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Australia's Economic Diplomacy in Asia

Professor P. J. Lloyd

Ritchie Professor of Economics
The University of Melbourne



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Professor Peter John Lloyd is the Ritchie Professor of Economics and the former Director of the Asian Economics Centre at the University of Melbourne. He has a BA and an MA (First Class Honours) from Victoria University of Wellington in New Zealand and a Ph. D. from Duke University in the United States of America. He is a Fellow of the Academy of the Social Sciences in Australia. Before coming to the University of Melbourne in 1983, he spent 14 years in the Department of Economics of the Research School of Pacific Studies at the Australian National University.

His main areas of specialisation are international economics and Asian economics and microeconomics in general. He has been a consultant to the OECD, the GATT, UNCTAD and a number of government departments and authorities in Australia and New Zealand. He was the joint editor of the Journal of the Economic Society of Australia, *The Economic Record*, for five years and has served on numerous committees for the Economic Society, the International Economic Association, the Academy of the Social Sciences of Australia and other bodies. He is an author or an editor of ten books and has written nine monographs and over one hundred articles in refereed journals or chapters in books. He was Dean of the Faculty of Economics and Commerce at the University of Melbourne from 1988 to 1993.

Australia's Economic Diplomacy in Asia

Professor P. J. Lloyd

Trade between Australia and Asia is a positive and valuable part of our total relations with Asia at a time when our political relations are sometimes awkward. Trade is, by its nature, mutually beneficial and there is general agreement in Australia and across Asia that it should be encouraged by appropriate liberalisation. However, disagreements have arisen over appropriate strategies and the extent to which Australia will or will not be included in new groupings of trading nations. It is therefore important to be clear as to the precise role of economic diplomacy in the broader context of diplomacy.

A number of journalists and some economists use the important trade between Australia and its Asian trading partners as a premise to argue that the Australian government should give priority in its trade diplomacy to Asian trading partners. The most important expression of this view is the opposition from some academics and journalists to the current negotiations between Australia and the US for a Free Trade Area (FTA). This opposition seems to adopt the view that we have to choose between negotiating bilateral deals with Asian countries or groups of countries on the one hand or with the US and other countries outside the Asian region.

This paper reviews the issues and options relating to Australia's trade diplomacy. The focus is on two issues; those relating to the current government policy of developing bilateral trading agreements and those relating to the growing links between trade policy and other non-trade policies such as the environment and national security. Other regional issues relate to trade disputes, immigration selection and multilateral trade policy.

The Economic Importance of Asia to the Australian Economy

As a starting point for the analysis of trade policy options, Table 1 below provides a profile of economic relations between Australia and Asia, and for comparison those between Australia and the US and the EU. Economic relations with these trading partners comprise trade in goods, services, capital

Table 1: Australian Dependence on Asia, the US and Europe, 2001–02

		Percentage of Australian total to/from E. Asia (ASEAN)	Percentage of Australian total to/from EU	Percentage of Australian total to/from US
Trade in Goods	Exports	54.7 (12.2)	10.1	9.9
	Imports	42.7 (14.7)	19.5	18.0
Trade in Services	Exports	33.8 (13.9)	18.1	16.2
	Imports	28.0 (14.3)	21.8	21.0
Foreign Investment in Aust.		10.1 (2.1)	33.4	29.6
Australian Investment Abroad		6.2 (3.0)	24.1	54.5
Settler Arrivals		28.4 (16.3)	12.9	1.3
Permanent Departures		29.0 (12.5)	23.9	11.5

Sources: ABS and DIMIA (various).

and the movement of people for temporary or permanent migration. In the EU, with its policy of removing all border and non-border restrictions on movements in these areas, these four relations are known as the “Four Freedoms.” One could add other areas such as the increasingly important student movements, foreign aid and cooperation among central banks on the regulation of financial flows and exchange rates. The four types of relations chosen here are central to the totality of our economic relations with Asia. Asia is taken to be East Asia, excluding Central Asia and South Asia.

