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A Pacific Free Trade Area

by Professor Kiyoshi Kojima, Tokyo

Great Britain's desire to join the Common Market has given a fresh impetus to the plans of a Pacific-Asiatic free trade area. Members of PAFTA are to be Japan, the United States, Canada, Australia, and New Zealand. By means of an economic integration of these nations, particularly Japan is interested in stabilising its position in the world economy and not to stand completely outside regional unions. Already last year, INTERECONOMICS published a critical comment to the PAFTA plans written by the Australian professor, H. W. Arndt. In view of the manifold problems and the economic disadvantages to be anticipated, he declared against an Australian participation in this project. In the following article, Professor Kojima, the initiator of the Pacific integration plans, takes a different point of view.

The devaluation of the pound sterling on November 18, 1967, and the uncertainty about the dollar which followed sterling devaluation, were a severe shock for Pacific countries. They warned of the precariousness of international economic and financial co-operation within the framework of the IMF and GATT and the need for tighter international economic integration. Ten days before sterling devaluation, an important report was published by Maxwell Stamp Associates, strongly advocating the formation of a North Atlantic Free Trade Area among the United States, Canada, and Britain.¹ The lessons of sterling devaluation suggest that the establishment of NAFTA will become an urgent task. Then, what course should Japan, Australia, New Zealand follow in the Pacific? The NAFTA plan treats them lightly: they may be permitted to participate as associate members. From our point of view, this hardly seems satisfactory. Why should the five Pacific countries, the United States, Canada, Japan, Australia, and New Zealand, not prepare for the formation of a Pacific Free Trade Area and welcome British participation? Might not PAFTA and NAFTA be linked together through common United States-Canadian participation?

The Static Effects of PAFTA

The Pacific is one of the two major centers of world trade and ranks alongside Western Europe. Trade among the five advanced Pacific countries, the United States, Canada, Japan, Australia, and New Zealand, increased by 97 per cent between 1958 and 1965, from \$ 9.16 billion to \$ 18.02 billion, and their share in world trade rose from 7.99 per cent

to 10.38 per cent.² Trade within the EEC grew from \$ 6.86 billion to \$ 20.84 billion over the same period.

Furthermore, mutual trade amongst advanced Pacific countries intensified over the years. Intra-areal trade constituted 32.5 per cent of total Pacific country trade in 1958, but 37.3 per cent in 1965. In contrast, intra-areal trade was 30.1 per cent of total EEC trade in 1958 and 43.5 per cent in 1965.

The formation of a Pacific Free Trade Area would, in fact, bring about more comprehensive trade liberalisation amongst participating countries, with the elimination of tariffs on a substantial proportion of their commodity trade, and would result in a larger trade expansion than is possible through tariff reductions of the Kennedy Round type. Complete regional trade liberalisation would appear to have considerable advantages over partial trade liberalisation in world markets. This is especially true if, as is most probable, another major round of global tariff reductions is not feasible within the next ten or twenty years. In that event, the formation of PAFTA would seem an effective alternative for mutual trade expansion among the five advanced Pacific countries.

The impact effect of Pacific tariff elimination would be to increase trade by \$ 5,000 million. This represents an expansion of 28 per cent on intra-areal trade, or 10.3 per cent on Pacific country exports to, and 11.9 per cent on imports from the whole world. In other words, there would be significant trade expansion, indeed, a far greater trade expansion than can be expected under Kennedy Round tariff reductions. Kennedy Round tariff reductions will probably only lead to a 5.5 per cent increase in exports and a 7.7 per cent increase in imports.

¹ Maxwell Stamp Associates, *The Free Trade Area Option, Opportunity for Britain, The Atlantic Trade Study*, London, 1967. See also Theodore Geiger and Sperry Lea, *The Free Trade Area Concept as Applied to the United States, Issues and Objectives of US Foreign Trade Policy, A Compendium of Statements*, Congress of the United States, September 1967.

² The trade diversion effects have not been estimated. If these had been included, the expansion of PAFTA would be much larger than our estimation.

