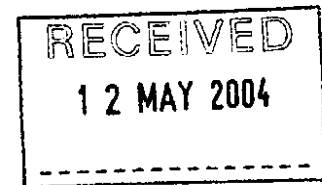


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5 May 2004



Senator The Hon Peter Cook
Chair
Senate Select Committee of Foreign Affairs and Trade
Parliament House
CANBERRA ACT 2600

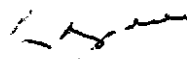
Dear Senator Cook

I attach a note on the effects of the terms that have been negotiated for the proposed Australia-US Free Trade Agreement on Australia's national economic interest.

I would be pleased if you would put this submission before your Committee.

I would also be pleased to discuss any aspect of the submission with the Committee at a time that is mutually convenient.

Yours sincerely



(Peter Drysdale)

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Submission to Senate Select Committee on the Proposed Australia-US FTA

The proposed Australia-US 'Free' Trade Agreement is seriously flawed in a number of respects. This submission draws the Committee's attention to one of its serious defects. On balance the Agreement negotiated is likely to *divert* as much trade as it *creates*, damaging Australia's economic interests and the interests of all our most important economic partners other than the United States.

What this means in simple terms is that the net effect of ratifying the Agreement on the terms proposed would be to provide protection in favour of higher cost American and against lower cost international suppliers from elsewhere to the Australian market, by more than it moved towards free trade. To the extent that the costs of these protectionist elements exceeded the gains from the free trade elements of the agreement, it would directly damage Australia's economic interests, lowering income and national welfare.

It will also indirectly damage Australia's economic interests by exposing Australia to the consequences of a drift away from multilateral trade in East Asia and elsewhere, leading to exclusion from opportunities for new access to markets.

There is an additional and substantial economic cost in the form of the damage this Agreement, between two important and efficient agricultural exporters, will do to Australia's interests in the negotiation of agricultural trade liberalisation in the multilateral trading system. The proposed terms of the Agreement exclude significant agricultural commodity trades, such as sugar, and includes policy instruments such as variable tariff levies that are at the core of agricultural protection regimes in Europe and elsewhere. These concessions in trade with the United States would effectively forfeit Australia's capacity to negotiate significant agricultural trade liberalisation anywhere else

in the world for many years to come. In this context, it is significant Australia was not represented at the recent discussions that took place at the instigation of USTR Zoellick between the United States, Europe and G20 countries.

The economic relationship between Australia and the United States is one of our two most important economic partnerships. But it is heavily asymmetrical in character (with a huge bilateral trade surplus in favour of the United States, a trade surplus that is forecast to rise if the proposed Agreement is implemented). The viability of our big trade partnership with the US depends on the complement of our equally important trade and economic partnerships with East Asia (in which Australia runs substantial trade surpluses). Trade arrangements that offer preferential treatment to the United States at the expense of our big and growing trading partners in East Asia are likely to damage Australia's overall trade and economic interests.

Australia's overwhelming trade policy interests are in multilateral trade solutions. One view, reflected but not carefully considered in the Government's latest study (CIE, p 21ff), is that the proliferation of 'free' trade agreements elsewhere means that there is no multilateral route open by which Australia can seek to liberalise trade so that Australia too must join the FTA game. First, the proposed Agreement is not, on balance, advantageous to Australia. It seems likely to protect inefficient production more than it frees trade. There is no case for proceeding with a bilateral Agreement which imposes such costs even if it were indeed the only option open. Second, Australia has not been without its own influence on the drift towards preferential bilateral trade deals in ways that are damaging to Australia's national economic interests. The choice not to proceed with this flawed proposal is likely to accelerate re-assessment of this trend in both or either East Asia and North America and to re-focus attention on the ongoing multilateral negotiations in the Doha Round.

