



# Australia's place in the world

November 2017

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We achieve this through a rigorous and evidence-based research agenda, and forums and events that deliver lively debate and critical perspectives.

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CEDA is an independent not-for-profit organisation, founded in 1960 by leading Australian economist Sir Douglas Copland. Our funding comes from membership fees, events and sponsorship.

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# Foreword



There has been much talk about the changing global environment in recent years with significant shifts in the global economy, politics and governance.

As a result, the standards and institutions that Australia has relied on, in some cases for decades, to underpin global relations are moving.

CEDA has commissioned the research in this report to examine the impact of these shifts and how well prepared Australia is to respond.

*Australia's place in the world* examines these issues through the perspective of experts in three areas:

- The global economy – in particular looking at trade and investment;
- Global security – from more traditional military conflicts to the emerging frontier of cyber warfare; and
- Global governance and institutions – examining what has caused the discontent with global institutions and if they will continue to be important for tackling significant issues facing nations including Australia from terrorism to climate change.

Growing discontent with aspects of globalisation has been a factor contributing to some surprising results in recent years from Brexit to the election of US President Donald Trump.

Australia's geographic isolation and more than a quarter century of sustained economic growth have shielded us from some of these drivers and the more extreme responses seen in other countries, but that does not mean we are immune.

Globalisation has delivered significant benefits for Australia. But it is important to ensure that we remain well positioned to continue to reap the benefits of global engagement, that those benefits are broadly enjoyed, and that we are prepared for emerging threats and challenges.

I would like to thank the contributing authors for their work on this timely CEDA report. I hope it generates discussion on issues fundamental to Australia's future prosperity.

A handwritten signature in black ink, appearing to read 'M Cilento', is centered on the page.

Melinda Cilento  
Chief Executive  
CEDA

# Executive summary

The world is a dramatically different place than it was two years ago. Brexit, the ascendancy of Donald Trump, increasingly deadly civil wars, the global refugee crisis, cyber crime, the continuing rise of China as a global superpower and the ongoing threat of terrorism have created a global climate of change and uncertainty. This poses both challenges and opportunities for Australia.

There are challenges to our national security, to the way we conduct trade, manage our alliances and even, potentially, how we go to war.

This report addresses Australia's place in the world at this time of unprecedented uncertainty. CEDA has assembled some of Australia's leading thinkers on the global economy, global security and global governance to analyse the current state of play and assess how Australia is responding.

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## Global economy

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The modern international economy has, for decades, been built on the notion of free markets backed by a series of free trade agreements. Brexit and the election of Donald Trump were severe shocks to this system, with Trump attempting to back peddle from any free trade agreement that does not result in a trade surplus for the US.

In their respective chapters, Alan Oxley and Professor Richard Pomfret make the case that a return to protectionism is not necessarily inevitable and would not benefit Australia.

Professor Pomfret notes in his chapter that Australia has been one of the world's best-performing economies over the past quarter century. This is attributed to past policies to abandon protectionism and promote domestic deregulation. He argues against any return to protectionism by Australia, arguing instead that Australian public policy should promote more trade.

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## Global security

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While terrorism remains a primary threat to global security, cyber attacks pose a growing threat that requires a determined response. Cyber attacks are increasing in number and growing more sophisticated. We have seen in recent times allegations of state-sponsored cyber attacks and even the use of cyber attacks to interfere with the political processes, including elections, within other countries. Australia is not immune to such threats, including the threat of cyber war.

Future wars may take place in cyber space. Professor Michael Wesley notes that Australia is currently not well prepared to deal with unconventional sources of influence and is “vulnerable in a world where uncontested western primacy is no longer the norm.”

In his analysis of Australia's response to cyber security threats, Professor Greg Austin notes that “a case could be made for shifting the public rhetoric away from terrorist threats to a much more nuanced approach to the threatening technological environment that Australia faces in military uses of cyber space.”

While Australia does not yet have capabilities to carry out cyber war, this could provide a growth area for Australia's cyber security industry.

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## Global governance

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The final section of this report turns attention to the role of global governance institutions in the global economy. The recent surge of populist sentiment against the liberal foundations of modern trade is analysed by Associate Professor Wesley Widmaier. He contends that our cultural stress on balancing the rights of capital and labour may provide a solution for this growing discontent.

John Denton furthers this point, noting that Brexit and Trump's election, triggers of global uncertainty, may have been in part a backlash against globalisation noting “citizens are disillusioned with (what has been for many) the failed promise of globalisation to make everyone better off and angry about the imposition of rules and laws by absent, anonymous, non-democratic agencies.” He calls for reform of the global governance regime to ensure the backlash against globalisation is temporary. Australia, he writes, must be an advocate for globalisation but changes need to be made to ensure globalisation works for the benefit of the majority.



# Contributions

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## Chapter 1.1: Alan Oxley

### The international trade inflexion – how serious is it?

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Alan Oxley, Principal, ITS Global, provides a current overview of the global economy, focusing on three prevalent macroeconomic topics; free trade in Asia, protectionism, and Australian international economic policy direction. He explains that the notion of free trade among Asian nations has been gradually introduced since the 1960s. As examined by Mr Oxley, President Trump has altered America's historically liberal stance on trade to an "America first" policy which intends to reduce all current American trade deficits. However, he disagrees with commentators who cite Brexit as an example of increased protectionism, believing that the UK's withdrawal will in fact increase openness in its markets. For the Australian perspective, Mr Oxley believes an erosion of our competitiveness in global markets is our biggest economic threat. A return to the pursuit of efficiency should be the overarching theme for Australian international economic policy. Lowering costs will provide an economic buffer for Australia while addressing the concerns of competition.

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## Chapter 1.2: Professor Richard Pomfret

### Australia in the global economy

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Professor Richard Pomfret, University of Adelaide, analyses Australia's current economic position as the benefits of the mining boom continue to fade while the ageing population continues to rise. He contends that over the last quarter century Australia has benefited from increased participation in the global economy, with an added windfall of the commodity boom and a demographic dividend. However, short-sighted policies during the boom, when governments cut taxes and increased expenditures rather than saving for the future, have left the economy requiring deliberate policy decisions to ensure continued prosperity for all. Beyond specific policies to address the increased volatility that exposure to the global economy inevitably brings, this can be achieved most effectively through completing the post-1983 reform agenda in public finance and workplace relations.

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## Chapter 2.1: Professor Michael Wesley

### Are Australian responses to the change in global security adequate?

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Professor Michael Wesley, Australian National University, examines the dynamics of global security over the past 12 months. He explains that while issues such as the rise of civil and sub-state wars as well as the decline of inter-state conflict are consistent with previous decades, "genuinely new" global security issues have arisen over the past 12 months. Coercive non-violent rivalry between global powers such as China and the USA is one of the new global security issues identified by Professor Wesley. Due to the increased codependence of global markets, traditional warfare tactics among states have become increasingly financially unviable. As a result, states have turned to non-violent options such as territorial disputes and geoeconomics to pursue their objectives. Transnational security issues as noted by Professor Wesley are not new to global security observers, however their evolution has increased its disruptive and violent capabilities. The increasing challenge posed by global security issues has triggered a proactive response from Australia; from military support to foreign allies to a reorganisation of national security.

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## Chapter 2.2: Professor Greg Austin

### Are Australia's responses to cyber security adequate?

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Professor Greg Austin, Australian Centre for Cyber Security, University of New South Wales Canberra analyses the Australian government's decision to place increased importance on the development of the nation's cyber security capabilities. He explores recent developments in Australian and international defence strategy that has led to what he has termed as "the Cyber revolution". Professor Austin writes that cyber threats pose a far larger risk to Australia than traditional security threats such as the Chinese military and terrorism. For Australia to ensure it is protected from cyber threats the government must commit to growing the sector. And most importantly, Australia must foster a community of interest around cyber warfare that allows interest and expertise from both the public and private sector to collaborate and share expertise and ideas.

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## Chapter 3.1: Associate Professor Wesley Widmaier

### Are global governance structures still working?

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Associate Professor Wesley Widmaier, Griffith Asia Institute, Griffith University provides a historic background and overview of concepts surrounding economic governance from 1930 to the Global Financial Crisis. He shows how these concepts and ideas have changed as crises have exposed their short comings. Professor Widmaier contends through examination of past crises and resolutions, that regulatory instruments are required to safeguard the economy from the abuse of market power. However, he warns that there has not been sufficient time yet to fully resolve debates over the cause of the most recent crisis (GFC) – as past crises were often fully understood only after decades.

