

12 March 2005

The Chair
Senate Foreign Affairs, Defence and Trade References Committee
Parliament House
Canberra

SUBMISSION TO THE INQUIRY INTO TRADE WITH CHINA

Purpose of this Paper

This paper is a submission in my capacity as a PhD student in the Department of Politics and Public Policy, Griffith University, to the current consideration of Australia's political and economic relationship with China, notably the prospects of a trade treaty.

I have previously made a submission to the Committee's 2003 inquiry on GATS and I refer to the content of that submission.

http://www.aph.gov.au/Senate/committee/FADT_CTTE/completed_inquiries/2002-04/gats/submissions/sublist.htm , submissions No. 53, 53A.

Also, I have previously made a submission to the 2004 Senate inquiry on the US Free Trade Agreement and I refer to the content of that submission. Some of the material there repeats my submission to the previous (2003) inquiry on GATS, but I added material on how to define 'national interest', an objective that must be conceptualised properly if trade policy is to be successfully meshed with other objectives of policy.

http://www.aph.gov.au/Senate/committee/fretrade_ctte/submissions/sublist.htm submission No. 449.

In the attachment I wish to make a number of comments under heading (a) in particular of the terms of reference.

I would welcome an opportunity to appear before the Committee in person to elaborate upon my submission.

Yours faithfully

(Signed)

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WHO GAINS, WHO BENEFITS?

DFAT's Independence is For Sale

Previous critical submissions on GATS and trade-related issues seem to have had little influence in shaping trade policy in Australia. The utopian assumption that trade liberalisation is always beneficial seems to be an article of faith with DFAT, which does not seem to want to engage in analytical debate about the merits of its case or the significant policy issues at stake. Although some of its published educational materials do acknowledge that there are criticisms, the responses are stylised and largely consist of repeating generalised and rose-coloured optimisms about the benefits of trade rather than grappling with the contradictions and dis-benefits that critics raise. I know of *no* internal reports which analyse the critiques and DFAT has not responded to several invitations to supply same.

I *recommend* that the Committee press the Government to set up a forum to debate analytically the implications of bilateral and multi-lateral trade policy for Australia. To counter the boosterism by the Government and most economic commentators (including the editorialists of most newspapers), there needs to be a serious debate. But there is no forum apart from the Senate Committees (which necessarily are constrained by formality) in which thinkers can get past the solidarity of the Government/DFAT's insistence that trade is axiomatically and always beneficial.

The existing Trade Policy Advisory Council and WTO Advisory Group populated by industry people and representatives of multinationals do not meet this purpose, (even though the WTO Advisory Group does include a couple of non-industry representatives).

DFAT's cronyism

DFAT does of course listen to some inputs. It accepts sponsorship from industry bodies including international corporations to publish its trade-related background reports. For example, its report on China, *China Embraces the World Market* launched in November 2002 was sponsored by BHP Billiton, Macquarie, First China Property Group, and TradeData International. For a sum of money, a sponsor can sit with the Minister and senior officers at the top table at the launch of a report by DFAT's Economic Analytical Unit.

No confidence can be had that DFAT's analysis represents the public interest as distinct from the interest of its sponsors. Core Government policy analysis of this kind, which no doubt is informing the Government's positioning for its trade deal with China, should not be outsourced.

I *recommend* that the Committee invite the leadership of DFAT to explain to the Committee how any reliance can be placed upon policy advice or even background research if it is sponsored. I *recommend* that the Committee call upon DFAT to cease accepting commercial sponsorship and to invite some of its trade critics from the NGOs to the top table (free of charge) at future launches of its trade analysis reports.

Absence of Coherent Supra-Trade Strategy

There is a mismatch between Australia's trade agenda and a range of other national objectives. DFAT's published reports do not explain how trade is to be reconciled with the various other foreign and domestic policy goals of the Government, not least the numerous environmental and human rights treaties that Australia has signed. The shallow bi-polar *Advancing the National Interest* (national interest consists of only security and economic prosperity) is conclusive evidence of this. The Government's pursuit of a deal with China should be accompanied by, at a minimum, an analysis

of how its position will help or hinder other proclaimed policy positions.

The absence of any obvious attempt to reconcile multiple objectives suggests that trade, a mere process, really is viewed by the Government as a goal in itself. Even assuming that prosperity is the only goal of public policy, the belief that trade with China will bring prosperity to Australia is utopian and indeed is contradicted by empirical evidence.

