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## Australia-US Free Trade: Benefits and Costs of an Agreement

ANDREW L. STOLER

In mid-March, a team of 40 American negotiators arrived in Canberra for the first session of a bilateral negotiation that was originally expected to produce a free trade agreement with Australia by “sometime in 2004.”<sup>1</sup> That same week, US Trade Representative Robert Zoellick and business and political members of the American-Australian Free Trade Agreement Coalition celebrated the launch of the negotiations as a “win-win” venture for both countries that would not only produce important economic gains in both markets but also contribute to the two partners’ relationships with others in the Asia-Pacific region and to the successful completion of the WTO Doha Round of multilateral trade negotiations.<sup>2</sup> More than two hundred companies have signed on to the US-based coalition in support of the FTA. In Australia, the negotiations enjoy the strong support of the Australia–United States Free Trade Agreement Business Group (AUSTA) and are seen as central to the Commonwealth government’s objective of strengthening Australia’s alliance with the United States (DFAT 2003, 86–91). Two Australian studies, discussed below, have suggested that an

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*Andrew L. Stoler is executive director of the Institute for International Business, Economics, and Law at the University of Adelaide and served as deputy director-general at the World Trade Organization from 1999 to 2002.*

1. Lead Australian negotiator Stephen Deady at a March 21, 2003, press conference with US lead negotiator Ralph Ives.

2. Remarks at the launch of the American-Australian Free Trade Agreement Coalition by USTR Zoellick, March 19, 2003, Washington.

FTA could produce significant economic benefits for both Australia and the United States, and both governments are actively seeking input and feedback from their private sectors in support of the negotiating effort.

The project also has important critics and detractors. In Australia, Professor Ross Garnaut of the Australian National University's (ANU) Research School of Pacific and Asian Studies argues that the completion of an FTA with the United States would not only diminish Australian economic opportunities but also weaken Australia's security. A February 2003 report prepared by ACIL Consulting for the Australian Rural Industries Research and Development Corporation downplays potential economic gains from an FTA and strongly suggests that an FTA will have a negative impact on Australian farmers (ACIL 2003). In Washington, representatives of the American dairy, sugar, and beef industries have testified that free trade with Australia would do irreparable harm to these sectors of the US economy, cutting farm incomes, forcing thousands of farmers out of business, and endangering United States security ("US Farmers See Red Over Free Trade," *Australian Financial Review*, January 22, 2003, 7).

President Bush and Prime Minister Howard have made it clear they would like to see the FTA deal done in the course of 2003; and both reiterated this objective during his October visit to Australia. In the face of this political imperative, the negotiators on both sides have now had to accelerate an already tight timetable.

Is this likely to be a good agreement or not? How will the negotiations affect the WTO's Doha Round and other strategic Australian and American interests? In this chapter, and at this early stage in the bilateral negotiations on an agreement, I propose to review the claimed benefits and costs of a free trade agreement between the United States and Australia, the core objectives of players on both sides of the Pacific, the potential trade and investment effects of an agreement, and the implications of an FTA for both countries' relations with third countries.

Although I am aware of the March 28, 2003, letter to President Bush by Senator Grassley and 17 of his Senate colleagues urging the inclusion of New Zealand in these FTA negotiations between the United States and Australia, I will not comment on that prospect in the body of this chapter other than to state the obvious: including New Zealand would clearly complicate the already politically dicey agriculture side of the negotiations, and it is difficult to see how the current US administration would put New Zealand on the same favorable political plane as Australia. American unhappiness with statements made by the New Zealand prime minister in the context of the recent war in Iraq have evidently translated into an unwillingness in Washington to include New Zealand in an FTA deal. In appendix 1, I briefly discuss how the Australia–New Zealand CER (Closer Economic Relations) Agreement might need to be factored into an Australia-US FTA and other issues relating to possible trade liberalization between the United States and New Zealand.

## Objectives of an Australia-US FTA

Political leaders in the two governments and their private-sector counterparts have already commented extensively on the objectives for a bilateral FTA. In the 2003 white paper on foreign and trade policy (DFAT 2003), the Australian government signals the coming FTA as an effort to make its economic relationship with the United States commensurate to their security relationship. The Australian authorities also see clear trade and other economic benefits as flowing from the FTA, provided it offers genuine liberalization of benefit to Australian exporters. Australians have identified priorities in a number of areas where they are globally competitive. As an example of a priority on the industrial side, Australian firms have developed a well-deserved global reputation for producing high-speed catamaran ferries and they see the FTA as an opportunity to gain an exemption from US “Jones Act” limitations on their use in the American market. Priorities in agriculture include access to the highly protected sugar and dairy markets, as well as to the more open but still protected American market for beef.

In a speech delivered in late October 2002,<sup>3</sup> Australia’s Trade Minister Mark Vaile cited as objectives *beyond those straightforwardly related to trade liberalization*

- attracting additional American investment to Australia, with consequent positive effects on employment and productivity;
- bringing about greater integration of business in the two markets and thereby enabling new synergies in areas such as research and development, materials sourcing, marketing, and use of information technologies;
- using the FTA to foster “competitive liberalization” through its demonstration effects in the WTO and other trade forums; and
- engendering a broader appreciation of the bilateral alliance and the role of the two countries in underpinning stability and prosperity in East Asia and the Pacific.

More recently, Minister Vaile added that he wants to use the FTA negotiations to discipline the extent to which food aid might be used by the United States to undercut commercial Australian agricultural exports to postwar markets in Iraq and elsewhere (“Vaile Wants Food Aid in FTA Terms,” *Australian Financial Review*, April 8, 2003, 5).

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3. “Australia and the United States: Opening Markets,” speech by Vaile to the launch of American Australian Business 2003, Sydney, October 29, 2002.