On the evidence of the Government's own study, this is an Agreement the direct trade effects of which appear likely to damage Australia's economic interests. An important element in the calculation of the direct costs and benefits of the trade effects of the

USFTA suggest that income losses through trade diversion will exceed income gains from trade creation by a small but significant margin (CIE, Table 7.1, p.83). Dr Stoeckel, in evidence before the Committee, has asserted that I am wrong in this respect. It is a reasonable interpretation of the data in table cited that the direct effects of trade diversion are larger than the direct effects of trade creation (the difference between the total of these effects in Columns 1 and 2 in Table 7.1). The effects reported in other columns in this table might seem to qualify this result. But the positive effects attributed to terms of trade, efficiency and other factors in those columns-- suggesting a modest overall income gain of \$360 million from the agreement instead of an income loss of \$19 million -- are problematic. And they are difficult to reconcile with the negative direct effects on the gains from trade of the agreement. In these assessments, a primary and proper focus is on the direct trade creation and trade diversion effects of an agreement.

The income losses from trade diversion would be associated a significant reduction of imports (of the order of \$3.7 billion) from trading partners other than the United States (CIE, p 91). The US will take an increased share of Australia's import trade at the expense of East Asia and Europe, and there will be a reduction of Australian exports to those markets (of the order of \$0.6 billion assuming no retaliation effects).

A significant proportion of this trade diversion occurs in the motor vehicle industry. Remarkably the Government's study identifies none of these costs in its case study of the motor vehicle industry. This result follows from its assumptions that there is no significant substitutability between American-produced cars and Australian-produced cars and that, because average local content in the industry is 75 per cent, the rules-of-origin provisions of the proposed Agreement are not relevant to its effects. The Government's appointed analysts appear to be unaware that the major Japanese automobile manufacturers operating in Australia produce similar models to their main Australian product lines in North America. They seem to be unaware of the variations in 'Australian plus US content' across the Australian operations of automotive producers. They appear also unaware of the implications of the proposed Agreement for the location

decisions and procurement decisions of these firms. The trade diversion in this sector is likely to lead to the migration of production capacity from Australia to the United States.

Given the qualified and distorted nature of the trade liberalisation measures under the proposed Agreement, this is the result that one would expect. The Agreement excludes trade in which clearly Australia is the lowest cost source of supply to the United States, such as sugar. An implication is that the dynamic effects of the proposed Agreement can also be expected to be negative not positive as the Government's study asserts because, of their nature, dynamic effects commonly and simply multiply the direct effects of such arrangements and in the same direction.

The other model used in the Government's review of effects of the USFTA is incapable of measuring the negative income and trade diversion costs of the FTA properly (as noted about the GGG-Cubed Model in CIE, p 82) but it is used to calculate large and positive dynamic effects. It is also used to calculate the 'dynamic' effects of the investment provisions of the proposed Agreement that lift the limit on foreign investments not subject to FIRB scrutiny from \$50 million to \$800 million. The Government's new study suggests that the dynamic benefits of this discrimination in favour of US investors and against investors from other countries will yield an income benefit of around \$4 billion a year. It is difficult to accept that there is any plausible or professional foundation upon which all of the assumptions on which these 'back-of-the-envelope-calculations' (CIE Appendix B) are based. The gains are likely to be many-fold smaller and the outcome to involve negative as well as positive effects.

But my concern here is to draw the Committee's attention to the investment diversion effects of the investment provisions of the proposed Agreement. If these provisions are not multilateralised (that is, extended to investment partners other than the United States), American incorporated investors will be given special protection and monopoly privileges over investors from other countries at Australia's economic cost. To the extent that the FIRB processes amount to material restriction of investment flows (and there is doubt about whether they do) this would effectively raise the rate of return to American

investors over the international rate of return on investments in Australia up to \$800 million. Nowhere are these investment diversion (income lowering) effects of the proposed Agreement incorporated in any of the Government's studies.

There is also a treaty obligation issue involved in respect of the investment provisions of the proposed Agreement. Article IX of the Basic Treaty of Friendship and Cooperation between Australia and Japan requires that Japanese companies be accorded treatment no less favourable than that of other countries in their investment activities in Australia. These treaty obligations have been invoked by the Government to resist the extension of preferential treatment in respect of investment under the Closer Economic Relationship arrangements between Australia and New Zealand.

The Government has announced that it does not intend to multilateralise the investment provisions of the proposed Agreement. If the gains from these provisions are in fact so large, presumably we would want to extend them to all countries as a matter of national interest. To do that does not require the negotiation of a 'free' trade agreement with the United States or any other country. It can be done unilaterally and without the costs of an FTA.

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5 May 2004