STATEMENT 4: AUSTRALIA IN THE WORLD ECONOMY

This statement discusses a range of fundamental changes in prospect for the world economy, and their implications for Australia. It then discusses the strategies Australia is adopting in its economic engagement with the world to address and respond to these changes.

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This statement examines Australia's place in the world economy. It begins by discussing some of the fundamental influences that are gradually changing the contours of the world economy. It focuses particularly on the far-reaching implications of the rising economic importance of China and India, before turning to the continuing process of globalisation, population ageing in both developed and developing economies, and possible exposure to adverse external shocks — in particular, terrorism, pandemics and threats to energy security. The statement therefore builds on Statement 4 in recent budgets, which have also examined fundamental global changes; in particular, the productivity-enhancing role of information and computer technology (2001-02) and the implications for Australia of population ageing (2003-04 and 2005-06).

The statement then turns to the strategies Australia is adopting in its economic engagement with the world to address and respond to these developments. The growing economic weight and influence of China and India, continuing globalisation, the evolving patterns of East Asian regionalism, as well as long-term security, resource and environmental concerns are placing new demands on international institutions and patterns of engagement — at the multilateral, regional, and bilateral levels. The statement discusses these issues with a focus on the strategic goals underpinning Australia's international economic engagement, the role of current activities in helping to achieve these goals, and the important challenges for the future.

CHANGES IN PROSPECT IN THE WORLD ECONOMY

China and India

Continuing strong growth in China and India is arguably the international economic development with the most far-reaching consequences for the global economy. China is already the world's second largest economy, and India the fourth largest. On plausible assumptions, it is possible that the size of China's economy could surpass that of the United States within fifteen years.[1] This shift in relative economic importance towards China, and potentially India, from the developed economies — Europe, Japan and to a lesser extent the United States — is already occurring and represents a major tectonic shift. As the metaphor suggests, the changing relative size of the key economies may sometimes see seismic disturbances with powerful economic implications. Managing these potential disturbances will be critical to maintaining an environment conducive to continued strong global growth.

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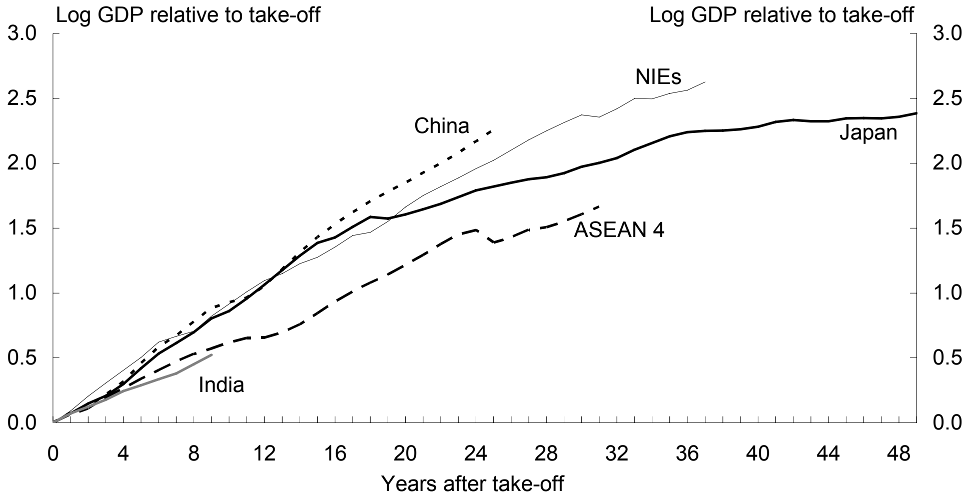
1 These estimates are on a purchasing power parity (PPP) basis. This is the preferred basis for comparing the relative size of economies because it uses a conceptually appropriate approach to estimating prices in both the traded and non-traded sectors of the economies, in contrast to comparisons based on market exchange rates.

Other large developing countries such as Brazil, Indonesia and Russia may also increase in economic importance in coming decades. We focus in this section on China and India because they are by far the most populous developing economies. As such, their continued rapid growth is of greatest importance for the global economy.

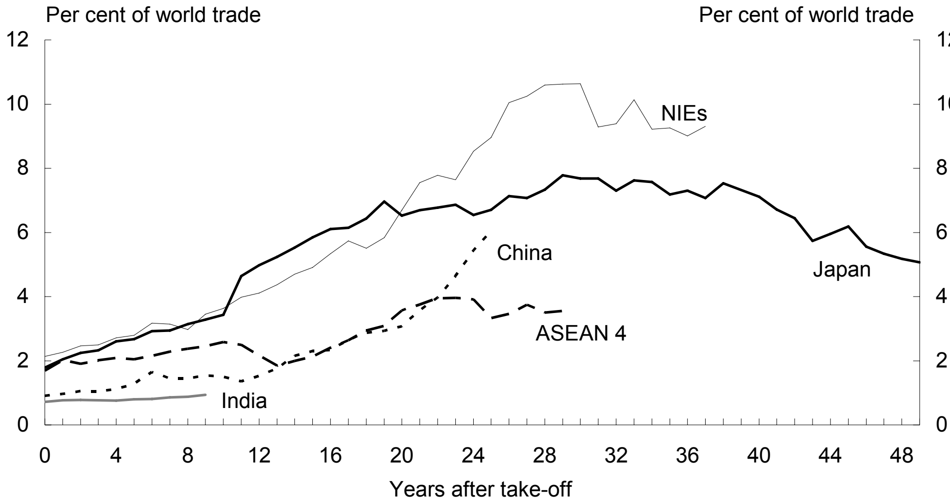
The recent growth rates of China and India have been very high relative to the standards of the developed economies but not dramatically different from those recorded in earlier decades by Japan, the East Asian newly industrialised economies (NIEs) (Hong Kong, Korea, Singapore and Taiwan), and ASEAN 4 (Indonesia, Malaysia, Philippines and Thailand) (Chart 1). China's share of global trade has thus far been less than Japan's (at comparable stages after take-off), but China's share is rising extremely rapidly and could soon surpass Japan's peak share of world merchandise trade during its rapid development (Chart 2). India's share of global trade remains small, but should grow strongly provided India continues to reform and open up its economy.

Chart 1: Growth after take-off



Source: IMF World Economic Outlook database, September 2005. Data shown are: Japan, 1955-2004, China, 1979-2004, NIEs, 1967-2004, ASEAN 4, 1973-2004, India, 1995-2004. Take-off is the first year when the country (or group) experienced at least 10 per cent annualised growth in the value of exports over the previous three years.

Chart 2: Share of world merchandise trade after take-off



Source: IMF World Economic Outlook database, September 2005. Data shown are for the same years as Chart 1.

The process of 'catch-up' in China and India is similar to that followed by Japan and the East Asian NIEs in past decades: moving towards the technologies, institutions and standards of living of the developed economies. The catch-up phase in China and India, however, may continue for longer because the gap between their productivity levels and those of the advanced economies is larger than was the case for their East Asian predecessors. This larger productivity gap arises primarily because the global productivity frontier has now moved further out than its position at the time of the rapid development of the other East Asian countries.

This line of argument suggests that China and India may continue to grow at around their recent average rates for quite some time to come, although they will undoubtedly experience inevitable bumps along the path to modernisation. Of course, bumps along the path to modernisation often require adroit policy responses — to ensure that they remain 'bumps' and do not evolve into something more serious and long-term. By similar logic, sustaining strong growth in these countries will depend on their continuing with internal reforms that will likely grow more demanding. For example, China will need to press on with improvements to fiscal sustainability, financial-sector reform, and reforms to its many remaining state-owned enterprises, and will also need to adjust to the inevitable appreciation of its real exchange rate. Much will depend on maintaining political and social stability through these processes of transition.

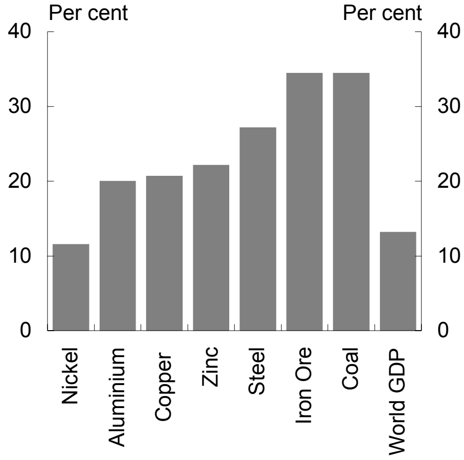
As discussed in more detail later in the statement, different demographic trends in the two countries will play an increasingly important role in their relative growth over time. China's working-age population is projected to begin to fall around a decade from now. By contrast, India is one of the few large economies projected to have a growing working-age population over the next 40 years and is projected to overtake

China as the world's most populous nation in the 2030s (United States Census Bureau 2005).

China's economy is large enough that its share of global demand for a range of commodities is already sizeable (Chart 3). Part of the reason for this, of course, is the sheer size of China's population — currently around 150 million more than all of the OECD countries combined (based on United Nations population projections for 2005).

