REPORT

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Bilateral and Regional Trade Agreements

CIE submission to the Productivity Commission's inquiry

Prepared for

Productivity Commission

Centre for International Economics
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Introduction

The CIE would like to congratulate the Commission on the production of a substantive review of Australia's bilateral and regional trade agreements, and the approach Australia should take to such agreements going forward.

On the whole, the CIE supports the Commission's (draft) recommendations.

Given the CIE's practical experience over the last decade in undertaking economic modelling of FTAs (mostly in the preparation of FTA Feasibility Studies) for various levels of Australian government, foreign governments and regional associations, we believed that we are well placed to comment on a few areas of the Draft Report.

Specifically, the CIE would like to comment on:

- areas where further research is still needed;
- the role of economic modelling in FTA Feasibility Studies;
- the Commission's own economic modelling and econometric analysis; and
- technical advancements in the economic modelling of trade and investment liberalisation made by the CIE over the last 5–6 years.

Our comments will mostly be related to various aspects of economic modelling and evaluation, and we are well aware that these are often very controversial aspects of trade policy (as the Commission is well aware from its own experience). Our comments here are offered in the spirit enhancing the usefulness of economic modelling for practical policy analysis.

The views expressed here are those of the CIE alone, and have not been commissioned or funded by any current or former client of the CIE.

1 Areas where further research is needed

This inquiry provided the Productivity Commission with a unique opportunity to undertake novel research into several areas of importance to both the wider trade liberalisation debate and the bilateral agreement debate. Specifically, is trade liberalisation associated with productivity gains and does compliance with rules of origin in bilateral agreements impose costs on exporters?

The Commission appears to only give these issues a cursory look, which is disappointing.

Trade liberalisation, competition and productivity gains

The Draft Report notes that a key rationale for trade liberalisation is that it:

> '…creates a competitive environment that drives productivity and a more efficient utilisation of resources…' (Draft Report, page XX).

While this quote is taken from a section of the Draft Report dealing with unilateral trade liberalisation, there is no reason to suspect that bilateral or multilateral trade liberalisation does not also have the potential to drive productivity improvements.

Most speakers at the recent Coombs Policy Forum also noted the association between trade liberalisation, competition and productivity.

The relationship between trade liberalisation and the so called dynamic productivity gains therefore seems particularly important. However, despite the apparent acceptance of dynamic productivity gains in the Draft Report's Overview, the actual discussion around trade liberalisation induced productivity gains in the Draft Report is very limited.

Indeed, despite the comments on page XX of the Overview, in chapter 10 of the Draft Report (pages10.10–10.13) the Commission appears to dismiss the notion of trade liberalisation induced productivity gains on the basis of a few select comments. This is despite the Commission itself citing numerous econometric papers that suggest trade agreements do give rise to productivity gains.

As this has been an area of considerable research in the trade literature, and as the Commission's views on this aspect of trade liberalisation are likely to be very influential, the final report may provide the Commission with an opportunity to clarify its views on this matter.

Indeed, given that productivity gains have the potential to swamp the other areas of trade liberalisation impact, and as the Commission has not undertaken independent research into this question for this inquiry, it may be appropriate for the Commission to make some recommendations about further research into this issue.

The CIE believes that the Commission would be the ideal body to carry out this much needed econometric research.

The CIE would also like to refer the Commission to our 2009 report into the potential economic benefits of an Australia–Indonesia FTA for a more comprehensive exposition of the dynamic productivity issue, the latest research (at the time that report was written), and a particular approach to the modelling of dynamic productivity gains.[1] The report can be found on the CIE's or DFAT's website.

In summary, the CIE endogenised trade and investment liberalisation induced productivity gains in our CGE model (as opposed to applying exogenous productivity shocks, which was the approach taken by the Commission). Of course, the issue comes down to what productivity gain do you attribute to the change in imports, exports and FDI? There is a growing body of econometric evidence from which to draw estimates. If of interest/use, we would be willing to share with the Commission our approach to the modelling of trade liberalisation induced productivity gains.

Rules of origin and trade liberalisation utilisation rates

Bilateral/regional agreements necessitate the use of rules of origin to determine whether items entering from the partner country(ies) are entitled to preferential tariff treatment.

