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Trade in Services

Policy Options and Implications for Australia-Asia Relations

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The focus of his research is Australia's economic relations with Asia. A special interest has been the measurement of the extent of impediments to trade in services and the design of strategies for services sector policy reform and liberalisation.

He is the co-editor with Tony Warren of *Impediments to Trade in Services: Measurement and Policy Implications* published by Routledge in 2000 and co-editor of two more recent collections of papers on services policy, both published by Asia Pacific Press; *Services Trade Liberalisation and Facilitation* (with Sherry Stephenson and Soonhwa Yi) and *Regulation and Market Access* (with Alexandra Sidorenko).

Professor Findlay has also been involved in research on the textiles, steel and air transport industries in East Asia and on the implications of developments in those industries for Australia.

Trade in Services

Policy Options and Implications for Australia-Asia Relations

Professor Christopher Findlay

Introduction

The service sector is huge. In OECD economies it accounts for about 70 percent of GDP. In developing countries the share is smaller at 55 percent for the middle-income countries and 42 percent for low-income countries.¹ In Australia, services account for over 80 percent of output and employment.

Empirical research shows that overall the gains from services reform are much greater than removing restrictions on trade in manufacturing or agricultural products. Service sector reform has contributed significantly to productivity growth in Australia.² Debate nevertheless continues on the best approach to policy reform in specific sectors such as distribution and transport services, broadcasting and telecommunications, the education sector, financial services, the provision of infrastructure services, and postal services.

Australia's experience suggests that policy towards trade in services is better derived from a broad strategy for the services sector, instead of being focused solely on trade and investment issues. International cooperation reinforces domestic reform through enhancing the credibility of policy reform and informing the guidelines for policy change. It can also contribute to offshore market access, although that is not its primary role.

This paper examines the link between the design of domestic services reform and the contribution of international cooperation. The next section provides an overview of Australia's services trade. The following section reviews the main impediments to trade in services and some of the constraints on reform. Options for the design of reform strategies are then discussed. The final section draws out the implications for regional coalition building between Australia and its trading partners in Asia.

Overview of Australia's services trade

Services trade is growing at least as fast as trade in goods. Services are exported when the consumer moves to the supplier (called 'consumption abroad', as in tourism), or when the producer moves to the consumer ('movement of natural persons', as in many professional services). Another option is to set up a new business offshore ('commercial presence'). In some cases, the buyers and sellers do not meet face to face but communicate through the Internet or other communications systems ('cross border supply').

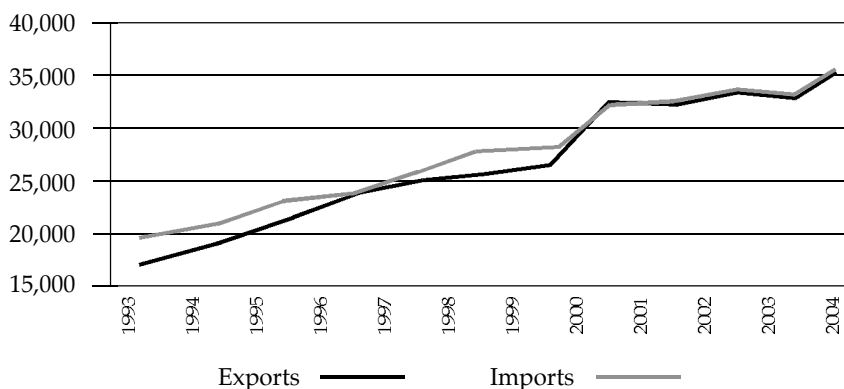
The relative importance of the various modes of supply is difficult to quantify but some estimates are reported in Table 1. Sales through commercial presence is clearly the most important category.

Table 1 World trade in services by mode of supply³

Mode of supply	Estimate (US\$b)
Commercial presence	2000
Cross border supply	1000
Consumption abroad	500
Movement of natural persons	50

Australia's services exports (except through commercial presence) are about \$A35b.⁴ Figure 1 shows the trend in this group of exports since 1993. Import growth has matched that of exports, which highlights the importance of two-way trade in services.