Asia is the most important of these three trading regions for trade in goods and services. For trade in goods, Asia is more important as an export market than as a source of supply of imports. For exports, Japan is our single most important country market, the Republic of Korea is our number 3 partner and China is number 5. However, we should not, as many do, display a mercantilist bias by focussing on exports of goods. As a source of imports, Japan, China and the Republic of Korea rank 2 (after the US), 3 and 5 respectively. As a source of foreign direct investment (FDI), Asia is the least important of the three regions. It has, however, become an increasingly

important source of permanent immigrants and it is the major destination of permanent departures from Australia.

These statistics measure the extent of our economic engagement with the regions. They do not measure the gains or losses from this engagement. Of course, there are many connections between the different flows. For example, foreign direct investment – both inwards and outwards – is often associated with the movement of people who work in foreign affiliates of domestic companies. And FDI can sometimes substitute for direct exports, and sometimes lead to new trade in sourcing inputs.

Perhaps the most important aspect of these simple statistics is that, overall, Australia's economic relations are distributed quite evenly among the three regions. No one of these three regions is dominant across the board today.

One could say that we have a difficult economic geography in that we are, compared to the vast majority of countries in the world, isolated from the major markets. Our latitude in the Southern Hemisphere location puts us a long distance from the three major markets of the world economy; and our longitude removes us further from markets in Europe and North America. Linguistically and culturally, Australia has been predominantly European, or more precisely British. However, our historic links with the UK have greatly diminished since UK accession to the European Economic Community (EEC) in 1973.

In economic terms, this means that we are not a “natural trading partner”¹ of any of the major countries with which we trade. A natural trading partner is one with whom we have closer relations because of shorter distance and historical links. Offsetting this somewhat in the case of Asia is the high degree of complementarity in Asia-Australia trade patterns.²

Complementarity in goods trade is the extent to which the commodity pattern of our exports matches that of Asian imports and *vice versa*. We are exporters of primary products and importers of manufactures, whereas countries such as Japan, Korea and China tend to have the opposite pattern. This complementarity does not mean, however, that our trade policies must give preference to trade with Asia. Trade should be directed to increasing the gains from trade with all markets. Underlying the analysis below is the general theme that the markets of all of the countries we trade with are increasingly integrated into a single global market. From a selling point of view, all countries are competitors and, from a buying point of view, all countries are suppliers.

Current Issues

Bilateral agreements

The big issue of the present time is whether Australia should proceed with a bilateral trading agreement with the US and, more generally, whether Australia should pursue bilateral trading agreements with a number of countries or return to the path of multilateral liberalisation that we followed throughout the last century, with the notable exceptions of British Empire/Commonwealth preferences and our bilateral agreement with New Zealand (a natural trading partner but too small to give great benefit to the Australian economy).

Trade disputes

Australia in recent years has had a number of disputes or disagreements with trading partners. These have mainly been in two areas: quarantine and anti-dumping actions. In the area of quarantine, we have had disputes with the EU, US, Canada, Thailand, the Philippines, New Zealand and other countries over a variety of products (pork meat, chicken meats, salmon, potatoes, bananas and mangoes and other tropical products, potatoes, apples and other fruits). We have had disputes over anti-dumping actions taken by Australia. Earlier this year China objected to proposed changes to Customs legislation that may give the Australian Customs Service greater discretion in determining whether goods from transition economies are dumped. Most of these disputes have not reached the WTO Dispute Settlement Procedures but they have involved challenges to Australian trade policies by Asian and non-Asian countries.

Immigration

Immigration policy is generally more contentious than trade policy at home but the main concerns among our trading partners have been with actions they might take to discourage, or turn back, illegal arrivals by boat.

Bilateralism v. Multilateralism – A False Choice

Disagreements over whether Australia should pursue a bilateral trading agreement with some partners reduce to two questions: 1) the prior question of whether we should pursue bilateral trading agreements; and 2) if the answer to the first question is affirmative, which partners should we choose?

In relation to the first question, trade economists almost invariably say that multilateral liberalisation is to be preferred. Being non-discriminatory, it avoids possible costs of trade diversion to the importing country and to countries

outside a regional trading agreement. A supporting reason is that multilateral liberalisation is much more comprehensive in the scope of countries involved and probably too in the value of trade involved.