The gains from tariff elimination would not be equally distributed amongst the five Pacific countries involved. Japan's exports would increase by \$1,740 million, or 56 per cent on its total exports to PAFTA countries, and its imports would increase by \$430 million, or 14.7 per cent on its total imports from PAFTA countries. Japan's trade balance with the Pacific, which was roughly in equilibrium in 1965, would consequently improve by \$1,310 million. United States' exports would increase by \$2,300 million, or 27.9 per cent, and imports by \$2,280 million, or 30.1 per cent, and the favourable balance in United States' trade with the Pacific, of about \$850 million in 1965, would be preserved. On the other hand, imports would rise more rapidly than exports for the remaining three countries. Canada's exports would increase by \$855 million but its imports would rise by \$1,480 million; Australia's exports would increase by \$65 million, whereas its imports would rise by \$650 million; and New Zealand's exports would grow by \$22 million, whilst its imports would rise by \$140 million.

The differential pattern of gains depends principally upon whether the country's exports are more or less heavily concentrated in manufactures, and suggests a need for fostering further industrialisation in Canada, Australia, and New Zealand. Indeed, the pursuit of this objective would be facilitated through the dynamic effects of establishing a larger and completely free regional market, and through the freer movement of capital, technical know-how, and managerial skills among member countries.

Closer Pacific Trade Partnership

At this stage, the PAFTA proposal seems premature, unless there is some further unforeseen disturbance in the free world economy. It is as yet neither economically nor politically feasible. Firstly, American interests are presently worldwide and the United States could not participate readily either in a Pacific or a European regional grouping. For the moment, the United States appears committed to a global non-discriminatory approach to freer trade.

Secondly, the five Pacific countries still lack the solidarity and degree of integration that would be necessary for dispensing with protective measures for the main sectors of their economies involved in re-

gional trade—the labour intensive industries in some countries, the agricultural and pastoral industries in other countries.

Thirdly, the static gains from complete trade liberalisation would differ widely from one country to another because of the disparity in stages of industrialisation within the region.

Whether or not a free trade area can ultimately be established, the five advanced Pacific countries should now set about establishing closer and more profitable trade partnerships with each other. To date, the United States has tended to look toward the possibility of ultimately "going in with Europe", and has tended to neglect the Pacific region. The flow of financial resources and direct investment from America to Pacific basin countries, including Asian and Latin American countries, has lagged behind that going to Europe. The Pacific, Asian, and Latin American region has a huge potential for trade growth and development compared with Europe, and it should be looked at more closely.

Before the establishment of PAFTA, several steps towards closer Pacific economic co-operation might be practicable immediately. Five main objectives suggest themselves:

- ☐ To increase the flow of financial resources from the United States to other Pacific countries, as well as to Asian and Latin American developing countries.
- ☐ To stimulate horizontal trade among the five advanced Pacific countries in heavy manufactures and chemicals and to expand production and trade of raw materials and intermediate goods more efficiently for the region as a whole.
- ☐ To readjust production and trade in agricultural commodities among the five Pacific countries, taking into consideration their relationship with Asian and Latin American developing countries.
- ☐ To readjust production and trade of light manufactures, which are labour intensive, with the aim of providing greater access for Asian and Latin American countries in advanced country markets.
- ☐ To co-operate the aid policy of the five advanced Pacific countries towards Asian and Latin American developing countries.

Practical steps towards closer Pacific economic co-operation can be taken by strengthening function-



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al, rather than institutional integration, and thus attempting to attain the favourable benefits of a free trade area whilst avoiding the unfavourable impact effects. To realise these objectives, I suggest the initiation of three codes of international behaviour and the formation of two new regional institutions.

□ A code of good conduct in the field of trade policy, under which countries would relinquish the right to raise tariffs or impose other forms of trade restriction, and would gradually reduce those trade barriers particularly on the import of agricultural products and labour intensive light manufactures, should be promulgated.

□ A code of overseas investment to promote mutual investment among the five advanced Pacific countries, most effectively from the United States, and to foster the activity of joint ventures is much needed to promote trade expansion, especially horizontal trade expansion in heavy manufactures, and for the development of the vast mineral resources of the Pacific region. A code which minimises the fear of American capital domination and maximises protection for America's balance of payments would greatly facilitate overseas investment and the better allocation of regional resources.

□ A code of aid and trade policies towards associated developing countries is also required, so that Asian and Latin American countries might enjoy the benefits of larger markets for their agricultural products and light manufactures. The flow of development aid must be increased, appropriate aid projects selected, and domestic industrial structures adjusted to meet the legitimate trade needs of affiliated less developed countries.

An Organisation for Pacific Trade Development (OPTAD) should be established in order to give effect to these codes of international behaviour. Its main features would be similar to those of the OECD, and it could be structured in the same way, with three committees on trade, investment, and aid.

