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**Trading blocs in the Asia-Pacific area**

**Gary Banks**  
**Centre for International Economics**  
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National Centre for Development Studies  
Research School of Pacific Studies  
The Australian National University  
GPO Box 4  
Canberra ACT 2601  
Australia  
Tel (062) 494705  
Fax (062) 572886

## Foreword

A major theme of research at the National Centre for Development Studies (NCDS) is the role international trade plays in economic development. A number of studies are under way exploring the import penetration of developing countries in industrial country markets (using data contained in the ANU's International Economic Data Bank), the impact of China's export growth on other Asia-Pacific exporters, and the effect of restrictive international trading practices on developing country efforts to industrialise through export growth.

One aspect of particular relevance to the trade and growth aspirations of developing countries, as well as Australia, is the increasing trend around the world towards the formation of trading blocs, such as the European Community and the Canada-United States Free Trade Agreement. In recent times, there have been persistent calls for the creation or extension of such trading arrangements among 'Asia-Pacific' countries. Despite the importance of the issues, however, there has been little systematic analysis of what is at stake for the countries concerned.

This paper provides a survey of the issues involved in various trading bloc scenarios in the Asia-Pacific. It was commissioned by the NCDS and carried out by Gary Banks, Projects Director with the Centre for International Economics (CIE), Canberra. The paper benefitted from discussions with and advice from Andy Stoeckel and David Vincent at the CIE, and Helen Hughes and Brian Brogan at the NCDS. David Vincent and Helen Hughes also contributed to the paper's concluding chapter on the scope for follow-up research. An earlier version of the paper was drawn on by the NCDS, as background for its submission to the Parliamentary Joint Committee to inquire into Asia-Pacific Regional Cooperation, 13 October 1989. In releasing this paper, NCDS hopes to stimulate interest in the further empirical and analytical work which is needed to understand the implications of these important trade policy questions.

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## Abbreviations

ABARE	Australian Bureau of Agricultural and Resource Economics
ANZCERTA/CER	Australia New Zealand Closer Economic Relations Trade Argument
APEC	Asian Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
BAE	Bureau of Agricultural Economics
BIE	Bureau of Industry Economics
CACM	Central American Common Market
CAP	Common Agricultural Policy
CIE	Centre for International Economics
EC	European Community
EFTA	European Free Trade Association
FTA	Free Trade Area
GATT	General Agreement on Tariffs and Trade
GDA	Geographically discriminatory trading arrangement
IAC	Industries Assistance Commission
NAFTA	New Zealand Australia Free Trade Agreement
NCDS	National Centre for Development Studies
OEEC	Organisation for European Economic Cooperation
OPTAD	Organisation for Pacific Trade and Development
PAFTA	Pacific Free Trade Area
PAFTAD/PACTAD	Pacific Trade and Development Conference
PATCRA	Agreement on Trade and Commercial Relations between Australia and Papua New Guinea
PBEC	Pacific Basin Economic Council
PECC	Pacific Economic Cooperation Conferences
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement
UNCTAD	United Nations Committee on Trade and Development
USITC	United States International Trade Commission
VER	Voluntary export restraint

## Summary

### Origins of trading bloc proposals

In the mid 1960s, proposals for a regional trade arrangement among Pacific countries emanated from Japan, but were opposed by the United States and other countries. The traditional United States aversion to regional trade agreements disappeared in the 1980s, however, with its participation in a number of preferential arrangements and possible interest in more. Asian countries have taken notice of this United States interest, as a possible way of resolving growing bilateral trade frictions.

In Australia there has been some influential support for Australian participation in an Asian trade bloc, largely to secure trade with our largest and fastest growing markets. There is particular concern about the United States forcing its way into Asian markets at Australia's expense, and of Australia being 'left on the shelf' if other countries join trading blocs.

### Economics of trading blocs

The term 'trading bloc' has been used loosely in the debate thus far. It covers a variety of arrangements providing more favourable market access to and among a select group of countries. Those which are most relevant to the Asia-Pacific debate are free trade areas (FTAs) — in which members eliminate tariffs against each other while maintaining their separate protection regimes for other trade — and Customs Unions, which have zero internal barriers and common external barriers.

In contrast to non-discriminatory trade liberalization, the effect of a trading bloc on the national welfare of participants and on global welfare is ambiguous, depending on the relative extent of 'trade creation' (displacement of high cost production by imports) and 'trade diversion' (displacement of lower cost imports from outside the bloc).

While some 'rules of thumb' are available for evaluating the likelihood of net gains, the effects of trading blocs can really only be determined empirically. Most existing work has been done on the European Community and has found it to have generated more new trade than it has displaced, but this has also reflected its participation in the major multilateral tariff reductions in the GATT. The estimated welfare effects have been very small. Larger gains have been found from 'dynamic' effects (scale economies, productive efficiency, terms of trade). Work on a Canada-United States FTA has found large gains



to the smaller partner from scale economies. However, analyses of trading blocs among developing countries have found most of them to have adversely affected growth and income distribution.

### **Trade and growth in the Asia-Pacific**

The 'Asia-Pacific' (see box 1) has become economically the most dynamic 'region' in the world. This dynamism has been concentrated in the countries of East Asia and is linked to their superior export performance.

Much of the Asia-Pacific area's trade growth has taken place within the area. While the area has also become much more important to Australia's trade, Australasia is the only region to have diminished in importance as a trading partner to the rest of the Asia-Pacific.

While Western Europe has declined in importance as a market for all countries in the area, it still accounts for one-fifth of Asia-Pacific exports.

The Asia-Pacific's impressive performance and the growing intensity of trade within the area has occurred without any formal intergovernmental institution for regional economic cooperation. The question is whether anything better could have been achieved under institutionalized trading arrangements.

### **Economic potential of Asia-Pacific free trade areas**

Ignoring questions about political feasibility and possible retaliatory repercussions, a free trade area encompassing the whole Asia-Pacific would be large and diverse enough to bring economic gains to its members — including Australia. Less encompassing FTAs are more difficult to evaluate without economic modelling. The Australia New Zealand Closer Economic Relations Trade Agreement (CER) seems unlikely to bring significant gains to Australia. FTAs with the United States and, especially, Japan have more potential, given the size of the markets and the barriers to some of Australia's key exports, but the outcome would critically depend on whether all products and non-tariff barriers were included. For the other countries in the area, the likely balance of benefits is less evident — there being considerable scope for trade diversion as well as trade creation.

From Asia's perspective, or that of the United States, there would be very little incentive in forming an FTA with Australia. However, for most Asian countries an FTA with the United States might be expected to yield substantial benefits if non-tariff measures (including 'voluntary' restraints) were eliminated. This would have substantial displacement effects on the trade of any country left out, however, including Australia's important agricultural exports to Asia.

### **Is an Asia-Pacific bloc feasible?**

A look at existing trading blocs reveals three features which most such arrangements have in common:

- (i) geographic proximity of the member countries;
- (ii) shared political and strategic objectives; and
- (iii) similar levels of 'development' or 'competitiveness'.

Measured against these three 'feasibility criteria', an FTA comprising the Asia-Pacific area as a whole does not look promising. As noted, the area is in all respects — economic, geographic, cultural and political — highly diverse.

'Sub-blocs' are more feasible and some exist already (such as CER and the Canada-US FTA). It is unlikely, though, that Australia could initiate a bloc or be included in one that excluded the United States. Although small as a market, Australia is a major supplier of agricultural produce to Asia in competition with the United States — which in turn is Asia's largest market. The United States is really the key to what is possible in closer Asia-Pacific trade relations. It is too important to the Asian economies for things to be otherwise. The prospect of the United States expanding its FTA agreements from Canada and Israel to include Asian countries seems unlikely by criteria (i) and (iii) above. But it is conceivable that political-strategic reasons could outweigh economic considerations.

### **Broader trade repercussions**

While the General Agreement on Tariffs and Trade (GATT) rules are weak and permissive about the formation of trading blocs, such arrangements can erode the multilateral system and make **global** liberalization even more difficult to achieve than at present.

An important 'systemic' consideration is that the formation of a trading bloc, in diversifying trade away from 'outsiders', could elicit a retaliatory response. The EC has

already expressed opposition to the notion of Asia-Pacific 'economic cooperation'. It could well use any preferential arrangements in the Asia-Pacific as an excuse to raise its external barriers or expand its own bloc — Eastern Europe now being a prime candidate for inclusion. Such potential losses could be a significant offset to any expected gains from a regional bloc and clearly need to be taken into account in evaluating the effects.

### **Alternative strategies**

The trading bloc idea has been influenced in part by the perceived shortcomings of the GATT trade liberalization process. But this has had a lot to do with the unwillingness or inability of member countries to 'follow the rules'. Developing countries in particular have been taking advantage of on the GATT system for years, contributing to its decline. Asia-Pacific countries are well placed to take a lead in redressing this — either individually or through collective action.

The underlying forces impeding liberalization are domestic, reflecting the disproportionate political influence of import-competing industries, and have been compounded by general ignorance about the economy-wide costs of protection. In Australia, the Industries Assistance Commission was created to help overcome this, and the subsequent (though gradual) change in Australia's traditionally protectionist stance in favour of more liberal trade and 'microeconomic reform' speaks for itself. Institutional arrangements of that kind could be similarly helpful in Asian countries — as well as in dealing with industrial countries' accusations of 'unfairness'. A number of countries already have 'tariff commission' type institutions that could be adapted for this purpose.

### **Research implications**

Despite protestations to the contrary, political circumstances could lead to the spread of regional trading arrangements in the Asia-Pacific. Because such developments are also influenced by their expected economic effects, more information is needed on those effects. From Australia's perspective, research is needed to provide detailed answers to two broad questions:

- What would be the consequences of various trading bloc scenarios in the region (excluding Australia) for Australia's trade and growth prospects?
- What would be the economic effects on Australia of participating in any such regional arrangements?

Answering such questions requires a comprehensive regional trade model covering national economic relationships and trade linkages among countries. The National Centre for Development Studies monitors and analyses the progress of the developing countries of East Asia. The Centre for International Economics has constructed an integrated model comprising Japan, the Asian 'tigers', the Association of South East Asian Nations (ASEAN), North America, the EC and Australia and New Zealand. It can simulate:

- effects of the key trading bloc scenarios on growth prospects for industries in Australia and elsewhere;
- overall macroeconomic performance in each grouping; and
- the commodity pattern of trade among Australia and the other countries.

Such information would not only help Australia evaluate the external threat posed by trading blocs, and thus to devise **reactive** strategies, but could also be helpful in demonstrating to other countries the consequences for them of these approaches — that is, in **influencing** their policies for the better.

## 1. Introduction

The question of a trading bloc within the 'Asia-Pacific region' has been much discussed in the past year, more so than at any time since the late 1960s. The recent interest has at least one thing in common with that of twenty years ago — concerns about 'fortress Europe'. But there are also some new ingredients, including the formation of a North American 'bloc' and perceived United States interest in doing further deals in Asia. Meanwhile, Australia has extended and consolidated its own regional trade agreement with New Zealand.

While debate about these developments and whether they could (or should) be extended has been vigorous at times, it has been conducted more at the level of rhetoric and 'gut feeling' than on the basis of careful analysis. Although regional trade agreements are often motivated more by political or strategic interests than economics, they can have important economic consequences — both for participants in the arrangements and for those countries excluded. Hard information about what the costs and benefits of trading blocs in the Asia-Pacific region would be is conspicuously absent at present.

The objective of this paper is to examine the origins, economics and political/strategic issues of various trading bloc scenarios for the Asia-Pacific area and to suggest directions for policy and more detailed research. The paper begins by tracing the origins of current concern about, and proposals for, an Asia-Pacific 'trading bloc'. It then looks at what this term actually means and how the economic effects are analysed, before examining the economic and then political implications of this approach in the Asia-Pacific area.

## 2. Origins of Trading Bloc Proposals

The current debate about whether the countries in the Asia-Pacific 'region' (Box 1) should form a trading bloc is in some respects a replay of a debate that took place about twenty years ago. That debate began with Japanese proposals for a Pacific Free Trade Area (PAFTA), made by Professor Kiyoshi Kojima of Hitotsubashi University and Takao Miki, Minister of Foreign Affairs and Leader of the Diet in the mid 1960s.

### **Beginnings: Kojima's PAFTA**

Kojima's proposal was for a free trade area among the five developed Pacific countries — the United States, Canada, Australia, New Zealand and Japan (Kojima 1966; 1968). He saw PAFTA as initially involving the mutual elimination of tariffs among these countries, while retaining tariff levels unchanged for other countries, and eventually extending preferential treatment on a non-reciprocal basis to the developing market economies of the region.

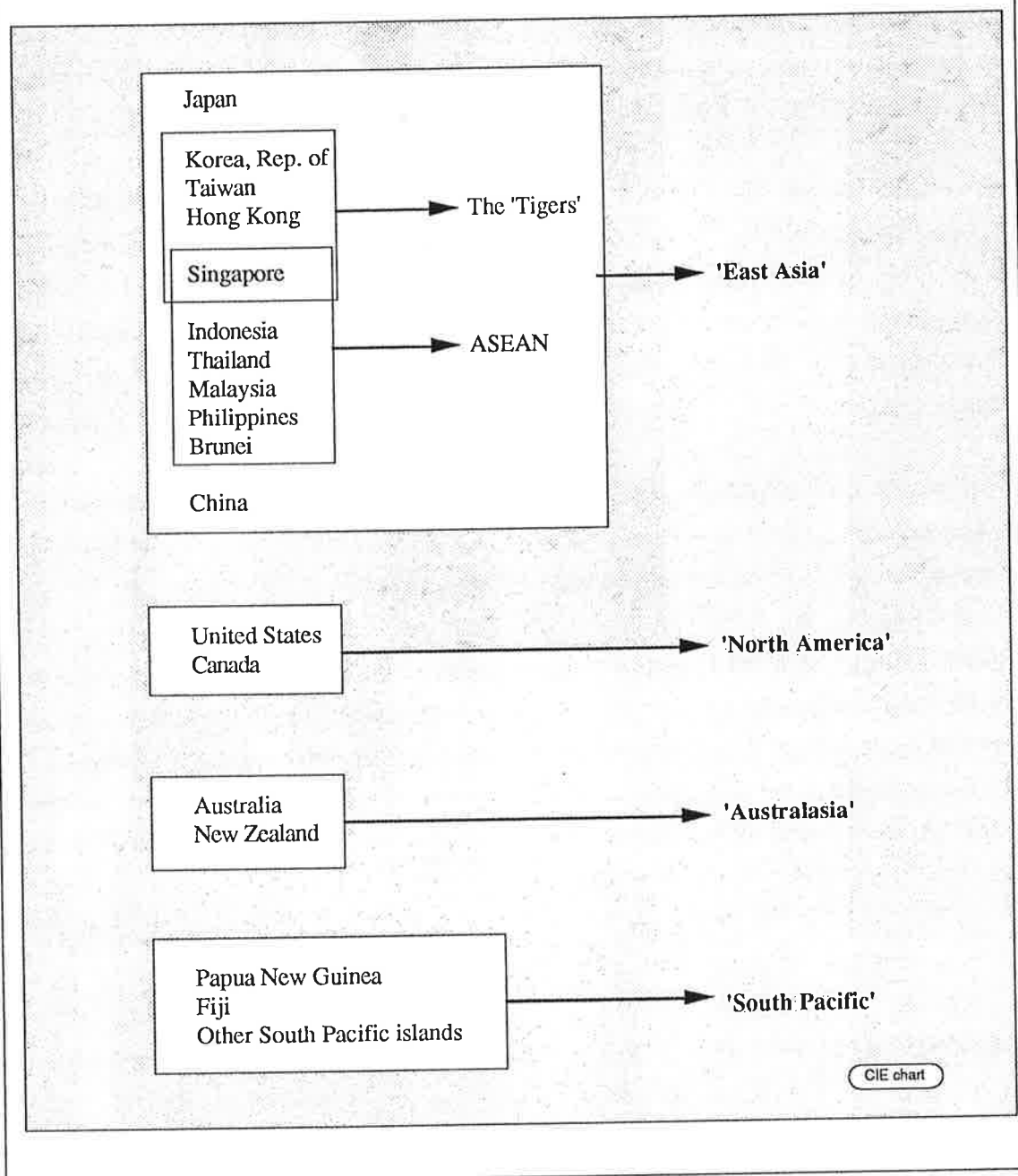
The inspiration for Kojima's proposal came from the establishment and entrenchment of EC, seen both as a threat to the region's exports and as a model for how Pacific trade could be accelerated for the benefit of Japan and other countries in the region.

