Adapting Australia to an era of geoeconomic competition
Executive Summary

**Geoeconomics is a fact of life in the 21st century Indo-Pacific.** As international rivalries among major powers have re-emerged, economic policies have become a key element in diplomatic toolkits. Many Indo-Pacific governments – particularly China and the US – have deployed geoeconomic strategies to manipulate economic relationships for geopolitical gain.

**Geoeconomics has increasingly proven a challenge for Australia.** Coercive trade warfare – at both the bilateral and multilateral levels – has already harmed Australia’s economy. China’s emergence as a global investor is posing vexing security and strategic externalities both at home and abroad. Australia’s diplomatic efforts in the Indo-Pacific have been hampered as the commitment of major powers to multilateralism has waned.

**Australia is particularly exposed to geoeconomic risks.** As a highly-open economy with significant trade and investment ties, geoeconomics threaten Australia’s national interests. Compounding matters, Australia’s commitment to liberal economic policy settings increases its exposure to risks, and reduces its capacity to respond to the geoeconomic strategies of others.

**Australia must adapt its foreign policies for the era of geoeconomic contestation.** While liberal economic policy settings have worked well in the past, there is need for new approaches to manage emerging risks. Australia now needs to strike a new and careful balance between the openness that secures Australia’s economic strength, and strategic considerations that protect against security risks and political coercion.

**Fortunately, Australia has many practical options in its geoeconomic toolkit.** These include diversifying economic relationships, developing ‘defensive’ capabilities against coercion, strategically deploying economic diplomacy, and working in coalitions with likeminded partners. These policies will be essential to adapting Australia to the geoeconomic currents of the 21st century Indo-Pacific.
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Introduction: Australia confronts geoeconomics

Geoeconomics – the application of economic instruments for geopolitical ends – has become a prominent feature of international politics in the early 21st century. As rivalries have re-emerged between the world’s major powers, governments have turned to economic tools as a way of advancing strategic agendas. This is especially true in the Indo-Pacific, a region home to most of the world’s major powers. It has been driven by the US and Chinese governments, which have both deployed geoeconomic strategies to prosecute their great power rivalry. Where economic interdependence was once a driver of cooperation in the Indo-Pacific, it has recently become a domain of strategic competition.

Geoeconomics poses an historic challenge for Australian diplomacy. For three decades, Australia has benefited immensely from a cooperative, rules-based and liberalising economic order in the Indo-Pacific. But as contestation replaces cooperation in the early years of the 21st century, Australia’s finds itself confronted with new economic challenges. The outbreak of coercive trade diplomacy has harmed the Australia economy, and threatened the integrity of global economic institutions. China’s Belt and Road Initiative has posed new security challenges at home, while catalysing infrastructure competition in the wider Indo-Pacific. As the commitment of major powers to multilateralism has waned, Australia’s diplomatic efforts at institution-building have also been hampered.

Australian policy settings complicate the challenge of managing geoeconomics. As an open and medium-sized economy, it is highly exposed to external shocks to its trade and investment ties. Compounding matters, Australia maintains a liberal approach to international economic engagement: based on open trade and investment policies at home, and a commitment to rules-based institutions with partners. These liberal settings served Australia well during the era of cooperative economic relations. But today they leave Australia exposed to risks emanating from the geoeconomic strategies of others.

This report examines how Australia can adapt to an era of geoeconomic competition in the Indo-Pacific:

- What is geoeconomics, and how is it reshaping the Indo-Pacific economic order?
- Where, and to what extent, is Australia exposed to geoeconomic risks?
- What strategies have been deployed to manage these risks, and how effective have these been?
- How can Australia adapt its policy settings to the geoeconomic environment of the 21st century?

The report contends that the rise of geoeconomics poses a major new threat to Australia’s national interests. Australia needs to reappraise its foreign economic policy settings, and adapt them to the challenges of geoeconomic contestation. While adaptation does not demand an abandonment of liberal economic principles, it does necessitate new strategies that are configured towards managing risks. Diversifying international economic relationships, developing ‘defensive’ capabilities against economic coercion, deploying economic diplomacy in strategic areas, and working in minilateral coalitions with likeminded partners, are essential components for Australia’s future geoeconomic toolkit.
Geoeconomic competition in the Indo-Pacific

It is widely recognised that economic relationships are fundamental for international politics. Domestically, a country’s economy is a principal source of national power: it provides the material and knowledge resources on which both civilian and military capabilities are based. Changes in economic relativities between states are a leading indicator of power balances in the international system. Internationally, the presence of cross-border economic connections – for goods, capital and knowledge – also create interdependence between states. Economic interdependence is unquestionably beneficial, as it allows a country to access resources and opportunities not available within its own borders. But it can also be a source of strategic risk, if it leads to external dependence, undermines sovereignty, or poses security externalities.

Analysts have coined the term ‘geoeconomics’ to understand the strategic effects of economic interdependence. In broad terms, it can be defined as “the application of economic instruments to advance geopolitical ends”. The concept argues that economic interdependence builds various forms of linkage between countries, and that these linkages have strategic implications – both positive and negative – that go beyond their purely economic effects. Moreover, these linkages can be deliberately manipulated by governments to project power and shape the international order in favourable ways.

Put simply, geoeconomics captures how economic policies can be used as a form of statecraft.

Geoeconomics goes beyond the simple notion that economics and security are linked. That it is economies which produce the ‘guns and butter’ underlying national power has long been recognised. Rather, geoeconomics describes how governments can deliberately use economic policies for the achievement of strategic, rather than purely economic, objectives. Free trade agreements (FTAs) provide an illustrative example. By mutually lowering trade barriers, FTAs produce an economic gain of increased trade. But they also change the form of interdependence between the involved members, with strategic implications for their relationships. When negotiating FTAs, government must therefore balance both economic and strategic objectives, and will often undertake agreements principally for their strategic results.

How do these ostensibly economic initiatives produce strategic outcomes? Because they change patterns of interdependence between governments. If Country A becomes dependent on its economic relationship with Country B, then A will face incentives to grant B concessions to secure that relationship. As Hirschman has argued, this creates an ‘influence effect’: where B gains some form of economic leverage over A that can be used to extract concessions. Geoeconomic strategies aim to exploit the influence effect by changing patterns of interdependence. Infrastructure platforms can lead to recipient countries becoming reliant on investment from the donor/s, creating an incentive for recipients to accommodate donors’ political requests. Regional trade agreements increase connections between their members, deepening influence effects within the blocs.
**Transactional diplomacy**
- Short-term sanctions (‘sticks’) and/or concessions (‘carrots’)
- Aid packages, trade sanctions, investment deals

**Structural linkage**
- Long-term connections that increase interdependence
  - Free trade agreements, cross-border infrastructure, digital connectivity

**Political influence**
- Political ties with local interest groups to shape domestic policy
- Business-to-business links, commercial diplomacy

**Geostrategic competition in the Indo-Pacific**

Geostrategic strategies can change political relations in multiple ways. Broadly speaking, three mechanisms can be identified (Figure 1):

- **Transactional diplomacy involves short-term, one-off exchanges.** It occurs when a government uses economic tools to reward or punish another, in the hope of changing the other’s behaviour. It can take negative forms, such through the application of trade sanctions; or positive forms such as offering aid packages or investment deals. Transactional diplomacy is a quid-pro-quo interaction whose influence effect lasts only as long as the transaction itself. It does not require longer-term political comity.

- **Structural linkage builds longer-term connections between economies.** It involves the development of lasting economic ties – such as free trade agreements, cross-border infrastructure or digital connectivity – to increase the density of ties between countries. In situations where there are size asymmetries, these connections give the larger partner an influence effect over the smaller. It is distinguished from transactional diplomacy by its longer-term nature, and therefore requires a degree of political alignment between governments.
• **Political influence operates indirectly at the societal level.** It results from the fact that international economic connections asymmetrically benefit certain groups within a state (typically, businesses that gain from economic opportunities). These groups develop an interest in supporting ties with a foreign country, and advocate for that country within domestic policy debates. Political influence is the deepest form of geoeconomics, and requires linkages between business and civil society groups.

**Importantly, geoeconomics changes the logic of foreign economic policies.** Economic objectives are no longer the sole concern of international economic relationships. Rather, they are also overlaid by a range of strategic considerations, some of which may have little to do with economics at all. These can include diplomatic concerns (such as building political ties with certain partners), or security concerns (including reducing economic exposure to partners considered hostile, and/or leveraging the exposure of partners for one’s own gain). This process is described as the “securitisation” of economic policy, wherein economic objectives are mixed with – and in extreme cases, entirely subsumed by – security considerations⁵. As a consequence, geoeconomics complicates the calculation of national interests with respect to foreign economic relationships, particularly when economic and security objectives clash.