Figure 1 Australia's Trade in Services



Australia's services exports (in Balance of Payments terms) are concentrated in travel services (48 percent in 2002-2003).⁵ The other important items are passenger and other transportation including freight services (23 percent) and 'other services' (nearly 30 percent). The latter includes a variety of business services exports which have been growing relatively rapidly in world trade. Australia's shares of world trade in these categories ranges from 1.5 to 2 percent.

Key issues ⁶

Many of the restrictions on services trade are the result of domestic regulation. Opening up trade therefore depends on regulatory reform, which is not the same as deregulation. In some sectors, regulation is required to foster competition and produce optimal economic outcomes. In network sectors such as telecommunications, elements of the system possess natural monopoly characteristics. Regulation of these services facilitates access to networks for new operators and limits the market power of large incumbents. The task is to redesign regulation, not necessarily to remove it completely.⁷

Many restrictions lead to higher prices because they protect suppliers from competition. Others increase the costs of service suppliers. Most economies regulate to ensure that services are provided at or above a certain standard. These rules often limit potential or existing service suppliers from operating efficiently, pushing up business costs. The gains are bigger from reform of restrictions which add to costs.

Table 2 provides an example for banking services of a two-way classification of restrictive policies into those aspects which are discriminatory or not, and those which affect establishment or operations. Discriminatory measures are those which treat foreign suppliers differently to domestic suppliers.

Policy assessments for Australia show low degrees of restrictiveness in banking, distribution and telecommunications services, as well as electricity. Higher measures are shown for sea and air transport services as well as some professional services. Other sectors such as education, broadcasting and various infrastructure services are yet to be assessed in this manner.

Table 2 An example of classifying trade restrictions on banking services

	Establishment (Commercial presence mode of supply)	Ongoing operations (cross-border, consumption abroad and movement of natural persons modes of supply)
Non-discriminatory	The number of banking licences is restricted.	Banks are restricted in the manner in which they can raise funds.
Discriminatory	The number of foreign bank licences is restricted.	Foreign banks are restricted in the manner in which they can raise funds.

Services reform which removes restrictions adds to capacity and removes bottlenecks in supply. By facilitating new entry and competition, it may also contribute to lower prices. These effects contribute in turn to the competitiveness of other sectors that use services as an input. Lower

communications and transportation costs, for example, have economy-wide effects, even in remote areas.

Additional gains are available from foreign participation in local services markets. Foreign suppliers add to the pool of potential entrants and therefore the competitive threat to incumbents. Even if a market is a natural monopoly, its integration with neighbouring markets may allow some competition. Foreign participation also generates the familiar gains from trade, as well as access to economies of scale and wider consumer choice.

Table 2 highlights the difference between discriminatory and non-discriminatory restrictions. Empirical research finds that the gains from removing the latter, which means opening up access to markets to both domestic and foreign providers, are far greater than those from removing the remaining discriminatory components alone.⁸

Options for reform

Services policy can be divided into two components: rules on market access and the complementary regulatory processes. The main interest here is the role of various forms of international cooperation.

Adjustment costs imposed by reform can be sustained politically when the resistance to change is offset by countervailing support from export interests who gain access to markets in trading partners. This argument is made for negotiation of international commitments on tariff reform in merchandise trade.

The case for reciprocity is weaker for services, especially when the effect of the policy under consideration is to increase costs. In that case even the incumbent may gain from reform, and there is less requirement to mobilise countervailing political forces in the home economy. Services restrictions can also constrain the size of a services sector so that liberalisation leads to new entry by both domestic and foreign firms. The gains to new entrants in this sector (and the employment generated) may be sufficient to offset opposition to change by the incumbent.⁹

Cooperation on regulatory reform underpins market opening commitments by assuring traders and investors that liberal market access will not be impaired by the imposition of new barriers. Establishing regulatory principles can be a good way to do this. International cooperation in this field is not straightforward, because of the resources and skills required to implement the changes. One suggestion is to differentiate among developing

countries according to the resources required.¹⁰ Benchmark practices should however be adopted by the time these countries reach particular levels of development. These implementation processes should be made explicit and supported by technical assistance. The procedures suggested involve temporary exemptions and in that regard are similar to 'special and differential treatment' applied to developing countries.