Japanese feelings of insecurity about trade policy developments in Europe — and elsewhere, for that matter — were understandable. Despite United States sponsorship, Japan had great difficulty entering the GATT and, for some ten years after it joined in 1955, fourteen countries invoked a GATT clause (Article 35) which enabled them to continue to treat Japan as if it had not joined. These countries included the United Kingdom, France, Belgium and the Netherlands. The price of their eventual recognition of Japan as a contracting party was a network of discriminatory side-deals involving voluntary restraints and quotas on 'sensitive' areas of trade (Patterson 1966).

Japan's desire for a free trade pact in the Pacific also reflected the increasing importance of markets in the region, particularly the United States. The share of Japan's trade accounted for by the four developed countries in the region had risen from 29 per cent in 1958 to 38 per cent in 1967. Kojima calculated that a PAFTA would see Japan's exports to these countries rise by 56 per cent.

## Box 1 What is the Asia-Pacific 'region'?

It is hard to think of New Zealand and Canada as neighbours. Yet both countries are normally included in a collection of countries referred to as the Asia-Pacific (or just Pacific) 'region'. In practice, the selection of countries is arbitrary and often leaves out a number of areas bordering the Pacific (eg Mexico, Ecuador, Chile and Indo China). The following categorizations are commonly used and will be followed in this paper.



Finally, Japan had reason for concern about future access to these markets. Japan's exports of cotton textiles had already caused a protectionist backlash in the United States, forming the beginning of what was to become the Multi-fibre Arrangement (MFA).

Japan's enthusiasm for a regional free trade arrangement was not shared by the other industrial Pacific countries. In the late 1960s, the United States was still the bulwark of the multilateral trading system and was on principle opposed to any form of discrimination in trade — including regional preferences. It had just seen the successful completion of a wider ranging round of GATT negotiations than had ever been achieved before (the Kennedy Round) and had little reason to look elsewhere for further liberalization. Also, and perhaps more to the point, the United States and other countries in the region were becoming alarmed at the burgeoning export competitiveness of the rapidly growing Japanese economy, as illustrated by the cotton textiles restrictions (Keesing and Wolf 1980).

This negative attitude was shared by the region's economists, who met at a Pacific Free Trade and Development (PAFTAD) conference sponsored by Japan's Ministry of Foreign Affairs, to consider Kojima's proposals.

The PAFTAD economists ... quickly formed one of the core groups of the Pacific Basin Movement. Nevertheless, coming from many different countries with different perspectives, these economists found it hard to accept Kojima's specific proposal. The globalists from the advanced countries did not want to see the world market broken up into regional trading blocs. Most economists from overseas did not believe the countries would benefit equally. Manufactured goods exporters like the Japanese were seen to be advantaged far more than primary goods exporters like the Australians, and these academic views seem to have reflected the views held by government economists as well (Morley 1987: 13-14).

Although not pursuing PAFTA, the PAFTAD group were attracted to the idea of achieving greater regional cohesion and economic cooperation — discussed at annual meetings ever since (Box 2).

### **United States about-face on FTAs**

The traditional United States aversion to regional trade agreements disappeared in the 1980s. This could be partly attributed to United States perceptions that the GATT was no longer achieving meaningful liberalization. This judgement was crystalized in the unsatisfactory outcome to a 'crisis' GATT Ministerial Meeting in November 1982, which the United States had hoped would lead to an initiative to liberalize trade in areas of increasing concern to the United States — including agriculture and services. Instead, GATT ministers merely agreed to study and exchange information on these issues.



## Box 2 Acronyms: a regional growth industry

Proposals for free trade and other forms of 'regional cooperation' have spawned a variety of regional organizations to discuss them — while the proposals for more concrete action have generally achieved little. The result is a confusing array of acronyms and a heavy program of annual meetings.

PAFTA	<i>Pacific Free Trade Area</i> — a proposal first made by Japan's Professor Kojima in 1966.
PBEC	<i>Pacific Basin Economic Council</i> — a businessmen's group which began in 1967 and holds conferences on regional economic issues.
ESCAP	<i>Economic and Social Commission for Asia and the Pacific</i> — a United Nations body intended to facilitate economic cooperation and development in Asia and the Pacific.
OPTAD	<i>Organization for Pacific Trade and Development</i> — a proposed OECD-like organization for the Pacific, associated with Sir John Crawford and Subiro Okita.
PACTAD (sometimes PAFTAD)	<i>Pacific Trade and Development Conference</i> — a series of meetings on regional economic issues attended by mainly academic economists which began in 1978.
PECC	<i>Pacific Economic Cooperation Conferences</i> — annual meetings of academics, businessmen and government officials, commenced in 1981.
APEC	<i>Asian Pacific Economic Cooperation</i> group — meetings of Ministers from Asia-Pacific countries on 'regional' economic issues, the first of which was held in Canberra in November 1989.

As a result, United States Trade representative William Brock started to push the idea of bilateral negotiations to liberalize trade. As Schott puts it, 'FTAs became part of a two-track United States strategy to provide a complement to, and potentially a substitute for, multilateral efforts to liberalize trade' (1989b: 4-5).

The first United States departure in favour of regionalism was Reagan's Caribbean Basin Initiative, which granted preferential treatment to selected exports from Caribbean countries, and was justified as a form of development assistance. (Note that developing country preferences through UNCTAD's Generalized System of Preferences scheme had been vigorously opposed by the United States in the 1960s — although the United States acceded to the scheme in the 1970s.)

Then in 1983 the United States began negotiations with Israel which, after some resistance in Congress, led to the United States–Israel Free Trade Area Agreement two years later. Under the agreement, each country is to remove all tariffs and most non-tariff forms of protection on mutual trade in goods by 1995. There is also a non-binding commitment to liberalize trade in services between the two countries.

The United States–Canada Free Trade Agreement had a longer gestation period, having first been the subject of negotiations in the 1940s and discussed and promoted in various quarters ever since (Wonnacott 1987). Negotiations between the two governments began in May 1986, following the successful completion of the United States–Israel agreement, and the United States Canada FTA came into effect in January 1989 — again, not without some domestic political hurdles in the two countries, especially Canada (Lipsey and Smith 1989). The agreement includes the elimination of barriers to trade in most goods by 1999 — the major farm policies in both countries remaining untouched — and establishes rules to liberalize trade in certain identified services.

At about the same time that the United States was involved in FTA negotiations with Israel and Canada, advances were also being made to countries in the Asia–Pacific region. These included Australia, New Zealand, ASEAN, Japan, Republic of Korea and Taiwan (Snape 1986; Tsiang 1989). A former United States Ambassador to Japan has recently continued to push for a United States–Japan agreement, and the United States International Trade Commission has prepared reports, at the request of Congress, on the 'pros and cons' of FTAs with Japan, Republic of Korea, Taiwan and ASEAN (USITC 1988, 1989).

Schott (1989*b*) attributes the current United States interest in FTAs to two related concerns: first, that the GATT is 'ill-equipped' to achieve meaningful liberalization in the present complex world trade scene (especially in services trade); and second, the United States trade deficit, which is politically attributed to 'unfair' trading practices overseas, and which Congress has decided needs to be confronted by the United States government bilaterally.

### **Asian perspectives**

The circumstances which led Japan to push for regional liberalization in the 1960s could be said to be shared by a number of other Asian countries in the 1980s. While Asian economies and their export interests are quite diverse, they generally have a common dependence on the United States market (Table 1). A sense of dependence on the United

States and other regional markets in Asia has been heightened by EC 1992 and by fears that the internal adjustment required by that process will be accommodated through demands for higher barriers to imports from outside Europe — the 'Fortress Europe' scenario.

As noted, United States trade policy has become hostile to Japan and other Asian exporters in recent years. Bilateral protectionist pressure has been exerted against subsidised exports from Asia and pressure to open protected markets to United States goods has increased. The coincidence of the 1988 Omnibus Trade Act, with its Super 301 provisions for tackling 'unfair' trade practices in nominated countries, and the formation of the United States–Canada trading bloc has raised questions about the future direction of United States trade policy. At the same time, United States soundings about FTAs in the Pacific have made Asian countries — who are each other's main competitors in the United States market — think about the consequences of being left out. In these circumstances, a number of countries would probably welcome the prospect of an FTA with the United States (Tsiang 1989; Ariff 1989; Kuroda 1989; Park and Yoo 1989). This applies in particular to those countries which have already embarked on liberalization programs, or who would see the external opportunities afforded by an FTA as a useful means of achieving desirable domestic reforms.

**Table 1 United States share of East Asia's merchandise trade, 1988 (per cent)**

Country	United States share of	
	Exports	Imports
Japan	34	23
Republic of Korea	36	25
Taiwan	39	26
Hong Kong	25	8
Singapore	24	16
Thailand	18	17
Malaysia	178	18
Philippines	36	21
China	7	12

Source: International Economic Data Bank, Australian National University, Canberra.

However, the focus of Asian trade on the United States also means that these countries are unlikely to be attracted by a trading bloc that excluded the United States. This may

well have been the real message behind a statement by Mr Hawke clarifying his proposal for achieving greater regional economic cooperation in the region:

In case there are any lingering doubts in this country [the US] or anywhere else I should stress again that what we are proposing is *not* a trade bloc. The countries of the region would not touch this with a forty foot pole, and rightly so (Hawke 1989).

### **Australian motivation**

While Mr Hawke's recent initiative to promote regional economic cooperation — the Asia Pacific Economic Cooperation group — is clearly not focused on a trading bloc, that concept nevertheless has its supporters in Australia.

Indeed, at various times in the leadup to the Uruguay Round, and prior to the mid-term review of those negotiations in December 1988, Mr Hawke himself had raised the prospect of trade liberalization within the Pacific, should the multilateral negotiations fail to deliver worthwhile results. ('We may join Asia trade bloc, PM warns', *The Australian*, 6 October 1988.) The perception in some countries in the region, despite Australian denials, continues to be that the longer term agenda behind the Australian regional initiative is for a trading arrangement (*Asian Wall Street Journal*, 4 July 1988: 1).

In 1988, the former Liberal Prime Minister, Malcolm Fraser, also hinted strongly at the need for a regional trading bloc, because of similar moves in the EC and North America ('Asian nations need unity to counter trade threats', *Age*, 20 September 1988). And the Opposition leader, Andrew Peacock, embroiled himself in a controversial debate last year when he repeated Fraser's proposals, this time calling explicitly for a trading bloc ('Time ripe for Pacific bloc', *Weekend Australian*, 17–18 June 1989).

Within Australian industry the manufacturing sector has been understandably quiet about the regional free trade idea, but the farmers have been more positive. The National Farmers' Federation Policy Director, Gus Hooke, has emphasized the importance to Australia of maintaining access to Asian markets. He has argued that:

... it would be in Australia's interest to investigate the merits of forming a closer trading relationship with Developing Asia. And if, as seems likely, the benefits are substantial, it should follow up with an action program to bring such a relationship about (Hooke 1989: 11).

The farmers' concerns about maintaining access to Asian markets reflect:

- (i) the increasing importance of those markets — since the United Kingdom joined the Common Market in 1972, East Asia's share of Australian merchandise exports has risen from 28 to 53 per cent (Figure 1);
- (ii) the projected expansion in Asian markets in the future — it is believed that at current growth rates, developing Asia (that is, excluding Japan) will account for nearly one-half of world income fifty years hence (Hooke 1989);
- (iii) the possibility that these countries will raise barriers to agricultural imports as they become more 'advanced' — a phenomenon typical of industrial countries (World Bank 1987);
- (iv) the prospect of predatory North American and EC trading blocs using their economic might to secure access to Asian markets for their own exports at the expense of Australia's; and
- (v) the possibility of the United States (or the United States and Canada) actually negotiating an FTA arrangement in one or more of our key Asian markets and displacing Australian exports.



These concerns are clearly of broader application to the Australian export sector than just to agriculture. They are legitimate concerns. The question is whether a trading bloc is the most appropriate policy response.

## The need for information

At this stage, although there has been much debate about the 'trading bloc question' much of it has been based more on intuition about political feasibility and economic effects than systematic analysis. As a result, it has become polarized between those who feel that it would be a 'good thing' and those who don't.

This has been exacerbated by semantic confusion about just what is being proposed. In Australia, this was illustrated by Mr Peacock's proposal for a regional trading bloc (referred to previously) and his subsequent retraction of the proposal following an admission from his office that 'he did not know that the term "trading bloc" referred to a group of nations with trading barriers to the outside world' ('Peacock's Pacific sinks in trade terms confusion', *Australian*, 13 July 1989).

The question of how Australia and other countries in the region should approach their mutual trade policies is too important to be addressed in the almost cavalier fashion that has typified the debate so far. A strategy for dealing with the above concerns must be soundly based. That means it must have available to it information allowing some answers to the following questions:

- What would be the economic effects of different institutional arrangements to promote regional integration — on Australia and other countries?
- How would such arrangements affect the trading system as a whole?
- What political and/or strategic conditions would be required and how does the region measure up?
- What alternative strategies are available?

These issues are addressed in the following chapters.

