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## **The future of trade policy in an uncertain world**

### **Address to the Lowy Institute**

**Sydney**

*Check against delivery*

**10 December 2010**

As the Lowy Institute points out in its selection of the topic of my address today, the global economy is experiencing a period of unusual uncertainty, with debt crises in Europe, further quantitative easing in the United States and overheating in China. In the aftermath of the deepest global recession since the Great Depression, global imbalances are especially large. A huge excess of spending over saving in the United States and Europe is mirrored by a big excess of savings over spending in China and other surplus countries.

The sluggish post-recession growth in the United States and Europe and deep import penetration of Chinese manufactures into the US market hasn't led to the greatly feared outbreak of protectionist trade wars. But it has contributed to currency wars. My first message today is this: currency wars are no substitute for trade liberalisation. At best, currency wars can only redistribute income and jobs; in a global context they can create neither. Why play this zero sum game when the positive sum game of trade liberalisation is available – where total global income and jobs are increased through the gains from trade made possible by specialisation?

The Gillard government is vigorously pursuing trade liberalisation at home and abroad. Domestic economic reform is essential to lifting productivity growth and through it the international competitiveness of Australian businesses. But even if Australian businesses were the most competitive in the world as a consequence of domestic economic reform and their hard work and ingenuity, it would amount to nought if they are shut out of foreign country markets. That's why the Gillard government will continue to devote enormous energy to opening up other countries' markets, gaining market access for our exporters.

For Australia and the world, 2011 can be the Year of Trade. The coming year can be one during which the Doha Round of Multilateral Trade Negotiations can be brought to a

successful conclusion, the Trans-Pacific Partnership of nine APEC economies can be advanced ahead of the US-hosted November APEC meeting in Honolulu, a trade agreement with Korea can be finalised, an agreement with Japan can be advanced, deadlocked negotiations with China can be unlocked, further liberalisation with countries like Indonesia and Malaysia and the Gulf states can be progressed and perhaps negotiations with India and a number of Latin American countries can be commenced.

These multilateral, regional and bilateral negotiations would constitute a hugely ambitious trade agenda. Actual progress on some may be disappointing and, frankly, Australia will pursue negotiations with those partners who are genuine about liberalisation. As Trade Minister, I am interested in results for our country and the global trading system, not in appearances of looking busy, mired in interminable processes that simply enable us to say that negotiations are proceeding. Nor am I interested in collecting trophies for the national mantelpiece, empty vessels engraved with the words *free trade agreement* if they are nothing of the sort and of token value to our country.

But if Australia is to achieve even half of its ambitious agenda of increasing jobs and prosperity through trade liberalisation, we need a coherent, guiding philosophy and a derivative set of principles against which to judge the proposed content of these various agreements.

As Microeconomic and Trade Policy Adviser to then Prime Minister Bob Hawke, I was involved in the development of such a philosophy. But during the period of the Coalition government, that philosophy was subjugated to foreign policy considerations and, towards the end of the Howard era, it almost completely disintegrated.

Before you conclude that I am being misty-eyed about economic reform and trade policy in the Hawke-Keating era and that I have failed to acknowledge that the world has moved on, the Hawke and Keating Labor governments did not invent an economic philosophy; they adopted one from orthodox economic thinking. Much of that thinking in Australia had been done by academics such as Sir John Crawford, Professor Heinz Arndt, Professor Max Corden, Professor Richard Snape, Professor Ross Garnaut and leading members of the various predecessors to today's Productivity Commission.

This body of intellectual thought and rigour was a vital counterweight to the protectionism within the business community and the broad labour movement at the time. In the 1970s this economic philosophy was sneeringly described as neo-classical economics. By the late-1980s its opponents had condemned it as economic rationalism. But as Bob Hawke would ask of his anti-reform critics: "what are they in favour of – economic irrationalism?"

Upon entering parliament in 1998, I was counselled by friends that my proposal to describe myself as an economic rationalist in my first speech amounted to an overly long political suicide note. By economic rationalism I meant advocacy of policies to increase national income that is then available to support the needy and create opportunity for all. Now, 12 years later, as Australia's Trade Minister, I remain one of those horrible economic rationalists; one who is hard headed and soft hearted.

At its essence, Labor's guiding philosophy of economic reform has been a commitment to markets and competition – a commitment reaffirmed by Julia Gillard as Prime Minister. Of course there can be a role for government intervention to correct for market failure, including

anti-competitive behaviour and inadequate private incentives for research and development. But the presumption must be that competition is good, more competition is better and markets are better than governments in allocating scarce resources among competing commercial uses.