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## Chapter 3.2: John Denton AO

### The future of global governance

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John Denton, Partner and Chief Executive Officer, Corrs Chambers Westgarth examines the current transitional state of global governance, as some nations begin to turn inward. Simmering tensions between national sovereignty and global governance could see a rapid fragmentation of international norms and institutions. National sovereignty has not just been compromised by institutions of global governance. In the current area of extreme interdependence; multinational corporations, regional groups and global problems can all limit national sovereignty. This transitional state of global governance has a profound effect on Australia as we rely on global stability and order as a mid-sized economy. Australia must continue to champion the cause of liberal values and globalisation to maintain our growth and prosperity.

# CEDA overview



**Diane Smith-Gander** is non-Executive director of AGL Energy and Wesfarmers Limited, Chair of Safe Work Australia, Asbestos Safety & Eradication Council, a board member of Keystart Loans, Henry Davis York, CEDA and immediate past President of Chief Executive Women, Australia's pre-eminent women's advocacy group.

Diane has held a wide range of non-executive roles in the past including Chairman of Broadspectrum, Deputy Chairperson of NBNCo, non-executive director of the CBH Group, commissioner of Tourism WA and board member of the Committee for Perth.

Diane holds an MBA from the University of Sydney and a BEc from the University of Western Australia (UWA). In 2015 she was awarded an Honorary Doctorate of Economics from UWA. She is a Fellow of the AICD and Governance Institute of Australia and an adjunct professor of corporate governance at UWA where she serves on the advisory board of the Business School. She is also a Council Member of Perth's Methodist Ladies College.

This CEDA policy perspective examines if the world has changed in the last 12 months and does Australia need to change as a result.

In today's interconnected global economy, our nation's success hinges on our ability to navigate relationships at both a political and economic level. However, given the changes globally occurring in the economy, governance structures and in security, it raises the question of if the status quo can remain or do we need to change how we interact and do business with the rest of the world. In addition, if we need to make changes, who should take the lead, government, business or will a new hybrid coalition emerge to set the economic policy agenda?

Re-examining *Australia's place in the world* will help ensure we continue to enjoy the high living standards and prosperity of the last 30 years. However, we must develop an integrated response that is capable of managing the "interplay of ideas, interests and crisis" as characterised by Associate Professor Wesley Widmaier (Chapter 3.1).

Of all stakeholders, Australian business has a key role to play in the domestic and international success of the country's economy. Australian businesses have both contributed to and benefited from strong economic settings that have made Australia arguably the most successful developed economy of the past 25 years. Increased openness of the economy following the end of protectionism and positive demographics created the environment for Australian companies to prosper domestically and internationally, with many becoming deeply connected to close Asian trading partners. Maintaining these strong domestic economic conditions is key to our continued success on the global stage. As is the continuation of liberal, free trade markets.

In mirroring Alan Oxley's contention, Australia's long-term economic prosperity relies on a foundation of liberal trade between our markets and Asia. The magnitude of the rapid urbanisation and growing wealth in Asia has progressively shifted the world's economic centre of gravity east (See Figure 1). This trend is forecast to continue as the mega-cities of Mumbai and Shanghai become global economic powerhouses. This shift in the economic gravity provides even more incentive for Australia to capitalise on its geographic proximity and already strong ties to Asia to further expand and deepen trade relations.

Along with the existing patterns of trade with the established economies of Asia, Australia should look to broaden its relations with emerging Asian nations such as Indonesia, Vietnam and the Philippines. This next wave of 'Asian Tigers' provides Australia with an increased scope in trade relations with the region. An expert panel discussing outbound investment at a CEDA Perth event this year<sup>1</sup> when asked of the biggest opportunity for the WA economy answered "Indonesia, Indonesia, Indonesia".

Continued consensus surrounding the benefits of free trade and anti-protectionist policy is needed. This consensus needs to be an inclusive one. Without broad based acceptance necessary policy settings will become politically unpalatable.

**FIGURE 1**  
**THE GLOBAL ECONOMY'S CENTRE OF GRAVITY**



Source: Quah, D. "The Global Economy's Shifting Centre of Gravity", *Global Policy*, Volume 2 Issue 2, January 2011.  
Notes: The orange dots are projections.

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## Domestic policy shortfalls

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We cannot be competitive internationally without strong economic policy facilitating growth within Australia. Failure to keep pace with the rest of the world hinders domestic company growth and success and reduces Australia's international competitiveness. This interplay between domestic policy and international competitiveness has become even more pronounced in the new era of interconnected markets and economies. Domestic policy must be set acknowledging global interconnectedness.

Despite the clear importance of strong domestic policy, business makes a strong case that much-needed economic reforms remain unfinished business.

Policies such as moving from transaction taxes on property to broad-based land tax to address housing affordability and labour mobility need to be designed along with transition pathways. GST reform with a broader base to remove the need for stamp duty could be another option. Australia's company tax rate is yet another area of contention.

The Enterprise Tax Plan provides an example of a positive step forward in the area of corporate reform. The decrease in all corporate tax from 30 per cent to 25 per cent would bring Australia more closely in-line with the current OECD average of 24 per cent, although the average in Asia is 21 per cent.<sup>2</sup> However, the 25 per cent rate would only be reached in the 2026-27 financial year, which seems certain to make Australia an uncompetitive destination for much foreign investment.

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## Australian business shortfalls

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Just as policy needs to keep pace with global changes, Australian business also needs to step up its role, be less risk adverse and become more dynamic and adaptable in order to capitalise on the opportunities created by globalisation.

The area that needs immediate business and policy solutions is developing the right skills and mindset within our domestic labour force to keep pace with the evolving jobs market.

An open economy that cannot deploy the right skills to offer advanced services on the global stage will struggle for growth.

The institutional skills of our nation and corporations are also not responding fast enough to globalisation. There remains a strong perception that Australian companies are not able to compete effectively offshore, outside the commodities sector.

Too many Australian companies seem convinced that our domestic market has the scale to deliver a sustainable future – a questionable belief given the projected trajectory of our Asian neighbours.

International competitors regard Australian markets as highly attractive. Twenty-four million mostly high-income earners packaged into five cities around a coastal fringe can support high margins.

Finding the potential for success in global markets therefore becomes a domestic risk management imperative for Australian companies because any domestic market offering that is not distinctive globally is ripe for attack from global competitors. If a business wants to future-proof its ability to continue to serve domestic customers it needs to have offerings that are internationally competitive. Even if there is no intention to offer them outside of Australia.

It is no longer acceptable to blame the tyranny of distance, with the weight of economic activity and future consumption moving to Asia. Peter Robertson of the University of Western Australia and Marie-Claire Robitaille of University of Nottingham Ningbo China found that unsurprisingly, trade partners who are further apart trade less with each other. They note Australia's distance from Europe and the United States still imposes enormous costs on our exports.<sup>3</sup> This should surely give Australian companies an imperative to turn to Asia.

The technology that is supporting Australian global competitiveness by reducing the tyranny of distance also raises risks. As Professor Michael Wesley (Chapter 2.1) points out the interconnected cyber world puts companies' infrastructure and many essential services Australians rely on in easy reach of hackers and other cyber criminals. We are worryingly underequipped to deal with the exponential growth in the threat of cyber security which leaves the nation vulnerable to attacks.

“The area that needs immediate business and policy solutions is developing the right skills and mindset within our domestic labour force to keep pace with the evolving jobs market.”

The overall Australian response to the threat of cyber warfare, as examined by Professor Greg Austin (Chapter 2.2), exemplifies Australia's lethargy in reacting to changing circumstances and highlights a key area where Australia is not responding fast enough to globalisation.

There is increasing evidence of a proactive government response with the launch of the National Cyber Security Strategy in 2016 and the development of the super portfolio in Home Affairs but Australia does not have a comprehensive response, inclusive of all stakeholders, yet. The Australian Cyber Security Centre's October 2017 threat report<sup>4</sup> notes that networks in Australia have been compromised by rudimentary techniques exploiting known vulnerabilities. They also note the increasing tendencies for attacks to be directed at a target's third party providers and for Australian networks to be vulnerable via the networks of their global service providers.