### 3. Economics of Trading Blocs

#### Definitions

The term 'trading bloc' can be used to cover a number of different trading arrangements. What they have in common is a set of market access conditions among member countries which differ from those for countries outside the 'bloc'. The main possibilities are as follows:

- **Preferential trading arrangement:** in which (i) a country applies lower tariffs to imports from a specified group of countries (like Australia's system of preferences for developing countries) or (ii) members apply lower tariffs to imports from each other than to those from non-member countries (like the system of Commonwealth preferences, in which Australia and other members of the Commonwealth granted each other an 8 per cent margin of preference — and to which the United States took exception in the formation of the GATT).
- **Free Trade Area (FTA):** in which members completely eliminate tariffs against each other, while maintaining their individual protection regimes for other trade. Examples: European Free Trade Association (EFTA) (except for agriculture), United States–Canada FTA and the Australia–New Zealand Closer Economic Relations Trade Agreement (CER).
- **Customs Union:** like an FTA, but with a common external tariff. The EC has this, but it also goes further.
- **Common Market:** EC 1992 will see the 'completion' of a process whereby the EC is transformed from a Customs Union to a 'Common Market', in which members eliminate barriers to trade in goods and services, as well as to capital and labour movements.
- **Economic Union:** complete economic integration to the point of common fiscal, monetary (currency) and socio-economic policies. Examples of complete integration of this kind are the 'Federations': the United States, the Federal Republic of Germany and the Commonwealth of Australia.

These various arrangements are sometimes given the generic title of geographically discriminatory trading arrangements (GDAs).

## Some theory

As noted, there are many unanswered questions about the economic effects of GDAs in the region — including such basic ones as who would gain or lose; what the net trade effects within the region would be; and effects on countries outside the region and on the world economy.

It is not always realized that these questions are also largely unanswered for multilateral and non-discriminatory unilateral liberalization. However, to the extent that such liberalization is across-the-board and trade barriers are heading for zero (assumptions on which recent developments in GATT negotiating rounds cast some doubt) it can be assumed that it will be welfare-enhancing for participants, perhaps making the need for information less critical. The analytical difficulty posed by GDAs is that they are at once trade **liberalizing** (for those inside) and trade **restricting** (for those left out).

Economics is not very good at answering questions about the welfare effects of moves from one distorted policy environment to another — that is, in dealing with the problem of the 'second best'. This emerges from the large literature on trading blocs — known as Customs Union Theory, although it is more broadly applicable than to Customs Unions. (Two useful surveys are Lipsey 1960 and Krauss 1972.) The contribution of this extensive literature can be summarized in three, rather inconclusive, propositions:

- a country can be **better off or worse off** from participating in a discriminatory trading arrangement, depending on its size, the nature of its trade and that of its trading partners, its initial (relative) protection levels, the scope for economies of scale and other factors;
- tariff reductions within a GDA **may or may not** bring larger gains to a country than could be obtained through non-discriminatory reductions; and
- the extent to which **global welfare** is enhanced by discriminatory trade arrangements is similarly dependent on the circumstances of the case at hand.

A fourth, and the only conclusive, result is that **global welfare** will always be increased more through non-discriminatory than discriminatory reductions in protection.



### Trade creation and diversion

The most basic theoretical analysis of the effects of trading blocs on the welfare of its members has, since Jacob Viner's (1950) seminal contribution, been conducted in terms of the concepts of 'trade creation and diversion' (Johnson 1960).

- **Trade creation** occurs when partner country imports displace higher cost domestic production and, through lower prices, allow greater domestic consumption of the products concerned — generating additional trade and raising real national income in the process.
- **Trade diversion** is when increased trade among the regional partners occurs merely at the expense of lower cost imports from outside the bloc, without any increase in total trade or consumption — thus lowering real national income.

All trading blocs will generally give rise to both trade creation and trade diversion; whether members gain overall depends on which of the two predominates.

This analysis is usually conducted (contrary to Viner's original conception) in 'static partial equilibrium' terms. That is, it assumes that the nature of production and demand remain unchanged; that foreign supplies are potentially unlimited at any given world price of an imported good; and that what happens in the market for one product doesn't influence what happens in the markets for other goods.

In the real world, none of these hold true. Thus, trading blocs can potentially give rise to other sources of gain (or loss) in a manner similar to that of non-discriminatory trade liberalisation. These gains might be called 'dynamic, general equilibrium' to contrast them with the simpler analysis.

### Economies of scale and specialization

An FTA, by increasing the market for suppliers within the region, opens the possibility of them reaping economies of large scale production. This can mean that even where an FTA initially causes trade diversion, subsequent scale effects could reduce the cost of that and possibly outweigh it.

The presence of scale effects means that in addition to expansion of existing trade, there may be specialization within industries and trade at a more disaggregated product level

than previously occurred. This is really just an extension of Adam Smith's principle that 'the division of labour is limited by the extent of the market'.

#### Increased productive efficiency

Import competition provides an important discipline on domestic firms to minimise costs and maximize productivity. To the extent that this is blunted by protection, there could be a loss of productive efficiency, especially where local firms can tacitly share markets. Whether regional trade liberalization will help, depends on how efficient other suppliers within the region are and the nature and height of barriers removed. (*Ad valorem* tariffs at moderate levels should not impede productive efficiency, but quotas could.)

#### Gains in export markets and improved terms of trade

As noted, the traditional analysis of GDAs assumed perfectly elastic supply (constant costs) on the part of exporting countries, so that any welfare gains would be appropriated by the liberalizing country's consumers. The resulting focus of economic analysis on the import side of the GDA, however, is the opposite of what motivates policy makers — namely, export growth (Johnson 1965). And in practice, as Adam Smith again pointed out, favoured exporters from discriminatory liberalization are the only unambiguous gainers — through higher prices (improved terms of trade) and increased exports. (The formation of a trading bloc can also lead to a change in the terms of trade of the bloc with the rest of the world, although this can go either way.)

Snape (1986) makes the important point that export-derived gains from preferential foreign tariff reductions and increased export demand for a country's (Australia's in this instance) goods, depend on the efficiency with which they are produced. Export gains imposed on a distorted domestic incentives structure could **reduce** national income. For example, imagine preferential foreign reductions in barriers to Australia's exports of footwear, which is a highly assisted industry (an effective rate of assistance of 160 per cent in 1988) and an inefficient user of domestic resources. The cost of footwear protection depends in part on how many shoes we produce. If the increased export demand resulting from a preferential arrangement has no production effects, but simply raises export prices, Australia is clearly better off. But if exports and production of footwear expand, the costs of protection also increase and national income may be reduced.

### Rules of thumb for gains from an FTA

All this suggests that it is not possible to say whether a trading bloc would bring gains to its members, let alone determine the size of those gains, without conducting a detailed empirical study of the countries concerned, their trade with each other and that with 'outside' countries.

Nevertheless, a number of rules of thumb can be postulated about conditions favouring net gains. A trading bloc is more likely to bring gains to participants:

- **The higher the initial levels of protection**

Higher protection means potentially larger gains from displacement of high cost domestic production, and larger gains to consumers, when protection is removed. It also means that pre-FTA imports are lower, reducing the scope for trade diversion relative to trade creation. (In the extreme case of a pre-existing import embargo, there can only be trade creation — and increased welfare — from an FTA.)

- **The more intensive is trade with the other countries forming a bloc**

With less imports from other countries, the potential for trade diversion is also smaller.

- **The more competitive/efficient are countries within the bloc compared to those outside**

The cost of any trade diversion will be lower, because the costs of supply are closer to world levels, and gains to consumers will be greater as import prices fall further.

- **The larger the number of partner countries**

This increases the scope for the lowest cost suppliers of goods being within the bloc.

- **The larger the partners**

This for the same reasons as the two preceding points, and also because preferential access to larger foreign markets increases the scope for scale economy gains and export price increases.

Other conditions which increase the likelihood of net gains, but are more difficult to evaluate than the above rules of thumb, are:

- the greater the price sensitivity (elasticity) of demand for tradables (more scope for consumption gains when import prices fall); and

- the greater the price sensitivity of domestic supply (more scope for imports to replace more costly domestic production and exports to respond to increased foreign demand).

These rules of thumb are also indicative of the economic effect of an FTA on outside countries. The fact that most discriminatory arrangements will give rise to some trade diversion suggests that outsiders will typically suffer a welfare loss — depending on the extent of the trade diverted. However, seen over time, any positive 'dynamic' effects of a discriminatory trade arrangement on its members will boost economic growth and demand — and could thus lead eventually to a catching-up of external trade.

### **The empirical work**

The theoretical literature demonstrates that the question 'are trading blocs beneficial to members?' can only be answered empirically. In fact, most empirical work on trading blocs has focused on trade effects, rather than effects on national income (welfare) and it has not provided a reliable basis for answering the key question.

#### The EC and EFTA

While there are a large number of trading blocs (Box 3) the bulk of empirical work has been done on the European Community (EC). The EC was based on the 1957 Treaty of Rome which provided for a 'common market', with free flow of goods, services, capital and labour. In practice many internal regulatory barriers remain (their elimination being what the EC 1992 process is about). Between 1958 and 1968, however, the members of the EC eliminated tariffs on goods, and formed a customs union with a 'common external tariff'.

The European Free Trade Association (EFTA) was formed in 1960 by countries which did not want to be part of the EC customs union, but which were anxious to negotiate with the EC to prevent trade diversion. Tariffs were eliminated on manufactured goods by 1966, though agriculture was excluded, and in 1972 EFTA and the EC established free trade in manufactures between the two blocs. (Negotiations are currently taking place concerning the possible entry of EFTA countries into the EC.)

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- the greater the price sensitivity (elasticity) of demand for tradables (more scope for consumption gains when import prices fall); and

### **Box 3 Who *isn't* in a 'trade bloc'?**

In the following (possibly not exhaustive) listing of countries in free trade areas and customs unions, Asia is conspicuous by its absence. On the other hand, some of these trading blocs — like the ones in Africa and Latin America — have not had the sort of outcomes which Asia would necessarily want to emulate.

#### **The European Community**

Belgium  
Denmark  
France  
Greece  
Ireland  
Italy  
Luxembourg  
Netherlands  
Portugal  
Spain  
United Kingdom  
West Germany

#### **The European Free Trade Area**

Austria  
Finland  
Iceland  
Norway  
Sweden  
Switzerland

#### **United States–Canada Free Trade Agreement**

Canada  
United States

#### **United States–Israel Pact**

Israel  
United States

#### **Closer Economic Relations**

Australia  
New Zealand

#### **The Economic Community of West African States**

Benin  
Burkina Faso  
Gambia  
Ghana  
Guinea  
Ivory Coast  
Liberia  
Mali  
Mauritania  
Niger  
Senegal  
Sierra Leone  
Togo

#### **Customs and Economic Union of Central Africa**

Cameroon  
Gabon  
Guinea

#### **The Lake Chad Basin Commission**

Cameroon  
Chad  
Niger  
Nigeria

#### **The South African Customs Union**

Botswana  
Lesotho  
South Africa  
Swaziland

#### **The Central American Common Market**

Costa Rica  
El Salvador  
Guatemala  
Honduras  
Nicaragua

#### **The Association for the Integration of Latin America**

Argentina  
Bolivia  
Brazil  
Chile  
Colombia  
Ecuador  
Mexico  
Paraguay  
Peru  
Uruguay  
Venezuela

#### **The Caribbean Common Market**

Antigua  
Barbados  
Belize  
Dominica  
Grenada  
Guyana  
Jamaica  
Montserrat  
St Kitts–Nevis–Anguilla  
St Lucia  
St Vincent  
Trinidad and Tobago

In terms of most of our rules of thumb, the EC and EFTA could have been expected to bring static gains to the countries involved.

- Protection levels were still relatively high when the blocs were formed. Nominal tariffs averaged 30 per cent and protection included a barrage of bilateral quantitative restrictions.
- Trade intensity among members was relatively high (around one-third of their total trade) before the union.
- Competitiveness at the time was high or potentially high among manufactures, but not in agriculture. The potential for trade diversion in agriculture was quite substantial, despite the existence of national quantitative restrictions before the union.
- The EC began with only six countries, which accounted for two-thirds of trade within Western Europe. But intra-European trade diversion was minimized by the simultaneous formation of EFTA and the subsequent linkage of these two arrangements.
- EC and EFTA contained some of the largest trading countries at the time (United Kingdom, Germany, France, Italy) and together accounted for one-quarter of world trade.

The formation of the EC and EFTA was associated with a considerable expansion of trade within these trading blocs. Between 1960 and 1970, merchandise trade among the six original EC countries, as a proportion of their total trade, increased from 35 to 49 per cent, while EFTA's internal trade increased from 16 to 22 per cent. The difficulty is to know to what extent this was induced by the elimination of internal tariffs during the sixties or by the preceding elimination of bilateral trading quotas under the Organization for European Economic Cooperation(OEEC) liberalizations, or just by the natural advantages of regional proximity.

More importantly, the rise in EC intra-trade tells us nothing about whether that trade was beneficial to the countries concerned. That depends in part on whether it occurred at the expense of higher cost domestic production or lower cost imports from outside the EC. A number of studies have estimated the amount of trade created and diverted, comparing trade and consumption patterns before and after integration. The results of these studies are shown in Table 2.

Reviewing these studies, Robson (1984: 200) comes to two 'important general conclusions':

- First, despite the considerable range of estimates presented for trade created and trade diverted, most estimates suggest that for manufactured products (to which most of the studies are limited) the trade created was considerable and far outweighed trade diverted. There has been some offset to this from trade diverted in agriculture.
- Secondly, several of the studies suggest that the formation of the EC has resulted in a good deal of external trade creation. From both points of view it may be concluded that the effects of the EC have been favourable to allocative efficiency at a global level.

**Table 2 Estimates of trade created and trade diverted in the EC**

Author	End year	Trade created		Trade diverted <sup>a</sup>	
		All goods (US\$b)	Manufactures (US\$b)	All goods (US\$b)	Manufactures (US\$b)
Prewo (1974)	1970	19.8	18.0	- 2.5	- 3.1
Truman (1969)	1968				
(unadjusted)		-	9.2	-	- 1.0
(adjusted)		-	2.5	-	0.5
Balassa (1975)	1970	11.3	11.4	0.3	0.1
Kreinin (1972)	1969-70	-	8.4	-	1.1
(unweighted average of 3 estimates)					
Williamson and Bottrill (1971)	1969	-	11.2	-	0
Aitken (1973)	1967	9.2	-	0.6	-

<sup>a</sup>Numbers with negative signs represent external trade creation.

Source: P. Robson (1984), *The Economics of International Integration*, 2nd edn, London, Allen & Unwin.

This assessment is shared by most other surveys (for example, Kreinin 1972). However, Robson's qualification concerning agriculture is important, for the Common Agricultural Policy (CAP) was designed to keep the least efficient EC farmers in business, thus ruling out trade creation. Balassa (1975) estimated the trade diverted by the CAP at between \$1.3 billion and \$1.7 billion for 1970, but this is still substantially less than the net trade created in manufacturing of \$11.3 billion. Other sources have suggested that it is likely to have been much larger than that, even to the point of casting doubt on the likelihood of overall trade creation in the EC (Pomfret 1988). Studies on the United Kingdom's entry into the EC, for example, found that trade-diversion effects from the CAP swamped any trade creation gains in manufacturing (Miller 1971).

