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International rules and strategic policy space

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The rapid development of the East Asian economies, the growth of intra-regional trade, financial and other economic interaction, and East Asia's new role in the global economy all underline the need for access to a vastly increased range of quality economic analysis on East Asia. Such analysis from both inside and outside government is essential to assist policymakers in responding to, and anticipating, issues confronting the East Asian economy.

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Chapter 3
International rules and strategic policy space

Shiro Armstrong

Background

The United States and China, the world's two largest economies, are locked into strategic competition and rivalry that complicates international policy choices for the rest of the world, but particularly for their partners in Asia. How do smaller countries, middle powers and the rest of the world navigate their economic, political and strategic choices when China and the US are increasingly applying pressure to choose between them? US allies such as Australia, South Korea and Japan need to balance their security interests alongside their economic interests, but are they destined to a prosperity–security trade-off, the parameters of which are fixed independently of their own strategic behaviour?

Economic policy was never separate from considerations of national security. The recipe for a modern, secure country – a strong economy that is globally integrated through trade and investment and cooperation – has not changed. But economics and security are increasingly entangled in a way that may cause damage to both, creating a dangerous trade-off and a negative feedback loop on both economic and security outcomes. There are policy choices that make countries poorer and less secure and there are policy strategies that can help manage risks to prosperity and contribute to national security. This chapter presents a simple framework to think about these policy choices as they relate to international economic exchange and the security policy choices that confront countries in the region. It also explains how multilateral engagement helps manage some of the risks they face by diffusing power and providing forums for collective action by small and middle powers that provide leverage.

Economic exchange always involves risks, including national security risks and the possibility of economic or political coercion. As Deng Xiaoping famously warned, if you open the window for fresh air, you have to expect some flies to blow in. If you want fresh air, the solution is not to close the window but to manage the flies.

Risks from international economic exchange can be managed with strong domestic rules, regulations and institutions. They can also be managed internationally with strong rules, norms and institutions that reduce the number and capabilities of malign actors, including by shifting the risk onto actors with malign intent. That process is strengthened, not weakened, through international cooperation. Risks have been managed and minimised under the US-led multilateral rules-based system that allowed decades of deepening economic ties, including for China with the rest of the world.

The risks of international exchange have come to dominate the calculus of some policymakers as the world becomes more complex and uncertain. There are three main

reasons for this trend: the rise of China, the rise in protectionism in the US and new technologies that international rules do not yet encompass.
The difficulty in managing China's rise as the world's largest trader and its second largest economy has been further complicated by President Xi's consolidation of power domestically and a more assertive Chinese foreign policy.

The US largely underwrote a rules-based order over the past 75 years that helped manage risks from economic engagement and reduced the costs of national security. President Trump's America First protectionist agenda and the US–China trade war signalled a departure from the US leadership on which the world had long relied. The structural problems that led to the rise of Trump in the US – growth in inequality, the erosion of the social safety net and the social compact, as well as a political psychology triggered by a *relative* decline in US global power – will, in the best of circumstances, take a generation to remedy. The Biden administration is pursuing a foreign policy for the middle class and those problems still drive US policy strategies and its foreign policy posture. The US under Trump became the biggest threat to the multilateral trading system that, for decades, underpinned both prosperity and security around the world, particularly in East Asia. Under Biden it may not be such an active threat to multilateralism. But its diminished relative size and its strategic competition with a rising China – the largest trading partner for most countries in Asia – mean that it is no longer able to play the same leadership role in that system that it once did.

New technologies like AI (artificial intelligence), 5G telecommunications and the growing importance of digital trade raise new economic opportunities and security challenges for which no clear rules exist. Multilateral rules in the World Trade Organization (WTO) may cover trade in goods adequately but are mostly non-existent for a large proportion of international commerce in the twenty-first century, such as services, investment and data flows. The patchwork of rules from smaller agreements that try to cover these issues leave major gaps at best and cause economic fragmentation in the global economy.