Australia should, therefore, be a strong supporter of the Doha Round. But does this preclude simultaneous initiatives on a bilateral basis? In my opinion, no.

This matter has been much debated in the trade literature under the heading "Are Regional Trade Agreements (RTAs) a stumbling block or a building block to multilateral liberalisation?" It has been investigated thoroughly by the WTO itself,³ the OECD⁴ and the World Bank.⁵ All of these reports concluded that the spread of regionalism/bilateralism has not hindered multilateral trade liberalisations. Certainly regionalism has proceeded alongside multilateral reductions in border barriers to trade in goods and services in most parts of the world over the last ten years (and, one should add, unilateral liberalisation has been an important additional liberalising influence in many countries). However, the coincidence of reductions in both preferential and MFN rates over time cannot be construed as regionalism encouraging multilateralism or *vice versa*. An encouragement effect requires some mechanism and proof of causality. Regionalism may encourage multilateral liberalisation in a number of ways, perhaps most notably in developing new modalities of trade liberalisation. For example, the General Agreement on Trade in Services is largely an imitation of the provisions of Canada-US Free Trade Area and the North American Free Trade Area.

A small trading country such as Australia can proceed on both fronts since what happens at the multilateral front is very largely out of our control and influence. The main reason for pursuing bilateral agreements is the possibility of our being excluded from major potential markets in the sense that we have conditions of access worse than those of major competitors who have concluded bilateral/regional agreements. In my view, this fear of exclusion is the major reason why bilateral/regional trading agreements have proliferated since the early 1990s. This view was put brilliantly by Alan Winters using an analogy:

Regional (preferential) trading arrangements are like street gangs: you may not like them but if they are in your neighbourhood, it is safer to be in one.⁶

Hence, participation in discriminatory RTAs is as much a defensive strategy (designed to protect our market access vis-à-vis our trading competitors) as it is an offensive strategy (designed to increase our market access vis-à-vis the domestic producers in the market).

There has been a domino effect as the proportion of trade having market access on preferential terms has steadily risen.⁷ The larger the market in which discrimination occurs, the stronger this effect is. For example, the negotiations in the Americas for a Free Trade Area (FTAA) is largely a response to the continued enlargements of the EU. There is a scramble in the world today for countries to form bilateral agreements with the larger countries or trading blocs, notably the EU and the US.

Asia v. Europe v. North America – Another False Choice

The second aspect of bilateralism is the choice of partner.

The first thing that must be said on this question is that choosing one partner does not preclude choosing another. RTAs are not like defence or national security agreements. It may be true in areas of national security that “the enemy of my enemy is my friend” or “the enemy of my friend is my enemy.” In the present context, two parties to a discriminatory agreement might be regarded as friends and a party outside might be regarded as an “enemy.” However, this type of relationship based on the positive or negative signing of bilateral relations does not hold in economics. Multilateral trade liberalisation is a positive sum game and, more to the point, all participating countries gain, with few exceptions. Bilateral/regional trade liberalisation is also a positive sum game for the members and for the world as a whole. Even when trade diversion occurs because of the preferential nature of the reductions in trade barriers, the members may still gain from this diversion as the reductions in prices to consumers and improved resource allocation increase national product and national welfare. Trade diversion is not necessarily welfare-reducing to the importing country whose trade is diverted.

The complication with discriminatory reductions in trade barriers is the possibility that outside countries may lose. This is usually presented in terms of the dangers of trade diversion in which the outside countries, by definition, lose. But trade diversion is only one kind of terms of trade effect. The formation of RTAs has more effects on the terms of trade than this trade diversion effect as the world demand and supply for goods shift, and it is the total terms of trade effect that determines whether an outside country gains or loses. Economic

models of trade discrimination show there is no presumption that an outside country will gain or lose. Empirical studies of RTAs, using computable general equilibrium analysis, confirm that outside countries may gain or lose. For example, Scollay and Gilbert carry out simulations of the effects of various bilateral and many-country RTAs in the Asia-Pacific.⁸ They find that all bilaterals have negative effects on some non-members and positive effects on other non-members, with small or zero effects on non-members in the aggregate. However, there is a tendency for larger blocs such as the proposed Free Trade of the Americas Agreement and ASEAN+3 (ASEAN plus China, Japan and Korea) to have larger negative effects on outsiders.

