

Introduction

For more than 200 years, trade has been central to Australia's economic development. During the 19th century, wool and gold emerged as major exports critical to maintaining jobs and attracting immigrants to the colonies: indeed, in the early 1950s wool still made up around half of Australia's merchandise exports. Since then, the structure of Australia's trade has been transformed, so that minerals and energy now make up the largest share of exports, with significant contributions from services, manufactures and rural exports. After declining between the early 1950s and early 1970s, trade's share of output increased again so that exports and imports together now constitute more than 40 per cent of gross domestic product (GDP). A little over one in five jobs are related to either exports or imports.¹

This book is about Australia's trade and our trading future. It has three broad aims. The first is to explore the history of our trade and the current stance of our trade policy. In addressing these questions, we look at Australia's trading patterns going back as far as Federation and at the forces in the global environment that have shaped the changes in our trade. We also look at the evolution of Australia's trade policy and the effectiveness of policy in the World Trade Organization (WTO) Doha Round of multilateral trade negotiations, in our free trade agreements (FTAs) and in driving domestic productivity growth.

The second broad aim is to look at what the future might hold for Australian trade in the medium and long term. We examine possible scenarios for the world economy out to 2025 and what these might mean for the international trading environment. We

also look at whether Australia's current good fortune is likely to hold. This includes examining whether Australia's current relatively high terms of trade are likely to persist and the future of our trade in minerals and energy, agriculture, manufactures and services.

The third aim is to examine how trade policy should be shaped in order to promote Australia's interests. We look at the role trade policy can play in giving renewed impetus to domestic microeconomic reform and at how it might respond to the changes in international influence that are occurring as a consequence of rapid growth in emerging nations, particularly in Asia. We consider too what can be done with the Doha Round and what outcomes Australia might expect from FTAs currently under negotiation and from negotiations that deserve serious consideration, such as an Australia–European Union FTA. We look also at whether more could be done in a range of other areas, from boosting trade with specific countries and regions to constructing a trade narrative and associated reform agenda that might resonate better with wider community interests and concerns.

In spite of the importance of trade to the Australian economy, there are relatively few studies on Australian trade. Those that exist are mainly concerned with the history of policy or with specific questions such as the role of FTAs. To our knowledge, this book is unique in terms of the breadth of the questions it asks and its focus on the future of Australia's trade. It is unique too in that the authors have all spent long periods working on trade issues in the Australian Department of Foreign Affairs and Trade (DFAT). One objective in writing this book is to add to the academic literature. But the main objectives are to contribute to discussions among economic and trade policy makers and to increase knowledge more broadly about trade policy among general readers who are interested in political economy issues.

The term 'trade policy' can, of course, be understood in different ways. Taking the term literally, to mean any government policies or actions affecting the import and export of goods and

services, would draw in an enormous range of policies going well beyond the scope of this book. Here we use the term to refer, on the international side, to policies aimed at removing distortions and impediments affecting Australian trade and barriers faced by Australian-based enterprises in other markets, and on the domestic side to policies which affect tariffs or other barriers to trade. It also includes policies which aim to shape domestic economic policy settings that directly affect trade (for example, by improving the productivity and efficiency of firms based in Australia). We also look briefly at trade promotion and its links with broader economic policy. Even with this narrower definition, trade policy has wide implications (see box 0.1).

In looking at Australia's trade and its trading environment, we also take account of foreign investment. Internationally, the expansion of foreign direct investment (FDI) has been one of the factors transforming the way in which business is conducted. In Australia, inward FDI has long been important in shaping trade with other countries, most obviously in the mining industry, but also in some areas of agriculture, manufacturing and services. Its role, and especially the benefits which flow from it, remain widely misunderstood, however. Australia's FDI in other countries has also become increasingly important. In the services sector, sales by majority-owned affiliates abroad have for some time been recognised as a form of services trade. More generally, outward FDI can be crucial to securing and expanding markets for Australian goods and services and can play a significant role in building global value chains (GVCs). We look, at a number of points in the book, at policies towards investment in the context of a broader discussion of trade policies. For example, investment is now an important aspect of many FTAs and it is a core component of the Asia-Pacific Economic Cooperation (APEC) agenda.

A key part of the development of trade policy is to contend with and reconcile as best as possible the interests of domestic stakeholders on the one hand and international actors (mostly other governments) on the other. On the domestic front, business

and various civil society groups maintain a close interest in trade policy. Consultations with these groups are part and parcel of good trade policy, not only because they are affected by trade policy, but because they are often the best source of information on the impediments to trade and investment which they face. In this book, we do not discuss in detail these disparate interests in trade policy – which would surely require another book. But they are very much part of the background contributing to our assessments.