The FTA negotiation with the United States also enjoys the strong support of the Business Council of Australia,<sup>4</sup> which sees it as enhancing the global competitiveness of Australian companies and the economy, and of the AUSTA Business Group, which set out a long list of its objectives for the FTA in a January 2003 submission (AUSTA 2003b) to the Department of Foreign Affairs and Trade (DFAT). Among other objectives, AUSTA wants to see all barriers to trade and investment removed within 10 years, a legal right to national treatment of investment, mutual recognition of professional qualifications affecting trade in services and in technical standards affecting goods trade, free movement of people, and safeguards on security of access to markets.

In his November 13, 2002, notification to the US Congress of the president's intention to enter into FTA negotiations with Australia, USTR Robert Zoellick provides considerable detail on US objectives for the FTA. On a broad political level, and much like his counterparts in Canberra, Ambassador Zoellick sees a number of objectives beyond the commercial considerations at stake in the agreement. His message makes clear that the FTA is also seen as a tool to enhance cooperation in the World Trade Organization (WTO) and to help to achieve jointly held objectives in a shared agenda. Another cited objective of the FTA is to strengthen the foundation of the security alliance and "facilitate the building of new networks that enhance our Pacific democracies' mutual interests, shared experiences, and promotion of common values so that we can work together more effectively with third countries."<sup>5</sup>

Ambassador Zoellick's notification letters contain nearly five single-spaced pages of detailed trade negotiating objectives for the Australian FTA. Selected examples of American objectives give a flavor of the likely approach of American negotiators. The USTR said he would seek elimination of duties and other charges affecting imports of American goods; the suppression of Australian single-desk export operations for wheat, barley, sugar, and rice; and strengthened cooperation between US and Australian authorities with responsibilities for sanitary and phytosanitary measures. The United States will be seeking to enhance the level of Australia's protection of intellectual property rights<sup>6</sup> and, in certain areas, will

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4. "BCA Backs Free Trade Talks," letter to the editor from BCA CEO Katie Lahey, *Australian Financial Review*, March 24, 2003.

5. USTR Zoellick's November 13, 2002, letters to Speaker of the House Dennis Hastert and Senator Robert Byrd; see [www.ustr.gov/new/fta/australia.htm](http://www.ustr.gov/new/fta/australia.htm).

6. USTR (2003a) expresses concern over Australian policies in respect to parallel imports (affecting CDs, books, DVDs, software, and electronic games), copyright piracy issues, a general low priority assigned to intellectual property rights enforcement, and the possibility that Australia may allow "springboarding" by generic pharmaceutical makers, enabling immediate marketing approvals on the expiration of patents held by others.

seek to have Australia apply levels of protection more in line with US law and practices. The USTR promised to pursue a comprehensive approach to market access in Australia for services and explicitly referenced financial services and telecommunications services. On the investment front, Zoellick's letters target "trade-distorting barriers to U.S. investment in Australia, including investment screening" and establish the goal of securing for US investors in Australia "important rights that would be comparable to those that would be available under U.S. legal principles and practice."

The 2003 edition of the USTR *National Trade Estimates* report on barriers to American exports reiterates concerns about aspects of the Pharmaceutical Benefits Scheme and elaborates on those areas where the United States believes Australia is lax in fighting infringement of intellectual property rights.

The timing of the FTA negotiations is felicitous for "fortune-tellers" aiming to predict the eventual content of a bilateral agreement. Considerable additional guidance on the core negotiating objectives of both the United States and Australia can be drawn from the free trade agreement each has recently separately concluded with Singapore. In fact, it seems that much of the discussion in the March and May negotiating sessions was devoted to focusing the attention of the bilateral negotiating groups on aspects of the Singapore texts. Evidently, the negotiators have found such attention to be particularly valuable in the case of the investment and services chapters of the Singapore agreement's texts. Of course, the Singapore texts are not especially instructive with respect to agriculture, one area of the US-Australian negotiation where objectives of the two sides seem certain to come into conflict (at least in the near term).

It could be that the US-Chile FTA provides insight into how Washington will handle the demands of another country with a strong interest in exporting farm products to the American market. A review of the Chilean agreement's provisions for market access in agriculture seems to have both good news and bad news for Australia's aspirations in beef, dairy, and even sugar. For beef, Chile will gain unlimited access to the US market at in-quota tariff rates after just four years. In dairy (cheese, milk powder, condensed milk, and "other" dairy products), Chile will see quantities available to its exporters increase by around 7 percent every year until limitations are fully removed in year 12. In sugar, the year-on-year increase is only 5 percent, but restrictions on quantities are again totally removed in year 12.<sup>7</sup> So the good news is that these sensitive products were on the table and trade will be liberalized. The bad news is that it will take a few years to get there—at least in dairy and sugar. Australians might also object to the side letter on sugar trade that is evidently part of the

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7. See "U.S. General Notes" and "U.S. Tariff Schedule" (USTR 2003b).

Chilean deal, and may worry over Chilean and American agreement that special “snapback” safeguards are possible in these sectors.

Both the Americans and the Australians profess publicly that everything is on the table in the negotiation and that there are no a priori exceptions. Both sides say their objective is a comprehensive negotiation. “Comprehensive” in this context has to be interpreted to mean that no area is ruled out for negotiation and that requests for policy modifications and liberalization will be entertained and acted on even if a final outcome does not produce immediate free trade across the board. Politics is sure to get in the way on both sides of the Pacific. For example, to be credible Washington will need to find ways to significantly liberalize existing barriers to beef and even dairy imports from Australia. Notwithstanding industry complaints, this can likely be done without genuinely serious consequences for these sectors in the United States.

