THE UNIVERSITY of ADELAIDE

**POLICY BRIEF 17**
ADAMS, WICKES & BROWN
JULY 2022

# Australia's response to Chinese economic coercion: towards a comprehensive strategic approach to export diversification

Institute for International Trade

## Executive Summary

**The policy challenge:** On a range of measures, Australia's merchandise exports have become more concentrated on China since 2000. Increasing geographical concentration reflects China's growing economic weight, opportunities created by its heavy industrial phase of development, and its emergence as the epicentre of growth in global manufacturing. Increasing product concentration across the range of Australian goods exports reflects our growing pre-eminence in minerals and energy and, to a lesser extent, rural products. This is not just an iron ore story about China: it applies to all our major commodity exports to the rest of the world.[1]

Over the last few years, an increasingly uncertain and difficult international environment, dominated by growing US-China rivalry, has accompanied escalating mistrust between Australia and China - a fact intensified by China blocking or limiting key Australian exports over the past two years. Mistrust has fuelled a debate in Australia on whether we are too dependent on the Chinese market and therefore overly vulnerable to disruptions to trade. It also has led to active government facilitation in diversifying export trade: the aim is to maintain trade with China while developing other markets.

**The policy response:** Australia's actions to date have reduced the cost of Chinese coercion to Australian business, though significant costs continue to be incurred for some products. But these actions do not address the long-term nature of market and product concentration of exports, or necessarily equip Australian businesses to deal with the many elements of an increasingly uncertain world.

This policy brief draws on historical and conceptual perspectives to make the case that the current China-focused debate in Australia on diversifying merchandise exports substantially misses the point on diversification both in terms of products and, to some extent, geography. Successful export diversification must involve productivity raising long-term economic reform and working with others to keep regional and global trade as open as possible.

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## Introduction: Economic coercion and export diversification

In 2020, China started to target selected Australian commodity exports that accounted for 13 per cent of China's merchandise imports from Australia in 2019, the year before bilateral relations began to deteriorate rapidly.[2]

Developed in its modern form in the inter-war period, the aim of economic coercion is straightforward. It is typically undertaken by larger countries pursuing their strategic objectives by damaging, or threatening to damage, the interests of usually smaller trading partners. From the perspective of the coercing power, success depends on trading partners having few, if any options, to diversify exports. This might be because they are dependent on the markets of the coercing power or because diversifying would be economically costly because of resource costs or politically costly owing to the strength of domestic vested interests in reinforcing the status quo.[3]

Some of these elements are familiar from recent trade disputes involving China and the United States (US). China has used economic coercion against a range of countries going back to at least the early 2000s in the cases of Taiwan and Japan.[4] And the US has been an inventive user of economic coercion. Honed on its embargo on Cuba, it is now the 'go-to solution for nearly every foreign policy problem.'[5] An innovation since the early years of the War on Terror combines US capacity to monitor global supply chains and flows of international payments at a highly detailed level with the credible threat to shut companies, or countries, out of the US-dominated global financial system if they cross certain US-determined red lines. China may be developing a similar capacity via its RMB-denominated Cross-Border Interbank Payment System (CIPS) if a range of banks outside China become direct participants as a result of present tensions. As demonstrated in its dispute with Lithuania, the Chinese Government has widened coercion as an economic tool to bar companies in third countries from selling into the Chinese market if their products contain Lithuanian components.[6]

While the playbook on using international trade as a coercive instrument is evolving, the three basic responses to it have not.

**Responding in kind** may be an appealing option for large traders like the US, China, the European Union (EU) and, at a stretch, Japan, but it is unlikely to be a realistic option for countries like Australia.[7] Reaching for options like disrupting supplies of iron ore would be both disproportionate and damaging to the Australian economy.[8]

**Smoothing over bilateral difficulties** could be a practical option for Australia. For smaller partners, 'asymmetry of attention' between large and small countries provides some countervailing influence.[9] Small- and medium-sized countries tend to focus minutely on their concerns with larger partners while the leaders of large countries have global interests and limited time to focus on what they may consider to be second- or third-order issues. This may create opportunities to resolve tensions quietly through bilateral negotiations or via international forums such as the World Trade Organization (WTO). But this comes with a sizeable caveat: these second or third-order issues must not be linked to the larger country's global interests. For Australia, by design or happenchance, Australia-China trade tensions have become linked to US-China tensions – Taiwan, the origins of COVID, and containment of China – suggesting they cannot be resolved any time soon.