**In recent years, many geoeconomic contests have emerged between the Indo-Pacific’s main powers.** One domain is infrastructure competition, which was catalysed by China’s launching of the Belt and Road Initiative (BRI) in 2013. Fearing that the BRI would provide China economic leverage over recipients in the region, counter-balancing infrastructure initiatives were launched by the Japanese, US and Australian governments in subsequent years⁶. On the trade front, the launch of the Trans-Pacific Partnership (TPP) by the US in 2010 unleashed a similar dynamic. Concerns – especially amongst China and smaller economies – that the TPP would create a US-dominated trade bloc within the region catalysed moves to commence negotiations for the competing Regional Comprehensive Economic Partnership (RCEP) in 2011⁷. Geoeconomic factors also play a role in regional disputes over cyber-security, foreign interference, territorial disputes, and most recently the COVID-19 pandemic.

**Economic integration has become a proxy domain for strategic competition between the Indo-Pacific’s major powers.**

**Geoeconomic contests have major implications for the regional order.** Integration through cooperative and rules-based institutions has been a feature of the Indo-Pacific for over three decades, and proved critical for its consistent developmental successes. But economic integration is becoming politicised – and its progress arguably undermined – due to competitive dynamics introduced by geoeconomics. In strategic terms, it also means that economic relationships are getting dragged into diplomatic and security competition between the region’s main powers. The political separation of economic and security relationships – which allowed strategic rivals such as the US and China to build deep trade and investment ties – is beginning to break down. As the remainder of this report illustrates, this turn towards geoeconomic competition poses significant challenges for a medium-sized and open country like Australia.
Australia’s exposure to geoeconomics

**Australia is highly exposed to the geoeconomic contests emerging in the Indo-Pacific.** It has been an enthusiastic supporter – and major beneficiary – of the wave of economic liberalisation that spread throughout the region in the three decades from the 1980s. Like other regional economies, Australia liberalised its foreign economic policy regimes, and progressively built mutually-beneficial trade and investment ties with partners across the Indo-Pacific. But while this trajectory supported Australia’s economic interests in the post-Cold War period, in an era of geoeconomic conflict it has become a liability.

**Australia’s engagement with geoeconomics is shaped by its relative weight in the region.** Given its intermediate size, there is a longstanding tradition of viewing Australia as playing a middle power role in international affairs. It is the world’s fourteenth largest economy by nominal GDP, and sixth in the Indo-Pacific. When measured against major powers Australia is comparatively small, at only one-thirteen the size of the US and one eighth of China. However, its small population (25 million) belies its status as one of the region’s most-developed economies, where it ranks only second behind the US on GDP per capita terms.

**Australia occupies a distinctive position in geoeconomics: at once a ‘respondent’ to the actions of larger powers, while capable of playing an independent ‘initiator’ role as well.**

**Australia’s concentrated trade profile exposes it to geoeconomic risks.** By world standards, Australia’s aggregate level of trade exposure is comparable to that of its peers. Its trade-to-GDP ratio of 42 percent is similar to that of the other major economies in the Indo-Pacific. However, its trade relationships might be characterised as “deep but narrow”. Sectorally, over half of Australian exports are mineral resources, with just three commodities – coal, iron ore and natural gas – accounting for the lion’s share (Figure 2). Geographically, it has also become highly trade exposed to the Indo-Pacific since reorienting its trade relationships towards fast-growing economies in the region. Indo-Pacific partners account for 84 percent of Australia’s merchandise exports, with China (35 percent), Japan (17 percent) and ASEAN (10 percent) the main markets.

**Figure 2 Sectoral composition of Australian exports, 2018**

Source: Author’s calculations, from DFAT and ABS
Figure 3: Market concentration in Australia’s top-20 exports, 2019

Source: Author’s calculations, from DFAT and ABS. Excludes confidential items of trade. Education and tourism report 2018 figures, as 2019 data is not available at time of writing. Labelled country identifies the largest export market. $ figures report the total value of Australian exports to all markets.
Australia’s exposure to geoeconomics

When disaggregated to the industry level, Australia’s trade concentration is revealed to be even more pronounced. Figure 3 shows the share of the largest five markets for Australia’s top-20 exports. It reveals that most industries rely on a single market much larger than the rest; and in many cases face monopsony conditions where a single buyer accounts for almost all sales. Very few products have genuinely diverse export markets. Moreover, this single market dependence is particularly focused on China, which is the top outlet for twelve of the twenty export industries. China’s dominance appears across all sectors, including minerals, agriculture, services and manufacturing.

Similar concentration is evident in investment relationships. Australia is very open to foreign investment, with inward investment stocks of $3.5 trillion. These make a material contribution to the economy, with net capital inflows in the decade to 2019 equivalent to 16 percent of all private investment. However, these investment are with very different partners to those for trade. Two ‘traditional’ partners – the US and EU – account for the majority of Australia’s two-way investment stocks (Figure 4). By contrast, the Indo-Pacific economies which are important for trade have a much smaller role, collectively accounting for only 15 percent of the total. Significantly, China plays a comparatively negligible investment role, despite being Australia’s top trade partner.

By their nature, all open economies are somewhat exposed to geoeconomics. However, Australia’s lack of diversity exacerbates the challenge. Its trade profile is heavily concentrated toward primary industry to the Indo-Pacific, with China the dominant export market. Its investment relationships depend upon the supply of capital from US and European markets. As a consequence, political shocks to one of these sectors or partners will have an outsized impact on Australia’s economy. A lack of diversity creates a number of geoeconomic ‘risk points’ that must be carefully managed.

Concentration in Australia’s international economic ties magnifies geoeconomic risks.
Adapting Australia to an era of geoeconomic competition

Australia’s engagement with geoeconomics is also constrained by its liberal policy settings. From the early 1980s, successive governments have engaged in a set of liberalising reforms, designed to open the economy and improve its international competitiveness. While these reforms have addressed both the domestic and foreign spheres, key policy settings of relevance to Australia’s international economic engagement include:

- Unilateral, bilateral and multilateral trade liberalisation, reducing average tariffs from 7% to 1%\(^7\)
- An open investment regime, which presumes in favour of foreign investment and only limits foreign ownership in a small set of sensitive sectors (such as critical infrastructure and residential property)\(^8\)
- Privatisation of state-owned enterprises (SOEs), with limited state-ownership outside of natural monopolies such as infrastructure and essential services\(^9\)
- A performance-oriented aid program, which emphasises accountability and efficiency in program delivery\(^10\)

From an economic standpoint, this liberal model has proven very successful. Australia has built world-class export industries across the primary and services sectors, and pioneered trade and investment relationships with the growth economies of the Indo-Pacific. International opening was a key contributor to Australia being recession-free for 29 years (1991-2019), presently a world record\(^11\). However, when it comes to geoeconomics, a liberal model reduces the number of policy tools available to government:

- **Strategic trade policy:** A strong commitment to liberalisation means Australia cannot manipulate tariffs for strategic objectives, as has recently been employed by the Trump Administration. During trade disputes, the only recourse is to dispute settlement mechanisms under the WTO or other FTAs.
- **Politicising investment ties:** An open investment regime reduces the scope for government to negotiate politically-managed investment deals. Furthermore, the absence of SOEs means Australia cannot use these firms to shape the direction of outward investment, as seen in China’s Belt and Road Initiative (BRI).
- **Conditionalised development assistance:** A performance-oriented aid program means economic considerations are most prominent in development assistance allocations. This constrains the ability to conditionalise aid transactions on agreed political outcomes.

As a consequence, institution-building has been the principal geoeconomic strategy. Consistent with its middle power position, Australia has used international institutions to shape its economic ties in ways that advanced national interests. Australia has pursued this through active engagement in the creation of a range of new economic institutions. In recent years, it contributed to the establishment of two multilateral dialogue bodies (the G20 and EAS); two mega-regional free trade agreements (the TPP and RCEP), and a new multilateral development bank (the AIIB). Since 2001, it has also completed negotiations for twelve bilateral free trade agreements, which now cover all of its main trade and investment partners\(^2\). These institution-building efforts are critical for Australia’s interests, as they contribute to the international rule-making that underpins its foreign economic and political ties.
Liberalism means Australia has found it challenging to respond to the recent emergence of geoeconomics. The Australian government has avoided state intervention in international economic relationships, and invested in developing competitive international markets and cooperative multilateral institutions. In periods of relative political harmony, liberal strategies provide better returns than more state-directed approaches offer. However, in periods of political conflict, it deprives government access to many of the common tools of geoeconomics, and raises exposure to risks emanating from their use by others. Compounding matters, Australia is also highly exposed to geoeconomic risks, due to its concentrated trade and investment profiles. These challenges are evident in how Australia has responded to three recent geoeconomic contests in the Indo-Pacific: navigating trade warfare, the rise of China as an investor, and contested regional institution-building.
Navigating neutrality in trade warfare

**Australia’s economic success depends on an open global trading system.** As a medium-sized economy, access to international markets enables Australia to exploit its comparative advantages on a larger scale than its domestic market allows. Many of its most important industries – across the resources, technology, agriculture, education, and services domains – have been developed with foreign investment to serve exports markets. However, in the last decade geoeconomic contests over trade have threatened the integrity of the global trading system. Governments around the world have abandoned liberal policy settings in favour of protectionist, and in some cases *politicised*, trade strategies. This shift has threatened both Australia’s trade relationships with its main economic partners, as well as the rules-based systems that govern the global trade architecture.