It is this philosophy that guided the Hawke and Keating governments in opening up Australia to competition, refashioning it from an economy supplying a small, domestic market protected by high tariff walls to an open, competitive economy supplying global markets.

Competitive forces were applied to the exchange rate, financial markets, product markets and government business enterprises. Trade policy and microeconomic reform were integral components of the overall economic reform program, intertwined and bound by the open, competitive philosophy.

Reducing tariffs and eliminating quotas were tools of trade in fashioning the open, competitive economy, essential in exposing Australian business to international competition.

At no time did the Hawke and Keating governments regard reducing tariffs and other trade barriers as bad for Australia, a necessary evil in extracting concessions from trading partners. Although painful for those directly affected, tariff reductions were considered to be in the national interest, part of an overall program of increasing national jobs and prosperity. And adjustment assistance was provided to those who were adversely affected by the necessary tariff reductions.

It is for these reasons that Hawke and Keating pressed ahead with scheduled tariff cuts through the teeth of the deep recession of 1991 and why, in that year, they legislated even greater tariff reductions. These policies required enormous political courage and the understanding of a visionary trade union movement. But, as an essential part of the overall economic reform program, they helped lay the platform for almost 20 years of sustained economic growth.

As a result of those far-sighted Labor government market-opening policies, continued by the Howard government after an early freeze, general tariff rates fell from more than 15 per cent to 5 per cent or zero, the combined tariff and quota rate on automobiles fell from 85 per cent to 5 per cent and tariffs on clothing and some textiles fell from maximum rates of 180 per cent to 10 per cent with a further reduction to 5 per cent scheduled for 2015. Tariffs on footwear and some other textiles have in fact already gone to 5 per cent this year.

At no time under Hawke was the elimination of automotive quotas conditional upon other countries eliminating their quotas; it was seen as good domestic economic reform policy in its own right. At no time under Hawke or Keating was the legislated reduction in automotive tariffs conditional upon other countries reducing their tariffs; again it was seen as a sound economic reform for Australia's sake. And at no time were reductions in general tariffs or tariffs and quotas on textiles, clothing and footwear conditional upon other countries reducing their tariffs.

This unilateralism in tariff reductions incidentally gave Australia credibility in international trade negotiations way beyond the relative size of our economy. To this day, Australia's views are sought and valued in global and regional trade negotiations.

Beneath the maximum auto tariff of 5 per cent are zero rates for imports from the United States and Thailand and a third major auto producer, Korea, is also pressing for the elimination of Australian automotive tariffs.

Clinging to the 5 per cent tariff as a bargaining chip to be played to extract tariff reductions from trading partners would be a repudiation of the unilateralism of the Hawke and Keating governments. That is not to say that Australia should not fight tooth and nail to bring down trade barriers confronting our exporters of goods and services. The Gillard government will vigorously fight protectionism against our exporters in all its forms.

The principle of unilateralism does not oblige Australia to accept trade deals in which other countries can continue to impose high tariffs against us. If so-called free trade agreements that contain ongoing trade restrictions against us are not in Australia's national interest then we should not conclude them. And trade agreements that enable our trading partners to impose high tariffs against our exports of key products are unlikely to be in Australia's national interest.

The trade liberalising reforms of the past quarter of a century have yielded very substantial income gains for Australians. A study by the Centre for International Economics found trade liberalisation in Australia had increased real household incomes by an estimated \$3,900 by 2008. These gains came not only from exporting more but from being able to buy imported goods more cheaply than they could be produced in Australia.

This analysis helps debunk the mercantilist notion that exports are good but imports are bad. Australian consumers have voted with their purses and wallets in favour of imports that are less expensive than domestically produced items. And less expensive imports that are inputs into Australian made goods and services, destined for local and global markets, help boost the competitiveness of those industries.

Yet, following the end of Labor rule in 1996, the notion has gradually crept back in that Australia's small remaining tariffs are good, that removing them is bad and that such evil should only be contemplated as bargaining chips in negotiations for future trade deals.

As Trade Minister, I want to reconnect with the Hawke-Keating governments' first guiding principle in economic reform that competition is good, and dispense with the bargaining chip approach to the remaining Australian tariffs. Australia should make its offers, our trading partners should make theirs, and where appropriate we should encourage them to go further. But if the final deal is not in Australia's national interest we should not accept it.