The above estimates are confined to changes in trade flows, not national income. Where effects on welfare have been estimated they have been very small. For example, Balassa's (1975) estimates of the net welfare effect of the EC customs union are less than



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0.1 per cent of the members' combined gross national product (GNP). This is consistent with the small estimates for welfare gains for multilateral liberalization that are generally obtained from the same sort of 'static partial-equilibrium' analysis. Much larger gains have been found when 'dynamic' and 'general equilibrium' influences are taken into account, and the same has occurred for trading blocs.

- On **scale economies**, for example, a study by Owen (1976) has been widely cited as finding that intra-EC net exports of manufactured goods in 1964 were partially explained by the differing extents to which industries exploited scale economies. But this and other work provides little evidence of a causal relationship to the customs union or of the magnitude of gains.
- On **X-efficiency** effects, evidence is mainly anecdotal. Pomfret (1988) notes that its potential was limited by the many retained barriers to the single internal market (which the 1992 process is designed to eliminate). National markets remained segmented for many industrial goods and the CAP probably reduced productive efficiency in agriculture.
- A number of studies have shown the EC to have had terms of trade effects; most estimates show these to have greatly exceeded static welfare gains, implying substantial transfers from non-members (Petith 1977).

#### United States–Canada Free Trade Area

It was observed in 1988 that a United States–Canada Free Trade Area was 'the most-studied non-existent' GDA (Pomfret 1988: 147). One year later it became a reality, largely because of these earlier studies, which focused on the gains to the smaller partner (Fogarty 1988). Applying the rules of thumb outlined previously, Canada is likely to gain domestically from the union. And because the Canadian economy is so small relative to that of the United States, removal of United States trade barriers would bring unambiguous export gains to Canada.

Wonnacott and Wonnacott (1967) estimated the net gain to Canada from an FTA with the United States at 10 per cent of gross domestic product (GDP). Compared to the estimates normally obtained from conventional partial equilibrium analysis, this gain is very large. It is mainly attributable to an estimated 6.5 per cent gain from the realization of scale economies in the liberalized United States market.

Similar results were obtained from more sophisticated analysis using a general equilibrium model incorporating scale economies and imperfect competition (Cox and Harris 1985). Although this work was done for multilateral liberalization, the predominance of the United States in Canadian trade means that in practice there is unlikely to be much difference.

Inevitably these results have given rise to some controversy about the assumptions used in the models, but even if the estimates were double the actual gains, it would still imply considerable potential gains for relatively small countries from FTAs with much larger ones.

#### Developing country trading blocs

Trading arrangements among developing countries have mostly produced poor results, with some being disbanded and most giving rise to internal conflicts about the distribution of gains (or losses) within the blocs (Vaitsos 1978). This is not surprising, given that many of these agreements were consciously intended to be part of a self-sufficiency drive in manufactures, so that trade diversion has often been the main objective. Most historical studies have shown that preferential trading arrangements among developing countries, with the exception of the Central American Common Market (CACM), had little economic effect. And even here, while there was a significant rise in internal trade, most studies suggest that there was net trade diversion overall, loss of exports to countries outside the CACM, little or no gains from economies of scale and negative income distribution effects because of the high cost of manufactured goods (Pomfret 1988).

#### 4. Economic Potential of Asia-Pacific Blocs

Asia-Pacific countries that are typically included in considerations of a trading bloc are more far flung than is usual for 'regional' trade groupings (Box 1). As noted, Kojima's original PAFTA proposal was for an FTA including the United States, Canada, Australia, New Zealand and Japan. While these countries are hardly members of the same geographic 'region' (in fact, it would make more sense to see them as representing three regions), they do have comparable income levels, political systems and, for four out of the five, cultural affinities. This cannot be said of the 'region' as a whole, which contains as heterogeneous a collection of countries as could be found.

##### Economic performance of the area

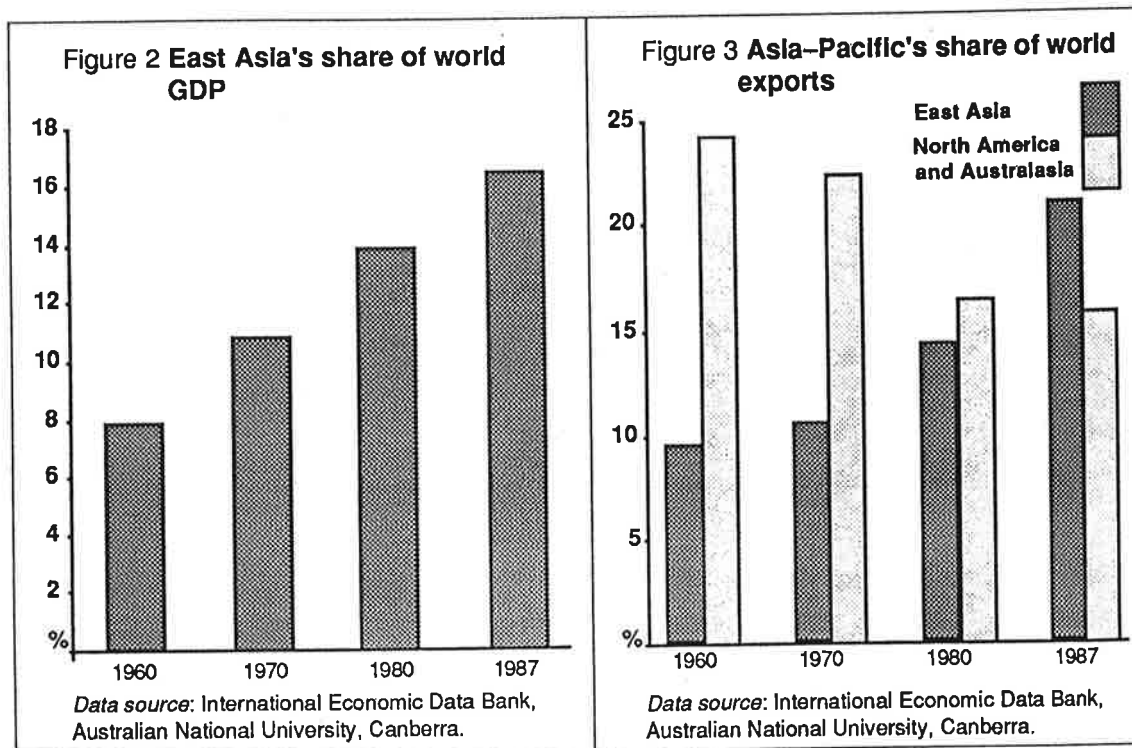
It is now commonplace to observe that 'the Pacific' has become economically the most dynamic 'region' in the world. This dynamism has been concentrated in the countries of East Asia. As shown in Table 3, per capita income growth in this area over the past twenty years has greatly exceeded that of developing countries outside it, as well as industrial countries within it. As a result, East Asia has doubled its share in world output in the past twenty years (Figure 2).

Income growth has varied considerably among Asian countries themselves. The fastest growing countries have been the 'Four Tigers' — Republic of Korea, Taiwan, Hong Kong and Singapore (Table 4). While the other Asian (mostly ASEAN) countries have performed less well, with the exception of the Philippines they have still achieved per capita income growth rates well above those recorded in other parts of the world.

Table 3 Asia-Pacific growth compared

Country	Per capita GDP growth in 1965-87 %	Per capita GDP in 1987 US\$	Total GDP in 1987 US\$ billion
East Asia	4.3	1 710	3 040.5
North America	1.9	18 271	4 914.9
Australasia	1.7	11 321	215.1
Latin America	2.1	1 790	730.3
Africa	0.6	330	128.8
South Asia	1.8	290	288.3

Source: International Economic Data Bank, Australian National University, Canberra.



### Trade performance

The growth performance of countries in the region appears to be linked to their export performance. It is apparent in Tables 4 and 5 that the fastest growing countries also had the best export performance — their exports expanding considerably faster than GDP, and accounting for a rising share of total world exports (Figure 3). For example, the Four Tigers increased their share of world exports from 1.7 per cent in 1965 to 7.8 per cent in 1987. They account for almost 50 per cent of the exports of manufactures of developing countries.

The slowest growing countries over this period — Australia, New Zealand, the United States and the Philippines — experienced a slower rise in the proportion of exports to GDP than other countries. (In Australia there was no increase in the proportion of exports to GDP.)

Much of this trade growth has been accommodated **within** the area. Trade among Asia-Pacific countries, as a proportion of total trade, rose from around one-half in 1965 to nearly two-thirds in 1987. Over the same period, all other regions (except the Middle East) declined in importance as trading partners for the Asia-Pacific (see Table 6).

Table 4 Trade and growth differences among Asia-Pacific economies

Country	Per capita income growth		Export volume growth		Exports as per cent of GDP		Share in world exports	
	1965-87		1965-87		1965	1987	1965	1987
	%		%		%	%	%	%
Australia	1.8	5.6	16.0	16.2	1.7	1.1		
New Zealand	0.9	4.1	22.1	28.4	0.5	0.3		
Japan	4.2	9.3	10.9	13.2	4.9	9.8		
Korea, Republic of	6.4	22.0	8.6	45.3	0.1	2.0		
Taiwan	6.7	..	60.3	72.0	0.3	2.5		
Hong Kong	6.2	14.0	50.5	104.9	0.7	2.1		
Singapore	7.2	12.0	101.6	175.1	0.6	1.2		
Thailand	3.9	9.2	18.3	28.1	0.4	0.5		
Indonesia	4.5	6.0	12.6	20.3 <sup>a</sup>	0.4	0.7		
Malaysia	4.1	6.1	47.5	56.9 <sup>a</sup>	0.7	0.8		
Philippines	1.7	5.9	17.2	23.3	0.4	0.2		
China	..	..	..	..	1.5	1.7		
Canada	2.7	6.5	18.6	26.0	4.9	4.2		
United States	1.5	4.4	5.0	0.70	15.9	10.6		

<sup>a</sup>For 1986. .. not available

Sources: International Economic Data Bank, Australian National University, Canberra; IMF, *International Financial Statistics*.

Table 5 Trade and growth in Asia-Pacific economies in the 1980s

Country	GDP growth		Export volume growth	
	1980-86	1987	1980-86	1987
	%	%	%	%
Australia	3.0	4.5	4.5	7.5
New Zealand	3.0	0.5	4.0	3.0
Japan	3.5	4.0	6.0	0.5
Korea, Rep. of	8.5	11.0	12.5	24.0
Taiwan	7.0	11.0	12.5	14.5
Hong Kong	6.5	13.5	11.5	33.5
Singapore	5.5	9.0	7.0	12.5
Thailand	4.5	6.5	9.5	17.5
Indonesia	4.5	4.0	2.0	-7.0
Malaysia	4.5	4.5	4.0	8.0
Philippines	-0.5	5.5	2.5	6.5

Source: GATT, *International Trade, 1987-88*, Volume II.

Table 6 Export markets of Asia-Pacific groupings

Exporter	Destination shares							
	North America		Australasia		East Asia <sup>a</sup>		Western Europe	
	1965	1988	1965	1988	1965	1988	1965	1988
	%	%	%	%	%	%	%	%
North America	29.6	36.1	3.1	2.1	10.0	20.2	31.4	23.1
Australasia	13.3	13.9	6.2	8.2	22.1	42.6	44.4	18.0
Japan	35.7	38.6	5.0	3.1	18.1	23.1	41.2	22.3
Taiwan	..	47.1	..	2.5	..	27.8	..	14.7
Other NE Asia <sup>b</sup>	34.6	33.6	3.8	1.9	18.4	37.7	28.6	17.7
ASEAN	29.3	22.7	3.7	2.5	32.5	48.6	25.1	16.3
China	1.1	8.0	2.1	0.8	51.8	61.2	23.5	11.1
Asia-Pacific total <sup>a</sup>	28.6	32.8	3.7	2.6	14.2	29.1	29.4	20.8

<sup>a</sup>Excludes Taiwan. <sup>b</sup> Hong Kong and Republic of Korea. .. not available

Source: International Economic Data Bank, Australian National University, Canberra.

The largest market for Asian-Pacific exports is the United States. Exports to North America as a proportion of total regional exports rose from 28.6 per cent in 1965 to 36 per cent in 1988. In addition, the region's share of North American imports rose from 50 per cent to 60 per cent over the same period, with Japan's share doubling and the 'Four Tigers' share quadrupling. As remarked earlier, this increased penetration of the United States market by Asian exporters has not passed unnoticed within the United States Congress.

Other notable features of the expansion of trade within the region were:

- an above-average increase in the region's importance to Australia's traditional exports and imports (contrary to common perceptions, China was the only Asia-Pacific country to reduce its share of Australian exports in this period);
- rapid growth in Japan's trade with the Tigers;
- the Tigers' exports to China, at 12 per cent of their total exports in 1988, were 12 times greater than in 1965;
- rapid expansion of trade among ASEAN countries; and
- the fact that Australasia is the only area to have diminished in importance as a trading partner to the rest of the Asia-Pacific.

Finally, it should be emphasized that while Western Europe has declined in importance as a market for all countries in the region, it still accounts for a substantial proportion (one-

fifth) of the region's exports. In the case of Australia and New Zealand, it takes half as many exports as East Asia, and one-third more than North America.

In sum, compared to other parts of the world, the East Asian region has performed very well over the past twenty or so years. The region has seen its total and mutual trade rise faster than elsewhere and, along with it, the standards of living of its people. This is in marked contrast to areas such as Latin America.

The Asia-Pacific's impressive performance and the growing intensity of trade within the area has occurred without any formal intergovernmental institution for regional economic cooperation. It has involved, to use Kasper's (1988) phrase, 'integration from below', reflecting the largely spontaneous forces of the market place. The question is whether anything better could have been achieved through attempts at 'integration from above', through intergovernmental organization.

#### An Asia-Pacific free trade area

We begin by ignoring questions about political feasibility and 'strategic' considerations such as retaliation (considered in the next chapter). These important issues aside, a trading bloc encompassing the Asia-Pacific 'region' would seem to pass all of the tests for a beneficial economic outcome. The region contains 14 significant trading countries, accounting for around one-half of world output and nearly 40 per cent of world trade. Two-thirds of that trade occurs within the Asia-Pacific, which includes the world's most efficient producers of many mineral, agricultural and manufactured goods (Table 7).

Table 7 'Revealed' comparative advantage of Asia-Pacific groupings<sup>a</sup>

	Australasia	North America	Japan	China	Tigers	Other ASEAN
Agriculture	3.3	1.2	0.1	1.6	0.5	2.3
Fuels, minerals and metals	2.2	0.7	0.1	1.0	0.4	2.3
Light manufactures	0.3	0.4	0.8	3.4	3.1	1.1
Heavy manufactures	0.3	1.1	1.6	0.3	0.8	0.3

<sup>a</sup> 'Revealed' comparative advantage is defined as the ratio of the share of a commodity group in total exports for a country or group of countries to that commodity group's share of world exports.

Source: Adapted from P. Drysdale and R. Garnaut, 'A Pacific free trade area?' in J.J. Schott (ed.), *Free Trade Areas and US Trade Policy*, Institute for International Economics, Washington, DC, 1989, pp. 217-54.