What is unknown is the cost exporters' face in complying with those rules of origin (RoO). If the costs are high, yet the preferential tariff treatment is low (due to the importing country having low tariffs), then it might not be worthwhile accessing the preferential tariff treatment. Rather, it may be more cost effective for the exporter to avoid the RoO cost and get levied with the MFN tariff.

When thinking about a bilateral agreement and the potential economic benefits, the utilisation of preferential rates is a critical consideration. It would therefore be very useful for the Commission to examine this area in much more detail. For example, a survey of exporters could shed light on:

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1 See pages 31–32 and appendix B of CIE 2009, *Estimating the impact of an Australia–Indonesia trade and investment agreement*, report prepared for the Department of Foreign Affairs and trade, Canberra.

- what are the costs associated with meeting value added or change in tariff classification type rules of origin, and what is the nature of these costs;
- whether compliance costs are incurred for every shipment or as a 'once-off' cost (that is, are production systems changed or is it just a documentation issue);
- whether compliance costs differ by export destination (for the same rules of origin system); and
- whether costs incurred differ by enterprise size.

The latter two areas could also help to identify possible trade facilitation measures (such as capacity building of customs authorities in certain export destinations).

Given the importance of the trade liberalisation utilisation rate issue, it would be valuable for those with the best knowledge of RoO compliance costs — the exporters — to be surveyed as to those costs. If the time is available, the CIE would strongly suggest that the Commission conducts a survey of Australian exporters to answer the above questions.

Finally, the issue of RoO and how they relate to services trade might be an area warranting further consideration.

2 *Use of economic modelling in FTA Feasibility Studies*

The Draft Report has once again raised the difficult issue of how should economic modelling be used, and the role it should play in practical policy making.

But before turning to the use of economic modelling in Feasibility Studies, it is perhaps best to take a step back and think about what can be taken from modelling results — whatever they be — and their contribution to policy formulation. Below we reiterate our view on how economic modelling results should be used, as put forward in RIRDC's submission to the inquiry.[2]

While the CIE believes that CIEG-Cubed — the CIE's in-house computable general equilibrium model of the global economy is an applied economic model ideally suited for dynamic trade analysis — it must be appreciated that the CIEG-Cubed model, like all CGE models, is far from perfect. By definition, economic models are a simplification of reality and rely on numerous assumptions about economic parameters, behaviour and relationships. As such, modelling results should only be used to infer the direction of outcome of trade liberalisation (positive or negative) and the broad magnitude of such impacts (small or large). It is inappropriate to, for example, report modelling results to the 2nd decimal point and claim that as the unambiguous impact of any trade reforms. That is, only broad messages and trends should be taken from the modelling results.

The same paragraph can typically be found in CIE reports on the economic impacts of trade and investment liberalisation (whether that liberalisation is bilateral, regional or multilateral).

What economic modelling can do is to provide a rigorous and best available quantitative framework for estimating the potential economic impacts of an FTA, noting the above comments about how modelling results should be taken. Without such a tool there is no real way of knowing whether a particular FTA should be pursued, or allowing potential FTAs to be prioritised. Of course, this assumes that trade agreements are pursued for economic reasons; the CIE appreciates that they may also be pursued for geopolitical/strategic reasons. Qualitative and geopolitical

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2 The CIE helped RIRDC to prepare its submission to the Commission's BRTA inquiry.

considerations will therefore also be important in deciding whether or not a country should enter into a particular agreement.

When undertaking a modelling simulation, the extent of liberalisation simulated will obviously be an important factor in explaining the magnitude of estimated impacts. Other factors driving the results include:

- the size of the barriers to (merchandise and service) trade and investment being liberalised;
- the contribution of exports and imports to GDP;
- the extent and composition of trade and investment between the partner countries; and
- baseline assumptions (for example, unilateral tariff liberalisation, other trade agreements entering into force etc).

With regard to the modelling simulation, countries typically adopt one of two approaches. In the CIE's experience, the Australian Government typically wants comprehensive and overnight liberalisation modelled, with liberalisation spanning merchandise trade, service trade, investment, non-tariff barriers (if estimates are available) and inclusion of dynamic productivity gains.[3] This approach is consistent with the Australian Government's preference to negotiate comprehensive agreements.

Other countries, such as New Zealand (at least in the CIE's experience), prefer to allow those undertaking the economic modelling to simulate what they believe could actually be achieved in the negotiations.

There are strengths and weaknesses involved with both approaches, as outlined below.