Consider the situation in the dairy sector. Following Australia’s FTA with New Zealand, the Australian dairy industry successfully undertook a series of structural adjustments, the outcome of which has been the focusing of producers and processors on responding solely to market demands. In the global context, it is a “fair trader.” In addition, the industry, while efficient, is small compared to other world producers and its likely focus in the US market would be on shipping increased quantities of value-added dairy products (mainly cheese), not the bulk dairy commodities (milk powder and butter) whose increased imports would burden the operation of the American support program for dairy. Seen in context, the ability of the United States to accommodate Australia in dairy seems clear: Australian dairy exports to the United States in 2001 amounted to just \$84.3 million, and a fourfold increase in that trade (an amount Australia might reasonably be expected to achieve over the medium term if trade were liberalized) would put total imports from Australia at just over 1.8 percent of the gross value of producer milk receipts in 2001.<sup>8</sup>

Sugar is another matter. US sugar policy has fostered price levels so high that other industries (e.g., corn sweeteners) depend on the maintenance of high sugar prices for their own continued profitability. Actually, it is not at all clear that Australian sugar producers would benefit from enhanced access to the American market—particularly if the United States also liberalizes trade in sugar in the Free Trade Area of the Americas (FTAA) or US-Mercosur (Southern Cone Common Market) contexts. The Australian sugar industry is in a real mess, according to a recent report by the Centre for International Economics (CIE 2002). Though Queensland was once the competitive leader in world sugar markets, the CIE notes, Brazil is now achieving cane-growing costs 30 to 40 percent below Aus-

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8. \$18.3 billion in 2001 (US Department of Agriculture, Federal Milk Order Market Statistics, 2001 Annual Summary [Statistical Bulletin no. 979], table 2, 11).

tralia's. Australian sugar exports could benefit from enlarged quotas at high US prices in the short term (while quotas restricted competitors' access to the American market), but the Australian sugar industry would probably not gain much from US liberalization of the market over the long term unless it took drastic steps to enhance its productivity.

Australian access to the US market for fast ferries is also problematic, both because of the general political difficulty in dealing with maritime questions and (significantly) because of the peculiar way in which the Jones Act restrictions are sheltered in the WTO.<sup>9</sup> That said, the Jones Act might not be as serious a barrier as one would think. Australian firms have reportedly negotiated special joint venture construction and leasing arrangements that get around these restrictions to some extent. In addition, the Jones Act applies only to cabotage trade; Australian fast ferries thus can still be sold to Americans for use in transport between US and non-US destinations.

In the same vein, Australia will certainly resist anticipated US demands for radical changes in single-desk export operations, restrictions in audiovisual services, and the Pharmaceutical Benefits Scheme. But as with the anticipated situation in US agriculture, Canberra's resistance does not mean that it would be impossible to meaningfully address specific problem areas raised by the United States. Canberra might even want to use the FTA negotiation as an excuse for change in areas like single desk (which has been criticized inside Australia as anticompetitive and which was singled out as a problem for the sugar industry in the CIE report referred to above).

Notwithstanding the obviously warm bilateral relations of the post-Iraq war period, it seems clear that neither the United States nor Australia could be expected to be satisfied with a "trophy" agreement without a credible free trade outcome. This might not be an agreement to bring about completely free trade overnight,<sup>10</sup> but both governments share the core objective of making the coverage of this FTA as comprehensive as possible.

## Potential Trade and Investment Effects of an FTA

For the United States, an Australia-US FTA clearly does not have an economic significance in the same league as the North American Free Trade

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9. See paragraph 3 of the General Agreement on Tariffs and Trade (1994), [www.wto.org/english/docs\\_e/legal\\_e/legal\\_e.htm](http://www.wto.org/english/docs_e/legal_e/legal_e.htm).

10. In part because of their federal nature, neither the American nor the Australian internal markets can be said to be completely free of barriers to trade. Whether we are concerned with insurance regulation, product standards, labeling requirements, or professional qualifications, substantial barriers exist inside both countries.

Agreement or the current FTAA exercise in the Western Hemisphere. The impact of an agreement will be proportionately much more important for Australia. Considerably less than 2 percent of total American exports are destined for Australia, compared to roughly 11 percent of total Australian exports destined for the United States. Still, the numbers are large enough to make the negotiation interesting for both sides. Two-way merchandise trade exceeded \$20.8 billion in 2002 (Australia recorded a deficit in goods trade of \$7 billion for the year).<sup>11</sup>

It is very hard to come by up-to-date data on services trade that have sufficient detail to be significant for this exercise. Against this background, in 2002, bilateral services trade reached nearly \$6.32 billion, with annual growth in Australia's services exports to America rising much faster than imports of services from the United States.<sup>12</sup> Clearly, there is already a certain amount of economic integration of the two markets. Sales of services in Australia by majority US-owned affiliates totaled \$15.1 billion in 2000, while sales of services in the United States by majority Australian-owned firms totaled \$8.7 billion. Total sales (goods, services, and investment income) of US affiliates in Australia amounted to \$56.6 billion in 2000, with Australian affiliates in the United States recording total sales of \$31.9 billion.<sup>13</sup> The United States is the largest recipient of Australian investment, at \$70.4 billion, and Australia's largest source of investment, at \$141.5 billion (DFAT 2003, 89).

Discussion in Australia of the possible economic effects of an FTA with the United States centers on three studies, two of which produced reports in mid-2001 and were undertaken at the request of DFAT (CIE 2001; AASC 2001); the third study, published in February 2003, was prepared for the Australian Rural Industries Research and Development Corporation (ACIL 2003). In addition to the reports themselves, the CIE in March 2003 issued a reaction to the ACIL report (Stoeckel and Davis 2003).

The original CIE study (2001) is the source for most of the positive economic claims made for an FTA by DFAT, AUSTA, and other proponents of an agreement with the United States. In their modeling of possible outcomes, CIE researchers made use of both the APG-Cubed model (i.e., the G-Cubed [Asia Pacific] model) and the GTAP (Global Trade Analysis Proj-

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11. Australian Bureau of Statistics Report 5422 (December quarter, 2002). In this chapter, certain statistics emanate from US sources and others from Australian sources. For consistency, all values are shown in US dollars. The exchange rate used is that for late April 2003, reported as A\$1.66 = US\$1.00.

12. Statistics from the Department of Foreign Affairs and Trade (DFAT), submission by the Department of Foreign Affairs and Trade to the Senate Foreign Affairs, Defence and Trade Committee Inquiry into the General Agreement on Trade in Services and Australia-US Free Trade Agreement, Canberra, April 11, 2003, table B-1, 62.