Some may hold the view that this sort of approach is naive; that our regional trading partners are all hiding behind high tariff walls, ready to reap the benefits of our liberalisation without offering anything themselves.

But that is not the reality. Among Australia's key trading partners in the APEC region, which account for 44 per cent of global trade and 70 per cent of Australia's exports, average applied tariffs have been lowered over the last quarter of a century from more than 25 per cent to around 5 per cent. APEC has helped establish the confidence necessary for economies to undertake unilateral trade policy reforms – a confidence in the knowledge that tariff reductions made sense from a domestic reform perspective and that regional partners were doing the same.

Nevertheless, it is true that substantial trade barriers remain in place for agriculture in a number of APEC economies and much work remains to be done in reducing behind-the-border restrictions on services exports. But overall, good trade liberalising progress has been made within APEC.

The second guiding principle of the Hawke-Keating era was that of non-discrimination. It is incorrect to suggest that the Hawke and Keating governments pursued only global trade liberalisation. Those governments negotiated bilaterally as well. But in doing so, they did not seek preferential access to markets, only an opportunity to compete.

The principle of non-discrimination is the foundation stone of the World Trade Organization's global trading rules. Unfortunately, owing to the proliferation of preferential bilateral and regional trade agreements, the non-discrimination principle nowadays is observed more in the exception than in the rule. Discriminatory trade agreements can divert trade away from more efficient, excluded producers to less efficient parties to the agreements. Like currency wars, trade diversion amounts to no more than a redistribution of jobs and prosperity instead of the creation of more jobs and prosperity. Worse, trade diversion is inherently job-destroying and income-destroying from a global perspective.

As countries in the global trading system have gradually reduced tariffs over the last three or so decades, the trade-diverting effects of any particular discriminatory deal are not as great as they would have been 30 years ago. But the number of such discriminatory deals has exploded from less than 10 half a century ago to almost 300 in force and many more under negotiation. Consequently, the total value of trade diverted from more efficient to less efficient producers could have increased substantially. The empirical evidence is inconclusive.

We can argue till the unsubsidised Australian cows come home about how much trade is being created by discriminatory trade deals relative to the value of trade diverted – but there is no good reason for discrimination and therefore no good reason to sacrifice jobs and income through trade diversion.

As Australian Trade Minister, I therefore re-embrace the second great Labor principle, the principle of non-discrimination. In negotiations with trading partners we neither seek exclusive nor preferential access to other countries' markets. I would like to be able to tell you that this is pure economic altruism. In reality it is because non-discriminatory trade agreements offer better long-run returns for Australia – they are more likely to result in trade creation instead of diverting trade from other countries that, in the absence of tariffs, would be lower-cost producers.

It's also worth mentioning that this approach doesn't mean Australia is obliged to repeat an error made in one concluded trade agreement in negotiating future agreements. Provisions that are in Australia's national interest obviously should be extended to other countries willing to settle high-quality, trade-creating agreements but those that are not in the national interest should not be extended to others for the sake of reaching a low-quality agreement. For example, an intellectual property clause which extends the duration of foreign copyright in one agreement and doesn't offer obvious economic benefits to Australia should not be part of a later agreement just because we had already used it.

Many other countries do not embrace the principle of non-discrimination. We can encourage them but we cannot force them. Consequently, Australia is likely to conclude further preferential deals in the future. But we should not insist on receiving preferential treatment but rather, an opportunity to compete on level terms.

The third great Labor principle of the Hawke-Keating era was to maintain a clear separation between trade policy and foreign policy. During the mid- to late-1980s, when the United States augmented its agricultural production-subsidising Farm Act with an export-subsidising Export Enhancement Program, or EEP, even the conservative-leaning National Farmers' Federation urged the Hawke government to put the US-Australian bases on the negotiating table. Hawke refused. I well remember Hawke, in meetings with President Ronald Reagan and George Bush Snr, running Australia's arguments against American agricultural subsidies hard but then moving on to a separate, positive discussion about the Alliance and foreign policy.