I *recommend* that the Government be asked to explain how its commitment to international human rights treaties such as the Vienna Declaration (to mention only one) will be played out as it pursues a trade deal with China.

Trade Amounts to Gambling on the Value of Labour and Money

Trade with other countries may rest not on genuine relative efficiency, competence or product differentiation, but on differences in exchange rates, or on exploitation of labour and environmental conditions, or on the relative value of labour to goods. Trade in services across national borders amounts to taking advantage of the relative differences in either wage levels or the value of money (exchange rate). This is not about efficiency but about commercial advantage, a move to join the world financial gambling casino, regardless of the welfare of the trading countries.

To replace domestic employment with cheaper foreign contractors amounts to buying services at prices less than their true (domestic) cost. Intuitively, this is unsustainable. It is also unfair, because the lower-wage partner does not share the windfall but still has to buy sophisticated expertise from foreign expatriates at Western prices. It is doubly unfair because, if Australia engages skilled employees from a developing country, it is denying that country one of the most essential ingredients to its own advancement.

A freely floating currency will always be vulnerable to speculation or even deliberate action by competitors to hold down their own currencies to gain trade advantage. There is every indication at the date of writing that China has been doing just that.

I *recommend* that the Committee request DFAT to explain why Australia, a developed country with a capacity to train and educate its own workers, should suck the capacity of skilled tradesmen and professionals from a developing country. (Even if China is regarded as a market economy, it's the need for skilled professionals cannot be doubted).

Ignores Fate of Producers

Published materials proclaim the benefits to consuming governments and corporations in outsourcing services overseas, but ignore the fate of domestic producers. Liberalisation of trade in goods has seen large sectors of Australian manufacturing evaporate. It was predicted in the 1980s and 1990s that the loss of factory jobs would be offset by a take-up in services. Newspaper commentary in the past few weeks has highlighted Australia's current account deficit. This was not supposed to happen. Has DFAT done any scenario planning? Plan A has not worked in manufacturing, as export of elaborately transformed manufactures is now faltering and the cost of imports is rising unabated. Before we complete this process in manufacturing by reducing the remaining barriers to Chinese goods or extend the same tried and failed theory to services, let DFAT and its policy community engage in a serious policy analysis and think through where free trade is taking our economy.

An IMF report in 2000 found that the value of information and communication technology produced in Australia was less than for every other advanced economy except Norway.

Under a services deal with China the range of producer victims will be expanded to embrace many white collar occupations. There is no reason why sophisticated engineering or information technology won't shift offshore. Chinese could be contracted to do almost any task for which the inputs and outputs can be mailed or e-mailed. The Government seems to assume that bilateral trade deals will prise open the services and professional markets of other countries, unilaterally. But any access is certain to be reciprocal.

A trade deal with China does not square with the vision of Australia as an information-rich economy. Many of the jobs now being outsourced in India are in new-era industries. The scenario with China will play out differently because it lacks an extensive class of educated English speakers, but the same economic logic applies. A trade deal with China will reduce Australia to being an exporter of raw materials and geographically anchored services like tourism. It is relatively easy to see the benefits for China: it can secure preferential access to a range of the minerals and energy resources that Australia has. It is more difficult to see the benefits to Australia. Previous policies of value adding to our mineral and fibre resources seem to have gone missing.

I recommend that the Committee commission its staff to prepare a background paper, comparing the promises made by the Government and other trade enthusiasts in the early 1980s about the fillip that trade liberalisation would give to our sophisticated manufacturing industries and the reality today, noting in particular the cost advantage that China has and will continue to have through its low wages. The paper would paint some scenarios as to where liberalisation is likely to lead and what classes of manufacturing are likely to survive.

Peak Oil and Efficiency

The Government's enthusiasm for swapping goods and services between countries does not seem to take into account that world oil production is likely to peak this decade (www.hubbertpeak.com; www.peakoil.net) and is probably plateauing now.

Australia passed its peak rate of production of oil in 2000 and now depends on the willingness of Muslim Indonesia and Muslim Middle East to keep its oil umbilical cord open. There is no indication in any trade documents that DFAT is aware of the geologically certain looming peak and the vulnerability that this profoundly trade-affecting phenomenon places upon Australia's economy.