International commitments can be made in the multilateral process or in bilateral preferential negotiations. A multilateral approach has some benefits but negotiations are moving slowly. A preferential approach through small groups appears to offer faster negotiation and implementation but runs the risks of trade and investment diversion and of limited coverage.

Multilateral negotiation

Converting policy changes into international commitments in the WTO process adds to their credibility. Infrastructure projects are relatively long-lived and involve substantial sunk costs, including losses that might be incurred in the early years. Investors will expect some commitment by government that the policy environment will not be reversed and that policy changes will be carried out as promised. If the policy change is not made, trading partners have recourse to dispute settlement and may impose trade sanctions when policies are bound originally through an international agreement.

Making services policy part of the current Doha Round in the WTO has a strategic advantage in terms of access to markets. This applies not just to developed economies. Developing countries also have a considerable set of market access interests. Examples include maritime services, air transport, audiovisual services, construction, health, telecommunications and data processing. Benefits are large from the supply services through the temporary movement of people.¹¹ 'Done right, services negotiations offer developing countries an opportunity to act in their economic interest and get paid for it.'¹²

Nevertheless, the use of the WTO process for services reform runs the risk of too much attention to the discriminatory aspect of services policy. Statistical modelling suggests that far more important is the set of conditions applying to market access for all suppliers. To offer commitments only on questions of discrimination excludes a major source of the gains from reform. This approach may redistribute rents instead of leading to good policy.

The current round of negotiations is moving very slowly. The request and offer process now underway had been tabled by July 2004 - the offers relate to 65 WTO members or only about 45 percent of the membership. The original deadline for offers of March 2003 has now been extended to May 2005.

The General Agreement on Trade in Services (GATS) was a standstill agreement that at best bound existing policy. It was never a path-breaking process and over time has lagged further and further behind best practice. Levels of commitments in many sectors or modes of supply are low and many countries have already implemented more liberal policies than those to which they have committed in the GATS. Significant progress cannot be achieved without a new round of offers.

A further limitation of the GATS is its procedure of a 'positive list', whereby commitments apply only to listed sectors. This approach complicates the treatment of new services that emerge with technological or other change in the organization of business. Many services firms cannot locate a GATS services category. This is an issue with respect to logistics services, for instance, and also with respect to energy services.

Preferential liberalisation

Although non-preferential liberalisation is likely to produce even larger gains, frustration with WTO processes has contributed to a surge of interest in preferential approaches to services trade liberalisation.¹³

The fundamental problem with this approach is the scope for trade diversion. When a policy change is agreed with a trading partner who is a relatively inefficient producer compared with world best practice, foreign entry may lower prices but, given remaining barriers to other suppliers, the policy change can allow the inefficient foreign supplier to capture profits in the protected domestic market without significantly reducing prices. The inefficient new supplier may also be difficult to dislodge later when barriers to other entrants are lowered. In this scenario, the liberalising country would be worse off.

The sequence of preferential liberalisation therefore matters more for services than for goods. Many proposals for preferential reform are proposals to redistribute rents rather than to provide genuine reform.¹⁴

Bilateral agreements can sometimes have to be implemented without discrimination because of the general nature of the policy instruments. Examples are rules on competition policy or on protection of intellectual property. However, there is no good reason why negotiations on such measures need to be embodied in and linked to a preferential structure in the first place. Bilateral negotiations may be the wrong vehicle for some otherwise very sensible services reforms.

