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GEOSTRATEGIC TENSIONS MANIFESTING AS TRADE CONFLICT: POLICY RECOMMENDATIONS FOR REBUILDING AUSTRALIA-CHINA RELATIONS

EXECUTIVE SUMMARY¹

There had been an expectation, or hope, in some Australian government circles that Australia-China relations might have been patched up to some degree during the northern winter of 2020-21 when China started to shoulder some of the costs of deteriorating relations with Australia, most notably in coal. Energy shortages and sharply rising coal prices on domestic markets forced China to scramble for supplies around the world, paying premium prices for non-premium product. This shock did not become the precursor to a thaw in the relationship because bilateral strains have become deeper than trade: maintaining the ban on Australian coal proved to be more important politically than the economic cost to China.

Strains in the Australia-China political and strategic relationship have been building for several years. China has increased both its ambitions to shape how the world and region works, and its power to pursue those ambitions, in ways that do not reconcile easily with Australia's approach to engagement with the region. Australia also has contributed to deteriorating bilateral relations by paying insufficient attention to how our policies and initiatives might be perceived by China. And the overall security environment has changed in major ways. China believes that its time has come. The United States has moved from a broadly cooperative approach to China to a more adversarial one marked by widening areas of strategic competition.² And this souring environment has, in turn, impacted Australia-China relations.

But just because there is little chance of getting back to the relationship that Australia and China enjoyed just four or five years ago should not mean that Australia settles for a relationship with China that is burdened by distrust. Nor should it mean that the present state of Australia-China relations should prevent a revival of mutually beneficial and broad-based trade and investment relations with China.

Trade can be a vehicle to advance relationships, including, and perhaps especially, between Australia and China where the mutual benefits on offer are so great. This need not be at the cost of security and broader strategic interests and could in fact enhance them, irrespective of cultural, political and historical differences. Building and maintaining the bridges that facilitate trade requires respect and commitment to rebuilding trust. These are scarce commodities that could be harnessed in managing wider tensions in the relationship and contribute both to better economic outcomes and a more predictable security environment.

This policy brief next reviews the present state of Australia-China relations and then attempts to answer three questions: what can be done domestically to repair relations? What can be done jointly with our partners around the world? And what options might exist – even unpalatable ones currently – to edge towards a workable settlement?

About the authors

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Background

The present state of play in the Australia-China relationship

The ‘ocean of good will’ between Australia and China³ has well and truly evaporated and has been supplanted by inappropriate language, including on the ‘drums of war’ and Chinese insinuations that Australia is racist and guilty of war crimes. Relations are now probably at their lowest point since diplomatic relations were established, and Australia is learning at first hand that it can be both uncomfortable and unproductive for middle powers to get too far out in front on issues that are central to superpower competition.

China’s targeting of Australia’s commodity trade directly affects, at a minimum, commodities that accounted for about 13 per cent of China’s merchandise imports from Australia in 2019, the year before relations began to deteriorate markedly.

This is a significant slice given that China does not have readily available alternative suppliers for major Australian exports like iron ore and greasy wool.⁴

Resulting costs are large. In the case of the eight most clearly targeted commodities — coal, copper ores and concentrates, frozen beef, wine, cotton, barley, rough wood, and rock lobster — Australian export revenue in China fell by around A\$6.6 billion over the eight months July 2020 to February 2021 compared to ‘trade as usual’. Casting the net wider to a group of 20 major commodities, including iron ore and liquefied natural gas (LNG), raises the estimate of lost export revenue from China because of changes in market share to more than A\$12 billion over the eight months to February 2021⁵. And likely adjustment costs could rise appreciably over the medium term for specific Australian industries, including iron ore and LNG, depending on their reliance on the Chinese market, the likelihood that China will switch purchases to other countries, and prospects in other markets as sales in China become more difficult.⁶

Industries hit hard by China’s policies have sought to diversify. Some authors have concluded that Chinese sanctions have had little effect on Australia’s trade because of our capacity to sell into other markets.⁷ Our capacity to diversify markets is made possible by an open world trading system. But the potential disruption and costs to Australia should not be under-estimated, and it is important to avoid a false sense of security from Chinese coercive actions. Those actions intensified from mid-2020. Increasing Australian exports to the rest of the world did not come close to offsetting lost sales to China comparing July-November 2020 and December 2020-February 2021 with March-June 2020 and were even less favourable with comparisons back to 2019.⁸

