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The Australia-United States Free Trade Agreement: An economic evaluation

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Abstract

A bilateral Free Trade Agreement (FTA) between Australia and the United States came into effect on 1st January 2005. Since the U.S. is one of the main trading partners for Australia, it was anticipated that the FTA would bring a substantial increase in Australia's bilateral trade with the United States. It would also have important implications for Australia's other main trading partners such as Japan, and China. This paper seeks to provide a quantitative assessment of the impact of the FTA by undertaking simulations using the Global Trade Analysis Project (GTAP) model. By simulating the GTAP multi-country CGE model, the paper evaluates various economy-wide effects, sectoral level effects, and trade diversion and trade creation effects in the two countries in response to bilateral free trade. It will also identify the effects on trading partners outside the FTA. The results will provide a preliminary indication of the magnitude of welfare gains involved.

1. Introduction

Australia and the United States officially concluded a free trade agreement (FTA) in February 2004. It came into operation on 1st January 2005. The Australia-United States Free Trade Agreement (AUSFTA) is the fourth of such agreements that Australia has signed so far and it is most

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likely that a few more will be negotiated in the near future.[1] The United States is an important trading partner for Australia accounting for 10% of merchandise exports and 17% of merchandise imports. The FTA is expected to create improved market access for Australian exports of manufactures and for most agricultural commodities with the exception of sugar and dairy products. The agreement will also enhance trade in services through liberalization and inflow of foreign capital with relaxed foreign investment rules. Due to methodological and data limitations, these aspects are not examined in the paper.

Because of the importance of bilateral trade with the U.S. to Australia and the extensive political and economic debate that has taken place during and after negotiations, it is appealing from the policy analysis stand to investigate the impact of the AUSFTA on the Australian Economy. Preferential trade treaties may result in trade creation, but usually discriminate against non-members and can therefore reduce welfare (Viner, 1950). This results from inefficiencies due to trade diversion and perhaps overweighs the benefits accrued from trade creation.

In the end, the eventual welfare outcome from an agreement such as AUSFTA becomes uncertain. Two comprehensive studies commissioned by the Department of Foreign Affairs and Trade (CIE, 2001, 2004) have provided quantitative assessments with respect to the likely outcomes of the AUSFTA. They both conclude that Australia stands to gain from the agreement. Brown, Kiyota, and Stern (2005) have used the Michigan model to examine the economic effects of the U.S. bilateral FTAs negotiated with Central America, Australia and Morocco. They incorporate the liberalization of service trade barriers in addition to goods trade tariffs, and their results indicate that the effects of service trade liberalization are far greater than those of goods trade liberalization for Australia.

The economic modeling exercises carried out in these studies have enlightened the policy debate to a certain degree, but some important trade issues still await analysis. For example, the discrimination stemming from the AUSFTA may put Australia's growing trade relations with Asia at risk. A bulk of Australia's exports of beef and wool goes to Korea, Japan and China (Garnaut, 2004). A significant proportion of Australia's imports is sourced from these markets. Hence, the impact of AUSFTA on non-members could be significant and may perhaps have long-run implications for Australia's external trade.

This paper seeks to investigate the long-run impact of the AUSFTA using a computable general equilibrium (CGE) modeling approach. We use the Global Trade Analysis Project (GTAP) model to simulate the effects of the agreement. The GTAP model has been widely used in studies examining the effects of preferential trade treaties. The model's comprehensive database accompanied by its theoretical framework gives a useful numerical approach for an investigation of the effects of the free trade agreement (Hertel, 1996).[2]

The paper is organized as follows: Section 2 provides a brief account of Australia's approach to preferential trade treaties. Section 3 emphasizes the bilateral trade between Australia and

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[1] Australia has entered into FTAs with New Zealand, Singapore, and Thailand and negotiations are under way with Japan, ASEAN, and China.

[2] Brown et al. (2005) use the Michigan CGE model which incorporates imperfect competition, increasing returns to scale, and product variety as important features and hence provide an alternative modeling framework to GTAP used in the present paper. One of the key features of the GTAP model is the use of Armington elasticities to specify the degree of substitution in demand between similar products sourced from different countries. The results of trade policy experiments are critically dependent upon the Armington parameters and the model structure (e.g., perfect competition versus monopolistic competition). In a recent paper, Lloyd and Zhang (2006) illustrate the influence of the Armington model in GTAP applications and propose some future directions for methodology and the model use.