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**THE GOOD, THE BAD AND THE UGLY:
ASSESSING CRITICISM OF THE AUSTRALIA-
UNITED STATES FREE TRADE AGREEMENT**

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**The Good, the Bad and the Ugly:
Assessing Criticism of the Australia-United States Free Trade Agreement**

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Negotiations on an Australia-United States Free Trade Agreement (AUSFTA) were completed in February this year, and the agreement was signed by Trade Minister Mark Vaile and US Trade Representative Robert Zoellick in Washington last month. Before it can go ahead, the agreement still needs to receive the approval of politicians in both countries. Meanwhile, debate over whether the deal is in Australia's national interest continues to rage on this side of the Pacific.

One particularly striking feature of this debate has been the way in which criticism of the AUSFTA has come from a wide range of sources, from prominent free-trade economists through to protectionist-inclined economic nationalists. But while the gamut of views has made the debate interesting, at times it has also made it frustrating, since the various objections – which vary quite considerably in quality – have tended to become muddled together in the public discourse.

It seemed worthwhile therefore to assess a sample of some of the more commonly heard criticisms. Below we distinguish between the various objections to the AUSFTA by sorting them into those that seem to us to have some merit (“the good”), those that we judge to be more dubious (“the bad”) and those that remain hard to evaluate (“the ugly”).

The good . . .

There are some good reasons to be sceptical about the merits of an AUSFTA. The starting point of many of these criticisms is the recognition that the AUSFTA is not really a “free” trade agreement at all. Rather, it is a preferential trade agreement (PTA). When countries agree to reduce trade barriers in multilateral trade negotiations under the auspices of the World Trade Organisation (WTO) they do so in a non-discriminatory way. That is, if a WTO member grants improved access to its markets to one trading partner, it must offer the same benefits to all other members, a requirement known as Most Favoured Nation (MFN) treatment. The great majority of economists are strongly in favour of this form of trade liberalisation.

While the economics profession as a whole is a strong supporter of WTO-led multilateral trade liberalisation, however, it is much more sceptical regarding the merits of preferential trade deals.

Unlike multilateral trade agreements, PTAs reduce barriers to trade only between the signatories of that specific deal (in this case, Australia and the United States). For non-members of the PTA, this leads to the possibility that they will see a reduction in their market share in member economies. As a result, PTAs have two offsetting effects. On the one hand, the fall in barriers to trade between member

countries will prompt trade creation. At the same time, the effective discrimination against non-members means that such agreements will also lead to trade diversion, whereby instead of creating new trade, they simply divert trade from non-members to members.¹

Crudely put, a PTA will be a 'good thing' only to the extent that trade creation exceeds trade diversion. Whether this turns out to be the case is an empirical matter, and will depend on the specific characteristics of each individual trade agreement. Hence there can be no automatic presumption that a preferential trade deal will be beneficial for a member economy.

In practice, trade diversion is less likely to be a problem when the countries involved in a PTA are already significant trading partners, and when the trading partners' MFN tariff barriers are already low.² Both of these conditions are broadly met by the AUSFTA; last year the United States was Australia's largest bilateral trading partner (taking trade in goods and services into account), and both economies are already relatively open by international standards, with fairly low levels of tariff protection. This suggests that intuitively we might expect the AUSFTA to lead to more trade creation than trade diversion. In addition, since the existing barriers to trade between the two countries are relatively low, it also suggests that the overall effects of bilateral trade liberalisation are likely to be fairly modest.

Economic modelling conducted by the Centre for International Economics (CIE) confirms that the AUSFTA will lead to both trade creation and trade diversion.³ The CIE estimates that while the agreement will lead to an increase in Australian exports to the United States of around \$3.35 billion, total Australian exports will increase by the smaller figure of \$2.77 billion. This is because some \$582 million of the increase in exports to the United States comes from the diversion of Australian exports from other markets. Similarly, while Australia is projected to increase imports from the United States by \$6.52 billion, total Australian imports are projected to increase by only \$2.82 billion. This implies trade diversion to the tune of \$3.7 billion, with 60% of the post-AUSFTA increase in US imports to Australia coming at the expense of other countries. (The CIE thinks that the main victims will be exporters in the EU and North Asia.) Trade diversion under AUSFTA is therefore predicted to be substantial. In net dollar terms, however, the agreement is still estimated to be trade creating, with total trade projected to increase by \$5.58 billion.⁴

What about the implications for national welfare, as measured by national income? The fact that a PTA leads to net trade creation is a necessary but not sufficient condition for it to boost a member

¹ PTAs can also generate protectionist pressures by prompting those groups and sectors that benefit from preferential access to lobby against any further liberalisation moves that would serve to undermine this advantage.