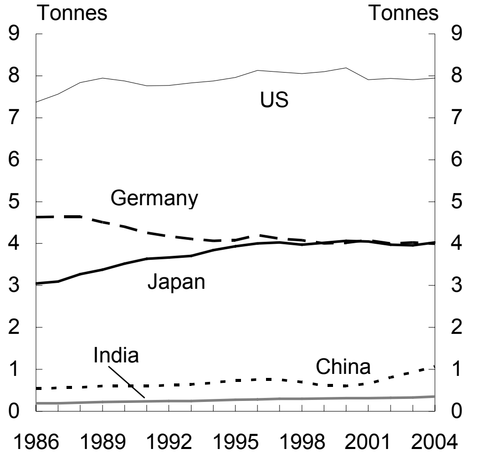
The effect of China and, to a lesser extent, India on world demand for imported forms of energy, especially crude oil, reflects the relatively high energy intensity of their economies (units of energy input per unit of output produced). China's consumption of energy per capita, however, is currently much lower than that of the advanced industrial countries (Chart 4), and the same is true of its consumption of metals. But as this per capita consumption rises, China may account for the majority of the world's growth in import demand for resource-intensive products for an extended period.

Chart 3: China's share of global consumption of materials



Source: Baffinland Iron Mines Corporation (2005), BP Global (2005), IMF (2005a), Morgan Stanley (2005), Richmond (2005). China's share of world GDP is at purchasing power parity exchange rates.

Chart 4: Energy use per capita



Source: World Development Indicators, BP Global (2005). Units are tonnes of oil equivalent per capita per annum.

The Chinese Government projects a doubling in energy use between 2000 and 2020. This projection may be conservative, however, given China's aim to quadruple its GDP per capita over this period (a goal economic historian and Nobel Laureate Robert Fogel regards as attainable; see Fogel 2006) and the recent experience that energy use has been growing faster than GDP (Sinton et al 2005). Even if China maximises the use of its domestic coal reserves and achieves sizeable improvements in energy efficiency, it is likely to have a rapidly growing demand for imported energy, especially oil for transport. In India as well, dependence on imported oil and other energy sources is likely to continue to rise.

Rising energy consumption in these countries will therefore have major implications for the balance of world energy supply and demand as well as for global efforts to restrain greenhouse gas emissions and hence climate change. International mechanisms aimed at containing global greenhouse gas emissions will clearly not be effective if they exclude these countries. This emphasises the need for mechanisms to promote the transfer of cleaner and more efficient energy technologies to developing economies, and for international agreements that aim to contain greenhouse gas emissions to include these countries as well as developed countries. Developing and deploying low-emissions technologies is a key focus of the recently established Asia Pacific Partnership on Clean Development and Climate, a collaboration between Australia, China, India, Japan, Korea and the United States, which together account for half of the world's energy use and greenhouse gas emissions.

Comparative advantage

Although China's future development is likely to involve progressively more capital-intensive production, its international trade will for a long time reflect its relative abundance of labour. That means China will continue to export mostly labour-intensive manufactures, and to import mostly raw materials, foodstuffs and capital-intensive manufactures.

A considerable literature modelling the implications for other economies of the likely further growth of China generally suggests that countries which specialise in labour-intensive manufacturing and assembly are most likely to be adversely affected by China's rise. By contrast, countries specialising in the production and export of components, capital goods and raw materials are more likely to be favourably affected.

The global effects of India's growth have so far been much less than those of China's, because India remains a relatively closed economy with only a small share of global trade in goods and services (Chart 2). If India continues to embrace globalisation and reform — which will support a continuation of its recent high growth rates — its trade will likely contribute increasingly to global growth.

One aspect of India's development that has attracted considerable attention is the outsourcing to India of services such as call centres and business data processing that were previously undertaken in developed countries. According to a McKinsey Global Survey, around 1.5 million services jobs were outsourced from developed countries (a number that includes all destination countries, not just India) in 2003 (The Economist 2005). Outsourcing is expected to grow rapidly (almost tripling by 2008 according to the McKinsey Survey), driven by advances in technology. Even the largest projections of jobs lost to outsourcing out to 2015, however, remain small relative to overall job turnover in the developed countries (OECD 2005).

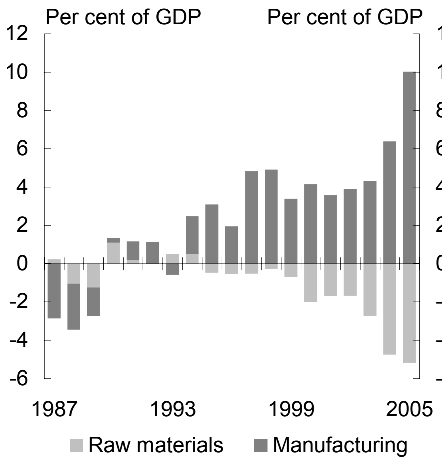
As is the case with opening up the economy to international trade, outsourcing enhances economic efficiency and generates net economic benefits for both source and destination countries. However, it imposes adjustment costs on those sectors of the economy, predominantly service sectors, that were previously insulated from overseas competition. Similar adjustments have been made by trade-exposed sectors of the economy over recent decades, in the process of reducing tariff and other barriers to trade, with widely accepted benefits for the economy.

Implications for Australia

The rise of China and other large developing countries presents opportunities for Australia to exploit its comparative advantage in natural resources and 'high-end' goods and services, although some more labour-intensive sectors are likely to face increasing competition.

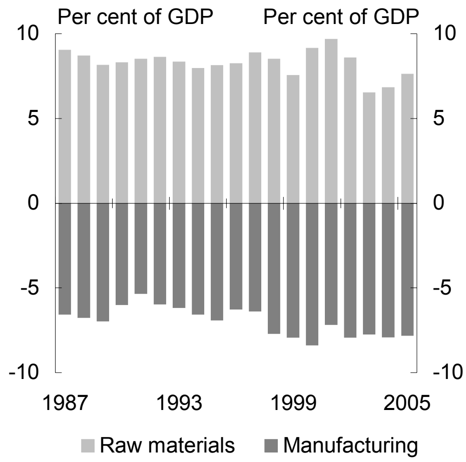
The complementarity of China's net exports and those of Australia is shown in Charts 5 and 6. China is a large net exporter of manufacturing goods, but a large net importer of raw materials, while Australia's net trade position in these two categories of goods is precisely the opposite.

Chart 5: China's net exports



Source: CEIC Asia Database.

Chart 6: Australia's net exports



Source: ABS cat. no. 5302.0.

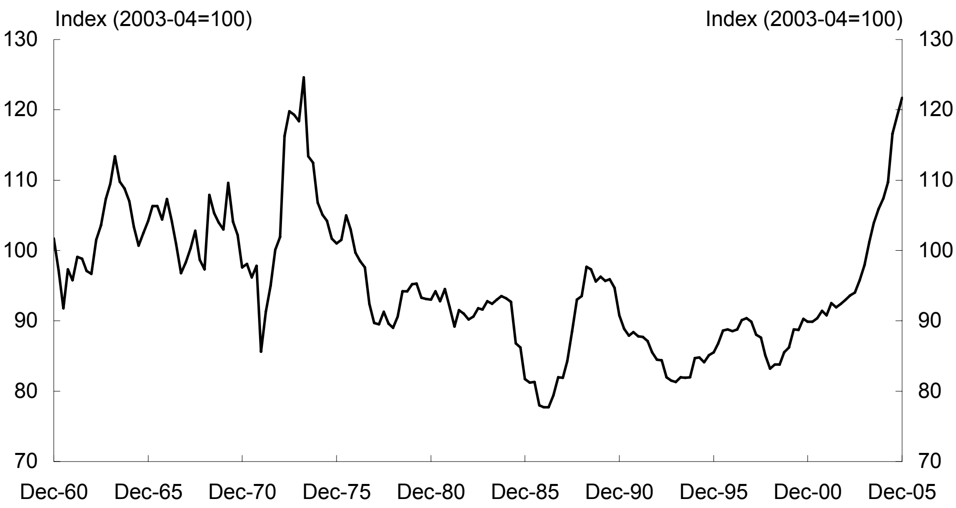
The additional demand for resources by China and other economies has manifest itself in a huge rise in Australia's terms of trade (the ratio of the prices we receive for our exports to the prices we pay for our imports) over recent years (Chart 7).

This huge change in relative prices has been absorbed by the Australian economy with minimal disruption, notwithstanding the heightened competitive pressures faced by many firms in both export and import-competing industries. In contrast, the previous similarly sized terms of trade boom in the early 1970s proved extremely disruptive, resulting in an inflationary boom that cast a long shadow over the economy (Gruen 2006).

In large part, the improved economic resilience in the face of the current terms of trade shock has been a consequence of improved institutional arrangements and the increased flexibility of the domestic economy. Of particular importance in this regard have been the floating of the exchange rate and the introduction of independent monetary policy. And the other crucial development — without which the first two would have been less effective — has been the increasing policy focus on the supply side of the economy — a focus on microeconomic reform. Industrial relations reforms and competition policy, in particular, have contributed significantly to macroeconomic stability both by allowing the exchange rate to act as an absorber of external shocks without generating inflationary impulses across the whole economy, and by reducing the need to resort to activist fiscal and monetary policy in an attempt to keep the economy on an even keel.

