Economic Tools for Statecraft and National Security

Shiro Armstrong, Gordon de Brouwer, Peter Drysdale and Tom Westland

Crawford School of Public Policy
The Australian National University, Canberra
### Outline

Argument in brief 1

Executive summary 2

1. The postwar order under stress 5

2. Australia’s economic and strategic circumstance 8

3. The crucible of strategic interests in Southeast Asia 16

4. Economic tools for national security 22

5. Integrating Australia’s economic and security interests 27

6. Australia’s economic and strategic choices 30

7. Priorities in economic engagement with regional partners 33
   - Infrastructure investment
   - Debt trap diplomacy and transparency
   - Foreign investment regulation and national security
   - Data governance and the digital economy
   - Supply chain resilience

Conclusion 47

References 49

Appendix: The security foundations of the postwar order 52

Table 2 — Australia’s regional partners’ economics-security positions vis-a-vis China 18

Box 1: Lessons from Chinese trade coercion 11

Box 2: Risk mitigation and resilience in economic recovery from pandemic 13

Box 3: Managing strategic competition in Southeast Asia 20

Box 4: The limits of geo-economic leverage in critical minerals 23

Box 5: Good-practice guide to national interest policymaking 28

Box 6: Guide to the design of public institutions 29

Box 7: Chinese lending and debt governance in the multilateral system 37

Box 8: Data dilemmas — TikTok in the United States 41

Box 9: Japan’s use of critical technology export controls against South Korea 44

We are grateful to James Curran, Allan Gyngell, Brendan Sargeant, Heather Smith, Rory Medcalf and colleagues at the Department of the Prime Minister and Cabinet for valuable feedback. All interpretations and any errors of fact and omission are our own. This paper was commissioned by the Department of the Prime Minister and Cabinet.
Argument in brief

Australia faces a new and threatening geopolitical environment that has provoked a rethink of Australia’s international strategies. A more powerful and assertive China and our primary ally, the United States, preoccupied with divisive domestic conflicts while engaged in tense strategic rivalry in East Asia, have laid bare vulnerabilities in security and diplomatic strategy and in global forces undermining our trade strengths and economic prosperity.

Regional and global coalition-building is one hedge against these security uncertainties. The elevation of the Quad to a leaders’ summit and AUKUS strengthen Indo-Pacific security and geopolitical cooperation. These developments elevate the importance of deep economic and political engagement with Southeast Asia.

Economic strength is absolutely critical to defence capabilities and alliance maintenance; it underpins national security. The realities that Australia faces: 1) that two-thirds of Australia’s trade is in Asia with China and economies inextricably linked with China and 2) the multilateral economic regime which, despite its inadequacies, protects Australia against economic coercion, is being undermined by our US alliance partner.

Decoupling from China, it must be recognised, would have large costs to Australia and its regional neighbours and isolate Australia in regional economic and political architectures. US protectionism is also a direct threat to Australian markets — not least in China.

A primary national security objective is therefore to maintain and revamp the multilateral institutions that guard Australia’s policy space, sovereignty and economic strength. Defending and upgrading the multilateral economic system are strategic goals, not narrow, technical economic issues. A multilateral play helps dilute the arbitrary exercise of power.

The unpalatable reality is that the United States and China will seek bargains that disregard Australia’s interests in that system. Australia’s diplomacy and leadership in international forums, in its representations in Washington and to Beijing, must give priority to multilateral solutions and global arrangements that support both prosperity and security. To this end Australia also needs proactive engagement with similarly affected partners in the region, such as ASEAN and India, using all the instruments of regional diplomacy that are available.

Equally, Australia must strive to enmesh China in markets and new rules, through existing platforms and by engaging proactively with China’s ambition to join the CPTPP. Like active cooperation with the United States and China on climate change, CPTPP offers a chance to work with China and keep the United States involved that should not be passed up.

A redoubled effort to engage with ASEAN is of the highest priority. Australia’s frontline economic and security challenges require a strategy of economic engagement with Southeast Asia that strengthens ASEAN and is a critical complement to the political hedge that the Quad provides. That can entrench ASEAN’s multipolar regional order of rules, openness and stability. Areas of priority are health and economic recovery; infrastructure, debt and foreign investment; sustainable finance; crisis prevention; and digital trade.

Global rules and the domestic institutions and laws protect open and contestable markets, and limit the adverse effects of attempts by other countries to deploy economic coercion.

The economic, defence, intelligence and social dimensions of Australia’s security are inseparable. Absent a policy framework that systematically integrates all dimensions of the national interest, Australia’s future will be poorer and less secure.
Executive summary

The postwar global order established at the Bretton Woods conference in 1944 secured economic prosperity and political security for Australia and its region. But it is under serious stress. Beyond the UN framework, its two main elements — the dominant power of the United States alliance framework and commitment of the major powers to the multilateral trade and economic regime — are less secure.

China's rise and its flexing of raw political muscle and the US retreat from the multilateral system starting under President Donald Trump have dramatically changed the regional and global security environment in which Australia now shapes its national economic and security strategies.

The United States has neither the capacity nor the will to underwrite the multilateral economic system. Its share of global trade is now only 8 per cent; China's is almost double at 15 per cent. Washington has frustrated the working of key multilateral institutions, such as the WTO dispute settlement mechanism. China's rise and increased assertiveness has destabilised confidence in the existing order.

This behaviour by its two largest players has weakened the global trade regime. The rules needed to manage a modern international economy, to cover the digital economy, investment and the role of state-owned enterprises, are yet to be established.

Addressing this is a reform agenda that is at the very essence of Australia's economic and security interests.

The trade system and its rules and institutions, with the WTO at the centre, underpins the confidence of all trading nations that trade and investment at their current extraordinary levels can be secure. So too does the IMF and World Bank on global financial stability and the ongoing need for economic development in most of the world. There is no appetite for, nor sense in, retreat from that.

National institutions and laws are the domestic counterpart that protect the contestability of and equitable access to markets, competition and innovation.

A new comprehensive national policymaking framework will mitigate risks and the unintended policy consequences of policies that make countries poorer, weaker and less secure, while maximising benefits from international engagement. Apart from a less secure global trading and economic regime, Australia also faces increasing political uncertainty and risk. Australia has thus strengthened national defence capabilities and leveraged national capabilities through alliance partnerships and hedging strategies. AUKUS, the Quad, the bilateral security arrangements with Japan and initiatives with European countries aim to strengthen Australian defence preparedness. In recent years Australian security policy has also responded to the reality that many international security challenges such as transnational crime, cyber threats and terrorism have domestic implications and has developed stronger response capacity.

But the heightened tensions and strategic competition between the United States and China and China's attempt at trade coercion against Australia have encouraged calls to drastically divert economic ties away from China. Some switching of trade is inevitable because of increased uncertainties but breaking economic ties will isolate and make Australia significantly poorer.
An economic retreat from China would mean retreat from Asia because of the complex interdependence of Asian trade, investment and financial flows. This is flawed as a security strategy, because it would gravely damage the Australian economy. Without economic strength, Australia cannot deliver the security networks and in the forums of which it is now so central a part.

There is a genuine alternative that can find a solution to two inescapable economic and security realities: 1) Asia is economically tightly bound up with China in global markets; 2) the weight of Australia’s economic interests and security challenges reside in Asia.

The East Asian region accounts for 66 per cent of all Australia’s foreign trade (compared with 17 per cent with the trusted Five Eyes allies or 27 per cent with the G7 industrial economies). All of Asia’s economies are deeply interdependent with China. The Chinese economy’s scale, openness and proximity make it the major market for every East Asian economy except Laos and Brunei. If China stopped growing tomorrow, India’s economy would not achieve parity with it until 2050 if it doubled its income every decade.

A retreat from the Chinese economy means a retreat from complex regional supply chains that would cause severe economic and political damage to Australia. Over 20 per cent of value added in Chinese exports is produced in other mainly neighbouring countries, 39 per cent of the total from foreign-invested firms. The first-round cost of a general regional decoupling from a China-interlinked Asian economy would be very large: an immediate drop of over 11 per cent in ASEAN incomes, for example. Japan (China’s largest foreign investment partner), Korea and other countries’ investment and trade in Asia would be undermined. Australia’s interest in avoiding this outcome cannot be overstated. Not only would such a retreat damage the Australian economy; a collapse in regional trade would increase the vulnerability of Australia’s Southeast Asian neighbours.

The alternative policy strategy that preserves Australian economic strength by protecting its huge trade with Asia is to strengthen and extend the disciplines of rules and by doing so to enmesh China in current and new trading institutions that impose disincentives to using trade coercion. It also needs to continue to build US enmeshment and commitment to the rules and shift the balance towards stronger economic engagement at a time when Washington shows few signs of retreating from the Trump administration’s assault on the multilateral system through pursuit of managed trade with Beijing (Tai, 2021) and its recently touted Indo-Pacific trade framework will need careful scrutiny.

China remains overwhelmingly a market economy, despite high profile Party politicking, where private and foreign-invested firms dominate its international trade despite the centrality of the Chinese state. State interventions damage confidence and trust in Chinese trade, as its punitive actions against Australia demonstrate. The costs to China of repudiating its transition to an open market system that respects international rules are high. Australia’s interest is to bind China into that system more deeply, for example by welcoming its cooperation in regional trade pacts.

China and the United States have both disrespected international trade rules, but equally they are not about to exit the system. They seek to change it to suit their own interests. Australia’s interest is in preserving the multilateral principles that have delivered its prosperity, and dilute the unilateral exercise of power by big countries. This multilateral system provided a significant cushion and protection to Australian exclusion from certain Chinese markets by allowing Australia to pursue profitable diversion of exports under sanction. That cushion is the foundation of the economic and political security of all Australia’s major trading partners in the region.
Within this new policy framework that seeks to fuse the nation’s economic and security strategies lies the key to a prosperous and secure Australian future. Australia needs to make these strategic economic realities as clear to the United States as it has strategic defence realities.

The vexed issues of global economic governance reform are the strategic priority that must guide all of Australia’s international economic policy efforts to complement and thereby enable Australia’s prudent build up of its defence preparedness. These are landmark political and strategic — not merely technical — issues. They are mutually reinforcing. They include the management of climate change, which will drive transformation of global markets over coming generations. Cooperation with the United States and engagement with China on climate change will reinforce other critical multilateral approaches.

In thinking about China, Southeast Asia must be front and centre; Australia’s future is inextricably linked with theirs. Southeast Asia and its organising grouping ASEAN are the buffer in their dealings with the great powers across Asia and the Pacific, including for Australia. Both superpowers need the cooperation of ASEAN. A fracture in ASEAN and its central balancing role in East Asia would be a major threat to Australian security.

Australia thus needs direct and proactive engagement with ASEAN and its partners using all the instruments of regional diplomacy and arrangements that are available. The key areas of engagement must be those that help deliver prosperity and security. This is an agenda that the United States has a deep interest in actively supporting, and one that aligns with Southeast Asia’s economic development imperative while not being anti-China. APEC is a particularly useful forum at this stage in history but requires deep and active engagement; US hosting in 2023 is an opportunity to be seized.

National economic policy and diplomacy to complement security strategy would:

1. On **trade and investment**, build coalitions to revive and reinforce the enforcement mechanisms within the WTO and mobilise the political capital for reform that binds China into rules that cover important areas of the international economy unaddressed by existing disciplines.

2. **Enmesh China in markets** and new rules with active multilateral cooperation on climate change and negotiation of regional arrangements that strengthen rules and institutions.

3. Deepen engagement with **ASEAN and East Asia** to keep **markets open and contestable** for supply chain and economic resilience in Asia. Increased regional capacity building on competition policy, for example, is an area where Australian expertise can be deployed with substantial benefits and only minimal cost.

4. On **infrastructure**, forge a partnership with ASEAN and partners centred on capacity building and robust governance that helps manage debt and investment.

5. On the **digital economy**, draw on APEC and work towards a multilateral digital economy framework to promote digital trade growth, centred on limiting discrimination and promoting transparency while preserving sovereignty.
1. The postwar order under stress

The postwar global economic order that has shaped relationships between the United States and Asia — and underpinned the prosperity and security of Asia and Australia with it — is under deep strain. As a small open economy, and a middle power in strategic terms, Australia has relied on the multilateral order as much as it has on its alliance relationship with the United States as a pillar in its national security, underpinning integration into the dynamic regional Asian economy.

The structure of global power has changed dramatically. This change was in large part wrought by the success of the postwar order itself, as Asia and importantly China joined the global trading system to achieve rapid economic growth. The rise of China, with its new economic heft and political assertiveness, is no longer seen within the United States and other places as a cause for celebration but is instead a wellspring of deepening disquiet. These pressures have intensified sharply through the COVID-19 pandemic and its impact on great power tensions and the global economy.

The rapid rise in all dimensions of China's power and its maritime projection in the South China Sea saw a hardening US security posture — first through the Obama administration's pivot towards Asia, then through the Trump's administration's 'America First' policy and trade and technology war, and now the Biden administration's doubling down on comprehensive strategic competition with China. The US–China trade and technology war has edged the system towards fracture.

Australia, in the frame of China's growing stoush with the United States, has been targeted by politically motivated Chinese trade sanctions. This has done serious damage to confidence in trade with, and trust in, China as well as the global trade regime. The economic fallout for Australia from China's import bans was less serious because most Australian exporters were quickly able to find alternative markets. The multilateral trading system makes that possible. But this experience is not a counsel of complacency. The multilateral trade system is under pressure.

The danger for Australia is that economic prosperity and national security, which since the end of World War II have largely functioned as complementary objectives, instead come to be seen entirely as rivals: that we come to see the world through the prism of a simple trade-off between security and prosperity. If this way of thinking were entrenched, Australia would have to choose between being poorer or being less secure.

The global vision and leadership that inspired the postwar economic order, and enabled higher levels of prosperity and security over the past three-quarters of a century, also inspired and husbanded the search for — and gradual development of — a framework for economic and political security in Asia and the Pacific within which the trade and economic potential of East Asia could be realised. Its two essential elements were the US alliance framework and the multilateral rules-based economic system.

It is in this region that the weight of Australia's economic and political security interests resides.

Australia is not alone in the region in facing hard choices about how best to navigate the new geopolitical environment. Across East Asia, the multilateral order has underpinned spectacular economic growth for decades. Just as importantly, it has been a necessary condition for political stability in the region. Smaller countries in the region have for the most part been able to avoid entanglement in great power rivalry because they could achieve their economic objectives by committing to its rules. The architecture of regional cooperation and engagement, most notably platforms like ASEAN, APEC and more recently the Regional Comprehensive Economic Partnership (RCEP), have been deliberately framed in order to complement and strengthen the rules-based global order, rather than to serve as a substitute for it.
The main exceptions to regional stability, the Vietnam War and the Korean War, were fought against nations that sat entirely outside the Bretton Woods system and those within that US-led order. At the end of the Cold War, the Bretton Woods system incorporated within its framework major powers that had previously operated outside that order — including China, India and Russia. Over time, the institutions within the Bretton Woods system were reformed and extended, particularly after the Global Financial Crisis, but their compass has failed to keep up with the pace and scale of changes that were taking place in the structure and character of the international economy, notably with the rise of China.

In 1960 the US share in global income was almost 40 per cent while; its share in global trade was 15 per cent. In 2020 its share in global income was 24 per cent; in global trade it was just over 8 per cent. China’s share in global income in 1960 was 4 per cent and its share in global trade was less than 2 per cent. By 2020 China’s share in global income was over 17 per cent and its share in global trade was 15 per cent. There are now 164 members of the WTO, each with a stake in the regime. East Asian economies, excluding China, account for almost 18 per cent of global trade — including China they account for a third.