² The hypothesis that PTAs are more likely to be welfare enhancing for countries that are already significant trading partners – sometimes called the "natural trading partners" hypothesis – has been criticised in a series of papers by Bhagwati and Panagariya. See for example Arvind Panagariya, The regionalism debate: an overview. *The World Economy* 22 (4) 1999.

³ Centre for International Economics, *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared for Department of Foreign Affairs and Trade*, Centre for International Economics, 2004 [cited 28 May 2004]. Available from <http://www.intecon.com.au/reports/AUSFTA.pdf>. p91

⁴ Tables 7.3 and 7.4 in *Ibid.* pp89-90

country's welfare.⁵ The CIE estimates that in volume terms the net impact of trade creation and trade diversion will be modestly negative for Australian national income.⁶ While this reduces expected welfare gains from the agreement, however, the projected loss in volume terms is more than offset by a positive price effect due to forecast changes in Australia's terms of trade. And when other effects from the agreement are included, such as changes in technical efficiency and capital accumulation, the model results confirm the intuitive suggestion that the AUSFTA is likely to lead to a modest net gain in overall welfare.⁷

This is not enough to swing the argument, however. A second important objection to PTAs relates to their impact on the health of the global trading system as a whole. Proponents of PTAs argue that they should be seen as complementary to the multilateral trading system since they provide positive demonstration effects of the benefits of trade liberalisation, and act as a spur to the more ponderous multilateral process. Critics however charge that, far from being building blocks towards freer world trade, preferential trade deals should be seen as major stumbling blocks. Indeed, many trade economists worry that the spread of PTAs will undermine the existing WTO-managed multilateral trade framework.

Much of this criticism centres on the distortionary impact of the rules of origin required to allow PTAs to operate. Rules of origin set out specific requirements – for example a minimum level of value-added created in a member economy – that have to be met before a product can receive access under a PTA. They are designed to stop non-signatories to a PTA benefiting from preferential access by first transshipping their exports via a member country (for example sending Japanese cars to the United States via Australia). Often these rules are extremely complex (NAFTA, the North American Free Trade Agreement, contained over 200 pages dealing with rules of origin) and can create substantial compliance and other transactions costs for exporters, in turn contributing to the trade diverting effects of PTAs.

Moreover, since there is no requirement for consistency between rules of origin across different PTAs, their distortionary effect is multiplied as the number of PTAs in the international economy increases. The proliferation of PTAs is therefore associated with the spread of a complicated, overlapping web of regulations that forms a growing barrier to international trade flows.

The AUSFTA incorporates detailed requirements for the manufacturing sector, with particularly heavy restrictions relating to textiles. The latest CIE assessment for example notes that the vast majority of

⁵ This is because the cost reduction associated with each dollar of trade creation may prove to be less than the cost increase associated with each dollar of trade diversion, with the latter effect outweighing the former.

⁶ Table 7.1 in Centre for International Economics, *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared for Department of Foreign Affairs and Trade*. p83

⁷ Clearly these results are sensitive to the assumptions made regarding the various inputs and parameters used in the modelling exercise. The CIE report estimates that the AUSFTA will boost Australia's national income by an annual \$359 million. Table 7.1 in CIE (2004) *Ibid*. p83. But an alternative assessment by Philippa Dee based on different – more pessimistic – assumptions puts the projected annual welfare gain at a meagre \$53 million. Philippa Dee, *The Australia-US Free Trade Agreement: an assessment: paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States*, 2004 [cited 17 June 2004].