The cyber security industry can provide a great opportunity for Australia to become a leading innovator and developer, strengthening both the economy and national security simultaneously. Israel provides a fascinating case study and role model of what is possible.<sup>5</sup>

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## Governance

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At the same time, maintaining global governance structures is also important for Australia. While international bodies such as the IMF, UN, WTO and WHO can at times seem removed from our daily lives, as the world faces global issues, from health pandemics to drug and illegal arms cartels John Denton writes (Chapter 3.2), these institutions will be vital for tackling problems that nations cannot tackle effectively on their own.

For example, terrorism remains a global security threat that no country, Australia included, remains immune from. And the ability of terrorists to cross borders and recruit followers via the internet means violence has become an export. Terrorism is spreading by franchise and becoming the stock in trade of civil wars.

As Professor Wesley (Chapter 2.1) writes, while inter-state armed conflict has decreased, the incidence of intra-state and civil wars has increased dramatically, meaning interstate intervention in civil wars is also on the rise. The increase in this type of conflict creates additional problems, the most evident being displacement of large numbers of people. Professor Wesley explains, "the past year has seen the highest levels of population displacement on record." The massive scale of this problem has demanded global attention but, unfortunately has not yet delivered a global solution.

There has been a lack of consensus among the international community on how best to deal with these displaced people, with some countries skirting their humanitarian obligations to refugees.



As Mr Denton (Chapter 3.2) points out middle powers like Australia need stable, non-discriminatory rules-based global orders. And in times of uncertainty, with problems that are increasingly global, new global governance formats are needed to drive global solutions. Particularly if, as Denton contends there is backlash against globalisation and global governance. The UK's pending withdrawal from the European Union following Brexit, the election of Donald Trump and growing popularity of right-wing political parties across the globe indicate a frustration with globalisation.

New models of globalisation, including global governance, that ensure benefits for the majority need to be developed to prevent a more serious backlash that could have negative consequences for Australia's economic competitiveness.

Can Australia play a pivotal role in shaping these new formats? There is no reason to believe that we cannot. Australia has been an enthusiastic participant in global forums for decades. As Mr Denton notes in this publication, Australia has played a key role in the formation of the United Nations, standing up for the smaller powers, helped to initiate the formation of the Asia-Pacific Economic Cooperation organisation (APEC) and was influential in forming the G20.

“Global cooperation is growing increasingly important in a world that faces a number of crises that require cross-border solutions.”

But does the political will to do so exist? Our “middle power innovator” potential might be negated by our willingness to be that shaper. And nations aren't the only players on this stage.

Many non-government entities are taking advantage of the “interdependence and inclusivity” of the world Mr Denton describes to claim influence in global governance regimes. The opportunity for these entities to influence and bring into effect the changes they seek relies on their ability to work in a multilateral, collaborative fashion with other like-minded groups.

Global corporations are in some cases doing this better and wielding more power than global institutions.

Global cooperation is growing increasingly important in a world that faces a number of crises that require cross-border solutions. Issues such as refugee crises in Europe, Asia, and the Middle East cannot be considered the sole responsibility of countries directly affected. Likewise, nuclear ambitions of states such as North Korea and Iran and China's flexing of its military muscle in the South China Sea will require international diplomatic efforts to resolve.

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## Conclusion

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The increased interconnection of global economies has provided the Australian consumer with a plethora of new products and services. The commodity boom and a favourable exchange rate gave many of us a taste for imported goods and foreign travel that is now taken for granted.

The ability to access foreign markets as if they were local (through e-commerce) has revolutionised the way in which Australians purchase. At the same time the increased range of options has opened Australian businesses to increased competition from overseas, (but likewise increased opportunity for the innovative).

Some industries, most acutely manufacturing, have felt a negative effect. Globalisation has opened the curtains on Australian business, exposing long-standing inefficiencies and flaws in our markets. There is no clearer example of the decline of Australian manufacturing than the sight of the last Australian-built Holden car rolling off the production line in Adelaide in late October 2017.

The dramatic decline in this industry locally has raised concerns about the benefits of liberal trade ideals. There will always be a cost to change, but in the case of globalisation, the overall economic benefits outweigh the costs. This is demonstrated by Alan Oxley (Chapter 1.1) who recounts that, as a result of tariff protection of motor vehicles in the 1980s “a Holden Commodore cost A\$ 85,000 in today’s money...the equivalent Holden today costs A\$ 45,000.”

The recent period of record economic growth in Australia is a direct result of increased trade liberalisation and globalisation. The benefits of increased public services, rising GDP and income per capita and reduced costs on imported items cannot be understated. It is all too easy to see individual costs of the process and then make a snap decision. Through stepping back and taking a macro focus, the benefits of continuing to wholeheartedly engage are evident. Hand in hand with this we must identify the communities potentially left behind and craft solutions to minimise impacts.

“Globalisation has opened the curtains on Australian business, exposing longstanding inefficiencies and flaws in our markets.”

We are late to a conversation to examine Australia’s place in the world to determine how best to reinvest capital and labor in new opportunities to create ongoing prosperity.

The conversation needs to begin between Australian governments and business. Dialogue between government and business is currently negative and internally-focused on domestic issues. Government and business must work together positively to promote Australian business overseas.

Continued commitment to globalisation, global governance and liberalisation of trade will be important. Opportunities for trade and commerce rely on a stable global system based on mutually agreed rules. Especially for Australia as a middle power, stable global conditions provide the best platform to prosper.

The nature of many problems that affect Australia are too large for us to solve on our own. Terrorism, global migration, changing trade patterns all affect us. These global problems are best solved with global solutions, that sees countries, businesses and individuals work multilaterally to address problems. Global governance provides this ability to tackle large scale problems through taking a multifaceted approach. While there has been a recent backlash against it, global governance provides the stability for Australia and indeed all economies to grow.

The geographic isolation Australia once felt has shrunk dramatically through advancements in technology and the increased access Australia has to foreign markets and foreign businesses in Australia. Geoffrey Blainey's seminal work *The Tyranny of Distance*<sup>6</sup> was published over half a century ago, and perhaps that is where the idea should remain, in the past.

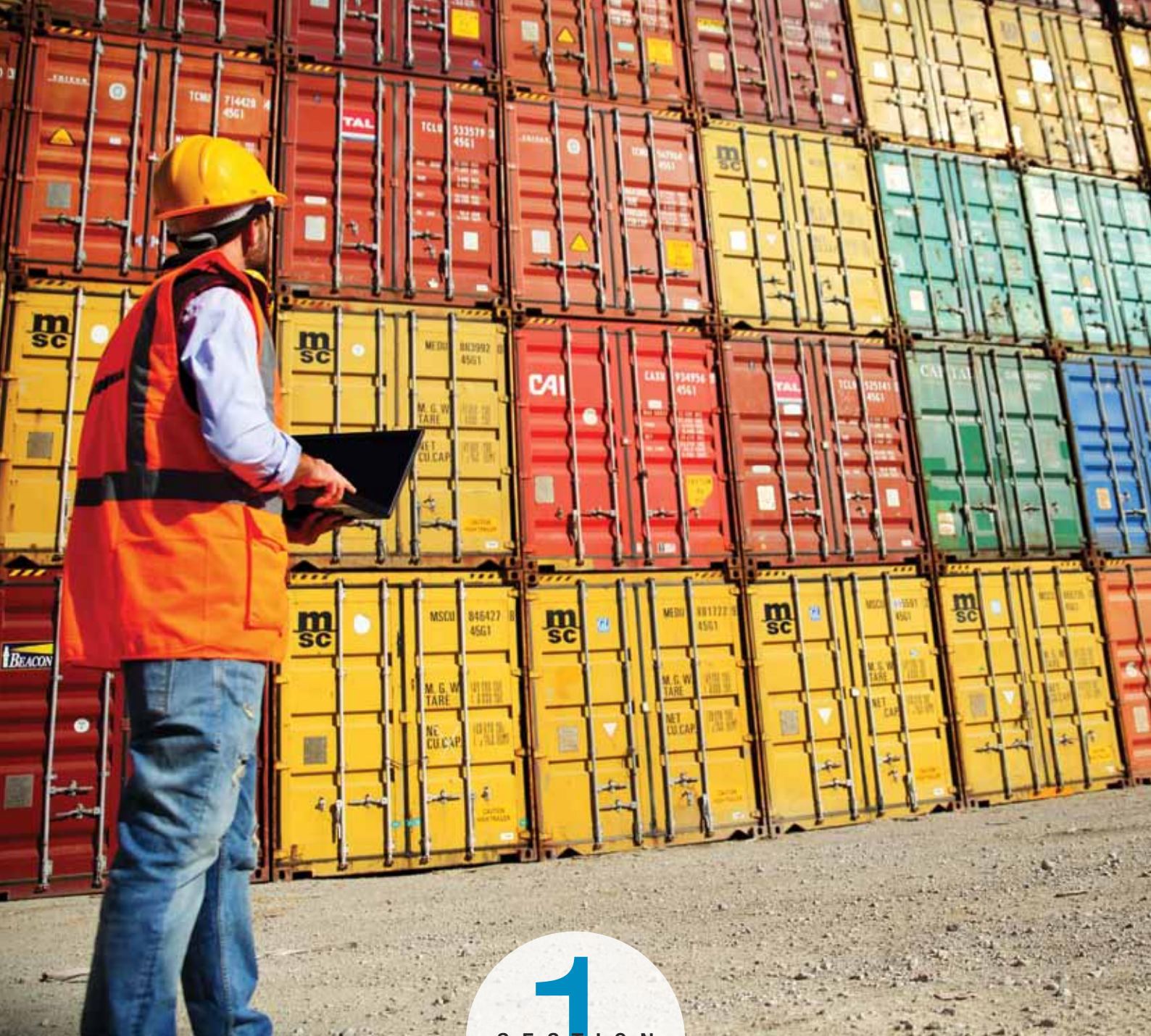
Australia is no longer a remote island country and cannot rely on geographic distance as a buffer to global forces. In this interconnected world Australia must take more proactive steps to build its resilience in the face of the potential negative impacts of globalisation. At the same time it must become more adaptable and agile in the way that we can capitalise on new opportunities in the expansive global market. And there is no doubt the opportunities are many.