The United States no longer dominates, nor can it underwrite, the international economic system as once it did. That is the contemporary geopolitical reality. Strategic competition between the United States and China, the world’s two largest economies and political superpowers, is a second geopolitical reality, along with deepening US and global distrust of China’s Communist Party state under President Xi Jinping. Australia’s ability to influence the direction of this strategic competition is limited. The form that it takes is likely to involve periods of economic conflict, like the US–China trade war, punctuated by limited bargains, like the ‘Phase One’ trade deal. In neither the conflict nor the bargains will the United States or China place much weight on Australian interests. A realistic response to this new geopolitical situation requires that Australia act to preserve as much of its policy space as possible.

The rationale of a robust and comprehensive rules-based economic order as a strategic anchor is as strong as it was when it was conceived in the middle of World War II. Established after the Bretton Woods meetings of 1944, Australia’s commitment to that system began with its wartime Mutual Aid Agreement with the United States in September 1942 (see Appendix). There is no alternative that does not involve Australia giving up a substantial slice of its national income or surrendering more of its sovereignty.

Many of the challenges now facing Australia, the region and the world, particularly those that involve the provision of international public goods, require even deeper cooperation than the architects of Bretton Woods could have envisaged. Addressing the most important international policy questions like climate change is not possible without cooperation among all the major industrial powers, including China.

Chinese assertiveness poses major problems for Australia. But purely strategic frameworks that do not address the economic security dimension of Australia’s regional engagements are unable by themselves to deliver on national economic and security objectives. Arrangements like the Quad and the Australia–United Kingdom–United States (AUKUS) security and technology sharing agreement serve as an important strategic hedge, for example, but by themselves they do not constitute groupings that could substitute for the security dimensions of Australian economic engagement with the region, including with China.

The postwar order enmeshed the United States, at the time the world’s largest economy and then as now the most important military power, in a system of rules that constrained its ability to use its economic power for its own strategic ends. That and the elimination of imperial power-based discrimination in economic dealings were the core objectives of its founders. The accession of China to the World Trade Organization (WTO) in 2001 was the beginning of a process by which it was similarly embedded into an order that constrains its ability to coerce smaller nations economically.
Though weakened by its inability to keep up with changes in the world economy as well as by the efforts to undermine its centrality, the WTO and participation in the liberal world order still remain essential to long-term growth and stability in the Chinese economy. Continued growth depends on the dynamism of its private sector — not on its generally inefficient state-owned enterprises (SOEs) on which concern about security risks has centred. Chinese participation in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) would require substantial commitments in this area, and could be leveraged in China to undertake politically difficult reforms just as WTO membership was two decades ago.

The global trade regime still undergirds the bulk of international trade, including that of the world’s largest trader, China, and that of the United States. It continues to provide insurance against political interference in trade for smaller economies through its legal appeal mechanisms and the substitution of trading partners that it facilitates and endogenises in the multilateral system. Despite the growing US-China restrictions on trade in semiconductors and related technology goods trade and the retention of tariffs imposed during the Trump administration, global real trade growth in 2021 is expected to be 8 per cent after falling by 5.5 per cent in 2020 (WTO, 2021). US exports to China have jumped 47 per cent in the first half of 2021 and imports are up 33 per cent.

But it is a system in need of renovation, and an expansion of its remit to cover economic interactions that are presently governed only by national-level regulation or an inadequate patchwork of bilateral agreements.

This is a major challenge and a task that Australia obviously cannot undertake alone. Cooperation with partners in the region and beyond who share a common strategic interest in a revitalisation of the multilateral order is the priority. Existing forums that have substantive buy-in from a broad range of partners, including but not limited to the G20 and APEC can be used strategically to mobilise political will and capital around this goal. The increased importance of the G7 plus group will need to be complemented by forums that engage emerging market economies, now half of the global economy.

This paper documents how other countries around the region today face similar challenges in navigating the twin goals of maintaining national security, resilience and sovereignty and pursuing economic integration and growth. The multilateral system and the rules that underpin it is the external dimension of Australia’s economic resilience and theirs too. Their challenges also include the task of addressing Asia’s infrastructure gap without jeopardising economic stability and ensuring that new technologies like 5G do not expose countries to security risks.

The national effort to engage with regional partners on these issues can bring Australian experience and capacity to bear on strengthening regional and our own national resilience and security. Building the international political momentum towards renovation of the multilateral system has priority as the overarching national task. The purpose of this paper is not to supply a comprehensive ‘playbook’, with detailed policy responses for every dilemma in every domain in which Australia faces policy challenges in reconciling economic and strategic security. Its purpose is rather to outline a rigorous, overarching framework within which to think through these policy dilemmas.
2. Australia’s economic and strategic circumstance

The United States and China, the world’s two largest economies, are locked in strategic competition and rivalry that complicates international policy choices for the rest of the world, but particularly for their allies and partners in Asia.

China accounts for 45 per cent of all trade in East Asia (here defined as the ASEAN+6 economies). It is the largest trading partner of every economy in the region except two (see Figure 1). The high degree of integration through production networks — otherwise known as supply chains — means that the trade interdependence of East Asian economies with China is complex and involves a high degree of third-country trade.

Policies that aim to unravel trade with China would undermine trade across the entire region. For example, over one-third of the production of Japanese manufacturing corporations (almost a half of Japanese electronics production) is undertaken not in Japan but offshore, a large proportion of it in China and elsewhere in Asia (Drysdale, 2009). Approximately 20 per cent of the value added in Chinese manufacturing exports is produced outside China, significantly in Japan, Korea and other countries in Asia (ADB, 2021). China’s growing middle class is becoming more important as a market for Japanese and other companies as Japan’s market stagnates and its population declines.

**Figure 1: Trade shares of the top two trade partners of ASEAN+6 countries**

![Chart showing trade shares of top two trade partners for ASEAN+6 countries]
Foreign invested firms account for 39 per cent of China’s total exports (National Bureau of Statistics of China, 2020), other private firms for 52 per cent. These data simply underline the scale and importance of the unintended consequences of trade and other economic policy measures that aim to target China in a world that is characterised by complex interdependence. The idea that it is possible to separate out the purely ‘China’ component in regional trade, investment, corporate ownership and finance is an illusion.

Allies like Australia, Japan and South Korea need to balance their US security interests with their overwhelming economic interests in the Asia Pacific region. Without catastrophic costs to their economies, Australia and other countries in the region are not able to change this geographic imperative to their comparative advantage any time soon. It is the power of gravity in markets that shapes their economic destiny in this way.

How do smaller countries, middle powers and the rest of the world balance their economic, political and strategic choices when China and the United States are increasingly applying various kinds of pressure to choose between them? How does the interdependence that characterises the regional economy constrain and inform those choices and economic policies to best serve security and economic policy objectives? Are they destined to a prosperity–security trade-off, the parameters of which are fixed independently of their own strategic behaviour?

This more complicated and uncertain international policy environment has led to deep questioning of the economic policies and policy strategies that delivered prosperity and security in the past. The risks of international exchange, not its benefits, have come to dominate the calculus of policymakers as the geopolitical world has become more uncertain.

Chinese restrictions on Australian exports for political reasons have caused pause in pursuing mutually beneficial economic exchange. Positive-sum trade and investment that involves China is now commonly viewed through a zero-sum prism, where one country’s gain is another’s loss, or even negative-sum, where risks and costs outweigh potential benefits. The possibility and now the reality of economic coercion has led to ideas about the pervasiveness and utility of weaponised trade and mobilising the weaponisation of trade — or securitisation of trade — to pursue political goals. This was a powerful idea behind some of the Trump administration’s unilateral trade policy initiatives, including measures that were directed not only at China but also at Australia, Japan and other allies.

The United States, despite talk of working with allies on the problem, has chosen to persist with unilateral management of its trade with China in a way that damages trade with allies and partners like Australia, Canada and the Latin American food and resource exporters. Its Phase One trade targets divert trade away from them towards US commodity exporters, including for products such as barley, beef and coal which have been the subject of Chinese trade sanctions against Australia. If the strategic competition between the United States and China leads to a broader pattern of tensions periodically resolved by bargains between the great powers, Australia’s economic and security interests are unlikely to be accorded any more consideration than they have been in the US–China trade conflict. The situation is fundamentally different from the Cold War rivalry between the United States and the Soviet Union, where Western countries could choose to align closely with one major power without any meaningful economic cost. The core argument of this paper is that Australia’s national interest is best served by a renewed engagement with and attention to the global institutions that, by mitigating the costs of economic coercion and preserving national policy space, limit the scope for using economic power for political ends.
With a shift to great power competition and strategic rivalry, Australia's international economic policy choices are increasingly framed with security objectives uppermost. Chinese economic coercion against Australia has reinforced this trend. This is most apparent in the elevation of risk — real and perceived — in trade and investment with China. It is also evident in thinking about Australia's international economic policy posture, and thinking more broadly about localisation of production and onshoring — particularly in the important area of the international digital economy.

Emphasis has been given to economic cooperation among the Five Eyes, Australia's closest security partners, and there is appeal to working with like-minded countries in groupings like the G7. But the Five Eyes group accounts for just under 17 per cent of Australia's global trade in goods and services, a share that continues to shrink, and even the G7 for only 27 per cent.

The bulk of Australia's global trade interests, 66 per cent, are located in Asia which is the centre of dynamism in the global economy, and also Australia's national security frontline.

Economic policy was never separate from considerations of national security. The recipe for a modern, secure country — a strong economy that's globally integrated through trade and investment and cooperation at the frontier of industrial technology — has not changed. But economics and security are increasingly entangled in a way that may damage 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. Managing risk is the key aspect of the framework for thinking about the policy choices that now confront countries in the region. It is also key to understanding how multilateral engagement helps manage some of the risks they face by diffusing power and providing forums and leverage through collective action by small and middle powers.

Australia's experience of economic coercion by China over the past two years is instructive in identifying the economic policy instruments and strategies that are crucial to managing risks in achieving national economic and political security objectives (see Box 1).
Box 1: Lessons from Chinese trade coercion

Chinese trade measures against Australia affected exports valued at A$17 billion or 12.3 per cent of Australian exports to China (and 4.7 per cent of Australian exports globally). Although these measures were ostensibly taken on anti-dumping, phytosanitary or technical grounds, they clearly aimed to punish Australia for political reasons. There were immediate costs to Australia from lost Chinese trade and the inability to immediately ship goods to alternative markets, but in the subsequent year a significant share of the affected Australian exports (see Table 1) were redirected to alternative markets and — with the exception of one or two commodities — export values substantially recovered (Productivity Commission, 2021). Moreover, increases in exports of iron ore, which were not subject to restrictions, roughly counterbalanced the decline in other commodities, ensuring that total Australian exports to China did not decline. Indeed, a range of Australian agricultural exports to China — that have not faced trade restrictions — have continued to grow under the liberalisation measures of the China-Australia Free Trade Agreement (ChAFTA) that sharply lifted Australia’s share in Chinese markets. For example, Australia’s milk exports — which enjoyed substantial Chinese preferential liberalisation under ChAFTA — increased by 15% in 2020.

China substituted import supplies from Australian competitors in markets affected by its trade restrictions (in some cases significantly from Australia’s closest allies, see Figure 2). The adjustment in both Australian and Chinese trade was not without cost to producers and consumers in each country — loss in value in Australian exports especially in the short term and more limited and higher priced products, especially coal, in China. But the options in open international markets guaranteed by the multilateral trading system considerably cushioned the costs of the adjustment to these Chinese policy interventions.

Damage to global confidence in trade and economic exchange with China and the global trading system more broadly is another element to assess in this episode (Treasurer, 2021). The longer-term reaction in markets to confidence-shaking policy interventions of this kind is an important object of economic policy and diplomacy. The US–China trade war has undoubtedly caused far bigger systemic damage to the global trade regime, but that inflicted by Chinese economic coercion against Australia is not trivial. The long-term effects on China are not certain; they will certainly depend on what credibility it can restore in future policy behaviour, including through its response to the application and development of trade law.

There are a number of key lessons from this experience. One is that absent effective diplomatic engagement, big powers — under any trade regime — have the clout to inflict trade damage on smaller powers where direct international trade interdependence is not mutually strong (as it is, for example, in Australia’s iron trade with China). The most important lesson from this experience, however, is that the multilateral trading system provides a buffer against these policy shocks. This is a well-tested proposition in the analysis of agricultural trade shocks (Anderson, 2016), and its logic is universal. The multilateral system reduces the risks, even from egregious policy shocks, and lowers their economic and political cost. Flexible markets react and respond to shocks, companies innovate around them, and policy actions can be tested in international legal processes such as the WTO.
Table 1: Least-squares growth rates of Australian exports to the world excluding China before and after China imposed trade restrictions (ABS, 2020)

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Average monthly growth rate to rest of the world before Chinese restrictive measures</th>
<th>Monthly growth rate to rest of the world after Chinese restrictive measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beef</td>
<td>0.5%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>Barley</td>
<td>2.5%</td>
<td>18%</td>
</tr>
<tr>
<td>Wine</td>
<td>-0.2%</td>
<td>1.07%</td>
</tr>
<tr>
<td>Coal</td>
<td>-2.8%</td>
<td>5.34%</td>
</tr>
<tr>
<td>Timber</td>
<td>0.07%</td>
<td>12.6%</td>
</tr>
</tbody>
</table>

Figure 2: Monthly Australian exports to China and the rest of the world, selected commodities, billion $A

Figure 3: Index (Nov 2020=100) of wine exports from United States to China and rest of the world after Chinese restrictive measures on Australian wine in November 2020
The multilateral trading system, with the WTO at its core, therefore remains fundamental to Australia's prosperity and economic and political security. This is not simply because it can limit the exercise of political power against Australia through trade coercion. It is because it is fundamental to all of Australia's major trading partners' economic and political security in the region. A breakdown in confidence in the multilateral trading system would unravel economic and political ties globally — but especially in East Asia where political cooperation is still underdone and has been shaped significantly by economic interdependence. The alternative is a world ruled by political might and competing blocs, one that would be considerably less prosperous and more threatening, with consequences in terms of political instability and human displacement detrimental to Australia's security interests.

The multilateral rules-based order still protects Australia's economic interests as it has in the past half century. Allowing the system to decay or, worse, to be replaced by a system of economic blocs composed of geopolitical allies, would cause very substantial damage to the Australian, Asian and world economies; it would also likely work to the relative advantage of emerging rather than advanced economic powers, as was the case in the interwar years (see Box 2). There is little to no appetite elsewhere in the world for replacing the Bretton Woods system — particularly in Asia.

The multilateral trading system — the many treaties and arrangements with the WTO at its core — is both flawed and challenged, but it still undergirds the conduct of the vast proportion of the US$35.3 trillion merchandise trade conducted around the world. The framework that was devised at the Bretton Woods conference in 1944 has endured over the past two generations. Institutions, however, are slow-moving, particularly consensus-based organisations like the WTO.

In framing a new push to regenerate the multilateral system, the reforms needed are those that secure prosperity and security for future generations, for example by facilitating a transition to a low-carbon economy over the coming decades. In areas like the digital economy and telecommunications where we now lack rules, consensus or competition will not be settled in the near future but we can begin to define a path towards an eventual multilateral system and open, contested markets. Domestically, an intergenerational perspective on policies that secure Australia's interests needs to emphasise investment in human capital as much as in the defence hardware spending connected with AUKUS commitments (see Box 2).

**Box 2: Risk mitigation and resilience in economic recovery from pandemic**

The collapse of the open international order in the interwar years benefited the future Axis powers more than the future Allied powers. Between the onset of the Great Depression and the outbreak of World War II, per capita income in Germany grew by a cumulative 33 per cent and in Japan by 31 per cent. Devastating competitiveness in global markets drove growth first, after which militarisation dominated. In Britain, incomes grew only by 14 per cent, in Australia by 11 per cent, and in the United States they declined by 6 per cent (Bolt and van Zanden, 2020). The protectionist turn in international trade relations from the end of World War I onwards was also more beneficial to the Axis powers: between 1920 and 1939, German exports grew by a cumulative 55 per cent and Japanese exports by 197 per cent, while British exports declined by 16 per cent and American exports by 12 per cent (Federico and Tena, 2019). A break-down in rules tends to favour emerging, not established powers.
Economic shocks, like the Great Depression, the Global Financial Crisis and the Covid-19 pandemic, commonly result in a turn towards protectionism. But there is often a delay. The Smoot-Hawley tariff increases in the United States came relatively swiftly after the crash of 1929, but the most damaging tit-for-tat protectionism took several years to spread to the rest of the world (Eichengreen and Irwin, 2010). After the GFC, it took some years before President Trump's America First agenda became popular enough for him to win a presidential election. It is likely that the next decade will see more pronounced protectionist sentiment around the world, if the policy reaction to the Spanish flu of 1918 is any guide: after the last major pandemic, countries which had suffered more deaths from the flu raised tariffs faster and higher (Boberg-Fazlic et al, 2021).