Having absorbed the huge rise in the terms of trade with minimal disruption to the aggregate economy, there are grounds for optimism that future volatility in the terms of trade can be similarly absorbed. The improved institutional arrangements and enhanced flexibility have reduced the vulnerability of the economy to the disruptive effects of sharp rises in the terms of trade. They should also do so were Australia to experience a sharp fall in the terms of trade at some time in the future.

Chart 7: Australia's terms of trade



Source: ABS cat. no. 5302.0.

Looking to the future, there are powerful economic influences tending to keep resource and energy prices high, and other powerful influences tending to reduce them. The most important influence tending to keep them high is the likelihood that a continuation of strong catch-up growth in the large developing economies will generate further increases in their energy and mineral needs over an extended period of time. This in turn would imply global resource requirements well in excess of existing capacity and continuing above-average rates of exploration and investment in the resource sector to meet these rising requirements.

The most important influences acting in the opposite direction, tending to reduce resource and energy prices, are the global demand and supply responses to the currently high prices. Over an extended period of time, these demand and supply responses can have a powerful moderating influence on prices, as was seen for example in the aftermath of the OPEC oil shocks of the 1970s. Furthermore, global responses to rising greenhouse gas emissions are also likely to reduce the rate of growth of energy demand below previous trend rates and put downward pressure on the prices received by resource suppliers over time.

Unfortunately, economists do not have an enviable track record predicting how powerful, but countervailing, economic influences will be resolved nor, in particular, the timing of their resolution. Given these unavoidable limitations with economists' crystal balls, it is worth discussing the main possibilities and their implications, at least in broad outline.

One possibility, which presumes no serious prolonged adverse developments that derail the catch-up process for the large developing countries, is that average prices for resources may remain relatively high — well above the average cost of production — for an extended period of time, especially given the size of the remaining productivity gap between the large developing economies and the advanced economies (Garnaut 2006). In that case, while there would undoubtedly be volatility in prices at times, Australia's terms of trade would continue at a relatively high average level for an extended period.

Were this outcome to eventuate, it would be outside the historical experience of the past several decades, as Chart 7 shows. It is therefore of interest to examine in some detail the implications for the Australian economy were the terms of trade to remain relatively high for an extended period.

To begin with, this would clearly have a strongly favourable effect on average Australian living standards. A long period of high resource prices would also generate a prolonged expansion of the resources sector, accompanied by a shift of capital and labour from other sectors of the Australian economy in response to higher average profits and employment opportunities in the resource sector. Capital and labour would likely be drawn out of some parts of manufacturing, and also parts of agriculture and services that are becoming increasingly tradeable.

Higher average returns in the capital-intensive resource sector for an extended period would raise the profit share of national income, and provide continuing stimulus for high levels of business investment in that sector. The implications for the current account deficit would depend on the response of national saving to the higher national income associated with the high level of resource prices (since the current account deficit is the excess of national investment over national saving). It is possible that the rise in investment would exceed the rise in saving, in which case the current account deficit would become larger, possibly for an extended period.

Such a development, should it occur, should not be cause for concern nor a sign that Australia was no longer able to compete in the global marketplace. It would instead be part of the process of Australia successfully reaping the broader economic benefits offered by the emergence of China, India and other large developing countries.

If these outcomes eventuate, the challenge will be to craft public policy with an eye to both distributional concerns and enabling the necessary adjustments to take place. There is a compelling case for helping to enhance individuals' capacity to adjust to economic changes that have adversely affected them, and hence an important role for education and training policies geared to this outcome. However, it would be counterproductive to provide trade protection or long-lived publicly funded economic support to sectors or firms that can no longer generate an economic return.

If we are at the early stages of a long-lived change in Australia's comparative advantage, this change is likely to generate significant reallocation of activity among major sectors of the economy; a reallocation that will be facilitated by the efficient functioning of product, labour and capital markets. On this score, Australia has achieved much in improving the functioning of its markets over recent years. For the economy to respond efficiently to a long-lived change in relative prices, however, will require a continued focus on improving the flexibility of the supply-side of the economy — that is on microeconomic reform. This will be particularly important in sectors relevant to enabling economic resources to reallocate with minimum disruption. In particular, pricing, competition and competitive neutrality issues in transport, energy and water need to be resolved to ensure both efficient infrastructure investment and service delivery.[2] Many policies designed to enhance flexibility clearly have important federal and state dimensions, and will therefore require cooperation between levels of government. The ambitious and broad-based reforms in the February 2006 Council of Australian Governments' National Reform Agenda represent an admirable example of such cooperation.

The future evolution of the terms of trade will also have implications for fiscal policy. At a time of strongly rising terms of trade, and hence strongly rising taxation revenues, there is a case for running larger-than-usual budget surpluses, because it remains unclear for how long the strongly rising taxation revenues will be sustained. This has been the strategy followed by the Australian Government, with the underlying cash surpluses over the most recent three years, 2002-03 to 2004-05, averaging 1¼ per cent of GDP, ½ per cent of GDP above the average over the previous five years.

If resource prices were to remain high on average for an extended period — which would, of course, only become apparent gradually over time — the case for continuing to run larger-than-usual budget surpluses would become progressively weaker. The budget strategy of balance over the cycle implies budget surpluses that are larger than

2 See Henry (2005) for more on reform issues in the transport, electricity and water sectors.

usual when macroeconomic conditions warrant it, but clearly cannot imply such surpluses at all times.

Having examined the implications for the Australian economy were resource prices to remain high on average for an extended period, it is worth also examining circumstances in which this outcome might not eventuate.

As argued above, continued strong catch-up growth by China, India and other large developing countries is a reasonable and plausible forecast, but it remains just that — a forecast. While the countries and country-groupings in Chart 1 have all experienced long periods of strong catch-up growth, the historical record also contains examples of countries that experienced a few short years of strong catch-up growth, after which they faltered.

The per capita output growth experiences of Korea and Brazil, for example, were strikingly similar in the first half of the 1970s. Moreover, important determinants of future per capita growth in these two countries, like saving and investment ratios to GDP and the behaviour of real wages, were also strikingly similar at that time. But while Korea continued strong catch-up growth after the early 1970s, Brazil did not (Sachs and Sundberg 1988). This example highlights the point that continued strong catch-up growth is not inevitable. Instead, it requires growth-enhancing economic policies and, at times, painful and unpopular adjustments in response to economic shocks which, for developing countries, can sometimes be hugely disruptive, both economically and socially.

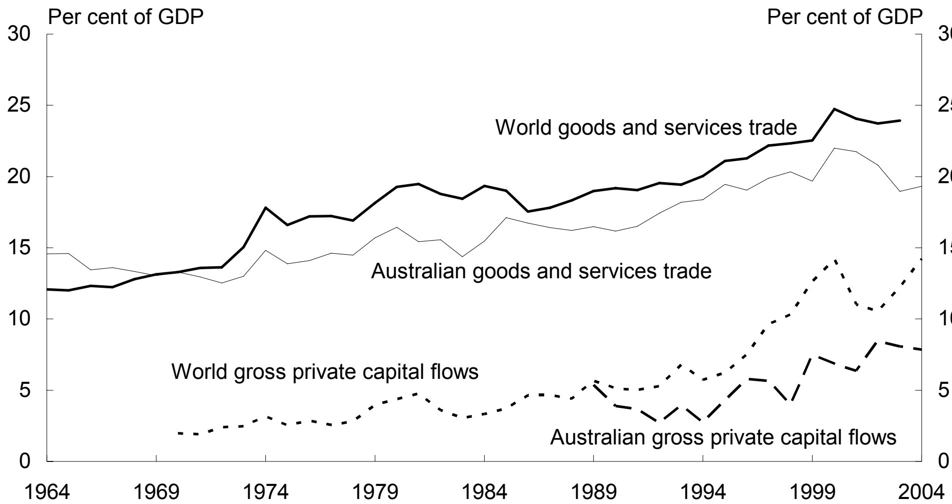
Developments across the rest of the globe are also relevant to whether resource prices remain high for an extended period, and whether China and India continue to grow rapidly for many years to come. As already mentioned, global demand and supply responses to the currently high resource prices may have a powerful moderating influence on prices, although with uncertain timing.

Furthermore, as also discussed above, continued strong catch-up growth in China and India will likely generate significant pressure for reallocation of activity among major sectors of the Australian economy. The size of the Chinese and Indian economies, especially if they continue to grow rapidly for an extended period, means that significant pressure for reallocation of activity among major sectors will be felt in many countries, not just Australia. Even if Australia responds flexibly to these challenges, there are no guarantees that others will do likewise — especially others whose economic welfare is seriously challenged by the rise of China and India. Inappropriate economic responses in other parts of the globe including, in particular, the rise of protectionism in any of its many guises, could do much to derail the process of long-term catch-up growth in China and India, with obvious deleterious implications for Australia and the world economy.

Continuing globalisation

The rise in the economic importance of China and India has been part, albeit an important part, of a process of continuing globalisation. A related manifestation of this process has been strong growth in international flows of goods and services and of capital, which have increased more rapidly than output over the past several decades (Chart 8). This has resulted partly from reductions in policy barriers to cross-border trade and capital flows, and partly from improvements in information and communications technology (ICT) and transport. This increase in economic integration has raised living standards by allowing countries to focus on producing and exporting those goods and services they can produce relatively more efficiently in exchange for those goods and services that others can produce relatively more efficiently. Financial integration allows savings to be invested where returns are expected to be highest and also enables risks to be better diversified.