The opportunities are only worth pursuing if the place Australia takes in the world is a place for all – we need to create equity for first Australians, LGBTI Australians, disabled Australians and female Australians – the policy settings necessary to achieve this will support policy settings around education, innovation and taxation that build the foundation for Australia in a global age.

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#### Endnotes

- 1 Smith-Gander, D, Emerson, C and Parker, A. *Outbound investment – the role for economic growth*, CEDA panel discussion, Perth, 4 May 2017.
- 2 OECD Tax database. Accessed from <http://www.oecd.org/tax/policy/tax-database.htm>
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1  
SECTION

GLOBAL  
economy



# 1.1

## The international trade inflexion — how serious is it?

Alan Oxley

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The election of Donald Trump has been a game changer for international trade. This chapter examines how the Trump Presidency has impacted international trade relations in the Asia Pacific and what this means for Australia’s economic interests.

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**Alan Oxley** is Principal of ITS Global, an advisory on trade policy, sustainability and resources. He is one of Australia's leading authorities on international trade. A former diplomat (postings to Singapore and UN New York) and trade official, he was Australian Ambassador to and Chair of the GATT during the Uruguay Round negotiations which established the WTO.

ITS Global has associations with US counterparts and consulted to most sectors of business. It has advised on trade policy and FTAs and sustainability matters to most economies in the Asian Pacific region. Mr Oxley is chair of the APEC Study Centre at RMIT University which is contracted by DFAT to support Australian activity in APEC. He is a member of the Legatum Commission (to support Brexit) in the UK and an Advisor to the ECIPE think tank in Brussels. He is a regular commentator in Australian and international media.

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## Introduction

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Donald Trump has changed the international trade game. He believes every trade agreement struck by the US should produce a surplus. His particular targets are economies where US trade is in deficit – China, Japan, South Korea and Mexico. He has sidelined the Trans Pacific Partnership Agreement and set his Cabinet and newly appointed advisors to re-orient US trade policy to support US industry.

This is a very significant departure from US trade policy. Since World War II the US has set global market trade liberalisation as a leading international goal. But the President is known for his bluster. He has stepped away from some radical calls, like cancelling the North American Free Trade Agreement (NAFTA) with Mexico and Canada. Analysts and media opinion pages were quick to declare an onset of trade protectionism is nigh. Will Australia be adversely affected? Does this undermine expectations of Asia Pacific growth in this century?

US economists are frothing at the mouth pointing out trade deficits do not automatically put an economy at a disadvantage. They need only look to Australia to demonstrate the point.

For most of the post-war period, Australia ran a trade deficit. That did not impede Australia's growth. But protectionism finally did in the late 70s. After the economic and trade reforms of the Hawke Government, Australia locked into a pattern of consistent growth which is now the longest of any industrialised economy since World War II. Only in the last five years has Australian enjoyed a trade surplus. This was principally the result of a significant increase in trade with China.

Trump has turned US trade policy inward. He withdrew the US from the draft Trans Pacific Partnership (TPP) free trade agreement (FTA). He tried to pressure South Korea to 'correct' (i.e. erase) its trade surplus with the US. He threatened to suspend the NAFTA with Canada and Mexico. And made a ham-fisted effort to pressure China to reduce its trade surplus with the US.

What does this mean for Australia's economic interests? The Asia Pacific region is Australia's leading focus for trade and investment. Three questions arise. Will Trump policy damage opportunities for Australian businesses to trade and invest in the Asia Pacific region? Or will it lead to a global reversal of the drive, led by US Administrations, since World War II to foster prosperity and encourage economic interdependence? Can Australia retain its mantle as the consistently highest-growth free-market economy?

The following analysis gives three answers. To the first question "no"; to the second "unlikely"; and to the third "we are at risk".

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## Building an Asia Pacific free market

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While the Gillard Government talked up "the Asian Century" the ambitions of Australian business to expand trade into the region were already well established. Japan surpassed the UK as Australia's leading export destination in the 1960s. The development of Australia's resources industries in the 70s and 80s, for which Japan was the key export market, particularly for steel and coal, were funded on Japanese financial guarantees.

Today, China is a bigger export market for Australia. Leading exports are iron ore, coal, tourism and education. Like Japan and Korea, China would also be a customer for natural gas, if available. Australia has huge resources. Demand for other Australian resources, such as coal, is forecast to grow by the International Energy Agency due to demand in the rest of the Asian region.

"While the Gillard Government talked up 'the Asian Century' the ambitions of Australian business to expand trade into the region were already well established."

When products traded are strategically significant – like natural resources and food – trade agreements are often not necessary. Australia was a major supplier of wheat to the communist regime in China in the 1960s while it refused to recognise the Communist Party as the government. That said, the system of global trade rules first adopted as the General Agreement on Tariffs and Trade (GATT) after World War II committed parties to follow trade rules which recognised natural advantage and encouraged reduction of protectionist measures.

This system was revised and extended in the 1980s culminating in the expansion of the GATT system into the World Trade Organization (WTO). The leaders of the GATT were the US and European economies. Emerging trading nations in Asia and the Americas joined that core and are also drivers today of the global trading system. Asia Pacific nations now generate 60 per cent of global GDP.

China's accession to the WTO capped that trend. Some key regional groupings also developed – particularly the formation of the European Union – and the North American Free Trade Agreement (NAFTA) comprising Canada, Mexico and the USA.

The World Trade Organization now has over 160 members, but 50-odd (the EU, the 21 members of APEC and other economies in South America) account for over 90 per cent of world trade. The large number of remaining developing economies who are WTO members has impeded further development of global rules to support further trade liberalisation and foreign investment in the WTO. Today tariffs are now generally low on most traded products. Agriculture remains the standout.

So, the focus today is on removing barriers to trade in services and foreign investment. It is common for developing economies (and this is notable in the Asian region) to regulate delivery of services of both national and foreign suppliers and limit foreign investment. This has impeded growth. China recognises this and is fostering expansion of output in services industries. ASEAN economies signed agreements to liberalise services and investment but have been slow to implement them.

The Asia-Pacific Economic Cooperation organisation (APEC), founded in 1989 at the initiative of Australia and South Korea, has emerged as the incubator of free and open trade by Asia Pacific economies. In parallel, negotiation of free trade agreements (FTAs) has been fostered by the Association of Southeast Asian Nations (ASEAN), the US and China. Australia, Singapore, New Zealand and Chile have also initiated a number of FTAs.

The most important step to date towards building an Asia Pacific free trade area was the negotiation of the Trans Pacific Partnership (TPP) free trade agreement. Twelve countries negotiated it. Japan and the US were the heavy hitters. But Trump stepped away from the draft TPP agreement as soon as he was elected. It is arguably the most advanced trade agreement yet negotiated with new provisions to liberalise services and foreign investment, which go beyond measures in the World Trade Organization agreements. This TPP, if adopted, would be the foundation for a wider agreement among all APEC economies.