The Howard government set about deliberately entangling trade policy and foreign policy – to the point where any Labor criticism of the likely or actual content of the Australia-US Free Trade Agreement was branded anti-American and un-Australian. Never mind that the Howard government's acquiescence to the exclusion of sugar from the Australia-US FTA, after promising our farmers it was a non-negotiable inclusion, has left a bitter taste in the mouths of Australian sugar producers. My criticism of the prospective deal as Shadow Trade Minister earned the wrath of the Howard government, the US Administration and even of a number of my own Shadow Cabinet colleagues. I have never been anti-American or un-Australian, but we should always retain the right objectively to scrutinise proposed trade deals to assess whether or not they are in the national interest.

So the third great Labor guiding principle is to maintain a separation between trade policy and foreign policy – the separation principle. As new Trade Minister I have been given a stream of advice that I should initiate so-called free trade negotiations with countries of strategic importance to Australia. It's as if the very announcement of the commencement of negotiations performs the task of affirming a strategic, geo-political relationship, with barely a moment's thought given to the prospects of concluding a successful, truly-liberalising agreement. Criticism by a home government or farming and business organisations of the foreign government's intransigence in negotiations can hardly be conducive to friendlier relations, but by that time, when the trade ministers and officials are slogging it out and industry associations are venting their frustrations, the foreign policy urgers have moved on to the pursuit through trade policy of another strategic, geo-political alliance.

Obviously this does not mean that Australia shouldn't conclude trade deals with strategically important countries. That would be absurd. But it's the quality of the deal, not the quality of the strategic relationship, that should determine whether the deal is worth having.

The formation of discriminatory trading blocs for geo-political reasons contributed to the outbreak of the Second World War. The application of two great Labor principles of non-discrimination and separating trade policy from foreign policy should ensure that no Labor government contributes to the creation of such tensions in the future.

So how does a country like Australia decide which countries should be prospective partners in bilateral trade negotiations? Applying the principle of non-discrimination, the answer is easy: any country that is genuinely interested in reducing its trade barriers is eligible, subject

only to the opportunity cost of deploying Australia's negotiator talent in those negotiations. The good news is that this approach would save taxpayers the cost of absurdly hypothetical computable general equilibrium studies on the gains from so-called free trade agreements between the two countries. These studies, commissioned by advocates of particular bilateral trade deals, will inevitably report enormous potential gains to both countries. Modellers are handed the assumptions by government officials and the computer models produce the results sought. This process is best described as an expensive farce designed to hoodwink the public.

The only value in such modelling would be analysis of a concluded deal – not a hypothetical deal. This fourth Labor principle of trade policy could be titled the 'no-bull principle' or less provocatively, the transparency principle.

The fifth and greatest principle is the grand unifying principle: that trade policy and microeconomic policy are as one; that they, in harmony with sound fiscal policy, constitute an economic reform program designed to lock in and increase prosperity and provide the dignity of work for all those who seek it. Guided by the grand unifying principle, the best trade policy is domestic economic reform: a productivity-raising, competitiveness enhancing microeconomic reform program supported by responsible fiscal policy.

Applying this grand unifying principle, Australia must not wait for other governments to reform their economies before reforming ours. Australian economic reform is good for jobs, good for prosperity. As reformers, we have never waited for the world and we need not wait for the world now.

Productivity growth accounted for 80 per cent of the increase in national income over the past 40 years. In an ageing population and a two-speed economy, productivity growth will need to do most of the heavy lifting over the coming 40 years too. Yet productivity growth began to slide from the turn of this century, starved of a new productivity-raising reform program to build on the Hawke-Keating Labor reforms.

Reviving productivity growth through a new economic reform program is core business for the Gillard government. Economic reform at home and securing better market access abroad work hand-in-glove in creating jobs and prosperity.

Australia's approach to trade policy should therefore be reviewed against the five Labor principles that have stood the test of time and served our nation well: unilateralism; non-discrimination; separation; transparency; and the grand unifying principle of trade policy as an indivisible part of overall economic reform.

Guided by these principles, I will be conducting a review of Australia's future trade policy framework for release around the end of the first quarter of 2011. A Productivity Commission report on the existing approach to trade policy will be released in the near future and will provide valuable input into that review.

Conducting the review will not put on hold Australia's present trade policy priorities such as our efforts to complete the Doha Round of Multilateral Trade Negotiations and the proposed trade deals with Korea, Japan, China and members of the Trans-Pacific Partnership. Of course, the review can have a bearing on the Government's approach to finalising some of these and other agreements. But it won't stall them. It will bring policy coherence to our

negotiations. And it will reaffirm Labor's commitment to ongoing trade liberalisation designed to lock in and increase prosperity and jobs in Australia, and around the world.

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