Chart 8: World and Australian trade and capital flows



Source: ABS cat. nos. 5206.0 and 5302.0 and World Development Indicators. Trade is the average of exports and imports. Gross capital flows are the average of net foreign purchases of domestic assets and net domestic purchases of foreign assets.

While the increase in global integration to date has been substantial, there is scope for it to go further. This applies particularly to services, which account for two-thirds of world output but less than one-fifth of world trade. While the services share of world output has risen significantly, its share of world trade is no higher than it was in the 1960s. These trends suggest that neither improvements in ICT nor the recent growth of offshore outsourcing of some business services have thus far had a big aggregate effect on services trade.

There are now few remaining barriers to capital flows between developed countries (although foreign direct investment into developed countries is still sometimes restricted). Perhaps surprisingly, the allocation of international capital remains much less globalised than might have been expected. Notwithstanding a doubling since 1990, the share of foreign assets in portfolios across a group of developed economies remains only one-fifth of the share that would be expected in a world in which national borders represented no impediment to the movement of international capital (IMF 2005b). Developing economies are even less integrated into global capital markets, in part because of a lack of capital market development in those economies. Countries defined by the World Bank as low and middle income (having incomes per person less than about US$10,000 at market exchange rates) account for less than 10 per cent of gross private *cross-border* capital flows in recent years. Yet these countries account for 45 per cent of world GDP in terms of purchasing power parity and 20 per cent in terms of market exchange rates.

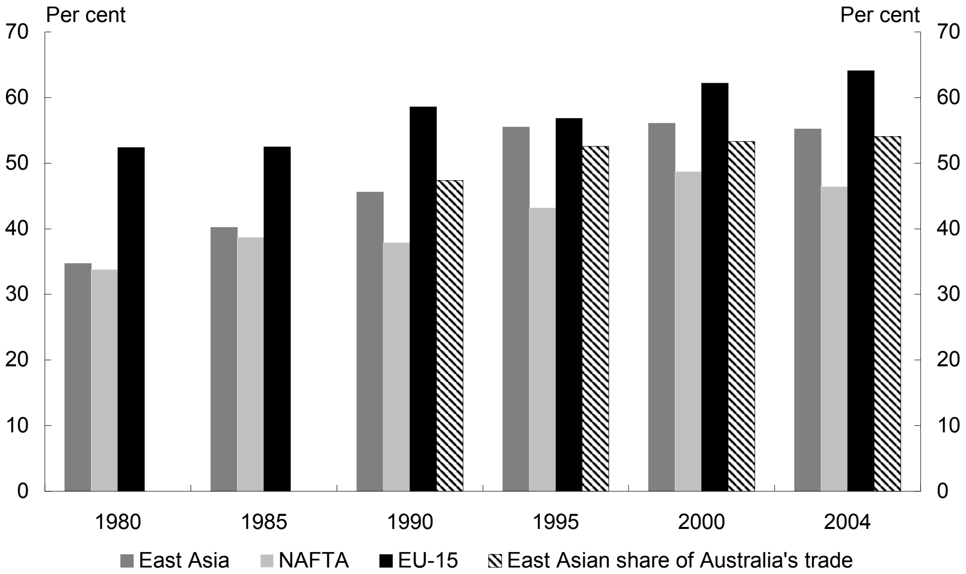
Cross-border capital flows are relatively small as shares of GDP because of both remaining policy barriers and 'home bias' on the part of investors. Home bias arises because investors usually know much more about the economic risks they face in their home countries than in other countries in which they may consider investing. But it also arises because of exchange-rate risk and differences in legal and regulatory systems. Many developing countries have explicit border barriers on some or all kinds of capital flows. Their integration into global capital markets is often further constrained by investors' perceptions of weak governance, low transparency and lack of policy and institutional credibility.

These observations suggest that while there is scope for much more international economic integration, the extent and pace of this integration are hard to predict. Further globalisation depends both on how far national governments liberalise policy barriers, and on whether pro-integration policies are supported by domestic policies and international arrangements to address 'behind-the-border' impediments and establish an environment in which cross-border transactions can flourish.

Regionalism

Trade for the three major economic regions of the world, Europe, North America and East Asia, has become increasingly intra-regional over time. Thus, for example, East Asia's intra-regional trade (trade between countries within the region) has risen from around 35 per cent of these countries' total trade in 1980 to 55 per cent in 2004, as Chart 9 shows. Trade *within* these regions, taken together, now accounts for over half of world trade. Australia has also been part of this trend, with a rising share of Australia's trade being undertaken with East Asia.

Chart 9: Intra-regional shares of total trade (exports and imports)



Source: ABS cat. no. 5368.0, Kawai (2005) and IMF Direction of Trade Statistics. East Asia comprises China, Japan, Korea, Hong Kong, Taiwan and the 10 ASEAN members.

Intra-regional integration has been accelerated by preferential liberalisation favouring intra-regional trade, both within the European Union (EU) and with the formation of the North American Free Trade Agreement (NAFTA). Integration within East Asia, including Australia, has been driven mainly by non-preferential liberalisation and economic complementarity. Even so, the intra-regional share of East Asia's trade is not far below that of the EU-15, as Chart 9 shows. East Asia's intra-regional integration has complemented its broader integration with the rest of the world, since much of the process has been driven by the development of intra-regional supply chains for the manufacture of goods for final sale in markets outside the region.

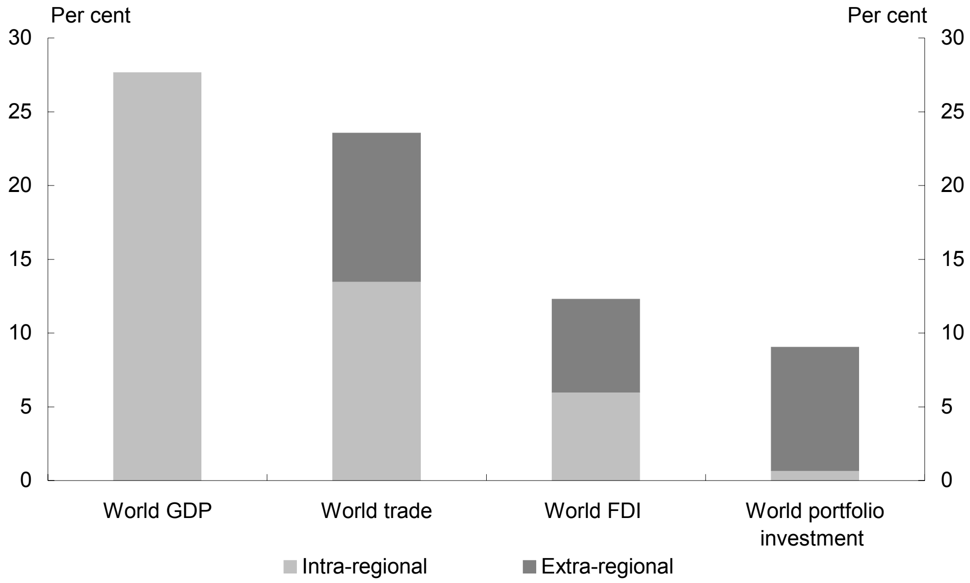
The situation in East Asia may, however, be changing. A number of preferential free trade agreements (FTAs) are under negotiation or consideration in the region, although their net economic benefits remain unclear, as discussed further below.

An equally important aspect of Asian regionalism has been a focus on regional financial cooperation with the aim of reducing financial vulnerabilities and better utilising the region's savings. In the Chiang Mai Initiative, the members of ASEAN+3 (the ten ASEAN countries plus Japan, China and Korea) have established a mechanism to provide mutual assistance in the event of future financial crises. Associated measures have been advanced in a range of forums to promote the development and integration of bond markets within Asia and the Pacific.

There appears considerable scope for further financial integration in East Asia, since international financial linkages remain much more limited than trade linkages. East Asia accounts for around one-quarter of world GDP and trade but only

12 per cent of foreign direct investment (FDI) and 9 per cent of portfolio investment (Chart 10). It is also notable that East Asia's intra-regional share of portfolio investment is very small relative to its intra-regional shares of trade and FDI. Australia's investment links with the region are also much more limited than our trade links. East Asia's share of Australia's inward and outward investment shrank during the Asian financial crisis, and has fallen further even after the region's recovery.

Chart 10: East Asia's shares, 2004



Source: CEIC Asia Database, Economist Intelligence Unit CountryData, IMF Coordinated Portfolio Investment Survey, World Development Indicators and the UNCTAD World Investment Report. Investment data are for total inward and outward investment stocks at year end. Intra-regional FDI based on intra-regional share of cumulative FDI flows for 1990-2002 (Kawai 2005).