Australia’s trade losses in China might not be of great concern if there was a real prospect that Australia-China relations would re-set quickly. Unfortunately, there is little prospect of this happening quickly: indeed, there is a good chance that relations could deteriorate further — a view that now seems to be shared by the Australian Government.⁹

Intemperate language used by both sides hardly helps to steady relations. Raising the stakes in tit-for-tat actions could deliver a breakthrough or, just as easily, plumb new depths in the relationship. And there is no obvious circuit breaker. At one level, a general election in Australia might produce a fresh approach on China, and China might or might not place a priority on patching up relations with Australia. But at another level, Australia-China

relations are just one part of a more complex process of eventually settling on a workable future balance between competing superpowers in our region and beyond — a process that involves numerous countries around the world. Establishing that balance might need to be struck first before Australia-China relations settle. But in acknowledging this, it must not become an excuse to accept others’ agendas as ordained fate. Australia has its own interests to pursue with China and the region and it has domestic and international options to do this.

What can be done domestically to repair Australia-China relations?

Australia has domestic policy options or approaches that could potentially be stepping-stones along the long road to repairing the Australia-China relationship. Four are considered here.

Trying not to make a bad situation worse: While it takes two to tango, the Australian Government should stick to measured public statements — strong and proportionate where necessary — that provide maximum space for diplomacy to work either directly with China or through intermediaries in our region. This could achieve two objectives. It would re-introduce more respect and civility into a key relationship: at the end of the day, Australia and China must co-exist in the Asia-Pacific region. And, beyond the relationship, it must address worrying evidence of discrimination against Chinese-Australians linked apparently to the origins of the pandemic and deteriorating Australia-China relations.¹⁰

Using special envoys or other discreet ‘back channels’: These channels could be useful in preparing the ground for leaders’ and ministerial meetings that will be crucial in re-setting the relationship. Their effectiveness would depend on the willingness of both sides to step back from confrontation, but there is no real downside.¹¹

Revitalising the ideas market within the Australian Government: Australia’s capacity to pursue our core national interests depends on the quality of our ideas about the world and region, and on being clever enough to turn serious ideas into cutting-edge, explainable policy. Having this capacity is increasingly important if Australia is to understand, and respond appropriately to, the challenges thrown up by China’s rise and by the new multipolar world. An open, balanced and respectful public debate on the issues raised by tensions with China, and how to ease them, should be an important part of encouraging and supporting the revitalization of ideas within the Australian Government.

The Australian Government can draw on huge potential assets: considerable talent within key government departments; deep knowledge of political and economic systems and policies within Australia’s global network of diplomatic and trade posts; and abundant capacity and skills within sections of the wider community.¹² These assets need to be leveraged more than is currently the case, and to be enriched over time by spreading and deepening knowledge of Chinese language, history and culture within government and the broader community.

Diversifying trade: The case for diversifying Australia’s export trade is compelling. Australia is far more exposed to the Chinese market as measured by trade as a proportion of gross domestic product (GDP) than almost all other developed economies and many developing and emerging economies. Diversification is already happening as Australian business seize commercial opportunities. It has overwhelming community support.¹³ And it is a necessary response to lessen risks to Australian exporters from targeted coercion and from Chinese policies to increase medium-to-long term food and energy security by diversifying sources of supply.

The Government has made a strong case for diversification over many months. But the messaging needs to make plain that diversification does not mean decoupling: the trade complementarities that Australia and China share and the mutual benefits on offer are too great.