In other words, the region is fairly representative of 'the world' and regional liberalization is likely to yield participants comparable gains to multilateral liberalization (though there would inevitably still be some trade diversion from Europe and other 'outside' suppliers).

The more interesting questions are how the overall internal gains from an FTA would be distributed and what the effects would be of the creation of 'sub-blocs' among countries in the region.

#### From Australia's perspective

The 'mini-worldness' of the Asia-Pacific certainly holds true from Australia's perspective. The countries in the region collectively account for 71 per cent of Australia's exports and 68 per cent of imports (Tables 8 and 9).

The region is fairly evenly represented across most major import categories (Table 10) accounting for the lowest proportion — implying the greatest potential for trade diversion — in food and beverages (32 per cent), chemicals (45 per cent) and paper and paperboard (44 per cent). Among these, chemicals represent a significant proportion of total imports, however, so that the cost of diversion in this sector may be important.

The potential for net trade creation is also influenced by Australia's protection. High protection means lower imports generally — thus more scope for trade creation and increased consumption and less scope for trade diversion. The most highly protected sectors in Australia are textiles, clothing, footwear and road motor vehicles. These are all sectors in which the Asia-Pacific is the predominant supplier, accounting for 70 per cent or more of Australia's imports of these products (Table 11). Thus big trade creation gains are likely in these areas.

A proper evaluation of these effects requires economic modelling. However, the qualitative evidence strongly suggests that the Australian economy would benefit overall from an FTA embracing the entire Asia-Pacific region. In practice, any FTAs are likely to fall short of this 'ideal' (chapter 5) and it is important to consider what the effects of less encompassing FTAs might be.



**Table 8 Importance of Australia's Asia-Pacific trade, 1988**

Country/region	Share in total trade		Trade balance \$m
	Exports %	Imports %	
New Zealand	5.0	4.4	223
Japan	27.1	20.1	2 899
Korea, Republic of	4.7	2.6	875
Taiwan	3.5	4.2	-286
Hong Kong	5.3	2.0	1 370
Singapore	3.2	2.3	390
Thailand	1.0	0.8	21
Indonesia	1.5	0.9	241
Malaysia	1.7	1.5	71
Philippines	1.0	0.3	184
China People's Republic	2.6	2.1	215
<b>East Asia and New Zealand</b>	<b>58.0</b>	<b>41.6</b>	<b>6 885</b>
Canada	1.8	2.3	-193
United States	10.7	21.4	-4 587
<b>North America</b>	<b>12.5</b>	<b>23.7</b>	<b>-4 780</b>
<b>Total Asia-Pacific</b>	<b>70.5</b>	<b>65.3</b>	
(EC)	(14.5)	(23.5)	(-3 851)

Source: Department of Foreign Affairs and Trade, *Composition of Trade, Australia*, Canberra 1988.

**Table 9 Asia-Pacific shares of Australia's major exports, 1987**

Product	Total exports US\$m	Shares			EC-12 %
		East Asia and New Zealand %	North America %	Asia- Pacific total %	
Coal	3 521.6	65.9	0.0	65.9	19.4
Wool	2 954.8	40.8	5.4	46.2	31.5
Alumina					
Wheat	1 425.6	46.7	0.0	46.7	0.0
Beef and veal	1 324.3	33.0	59.9	92.9	3.1
Iron ore	1 183.8	83.1	0.4	83.5	15.1
Aluminium	1 126.4	94.7	3.1	97.8	0.2
Crude petroleum	677.2	47.2	51.0	98.0	1.8
Refined petroleum	646.1	23.2	7.7	30.9	0.0
Sugar and honey	476.3	1.8	0.7	2.5	2.1
Hides and skins	435.1	22.3	0.6	22.9	59.9
Crustaceans & molluscs	371.3	64.5	26.2	90.7	8.9
Pulpwood	254.9	100.0	0.0	100.0	0.0
Cotton	230.9	70.8	0.0	70.8	17.7

Source: International Economic Data Bank, Australian National University, Canberra.

Table 10 Country/region shares of Australia's major imports, 1987

SITC <sup>a</sup> Rev 2	Product	Partner's share												Total imports US\$m
		Japan %	Hong Kong %	Republic of Korea %	Taiwan %	ASEAN %	China %	Zealand %	New Zealand %	Canada %	USA %	Asia- Pacific total %	EC-12 %	
0	Food and live animals	2.1	1.2	1.4	2.3	19.5	2.5	17.0	3.9	12.1	61.9	16.1	1160.9	
1	Beverages & tobacco	0.7	0.0	1.2	0.0	1.2	0.2	6.7	1.0	21.0	31.9	55.2	225.3	
2	Crude materials (excl. fuels)	4.3	0.2	0.4	1.6	13.0	1.4	17.2	19.9	16.4	74.4	6.6	833.0	
3	Mineral fuels	0.3	0.0	1.0	0.0	38.5	0.5	3.3	0.0	9.9	52.5	3.2	1306.4	
33	Petroleum	0.3	0.0	1.0	0.0	38.4	0.5	3.2	0.0	9.9	52.5	3.0	1301.4	
4	Animal and vegetable oils	0.5	0.7	0.0	0.0	43.8	1.1	0.9	0.0	3.0	50.0	25.7	71.4	
5	Chemicals	8.0	0.3	0.9	2.3	2.1	1.1	2.4	2.1	25.8	45.0	36.5	2726.6	
51	Organic	10.8	0.1	1.3	1.0	1.8	1.6	0.8	0.5	23.6	41.4	32.0	685.1	
6	Manufactures	17.9	3.1	4.9	6.8	5.3	3.2	7.1	2.1	9.4	59.6	24.5	4627.2	
641	Paper & paperboard	10.2	0.0	0.9	0.6	1.1	0.2	10.3	7.8	13.1	44.0	28.3	668.7	
65	Textiles	12.5	7.6	8.7	11.3	7.2	8.9	8.2	1.0	6.7	71.5	16.4	1323.4	
7	Machinery & transport equipment	32.0	1.2	2.0	3.3	1.9	0.4	1.5	1.1	25.3	67.2	24.3	10737.9	
71	Power generating	37.0	0.0	0.1	1.5	0.2	0.0	0.3	3.2	37.8	77.1	16.1	706.0	
72	Specialized industry machinery	19.8	0.8	0.1	1.7	0.6	0.1	2.4	1.3	24.1	50.8	36.4	877.9	
752	Computers	25.3	2.0	1.9	7.3	3.2	0.0	0.7	0.4	42.1	82.4	13.4	1144.2	
78	Road vehicles	61.0	0.0	1.4	2.8	0.1	0.3	0.5	1.0	10.6	77.6	18.1	1903.6	
792	Aircraft	0.6	0.0	0.0	0.0	0.2	0.0	0.3	0.5	73.3	74.9	24.1	504.9	
8	Misc. manufactures	17.0	7.2	4.7	9.6	4.1	6.2	2.8	0.7	16.8	69.0	23.9	3790.8	
84	Clothing	1.7	16.0	10.5	12.9	5.0	27.5	3.3	0.1	1.3	78.3	10.1	491.0	
851	Footwear	0.1	2.7	14.1	29.4	8.0	12.8	1.9	0.7	0.8	70.0	19.0	175.7	

<sup>a</sup> Standard International Trade Classification.

Source: International Economic Data Bank, Australian National University, Canberra.

**Table 11 Asia-Pacific share of Australia's imports of highly protected products, 1981**

Industry	Nominal assistance	Effective assistance	Asia-Pacific share of imports
	%	%	%
Textiles	22	69	72.0
Clothing	67	176	70.1
Footwear	56	41	70.0
Road motor vehicles	27	86	77.6

Source: Industries Assistance Commission, *Annual Report 1987-88*, Canberra, AGPS; International Economic Data Bank, Australian National University Canberra.

#### A precedent: Australia-New Zealand Free Trade

The CER agreement commenced in 1983. It was preceded by NAFTA, a selective bilateral liberalization agreement, confined to non-sensitive areas where tariffs were relatively low. CER is a proper free trade area, providing for the elimination of barriers to all trans-Tasman merchandise trade as well as freeing up trade in services (other than those on a fairly extensive list of exclusions).

According to the rules of thumb outlined in the previous chapter, CER could be either trade diverting or creating. While initial protection levels in both countries were relatively high, trade intensity is relatively low for most commodity groups from Australia's perspective, though Australian trade is a larger component of New Zealand's total trade (Table 12).

**Table 12 Australia's trade with New Zealand, 1987-88**

Product	Exports		Imports	
	Value	Share	Value	Share
	\$Am	%	\$Am	%
Food & live animals	143.7	1.8	311.1	18.6
Beverages & tobacco	21.2	0.3	24.5	7.2
Crude materials	32.9	0.0	238.1	18.0
Mineral fuels, lub etc	157.7	2.2	65.9	3.2
Animal/vegetable oils	1.0	0.1	0.8	0.1
Chemicals	218.0	24.4	102.5	2.4
Manufactured goods by material	382.3	7.9	522.1	7.4
Machinery & transport equipment	712.7	25.9	242.1	1.5
Miscellaneous manufactures	238.6	23.1	162.5	2.9
Other	225.6	7.2	63.6	3.7
Total	2163.7	5.2	1733.2	4.3

Source: Bureau of Industry Economics, *Trade Liberalization and Australian Manufacturing Industry: The Impact of the Australia-New Zealand Closer Economic Relations Trade Agreement*, AGPS, Canberra, 1989.

More importantly, Australia and New Zealand are both relatively high cost producers of manufactures, so that there would appear to be considerable potential for trade diversion in this sector. However, this is likely to be more of a problem for New Zealand than Australia. Australia, although inefficient by world standards, is a lower cost manufacturer than New Zealand in most areas. That means that eliminating tariffs for New Zealand exporters is still unlikely to make them more competitive than existing suppliers in most markets in Australia. But the opposite could well occur in the New Zealand market. (For example, Australian textiles displacing tariff-inclusive Asian imports as well as higher cost local production.) Finally, given the relatively small size of the New Zealand market compared with Australia's, any economies of scale gains are more likely to go New Zealand's way.

The Australian Bureau of Industry Economics (BIE) has recently published a study on the effects of CER on the manufacturing sector in Australia (BIE 1989). Using changes in trade and production shares in domestic consumption as rough indicators of trade diversion and creation, the BIE found the latter to have predominated (Table 13). However, the results also suggested that any net trade creation from CER was swamped by external trade creation resulting from more general, non-discriminatory reductions in protection. The study also showed that Australia's manufactured exports to New Zealand increased significantly between 1981 and 1987. As noted previously, this may or may not be of benefit to Australia, depending on the relative efficiency of the industries concerned.

Table 13 Trade creation and trade diversion ratios for ANZCERTA

	Industry category		
	Unaffected <sup>a</sup>	Affected <sup>b</sup>	Modified <sup>c</sup>
Number of industries	77	17	27
Value of output 1986-87 (A\$b)	41.8	10.4	32.6
Shares in domestic consumption 1986-87 (%)			
NZ imports	1.2	0.7	1.4
RoW imports	24.0	20.5	24.8
Australian industry	74.8	78.8	73.8
Changes in shares of domestic consumption 1981-82 to 1986-87 (percentage points)			
NZ imports	+0.4	+0.2	+0.2
RoW imports	+3.7	+6.0	+1.6
Australian industry	-4.1	-6.2	-1.8
Share of Australian exports to NZ 1986-87 (per cent)	21.5	31.4	29.4
Change 1981-82 to 1986-87 (percentage points)	+1.6	+8.8	+4.7

<sup>a</sup>Industries that were free of trade restrictions at 1 January 1983.

<sup>b</sup>Industries significantly liberalized under CER.

<sup>c</sup>Industries subject to modified (slower) liberalisation arrangements.

Source: Bureau of Industry Economics, *Trade Liberalization and Australian Manufacturing Industry: The Impact of the Australia-New Zealand Closer Economic Relations Trade Agreement*, AGPS, Canberra, 1989, p 19.

The BIE study also attempted to measure the gains to be had from increased specialization and economies of scale in trans-Tasman trade. It found that these sources of gain, as well as trade creation, were substantially greater, both absolutely and relatively, for New Zealand than for Australia — for whom they were relatively insignificant.

#### An Australia–United States FTA?

In contrast to New Zealand, the United States would seem to have a number of economic pluses as a free trade partner for Australia:

- it is a massive market,
- it is a major trading partner already, and
- it has high barriers to some of Australia's comparative advantage exports — especially beef, sugar and dairy products (Table 14).

**Table 14 Tariff and non-tariff barriers facing major Australian exports to the United States, 1988**

Product	Tariff	Non-tariff barriers
Beef: frozen, boneless	4.4 cents/kg	Monitoring, VERs <sup>a</sup>
Alumina	0	
Lobsters	0	
Sugar	1.5 cents/kg <sup>b</sup>	Import quotas —
Uranium compounds	0	Threatened
Wool, greasy or fleece washed	5.5-6.6 cents/kg clean	
Sheets of iron and steel	5.1-6%	VERs
Aluminium bars, plates	3.0%	
Unwrought nickel	0	
Titanium ore	0	
Unwrought zinc	1.5%, 19%	Threatened
Zinc alloys	19%	
Casein	0.44 cents/kg	Threatened
Uranium oxide	0	Threatened
Natural gas	0	
Crude petroleum	5.25-10.5 cents/barrel	
Wheat gluten	8.0%	
Lamb	1.1 cents/kg	Monitored, other barriers threatened
Cheddar cheese	16%	Import quotas
Wool tops	7.7 cents/kg + 6.25%	Threatened

<sup>a</sup> Voluntary export restraint.

<sup>b</sup> Approximate.

Source: R. H. Snape, 'A free trade agreement with Australia', in J.J. Schott (ed.), *Free Trade Areas and US Trade Policy*, Institute for International Economics, Washington, D.C., 1989, p.176.

On the import side there is some potential for trade diversion, including in the highly protected sectors — textiles, clothing and footwear and motor vehicles (Tables 10, 11 and 15). Snape, in a study prepared for the Economic Planning Advisory Council in 1986 and updated last year (Snape 1986 and 1989), used a partial-equilibrium model developed at UNCTAD to estimate the amount of trade that would be created and diverted by an FTA with the United States — covering only tariffs. While the model's results indicated that the net trade creation for Australia from the mutual elimination of tariffs was not large, in all cases the estimated trade created is significantly greater than that diverted. Snape argued that these gains alone provide little economic incentive for Australia to engage in such an agreement.

The main action for Australia on the export side would depend on what the United States did with its non-tariff barriers. United States tariffs are already low for the main categories of Australian exports (Table 14). The main gains would come from elimination of barriers to our exports of beef, sugar and cheese.

