic assumption that all barriers to trade and services would be removed. There is no point, in our view, making that assumption for two main reasons:

1. The removal of all barriers simply won't happen.
2. The whole debate about the pros and cons for an AAFTA is anticipating who the winners and losers will be, which sectors will remain protected and which won't, and therefore whether Australia will benefit overall or we won't in the long and short term. To assume the removal of all barriers is to deny the very basis for debate and concern.

¹ Centre for International Economics, *Economic Impacts of an Australian - United States Free Trade Area Idea*, 2001.

It is now time to look at the key considerations of any FTA.

Australia & U.S. Trade Relations

We must be clear how insignificant we are to the U.S. in terms of pure business size.

For example, the U.S. supplies one third of all foreign investment into Australia, the largest by far of any country. Conversely, over fifty percent of our foreign investment is in the U.S. but this represents only one percent of foreign investment in the U.S.

Moreover, we are only ranked 32nd as far as an exporter to the U.S. in dollar terms is concerned.

The U.S. is therefore very important to us but we are not so important to them.

This immediately means that the bargaining positions of the two countries are enormously unequal. This further means that agreements in areas of existing conflict between U.S. and Australian markets are unlikely to be resolved in our favour.

The best example is trade in primary products, especially agriculture. If our Government could pull off a favourable agreement with the U.S. in this area, that would be something really worth noting. But the chances are that they won't.

The key is to pull off a *favourable* agreement, not just any agreement. For example, if we take the example of Latin America, countries in this region are finding subsequent FTAs with the U.S. a mixed blessing at best. Under the terms of their FTA's these countries have agreed to open up their agricultural product markets to US subsidised imports. As a result, in some cases, their own agricultural industries have been destroyed. We have not heard anything about this in our FTA negotiations with the US, but if we are not careful we may find ourselves - like the Latin Americans - committed to opening up our unprotected agricultural industries to subsidised US imports. Potentially, that could be much more damaging to Australia than anything we may have to gain from selling more of our product to the US.

Another example of glass barriers in a likely FTA concerns so-called "rules of origin". In an FTA, the benefits of preferred access to the U.S. market for Australian goods will only apply to those judged to be "Australian" according to U.S. rules of origin. Effectively, this term measures how much of the contents of the goods are actually made in Australia. The U.S. requires a much higher percentage of "local content" than does Australia in any goods it will permit entry

from the U.S. under the preferential FTA. Here again, unless we can get some balance into these arrangements, Australia could be seriously disadvantaged.

There are countless examples from all sectors and all industries where the benefit or harm of any FTA is in the detail. The problem we have is that we do not have a great deal of bargaining power. Moreover, even though the grand announcement of an AAFTA sounds good, we suspect that judging by the political desire of the Government to announce a possible agreement sooner rather than later, not a great deal of thought has been given to what will actually happen at the negotiation table: what strategies and tactics the U.S. will use, where their priorities will lie, what we (and our rivals) have to offer them.

Bear in mind that the U.S. is clearly putting their fingers in many pies. The agreement by 34 North and South American countries to form a Free Trade Area of the Americas (FTAA) by 2005 has immense ramifications for any future AAFTA. Several of Australia's strongest competitors in primary products are among the FTAA countries and will compete intensely with Australia for preferential treatment by the U.S. Are we more important than 33 other North and South American countries to the U.S. as far as trade is concerned? It seems unlikely.

AAFTA and the WTO

It is clear that neither side wants any bilateral trade agreement to be inconsistent with WTO stipulations and agreements. Why? Because there are huge advantages in having an established trade system that major countries buy into. This creates not only a framework for agreement, but more importantly, a framework for disagreement and the handing out of sanctions. In other words, dismantling the effectiveness of the WTO would create a more chaotic trade system and the devil we know is seen as better than the devil we don't.

For Australia in particular, a top priority in the medium-longer term is to eliminate tariffs on agricultural products globally. This will only ever be done through the WTO, not through dozens of individual agreements with different countries. Hence, maintaining the effectiveness of the WTO system remains the top priority.

What bilateral FTAs tend to do vis-à-vis the WTO is create 'benchmarks' that can be applied in a global context. For example, the agreement between Australia and New Zealand in ANZCERTA to open services markets set a benchmark for the negotiations in the WTO Uruguay round.

In this sense, if Australia can manage to negotiate genuinely liberalising agreements in, say, agricultural trade, this not only benefits our agricultural trade to the U.S. but also introduces a model for future WTO rounds to proceed. This would probably ultimately benefit Australia.

Conclusion

The key question with any AAFTA is ultimately: what's in it for the U.S.? They hold almost all the aces.

While we are generally supportive of an AAFTA, we recognise that the mere intention to form a FTA means very little. It might be a political gesture of good will but multiple rounds of hard, frustrating negotiations are still to come. Moreover, we must ask whether we are ready to negotiate a FTA with the U.S. Has the Government really done the homework required for sitting at the negotiation table?

We wouldn't yet hold our breaths for a world of unrestricted trade with the U.S. We would also be sceptical of the claims made by the Government as to the benefits because we don't even know what the terms are yet. Indeed, the reality and gains are likely to be much more modest than they suggest.

It is worth noting that FTAs can mean very much and can also be meaningless. They sound good for Governments but international economics is littered with FTAs that do not deliver.

The morale of this edition: Don't get caught up in the rhetoric of grand sounding pacts like an Australia-American-Free-Trade-Agreement. Stick to the cold, hard detail to come.