Available from http://www.aph.gov.au/Senate/committee/freetrade_ctte/report/DeeftaReport.pdf. p.35

Australian textile and clothing exports will not be eligible for preferential access under AUSFTA under these rules.⁸ The agreement is clearly vulnerable therefore to the criticism that it adds to the growing global network of rules of origin.⁹

While there is clearly substance to the argument that the rise of PTAs entails risks for the health of the multilateral trading system, does this mean Australia should pull out of the AUSFTA? By signing up to new PTAs, Australia adds momentum to the global PTA bandwagon, and hence risks inflicting collateral damage on the multilateral trading system. But a decision to stand aside from the worldwide move towards PTAs would also entail risks, including the danger of being left out in the cold if the rest of the world continues to sign up to preferential deals.

In our view, this trade-off makes the case for Australia signing a PTA with the United States a judgement call, one that is dependent upon an assessment of the relative risks of damage to the multilateral system against being left behind in the general move towards PTAs. Unfortunately, both of these risks are difficult to quantify satisfactorily.

Still, our judgement is that - given the current global environment - it does make sense from a risk management perspective for Australia to pursue PTAs with its major trading partners. The vast majority of our trading partners are currently either already members of PTAs or are in the process of conducting negotiations to become members. In our view it is very doubtful that a decision by Australia to opt out of this generalized move to PTAs would reverse this trend. Moreover, to the extent that slow progress with multilateral trade liberalisation reflects the fact that international trade policy is currently vulnerable to domestic political pressures, then the formal structure of the AUSFTA could provide Australia with some valuable insurance against future political incursions into trade relations with a key partner.

At the same time, a deal with the United States would tie Australia into both the world's largest economy and its largest trading nation, no mean achievement. Moreover, if an agreement with the United States were to be followed by a deal with China, as is currently envisaged, this would give Australia PTAs with two economies that between them account for roughly one-third of world output and one-fifth of world merchandise trade. Reaching agreements with major global economic players may at least minimise the distortions involved in signing a greater number of agreements with a series of much smaller economies.

⁸ In the case of the automotive sector however the CIE notes that discussions with the Federal Chamber of Automotive Industries (FCAI) and the Federation of Automotive Products Manufacturers (FAPM) suggested that the Australian automotive sector felt that Australian exports would be able to meet the rules of origin requirements. Centre for International Economics, *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared for Department of Foreign Affairs and Trade*. pp52-53

⁹ One reason that the Dee report gives lower estimates of welfare gains than the CIE report for example is that Dee reduces the overall effects of merchandise trade liberalisation (by one third) as a way of taking into account general compliance costs associated with rules of origin. This is over and above the adjustments that the CIE makes for their specific impact on Australian textile and clothing exports. Dee, *The Australia-US Free Trade Agreement: an assessment: paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States*. p.34

We would, however, also acknowledge that all of the evidence indicates that signing up to a PTA, even with a major trading power, remains very much a “second best” strategy when stacked against the benefits that would be offered by further progress in multilateral trade negotiations.

The bad . . .

Criticisms of the AUSFTA based around the problems associated with PTAs clearly have some merit. However, some other objections seem to us to make much less sense.

For example, one frequently advanced proposition is that the AUSFTA will lead to a worsening of Australia’s bilateral trade deficit with the United States. This prediction will probably turn out to be factually correct: the CIE numbers noted above for example suggest that while exports from Australia to the United States will increase by an estimated \$3.35 billion, imports from the United States are projected to increase by \$6.52 billion. But a forecast increase in the bilateral trade deficit is completely irrelevant when it comes to assessing the merits of the AUSFTA. In general, it doesn’t make a great deal of sense to focus on a single bilateral trade deficit, and there is certainly no sensible economic reason for expecting a country to run ‘balanced trade’ with each of its trading partners.

What *does* make sense is to look at an economy’s overall balance of trade in goods and services; that is, its current account balance. But economic theory (in the form of a simple balance sheet identity) tells us that an economy’s current account profile reflects basic economic fundamentals such as savings and investment behaviour. Commercial policy (including trade agreements) will only have an impact insofar as it influences these savings and investment decisions. Focusing on the AUSFTA – or any other trade agreement for that matter – as a major explanation for trends in Australia’s current account position is therefore fundamentally misguided.

