

Mark Thirlwell

**Death knell for the old terms of trade**

Australian Financial Review

7 November 2005

P. 25

Preferential trade across the world

Share of imports 2005 (est)

World	51.20%
Asia	16.20%
Latin America	63.60%
Middle East	38.10%
Africa	43.60%
North America	51.60%
Transition econs	61.60%
Western Europe	67.00%

Source: World Trade Organization  
(appeared as graph)

Trade policy is once again in the headlines. The current Doha round of international trade negotiations is limping, battered and bruised, towards the World Trade Organization's ministerial meeting in Hong Kong next month.

But even as trade ministers have been scrambling frantically to stitch together a deal on agricultural trade, in a last-ditch attempt to head off another Cancun-style fiasco, pessimism about the trade round's future has mounted.

The window available for concluding the Doha round, before the US president's "fast track" negotiating authority expires in July 2007, is closing rapidly.

Meanwhile, Australia's trade negotiators are also keeping busy on other fronts: they are negotiating preferential trade agreements (PTAs) with the Association of South-East Asian Nations (alongside New Zealand), China, Malaysia and the United Arab Emirates and a feasibility study for a deal with Japan has also been commissioned.

The context for all of this activity is an international trading environment in flux and the pressing challenge for Australia is how to manage the resulting new terms of trade.

What are the new terms of trade?

Usually when economists talk about the terms of trade, they are referring to the formal definition of the ratio of export to import prices. Even in this technical sense the terms of trade have changed: the ratio of Australian export to import prices is now higher than it has been for more than three decades, giving a significant boost to our real income.

However, the terms of trade have also changed in a broader sense, in that the terms on which we engage with the rest of the world through international trade have altered.

For example, there have been a series of shifts in the structure of international trade at the global level.

These include the increasing share of trade in world output; the expansion of trade into new areas such as services; the intensifying links between trade, foreign direct investment (FDI) and international production chains; and the arrival of "new" trading powers such as China and India, along with their distinctive impact on the location of global manufacturing and services.

Indeed, these developments tend to be closely linked: China's expanding role in world manufacturing has been facilitated by its position in international production chains and a stock of more than \$US500 billion (\$683 billion) of FDI; India's growing presence in the offshore outsourcing market owes much to a technology-powered rise in the tradeability of services.

These structural shifts have been accompanied by, and have contributed to, a transformation in the international policy environment.

The multilateral system that has supported world trade since the end of World War II is under significant strain: two of the past three WTO ministerial meetings have now ended in failure, and only one successful multilateral trade round has been concluded in the past quarter-century.

Due to a combination of factors that include an expanding and increasingly diverse membership roll, the growing complexity and sensitivity of trade negotiations and a terrible public image, the negotiating machinery of the multilateral system is in danger of breaking down.

With multilateral negotiations progressing at a glacial pace at best, policymakers have looked elsewhere for trade policy action. The proliferation of PTAs, typically in the form of so-called bilateral free-trade agreements and multi-member regional trade agreements, has been one consequence, with hard-to-assess, but potentially troubling implications for the future of the international trading system.

To these global trends must be added shifts in the regional environment in East Asia.

Here, too, there have been important changes, including the expanding importance of intra-regional trade and the spread of PTAs into a region that had (until recently) been one of the last bastions of multilateralism.

Perhaps the most striking development, however, has been the way in which the mounting economic and political weight of China has exerted a gravitational pull on the rest of the region, influencing both regional trade flows and institutions.

Since roughly half of all Australian merchandise trade now takes place with East Asia, these trends are another crucial part of our new terms of trade.

Finally, these developments at the global and regional level have also been reflected in Australia's own trade profile.

Thus the share of trade in output has risen over recent decades, services have become a more important part of our trade mix, China has become a key bilateral trading partner and Australia has joined the worldwide shift to preferential trade.

These new terms of trade are set to provide policymakers with a whole series of tests over coming years, but three issues are likely to be particularly important:

\* At the global level there is an urgent need to protect and then rejuvenate the multilateral system.