Demographic change and labour mobility

Different demographic trends across the globe (discussed in Box 1) will be reflected in different patterns of labour force growth. Abstracting from net migration between regions, the total labour force in Russia, Eastern Europe, China and the high income countries taken together is projected to fall by around 30 million by 2025 and almost 250 million by 2050. By contrast, lower income countries will add around 800 million workers to the global labour force by 2025 and 1½ billion by 2050 (Holzmann 2005).[3]

3 In those countries with declining labour forces, there is projected to be a large rise in the number of people aged 65 and over, while in those with growing labour forces, it is projected that a 'demographic bulge' of young people will move into the working age population. The global population is projected to rise substantially — up by about 1.4 billion by 2025 and 2.6 billion by 2050 (United Nations Department of Economic and Social Affairs 2005).

These huge changes in labour supply will, in turn, likely lead to a gradual shift in the pattern of global growth from the high-income to the lower-income economies. As discussed earlier, while both China and India are projected to continue their strong economic growth and to increase significantly their shares of global output, China's more rapid ageing may gradually shift the balance between them.

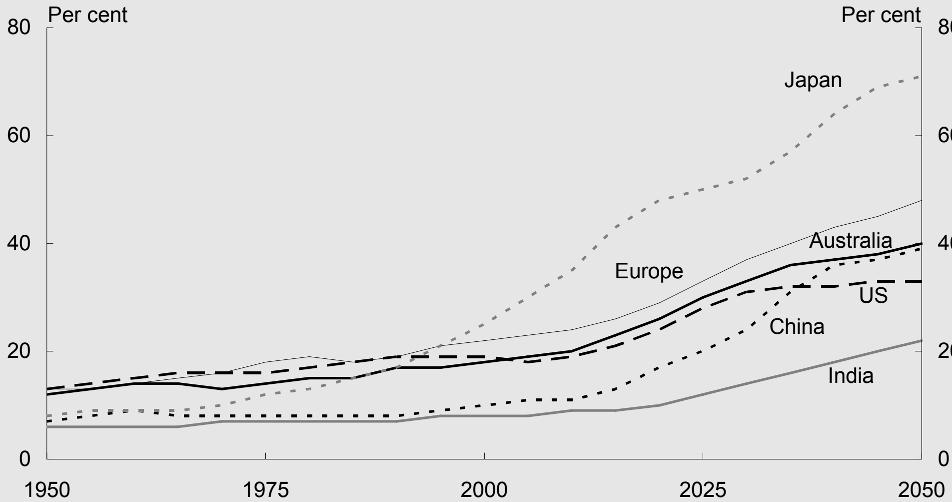
Box 1: Global demographic change

Populations across the globe are ageing because of declining rates of both mortality and fertility, which are in turn being driven by rising levels of development and improving health care. There is, however, significant diversity across countries in the rates at which these changes are occurring.

These demographic trends are manifesting themselves in rising old-age dependency ratios, which are projected to at least double for Australia, Europe, India, and Japan, but more than triple for China from now until 2050 (Chart 11). The United States old-age dependency ratio is also projected to rise but, with relatively favourable demographics, this rise is projected to be smaller than for other major countries and regions.

Chart 11: Old-age dependency ratios

Ratio of 65+ year olds to 15 to 64 year olds



Source: United Nations 2004 Revision Population Database, medium variant projections.

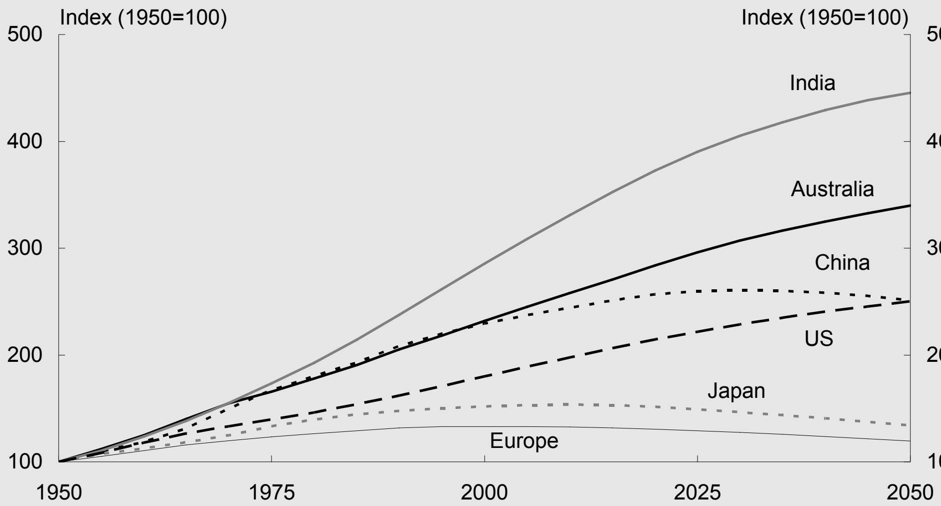
Increases in dependency ratios are projected to significantly raise government expenditures on both health and social security in both developed and developing economies. At the same time, slower economic growth — also due to population ageing — will make it difficult for many countries' governments to generate sufficient revenues to meet these projected higher levels of expenditure.

Box 1: Global demographic change (continued)

Differences in both demographic trends and openness to immigration will be reflected in sizeable differences in population growth rates across the globe (Chart 12). Due in large part to higher projected rates of immigration, population growth in Australia out to 2050 is expected to be faster than in all the other countries and regions in Chart 12 with the exception of India.

As the Chart shows, some countries and regions are expected to experience either declining or very slowly growing populations. For example, both Europe and Japan are projected to decline in population from now to 2050. China's population is projected to rise by around 10 per cent over the next quarter-century, before declining gradually after that.

Chart 12: Projected population trends[4]



Source: United Nations 2004 Revision Population Database, medium variant projections.

These changes in the global pattern of labour-force growth will generate pressures on the global economy, which may be resolved in a number of ways, including through changes in the flows of capital, people, and goods and services.

Capital mobility may be an important mechanism of adjustment to global demographic change. Internationally mobile capital should be expected to shift out of more-rapidly ageing economies into those with growing working age populations, including many developing economies and the United States. There will also be enhanced incentives to outsource business activities to lower-income countries to take

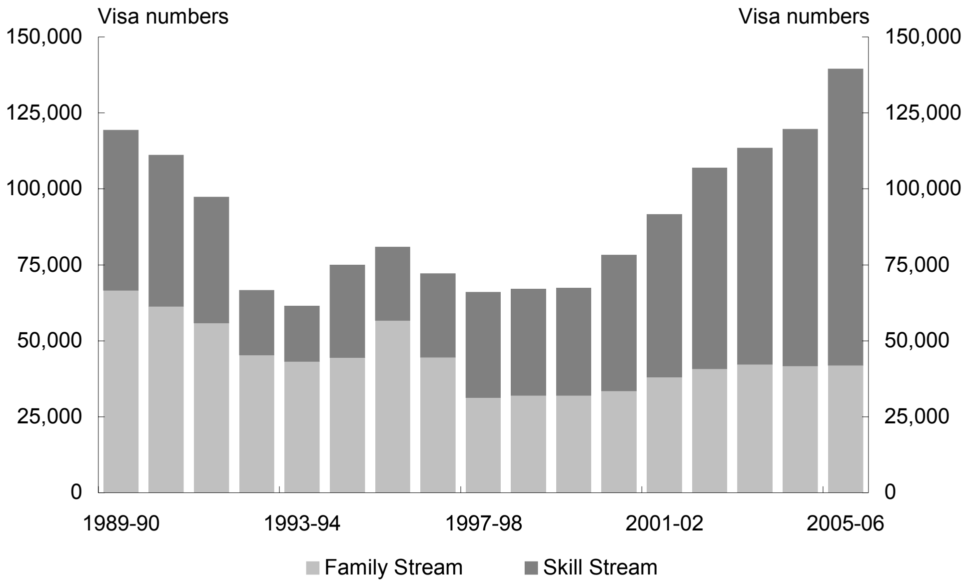
4 The projections shown for Australia differ slightly from those in the 2002-03 Intergenerational Report because they are based on slightly different assumptions.

advantage of labour cost differentials enlarged by the relative growth in labour supply in those countries.

Increased labour mobility might also be part of the adjustment process to demographic change, with at least some people moving from countries where labour is abundant to those where it is increasingly scarce, due to declining domestic labour forces. But increased immigration can only delay population ageing in developed economies since immigrants also age. Nevertheless, by delaying population ageing, increased labour mobility may give countries more time to fashion domestic policies that are more appropriate for an ageing population.

As these global demographic shifts play out over the next few decades, there is likely to be increased competition for skilled migrants as many developed countries seek to augment their labour forces via immigration programmes. This increased competition may gradually make it more difficult for Australia to attract skilled immigrants in the sort of numbers that have been attracted in recent years and may make it harder to retain skilled labour in Australia (Chart 13).

Chart 13: Composition of Australia's permanent immigration programme[(a)]



(a) Visa numbers for 2005-06 are planned rather than actual.
Source: Productivity Commission (2006).

Exposure to adverse external shocks

An increasingly integrated world can also generate enhanced vulnerability to international adverse shocks, although integration also enhances the possibility of international cooperation in responding to such shocks (as was the case with the global response to severe acute respiratory syndrome (SARS)), as well as increasing the scope to share risks through global financial markets. The most obvious new, or newly enhanced, possible adverse shocks include terrorism, disease epidemics or pandemics, and interruptions to energy supplies.

