

Old Wine in New Bottles: Are Free Trade Agreements the New Protectionism?

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*Poor Mexico, so far from God and so close to the United States
Porfirio Diaz, Mexican Dictator, 1876-1880 and 1884-1911*

ABSTRACT

Free trade agreements have proliferated wildly in the past five years. This paper tries to make sense of this alternative approach to trade policy by carefully distinguishing free trade from free trade agreements. The motivation for the first approach is largely economic, while politics is the key driver behind the latter. In particular, large economies find it simpler to impose their objectives on smaller economies than in the multilateral environment of free trade. In particular, the allure of access to large markets can bind small countries to their larger counterparts in an interplay of political and economic ties. The leverage provided by such agreements affects the foreign policy decisions of these smaller economies and tends to draw them into conformity with that of its larger partner. In much the same way, such agreements allow large economies to foist standards involving intellectual property rights, quarantine inspection, or business practises that advance prominent vested interests within the large nation. While no single small country is significant, each agreement signed creates a precedent for the next. In aggregate, this creates de facto universal standards that are far more conducive to national interests than could be expected in multilateral negotiations.

To make these points clear, I examine the recent Australia/US Free Trade Agreement. This treaty, in its way, represents some of the gravest shortcomings of this preferential approach to trade policy. By evaluating this agreement using checkpoints provided by a proponent of free trade agreements (Summers), as well as a list suggested by an academic opponent (Bhagwati), I am able to

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demonstrate how economics took a clear back seat in negotiating such a treaty. Given that both China and Japan, as well as the US, are now eagerly pursuing such arrangements in the Asia Pacific region as well as elsewhere, this study may provide policy guidelines to future negotiations for free trade agreements.

KEYWORDS: Free Trade Agreements, Australia, United States, British Imperial Preference System

Introduction

One unarguable fact of the last two decades has been a startling increase in Free Trade Agreements as well as the surprising variety of these packages. In the years since 2000, such trading arrangements, and the negotiations for still more, have reached almost epidemic proportions¹.

Responses to this new trade addiction have been almost monotonously predictable. Free Trade Agreements have been seized upon by both the opponents and proponents of globalisation (a term whose use manages to confuse rather than clarify any discussion). Ideologically inclined opponents find any trade arrangement distasteful². Change, whether negotiated or not, will always reward some groups and punish others. By detecting groups disadvantaged by trade agreements, these critics leap to a blanket condemnation of any and all such arrangements.

Such arguments, however, rest on logically flawed ground. Extrapolating such logic would mean that praise was reserved only for the status quo, since change of any conceivable sort rarely benefits each and every single individual composing an economy. To be consistent, any exchange of whatever type should be vehemently opposed on principle. Condemnations should be sufficiently extensive to include trade between neighbouring regions of a state or even different sections of the same city. The only consistent position such trade-phobics could legitimately adopt is a strict policy of autarchy. But even autarchy must be controversial, as it would necessarily involve a major reordering of the existing status quo.

In a sense, the more extreme partisans of anti-trade policies are not unlike the courtiers who surrounded King Canute. Given that, more realistically, change is inevitable, the question becomes whether change should indeed be channelled and in what specific directions should such channelling head.

In the opposite camp are those who never met a trade agreement they didn't like. These are the trade cheerleaders. The mere use of the term *free trade* is sufficient

to gain their wholehearted support and approval. These latter-day Pollyannas³ are unswerving in their devotion, despite the fact that Free Trade Agreements may have the same precise relation to “free trade” that virgin olive oil has to virgins.

Advocates see each and every one of such regional or preferential agreements as moving almost inevitably toward a world where any type of barrier to trade would become a distant memory. For these supporters it is not the short-term or even medium-term gains that are crucial (though these are estimated as clearly positive). What is crucial is that these agreements are only a means to an end, namely, a world where free trade is the only trade.

Unfortunately, life is often messier than most ideologues allow. Perhaps that explains why their arguments and claims have become increasingly strident when faced with complex empirical evidence. It turns out that all free trade agreements are not the same. Whether they are economically advantageous at all, and what the magnitude of any supposed benefits might be, depends on the terms of those agreements and the distinguishing characteristics of those who are party to these arrangements. It is also far from clear whether such agreements are the best that can be accomplished given an imperfect world, or serve only to block superior outcomes from happening.

Given that all Free Trade Agreements are not created equal, some insight can be gained by looking at a particular instance of these arrangements. I intend to examine the recent (2005) Australia–US Free Trade Agreement for several reasons. The Pacific Rim contains the world’s three largest economies and the trading arrangements they negotiate will have a relatively large impact on the world economy⁴.

Related to this characteristic, but perhaps more important, is the nature of this particular agreement. It has been negotiated between the world’s largest economy and one that is considerably smaller. As a result, the potential gains and losses facing the smaller economy are clearly larger, relative to the size of its economy, than for an economic behemoth like the US. This makes the relevant opportunity costs for the smaller economy larger, which provides the larger country with a clear negotiating advantage⁵. It is this reality that allows such agreements to qualify as a type of post-protectionism. They achieve many of the objectives of mercantilist-type policies while being promoted under the guise of freeing up trade⁶.

To illustrate this point, I will assume that Free Trade Agreements can be a productive strategy under the right conditions. I will adopt a set of conditions put

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forward by one of the staunchest supporters of such agreements, Lawrence Summers (1999)⁷, as well as those offered by a hardened opponent, Jagdish Bhagwati (2002). What will be clearly indicated once the Australia–US agreement is measured against these two sets of checkpoints is that the drivers behind this agreement were political rather than economic. By political, I mean not only clear cut matters directly related to strategic international relations, but also the advancement of vested economic interests. However, an initial stroll through trade theory may illuminate why the arguments for free trade need not extend to free trade agreements.

Is Free Trade Fair?

Let us, however, consider a little more carefully what the position of a nation is which opens its ports whilst other nations are shutting theirs; what our position would be, on the hypothesis (which is untrue) that, whilst we retain a Free Trade tariff, all other nations put heavy duties on our goods. I think it can be proved that, though we shall not have as much trade absolutely as we should have if other nations were free like ourselves, we shall be better off relatively; the trade and the production of the world will be less, but we shall have a larger share of it (Farrer 1997:68).

That economics has come to have an entire field of study devoted to trade theory seems more of an historical curiosity than anything else. That economists have focused for so long on trade theory is partly accidental and partly a reflection of government policy. On the face of it, foreign trade is no different than the contracting that lies at the heart of any given economy. The economics behind contracting is simple. Its clear enunciation extends back at least to Adam Smith. Clearly, foreign trade can vastly increase the extent of the market, but so can any other form of exchange.⁸

As it is the power of exchange that gives occasion to the division of labour, so the extent of this division must always be limited by the extent of the market. When the market is very small, no person can have any encouragement to dedicate himself entirely to one employment, for want of the power to exchange all that surplus part of the produce of his own labour, which is over and above his own consumption, for such parts of the produce of other men's labour as he has occasion for (Smith 1970:121).

People exchange goods and services because such trade is mutually beneficial. Given that individuals, by assumption, desire to be better off, no

exchange occurs if it is harmful to one of the parties concerned. By definition, no benefit equals no contract. By moving away from autarchy, exchange allows division of labour, which allows for economic growth. In essence, this translates into the concept of absolute advantage, or specialising in what one does best (ala Smith).

Equally, economists can derive the concept of comparative advantage in which an individual specialises in an area of relative skill (ala Ricardo)⁹. Trade should be seen as no more than an aggregation of such contracts and not as a particularly compelling and separate area of study. However, the historical context in which classical economics was born perhaps explains why the trade concerns came to dominate early forms of analysis.

Smith's work was a product of the colonial area in which he lived. The problem with International Trade lay in the restraint of these flows, not with its positive accomplishments. While it is the individuals and companies within a country that form contracts with those of another, it is the governments of those respective countries that can, and in the past have, restrained trade. Smith was writing at a time when the scandals surrounding the British East India Company and Robert Clive led to a prolonged Parliamentary inquiry¹⁰. Given such circumstances, Smith could only view the granting of monopoly trading rights as a pernicious form of pure self-seeking that was antithetical to economic growth ('the wealth of nations').

In the same sense, Ricardo's first homely little example of comparative advantage¹¹ served as part of a broad-based attack against the Corn Laws, which attempted to protect domestic cultivation of grain.

It cannot, I think, be denied, that, within these few years, great progress has been made in diffusing correct opinions on the impolicy of imposing restrictions on the importation of foreign corn; but, unhappily, much prejudice yet exists on this subject, and it is to be feared that the generally prevailing errors in the minds of those who are suffering from the distressed state of our agriculture, may lead to measures of increased restriction, rather than to the only effectual remedy for those distresses, the gradual approach to a system of free trade (Ricardo 1999:129).

Without this historical context, and the importance played by trade in these early works, it is questionable whether trade theory would have achieved such early and continuing prominence in the profession. Here is certainly a case of policy issues driving theoretical considerations.

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In a sense, Smith and then later Ricardo took the basic principles of exchange and applied them at a very general level to trade between countries. There is, however, one overwhelming problem with speaking about trade as if it were the country of Portugal trading wine for the cloth sold by England. Quite simply, countries do not trade. Individuals and firms trade. Speaking about the aggregate of a country's trade in the manner of Ricardo is to treat trade as though it were performed by representative agents.

However, if trade theory is to translate into trade policy, it is essential to keep in mind the microeconomics of exchange, which must consist of all the individual instances that compose foreign exchange. If the economic environment that defines that trade changes by altering the existing government constraints on such international commerce, there will almost inevitably be winners and losers in each country. Such a result is completely unsurprising, since when governments change the terms of contracting, they change income distribution. Standard public choice theory demonstrates that this creates incentives for rent-seeking behaviour.

Successful lobbying creates windfall gains for particular vested interests within an economy. This is because trade policies can restrict international trade in order to protect some particular sector or industry. Agriculture in many industrialised countries is sheltered in exactly this manner¹². It is more than conceivable that a trade agreement can exactly reflect the goals of those vested interests, even if such arrangements provide more costs than benefits to the economy at large. Costs may be spread widely. Benefits may accrue narrowly. It would not be worthwhile for those who are injured by such measures to bear the brunt of opposing their passage. Those who stand to gain, however, will have every incentive to invest in a successful lobbying campaign¹³.

Policy choices remain controversial even in those cases where the benefits clearly dominate. Most economists see free trade as economically beneficial¹⁴. However, international trade is no more than the sum of many individual contracts. Removing trade constraints creates losers as well as winners. Over time, as resources are shifted to more productive uses, benefits will begin to accrue. But in the short and even medium term, such changes must translate into distinct job losses for some sectors of the economy.

Therefore, the statement that "free trade is beneficial" should always carry along with it the proviso, "as long as compensation is actually paid to the losers"¹⁵. As an example, Scott (2003:7) makes the claim that there has been a net loss of 879,280 jobs in the US due to the North American Free Trade Agreement. (Free

Trade Agreements are not equivalent to Free Trade, but the point is that jobs will be lost as well as gained when the terms of trade are changed via negotiated settlements¹⁶.)

... trade both creates and destroys jobs. Increases in U.S. exports tend to create jobs in this country, but increases in imports tend to reduce jobs because the imports displace goods that otherwise would have been made in the United States by domestic workers (Scott 2003:2).

Clearly, statements like this are misleading, since workers who lose jobs will not stay unemployed but will shift to a different market sector, one where their labour will be more productive. However, this will not occur instantaneously and will incur costs of retraining plus various welfare payments. A certain percentage of those dislodged in this fashion will slip into the ranks of the long-term unemployed.

Also by focusing solely on the issue of job losses, these critics deliberately ignore the gains provided by goods and services available at cheaper prices to all consumers¹⁷ Looking simply at trade balances and jobs immediately associated with changes in trade is a too narrow and often misleading approach to estimating net benefits and losses from any trade agreement. This looks only at bilateral trade in isolation from a country's overall trade patterns. It also ignores indirect gains in efficiency from cheaper imports and shifting resources to more productive sectors.

These gains are perhaps even more advantageous to poorer households who must, by necessity, spend a larger portion of their income on consumption. It is no simple matter to judge the net gains (or losses) that result from any trade agreement. Free Trade is not necessarily fair to all and much less so will be the case of Free Trade Agreements which often promote much more narrow interests than does the promotion of multilateral Free Trade.