One common argument for FTAs is that as more and more such agreements are negotiated the outcome will eventually converge on free trade.¹⁵ The problem is that after some point it is in the interest of incumbent suppliers to try to stop further accession to specific agreements, especially those generating long-term rents. Unless there is foundation commitment to open membership, the liberalisation momentum therefore stalls.

What has been the actual treatment of services in preferential agreements? An OECD assessment of coverage of services in preferential agreements is that in some areas regional agreements have gone further than the GATS (including quantitative restrictions and domestic regulation) but generally they made little progress on sectors which were also difficult to deal with at the multilateral level.¹⁶

A review of some of the recent Free Trade Agreements involving Singapore found that these agreements tend to focus on specific bilateral market access issues. Despite some exceptions in specific agreements, they do not much advance issues that are still evolving under the GATS such as competition policy, mutual recognition or domestic regulation.¹⁷

A review of the Australia-US Free Trade Agreement (AUSFTA) has found little evidence of breakthroughs in services. There are a 'small but significant number of sectors where AUSFTA has gone beyond the GATS' and where barriers to trade in services are removed (Australia made relatively more market access commitments than the United States). Overall, however, AUSFTA is primarily a standstill arrangement.

Many of the apparent concessions in AUSFTA had already been made on a multilateral basis in the GATS.¹⁸ At the same time, reservations made by the United States and Australia in the GATS have been retained in AUSFTA: examples are the claims of blanket exemption for all existing trade restrictions at a state government level and also various reservations in sectors like air transport, maritime services, education, health and financial services. The US has taken out a blanket exemption for all existing and new restrictions on

market access for all modes of delivery and Australia did likewise for the mode of delivery through the movement of natural persons. From this perspective, the agreement avoids Australia being subject to new discriminatory measures rather than rolling back existing measures.

There may be a good reason of political economy why recent FTAs have been so feeble when it came to services trade liberalisation. In a small group setting, it can be impossible to mobilise enough broad support in export sectors to offset the determined resistance mounted by entrenched, rent-seeking interests in specific sectors. According to the OECD, this is a strong argument in favour of multilateral negotiations: 'in some sectors, the political economy of multilateral bargaining, with its attendant gains in critical mass, may help overcome the resistance to liberalisation arising in the narrower or asymmetrical confines of regional compacts.'¹⁹

Implications for Australia-Asia relations

Australia's major trading partners are developed countries: the US (16 percent) and the UK (11 percent) followed by Japan (10 percent) are the top three export destinations. ASEAN as a group accounts for 15 percent of the total. Other large markets are New Zealand, Singapore, Hong Kong, followed by China, Indonesia, Korea and Taiwan).

These countries are also major sources of services imports, highlighting the significance of two-way trade in services. Australia has some particular market access interests in these and in other prospective markets, and is keen to remove aspects of discrimination against its suppliers, just as exporters in those markets have similar objectives in relation to removing any discrimination under Australian policy. However, the long-term benefits from non-discriminatory market access are likely to be even greater. Among this group of trading partners, there is a mutual interest in the design of policy change.

These considerations suggest the following key elements of a regional agenda on trade in services issues:

- **Better results in the WTO**

Extending the number of offers is important for domestic reform and but also has a strategic value in the process of negotiations. They may stimulate market access offers by others in services and in other sectors, which will be

important for the outcome of the current round of negotiations. Some of Australia's partners in the region have yet to make their offers and work to support their effort to do so is valuable. Especially important for developing countries in the region will be support for treatment of access to markets through the movement of people.²⁰

A key point in this dialogue is to reach an understanding on the value of commitments related to market access, and avoid limiting commitments to matters relating to national treatment. Australia could check its own services offer for these points.²¹

Questions remain about the treatment of rules in the WTO process. A valuable talking point in the region is therefore priorities for progress on various rules, and the role of the WTO in the specification of principles to be applied to the specification of rules affecting trade in services. Besides the treatment of domestic regulation, other topics include safeguards, subsidies, government procurement, and autonomous liberalisation.