**Geoeconomic conflicts over trade are testing Australia’s liberal trade strategy.**

**A global turn towards protectionism poses a major threat.** Australia has enjoyed a highly favourable trade environment for several decades. It has benefited from a global trend towards trade liberalisation, which saw average applied tariffs fall from a peak of 8.6 percent in 1994 to only 2.6 percent by 2017.

However, in the last decade this liberalising trend has begun to falter. Beginning in the wake of the Global Financial Crisis (GFC), many governments responded to recession conditions by imposing restrictive trade measures designed to protect local industries. The trend towards protectionism has gathered pace in the years following post-GFC recovery (Figure 5). According to data compiled by Global Trade Alert, in the decade to 2019 governments have imposed 2751 measures that restrict international trade, in comparison to 807 liberalising measures – a roughly three-to-one ratio. This trend is accelerating, with the number of restrictive measures exceeding 500 for the first time in 2019.

**Figure 5** Trade interventions by governments by type, 2009-2019

Source: Global Trade Alert GTA Database

Adapting Australia to an era of geoeconomic competition
While many governments have participated in this protectionist trend, the behaviour of the US has had the most significant effects. Since taking office in January 2017, the Trump Administration has deployed coercive trade diplomacy against many major economies (Table 1). This includes withdrawal from the Trans-Pacific Partnership (TPP) agreement; the renegotiation of several existing trade agreements under threat of tariff imposition; several bilateral trade disputes; and the veto of nominations to the WTO’s Appellate Body in an attempt to force governance reforms. The bilateral trade disputes alone have targeted a group of ten economies that collectively account for half of world GDP in 2019. The most prominent of the bilateral disputes is the US-China trade war, which over the course of two years escalated through several cycles of tariff and counter-tariff actions to ultimately cover $735 billion of trade between their economies.

Coercive US trade diplomacy is a worrying development, given its historical role as an advocate for trade liberalisation and leader within the WTO.
Adapting Australia to an era of geoeconomic competition

Table 1 Coercive US trade diplomacy under the Trump Administration

<table>
<thead>
<tr>
<th>Jan 2017</th>
<th>Aug 2017 – Sep 2018</th>
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<tr>
<td>TPP PARTNERS</td>
<td>CANADA AND MEXICO</td>
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<tr>
<th>Mar 2018</th>
<th>Jan – Sep 2018</th>
</tr>
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<tbody>
<tr>
<td>WORLD</td>
<td>KOREA</td>
</tr>
<tr>
<td>Tariffs applied to solar panels, washing machines, steel and aluminium imports on national security grounds. Canada, China, the EU, India, Mexico, Turkey and Russia all impose retaliatory tariffs.</td>
<td>Renegotiation of Korea-US Free Trade Agreement under threat of termination.</td>
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<table>
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<tr>
<th>Aug 2018</th>
<th>July – ongoing</th>
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<tbody>
<tr>
<td>TURKEY</td>
<td>CHINA</td>
</tr>
<tr>
<td>Removal of Turkey from US Generalised System of Preferences (GSP) scheme; imposition of additional 25% tariff of Turkish steel (enacted August 2018, withdrawn May 2019, reimposed October 2019).</td>
<td>Escalating application of tariffs to demand a bilateral trade agreement, rising to cover $550 billion of imports from China. China repeatedly retaliates, with tariffs imposed on $185 billion of exports from US.</td>
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<tr>
<th>May 2019</th>
<th>Apr – Dec 2018</th>
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<tr>
<td>EUROPEAN UNION</td>
<td>JAPAN</td>
</tr>
<tr>
<td>Imposition of retaliatory tariffs on $7.5 billion of EU exports in Airbus dispute. Threatened imposition of 25% tariff on automobiles to force a trade-balancing bilateral agreement.</td>
<td>Negotiation of a bilateral trade agreement favouring US agricultural exporters under threat of tariff imposition.</td>
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<tr>
<th>June 2019</th>
<th>Dec 2018</th>
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<tr>
<td>INDIA</td>
<td>BRAZIL AND ARGENTINA</td>
</tr>
<tr>
<td>Removal of India from US Generalised System of Preferences (GSP) scheme.</td>
<td>Removal of exceptions from steel tariffs in retaliation for alleged currency manipulation.</td>
</tr>
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</table>

Source: See note 26.

Adapting Australia to an era of geoeconomic competition
The Trump Administration’s use of coercive trade diplomacy is harmful to Australia’s trade interests. Exports to the US have not been directly affected, as Australia negotiated national security exemptions to steel and aluminium tariffs. However, they still carry indirect effects due to complex linkages within global value chains. As Figure 6 illustrates, Australian minerals (iron ore, coal and bauxite) power the Chinese metals sector, which feed into its metals-related manufacturing industries, whose products are then exported to global markets. As a result, a direct US tariff against Chinese metals and metal-based manufactures is also an indirect tariff against Australia’s most significant mineral exports. Exports to China of these three minerals alone was worth $95 billion in 2019, a quarter of Australia’s total merchandise exports. Value chain linkages in the Indo-Pacific mean the Australian economy is exposed to coercive US trade diplomacy, even when it is not targeted directly at Australia.

Figure 6 Tariff effects in the Chinese steel and aluminium value chain

Source: See note 29
Equally significantly, the Trump Administration’s trade strategy has undermined the effectiveness of Australia’s own trade diplomacy. US withdrawal from the TPP in January 2017 is one example. While this did not ultimately lead to the failure of the agreement (which was later resurrected as the ‘CP-TPP’ by the remaining eleven members), it greatly reduced its systemic impact. While the original TPP accounted for percent of world trade, US withdrawal reduced its size to only 15 percent. Similarly, the Trump Administration’s veto of new appointments to the WTO’s Appellate Body – ostensibly made to demand legal reforms – meant the body became inquorate and unable to hear cases in December 2019. This has compromised the integrity of the WTO’s Dispute Settlement Mechanism (DSM), a key instrument by which Australia protects its trade interests in the global trading system.
**Emerging political disputes with China pose a more direct threat to Australia’s trade interests.** In the first half of 2020 there was a sudden and rapid deterioration in the Australia-China relationship, catalysed by the convergence of a range of irritants. However, this political dispute quickly spilled over into the trade relationship. On April 27, Chinese Ambassador Cheng Jingye made explosive remarks intimating that Chinese consumer boycotts against four exports (beef, wine, education and tourism) were likely, due to Australia’s position on a COVID-19 inquiry. On May 17, it was revealed that China would apply massive retaliatory duties to Australian barley exports, as the result of a long-standing anti-dumping investigation. In subsequent months, similar coercive trade measures were applied to Australian beef, education and tourism, wine, cotton and coal exports (see Box 1). International media have also been briefed on a purported Chinese “hit list”, which threatens to extend such trade sanctions to dairy, seafood, oat and fruit exports if relations further deteriorate.