Until Donald Trump was elected, the US was a leading force in constructing free trade agreements with APEC economies. China and the ASEAN group also developed FTAs. But many had weak provisions and enforcement – ASEAN members were uncomfortable with measures which were legally binding and China struck a number of agreements which principally secured better access for some Chinese products rather than promoting broad strategies to build open markets.

Trump regards a good trade agreement as one in which the US has a surplus with a trading partner. Economists know this approach is not sound economics. The point of effective trade agreements is to facilitate trade in lowest-priced products and stimulate growth. Trump is deviating from this basic principle. He was on the verge of cancelling the NAFTA agreement (with Mexico and Canada) and the US

“The most important step to date towards building an Asia Pacific free trade area was the negotiation of the Trans Pacific Partnership (TPP) free trade agreement.”



FTA with South Korea. Advisors pointed to negative consequences of cancelling those agreements (the US is a big agricultural exporter to Mexico and relations with South Korea were important because of the North Korean missile launches). The President relented. He has similarly cooled antipathy to China's large trade surplus with the US. Collaborating with China to handle North Korea's cavalier military manoeuvres is a higher priority. Although he has stated he will contest China's practice of requiring tech businesses to sign over Intellectual Property rights to Chinese authorities.

The TPP agreement is not dead. Currently Japan and Australia are testing the feasibility of adjusting the agreement (excising key US positions) to bring it into effect with remaining parties. Whether this succeeds or not, the advanced measures negotiated in it (for example liberalising services and investment) will resurface in some form in the future in other international trade agreements.

Any future trade agreement covering Asia Pacific economies must of course include China. It sounded out the US informally about participating in the TPP. The US response was China did not have the regulatory standards to facilitate removal of restrictions on delivery of services and/or provide investment security to foreign investors. While China acquitted itself impressively to comply with WTO trade rules (mostly relating to tariff reductions) when it acceded to the WTO in 2002, it is not in that space now with the TPP.

“The TPP agreement is not dead. Currently Japan and Australia are testing the feasibility of adjusting the agreement (excising key US positions) to bring it into effect with remaining parties.”

One result was the US and China jointly led a 2015-16 review in APEC of what would be required in the long run to develop a Free Trade Area of Asia and Pacific (FTAAP) among all 21 members of APEC. A blueprint was laid out. Chinese officials readily concede it could not meet the regulatory requirements to adopt such an agreement inside a decade. China's economic condition is in a state of flux. In addition, labour costs are rising as are the prices of the low-cost manufactured products which figured so significantly in its growth in recent decades. Debt in China is also high and currently the government is reviewing outward investment to see it aligns with national fiscal policy.

Does the stalling of the TPP agreement or other Trump trade decisions put Australia at economic disadvantage? No. Australia's trade barriers are low and its markets for services and investment are open. There are some contrarian elements settling into domestic policy, however, which are pertinent to the third question.

Australia's major trading and investment partners are China, Japan, USA, NZ, UK, South Korea and Singapore. Australia has FTAs with all of them (except the UK) which provide access to those economies. Australia's trade interests will depend on demand and openness in those economies.

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## Is global protectionism on the rise?

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Donald Trump's election and the UK "Brexit" vote to leave the EU led members of the G20 and European media, the London *Financial Times*, in particular, to express concern global protectionism was on the rise and global trade was lagging. Yet this has been regularly intoned at G20 meetings since the Global Financial Crisis nearly a decade ago.

The WTO maintains a register to measure the annual incidence of application of protectionist measures. This was the basis of the warning protectionism was on the rise. But this was not out of the ordinary. When global growth slumps, a typical side effect is increasing resort to price cutting. In such circumstances it is standard practice to claim the low-cost producer is "dumping" – i.e. selling below market prices. Common "dumpers" are Argentina, Brazil and Venezuela. The global economy has remained in slow growth mode since the Global Financial Crisis.

The WTO has rules to measure whether a foreign-made product has been "dumped". Those rules are loose. The US and the EU (and now Australia) have sophisticated systems to determine "dumping" and impose price penalties on the imported product. Australia adopted stringent rules to limit misuse of such rules (during the Hawke Government) but these have been progressively whittled back by governments on both sides of politics.

At the last G20 Summit, the WTO reported the incidence of dumping appeared to have eased.

The second supposed indicator of protectionism, according to European media, was the referendum supporting Brexit (the UK's strategy to withdraw from the EU). This reflected a lack of understanding of the UK's main intentions in withdrawing from the EU which were: to increase the UK's competitiveness, maintain its distance from an increasingly fragile Eurozone, reassert sovereignty against legislative creep in Brussels and ameliorate concerns about surges of refugees. The *Financial Times* led the criticism of Brexit, clearly viewing the situation through the lens of the UK finance sector. It had been quick to claim regulatory barriers would impede delivery of UK financial services.

The ease of UK-based business to trade financial services into the EU would be subject to different processes after Brexit. Claims this would significantly harm the UK economy are weak. The UK is the biggest trader of services in the EU but the leading industries are professional services industries (e.g. engineering, business services and architecture) which contribute 25 per cent of UK GDP. Financial services contribute just 13 per cent.

The pro-Brexit referendum result was principally triggered by the surges of refugees into the EU. In Europe, the refugee surge spawned backlashes from right wing groups in EU member states. The UK is yet to settle how it will deal with freedom to travel to the EU. Claims to the contrary notwithstanding, the UK withdrawal from the EU will not create increased protectionism. It is likely to result in more open markets in the UK.

Since the EU expanded to 28 members, EU processes are increasingly incapable of settling complex issues. It should be noted as well the UK is not part of the Eurozone and has no say in Eurozone policy. Given the negative impact fiscal and monetary policy has had on some Eurozone members (especially Italy, Spain and Greece), and on economic policy in the EU at large, it's arguable the UK is better off out of the EU. How incisively the UK Government achieves this is now open to question following the reduction in the Conservative Government's authority after its recent narrow election victory.

Trump's declared policy objective is for US trade in goods with other economies to be on even terms or showing a surplus for the US. He came to office opposed to NAFTA (Mexico's trade was greater than the US), determined to have US trade with China, Japan and Korea (all in surplus) adjusted and opposed to the TPP agreement. He scrapped the latter; agreed to revise, not scrap NAFTA (after being informed a dozen US states were major agricultural exporters to Mexico) decided to ease pressure on South Korea to change its trade relationship given the strife with North Korea; and seems to be collaborating with China over managing the North Korean nuclear threat.

Trump's administration is not expected to pay much attention to the World Trade Organization (WTO) although he came to office with bullish intentions to do so. He appears to have been briefed that membership of the WTO carries legally-binding obligations to comply with key rules and penalties for non-compliance. It appears he and his Commerce Secretary (Wilbur Ross) came to office unaware much of the WTO is underpinned by black letter law. Failure to comply can be costly. Some years back the EU refused to remove restrictions on imports of beef. WTO dispute panels ruled the EU was in breach of WTO rules. The EU was required to reduce annual tariff charges on US trade with the EU to the tune of US\$ 125 million as compensation for the trade damage done by refusing US beef exports.

One area Trump's US Special Trade Representative, Robert Lighthizer, has shown some interest in is services. A program to improve commitments in the WTO to liberalise trade in services among leading members of the WTO has been developed with US (and EU and Australian) leadership. But it is unlikely to be a high priority in this term given how many other international issues confront the White House. The US is supporting analysis in APEC to demonstrate the economic gains for liberalisation of trade in services.

All this suggests the Trump Administration will focus on domestic trade issues in this term and is unlikely to continue to promote trade liberalisation as predecessors did, particularly in the Asia Pacific region. Trump would not be the first President to come to office disinterested in free trade. But the reality is there is a strong desire among Asia Pacific economies to develop an open regional market. This is a strongly held view among US business and has considerable currency in the current US legislature. It is worth noting Barak Obama showed little interest in trade in his first term but took up the case for an Asia Pacific FTA (the TPP agreement) in his second term.

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## Directions in Australia's international economic policy

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Trade policy has recently commanded considerable attention in Australia. Free Trade Agreements with Korea, Japan and China have created new opportunities to expand agricultural exports and facilitate two-way investment and expansion of trade in services.

