Australia's exposure to geoeconomics

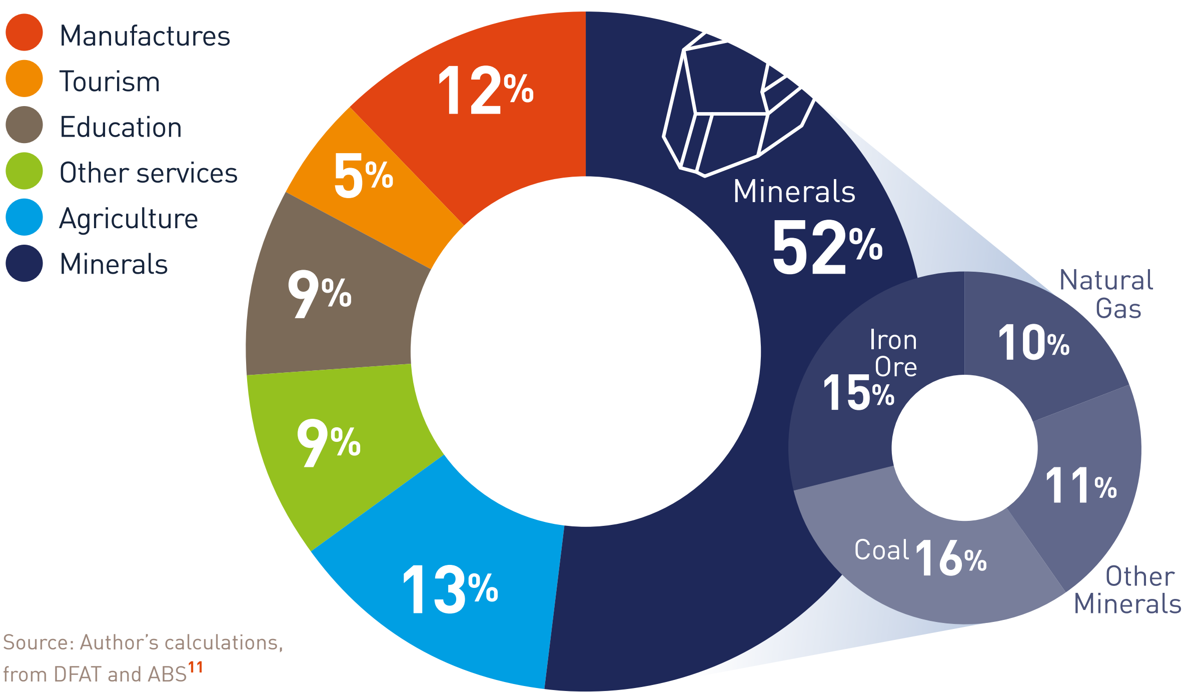
Australia is highly exposed to the geoeconomic contests emerging in the Indo-Pacific. It has been an enthusiastic supporter – and major beneficiary – of the wave of economic liberalisation that spread throughout the region in the three decades from the 1980s. Like other regional economies, Australia 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[8]. It is the world's fourteenth largest economy by nominal GDP, and sixth in the Indo-Pacific[9]. 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.

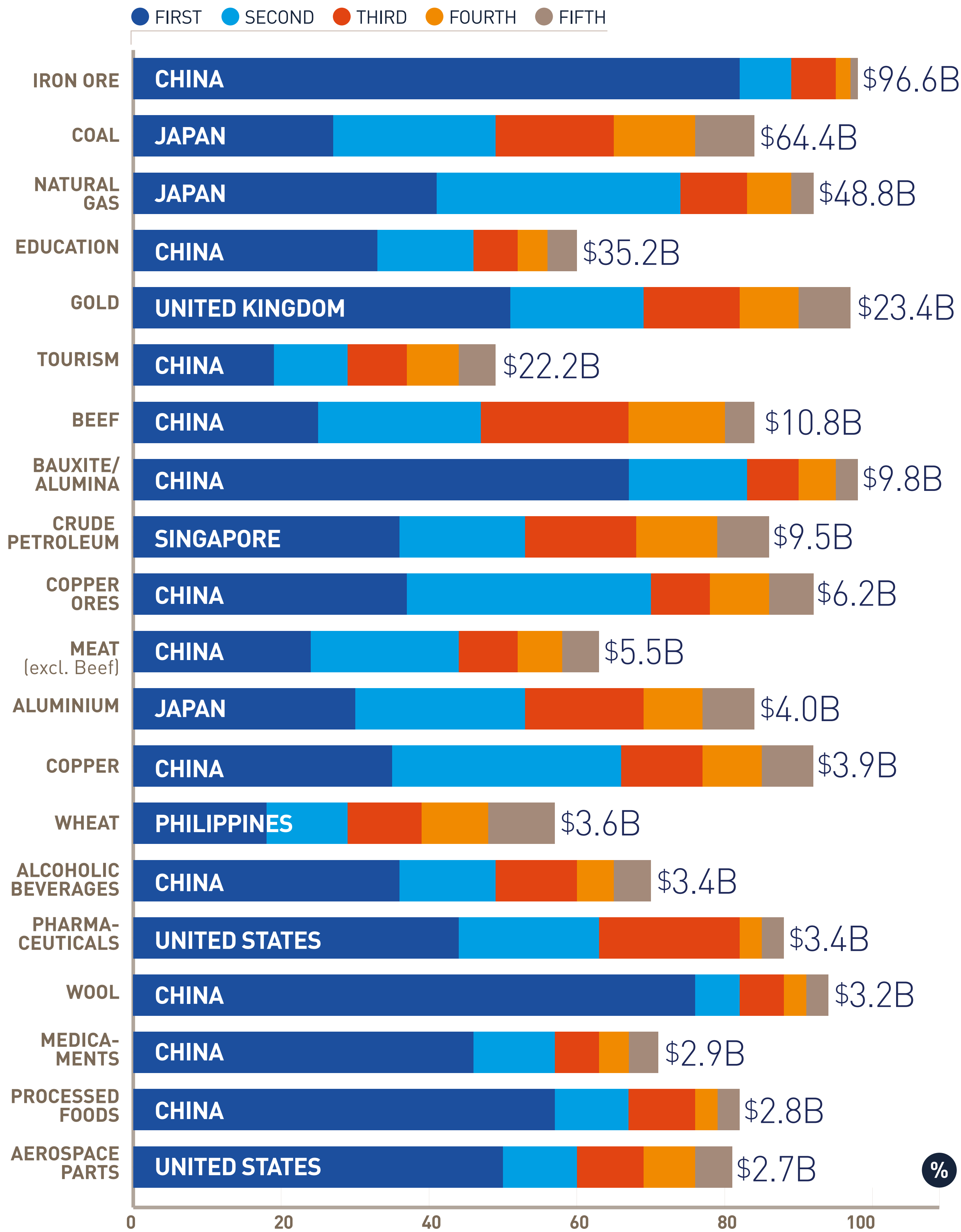
Australia's concentrated trade profile exposes it to geoeconomic risks. By world standards, Australia's aggregate level of trade exposure is comparable to that of its peers. Its trade-to-GDP ratio of 42 percent is similar to that of the other major economies in the Indo-Pacific[10]. However, its trade 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[11]