Table 15: Main products imported by Australia from the United States

SITC Rev 2	Product	Value (A\$m)	Sources of imports		%
			United States %	Other countries	
792	Aircraft	502	80	France	8
752	ADP equipment	428	43	Japan	27
874	Measuring, control instruments	368	40	Japan	16
759	Office, ADP mechanical parts, accessories	206	58	Japan	23
749	Non-electrical machines, parts <sup>a</sup>	127	31	Japan	18
892	Printed matter	127	35	UK	34
723	Civil engineering equipment	114	35	Japan	33
713	Internal combustion piston engines	103	26	Japan	48
784	Motor vehicle parts, accessories, nes	103	23	Japan	43
598	Miscellaneous chemical products, nes	84	38	UK	25
728	Other machines for specific industries	79	22	W. Germany	21
872	Medical instruments, nes	75	45	W. Germany	15
515	Organic-inorganic compounds, etc.	69	33	UK	9
764	Telecommunications equipment, parts, accessories, nes	69	11	Japan	50
641	Paper and paperboard	68	13	Finland	17
782	Vehicles, special motor vehicles, nes	67	12	Japan	74
898	Musical instruments, parts	67	30	Japan	32
743	Pumps, nes, centrifuges, etc.	65	27	Japan	21
334	Refined petroleum products	62	9	Saudi Arabia	27
882	Photographic and cinema supplies	60	32	Japan	28

<sup>a</sup> Not elsewhere specified.

Source: Based on R.H. Snape, 'A free trade agreement with Australia', in J.J. Schott (ed.), *Free trade areas and US trade Policy*, Institute for International Economics, Washington, D.C., 1989, pp. 174-75.

On the import side, how non-tariff barriers are handled can also influence the outcome. Since the dismantling of quotas on motor vehicles last year, textiles, clothing and footwear are the only industries under quota. As long as these quotas continue to bite, tariff preferences for the United States would result in trade diversion without any trade creation — which could impose significant costs on Australia, as low cost developing country supplies are displaced by United States products.

The Snape study was confined to possible static gains and losses. The preferential access of a small supplier like Australia to the large United States market might also be expected to bring 'dynamic gains' through economies of scale, increased specialization and greater productive efficiency, as discussed earlier. In practice, for most products for which economies of scale would be available, the United States market is already largely open and scale economies could be attained by Australian exporters under present arrangements. Productive efficiency gains in Australia depend on increased competitive pressure from lower cost United States imports. The fact of trade creation would suggest a rise in such pressure, but the extent to which it can be met through cost cutting opportunities which were not exploited before is an open question.

#### Japan: an ideal partner?

In terms of the rules of thumb outlined above, if Australia were to participate in an FTA with any single country, Japan would appear to be the ideal partner. Japan's economy and pattern of trade are almost perfectly complementary to Australia's: both countries have high barriers to the other's most efficient exports; Japan has a very large market, with plenty of scope to reap any economies of scale; in manufactures, Japan is among the world's lowest cost suppliers; Japan already supplies one-fifth of Australia's import needs and takes one-quarter of our exports. In short, there is the likelihood of large net trade creation and the right conditions for additional, dynamic gains.

The main trade diversion possibilities for Australia, where Japan accounts for a significant but minority share of imports, are in data processing equipment, chemicals, machinery and light manufactures (Table 10). However, Japanese competitiveness is likely to be such that losses in these areas would not be great and would in any case probably be outweighed by gains from displacement of higher cost domestic production.

It is apparent from Table 16 that Australian export gains from an FTA with Japan would depend on the elimination of non-tariff measures; tariffs are negligible for most products. If Japan kept agriculture out, there would be little scope for gains on the export side that

Table 16: Australia's leading exports to Japan and Japan's trade barriers, 1987

SITC Rev 1	Product	Exports to Japan		Share of exports to world	Share of Japan's imports		Trade barriers	
		US\$m	%		Australia	USA	Tariffs	Non-tariff
3214	Coal	2157.66	50.67	46.57	12.60	0.0	A,B,C	
2813	Iron ore	949.12	55.78	36.25		0.0		
6841	Aluminium, alloys, unwrought	548.97	56.96	21.76	13.08	7.9		
2621	Wool greasy	419.65	16.88	94.24		0.0		
0111	Bovine meat	364.24	26.31	45.54	47.63	25.0	D,E	
6318	Wool simply worked	319.42	96.78	38.59	35.20	0.0		
2622	Wool degreased	236.50	39.74	60.02	0.07	0.0		
0313	Shell fish	206.84	53.62	5.24	5.17	3.7	A,E	
3411	Gas natural	182.20	88.26	2.59	2.18	0.0		
0410	Wheat etc unmilled	132.64	8.39	16.90	54.14	1.8	G	
0611	Sugar	101.64	31.58	35.17		50.1	D,E	
2631	Raw cotton	101.47	43.16	9.11	37.91	0.0		
2835	Zinc	82.17	45.02	41.72	1.04	0.0		
2763	Salt	74.78	66.85	48.47	0.04	0.0	A	
0112	Mutton	58.65	25.47	45.46	0.32	14.4		
0430	Barley unmilled	57.51	32.46	43.19		0.0	A	
2832	Nickel ores, concentrates	53.33	37.41	23.47		4.9		
2831	Copper ores, concentrates	47.30	90.50	3.20	9.27	3.7	C	

A: global quota.

B: subsidies.

C: price supports.

D: variable import levy.

E: health regulations.

F: import authorisation.

G: imports confined to nominated importer.

Sources: International Economic Data Bank, Australian National University, Canberra; Department of Foreign Affairs and Trade, *Non-tariff Barriers to Australian Exports*, AGPS, Canberra, 1989; GATT Tariff Study.



could not be achieved outside such an arrangement. And on the import side, while there would still be the trade creation gains, the amount of adjustment needed would not be much less than that involved in non-discriminatory liberalization.

From Japan's perspective, the Australian market accounts for only two per cent of exports and would be a relatively small market even when 'open' — which provides little attraction in participating from the export side. Imports from Australia are more important, and liberalization could bring substantial gains (though again multilateral gains would be greater). Thus, to the extent that the chemistry of an FTA requires a major export attraction to counter resistance from import competing countries (discussed in the next chapter), a Japan–Australia FTA does not look good from the Japanese side.

#### Other East Asia

For the other countries in Asia the likely balance of benefits is less evident. For example, given the similarity of the Tigers and Japan, we could expect considerable trade creation from FTAs with any of these countries. But for the same reason, there would also be trade diversion against those members of this group left out. (Note the similar profile of imports from the Republic of Korea, Taiwan and Hong Kong in Table 10.)

On the export side, the higher trade barriers of the Tigers, compared to Japan, would be conducive to greater gains through Australian exports substituting for local production and imports from other sources. While the markets in these countries are considerably smaller than that of Japan, rates of growth are such that the gap is likely to close fairly rapidly.

A problem confronting even a qualitative analysis of these possibilities is the lack of consistent information on the trade restrictiveness of the protection regimes in these countries. Such information as is available in Tables 17 and 18, for the Republic of Korea and ASEAN respectively, shows that there is a proliferation of non-tariff barriers, in addition to sizeable tariffs in some sectors. An important requirement for further analysis of the effects of different trading bloc scenarios is the quantification of these barriers.

It has been suggested that Australia form an FTA with China (see for example, Hooke 1989). As a bilateral arrangement this would raise the normal issues about trade creation versus diversion on the import side for Australia. On the export side, the logic is that while China is a relatively small market overall it is an expanding market. This also applies to the other Asian countries. Apart from any strategic or development issues, a basic problem with China is that as long as it remains a controlled economy, at least in

Table 17: Australia's leading exports to the Republic of Korea and Korea's trade barriers, 1987

SITC Rev 1	Product	Exports to Korea		Share of exports to world		Share of Korea's imports		Trade barriers	
		US\$m	%	US\$m	%	Australia	USA	Tariffs	Non-tariff
3214	Coal, excl. briquettes	338.16	7.94	34.63	19.21			1.0	F
2813	Iron ore, etc, excl. pyrites	144.46	8.49	36.71	0.0			1.0	F
6841	Aluminium, alloys, unwrought	117.70	12.21	39.43	4.52			20.0	F
2621	Wool greasy, fleece-washed	113.35	4.56	97.64	0.0			15.0	
2622	Wool degreased	51.23	8.61	48.58	0.12			15.0	
0611	Raw beet and cane sugar	44.06	13.69	23.64	0.00			20.0	F
0410	Wheat etc unmilled	41.83	2.65	9.73	55.27			5.0	E,F,H
3310	Crude petroleum, etc	40.98	6.31	1.11	0.34			5.0	
2835	Zinc ores, concentrates	40.52	22.20	46.93				1.0	
6851	Lead, alloys unwrought	38.67	13.88	68.30	2.13			18.3	
2111	Bovine, equine hides	27.24	11.90	3.56	84.52			10.4	
2820	Iron and steel scrap	27.02	35.96	7.07	72.80			2.0	
2763	Salt	20.26	18.11	77.91	0.01			20.0	
6725	Iron, steel blooms, slabs etc	19.21	19.53	10.60	1.06			15.2	
2631	Raw cotton, excl. linters	19.16	8.15	3.73	61.76			2.0	F
8624	Photo film exc dev. cinema	16.57	12.61	12.77	11.19				
6842	Aluminium, alloys worked	15.31	12.09	9.75	11.72			22.6	
8912	Sound recording tape, discs	10.03	19.49	11.65	30.48			28.4	
2837	Manganese ore, concentrate	9.57	16.45	50.68				1.5	

E: health regulations.

F: import authorizations.

H: prohibition.

Sources: International Economic Data Bank, Australian National University, Canberra; R. H. Snape, *Should Australia Seek a Trade Agreement with the United States?*, Discussion Paper No. 88/01, Economic Planning Advisory Council, Canberra, 1986; Department of Foreign Affairs and Trade (1989); GATT Tariff Study tapes.

Table 18 **Tariff and non-tariff barriers facing principal Australian exports to ASEAN**

SITC Rev 1	Product description	Tariffs of countries within ASEAN <sup>a</sup>				
		Indonesia %	Malaysia %	Philippines %	Singapore %	Thailand %
0410	Wheat and meslin, unmilled	1.0	—	10.0 <sup>cd</sup>	—	19.0 <sup>h</sup>
0430	Barley, unmilled	5.0	—	20.0 <sup>cdef</sup>	—	27.0
0611	Raw sugar, beet and cane	60.0	16.0	50.0 <sup>c</sup>	35.0	..
6861	Zinc and zinc alloys, unwrought	2.5	5.0	10.0	—	1.0
2836	Tin ores and concentrates	2.5	—	10.0	—	3.0 <sup>g</sup>
0222	Milk and cream, in solid form, blocks or powder	32.5	—	6.7 <sup>ceg</sup>	—	2.0 <sup>ghj</sup>
3310	Petroleum, crude & partly refined	1.3 <sup>c</sup>	—	15.0 <sup>g</sup>	—	— <sup>g</sup>
6841	Aluminium and aluminium alloys, unwrought	2.5	—	10.0	—	0.5 <sup>g</sup>
3323	Distillate fuels	5.0	—	20.0	11.0	9.0
2813	Iron ore & concentrates ex. roasted iron pyrites	—	—	10.0	—	3.0 <sup>g</sup>
8624	Photo. film etc. & developed film other than cine	23.4	13.3	18.3	—	27.3
3325	Lubricating oils and greases	8.1 <sup>b</sup>	—	24.0 <sup>g</sup>	—	16.7 <sup>g</sup>
3324	Residual fuel oils	5.0 <sup>b</sup>	3.0	20.0 <sup>g</sup>	—	— <sup>g</sup>
0482	Malt — including malt flour	30.0	—	30.0	—	18.0
3214	Coal/anthracite, bituminous	2.5	—	10.0 <sup>ef</sup>	—	—

<sup>a</sup> Trade weighted tariff average; non-tariff barrier data not available for Malaysia. <sup>b</sup> Plus automatic licensing. <sup>c</sup> Plus authorization depending on certification. <sup>d</sup> Plus state monopoly of imports. <sup>e</sup> Plus global quota. <sup>f</sup> Plus discretionary licence. <sup>g</sup> Plus import authorization. <sup>h</sup> Plus health and safety regulation. <sup>i</sup> Plus prohibition. <sup>j</sup> Plus licence. .. Not available.

Source: R.H.Snape, *Should Australia Seek a Trade Agreement with the United States?*, Discussion Paper No 86/01, Economic Planning Advisory Council, Canberra, 1986, p. 116).

relation to foreign trade, an FTA is meaningless — as there is not a formal market instrument like the tariff which determines the allocation of imports.

### What's in it for the others?

Table 20 indicates that Australia is only a minor market overall for most countries in the region, New Zealand being the exception. Australia's position could possibly be more significant if barriers to imports of such highly protected items as textiles, clothing and footwear were removed. But even then the Australian market would remain of minor interest compared with the EC (as well as, within the area, Japan and North America).

Table 19 Australia's leading exports to ASEAN

SITC	Product	Exports to ASEAN US\$m	Share of ASEAN imports		
			Share of total exports %	Australia %	United States %
3310	Crude petroleum, etc	172.95	26.64	3.15	-
0410	Wheat, etc unmilled	164.69	10.42	41.03	40.71
6841	Aluminium, alloys, unwrought	115.36	11.97	49.25	4.96
0611	Raw beet and cane sugar	111.42	34.62	68.87	-
0222	Milk and cream dry	83.98	55.08	22.97	0.71
6861	Zinc, alloys, unwrought	55.80	28.74	60.33	0.05
3214	Coal, excl briquettes	45.87	1.08	75.57	0.02
2836	Tin ores, concentrates	39.66	98.94	27.91	0.29
8624	Photo film excl dev cinema	31.02	23.61	13.26	16.15
2621	Wool greasy, fleece-washed	30.87	1.24	95.17	-
3324	Residual fuel oils	29.37	31.05	2.02	4.09
2813	Iron ore, etc, excl pyrites	27.42	1.61	32.89	-
0545	Other fresh vegetables	24.47	37.96	19.43	1.46
6725	Iron, steel blooms, slabs, etc	23.98	24.37	21.08	0.03
9310	Special transactions	22.21	4.91	1.91	24.22
6851	Lead, alloys unwrought	21.46	7.70	52.64	0.48
0482	Malt including flour	20.68	27.25	53.05	8.07
5812	Prod of polymerizing etc	19.66	24.31	1.54	20.27
0011	Bovine cattle	19.44	35.36	62.47	19.92
6748	Iron, steel thin coated nes	18.87	17.88	7.89	0.31

Source: International Economic Data Bank, Australian National University, Canberra.

Table 20 Australia's importance as a trading partner to Asia-Pacific countries, 1988

Country	Australia's share of	
	Exports %	Imports %
New Zealand	15.8	20.3
Japan	2.2	5.3
Korea, Republic of	1.3	3.1
Taiwan	2.2	2.7
Hong Kong	1.7	1.3
Singapore	2.7	1.9
Thailand	1.9	1.8
Indonesia	2.0	4.0
Malaysia	2.2	4.1
Philippines	1.8	3.2
China	0.8	3.1
Canada	0.5	0.5
USA	2.2	0.8

Sources: IMF, *Directions of Trade Statistics Yearbook*, 1988; Taiwan Customs Statistics.