If countries do not get the framework right to manage strategic policymaking in these new circumstances, there could be a return to the economic and security policy environment of the interwar period. That was a period of 'beggar-thy-neighbour' policies, unilateralism, trade discrimination and escalating protectionism through the exercise of raw national power. The multilateral system born at Bretton Woods moved the world to cooperative outcomes with rules that avoided these prisoner's dilemma or lose-lose outcomes.

The next section presents a simple framework to understand how the interaction between prosperity and national security – or economics and security for short – can be understood. The starting point is that the pursuit of economic and security objectives is rarely sensibly framed as a zero-sum game in which a nation cannot attain more of one by surrendering certain amounts of the other. It is a multidimensional game in which (not always, but to a significant degree) these objectives are indeed complements, and in which more of one enhances attainment of the other and mixed interests are common. The chapter explains how multilateralism helps to preserve the external policy space for countries to pursue economic policies that promote both prosperity and security. It concludes by identifying some principles for international cooperation in bilateral, regional and plurilateral arrangements that may contribute to, rather than divert from, the inclusive multilateral rules that underpin economic and political security in the region.

Entanglement of economics and national security

International trade is driven by mutually beneficial trade and investment and its win-win, positive-sum aspects have helped deliver development and prosperity to countries that have participated in opening up their economies. Many of the most successful development stories are in East Asia. International specialisation has allowed higher levels of production and consumption to spread across the region and accelerated growth through production fragmentation in international supply chains.

Regional economies have achieved economic strength through international economic integration; economic strength and the system of multilateral economic ties have also reinforced political independence and security.

The growth of strategic rivalry between the US and China in recent years has encouraged reversion to narrower conceptions of national security or geopolitics characterised by zero-sum, or even negative-sum, thinking. For one country to gain, it must do so at the expense of another. The Cold War between the US and its allies against the Soviet Union was an earlier example. Strategic rivalry between countries is often framed such that any gain by a strategic competitor registers as a loss for the other. There are also positive-sum elements between countries when one country's stability and security has positive spillovers to others, but usually military security – the contest for territorial control, for example – and great power rivalry is zero-sum.

Under the US-led multilateral economic order, for those countries that had committed to the system even during the Cold War, the conduct of trade policy could, to some extent, be pursued separately from national security considerations (Cooper 1972). Under that system, participants surrendered the right to use trade levers to exercise political coercion, except in special and unusual circumstances. The General Agreement on Tariffs and Trade (GATT) allowed trade between countries under agreed multilateral trade rules that largely quarantined them from geopolitics. There were, of course, economic and political disputes between countries, and some of those disputes led to trade sanctions and political coercion outside the rules, but disputes were generally nested in the multilateral geopolitical order and were the exception, not the rule. Many could be resolved peacefully within the GATT framework. In that way, international economic policy was largely siloed from national security policy. Within its ambit, the US hub-and-spokes security system added to political stability in an environment where multilateral trade rules could manage economic exchange to the benefit of countries that signed up to them.

That was then, while the rules could keep pace with developments in commerce and before the rise of China and other emerging countries meant that the system could no longer be led mostly by one superpower, the US. The system has steadily and fundamentally changed. China joined the GATT's successor, the WTO, in 2001 and grew to become the world's largest trader and the largest trading partner of around 130 countries.

The level of uncertainty about the ability and willingness of the US to lead the multilateral trading system has grown in tandem with these developments. The US withdrew from the 12-member endeavour under the aegis of the Trans-Pacific Partnership (TPP) agreement whose aim was to create new rules, disciplines and market liberalisation in the Asia Pacific. US non-participation in the TPP evolved as a bipartisan policy position. Under the Trump administration, the US actively undermined the WTO by deploying trade measures and doing deals outside of the established rules (notably, but not only, in its trade war with China), as well as vetoing the appointment of appellate body judges to the dispute settlement system. Many of those policies remain in place under the Biden administration.