Further, a Pacific Bank for Investment and Settlement would be established with the aim of facilitating investment and settlement within the Pacific, Asian, and Latin American region, and equipped with a mechanism for preventing the drainage of gold from the United States.

Professor Arndt's comment in this journal³ on my earlier examination⁴ of the possible gains from

PAFTA is much appreciated. However, his assessment of the implications of PAFTA for Australia seems altogether too pessimistic. Moreover, he presents no alternative programme for Australia's economic future in the world economy. He fears that a free trade area with the Pacific and Asia would virtually wipe out Australia's manufacturing industry, and that Australia would be forced to specialise even more heavily in exporting primary agricultural, pastoral, and mineral products. In brief, he fears that Australia would be forced to regress to an economic structure too reminiscent of its colonial past.

Implication for Australia

"For Australia, the effects of the (PAFTA) scheme would be much more drastic and far-reaching. Tariff-free access to the manufactures of the United States, Japan and Canada at the present exchange rate would wipe out considerable sections of Australian manufacturing industry. If Australia were expected also to give substantially free entry to light industrial products of South-East Asia, some of the industries able to survive Japanese and American competition would disappear... Against all these disasters could be set only the prospects for expansion of exports of rural and mining products that would come with free access to the large Japanese and North American markets, and perhaps similar prospects for a few specialised manufacturing industries that could take advantage of the economies of scale offered by the PAFTA market." (H. W. Arndt, p. 273).

It is impossible not to agree, to some extent, with Professor Arndt that the prevalence of protectionist attitudes and fears, not only in Australia but also in the other four Pacific countries, makes the hasty establishment of PAFTA quite impracticable. A more pragmatic step-by-step approach towards Pacific economic co-operation amongst Pacific countries must be taken. It might be best to concentrate on the expansion of production and trade in heavy manufactures, chemicals, and raw materials and refrain from pushing the abolition of protectionism in light manufacturing and agriculture, as a first step towards

³ H. W. Arndt, PAFTA: An Australian Assessment, in *INTERECONOMICS*, No. 10, 1967, p. 271 seqq. German version: Pazifische Integration bringt auch Australien Vorteile, in *WIRTSCHAFTSDIENST* No. 9, 1967, p. 472 seqq.

⁴ K. Kojima, A Pacific Economic Community and Asian Developing Countries, *Hitotsubashi Journal of Economics*, Vol. 7, No. 1, June 1966.



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wider Pacific integration. If the expansion of growing sectors is sufficiently large and rapid, readjustments in the lagging sectors will follow smoothly without so much trouble. For this reason, the sectoral free trade approach has much to recommend it as a first step.

Any change in trade policy, however minor, involves structural readjustment and encounters difficulty and opposition from vested interests. But if the difficulties of short-run adjustments dominate our thinking, no long-run economic progress will ever be realised. We would be stuck with the status quo forever.

Professor Arndt suggests that most Australian economists would prefer a more humdrum approach to the establishment of PAFTA. What is this more humdrum approach? "They would like to see a much more selective policy of industrial protection, the gradual elimination of industries requiring very high effective rates of tariff protection, and the deliberate use of tariff and other policies to encourage a more competitive industrial structure." (H. W. Arndt, p. 276). This implies some rationalisation of Australia's present excessive protectionism. What would the end result of this rationalisation be according to Professor Arndt? In fact, Australia would have to enlarge its import replacing manufacturing activity under heavy tariff protection, and its exports would continue to be heavily dependent on primary industries. When

would Australia be able to dispense with excessive protectionism if it sticks to that course of economic development? I am afraid that the need for protection of a home-market oriented, import-replacing industrial sector would have to continue far into the foreseeable future, and protectionism will continue to rise as wages are forced up. There would be few opportunities for freer trade, let alone free trade, expansion if Australia haphazardly followed that line of economic growth.

Paradoxically, as Professor Arndt pointed out, "the free trade area proposal, with its promise of greater opportunities for export expansion, presents more of a threat to Australian protected manufacturing industries than a proposal for unilateral abolition of tariffs by Australia," since "the greater the expansion of exports, the less the protection given to, and the greater the contraction of, import-competing manufacturing industries." (H. W. Arndt, pp. 273-4). To Professor Arndt, this is the way to industrial retrogression and stagnation. He sees no solution but the expansion of service industries to absorb unemployed resources.