Box 0.1 Why trade and trade policy matter

Trade has always mattered. This was true going well back in human prehistory, even before the development of agriculture. It matters because clans and tribes, cities and states have never had all of the resources and skills they need to produce the things they want when they require them. The benefits from trade are evident in almost every product and service we use. The humble pencil might be the product of timber from New Zealand, graphite from central Europe, zinc and copper from Australia, oil-based products (for the eraser) from Southeast Asia, and processing machinery from the United States.² A computer is the product of complex and fast-evolving regional and global value chains. Increasingly, final products and services are the outcomes of unravelled, specialised production processes and trading in tasks.

Trade policy also matters. It too has always mattered at least since cities and states discovered the expediency of taxing silks and spices and exchanges of wool and wine, and governments learnt how the sinews of evolving industrial states could be supported by taxing triangular trades in manufactures, slaves and sugar. It might be thought that trade policy matters less now than in the past: technological change and trade liberalisation have transformed global business over the last three decades. But that assessment would be wrong.

Trade policy matters because borders still impede markets. The impediments have changed over the years: tariffs have come down; behind-the-border regulatory obstacles have become more prominent as trade has

become more closely linked to investment and establishing an overseas commercial presence. Impediments wax and wane with the moods of political economy. Some impediments are protectionist in intent. Many are justified for other public policy reasons – to promote industry adjustment, a better environment, safer food standards and so on – but still may distort trade and investment flows. The job of holding back and removing protectionist measures and of designing policies to meet important national objectives with less distortion of trade and investment is endless.

Trade policy matters because trade enhances growth and productivity, which in turn can be linked to increasing jobs and higher living standards over the medium term. Credible enabling environments for productive and efficient businesses are built around the indivisible relationship between trade policy and domestic economic policies.

And it matters also because trade has long been a vehicle for building links and understanding between nations and cultures and widening the horizons of those participating in it.

One of the central themes of this book is that, while Australia's current trading position is at first sight fortunate thanks to the minerals boom, there is a significant risk of a tough international trading environment, both in the medium term and further out to 2025. Near-term risks are focused on sovereign debt and bank solvency issues in Europe, as well as sovereign debt problems in other major developed economies. High levels of public and private debt may mean slow growth in much of the developed world for a decade or more (most notably in Europe, but perhaps also in the United States). If this occurs, it should dampen growth among major emerging economies such as China – indeed, China's growth has already slowed appreciably. It is quite possible that there will be adverse knock-on effects, including increased protection and trade conflict. Risks have been accentuated by the virtual collapse of the Doha Round of multilateral trade negotiations and by the impact on global decision making of the historic shift of power to key emerging economies which has brought different perspectives

to the negotiating table. In these circumstances, Australia may be in for a bumpy ride.

Australia's trade policy has been debated for almost as long as Australia has traded. Protectionism emerged as a major issue in the second half of the 19th century in the aftermath of the gold rushes, when Victoria sought to build up a wall of tariffs to shield domestic manufactures and create employment. Difficulties created by differing tariffs continued to be a source of discord among the colonies until Federation in 1901, when 'protection all round' quickly became one of Australia's settled policies. By the late 1920s, Australia's average tariff was second only to that of the United States among high-income countries (see chapter 3). The folly of the inefficient framework of protection that sheltered Australian industry from effective competition became clearly evident during the economic upheavals of the 1970s. The subsequent shift away from protection began in earnest under the Hawke and Keating governments over 1983–96 and, along with other reforms, contributed to a significant improvement in Australia's economic performance.

The case for free and open trade has long been a compelling one. British political economist David Ricardo's key insight – that differences in relative costs create the conditions for mutually beneficial gains from exchange among nations – remains just as valid now as it was in the early 19th century. Although there are some theoretical exceptions to the case for free trade (such as the infant industry argument, optimal tariff theory and strategic trade policy), in practice effective intervention is difficult to design and trade liberalisation typically promotes economic welfare (see box 0.2). Well-considered and thorough studies generally conclude that openness plays a key role in driving productivity growth and increases in economic output.³ Productivity growth is in turn a key to ongoing increases in wages and the standard of living. In Australia's case, the Productivity Commission and its predecessors have made a strong case for industry deregulation and trade liberalisation over several decades. This helped to transform attitudes towards protection in Australia.

Box 0.2 The case for trade liberalisation

Standard textbook partial equilibrium analysis suggests that removing tariffs will result in welfare gains for the economy. In this type of analysis, the size of these ‘static’ gains depends on the domestic supply and demand curves for the product being imported and the size of the tariff. Removing tariffs can also lead to ‘dynamic gains’ such as those arising from greater competition in the economy. These are often held to be considerably larger than the static gains, but are difficult to measure.