Australia is more important as a supplier to most countries than as a market. This largely reflects a concentration on relatively few commodities. (Note that there is nothing 'wrong' with these imbalances. It is a normal and desirable feature of the multilateral trading system that bilateral trade flows rarely balance.)

#### Costs of being 'left out'

As noted, the United States has made some noises about forming FTAs with countries in Asia. For most countries in the region an FTA with the United States might be expected to yield substantial benefits on the export side, especially if it involved the dismantling of non-tariff measures (especially VERs), which are the main obstacle to trade.

Given the similarity between the composition of exports to the United States, from Japan and the Tigers, a bilateral arrangement between any one of these countries and the United States could be expected to have major trade diverting effects on the others. For example, Taiwan's leading exports to the United States all compete mainly with Japan and the three other 'Tigers' (Table 21). For most of these commodities, the United States tariff rate is not high and tariff preference alone would have little effect. The real constraint on exports is the voluntary export restraints which these countries have with the United States (Hufbauer et al. 1986).

Table 21 Taiwan's major exports to the United States, 1987

Merchandise	Export value	Taiwan's market share	Chief competitor's market share <sup>a</sup>		Tariff rate <sup>b</sup>
			United States\$m	%	
Apparel	2 638	14.7		36.7	20.1
Metal products	720	17.0		28.9	4.4
Metal products	1 229	24.0		22.4	5.3
Machinery	2 767	9.4		56.4	3.8
Electrical products	4 239	9.5		53.4	4.8
Footwear	3 301	24.1		29.0	9.6
Instruments	1 489	15.0		38.1	4.0
Sporting goods	2 133	30.9		39.1	6.3
Rubber and plastic products	1 188	18.0		27.2	4.4

<sup>a</sup> The chief competitors are Japan, the Republic of Korea, Hong Kong, and Singapore. <sup>b</sup> Tariff rates are measured by the ratio of the tariff actually paid to the dutiable import value.

Source: S.C.Tsiang, 'Feasibility and desirability of a US-Taiwan free trade agreement', in J.J. Schott (ed.), *Free Trade Areas and US Trade Policy*, Institute for International Economics, Washington, D.C., 1989.

As noted earlier, the increased exports from the United States to any of the countries in East Asia would, in agriculture, be likely to displace Australian exports. As shown in

Tables 16, 17 and 19, the United States is an important competitor for most of Australia's leading exports to Japan, the Republic of Korea and ASEAN, respectively.

### Summing up

In this chapter we have applied some simple rules of thumb about the likelihood of FTAs bringing economic gains to Asia-Pacific countries.

Strategic considerations and possible retaliatory implications aside, a *comprehensive* Asia-Pacific FTA is likely to bring gains to the group, including Australia. Smaller groups are more problematic. Although Japan and the United States would seem to be advantageous bilateral FTA partners for Australia if all products and non-tariff measures were included, the situation for other Asian partners is more speculative. Any FTA in the region which included only one of North America and Australia is bound to be costly to the other country, and proportionately more so for Australia. The extent of such a loss depends on the nature of the agreement and the particular countries involved.

Static partial equilibrium analysis can provide only limited insights into these important questions. The interdependence of trade among countries within the region, and outside it, as well as the interdependence among different industries and sectors within each economy, calls for a broader approach. Importantly, there also needs to be some account of the possible effects which an FTA would have on exports to countries that are excluded — through international trade policy repercussions. Such issues are discussed in the next chapter.

## 5. Political and Strategic Issues

The previous chapters explored some of the 'internal' economic implications of trading blocs. While more detailed and systematic research is clearly required, it may be assumed that a trading bloc embracing all the countries in the Asia-Pacific, though bringing less gains than a global FTA, would benefit the participants economically. Like the formation of the EC, it would also divert trade from the rest of the world, but its potential for generating dynamic gains could even outweigh this influence in the longer term.

This, however, raises two further and equally fundamental questions: is such an all-encompassing trading bloc feasible; and what might its 'external' repercussions be — on other export markets and the multilateral trading system as a whole?

### Is an Asia-Pacific bloc feasible?

Mr Hawke was quoted earlier observing that the countries in the region would not touch a trading bloc 'with a forty-foot pole'. However, this could not apply to all countries and all conceivable blocs. The region already contains two FTAs — Australia/New Zealand and United States/Canada — as well as an attempted one (ASEAN), and a number of partial preferential arrangements (SPARTECA, PATCRA). Moreover, it is known that the United States has made tentative overtures to a number of countries in the region in recent years, and that at least some have not reacted negatively (Chapter 2).

It has often been observed that economics has generally not been the overriding determinant in the formation of trading blocs. Political and strategic influences have played an important part. A review of such trading arrangements throughout the world (Box 3) suggests a checklist of three features which most regional trading arrangements have in common — a different list from the rules of thumb for gains from a trading bloc considered previously.

#### Three 'feasibility criteria'

##### 1. Proximity

Most 'regional' trading arrangements are just that — they comprise a group of countries in a fairly well defined region. (Looking at Box 3, the arrangements with Israel are the exceptions which prove that rule, as discussed below.) The EC commenced with six 'neighbours' — France, Italy, Germany, Belgium, Luxembourg and the Netherlands —

and its subsequent expansions merely added to the union the successively outlying neighbours of the perimeter countries.

Regional proximity is important for several reasons. Geographically close countries generally also have cultural and institutional affinities and more extensive economic and trade integration to begin with than countries that are more distant. They also of necessity have some common strategic concerns.

## **2. Shared political and strategic objectives**

The eminent British economist Lionel Robbins believed that free trade was of benefit less for its direct economic gains than for its 'peace-inducing' qualities. Countries that are heavily engaged in selling things to each other have important reasons for keeping their political relations friendly. While this need not apply to trading blocs — because of other tensions to which they can give rise — the goal of political stability in Europe was an important reason for the formation of the EC after the Second World War. (It is of interest that the EC was formed without any detailed assessment of its likely economic effects. All those studies were done a decade or more later.) Other 'political' objectives in the creation of trading blocs have been a desire to achieve independence from industrial countries (the Latin American blocs) or a wish to expand or sustain spheres of influence (used to effect by Nazi Germany with the Balkan states) or distant objectives of political unification (sometimes raised in the context of ANZCERTA).

## **3. 'Similar levels of development.'**

It is often remarked that the creation and durability of a trading bloc depends on having similar levels of development among the partners (Wonnacott and Lutz 1989). In practice most trading blocs have exhibited this characteristic, at least in the initial stages. (The EC has only recently added Portugal and Greece and these countries are near the top of the World Bank's 'upper middle income' category.) It is in fact the opposite of the rule of thumb about economic complementarity for trade creation gains from a trading bloc. It reflects a basic domestic political constraint, which is also behind the difficulty that countries have in liberalizing multilaterally within the GATT: namely, that uncompetitive domestic industries generally have a predominant influence on trade (protection) policy — as they have the most to lose from exposure to world competition. That is why multilateral negotiations tend to be sector specific (each country's 'sensitive' sectors being excluded) and also why regional agreements among 'similar' economies are easier to negotiate — the adjustment threat is much lower. The importance of the anti-adjustment



lobby as a determinant of what is politically feasible is illustrated by the difficult passage of even the United States–Israel FTA through Congress; by the many exceptions which permeated the NAFTA agreement between Australia and New Zealand; by the exclusion of agriculture from EFTA and of textiles, clothing and footwear from SPARTECA. Many more illustrations could be given. The real source of difficulty is not 'development levels' as such, but rather the gap in competitiveness between prospective trading bloc partners.

#### How does the Asia–Pacific measure up?

Measured against these three 'feasibility criteria', an FTA comprising the Asia–Pacific 'region' as a whole does not look promising — despite the fact that an FTA on that scale would bring the largest gains to participants.

- With respect to the first criterion — 'proximity' — we have already noted the geographic, cultural and institutional diversity of the 'region'.
- It is hard to think of any major unifying strategic interests across such a broad group of countries, although they would certainly exist for some subgroups.
- It is also hard to think of a group of countries having greater disparities in levels of development. In 1987, per capita incomes (as measured by the World Bank) ranged from US\$290 in China, to US\$18,530 in the United States. Just as these differences in labour costs are the source of economy-wide gains from liberalized trade, they also bring major adjustment pressure on uncompetitive industries — and commensurate political resistance to trade liberalization.

#### **Sub-bloc scenarios**

While an Asia–Pacific-wide trading bloc seems a non-starter, a sub-bloc need not be. After all, there are three in the region already (United States–Canada, Australia–New Zealand and ASEAN). A question of interest to Australian trading interests is whether wider arrangements could develop, or be developed, in the region and what Australia's role might be.

#### Could Australia initiate a bloc?

It has been suggested that ANZCERTA could be extended to include an Asian country, as a first step in Australia creating a regional trading bloc around itself (Hooke 1989). From Australia's (economic) perspective, the potentially most beneficial bilateral arrangement

would be with Japan. But perhaps others could also bring gains — detailed empirical analysis would tell us which. How feasible is such an approach?

It is again convenient to first look at our three measures. On the first, proximity, Australia is geographically fairly close to East Asia, or at least Southeast Asia, but as a recent arrival in the region this is not associated with other elements of 'closeness'. Indeed, it is only since the 1970s that Australia began to permit Asian immigration. Strategically, Australia has not forged close links with Asian countries, remaining closer to the United States; but it has shared the concerns of Asian market economies about Communist influence in the region. As for levels of 'development', Australia is way ahead of most countries in the region, but some are gaining fast. More to the point, Australia remains highly protectionist in labour-intensive areas of trade in which Asian countries are world leaders in competitiveness. It would be a major shock to the manufacturing sector (textiles, clothing and footwear industries, for example) if Australia formed a free trade pact with China, any of the Tigers, or ASEAN.

From the perspective of Japan and some other Asian countries, permitting free entry of Australian agricultural products would meet similar political resistance. The small size of the Australian market means that it would probably be difficult politically to justify such sectoral pain by the gains to export industries; in other words, the mercantilist logic that imbues most international trade negotiations would not favour Asian–Australian FTAs.

Even ignoring these problems, there is a more important obstacle for most countries. The political difficulties associated with domestic adjustment to imports of Australian agricultural goods would probably be overshadowed by concerns about the reaction of the United States to the inevitable displacement of its exports. As shown in the preceding chapter, the United States and Australia are principal rivals in a range of commodity exports to the Asian region. It would take a brave (or foolhardy) country to join an FTA which excluded its major export market, simply for domestic resource allocation gains that could be achieved unilaterally/multilaterally anyway.

#### Critical role of the United States

The United States is the key to what is possible in closer Asia–Pacific trade relations — it is too big and important to the Asian economies for things to be otherwise.

When Kojima first made his PAFTA proposal (Chapter 2) the United States was not interested. However in those days the United States was against GDAs on principle; that is no longer so. At first sight, the recent United States agreements would all seem to have

special characteristics which do not apply to Asia. The United States–Canada FTA is a natural extension of the already high integration between these regionally and culturally close countries. The United States–Israel agreement has obvious political forces behind it in the United States, as well as the gains to Israel from enhanced access to the massive United States market (Pelzman 1989). The Caribbean initiative too can be seen as strategically motivated developmental assistance to countries on the United States doorstep.

As noted previously, the Asian countries most cited in the United States as potential FTA partners are Japan, the Republic of Korea and Taiwan (USITC 1988, 1989). Measured against our three 'feasibility criteria', however, these combinations would seem ill-suited according to 1 and 3. In particular, since the United States has spent the last decade erecting discriminatory barriers to the exports of these very countries, there would need to be some important reasons of a strategic or political nature (category 2) to bring about a complete reversal of that trend (that is, to achieve discrimination in **favour** of those countries).

In practice all three countries are of some strategic importance to the United States, and the recent bilateral trade conflicts have been viewed with concern in this respect. A closer trade relationship, with 'lower track' (less politicized) procedures for resolving disputes on the basis of mutually agreed criteria is seen as having attractions on both sides of the Pacific (USITC, 1986, 1989; Schott 1989*b*; Park and Yoo 1989; Tsiang 1989). But this need not mean a 'pure' FTA. It could just mean an extension of the bilateral discussions and agreements on particular sectors and products which have characterized United States–Japan trading relations in recent years.

The question of United States bilateral political relations with countries in Asia and how they relate to trade policy requires a more intensive examination than can be provided here. All that can be said is that the chances of bilateral arrangements happening is at present unlikely.

As noted earlier, it would only take the establishment of one such arrangement to lead to major pressures for more. For example, a United States–Taiwan FTA — which is a plausible starting point (Tsiang 1989) — would inflict damage on Japan's and the Tigers' exports to the United States, and could make these countries go all out for deals of their own, or increase pressures to expand the existing arrangement. Having got one Asian FTA through Congress, it could well be easier to add other countries to the list. For one

thing, the political ground for accepting import adjustment would have been prepared; and the need to reduce conflicts with the other countries would have become very apparent.

## **Trade blocs and the multilateral trading system**

### GATT rules

The GATT's Article 24 permits member countries to form a customs union or free trade area on condition that:

- its purpose is 'to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties';
- trade barriers among members of the arrangement are 'eliminated on substantially all' their mutual trade (GATT 1969).

These rules, while included through expedience, were designed to limit the scope for such arrangements to lead to *ad hoc* discrimination. In practice, they have not been enforced. One expert on GATT law has observed that 'perhaps only one of the more than one dozen regional agreements that have come before the GATT complied fully with the Article XXIV criteria ... and even in that case certain doubts are expressed ...' (Dam 1970:290).

This means that in practice there is no real GATT obstacle to the creation of even a partial FTA, which for reasons given previously is a more likely outcome where countries at different development levels are involved. As Thomas (1977) indicates, the NAFTA agreement existed for many years in contravention of the 'substantially all trade' provision of Article 24, until Australia and New Zealand of their own accord decided to create a proper FTA.

The question remains, however, as to what effect a (further) move to trading blocs in the Asia-Pacific would have on the GATT system. One observation is that most GATT members are already members of regional arrangements. It is difficult to say to what extent this has contributed to the increasing difficulties experienced by the GATT; however the EC experience suggests that it has played a considerable part. The United States Administration has argued rather dubiously that the United States-Canada FTA is conducive to a better functioning GATT, as it has acted as a trail blazer in getting a multilateral agreement on services.

While a network of discriminatory arrangements is in itself the antithesis of the multilateral, non-discriminatory GATT ideal, over the longer term it could evolve in that direction if the blocs were open to new entrants and/or negotiated free trade deals among themselves. A more likely scenario is that a point could be reached well in advance of this where arrangements stabilized in a number of large, relatively self-sufficient blocs. How these blocs chose to interact would have an important bearing on the eventual outcome. Historical experience suggests that the interaction is most likely to be adversarial, yielding a negative outcome.

### GATT negotiations

It has been argued that attempts to negotiate a trading bloc, if occurring at the same time as GATT negotiations, represent a diversion of effort and attention by the governments concerned and thus weaken the prospects of the multilateral negotiations succeeding (Schott 1989*b*).