Australia's economic resilience will depend on two major factors: first, the ability of the global rules-based order to constrain protectionism; and second, the capacity of its companies and workers to adjust quickly to new economic conditions. The first factor is dealt with comprehensively in the body of this paper. The second factor requires sustained attention by domestic policymakers. In a carbon-constrained world, demand for Australia's second-largest export, coal, will go into secular decline. Structural change and climate policy in China is already affecting the demand for the nation's largest export to that country, iron ore. Key to Australia's economic resilience in this new environment is its stock of human capital. The education system has come under strain during the pandemic, unavoidably in part, as lockdowns have forced instruction to go online, but partly as a result of policy choice. The state of Australia's universities is concerning: many have been forced to make drastic cuts in response to falling revenue during the pandemic. A lack of income support for international students stranded due to the pandemic has damaged Australia's reputation as a study destination compared to competitors like the United Kingdom, Canada and even Japan.

The Australian government committed an extra $1 billion in research funding, but a long-term human capital strategy is required if Australia is to remain at the knowledge and technological frontiers. The AUKUS deal will facilitate the transfer of military technology. Alongside the Quad, it is expected to bring new opportunities for technology and information sharing and coordinating investment in sectors such as artificial intelligence and quantum computing. Australia's access to critical technologies will be maximised if these 'minilateral' vehicles are complemented by an integrated regional economy and domestic institutions that help realise the technological gains from trade and investment more broadly.

The predominance of dual-use technology demands a combination of government-to-government cooperation and deep integration with global markets. Technologies with defence applications are frequently commercial in origin (such as 5G) or typically provided by private firms (such as cloud computing). To illustrate, a former US general estimates that while in the 1980s '70 per cent of the technology that mattered to military commanders was proprietary to the government' and the rest 'off-the-shelf', today 'it is 70 per cent off-the-shelf' (The Economist, 2019).

Domestic efforts and selective international cooperation will not suffice for Australia to access the technologies essential to standards of living, defence and security. Australia's position at the technological frontier rests on research and commercial links with diverse partners. Australia accounts for about 1.1 per cent of global R&D expenditure, while the United States, China and Japan represent 26.2, 20.1 and 7.9 per cent respectively (UNESCO, 2021). In 2020, more than 90 per cent of applications for Australian patents were from non-residents (WIPO, 2020).
The choices and difficulties that Australia faces in its international trade relations continue to be framed within an international trade and economic environment that is conditioned by reference and appeal to the WTO. The WTO that has been a pillar of Australia’s economic and political engagement with the world is weakened by the two largest trading powers disregarding its core principles. It is also weakened because international rules are largely non-existent for a growing proportion of international 21st century commerce such as services, investment and data flows. Yet neither the Biden-led United States nor China has walked away from its fundamental commitment to the WTO. As the world’s largest trading nation, China has a substantial stake in a functioning multilateral trading system — even if it still has yet to be persuaded that its significant transgressions against it harm that system. While the Biden administration’s foreign economic policy for the American middle class also risks weakening the multilateral system, the United States calls for its reform, not its abandonment.

This understanding of the WTO, the multilateral economic system and the challenges facing it is the bedrock to properly framing Australia’s trade and economic policy strategies consistently with national economic and security policy objectives. It is central to prioritising the national and diplomatic efforts now needed to fix what is broken in the system — or has never worked — and avoiding mistakes that would be economically costly and aggravate the security situation. This understanding is not only fundamental to Australia. Australia’s neighbours, in a region that accounts for 66 per cent of Australia’s global markets and is also its security frontline, rely heavily upon economic interdependence to manage their political relations. Australia may not achieve every single item on a reform agenda for the multilateral system, but it is important that the system’s strategic importance for Australia’s economic and national security be placed back at the heart of the national diplomatic agenda. Our interest in WTO reform, for example, is not simply a question of small technical fixes in areas of Australian trade specialisation, but must instead be about our overwhelming interest in the health of WTO as a whole.
3. The crucible of strategic interests in Southeast Asia

The international frameworks that have allowed Australia to navigate a new environment in which economic interactions are being leveraged to exert political pressure face major challenges. As a relatively small open economy with limited market power, Australia has little scope to use economic tools to achieve its own strategic objectives. The Australian national interest is best served by a framework that effectively constrains states’ abilities to exert economic pressure for strategic ends. Australia’s strategic situation is similar to that of other small or middle-ranking open economies in the region, including notably the member states of ASEAN.

In Southeast Asia, the organising framework of ASEAN reinforces the multilateral principles of equal treatment. ASEAN has a population of 650 million and its share in global GDP is 3.4 per cent; as an economic entity it ranks fifth after Germany. ASEAN itself provides a buffer for individual Southeast Asian countries in their dealings with bigger regional and global powers. That buffer includes convening power, with the role it plays in the East Asia Summit and the ASEAN Plus arrangements. But it also shapes the organisational framework of its own political relationships and those in the broader East Asian region. For example, in April 2020, led by Indonesia, ASEAN convened an ASEAN+3 Special Summit which brought leaders from China, Japan, South Korea and ASEAN member states together to coordinate responses to the COVID-19 outbreak. That arrangement was the locus for the region’s dealing with the crisis, not any arrangements with the major powers in North America or Europe.

Multilateral principles suffuse not only the economic but also the security lens through which Australia’s frontline Southeast Asian neighbours view their strategic interests in the world. Engagement with the United States is certainly for them an important hedge against China and its growing strength. But from where they sit in Asia, with China next door — and with their large scale, complex economic interdependence in the East Asian region — most of Australia’s frontline partners in Asia do not see their policy choices through the prism of a US alliance framework. In Northeast Asia, that prism shapes many of Japan’s perspectives, but for South Korea the primary purpose of the US alliance framework is to manage the threat from North Korea.

Table 2 summarises the Asian matrix of economic and security interests, in relation to China, within which Australia must forge its own economic and security goals.

For Southeast Asian nations, there is little sense in separating international economic engagement from security strategies. With the exception of Singapore and Brunei, all are still developing economies — rapid economic growth is seen as a predominant policy objective, not just in its own right, but also as a strategic necessity given the need to maintain and upgrade their militaries. While there has been a slight decrease in the proportion of military spending to GDP in the region since the end of the Cold War, there has also been massive growth in income, and aggregate military spending has increased almost commensurately. There is a strong correlation between levels of economic development and expenditure on defence (Figure 4). Withdrawal from Chinese trade and investment links would cause serious economic damage to Southeast Asian countries and constrain spending on upgrading their defensive capabilities. The strategy of Indonesia and ASEAN is to ‘engage, balance and benefit’ from the China relationship and they are determined not to sacrifice economic development over security issues short of real interference or conflict.
The economic growth that Southeast Asian nations have enjoyed has been predicated on their increasing involvement in cross-border supply chains. As unattractive as the choice of withdrawing from the regional economy to focus on a US-centric economic bloc would be for Australia, that choice is unthinkable for the member states of ASEAN. They are deeply enmeshed in regional supply chains for which there is no substitute outside the region. OECD modelling suggests that in a ‘localised’ world characterised by a general retreat from cross-border supply chains, Southeast Asia’s economy would shrink by around 11 per cent and its exports by around 30 per cent (OECD, 2021). This is simply not an economic trade-off that ASEAN members are able to make, and in all likelihood the strategic position of Southeast Asian governments will be framed in light of economic imperatives, not the other way around.

The policy strategy of using economic development and integration of ASEAN economies into the global economy to strengthen national security is an entrenched norm where cooperation within ASEAN aims to preserve strategic policy space and freedom in policy choices. ASEAN has very low intra-regional trade shares itself, so the ASEAN Economic Community agenda helps the grouping expand trade and investment with the major powers surrounding it as much as within the group.

A balancing of power between Washington and Beijing suits ASEAN best, allowing it to retain its own space to serve the interests of its member states rather than those of either hegemonic power. ASEAN’s approach has been one of non-interference and non-alignment, with strong respect for individual country sovereignty. The broad philosophy of non-interference and non-alignment can be seen in ASEAN’s response to political turmoil in Myanmar both in 2007 and in the past year: ASEAN avoided moralising about the political crisis while firmly pushing for a peaceful resolution behind the scenes.

ASEAN members are concerned by the deterioration of US–China relations, and by the growing political sway of China in the region. The military gap between China and ASEAN member states has widened considerably in the past few decades, cementing a perception of China as a potential military threat in the eyes of many policymakers in Southeast Asia.
<table>
<thead>
<tr>
<th>Country</th>
<th>Security posture</th>
<th>Trade policy settings</th>
<th>Foreign investment</th>
<th>Infrastructure</th>
<th>Technology</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>Alliance Frame-</td>
<td>China-Japan trade rel-</td>
<td>Changes in 2020 to</td>
<td>Heightened joint</td>
<td>Introduced reg-</td>
</tr>
<tr>
<td></td>
<td>work</td>
<td>tionship third largest</td>
<td>a more restric-</td>
<td>infrastructure</td>
<td>ulations phas-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>globally. Ineffec-</td>
<td>tive screening</td>
<td>cooperation with-</td>
<td>ing out Huawei,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>tive subsidies (~US$2b)</td>
<td>regime. Closed to</td>
<td>out signing on to</td>
<td>ZTE from govern-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>for Japanese com-</td>
<td>FDJ generally.</td>
<td>China's Belt and</td>
<td>ment procure-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>panies to onshore and</td>
<td>Largest non-Chi-</td>
<td>Road Initiative</td>
<td>ment under US</td>
</tr>
<tr>
<td></td>
<td></td>
<td>invest in SE Asia</td>
<td>nese source of</td>
<td>BRI). Key driver of</td>
<td>pressure. Joint</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(relocate produc-</td>
<td>investment in</td>
<td>G20 outcomes on</td>
<td>investment with</td>
</tr>
<tr>
<td></td>
<td></td>
<td>tion from China).</td>
<td>China, contin-</td>
<td>quality invest-</td>
<td>the United</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Leading role pro-</td>
<td>ues to grow. Stoc-</td>
<td>ment principles.</td>
<td>States and Ger-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>moting quality re-</td>
<td>k of FDJ in China</td>
<td></td>
<td>many in future</td>
</tr>
<tr>
<td></td>
<td></td>
<td>gional trade rules</td>
<td>is US$143.5 billion</td>
<td></td>
<td>telecoms tech-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(CPTPP) and in the</td>
<td>(increasing by</td>
<td>nology. Economic</td>
<td>nology. Eco-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>negotiation of RCEP.</td>
<td>$11.3b in 2020).</td>
<td>security policies</td>
<td>nomic security</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CJK (see below).</td>
<td></td>
<td>to manage US-China</td>
<td>to de-</td>
</tr>
<tr>
<td>South</td>
<td>Alliance Frame-</td>
<td>Bilateral FTA with</td>
<td>Foreign Invest-</td>
<td>Focus has been</td>
<td>Coupled.</td>
</tr>
<tr>
<td>Korea</td>
<td>work and</td>
<td>China since 2015,</td>
<td>ment Promotion</td>
<td>on lending niches</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Hedging</td>
<td>both signatories</td>
<td>Act revised slight-</td>
<td>in which Korean</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>to RCEP, and ongo-</td>
<td>ly in 2020; For-</td>
<td>construction com-</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>ing talks on tre-</td>
<td>eign Investment</td>
<td>panies can com-</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>ialateral FTA with</td>
<td>Committee that</td>
<td>pete (smart</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Japan. Second</td>
<td>screens national</td>
<td>cities projects</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>phase China FTA</td>
<td>security impli-</td>
<td>in particular),</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>under negotia-</td>
<td>cations of in-</td>
<td>since it cannot</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>tion.</td>
<td>bound FDI now</td>
<td>outspend Japan and</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>China-Japan-Ko-</td>
<td>includes a mem-</td>
<td>China.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>rea FTA negotia-</td>
<td>ber from the</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>tions slowly</td>
<td>security ministry.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>progressing; tri-</td>
<td>Ongoing negotia-</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>lateral invest-</td>
<td>tions with China</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>ment treaty</td>
<td>to expand the</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>in 2012.</td>
<td>investment chapter</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>Hedging</td>
<td>Joint military</td>
<td>Major liberalisa-</td>
<td>Significant partic-</td>
<td>Using Huawei,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>exercises with</td>
<td>tion of foreign</td>
<td>ipation in the BRI</td>
<td>ZTE, Nokia and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>China and the US in</td>
<td>investment regime</td>
<td>Also significant</td>
<td>Ericsson to build</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2021; alongside</td>
<td>under the Omnibus</td>
<td>Japanese infra-</td>
<td>5G network.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>increased military</td>
<td>Law of 2020 and in</td>
<td>structure invest-</td>
<td>Large increase in</td>
</tr>
<tr>
<td></td>
<td></td>
<td>cooperation with</td>
<td>the New Invest-</td>
<td>ment in Indonesia</td>
<td>Chinese invest-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Japan, Austra-</td>
<td>ment List (replac-</td>
<td>— Indonesia le-</td>
<td>ment in Indian-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>lia and India.</td>
<td>ing the 2016 Nega-</td>
<td>verage strategic</td>
<td>nese tech sector</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Against AUKUS</td>
<td>tive List). Foreign</td>
<td>competition in</td>
<td>in response to</td>
</tr>
<tr>
<td></td>
<td></td>
<td>and strongly</td>
<td>investment in crit-</td>
<td>infrastructure</td>
<td>Indian protec-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>promotes ASEAN</td>
<td>ical infrastructure</td>
<td>space to max-</td>
<td>tion measures.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>centrality, Treat-</td>
<td>like energy and</td>
<td>imise investment.</td>
<td>Signed MoU with</td>
</tr>
<tr>
<td></td>
<td></td>
<td>y of Amity and</td>
<td>airports is now</td>
<td></td>
<td>China on cyber-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cooperation</td>
<td>encouraged.</td>
<td></td>
<td>security; first such</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(TAC) and Zone of</td>
<td></td>
<td></td>
<td>agreement China</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Peace Freedom</td>
<td></td>
<td></td>
<td>has signed with</td>
</tr>
<tr>
<td></td>
<td></td>
<td>and Neutral-</td>
<td></td>
<td></td>
<td>foreign country.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>ity (ZOPFAN).</td>
<td></td>
<td></td>
<td>Jointly producing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>‘Independent and</td>
<td></td>
<td></td>
<td>Sinovac.</td>
</tr>
</tbody>
</table>

3. The crucible of strategic interests in Southeast Asia
Table 2 — Australia’s regional partners’ economics–security positions vis-a-vis China

<table>
<thead>
<tr>
<th>Country</th>
<th>Security posture</th>
<th>Trade policy settings</th>
<th>Foreign investment</th>
<th>Infrastructure</th>
<th>Technology</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>Hedging</td>
<td>Launch of the Digital Free Trade Zone in 2018 and associated payments platforms largely controlled by Alibaba have sparked some concerns over the contestability of some services sector markets. Chinese tech firms market leaders.</td>
<td>China Special Channel established in 2019/20 to coordinate investment in Kuala Lumpur tech sector from Chinese sources.</td>
<td>Full engagement with BRI under Najib administration, but mounting criticism of corruption and profligacy associated with major projects a factor in the defeat of the government. Mahathir was critical of projects but kept many and renegotiated others.</td>
<td>Huawei lost out to Ericsson to supply the 5G network. However, there will be a joint Malaysia–Huawei cybersecurity hub established. Need for cyber warfare capabilities discussed in 2019 Defence White Paper.</td>
</tr>
<tr>
<td>Singapore</td>
<td>Hedging</td>
<td>Severely affected by the US–China trade war, because of extensive integration into regional supply chains for US-bound exports.</td>
<td>No major recent changes. Very liberal regime, but national security exemptions exist.</td>
<td>Chongqing Connectivity Initiative — intergovernmental and private sector cooperation with China on infrastructure. Singaporean firms have been involved in BRI projects mainly offering ancillary services (finance, risk management, project management etc.).</td>
<td>Huawei not included in the 5G rollout in favour of Ericsson and Nokia. Singapore has expanded cooperation with the US on cybersecurity, signing an MoU this year. Huawei may be involved in broader 5G ecosystem at reduced capacity.</td>
</tr>
<tr>
<td>Vietnam</td>
<td>Qualified Hedging</td>
<td>A major beneficiary of the US–China trade war, with substantial trade diversion and supply chain diversification in its favour. Position in regional supply chains underlies the economic benefit of a neutral posture towards major powers.</td>
<td>Amended Law on Investment in 2020: allows the government to terminate any foreign investment deemed a risk to national security; rest of law broadly liberalising.</td>
<td>Vietnam officially participated in BRI in 2015 and some BRI projects since then, as well as Japanese ODA projects.</td>
<td>Huawei is not included in the 5G rollout in Vietnam, though officially for technological reasons.</td>
</tr>
</tbody>
</table>

3. The crucible of strategic interests in Southeast Asia
3. The crucible of strategic interests in Southeast Asia

Assertiveness in the South China Sea is the main touchpoint of this concern for ASEAN member states.