13. US Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, December 2002; available at [www.bea.doc.gov/bea/pub/1202cont.htm](http://www.bea.doc.gov/bea/pub/1202cont.htm).



ect) model. The CIE explains that both models were used in order to exploit the advantages of each: the APG-Cubed model provided greater information on financial flows, the timing of effects, and the macro economy; the GTAP model provided greater sector and country detail. The CIE, in its study, assumed complete removal of all identified barriers to trade between the United States and Australia. Calculations were also done on the basis of a 50 percent removal of barriers and a 25 percent removal of barriers, with the models yielding roughly proportional results in economic benefit to the participants. In all of the scenarios studied by the CIE, both the United States and Australia gained through the negotiation and implementation of an FTA. The CIE also concluded that the FTA would create more trade than it would divert and that there would be a positive economic impact on third countries (particularly for New Zealand).

Some of the figures regularly quoted by the Commonwealth government and attributed to the CIE study are:

- net economic welfare gains over 20 years of about \$20.1 billion, shared evenly between the two countries;
- a 4 percent (about \$2 billion) increase in Australian GDP by 2010, with a cumulative benefit over 20 years of about \$15.5 billion;
- a 0.8 percent overall rise in Australian exports by 2006 (with a potentially greater than 350 percent increase in dairy exports);<sup>14</sup> and
- enhanced investment flows into key Australian economic sectors, such as mining and agriculture. (DFAT 2003, 91)

Central to a large proportion of the economic gains found in the CIE report are researchers' assumptions with respect to the impact of services trade liberalization. With such a large percentage of the two countries' economies now accounted for by services, it seems reasonable to assume that the removal of barriers to trade in services through the FTA would produce cost reductions contributing to economic welfare. In its study, the CIE notes the many difficulties associated with quantifying the impact of services liberalization. Research in the area to date is fairly slim, and the CIE relied primarily on estimates of the costs of trade barriers produced by staff members in various studies done at the Australian Productivity Commission. For example, these studies estimated the cost (in terms of price impact) of barriers in the Australian banking sector at 9.3 percent, and at 0.57 percent in the Australian retailing and wholesale sectors. Estimates of the price impact on professional engineering services in the

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14. In its discussion of the sectoral changes found in the modeling, the CIE is careful to point out that certain very large percentage gains (e.g., in dairy and sugar for Australia) rise from very low bases.

United States were 3.6 percent and 2.26 percent for the American retail and wholesale sectors (cited in CIE 2001).<sup>15</sup> Overall, the CIE researchers appear to have taken a conservative approach—for example, they limited Australia’s impact on the US services market to 1/20th of what could be the potential effect of Australia’s entry (because Australia’s GDP is only about 1/20th of the US GDP). Globally, (for the FTA) CIE seems to have been conservative as well, estimating the cost reduction to the economy as a result of assumed full liberalization of services trade at only 0.35 percent (CIE 2001, 58–68).

ACIL (2003) takes a different approach, and ANU’s Professor Garnaut argues that the “uplift” in services productivity (the 0.35 percent) found by the CIE should be discounted because it arises out of an unrealistic assumption that all barriers to services trade would be removed by an FTA (Garnaut 2003a).<sup>16</sup> How services trade is treated is therefore very important, but nobody who has looked at the potential FTA so far seems to have a firm grip on what would realistically happen to trade patterns and efficiency gains in particular services sectors. This important gap in the research is a problem for the analysis of the Australia-US FTA.

As noted earlier, the CIE modeling was done on the basis of the total removal of all identified trade barriers. Under these assumptions, it is not surprising that the sectors shown by CIE as deriving the greatest benefits from the FTA are dairy and sugar. Other sectors forecast as likely to benefit from reasonably large increases in exports to the United States include ferrous metal products and motor vehicles and parts. For the United States, CIE sees the biggest potential gains in exports of motor vehicles and parts and metal products, with smaller gains for beverages and wood and paper products (CIE 2001, tables 4.5 and 4.6).

The 2001 study prepared by the Australia APEC Study Centre at Monash University (AASC 2001; hereafter referred to as “the Monash study”) takes a far less quantitative approach to examining the possible benefits to Australia of an FTA; in fact, for its statements on quantifiable economic benefits it relies heavily on the slightly earlier CIE study’s findings. The Monash study devotes most of its commentary to the anticipated qualitative benefits to the Australian economy over the longer term as a result of its integration with the much larger American economy. For example, the study expects that an FTA would foster greater competitiveness in the Australian economy by influencing businesses’ adaptation to new information and communication technologies, by shaping business culture, and by encouraging best practices in key aspects of economic activity.

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15. These figures were referred to on p. 61 (retail/wholesale) and p. 62 (professional engineering) of the CIE report. They refer back to Kalirajan (2000) and Nguyen-Hong (2000), respectively.

16. Garnaut (2003a) notes that, at the very least, it is hardly likely that Canberra would anytime soon remove ownership restrictions affecting Telstra and major Australian banks.

The Monash study also predicts important positive inward investment effects for Australia as a result of the FTA's contribution to improved conditions for investors and its endorsement of Australia's long-term prospects as a place for American firms to do business. Among the important qualitative benefits to Australia identified by the Monash study are FTA-inspired institutional arrangements intended to resolve problems relating to business visas, technical standards, recognition of professional qualifications, and other regulatory issues (AASC 2001, xii). The Monash researchers are right, I think, when they say that such issues, while hardly sexy, can often be serious impediments to the conduct of business across frontiers.

Coincidentally, the 2003 ACIL study began making the rounds just as those who criticize the FTA for its projected negative impact on Australia's regional and security interests were intensifying their public attacks. The ACIL report faults the "robustness" of the CIE study, finds a likely negative impact of an FTA on Australian farmers, and even postulates that complete bilateral free trade by 2010 would be "slightly detrimental" to the Australian economy. The ACIL analysis completely discounts CIE's service sector benefits analysis and assumes that the conclusion of an FTA with the United States "could undermine Australia's participation in the WTO and its multilateral negotiations" and "have a deleterious effect on the prospects for advancing other forms of trade liberalisation" (ACIL 2003, vi). ACIL states that its GTAP-type modeling was "arguably more standard" than that employed in 2001 by the CIE (ACIL 2003, 39).

