# CONTEMPORARY CHALLENGES FOR AUSTRALIA IN THE INTERNATIONAL ECONOMY

**Ross Garnaut**
**Professor of Economics**
**Research School of Pacific and Asian Studies**
**The Australian National University**

**Background notes for the presentation to the Trade & Development Seminar, Division of Economics, Research School of Pacific and Asian Studies, 24 August, 2004.**

Australia is now entering its fourteenth year of unbroken economic expansion The recent period is at once the longest time of unbroken growth since Federation (accepting that only a recession, or two successive quarters of falling output, counts as a break), and the only long period since Federation in which average rates of growth in Australia have exceeded those in almost all other high-income economies.

The strong growth in total output was accompanied by rapid increases in export volumes and in the ratio of exports to GDP until 2000. The external accounts have neither been nor been seen as a constraint on macro-economic expansion.

It is widely accepted that Australia's strong growth performance in recent times owes much to the international financial deregulation and the reductions in protection of the 1980s and early 1990s, together with the productivity-raising domestic reforms that were facilitated by reductions of barriers to international economic transactions. The productivity-raising reforms, in turn, were supported by strong export growth across all sectors, themselves encouraged by non-discriminatory trade liberalisation and rapid growth in imports into Australia's main export markets in East Asia. A couple of periods of weakness in the external economy, notably in the Asian financial crisis, did not break the momentum of Australian export expansion, as real depreciation encouraged diversification of export growth.

The pattern of export growth has been broken since 2000, for reasons that are not altogether clear, but which have included a considerable real appreciation over the past two years. The restoration of export growth will be an integral part of the set of adjustments that have to occur if strong economic growth on the pattern of the past one and a half decades is to be maintained. This will be made more difficult by the recent weakening of the Australian political system's capacity for further internationally-oriented reform, and by the weakening of momentum in non-discriminatory trade liberalisation in Australia and East Asia. The most important manifestation of the latter weakening is in the increased legitimacy of demands that one country's liberalisation should be made to depend on others' reciprocation, and in the associated retreat into preferential trade.

In the seminar, Australia's external macro-economic challenges are the backdrop to a discussion of the challenge of preferential trade. Two small discussion pieces are attached to these notes as background to the seminar. The first discusses the growing external imbalances. The second focusses on the question: how can Australia and its partners in the Asia Pacific region minimise the damage to incomes-raising trade expansion in an era of preferential trade. The ideas in the second of these notes have not been raised in a public forum before, and will be the main focus of the presentation at the seminar.

## THE COMPETITIVENSS CHALLENGE TO THE AUSTRALIAN PROSPERITY

The 2004 election contest is premised confidently on continued prosperity. A harder reality is likely to intrude before the next Parliament has finished its work.

Over the years since the 1991-92 recession, the economy has performed better than ever before relative to other rich countries. Economic growth in the nineties was underpinned by the strongest export expansion in our history.

All of this began from the mid-eighties, when there was for a while a broadly based acceptance that economic analysis was relevant to economic policy. This acceptance was a sharp departure from earlier Australian political culture, which had weighed pressures from vested interests more heavily in the balance of economic policy-making.

I do not come to the view that the comfortable times are fading from any general predilection to gloom. In *Australia and the Northeast Asian Ascendancy*, I challenged the political orthodoxy of the time in anticipating the lift in productivity and export diversification and growth that would accompany the internationalization of the Australian economy. As the Thai economy was falling into depression in late 1997 and the contagion spread through East Asia, I wrote in a paper for the Australian Business Council that we could expect continued strong growth for our own economy. Prime Minister John Howard in speeches inside and outside the Parliament broadcast the optimism that I expressed at The Australian's 1997 conference, *Australia Unlimited*. I spoke then about the shock that Australians would soon experience as they realized they were part of the third period of sustained prosperity in their country's history.

I have long expressed the view that no economic expansion is doomed simply on account of its longevity.

Australia's biggest economic problems before the recent prosperity came mainly from two sources. The first was expansion of domestic expenditure beyond the productive capacity of the economy. Sometimes the unsustainable increase came from spending the benefits of increased export prices (terms of trade), that turned out to be temporary.

The second source of problems was policies which constrained the efficiency with which Australian resources were used. Low productivity growth sharpened the difficulty of holding expenditure within the economy's (diminished) capacity.