**Responding to coercion by diversifying exports** is probably the first option considered by small- and medium-sized countries. Diversification contributes to more predictable and balanced development by lessening adverse trade shocks and reducing volatility in export earnings. Geographic diversification, globally and regionally with countries like India, Vietnam, and Indonesia, is manifestly in Australia's interests. But, again, there is an important caveat. The whole point of coercion is to raise the political costs of pursuing specific policies, and to bring about some degree of course correction; its effectiveness increases in correlation to the extent that industries subject to coercion have few alternative markets. This helps to explain, in Australia's case, the different fortunes of industries like rough timber (that have struggled) and barley (that have not).

The policy objective of diversifying merchandise exports must be grounded in reality. The Australian Government has only indirect policy levers to diversify merchandise exports by product or market. They include political and business messaging, negotiating new free trade agreements (FTAs) and updating old ones, increasing economic cooperation with various countries, and stepping up trade promotion efforts. The potential for

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diversification is driven fundamentally by commercial factors. This, in turn, is driven primarily by shifts in the structure of the world economy. Manufacturing growth has been concentrated for most of this century in China, and its pulling power accounted for almost one-third of global growth in some recent years, though this has now fallen to about one-quarter.[10] There is no other equivalent market to China for many Australian primary commodities, and none for commodities like iron ore and wool where there is one principal buyer - China.

Australia has no compelling options in responding to Chinese coercion in the short term, though its worst effects have been mitigated by private firms redirecting exports to other markets and the good luck of strong commodity prices on world markets. Australia does, however, have potentially good options over time. The issue is how to move forward and make the most of an unwanted wakeup call.

## Policy Response: A comprehensive strategy on export diversification

To be effective, Australia's response to this wakeup call must be relevant not only to the ebbs and flows in our relationship with China but to changes in the international trading environment more broadly. The boundary between market and state-based forces in shaping international trade is always shifting. It virtually disappeared during the 1930s amid great power competition, widened during the most expansive phase of globalisation in the three or four decades before the global financial crisis (2008-09), and has now narrowed again with the resurgence of great power rivalry, and concerns over supply chain vulnerabilities, climate change and widening social inequality.

Blurring the lines between trade and industrial policy, foreign policy and national security inevitably impacts Australia. Evidence of this comes through in various public statements from the Australian Government (and Opposition) on the slow-down of globalisation; the invigorated role of geopolitics; the growing resort to economic coercion in international relations; and the no longer remote possibility of great power conflict.[11] As a trading nation, this frank assessment is confronting because Australia has never prospered when world trade has been fettered: the retreat of globalisation in recent years, should it continue, risks dividing the world into blocs and potentially locking Australia into a long-term low growth trajectory. And it is challenging too from a policy perspective because diversifying our exports and lessening our reliance on China is part of a much bigger adjustment needed in response to climate, technology, and geopolitical changes regionally and globally.

**Central strategic objective:** Keeping regional and global markets open and growing while improving our domestic competitiveness should be the twin objectives of Australia's economic policies in response to mounting international insecurity, coercion, and the protectionism that is a by-product of the closer integration of trade, foreign and security policy. In cooperation with 'allies,' 'trusted partners' and others, effective pursuit of these objectives would increase Australia's resilience to external trade shocks.

This strategy is built on two structural supports. **First, a flexible economy widens trade options.** Successful trading nations produce goods and services based on their comparative advantages. International trade sharpens those advantages by driving less productive firms, and their offerings, out of the market. But therein lies the basis for the eternal balancing act between comparative advantage and self-reliance. International trade promotes economic growth over time and trade liberalisation increases productivity and real incomes (again over time), but not necessarily over the short- or even medium-terms.

Support for open markets peaks when economies are growing solidly, and people are confident about their own futures. But support wanes when economies turn sour and/or confidence in governments, markets and economic institutions erodes. Leaders can then make the argument more easily for policies to justify more self-reliance or more support for targeted industries or more reliance on 'trusted' partners.

No one knows just how the diversification story is going to unfold. Southeast Asia, India, and perhaps Africa may in time become major hubs of world manufacturing growth and leading markets for internationally traded commodities. This will depend ultimately on issues such as responses to climate change, protectionism, the quality of governance, and geopolitical factors. But whatever happens to the structure of the world economy, Australia's national interest is best served by having a relatively flexible economy – and multiple trade options – so we can respond quickly to opportunities and challenges in a relatively open world economy.