In the past half decade, there has also been an eruption of instances of economic coercion. These have led to ideas about the pervasiveness of weaponised interdependence and the mobilisation of the weaponization of trade – or securitisation of trade – to pursue political goals (Farrell and Newman 2019). US tariffs on imports from China, and sanctions on Chinese companies or US and other companies selling to Chinese companies during the Trump administration, introduced many national security exemptions to multilateral commitments. These measures were outside of established rules and norms and were deployed for political purposes that were responded to tit for tat in an array of Chinese measures. Chinese trade sanctions on Australia from 2020 were also deployed for largely political purposes and their legality is yet to be tested in cases brought before the WTO. The perception of economic exchange between countries as weaponised or giving an adversary leverage turns positive-sum economic exchange into a zero-sum or negative-sum calculus. Economics and national security thinking have thus become entangled in a way that complicates policy choices and that can lead to countries becoming poorer and potentially less secure.

Complementarity of economics and security

The most basic complementarity of economics and security starts with the need for a strong economy to finance a military and defence force. National security includes military security and protecting sovereignty: both are achieved more readily if a nation achieves economic strength. Economic exchange builds national wealth and power and is a source of economic and therefore military strength.

For centuries there has also been a recognition that economic exchange between countries has a peace dividend by increasing the costs of conflict. Montesquieu (1748) argued ‘peace is the natural effect of trade’ because trade made countries reciprocally dependent. Karl Polanyi famously argued that the ‘long peace’ in Europe in the nineteenth century was enforced by high finance, which would tolerate no expensive wars that would threaten the fiscal stability of states to which it loaned money and in which it conducted most of its profitable business (Polanyi 1944; Flandreau and Flores 2012). Economic engagement between countries can strengthen national security by reinforcing and habituating adherence to a rules-based order that creates a bigger and broader plurality of interests. Foreign investment creates foreign stakeholders in the health of an economy in which they are invested.

While trade may encourage peace, it can also be a source of conflict. There is ‘the possibility of using trade as a means of political pressure … in the pursuit of power’ (Hirschman 1945).

The gains from trade between nations can be unequally distributed within countries as well as between countries, leading to a change in the structure of power within a country and between countries. Economic interdependence can introduce vulnerability in relations with another nation (e.g. through exposure to a dominant resource or strategic goods supplier) and sensitivity to dependence (e.g. through the effect of economic shocks such as inflation or exchange rate volatility in one country on another).[1]

The multilateral trading system that Hirschman foreshadowed to address these vulnerabilities through trade in 1945 was conceived to help manage these negative externalities from growing trade shares. Its real world manifestation, the GATT, was designed to discourage and constrain the use of trade sanctions for political pressure while the other Bretton Woods institutions were designed to help manage the sensitivity to international economic dependence and manage the change in the structure of power between countries. The multilateral system is protection for small and medium powers: while it reduces the costs of trade coercion to both perpetrator and victim, the reduction is comparatively far greater for the 'victim' nation, which can use the system to find new markets for its imports or exports.

Confidence in the multilateral trading system is fracturing under the pressures unleashed by China, the US and new technologies. Trade and international commerce is once again increasingly seen as a source of vulnerability in relations with other countries. The use of trade as an instrument of political pressure in the way that characterised the interwar period Hirschman described threatens to return (at least in some measure).

Economics and security in a negative feedback loop

Economic policy deployed for national security or geopolitical purposes, sometimes called *geoeconomics*, can make countries weaker, poorer and less secure. Economic exchanges, in this conception of the world, are thought of as tools to achieve zero-sum or negative-sum outcomes instead of creating mutually beneficial economic outcomes. This misdirection can damage both economic and national security outcomes. North Korea is an extreme case in which the pursuit of security objectives through self-sufficiency strategies ignores economic considerations: North Korea has secured itself from vulnerability to economic dependence on other countries, and from sensitivity to economic shocks from other countries, at the cost of prosperity and durable military strength.

Ever since US President Jefferson's *Embargo Act 1807*, which banned trade, sent the newly founded US into a recession with little impact on European powers but threatening its own security, governments have misapplied economic tools in ways that result in self-harm. A recent example is the Trump administration's tariffs on steel, aluminium, washing machines and solar panels, and the tariffs it threatened on automobiles. These measures, justified in the name of national security, would merely make the US poorer and weaker.