As relations between the United States and China have deteriorated, particularly since the start of the Trump administration and the hardening stance of the Xi presidency, Southeast Asian governments have been forced to navigate very choppy geopolitical waters. On the one hand, the road to rapid economic growth lies in deep regional economic integration into a global economy of which China is a central part. There is anxiety to avoid the lose-lose proposition of becoming embroiled on either side of a trade war between China and the United States. The need for hard infrastructure to facilitate this integration is acute, and China’s Belt and Road Initiative (BRI) is seen as a crucial source of funds for building the large stock of infrastructure required across the region. On the other hand, some countries are wary of China’s more assertive political stance — especially over territorial claims in which several have direct interest. Increasing tensions between the United States and China have raised questions about the economic implications of the evolving strategic order. The response to BRI is to accept its benefits and try to manage difficulties that arise — which is why strengthening domestic governance, transparency and effective regional dispute resolution, and pushing hard on multilateral mechanisms and institutions (to dilute the influence of individual big players) is likely to be more effective as a strategy for building economic resilience and security over time.

Policy responses across the region have differed, but a common policy goal is the search for a way to address any security concerns without closing off trade and investment flows with China. Pulling back from integration into the regional economy would have deleterious impacts, not only on national economies but also on national security. For Southeast Asian countries, the primacy of economic development and its interaction with the objectives of security are well entrenched.

Box 3: Managing strategic competition in Southeast Asia

As a leader of ASEAN, Indonesia exemplifies a strategy in which the primacy of economic development is entwined with security objectives.

ASEAN’s response to the idea of a Free and Open Indo-Pacific coming out of Tokyo, Canberra and Washington was to release the ASEAN Outlook on the Indo-Pacific. With Thailand as chair of ASEAN, Indonesia was instrumental in developing the Outlook. It emphasised an inclusive region with economic integration complementing the maritime and other security elements of external conceptions of the Indo-Pacific. The incorporation of ASEAN’s Outlook on the Indo-Pacific into the East Asia Summit process had Australia, Japan, the United States and importantly China sign on to the idea. A similar reliance on ASEAN as a platform for member countries to engage productively with China can be seen in Indonesia’s role in the conception and negotiation of RCEP. An ASEAN-led RCEP with Indonesia successfully chairing the negotiating committee to the conclusion of the agreement demonstrates a new step-up in regional leadership. There is a substantial economic cooperation agenda in RCEP that many in ASEAN see as a future avenue for deeper economic and political cooperation.

ASEAN has not been passive, even if it has been slow-moving. Despite differences between member states, negotiations with China over a Code of Conduct for the South China Sea have progressed over the last decade and are due to conclude next year.
The economic imperative that Southeast Asia must remain open to all major powers also helps to explain the response of ASEAN to the Free and Open Indo-Pacific (FOIP) framework, which was crafted in response to China’s rise. The FOIP framework was an initiative about US strategic rivalry with China in the Asia Pacific. ASEAN has concerns that the US approach is about containment, which is not consistent with the ASEAN approach to big powers, either the United States or China. ASEAN’s diplomatic response is instructive. It involved issuing its own statement, the ASEAN Outlook on the Indo-Pacific. It embedded its response to the United States in an existing multilateral platform, the East Asia Summit, where ASEAN could veto any attempt to override it. And most tellingly, it added new dimensions on economic cooperation and development that were largely absent from the FOIP.

The message this sends is clear: ASEAN has no interest in any new paradigm of regional security that neglects the economic development and cooperation dimension, or that subordinates it to strategic rivalries between competing hegemons. For individual ASEAN nations, the organisation remains an important buffer that allows them to sidestep attempts to draw them into either side of a geopolitical contest in the region. While ASEAN’s members will obviously continue to engage with China and the United States in a manner that accords with their own national security objectives, those objectives themselves will be in the service of a broader conception of regional diplomacy that prioritises economic development and openness, not geopolitical rivalry.

Key to attaining the dual objectives of economic growth and national security — and deploying economic integration as a key instrument in achieving both — has been to embed discussion of the issues arising from US and Chinese strategic competition into existing ASEAN plus regional structures.

Achieving both economic growth and strong national security does not require that solutions always be found in the domain of foreign policy. Many challenges faced by Southeast Asian nations are likely to be best solved by strengthening domestic and regional institutions governing investment, infrastructure, cyber and other areas of foreign economic engagement. This is an important opportunity for cooperation with regional partners like Australia.
4. Economic tools for national security

The uncertain international policy environment and weakened multilateral system change the economic policy calculus and priorities of Australia and others. They do not change the fact that some economic policy choices make countries poorer, weaker and less secure. Some economic policies increase security risk in an environment where economic choice and political options are more limited. Economic policy options may also narrow or change because of the actions of other countries, so a critical aspect of maximising choice and economic options while mitigating risk is targeted, proactive economic diplomacy.

The starting point in analysing the pursuit of economic and security objectives is that framing it as a zero-sum game — in which economics and security are substitutes and a nation cannot attain more of one without surrendering some amount of the other — is rarely sensible. It is a multidimensional mixed-interest game in which these objectives are often complements, where more of one enhances attainment of the other.

Countries have achieved economic strength through international economic integration; economic strength and the system of multilateral economic ties have also reinforced political independence and security. This is the experience that is observed within our region.

Strategic rivalry between the United States and China has encouraged reversion to narrower conceptions of national security or geopolitics characterised by zero-sum, or even negative-sum, thinking. The alternative conception embraces economic and security goals as complements where they can be. The pursuit of economic and security objectives as complements has two dimensions. The first is that economic security obviously contributes to national security through enhancing wealth and national power. The expansion of Australia’s defence budget is in part funded by the taxation payoff from trade with China.

The second is that it creates network effects — effects that increase contestability and competition and limit power — entrenching vested interests that ameliorate the costs of economic and political conflict. The Northeast Asian nations that depend heavily (for over two-thirds of their needs) on Australia’s supplies of critical industrial raw materials and energy are substantially constrained in political dealings with Australia. This ‘peace’ dividend (Oneal et al, 2003; Garzke et al, 2001) is no automatic or inevitable consequence of expanding trade and commerce. It will be secured only by properly structured national institutions, regulations and laws as well as international institutions, rules and agreed norms that mitigate accompanying natural and policy risks.

These are the two objects of policy that enhance achievement of national economic and political security goals. They must be achieved in cooperation with partners in the main theatres of Australia’s economic and security concern.

There is another aspect of complementarity in the pursuit of national economic and security objectives. It is the circumstance in which economic policies deployed for national security purposes carry unintended consequences including adverse economic, political and security outcomes.

Weaponising economic diplomacy has also been on the rise more broadly in East Asia. Japan has introduced new export controls against South Korea in a process widely seen as politicised (see Box 9), while Indonesia’s nickel ore export ban — though it had been planned for some time — has been interpreted by some as instigating a ‘trade war’ in retaliation for European restrictions on palm oil (Federation of Mining and Energy, 2021). The increasing use of economic policy levers as security measures has mostly been reactive, without full analysis of the long-term balance of costs and benefits.

This is more important now than ever when the weaponisation of economic policy has garnered appeal. We examine in Box 4 the first of two cases from Northeast Asia where market power was exercised — from a near monopoly position with few alternative suppliers — and bore such unintended consequences.
Box 4: The limits of geo-economic leverage in critical minerals

A collision between a Chinese trawler and the Japanese coast guard in the East China Sea in September 2010 led to a dispute over Chinese export restrictions of strategically important rare earths to Japan. At the time, China had a near monopoly by producing 97 per cent of global rare earth supplies despite only having an estimated one-third of global reserves. Rare earths are a group of 17 minerals that are essential for manufacturing smartphones, electric vehicles, military weapon systems and other high-tech products. Japan was the largest global customer, followed by the United States and the European Union.

The ban on rare earths exports is now commonly cited as an example of Chinese economic coercion for geopolitical purposes. There is uncertainty as to whether the ban was related to the Japanese coast guard incident, as reported by the New York Times (Johnston, 2013), with China having gradually tightened export restrictions of rare earths from a decade before. Border restrictions (the easiest tool to deploy) were used to consolidate a fragmented domestic industry that included many illegal miners causing significant environmental damage.

There are two important lessons from this episode. First, the response of the international market to China’s export restrictions — whether they were aimed at domestic market consolidation or coercing Japan politically — meant that they were an own goal. The perceived shortages in supply of rare earths and the uncertainty that China’s actions caused in markets meant that the price of rare earth minerals rose rapidly, making it profitable for others to enter the global market (see Figure 5). Second, Japan, joined by the United States and European Union, launched a successful case against China in the WTO in 2015 with China accepting the ruling.

There are well known problems with the dispute settlement system in the WTO — such as the length of time it takes to effect a ruling — but this case demonstrates China’s adherence to the rules-based trading system at the time, and the priority that should attach to maintaining confidence in the enforcement of its rules.

How could the world let any one country come to supply 97 per cent of a material critical for high-tech manufacturing? There are two related reasons. The mining and production of rare earths involves significant environmental damage that many potential producers were unwilling or unable to afford. Chinese policies that encouraged the production of rare earths, combined with its initial inability to price environmental costs in their production, meant that it enjoyed a large international cost advantage. The cost advantage was not the only factor — China’s membership of the WTO, that signalled its commitment to international trade rules and norms, increased importers’ confidence in China as a reliable supplier. The Chinese track record and WTO commitments meant that the risk-adjusted price was low enough for countries to rely on China as the primary, and often only, supplier.

Chinese export restrictions and their politicisation meant that the risk-adjusted price increased rapidly as confidence was shaken in China as a reliable supplier.

---

1 China agreed to obligations in its WTO accession that meant it was not allowed to restrict the export of natural resources — something that went above and beyond other WTO members — as the price of entry (for example, the United States had restricted the export of oil for many decades).
Although the international supply response was not instantaneous, it was quite rapid. The increased risk-adjusted price meant that other potential suppliers found it profitable to produce rare earths, and the uncertainty around China as a reliable and stable supplier meant that there was incentive for governments to subsidise the production of rare earths elsewhere.

In 2020 China still supplied 85 per cent of global rare earths but, in the immediate aftermath of the 2010 incident, Japan rapidly diversified its import sources. From relying on China for over 90 per cent of its rare earth imports in 2008, by 2012 Japan had reduced reliance on China to under 60 per cent and to roughly half by 2015.
Intervening in the market to take advantage of dominant market positions for geopolitical or monopoly rent-seeking purposes may be attractive in the short term when supply is inelastic — when it is difficult for immediate substitutes and new supply to enter the market — but it increases market uncertainty and corrodes market power in the medium to long term. An intervention outside the established rules and norms of the global trading system will increase risk-adjusted prices, and prices will rise rapidly the more inelastic the supply. If supply is relatively elastic, intervening in the international market will have little effect given that other suppliers can take market share or substitute goods can be used. And supply is only inelastic in the short run. These observations suggest that careful calculation of supply responses in international markets should be foremost in the management of security risks, not market exit. Even new mines or factories that take some years to come on stream eventually do, and a rapid rise in price creates a large incentive to accelerate the supply-adjustment process and to find or create substitutes. Careful calculation of these market responses in international markets of relevance (such as the international iron ore market), rather than casual assessment, is the proper foundation for economic security analysis (Drysdale and Hurst, 2012).

Economic exchange builds national wealth and power that is crucial to manage economic and security risks. Those risks have increased and become harder to identify, but that is no reason in itself to limit or cut off trade. Even if it is predictable that trade may be closed off in some political eventuality, the shrewd calculation is usually to exploit opportunities while they exist.

Understanding the sources and the fulcrum of risk is essential to its mitigation.

Many of the risks to security of supply and integrity of production are managed by sophisticated systems and players in international markets. National institutions, regulations and laws; and international institutions, rules and agreed norms are the two broad instruments that can be brought to bear on managing national economic and security risks.

Domestic institutions, laws and regulation are the first line of defence in mitigating the security risks in international exchange. It is within that framework that exclusion, inclusion or localisation requirements are determined. The exclusion of Huawei from Australia’s 5G network is an example of the exercise of sovereign power in an effort to lower risk. Domestic laws and institutions also define what is acceptable behaviour in terms of market integrity, competition and data privacy. In principle, enforcement and compliance and the imposition of criminal or other penalties for unacceptable behaviour by national or foreign residents is within the power of the national government. A risk-based approach that mitigates and manages risks can avoid all-or-nothing outcomes. Policy processes that bring different interests together to identify risks and consider different tools and strategies for mitigating those risks can produce policies that enhance prosperity, national security and social stability, and can help to avoid unintended consequences.

Enforceable international rules and trusted norms in the trading system also help to diffuse economic and political power. They are an essential component in the armoury of smaller powers in managing risks. Application of the body of trade law under the WTO is the primary international instrument for mitigating national risk in international trade. Engagement with regional and other partners can increase options, diffuse power and reduce risks from potentially malign actors. The geography of Australia’s international economic interests means that appeal to the multilateral economic regime dominates dealing with economic risk. The economic logic of multilateralism mirrors its political and security logic. The economic principle of most-favoured-nation treatment has an equivalent political dimension. Agreement to an economic equality principle in multilateral rules surrenders political leverage that might otherwise be available to countries to exercise economic power for political ends.
The exercise of political leverage through economic sanctions is subject to both the international market response and the enforcement of the rules. And, as we have observed, the open multilateral trading system has cushioned the economic damage that Australia faced from Chinese trade coercion. Some of the Chinese measures (on barley and wine) are being challenged in the WTO dispute settlement process, but redress there is slow. Restoration of market confidence in the reliability of trade with China will require high-level national commitments and understandings that affirm mutual interest in dependable trade, renouncing interventions not sanctioned by the reasonable application of trade law.
5. Integrating Australia’s economic and security interests

The more complicated and uncertain international policy environment has made policy choices more difficult in the pursuit of the national economic and security interests. This is in part because the stable international order and its defined domains meant that the economic and security agencies of governments worked in silos for decades, and in part because the circumstances have changed so sharply.