Messaging also needs to be anchored more firmly in practical realities:

- For many Australian exporters, diversification will require trading off higher returns on offer from China for a broader, more resilient export portfolio.¹⁴
- Given its massive size, China's market for Australian commodities and services cannot be replaced easily or quickly. India is often seen as a replacement market, and it may well prove to be, but protectionist and liberalising views on India's future economic direction jostle for prominence in policy formulation.¹⁵
- There is little prospect that closer strategic ties with the United States, while critical in maintaining regional stability, will result in more market access for Australian goods in US markets or provide Australia with a freer hand in the Chinese market.¹⁶

Further, the policy behind the messaging needs to be spelt out. It obviously must cover international policy elements such as the Australian Government's commitment to expanding export opportunities by negotiating FTAs with a wide range of countries. But if Australia is serious about diversifying trade by building new areas of competitive strength while continuing to build on existing strengths, the only assured basis is for successive Australian governments to develop policies that contribute to increasing productivity over time. Productivity-raising microeconomic reform is missing from the Government's narrative on diversification.

What can be done working with partners?

Australia is not alone in facing the challenges of a rising and far more powerful China. Other countries in the region also are grappling with them.

The United States will be a central part of any settlement that Australia reaches, or aims to reach, with China. We should seize every opportunity to press our views and initiatives on the United States rather than waiting for it to drag us into their agenda.

One positive outcome from pressing our views early is a US commitment that US-China relations will not settle without some settling of Australia-China trade problems. Australia, for its part, has strongly supported the US view that the future direction of the world is at an inflection point; that democracy is in a titanic struggle with autocracy; that the United States and its allies are in 'a long-term strategic competition with China'; and that allies need to align their strategies closely on China to ratchet up pressure on a strategic rival.¹⁷

Advancing many of our core interests on China must involve working effectively with regional partners as well as the United States. Balancing wider security and economic interests is hard with a powerful country that does not, and is not likely to, share our values. But this balancing act is also difficult for China's neighbours in East Asia and elsewhere. Like Australia, they too must adjust to a more confident, rising China. They want to protect their sovereignty. And they have long histories of dealing with China and fully understand that it is both an opportunity and a challenge.

Asian perspectives are relevant to Australia and working closely with regional countries should be a key part of Australia's approach to engaging with China.

It might hopefully lead to the development of policies that are grounded in the fact that Australia and China must co-exist. It might also sharpen any contribution Australia can make to an eventual 'settling point' between the United States and China.¹⁸

Finally, Australia must take advantage of the big elements of the international agenda where we can work cooperatively with China. Climate change, tackling COVID-19 and regional trade liberalization are some of the areas that can add ballast in the bilateral relationship. And, beyond this, Australia needs to try to convince the Chinese leadership that we very much want to develop a modulated and respectful relationship.



What can Australia do over time?

Australia needs policies that chart clever, innovative and sustainable ways to live with China, and also needs to think hard about how trade figures in all of this. Some of these policies may look politically unpalatable and impossible to implement currently. But this should not impede serious thinking on ways to advance bilateral relations and our long-term national interest. In the normal way of relations between superpowers and middle powers, Australia would have to do much of the heavy lifting. Four policies are considered here.

Build Regional Trade: When bilateral channels are blocked or difficult, multi-party fora provide a basis for engagement multilaterally – for example Australia, China and others worked together to develop the Multiparty Interim Appeal Arbitration Arrangement in the WTO – and regionally. China, like Australia, has a strong interest in promoting regional economic integration and in shaping international rules to address 21st century challenges to trade and investment. There are well established regional forums - Asia-Pacific Economic Cooperation (APEC) and the East Asia Summit (EAS) - to which both belong. They may well provide scope for further cooperation on specific issues of interest to both members, as well as to the United States and ASEAN.

Two other forums – the Regional Comprehensive Economic Partnership (RCEP) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) – are more recent examples of actual (in the case of RCEP) and potential (in the case of CPTPP) Australian engagement with China on the regional rule making and institution building.

Australia, ASEAN, China, Japan, the Republic of Korea, and New Zealand developed the rules for RCEP and will need to engage actively on the Agreement's effective implementation once it enters into force. The cooperation agenda, in particular, is extensive and will require close involvement of the parties over many years. Opportunities to work jointly with China on individual projects should be actively explored.

There could be opportunities for future engagement with China on the CPTPP. A great deal of water would have to flow under this particular bridge before the notion has any substance. But China has expressed interest in joining¹⁹ and, under appropriate circumstances, it would be well worth Australia exploring the idea with regional partners if China can meet the required standards. A more open and inclusive grouping must be to our advantage as well as the region's. Possible Chinese participation in CPTPP would test its seriousness about contributing to evolving regional economic architecture and working within international rules and norms. And keeping the door ajar for possible Chinese and US membership would appear to offer the best chance of ensuring that the region remains integrated and that ideas in APEC like an eventual Free Trade Area of the Asia Pacific are not just flights of fancy.