The ACIL report, with its criticism of the CIE's approach, has drawn a swift and strongly argued reaction from the CIE, which calls ACIL's analysis flawed and points out that ACIL's conclusions contradict its own analysis (Stoeckel and Davis 2003). Aside from taking issue with ACIL's misrepresentations of the CIE's earlier work and discussing the errors in ACIL's treatment of trade diversion effects, the CIE criticizes ACIL for using in its modeling parameters for the elasticity of Australian export demand that are unresponsive to changes in sales. The CIE points out that the "Armington elasticities" (the degree of substitutability between locally sourced and imported products) used by ACIL in its modeling were too low and should have been doubled (as was done in the CIE study and as is recommended by the GTAP model's developers). The CIE argues that if ACIL had "corrected" the elasticities used, its analysis of the FTA's economic impact would have approximated the findings of the CIE study (Stoeckel and Davis 2003, 5).

In the context of this FTA, I think ACIL might be faulted for its presumption that free trade with the United States would lead to no productivity increases in Australia's services sector (ACIL suggests that such increases are a matter of opinion). ACIL also appears to start with a strong bias in its report. In a statement that seems to reveal much about ACIL's mind-set going in, the report categorically concludes that "bi-

lateral free trade cannot on first principles be given a clean bill of health. The merits of a bilateral deal are difficult to estimate with confidence, but they will always hurt some trading partners and benefit others" (ACIL 2003, 48).

The ACIL study is likely to be relied on by those who are naturally critical of the FTA for other reasons and who seek to bolster their claims with studies that support their own position; however, it is unlikely to displace the CIE study as the more generally accepted basis on which to judge the probable economic effects of a bilateral FTA. There is some argument with the CIE's initial assumptions (in particular, whether they are realistic), but overall the study appears well reasoned and documented and the CIE criticism of the ACIL methodology seems justifiable.

The first US-based study of the potential trade and investment effects of a bilateral Australia-US free trade agreement seems to be John Gilbert's CGE simulation of US bilateral FTAs prepared for the conference that occasioned this volume (Gilbert 2003). The US International Trade Commission (USITC) also has a study under way of the potential impact of the FTA on United States interests, but the USITC report will be a confidential document available only to American negotiators.

Gilbert's study does not include an analysis of the impact of trade in services liberalization, and it addresses only liberalization through removal of tariffs affecting trade in goods. Even on this basis, Gilbert finds small welfare gains for both the United States (0.01 percent of GDP) and Australia (0.02 percent of GDP), which he ascribes to an expected improvement in both countries' terms of trade vis-à-vis nonmembers (Gilbert 2003, 9).

## **Implications of an FTA for Trade (and Other) Relations with Third Countries**

There are really three issues worth discussing in this section of the chapter: (1) What could be the impact of the FTA on Australian (and to a lesser extent US) political, security, and trade interests with East Asian countries? (2) Should we expect the proposed FTA to produce important trade diversion effects? And (3) Would the negotiation of an FTA undermine the prospects for a successful WTO Doha Round?

### **Relations with Third Countries**

In Australia, by far the greatest heat has been generated by the debate on the third of the issues raised above. Early architects of Australian policy regarding East Asia have argued that the negotiation of an FTA between Australia and the United States would be a disaster on a number of fronts. Probably the most vocal spokesman for this viewpoint is Ross Garnaut, who has stated categorically that he is opposed to the free trade agree-

ment with the United States “amongst other things, because it is not free trade, and because it would be antithetic to continued progress towards free trade” (Garnaut 2003a, 26). Most recently, his criticism of the FTA has focused on what he believes will be the very damaging effects on trade of the American approach to rules of origin in preferential trading arrangements (Garnaut 2003b, 13). As noted above, Garnaut also doubts that there would be real benefit to Australia from an FTA—not because he disagrees with the CIE’s economic analysis, but because he challenges the DFAT assumptions on which the CIE was obliged to base its analysis.

Although he is critical of the FTA on a number of counts, Garnaut’s main concern seems to stem from the belief that governments in Australia’s all-important East Asian markets will react to a bilateral agreement with the United States by reappraising their historical resistance to preferential trading arrangements. Having argued successfully in favor of multilateralism in trade relations and against regionalism, Australia has so far been able to avoid a situation in which these East Asian markets see it as in their interests to create their own preferential arrangement that could exclude Australia. Garnaut acknowledges that China and the ASEAN (Association of Southeast Asian Nations) countries announced in 2002 that they would seek to enter a free trade agreement, but he argues that negotiation of such an agreement “will not be a straightforward matter. The presence of trade diversion in an Australia-United States free trade agreement against East Asian countries would generate reactions that increase the probability of it happening” (Garnaut 2003a, 16). Garnaut believes that the FTA would likely create significant trade diversion, that preference margins post-FTA would disadvantage East Asian exporters, and that the global significance of the Australia-US agreement would (probably) be enough to move East Asia to create its own regional framework at the expense of Australia.

In fairness, Garnaut opposes the FTA on other counts as well, including on the theory that it would actually *worsen* relationships with the United States. First, as noted earlier, he takes issue with the assumptions underlying the economic analysis of the CIE and expresses doubt that the deal would bring real benefit to Australia. Second, he is among those who believe that the negotiation of an FTA will distract Canberra and Washington from the important WTO work in Geneva and decrease the prospects for a successful Doha Round. Third, he sees this as a dangerous time to risk souring the bilateral US-Australia alliance by placing contentious trade issues on the table. Garnaut’s views are echoed by other commentators at the Australian National University.