**Box 1 Recent restrictive Chinese trade practices toward Australia**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
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<tbody>
<tr>
<td>February 2019</td>
<td>Changed customs procedures for Australian coal at Dalian Port, which delayed the handling of export shipments. The Australia-China coal trade was worth $13.8 billion in 2019.</td>
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<tr>
<td>May 2020</td>
<td>Imposition of an 80 percent tariff on Australian barley exports in May 2020 (comprised of both anti-dumping and anti-subsidy components), which will price Australian barley out of the Chinese market. The Australia-China barley trade was worth $591 million in 2019.</td>
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<td>May 2020</td>
<td>Suspension of export licenses for four Queensland abattoirs in May 2020, which collectively account for approximately one-third of beef exports to China. The Australia-China beef trade was worth $2.6 billion in 2019.</td>
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<tr>
<td>May 2020</td>
<td>Briefings to international media indicate China is considering applying further restrictive measures to Australian wine, dairy, seafood, oatmeal and fruit, which will be applied if political relations deteriorate further.</td>
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<tr>
<td>June–July 2020</td>
<td>The Chinese Ministries of Culture and Tourism and Foreign Affairs issue advisories against tourism and education travel to Australia. They cite a “significant increase in racist attacks” and “arbitrary searches by law enforcement” against Chinese citizens. Australia exported $12.1 billion of education services, and $16.3 billion of travel services, to China in 2018-19.</td>
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<td>August 2020</td>
<td>The Chinese Ministry of Commerce launches anti-dumping and subsidy investigations into Australian wine exports. In October, interim anti-dumping duties of 107-212% were applied. Australia exported $1.2 billion of wine to China in 2019.</td>
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<td>October 2020</td>
<td>Several Chinese steel and electricity companies are instructed to cease buying Australian coal.</td>
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<tr>
<td>October 2020</td>
<td>Chinese textile mills are instructed by the National Development and Reform Commission to cease buying Australian cotton under a WTO tariff rate quota of 1%. Australian cotton would instead by subject to a 40% duty. The Australia-China cotton trade was worth $1.1 billion in 2019.</td>
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<tr>
<td>November 2020</td>
<td>Industry reports confirm that an additional eight Australian commodities have been subject to “bans” by Chinese Customs. The commodities include wheat ($102m), wool ($2.4b), lobster ($707m), coal ($13.8b), sugar ($99m), copper ore ($2.3b), timber ($625m) and wine ($1.2b).</td>
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These measures are a clear example of China leveraging trade dependence to politically sanction Australia.

The Chinese government officially maintains they are technical measures of a non-political nature, enacted consistently with relevant bilateral and international trade rules. Australian Government representations, and many independent analysts and industry parties, contend these measures are without legal or technical merit. Coming at a time of deteriorating relations between the governments, many have argued they are instead a ‘grey-zone’ economic sanction in retaliation for recent Australian foreign policy actions. Chinese state media, and leaks from official sources, have frequently described them as political sanctions for supposed Australian ‘insults’ to China.

The Australian government has struggled to articulate defensive countermeasures to coercive trade practices. Politically, it is difficult to maintain ‘neutrality’ in the US-China trade war while still responding to the negative effects for Australia’s trade interests. There is also the risk that taking a strong diplomatic stance against US or Chinese practices might elicit additional retaliatory acts. In balancing these risks, Australia’s principal defensive responses have included:

- **Negotiating ‘national security’ exemptions to US steel and aluminium tariffs.** These exemptions not only protected exports to the US but actually doubled them, as Australia captured market share from affected third parties. However, these products reflect only a very small proportion of Australia’s trade with the US (only 6 percent of exports in 2019). More significantly, the national security exemptions do not protect against indirect trade losses from US tariffs associated with value chain effects. Nor does it protect against trade diversion caused by the US-China Phase One deal.

- **Resurrecting the TPP following US withdrawal.** Through coalitional diplomacy with like-minded partners, Australia supported the completion of the Comprehensive and Progressive Agreement for the TPP (CPTPP) in March 2018. The CPTPP retains most of the TPP’s regulatory content – with only a small number of US-demanded provisions suspended – and keeps open opportunities for new member accession. However, it has also greatly reduced its systemic impact. Now accounting for only one-sixth of the world economy, and absent the US, the CPTPP cannot function as a ‘standard-setting’ agreement in the international trade system.

- **Avoiding trade war with China.** The Australian Government has responded cautiously to Chinese trade sanctions: officially rejecting China’s (purported) rationales for the imposition of tariffs and travel warnings; while requesting consultations to negotiate a resolution. It has thus far declined to take normal counter-measures, such as imposing retaliatory measures or lodging a formal WTO dispute. This ‘diplomacy-led’ response has prevented the dispute escalating in the manner of the US-China trade dispute. However, it has also failed to address Chinese sanctions in any way, as the Chinese Government has refused to respond to official Australian requests for consultation.

- **Contribution to WTO reform efforts.** Australia has participated in two reform processes within the WTO, intended to address challenges currently facing the DSM. One is the ‘Walker process’, an informal consultation aiming to design workable and agreeable solutions for reform of the Appellate Body. Another is the ‘Multi-Party Interim Appeal Arbitration arrangement’ (MPIA), which provides an interim dispute resolution mechanism while the Appellate Body is inquorate. However, neither process currently offers an effective substitute for the handling of trade disputes. The US has indicated that the reforms proposed by the Walker process fail to fully address its concerns with the dispute settlement mechanism. The MPIA currently comprises only the EU and 18 other countries, and therefore fails to substantially provide cover across the WTO’s 164 current members.
Navigating neutrality in trade warfare

Fundamentally, none of these responses have fully succeeded in protecting Australia’s interests in the face of trade conflicts. Negotiating sector-specific exceptions to US tariffs has not addressed broader value chain risks; while the Chinese Government has thus far refused to even consult with Australia over its sanctions. Resurrecting the TPP and contributing to WTO reform has ‘kept the fires burning’ for trade multilateralism, but has done little to address the underlying disputes threatening the global trade system.

While Australia has avoided escalation, it has not proven capable of mounting an effective defence against trade warfare.

Australia’s constrained defensive capabilities are an inherent feature of its liberal trade policy. Unilateral liberalisation means that Australia’s tariffs are already very low, reducing its ‘negotiating coin’ when bargaining in trade disputes. Applying retaliatory tariffs to either the US or China (as many other governments have done) would also be a high-risk response. Economically, the costs would be borne by local consumers, undoing the benefits of open trade settings. Politically, it would mean prosecuting a trade war with either Australia’s top trade and/or investment partner, with attendant risks of escalation. Given the size differential to the Chinese and US economies, neither trade war would be one that Australia could realistically hope to ‘win’. While liberal trade policy benefited Australia enormously in past years of economic cooperation, it now constrains defensive responses during a period of geoeconomic conflict.
Managing China’s emergence as an investor

The rise of China as an outbound investor has forced a reappraisal of Australian investment policy. For its entire modern history, the Australian economy has relied on capital inflows from ‘traditional’ partners – initially the UK, with the US and other European investors joining in the post-war years. The arrival of Japanese investors during the resources boom of the 1970s somewhat widened the base, but did not lead to an ‘Asian reorientation’ in investment ties similar to that seen in trade. It was a sudden uptick in Chinese investment in the mid-2000s that catalysed a rethink of Australia’s investment outlook and policy settings.

The surge of Chinese investment was driven by both push and pull factors. On the push side, it was catalysed by an acceleration of China’s ‘Going Out’ policy in 2004, under which SOEs were provided government support to internationalise through overseas acquisitions in strategic sectors. On the pull side, Australia had emerged as a critically important mineral supplier, particularly for iron ore and metallurgical coal to feed China’s rapidly expanding steel industry. As the mid-2000s resources boom drove the price of these minerals to record levels, Chinese industrial firms began investing in Australian mining projects. From negligible levels, Chinese direct investment in Australia soared from 2006, before stabilising and diversifying into a broader range of sectors following the end of the resource boom (Figure 7).

Figure 7 Chinese direct investment in Australia, 2001-19

Source: ABS. Note: Includes both PRC (mainland China) and Hong Kong investments, see note.

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Managing China's emergence as an investor

Chinese investment relationship posed new challenges for Australia’s foreign investment regime. Chinese investment differs from that of Australia’s traditional partners in two ways. First, it tends to come from SOEs, which are common across the Chinese economy and dominate the heavy industry and infrastructure sectors. Second, investments are often funded by state-owned banks, which offer so-called ‘policy finance’ for projects selected by the government. These characteristics pose complex questions regarding the intent and implications of Chinese investment in Australia. Do Chinese firms adopt a commercial (i.e. profit-motivated) orientation to their investments, as with the private firms from traditional investment partners? Or do state-ownership and financing links mean the investors pursue strategic objectives on behalf of the Chinese government that are inimical to Australia’s interests?

Never before had Australia needed to manage foreign investment from state-connected firms.

An initial controversy concerned the commercial orientation of Chinese SOEs. In January 2008, Chinalco – a state-owned aluminium producer – moved to prevent an attempted BHP takeover of Rio Tinto through a massive $15 billion ‘dawn raid’ on Rio’s London-listed shares. Made with the backing of China’s State Council, but without the approval of Australia’s Foreign Investment Review Board (FIRB), the move was widely interpreted as a Chinese governmental intervention in an otherwise commercial matter. The Chinalco raid caused significant consternation, and led to the issuing of an updated ‘national interest test’. The new test added an additional principle by which the FIRB would review applications by SOEs, requiring that investments must conform to commercial principles.
Overall, there is little evidence this reform seriously inhibited bilateral investment. Since 2008, the Australian government has declined only six major Chinese investment applications, none of which were due to the commerciality test\textsuperscript{55}. However, Chinese parties consider it a discriminatory barrier. Surveys of Chinese firms consistently identify FIRB screening as a major obstacle\textsuperscript{56}, especially for SOE investors who must pass the commerciality test. For its part, the Chinese government made loosening FIRB rules a top priority in negotiations for the China-Australia Free Trade Agreement (ChAFTA)\textsuperscript{57}. Australia agreed to Chinese requests to lower screening thresholds for private but not state-owned enterprises, which reportedly required that it drop market access requests for sugar and rice from FTA negotiations\textsuperscript{58}.