Sophisticated economic modelling, which takes into account the myriad linkages between economic agents and industries, confirms that there are substantial gains from unilateral trade liberalisation. In Australia’s case, for example, the Centre for International Economics in a 2009 report employed a suite of computable general equilibrium models – ORANI, GTAP and CIEG-Cubed – to estimate the long-run impact of trade liberalisation since 1988. The Centre concluded that GDP was, on average, 2.5 per cent higher as a result of liberalisation, even without considering dynamic gains. When estimates of dynamic gains (partly drawing on the use of the AUS-M model) were included, the increase in GDP rose to 3.4 per cent and the increase in national income to 2.7 per cent. This amounted to an increase in real income of around \$3900 per annum for each working family (CIE 2009, p. 20).

There are some theoretical exceptions to the case for free trade which are discussed at some length in texts on international trade and economics, but all have problems. They include:

- *The infant industry proposition*: Argues for protection for industries in the initial phases of their development until the scale of their operation has lowered costs and they have become competitive with imported goods (see Feenstra 2004, pp. 240–41; Krugman & Obstfeld 1994, pp. 257–59). In practice, governments find it difficult to target industries which are likely to become competitive and equally difficult to withdraw protection once it has been granted.
- *Optimal tariff theory*: Argues that imposing tariffs can positively influence a country’s terms of trade and that there is thus a non-zero optimal tariff which maximises welfare (see Feenstra 2004,

pp. 215–20; Van Marrewijk 2002, pp. 153–58). This theory is mostly applied to large economies, although it has been used in the debate on the impact of tariffs on motor vehicles and parts in Australia. In the latter case, a key determinant of any optimal tariff is the export-demand elasticity for Australia, but this is the subject of debate among economic modellers.⁴ For contending views, see Dixon (2009), Gropp, Jomini and Salerian (2009) and Dixon and Rimmer (2010). Even if an optimal tariff of this kind exists, unilateral liberalisation may yield benefits through dynamic gains.

- *Strategic trade policy*: Argues that government intervention for imperfectly competitive industries (usually oligopolistic) can have flow-on effects which justify it. For example, subsidising an industry that is part of a global oligopoly can result in welfare gains to the nation applying these measures if it leads to a bigger market share and higher profits for national firms (see Krugman & Obstfeld 1994, pp. 284–87; Van Marrewijk 2002, pp. 210–19). This is really only relevant to certain industries (such as the global aircraft industry) and the degree and kind of intervention required to realise gains is, in any event, very difficult to calculate.

The traditional argument for maintaining Australia’s residual tariffs is that they can serve as bargaining chips in international trade negotiations aimed at removing border protection in other economies. But this is not a strong argument given the substantial benefits which can be realised from unilateral trade liberalisation. It is, in any case, possible to liberalise applied tariffs while allowing bargaining to occur in the WTO over bound tariff rates (that is, the legal maximum rates in the WTO). Another argument is that tariff liberalisation would expose the weakest sections of the community to heightened competition. This suggests a need to undertake reform in conjunction with training for affected workers, but is not a strong argument for perpetually delaying tariff reductions. Tariffs can also be defended on the ground that they add to government revenue, though in practice cutting tariffs can deliver increased income and other tax revenues because of the spur to economic activity which this creates. This can offset all or part of the loss of tariff revenue.

The case for liberalising protectionist-inspired non-tariff barriers (whether they be phytosanitary barriers not justified by science, anti-dumping provisions which operate to restrict legitimate trade or regulatory barriers to services trade) is just as compelling as the case for liberalising tariffs. Indeed, non-tariff barriers are often less transparent than tariffs and can lead to larger welfare losses (see, for example, Van Marrewijk 2002, pp. 208–209). Phytosanitary barriers and anti-dumping remain important conduits for protectionism in Australia (see chapters 4 and 7).

Australia needs a program of economic reform that will stimulate long-term productivity growth and help it weather the shocks from the global economy that will come over the next decade and a half. Trade policy has an important part to play in executing the reforms needed. In Australia, the shift away from protectionism was one of the factors that helped to drive increased productivity growth in the 1990s. Productivity growth, in turn, helped to drive improved trade performance. In the past decade, however, productivity growth has been lacklustre. A new productivity agenda will need to go well beyond tariffs (though we argue that removing residual tariffs would be a valuable reform). It will need to encompass taxation, skills, infrastructure, labour markets and further industry deregulation, all undertaken with the objective of making Australia's economy more flexible and efficient. If this comes about, it will have important implications for trade policy, including by broadening and strengthening Australia's trade base, and by increasing gains that can be won with other parties in trade negotiations by binding our openness or further liberalising access to our markets.