A business perspective on trade in services can enliven the WTO negotiating strategy of any country. The evolution of the nature of services business, not just through the impact of technology but also through new ideas about how to organise processes of production and value adding, gives a new focus in the negotiations. The possibilities of decomposition or unbundling of existing processes are important to take into account. These points suggest the value of shifting to a negative list approach to commitments, to seeking to make commitments that are neutral in terms of the modes of delivery of services and of designing a strategy which recognises the complementarity between services and goods trades.

- **Reinvigorating the contribution of APEC to services reform**

APEC members can implement a far more extensive program of trade and investment facilitation and they can work on liberalisation topics not covered in the WTO. The APEC Business Advisory Council recently endorsed work of this type under what they called their Trans Pacific Business Agenda. This effort should be made comparable to the EU's Single Market agenda, but would have to be implemented in a different way given the diversity of the economies involved. This single market agenda will be important for dealing with 'behind the border measures' which affect access to markets by both domestic and international suppliers, especially in services. As noted, this sort of reform creates challenges for domestic institutions, such as competition

policy authorities and regulatory agencies. This is where APEC has a key role to play in support - the success of the single market agenda relies on APEC's strength in running capacity building programs. Many of the suggestions for items on that agenda include the regulatory and standards problems mentioned earlier. Dealing with these outside a preferential framework is not only possible but very desirable, given the size of the gains they offer if they are widely applied. But as noted earlier, those changes can be made in a way which allows some APEC members to move faster than others on implementation - that is, as long there are some overriding principles that sustain the openness of those initiatives. Again APEC makes a contribution in reaching understandings on those principles.

- **Shift the focus in bilateral negotiations**

Some regulatory measures can be dealt with only through explicit bilateral discussion, for example the recognition of standards applied by domestic regulatory agencies. There is benefit in locating those discussions within the framework just discussed. Other measures might be identified in bilateral discussion but implemented in a non-discriminatory manner. An understanding on the best use of bilateral negotiations would be helpful, as are illustrations through benchmark agreements.

- **Sharing experience of unilateral action**

The value of unilateral action has been a theme of this paper. Some of the resistance to reform comes from the anticipation of adjustment costs and the political reaction to those costs. Experience can be shared on the extent and the management of those costs and on the nature of the gains from reform, including the intersectoral impacts. Australia has particular experience in the maintenance of services in isolated regions, which especially in infrastructure services is another source of sensitivity in reform programs.

Complementary research might involve assessing the restrictiveness of current policy to infer the likely gains from action in areas where the degree of restrictiveness remains high. This research would feed into the identification of priority areas for domestic reform and thereby into the design of strategies in international agreements to bind domestic policy reform. There are examples of such a collaborative of this kind of international approach within APEC's Group on Services work program. It is complemented by training courses and through sharing ideas about institution building. A good example

would be sharing the Australia experience of the Productivity Commission and its impact on the domestic policy debate.

Conclusion

Services reform is difficult. It requires attention to a large number of policy instruments and requires coordination across many parts of government. Australian experience suggests there are substantial gains from reform, and that strategies for reform are best driven from a domestic agenda on economic growth. Governments also have open to them a variety of forms of international cooperation, through the multilateral, regional and bilateral channels. These can help reinforce their domestic policy change. However, the allocation of tasks to institutions of international cooperation is a matter of 'horses for courses': it is important to agree with trading partners which forms of cooperation are best done in which institutional setting. Incorrect choices undermine the domestic reform agenda. Getting it right maintains the momentum.