The central national interest question a few years back centred on the collision between Australia’s economic interests in China, and Asia more broadly, and Australia’s security alliance with the United States. This emerged as China became more nationalist and assertive, and the United States under former president Trump became more populist — withdrawing from international institutions and threatening international norms — and both countries moved into overt strategic rivalry. Grappling with these developments from the separate perspectives of economic and security interests presented a major challenge.

The central challenge is how to identify the economic and security elements of national interest in formulating policy strategies that comprehend both dimensions, not what security or economic interests might be in isolation. This involves identifying the security and economic risks and how they interact; exploring how these various risks could be effectively mitigated in an enduring and practical way; drawing out the longer-term impacts and possibility of unintended consequences; and testing that the strategy taken fits with the endgame (or what sort of world) we want to end up with.

The world has become harder to manage. The further consolidation of the power of the Chinese Communist Party (CCP) under Xi Jinping, its cyber incursions, and its use of the bilateral economic and trade relationship to intimidate and force changes in Australian policy — all of which have destroyed trust in China as a natural partner for Australia — give a new edge to the national policy choices Australia now has to make. At the same time, the short-run economic impact of the pandemic on China has been notably smaller than for other countries, elevating its global economic position, power and prestige. China will continue to be a very big player in the region and globally in the coming decades. Given the openness and complex integration of goods, services and capital markets, it is impossible to comprehensively isolate the direct and indirect China links in Australia’s economic activity.

Across the Pacific, the shift from the Trump to the Biden administration has brought the United States back as an influential player in international institutions and systems, and the United States is now a more constructive and collaborative global player. Most of the world has breathed a sigh of relief at this development. Yet nationalism still plays a big role in that country, and the United States is unlikely, for example, to enter some of the trade, economic and monetary arrangements that Australia values highly (like the CPTPP or reform of the IMF and the global financial safety net) any time soon. President Biden is intent on improving the economic life of working America after decades of falling real wages, and the administration knows that if it is not successful in this pursuit, the country could face further nationalist outbursts in the future.

The world has changed significantly in recent years, but it is likely to change again, including in ways we do not expect. At times of profound change and uncertainty, it is easy to be caught up in the day-to-day developments, react viscerally, and feel a need to respond to every action with a reaction. The danger in this regard is loss of perspective about longer-term interests, becoming reactive rather than proactively strategic, and, after a succession of tactical responses, ending up stuck in positions without flexibility to adjust.
this risk, it is useful to reflect on longer-term objectives — keeping the eye on the prize of enduring national economic strength, resilience and security — and on unintended consequences.2

In this context, it is useful to set out a practical good-practice guide to thinking through how to achieve the national interest in an uncertain, unstable and complex world.

**Good-practice guide to national interest policymaking**

The first question is what are the security, economic and social risks, and how do they interact, in a particular area, sector or topic of importance. The risks may vary by sector or area, such as telecommunications, infrastructure, energy, education, foreign investment and the role of foreign firms, cyber risk or finance.

The second question is what sort of domestic measures would help mitigate those risks. These measures might include:

- exclusion, inclusion or localisation requirements in a market, including requiring local listing, staffing, management or board;
- strengthening domestic laws, standards and institutions, including about what is acceptable behaviour in terms of market integrity, competition and privacy (e.g. use of data); and
- greater enforcement, compliance or penalties for bad behaviour, including criminalising particular actions for locally employed staff.

Most domestic laws and institutions have an international dimension based in a treaty, an international professional body (like IOSCO, BIS and WIPO), an international rules-based organisation (like WTO, IMF, IEA and IAEA) or an international political body (like G20 and APEC).

The third question is what sort of international diplomatic initiatives across government agencies would help mitigate those risks. Such initiatives might include:

- reprioritising national economic diplomatic efforts to address the principal weaknesses and gaps in the multilateral system (including through forging common cause with partners in global forums, the region and elsewhere);
- reinforcing the integrity of Australia’s own practices, laws and institutions by working with others to reinforce, strengthen or extend these international systems;
- identifying priority issues and countries in priority areas (investment, infrastructure, the digital economy or competition arrangements) with whom to collaborate in reinforcing the integrity of their practices, laws and institutions;
- engaging broader partnerships in business, not-for-profits, think tanks and universities to work through issues of concern; and
- developing a sequence of priorities and issues, potential partners and potential forums to be engaged pragmatically over time.

---

2 For example, Australia’s interests in digital privacy differ significantly from those of China on the one hand and Europe (if less extremely) on the other, but they are also best achieved in an open and coherent global system — the challenge is not losing sight of long-run interests in managing short-run responses. Similarly, 5G technology in a highly concentrated market creates security and economic risks, yet there are changes in innovation policy, technology and market structure that may better manage those risks with 5G+ or 6G in two or five years’ time. The challenge is to create proactively the conditions for such a market to exist while dealing with short-term risks.
The fourth question is what are the key features of the sector or activity that we want in 5, 10 and even 25 years that meet Australia’s economic, security and social interests, and what steps or actions do we take to ensure this. For example, what would be the features of telecommunications that would satisfy Australia’s interests in say, 5 years and what technological, market design and security innovations and partners would we need to work with to achieve the national interest? The point here is to ensure that Australia’s short and long-term interests are considered explicitly, that individual steps do not have unintended consequences, and that government is proactive rather than reactive in its strategies.
Guide to the design of public institutions

The first question is whether the Cabinet is provided with all the full range of perspectives and contestability of views to make its decision in bringing the economic, security and social dimensions together. This is the Prime Minister’s decision, through:

- the whole Cabinet for open discussion on big cross-cutting matters;
- existing specific committees, like the National Security Committee of Cabinet but expanding membership (to the Trade Minister) and calling in relevant ministers on specific cross-cutting issues and decision making; or
- establishing a high-level strategic Cabinet committee of senior Ministers on cross-cutting multi-interest strategic matters, like infrastructure, foreign investment, communications, dual-use technology and supply chains (with NSC retaining responsibility for specific military, security and intelligence strategies and decisions).

The second question is whether administrative arrangements within the Australian Public Service support strategic decision making by Cabinet. Ways to do this include:

- key departments creating multi-disciplinary teams — to broaden internal expertise, like the way Defence and Home Affairs have an economic branch and Treasury has a security branch — supported by cross-government networks;
- strengthen PM&C’s coordination and integration role by creating a multi-disciplinary strategic oversight office inside PM&C (rather than ONI) that is responsible for providing integrated whole-of-government advice to the Prime Minister and Cabinet;
- use the International Economic Policy Group to provide advice and guidance to government departments and agencies on how they conduct international economic relations within their policy remit and how to use international organisations and forums strategically, with oversight by Secretaries Board;
- extend forums on integrated strategic analysis by government officials with a wide range of academics, businesses and international not-for-profit agencies, and explore placements and exchanges; and
- broaden connections and interaction with counterparts overseas, beyond the normal network, to gather fresh perspectives.

The third question is whether government is making full use of the range of tools and perspectives in forming its advice to Ministers and the Cabinet. In terms of tools, genuine multi-disciplinary scenario analysis, simulation analysis and management-firm complex problem-solving techniques are practical tools to identify issues, explore enduring solutions and build relationships and networks. In terms of perspectives, it is worth erring on the side of seeking a wider group of views — inside and outside government — beyond normal connections to explore issues.
6. Australia’s economic and strategic choices

With harder policy choices for countries like Australia, and narrowing policy space due to great power strategic competition, an international economic policy strategy that strengthens multilateralism at every step will help maintain strategic policy space. The global economic regime is under intense pressure, but it still provides substantial insurance and protection from coercive behaviour and political leverage from larger countries. The multilateral trading system and the rules that underpin it are the external dimension of Australia’s economic resilience. That resilience no longer provides comprehensive, automatic insurance against political interference in trade: it is now a major, strategic objective of international policy.

The fundamental insight still holds that open economic systems, structured around competitive and well-regulated markets and effective institutions, are the cornerstone of national and international prosperity. The world has changed but that insight has not. It is an enduring element in the conception of national and international security.

Defence and preservation of the global trading, investment and finance system is a strategic priority. A retreat from multilateral rules will unravel economic and political arrangements globally, and East Asia will be particularly hard hit because of the nature and structure of interdependencies within the region. Reforming and reviving the enforcement mechanisms in the WTO is a necessary first step. Australia, China, the European Union and 17 other members — without the United States, Japan, Indonesia and India — are party to an interim arbitration arrangement which demonstrates the stake those countries have in a rules-based trading system (WTO, 2020b).

Upgrading rules where there are substantial gaps, like in those governing the digital economy and subsidies, is also a priority. Mobilising political capital around a comprehensive reform package of the WTO will help enmesh China in new rules, just as the United Kingdom did 75 years ago in the face of a rising United States.

Enmeshing China in markets and new rules is a strategic priority for Australia and its regional partners to ensure both economic and political security. The private sector is pervasive in China and crucial to its ongoing development, prosperity and power, despite the illiberal turn in government and the large presence of SOEs in some sectors. A fundamental retreat from private enterprise and foreign investment, which together account for more than 91 per cent of Chinese exports, would lead to economic, social and political collapse and instability. The market and private enterprise are the most robust constraints on the Chinese government domestically. And the Chinese economy is deeply integrated into the international economy and China continues to demonstrate its fundamental stake in an open global system despite its self-defeating experiments in the exercise of economic leverage. New international rules can help to reinforce market forces in China and reinforce China’s stake in international markets.

Re-building the stake of the United States in the system is another major objective, entrenching its commitment to established rules and the shaping of new rules.

Given Chinese economic weight and power, collective action that engages China in international rule-making is the right way forward. An important element in dealing with risk — be it Chinese assertiveness or US nationalist insularity — is to multilateralise engagement. The problem is not so much one country’s leadership in a forum but ensuring that governance systems protect the voices of the broad membership and that rules are upheld. Bilateral deals like the Phase One trade deal with the United States do not account for the broader
multilateral interests of small and medium powers, or systemic integrity. Multilateral efforts and rules have the best chance of Chinese buy-in and success. China’s willingness to sign on to new commitments in RCEP, and in trying to reach an investment agreement with Europe, are positive developments. Beijing’s application to join the CPTPP agreement would require significant new commitments in areas such as subsidies and SOE reform. Though they are a high hurdle, that interest should be welcomed. It puts Australia and other CPTPP members in the box seat in engaging with China on some of the key issues in the agenda for international trade reform. The interest is for China to use external leverage to reform SOEs that are a significant drag on the Chinese economy, just as WTO membership was used to overcome domestic vested interests 20 years earlier.

Australia’s national interest is to work at building strategic engagement with China in multilateral settings and forums in ways that strengthen global institutions and lead to progress towards filling the gaps in multilateral rules. This is an effort that need not await rebuilding the bilateral relationship — on the contrary, it is an essential foundation stone and reference point in successfully achieving that objective.

Cooperation with China in the UN framework on international climate change mitigation is also central to Australia’s future economic prosperity and security. This issue is not merely about reducing carbon emissions and slowing global warming. It is key to how successfully the transformation of Australia’s industrial and trade structure — which is integral to the achievement of climate policy goals — is managed. China is already the largest and most competitive global supplier of solar panels. It already produces the lowest-cost electric vehicles and will become the largest producer and exporter of electric cars in the coming two decades. It is the largest potential market for copper, nickel, lithium and other renewable industry material inputs, areas of great potential for Australia. China will inevitably be a major part of the process of trade, technology and financial market transformation reshaping Australia’s specialisation in the global economy in the decades immediately ahead.

Emerging market economies now account for half of the global economy and will also be crucial to the settlement of multilateral rules, including commitments that affect moderating climate change.

Indonesia is president and chair of the G20 in 2022 and chair of ASEAN in 2023. Its own trade policy credentials are not strong, but its revealed strategic interests for preservation of the multilateral rules-based trading system are clear. Indonesia is the chair of the G33 coalition of developing countries in the WTO and it initiated a WTO reform strategy during Japan’s G20 presidency. A developing country agenda will feature heavily over the next few years as India and then Brazil chair the G20 after Indonesia. And the same will be the case for Thailand hosting APEC in 2022, followed by the United States in 2023. For Australia, Indonesia and Southeast Asia present an important opportunity to shape regional outcomes and global governance.

The world’s geopolitical, economic and security fault lines are in Asia, at the centre of the Indo-Pacific. Southeast Asia and its organising grouping ASEAN are the buffer for great powers across Asia and the Pacific, including for Australia. ASEAN has its origins in security cooperation but its political–security community is underpinned by economic integration and community building, importantly with a focus on economic integration with its big power neighbours. Without ASEAN, Southeast Asia would revert to a fragmented, fractious group of 10 small and medium powers. A fractured ASEAN is a major threat to Australian security.

The elevation of the Quad grouping of Australia, India, Japan and the United States to a leaders’ summit brings substantial geopolitical cooperation to the Indo-Pacific theatre. Its focus on defence cooperation and the provision of regional public goods, desirably inclusive of ASEAN, provides a hedge against Chinese power. AUKUS is a significant security intervention although there is no foundation for an Indo-Pacific NATO, and the economic and security challenges Australia faces in Asia require direct and proactive engagement with our neighbours in the region, using all the instruments of regional diplomacy and arrangements that are available.
A strategy of economic engagement with Southeast Asia that will buttress and strengthen ASEAN is needed, alongside the hedge that the Quad provides, to entrench its multipolar regional order of rules, openness and stability. Australia should also prioritise an economic diplomatic effort to encourage India to engage more fully in plurilateral arrangements in the region, particularly RCEP: a growing Indian economy predicated on deeper trade and investment integration with East Asia would enhance the strategic value of its participation in the Quad.

Although Australia’s trade shares with ASEAN are less than a third of its trade shares with Northeast Asia, Southeast Asia is at the heart of the East Asian supply chains that are central to Northeast Asian productivity and prosperity. Imports from China incorporate production from Vietnam and Thailand, for example, as well as Japan, Taiwan and South Korea. As China begins to shed labour-intensive manufacturing to low-wage countries in the region, Australian exports of raw materials to Southeast Asia can be expected to grow. Australia, China and Japan’s economic futures are interdependent with Southeast Asia — barring significant unravelling of supply chains at substantial economic and political cost.

In Southeast Asia there is an intersection of economic and security risks from foreign investment, importantly in infrastructure, and exposure to international debt that is at the leading edge of its engagement with China and the rest of the world. ASEAN would be open to a cooperative agenda that helps reduce and manage that set of risks for Southeast Asian capital importers. Cooperation on regional financial safety nets in the ASEAN+3 processes can complement this effort through management of macroeconomic financial risks. Australia’s priorities for engagement with ASEAN are in the areas that help deliver prosperity and security while addressing their proximate economic-security risks. Elevating engagement with ASEAN in key economic areas has economic, political and security payoff.

A forward-leaning, proactive agenda of capacity and institution building with deep engagement in Southeast Asia will contribute to a more open and resilient region. ASEAN remains the critical shock absorber for great powers in the broader region, which complements Australia’s interests in a region with suffused economic, political and security power.

Markets are most vulnerable and susceptible to foreign interference when they are uncompetitive and poorly governed. Contestable markets raise costs of intervening in them, dilute economic leverage and thwart the exercise of market power. More competition among telecommunication suppliers, digital platforms and supply of critical minerals all reduce risks by shifting risks from societies and governments to market actors. Contestable markets constrain economic and political power. Australia has a track record of successfully building competition policy capacity in Southeast Asia through the ASEAN–Australia–New Zealand Free Trade Agreement. Still, a larger effort is needed to make economies in Australia’s region more resilient. Contestable markets also help to make supply chains more resilient, as explained later in this paper.