Not surprisingly, Garnaut is on a more or less permanent collision course with Alan Oxley, a principal author of the Monash study, head of the AUSTA Business Group supporting an FTA, and Australia’s former ambassador to the General Agreement on Tariffs and Trade (GATT) in Geneva. Oxley’s Monash study accepts and endorses the CIE findings in

respect of trade diversion from an FTA<sup>17</sup> and stakes out a position (already in 2001) in opposition to Garnaut's view on the East Asian dynamic:

If the suggestion is that Australia needs to consider any proposal for strengthening its relationship with the United States, such as negotiating an FTA, in the light of its possible impact on relations with countries in East Asia, that is an altogether different proposition. Other countries in the region do not feel so constrained (Singapore is negotiating an FTA with the United States and South Korea is studying the idea). And given that the strengthening of the relationship with the US is important to Australia's economic and political interests, to suggest that actions to strengthen ties should not be pursued for their own merit must surely be to subsume Australia's national interest to that of another country's. (AASC 2001, 90)

In its recent submission to the Australian Senate, the AUSTA Business Group continues this line of reasoning, stating that "there is no evidence China considers an Australian/US Free Trade Agreement will chill Australian-China economic relations" (AUSTA 2003a). Not everyone gets the same impression, however. An article appearing in *The Australian* newspaper cited "apparent concerns in China that the free trade agreement being negotiated between Australia and the US is a signal that Canberra is placing less emphasis on its Asian trading partners" ("Beijing Vents Fury over Trade Plan Snub," March 26, 2003, 12). These "apparent concerns" were reportedly recounted by Labour's shadow minister for trade, Craig Emerson, after his return from a former visit to China. Emerson and his staff declined to elaborate when I contacted his office for comment.

What about the impact of the Australia-US FTA on the Asia Pacific Economic Cooperation group (APEC)? It seems doubtful there would be much effect either positively or negatively, as APEC seems to have lost Australian policymakers' attention as a forum for trade liberalization. Most APEC trade-related discussions these days seem either to be related to backstopping work in the WTO (e.g., APEC TEL workshops on WTO telecommunications services negotiations) or focused on regional issues, such as how to deal with the need for enhanced security requirements for containers and the like.

## Trade Diversion

The CIE study found a number of cases in which an FTA between the United States and Australia could be expected to produce trade diversion, but also concluded that trade creation for Australia, the United States, and the world as a whole would outweigh the trade diversion. For example, CIE found increased American automotive exports to Australia displac-

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17. The CIE found there would be some trade diversion but that it would be outweighed by global trade creation due to the FTA.

ing a considerable value of auto exports from Japan and Europe and increased Australian sugar and dairy exports to the United States displacing Latin American and European products. But the modeling also shows the FTA leading to considerable increases in these regions' exports of other goods to the United States. In terms of net trade creation, the CIE estimated an increase in net imports to Australia of \$675 million and an increase in net US imports of \$1.1 billion (CIE 2001, 42–44).

It should be pointed out that Garnaut does not accept the CIE conclusions regarding trade creation and trade diversion. He argues that “it would be possible for the total value of world trade to expand even if there were substantial trade diversion and no trade creation at all” (Garnaut 2003a, 9).

In marked contrast to the CIE study, the ACIL study asserts that one reason the proposed FTA would negatively affect Australia is “the predominance of trade diversion, especially from Asia, that such an agreement would create” (ACIL 2003, 37). As the CIE points out in its reaction to the ACIL report, no economic modeling results are offered by ACIL to explain this statement. In fact, ACIL's only basis for such a position seems to be its acceptance of the likelihood of trade diversion as articulated separately by Garnaut (ACIL 2003, 35). The CIE response to ACIL's claim makes for good reading as the authors provide a step-by-step tutorial on why ACIL's focus on potential effects in Australian export markets is misplaced (Stoekel and Davis 2003, 10–11).

In general, I have found little reason to criticize the CIE study; however, the modeling results in respect to trade diversion produce some results that seem either counterintuitive or at odds with other CIE studies. For example, Australia is forecast to greatly expand sugar exports to the United States largely at the expense of Latin American sugar exporters, yet in its own separate study of the sugar sector in Australia (CIE 2002), the CIE notes the huge cost advantage now enjoyed by Brazil (also negotiating an FTA with the United States). Similarly, it is hard to believe that US exports to Australia of automotive vehicles and parts would actually rise more than \$500 million at the expense of Japanese and European manufacturers.

## **WTO Negotiations and Impact on the Doha Round**

Free trade agreements are not popular among certain “multilateralists” in the trade community. WTO Director-General Supachai Panitchpakdi and many academics have pointed out that the worrying tendency to negotiate FTAs has accelerated significantly in recent years; and in public remarks he has made since taking office, Supachai has been critical of FTAs as undercutting the Doha Round. A frequently voiced criticism is that FTA negotiations divert trade officials from the more important job at hand—the negotiation of multilateral trade liberalization. This view enjoys considerable support in some Australian circles.

ACIL's report strongly supports the multilateral negotiations under way in Geneva in the context of the WTO Doha Round. (Who in this debate does not?) ACIL's modeling, not surprisingly, finds full multilateral trade liberalization creating significantly greater economic benefits for Australia than a bilateral FTA or unilateral Australian liberalization. ACIL goes on from here to strongly criticize the planned FTA on the grounds that it would be a distraction, wastefully consuming officials' time and government interest. Worse still (and this is really curious), ACIL suggests that "[t]he US, for example, might feel it had done enough if it had moved somewhat to meet Australia's demands in the FTA context and might be less interested in meeting those demands in the WTO context" (ACIL 2003, vii). ACIL also sees a potential problem if Australia agreed to pursue an FTA with the United States that excluded agriculture, pointing out that this decision might undermine the credibility of Australia's position on agriculture in the WTO.

These are not plausible concerns in my opinion and, in fact, fly in the face of recent Australian government policy statements. DFAT's recent white paper makes explicit that agriculture has to be dealt with in the FTA with the United States. That same document makes clear that the Commonwealth sees the WTO Round as its best hope for major trade gains and that liberalization of agricultural markets is a priority for the country in the multilateral negotiations (DFAT 2003, 53).