China has blatantly deployed economic coercion for geopolitical purposes. Its securitisation of trade has also been largely counterproductive. Its restriction of rare earths exports against Japan over territorial disputes was checked by application of the multilateral trade rules and

[1] See Mansfield and Pollins (2001) for a review of this literature on sensitivity and vulnerability.

the emergence of alternative suppliers led it to lose market power. Its economic sanctions against South Korea over the Terminal High Altitude Area Defense system, on the other hand, largely lay outside the discipline of multilateral rules. China's economic sanctions against Australian barley, wine and other commodity exports are the most comprehensive and glaring Chinese attempts so far at economic coercion. But these measures have not been without cost to China, as they increased Chinese costs and prices and undermined confidence in Chinese trade because of significant changes in the political risk calculus for businesses.

Nor did China's coercive measures lead to political capitulation by South Korea or Australia. New technologies have also multiplied security concerns about 'weaponised interdependence'. Economic network risks are being exploited by both state and non-state actors with cyber theft and cyber attacks. The US domination of the inter-bank exchange market (SWIFT), for example, meant that Europe had to comply with unilateral US sanctions against Iran. Yet arguments that technology is providing asymmetric leverage ignore the fact that technology is also increasing the supply of alternatives and making markets more contestable. To the extent that nations exploit their current technological advantages likely means that those advantages will not last long if they do not remain open and connected to new ideas.

National security relies on the logic of command and control and applying resources in contests of attrition. That is not how economies work. A focus on security risks without considering forgone economic benefit or mitigation strategies to deal with those risks leads to all-or-nothing outcomes when all-or-nothing outcomes are not the only option – in the language of economics – to corner solutions when the utility-maximising solutions are interior ones. Concern about foreign influence over technology has led the US and some of its allies to decouple from Chinese technologies, such as 5G telecommunications, AI, machine learning and quantum computing. Such disengagement can damage national security, not only in areas where China already has technologies that are more advanced than the rest of the world.

Innovation in the modern economy means working with ideas from wherever they are sourced around the world. There is no other way of staying close to the global technology frontier. An inability to keep up with the technological frontier will make countries poorer and reduce the strategic options available to them.

If trade and investment is not managed with robust domestic regulation and international rules, positive-sum economic exchange may indeed become zero-sum or negative-sum games. If domestic rules and institutions are unable to regulate foreign investment, the risks that come from allowing foreign ownership of economic and strategic assets might outweigh the economic benefit from the investment. Foreign ownership of an asset that includes health and other sensitive data, for example, would need strong laws, credible enforcement and punishment, and capability to police those laws. In the case of data assets, it is often not the ownership of the asset that is the fulcrum of risk, but the cyber security surrounding that asset (see Chapter 2). Without the capacity and effort to identify the risks and regulate appropriately, perceptions of risk may too easily outweigh the potential benefit of trade and investment transactions and the benefit from them will be foregone.

The direct economic benefit from a foreign investment and its positive externalities, including its peace dividend, will be forgone because of the negative externality of risk to national security. With proper domestic rules and regulations, however, the security and other risks can be readily mitigated.

Multilateralism and preserving policy options

Domestic rules and institutions help manage some of the risks from malign actors and actions in international economic exchange. Enforceable international rules and trusted norms in a multilateral trading system that help diffuse economic and political power are an essential complement in the national armoury of smaller powers in managing these risks.

Multilateralism requires that participating nations cede political power and sovereignty and binds them to principles of equal treatment in international transactions. Countries have been prepared to cede this power to avoid more costly beggar-thy-neighbour prisoner's dilemma behaviour and trade outcomes. The GATT was created to avoid these outcomes that were pervasive in the 1930s. Under a well-functioning multilateral trading system, countries inoculate themselves against their own protectionist or nationalist instincts and constrain their own ability to deploy unilateral and discriminatory measures against partners. The economic principle of most favoured nation treatment has a vital political dimension. Agreement to an economic equality principle in multilateral rules surrenders some of the particular political leverage that might otherwise be available to countries, especially big countries.