The next section sets out the priorities for engagement with Southeast Asia — on infrastructure, debt management and foreign investment where economic and security interests overlap — and the soft infrastructure that is needed to build multilateral rules and resilient economies: digital governance and supply chains. Engagement on the closely related issues of infrastructure investment, debt management and foreign investment will build habits of cooperation and trust that will also help with cooperation on digital governance and supply chain resilience.
7. Priorities in economic engagement with regional partners

Infrastructure investment

There are large-scale infrastructure needs across developing Asia and the Pacific Islands with high and steady potential returns for investors over long-time horizons. By some estimates, the need for infrastructure finance in the Asia Pacific is around US$1.7 trillion a year, or US$26 trillion in total, between now and 2030 — or around double the current average annual rate of investment (ADB, 2017). The large pools of capital in international markets have not found their way to these countries because they are high risk and there is no pipeline of bankable projects. Many of the problems in infrastructure investment stem from weak governance in host countries and lack of capacity to assess and regulate proposals and negotiate with investors.

The large sums of relatively cheap capital being pushed out of China in search of higher returns, with government backing in the form of the BRI, is finding its way to many countries deemed too risky for other sources of investment. Lower cost capital, with a mix of subsidies and the inability to price projects properly, are attractive to governments trying to build infrastructure to achieve development, economic and political security. The BRI has been embraced by some countries in the region, while others, like Vietnam, have remained aloof. In some countries, like Malaysia, participation in the BRI has proved to be a political flashpoint.

Chinese infrastructure finance is in theory mutually beneficial to borrower and lender alike — as the rate of growth of the Chinese economy slows, capital can flow to high-yielding projects in the region, and surplus industrial capacity in China can be put to work. Meanwhile, low-income countries in Asia gain a new source of long-term finance, one that is usually happy to leave considerable scope for host governments to define their own priorities. Long-term Chinese lending can also open up fiscal space in borrowing countries, as Chinese lenders appear less concerned about countries’ fiscal capacities (Kaplan, 2016).

The Blue Dot Network has the potential to provide a globally recognised evaluation and certification system that helps draw attention to bankable projects for private capital, mitigating economic and political risk for all parties. Engagement with the recipients can help to get more projects recognised by the Blue Dot Network. But many governments will continue to welcome Chinese infrastructure investment even with a successful Blue Dot Network.

Australia’s direct contribution to funding infrastructure investment in the region will be limited due to its relatively small economy and national investment pool. The Australian Government, and Australian private capital, cannot outspend China. Japan is a major source of capital and has its own priorities and agenda. But Australia can cooperate with Japanese government institutions and also help to shape its interventions. The support of the US Government and private sector remain important, but China is likely to become a more important player than it already is.

Australia’s strength is in its institutions, capacity to manage large-scale projects, and ability to mobilise coalitions to strengthen governance and regulatory arrangements. The most effective strategy for Australia in shaping infrastructure outcomes in terms of both quality and structure in Southeast Asia and the South Pacific will be to contribute to strengthening regimes for the scrutiny and management in the region. APEC is a natural mechanism because it is cooperative, focuses on building capacity, and allows for pathfinders or
sub-groups of members to work together and lead action rather than waiting for the whole group to join in initiatives. It would be an excellent platform for an Australian initiative with Indonesia and Vietnam.

There are three main elements in such a strategy: fostering a robust ASEAN regime for infrastructure management, building project management capacity, and developing dispute management institutions.

**Foster a collective response from ASEAN.**

The Master Plan on ASEAN Connectivity and other regional initiatives have been largely irrelevant to the region’s management of infrastructure investment. The 10 Southeast Asian nations have competed independently for foreign infrastructure funds, and sources of capital have been able to avoid dealing with the group together.

Important first steps are the framing and acceptance of agreed principles and standards for both investors and recipients, the mobilisation of a common pool of resources that can be called upon for assistance in project management, and the creation of a process that embeds experience and capacity sharing and engagement. This model could be replicated elsewhere, such as in South Asia. An initiative such as this is critical to securing the regional infrastructure investment regime on better terms. It requires major diplomatic commitment, working not only with investment recipients but investors — including China — in framing arrangements that will make a difference both for borrowers and for lenders. Australia has assets that it can bring to bear on an effort like this. For Pacific Island nations, greater use of multilateral development bank capacities and a broader regional framework to appeal to would diffuse power and capacity asymmetries.

**Build capacity for assessing, managing and bringing transparency to projects.**

Capacity for cost–benefit analyses, contract negotiation and bringing transparency to processes will mean higher-quality infrastructure projects. The capacity to manage infrastructure investment more efficiently can help to mitigate economic and security risks. Competition policy, economic intelligence and best practice regulations can also improve outcomes over time. Multilateral development banks such as the World Bank, the Asian Infrastructure Investment Bank (AIIB) and the Asian Development Bank (ADB) bring to bear resources and experience that can assist in this process.

Australia has high-quality, respected, independent policy review institutions in bodies like the Productivity Commission and Infrastructure Australia. Cooperation between Australia and partner countries in the region could involve relatively low-cost institutional capacity building mechanisms to establish or reinforce project selection processes within or outside government.

**Develop a dispute mediation and eventually a dispute settlement mechanism.**

Assisting ASEAN to develop dispute mediation and settlement processes that involve sign-on by investors will also help avoid political influence through infrastructure investment. Courts in Singapore could be arbiters for failed projects, and processes that allow renegotiation of existing agreements and avoid disputes could also be structured in.

Such measures will help partners in the region manage risks from economic engagement with China, lift infrastructure standards, bring more private capital into the region, and bring tangible benefits to Australia and its partners in shaping regional outcomes.

Failed infrastructure projects bring economic, political and geopolitical problems for recipient countries as well as investing parties. Japan is a key partner in working with ASEAN on this program of engagement. Japan has successfully led high-quality infrastructure standards through its hosting of the G7 (Ise-shima)
and later G20 (Osaka) summits, with Chinese sign-on, including changing the language and approach used at the second Belt and Road Summit. Japan is also involved in 54 joint infrastructure projects with China in Southeast Asia and other countries that are committed to Japanese (and top international) standards — not necessarily always to Australia’s benefit. These joint infrastructure projects are a way to build Chinese capacity and elevate standards, something that is of interest to both countries.

Japan has a long history of success and failure in exporting infrastructure projects. While Japan has its own interests that will not always be aligned with those of Australia, it has the weight and commonality of objectives to be an effective partner in this endeavour — as it has been already. Australia can also help shape strategy on some Chinese capital outflow as a member of the governing board of the AIIB, and bring the AIIB into play in these efforts.

Japan’s experience, and to a lesser extent that of Australia, show that there are windows and opportunities to shape and influence Chinese infrastructure investment abroad in a way that reduces economic and political risk. The People’s Bank of China (PBoC) is working with the World Bank and the IMF on a debt sustainability framework for structuring debt vehicles for infrastructure investment, as failed projects abroad like that in Sri Lanka carry significant economic and geopolitical costs. China has bought into the G20’s Common Framework on Debt Burden Relief, and is participating as a member on the first Creditor Committee (for Chad) along with France, India and Saudi Arabia, which demonstrates that the right framework can help move Beijing away from purely bilateral debt negotiations.

There are broader strategic implications of foreign lending for infrastructure investment in the region. These include the possibility of ‘debt trap diplomacy’ in which a lender might exercise power over a distressed borrower, the seizure of major assets in case of default, and the possibility that borrowing countries will exhaust their fiscal capacity to service poor-value projects, damaging future economic growth. While these concerns could arise in respect of any sovereign lender, most interest focuses on China. For some governments in the Asia Pacific, China is the main lender — this includes Laos and Cambodia, and some smaller Pacific nations like Tonga and Samoa. Some of these countries have poor fiscal outlooks; Laos in particular may well require some kind of multilateral debt restructuring and relief in the short or medium term if its fiscal situation continues to deteriorate, with public debt on track to reach 66 per cent of GDP this year.

Debt trap diplomacy and transparency

The notion of ‘debt trap diplomacy’ has become commonplace in discussions of Chinese economic influence overseas in recent years (Brautigam, 2020). But the idea has been widely contested by experts familiar with the countries in question. They argue that many of the characteristics of Chinese lending are familiar features of sovereign lending in general. Moreover, they argue, the most common narratives about ‘debt diplomacy’ — for example in Sri Lanka and Malaysia — obscure the role of poor domestic policymaking and corruption in generating excessive debt obligations.

The most commonly cited case is that of the Hambantota Port in Sri Lanka, financed largely by Chinese banks including the Exim Bank. Sri Lanka found itself in deep fiscal difficulty by 2017, and it concluded an arrangement for long-term lease of the port to the firm China Merchants Group. The US$1 billion that Sri Lanka received from the firm was used to shore up its balance of payments. Crucially, the port was not ‘seized’ — indeed Chinese lenders do not appear to have ever seized assets after default (Bräutigam, Acker and Huang, 2020). Sri Lanka’s broader debt problems were not only a result of Chinese lending: much more was owed to traditional lenders like the World Bank and the ADB. Debt service for the Hambantota loans amounted to just 5 per cent of total Sri Lanka debt repayments (Wheeler, 2020). There is a similar case in Laos, where in 2020 a Chinese firm took a controlling stake in the national power grid in a joint venture with the state-owned Électricité du Laos. Although there is some strategic risk with foreign ownership of an asset
like an electricity grid, the sale was forced on Laos by its own poor macroeconomic decisions rather than by Chinese design.

Much of the concern about debt diplomacy stems from a misunderstanding of the way in which development finance is run in China. A driving impetus behind the BRI is finding an outlet for surplus industrial capacity in China. The process of project selection generally involves requests from borrowing countries and lobbying from Chinese SOEs. This was the case, for example, for the Hambantota Port, which was a project devised by Western lenders with Chinese banks after the Global Financial Crisis when traditional sources of credit had dried up. Concerns about lenders being able to use sovereign lending as a tool, either to obtain geopolitical concessions from borrowers or to seize strategic assets, are best addressed by borrowers strengthening domestic macroeconomic policymaking to ensure a sustainable debt trajectory.

Even very low-income borrowers have policy space within which they can manoeuvre to secure better outcomes. The case of Myanmar’s Kyauk Pyu Port is instructive. There is a solid economic case for a deepwater port at Kyauk Pyu given its natural harbour, its position at the terminus of the oil pipeline to Kunming, and congestion at the Port of Chittagong. A Chinese consortium led by CITIC Group won the right to develop the port, with an initial price tag of US$7.3 billion. However, concerns over the cost of the project and Myanmar’s ability to repay the debt were widespread even within the former NLD government. Behind the scenes, the United States offered technical assistance in renegotiating the agreement down to a more manageable US$1.3 billion project, to the satisfaction of the then government.

While this outcome was on balance a good one for Myanmar — it would have struggled to service the loan if the port project did not prove as successful as the initial projections suggested — China was not happy with the US interference (Sun, 2020). Avoiding unnecessary tension with lenders like China is desirable from both a strategic and an economic perspective, since a perception that American geopolitical interests are behind the downsizing or cancellation of China-backed projects could lead to further opacity in Chinese lending, and Chinese withdrawal from the infrastructure space. There are elements within the Chinese system, such as in the PBoC, that are aware of the fiscal and reputational danger of failed projects and bad loans, and efforts should be made to engage productively. Precedents exist for fruitful cooperation, especially in Japanese efforts to engage China on infrastructure through the G7 and then the G20.

More generally, in developing Asian countries where there are domestic concerns about the capacity to service large infrastructure loans, and efforts to address concerns about debt distress or asset seizure, project selection and governance can be strengthened through regional mechanisms (see the specific recommendations above). But it is crucial that any cooperation be structured within a cooperative process that has substantial political buy-in from borrowing and lending countries in the region. The process should not be seen as targeting projects financed by any one sovereign lender, and should acknowledge China’s legitimate interest in stimulating demand for Chinese industrial capacity as Japanese and American governments before have done.

A number of existing or new initiatives could play a part in this process. The Blue Dot Network, if successful, would provide a certification process that could help overcome some of the uncertainty and information asymmetries that discourages private-sector investment in long-term lending for infrastructure in the region. The network is not itself a source of finance for infrastructure, so its success will depend on its ability to mobilise capital from the private sector or from traditional bilateral or multilateral lenders. Bilateral initiatives like the US Infrastructure Transaction Assistance Network and Australia’s Southeast Asia Economic Governance and Infrastructure Facility could potentially feed into a broader framework of regional technical cooperation on infrastructure governance. It is important, however, that regional partners can take ownership of the process — to some extent on a national level but also through ASEAN.
Box 7: Chinese lending and debt governance in the multilateral system

Recently a major study of Chinese-financed projects around the world argued that Chinese loans tend to be more opaque, and involve novel requirements not present in most full-recourse sovereign lending (Gelpern et al., 2021). For example, a significant minority of the Chinese loan contracts studied required repayment from special accounts funded either by the revenue from the project being funded or from other hypothecated sources. The authors also found that confidentiality clauses in Chinese loan contracts go well beyond the terms in similar contracts from other lenders. A potential point of economic leverage that could be used for strategic purposes is the ‘no Paris Club’ clauses contained in around 75 per cent of the Chinese loans studied by the authors. Because debt relief from traditional lenders usually requires comprehensive restructuring, China can effectively block multilateral debt relief to countries to which it lends. Even when it does not block other lenders from offering relief, lack of transparency may help China to effectively free ride on other lenders.

Confidentiality clauses that restrict borrowers from revealing terms of — or even the existence of — loans can impose externalities on other sovereign lenders. For example, in the case of special repayment accounts from hypothecated income sources, if these arrangements are not known to other potential creditors, the sustainability of a country’s entire portfolio of debt can be exaggerated. This could discourage sovereign lending to countries known to have contracted debts with lenders that have historically imposed such conditions, even if the debts in question do not contain such clauses. This could in turn lead to borrowing countries depending heavily on a single source of sovereign finance to fund infrastructure, which may provide the kind of environment in which ‘debt diplomacy’ would be effective, as lenders could impose strategic conditions on restructuring or relief.

Nonetheless, the reason we know so much about Chinese loans is because the authors of the report were able to access all of Cameroon’s sovereign debt contracts (thus making a comparison of Chinese with non-Chinese lenders possible). Cameroonian law mandates the publication of these contracts, thus limiting the ability of lenders to impose confidentiality on the borrowing country. This points to an important feature of engagement with China: many of the potential risks of engagement can be properly mitigated by strengthening domestic law and institutions, rather than foregoing borrowing altogether. Capacity building in borrowing countries could include help with devising legal frameworks that maximise transparency around sovereign borrowing while maintaining a conducive environment towards foreign investment in infrastructure.

More broadly, the dynamics of lending in the region — particularly in the wake of COVID-19, when fiscal space will be constrained into the future in many emerging markets — suggest that a sovereign lending framework that embeds China fully within the restructuring process is necessary. Until now, the most important such framework has been the Paris Club. But its membership is largely limited to European and North American lenders, along with Japan, South Korea and Israel. Since these countries have historically provided the lion’s share of finance to developing economies, this geographical narrowness was not a problem. But with the growth of lending from China — which is not a member of the Paris Club — as a sovereign lender, a new paradigm is required. The G20’s Common Framework could potentially be strengthened progressively to provide such a framework. The Common Framework emerged from the Debt Service Suspension Initiative, a temporary agreement in the context of COVID-19 that offered relief to low-income countries.
The Common Framework establishes a mechanism for creditor committees for countries in distress. So far three countries, all African, have entered into negotiations under the Common Framework: Zambia, Ethiopia and Chad. A committee for Chad has already been formed, with China joining France, India and Saudi Arabia. Political instability and conflict in Chad and Ethiopia may make the work of the creditor committees difficult. It is too early to tell whether these proceedings will provide the confidence that countries like China (and other new sovereign lenders like Saudi Arabia) will need to commit to a durable new framework for debt restructuring. However, the participation of China on Chad’s creditor committee is at least a demonstration that China is willing to participate in multilateral processes around these issues if it is given a say in the rules of the game.

Another possibility might be to build a framework that embodies these principles in the region, through ASEAN or the ASEAN Plus frameworks, using APEC processes as a vehicle for dialogue, developing options and building consensus for action, even among critical pathfinders.