In everything it has said publicly on the subject, the government of Australia, like the US government, clearly sees the negotiation of an FTA as a complement to the multilateral negotiations of the WTO. Both Washington and Canberra have used the term "competitive liberalization" to explain how the demonstration effect of an FTA could help to achieve objectives in the WTO. On this point, I cannot help but note that one of the largest FTAs, NAFTA, was concluded at a critical stage of the Uruguay Round negotiations; indeed, many commentators have credited the NAFTA negotiation with helping to push the Uruguay Round toward a successful conclusion.

## Conclusions

This negotiation has only just started. It's going to be an interesting exercise, particularly in light of the political-level decision to accelerate the timetable for concluding the talks. Chief negotiators Ralph Ives and Stephen Deady and their teams have their work cut out for them. Notwithstanding the extremely friendly atmosphere that characterized the start of negotiations in Canberra in March, there are certain to be difficult discussions in the months to come.



## **Costs to Australia's Regional Relationships**

Is Australia likely to do irreparable harm to its important political and economic relations with East Asia if it concludes an FTA with the United States? That seems very doubtful. For starters, there are probably only a very limited number of goods and services over which US and East Asian exporters are likely to be competing head-to-head in the Australian market, so the introduction by Australia of preferences favoring US suppliers is unlikely to divert importers away from Asian and toward American suppliers. The CIE study (2001) identified autos as an area where Japan could lose out to the Americans in a post-FTA world, but my observation is that there are many incentives for Japanese firms to both produce in, and export to, the Australian market. At the same time, the incentive to Ford and GM to ship large numbers of US-produced right-hand-drive vehicles to Australia is not that clear, given their important existing investments in Australian manufacturing operations, which have now been integrated into their global production plans. The new Pontiac GTO is a rebranded Holden Monaro, produced in Australia for world-wide markets.

Another reason to doubt the potential East Asian backlash predicted by some is the East Asian history of choosing deals with clear economic benefits when faced with a choice of concluding either a politically or an economically motivated trade deal. China recently faced such a choice when negotiating a long-term gas supply contract. A political choice favoring regionalism would have given the prize to Indonesia, but China chose Australia as its partner because the economics outweighed the politics.

Finally, the negotiation of an FTA with the United States is no more a sign of Australia disengaging from East Asia than it is of Australia abandoning multilateralism for bilateralism. Australia has negotiated FTAs with Singapore and Thailand. A bilateral dialogue with Japan on closer economic relations has been under way for some time, and Canberra and Beijing are in the early stages of a similar discussion.

I just don't see the big risk.

## **Costs to the Multilateral Trade Negotiations**

What about the impact of the FTA negotiations on the WTO process? Well, where are the Doha Round negotiations in the wake of the collapse of the Cancun Ministerial? Anyone reasonably familiar with the Geneva negotiations and their prospects would say that there is currently no risk that the FTA negotiations are going to get in the way of progress in Geneva. The Geneva negotiations have slowed on their own merits. Quite pre-

dictably, the talks are stalled, awaiting one of those occasional political crises in the GATT/WTO that inspire everyone with the need to compromise and move on. Through periodic surveys of experts, the Adelaide-based Institute for International Business, Economics and Law has been collecting some fairly reliable information on attitudes to the WTO talks in Geneva and in key capitals. What the polls<sup>18</sup> have shown is that everyone continues to support the WTO talks as the biggest game in town, almost nobody thinks the Doha Round will finish on schedule, and most trained observers of the WTO are not worried about this scenario because it is “normal” for a multilateral trade negotiation. In the words of a good friend, “We’ve all seen this movie before.” The professionals understand that like the war in Iraq, the Doha Round will take as long as it takes.

The round will finish eventually and it will finish successfully, because finishing successfully is important to all of the WTO’s members. There is no substitute for the global system, and it will take a long time before the trend toward regional trade agreements takes (most of) us away from the belief in the primacy of the multilateral system—if for no other reason than only the WTO talks can credibly address the need to reform global trade in agriculture. This reform is important for the United States, Australia, and the Cairns Group. It is also, and perhaps more significantly, an objective that represents the only hope for many least-developed countries to trade their way out of poverty.

Director-General Supachai and his deputies at the WTO will make speeches about the threat to the organization posed by regionalism while USTR Zoellick and Trade Minister Vaile speak of their competitive liberalization efforts in the FTAs they are negotiating. Conventional wisdom in Geneva ties progress in the GATT/WTO multilateral sphere to successive EU enlargements. It seems to me that it’s just as easy to accept that the competitive liberalization of non-EU preferential agreements could also contribute positively to the multilateral negotiating dynamic.

## **Economic Benefits of a Free Trade Agreement**

This chapter has looked briefly at the studies done in Australia concerned with the potential economic benefits of an FTA, and I think there are clearly more reasons to side with the CIE analysis (2001) than with the ACIL report (2003). DFAT might have given the CIE some unrealistic assumptions to work from, but those assumptions are not impossible. For its part, ACIL clearly started with a big chip on the shoulder against any FTA and that attitude probably poisoned the outcome. Gilbert’s study (2003) might not see big gains for either side (although he does not treat

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18. See the Global Trade Opinion Polls at [www.iibel.adelaide.edu.au/hot/](http://www.iibel.adelaide.edu.au/hot/).

services, which figured so importantly in the CIE study), but it also does not find the FTA affecting either country negatively.

Leaving aside the studies, it is clear that the majority of those in the business community in both countries are strongly supportive of an FTA. Companies know there are gains to be made in enhanced movement of personnel, elimination of duplicate product testing, potential rationalization of existing labeling requirements, and a more secure environment for investment and movement of capital. FTAs are also valuable because they gradually implement institutional mechanisms that can be important tools for resolving business problems or discussing additional trade liberalization. In addition, there is a good chance that difficult problems and barriers will be significantly modified if not eliminated. There really do not appear to be any important economic downsides to this agreement, given that the two countries are already relatively open to each other in most key sectors.