Taking the Free Trade out of Agreements

The policy debate on PTAs [Preferential Trade Agreements] today finds economists arrayed on different sides. The main division appears to be among those who find them a mixed bag and would therefore content themselves with an effort at reducing their downside by reforming Article 24 and other disciplines ... at the WTO so as to minimise the damage they can create, those who would reject them as a pox on the trading system and would like to

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see either a standstill or even a rollback, and those who would go along with them on a “GATT plus” view of trade policy. It is fair to say that those who are sceptical or hostile have gained some ground on the intellectual side (Bhagwati, Greenaway and Panagariya 1998:1145).

The battle for and against trade restraints has roiled the none-too-pacific waters of policy from the time of Smith onwards. There has always been a large disconnect between trade theory and trade policy. Policy, viewed from a strictly nationalist prospective, sees gains in trade as coming necessarily at the expense of trading partners. A trade package is politically easier to sell if it is sold as gains wrested away from stubborn opponents. National policy could be expected to swing sharply as nations redefined their own strategic interests. Free trade, as advanced in the nineteenth century, differed but little from the protectionist views advanced more than a century before by various mercantilist writers.

If any nation hath naturally any materials of manufacture, it is far more advantageous to export them in manufacture, rather than the raw materials, because the manufacture is so much more valuable, and will make a return of five, ten, or twenty times more treasure to the nation than the raw materials. Besides, it is most dangerous to export the materials of manufacture, since it may transfer the manufacture itself into some neighboring nation. ... But if foreigners will vend their raw materials of manufacture, it is necessary, or highly convenient, for a nation to import them, and put them into manufacture at home (Petyt quoted in Irwin 1996:38).

Considered in this context, the English pioneering push for free trade did not depart so dramatically from this mercantilist spirit that focused on gains from trade. Import raw materials and transform them into manufactured goods. Import basic food stuffs to keep wages down and continue to dominate the international market for manufactured goods. In the nineteenth century, where British manufacturing had no rivals, imposing import restrictions on needed raw materials was clearly counter-productive. Under such circumstances, policy prescription is rather simple. Yet at its heart the British still took a zero-sum approach to trade that differed little from the earlier mercantilist credo. If other nations incidentally happened to benefit from free trade, that was largely coincidental and not worthy of note.

The struggle surrounding the Corn Laws in England was the first great battlefield in which free trade triumphed. Unlike current bilateral trade negotiations,

trade restraints were removed unilaterally after a sustained campaign by those English interests most damaged by protecting the agricultural sector¹⁸.

More particularly, as the industrial prosperity and export boom of the early 1830s began to crack, industrialists became increasingly vocal about 'unfair' protection enjoyed by the agriculturists. Beginning in 1836, an economic downturn together with a series of poor harvests sparked the industrialists into action. High food prices and unemployment gave impetus both to the middle and working classes, the former organised as the Anti-Corn Law League and the latter as the Chartist movement (Schonhardt-Bailey 1999:6).

During the period following the repeal of the Corn Laws in 1846, England remained staunchly in favour of free trade, virtually ignoring the trade policies of others in doing so¹⁹. In contrast, in the United States, the victorious North, after defeating its Southern rebels in a Civil War, remained staunchly protectionist. Both saw their respective approaches as simply advancing their economic self-interest. The British, though, by the turn of the century, started to display doubts in single-mindedly pursuing a policy of unilateral free trade, once British manufacturing ceased to be uncontested. The economic rise of Germany generated the same sort of alarms during this period as Japan would later create in the US during the eighties²⁰. The result was a series of bills brought forward (1904) by Joseph Chamberlain to create a preferential trading zone within the imperial economic region.

Mr. Chamberlain has opened his second campaign. Throughout his speeches two great themes persistently stand out – the economic condition of England and the political condition of the British Empire. Under each head he has made proposals. On the one hand, he advocates duties upon certain kinds of manufactured imports, no matter from what source they come; on the other hand, duties upon foreign imports of agricultural produce, from which colonial imports shall be exempt. Both proposals alike will, he declares, confer an economic benefit upon the mother country; and, in addition to this, the second will enable us to secure at once valuable concessions from, and a closer union with, our colonial fellow-subjects ... (Pigou 1999:237).

As might be suspected, the economic thinking surrounding trade issues, of even the best known authorities, seems to reflect the changing temper and economic realities of a given era. During the inter-war years, the Imperial Preference System gained its supporters even among the best known economists. John Maynard

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Keynes turned away from orthodoxy not only as regards money, employment, and interest rates but also managed to qualify his thinking on free trade²¹. Where economists then and later would scoff at the mercantilist thinking that underlay much of trade policy, Keynes instead suspected that such ingrained objections were not without foundation. Politicians, according to his insights, balked and resisted free trade proposals, not out of sheer obstinacy but because such policy depended upon flawed analysis. An understandable reluctance to embrace policies advanced by classical economists is framed clearly by this one, great apostate of free trade, John Maynard Keynes:

I remember Bonar Law's mingled rage and perplexity in the face of the economists, because they were denying what was obvious. He was deeply troubled for an explanation. One recurs to the analogy between the sway of the classical school of economic theory and that of certain religions. For it is a far greater exercise of the potency of an idea to exorcise the obvious than to introduce into men's common notions the recondite and the remote (Keynes 1964:350-1).

In an earlier essay (*National Self Sufficiency*), Keynes places unmistakable limits on the extent to which trade might be economically viable. Markets tended to overreach and regulation became necessary to provide the proverbial sand within the gears to slow down potentially destructive market inevitabilities.

We do not wish, therefore, to be at the mercy of world forces working out, or trying to work out, some uniform equilibrium according to the ideal principles, if they can be called such, of *laissez-faire* capitalism. There are still those who cling to the old ideas, but in no country of the world to-day can they be reckoned as a serious force (Keynes 1933:4).

Keynes was not calling for a return to some primitive form of protectionism. He was not about to deny the real and positive contributions that the expansion of trade had accomplished. However, for Keynes, that evolutionary development had reached a point of diminishing returns. Trade now needed careful regulation so that international competition could be channelled and contained²². In effect, regional arrangements, exemplified by the Imperial Preference System, would serve British objectives best.

Meanwhile those countries which maintain or are adopting straightforward protectionism of the old-fashioned type, refurbished

with the addition of a few of the new plan quotas, are doing many things incapable of rational defense. Thus, if the World Economic Conference achieves a mutual reduction of tariffs and prepares the way for regional agreements, it will be a matter for sincere applause (Keynes 1933:6).

It is tempting to read between the lines and follow a possible subtext behind Keynes' thinking in regard to trade. Free trade was rightfully espoused when Britain economically dominated the world and could reap great advantage by doing so. However, that no longer held, given the rise of a number of other economic competitors. It is possible here to be convinced of Schumpeter's suspicion that Keynes' economic thinking was always flavoured by his rock-solid patriotism²³²³ Keynes exemplifies a tendency among economists to allow general economic doctrine to become influenced and even confused with particular economic interests.

So they [advocates of free-trade] based sweeping general propositions on English facts and English conditions. ... This gave to their argument much apparent lucidity and simplicity, which hastened their victory. And their victory was two-fold. For it was followed by so great an increase of England's prosperity, that other nations began to open their ports in imitation of her and this doubled the benefits with Free Trade conferred on England. ... other nations would have been warned beforehand that the removal of Protective duties could not be expected to confer the same unmixed benefits on their best industries as it had done on those of England. As things were, they had to learn it in the hard school of experience (Marshall 1923:84-85).

The English disease, as applied to economics, confuses the particular with the general. Classical economists failed to distinguish between the particular set of circumstances favouring development in England with a universally applicable recipe relevant at all times in all places. Rather than a sketching out of immutable laws of exchange, theorems as presented by these economists were often, whether consciously or not, in service of a particular partisan position. Ricardo's methodology in the hands of partisans became unhistorical, unrealistic; the tool of a political party. Keynes, in breaking with these Classical traditions, did so in part because the free trade implications of that theory had turned against his country's best interests. So that where he once was so eloquent in defending comparative advantage, he now proved as adept at attacking the notion.

In any case, it should come as no surprise that in the post-war negotiations over trade that led to the formation of the General Agreement on Trade and Tariffs

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(GATT), Keynes and Britain pushed hard to retain its Imperial Preference System (regionalism) in place of the all inclusive multilateral free trade approach pushed by US delegates. (The US was coincidentally the unchallenged economic power of the time.) Article XXIV, the loophole in GATT justifying regional agreements, reflected in part this British recalcitrance²⁴. Regional agreements were born due to political considerations, and it is fair to say that their more recent rebirth reflects the essentially political, rather than economic, character of these agreements.

Though the British had lost faith, it is difficult to assert that their faith had ever been deeply founded. Even America's Pauline-like conversion on the road leading away from the Second World War shared the same opportunistic quality that characterised the British. The US had been staunch protectionists since the days when its first Treasury Secretary Alexander Hamilton thought to advance and develop industry by restricting imports. The US as free trader reflects changes in the post-war economic environment more than any fundamental change in the country's attitude toward free trade. True free traders simply did not exist at any policy level.

There are few free traders in the present-day world, no one pays any attention to their views, and no person in authority anywhere advocates free trade (Viner quoted in Capling 2001:19).

The Politics of Free Trade Agreements

In the guise of freeing trade, PTAs have managed to recreate the preferences-ridden world of the 1932 as surely as protectionism did at the time. Irony, indeed! (Bhagwati, Greenaway and Panagariya 1998:1139).

It can be claimed with all fairness that Free Trade Agreements, especially between large and small economies, have little to do with economics and much to do with politics. Opposition to such agreements can easily be misrepresented. Opponents of free trade agreements are often confused with those who oppose free trade on quasi-ideological grounds. These retro-protectionists aspire to channel the flows of trade into patterns they consider fair and appropriate. However, objections to Free Trade Agreements also can be raised based on whether they promote or hinder the wider objectives of free trade itself.

So, FTAs are two-faced: they free trade and they retreat into protection, simultaneously. Of course, those who are used to sound bites and cannot think of more than two words at the same time will

read *free trade area* as *free trade*! So, since clearly the phrase *FTA* is calculated to confuse it with free trade, I have urged over the years, with some success, that economists call FTAs by the phrase *PTAs* [Preferential Trade Agreements], which, at minimum, alerts the public and the politicians to the fact that here we have another species (Bhagwati 2001:107).

The two-faced nature of these agreements is nothing new in the realm of trade policy. In many ways, the current craze for promoting regional agreements harks back to the interwar years. Unlike England, the settler colonies of Australia, Canada, New Zealand, South Africa, and the US had traditionally been heavily protectionist of certain sectors of its economy. Given the changing economic environment, as mentioned above, unilateral free trade, as a policy, had already lost the lustre it once had displayed in the days when England clearly dominated manufactured trade.

The idea of an Imperial Preference System originates with the British Dominions rather than with Britain itself. Canada first extended a remittance of 25 per cent of import duties on all goods of British origin in 1897. This was expanded to 33 1/3 per cent in 1900. In a similar manner, New Zealand extended preferences to British goods in 1903, with South Africa and Australia following in 1904 and 1907, respectively. However, it took the Great War to push Britain towards a version of reciprocal preferences. This structure reached its fruition in 1932 with the Ottawa agreement establishing preferential agreements between Commonwealth and Empire countries. In some sense, the infamous Smoot-Hawley tariffs (1930) acted as a catalyst which created the Imperial Preference system. Certainly, other countries responded to the unilateral impetus of US trade policy. Tariffs rose worldwide and international trade dipped.

As the depression deepened, most trading countries tried desperately to “export unemployment” through tariffs, quotas, and currency depreciations. The United States introduced the Smoot–Hawley Tariff in 1930 in response to pressure from the “Political isolationist forces” in the United States (Harper 1987:69).

Unfortunately, the Imperial Preference System represented more than a simple reaction to a tragically wrong-headed piece of tariff protection. Much of what drove this system would become the underlying impetus for the mushrooming of Free Trade Agreements more than 50 years later. Again, the impetus was to protect certain key economic sectors, as well as boost the security of participating countries. Both parallel approaches to trade policy sought to benefit those

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participating in the agreements, at the expense of outsiders, through a system of trade diversion²⁵. As we will see, the key difference between the two approaches is that while the Imperial Preference System was openly protectionist, such blatant adherence to these policies had become politically incorrect by the 1980s. (In simple language, protectionist measures were politically popular, but only when packaged as something else.) The genius of those who devised these more recent agreements was to spin them as measures to promote trade rather than divert trade, as leading to wider trade agreements rather than creating stumbling blocks for those attempting to negotiate multinational treaties. To understand the limitations of modern free trade agreements and specifically the faults embedded in the Australian–US one, it should prove useful to examine an earlier prototype – namely, the British Imperial Preference System.