The launch of China’s Belt and Road Initiative (BRI) in 2013 further complicated matters. The BRI aims to improve economic connectivity between China and its Indo-Pacific neighbours. Chinese SOEs provide investment, loans and construction contracts for infrastructure projects to regional partners. The BRI is an archetypal geoeconomic strategy. Economically, it aims to develop China’s western provinces, encourage greater trade integration with contiguous partners, employ China’s massive foreign currency reserves, and provide an outlet for surplus industrial capacity. Strategically, the BRI is designed to strengthen China’s political influence abroad, secure China’s energy supply, improve the country’s diplomatic image, and increase its economic leverage over its neighbours\textsuperscript{59}. Since 2014, China has channelled USD 274 billion of investment and construction contracts to Indo-Pacific countries under the BRI program [Figure 8].
Managing China’s emergence as an investor

Figure 8

Chinese investment and contracts in the Indo-Pacific, 2014-19

Value shown are USD billions

Source: AEI China Global Investment Tracker database. Also see explanatory note.®
Adapting Australia to an era of geoeconomic competition

Around the world, there has been a heated debate on how to balance the economic opportunities and strategic risks of the BRI. Its principal strength is the channelling of significant volumes of capital – estimated potentially in excess of $1 trillion – to developmentallyimportant infrastructure projects around the Indo-Pacific. For Australia, this is likely to open new trade and investment opportunities by improving transport and telecommunications links to key economic partners. However, several concerns have been raised regarding the strategic implications of the BRI.

- Limited transparency in SOE-managed projects, which may undermine ‘good governance’ development financing.
- The prospect of debt burdens, in which small economies are unable to fiscally-sustain repayments on large infrastructure loans.
- Security concerns surrounding port projects with mixed civilian and military uses, particularly ports and digital technologies.
- Risks that ‘chequebook diplomacy’ will be used to compete for geopolitical influence over smaller economies.

The Australian government has had to balance competing concerns in its response to the BRI. At times messaging has been positive, including the establishment of the Australia-China One Belt One Road Initiative (a business engagement NGO) in 2016, and official statements that Australia sees “opportunities for collaboration” in the BRI. But Chinese approaches to formally establish intergovernmental mechanisms for infrastructure cooperation have been consistently rebuffed for strategic reasons. These include proposals to ‘link’ the BRI with the Northern Australia Infrastructure Fund, or to sign an MoU for BRI cooperation with the Chinese government. Despite refusing formal links, the Commonwealth Government maintains that it will consider participation in BRI projects on a case-by-case basis.

On the domestic front, critical infrastructure has proven a significant BRI challenge. This infrastructure – assets important to Australia’s defence, national security and/or social and economic stability – poses unique policy challenges. While foreign investment makes an important contribution to Australia’s infrastructure estate, there are concerns that allowing investment from Chinese enterprises with government links may compromise national security. Three high-profile cases illustrate these concerns:

- The 99-year lease of Darwin Port to Chinese company Landbridge in 2015 sparked controversy. The Northern Territory government was criticised for its failure to consider the implications of the lease for Australia’s maritime and transport security.
- Chinese telecommunications company Huawei was prohibited from providing technology for both the National Broadband Network (2012) and the 5G network (2018) due to the risk of cyber-attacks and intelligence gathering on behalf of the Chinese government.
- The sale of NSW electricity distribution network Ausgrid to Chinese company State Grid was vetoed by the Treasurer in 2016. The Ausgrid network hosts infrastructure that is critical for the Australia-US Joint Defence Facility Pine Gap.

These cases elicited further reforms to the foreign investment regime. A Critical Infrastructure Centre was established in 2018, which provides specialist advice to the FIRB and identifies and manages risks facing critical infrastructure projects. A new ‘national security test’ was also added in 2020. This upgraded the regulatory approvals required for foreign investment in a ‘sensitive national security business’, and greatly increased compliance and monitoring powers. While official statements described these changes as ‘country agnostic’, they were widely understood to be a defensive measure against security risks posed by Chinese investments in critical infrastructure.
A significant number of businesses are in favour of engaging with the BRI, lest Australia is excluded from the new market opportunities in the region it is creating. Concerns have also been raised regarding the way that new critical infrastructure rules reduce investor certainty (for both Chinese and non-Chinese firms); and may close off access to Chinese sources of investment. For its part, the Chinese government has sought to convince Australian states to break with the Commonwealth and sign their own sub-national BRI MoUs. Such efforts were directed at Victoria and Western Australia, with the former successful in 2018. This led to suggestions that China was attempting to foment splits within the Australian federal system. The Prime Minister has declared Victoria’s BRI MoU is against Australia’s national interest, and in 2020 announced a review of all international agreements by subnational bodies.

Internationally, China’s BRI investments in the Pacific Islands has been a source of concern for Australia. While the Pacific is only a minor focus in the overall BRI program (Figure 8), these investments have a significant effect in these small economies. Australia has long been the biggest foreign investor and provider of aid in the Pacific Islands, and has identified a number of strategic concerns. One is the risk of indebtedness, where small Pacific governments are unable to fiscally sustain large infrastructure loans. Another is that China may leverage its investment in infrastructure through the dual-use of ports to establish military bases, such as the Chinese-built wharf on Espiritu Island in Vanuatu. Risk have also been reported to the security of digital infrastructure, including for datacentres and undersea internet cables. In 2018, the Foreign Minister publicly expressed concern that BRI investments in the Pacific would be “detrimental to [these countries’] long-term sovereignty”.

Australia responded to these risks with the ‘Pacific Step Up’ program, announced in the 2017 Foreign Policy White Paper. The Pacific Step Up program prioritises the region in Australia’s foreign policy, with a stated objective of ensuring the ‘soverignty, stability, security and prosperity’ in the region. It also established the $2 billion Australian Infrastructure Financing Facility for the Pacific (AIFFP) to support infrastructure projects in Pacific island countries. In 2019, Australia’s also announced it would cover two-thirds of the cost to build an undersea internet cable from the Australian mainland to the Solomon Islands. It was widely reported that this move was made in order to displace a proposal by Huawei, which had been previously excluded from Australia’s digital infrastructure on security grounds.

The challenge posed by Chinese investment in Australia stems from the fundamental differences between economic systems. The dominance of SOEs in the Chinese economy – and their corresponding role in advancing policy mandates – clashes with Australia’s predominantly private corporate system. Australia’s liberal investment policy settings are not suited to managing risks associated with state-owned investors, either within Australia or in the region. Domestically, Australia has repeatedly tightened its foreign investment regime and refused formal linkages with the BRI, both of which have managed these strategic risks at the economic cost of erecting barriers to Chinese investment. In the region, Australia has been drawn into direct competition with the BRI, a trajectory that augurs poorly for bilateral economic relations. Australia’s liberal approach to foreign investment thus puts it at a decisive disadvantage when responding to the surge of geoeconomically-driven investment from Chinese SOEs.
Institution-building and coalitional diplomacy

Given constraints in the trade and investment spheres, Australia’s principal geoeconomic tool has been institution-building efforts. This is somewhat expected, given its middle power status in the Indo-Pacific. International relations scholars have long argued coalition-building with likeminded partners is the *sine qua non* of middle power diplomacy. With the capacity and interest to shape international order, but lacking the heft to execute alone, middle powers often pursue strategic objectives through the creation of cooperative institutions. By exercising power on a collective and institutional basis, Australia is capable of greater influence and leadership than its individual resources would allow. However, Australia’s institution-building efforts have also had to respond to the behaviour the region’s major powers – particularly the US and China – in order to be effective.

**Australia’s most commonly-used geoeconomic tool is the negotiation of free trade agreements.** For most of the post-war period, Australia has been a ‘committed multilateralist’ in trade policy, largely working through global-level GATT/WTO processes. But in the early 2000s, its trade diplomacy shifted towards preferential free-trade agreements (FTAs) negotiated outside the WTO system. This began in the early 2000s, and by 2020 Australia had concluded FTAs with twenty-one economies, predominantly from the Indo-Pacific region (Table 2). In the early stages, economic objectives were dominant in FTA diplomacy, with a focus on securing market access gains in agricultural and services exports. This economic agenda is evident in partner selection, with a preference for major export markets such as the US, Korea, Japan and China. The success of these efforts is reflected in the fact that the ‘coverage ratio’ of Australia’s in-force FTAs now accounts for 81 percent of its total exports.