On the second, there has been a gradual corrosion of support for and less and less action on productivity-raising reform over the past decade. Much of the legacy of the reform period remains, including a much more open economy, more competitive domestic markets, deep integration into Asian economies, an economically productive immigration programme and a somewhat more flexible labour market. But there is now little political interest in removing remaining barriers to Australian economic efficiency. A new low water mark for the influence of economic analysis was reached last Saturday, when an editorial in support of the US FTA in *The Weekend Australian* asserted that "economic sense and political reality are rarely related".

The decline in support for productivity-raising reform in Australia has already contributed to less efficient resource allocation. It would compound the costs of any economic downturn in the period ahead.

The problems from excessive demand expansion are acute right now.

Over the past several years, real private consumption and total domestic demand have risen more strongly than over any comparably long earlier period, and real public expenditure has not been held back to offset them. Private consumption has been driven by one of the strongest sustained real expansions of bank lending ever. The real domestic demand expansion of recent years is at least as virulent as that which precipitated the extreme monetary tightening of the late 1990s. The savings share of household income fell in the boom of the late 1980s, but remained in the range of 8-10%. It was minus 3% in the March quarter of 2004.

We now know that interest rates were increased too far in the late eighties. That error should not be repeated. But to react too little to the problem that has emerged would be to err in another way, with different immediate but regrettably similar medium-term consequences.

The economist's starting point for assessing changes in international competitiveness is the ratio of prices of non-tradeable (domestic) goods and services to those of tradeables (exports and imports). In the March quarter of 2004, this ratio was higher than at any time over the two decades for which we have data, despite export prices being the highest ever over that period. The inflation in domestic prices seems now to be deeply entrenched near 1% per quarter—far higher than in any of Australia's large trading partners.

The extent of the on-going domestic inflation has been obscured by falling prices for tradeable goods, in the year to February reinforced by a rising currency. The fall in the foreign exchange value of the Australian dollar since then brings inflation into sharper focus. The increases in Australian dollar prices of imports and exports in the June quarter will find their ways into the broad-based indexes through the remainder of 2004.

One symptom of the extraordinary expansion of domestic demand has been a current account deficit near record levels as a proportion of GDP, despite record terms of trade and historically low international interest rates.

One symptom of the corrosion of competitiveness has been the collapse since 2000 of the strong export growth that began with the reforms from the mid-eighties. From the March quarter of 1986 to the March quarter of 2001, the volume of Australian manufactured exports increased by around 700% and of services by around 450%. The volume of agricultural exports grew by around three quarters and resources by around 250% over the same 15 years.

By contrast, over the three years from March 2001 to March 2004, the volume of manufactured exports increased by a total of 4%, services by 1%, and rural and resources exports both declined.

Defenders of the complacent view point to a number of specific causes of weak export growth in recent years: the drought of 2002; the effects on tourism of SARS and the Iraq war in the first half of 2003; and the United States recession of 2001. Closer analysis shows that by the March quarter of 2004, the record grain harvest of 2003 was making its way through the export terminals. International tourism had recovered strongly in the rest of the world. Economic recovery in the US, unexpected growth in Japan, and the China boom helped to make the March quarter perhaps the strongest ever for imports into Australia's export markets.

The best groups of applied economists in Australia are in the Reserve Bank of Australia and the Treasury. Such is their intellectual dominance that private sector economists ensure that their own forecasts do not vary much from these authorities. But even my friends in the Bank and Treasury seem to have succumbed to the great Australian complacency of the early twenty first century.

In the May 2001 budget papers, Treasury forecast export volume growth of 5%, said to be a "little below trend". The next year's budget reported the outcome at minus 2%.

The same forecast for 2002-03 was 6%. The reported outcome was zero.

The forecast outcome for 2003-04 was again 6%. The outcome was reported the next year as 2%.

So what do we make of the current budget forecast of 8% growth in export volumes?

The contemporary data provide reasons to expect new disappointments in the Budget papers for 2005.

Domestic demand has to be reduced significantly from its current trajectory for a start to be made on correcting the dangerous imbalances in the economy. The anticipated correction in the housing market can deliver only part of the adjustment that is required.

The necessary policy adjustment would be less damaging to long-term growth the earlier it came. It would be least disruptive if it were led by a tightening of fiscal policy. But this is hardly likely in the febrile depths of a year-long election campaign. Or soon after a campaign has been won by one or other party by promising that the easy times will continue forever.

If budget surpluses were increased for the duration of the excessive domestic demand, monetary tightening would still be necessary, but would not have to go so far. The increases in interest rates would be less the earlier they came. Leave it too late, and the markets will impose their own sudden and disruptive solution. But judiciously timed monetary policy, too, is constrained by the year-long election.