One way to get a flavour of the forces pushing for such an Imperial arrangement is to scrutinise a speech presented 1 September 1921 by Ben Morgan to the Empire Club of Canada. Mr. Morgan at the time was the Chairman of the British Empire’s Producers’ Association, a classic self-interested group actively pushing for exclusionary trading policies. His argument rests on two supposedly self evident legs. The first is based on securing key war materials.

What proved our greatest weakness, however, was the lack of an economic policy, with the result that many of the principal key industries were, even in the hour of danger, found to be controlled by enemy countries and enemy organizations, and even the raw materials essential for the conduct of the war and for the daily life of the people were in the hands of foreign corporations (Morgan 1923:216).

The second great principle, not entirely divorced from the first, is basically one of trade and investment diversion. Here we have the typical politician’s view of trade as a zero-sum game. Or more exactly, the approach can best be described as a case where charity begins at home. The industries of the British Empire must come first and be supported no matter what effect this may have on countries outside this preferential zone. Again, there is no sense that such arrangements may harm the preferred members of the agreement, as well as those excluded. The simple idea is that the country that can grab trade and investment away from another, using whatever means, is by definition the country that gains at the other’s expense.

Previous to the war the sugar industry of the Empire, as you know, was languishing under German and Austrian competition. The British

Empire Producers' Organization put a deputation to the government and impressed upon it the serious position of the British sugar industry, with the result that British-grown sugar was given a very substantial preference in the British tariff (Morgan 1923:219).

Now, how is this great instrument of finance being used? And how was it used before the war? The bulk of the capital issued in the first six months on the London market in the present year was for foreign enterprises – and this at a time when we need all our means for the reconstruction work and for developing our industries to enable us to bear the burden of the war (Morgan 1923:219-220).

Unfortunately, the measurable benefits of this preferential approach are more difficult to locate. Australia's role in this arrangement brought far more problems to it than discernable benefits. Australia used the excuse of the 1930 Smoot–Hawley tariff to attempt to correct its trade imbalance with the US.

On balance, the United States sold to Australia between four and six times what it purchased: imports from America formed about 24 per cent of Australia's total imports, and Australia's exports to the United States were about 6 per cent of the Australian total (Harper 1987:68).

As expected, trade was diverted in the form of increased intra-Empire trade but at the cost of growing European resentment and the wrecking of trade with Japan. Nor, as applied, did it do much to shift trade balances.

Japan adopted immediate retaliatory action and in June banned imports of Australian wool, wheat, and flour except under licence and then extended the licensing system to almost all trade with Australia. Australia had made a grave miscalculation about Japanese dependence on Australian wool. Japanese buyers quickly moved to purchase New Zealand and South African wool, and despite a partial reversal of its policy in December, Australia did not recover her lost markets in Japan (Harper 1987:68).

What should have become clear is the lack of leverage small economies have acting unilaterally, as well as the futility of trade diversion. Australia's attempt was a dismal flop.

I do not think our trade diversion policy worried the Americans more than a fly does a horse or a flea a dog. ... A relatively small country

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like this cannot have upon America or the British Empire or the rest of the world the effect that some people here imagine (Gordon Brown quoted in Harper 1987:80)

The lessons Australia should have taken to heart from its dalliance with the Imperial Preference System was twofold. Avoid preferential trade agreements, especially with large economic powers, and in trade matters, focus on multilateral arrangements where even small nations can have some impact. Until the ill-conceived pact with the US, Australia has not been keen on entering the spaghetti bowl of entangling alliances known as free trade agreements.

Quacking Like a Duck – Free Trade versus Free Trade Agreements

... it is worthy of note that FTAs have gone from being a little-used economic device to being a principal tool of U.S. foreign policy, and that is a development worthy of great attention – far more than it has received to date (Mastel 2004:45).

Free trade has been the keystone of US trade policy only when it served US' narrowly defined interests. Free trade agreements, though sounding quite similar, are preferred by US policy makers since they always serve US interests, not only at the expense of those external to these arrangements, but even to US partners in such agreements. What induces smaller countries to sign is the candy US negotiators shrewdly dangle in front of every prospective partner. Relatively easy access to the rich 300-million consumer market (or at least those parts politicians deem acceptable) that is now the US is only possible through such agreements.

Thus, the implied threat is that even the status quo may deteriorate without the safeguard of such arrangements. The policy is clearly one-sided. For the most part, the US is economically unaffected by its trade with a much smaller nation. Need produces negotiations that are badly biased. As a result, agreements promote those economic interests that Washington deems imperative. (These often coincide with those firms who are major campaign contributors.) Equally important is the unquestioning support of US foreign policy objectives. This is a clear contribution of the Bush administration, which seemingly discovered the leverage economic power can provide in a range of negotiations²⁶.

Still, the Bush administration has seemed to inject political and diplomatic concerns – often entirely unrelated to trade and commerce–

to a degree not previously seen. For example, the Bush administration seemed to engage in a rather ham-handed punishment for Chile's failure to support the U.S. invasion of Iraq by refusing for a time to send the U.S.–Chile FTA to Congress for approval. ... Similarly, it has been clear that the motive behind not pursuing an FTA with Australia's neighbour, new Zealand, has been at least in part to punish the tiny country for two decades ago denying the United States the right to dock ships carrying nuclear weapons. ... Beyond these specific instances, the Bush administration's chief trade negotiator, Robert Zoellick, formally listed various elements that could broadly be called "foreign policy compatibility" in his description of the criteria by which the United States selects future FTA partners (Mastel 2004:46-47).

In a similar way, the US has sought to establish de facto intellectual property standards by imposing American requirements sequentially on each of its trading partners through Free Trade Agreements. Again, access to the large domestic US market is to be obtained solely by surrendering locally defined standards, whether or not they are inferior. The US is the dominant supplier of such intellectual property and the US firms that own such properties often are major political contributors to party coffers. In this way, proper delineation between economic, political and strategic security becomes hopelessly, and perhaps deliberately, confused.

To seek some clarity and to understand why these agreements can become tactics in an essentially zero-sum game, we need to start by understanding the way in which such preferential agreements can reach objectives differing greatly from those of free trade. Some simple taxonomy may help clarify the differences attached to differing trade policies.

A free trade agreement (FTA) describes a preferential arrangement in which tariffs are lowered relative to other members but maintained against the outside world. A customs union is a preferential arrangement in which all tariffs among the members are eliminated, while external tariffs are adjusted to a common level. By GATT/WTO rules, the common external tariff must on average be no higher than the pre-union tariff, and "compensation" is negotiated by non-member countries when accession of a member "harms" the non-member. The United States, for example, received compensation when Spain joined the European Union because, inter alia, the United States was disadvantaged with respect to wheat exports to Spain. A common market is a customs union which, in addition, permits free movement of factors of production, like labor and capital among

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the member countries. Finally, an economic union is a common market which additionally has common economic laws covering issues such as standards across members. As Viner (1950) presciently pointed out, the more extensive the coverage and the more complete the reduction in trade barriers, the more political pressures there are likely to be to achieve a “level playing field” with respect to tax treatment, government policies (as, for example with respect to environmental protection), and other issues (Krueger 1999:109).

This is a simple list of categories based primarily on trade in goods and trade in factors of production. Clearly, actual agreements are much less clean cut, mixing elements of all four levels of trade agreement. Such treaties need not limit themselves to matters of goods and services. Inputs, as well as finished products, can flow between borders. Thus, the US has been intently focused on capital flows, forcing both Chile and Singapore to remove all and any capital controls before signing free trade agreements with them.

The US, like many other countries, is less encouraging of labour flows, although the recent free trade agreement with Australia creates a mechanism to enable professionals to ply their trades more easily between countries. Above all, the US has been more than keen to establish its standards as a de facto universal, by leveraging its trade power to negotiate country-by-country agreements. Again, in the Australia/US treaty, the Americans impose their standards in regards to intellectual property as well as quarantine restrictions.

It might be argued that preferential agreements have no rational place in the post-war era of free trade promoted by multilateral arrangements like GATT which are premised on non-discriminatory trade (the most favoured nation requirement). Curiously enough, these clear exceptions are sanctioned by that same GATT agreement in what appears to be an inexplicable loophole, namely Article XXIV.

Under Article XXIV, countries may enter into preferential trading arrangements provided that: (1) the preference is 100%, (2) preferences cover substantially all aspects of trade, and (3) the average tariff barrier against third countries is no higher after customs union (CU) than before (Krueger 1997:169-170).

Two immediate questions arise: why did such an anomaly make its way into a document ostensibly promoting free trade; and what was the rationale for such a clause? These are not the same issue, though it is simple enough to confuse

the two. Bhagwati provides three rationales (1999:7), all of which are variants on the theme that sees preferential trade agreements as stepping stones to the acknowledged greater good of free trade. This, though, seems to be in the nature of an after-the-fact rationale. The insertion of this article most likely reflects an effort to resolve conflicting interests in the post war era.

Though Krueger (1999:105) offers some interesting anecdotes, she is more convincing when citing American/British differences in that period (Krueger 1997:169). Bhagwati (1999:3) also speaks of Keynes' (the chief British negotiator) entrenched opposition to incorporating a non-discrimination principle in an International Trade Agency. In truth, the British (as represented by Keynes) favoured a restoration in some respects of the British Empire, but more particularly the resuscitation of the British Imperial Preference system²⁷. Given this analysis, Article XXIV can no longer masquerade as allowing pragmatic steps toward free trade. Its roots lie deeply buried in protectionist soil. Therefore, any ideas that these preferential agreements represent a natural evolutionary stage toward free trade should be viewed with a great deal of suspicion.

The vagueness of the article, especially paragraph 5(a) which describes external tariffs, seems particularly ambiguous and, more importantly, unlikely to prevent preferential trade agreements from being struck which are clearly detrimental to world trade^{28,28}. In a very useful piece of analysis, MacMillan lays out some of the problems attending Article XXIV.

. In fact, individual national self-interest has insured that no free trade agreement has been challenged or questioned under this clause. Given that all countries seem to be actively engaged in such arrangements or hoping to be so, a mutual atmosphere of tolerance has arisen. This, however, does not reflect in any way the effectiveness of this paragraph or the article in general. Being largely unworkable, the article is ignored in practise. It serves its purpose solely by providing a convenient legitimacy to countries' trade objectives.

It is clearly trade flows that are important, not merely tariff levels, in determining the extent to which a free trade agreement might be detrimental to external trading partners. Nor does this GATT regulation take notice of, or even consider, non-tariff barriers such as voluntary export restraints, anti-dumping procedures, import licenses, or quarantine restrictions. It is quite accurate to say for a preferential trade agreement to improve the welfare of the signatory countries without harming others. This is, after all, the essence of the Kemp–Wan (1999) proposition concerning custom unions. But this is simply an existence proof. Whether countries

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have any incentive to achieve such an objective is another matter entirely²⁹. Moreover, Kemp (2001) demonstrates that a welfare superior custom union can exist relative to any given free trade agreement conceivable³⁰. Both practically as well as theoretically, free trade agreements are inherently suspect.

One major problem with free trade agreements is the lack of common external tariffs which differentiates these agreements from those characterised as custom unions. The way in which this promotes potential protectionism of market sectors is clear. It would be possible to circumvent a given country's trade barriers by going through its trade partner. If then Country A has duties on imported cars of 10 percent while Country B imposes levies of 20 percent, the simple solution is to export to Country B via Country A. To close this loophole, countries with higher duties demand a formula for deciding whether a good or service should be considered to have been manufactured in a given country. These rules of origin (ROOs) use some agreed-upon formula based on weight, value added, or some other common measure. The problem is that not only do such rules create added costs (estimated at 3 percent of total cost), but they also create the opportunity to protect domestic industries through backdoor rather than direct measures. Given a sufficiently restrictive formulation, any product or good can be effectively barred from or highly limited in its entry to a domestic market. With the potential gains at stake, standard rent seeking ploys by the affected industries should come into play³¹.

... the fact that ROOs must be established under an FTA provides domestic producers with an opportunity to lobby for protection in a relatively straightforward, and hardly transparent way (Krueger 1997:179).

Moreover, such rules can distort international investment as well. As pointed out by Krishna and Krueger (1999:555), "ROOs tend to lead to FDI [foreign direct investment] in the lower-cost country in the FTA, as this provides access to the FTA market at a lower cost to the investor." Clearly, this does not occur by any necessity in the most efficient international producer, as would be the case in multilateral trade arrangements.

Looking more broadly, there are essentially two fundamental problems with free trade agreements as there are with any preferential trade arrangement. The fact that both have largely been dealt with by summarily dismissing them indicates that these two issues go to the heart of the problem and in fact distance these arrangements from those that clearly promote free trade.