Australia asked for this negotiation. In fact, Australia started asking for this negotiation quite some time back. Ambassador Zoellick has long believed that it is in the interests of both countries to conclude an FTA. The recent war in Iraq complicated public debate on the issue, at least in Australia. Some commentators openly expressed the view that Australia would be given economic benefits through the FTA as a dividend of the country's participation in the coalition. I have sought to dissuade people from perpetuating this position. I have made the point that even if the Bush administration wants to reward Australia in this way, that wish won't carry much water with those facing a loss of protection in their market and a consequent reduction in profitability. Sensitive political issues will come up on Capitol Hill, and members of Congress are going to support an FTA only if they believe it's a good deal for the United States. Of course, Canberra is also committed to the negotiation of a good deal.

There are plenty of indications that the Australia-US FTA can be a successfully negotiated, economically meaningful agreement of benefit to both countries. The two governments are committed to pursuing a "large" agreement in a relatively short time frame. Reliable economic studies support the prospect of mutual gains. And in both countries, the mainstream business community appears strongly supportive of the FTA and eager to get on with an integration process. In Australia, early skepticism over the benefits of an FTA seems to be changing in favor of broader support. Reportedly, 56 percent of respondents to a March 2003 poll said they would support an FTA, against only 22 percent opposed to a deal.<sup>19</sup>

Of course, that's not all there is to the story. In this case, there will be considerable opposition to a "full-scope" FTA from vested interests in both countries, and some will continue to argue against an FTA on more political

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19. Hawker Briton UMR research poll, carried out March 28–30, 2003, for political lobbyists and reported in "Vaile Wants Food Aid in FTA Terms," *Australian Financial Review*, April 8, 2003.

grounds. All of these factors will keep things interesting for the negotiators and the newspapers. As of this writing, the question is not whether a good deal can be done, but rather whether it can be done by the end of 2003.

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## Appendix 5.1

### Australia–New Zealand Closer Economic Relations (CER) and Issues Relating to New Zealand in an FTA with the United States

At the outset of this chapter, I noted that I believed the chances for a New Zealand–US FTA were relatively remote and therefore planned to concentrate on a strictly bilateral Australia-US FTA. Nevertheless, there are some issues worth reviewing, if only briefly.

CER entered into force in 1983 and has been hugely successful in integrating the economies of Australia and New Zealand.<sup>20</sup> Through three general reviews of CER's operation, it was progressively widened and deepened. Apart from eliminating tariffs and quantitative restrictions on trade in goods and extensively liberalizing trade in services, CER replaced the use of antidumping actions with competition policy instruments and has moved far into "domestic" policy measures in other areas as well. CER embodies agreements on industry assistance, technical barriers to trade, and harmonization of regulatory barriers to trade, such as the setting of food safety standards. CER has by all accounts been a huge success that has linked the two partners so closely that it is not unusual in 2003 to read serious discussion of monetary union.

The extent to which New Zealand exporters might benefit *directly* (through CER) from an Australia-US Free Trade Agreement is hard to assess in the absence of knowing what rules of origin would apply in the new FTA. CER origin rules specify that in order for merchandise trade to qualify for free movement, the last process of manufacturing and at least 50 percent of the value of the product should be in expenditures associated with materials, labor and factory overheads, or inner containers originating in the area. In the case of the US FTA with Singapore, origin rules go on for pages and appear complex. However, apart from the numerous product-specific rules of origin, the United States seems to have settled basically on an approach that requires either that the good be "wholly obtained or produced entirely in the territory" of Singapore or that it undergo such additional processing in Singapore as to bring about a "change in tariff classification" of the product in question (USTR 2003c, chapter 3).<sup>21</sup> On the face of it, the application by the United States to Australia of Singapore's FTA origin rules could complicate the operation of CER, given the integration of the trans-Tasman economies. It would seem that about the only New Zealand–origin goods that would make it to the United States under the FTA would be those further processed in Aus-

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20. Background information on the CER is summarized from DFAT (1997).

21. To be considered wholly obtained or produced entirely in Singapore, less than 10 percent of the adjusted value of the good must be from non-Singapore sources.

tralia enough to undergo a change in tariff classification. Many products would likely fail the 90 percent plus content test of the Singapore-US deal. Whether Australian industries and the negotiators in Canberra would be happy with such a scenario is not known, but it is likely to be an interesting and complicated aspect of the negotiations, given the CER context.

In the main body of the chapter, I briefly noted that the CIE study (2001) had found *indirect* benefits to New Zealand of an FTA between Australia and the United States. These arise in part because, as the Australian economy expands as a result of the positive impact of the FTA, New Zealand benefits from increased demand in the Australian market. To the extent that the Australia-US FTA liberalized dairy trade, New Zealand would gain there as well, mainly because it would pick up dairy sales in Japan and elsewhere as Australian dairy exporters diverted some portion of exports to a more profitable American market (CIE 2001, 26). It should also be noted that Gilbert's study (2003) finds a welfare loss for New Zealand in the case of a US-Australia FTA owing to a deterioration in New Zealand's terms of trade.

Notwithstanding the letter from Senator Grassley and his colleagues, it is unlikely that the United States will soon enter into free trade agreement negotiations with New Zealand or that Washington would negotiate a CER-wide FTA with both Canberra and Wellington simultaneously. I am assuming that New Zealand's continued policy with respect to the visits of nuclear-powered and -armed ships and the Clark government's statements made during the war in Iraq will stand in the way of the American administration's willingness to put trade relations with New Zealand on the same footing as those with Australia. This may be good news for Australia, not only because its exporters will not have to compete directly in the US market with New Zealanders but also because it could be more difficult for the United States to liberalize certain agricultural restrictions if it had to contend with imports from both countries. New Zealand creates no difficulties in the sugar sector but it is an important exporter of both beef and dairy products. Over the longer term, an inevitably sequenced approach might actually work to New Zealand's benefit if, through a good experience with increased imports from Australia, American agricultural interests come to believe that they could also live with more beef and cheese from New Zealand.