Modelling comprehensive liberalisation

The comprehensive liberalisation approach shows the economic impacts that could be expected should all barriers to trade and investment be removed; and bearing in mind the abovementioned point about how modelling results should be used (positive or negative, small or large).

Whether these are 'outer envelope' impacts depends on views about the values assigned to particular model parameters, whether the barriers in the model's database accurately reflect restrictions placed on imports, factors such as whether

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3 Note that the Feasibility Studies may also contain additional modelling simulations. For example, in the economic modelling undertaken for both of the Australia–India and Australia–Indonesia FTA Feasibility Studies, slower paced liberalisation scenarios that saw barriers being phased out over 5 and 10 years were also simulated.

any dynamic productivity gains will arise, whether the modelling can adequately take into account all negotiated provisions (such as trade facilitation measures) and so on.

An advantage of the comprehensive liberalisation approach is that it does not pre-empt negotiations, nor does it give away the negotiating position of the partner countries. While the Commission would be well advised to clarify this point with the Department of Foreign Affairs and Trade, CIE can see a strategic rationale for modelling a comprehensive liberalisation scenario. If a scenario was modelled that incorporated sector carve outs and the slow phasing out of barriers, and Australia accepted those results and still wanted to enter into FTA negotiations, then Australia's negotiating position may be compromised — Australia has in part given away what it is willing to offer and accept.

It is easy to conceive of a situation where the partner country may ask 'if you [Australia] accepted the phasing out of tariffs on Australian exports of ABC over 20 years in the Feasibility Study, why are you suddenly pushing for tariffs on ABC to be phased out over 5 years when it comes to the actual negotiations — you accepted the 20 year phase out in the Feasibility Study.' And as Australia benefits from its own comprehensive liberalisation (whether unilateral or bilateral), modelling and accepting sector carve outs may prevent this from being realised.

Of course, a disadvantage with the comprehensive liberalisation approach is that any negotiated agreement is unlikely to match the liberalisation that was simulated in the Feasibility Study. If less ambitious/comprehensive liberalisation is negotiated, then the impacts will likewise be smaller. It is unfortunate that this is often overlooked.

More plausible liberalisation

The approach taken of late by New Zealand, in the CIE's experience, sees what could be considered a more 'plausible or realistic' liberalisation scenario being modelled. The actual liberalisation simulated is left up to those conducting the study, and is typically based on what has been achieved in past FTA negotiations, areas of domestic sensitivities, and through discussions with stakeholders. This sees the pace and scope of liberalisation differing across sectors, and across negotiating partners.

As more limited liberalisation is being simulated, the economic impacts are smaller than would be the case if comprehensive liberalisation was to be simulated. Only New Zealand's Ministry of Foreign Affairs and Trade will be able to advise on whether the simulation of a more plausible liberalisation scenario in the Feasibility Study compromised their negotiating position when it came to negotiating an FTA (with the Republic of Korea), or resulted in less ambitious trade liberalisation.

The advantage of this approach is that the decision to enter into FTA negotiations is not premised on an outcome — comprehensive and overnight bilateral trade and investment liberalisation — that is unlikely to be realised in reality.

The main disadvantage of this approach is that the group producing the Feasibility Study is pre-empting what a negotiated agreement will deliver, with there being scope for error.

What is the CIE's view?

The CIE can see strengths and weaknesses with both the Australian and New Zealand approach to (the economic modelling component of) Feasibility Studies. However, we are not in a position to be able to speak with authority on if/how modelling comprehensive liberalisation versus a more plausible liberalisation scenario compromises countries' negotiating positions. The Commission will need to seek the opinions of DFAT and MFAT on this issue.

The point that we make is that there are 'real world' reasons as to why a particular approach is taken to the modelling of FTAs, and it is important to understand this in any critique of Feasibility Studies.

The CIE also believes that the exact role of Feasibility Studies needs to be clarified. In our opinion, a Feasibility Study should be used to address/answer one question only — 'should countries A & B enter into FTA negotiations?'

Whether or not countries A & B should then enter into a negotiated FTA is a different question, and one that the Feasibility Study typically cannot answer.