Notes

- 1 From the World Bank's World Development Indicators (<http://www.worldbank.org/data/wdi2002/>)
- 2 For more detail on sectoral contributions to labour productivity growth and to multi-factor productivity growth, see T. Cobbold, and A. Kulys, *Australia's Industry Sector Productivity Performance*, Productivity Commission Research Memorandum, Canberra, 2003.
- 3 Data from G. Karsenty, 'Assessing trade in services by mode of supply', in P. Sauve and R. Stern (eds), *GATS 2000: New Directions in Services Trade Liberalisation*, Brookings Institution, Washington DC, 2000.
- 4 Data on sales through commercial presence are not commonly available. Data for transactions in the other categories are available from the Balance of Payments, which are the source of the data in Figure 1.
- 5 Department of Foreign Affairs and Trade, 'Market Information and Analysis Section, 2004', *Trade in Services Australia 2002-2003*, available from <http://www.dfat.gov.au/publications/stats-pubs/tis.pdf>. Travel services includes education exports which are the fastest growing export category.
- 6 This section summarises material from Greg McGuire and Christopher Findlay, 2005, 'Restrictions on trade in services: trade liberalisation strategies for APEC member economies', *Asian- Pacific Economic Literature*, forthcoming publication.
- 7 See S. Doove, O. Gabbitas, D. Nguyen-Hong, and J. Owen, *Price Effects of Regulation: Telecommunications, Air Passenger Transport and Electricity Supply*, Productivity Commission Staff Research Paper, AusInfo, Canberra, 2001.
- 8 These results are from P. Dee, and K. Hanslow, *Multilateral Liberalisation of Services Trade*, Productivity Commission Staff Research Paper, Ausinfo, Canberra, 2000.
- 9 These points and an assessment of the terms of trade arguments for reciprocity in services negotiations are explained more carefully by Philippa Dee and Alexandra Sidorenko, 'The Rise of Services Trade: Regional Initiatives and Challenges for the WTO', paper presented to the 29th PAFTAD conference, Jakarta, December 2003.
- 10 Bernard Hoekman in 'The International Trade Order: Cooperation for Economic Development', paper presented to the 29th PAFTAD conference, Jakarta, December 2003, makes this observation and presents the idea for a 'rule related SDT' which follows.
- 11 L.A. Winters, T.L. Walmsley T.L.; Wang Z.K.; Grynberg R., 'Liberalising Temporary Movement of Natural Persons: An Agenda for the Development Round', *The World Economy*, August 2003, 26(8), p. 1137-1161.
- 12 This quotation is from Patrick Messerlin and Ernesto Zedillo, *Trade, Development and the WTO: An Action Agenda Beyond the Cancun Ministerial*, Report of Task Force 9 on Open, Rule-Based Trading Systems, UN Millennium Project, p. 63.
- 13 Gains from services reform associated with preferential agreements are discussed by A. Mattoo and C. Fink, 'Regional agreements and trade in services: policy issues', World Bank Policy Research Working Paper no. 2852, World Bank, Washington.
- 14 This conclusion is stressed by Dee and Sidorenko.
- 15 These results are found in Andriamananjara, Soamiely, 1999, 'On the size and number of regional integration arrangements: a political economy model', World Bank Policy Research Working Paper 2117, May.

- 16 OECD, 2002, 'The relationship between regional trade agreements and the multilateral trading system: services', Working Party Paper of the Trade Committee, TD/TC/WP(2002)27, OECD, Paris.
- 17 Jane Drake-Brockman, 'Regional approaches to services trade and investment liberalisation', *Pacific Economic Papers*, No. 337, 2003.
- 18 This summary is taken from Philippa Dee, 'The Australia-US Free Trade Agreement: An Assessment', paper prepared for the Senate Select Committee on the Free Trade Agreement between Australia and the United States of America, June 2004.
- 19 OECD, 2002, 'The relationship between regional trade agreements and the multilateral trading system: services', Working Party Paper of the Trade Committee, TD/TC/WP (2002) 27, OECD, Paris, p. 6.
- 20 Patrick Messerlin and Ernesto Zedillo, *Trade, Development and the WTO: An Action Agenda Beyond the Cancun Ministerial*, Report of Task Force 9 on Open, Rule-Based Trading Systems, UN Millennium Project provide a comprehensive set of proposals for liberalisation of this mode of supply.
- 21 Australia's current offer is available at http://www.dfat.gov.au/trade/negotiations/gats_schedule_initial_offer_0303.pdf

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