There are examples of preferential agreements that have harmed outside countries. Australia certainly experienced a major loss when the UK acceded to the European Economic Community in 1973. At that time the other members of the EEC gained preferential access to the markets of the UK that had been our largest goods market and, moreover, we lost the preferences that we had enjoyed over other Continental and non-Commonwealth countries for our trade in lamb, beef, dairy and other primary products. Similarly, if Australia does conclude an agreement with the US, New Zealand will lose, as it is a close competitor of Australia in the US markets for some agricultural products. This same fear of a loss of market access is what is driving Australia's search for bilateral partners.

Our Asian trading partners, however, need fear little trade diversion in the event of our reaching a preferential agreement with the US. We are not close competitors with them in many US markets precisely because of the trade complementarity noted above. Indeed, our completing an FTA with the US would make an FTA with an Asian partner or partners more attractive to them as this would restore competition on equal terms between Asian and US competitors in Australian markets and, in a few cases, might also facilitate their access to the US market by sending components and other intermediate inputs to be incorporated in products produced in Australia and exported to the US.

Opponents of the FTA proposal argue that Asians will have a perception that Australia is turning its back on Asia. The world situation regarding the diplomacy of RTAs is very different now than it was 10 years ago. All countries in the WTO with the exceptions only of the People's Republic of China, Hong Kong, Taiwan and Mongolia, have now concluded RTAs with other countries, and the majority have now concluded or are currently negotiating more than one agreement. Japan concluded its first RTA with Singapore in 2001 and is

now at various stages of discussion with a number of other trading partners. Many countries are now pursuing a strategy of negotiating agreements with significant trading partners that are willing – for example, Canada, Mexico, Singapore. Others are moving in this direction. I would put Australia in this group along with Thailand.

The Australian government seems to have first adopted this strategy in its 1997 White Paper on Australia's Foreign and Trade Policy⁹ and subsequently widened the net to AFTA-CER, Singapore, and Thailand and exploratory talks with Korea and Japan before reaching agreement with the US to begin negotiations. In a recent speech, the Minister for Trade described the current Australian strategy of simultaneously pursuing multilateral and bilateral and regional liberalisation of trade in goods and services and investment as "competitive liberalisation."¹⁰ While the description is inaccurate and infelicitous, this marked a conscious adoption of a strategy of pursuing both fronts. One may note that this speech refers explicitly to "investment" as well as to trade in goods and services.

In my recent submission to the Hearings into the US-Australia FTA proposal conducted by the Senate Committee on Foreign Affairs, Defence and Trade in April,^{xi} I advanced the view Australia should pursue these negotiations subject to two important caveats. The first is the obvious one that final commitment should depend on the outcome of these negotiations. The second caveat is that the negotiations should be accompanied by diplomatic initiatives on the part of Australia to assure our Asian trading partners that this proposed agreement does not represent a downgrading of our relations with these economies and, furthermore, that we stand ready to negotiate parallel trading RTAs with these countries.

The fact that several of our Asian trading partners are pursuing a similar strategy of multiple RTAs indicates that these countries should not logically object to us on grounds of trade discrimination. Nevertheless, such considerations apply less strongly to Malaysia and Indonesia whose RTA plans are confined at present to ASEAN links to North Asia. Since Malaysia and Indonesia are the two countries in Asia with whom Australia's official diplomatic relations have for some time been most troubled, particular diplomatic effort should be warranted with these countries.

Complementary trade policies may increase the gains from regional trading agreements. The pursuit of both unilateral trade liberalisation, as

Australia has done for more than a decade, and multilateral liberalisation will increase the net gain to Australia and reduce the likelihood of a net loss for countries outside the preferential area by reducing trade diversion. In this regard, the pursuit of more than one RTA has a similar effect of reducing the trade diversion resulting from each one in isolation. For example, a US-Australia FTA may divert some automobile imports from Japan and Korea to the US but this would be reversed if we also formed an FTA with Japan and Korea.