Foreign investment regulation and national security

Around most of the world, COVID-19 has led to the introduction of new restrictions on foreign investment. In Asia, on the other hand, the need to encourage strong economic growth has led some countries to somewhat liberalise laws governing foreign investment over the past several years. Vietnam moved to a new policy framework in 2019, Indonesia’s Omnibus Law was approved in February 2021, and Malaysia and the Philippines are both contemplating substantive liberalisation to encourage long-run economic growth. In common with some other developed countries, including Australia, Japan has chosen to introduce new restrictions on foreign investment. The scope for liberalisation around the region is considerable — in the latest ASEAN FDI Regulatory Restrictions Database (OECD, 2018), 27 sectors across the ASEAN member countries were scored at 0.5 or above (where 1 is the most restrictive measures possible), mostly service sectors such as finance, legal, media and electricity.

The 2019 reform of Vietnam’s foreign investment environment (Politburo Resolution 50/NQ-TW) moves the regime to a negative list approach. The new legal framework also contained provisions for explicit national security screening; the government reserves the right to suspend a foreign investment activity if it is deemed to pose a national security risk to Vietnam. Indonesia’s Omnibus Law substantially lowered barriers to foreign investment in the Indonesian economy, moving away from piecemeal sectoral regulation to a more coherent policy framework. The law represents a partial reversal of a recent swing towards a policy focus on swasembada, or self-sufficiency, that has resulted in the introduction of protectionist measures — though in many areas Indonesia’s policy stance remains inward-looking. No specific institutional mechanism exists for screening foreign direct investment (FDI) for national security concerns in Indonesia, with the framework relying solely on blanket restrictions in sensitive sectors. That said, the Omnibus Law brought liberalisation to some sectors that have sometimes been the subject of security-related concerns, with restrictions removed on foreign investment in the telecommunications and healthcare sectors.

Japan’s changes have mostly been in the direction of further restrictions on FDI. It has made significant changes to its investment regime with the Foreign Exchange and Foreign Trade Act, including lowering the threshold for prior notification in sensitive sectors from 10 per cent of equity to 1 per cent. The criteria for including companies on the list for prior notification have been criticised for being vague and non-transparent.
More generally in the region, processes that facilitate the assessment of the national security implications of foreign investment lack transparency, and this opacity may deter investors unnecessarily. For example, in Malaysia, approval for industrial projects above a certain threshold must obtain approval from the Malaysian Industrial Development Authority. However, the Authority does not independently carry out assessments of projects, but relies on various ministries' input into final decisions. This fragmented process does in theory allow for questions of national security to be addressed at the approval stage, but it is unclear how effective this process is in practice. The opacity of the process is also likely to contribute to investor uncertainty. Regulatory reform with the objective of clarifying procedures and the criteria by which investments are assessed for national security implications would improve confidence in the system for both investors and the electorate.

The WTO's plurilateral agreement on investment facilitation helps countries improve investment environments, and the CPTPP and RCEP agreements help to further liberalise regimes and bring some coherence between countries in the region. But without multilateral rules for foreign investment, the patchwork of bilateral and regional agreements with security exemptions will continue to result in considerably different regimes across countries. The lack of confidence in managing security risks from foreign investment will mean many countries are deprived of the economic and social infrastructure important for their prosperity and social cohesion (de Brouwer, 2021). An incremental, risk-based approach that helps mitigate the social, economic and security risks from foreign investment can mean the benefits of foreign investment can be reapplied instead of forgone. Australia and Japan are yet to confidently settle on the right balance in navigating the risks from foreign investment within the context of United States–China strategic competition. It is a shared challenge with regional partners that suggests experience sharing and cooperation through forums such as APEC and RCEP will be able to help build capacity.

**Data governance and the digital economy**

Digital transactions are now a major element in the international economy, and the pervasiveness of digitalisation presents special challenges in navigating the nexus between economic and security objectives (PECC, 2021). One issue is about the accessibility of digital information and how to secure it against cyber crime. Another is the development of a regulatory regime appropriate for managing the social, political and economic issues raised by the expansion of digital transactions across borders. Some of the solutions to these problems are technical, while others require institutional and regulatory development where it is presently insufficient or absent.

Multilateral rules and norms do not exist for the global digital economy. Bilateral, regional and some plurilateral agreements complement a cacophony of different rules by different governments. These different approaches, and the global governance deficit, risk a globally divided digital economy where risks from engagement dominate potential productivity and innovation benefits. The new technologies present new challenges, but the same principles as those applied to other forms of international exchange still apply in the digital area too. Increased international interdependence with contestable markets backed by strong multilateral rules and norms can increase the costs to malign action, both with high costs imposed by the international market and through enforceable rules. Technology may provide asymmetric leverage, but technology is also increasing the supply of alternatives.

Digitalisation has been at the centre of economic and social change for several decades, transforming trade, development and security. The digital economy’s rise has been enabled by the near-zero costs of transmitting data, and the network externalities and economies of scale that reward big platforms. These same characteristics exacerbate economic and security risks, notably by creating natural monopolies and constricting competition, as well as by creating the opportunity for the misuse of sensitive data.
The processing of data is likely to be the largest source of value-added in the future economy (Tirole, 2017). Six of the world’s seven largest companies by market capitalisation are ‘two-sided platforms’\(^3\). In such platforms, the company’s main service is an intermediary that processes and transmits information between buyers — such as social media users, credit card holders or gamers — and sellers, such as advertisers, app developers or merchants.

Network externalities are widespread and they can result in markets dominated by a few major players. In social media, for example, friends need to be on the same platform to interact with each other. More users enable better services, such as more accurate search engine results. For two-sided platforms, prices on the ‘buyer side’ of the market may be very low or zero, because sellers place a high value on the buyers’ aggregated data.

Who owns data? The difficulty in answering this question in practice raises issues for economic welfare and security. It can be difficult to separate data, which an individual provides, from the assembly and processing of data, which a company provides. Consumers may offer formal consent, but data can be aggregated and repackaged in new ways that change its meaning or utility. The proliferation of personal data has had a transformative impact on security. Surveillance, for example, has been marked by deeper integration of state and commercial actors who share incentives to gather and aggregate large volumes of fragmented data (Lyon, 2014).

Issues of market concentration in the digital economy have analogues in national power, described by Farrell and Newman (2019) as panopticon effects. States with physical access to, or jurisdiction over, key hubs in a network may be able to use their influence or authority to extract information passing through that network. If the hubs are critical to international communication, it can be costly or impracticable for other actors to avoid them. Examples of this effect include the use of SWIFT financial transactions data to track terrorist financing or to impose economic sanctions, and the concentration of global e-commerce and network hubs in the United States facilitating the PRISM surveillance program (Farrell and Newman, 2019).

When institutions governing data flows are underdeveloped, governments face a hard choice: expose themselves to security risks, or ‘decouple’ and disengage from digital commerce. The case of the United States and TikTok, discussed below, illustrates this problem. Predictable, well-enforced domestic rules complemented by a competitive international environment help countries reach solutions between these two extremes.

---

3 Apple, Microsoft, Amazon, Alphabet (Google), Facebook and Tencent. The other is Saudi Aramco (PWC, 2021).
Box 8: Data dilemmas — TikTok in the United States

TikTok, a platform for making and sharing short-form videos, was the Apple Store's second-most popular app of 2020 behind Zoom. The platform has raised data security concerns in the United States since 2017, when its previous incarnation, Musical.ly, was acquired by Chinese firm ByteDance.

TikTok's transparency reports maintain that it does not share data with state actors. But without institutional mechanisms to verify these claims independently, the company has been unable to assuage US lawmakers' concerns. The Trump administration therefore proposed banning the app. In June 2021, following multiple legal challenges, the Biden administration wound back the proposal and ordered a review of security concerns posed by foreign adversaries accessing US personal data.

Bans and divestment orders, though they may be justified in some cases, can set precedents for arbitrary state intervention, reduce investment, needlessly interfere with consumer preference, and impede supply chains. There is also a risk that banning technology companies from one country on broad national security grounds descends into 'whack-a-mole', where new, similarly risky products pop up in the banned provider's place. One approach for avoiding this risk is to develop country-agnostic standards for companies' access to and storage of data, and invest in stricter compliance processes with regular audits against these standards (Sacks, 2020).

If TikTok cannot negotiate a plan addressing US concerns, and is banned or has its operations restricted, what happens next is shaped by international rules. Standards like those espoused in the CPTPP and other agreements raise the bar for countries' protection of personal data. As a result, they make it easier for an international competitor with more agreeable data practices to replace TikTok in the US market. Similarly, more competition would raise the pressure on companies like TikTok to demonstrate and invest in their data governance credentials. These benefits of competition are strongest under a multilateral arrangement.

Were the United States to increasingly cut off data flows to specific countries in a unilateral fashion, it would raise another set of economic-security risks. These include being seen to prove the need for data localisation requirements and other measures limiting data flows (Reinsch et al., 2020). Third countries would be encouraged to follow suit, taking an approach more like that of China than the open cyberspace the United States has historically espoused. This would corrode the United States’ economic advantage in digital technology, as well as a key source of national power — with its unique concentration of digital commerce and communication nodes.

Much of the digital economy concerns public goods, making barriers to digital trade particularly detrimental to growth and welfare. The collection and analysis of large health datasets, for example, will allow the development of more precise diagnoses and cheaper treatments. Strong domestic institutions and consistent international frameworks offer middle ways between taking on unacceptable security risks and decoupling from digital trade by default.

Effective risk mitigation requires comprehensive domestic enforcement of strong laws punishing cyber attacks; defining digital property rights, including of data about people; and protecting privacy. Market structure is also important. The more participants and the more diverse the structure of the market, the lower the risk associated with any one firm. With a competitive market that does not have prohibitive switching costs, platforms or companies that breach the trust of consumers or regulators will lose market
share quickly given the network effects. Policies that encourage innovation and the creation of new firms, along with policies and laws to protect market contestability, help mitigate security risks and improve economic outcomes (de Brouwer, 2019).

Internationally, progress on rules governing the digital economy is complicated by the diversity of political systems and interests at play. There are system differences between countries — diversity in systems of government, economic structures, digital maturity and readiness, approaches to data privacy and ownership, governance regimes, and attitudes to international trade and investment. So far, this has led to the patchwork of bilateral, regional and plurilateral agreements covering various dimensions of digital trade.

Middle powers like Australia can lead the creation of solutions to fragmentation of the international digital economy. Geopolitics is contributing to a digitally divided global economy with strategic rivalry between China and the United States leading to attempts at digital decoupling. Japan has led in the creation of multilateral principles for governing the digital economy in the G20, and is a natural partner for Australia in the region and globally in taking the lead in finding creative and inclusive solutions to foster an open and secure international digital economy (Armstrong et al., 2021).

The 2022 G20 summit, with host Indonesia elevating the digital economy to a working group, provides a critical opportunity to shape future multilateral rules and standards. The G20’s broad membership of large and middle powers with diverse interests in respect of data governance makes it ideally placed to define points of difference and scope out potential solutions. The Data Free Flow with Trust concept, introduced by Japan as host in 2019, provides a foundation for dialogue.

Work towards a multilateral digital economy framework could take the form of an open-accession agreement of a few regional economies, including Australia, coupled with capacity-building initiatives for countries who are willing but not yet ready to join. Such a framework could draw in part on formal provisions in the CPTPP, the development of discussion within an APEC framework, and build on G20 discussions and WTO e-commerce negotiations.

The CPTPP is perhaps the most advanced plurilateral agreement in force on digital trade, with commitments to not impose localisation requirements and on personal data protection. Countries as diverse as China, Indonesia, the Philippines, South Korea, Taiwan, Thailand and the United Kingdom have signalled a wish to join the CPTPP. Some do not yet have policy frameworks that are compatible with the CPTPP’s e-commerce standards. For countries like Australia and Japan, this presents an opportunity to seek potential concessions from countries with different systems and interests. Bundling various commitments or reforms together may offer ways forward. The Australia–Singapore Digital Economy Agreement is perhaps the most advanced bilateral agreement with scope for expansion of membership.

APEC has a unique role to play in mobilising governments, technical experts and business to promote economic cooperation on digital trade facilitation, and progress on a multilateral framework. An economic cooperation process needs to involve multiple stakeholders — including governments, big tech companies, small and medium-sized companies, entrepreneurs, investors, workers, consumers and technological experts. These groups can be mobilised in existing cooperation frameworks within APEC.

Mitigating risks within the international digital economy is a top priority. A multilateral digital economy framework that serves that objective, while promoting digital trade growth, would allow governments to set their own policies. They could also retain sovereignty under multilateral rules that limit discrimination, promote transparency and predictability, and constrain governments from protectionist policies. Common rules and standards would be guided by multilateral principles — avoiding a lowest common denominator approach — by building trust across different sovereign systems through technical and economic cooperation (Armstrong et al., 2021).
Supply chain resilience

Specialisation in international supply chains has enhanced efficiency in the global economy, reducing production costs and lifting incomes. The pandemic exposed the vulnerability of supply chains with initial disruptions to supply of personal protective equipment and medical supplies as Chinese factories and suppliers went into lockdown. The outbreak of COVID-19 was a reminder of how interconnected economies are as the adverse economic — not only health — impacts from China spread rapidly to many countries through the disruption of supply chains.

Disruptions to semiconductor production, a shipping blockage in the Suez Canal, and other disruptions along supply chain bottlenecks have been shown to have profound effects on complex supply networks downstream. They affect access to parts, components and inputs to strategically important production, as well as health and economic outcomes.

The fragmentation of production along cross-border supply chains has brought significant opportunities to countries to participate in production, lower costs of production, and spread risk for production generally. However, the scale of the complex supply chains has increased systemic risk. Different countries have tried various policy responses to the uncertainty around stability of supply, leading many to introduce policies that seek retreat from supply chains and to onshore production.

In response to supply disruptions from China and concerns about being caught in US–China decoupling, Japan introduced subsidies that became known as ‘China exit’ subsidies. In 2020, the Japanese government allocated ¥220 billion (roughly US$2 billion) to promote domestic investment by relocating overseas production bases back to Japan, or reshoring. It also allocated ¥23.5 billion (roughly US$200 million) for Japanese firms to move or establish their production bases in Southeast Asia and South Asia. The subsidies were oversubscribed by companies and the program expanded. The policies failed to reduce Japanese dependence on Chinese supply chains. Due to rising Chinese wages, Japanese companies were already in the process of relocating some assembly and simple manufacturing production out of China to lower cost destinations in South and Southeast Asia. Some Japanese companies based in the United States returned to Japan. Meanwhile, Japanese foreign investment to China grew by US$11.3 billion in 2020 and US$2.4 billion in the first quarter of 2021. At the end of 2020, the stock of Japanese investment in China was US$143.5 billion.

The onshoring of production has visibility and political appeal. But it can also concentrate risk and raise costs. Supply chains that are concentrated onshore are more vulnerable to other kinds of shocks. A natural disaster or home-grown crisis can wipe out whole industries — as did Japan’s Great Tohoku earthquake in 2011. The best insurance against disaster, flood, drought or crop failure in one part of the world is openness to supply from producers all around the world. The key is to manage supply chain risk. Companies diversify risk by spreading investments, procurement and production across different locations.

The OECD (2021) has calculated the costs and benefits of a general global retreat from cross-border supply chains, and found that onshoring production would make Australia substantially poorer (reducing GDP by around 9 per cent) and also increase the volatility of GDP. For some countries like Korea and those in Southeast Asia, there is a very unattractive trade-off in a retreat from supply chains between volatility of income and levels of income. For Australia and Japan, onshoring leads to both lower incomes and higher volatility from increased exposure to shocks. Intervening in supply chains has unintended consequences from concentrating risk and crowding out private investment in risk management.