But the contribution of trade of goods and services to Australia's GDP is smaller than most other countries, particularly European countries, and export-focused economies such as Germany and South Korea. This is a function of the distance of Australia from major markets.

Nearly half of Australia's exports are minerals, underlining the fact Australia is the most mineral resources rich country in the world. Australia is not the cheapest minerals extraction economy, but it is arguably the world's most efficient.

But it is not the capacity to innovate and develop systems of extraction and processing of mineral resources alone that has made Australia the consistently fastest growing industrialised economy for the last quarter of a century. Liberalising the economy by removing protectionist measures made the biggest difference.

Tariff protection of motor vehicles at its peak in the early 1980s was over 100 per cent. At that time, a Holden Commodore cost A\$ 85,000 in today's dollars. This did not take into account the hundreds of millions of dollars paid annually to vehicle manufacturers to subsidise production. With the progressive reduction of the tariff and other subsidies, the equivalent Holden today costs A\$ 45,000.

Other restrictions and subsidies paid to agricultural producers and over regulation of services businesses, such as finance, were also progressively removed. Reducing regulation of goods and services and increasing competitiveness paid dividends. It made Australia the most consistent, high-growth developed country for nearly three decades.

Since the Global Financial Crisis, now nearly a decade on, our economy has not retained the same standard of competitiveness and efficiency. The debt incurred to ride out the crisis has not been paid out. It has expanded. Near-minority governments and lack of balance of power in the Senate has forced provisional agreements, temporary measures or straight out payouts for votes to secure the business of government.

We have recently been reminded by Henry Ergas and David Uren in major analyses in *The Australian* and commentary by Terry McCrann in the *Herald Sun* of the continuing and latent risk in the global economy today. The level of debt is high and commentators are constantly reminding us the financial condition in China is increasingly precarious. In this rather financially indulgent environment, there are

“The level of debt is high and commentators are constantly reminding us the financial condition in China is increasingly precarious.”

worrying signs we are beginning to return to the special conditions which, in the past, encouraged business to seek and be granted special privilege by government to the cost of the community.

One example is the Anti-Dumping authority which was set up by a Labor Government. It is extending its remit to restrict entry into Australia of competitive products. The leading focus has been on steel products, processed foods and some heavy equipment. The authority is a mechanism for creeping protectionism. LNP governments have been no less enthusiastic to work with businesses seeking protection than recent Labor governments. Substantial bail outs by governments for major steel makers have recently been capped by regulatory provisions which makers of steel products consider puts them on the back foot and certainly leaves them in an uncompetitive situation.

The cost of climate change policy on the economy at large has been neglected in the long debate on this issue. Policy on climate change has been allowed to be determined by proposals on how to reduce emissions by a certain date, without regard to the costs of the various systems for delivering renewable energy which are now being advanced to replace conventional systems for generating power.

Community apprehension about power blackouts and rising power costs is on the rise among consumers and governments. Governments have been side-tracked by the climate change debate including moratoria by state governments on extraction of fossil fuel. The significance of the United Nations Paris Agreement on climate change has been greatly overstated. There are no legally-binding commitments and no penalties for non-compliance. Moreover, firm voluntary commitments by other governments to reduce emissions are few and far between.

Premature closure of electricity generators and coal mines as well as restrictions on extraction and export of gas (Australia's gas reserves are estimated as among the highest in the world) is hiking power costs and will reduce competitiveness in global markets.

Analysts forecast some form of contraction in the Chinese economy in the foreseeable future to address fundamental weaknesses, mainly very high levels of debt. Chinese demand for Australian mineral resources is likely to contract for a while. Developing gas for export to other markets would ameliorate the loss of trade. Australia's gas reserves are rated as one of the largest in the world. The mishandling of energy policy by state and federal governments has put that important trade opportunity at risk.

“The significance of the United Nations Paris Agreement on climate change has been greatly overstated. There are no legally-binding commitments and no penalties for non-compliance. Moreover, firm voluntary commitments by other governments to reduce emissions are few and far between.”

It is vital that governments in Australia set targets to improve efficiency and reduce costs. Not just to be in a position to weather any storm if China falls into a financial crisis, but to return to the financial and economic mores which underpinned Australia's strong growth two and three decades ago.

Australia has played a major role in working with economies in the Asia Pacific region to set the foundations for building an open economy among the region's economies which today account for 60 per cent of global gross domestic product. Donald Trump's intercession will, in time, be seen as a temporary digression. There is plenty of time to establish an Asia Pacific free trade area. China needs that time to lay the foundations of an economy that can comfortably operate in such an open market in which property rights are legally protected to facilitate foreign investment and services are traded freely.

China is not the only economy that needs to adjust its settings to introduce such change. ASEAN economies too have been loath to treat foreign investment on the same terms as domestic investment and to foster competitive services industries which can make the same contribution to their GDP as advanced industrialised economies now achieve.

Australia not only has to curb provision of special terms to large companies, it needs to encourage foreign investment in agriculture and ensure its most important sector – minerals – is not priced out of global competitiveness. Australia's success in the last three decades has been driven by efficiency. Restoring that efficiency must remain the leading national economic priority.



# 1.2

## Australia in the global economy

Professor Richard Pomfret

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This chapter explores how Australia's place in the world's economy has been influenced by external events, such as booms and busts, as well as policy reform. It builds a case for public policy to promote more trade by cutting the costs of participation.

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## Introduction

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Australia has been an open economy since Federation, affected by global depressions and by booms or busts in world demand for its commodity exports. In the first three-quarters of the 20th century, the manufacturing sector was largely sheltered from global competition by high tariff barriers, at a cost in foregone prosperity and reduced consumer choice. Since 1983 protectionism has been abandoned and substantial domestic economic deregulation has been implemented, with bipartisan support. Despite adjustment problems, the overall outcome over the last quarter century has been that Australia has been one of the world's best-performing economies.

This chapter looks at Australia's position in the global economy and examines if we should adapt to new macroeconomic events. Within this theme, questions to be answered include: How does Australia smooth the impact of external forces? Does Australia need to be able to adjust more quickly and how do we do that? Do we need to place increasing emphasis on flexibility and on retraining and compensation policies to help smooth adjustments? How do we help key sectors exposed to global movements adapt? These questions must be set in the context of external volatility, highlighted by the mining boom, and demographic changes, as well as the incomplete nature of the post-1983 policy reform agenda.



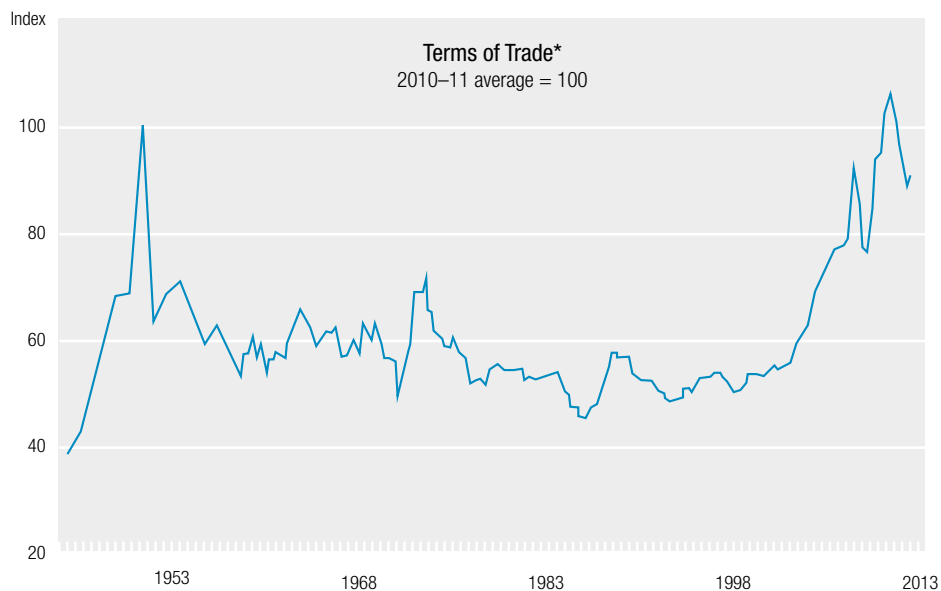
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## The long shadow of the mining boom and an ageing population

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Greater exposure to the global economy has left Australia subject to external economic forces. In recent decades these forces, notably the rapid economic growth of East and Southeast Asia and the related commodity boom, have been mostly beneficial. The improvement in Australia's terms of trade (the ratio of export to import prices) between 1998 and 2011, and especially after 2003, was the largest and most sustained in the country's history (Figure 1). Most Australians prospered. They responded to relative price changes, notably the appreciation of the currency, by spending more on overseas travel and imported consumer durables, while housing and other non-traded goods and services became relatively more expensive.