When it comes, the tightening of monetary policy will temporarily exacerbate the problem of competitiveness, by lifting the dollar (or, more likely, constraining the fall that would otherwise be associated with the weak external payments). Like it or not, sustainable, non-inflationary improvements in competitiveness may be preceded by what seems a backward step.

Is there no happy ending? Won’t the China boom, with India to follow, avoid the need for adjustment by continuing to raise our terms of trade?

Without Chinese growth we may have had a crisis before now. But the China boom of early 2004 is about as good as it gets. We will indeed be the lucky country if the terms of trade hold at current high levels. The next period of sustained prosperity, like the one that is now fading, will be made in Australia.

## “MEETING THE CHALLENGES OF PREFERENTIAL TRADE”

A new era of preferential trade will open for Australia in early 2005, when the US-Australia FTA takes effect. This will introduce international trade transactions costs and trade diversion in ways unknown since the 1930s. The problems will surprise Australians, because they have not been prepared for them by the public discussion so far.

The problems of preferential trade will interact with the challenge presented by the decline over recent years in the competitiveness of most of our export and import-competing industries.

For now, the Australian policy debate about whether Australia should enter new preferential trading arrangements has been concluded decisively. For the time being, there is irresistible momentum towards the proliferation of preferential arrangements involving all substantial economies in the Asia Pacific region.

For two hundred years, economics has been the “dismal science”, because it has advised that economic policy has consequences independently of political hopes. Whatever one’s views on the overall balance of costs and benefits from the shift to preferential trade, there will be some negative consequences. How do we make the most of the new circumstances, minimize the costs of preferential trade, and accelerate progress on the general trade liberalization in Australia and its partners that everyone recognizes as best for Australia?

The starting point is to recognize the problems early and clearly.

The first problem derives from Australia, through the FTA with the United States, placing itself in an unusual position in world trade—a position that history demonstrates to be unsustainable. It introduces systematic discrimination in Australian import policy in favour of one country that is a major trading partner, and against others of comparable importance. The associated diversion of imports away from countries that are Australia’s major export markets will, if it persists, generate tensions, affecting all aspects of the trade relationship. Recognition of the potential for problems has helped to give impetus to the Australian effort to secure new FTAs in Asia.

Unfortunately, new FTAs of the conventional kind will not solve the problem of discrimination and trade diversion. There will always be exclusions at the margin, and there is no defensible rationale for favouring Chinese over Indian textiles, or

Malaysian over Hong Kong computers, any more than American over Japanese cars.

The second problem with preferential trade arises from the rules of origin. The problems are more acute now than they would once have been, since goods (especially) and services are now invariably made from inputs produced in many countries. This is what globalization is all about, and it goes further every month and year. There is no completely Australian-made fashion clothing any more, or Malaysian-made laptop computers. But there is a lot of fashion clothing exported from Australia, and computers from Malaysia, providing many good jobs in those countries. These exports are competitive because they draw components from the places in the world that can supply them at lowest cost.

It is simply not possible for Australian clothing or Malaysian computers to meet US-style rules of origin and to remain internationally competitive. The costs of meeting rules of origin cause virtually all Singapore exporters to pay the generally applicable tariff rather than use the FTA in exports to the United States: it is cheaper than meeting the compliance costs and the costs of restructuring to ensure that components are drawn from Singapore or the United States. The compliance costs of the rules of origin are said to be equivalent to a 2 per cent tariff on Mexican exports to the United States. The costs of the rules of origin mean that there would be problems in a world of preferential trade, even if 4,000 FTAs joined every combination of potential bilateral trading partners.

The Productivity Commission study of Closer Economic Relations between New Zealand and Australia shows that the generous rules of origin embodied in that agreement (far simpler and more liberal than in the Australia-US FTA) have become more damaging over time, as globalization has increased the benefits of drawing higher proportions of inputs from a wider range of countries.

Big countries, first of all the US and China, have much less difficulty in meeting US-style rules of origin. The US and China may gain relatively in a world of preferential trade, but nevertheless suffer costs from the constraints on efficient specialization in their trading partners.

We have now seen enough of the new preferential trading relations in the Asia Pacific region to see that they are not vehicles for significant trade liberalization. So there is a third problem with the shift into preferential trade: it is absorbing scarce political and other resources that are in principle available in support of freer trade, without producing liberalization.

Every preferential trading relationship contains potential for movements towards free trade, and for increased protection. The “free trade” elements involve “trade

creation", or the replacement of high-cost production in one partner country by lower-cost supplies in the other. The "protectionist" elements involve "trade diversion", or the replacement of low-cost production in a third country by high-cost supplies from an FTA partner.