The Link between Trade Policy and Non-Trade Issues

Another major issue is that of linking trade policy (and diplomacy) to non-trade policies (and diplomacy).

This is increasingly seen in the WTO. In the current Doha Round a number of issues that do not involve trade, or more precisely do not involve border policies of the WTO members, have been added to the agenda. These include competition policy and parts of foreign investment. Both of these issues were added at the Singapore Ministerial Meeting of the WTO in 2000. The immediate focus is on “trade and competition” and “trade and investment.” Competition certainly affects international trade in goods and services and, conversely, international trade in goods and services certainly affects competition in product and service markets. Competition policy is, however, mainly a matter of domestic inside-the-border policies such as privatisation, deregulation and competition law. Few environmental problems – even those that involve transborder environmental effects such as acid rain, the ozone layer and global warming – involve trade in goods as the means of transmission. FDI policy has border measures – such as screening that affects the rights of establishment and the repatriation of profits and capital – but it also involves a number of non-border measures such as financial incentives and dispute settlement and investor protection. The main reason for the attempts by some governments and NGOs to expand the scope of the WTO rules to new areas seems to arise not from an intrinsic connection between trade and these new issues but because the WTO has the only binding and enforceable international law in these areas.

In a similar way, the scope of measures coming under recent RTAs has been expanded in some cases to include these new non-border areas. In the submissions to the Senate Hearing on the US-Australia FTA, a number argued for including in the Agreement provisions relating to non-trade issues such as

the environment¹² and human rights.¹³ Again the motivation appears to be access to the Dispute Settlement Procedures provisions of a possible agreement.

Such links are bad policymaking. They are undesirable for trade policymaking in a number of ways: they extend the agenda and the difficulties of reaching consensus and they invite the use of trade policy instruments for non-trade purposes that would introduce new forms of trade restriction. They are undesirable for policymaking in the non-trade areas because trade flows, and trade policies affecting trade flows, are not directly related to the activities which cause environmental problems or breaches of competition law or whatever. These problems cannot, therefore, be substantially ameliorated by trade policy changes.

With regard to the current negotiations with the US over an FTA, the possible link is between trade on the one hand and national security on the other. This poses a link between an economic alliance and a national security alliance, and it raises the same question as to whether this link is desirable or not.

It is evident that around the world the choice of trading partners in regional trading agreements depends much on political/security and other non-economic relations. The EEC and ASEAN were both established with regional defence and security in mind as well as trade gains. On the negative side, we have seen in 2000 the collapse of the proposal for an AFTA-CER Free Trade Area, primarily because of opposition from Malaysia but also, to a lesser extent, from the Philippines and Indonesia. This opposition derived from political antagonism, even though the joint Taskforce had found that both ASEAN and CER countries would gain economically from a free trade area.

The link between defence and security on the one hand and trade preferences seems to be particularly strong in the US. Apart from its natural partners in NAFTA, the past choice of Israel, Jordan, Singapore and Chile as well as the current choice of negotiations with Australia and with Morocco and with the Central American Free Trade Area illustrate that the US choices are not driven by economic gains. As the hegemon of the world, the US is rewarding countries that are allies in its broad geopolitical strategy by offering them improved preferential access to US markets and punishing those (such as New Zealand) that are not close allies by denying them preferential access to US markets. The circumstances post-Iraq make the environment in which Australia negotiates a trade treaty with the US more favourable than at any time in the past – and possibly for the foreseeable future.

The position of Australia in this situation is, however, very different than that of the US. We are not a major military power and anything we do in the area of security and defence will have a small effect on global geopolitics and security. Nor will it have a major effect on the US alliance in security and related areas, such as the campaign against terrorism. This alliance continued and intensified over decades before the present negotiations began. We should therefore be wary of a bilateral trading agreement on the grounds of a “warm and fuzzy” feeling arising from recent cooperation in military and security domain. Our negotiators should protect those domestic policies that are seen as desirable; for example, the Pharmaceutical Benefits Scheme and, in my view, the TV and radio content plans. The negotiations will not be easy as the US is a tough negotiator with a firm agenda.