For much of Australia's history, the international dimensions of Australia's trade policy – multilateral, regional and bilateral – have not attracted the same degree of intense discussion as the tariff. But this has changed in recent years with multilateral negotiations, which have held centre stage since the Second World War, being complemented increasingly by the pursuit of FTAs. This has

occurred against the backdrop of rapidly spreading bilateral and regional trade agreements globally.⁵ The WTO Secretariat advises that around 240 ‘physical agreements’ (that is, counting goods and services agreements as one) are in force among those notified to the WTO (see chapter 1). For its part, Australia is a party to seven reciprocal FTAs and is negotiating another nine (see chapters 3 and 10 for a detailed discussion).

The dynamics of international negotiations are currently being influenced by the effective failure of the Doha trade round. This has increased interest in bilateral FTAs and, more recently, regional FTAs. Trade policy processes are active and complex, but the prospect for worthwhile outcomes remains very uncertain. Can something be salvaged from Doha? If a plurilateral services agreement is negotiated (see chapter 9), can it do more than bind existing levels of openness? Can prospective mega-agreements like the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP) push the boundaries of trade liberalisation? Can these agreements turn a spaghetti bowl of overlapping arrangements into a new force for broader trade liberalisation? If they can, will they harmonise smoothly with whatever, if anything, may emerge plurilaterally? Is it reasonable to expect that, at some point, regional and plurilateral processes will feed back into multilateral ones, picking up the pieces of Doha in areas like subsidies and agriculture? And is there a solid role for APEC in this dramatically changing global and regional environment? It formed a critical part of Australia’s regional trade policies in the 1990s, but does its future as a top-tier international process now hang in the balance with growing interest in regional FTAs and the emergence of newer processes like the East Asia Summit?

There are many loose ends floating in the ether. How and if they come together is largely guesswork, may require careful reappraisal of at least some of Australia’s international trade policies and is a key theme of this book.

There are many areas where Australia’s trade and related policies need a substantial overhaul. For example, we suggest that

India, given its status as an emerging economic power, warrants more attention than it has been given by either side of politics in Australia. Latin America is an even clearer case of relative neglect, with an extremely limited commercial relationship in spite of many instances where developing economic links could prove mutually beneficial. In the area of skills, proficiency in other (especially Asian) languages should be a core competency for an Australia seeking to make its way in the region and the world and this effort needs to be accorded higher priority (Australian Government 2012, p. 2), notwithstanding the fact that English is quite widely accepted as the lingua franca in Australia's region and that Australia already has among its citizens many first- and second-generation Asian language speakers.

The organisation of the book

This book is organised around the three broad aims sketched above. It commences in Part I with four chapters that explore the history of Australia's trade and Australia's current trade policy. Chapter 1 looks at the main changes in Australia's external environment, focusing on the period since the Second World War. It discusses the reasons for rapid growth in trade over this period and the changing locus of economic activity in the world economy, as well as providing an introductory discussion on the main international economic institutions, agreements and processes which figure later in the book. Chapter 2 provides an overview of Australia's trade since Federation. It includes discussion of the significance of trade to the Australian economy over this period, as well as changes in the composition and direction of trade. Foreign investment is also discussed.

Chapter 3 examines the evolution of Australian trade policy. It includes a detailed discussion of the rise of industry protection in Australia and the subsequent shift away from it during the Hawke and Keating governments, as well as an overview of the role of multilateral, regional and bilateral trade policies since the Second

World War. Chapter 4 examines the changing effectiveness of Australian trade policy, looking in some depth at the reasons for the impasse in the Doha Round, the role of APEC, the effectiveness of Australia's FTAs and the influence of trade policy on domestic economic policies.

Part II discusses the outlook for Australia's trade to 2025. Chapter 5 examines scenarios for the global economy in both the short and long term, and looks at the main risks to the global economic outlook over this period. It also examines the outlook for the United States, the European Union, Japan, China, India and Indonesia, and explores optimistic and pessimistic scenarios for the international trading environment. Chapter 6 discusses the future of Australia's exports of minerals, agricultural products, manufactures and services and considers whether they can continue to finance rising imports and add impetus to Australia's economic growth over the next decade and a half.

Part III addresses the implications of the previous analysis for Australia's trade policy, as well as for other government policies. Chapter 7 takes up the question of how trade policy can support microeconomic policy in building a more internationally competitive Australian economy. Chapter 8 looks at trade and related foreign policy responses to changing global power balances and issues, examining in turn what policy might do in such areas as relations with China, India, Latin America, and trade and the environment. It also looks briefly at the role of the Australian Trade Commission (Austrade) in the changing trade policy environment. Chapters 9 and 10 focus on the trade negotiations agenda. They look in detail at what can be salvaged from the Doha Round and consider possible outcomes from Australia's free trade agreement agenda (including the prospects for negotiating an FTA with the European Union). Chapter 11 draws together the main conclusions and sets out a number of recommendations across domestic and international aspects of trade policy.