Preferential trade agreements, whether FTAs or custom unions, not only create trade between member nations but also divert trade away from non-members³². The final result in this struggle between trade creation and trade diversion is far from obvious. This is one of the many questions that can only be decided by empirical research or specifically by measuring the change in trade flows that such agreements engender.

A simple example should clarify the issue. Suppose the US can buy shirts of equal quality and fashion from either Mexico or China. Shirts from Mexico cost \$22 while those from China run \$20. Given an existing tariff of \$4 per shirt, Americans would prefer to purchase the shirts exported from China. Next, let a free trade agreement be signed between the US and Mexico removing tariffs on shirts. Export flows of shirts are diverted from China to Mexico. Certainly, consumers can now purchase shirts for less than before (\$22 for the Mexican shirts rather than the \$24 including tariff from China). However, the government collects \$4 a shirt less revenue. True, the choices of consumers are no longer as distorted as they were with the imposition of the tariff, but they would certainly be better off if shirts were imported from China sans tariff. It is not at all clear that the overall welfare of the US has been lifted. In addition, foreign investment decisions are distorted as capital flows into shirt factories in Mexico rather than their more efficient counterparts in China. The Viner problem of trade diversion versus trade creation remains an empirical one, not to be dismissed by fiat.

Viner thus threw a spanner in the works for those who believed that any move, even preferential, towards free trade was welfare-improving. As we see the frantic rush to form ever more PTAs, this lesson is clearly forgotten and the erroneous pre-Vinerian intuition has returned to center stage. It has been aided also by unsupportable arguments in favour of such an “unarchitectural” and technically regressive approach, embracing all forms of trade liberalization as equally good, by economists of the enormous calibre of former U.S. Treasury secretary Larry Summers, who has argued that trade diversion is a distraction best discarded from policy debate (Bhagwati 2002:108).

The other much-debated issue questions whether preferential trade agreements, including the increasingly popular free trade agreements, are building blocks or stumbling blocks on the way to increasingly widespread multilateral free trade. Those who see even bilateral agreement in this positive light not only judge such policy initiatives to be better than nothing, but in fact to be part of an evolutionary process. Each agreement is a small step, but an essential one that

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inevitably draws nations as though by a centrifugal force into wider-ranging trade agreements.

If the bloc [trading bloc] enlarges, the cost to the non-members increases, since they now face a cost disadvantage in an even greater number of markets. This second-round effect will bring forth more pro-EU political activity in non-members, and thus may lead to further enlargement of the bloc (Baldwin 1999:500).

A similar idea views large economies as exerting what is in effect a gravitational pull. Small countries are motivated to do their best to lock in the benefits from these altered trading regimes. Competition brings in increasing numbers of these small countries to cluster around the large economy acting as a type of prime mover. Ethier (1998) presents the clearest version of this analysis, in effect dismissing out of hand any Vinerian type of problems.

An individual regional arrangement may by itself do more harm than good. But widespread regionalism of the sort we are experiencing in effect internalises a critical global externality and produces an outcome superior to that obtainable by multilateralism alone (1160).

Part of the popularity and support for this type of regionalism simply reflects an impatience with attempting to craft multilateral agreements. Countries like the US want trade benefits now and also want gains that are clearly favourable to US interests.

The “Memorial Drive” school³³ holds that GATT is dead (Thurow:Davos) or that GATT should be killed (Dornbusch). Regionalism is then presented in effect as an *alternative* to multilateralism. This school, aptly named in view of its funereal approach to multilateralism, has influence in Democratic circles and plays to the prejudices that one finds in Congressional circles that mistakenly identify multilateralism with America’s postwar altruism and regionalism ... with the presumed current necessity finally to “look after one’s interest.” (Bhagwati 1999:10-11).

In all of these explanations supporting preferential trade agreements as stepping stones to improved trade policy, the idea that such agreements inexorably lead to free trade has the same aspect of deliberate ingenuousness that characterises the idea of forcefully compelling a nation to be democratic. Discussions of these

issues unfold with a sense of grim seriousness and are conducted with unbending straight faces universally devoid of even the slightest twinge of irony. Endowed with strong a priori knowledge of expected results, objections are exiled with a tap of the keyboard and objectors ostracised from polite society.

However, the view that these free trade agreements might in fact be stumbling blocks should be too compelling to dismiss if we confront the problem without any prior beliefs or sworn convictions.

Clearly, regional trade agreements are ruled by rent-seeking agents. It should also be somewhat obvious that those within a large economy will have more success in influencing the outcome of a bilateral negotiation process (especially with a small country) than in determining the result of complex multilateral agreements. Rent seekers overwhelmingly should prefer vehicles like free trade agreements to multilateral ones. Once in place, shifts away from these collections of free trade agreements to multilateral ones should involve changes antipathetic to vested interests who gain their rents through implicit protectionist measures. It is fair to expect any move away from this FTA status quo to be blocked by these same interests that were instrumental in establishing the original trading arrangements.

Levy ... has shown that in a standard trade model, bilateral trade agreements can never increase support for multilateral free trade and are likely to generate the most opposition when the factor endowments of the partner countries are similar. Even export interests will provide less political support for multilateral liberalization, once they have already gained access to additional markets within a preferential trading agreement (Krueger 1999:117).

There is also the closely related ‘spaghetti bowl’ problem³⁴. The image as expressed by Bhagwati is clear:

... I remarked that the situation was turning into a “spaghetti bowl”: a messy maze of preferences as PTAs formed between two countries, with each having bilaterals with other and different countries, the latter in turn bonding with yet others, each in turn having different rules of origin ... for different sectors, and so on. I called it a spaghetti bowl because it is an unruly mass of criss-crossing strings that, in any case, is beyond my capabilities (Bhagwati 2002:112-113).

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This complexity problem, the not unexpected result of vested interests at work, make it increasingly difficult to rationalise such an intricate set of rules without having some (if not all) of those interests bear undesired costs. To reiterate, free trade agreements create disincentives to change, producing stumbling blocks to any attempts at multilateral treaties.

The biggest problem with those who push free trade agreements as the logical off ramp to free trade is that there is no clear link or compelling evidence that a strong motivation exists for those who negotiate regional or preferential agreements to move toward multilateralism. The logic here is parallel to those 1930s films that saw smoking marijuana as a first step leading inevitably to heroin use. What tends to be forgotten is that the goals and incentives motivating countries to negotiate free trade agreements may be in conflict with those leading to free trade.

The Godfather Gambit – Understanding the Australia/US Free Trade Agreement

My father made him an offer he couldn't refuse (Michael Corleone in *Godfather*, 1973).

In 1997, Australia passed up the chance to strike a free trade agreement with the US. The importance of the Australia–US alliance was clearly recognised at the time.

Australia's alliance relationship with the United States is an asset both redefined and strengthened by the end of the Cold War. It is a central component of Australia's defence and continues to provide Australia with beneficial access to technology, military equipment and intelligence (1997 White Paper on Foreign Affairs and Trade quoted in ACIL 2003:19).

Yet politicians of the time felt no compulsion to become entangled in a trade agreement with the world's dominant economic power. The reason for this reluctance becomes clearer given the Australian assessment of US motives.

US trade policy will be an important factor in determining the effectiveness of its leadership in the Asia Pacific and globally. The United States will remain a critical force for regional and global trade liberalisation. At the same time, it is likely to continue to pursue reciprocity in trade arrangements, and future US Administrations can be expected to follow an aggressive approach to opening markets

using all available mechanisms to induce its trading partners to adopt measures which suit the interest of US business (1997 White Paper on Foreign Affairs and Trade quoted in ACIL 2003:19).

Some seven years later, the government of the day (comprised of the same political coalition and led by the same prime minister) would imply that opposition to a free trade agreement with the US was roughly equivalent to a virulent form of anti-Americanism. Potential economic gains were touted by Trade Minister Mark Vaile as being as large as \$A57 billion, including the creation of some 30,000 new jobs (Banham 2005:1). On the surface, such a dramatic switch makes little sense. Certainly US objectives hadn't changed. It was still quite true that in one-to-one negotiations, the US would always hold all the cards.

Experience from the time the GATT was created in 1947 shows that in practice Australia has little negotiating coin. Offers of access to the Australian market carry little weight with governments concerned about their own domestic agricultural politics. ...the likely drivers of liberalisation for Australia's exports will be domestic politics in overseas countries, and to a lesser extent international strategic considerations, and not what Australia "offers" (ACIL 2003:14).

Australia went into negotiations knowing that it had very little leverage. Though the US had entered into only a few such preferential trade agreements, its strategy had been consistent throughout.

... the rise of the FTA as a foreign policy tool is perhaps inevitable. It is one of the most widely desired carrots the United States has to offer. As a result of the large and attractive U.S. market, access is a significant inducement to other countries. The FTA is the most significant and credible (and increasingly widely used) carrot in the U.S. foreign policy arsenal. FTAs do allow the United States to harness the strength of the U.S. economy directly to move other countries on foreign policy issues (Mastel 2004:48).

The US has a domestic negotiating advantage as well. Like most countries, attention need be paid only to producers since consumers tend to be poorly organised and more dispersed. If by keeping out Australian sugar, consumers are penalised, they are likely to remain unaware of this fact, while US cane growers limited to such key electoral states as Florida are well aware of the potential dangers and will lobby to maintain privileges. As an extension of this idea, gains to the US from such a relatively small economy as Australia are so limited that the terms of the agreement

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are unlikely to affect most Americans. In fact, very few amongst the population will be aware that an Australian–US Free Trade Agreement exists³⁵.

The aims of the US when negotiating a free trade agreement remain twofold. One is the use of trade agreements as an extension of foreign policy. Countries are allowed degrees of access to the lucrative US market in return for their support of US policies³⁶. Economically, as expected, the US uses these preferential agreements to push the interests of key US export and investment sectors. The form this takes is to establish de facto standards by co-opting smaller countries one by one. Thus the US, being a major exporter of goods and services based on intellectual property, has attempted to internationalise US approaches to intellectual property rights. This means going beyond the current World Trade Agreement on Trade-Related Aspects of Intellectual Property (TRIPS), itself heavily influenced by US aims³⁷. Each country that yields to US pressure becomes a precedent for the next. In this way, with the US holding negotiating leverage, the rest of the world can be recreated in the desired American image. In multilateral arrangements where coalitions of smaller countries can mount an effective defence, such US-biased standards are not as easily imposed.

The US then has not so eagerly entered the realm of preferred trade agreements in order to foster the role of free trade. To think otherwise is to accept US intentions at face value. As pointed out, the US transformation into the leading post-war free trader was simply opportunistic. It was a cloak easily shed when the US absolute advantages in trade matters eroded. Though the US still puts itself forward as a warrior for free trade, its actions belie its assertions. The history of US attempts to forge free trade agreements suggest that they have always been seen as extensions of foreign policy rather than driven by an economic vision of reciprocal wealth creation. Americans came late to the preferred trade party but tipped their hand almost immediately.

Those who like to think nice thoughts will claim that the US was forced to resort to this second-best alternative in the 80s when any sort of viable multilateral approach stagnated with the end of the Tokyo Round of trade negotiations in 1979. However, America's increasingly protectionist stance in the face of Japanese competition raises doubts as to how anxious the Americans were to resume multilateral engagement³⁸. Finally, the choice of trading partner for the first US FTA in 1985 makes clear the political, rather than economic, nature of these treaties.

Israel and the US as trade partners ring no obvious economic chimes. Clearly, a country like Israel would have minimal impact on total US trade, even

if that trade should be noticeably expanded. In other words, no compelling economic reason exists why Israel should be the first recipient of a Free Trade Agreement rather than numerous other possibilities. Clearly, Israel has benefited over the twenty years of increased trade with the US. Then again, how much of this represents trade diversion from European markets is unclear. Nor is it clear whether trade with the US holds more opportunities than opening up the forbidden markets of the Middle East. The only credible reason for such a treaty lies in its foreign policy and domestic political considerations.

The early 80s comprised a particular rocky period in US/Israel relations with the attempt by the US during the early Reagan years to take a more balanced approach to the Middle East. The pro-Israel lobby suffered some rare setbacks in Congress. This was the period of Israel's invasion into Southern Lebanon and the failure of the US peacekeeping force there. Against Israeli lobbying, the US sold AWACS to Saudi Arabia while Israel in turn rejected out of hand the Reagan peace plan for the Middle East. Nor did Reagan visiting Bitburg cemetery in Germany, a site of Nazi SS graves, do anything to soothe relations abroad or woo domestic voters. Simply put, the US was in need of some policy initiative to appease ruffled Israeli sentiments as well as provide some domestic offset for the pro-Israel lobby. A Free Trade Agreement was a relatively low-cost approach to allay the fears of an ally.