**Table 2  Australia’s FTA partners 2020**

<table>
<thead>
<tr>
<th>PARTNER</th>
<th>STATUS</th>
<th>ENTRY INTO FORCE</th>
<th>SHARE EXPORTS 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Zealand</td>
<td>In-force</td>
<td>1980</td>
<td>2.6%</td>
</tr>
<tr>
<td>Singapore</td>
<td>In-force</td>
<td>2003</td>
<td>3.1%</td>
</tr>
<tr>
<td>Thailand</td>
<td>In-force</td>
<td>2003</td>
<td>1.2%</td>
</tr>
<tr>
<td>United States</td>
<td>In-force</td>
<td>2004</td>
<td>3.9%</td>
</tr>
<tr>
<td>Chile</td>
<td>In-force</td>
<td>2008</td>
<td>0.1%</td>
</tr>
<tr>
<td>ASEAN</td>
<td>In-force</td>
<td>2009</td>
<td>10.5%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>In-force</td>
<td>2012</td>
<td>2.3%</td>
</tr>
<tr>
<td>China</td>
<td>In-force</td>
<td>2014</td>
<td>38.3%</td>
</tr>
<tr>
<td>Japan</td>
<td>In-force</td>
<td>2014</td>
<td>14.8%</td>
</tr>
<tr>
<td>Korea</td>
<td>In-force</td>
<td>2014</td>
<td>6.7%</td>
</tr>
<tr>
<td>CPTPP</td>
<td>In-force</td>
<td>2018</td>
<td>25.2%</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>In-force</td>
<td>2019</td>
<td>1.9%</td>
</tr>
<tr>
<td>Peru</td>
<td>In-force</td>
<td>2019</td>
<td>0.0%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>In-force</td>
<td>2020</td>
<td>1.6%</td>
</tr>
<tr>
<td>PACER Plus</td>
<td>In-force</td>
<td>2020</td>
<td>0.1%</td>
</tr>
<tr>
<td>RCEP</td>
<td>Awaiting ratification</td>
<td></td>
<td>72.9%</td>
</tr>
<tr>
<td>India</td>
<td>Under negotiation</td>
<td></td>
<td>3.7%</td>
</tr>
<tr>
<td>European Union</td>
<td>Under negotiation</td>
<td></td>
<td>3.2%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Under negotiation</td>
<td></td>
<td>3.9%</td>
</tr>
<tr>
<td>Coverage of all in-force agreements</td>
<td></td>
<td></td>
<td><strong>81.1%</strong></td>
</tr>
</tbody>
</table>

Source: DFAT
Strategic objectives became a more prominent in Australia’s trade diplomacy from 2010. As bilateral FTAs had been secured with all major trade partners, strategy shifted from a predominantly economic (market access) agenda to include diplomatic (partnership building) objectives. FTA negotiations with India and Indonesia fit this pattern. Unlike Australia’s previous FTAs, neither were major export markets. However, FTAs were viewed as a key step in building broader diplomatic partnership with these important regional players. Opening negotiations with Indonesia was billed as a key step to advance broader “comprehensive partnership” established between the governments in 2009. Similarly, the India-Australia FTA was promoted as one of the economic components required to realise a bilateral “strategic partnership” that covered a range of defence, diplomatic and regional collaborations.

On the multilateral front, Australia also actively participated in negotiations for two ‘mega-regional’ FTAs: the 12-member Trans-Pacific Partnership (TPP) and ASEAN+6-based Regional Comprehensive Economic Partnership (RCEP) agreements. Economic rule-making, rather than tariff reduction, was the principal focus of these agreements. The US-led TPP was billed as a “21st century” trade agreement, which included a range of regulatory provisions covering areas as diverse as services, investment, e-commerce, intellectual property and environmental standards. RCEP unites the six ‘ASEAN Plus One’ FTAs into a single trade bloc, which would providing a coherent set of trade rules for the region’s economies. These mega-regional trade negotiations demonstrated an Australian focus on collective rule-making, rather than bilateral bargaining, as a means for realising liberalisation preferences.

By combining economic and strategic objectives, Australia’s recent FTAs embody a geoeconomic approach to trade diplomacy.

Participation in the Trans-Pacific Partnership (TPP) was a landmark in Australia’s use of geoeconomics. Launched in 2010, the TPP marked a radical break with previous FTAs in the Indo-Pacific. First, the agreement went beyond existing models for trade reform, by combining traditional market access provisions (i.e. tariff and subsidy reductions) with a range of trade-related regulatory disciplines. Investment, services, e-commerce, intellectual property and financial services were all included. Second, the TPP was multilateral, and intended to build a political coalition of likeminded governments that favoured a more ambitious approach to trade liberalisation. Third, it included and was led by the US, which despite being a major economic partner had hitherto not been substantively engaged with trade diplomacy in the region. The TPP was an ideal fit with Australia’s preferences for an ambitious, multilateral and US-engaging regional trade bloc.

Figure 9 Timeline of TPP negotiations
The TPP would ultimately fall victim to domestic US electoral politics. The TPP became a controversial aspect of the 2016 presidential election, with both candidates voicing opposition to the deal. Donald Trump made anti-TPP rhetoric a centrepiece of his campaign, and following his election victory withdrew the US from the agreement with his first executive order as President. US withdrawal terminally compromised the TPP. As per its entry-into-force requirements, at least six members—accounting for 85 percent of the GDP of the bloc—were required for ratification. As the US accounted for 65 percent of the TPP’s size, withdrawal made it numerically impossible for the agreement to take force. Absent US leadership, in early 2017 many observers concluded the TPP was moribund and would quickly collapse.

Defying these expectations, the remaining TPP members quickly began efforts to salvage the agreement. These were led by Australia and Japan, whose Prime Ministers made a joint commitment to work towards finalising the TPP. While initial efforts targeted at the US failed to change the position of the Trump Administration, they were successful in building supportive coalition amongst the other eleven members. In a landmark achievement, the remaining parties finalised the Comprehensive and Progressive Agreement for the TPP (or CPTPP) in March 2018 (see Figure 9). The CPTPP did not replace the TPP, but functioned as a ‘bridging’ instrument that enabled its entry-into-force in the absence of the US. It also preserved almost all of the regulatory content of the original agreement, with only a small number of US-requested intellectual property provisions suspended.

By working with Japan to create the CPTPP, Australia was able to secure a systemically-important addition to the regional economic architecture without US support or leadership.

Australia also deployed multilateral diplomacy to shape Chinese infrastructure diplomacy. This was achieved through membership in the newly-formed Asian Infrastructure Investment Bank (AIIB). Proposed by the Chinese government in 2013, the AIIB is a new multilateral development which specialises in financing infrastructure projects in Asia. Announced at the same time as the BRI, the AIIB reflected China’s intentions to use infrastructure investment as a basis for its economic diplomacy with Indo-Pacific partners. Unlike the bilaterally-oriented BRI, however, it offered a multilateral and rules-based architecture for China’s infrastructure diplomacy efforts. Significantly, it was also the first time the Chinese government proposed, led negotiations for, and secured the presidency and headquarters of, a formal intergovernmental body of any kind.
The AIIB proved controversial. Several critics alleged it was a ‘revisionist’ attempt to change the international financial system and undermine existing governance standards; and/or a financing vehicle for the contentious BRI program. The US and Japanese governments declined membership; and during 2014 the Obama Administration lobbied partners against joining on the grounds the AIIB would fail to uphold good governance standards. However, these US lobbying efforts failed to sway the Australian government. In March 2015, Australia joined with Korea and sixteen western European governments in accepting Chinese invitations to become founding members. These western country members – including four of the G7, fourteen of the G20, and twelve of the twenty-seven EU states – greatly increased the international legitimacy of the AIIB, and conferred a degree of prestige for China’s diplomatic efforts.

**Australia and its European partners were far from passive participants in the setup of the AIIB.**

Founding membership allowed these governments to participate in the drafting of the AIIB’s *Articles of Agreement*, which were completed in May 2015. These governments had a decisive impact on governance arrangements, securing provisions which ensured the new bank would conform to agreed international best practices for development financing (see Box 3). These provisions each involved compromises on initial Chinese proposals, which were agreed to accommodate the requests of the western country members. As a result, the AIIB now embodies similar functionally, identical loan practices and governance standards to established multilateral development banks such as the World Bank and Asian Development Bank. The AIIB has since expanded to 76 member states, and by the end of 2019 had extended USD 12 billion in loans or technical support to 63 infrastructure projects in the region.

Active engagement with the AIIB provided Australia an effective mechanism to shape China’s infrastructure diplomacy. Concerns regarding the strategic implications of the BRI – particularly around transparency and financial sustainability for small economies – precluded bilateral engagement through a BRI MoU. But by engaging multilaterally through the AIIB, Australia was able to draw on a wider political coalition to shape Chinese infrastructure investment in more amenable ways. Responding to earlier concerns about AIIB governance, the Australian Treasurer would comment: “We are absolutely satisfied that the governance arrangements now in place will ensure there is appropriate transparency and accountability in the bank.” This outcome would have been impossible without the pool of diplomatic resources offered by European partners.