While the Australia-United States FTA is not the most protectionist of the new preferential arrangements in the Asia Pacific region, the Government's own report on the effects of the US-Australia FTA shows that trade diversion exceeds trade creation, and Philippa Dee's excellent study for the Senate Committee shows that the methodology of the government report underestimates trade diversion.

The general tendency is for countries to seek FTA partners which have limited scope for trade creation, and within those partnerships to restrict trade creation by exclusion or special safeguards for "sensitive' industries.

The costs that Australia imposes on itself through discrimination against important trading partners, and from introducing rules of origin into its import trade, could be removed by one policy step. Australia could allow all of its trading (and investment) partners the same terms of access that it grants to its FTA partners. It would be necessary to generalize the most liberal terms allowed in each sector, since the arrangements differ greatly across agreements. In most cases, the terms for New Zealand would be the most favourable.

There is much to be said for this solution. It would yield immediate and large benefits for Australian economic performance. It would contribute directly and quickly to improvement in the competitiveness of industries in which Australian comparative advantage is strong. This is especially helpful now, with problems of competitiveness emerging in recent years across most export industries. This approach would also encourage multilateral approaches to trade liberalization elsewhere, including in WTO negotiations.

There are two difficulties with this straightforward and attractive approach. First, it runs counter to increasingly protectionist thinking in Australian trade policy-making in recent years, manifested in the opposition to domestic liberalization that is not matched by "concessions" in trading partners.

Second, it would not directly reduce the costs to Australia from the increasing tendency for FTAs of its major trading partners to discriminate against Australia. This is not as big an economic issue as is generally presumed, as other countries' competitiveness in global markets falls when they enter trade-diverting FTAs. For example, Australian exporters gained from the dramatic decline in Canadian exporters' shares in East Asian markets after the formation of NAFTA. And the competitiveness gains from Australia moving promptly to completely open trade

and investment would offset much of the cost of exclusion from others' trading blocks.

Nevertheless, the costs to Australia in exclusion from other preferential trading arrangements are of some importance in themselves, and compound the difficulty of implementing unilateral trade liberalization at this time. It is tempting to think that Australia's return to comprehensive liberalization would help to persuade others to a similar course. Unfortunately, protectionist demonstration effects seem to be more immediately influential than their opposites. While Australia has been influential in shifting other Asia Pacific economies towards preferential trade, its own return to comprehensive trade liberalisation is unlikely to be similarly influential in the short term.

An alternative approach could be built around the integration of comprehensive liberalization with an extension of the current Australian discussions of an FTA with China and separately with ASEAN.

The alternative approach would have the following elements.

The new Asian-Australian FTAs would embody the simplest and most liberal of the rules of origin amongst established Asia Pacific FTAs. Either Australia-New Zealand Closer Economic Relations or the ASEAN FTA would be the model.

The first of the new Australia-Asia FTAs, presumably with either China or ASEAN, would be the starting point for a new Open Trade Arrangement (OTA). It would be sensible for New Zealand to be closely involved in the development of the new approach, and to join the new arrangements soon after the formation of OTA. It would be an objective of the initial discussions to achieve early membership of OTA by Japan, Korea, India, and the separate WTO customs areas of Hong Kong and Taiwan.

Membership of OTA would be available to any country that agreed to meet the arrangement's rules.

Each member of OTA would agree to extend to its partners terms of market access at least as liberal in each sector as it had made available to any other country in a preferential trading agreement. Thus if the first of the new Australian FTAs were with China, Australia would extend to China the New Zealand CER conditions. China would provide access for Australia at least as liberal as to ASEAN or New Zealand under FTAs currently under negotiation.

All members of OTA would accept value-added within any OTA member as regional value added for rules of origin purposes.

In recognition of the reality that improved market access has little meaning if members apply subsidies for exports or production, all members would agree to tight constraints on the application of trade-distorting subsidies. This would not be a significant barrier to entry of East Asian or Southwest Pacific economies or of India.

Each of the members would be encouraged to provide OTA partners with liberal market access. The chances for subsequent success would be greater the more liberal the terms offered for access to the Chinese, Japanese, Korean and Australian markets. However, the first objective within OTA would be to reduce the practice and the costs of trade discrimination. For this objective, ease of entry for new members is more important than liberalization at the point of entry. The entry of subsequent members would not be the subject of demanding case-by-case negotiations. New members could join so long as they offered access that met the (soft) requirements of consistency with what are accepted as WTO standards. In practice, the abandonment of high ambitions to use entry into the free trade arrangements as an opportunity to negotiate major liberalization has little cost, given the tiny element of net liberalization in the FTAs negotiated in recent years in the Asia Pacific region.