Terrorism

The direct economic impacts of even major terrorist attacks — through loss of life, damage to property and infrastructure, and disruption to financial and other markets — have so far been limited. The September 11 2001 attacks are estimated to have reduced United States annual GDP in the short term by only about ¼ per cent (Bruck and Wickstrom 2004). Such an estimate is clearly inherently speculative and cannot capture the impacts on wellbeing from loss of family and friends, trauma for survivors and a reduced sense of security.

In the longer term, the indirect costs of terrorism may be significantly greater. These costs arise from the deterioration in people's confidence about engaging in activities with perceived heightened terrorist risks, as well as from counter measures aimed at reducing those threats or perceptions. Some of these indirect costs — increased security, higher insurance premiums, and administration of financial and other counterterrorism regulations — are easier to estimate. The long-term cost of tighter security precautions in the wake of the September 11 attacks, for example, has been estimated to be as high as ¾ per cent of world GDP (Gupta et al 2002). And there are undoubtedly other costs associated with the threat of terrorism, which can be reduced by counterterrorist measures, although not eliminated.

Pandemics

Since late 2003, outbreaks of avian influenza have occurred in East Asia, Europe and the Middle East. This has raised concern at the prospect of a new pandemic if the avian influenza virus were to mutate to become highly infectious and lethal for humans — something the World Health Organization and other experts warn is possible.

In today's world of pervasive human mobility, a mutation of the virus which passed from human to human could spread rapidly and cause a pandemic, perhaps a global one. The counter measures needed to prevent this are not unprecedented, but would place enormous strains on public health systems for which few countries are as yet prepared.

Australia is, however, well-placed with preparatory measures including research, communication campaigns and enhancing the preparedness of regional neighbours. In addition, Australia has one of the largest stockpiles of anti-virals in the world and the Council of Australian Governments has agreed to develop an Australian Influenza Pandemic Prevention and Preparedness Action Plan (the National Action Plan) by mid-2006.

Unsurprisingly, the economic and social costs of a pandemic could be enormous. Kennedy, Thomson and Vujanovic (2006) estimate that a nationwide influenza pandemic could reduce Australian GDP by over 5 per cent in the first year. McKibbin and Sidorenko (2006) discuss a range of scenarios, and suggest that a 'severe' global pandemic could lead to the deaths of around 1 per cent of the world population and reduce GDP in the world's major economies by between 3 and 8 per cent in the first year. While such estimates are inherently speculative, they highlight the potentially extremely serious implications were a pandemic to occur.

Energy security

The world is heavily reliant on energy and, in particular, on the supply of oil. World oil demand is projected to increase by around 45 per cent over the next 20 years. Potential vulnerability is magnified by reliance on supplies from the Middle East, which already accounts for 30 per cent of world production — of which 11 per cent is from Saudi Arabia. This reliance on Middle East sources is projected to rise to 46 per cent by 2030.

Disruptions to oil supplies might arise from conflict involving key energy producers, unfavourable political shifts or major terrorist attacks. Because demand for oil is so unresponsive to price in the short run, disruptions that lead to only modest reductions in world supply could raise oil prices very substantially, at least for some time (National Commission on Energy Policy and Securing America's Future Energy, 2005).

INTERNATIONAL ECONOMIC ENGAGEMENT

The tectonic shifts reshaping the global economy have important implications not only for domestic economic policy but also for Australia's approach to international economic engagement.

Australia has a long and successful tradition of international economic engagement, and plays an active role in key global institutions such as the International Monetary Fund (IMF), the World Bank, the OECD and the G-20.[5] Australian leadership, commitment and expertise have supported the development of the Asia-Pacific Economic Cooperation (APEC) forum and other mechanisms of regional cooperation. And Australian engagement at the bilateral level has fostered a range of enduring and successful partnerships. The pattern and focus of Australia's international economic engagement, however, cannot remain fixed in the face of the far-reaching global and regional changes outlined earlier in this statement. Australia's engagement strategies,

5 The members of the G-20 are the finance ministers and central bank governors of Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States. The European Union, also a member, is represented by its Council presidency and the European Central Bank. The Managing Director of the IMF, the President of the World Bank and the chairs of the International Monetary and Financial Committee and Development Committee of the IMF and World Bank participate on an ex-officio basis. The G-20 member countries represent around 90 per cent of global GDP and around two-thirds of global population.

and the global and regional institutions it works through, must adapt to the challenges and opportunities posed by these changes.

This section focuses on three key issues:

- the strategic goals which underpin Australia's international economic engagement;
- how Australia's current engagement activities — at the multilateral, regional, and bilateral levels — help achieve these goals; and
- important engagement challenges for the future.

Before considering these issues, it is worth clarifying what is meant by the term international engagement. Put broadly, international engagement refers to Australia's efforts to persuade, negotiate with, cooperate with, learn from, and resolve differences with other governments, both directly, through bilateral relationships, and indirectly, through regional and multilateral institutions and agreements.

Australian governments since Federation have recognised the importance of effective international engagement. In an interdependent global economy, Australia will always be exposed to international risks and vulnerabilities — ranging from financial shocks or the slowdown of a major economy, to more recent threats such as terrorism or an influenza pandemic. While national efforts, including economic reforms to boost the flexibility and resilience of our economy, have played and will continue to play a central role in managing these risks, engagement with regional and global partners is also critical. It is only through effective engagement that sustained international attention and resources can be mobilised, cooperative strategies developed, and effective international rules and norms established, to deal with current and emerging regional and global challenges.

What, then, are the key strategic goals underpinning Australia's international economic engagement activities?

The overarching goal is to create a favourable international economic environment for Australia. Key elements of such an environment are:

- A stable, open and sustainably growing global economy — underpinned by effective, responsive and efficient rules-based institutions of global economic governance.
- Continued growth, development and stability in the Asia-Pacific region — and further progress in regional economic cooperation and integration.
- A network of strong, mutually supportive bilateral relationships with key strategic, commercial and development partners.

The following section examines the contribution of Australia's main engagement activities — at the multilateral, regional and bilateral levels — to these international objectives and discusses future challenges and directions.

Multilateral engagement

As a medium-sized, open economy dependent on access to global markets for goods, services, capital and labour, Australia has always had a strong stake in an open, rules-based and stable international economic system.

Through its multilateral engagement activities, the Australian Government works with other countries to: shape global trading and other rules; provide a range of global public goods including a stable global financial system; mobilise resources and expertise to support the development efforts of poorer countries; and manage challenges such as energy security, terrorism and the risk of an influenza pandemic.

This section outlines briefly three important vehicles of multilateral engagement: the World Trade Organization (WTO), the Bretton Woods Institutions (the IMF and the World Bank), and the G-20 forum of finance ministers and central bank governors.

The World Trade Organization

The WTO underpins the rules-based global trading system. The WTO's dispute resolution procedures and guiding principle of non-discrimination aim to ensure economic opportunity and fairness for all countries, regardless of economic size. Through a succession of negotiation rounds, the WTO (and its predecessor the General Agreement on Tariffs and Trade, GATT) has significantly reduced many barriers to global trade. As discussed earlier, the liberal trading system fostered by the GATT and WTO has, along with falling transport and communication costs, helped spur the process of international integration, and thereby generated expanding economic opportunities for Australia.

The scope and ambition of multilateral trade negotiations have widened significantly over recent decades. Early negotiating rounds of the GATT mainly involved a small group of developed countries and focused on lowering trade barriers for manufactured goods. The Uruguay Round, concluded in 1994, added the long-neglected areas of services and agricultural goods to the negotiation agenda and included a much wider range of countries. The current Doha Development Round of WTO talks is arguably the most ambitious on record. For the first time, large developing countries such as China, India and Brazil are playing a major role in negotiations.

These developments have increased considerably the potential global benefits of multilateral trade liberalisation (with estimates of potential gains ranging from US$18 billion to US$300 billion, depending on modelling techniques and assumptions about the coverage of the anticipated liberalisation). At the same time, they have added considerable difficulty and complexity to the negotiation task. In part, this is because of sensitivities associated with particular sectors, such as agriculture and services; in part, it is a reflection of the much wider, and more diverse, range of negotiating partners involved.

While Australia was an original contracting party to the GATT, Australia did not participate extensively in GATT negotiating rounds until the 1980s. Furthermore, it is important to bear in mind that the steps successive Australian governments have taken over recent decades to reduce protection for manufacturing industries have been undertaken on a unilateral basis to drive domestic competition, not as a result of trade negotiations. The key Australian objective for the Doha Round is to secure freer (and less distorted) trade in agricultural goods and services. To the extent that cuts to manufacturing tariffs are achieved, and they improve the export prospects of economies in East Asia, Australia — which supplies many of their inputs — will also benefit. Australia is already committed to further phase down its by-now-much-smaller manufacturing tariffs, and Doha Round commitments are unlikely to alter this timetable.