In the same way, a Free Trade Agreement with Jordan reflected a conscious attempt to reward Jordan for remaining a faithful US ally over many decades. Like Israel before it, Jordan also reaped substantial economic gains out of this free trade agreement. Exports grew from \$4.1 million in 1998 when the US granted Jordan its first tariff concessions to \$133.3 million in 2003³⁹.

The experience of Jordan has no doubt encouraged countries around the world to look to an FTA with the United States as a path to economic growth. Certainly, many countries would seem at least as well situated as Jordan to benefit from an FTA with the United States (Mastel 2004:50).

To once again reiterate a key point, smaller economies eagerly seek Free Trade Agreements with the US for fear of losing access to the US market as well as potential US overseas investment⁴⁰.

There may be other real and perceived gains as well. Some countries may perceive stronger ties as being in their interest because an FTA

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might connote a U.S. investment in the country, which may result in financial or even military support in a crisis (Mastel 2004:50).

It is easy to understand why Australia would be caught up in the frenzy surrounding a Free Trade Agreement with the US. Moreover, the Howard government might naively reason that the US would be willing to be generous with its terms. Namely, this was to be the reward for Australia's staunch defence of US foreign policy under Bush. Only the British also provided troops for the invasions of both Afghanistan and Iraq despite the lack of public enthusiasm for such adventures.

Australia, in this case, seemed to misunderstand US motivation when negotiating such agreements. An agreement would have little if any impact on the US economy, at least directly. Nor was there any political advantage to be gained through such an arrangement. Under such circumstances, clearly, US vested interests would need to be placated. The US had no incentive to provide Australia with a good deal at any time in the negotiations.

For the U.S. economy as a whole, however, a U.S. Australian FTA – the largest currently under negotiation in terms of volume of trade affected – is likely to have a limited impact on the United States. In fact, in its recent analysis of FTA possibilities, the International Trade Commission concluded that none of the possibilities being considered would have more than a 0.5 percent cumulative impact on U.S. GDP (Mastel 2004:51).

A shrewder Australian negotiating team should have, from the very first instance, been well aware that Australia had very little to gain from such an arrangement no matter what latter-day spin and hype the government of the day chose to attach to it. This can be easily demonstrated using two sets of criteria for gains from trade arrangements.

The first checklist is courtesy of Lawrence Summers (1999) in a paper originally published (1991) before he became a hired cheerleader for the Clinton Administration. In a somewhat stunning dismissal of nearly four decades of work dealing with the potential problems attached to regional agreements, Summers finds good in almost all such trade arrangements.

I therefore assert and will defend the following principle: economists should maintain a strong, but rebuttable, presumption in favour of all lateral reductions in trade barriers, whether they be multi, uni, bi, tri, plurilateral. Global liberalization may be best,

but regional liberalization is very likely to be good (Summers 1999:562).

Both Krueger (1999) and Bhagwati and Panagariya (1999) argue forcefully against some of the more glib aspects of Summers' (1999) argument. Nonetheless, it may be useful to look at Summers' (1999:562) four propositions and see if it throws any light on the likely success of an Australia–US Free Trade Agreement. In essence, does this analysis point out potential areas of gain or rather indicate the lack of opportunity of success from the very start of negotiations?

- Plausible regional arrangements are likely to have trade-creating effects that exceed their trade-diverting effects;
- Even trade-diverting regional arrangements may increase welfare;
- Apart from their impact on trade, regional trading arrangements are likely to have other beneficial effects;
- Reasonable regional arrangements are as likely to accelerate the general liberalization process as to slow it down.

The first point assumes that there are certain natural trading partnerships due to propinquity or some type of complementary match in the items traded. The classic example is US and Canada, with the Canadians shipping raw or semi-finished materials to the US. We can then judge the potential of a potential US–Australia agreement by examining the nature of Australian Trade and the countries with which they trade⁴¹.

Table 1. Australia's trading partners - exports

Regions	1985-86%	2003-2004%
Rest of developing Asia	16	24
Japan	25	16
Europe	16	15
United States	12	10
China	4	8
New Zealand	6	7

Gittens 2005:42

It should be clear that for Australia, Asia is the prime focus for export markets (Table 1) with the US declining in importance. Moreover, the major exports to the US are agricultural, namely, meat and edible meat offal (18.5%); and beverages, spirits and vinegar (9.7%). Most mineral and fuels go to Asian markets. Major

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export services like education and tourism are also focused on the Asian market. If new markets in the US were to open up at all, the reasonable expectation was that these would be agricultural in nature. This limitation boded ill for any Australia–US deal from the very beginning. Access to other countries’ agricultural markets has been heavily limited leaving Australia’s rural exports to fall in relative importance. The two particular farm markets where Australia placed most of its hopes (sugar and dairy) were those with the highest levels of historical protection⁴². Moreover, US moves to liberalisation had been thwarted quite recently by the US Farm Security and Rural Investment Act 2002 passed on May 13, 2003.

Despite US statements to the contrary, the new Farm Act cannot be reconciled with a policy of agricultural liberalisation. It represents a response to political pressures from domestic farm interest groups which have been exacerbated by falls in some agricultural prices (ACIL 2003:7).

It was clearly unlikely that Australian negotiators would gain much. The reality was even more disappointing as shown below (Table 2).

Table 2. Agricultural payoffs

Australia	United States
Removal of all tariffs, quotas, seasonal restrictions and subsidies from day one	Many of its tariffs, quotas, seasonal restrictions and substantial subsidies remain
No tariffs remain	Tariffs remain in place for key sectors like wool (10 years), wine (11 years), steel, as well as beef, dairy, horticulture and cotton (18 years)
No import safeguards negotiated	If Australian exports to the US rise too quickly or Australian prices become too competitive against the exchange rate, the US can slap tariffs back on
No seasonal restrictions	During Australia’s peak production times of certain horticultural products (like avocados), Australia is allowed to export only a limited amount to the US
Severe restrictions on the US sugar imports	No restrictions on importation of Australian sugar remain in place

Weiss, Thurbon and Matthews 2004:7

Summers' second point is equally suspect. As even he admits, "Only where trade diversion involves replacing efficient producers with inefficient producers is it a problem⁴³." (1999:564) But it is difficult to see how much of the increased imports from the US will not come in the form of trade diversion from Asian suppliers. For the most part, current Australian tariffs are so low (an average of 3.8%) as making their removal negligible for trade flows. Given that these tariffs are mostly under 5% and that establishing rules of origin can cost up to 3% of product price, the Australian gain from removing these tariffs are not worth contemplating. It is true that textiles, clothing, and footwear run up to 25%, with most being 10%, while cars also have a similar 10% tariff. But even on these items, it is hard to see what gains a Free Trade Agreement would yield. Textiles, clothing, and footwear for the most part can be better sourced from Asian suppliers. Any noticeable US gains in the Australian market would represent, for the most part, a clear case of trade diversion. Given the difference in right-hand versus left-hand drives, imported US cars are a non-issue. The difference, if any, must come in the realm of parts. But here too, this would likely seem to be a case of trade diversion except in the case of engines and drive trains. Some gains might accrue to Australian consumers, but given the already low tariffs, these wouldn't be significant.

Summers' third point speaks eloquently to the case where more competitive and efficient standards are adopted as the result of a free trade agreement. Would this were the case with the Australia-US one. Given US aims, it was once again highly unlikely that the result of negotiations would be favourable. It could be argued that Australia's quarantine restrictions were no more than implicit barriers to entry. It is quite clear that such standards can be and have been used by countries for this exact purpose.

Unfortunately, it is not unquestionably the case for Australia. Given the importance that agricultural exports play and the fact that Australia is clear of a number of pests and infestations, it makes obvious economic sense to maintain stringent controls on agricultural imports. This naturally conflicts with US aims to establish standards conducive to the interests of key export sectors. The logical consequence of this approach would be to knock down contrary quarantine standards country by country, with each victory creating a precedent for the next. Driven by US agricultural interests (a group with strong lobbying leverage in Washington), free trade agreements would accomplish what couldn't be done through the WTO Agreement on Sanitary and Phytosanitary Measures with which Australian standards comply⁴⁴. In negotiations, the US could successfully circumvent this treaty despite the stance taken by the Australian Minister for Trade prior to concluding the free trade agreement.

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I make no apologies for our conservative level of protection. As an island continent we are free from many of the pests and diseases prevalent in other parts of the world and our quarantine regime is designed to ensure that we stay that way ... Quarantine decisions in Australia are, and will continue to be, made by AQIS [Australia Quarantine and Inspection Service] in an impartial and objective manner – based on science ... as a nation that exports two-thirds of its agricultural produce, strong science-based international rules on quarantine – as exhibited in the WTO SPS Agreement – are very much in our national interest ... Let me be very clear on this. Quarantine barriers are not something that the government will trade off for any reason – be it in response to political pressure or to gain better market access for some other commodity (Mark Vaile, Minister for Trade, quoted in Weiss, Thurbon and Matthews 2004:31).

If anything, US intentions behind a free trade agreement become even more transparent when dealing with issues of intellectual property. Economically speaking, intellectual property rights are the key drivers behind current US efforts to expand its web of free trade agreements. The flows of services obtaining from intellectual property rights can be argued to be the key to future economic dominance. The US is a net exporter of the goods and services that flow from these rights. The current US system of patents, copyrights, and trademarks represent the triumph of vested interests over economic efficiency or innovation.

The only justification for a copyright that runs 70 instead of 50 years is simply to create extra rents for the owners of the intellectual property. There is no clear evidence, or perhaps evidence of any kind, that such extended rights create more or higher-quality output. It is this aspect of the Free Trade Agreement that should prove most costly to Australia over the long run, creating cash flow for US firms without any discernable benefits for Australians⁴⁵. It is useful to classify the problems associated with imposed US standards by using four categories described by Roger Clarke (2004:5):

- Extension of the already very long life of copyright by 20 years;
- Enormously increased powers for copyright-owning corporations, enabling them to disturb business, attack normal consumer practices, and suppress information;
- Draconian requirements of Internet Service Providers which would be burdensome for those businesses and intrusive to the activities of business and consumers;

- Issue of patents for mere descriptions of business processes, which is completely at odds with the very notion of patents and seriously constraining on the conduct of business⁴⁶.

Clearly, there is no economic justification for imposing US standards in the realm of intellectual property. If we assume the scepticism that characterises the rent-seeking framework in economics, these US regulations seem to bestow lucrative rents on certain key US corporations. Given that the same corporations tend to be major political campaign contributors, we have the type of linkage that would warm the soul of George Stigler and his colleagues.

In the US there is a whole industry built around suing software developers for copyright and patent infringement, and in using the legal system to suit the requirements of the rich and powerful. We've seen evidence of this in recent attempts by US computer companies to bully the CSIRO into giving up the rights for wireless communications technology (Philipson 2005:5).

In much the same way, the big pharmaceutical companies use US free trade agreements as a mechanism to insure higher prices in foreign countries. Again, the strategy is to pick off country by country until a de facto universal standard is in place. Pharmaceutical companies have long asserted that what the general public may see as excessively high prices merely reflect the research risks borne in developing therapeutic drugs. This is, of course, what such corporation could be expected to claim whatever the validity of such statements.

Unfortunately, evidence is at best of a more mixed variety. Whatever virtues attach to this drive for universal higher prices, the impact of the Free Trade Agreement on Australia's pharmaceutical market is much less ambiguous. This is so despite last-minute changes that lessen the ability of patent holders to extend their property rights and to undermine the ability of generic versions to compete. The three major changes to current pharmaceutical policy under the Australia-US Free Trade Agreement are (Weiss and Thurbon 2004:20-21):

- The explicit prioritisation of policies that support and reward the 'innovation' and 'research and development' activities of pharmaceutical companies;
- The creation of a new review process to independently assess contested listing decisions of the Pharmaceutical Benefits Advisory Committee;

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- The extension of pharmaceutical patent protection via new data protection measures and measures relating to delays in marketing approval and the marketing of generics.⁴⁷

The possible and, unfortunately, probable outcomes of these provisions are (Weiss and Thurbon 2004:21):

- PBS determinations will be compelled to reward ‘innovation’ at the expense of the fundamental goal of ensuring the affordability of therapeutically effective medicines for Australians⁴⁸.
- The new ‘Transparency’ measures will favour the ‘non-transparent’ costing claims of the drug companies. US pharmaceutical companies will manipulate the review process in their quest to have their drugs subsidised. This will result in wastage of public funds in order to subsidise fictitious innovation costs.
- Patent extensions will significantly increase the financial burden of the PBS and delay the entry of generics in the Australian market.
- Australian drug prices will rise by a substantial amount.