**Working with a likeminded coalition through multilateral diplomacy enabled Australia to shape the form of Chinese geoeconomics.**

The success of institution-building efforts demonstrate that Australia can effectively engage in geoeconomics. Australia’s medium-size and liberal policy settings may constrain Australia’s responses when working on its own. But by collaborating with like-minded partners, and formalising cooperation through international institutions, it has proven highly capable of shaping geoeconomic contests. It has used bilateral FTAs to build partnerships with a diverse range of Indo-Pacific governments, led an international coalition to resurrect the TPP following US abandonment, and contributed to efforts to improve the transparency of China’s AIIB. Indeed, its most effective responses to adverse geoeconomic behaviour by the US and China have come through international coalitions. This record – of weak individual, but strong collective responses to geoeconomics – affirms the utility of coalition-based strategies for a middle power like Australia.
Adapting Australia to an era of geoeconomic competition

Box 3 International best practices in the AIIB

**GLOBAL MEMBERSHIP:**
At commencement of operations, the AIIB included 21 members from outside the Indo-Pacific region. This has since risen to 32 extra-regional members.

**COMMERCIAL BEHAVIOUR:**
The AIIB will only issue USD-denominated loans, which are made at commercial (rather than concessional) rates.

**GOVERNANCE POLICIES:**
The AIIB developed a formal set of transparency and social safeguard policies; and adopted an open and competitive procurement policy which emphasises efficiency, value-for money and transparency.

**VOTING STRUCTURE:**
China relinquished an earlier claim to hold a formal veto power, and agreed to a voting structure under which no member holds a veto over formal loan decisions.

**INSTITUTIONAL PARTNERSHIPS:**
the AIIB signed a co-financing agreement with the World Bank, and cooperative MoUs with twelve other development banks.

Source: Wilson and AIIB

31 Adapting Australia to an era of geoeconomic competition
Adapting Australian policy for the geoeconomic era

The rise of geoeconomic contestation is a new and major challenge for Australian foreign policy. As open and cooperative global economic system are under threat, economic interdependence has become a domain of conflict. And as a medium-sized and open economy, Australia is highly exposed to risks from the geoeconomic strategies of major powers. Compounding matters, its liberal policy settings are poorly configured to respond to geoeconomics, as governments seek to manipulate economic relationships for strategic purposes. The era of cooperative and rules-based economic order in the Indo-Pacific – from which Australia has benefited immensely over the last three decades – has unfortunately come to an end.

Australia’s foreign economic policy needs an update for the era of geoeconomic contestation.

However, adapting to geoeconomics does not imply abandoning liberal policy. The simplistic response would be to start strategically manipulating economic relationships as well. However, this ‘if you can’t beat them, join them’ approach would carry serious costs. Economically, it would mean erecting barriers to the trade and investment flows that have been critical to Australia’s economic success for its entire modern history. Nor, given Australia’s medium size, can it realistically expect to ‘win’ trade wars or investment races against larger players. Politically, it would pose risks of being drawn deeper into the strategic rivalries that presently divide the Indo-Pacific. An Australia that naively abandons liberalism would be poorer, more exposed to risk, and potentially at the whim of the region’s major powers.

Instead, Australia will need to strike a new balance between openness and security. Maintaining open and liberal policy settings will be essential for Australia’s future prosperity and integration with the Indo-Pacific. But introducing a greater degree of strategic considerations is necessary to minimise its exposure to the rising tide of geoeconomic contests in the region. This is a balancing act that requires complex trade-offs. Too little of the strategic imperative and Australia will be exposed to economic risks and political coercion. Too little openness and Australia will harm the economic relationships on which its prosperity depends. Policy settings will need to be continuously reappraised in light of the changing mix of opportunities and risks.

Five key policy objectives that should inform how Australia adapts its foreign economic policy for the geoeconomic era:

Australia’s concentrated economic relationships magnify the effects of external shocks. In an era of geoeconomic conflict, any trade and investment link that is dependent on a single partner becomes an ‘exposure point’ for risk. Building more diversity into these relationships will spread risk, augment shock resilience, and reduce the impacts of political coercion.

Importantly, diversification does not mean engaging less with existing partners. Trading less with China, or investing less with the US and Europe, would simply make Australia poorer. Rather, it demands that future growth efforts are directed at building new or stronger ties with hitherto under-realised partners. Australia is well-positioned for this, as the Indo-Pacific is home to many of the world’s fastest growing major economies, including India, Indonesia and Vietnam. Realising the potential of these nascent relationships should be Australia’s top foreign economic policy priority.

On the trade front, diversification efforts should focus on developing new export relationships for industries which are dependent on a single large market. Recent trade initiatives – including RCEP, the bilateral trade agreement with Indonesia, and economic diplomacy with Vietnam – are steps in
the right direction. On the investment front, Australia should aim to build deeper relationships with the Indo-Pacific to broaden the geographic base of capital inflows and outflows. This will require Australian economic diplomacy to place equal emphasis on investment alongside trade. In both cases, business must also be provided assistance to take advantage of opportunities created by new government-to-government platforms.

Australia has been repeatedly affected by geoeconomic risks in recent years, and will face more in the future. Its previous defensive strategy – of relying on multilateral institutions such as the WTO – is no longer effective, as consensus behind these institutions breaks down. Australia needs to put new policy instruments in place to effectively and quickly respond to geoeconomic risks when they occur.

Recent reforms to the foreign investment regime are an instructive example of what is required. They have allowed Australia to manage new risks surrounding state-owned investors and critical infrastructure while maintaining the overall openness needed to attract investment. However, many other economic policy frameworks will need to be similarly reformed. One immediate example is international value chains for ‘critical’ commodities such as essential technology, resource and medical products. New policies are needed to build greater resilience into these important sectors.

With coercive trade diplomacy rising, Australia must also develop new ways to respond to trade disputes. Diversification is part of the solution, as it reduces economic exposure. Australia will also need to much more actively litigate trade disputes than in the past: using both the WTO’s interim MPIA mechanism, as well as provisions in its fifteen FTAs. And in cases where these mechanisms fail, the Australian Government will need to offer countervailing support to industries affected by political actions that fall outside normal business risks.

Historically, Australia has deployed its economic diplomacy primarily for economic ends. However, in an era when many governments are adopting geoeconomic strategies, Australia will be at a disadvantage if it does not do the same. Australia’s medium size prevents it from mounting strategies on the scale seen by major powers. But Australia has many geoeconomic policy levers which can nonetheless be pulled.

The recently announced Pacific Step Up is a first move in this direction, as it recognises the more prominent role strategic considerations will need to play in the aid program. But more of these type of programs will be required in coming years, and will involve more than just aid program spending.

Trade diplomacy will need to change its orientation, to place higher priority on ‘rule making’ efforts rather than simply pursuing market access [i.e. export] gains. This is evident in the mega-regional FTAs (the TPP and RCEP), whose principal utility for Australia is as rule-making agreements. Rule-making should also play a larger role in bilateral economic diplomacy, particularly with non-FTA partners such as India and Vietnam.

Australia could also leverage its outbound investment – which averages $34 billion per annum118 – to build links with key partners. While government cannot ‘direct’ the investment activities of private firms, it can certainly shape them through supportive action. Commercial diplomacy programs (delivered through Austrade and other sectorally-focused agencies) provide government an opportunity to promote outbound investment in domains where it is strategically beneficial.
Australia’s most successful responses to geoeconomics have come via working through international coalitions. These are a force multiplier for Australia, pooling political and economic resources with others to deliver better results than acting alone. And in an era where consensus behind economic openness is faltering, coalitional diplomacy will need to focus on partners that share Australia’s commitment to liberal principles. This will necessitate a shift from multi- to mini-lateralism in economic diplomacy, where smaller groups of likeminded governments come together to advance cooperation in functional areas.

These coalitions will also be critical to sustaining formal (i.e. treaty-based) economic institutions. Coalitions can nimbly deploy informal instruments not available to formal bodies, such as dialogue processes, coordination mechanisms and non-binding agreements. These informal instruments lower accession costs for governments, and focus attention on building consensus around norms and principles. Moreover, informal instruments can help sustain formal institutions during period of conflict, as has occurred recently at the WTO.

Foreign economic policy has historically been the preserve of a limited number of Australian government agencies: principally DFAT, the Treasury and groups within relevant line agencies. However, as geoeconomics requires a greater sensitivity to strategic considerations, a broader range of government agencies need to become involved in the policymaking process. And, as the recent debate over the risk sub-national economic agreements illustrates, it also should incorporate state governments as well.