Petroleum geologists agree that about half of the world's readily accessible oil reserves have been consumed. Beyond 2010, it will become increasingly difficult for suppliers to pump oil at a rate sufficient to sustain modern industrial societies. This factor alone places an imperative upon avoiding the waste of fuel by flying and shipping goods around the world. Oil-fuelled trade cannot continue to grow, for geological reasons, regardless of economic argument about the price mechanism and even without factoring in greenhouse policy.

A narrow focus on swapping goods with China for profits to individual private companies neglects the more fundamental macro-economic issue, being that trade wastes resources.

Under FOI, I have obtained copies of what I am advised are the only briefs since 2000 to the Secretary or Minister on the implications of oil prices for trade policy. The briefs are unduly optimistic and also in effect see oil supply as an economic phenomenon as distinct from a geological phenomenon: noting that real prices are lower than historic highs and there is volatility in supply, both of which statements are true but misunderstand the extent of Australia's dependence upon imported oil and the extent to which trade policy is fuelling that dependence.

Expectations of continued growth through trade cannot be realised, for two reasons. The first is that the productive capacity of the world's factories now far exceeds the earning power of the world's population to purchase their products. The second is that the absolute limits to the earth's ecosystem capacities are now in sight. However, the Government has no Plan B.

In economics, 'efficiency' refers to capacity to market a good at a lower price. In common language, efficiency refers to capacity to produce a good less wastefully. The difference in meanings is not just semantic but goes to the heart of the flaws in trade policy. For example, although the transport between countries of similar goods produced by near-equally competent suppliers may be economically 'efficient', that is *profitable to the traders*, it is wastefully 'inefficient' in use of resources. Free trade is not about efficient allocation of scarce resources in any material sense, but about diverting profits to the traders. Oil is the resource most illustrative in this debate.

I *recommend* that the Committee ask its staff to prepare a research paper on the implications of the peak oil phenomenon and climate change for transport-dependent trade policy between continents.

Comparative Advantage

The intellectual case for free trade traces its origins to the theory of comparative advantage, expounded by classical economist David Ricardo in 1817. *If certain pre-conditions are satisfied*, two countries can both benefit from trade if they specialise in manufacturing those goods which they can produce most efficiently. This situation is known as *comparative advantage*. Gains arise mathematically from the differing opportunity costs of capital within each country.

Comparative advantage remains at the centre of modern policies of trade. It rests critically upon two pre-conditions (additional to those common to economics generally):

- *employment is full*: the labour or capital displaced by imports can be readily absorbed by more 'efficient' enterprises, in all participating countries. However, most countries now have surplus labour and this is manifestly applies to China;
- *labour and capital are not mobile* across international borders. For capital, this assumption is nowadays nonsense.

Any theory is valid only to the extent that its underlying assumptions are valid. If just one fails, the theory collapses. The two foundations mentioned are both rotten at the core.

If free trade is as universally beneficial as DFAT claims, then there must be some durable and widely applicable theory underpinning it. Obviously this cannot be the theory of comparative advantage, as that depends upon immobility of capital, which nowadays is a nonsense. It cannot be economies of scale, for that would surely convince any analyst that it would work in China's favour. Without an adequate theory, success or failure becomes a matter of trial and error, with no guarantee that what worked in one circumstance will work somewhere else. Ironically, globalisation does not make free trade inevitable, it negates its theoretical basis by advocating removing barriers to movement of capital.

If comparative advantage does not apply because of the inapplicability of its pre-conditions, the default position of absolute advantage prevails. In practice, this means that the strong benefit at the expense of the weak, or that China will benefit at Australia's expense in all those sectors where it can produce goods and services absolutely cheaper than Australia. These weaknesses are not merely

market failures in an otherwise sound theory, they are inherent in trade theory. The only avenue Australia has to make trade work in its favour is to retain the tools (such as tariffs, industry planning and foreign investment regulation) it has to express its sovereignty and to conserve its own national interests.

DFAT should commission some independent research on these policy issues. The NGO movement has sufficient technical expertise and analytical power to give very good value for money by performing or managing one or more consultancies on these subjects. Many of the NGOs are competent to do this but are staffed by volunteers and are also despairing of having any effect on DFAT trade policy.

I *recommend* that the Committee request DFAT to explain the theoretical underpinning of DFAT's pro-trade policy stance.