Strong clues that these aspects in the Free Trade Agreement are meant to shift concerns in Australia’s Pharmaceutical Benefit Scheme from consumers to producers are best indicated by what is missing from this agreement and the source of its strongest support.

The PBS has always based its drug listing on the criteria of universal access, cost-effectiveness and therapeutic value. Now, however, these criteria are to be reversed, overturning 50 years of public health practice in Australia. Instead, under the FTA, the PBS will be forced to prioritise policies and decisions that reward the ‘innovation’ and ‘research and development’ activities of pharmaceutical companies. In fact, the traditional goals of ensuring the affordability of therapeutically effective medicines for all Australians are *entirely absent* from both Annex 2-C⁴⁹ and the ‘Exchange of Letters on the PBS’ between Minister Vaile and USTR [United States Trade Representative] Zoellick (Weiss, Thurbon and Matthews 2004:63).

In hearings on the FTA conducted by the US Senate Finance Committee, on 9 March 2004, there was the forthright suggestion made that Australian PBS prices of patented drugs would increase as a result of the FTA. Senator Kyle

[Arizona] congratulated the US Trade Representative, Robert Zoellick, on having secured an agreement that would deliver higher prices paid by the PBS for US-patented drugs. This is the clear understanding of the deal in the United States (Weiss, Thurbon and Matthews 2004:69)⁵⁰.

Reverting to the list of requirements provided by Lawrence Summers, his last point is a bit more equivocally stated than most FTA advocates would prefer. As pointed out in the previous section, claims that a tractor-like beam draws countries step by step from small regional arrangements to multilateral agreements seem to be a triumph of hope over reality.

... we must not forget that politicians, and much of the media, often do not understand the distinction between Free Trade and Free Trade Areas: they hold pre-Vinerian 'all-trade-is-good' views for the simple reason that they have not been taught the distinction (Bhagwati, Greenaway and Panagariya 1000:1146).

Summers wants to hedge by saying that such agreements can do no harm to future multilateral agreements. Given other possible gains from these arrangements, arguments against them must not fully hold water. However, even Summers' mild plea for neutrality may be overstepping the mark. Any government only has so many resources to expend on trade matters. Given the increased focus on achieving free trade agreements, would that not make the case for multilateral arrangements less than compelling? This would be reinforced if countries weighed the difficulty of reaching multilateral agreements against the more straightforward case of free trade agreements.

Clearly, this is an issue that can only be resolved in any conclusive way through resort to empirical data. Still, if prior to such detailed examination, we were to look at a reasonable subjective probability, the odds would most likely lean to such arrangements acting as a stumbling block. Certainly, the case can be made that the pursuit of such preferential arrangements has diverted the attention of Australian policymakers.

The failure of the Australia-US free trade agreement is made even more self-evident if we look at a somewhat different checklist put forward by a clear opponent of such treaties, Jagdish Bhagwati (2002:35-36).

- Increased exploitation of economies of scale
- Enhanced diversity of choice among differentiated good

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- What Harvey Leibenstein used to call x-efficiency (i.e., the effect of competition through openness on pressuring firms to upgrade the productivity of their resource use instead of ‘goofing off’),
- The demonstrated possibility that trade can be a conduit for know-how that can (as with a public good) be appropriated without acquisition cost, and
- Increased efficiency of capital, leading to enhanced productive investment, thanks to integration into world economy.

Most of the points in the list obtain in situations where major impediments to trade exist. This can hardly be an accurate description of the conditions relevant to Australian–US trade prior to the free trade agreement. It is then highly unlikely that this treaty would have opened up possibilities for sectors of either country to achieve economies of scale previously. For the US, of course, the Australian market is simply too small to make a difference in terms of economies of scale. The only potential gains would be on Australia’s part. Yet even a modicum of consideration would show the unlikelihood of this occurring. In most cases, it isn’t feasible. Where feasible, the US is careful to forestall any practicable inroads.

For instance, the Free Trade Agreement supposedly opens the \$US 314 billion market for supplying goods and services to US state and federal agencies (Banham 2005:1). The reality is that the US retains a number of set-asides, particularly for American small and medium enterprises. It is here where Australian firms might be most competitive and it is here where entry is made most difficult.

Mr. Hudson [trade lawyer] said the best chance Australian companies had of picking up contracts with US Government agencies was to offer “unique niche products” (Banham 2005:1).

Where Australia has a unique product, such as its fast ferries, US law makes it virtually impossible to sell into that potential market. Given that for Australia, gaining economies of scale may mean buying at least some foreign made components, the standard complex rules of origin⁵¹ that attach to any free trade agreement will essentially shut the door on Australian goods if an attempt to gain economies of scale is successful.

Moreover, what in the past has deterred Australian expansion into the US market both prior to and after the Free Trade Agreement was signed with the sunk cost investment required.

... Mr. VanGorder [vice-president of the Washington Management Group] conceded that it would be difficult for Australian companies to make inroads into US markets without having staff based in America and “sales people who can reach out to customers directly” (Banham 2005:1).

It should then hardly come as a surprise that nine months since both parties signed the agreement (October 2005), few Australian companies had taken advantage of this vaunted opening up of the US government procurement system. This may simply indicate that no significant opportunities were, in fact, created.

Bhagwati’s second point is not worth lingering over. The agreement doesn’t open the floodgates for new products or new competitors, either on the Australian or the US side. The few exceptions may be US agricultural products previously blocked by quarantine restrictions and some pharmaceutical products that may gain speed in dissemination, depending on exactly how the trade agreement affects the Australian Pharmaceutical Benefit Scheme. However, as discussed previously, it is unclear that Australian consumers will necessarily benefit from these changes.

The x-efficiency point (Bhagwati’s third) is relevant when trade agreements open up domestic markets to greater competition. This is not noticeably the case regarding the Australian–US Free Trade Agreement. To reiterate, in those markets like agriculture, where Australia is more than competitive with the US, those same markets have been closed off or will be opened at a snail’s pace. US consumers should notice no benefits accruing from this treaty. On the other hand, Australian markets prior to this agreement have largely been opened to US trade. No significant increase in beneficial competition could be expected from this treaty.

One exception might be in opening up Australian government contracts. Here, US providers facing open competition may push Australian competitors into becoming more efficient, or withdrawing from the market altogether. However, this result could have been achieved unilaterally. Such routes are almost by definition more efficient than negotiated ones.

Bhagwati’s last two points are best taken together. Prior to the agreement, virtually no constraint existed on US investment flows into Australia. The ostensible limitations were mostly pro forma. As opposed to the US where pressure is applied for national security reasons (the sale of Conoco to Chinese oil interest or Westinghouse to Mitsubishi), it is difficult to recall a recent incident of foreign investment being blocked by government decree. The only significant limitations on

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investment have come in the areas of aviation and media ownership. But here, the size of the marketplace itself represents the chief limitations. Foreign firms may buy existing Australian assets in the airline or media markets. But it is unlikely that there is much room for new entrants into these markets, or that American firms would be interested. Right now, the domestic market for air travel seems fully competitive, at least as far as price levels represent a reasonable indicator. To generalise this logic, any increased investment into Australia from the US is likely to take the form of buying existing assets. Given that such mergers or takeovers tend to have a relatively low rate of success (as indicated by share price), it is difficult to see what the new trade treaty has to offer Australia in terms of investment policy.

Lastly, we should not forget that trade diversion often can lead to investment diversion as well. The opening up of a backdoor conduit into the US market could possibly make Australia artificially attractive for certain capital flows. In this way, investment ends up diverted from its most efficient use.

Whether we use the checklist of an unquestioned supporter or opponent of these agreements, the Australia–US pact clearly lacks any redeeming value. The negotiating starting point for Australia was that the US owed Australia something for all its unquestioning past support. In international agreements, nothing is owed. The only issue at stake in such arrangements is the power of each side to carry out (or ignore) the basis of such contracts.

Anything Goes – Achieving Old Aims by Reupholstering Familiar Furniture

In olden days a glimpse of stocking
Was looked upon as something shocking,
But now, God knows,
Anything goes (*Anything Goes* by Cole Porter).

No government has ever fully bought the theory behind free trade. England, from 1860 to the First World War, espoused its principles while being motivated more by Mercantilist reasoning. The US assumed the mantle of free trader in the post-war period but quickly lost interest as its absolute trading advantage ebbed. Politics is often a very pragmatic profession, interested in immediate results rather than theoretical outcomes. Trade has always been looked upon as a means to an end by political leaders. In a rather single-minded fashion, trade has been simply a mechanism by which one state could dominate another. Large economic states compete to bind smaller countries through their existing economic leverage.

... as part of the bilateral quid pro quos in an FTA or a CU, weak states may agree to specific demands of strong states, in ways that are not exactly *optimal* from the viewpoint of the economic efficiency of the world trading system. In turn, however, these concessions can distort the outcome of the multilateral negotiations (Bhagwati 1999:24)

Success extends that leverage. The objective in pushing forward Free Trade Agreements, such as the Australia–US one, is to create an environment conducive to the specific American economy. Japan has followed a nearly identical agenda in its trade policy, with China eager to follow the same route. In effect, these large countries want to create a quasi-empire via a hub-and-spoke system where all roads (trade routes) lead to the US (or Japan or China). Using free trade agreements encourages two distinct strategies. One imposes de facto standards (such as those revolving about intellectual property rights). The other constrains independent foreign policy by imposing economic dependency. The two are not unrelated.

Large economies entering the race to nail down as rapidly as possible such preferential agreements immediately cast doubt on their role as free trade catalysts. As shown, the intention is simply to further broadly defined foreign policy aims. Every aspect of trade becomes a bargaining chip; a hostage to national objectives. To act unilaterally to extend trade is dismissed as foolishly throwing away valuable chips without extorting any benefit in return. Even regional agreements between smaller nations are suspect. They tend to distract the focus of these countries away from more complicated multilateral agreements by convincing them that these deals, despite problems of trade diversion, are a practical alternative to more desirable resolutions⁵².

When negotiating with a large economic power, it is best to remember that such countries cannot be held accountable for their actions. In such one-on-one negotiating stances, large countries see no reason to compromise. Forgetting this led Australia to make fundamental mistakes in its negotiating strategies. Buoyed by its staunch support of US foreign policy, Australian negotiators made the rash assumption that the US would feel obligated. The Australian government, anticipating a more favourable outcome, oversold the importance of such a treaty. They viewed this free trade agreement as an accomplishment to justify unpopular foreign policy initiatives. Given the nearing election, Prime Minister John Howard and his ministers essentially boxed themselves in. They felt incapable of walking away despite the dubious advantages of the final document. The choice was to

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attempt to spin a potential liability into an asset. In this way, preferential trade agreements become packaged as free trade, and free trade, in turn, becomes synonymous with economic prosperity.

What can we say more than on the subject, than that since the only real wealth of a country is that which proceeds from a full employment of its industrious population, whenever free trade gives this, it is beneficial; when it does not, it is detrimental. Remembering, however, that “we must not change a prudent doubt, for an insecure conclusion.” (Cayley 1997:269).

Notes

- ¹ From a handful of approximately 40 such agreements in 1992, by 2004 the number had reached well over 200. In the particular years following the turn of the century, the number had approximately doubled. By July 2003, only three WTO members — Macau China, Mongolia, and Chinese Taipei — were not party to a regional trade agreement. The surge in these agreements has continued unabated since the early 1990s. By May 2003, over 265 had been notified to the WTO (and its predecessor, GATT). Of these, 138 were notified after the WTO was created in January 1995. Over 190 are currently in force; another 60 are believed to be operational although not yet notified. Judging by the number of agreements reportedly planned or already under negotiation, the total number of regional trade agreements in force might well approach 300 by 2005 (WTO 2004). Chinese Taipei (Taiwan) would clearly like to join the party but is limited due to its enforced limbo status. Macau China's aims are constrained by PRC wishes. Essentially, it would be accurate to specify Mongolia as being the only remaining wallflower. There is almost a copycat mechanism driving this explosion (not unlike that which drives criminals to imitate remarkable or heinous crimes). This has been noted facetiously: Meanwhile, the ‘small’ PTAs [Preferential Trade Agreements], usually without some big country providing the centre to them, continue to proliferate, chiefly (though not exclusively) among the developing countries. The incentives to have these are often political. Each Trade Minister and his Prime Minister wish to leave their names behind on some trade grouping of their own; multilateralism produces no such rewards. Then there is the CNN theory of such PTAs: whereas multilateralism produces photo-ops only for the big players such as Sir Leon Brittan and Ambassador Mickey Kantor, and nothing for the others, matters are more balanced at the regional trade meetings (Bhagwati, Greenaway and Panagariya 1998: 1145).
- ² Some economists may be reluctant to oppose such agreements given the ideology of their erstwhile allies. Most economists would loathe to be grouped with what essentially is the flat-earth position espoused by many protectionists.
- ³ In the novel *Pollyanna* (1913), the eponymous heroine teaches her new neighbours the glad game. This involves an ability to see the positive in any outcome or event, no matter how dreary or onerous it might appear on a surface level.
- ⁴ In contrast, the FTA between New Zealand and Singapore is unlikely to catch the attention of anyone outside of those two countries.