International Monetary Fund and the World Bank

The IMF and the World Bank were established after World War II to underpin the stability of the global financial system and mobilise resources for reconstruction and development. While the core responsibilities of these institutions remain unchanged, fundamental shifts in the global economy and financial markets, and the remarkable economic success of many Asian countries discussed earlier, have prompted these bodies to reconsider their roles and functions.[6]

In its early decades, the IMF fulfilled its mission by overseeing a system of fixed exchange rates with rules to prevent unilateral adjustment. When necessary, the Fund provided short-term financing support to countries experiencing temporary balance of payments difficulties; it would sometimes approve changes in exchange rates when they were assessed to be in 'fundamental disequilibrium'. As the fixed exchange rate system broke down and private capital flows increased, however, industrialised countries had less need to draw on Fund resources, and the Fund's lending activities increasingly focussed on emerging market and developing countries. Over this period, the Fund's surveillance of member countries' macroeconomic policies gradually expanded, together with its analysis of broader financial system risks and vulnerabilities. In today's world of more flexible exchange rates, sophisticated financial markets, still-growing capital flows, integrated economies and increasingly significant developing economies — many with potentially serious financial fragilities — a vigorous debate is taking place on how the Fund can best deliver on its core mission to promote the stability of the global financial system.

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6 See also Parkinson and McKissack 2003, Taylor, Tipping and McKissack 2004 and papers on the reform of the Bretton Woods institutions (Treasury Press Releases No. 6, 2005 and No. 2, 2006).

The risks posed by high and rapidly growing global imbalances are adding considerable urgency to this debate. While views differ on the causes of these imbalances and how long they can persist, it is a matter of economic logic that they cannot continue to grow forever. The question is, how will the needed adjustment unfold? In a highly integrated global economy, disorderly adjustment would cause considerable economic dislocation, and likely exacerbate already-mounting protectionist sentiments. An orderly adjustment, however, is unlikely to be achieved without concerted policy actions by the major economies. While the scope and direction of needed reforms are well known, disappointingly little progress has been made in implementing them — in part, this is a collective action problem, with each major economy reluctant to bear the possible costs of acting alone.[7] Achieving sustained progress in addressing global imbalances requires a strong multilateral response. Bilateral measures focusing on trade balances and exchange rates may pander to mercantilist sentiments, but will not, by themselves, resolve the underlying problem — which is a consequence of policies across a range of countries. Nor can the G-7, acting alone, engineer a solution, given the important role that emerging and developing economies must play in resolving imbalances. The IMF, through its surveillance activities, its planned multilateral consultation processes, and its policy advice, can support and guide the needed responses by national authorities.

The World Bank faces its own set of operational and strategic challenges. While its poverty-reduction mandate remains central, its operations continue to evolve in response to both experience and research on development. Persistent development failures, particularly in Africa but also in other regions including the Pacific, the success of some developing countries in accessing global capital markets, and increased scrutiny of Bank-supported projects, have required the Bank to examine critically its strategies, structure and effectiveness.

Successive Australian governments have played a leading role in setting the priorities and shaping the strategies of these organisations. Over the past decade, Australia has stepped up its efforts to support the reform and refocusing of these international financial institutions (IFIs). While these organisations have made some encouraging progress, reflected, for example, in the March 2006 IMF report on its medium-term strategy, Australia believes the international community must be more ambitious and comprehensive in reviewing the IFIs. The G-20 forum is well placed to support and influence this process.[8]

7 Budget Statement 3 also discusses global imbalances and needed policy responses.

8 Indeed, as G-20 chair, Australia participated in the G-7 finance ministers' discussion on these issues in April 2006.

G-20

The G-20 forum was established in the wake of the financial crises that led to savage recessions in many emerging economies in the late 1990s. Taking a longer view, its formation can be seen as a response to the growing importance of China, India and other developing economies. The forum brings together the finance ministers and central bank governors of systemically important developed and developing countries to discuss current and emerging global economic challenges, ways to strengthen international economic governance, and shared economic policy priorities. The presence of the G-20 sends a powerful signal to other international institutions: if they fail to adapt to these challenges, including giving adequate voice to major emerging economies, they risk ineffectiveness and irrelevance.

Australia was represented at the first G-20 meeting in 1999 and has continued to play an important role in the group's short history. In late 2004, members adopted the G-20 Accord, a set of principles for sustained economic growth. In Beijing in November 2005, G-20 members proposed a 'roadmap' to shape future reform of the IMF and World Bank. In response to Australian suggestions, the G-20 has added demographic change and resource and energy issues to its agenda. In a speech delivered to a high-level forum in Los Angeles in January this year, the Treasurer outlined a vision for an 'energy freeway' linking Australia to major energy importers in the Asia-Pacific region, arguing that true energy security must be based on effective and transparent energy markets, strong regional cooperation and sound policy and regulatory frameworks at the national level.[9] Australia's hosting of the G-20 forum this year, which culminates in the ministers and central bank governors meeting in Melbourne in November, presents a valuable opportunity to advance this agenda.

Having outlined some of Australia's key multilateral engagement activities and priorities, it is appropriate to also look to the future. It would be desirable for multilateral institutions — and the rules and patterns of cooperation they foster — to play an increasing role in the future to underpin global growth, stability and sustainability. The historical record suggests that profound structural shifts in the global economy often generate opportunities for wealth creation but can also result in new sources of vulnerability and risk. Strong and effective multilateral institutions can play an important role managing these risks. Economic institutions like the IMF can help national governments deal with the policy challenges associated with the significant adjustment pressures they will face. The failure of national policy-makers to respond flexibly to the complex challenges posed by the rise of China and India, technological change and demographic pressures will result not only in missed economic opportunities; it could also spark a retreat from economic openness and the adoption of new forms of protectionism. As the period between the two World Wars amply demonstrated, there is nothing inevitable or unassailable about an open and

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9 Both the G-20 Accord for sustained growth and the roadmap, the G-20 Statement on Reforming the Bretton Woods institutions, are available on the G-20 website, http://www.g20.org/. The Treasurer's speech is available at http://www.treasurer.gov.au.

stable global economic system. The founding purpose of the multilateral institutions discussed here — the GATT (the predecessor of the WTO), the IMF and the World Bank — was to restore a shattered international economy and hold in check the forces of protectionism and economic nationalism. Their task in today's world is no less urgent or important.

In fulfilling this task, these institutions must successfully negotiate three interconnected challenges. First, as mentioned above in relation to the WTO, key parts of the integration agenda are likely to be more complex and difficult than those in earlier periods. Liberalising 'behind-the-border' trade barriers, for example, is forcing trade negotiators to come to terms with a range of domestic policy constraints and sensitivities. In a world of integrated capital markets, the IMF's role in securing global financial stability requires an understanding of the structure, composition and interaction of national balance sheets. Second, as global institutions provide a greater voice to emerging economies, reaching a shared understanding on global challenges — let alone achieving consensus on common approaches — will become more difficult. Discussions and negotiations will involve a greater number of people, articulating a more diverse range of perspectives and concerns. This trend is already apparent, but will continue in coming years. It will pose particular challenges for developed economies like Australia, who will have to adapt their arguments and approaches to this new environment — and be prepared to respond to emerging economy priorities and concerns. The third challenge multilateral institutions are facing is greater demands from non-government groups — citizens, the media and interest groups — for greater transparency and accountability. While the steps multilateral institutions have taken to engage these groups should be welcomed, this needs to be balanced against their primary responsibility, which is to national governments. And in meeting this primary responsibility, greater transparency is not always appropriate. Instead, to be effective, peer discussions, surveillance activities and negotiations must take place with a degree of confidentiality. Successfully meeting these challenges will be critical to the future legitimacy, relevance and effectiveness of multilateral organisations.

Regional engagement

While Australia has global interests and engagements, our security and prosperity depend critically on the stability, growth and development of the economies of Asia and the Pacific. This section discusses APEC before turning to East Asian regionalism.

APEC

APEC is an integral part of the regional architecture of the Asia-Pacific. It is the only forum which enables Australian leaders and ministers to meet regularly with their counterparts from China, Indonesia, Japan, Korea, the United States and other Asia-Pacific economies. The APEC forum's 21 member economies represent around 40 per cent of the world's population, over half of global GDP and just under half of world trade. APEC's founding mission is to promote non-discriminatory free trade and investment in the Asia-Pacific region. In recent years, its agenda has broadened to include issues such as counter-terrorism, the risk of health pandemics and other security issues. APEC's wide membership, flexible agenda, consensus-style decision-making and lack of institutionalisation are important strengths, but also potential sources of weakness. APEC, more than most other forums, depends heavily on the commitment, skills, and vision of its members to achieve meaningful results.

Australia pursues three key economic objectives through APEC. The first is to promote unilateral trade and investment liberalisation by member countries — an objective enshrined in the Bogor Goals of free and open trade and investment in the Asia-Pacific by 2010 for industrialised economies and 2020 for developing economies. A second objective is to encourage APEC members to reduce 'behind-the-border' barriers to trade and to adopt a range of trade-facilitation measures. Behind-the-border barriers refer to domestic regulatory, competition and other restrictions which limit the productivity of member economies. With the reduction or removal of many tariffs and other border restrictions on foreign commerce, addressing domestic — or behind-the-border — barriers has become more pressing. A third objective is to boost APEC's role in fostering sound economic and fiscal policies, financial development and stability, and capital mobility through the APEC finance ministers' process.