Developed economies tend to have more diversified export portfolios than less developed economies, and large economies like the US, the EU, China, and Japan have substantially more diversified export portfolios than middle income countries and most developed economies. There is, however, no clear-cut relationship between development and export diversification. Some empirical research suggests that economies tend to increase export specialisation in specific goods and services as they move beyond a reasonably high threshold of per person GDP.[12] Other studies suggest that growing openness to trade could as easily result in greater export specialisation as more diversification.[13]

In our view, export diversification is linked to: the quality of human capital – a broad indicator of development; transport costs, including regulatory costs at the border; membership of regional trade agreements that are ambitious and broadly based to include new generation trade and investment issues; direct foreign investment that creates opportunities for future growth particularly by creating links between domestic and regional economies; and productivity-raising unilateral economic reform.

Improvements in any of these variables could reasonably be expected to result in more opportunities to diversify exports or to increase specialisation where appropriate. But this comes up against three challenges.

- Growth in global trade and investment has been anaemic over the last decade. Export diversification has generally become sluggish globally, regionally, and across countries grouped by per capita income after increasing steeply in the decades prior to the GFC.[14]
- Export diversification is linked to import openness. Increasing competition from imports boosts productivity – and therefore opportunities for export diversification and growth - by increasing access to cheaper and perhaps higher quality inputs. It also may increase productivity via technological 'spill-overs' and skill transfers.[15]

- The Australian Government is using a range of subsidies and other initiatives to support businesses, particularly in defence-related industries, the energy sector – clean hydrogen, ultra-low-cost solar and long-duration energy storage – and in metals like low-emissions steel and aluminium.[16] There might well be a strong case for relying on subsidies to build up some industries purely on strategic grounds. But the government needs to be clear about the balance of benefits from increased use of subsidies and the damage they cause to Australia's trade – and world trade more broadly – by limiting market access and skewing competition. Almost two-thirds of world trade is now subject to subsidy measures adopted by the US, the EU and China,[17] and there is every chance that this will rise in the years ahead in response to the pandemic, the shift to a low carbon economy and geopolitical factors.

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So, is there a nationally galvanising message that could underpin economic reform? Chinese coercion against a small, yet highly significant, group of Australian commodities has generated a vigorous reaction in Australia at the political level, and more broadly in society judging by shifting public opinion on China and a voluminous literature focused on export diversification. Is it feasible to harness some of the momentum and political vigour generated by China's economic coercion to reboot domestic economic reform and widen options for diversifying product and geographical markets? Australia's experience in the Hawke-Keating and Howard years suggests that this might be feasible providing it is built around a compelling enough national narrative, and providing there is sustained political leadership, support from sections of business and the trade unions, and good bureaucratic processes.

**Advancing the open international trading system is the second structural support for a comprehensive strategy on export diversification.** Trade can be used in a variety of ways to achieve useful economic ends and as part of a power play to influence the policies of other governments.

The multilateral trading system, and the authority of international rule-making bodies more broadly, provide partial safeguards against coercion and the broader threat of strategic trade policies being used against us, and others. If key international bodies like the WTO cannot create rules and disciplines and then enforce them, then the conclusion of two world wars and the disastrous interwar period is that powerful countries will seek security and stability for themselves by making and playing by their own rules. But if there is a degree of stability and predictability in the international trading system, and at least a rudimentary trust between key trading partners, then the conclusion from the second half of the 20th century, and for most of this century, is that the incentive for creating obstacles to international trade is at least lessened.

It is more than time for some boldness in Australian international trade policy multilaterally, regionally and bilaterally directed at upholding the world trading system, including by doing all that we can to prevent it from splitting into trade-destroying US and China centred zones.[18] One approach would be for Australia to work harder with others to conclude open plurilateral agreements within the WTO on a range of issues – from domestic services regulation and investment facilitation to labour and the environment - that are central to 21st century trade. The diversity of WTO members, and the different perspectives they bring, must add to the complexity of negotiations. But broadening participation well beyond narrow like-minded groups offers a more assured path to global application. Boldness in setting ambitious goals and maximising participation should be Australian priorities.

The Australia-Japan Commerce Treaty (1957) is a fine example of the trade policy boldness that is needed bilaterally and regionally. Imaginative and undertaken in the face of strong opposition across Australian political parties, business, and the broader community,[19] the Commerce Treaty is arguably the most important bilateral trade agreement that Australia has negotiated: it laid the foundations for Australia's engagement with the then fast-growing East Asian economy and became the bedrock of Australia's export diversification by product and market for several decades.