- ⁵ This is crucial since, as Paul Krugman notes, negotiations are structured rhetorically as if winners and losers must emerge. Anyone who has tried to make sense of international trade negotiations eventually realizes that they can only be understood by realizing that they are a game scored according to mercantilist rules, in which an increase in exports – no matter how expensive to produce in terms of other opportunities foregone – is a victory, and an increase in imports – no matter how many resources it releases for other uses, is a defeat (Krugman 1997:114). Given the political nature of these agreements, each side must claim to have triumphed over the other. These treaties are marketed in a very one-sided manner, namely, the advantages wrested from the other, weaker side.
- ⁶ Further complicating any useful analysis of Free Trade Agreements, particularly those negotiated by large economies, is the fact that these documents are often political rather than economic in nature. Rent-seeking by vested interests is the most obvious political aspect. (Grossman and Helpman (1999) provide a good introduction to the theoretical aspects of this issue.) Even this explanation remains within the political economy boundaries of the problem. There is another that is more starkly geo-political: Large countries can use the promise of such agreements to bind a trading partner to the strategic objectives of the dominant country.
- ⁷ In passing, I will point out some of the problems with Summers' criteria. However, the important point will remain that even by these most optimistic of all standards, the US–Australia Free Trade Agreement fails to measure up to economic requirements.
- ⁸ Foreign trade for Smith is clearly mutually advantageous, although he does use the short hand of an implicit representative agent when describing trade between London and Calcutta. Increased exchange happens because it is mutually beneficial. Were there no other communication between those two places [London and Calcutta], therefore, but by land-carriage, as no goods could be transported from the one to the other, except such whose price was very considerable in proportion to their weight, they could carry on but a small part of that commerce which at present subsists between them, and which they, at present, mutually afford to each other's industry (Smith 1970:123). Smith does, at the same time, indicate some of the problems associated with Foreign Direct Investment, which has its possible benefits edged by a sense of impermanence. A merchant, it has been said very properly, is not necessarily the citizen of any particular country. It is in a great measure indifferent to him from what place he carries on his trade; and a very trifling disgust will make him remove his capital, and together with it all the industry which it supports, from one country to another (Smith 1970: 519).
- ⁹ The simple illustration is of a business executive hiring an administrative assistant to handle scheduling and other more routine chores. Even if the executive could perform those tasks better himself or herself, this time could be better employed elsewhere.
- ¹⁰ Baron Robert Clive (1725-1774) was instrumental in securing India for England. Though acquitted of peculation by Parliament in 1773, the scandal proved to be too much for him. He committed suicide the following year.
- ¹¹ The simple example involves England producing and trading cloth to Portugal in return for wine. Again, this clearly illustrates how historically conditioned these classical works are. Ricardo, writing less than a decade after the Napoleonic Wars, would have in mind the role Portugal has played as the traditional ally of England, particularly in that period. Part of that close alliance derived from the close commercial ties between the two. Much of Portugal's port and sherry production was not only shipped to England, but the result of English investment and management of vineyards in that country.

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- ¹² Clear examples are rice in Japan and sugar in the US. Japanese consumers have paid prices in the past equivalent to six times the world price for domestically grown rice. Likewise, a quota system restricts foreign sugar from entering the US and pushes up the cost to domestic consumers. The motivation for such measures is clear. In the US, Florida grows sugar. Florida tends to be something of a swing electoral state in presidential elections. Florida sugar growers are key contributors to the campaigns of Republican candidates. In Japan, for the fifty years the LDP has governed, it has depended upon rural votes to stay in power.
- ¹³ George Stigler (1971) presents an early and still useful analysis of this problem.
- ¹⁴ Like everything else in economics, this is true under a given set of conditions. However, most economists would accept that these conditions hold except under exceptional circumstances.
- ¹⁵ See Kemp and Pezanis-Christou (2001:209-213) who point out that Pareto meant actual, rather than potential, compensation in the Kaldor-Hicks sense. From a policy standpoint, the fact that that part of the population which bears the costs of change could be compensated but are not, is of little use from either the standpoint of welfare economics or in terms of hard-nosed policy analysis. Practical policy sides with the Pareto approach in that included in treaty agreements are often phase-in mechanisms, as well as additional measures of assistance for affected sectors of the economy. Congress and the Clinton administration, concerned that even employment effects, which were small in the aggregate, appeared likely to be concentrated by industry and region, enacted NAFTA-TAA [North American Free Trade Agreement Trade Adjustment Act] as part of the NAFTA implementing legislation. NAFTA-TAA expands the trade adjustment benefits ... by providing job training as well as additional income support for workers displaced by imports from Mexico and Canada (Burfisher, Sherman and Thierfelder 2001:129).
- ¹⁶ The plight of many small Mexican farmers illustrates this particular point. Subsidised US crops have undermined the viability of these farmers resulting in at least some, if not a majority, ending up as illegal immigrants into the US. Such costs, however, are not taken into account when estimating the net benefits of Free Trade Agreements. All too often, proponents overstate such benefits. This stance is unfortunately sometimes matched by opponents who overstate costs.
- ¹⁷ Looking simply at trade balances and jobs immediately associated with changes in trade is a too narrow and often misleading approach to estimating net benefits and losses from any trade agreement. This looks only at bilateral trade in isolation from a country's overall trade patterns. It also ignores indirect gains in efficiency from cheaper imports and shifting resources to more productive sectors. The only blemish marring this otherwise exemplary use of economic analysis in a policy debate [over NAFTA] was the occasional use of mercantilist arguments that attempted to infer the effect of trade liberalization by applying simple multipliers to projected bilateral trade balances. Such methods are inappropriate for the analysis of the benefits and costs of trade liberalization, and were criticized during the debate (Burfisher, Sherman and Thierfelder 2001:141).
- ¹⁸ The Corn Laws were repealed in 1846. The Anti-Corn Law League can be seen as a forerunner of pressure groups formed by vested interests. It was certainly the first time in modern Britain that such a political grouping arose at the national level.
- ¹⁹ Such attitudes now seem quaint. Trade negotiators, when they reach agreement, must demonstrate gains that they wrested away from recalcitrant opponents. Economically, a unilateral, let alone a mutual, relaxation of trade barriers is in any country's self-interest. Transforming what is clearly a positive-sum game into a zero-sum one is good politics,

rather than good economics. Never mind that the ‘concessions’ trade negotiators are so proud of wresting from other nations are almost always actions these nations should have taken in their own interest anyway; in practice, countries seem willing to do themselves good only if others promise to do the same (Krugman 1997:113).

- ²⁰ Marshall, the great man of British economics, reflects the ambiguous posture the English took regarding the virtues of free trade. Where national interest was not so overwhelmingly carried, support for free trade could not be so unambiguously asserted. Given the rising competitive challenge by Germany, Marshall was no longer such an adamant supporter of free trade, but instead willing to consider more fully the case for protectionist measures. Marshall had suspected that the English case for free trade had always been more of political convenience than driven by the self-evident truth of economic doctrine. Political bias then, as always, hid a great power of enabling people to see just those parts of economic truth which fitted in with their policy and to remain honestly blind to those which did not (Marshall 1923: 724).
- ²¹ As in the *General Theory* which would appear some three years later, his essay (National Self-Sufficiency) contains the same attitude of a sinner who is made aware that he has been blind. I was brought up, like most Englishmen, to respect free trade not only as an economic doctrine which a rational and instructed person could not doubt, but almost as a part of the moral law. I regarded ordinary departures from it as being at the same time an imbecility and an outrage. I thought England’s unshakable free trade convictions, maintained for nearly a hundred years, to be both the explanation before man and the justification before Heaven of her economic supremacy (Keynes 1933:1).
- ²² During the thirties, the temptation to preserve dwindling domestic employment through protectionist trade measures became overwhelming. The now infamous Smoot–Hawley tariffs, passed by the US in 1930, is perhaps symbolic of the trade restrictions and subsequent policy of retaliation that undermined world trade (and economic prosperity) prior to World War II. In the Cambridge tradition, Keynes’ inherent patriotism skewed his view into considering policy from a somewhat narrow national stance. Given the harsh reality of an ongoing economic recession, the focus needed to be on the short-run objective of saving jobs, even if it was at the expense of future growth and international economic health. The main thing which caused so much liberal opinion in England to lose its faith in free trade was the helplessness of older liberalism in the face of massive unemployment and the possibility of using import restriction as an element in an active programme fighting unemployment. One is, of course, obliged to associate this line of thought with the name of Keynes. It was this, almost alone, which let Keynes to abandon his early belief in Free Trade (Hicks quoted in Bhagwati 2002:16).
- ²³ Keynes exemplifies a tendency among economists to allow general economic doctrine to become influenced and even confused with particular economic interests. So they [advocates of free-trade] based sweeping general propositions on English facts and English conditions. ... This gave to their argument much apparent lucidity and simplicity, which hastened their victory. And their victory was two-fold. For it was followed by so great an increase of England’s prosperity, that other nations began to open their ports in imitation of her and this doubled the benefits with Free Trade conferred on England. ... other nations would have been warned beforehand that the removal of Protective duties could not be expected to confer the same unmixed benefits on their best industries as it had done on those of England. As things were, they had to learn it in the hard school of experience (Marshall 1923:84-85). The English disease, as applied to economics, confuses the particular with the general. Classical economists failed to distinguish between the

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particular set of circumstances favouring development in England with a universally applicable recipe relevant at all times in all places. Rather than a sketching out of immutable laws of exchange, theorems as presented by these economists were often, whether consciously or not, in service of a particular partisan position. Ricardo's methodology in the hands of partisans became unhistorical, unrealistic; the tool of a political party. Keynes, in breaking with these Classical traditions, did so in part because the free trade implications of that theory had turned against his country's best interests. So that where he once was so eloquent in defending comparative advantage, he now proved as adept at attacking the notion. Barring some of his artistic tastes, he was surprisingly insular, even in philosophy, but nowhere so much as in economics. And, he was fervently patriotic – of a patriotism which was indeed quite untinged by vulgarity but was so genuine as to be subconscious and therefore all the more powerful to import a bias to his thought and to exclude full understanding of foreign (also American) viewpoints, conditions, interests and especially creeds. Like the old free traders, he always exalted what was at any moment truth and wisdom for all times and places (Schumpeter 1951: 274).

²⁴ It is only fair to point out that while Britain, the devout free trader, represents a conversion to regional agreements, many other nations also found US trade objectives less than irresistible. But the Australian government, like many Western European governments, was less than enthusiastic about the American emphasis on non-discrimination in the postwar trade system. For their part, the Western Europeans were tinkering with the concept of regional economic integration whereas the Australian government was quite keen to preserve the imperial preferential system with its Commonwealth country trade partners (Capling 2001:14).

²⁵ It is perhaps more precise to note that these insiders were more likely to be indifferent rather than antagonistic to the welfare of countries outside these preferential treaties.

²⁶ Partners to US trade agreements continue at a disadvantage after signing, as well as during, the negotiation process. Access to US markets is always significantly more important than US access to smaller trade partners' markets. Any retaliation against the US will tend to hurt the country imposing such penalties more than it does the US. Thus, threats must reduce to no more than empty bluster designed for local consumption. In fact, nothing constrains the US to keep to the terms of its agreements. The current controversy over Canadian softwood lumber exports to the US makes this quite clear. Canada has long been dominated economically by the US. Trade itself comprises 40 percent of Canadian GDP (supporting 1 in every 4 Canadian jobs). Since initially signing a trade agreement with the US (which evolved into the North American Free Trade Agreement), trade with the US has grown to 86 percent of the total trade. Thus, anything Canada could do to retaliate against unfair US trade practices would only work against Canadian interests by interfering with trade between the two countries. The US has long claimed that Canadian softwood lumber exports to the States were subsidised. Clearly, this charge of dumping was motivated solely by US lumber mill and forest interests. This, in fact, led to a 19.31 percent tariff on such wood as of 2001. No resolution of this issue occurred despite numerous rulings by the relevant NAFTA tribunals or by the World Trade Organisation. The problem flared up again in August 2005 with Canadian officials making empty gestures, all of which had no discernible effect on US intentions. Where trade agreements conflict with the vested interests of certain sectors of the US economy, it is often the rules of the agreement that are ignored. This nation [US] sees rules as sets of restrictions that we can sometimes trick other countries into following. Nothing more, nothing less. All of the talk of "free trade" and globalization are just schemes, attempts to

trick other nations into following rules that will deluge the coffers of US corporations with money (Sexton 2001:1).