In recent years, steps have been taken to invigorate these agendas. In 2005, APEC formally endorsed a structural reform agenda to pursue behind-the-border barriers, giving the officials-level Economic Committee a new role in coordinating structural reform activities. Under the finance ministers' process, Australia is co-sponsoring initiatives on insolvency reform, fiscal risk management and financial sector reform, with the aim of reducing medium-term structural risks in the Asia-Pacific region. Australia has become convenor of the APEC Investment Experts Group, which has been given the task of progressing APEC's investment liberalisation objectives. Australia's hosting of the APEC leaders' and ministers' meetings in 2007 provides an opportunity to achieve meaningful outcomes in these and other areas, and to secure APEC's standing and influence in the future.

East Asian regionalism

The trend towards increasing regionalism in East Asia, discussed earlier, is likely to continue for the foreseeable future. While EU-type integration is not on the agenda, East Asian countries' pursuit of regionally-based economic cooperation and integration initiatives is broadening and deepening. To date, growing regional integration has been largely a market-led process, driven by a range of factors. The most important of these factors have been: East Asian economies' outward-oriented development strategies and the associated strong demand for their manufactured exports from the United States and other industrialised economies, the emergence of region-wide supply chains and, in recent years, the rise of China as a focal point for regional economic activity. Government-led efforts have played a lesser role, although in recent years the pace, depth and ambition of regional cooperation initiatives have picked-up, led by the ASEAN+3 grouping and with the Asian Development Bank playing a supporting role.

Efforts to deepen and broaden regional integration are continuing. While the region's array of overlapping forums, including APEC, the East Asia Summit, and ASEAN+3 should be seen as an asset rather than a liability, care needs to be taken to avoid forum-overload and duplication of effort. Future regional integration efforts should be outward-looking — recognising the region's linkages with external markets — and supportive of the multilateral system. They should also be based on continued reform and liberalisation at the national level.

Australia's participation in the inaugural East Asia Summit (EAS) in Kuala Lumpur in December 2005 opened up a potentially valuable new avenue for this engagement. The EAS remains at a formative stage, with key questions concerning its role, focus, and operation yet to be settled. Nevertheless, this forum, if properly developed, could make a useful contribution to regional cooperation and integration efforts.

Australia has been a consistent supporter of regional integration and economic stability. In the wake of the Asian financial crisis, Australia and Japan were the only countries that pledged financial support for the three worst-affected countries, Indonesia, Korea and Thailand. The Treasurer has expressed support for the Chiang Mai Initiative and has signalled Australia's willingness to support its further development.[10] Australia was at the forefront of the international response to the 2004 Boxing Day tsunami, committing an initial $68 million for humanitarian assistance for Indonesia, Thailand, Sri Lanka and other affected countries, and announcing the $1 billion Australia-Indonesia Partnership for Reconstruction and Development (AIPRD).

Bilateral engagement

Australia's bilateral relationships are fundamental to the achievement of its economic engagement goals. Nation states remain the most powerful actors in international relations, notwithstanding the increasing importance of non-state actors, such as multinational corporations and non-governmental organisations, and the influence of multilateral and regional forums. Indeed, if multilateral initiatives are not supported by nation states, they cannot succeed.

Bilateral engagement between nation states is pursued for a number of reasons. Through regular contact and dialogue, ministers and officials can strengthen their understanding of other countries' policies and priorities. Bilateral economic agreements can sometimes achieve deeper levels of cooperation and integration than would be possible at the regional and multilateral levels. Bilateral diplomacy is often the starting point for regional and multilateral initiatives — indeed, by creative use of their bilateral networks, medium-sized countries like Australia can multiply their influence.

10 See the Treasurer's address to the China-Australia Chamber of Commerce, 17 October 2005, available at http://www.treasurer.gov.au.

Australia's bilateral relationships will not be described in detail here. Suffice it to say that our strong alliance with the United States, deep and long-standing relationships with like-minded regional countries such as Japan, Korea and Singapore, traditional links with New Zealand and the United Kingdom, our crucial partnership with Indonesia, our deepening ties with China and India, and our engagement with key Pacific economies serve a range of important economic and security interests. Australia's bilateral engagement in recent years has been innovative, and has evolved in response to emerging opportunities and threats.

Australia's crucial relationship with Indonesia, for example, has been given new depth and impetus under the AIPRD, which is guided jointly by Indonesian and Australian ministers and officials. Under this partnership, a range of Australian Government agencies are forging close working links with their Indonesian counterparts.

Australian officials are also playing an important role in whole-of-government efforts to support development and reform in the Pacific. Officials have been deployed to Papua New Guinea, the Solomon Islands and Nauru to support fiscal management and economic reform efforts in these countries.

These initiatives represent a fundamentally new type of bilateral economic engagement. Under this approach, Australian policy advisers are working side-by-side with their regional counterparts in support of their efforts to build strong and effective institutions of economic governance. While traditional bilateral diplomacy remains as important as ever, the depth, complexity and range of official level contacts have increased markedly — a trend that opens up new opportunities for Australian influence, but also carries potential risks.

Bilateral free trade agreements

In recent years, the Australian Government has actively pursued preferential free trade agreements (FTAs). The first of Australia's four current FTAs was concluded with New Zealand in 1983 — the Closer Economic Cooperation (CER) agreement. This agreement initially focused on eliminating tariffs applying to trans-Tasman trade, but has been progressively expanded to include a wide array of integration issues, with the aim of creating a seamless market across both countries. The Government has recently concluded FTAs with the United States, Singapore and Thailand. FTAs are currently under negotiation with China, the 10 member countries of ASEAN, Malaysia and the United Arab Emirates. Australia and Japan are jointly studying the feasibility of a bilateral FTA.

Australia's interest in FTAs is part of a wider international trend. The WTO had received notification of 193 of these agreements in force as of 1 March 2006. The number of FTAs in the Asia-Pacific region has grown strongly: a recent APEC inventory available on its website lists 54 FTAs involving member economies, 38 being negotiated, and a further 6 under consideration. FTAs are entered into for a range of political, economic and strategic reasons. The slow pace of multilateral trade liberalisation is often cited as a motivation to conclude FTAs. Indeed, the Australian Government has stated that it will pursue FTAs which promise 'substantial economic and commercial benefits across all sectors faster than through multilateral reform'. Countries also seek FTAs for defensive reasons; to ensure that they are not excluded from networks of such agreements that one day might coalesce into trading blocs. In the view of some analysts, this competitive dynamic is one of the factors driving the proliferation of FTAs in the Asia-Pacific region.

By definition, FTAs are both liberalising (by removing trade barriers between the contracting parties) and restrictive (by retaining external barriers against excluded countries). As a general rule, FTAs that are comprehensive in scope, eliminate internal trade barriers most rapidly, cut external barriers over time (under wider regional or multilateral initiatives), and avoid restrictive rules of origin, will generate the highest net benefits for participating countries and do the least harm to excluded countries and the multilateral trading system. Australia and other countries that have embraced FTAs stand to reap important benefits from the deeper and faster liberalisation they offer, particularly in areas such as services and investment which have yet to be decisively dealt with in the WTO. Balanced against this must be recognition of the potential systemic costs of FTAs. The proliferation of FTAs in the Asia-Pacific region, for example, could create a complicated and costly business environment for traders and investors. Overlapping rules of origin, moreover, could stifle the development of region-wide supply networks — networks which are playing an important role in East Asian integration and the growth of China. FTAs can also divert attention and political commitment from the rules-based multilateral trading system — a system that open, medium-sized economies like Australia depend on so heavily. To this end, Australia is working with others in APEC to promote greater transparency, simplicity and consistency in Asia-Pacific FTAs.

CONCLUSION

This statement has discussed a range of fundamental changes in prospect for the global economy. It has focused in particular on the continuing rise in the economic importance of China and India, but also on the continuing process of globalisation, population ageing in both developed and developing economies, and the possibility of exposure to adverse international shocks like terrorism, pandemics or threats to energy security.

These prospective changes in the global economy will present both opportunities and challenges for the Australian economy in coming years. Australia's success in responding to them will depend, to a considerable extent, on maintaining high quality domestic policies and institutions; in particular, on the extent to which they support a flexible, innovative economy while at the same time providing an environment that enables individuals to adjust successfully to economic or other changes that have adversely affected them.

Over coming years, Australia's international economic engagement strategies will also play an important role in shaping our external environment. The fundamental shifts taking place in the world and our region promise expanding economic opportunities, but at the same time have sharpened existing vulnerabilities and given rise to new threats. The actions taken by the international community over the next decade, at both the global and regional levels, will play an important part in determining whether these fundamental shifts are successfully negotiated, or result in conflict and instability.

Australia's international engagement strategies are well placed to help influence these agendas. Efforts to encourage the IMF and World Bank to give major emerging economies greater voice and influence directly assist our regional engagement goals. A stronger multilateral trading system can help reduce the systemic risks posed by proliferating bilateral FTAs. Australia's network of bilateral relationships can help us project influence in regional and global forums.

Australia's hosting of the G-20 forum this year and APEC in 2007 provides an unparalleled opportunity to influence and help shape global and regional responses to the fundamental shifts described in this statement.

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