\* At the regional level the challenge is to respond to a new environment characterised by multiplying PTAs and an increasingly influential China.

\* At the national level the task is to maximise the benefits and minimise the costs associated with the recent shift to preferential trade.

The most pressing issue for policymakers is safeguarding the international trading system.

True, some critics argue that the WTO and the system it was created to oversee have had their day; that globalisation in the form of technological innovation and low formal barriers to trade has rendered the international system of trading rules irrelevant.

Others denounce the WTO for a lack of transparency and allegedly undemocratic ways, sometimes suggesting that the world's poorer and smaller countries would be better off without the pernicious influence of this "Great Satan" of globalisation.

Yet in many ways the need for the multilateral system is greater than ever. Not only is trade playing a steadily greater role in national economies as sectors once thought to be "non-tradeable" become an increasingly important part of international commerce, but at the same time the world economy is having to adapt to the re-emergence of China and India as key players.

Inevitably these developments will generate friction and adjustment strains. In fact, these are already evident: witness, for example, the US Congress's focus on the bilateral trade deficit with China and rumblings in the developed world about the threat to white-collar employment posed by outsourcing service sector jobs to India.

A well-functioning multilateral process is one of the best ways we have to ensure that the resulting tensions do not undermine the international trading system and ultimately the health of the global economy.

Indeed, Australia has a particularly strong interest in the continued health of the multilateral system.

While trading superpowers like the United States or the European Union may be able to operate reasonably effectively in an international economy lacking a strong rules-based framework, such an environment would be a far less comfortable place for a medium-sized player like Australia.

Moreover, it is only the multilateral system that is likely to deliver any significant progress in liberalising agricultural trade, an outcome which remains a key trade policy objective for Canberra.

The immediate challenge is for policymakers to ensure that the current Doha round of trade talks does not end in ignominious failure; something which now looks to be a serious risk.

Ideally, saving the multilateral system would begin with saving the Doha round, since although a collapse of the round might not inflict a fatal wound on the multilateral system, it could come perilously close to doing so.

Furthermore, even if the system did manage to survive, it would risk being crippled, leaving the repair job looking even more daunting than it does now. Unfortunately, time is running out.

In the longer term, reinvigorating the world trading system requires more than just a patch-up job for Doha.

First, it means restoring the effectiveness of the multilateral system as a negotiating forum; that is, pushing ahead with reforms — for example, watering down the requirement for consensus in WTO decision-making and allowing an element of "variable geometry" whereby WTO members would be allowed to pursue more ambitious commitments ahead of their more reluctant counterparts — to ensure that trade rounds can once again deliver results and do so in a reasonable time frame.

Second, it involves convincing a generally sceptical public that the system itself is in fact worth saving.

While the global policy framework is of critical importance to Australia, the geographic concentration of our trade means that developments in East Asia are also crucial.

Here the task facing Canberra is to work to ensure, as best as possible, that the ongoing process of regional trade integration and the associated policy initiatives unfold in ways that are beneficial both for Australia and for the region as a whole.

This means making sure that we have a voice in emerging regional architecture such as the East Asian Summit and then using that voice to continue to push for as open and comprehensive regional trading arrangements as possible.

It is possible that there may even be a role here for the Asia-Pacific Economic Co-operation forum, an organisation that has lost its way in recent years.

Although Canberra can work to influence policy at both the multilateral and the regional level, clearly the actions of other, larger players will tend to dominate any eventual outcome. That means that it is particularly important to get national policy right.

With Australian trade policy now committed, in the near term at least, to following the preferential trade approach in tandem with the multilateral route, the policy objective is to maximise the net economic gains from that policy switch.

This will require, for example, efforts to achieve the greatest possible degree of consistency across the various existing and proposed arrangements.

But it should also involve a process of submitting completed agreements to a rigorous, independent and regular review in order to gauge their ongoing economic impact, and so test the effectiveness of this new trade strategy.

*Mark Thirlwell is program director, international economy, at the Lowy Institute for International Policy. Lowy Institute Paper 07, The New Terms of Trade, will be available from the institute's website from November 18.*