Strengthening of New Growth Sectors

Of course, what is really needed for Australia's further industrial transformation is the strengthening of new growth sectors in heavy manufacturing industry, which can absorb labour and capital transferred from excessively protected inefficient manufacturing industries. These new growth sectors are the heavy industries which utilise Australia's cheap and rich natural resources. With Pacific economic integration they could be made more export-oriented and efficient.

First of all, because of good prospects for the development of Australia's huge deposits of high quality coal, iron ore, bauxite, and copper, by the middle seventies a complete transformation in Australia's whole specialisation in the world economy and profound changes in the whole fabric of Australia's political economy will have been effected when minerals and associated manufactures displace wool as its chief export earner.

Secondly, Australia's heavy industries such as steel, motor vehicles, metal based industries, and engineering industries are potentially extremely efficient, because of Australia's strong comparative advantage in the raw materials upon which these industries are based, if optimal scales can be achieved. In some industries, optimal scales have already been realised. But, as Professor Arndt warns, the relatively small domestic market and shortage of domestic capital have prevented the achievement of optimal scales in many other potentially competitive industries. PAFTA could surely provide Australian industry with large assured export markets and improved access to international capital and technology.

The expansion of Australia's heavy industry should be encouraged since heavy industry is not so much

affected by growing wage costs as is light manufacturing industry. The reason that primary products like wool and wheat have maintained their dominant position in Australia lies in the fact that they are land and capital intensive industries, export-oriented, large-scale, and not directed towards a limited domestic market. The success of the new mineral resource development depends on the same factors. Surely the same factors are also relevant in the case of heavy industry, especially heavy industry based on Australia's rich mineral resources. Heavy industry can certainly not rely on limited domestic markets if it is to achieve full economies of scale. If it were export-oriented from the beginning, these economies would be achieved more readily.

Take, for example, the Broken Hill Propriety Co. It presently monopolises the supply of steel in Australia at internationally competitive prices. But there is ample scope for a huge additional steel complex which would begin operations in competition with BHP. It could be located in the north of Australia, and be established as a regional joint venture to produce mainly for export. This would reduce the domestic price of Australian steel, and it would quicken the delivery of an appropriate variety of steel. Local demand would expand, and steel-based industries, such as motor vehicles and ship-building, could be made more internationally competitive and expand overseas sales. The advantageous effects of cheaper steel for Australia would be extremely wide-ranging. Moreover, could, say, 50 per cent of mineral production be consumed domestically, and the other 50 per cent turned to export, the mining industries would also achieve more effective rationalisation and cost control.

Thirdly, growth in the share of Australian exports destined for the United States has been far from impressive. Significantly, this results from the persistence and effectiveness of protectionist pressure in the United States against Australia's principal exports, wool, minerals, and foodstuffs, all of which are subject to high tariff duties or import quota restrictions. The only measure which could effectively

remove these barriers once and for all is the formation of a free trade area. This is also true for Australian exports of foodstuffs to Japan.

Finally, it should be stressed that my step-by-step approach, preliminary to the establishment of PAFTA, aims at levelling up the degree of industrialisation in Canada, Australia, and New Zealand, and promoting horizontal trade in heavy manufactures, chemicals, and raw materials within the Pacific region. These industrial sectors would reap the largest dynamic benefits through the enlargement of market-size, the freer movement of capital, and technical and managerial know-how beyond national frontiers. These dynamic benefits would be most favourable for the relatively small partner-countries with abundant natural resources.

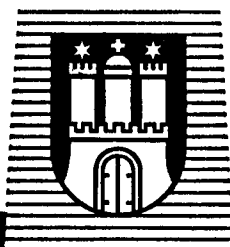
Two Options for Australia

Thus, it seems to me that there are two options for Australia: (1) either to continue the encouragement of small-scale, import-replacing industry with increased protection or (2) to expand new industrial export sectors in minerals and heavy industries on a Pacific and Asian scale.

Closer Pacific economic co-operation should be a stepping stone for Australia's new international economic orientation. The complete re-orientation of Australia's economic and political relations away from Britain and Europe towards the Pacific and Asia has already become inevitable. Recent events in Britain and Europe now make the task more urgent.

Either with or without Australia and New Zealand, Japan should and will approach North America in close and freer trade arrangements.⁵ Then, what option is left for Australia? At this turning point in its commercial history, Australia, too, could do well by directing its international economic policy towards achieving some form of closer Pacific economic integration.

⁵ See my critique on Australian tariff policy: K. Kojima, *Australian Tariff Protection and Industrial Structure*, *The Australian Quarterly*, December 1966.



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