Manufacturing COVID-19 vaccines in Australia may be commercially and economically viable, but it will not eliminate supply chain risk. All the major vaccines require inputs from complex supply chains that involve dozens of companies in over 100 locations globally (Bown, 2021).
Just as no simple intervention in supply chains will make them more resilient, their dispersed and decentralised nature thwarts their control for economic or political leverage. Supply chain exposure to China or any country that uses economic tools for political or security leverage is a double-edged sword. Supply chains shift rapidly in response to disruptions. An example is Japan’s export restrictions on critical technology to South Korea (see Box 9). China’s restrictions of critical mineral exports to Japan reveals the limits of leverage from such interventions. Supply chains rapidly adjust to market shocks, some with higher costs of adjustment than others. These responses in the market deserve detailed and thorough analysis but without presumption that complex supply chains increase risk. International rules can minimise those disruptions and costs.

Box 9: Japan’s use of critical technology export controls against South Korea

Since 2019, Japan has begun to deploy economic security policies that have included restrictions on foreign investment, export controls and ‘China-exit’ subsidies for supply chains — a departure from earlier ideas of economic security that meant securing supply of strategic raw materials, energy and food on the international market. These new economic security policies and arrangements include export controls over advanced technologies that could end up in a country or actor under sanctions from Japan or the United States, or that might be used to undermine Japan’s security (Armstrong and Urata, 2021). There is a concern that critical technology might end up in North Korea or in the Chinese military. There are also fears of being caught in US–China technological competition and decoupling.

Japan introduced export controls on three high-tech materials to South Korea in July 2019 immediately after the Osaka G20 summit, and then in August removed South Korea from its ‘white list’ of preferred countries to which it can export those high-tech materials without licencing for fear that their end uses were not being adequately monitored and may have ended up in China or North Korea (METI, 2019). This placed a new and additional burden on South Korean firms that rely on imports of those materials. It introduced significant uncertainty for South Korean multinationals, including about whether they could secure credit in Japan, and uncertainty for smaller South Korean firms as to whether they could navigate the new licencing requirements without import disruptions.

The commercial, economic and security implications of these export restrictions were material. The tightened export controls affected three high-tech materials — fluorinated polyimide, photoresist and hydrogen fluoride which are key inputs for the South Korean production of semiconductors; memory chips (of which it is the largest producer in the world); and LCD and OLED displays. Japan is the major supplier to South Korea of these materials, and accounted for 94 per cent of South Korean imports of fluorinated polyimide, 92 per cent of photoresist imports and 44 per cent of hydrogen fluoride imports (Zafar, 2019). These shares have all fallen significantly.

The tightening of export controls was heavily politised. The timing of the export restrictions tied it to the South Korean Supreme Court decision allowing the seizure of Japanese company assets to compensate victims of the Japanese occupation of South Korea during World War II. That ruling was

---

4 There is the memory of Toshiba being fined for sales to the Soviet Union in the early 1980s for violation of the US Coordinating Committee for Multilateral Export Controls.

5 The export controls were considered alongside other measures by the House of Representatives Committee on Financial Affairs. Other measures included blocking South Korean participation in the Trans-Pacific Partnership, tightening border controls on visas for South Koreans and import tariffs on South Korean goods, and the foreclosure of South Korean companies in Japan (House of Representatives, Japan, 2019).
contrary to the 1965 treaty between Japan and South Korea. The timing and politicisation of the export controls has led to the trade dispute being labelled an economic or trade war that relates to history, economic competition, regional rivalry, disputed territory and existing political tension. Former prime minister Shinzo Abe is said to have asked for a way to retaliate against South Korea, and Ministry of Economy, Trade and Industry (METI) -linked officials close to Abe in the Prime Minister's Office advised the restriction of exports of these key chemicals. One motivation for METI is said to have been to weaken South Korea's dominance of the downstream LCD and memory chip industries.

The tightening of Japanese export controls has affected South Korean imports of the materials, the commercial fortunes of the Japanese exporters, and the international market for those materials — but the effect on South Korea's downstream industries was short lived.

Korean imports of hydrogen fluoride — used in semiconductor production — from Japan fell sharply from US$66.85 million in 2018 to $9.37 million in 2020. Japan's share in Korean imports fell from 44 per cent to 13 per cent. Korean imports of photoresist from Japan increased 22 per cent in 2020 and dependence on Japan is at roughly 80 per cent. There has been some substitution away from polyimide fluoride for some Korean smartphone products, but Japanese export data to South Korea show a 15 per cent increase to US$44.3 million in the first half of 2021.

Japanese firms have been trying to maintain their sales in Korea, which is their most important market. Several Japanese firms set up plants in Korea. Exports of hydrogen fluoride by Japanese-affiliated firms like Stella Chemifa and Morita Chemical Industries were replaced by local production and sales in Korea by Korean firms Seoul Brain and SK Materials Co. Japanese firm JSR began exporting photoresist from their joint-venture company in Belgium instead of from Japan.

There is now an active policy of support from the Korean government to produce these materials in-country and reduce dependence on Japan. The risk of supply-chain disruption from Japan has led to Samsung, LG and Korean government subsidiaries investing in R&D to replace Japanese production of a range of key inputs, such as coater/developers and etchers that are key to semiconductor manufacturing.

South Korea initiated a case against Japan at the WTO (WTO, 2020a). There are also broader strategic and geopolitical ramifications, with Japan–South Korean political and security cooperation deteriorating, and intelligence sharing agreements between them cancelled and those with the United States being put at risk.

Japan still dominates international production of these materials, but its actions have accelerated the development of the industry in South Korea and shifted some of Japan's production offshore — among other places to South Korea.

Japan has undermined the primary technical justification for the export controls — that South Korea lacked the capacity to monitor or control exports of those materials and stop them from reaching North Korea or China — as Japan now has less ability to monitor the end users of the materials. In hindsight, the Japanese government could have taken a risk-based and iterative approach by using diplomacy to work with the South Korean government to jointly address capacity and governance concerns. The politicisation of the issue helped to increase uncertainty in the trade of those materials between Japan and South Korea, with spillover effects on other sectors in the bilateral trade and economic relationship as well as security relations.
Diversifying supply across the global system where there are differences in climate, technology, costs and endowments makes supply chains more resilient. Decisions to locate or relocate production are usually best driven by private companies that already diversify and mitigate risk. China will continue to be at the centre of Asian supply chains for the reasons that made it the ‘factory of the world’, and regional and plurilateral cooperation in standards and regulation can reduce supply chain vulnerability.

Comprehensive supply chain resilience requires a multilayered approach. Complex supply chains have driven complex international interconnectedness and interdependence and require international cooperation to make them more resilient. To reduce supply chain vulnerability, governments must commit to avoiding tariffs and export controls and facilitate the digital infrastructure that helps manage supply chain risk. Openness to FDI will help businesses diversify risk. International and regional banks need to allocate more capital to small- and medium-sized enterprises while also supporting programs designed to upskill the labour force in those firms. Developing digital infrastructure and creating international regulatory coherence in digital trade protocols will enhance visibility across supply chains beyond immediate tier one suppliers and help identify vulnerabilities. Regional data privacy standards, tax and other incentives to share data will encourage the use of digital supply networks.

Incentives and regulatory coherence can bring visibility across supply chains and help with identifying bottlenecks, choke points and security risks. Proportionate and risk-based approaches to managing risks can help avoid costly unintended consequences.

Improved supply chain resilience in Southeast Asia will strengthen their economies. Keeping markets open and contestable in Southeast Asia can be assisted through building capacity through economic cooperation frameworks like APEC and in RCEP. Australia’s successful program for technical cooperation and capacity building in competition policy in the ASEAN-Australia-New Zealand Free Trade Agreement is a model that can be expanded for deeper cooperation in ASEAN.
Conclusion

Australia has so far weathered the storm of Chinese economic coercion well thanks to its economic resilience. That resilience comes from the strength of domestic institutions and flexible, open international markets. The multilateral trade system with its history of working rules and cooperation — the open international rules-based economic order — helped to cushion the blow by securing access to alternative new export markets. Realists recognise that closing the economy, even to China, will significantly damage Australia’s long-term prosperity and undermine security.

The multilateral trading system and the WTO — however weakened it is — is at the centre of this international rules-based order and the rules and principle of equal, or most-favoured nation treatment help to protect against the use of economic and political power. It is the external dimension of Australia’s economic resilience. For Australia and other small and medium powers, the multilateral trading system — and the rules that underpin it is critical to maintaining strategic policy space and sovereignty.

A primary objective of national security policy must be to maintain and strengthen the multilateral institutions that give this protection and allow Australia to grow economic strength essential to underpinning military and other aspects of national security. The full range of regional and international cooperation venues — notably APEC, the G20, and the new cooperation plank in RCEP — can be mobilised to this end.

If the United States and China can be persuaded of the direct benefits to them of an improved regime, including in China’s case the acceptance, for example, of the strictures of CPTPP, that will enmesh both in an environment of stability and peaceful enterprise while strategic competition plays out.

While Australia has suffered some fallout from Chinese sanctions and may suffer more, they are a direct example of how such moves can be deflected by the trade regime that is already in place now.

Chinese restriction of rare earth exports — critical minerals — to Japan induced an international supply response and was checked by WTO rules. Japanese export restrictions of critical technologies to South Korea have backfired due to the response in international markets. Supply chains are generally too complex and multinational to be easily leveraged for national advantage.

A major problem faced in Australian policymaking is the zero sum approach of assuming that national security improvement must inevitably be at an economic cost. This is not so. National security policy should embrace an improved regime for global trade growth that builds Australia’s national security strength.

The world’s geopolitical, economic and security fault lines are in Asia, at the centre of the Indo-Pacific region. Southeast Asia and its organising grouping ASEAN are the buffer for dealing with the great powers in Asia and the Pacific, including for Australia. Both superpowers need the cooperation of ASEAN. ASEAN complements Australia’s interests in a region with suffused economic, political and security power. A fractured ASEAN would be a major threat to Australian security. Australia must support a coherent liberal market-oriented economic growth strategy for ASEAN that remains a key economic and security frontline for Australia.

Keeping the United States locked into the region and the global regime is the other strategic priority. To this end Australia needs direct and proactive engagement with neighbours in the region, using all the instruments of regional diplomacy and arrangements that are available. The elevation of the Quad grouping of Australia, India, Japan and the United States to a leaders’ summit brings substantial geopolitical cooperation to the Indo-Pacific security theatre. Encouraging India to rejoin economic cooperation efforts like RCEP would increase the Quad’s value as a strategic hedge by deepening cooperation between the Quad members and ASEAN.
AUKUS is a major security initiative that elevates the importance and urgency of deep economic and political engagement with Southeast Asia.

The economic and security challenges that Australia faces in Asia require a strategy of economic engagement with Southeast Asia that will buttress and strengthen ASEAN and is a critical complement to the political hedge that the Quad provides, to entrench its multipolar regional order of rules, openness and stability.

The key areas of engagement with ASEAN should be those that help deliver prosperity and security while addressing proximate economic-security risks. Elevating engagement with ASEAN in their management of infrastructure investment, avoiding debt traps and maintaining openness to investment, supply chain proliferation and developing their digital economy governance has economic, political and security payoff.

That is an agenda that the United States has a deep interest in actively supporting, one that aligns with Southeast Asia's economic development imperative while not being anti-China.

While engaging ASEAN for its own value to Australian national economic and security interests, the larger strategic priority must be to enmesh China in markets and new rules. An active program of cooperation with the United States and engagement with China to address the challenge of climate change will reinforce multilateral approaches.

Multilateral system preservation and the updating of the rules requires the active participation and leadership of emerging market economies that are now half of the global economy. Indonesia's presidency of the G20 is a strategic opportunity for setting the direction for digital economy rules and WTO reform, including reviving its dispute settlement system. India and Brazil follow Indonesia's G20 presidency and setting the direction of the developing countries' leadership is key. Thailand and then the United States hosting of APEC, and Australia's continued participation on the sidelines of the G7 can help steer the global economy towards stronger rules and equal treatment.

The development of new rules and equal treatment under those rules is what the United States and United Kingdom led in the wake of World War II. The transition to a multipolar world now involves more countries with large stakes in the system. The vexed issues of global governance reform are fraught and progress will be slow, but they are the top strategic priority that should focus and guide all of Australia's international policy efforts.
References


Appendix: The security foundations of the postwar order

The origins of the global economic order lie in World War II itself, and ultimately when the Allied powers came together in 1944 at Bretton Woods (Drysdale, King and Triggs, 2021). Their goal was to put in place a new system of internationally-shared ideas, norms, and practices — an order — that could stem the trade protectionism, currency wars and economic deprivation that had characterised the world economy throughout the 1920s and 1930s. The main elements of the global economic order today were forged in the middle of world war. Economic and security challenges were tightly enmeshed in the thinking that led to its creation. The Great Depression and the unchecked economic competition of the 1920s and 1930s had helped to fuel the national rivalries that propelled states into military conflagration. The principles upon which the postwar order was structured sought to avoid the fundamental causes of insecurity and conflict at the same time as achieve more widely shared prosperity.

The three institutional features of the Bretton Woods system, features still recognisable today, were: two new multilateral institutions — the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD, or the World Bank) — and the General Agreement on Tariffs and Trade (out of which the World Trade Organization was later formed). Three ideas defined these institutions and their role: the idea of development; the idea of ‘embedded liberalism’; and the idea of ‘multilateralism’. These rules for economic exchange and institutions for economic cooperation were as much about political security as they were economic security.

The military crisis of World War II provided impetus for global cooperation to institutionalise the foundational ideas of the postwar order. In the United States and Britain, in particular, leading thinkers articulated the relationship between the economic drivers of inter-state conflict and their view that a liberal international economic system would provide the best security foundations for a lasting postwar peace. A combination of US material power, and the ideas and wartime economic plans of American and British officials, provided the foundation around which other Allied nations had the opportunity to make their distinctive input, and the new postwar international order was shaped.

The creation of the new world order was heavily contested despite the overwhelming hegemony of American power. It also evolved in ways that compromised some of its core aspirations. It was intended to be a genuinely global order, led by the four leading Allied powers — the United States, Soviet Union, Great Britain and the Republic of China — whose role was embedded into the architecture of the United Nations framework and its Security Council. But the growth of tensions between the United States and the Soviet Union in the last stages of World War II, and the onset of the Cold War in Europe and East Asia, fundamentally frustrated the global character of the Bretton Woods economic order. The onset of the Cold War, security tensions and the bipolar alliance framework that grew around it, skewed the global practice of international economic relations. During the Cold War, the world was bifurcated into the Western and Eastern blocs. The Western bloc, with its economic foundations built on Bretton Woods multilateralism, sped economic recovery in Europe, opened opportunity for the transformation of the East Asian economy and, three or four decades later, came to dominate global trade and economic power.
Economic and security logics coalesced into the conception of the Bretton Woods order, in an understanding that global economic integration and national security were intimately linked. The prosperity that comes from international trade, investment and commerce not only provides governments with the funding for social and military spending that bolsters national security. It also provides a peace dividend by making conflict more expensive and diplomacy a more effective means for resolving conflict. Economic ties between businesses and households across countries impel governments to expand their cooperation with one another and build people-to-people connections, improving understanding and awareness of different societies and cultures. The multilateral principles around which these institutions were organised balanced off the risks stemming from power asymmetries in international trade and economic relations. Discrimination became more costly, lowering the risks of trade disputes and the spiralling protectionism of the interwar years.
Authors

Shiro Armstrong is an Associate Professor of economics at the Crawford School of Public Policy in the College of Asia and the Pacific at The Australian National University. He is Director of the Australia-Japan Research Centre, Editor of the East Asia Forum, and Director of the East Asian Bureau of Economic Research.

Gordon de Brouwer is Professor of economics at the Research School of Economics in the College of Business and Economics and the Crawford School of Public Policy in the College of Asia and the Research the Pacific at The Australian National University. He is former Secretary of the Department of the Environment and Energy.

Peter Drysdale is Emeritus Professor of Economics and the Head of the East Asian Bureau of Economic Research and East Asia Forum at the Crawford School of Public Policy at The Australian National University.

Tom Westland is a Research Fellow in the Crawford School of Public Policy in the College of Asia and the Pacific at The Australian National University and is Research Director of the East Asian Bureau of Economic Research.