Support regional infrastructure development: Australia should keep its approach to China's Belt and Road Initiative (BRI) under review as part of a broader strategy to increase its engagement in developing regional infrastructure.

BRI presents significant policy challenges for Australia – it is spreading Chinese influence across the region and its governance arrangements are far from best practice.²⁰ But it responds to major infrastructure deficiencies in our region and beyond²¹, and has the potential to make a positive contribution to regional development.

The BRI model is changing, and will continue to change, in response to shifts in geopolitics and growing problems with debt and environmental sustainability. A more accommodating approach to China on BRI would potentially be a small step

forward in meeting big infrastructure gaps in our region and could be a significant step forward in repairing bilateral relations. A key test is the extent to which China is willing to address deficiencies in BRI to improve its governance and economic efficiency.

Given enough diplomatic preparation and commitment to improving governance standards, Australian involvement in BRI should not necessarily be precluded by our prospective involvement in the US-led G7 Build Back Better World initiative.²²

Send an unambiguous signal welcoming foreign direct investment (FDI): Throughout our history, our small population has needed to supplement domestic savings with foreign investment to develop the natural resource base, infrastructure and, in more recent decades, manufacturing and services. FDI has brought a unique combination of equity capital, management and skills, technology and (in some cases) access to global supply chains and export markets. Inflows of FDI, and now considerable outflows, in turn have helped to sustain rising productivity, economic growth and improving living standards.

Chinese direct investment in Australia peaked in 2016 and has fallen steeply in recent years.²³ In part this downward trend reflects the lacklustre state of direct investment globally and especially the crushing impact of the pandemic on global flows. It also reflects growing security concerns in Australia.

Australia is not alone in this: almost all developed countries have applied more rigorous screening to inwards FDI in strategic industries in recent years.²⁴ But recent resistance to Chinese investment unrelated to security concerns raises questions about whether Chinese direct investment is welcome.

Changes to Australia's foreign investment regime introduced on 1 January 2021 have added to perceptions that Chinese investment in Australia may not be welcome. The changes include mandatory Foreign Investment Review Board (FIRB) approval for direct investments in businesses and land that may pose risks to national security, and increased powers for the Treasurer on national security grounds. The changes are non-discriminatory, in line with the basic principles of international economic law. But there can be no doubt that they were made with China's investments in Australia in mind.²⁵

Subject to rigorous and consistent screening, including in relation to national security, the Australian Government should continue to reassure investors that Australia welcomes foreign investment from China, as it does from all other countries.

Reinvigorate the China-Australia Free Trade Agreement (ChAFTA): ChAFTA has been missing in action in helping to calm and settle the escalating disputes between Australia and China. The dispute settlement chapter of ChAFTA runs to 16 pages. China has either ignored it or has frustrated its intent by playing games with rules on transparency and sound regulatory and administrative processes.

In large part China's actions demonstrate the difficulty of a smaller and weaker party holding a more powerful party to account. Whatever the reasons behind China's actions to date, a review and subsequent reinvigoration of ChAFTA should be promoted as part of reviving the bilateral trade relationship and restoring some degree of trust between the parties. But this will only be possible when the conditions for ministerial and meaningful official dialogue have been re-established.

Conclusion

If Australian foreign and trade diplomacy on China is to be effective, it must be grounded in the world as it is: one where Asia's rise is in large part the story of China's rise regionally and globally. This means that Australia's neighbours all have a strong interest in finding ways to engage and cooperate with China to ensure that it continues to support improved economic and social conditions in the region. It also means that Australia must try to convince the Chinese leadership that we will cooperate, compete and disagree with them on various issues – building on the first of these as part of re-developing a respectful relationship.

As a middle power, we must work with others to achieve our core objectives. Working closely with the United States is centrally important, but so too is coordinating with, and learning from, China's neighbours who probably have the fullest understanding of how to balance risk and opportunity with a re-born superpower.

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