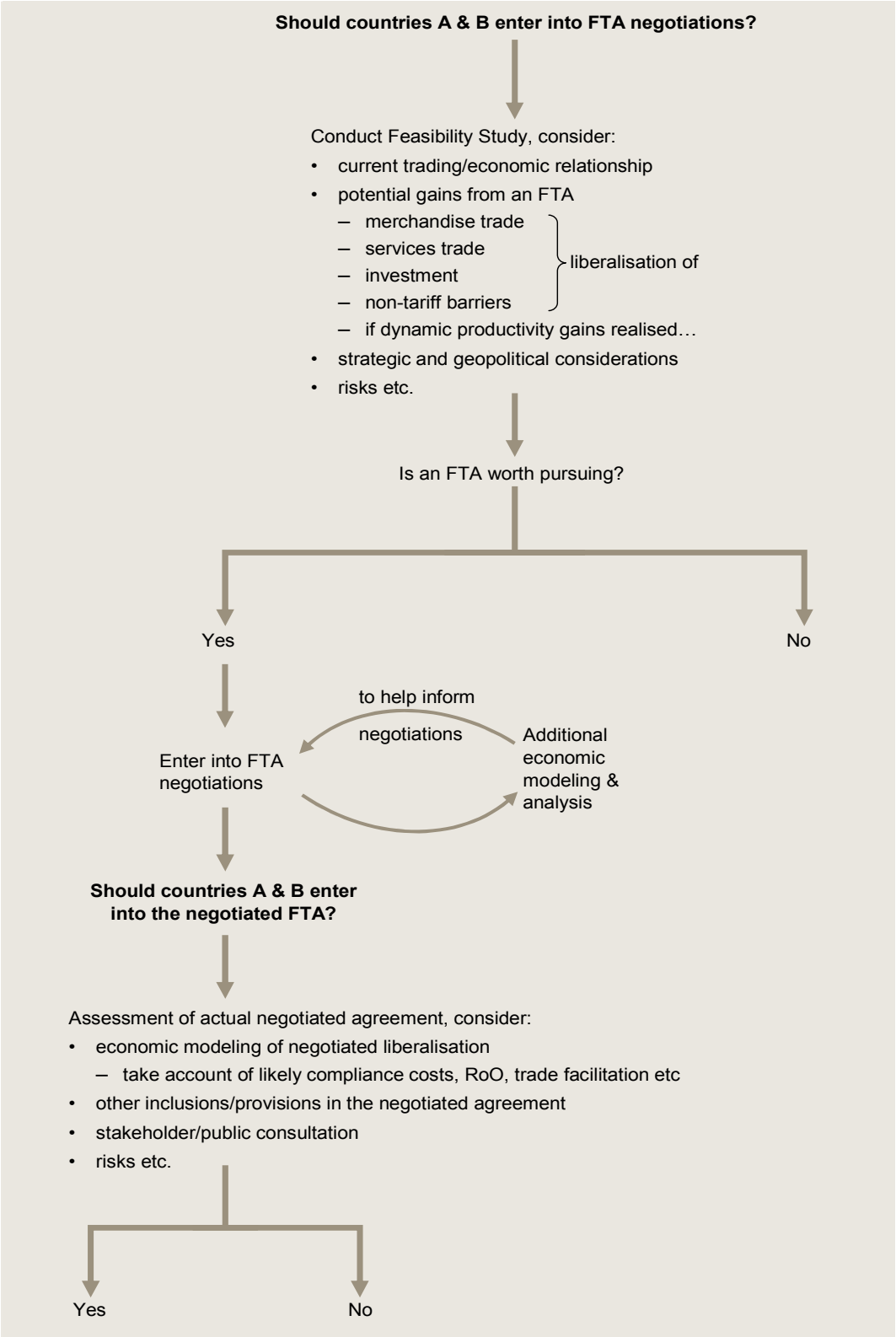
Chart 2.1 outlines CIE's view on how economic modelling and Feasibilities Studies could be used in the FTA evaluation process. As can be seen, we see a role for quantitative analysis at several stages in the FTA evaluation process — in the Feasibility Study, to help inform the negotiations, and in quantifying the expected economic impacts of the negotiated agreement.

At the Feasibility Study stage, it is probably 'cleaner' to consider comprehensive liberalisation, and to conduct economic modelling on that basis. However, when reporting findings, it should be made very clear what underpins those results — comprehensive trade and investment liberalisation.

Simulating phased liberalisation, sector carve outs etc is probably best suited to informing the negotiations about the economic impact of certain liberalisation options.