An open multilateral trading system is also a source of resilience for countries hit by shocks. Australia managed to cushion the economic damage from Chinese trade sanctions in 2020 and 2021 by expanding trade with other countries. Japan was able to source rare earth imports from countries other than China when security of supply from China was uncertain, as international supplies responded to the increased price. A virtue of an open international trading system is that it allows markets to adjust to supply and demand disruptions whether from deliberate policies, natural disasters or business cycles, because of the geographic contestability that it embeds in the trading system.

The weaknesses in the multilateral trading system – the gaps in rules and the difficulty of reforming the WTO – have opened up grievances and provided the excuse for its abuse by the major powers, especially the US and China. Their Phase One trade deal in 2019 was done outside the established rules and moved the two countries towards managed trade – that is, trade determined by negotiated quotas instead of by market forces.

There are no multilateral rules and there is no WTO for foreign direct investment. The negative security externalities from foreign investment are currently managed by countries unilaterally by domestic law or to some extent in bilateral or regional agreements; consequently, the burden of managing foreign investment falls heavily on domestic regulation. In countries where governance is weak, there are often insufficient protections from multinational enterprises that avoid tax, exploit weak labour and environmental standards, and pose security risks in ownership of critical infrastructure and sensitive data. Combined with new digital technologies that also lack governance under multilateral rules, there is a lot of pressure on the capacity of governments to manage foreign investment confidently in particular industries or from particular sources.

International rules can prohibit harmful behaviour. A priority is to work towards the creation of international rules in areas of importance to the international economy where no such rules currently exist. Strategic deployment of regional and plurilateral coalitions can help create rules from the bottom up and support multilateral processes. They have a greater chance of being effective and successful if they engage both China and the US. At a time when the multilateral system is under threat, regional and plurilateral initiatives and agreements need to complement, preserve and strengthen multilateralism, not substitute for it. The proliferation of bilateral and regional agreements are creating new rules in areas like the digital economy, but where multilateral principles are lacking, there is the risk of the fragmentation of rules that seriously detract from multilateral outcomes.

Mutually beneficial engagement makes nations more prosperous. If the security risks are managed, the engagement can also make countries safer and more secure. But without rules of engagement, the security risks can easily dominate or be exploited, compromising both economic and political security goals.

It is possible to find ways to mitigate and spread risks by deepening engagement and by strengthening and extending the rules, not avoiding engagement. Economic engagement builds national wealth and power and, when combined with multilateral rules, broadens the range of strategic policy options available to policymakers. This is what ASEAN helps preserve for its Southeast Asian members, as this book describes. There are solutions, mixed interest games and ways to have risks borne in the market rather than by government or society that can avoid binary all-or-nothing security choices.

Conclusion

Economic engagement and integration into markets increases the costs of harmful international behaviour and enhances national security, but inevitably involves some security risk. If security concerns and policies dominate economic choices, the policy space is narrowed significantly. It is the important job of security agencies to look for and mitigate risks, but economic interests also need to be balanced. Risks can be mitigated through a combination of international cooperation, multilateral rules and strong domestic laws. Reducing trade or investment to avoid security risks is not the right answer in a world of integrated markets and economies, unless countries want to be poorer, weaker, and live in a less certain and stable world. These are shared challenges and opportunities for countries navigating a more complex world.

Large powers, like the US and China, naturally prefer to deal with countries bilaterally where the asymmetry of their power offers most leverage. That forces the world into even harder choices. The US and China, left to their own devices, may try to decouple their economies and divide the global economy into two spheres. They are big and influential players in the system but the response of the rest of the world to their behaviour will be important to the outcome.

Small and middle powers need to get the balance of economics and security right in strategic policymaking and work together to avoid a big-power dominated, bilateral world of zero-sum outcomes. Acting strategically and not falling into bilateralism is for them the sensible way forward. Agreements that support, and do not detract from, multilateral outcomes will help to preserve and expand policy options for countries in the region and make them better off economically and more secure, instead of poorer, weaker and less secure.

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