I *recommend* that the Committee invite a respected economist who is familiar with the non-mainstream sub disciplines to prepare a research paper for the Committee on the theoretical basis of free trade policy. I can supply names if the Committee so wishes. (Explanation: it is well known that the discipline of economics relies upon assumptions for its modelling. These assumptions are so deeply embedded that many modern economists tend to forget them).

Empirical Considerations

All wealthy countries started off protectionist. Australia's infant industrial economy found its feet behind tariff fences of a kind which it now seeks to break down for itself. Chang (2003) has explained this process, aptly termed "kicking away the ladder". It can apply anew to the modern high technology industries as much as it did and does for basic manufactures.

The reasons advanced a century ago for the tariff show how far modern Australia has abandoned the earlier consensus as to what is good public policy. Then, protection was seen as allowing manufacturers the financial space to innovate and to develop competitive muscle; nowadays, tariffs are seen as obstructing innovation and competitiveness. Then, and especially during the World Wars, tariffs were seen as a tool for achieving self-sufficiency in manufactures in an uncertain and hostile world; nowadays, tariffs are seen as an obstacle to a US-led or perhaps China-led global economy. Then, tariffs were seen as enabling manufacturers to pay a 'fair and reasonable wage' to employees — the 1906 *Excise Tariff Act* even gave that link statutory force; nowadays, economists press to abolish tariffs to force wages and conditions downwards.

A century ago it was widely held that competition with imported products of underpaid foreign workers was unfair. Yes, there was a racist edge to this viewpoint, but it was more than that: Australians believed that workers were due a fair reward for their labour. Now, our trade enthusiasts rejoice at the bargains that consumers can steal by undercutting Australian labour through outsourcing goods from overseas.

Some quite insightful papers are emerging about the real pathways to prosperity and the close linkages between protection and prosperity. I mention two authoritative works as examples.

Chang, Ha-Joon. 18 Apr. 2003. "Kicking Away the Ladder — The "Real" History of Free Trade". Paper presented at the conference on Globalization and the Myths of Free Trade, New York School University.

Mendoza, Ronald and Chandrika Bahadur. Jun. 2002. "Towards Free and Fair Trade: A Global

Public Good Perspective". Unedited draft paper, p.13, from UN Development Programme.

I *recommend* that the Committee urge the Government to commission reports by one or more of the NGOs as well as social or environmental experts, scientists or heterodox economists on its trade policy.

Summary

In summary, unless the free trade deal sits on a solid theoretical and policy foundation, which at present is missing, DFAT's best efforts to negotiate the details carefully will be fragile and its rosy hopes will not be realised.

I respectfully invite the Committee to challenge DFAT to engage genuine critical opinion. If DFAT's theory and policy are sound, there is nothing to fear by testing them publicly or privately. If they are flawed, then consulting like-minded sources from business and multinational corporations as is their usual practice will not reveal the flaws.

This submission is not arguing against trade, only against simplistic free trade ideology. For a policy to be prudent, it must reflect a robust theoretical foundation and be supported by empirical evidence from those places or times that it has been applied elsewhere or previously. Factors such as exchange rates, hidden variations in wage-price structure, environmental deterioration, availability of natural resources and political jostling are variables, not absolutes to be assumed away.

Australia's industries are now feeding on their own flesh. In the 1980s and 1990s tariffs were reduced to force so-called fat and lazy industries to reduce costs. Now manufacturers and farmers are being told that their costs must be reduced in order to match international prices, that is, to maintain low tariffs. If Australia enters a free trade agreement with China, this beggar-the-producer policy would be extended to the remnants of Australian manufacturing, the professions, service industries and investors.

A large number of countries have enough natural resources to become more-or-less self-sufficient. Australia is one. The main obstacle to robust self-sufficiency is free trade and investment, which discourage manufacturers from deepening factory capacity, stultify research, down-value corporate loyalty and distort nation-building strategies such as building public institutions.

Under free trade and investment, as in competitive markets generally, the strong become stronger and the weak fall further behind. This feature is well attested and has both theoretical and empirical explanations. It is the reason why trade practice laws to prevent misuse of market power are necessary.

The primary message which I leave for the Committee is the shallowness of so much of what is presented as argument in favour of free trade in general and the publicly advocated cartel agreement with China in particular. Critical, multi-disciplinary analysis is missing and those who will benefit have not been identified.

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