Another problematic argument advances the general proposition that the AUSFTA is somehow a bad deal because Australia has liberalised trade in agriculture and manufacturing more than the United States has done. This complaint that the deal is “unfair” often seems to assume that domestic liberalisation *per se* is wholly a bad thing, which needs to be mitigated by achieving an equivalent, offsetting amount of liberalisation overseas. Yet economic theory tells us that there is a strong case to be made for unilateral trade liberalisation. That is, by going ahead and reducing tariff barriers on its own, Australia will tend to be better off regardless of what our trading partners do.¹⁰ Of course, the gains from trade liberalisation will be even greater if they also choose to reduce their trade barriers. And the idea of reciprocal concessions may be politically advantageous when it comes to selling trade agreements to voters. But that is certainly not the same thing as saying that Australia will lose out by

¹⁰ That is, unilateral liberalisation with respect to all trading partners. As noted in the previous discussion on trade creation and trade diversion, there can be no presumption that unilateral liberalisation on a preferential basis would enhance welfare.

reducing its trade barriers more than other countries. This objection to the AUSFTA therefore also doesn't seem to make much sense.¹¹

Indeed, these two criticisms of the AUSFTA both appear to have at their heart a profound misconception about the benefits of international trade. They each seem to treat imports as a necessary evil that a country must endure in order to be allowed to export into overseas markets. Each additional dollar of imports allowed in is somehow a "loss", and each dollar of exports sent overseas a "win". This is to turn international trade theory on its head. The big gains from international trade come from imports; exports are what we have to generate in order to pay to import the goods and services that we want. Assuming that allowing in more imports is bad for the economy is to make the basic mistake of confusing the sectoral interests of import-competing producers with the overall national interest.

These "bad" objections to AUSFTA therefore seem to rest on a misguided view of international trade in goods and services as a form of zero-sum (win-lose) competition, with increases in exports a win and increases in imports a loss. Since international trade is really about the mutual gains that come from exchange, such arguments should largely be dismissed when it comes to weighing up the costs and benefits of the agreement.

That said, however, there are some areas of the AUSFTA that are more amenable to this kind of approach.

Proponents of bilateral trade agreements frequently argue that one of their big advantages is that they provide member economies with the scope to broaden the negotiations beyond trade in goods and services, and hence allow for a process of deeper economic integration. This in turn raises the possibility of dynamic benefits that in theory at least could turn out to be much bigger than the one-off static gains generated by cutting trade barriers. Thus the AUSFTA contains provisions on labour and the environment, and covers areas such as investment regulation, competition policy, intellectual property rights and government procurement. The complicating factor is that in some of these areas, such as the patents and copyrights that comprise international property rights (IPR) protection, the positive sum (win-win) logic of international trade does not necessarily apply. For example, there is no guarantee that the application of US standards of IPR will be welfare enhancing for the Australian economy.¹² At bottom, the assignment of IPR protection is about how long the recipient of that protection should benefit from monopoly profits. Thus it is hard to see the proposed extension of copyright protection for books, artwork and sheet music from 50 years after the death of the author to 70 years (and the similar provision for sound recordings and films) as anything other than a

¹¹ Where this objection would bite however is if it was allied to the political economy problems with PTAs noted in footnote 1. Thus if domestic trade liberalisation under the auspices of the AUSFTA becomes a permanent substitution for more general trade reform, and even creates obstacles to future liberalisation, then it will have significant costs. However, most of the criticisms levied against the AUSFTA on the grounds of unequal liberalisation do not seem to us to be coming from the perspective that the problem with the agreement is that it risks undermining the chances of *additional* liberalisation.

¹² The issue of IPR and its relation to international trade policy will be the subject of a forthcoming Lowy Institute publication.

straightforward redistribution away from the Australian consumer that has few – if any – redeeming features in terms of improved incentives for the creation of new intellectual property.