The negotiated agreement should also be subjected to a rigorous quantitative exercise to assess/estimate the expected economic impacts. It is on the basis of this modelling

2.1 FTA evaluation process



Source: The CIE.

exercise, plus assessment of qualitative and geopolitical considerations and risks, that the decision should be based about whether or not a country should enter into a particular agreement.

Due to (likely) differences between comprehensive liberalisation and the actually negotiated provisions in an FTA, the modelling results from FTA Feasibility Studies should not be used to portray the gains that could be expected from a negotiated FTA.[4]

4 Unless, of course, the negotiated FTA saw the overnight and comprehensive liberalisation of all barriers to merchandise trade, service trade, investment etc.

3 The Commission's own quantitative analysis of trade agreements

Comparing gains from bilateral, unilateral and multilateral reforms

The Commission undertook a number of CGE modelling simulations to compare the economic gains arising from merchandise trade liberalisation undertaken bilaterally (with a small and large country), regionally (APEC), unilaterally and multilaterally. The table below repeats the Commission's findings.

3.1 **Estimated Australian gains from merchandise trade liberalisation**

Simulation	*Impact on GDP*
	Per cent
Bilateral FTA with a small country	0.05
Bilateral FTA with a large country	0.12
Unilateral liberalisation	0.56
APEC liberalisation	0.86
Multilateral liberalisation	0.94

Source: PC 2010, *Bilateral and Regional Trade Agreements*, Productivity Commission Draft Research Report, table 12.1.

This pattern of results is not surprising, and reflects a priori expectations. But what is missing from the above table and the commentary in the Draft Report is any sense of the probability of any of these outcomes being realised. Without this discussion, the above table (and tables 8.6 and 12.1 in the report) is somewhat misleading. Imagine if this inquiry had been undertaken in 2001. Based on the above table, people would be right in saying that Australia should drop all other trade liberalisation negotiations in favour of concentrating on multilateral liberalisation under the auspices of the WTO's Doha Round, as this would deliver the greatest gains. However, nearly ten years later we are still waiting for the Doha Round to deliver any trade liberalisation. In hindsight, the decision to focus only on multilateral liberalisation in 2001 would probably have been regretted. Hence what is the probability that the 0.94 per cent GDP gain will be realised, and when?

We suspect that all economists, including those at the CIE, believe that multilateral liberalisation has the potential to deliver the greatest gains. However, we also believe that there is a need to be pragmatic about the probability of bilateral, unilateral

and/or multilateral liberalisation being realised (and when). In other words, what is the *expected* GDP gain?

Trade creation versus trade diversion

In certain sections of the Draft Report, it could be interpreted that the Commission believes trade diversion to be large, and that the presence of trade diversion means that the economic potential of Australia's FTAs has been oversold (see page XXII).

The Commission also goes on to note:

> Despite the potential for increased bilateral trade flows, once account is taken of the offsetting effects of trade creation and trade diversion, the resulting changes in economic activity and income are likely to be small. (Draft Report, page 8.26)

However, in the Commission's own CGE analysis, trade creation exceeds trade diversion (see tables 8.1 and 8.2 on page 8.11). Given this it is not clear why the Commission views the economic potential has been 'oversold'? The Commission's own CGE work (and that of others) does take into account trade diversion and trade creation. Indeed, the Commissions gravity model analysis also seems to support the case that trade creation exceeds trade diversion.

Furthermore, the Commission's quantitative analysis does not appear to take into account policies — such as the presence of other FTAs or unilateral action — that can act to reduce the amount of trade diversion attributable to any one single FTA.

For example, as a country's FTAs increase in number, the effective liberalisation will eventually approach multilateral liberalisation. Hence the quantum of trade diversion will be lower with each additional FTA. By way of example, Australia's existing FTAs, with ASEAN, Chile, New Zealand and the US, sees 30 per cent of Australia's total (import and export) merchandise and service trade in 2008 being subject to preferential trade liberalisation. If Australia concluded FTA negotiations with China, Japan and South Korea then a further 32 per cent of total trade would be covered by FTAs. Hence these seven FTAs could see some 62 per cent of total Australian trade being subjected to preferential trade liberalisation; well on the way to achieving multilateral liberalisation.

It is not clear whether the Commission's quantitative analysis has taken account of Australia's other FTAs.

Investigating others' claims about the impacts of FTAs

We do note that significant sections of the Draft Report (chapters 8, 9 and 10) seem to be devoted to critiquing one of our older studies, yet surprisingly, the same level of attention is not devoted to others' claims about the gains (or losses) arising from AUSFTA.