Figure 3 Market concentration in Australia's top-20 exports, 2019

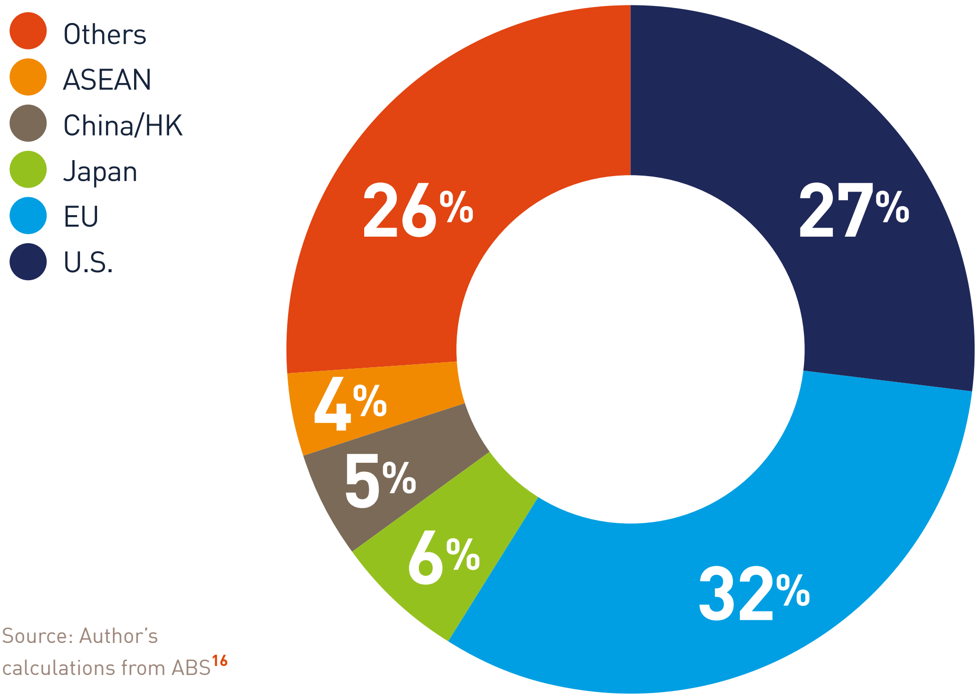


Source: Author's calculations, from DFAT and ABS[13]. Excludes confidential items of trade. Education and tourism report 2018 figures, as 2019 data is not available at time of writing. Labelled country identifies the largest export market. $ figures report the total value of Australian exports to all markets.

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[12] 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 outet 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[14]. 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[15]. 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.

Figure 4 **Australia's two-way investment partners, 2019**



Source: Author's calculations from ABS[16]

[Concentration in Australia's international economic ties magnifies geoeconomic risks.]

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.

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%[17]
- 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)[18]
- Privatisation of state-owned enterprises (SOEs), with limited state-ownership outside of natural monopolies such as infrastructure and essential services[19]
- A performance-oriented aid program, which emphasises accountability and efficiency in program delivery[20]

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[21]. 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.

Economic liberalism means Australia lacks many of the common tools of geoeconomics.

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[22]. 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.