Still, in the specific context of judging the net cost or benefit of the AUSFTA to the economy, the potential losses associated with these changes in IPR have to be balanced against the potential gains that would accrue from other features of the move to ‘deeper integration’, including the liberalisation of investment flows and the consequent possible reduction in Australia’s risk premium. Again, there is considerable scope for disagreement over the precise magnitude of such effects, but our judgement here is that the gains associated with the latter are likely to exceed the losses associated with the former.¹³

The tendency to view bilateral trade negotiations in strict win-lose terms has another interesting feature. Presumably, in international trade negotiations, as in any other form of negotiations, outcomes are likely to reflect the balance of power. Last year’s trade negotiations were between an almost US\$11,000 billion economy and a US\$510 billion economy: Australia’s GDP at market exchange rates is roughly the same as the US state of Pennsylvania, and is less than 5% of total US GDP. It should not be too surprising therefore that the outcome of the negotiations sometimes reflects this, as can be seen for example in the exclusion of sugar from the deal and the restrictions on other Australian agricultural exports.

The key question is whether this effect is a good argument against signing the AUSFTA. True, the presence of this kind of imbalance of power in a bilateral trade negotiation does provide another reason for a general presumption in favour of multilateral trade negotiations over PTAs. Yet it is not a good reason to reject the AUSFTA in particular. This is because the flip side of the imbalance in economic power is an imbalance in economic benefits. In other words, the very different sizes of the two economies involved also mean that Australia stands to benefit far more in relative economic terms from the AUSFTA than does the United States.

Moreover, as we argued above, for much of the substance of trade negotiations, a win-lose framework does not make much sense. If it did, and if Australia’s overriding objective was to maximise the number of trade “concessions” it could win relative to its negotiating partner, then presumably the policy implication would be that Australia should only look to negotiate where the balance of economic power would be firmly in our favour – say with the Solomon Islands. In reality of course, this would not make for a particularly promising trade strategy.

¹³ The scope for disagreement can be seen for example in comparing the CIE and Dee reports. Thus the former judges that the gains from a reduction in investor uncertainty due to changes in the FIRB screening process will lead to a fall in Australia’s equity risk premium (of around five basis points) that will in turn have a significant positive effect on investment and output. Centre for International Economics, *Economic analysis of AUSFTA: impact of the bilateral free trade agreement with the United States: prepared for Department of Foreign Affairs and Trade*. p.34 and p.78. In contrast, Dee argues that the impact of changes to the FIRB process will be restricted to minor implications for transactions costs and will not affect the risk premium at all. Dee, *The Australia-US Free Trade Agreement: an assessment: paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States*. p.30

And the ugly

Finally, our last category of objections to the AUSFTA relates to those which remain in some way difficult to evaluate. Probably the most obvious – and certainly the most prominent – of these relates to the Pharmaceutical Benefits Scheme (PBS), although similar types of arguments have also been advanced related to the impact of the AUSFTA on Australian quarantine and food safety regimes. Critics of the agreement charge it will undermine the PBS and lead to a marked increase in the cost of pharmaceuticals for Australians.

At first – and even second – glance, it is difficult to see where this fear comes from, since the available details of the agreement don't seem to indicate any such dramatic effects. Thus what the AUSFTA essentially does is commit Australia to increase the transparency and timeliness of the process for listing a drug on the PBS. Changes to the scheme include the introduction of a Medicines Working Group and of a review process for companies that have a drug rejected by the Pharmaceutical Benefits Advisory Committee (PBAC). It is hard to see why these measures would, on their own, lead to the demise of the PBS.

Where critics may prove to have a point, however, is in the dynamic nature of the AUSFTA process, a feature that is normally cited by proponents of the deal. There is some risk that the changes envisioned under the agreement, along with future developments within the new framework provided by the AUSFTA, will have cumulative effects over time that could prove detrimental to the PBS – say by gradually increasing the leverage of US pharmaceutical companies in the listing process through the workings of the appeals process. But at this stage it seems very difficult to quantify this risk.

Getting the arguments right

Whether Australia should go ahead with the AUSFTA is an important question, the answer to which will have significant implications for our international economic policy and our future economic well-being. It is therefore crucial that the grounds on which the agreement is evaluated are sensible ones. Unfortunately, not all of the criticisms of the AUSFTA that have been advanced to date meet that requirement.

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