ACIL's 2003 report into the economic impacts of AUSFTA provides a case in point. The ACIL analysis suggested that AUSFTA would see a reduction in Australian GNP of 0.09 per cent. The Draft Report correctly notes (on page 8.5) that models can give differing results depending on what was simulated and certain assumptions regarding parameter values. A quick look at the ACIL report should make clear what modelling approach ACIL took, and the ramifications of this approach for trade policy formulation. ACIL choose to use very low values for the Armington elasticites — and go against the standard approach used by the GTAP community — and hence get large terms of trade losses, which sees AUSFTA having a negative impact on Australia.

While this is interesting from a modelling perspective, what should be of concern to the Commission is what does the use of low Armington estimates mean for trade policy formulation in Australia. ACIL also simulated unilateral and multilateral liberalisation. According to ACIL's analysis, unilateral liberalisation is bad for Australia — GNP is 0.6 per cent below baseline. Such a finding is clearly at odds with the Commission's work over the last 30–40 years.

The ACIL analysis also means that Australia would be best served by withdrawing from multilateral (WTO) negotiations while cheering the world on to liberalise from the sidelines. Once again, this conclusion is contrary to the Commission's views and findings in the Draft Report.

We are surprised to see the Commission implicitly endorsing this antiliberalisation view, or at least not commenting on it in more detail. For the Commission's information, the CIE looked into ACIL's 2003 report. Our comments on the ACIL report can be found at: http://www.thecie.com.au/publication.asp?pID=17.

The Commission's CGE analysis

Due differing modelling simulations, model closures, using databases pertaining to differing years, and differing assumptions about baseline liberalisation, it is hard to draw a comparison between the CIE's CGE modelling results and those of the Commission. (The CIE assumes that the 'small' country results reported in chapter 8 relate to Thailand, while the 'large' country results relate to the United States.)

Turning to TAFTA, the Commission's GTAP modelling suggests that Australian GNP will be some 0.05 per cent above baseline as a result of removing all tariff barriers to merchandise trade. The CIE's modelling suggested that the negotiated TAFTA would see Australia's GDP (note, not GNP) being some 0.025 per cent above baseline. As the CIE's modelling took account of the timing of liberalisation and only included limited services trade liberalisation by Thailand, we consider our results to be broadly comparable to those obtained by the Commission.

We believe that our modelling results for AUSFTA are also comparable to that of the Commission's.

The Commission estimated that the merchandise liberalisation of all Australia–US trade would see Australian GNP being around 0.1 per cent above baseline. The CIE's 2004 study suggested that the negotiated merchandise and service trade liberalisation under AUSFTA, which took account of sector carve outs and the phasing of trade liberalisation, would see Australia's GDP being around 0.15 per cent above baseline. This result was obtained using the G-Cubed model, which has a much more sophisticated treatment of investment and capital accumulation than does the version of GTAP used by the Commission. However, the CIE also used a comparative static version of GTAP to simulate AUSFTA, and according to that model merchandise and service trade liberalisation under AUSFTA would see Australian real GDP being around 0.05 above baseline.

Hence the Commission's estimate of 0.1 per cent for merchandise trade liberalisation lies midway between the CIE estimates of 0.05 (GTAP) and 0.15 per cent (G-Cubed) for the negotiated merchandise and service trade liberalisation. We expect a large part of the variation in the three sets of modelling results is due to the sophistication of the investment and capital accumulation dynamics of the models. Therefore, we see our modelling results for AUSFTA very similar to that obtained by the Commission (in terms of trade liberalisation).

Given the apparent similarity of modelling results, it is clear that the CIE's approach to modelling FTAs is entirely consistent with that of the Commission's.

For ex-post studies, the issue then turns to the impact of rules of origin, and costs associated with complying with the RoO. The CIE welcomes the Commission's research/work in this area. However, it should be noted, as was done in our 2004 AUSFTA report, that CGE models cannot typically account for RoO in a satisfactory way. This situation arises as RoO are typically specified at the HS8 digit level — of which there may be around 15 000 such codes in a bilateral FTA — yet economic models typically operate at the 42 merchandise sector level.

Does the Commission have a view on how RoO compliance costs and production costs (in order to access preferential tariffs) vary by sector, and by type of RoO (value added or change in tariff classification)?