Expanding the network of involved agencies necessitates new and better mechanisms for intra-governmental policy coordination. The technical and specialist nature of many issues will also demand that expertise is shared more broadly across government, rather than being sequestered in departmental silos. The Critical Infrastructure Centre, established in 2018 to advise across the government and corporate sectors on critical infrastructure issues, provides an example of an appropriate model.

Finally, government will need to more closely incorporate business into strategy and policy-making discussions. Businesses are the front line troops of geoeconomics, as it is they – and not government itself – that ‘do’ trade and investment. Geoeconomic risks fall directly upon businesses; and many national responses (such as trade diversification) require business to take the lead. Much closer and responsive government-business relations will be required for Australia to successfully adapt its foreign economic policy to the geoeconomic era.
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Acknowledgements

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Dr Jeffrey Wilson is the Research Director at the Perth USAsia Centre. He provides leadership and strategic direction in developing and managing the Centre’s research programs across its publications, policy and dialogue activities. He specialises in how transformations in the regional economic architecture – including trade agreements, multilateral organisations and policy dialogues – are reshaping the contemporary economic and business environment of Asia. He has contributed to a range of national and international policy dialogues with the governments of the US, Japan, China, Korea, Indonesia, India, Singapore and Australia. He is the author of two books, over two dozen scholarly articles and chapters, and a wide range of policy analyses and reports for both Australian and international audiences.

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1 A clarification on nomenclature: In the scholarly literature, both the terms ‘geoeconomics’ and ‘economic statecraft’ are commonly used. The concept of economic statecraft was introduced by Baldwin (1995), while geoeconomics was coined by Luttikau (1990). Blackwell & Harris (2016) have since re-popularised geoeconomics, and Norris (2016) has deployed economic statecraft. Both conceptual formulations ultimately derive from Hirschman’s (1945) analysis of the strategic implications of international trade. While this report uses geoeconomics for consistency, for the purpose it is used here both conceptual terms may be used interchangeably. See Albert Hirschman (1945), National Power and the Structure of Foreign Trade, University of California Press, David A. Baldwin (1995), Economic Statecraft, Princeton University Press, Edward Luttwak (1990), ‘From Geopolitics to Geo-Economics: Logic of Conflict, Grammar of Commerce’, The National Interest, 20: 17-23; Robert D. Blackwill & Jennifer M. Harris (2016), War by Other Means: Geoeconomics and Statecraft, Harvard University Press; William Norris (2016), Chinese Economic Statecraft: Commercial Actors, Grand Strategy, and State Control, Cornell University Press.

2 Blackwell & Harris, War by Other Means, p. 9.


4 Hirschman, National Power and the Structure of Foreign Trade, p. 11.


8 Andrew F. Cooper et al. (1993), Relocating Middle Powers: Australia and Canada in a Changing World Order, Vancouver University of British Columbia Press.

9 Author’s calculations, from UNCTADStat database.

10 Author’s calculations, from UNCTADStat database. This is similar to the trade-to-GDP ratios of China (39 percent), Japan (36 percent); slightly higher than the US (27 percent), and slightly lower than the OECD average (57 percent).


12 Monopsony refers to a situation where a single dominant buyer accounts for the majority of a defined market, and is able to suppress competition in that industry. It is the inverse of the better-known concept of monopoly, which refers to markets with a single seller.

13 Super note 11.


15 Author’s calculations, from ABS International Investment Position, Australia: Supplementary Statistics and Australian National Accounts: National Income, Expenditure and Product (Cat No. 5206.0).

16 Author’s calculations, from ABS International Investment Position, Australia: Supplementary Statistics.


21 Except the EU, UK and India, with whom bilateral FTAs are presently under negotiation. See Table 2.

22 Author’s calculations, from World Development Indicators database, https://databank.worldbank.org/reports.aspx?source=2&series=TM.TAX.MRCH.WM.AR.ZS


25 52 percent of world GDP in 2019. Author’s calculations, from World Development Indicators database.


28 Author’s calculations, from DFAT Trade Statistical Pivot Tables.
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29 Trade data from UN Comtrade database. 2017 data is used to reflect trade volumes prior to distortions associated with imposition of US tariffs against China from 2018. Minerals comprise HS codes 2601 (iron ore), 2606 (aluminium ores) and 2701 (coal). Metals comprise HS codes 72 (iron and steel), 73 (articles of iron and steel) and 76 (aluminium and articles thereof). Metals-based manufactures comprise HS codes 86 (railway stock and equipment), 87 (vehicles other than railways), 88 (aircraft, spacecraft and parts thereof) and 89 (ships, boats and floating structures).


33 The precise cause of the rapid deterioration in the Australia-China relationship in early 2020 is a matter of debate. Some of the involved factors include Australia’s advocacy for an independent international enquiry into the COVID-19 pandemic, China’s imposition of a national security law in Hong Kong which breached the ‘one country, two systems’ principle, allegations of Chinese interference in the Australian political system, and escalation in the South China Sea dispute, amongst others. For a brief summary, see Jeffrey Wilson (2020), The Australia-China trade war: Vale the grand bargain?, China Story, 18 May, https://thechinastory.org/the-australia-china-trade-war-vale-the-grand-bargain/


37 Many incendiary examples abound, but some of the most prominent include: Global Times (2020), ‘Australia, pay heavy economic price’, 14 May; China Daily (2020), ‘Australia delusional in expecting normal trade amid tensions with China’, 15 October.

38 However, of the trade measures listed in Box 1, the Chinese government has not officially acknowledged measures applied to coal and cotton.


41 Between 2017 and 2019, Australian steel and aluminium exports to the US doubled to $999 million. Author’s calculations, from DFAT, Trade Statistical Pivot Tables.

42 Wilson & Seymour, Expanding the TPP.

43 ABC News (2020), ‘China denies Australian minister’s request to talk about barley amid coronavirus investigation tension’, 18 May; South China Morning Post (2020), ‘Why has the China-Australia relationship deteriorated into what some are calling ‘trade war 2.0’?’, 1 July.

44 The Walker process developed a draft Appellate Body reform proposal which was presented to the WTO General Council in October 2019. See World Trade Organisation (2019), General Council – Agenda item 4: Informal process on matters related to the functioning of the Appellate Body – Report by the Facilitator, H.E. Dr David Walker [New Zealand], 15 October 2019, [Doc No. JOBC/221], https://docs.wto.org/dol2e/EN/Pages/SSS/directdoc.aspx?filename=JOBC/221.pdf


52 ‘Policy finance’ refers to financial support provided by state-owned banks on some kind of concessional terms (typically, but not limited to, concessional interest rates). It is a form of investment subsidy, designed to encourage a firm to undertake an investment that would not be commercial in the absence of government support. While many countries’ state-owned banks offer policy finance – as do multilateral development banks such as the World Bank – it is particularly common in the Chinese economy due to the prevalence of state-owned industrial and commercial banks.


55 According to publicly-available information, only six major Chinese investments have been blocked since these rules were adopted in 2008. These include: a Simotech investment in Murchison Metals in 2008 (rejected on competition grounds, then subsequently approved following revision); a China Nonferrous Metals Corp takeover bid for Lynas Corporation in 2009 (rejected on competition grounds); a bid by China Minmetals for OZ Minerals in 2009 (rejected due to security concern, then subsequently approved following revision); the sale of 50.4 percent of a 99-year lease of Ausgrid to China State Grid in 2016 (rejected due to security concerns); Dakang Australia Holdings bid for beef producer 5 Kidman and Co. in 2016 (rejected on competition grounds); and China Mengniu’s acquisition of Lion Dairy in 2020 (no official rationale provided, but understood to be due to food security considerations). However, FIRB rejections are not required to be published by the Treasurer and/or applicant, so the exact number of rejections and their rationale is not publicly-known. For details of these rejected applications, see Wilson (2011) supra note 53, Productivity Commission (Australia) (2020), *Foreign Investment In Australia*, https://www.pc.gov.au/research/completed/foreigninvestmentpdf; ABC News (2020), ‘Plan for China’s Mengniu to buy Lion Dairy ditched after Josh Frydenberg labels sale ‘contrary to national interest’, 25 August.


60 Author’s calculations from American Enterprise Institute (2020), *China Global Investment Tracker Database*, https://www.aei.org/china-global-investment-tracker/; Data includes both the value of direct investments and construction contracts executed by Chinese companies.

61 The AEC CDT database is not an official dataset, and likely has incomplete coverage of smaller Chinese investments (such that actual values are higher than those reported). However, the quality of official Chinese outbound investment statistics does not allow these values to be calculated using official data. CBIT is the highest-quality dataset on Chinese outbound investment activity presently available.


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