This begs the question: is there a big, bold, and imaginative international initiative that could have a similarly transformative impact on trade and the framing of trade, foreign and national security policies in Australia and across the region? Australia promoting the expansion of the Comprehensive and Progressive Agreement on Trans-Pacific Partnership (CPTPP) might fit the bill if it included both the US and China, as well as other major economies, with a very high bar of required commitments and significant down payments from all. Such a development also would send a powerful signal for revitalising the WTO.[20]

As things stand at present, it is hard to imagine Australia promoting such an initiative given the parlous state of Australia-China relations, the rancour from China's continuing economic coercion and probable resistance from CPTPP members like Japan and Canada who have their own testy relations with China. Similarly, it is easy to dismiss China's application to join the CPTPP as a cynical exercise to lock out the US from membership and cement Chinese economic dominance in the broader East Asian region. And it is hard to go past the acrimony in US-China relations - and how

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this reverberates around the world - and the long-stated Biden Administration's position that it has no intention of joining the Agreement.

But today's impossible can become tomorrow's possible if there is enough vision, strategic dexterity, and political will. The benefits are potentially huge. For the US, it would provide economic heft to its strategic commitment to the region. For China, it would be a powerful external force reinforcing domestic economic reform. With its mounting economic challenges, China could just double down on more centralised control of the economy – which is its main direction of travel – but more market-oriented adjustments need to be considered as part of the mix to raise lagging productivity. For Australia, the accession process would provide opportunities to work with China on issues that have contributed to deteriorating relations. For the region, it could lead over time to Chinese trade and industrial policies becoming somewhat more market-oriented and subject to international disciplines.[21] And, for all, it could eventually shift the narrative from deepening strategic rivalry and blocs forming around the US and China to the economic and strategic benefits flowing from stronger trade and investment links.

Until the US and China chart a way forward that builds on their common core interests– and CPTPP has the potential to become a much broader and more important platform in the trade and investment space – the international trading system will continue to diminish as power politics grows. This would be to the disadvantage of countries like Australia and, eventually, to the superpowers themselves given the benefits they derive from open and growing world trade.

No one should expect miracles. Inspired diplomacy would be needed for both China and the US to join CPTPP. Australian diplomacy must enlist the support of countries in the region and beyond and be clever and tough enough to differentiate itself from US policy objectives. At some point, Australia and China must revisit their perceptions and expectations of each other if the bilateral relationship is to move forward.

Saying this does not underplay the difficulty for any Australian Government (or indeed for China) of moving outside its political and diplomatic comfort zone. Nor does it underplay the challenge for public diplomacy in explaining the world in its complexities rather than in simple black and white tones. But these difficulties pale into insignificance against the possible dire consequences of not trying to reach out and establish common ground.

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7. While not linked directly to responding to coercion, Australia has been an active user of anti-dumping and countervailing measures against various Chinese products, including steel, aluminium, chemicals, and some solar products.
8. The authors estimate gross losses in Australian export revenue in the Chinese market from coercion on nine significant commodities at about A$27-30 billion over the period from July/October 2020 to December 2021. At A$18 billion, coal exports make up the biggest single item in these losses: R. Wickes, M Adams & N Brown 2022. This compares, for example, with Australian iron ore exports to China in 2021 of US$115.7 billion.

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14. OECD/WTO, *Aid for Trade at a Glance: Economic Diversification and Empowerment*, OECD Publishing, Paris, 2019, Ch.1. The stalling in export diversification is linked to the changing pace of globalisation. While the demise of globalisation is greatly exaggerated, growth in global trade and investment has been slow over the last decade and promises to remain slow for some years to come because of factors like tensions in the US-China relationship, growing protectionism and the impact of the pandemic on re-shoring and supply chain resilience.

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18. While the US says that it does not want a bipolar world, the risk is acknowledged as it emphasises working on trade and competitiveness issues with partners bound by common core values and principles: see, for example, J Yellen, address to the Atlantic Council, 13 April 2022.

19. Sir John McEwen (Deputy Prime Minister and Minister for Trade) negotiated in his personal capacity so that any failure was his and not the government's: P Golding, *Black Jack McEwen: Political Gladiator*, Melbourne University Press, 1996, p.192.

20. The authors are indebted to feedback on this point from an interactive discussion on Australia-China relations hosted by the Institute for International Trade in partnership with the Australian Chamber of Commerce and Industry, 1 September 2021.

21. This observation comes with sizeable caveats. In a WTO context, for example, China has a reasonable record of complying with the letter of WTO dispute settlement rulings and has been helpful in developing workarounds after the US undermined the WTO appellate body. But its record more broadly in the WTO is chequered. Among other things, this probably reflects tensions between China's status as a superpower and its claims for special and differential treatment as a developing country, as well as China simply copying the US approach to observing international trade rules.


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