The CIE would suggest that as the cost/impost associated with complying with RoO will differ across tariff lines, it is inappropriate to apply the same RoO induced compliance cost or change in production process impost across the merchandise sectors.

The CIE would also contend that both compliance costs and production costs are constrained by the difference between the preferential tariff and the MFN tariff. As currently read (see text around page 8.17), it appears as if the Commission is only

considering the later to be constrained. Exporters will not voluntarily incur additional compliance costs or production costs in order to access preferential tariffs if the cost impost is not more than offset by the difference between preferential and MFN tariffs.

Finally, it is not immediately clear what the Commission's baseline assumptions were in the CGE work.

The Commission's gravity model analysis

As far as the CIE can see, gravity models principally give insight into whether merchandise trade between two (or more) countries is higher as a result of a trade agreement than could otherwise be expected after accounting for a range of other factors that influence trade flows, such as economic size, physical size, physical/economic distance apart, the sharing of a common border and/or language, cultural/colonial background, migration patterns, whether land locked or an island, and so on.

But as the Commission itself correctly notes

> It should also be noted that changes in trade flows, do not, of themselves, represent economic gains. (Draft Report, page 8.21)

Hence no economic welfare insights can be drawn from the gravity model's estimated change in trade flows as a result of an FTA. Surely it is economic welfare considerations that should inform the decision as to whether or not Australia should enter into a negotiated FTA.

Given this, presumably the objective of the gravity model analysis is to provide insight into the trade creation versus trade diversion debate. If so, does the Commission interpret the gravity model results as suggesting that agreements result in net trade creation (as was also suggested by the Commission's CGE analysis)?

If the answer to this latter question is 'yes', then we are not clear what evidence the Commission is drawing on when concluding:

> Despite the potential for increased bilateral trade flows, once account is taken of the offsetting effects of trade creation and trade diversion, the resulting changes in economic activity and income are likely to be small. (Draft Report, page 8.26)

As there is limited discussion in the Draft Report on the Commissions gravity model analysis, there are a number of important general questions that it raises.

- It is not clear whether trade agreements entered into by 140 countries over the last 40 years can shed any light on Australia's trade agreements in 2010. A related question concerns how the Commission has taken account of the differing degrees and phasing of merchandise liberalisation (and differing negotiated provisions) under the various agreements included in the econometric analysis? Do early

harvest agreements yield the same increase in trade as do the more comprehensive free trade agreements?

- Have the trade agreements been assessed on an agreement-by-agreement type basis, or all (simultaneously) at the same time? If the former, the standard errors for the bilateral agreements (hence only 2 observations in each time period) could be expected to be large. Will the Commission be reporting standard errors, and have standard errors been correlated across time periods?
- How have MFN tariffs, and changes in MFN tariffs, been accounted for in the analysis?
- Given the availability of data, would the gravity model work not give greater insight if it were undertaken at the HS chapter level (as opposed to the country level)?
- Is the 'fixed effects' explanatory variable allowed to vary over time (reflecting the fact that trade often follows/is associated with migration and investment flows)?

While the CIE has used gravity models in the past, we do not claim to be experts in their application. However, we believe that there are substantive questions raised by the Commission's gravity model work to warrant considerably more explanation in the Final Report, perhaps with an independent peer critique.

4 Economic modelling of trade and investment liberalisation

General comments

The CIE would like to make a few comments concerning the way in which our FTA work has been portrayed in the Draft Report.

Taking Box 8.1 (page 8.4) as a starting point, the Draft Report notes:

> …this [Feasibility Study modelling] has involved assumptions of full reduction of tariffs on trade between partners to zero with no carve outs or phasing in periods. Similar assumptions were also made for the liberalisation of services trade and investment. (Draft Report, Box 8.1, page 8.4)

The sentiment expressed in this quote is factually incorrect. Numerous CIE FTA Feasibility Studies include simulations of differing liberalisation phase in periods (for example, see Indonesia, India, Japan and US (2001) studies). The Thailand (2004) and US (2004) simulated the actually negotiated tariff liberalisation, hence include phase in periods and sector carve outs as negotiated.[5]

Furthermore, not all (of the CIE's) studies simulated comprehensive merchandise, service and investment liberalisation and inclusion of dynamic productivity gains. For example, the already mentioned Thailand (2004) study only considered trade liberalisation (as negotiated) and very limited services liberalisation on behalf of Thailand (Australia's service liberalisation, as negotiated, was essentially standstill). Investment liberalisation was not simulated nor dynamic productivity gains included.