- ²⁷ That Keynes looked upon free trade doctrine with a great deal of scepticism has been previously established. He retained this stance, focusing on British national interests in perhaps a rather narrow context. My strong reaction against the word “discrimination” is the result of feeling so passionately that our hand must be free ... [T]he word calls up and must call up ... all the old lumber, most-favored-nation clause and all the rest which was a notorious failure and made such a hash of the old world. We know also that it won’t work. It is the clutch of the dead, or at least the moribund, hand (Keynes quoted in Bhagwati 1999:3).
- ²⁸ In a very useful piece of analysis, MacMillan lays out some of the problems attending Article XXIV. The second criticism of the rule against raising average external tariffs is that, as it is written, it is vague. Paragraph 5(a) of Article XXIV states that external trade barriers ‘shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of such union’ ... But nowhere is it specified how the ‘general incidence’ of a set of tariffs is to be measured (Macmillan 1993: 299).
- ²⁹ The Kemp/Wan proposition originally published in 1976 (republished 1999) is a seminal work in the study of Regional Integration Agreements. (Notice the many colours under which these agreements are packaged. This, I would suggest, is symptomatic of a protectionist core that is buried under trade promoting marketing.) They looked at regional integration from a different angle from Viner and offered a theorem that, in clarifying the sense in which RIAs are unambiguously a good thing, is one of the most elegant and important of all contributions to the theory of customs unions: *It is always possible for a regional integration agreement formed among an arbitrary group of countries, to structure itself in such a way as to make the member countries better off without making any of the non-member countries worse off* (Macmillan 1993:293).
- ³⁰ Here also see the work of Panagariya and Findlay (1999).
- ³¹ In this context it is useful to remember the general findings of Grossman and Helpman (1999:328): A free-trade agreement requires the assent of both governments. We have found that this outcome is most likely when there is relative balance in the potential trade between the partner countries and when the agreement affords enhanced protection rather than reduced protection to most sectors. With enhanced protection, an exporting industry captures the benefits of the high domestic prices in the partner country. With reduced protection, an import-competing industry sees its domestic price fall as a result of the duty-free imports from the partner. Whereas reduced protection may involve some trade creation, enhanced protection gives rise only to trade diversion. Thus, the conditions that enhance the viability of a potential agreement also raise the likelihood that the agreement would reduce aggregate social welfare.
- ³² Economists are obligated for this insight to the pioneering work of Jacob Viner (1999) who tackled this issue in the early post-war period (1950). As a matter of economic theory, however, Jacob Viner ... had pointed out that the welfare effects of a customs union could be ambiguous. A customs union could result in both beneficial trade creation among its members, as trade barriers within the group were reduced, and also trade diversion, in which the increased trade between countries forming the preferential trading agreement comes at the expense of trade formerly with third countries. Trade diversion can create a situation in which members of the preferential trading agreement end up buying from higher cost sources – their partners in the preferential agreement – while also losing the

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tariffs they would previously have charged to those outside the preferential trade agreement, and thus reducing their welfare (Krueger 1999:110).

³³ Reference here is to the fact that MIT is located on Memorial Drive in Cambridge, Massachusetts.

³⁴ Bhagwati (2002:112)) modestly takes credit for the term. However, Krueger (1999:112) bestows that honour on Snape (1996).

³⁵ During an extended stay throughout the US (September 2005), I asked a number of my friends and acquaintances about the FTA between the two countries. This was a strictly unscientific, anecdotal survey. Still, these people were spread throughout the country. All were well informed; some were academics and even economists. None were aware that such a treaty had been signed and was now in effect. Therefore, pressure on the US bargaining position will only come from some very limited vested interests. This contrasts with Australia, where the agreement was widely discussed in the lead up to its ratification.

³⁶ This goes beyond the age-old idea that increased trade binds countries together in peaceful commerce. In other words, any disruption of stable relations between countries becomes too costly in terms of loss of trade. The trade creation aspect of PTAs, particularly regional PTAs, is seen as a contribution to increased security. Intuition, as well as empirical evidence, indicate that increased trade among nations reduces the chance of military conflict ... increased trade among members of PTAs – particularly PTAs involving deeper integration – can increase intragroup “trust” and thereby reduce tensions (Asian Development Bank 2002:2). The large power use of these treaties is to directly influence the foreign policy stands taken by smaller economies. Thus, Australia, eager to reach terms with China, has become more circumspect in denouncing human rights violations or supporting Chinese dissidents.

³⁷ Key sectors such as pharmaceutical companies, software companies, and various segments of the media all benefit by extending the favourable patenting and copyright laws that obtain in the US. The extension of copyright law from 50 to 70 years, as well as the increased ease of patenting business processes, yields desirable rents for US multinationals. Not coincidentally, such firms are also major contributors to political parties.

³⁸ The US responded to the influx of imported Japanese cars by pressuring Japan to accept Voluntary Export Restraints on cars sent to the US. Such actions supposedly saved US jobs by countering unfair (and often unspecified) Japanese trade practices. While denying US consumers access to cheaper (and often better quality) Japanese cars, the restrictions raised Japanese profit margins by shifting exports toward higher-priced models. Such profits helped fund Japanese car assembly in the US. Today, those very US car companies such actions sought to protect are facing ever-shrinking shares of the US car market. However, this has not seemingly deterred US policy makers. The Super 301 provision of the 1998 Omnibus Trade and Competitiveness Act took the idea of unfair trade practises to the extreme of providing the US president the license to unilaterally declare any foreign trade policy as unfair and to react accordingly. Again, trade is seen as war by other means. American protectionists, compared to those elsewhere, have therefore found it strategically smarter to use “unfair trade” as their political weapon against foreign firms even as it has become unfashionable and unproductive ... to seek protection by claiming that you cannot compete (Bhagwati 2002:52).

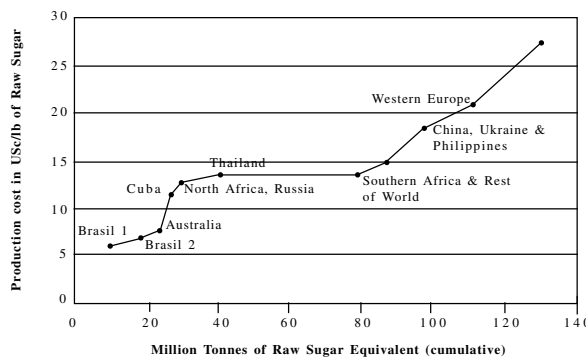
³⁹ Figures quoted from Mastel 2004:50.

⁴⁰ It is not difficult to imagine that competition to sign these treaties would leave the US with a strong negotiating hand. Even if the terms of the agreement were slanted to US interests, the threat of being denied the same access as more favoured trade partners

would act as a spur to smaller countries. That these treaties with small economies tended to upset no vested US interest can be seen by the wide margins of Congressional approval for the preferential arrangements extended to Singapore, Chile, Jordan and Australia. First, if neighboring (and often competing) countries do have FTAs with the United States, other countries could find themselves at a strong competitive disadvantage in an important market if they cannot also secure an FTA. Second, many countries likely perceive the major advantage of an FTA with the United States as the enhanced ability to attract new foreign investment – presumably from companies that are attracted by the opportunity to easily import from and export to the U.S. market (Mastel 2004:50).

- ⁴¹ Ties between Australia and the US have been driven by security concerns rather than economic imperatives. Initial contacts, as reflected by the 1908 visit of the American Pacific fleet to Australian ports, was driven by perennial Australian insecurity. With the Japanese triumph over the Russian fleet in 1905 (Russo-Japanese War) and the British naval pullback in the Pacific following the British–Japanese Treaty of 1902, an increasingly nervous Australia looked for other potential protectors with shared and common interests. In Australia, the fear of the *yellow peril* was never far from the surface of diplomatic maneuvers. The visit of the United States fleet is universally popular here, not so much because of our blood affection for the Americans, though that is sincere, but because of our distrust of the Yellow Race in the North Pacific and our recognition of the ‘entente cordiale’ spreading among all white men who realise the Yellow peril to Caucasian civilization, creeds and politics (Alfred Deaken, Australian Prime Minister quoted in Harper 1987:11).
- ⁴² The great hope was sugar where Australia had a clear edge over heavily subsidised US sugar. Not only did the US fail to open its market (not an additional bag of sugar got through), but the Howard government felt obliged to spend \$A900 million on assistance to irate Queensland sugar farmers. No doubt this was intended to keep them sweet given the upcoming 2004 election.

Figure 1. Sugar: average cost of production in selected countries (US cents/pounds)



Source: ACIL estimates

Notes to figure:

- Estimates are based on industry opinions obtained by ACIL in June 2002.
- Volumes are based on mean production for the three years to 2001.
- Region 1 Brazil is the low cost South-East Region, while Region 2 is the rest of that country.

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- ⁴³ This in itself is a questionable statement since it is difficult to imagine what alternative form of trade diversion he thinks economists focus on.
- ⁴⁴ The US farm lobby clearly saw an imposition of favourable quarantine standards as the key focus for potential export gains. The fact that these goals could not be accomplished through the mechanisms the World Trade Organisation provides makes the imposition of such standards through the FTA channel suspect at best. The draft [Free Trade Agreement] provides for follow-up talks on sanitary and phytosanitary measures ... gains in United States exports of meats (particularly pork) and fruits and vegetables (including items such as citrus products, apples, and stone fruits) depend on the success of these sanitary/phytosanitary talks (American Farm Bureau Federation report quoted in Weiss and Thurbon 2004:4).
- ⁴⁵ The ruling WTO intellectual property agreement (TRIPS) reflects heavy US influence. Still, this has not proved a standard that is sufficiently conducive, or lucrative enough, to meet US appetites.
- ⁴⁶ Given falling staff numbers and pressures to expedite all regulatory processes, patents are now granted with even greater ease. It is not clear that the net result of such a shift is beneficial in any general welfare sense or conducive to innovation. Process patents are an especial concern. Since the Carter Administration, patents have been an explicit weapon of U.S. international competitive strategy. The U.S. Patents Office has lowered the threshold of innovation required of a patent application to the point that almost anything is approved. The 'contribution' can now be a minor and obvious refinement, it may relate to a mere 'business process' rather than an 'industrial process', and even vague generic claims are accepted. Progress in eBusiness is being seriously harmed by assertions of rights in fundamental ideas such as 'one-click shopping', 'reverse auctions', 'automated credit-checking' and even the option of a 'hot-link' (Clarke 2004:4).
- ⁴⁷ This is the one aspect of the treaty that was modified due to pressure exerted by the opposition Labor Party in the run-up to Federal elections (2004).
- ⁴⁸ In the past, pharmaceutical companies have argued that the number of drugs listed on the pharmaceutical scheme was too restricted. Such ire could be seen subsequent to the unsuccessful campaign to include the impotence drug *Viagra* as worthy of government subsidisation. The boost to sales of a successful campaign is obvious. Even though the price to the pharmaceutical companies is discounted, the increased volume due to the government-subsidised price results in a sizeable increase in revenues.
- ⁴⁹ This is the section within the Free Trade Agreement that deals with pharmaceutical issues.
- ⁵⁰ Perhaps the most incisive political condemnation of the changes to the Pharmaceutical Benefit Scheme came not from an Australian but an American politician. At least one US congressman agrees that it would have been better if the PBS was never put on the table. The report quotes Tom Allen [Maine] as telling Congress, "Domestic health care policy should not be decided in trade agreements. It is wrong for us to interfere with another country's domestic health policy, particularly when it comes to the affordability of medicines ... this is special interest policymaking at its worst" (Toohey 2004:25).
- ⁵¹ As previously pointed out, rules of origin lend themselves wonderfully to creating surreptitious barriers to trade. It is one consistent element that makes many free trade agreements implicit vehicles for protectionist objectives.
- ⁵² Certainly, Australia's former focus on multilateral arrangements, as demonstrated by its efforts within the Cairns group, is much less than it was a decade ago. Most of the attention paid to trade matters is now narrowly focused on obtaining additional free trade agreements, especially one with China.

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