A more interesting question for the longer term is how the nature of negotiations among GATT members would be altered by having an Asia-Pacific bloc or blocs. Here a distinction should be made between customs unions and FTAs. As the EC experience has shown, the need for members of a customs union to agree on common external barriers, and common liberalization strategies, tends in itself to impede progress, and often results in the lowest common denominator (highest protection) prevailing. This need not be a problem with an FTA, as each country is free to negotiate its external barriers separately. However, it is also true that any reduction in external barriers will erode the value of preferences to some country within the bloc, which may try to exert influence to prevent this happening.

The GATT is sometimes characterized as an unwieldy vehicle for trade negotiations because of the large number of countries involved (about one hundred). Thus it might be thought that it would be easier to 'get things done' with negotiations among a few large blocs. However, bargaining about trade barriers has traditionally been carried out among small groups of GATT members — the 'principal suppliers' — so that this aspect has not been such an obstacle.

Nevertheless, there are times when the number, and more important, diversity of views, among contracting parties have impeded progress. While having a few large entities would simplify negotiations in this sense, it could well weaken the potential for mutually beneficial outcomes, because of the 'lowest-common-denominator factor' within the blocs, and a greater tendency to use power tactics where greater power exists. We enter

here into the realm of the 'game theorist', where anything is possible — but it is not difficult to imagine a 'warring blocs' scenario in which barriers to inter-bloc trade rise.

### Retaliation

This brings us to the important possibility that a trading bloc, in diverting trade from other countries, may well elicit adverse policy repercussions from outside the bloc. It was noted that Asian countries would be reluctant to form a trading bloc which excluded the United States, especially if Australia were to be included. However, similar reservations would apply for most of these countries in relation to the EC and EFTA. As shown in Table 6, while Western Europe has declined as a regional trading partner, it remains an important source of export revenue and has the potential to become a more dynamic market after 1992.

The EC has already expressed opposition to the notion of Asia-Pacific 'economic cooperation' and could well use that as an excuse to raise barriers to Asian exports. Alternatively, given recent political developments, it might seek to expand its own bloc to Eastern Europe, which would divert trade from Asia. These potential losses could be a significant offset to any expected gains from a regional bloc and should be analysed as part of any more detailed empirical work.

Within the region, the formation of sub-blocs, such as an FTA between the United States and a 'Tiger', could well elicit a similar response if the arrangements were not made open to the countries most adversely affected. As Viner (1951: 355) has remarked:

Tariff discriminations are invariably resented by the countries which are discriminated against, and three centuries of experience demonstrates that under all circumstances they operate to poison international relations and to make more difficult the task of maintaining international harmony.

### **Alternative strategies**

While the potential for some trading blocs in the region exists, Australia and other countries need to do their homework about the economic implications. However, given the systemic risks from such an approach, there is also a need to consider alternative strategies for meeting trade objectives.

### Making better use of the GATT

The GATT provides a vehicle for reaping the largest gains from negotiated reductions in trade barriers; it is the ideal trading bloc — one that encompasses **all** trading countries. It is apparent that the failure of the GATT to deliver the universal liberal trade that it was designed for is more the fault of its members than the system. This has had domestic political causes within each country but it has also been a cumulative and interactive process. If country A does not contribute to GATT negotiations or flouts the rules, the task for the government of country B to convince its own electorate that participation is worthwhile becomes much harder.

United States and EC protectionism, which are motivating forces for considering trading bloc options in the Asia-Pacific, have partly had a life of their own. But they have partly also reflected, or at least been facilitated by, a perception that developing countries are 'free riding' on the GATT system. Developing countries have indeed had a 'privileged' position within the GATT, in which they have been allowed to maintain their trade barriers intact for 'development' reasons, while benefiting from industrial countries barrier reductions. However, such positive discrimination has opened the door to negative discrimination, so that in the end developing countries have been made doubly worse off — from their own barriers and those (discriminatory) ones erected by industrial countries against their most competitive exports.

If the fact that developing countries have not been good GATT citizens in the past has contributed to the decline of the GATT system, an obvious strategy for those countries is to reverse this behaviour. Asia-Pacific countries — most of which are GATT members (Table 22) — are well placed to take a lead. The region already contains two of the most open countries (to merchandise trade) in the world — Hong Kong and Singapore. And the Asian Tigers were instrumental in breaking the united opposition of developing countries to the Uruguay Round and in particular the inclusion of trade in services. ASEAN countries have been less forthcoming, however.

The more that countries in the region are prepared to participate, the better the demonstration effect on industrialized members themselves. Greater liberalization would also resolve many of the potential discriminatory tensions in the region; for as trade barriers become lower, preferential arrangements lose their effectiveness. Thus, for example, Australia would have little to fear from any United States overtures to Japan if Japan had a relatively low, tariff-only regime for agriculture. And the same applies to the Republic of Korea and Taiwan.

Table 22: The GATT accession of the Asia-Pacific

Country	Date of accession
Australia	1 January 1948
Canada	1 January 1948
United States	1 January 1948
New Zealand	30 July 1948
Indonesia	24 February 1950
Japan	10 September 1955
Malaysia	24 October 1957
Singapore	20 August 1973
Korea, Republic of	14 April 1967
Philippines	27 December 1979
Thailand	20 November 1982
Hong Kong <sup>a</sup>	23 April 1986
China, People's Republic of	Application in process

<sup>a</sup> Previously represented by United Kingdom.

Source: Communication from GATT Secretariat.

One approach would be for Asia-Pacific countries simply to make greater individual contributions to the negotiations — liberalizing their markets in a non-discriminatory way in exchange for concessions from industrial countries.

Another approach would be to form an alliance within the GATT to pursue common priorities. A problem in achieving an effective regional coalition on trade matters is the diversity of export interests within the region. What coherence the Cairns Group has achieved reflects the fact that it is a 'single issue' group — of agricultural exporters. And even for this group it has not always been possible to achieve consensus on strategy.

There is one issue on which most countries in the region should be united, however, and that is the strengthening of the non-discrimination rules in GATT. It is the erosion of these rules in policy practice which constitutes the major threat to Asian export-led development. The problem for a broader alliance among Asia-Pacific countries on this issue is that the United States is one of the main culprits.

#### 'GATT-plus'

A second possibility is for countries in the region to agree on trade liberalization commitments among themselves, which are not exclusive to themselves. Such an approach was discussed by some developed countries in the stalemate years of the Tokyo Round and referred to as 'GATT-plus'. There are two conceivable approaches:



- The first would be a conditional (MFN) approach whereby Asia-Pacific countries would agree to reduce barriers, but to extend these reductions to any other country which made similar commitments. This is essentially how the Tokyo Round Codes operate.
- The second approach would be to have an exchange of concessions among Asia-Pacific countries on items of particular trade interest within the region, but applying the concessions on a non-discriminatory basis. Such an approach would involve more adjustment than an FTA, but without the diversion costs.

To the extent that reciprocity has an influence on what is politically feasible in trade policy, the first approach is more plausible than the second. The second approach has the political disadvantage of providing access to free riders, some of whom would also be agricultural subsidizing nations (mainly the EC). A condition therefore for an agreement of that kind would presumably be an agreement among participating countries on subsidy countervailing rules and procedures. Otherwise an Asia-Pacific liberalization could see the displacement of Australian or United States agricultural exports by subsidized EC produced in some markets (Snape 1986).

#### Domestic transparency arrangements

The main obstacle to liberalization — whether unilaterally, multilaterally within GATT, or in a trading bloc — is the political influence of those uncompetitive domestic industries which have most to lose from the elimination of trade barriers.

That influence has three forces behind it.

- There are greater incentives for the industries in industrial countries that are losing competitiveness to organize to avert adjustment than there are for other (export) industries and consumers generally, who carry the burden of protection, to support adjustment. This is because the gains are more highly concentrated and visible for the first group than are the losses for the second group. (The same logic applies to 'infant industries' seeking protection in developing countries.)
- This is compounded by lack of information, as well as misinformation, about the costs of protection.

- It is also compounded by the fragmentation and 'sponsorship' structures of national bureaucracies, which commonly react to the needs of their client industries without getting an economy-wide perspective into decision-making.

A recent report by an international study group chaired by former GATT Director-General Olivier Long, has recommended that these underlying causes of protectionism need to be addressed by the creation in each country of 'domestic transparency institutions' such as the Industries Assistance Commission in Australia (Long et al. 1989). These would have two important functions: scrutiny of claims for protection on the basis of what the effects on the economy as a whole would be, and continuing general reporting on the existence, costs and benefits of policies in place.

As has occurred in Australia, such arrangements could be expected to improve community understanding of the costs of protection and the benefits of liberalization, creating a political environment more conducive to reform.

Such arrangements would also be helpful to Asian countries in dealing with accusations from the United States and EC about 'unfairness' in their trade and industry assistance policies. As things stand, there is great suspicion about the policy environment facing imports in these countries even where, as in Japan, conventional trade barriers have been greatly reduced.

New Zealand has sponsored in the GATT the Long Report's proposal that there be an international agreement on domestic transparency in the Uruguay Round. This proposal has been supported by only a few countries, including Australia. Asian countries could be well placed to take a lead. A number of countries in the region already have 'tariff commission' type institutions that could be adapted for this purpose.

## 6. Implications for Research

When policies are 'first best', informational needs are minimal. If all countries were 'free traders' — or were at least reducing their trade barriers to negligible levels — and were non-discriminatory and open in their policy-making processes, each government could just let its private traders get on with the job. But trade and industry policies are not first best, or even second best, and they can have an important influence on the performance of each economy.

Economic theory (and practice) teaches us that for a small country in a large and complex world trading system, the best policy strategy is to go for first best at home, regardless of what other countries are doing. (Recent so-called theoretical breakthroughs in strategic trade theory notwithstanding.) But that does not mean that policy developments overseas should be ignored. Getting policy right at home is a large part of the game, but as long as foreign policies constitute a threat to the realization of a country's economic potential, it cannot be **all** of the game.

A government confronted with adverse policy developments overseas, but wishing to keep its own economic house in order, has two approaches available to it:

- it can find ways of influencing other countries' policies for the better, and
- it can devise external strategies which make the 'best of a bad thing'.

Strategies of the first kind were considered briefly at the end of the previous chapter. They need to be based on a recognition that, at the end of the day, each country's policies will be shaped most by perceptions of what is in its own best interests. Protectionism is a problem largely because national perceptions about protection's effects on national welfare are ill-informed.

Information in each country about the costs of protection is a key to each country opening its markets. Recognition of that fact was behind the Bureau of Agricultural Economics 'Red Book' assault on the CAP, its successor's study of Japanese agricultural policies, and the Centre for International Economics 'Global' study of the costs of protecting agriculture in the United States, Japan, the EC and developing countries — which harnessed the expertise and credibility of local economists in each of those countries (BAE 1985; ABARE 1988; Stoeckel *et al.* 1989). More work of that kind is needed.

But information is also the key to the second strategy — adapting to the external policy environment. The previous discussion makes it clear that, as difficult as things have been for Australia in a world in which agricultural production is heavily assisted, they could get worse.

Despite protestations to the contrary, there are plausible circumstances in which regional trading arrangements could spread in the Asia–Pacific area. Those circumstances are political and strategic as well as economic and it is important to understand them. That is one avenue for research — to help put a probability on different regional trade policy developments.

Because such developments are in part influenced by their expected economic effects, more information is also needed on those effects. From Australia's perspective, information on which to base a regional trade strategy should provide detailed answers to two broad questions:

- What would be the consequences of various trading bloc scenarios in the region — excluding Australia — for Australia's trade and growth prospects?
- What would be the economic effects on Australia of participating in any such regional arrangements?

This report has sought only to illustrate the sorts of effects to be expected. More detailed existing studies have been confined to bilateral arrangements with New Zealand and the United States. They are 'partial' in nature and do not address the regional concerns raised above.

What is needed to answer broad questions of this type is detailed analysis of economic developments in the countries of the region and a formal quantitative regional economic framework to analyse the interactions among them.

In addition to knowledge about the United States, Canadian, Australian and Japanese economies, any analysis must provide a detailed explanation of the changing nature of the East Asian developing economies. Information about industrial countries, including Japan, is readily accessible. However, objective detailed monitoring of the developing countries of East Asia is more difficult. The multilateral institutions (IMF, World Bank, Asian Development Bank) are important information sources, but do not systematically focus on trade issues. This has led the NCDS to undertake evaluations of the economics of East Asia giving particular attention to trade and investment. Trade analysis includes

global, regional and bilateral trends, with particular attention to Australia's trade and investment interests.

### **The CIE regional trade model**

A quantitative regional economic framework must provide, for each country in the region, an economy-wide representation of factor endowments, production technology and the links between production and demands at the sector level. Second, it must incorporate the links, through trade flows at the sector level, between each country within the region and between each country and the rest of the world (that is, outside the region). Third, it must incorporate existing barriers to trade at the sector level between countries which are likely to be affected in the formation of various trading blocs. Finally, it must contain a treatment of how producers and consumers in each country are likely to respond, in terms of altering the level and sectoral composition of production and sales — and their trade with countries within the region and outside it — in response to changes in their prices and costs resulting from the formation of trading blocs.

This type of framework must have as its centrepiece an integrated regional input-output information base which describes:

- (i) **the production technology** of each sector in each country — in terms of domestically produced inputs and primary factors such as land, labour and capital, and inputs imported from each country within the region and from the rest of the world;
- (ii) **the sales structure** of each commodity produced in each country — to domestic industry users, domestic households and governments and to industry users, households and governments in each of the other countries of the region; and
- (iii) **taxes and subsidies** (whether explicit or implicit) at the commodity level for trade between regions.

The framework is completed by imbedding this information base in a set of economic behavioural relationships which collectively measure the extent to which each of the items in the information base are likely to change as a result of the trading arrangements associated with each trading bloc scenario.

The Centre for International Economics has constructed such a framework. It provides an integrated description of production and trading relationships between the following economic groupings:

- Japan
- Asian Tigers
- ASEAN
- North America
- European Community
- Australasia

That framework can be used to address the key questions about Asia–Pacific trading blocs raised in previous chapters. For example, what would be the impact on Australia if:

- North America and Japan (or the Tigers, or ASEAN) were to form a free trade area?
- Australia formed a free trade area with particular Asian countries?
- the EC raised trade barriers in retaliation?

It can also answer similar questions from the perspective of other countries in the region as well as determining the impact on the rest of the world — and the EC in particular.

It can simulate the effects of each of the above scenarios on:

- growth prospects for industries in Australia and in the other regions:
- overall macroeconomic performance (real GDP growth, aggregate employment etc) in each grouping; and
- the commodity pattern of exports and imports among Australia and the other country groups.

### **Research objectives**

To evaluate the external threat posed by trading blocs, and thus to devise reactive strategies, requires considerable analytical effort. Such work has obvious benefits to Australia and could also be helpful in demonstrating to other countries the consequences for them of alternative trade arrangements. That is, research of the sort contemplated here could make an input into their policy formulation as well.

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