Now that the Australia-US FTA, with its major exceptions for agriculture, has been accepted as being consistent with WTO requirements, OTA membership by the Northeast Asian economies with highly protected agricultural sectors (Japan, Taiwan and Korea) becomes much less problematic.

China has made Australia's acceptance of its "market economy" status a condition for commencing negotiations on an FTA. I have argued for many years that it is desirable on the merits of the issue for Australia to accept this status, independently of the FTA negotiations. It would be helpful to others' ease of entry into OTA if China did not place similar conditions on other countries' membership, leaving this issue to be settled case by case in separate discussions.

The main dynamic for trade liberalization would come from two other elements of OTA. This dynamic would be more powerful and effective than negotiation of bilateral FTAs on the established pattern.

First, each member would be required to establish an institution for transparent, independent analysis of the effects of trade policy choices along the lines of Australia's Productivity Commission. This would not in itself involve new commitments to trade liberalization, but would lay the basis for liberalization over

time. Bill Carmichael and I have developed and advocated a model for the domestic transparency institution.

Second, each member would commit itself to cooperation within OTA to achieve a liberal outcome from WTO negotiations. OTA members would work through the WTO to achieve free and open global trade and investment by a definite date. The definite date would be consistent with the revised end dates for free and open trade in the Asia Pacific region that are due to be discussed at the APEC mid-term review of the 1994 Bogor Declaration, scheduled for 2006, at the APEC meeting to be hosted by Australia.

Would membership of OTA be attractive? For all members, it would reduce, and if and when OTA's membership had expanded to encompass China, Japan, Korea and ASEAN, remove, an important source of anxiety and cost from the shift to preferential trade in East Asia.

Developing countries with significant Asia Pacific trading interests would find membership relatively straightforward.

The United States in its current mood on trade and strategic matters would find the removal of agricultural subsidies prohibitive pending progress in the Doha Round of multilateral trade negotiations, and would have inhibitions about "free trade" with China. The NAFTA partners would be reluctant to accept the liberal rules of origin. The European Union would also have difficulties with agricultural subsidies and rules of origin.

The likely absence in the early years of the US and the European Union mean that OTA would not remove the costs of preferential trade for Asia and the Southwest Pacific. But it would greatly reduce them.

OTA would not threaten essential US interests, beyond the threat implicit in the current proliferation of bilateral FTAs in Asia. There would be some large pluses for the US. OTA would be a useful partner of the US in global and Asia Pacific trade liberalization discussions.

There would be economic advantages, as well as gains to the political relationship with the United States, if Australia, and any other country that chose to do so, extended OTA terms of market access to all trading partners. For Australia, this step would avoid replacing pro-US discrimination against Asia by pro-Asian discrimination against the United States—an unfortunate possible outcome from Australia's entry into new conventional FTAs in Asia.

It has to be acknowledged that this alternative approach to reducing the costs of preferential trading arrangements, like straightforward comprehensive liberalization, would run foul (to a smaller extent) of the increased protectionist sentiment in the Australian polity in the era of preferential trade. While there are elements of specific reciprocity, most importantly the removal of discrimination against Australia, the alternative approach contains undeniable elements of unilateral liberalization. That unilateral liberalization in the 1980s and 1990s, on a much larger scale than anything now required, was brilliantly successful economically, seems to count for little in the contemporary political discussion. However, that it was, with good leadership, politically manageable, should be a source of encouragement.

The political resistance is best challenged by a return to independent, authoritative and transparent analysis of trade policy options as a basis for public education and discussion. This is the approach that facilitated trade liberalization in the 1980s and 1990s. The Government that is formed after the coming elections would be wise to provide a reference to the Productivity Commission, to report on the costs and benefits to Australia of alternative trade strategy options, including the alternatives presented in this paper.

Informed public discussion of the effects of trade policy choice has in the past changed the constellation of public policy possibilities. There is no reason why it would not do so again. In the meantime, agreement that there are problems in the proliferation of bilateral FTAs, that alternative approaches that do not seek to overturn decisions that have already been made by the Government are worth considering, and that these should be the subject of Productivity Commission references after the election, would avoid the risks of potentially good possibilities being excluded by positions adopted in the heat of a fiercely contested election campaign.