The final decision on our part on whether to sign an FTA with the US must rest solely on the economic gains or loss to us of the negotiated agreement. The strengthening of the security alliance may, however, play a role in public acceptance of such a major policy change. Closer security ties between Australia and the US probably increase the acceptability of a satisfactory FTA in both Australia and the US.

Concluding Points

Economic or trade diplomacy concerns very specific issues relating to economic relations between countries. We do not require a different economic diplomacy for Asia, or for that matter with other regions. The markets of all of the countries we trade with are linked by trade in an increasingly integrated single global market. We should pursue all bilateral, regional, and multilateral agreements that open our economy to increased trade with other countries. (Parenthetically, I note that the potential market that seems to have been most neglected by Australia in recent times is India or the South Asian sub-continent generally.) Careful economic diplomacy should seek to further improve our relations with Asian countries without harming our relations with other areas.

Notes

- 1 In the sense of Paul Krugman, "Is Bilateralism Bad?" in E. Helpman and A. Razin (eds.), *International Trade and Trade Policy* (Cambridge, Mass.: MIT Press, 1991), pp. 9-23.
- 2 P.J. Lloyd, "Closer Economic Relations with East Asia?" *The Economic Record*, 77, September 2001, pp. 228-241.
- 3 World Trade Organisation (WTO), *Regional Trading Arrangements and the World Trading System* (Geneva: WTO, 1995).
- 4 Organisation for Economic Cooperation and Development (OECD), *Regional Integration and the Multilateral Trading System: Synergy and Divergence* (Paris: OECD, 1995).
- 5 World Bank, *Trade Blocs* (Washington, D. C.: World Bank, 2000) and Maurice Schiff and L. Alan Winters, *Regional Integration and Development* (Oxford: Oxford University Press, 2003).
- 6 C. Findlay, "Old Issues in New Regionalism," a paper presented to 2000 APEC Economic Outlook Symposium, Manila, the Philippines, 24-25 July 2000, p. 1.
- 7 For further analysis see P. J. Lloyd, "New Bilateralism in the Asia Pacific," *The World Economy*, 9, September 2002, pp. 1279-1296.
- 8 See Tables 3.2 a-f in R. Scollay and J. P. Gilbert, *New Regional Trading Arrangements in the Asia Pacific?* (Washington, D.C.: Institute for International Economics, 2002).
- 9 Commonwealth of Australia, *In the National Interest: Australia's Foreign and Trade Policy* (Canberra: Department of Foreign Affairs, 1997).
- 10 Minister for Trade, "A Trade Strategy for Australia," speech delivered in Perth 11 April 2003. A transcript of this speech is available on the DFAT website at www.dfat.gov.au.
- 11 P.J. Lloyd, Submission to the Senate Committee on Foreign Affairs, Defence and Trade, 31 March 2003. A transcript of this and all other submissions are available on the Senate's website at www.aph.gov.au/senate/committee/fadt_ctte/GATS/submissions/sublist.htm.
- 12 Australian Conservation Foundation, Submission to the Senate Committee on Foreign Affairs, Defence and Trade, March 2003.
- 13 Victorian Council for Civil Liberties, Submission to the Senate Committee on Foreign Affairs, Defence and Trade, March 2003.

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Dr Jim Leibold

4/ F Sidney Myer Asia Centre
The University of Melbourne
Parkville, VIC 3010
AUSTRALIA
Tel: +613 8344 3575
Fax: +613 9347 1768
Email: j.leibold@unimelb.edu.au



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Design / Layout: Ian Robertson

The Melbourne Institute of Asian Languages and Societies

Sidney Myer Asia Centre
University of Melbourne VIC 3010
Telephone: +613 8344 5990
Fax: +613 9349 4870
www.mials.unimelb.edu.au

The Asialink Centre

Sidney Myer Asia Centre
University of Melbourne VIC 3010
Telephone: +613 8344 4800
Fax: +613 9347 1768
www.asialink.unimelb.edu.au

Asian Law Centre

Faculty of Law
University of Melbourne VIC 3010
Telephone: +613 8344 6847
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Asian Economics Centre

Faculty of Economics and Commerce
University of Melbourne VIC 3010
Telephone: +613 8344 3880
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Department of Management
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Telephone: +613 8344 5340
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