**FIGURE 1**  
**AUSTRALIA'S TERMS OF TRADE 1945–2013**



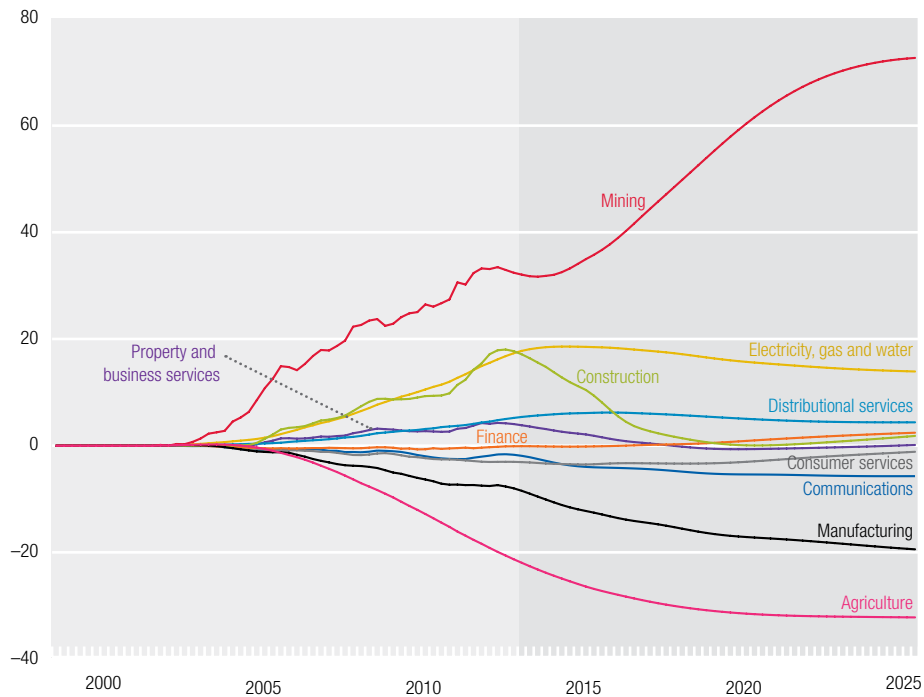
\* Annual data are used prior to 1960

Sources: ABS; RBA

Source: Richard Pomfret "Reorientation of Trade, Investment, and Migration" in S. Ville and G. Withers (eds.) *The Cambridge Economic History of Australia* (Cambridge University Press, Port Melbourne, 2015), 397–418.

The expansionary effect of the resources boom reached its peak in late 2011, when the terms of trade began to decline. The terms of trade fell because China shifted to a model of growth in which energy and metals, and especially thermal coal, were to be used less intensively<sup>1</sup>. For Australia, the declining impact of the China resources boom ushered in the dog days of economic policy from late 2011, when government revenue and private incomes growth sagged below expectations. By then, the exchange rate was at levels that rendered uncompetitive much internationally traded economic activity outside mining (Figure 2).

**FIGURE 2**  
**IMPACT OF THE MINING BOOM ON EMPLOYMENT BY SECTOR**



Source: Peter Downes, Kevin Hanslow and Peter Tulip: "The Effect of the Mining Boom on the Australian Economy", *Reserve Bank of Australia Research Discussion Paper 2014–08*.

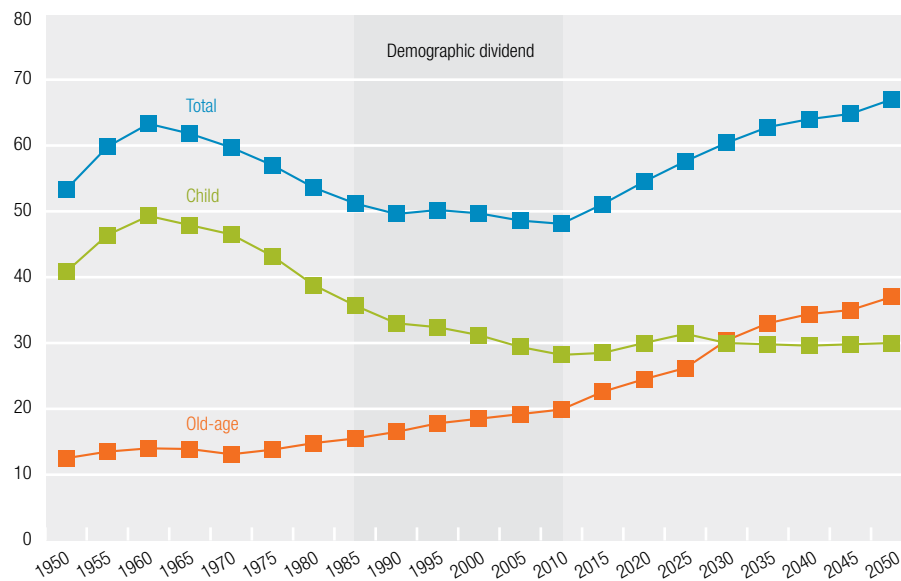
Notes: Percentage deviation of estimates from the no-mining-boom counterfactual.

A large depreciation of the exchange rate was necessary to maintain employment and economic growth, and to take advantage of rapidly expanding opportunities in activities in which Australia has comparative advantage, such as education, tourism and other services, high quality foodstuffs, and specialised manufacturers based on innovation. However, a depreciating Aussie dollar increased the price of imported goods and of foreign travel, to both of which many Australians had become accustomed during the boom.

Looking forward we can expect both good and bad influences from the global economy, and the question is how to be best prepared. A key phenomenon, not at all unique to Australia, is that governments tend to be ready to claim benefit for economic booms and place blame for economic busts elsewhere. Governments also tend to have rosy views of the sustainability of booms – or else have short time horizons. During the 21st century commodity boom, successive Australian governments cut taxes and increased spending, introducing new programs that would be politically difficult to abandon. During the boom, the Henry Tax Review, completed in 2009, made recommendations, most of which have been ignored by both Labor and the Coalition; tax reform is difficult, and takes leadership because there are always losers who complain louder than winners rejoice. Strikingly, and unlike most commodity-exporting countries which had learned a lesson from the 1973–1986 cycle, Australia did not introduce a sovereign wealth fund to save for a rainy day. Even more strikingly, the country's external debt increased.

A particular challenge facing Australia is that the squandered mining boom coincided with a demographic windfall, with fewer dependents as a proportion of the population (Figure 3). Falling birth rates led to a decrease in the proportion of the population under working age (child dependents) before the ageing baby-boomers led to an offsetting increase in the population retired from working (aged dependents). Between 1985 and 2010, more money was free to be used for discretionary spending and investment, and the effect was more pronounced because it happened to coincide with major economic reforms. The combination set high expectations on what the average Australian could afford to buy and the lifestyle they could afford to lead.

**FIGURE 3**  
**DEPENDENCY RATIOS IN AUSTRALIA, 1950–2050**



Source: Warwick Smith, "Ageing population and mining: a tale of two booms", *The Conversation*, 10 September 2013, based on data from <http://esa.un.org/wpp/>

Note: points after 2010 are projections based on an intermediate birth rate scenario.

For Australian governments, lower dependency ratios were a bonanza. The Howard and Rudd Governments put in place income tax cuts. Today Treasury and health bureaucrats must worry about increasing costs of health-care and age pensions combining with falling tax receipts. Figure 3 suggests that the dependency ratios will remain lower than in the 1960s, at least until the 2030s. However, there is a challenge of increased expectations as parents spend more on each child and as pensioners are accustomed to far higher living standards than the elderly in the last century.

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## Adapting to new macroeconomic events

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A first priority must be recognition that exposure to the world economy necessarily introduces added sources of volatility, especially for a major commodity exporter such as Australia. Moreover, it is undesirable to completely smooth out the volatility. The primary mechanism is the exchange rate, which provides information about the relative cost of domestic and foreign goods and services. Thus, in the 2003–11 commodity boom, it was appropriate to follow price signals about exploiting Australia’s mineral resources and that Australians could shift consumption patterns in favour of foreign travel and imported goods.