We would also like to point out that some of the real GDP gains that have been reported as coming from our work are incorrect. For example, Australia's real GDP gain 10 years post FTA are 0.025 per cent in the case of TAFTA (versus 0.04 as reported) and 0.6 per cent in the case of AJFTA (0.7 per cent is reported). Other reported findings are in line with the estimates in our various reports.

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5 Box 8.1 refers to our second US FTA study as being a 2003 study. According to the CIE's records, the study was undertaken in 2004. Box 8.1 will therefore need to be updated with the correct reference.

There has been significant model development

The discussion in the Draft Report fails to appreciate that significant model development has (iteratively) occurred over the last decade, which has in turn allowed improved modelling of trade liberalisation. It also means that that the modelling results from the cited reports in Box 8.1 cannot be compared, as differing things will have been simulated via differing approaches.

For example, the CIE has made significant advancements in terms of modelling dynamic productivity impacts and FDI liberalisation. With respect to the latter, the Draft Report correctly notes:

> The first type of barrier [screening barriers leading to the creation of economic rents accruing to foreign investors] would require accounting for the economic rent in the database — something which is difficult. (PC Draft Report, page 9.12)

Not only do rents need to be taken account of, but also needed is a measure of the (rent and cost creating) barriers. And yes, it is indeed difficult. It took CIE a substantial amount of time to assemble the FDI data, develop a methodology for calculating the magnitude of rent and cost creating FDI barriers, and to recode our CGE model to allow simulation of FDI liberalisation. While our approach could always benefit from more work, the point is that the CIE has at least already met some of the challenges alluded to by the Commission. Our approach to the modelling of FDI liberalisation is documented in a forthcoming report due to be released by DFAT.

It is also worth noting that the CIE has been very active in trying to ensure that our findings and developments in the area of calculating FDI barriers and simulating their removal can be transferred to the Productivity Commission so as to assist the Commission in its own economic modelling of this important area. From what we understand, the Commission would like to use our approach/estimates.

What can and should be modelled?

Trade liberalisation can comprise numerous areas of liberalisation — merchandise trade, service trade (via Modes 1, 2 and 4), potentially non-tariff barriers and investment liberalisation (equivalent to Mode 3 service delivery).

When modelling the potential gains from trade liberalisation, whether that liberalisation is bilateral, unilateral or multilateral in nature, all areas of liberalisation need to be considered if the modelling is going to provide a rigorous assessment of the potential impacts. Furthermore, if trade liberalisation is thought to bring about additional competition, which in turn leads to productivity gains, then the trade liberalisation induced productivity gains should also be included in the modelling.

While modelling merchandise and service trade liberalisation, removal of NTBs, investment liberalisation and (any) resultant productivity gain is difficult, it is possible to do it.

The Commission's modelling results typically pertain to merchandise trade liberalisation only. Given that only one area of liberalisation is modelled, it is not clear the economic gains, as reported, are 'outer envelope'.

(We do note that the Commission has done some stylised investment and liberalisation induced productivity gain simulations. However, given the stylised nature of these modelling simulations, we have assumed that they are for illustrative purposes only as opposed to a more comprehensive and rigorous assessment of the economic impacts of bilateral trade liberalisation.)

What 'weight' should be assigned to economic modelling results?

The CIE appreciates that the Terms of Reference for this inquiry specify that the Commission needs to consider the economic impacts of bilateral and regional trade agreements (amongst other things).

However, it is the CIE's experience that modelling results only play a very small part in deciding whether two countries should negotiate a trade agreement. Also important are strategic and geopolitical considerations and qualitative assessments. As noted in chapter 1, modelling results should only be used to infer the outcome of trade liberalisation (positive or negative) and the magnitude of such impacts (small or large). That is, only broad messages, insights and trends should be taken from the modelling results. This reflects the fact that economic models are not perfect, nor can they adequately simulate/replicate all provisions contained in a trade agreement.

We believe that the report could benefit from a discussion about the role played by economic modelling results in influencing the decision about whether two countries should negotiate a trade agreement. As currently read, the Draft Report gives the impression that economic modelling results are assigned a large weight in the decision making process. We are not sure that this is the case.