The boom put pressure on import-competing industries and people employed in those industries, but created bonanzas for those willing to fly-in-fly-out of isolated mining communities, for construction industry workers and for many others. Carried too far this could pose problems if activities shut down whose long-term prospects were good but for which the costs of closing and reopening are prohibitive. This is the Dutch Disease argument for muting the price effects of a resource boom. The opposite argument, tracing back to Schumpeter’s creative destruction and von Hayek’s analysis of business cycles, is that such a cleansing provides the useful function of driving out less efficient producers in the negatively-impacted industries while the more efficient firms will survive until the cycle turns in their favour.

“The boom put pressure on import-competing industries and people employed in those industries, but created bonanzas for those willing to fly-in-fly-out of isolated mining communities, for construction industry workers and for many others.”

An effective way of balancing market forces and the negative impact of excess volatility during a boom is to establish a sovereign wealth fund. Especially if volatility continues to be driven by changes in world commodity prices, a sovereign wealth fund can help to smooth fluctuations in foreign exchange earnings and public finances. Norway provides a good blueprint. Voters were persuaded in the 1990s that revenues from an oil and gas boom should be put aside for future use rather than being used to finance greater government expenditures and cut taxes. In September 2017, the value of Norway’s fund passed US\$ one trillion. In the 1970s the Whitlam government toyed with a similar fund for Australia, but it was set aside then and by all future governments. Clearly, the horse has already bolted in the sense that the opportunity to save revenues from the pre-2011 boom has been squandered, but the commodity bust is a good time to discuss the next boom and rethink resource taxes, wealth funds and other smoothing mechanisms.

Keynesian monetary and fiscal policies can also play a role, but less so if cycles are externally driven than if we are facing domestic business cycles. The Reserve Bank of Australia should be given clear targets, and not expected to achieve all goals. Similarly, countercyclical fiscal policy has limits. Rapid increases in public expenditure will be associated with inefficient choice of projects, as happened with the October 2008 and February 2009 stimulus package<sup>2</sup> while tax cuts are often difficult to reverse.

Does Australia need to place increasing emphasis on flexibility and on retraining and compensation policies to help smooth adjustments? Yes. However, it is difficult to predict specific training needs, so the emphasis should be on developing general-purpose skills (e.g. financial training for personal finance, running a small business, etc). Such courses should be offered to all age groups from teenagers up, including delivery as easily-accessible short-courses for adults. These are medium-term policies to increase workforce flexibility whose desirability goes beyond responding to external challenges.

The most difficult challenge for public policy is how to identify and assist those who are hurt by forces beyond their control. The training policies outlined above should increase the ability of individuals to adjust more nimbly. However, in the short-run, the government must offer unemployment insurance to help people between jobs. As with all social policies the challenge is to balance the claims of fairness and support for Australians down on their luck, with the logic of price signals pointing in directions that are not embraced by all potential workers.

There may also be special cases where help is needed for sectors exposed to global movements. The policies advocated above are inadequate if a company town is struck by negative shocks. This is difficult because, without the steel mill, there may be no reason for 20,000 people to live in Whyalla on the northwest coast of the Spencer Gulf, but many people resist geographical mobility. Similarly, residents of Elizabeth have been hard hit by General Motors ending Australian assembly of Holden cars. However, the sad history of the car industry's drawn out death since 1983 at huge cost in public subsidies suggests that the answer must be more imaginative than pouring cash into declining industries.

It is important to counter populist arguments that job losses are caused by trade. Although debate continues over whether trade or technology has been the main driver, on current evidence technology is the principal cause of workplace changes such as the hollowing out of mid-skilled employment. Trade contributes, because exposure to trade increases the pace of technical change. From a macro perspective, however, technical change is good, because increased productivity is a source of increased per capita output and incomes. Trade helps consumers by increasing choice and reducing cost, and helps producers by providing access to lower-cost or better-quality inputs than are available in the domestic market. Closing off trade reduces potential aggregate income and is regressive, because protectionism hurts poorer consumers who disproportionately purchase low-priced imported goods.

In sum, while protecting those facing short-term disruption, public policy should promote more trade by cutting the costs of participating in trade. Australia has ratified the WTO Trade Facilitation Agreement and should follow up on this declaration of principles by specific measures to simplify border procedures, reduce the cost of trade finance and so forth. Trade costs could also be reduced by investing in infrastructure. Unnecessarily high costs of trade especially hurt small and medium-sized enterprises and consumers of low-priced imported goods. Trade facilitation is the opposite of protectionism in that it increases average incomes and reduces the regressivity of obstacles to trade.

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## Completing the reform agenda

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Beyond these answers to the specific questions of adjusting to trade-driven economic change, there is pressing need for reform of government taxation and expenditure, and reform of workplace relations. Despite some preliminary steps, such as the introduction of the GST and industrial relations legislation in 1993 and 1996, public finance and workplace relations remain the two most incomplete areas of the economic reforms initiated 34 years ago.

Public finance reform relates to fundamental issues of federal-state-local government relations. For example, there is widespread agreement about the economic inefficiency of stamp duty that discourages sale of residential property and hence hinders labour mobility, but state governments depend heavily on this revenue source. Zoning issues that lead to conflicts between local and state governments may be hampering desirable increases in the housing stock that would also help mobility.

Public finance reform is crucial in the medium term as Australia faces the challenge of balancing entrenched, or difficult to reduce, entitlements and diminishing real revenues. There is widespread agreement that good infrastructure and investment in human capital are keys to future growth, and both are areas where externalities suggest the need for public spending. Without broad public acceptance of the level and type of taxes and of public spending, the demands of infrastructure and education, including the adult-training advocated above, will not be addressed adequately.

Even more controversial, and a major divide between the two main parties (and obstacle to bipartisan reform), are changes to workplace relations. Moving away from centralised wage and employment determination was an important part of Australia's reform package. The Keating Government's *Industrial Relations Act 1993* initiated the transition from centralised wage-setting to productivity-focused enterprise bargaining, underpinned by compulsorily arbitrated awards and arbitrated wage increases, and the Howard Government's *Workplace Relations Act 1996* continued the process. The thrust of these reforms was to shift, as far as possible, responsibility for determining matters affecting the employment relationship to the employer and employees at the workplace or enterprise level. However, over the next dozen years bipartisan consensus broke down, and the Rudd Government's *Fair Work Act 2009* unwound some elements of the previous reforms. Separate reviews by the 2012 Fair Work Act Review Panel (appointed by then Minister Shorten) and a 2015 Productivity Commission report have identified a number of areas in which the *Fair Work Act* could be improved, for example with regard to union right of entry into workplaces, transfer of business and unfair dismissal provisions.

The Productivity Commission Report highlighted the challenge of designing a workplace relations framework that addresses potentially unequal bargaining power, while encouraging employment and enhancing economic efficiency, and

“Public finance reform is crucial in the medium term as Australia faces the challenge of balancing entrenched, or difficult to reduce, entitlements and diminishing real revenues.”

highlighted “several major deficiencies” in need of reform. In particular, it stressed the drawbacks of an over-legalistic system and the ways in which the *Fair Work Act 2009* gives too much weight to procedure over substance. For example, despite serious misconduct an employee may receive compensation under unfair dismissal procedures. Awards often introduce inconsistencies, and penalty rates for Sunday work are an anachronism. Lack of flexibility in awards can cause problems in some cases, especially for greenfield operations. Processes for voting on strikes, limits to employers’ range of responses, and lack of punishment for sham contracts are other areas the Commission associates with the current system’s legalistic bias and lack of flexibility.

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## Conclusions

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As with any major economic force, globalisation creates winners and losers. The evidence for Australia from before and after the 1983-2003 reforms is of large foregone opportunities due to protectionism before 1983 and large aggregate gains over the last quarter century from trade liberalisation. The 21st century has also seen greater relative price volatility, associated with a commodity-driven exchange rate. While some individuals benefited hugely and many consumers revelled in the greater range of consumer goods and opportunities for foreign travel, workers worried about reduced job security. Many became unemployed, with some groups, such as elderly workers or workers in disadvantaged regions, experiencing difficulty in finding new jobs.

The political challenge for Australia is to balance the benefits and costs. On the one hand, boosting productivity so that ever more gains from trade can be realised. On the other hand, providing a decent safety net so that those losing their job are helped through the difficult period of transitioning to new employment, and those permanently disadvantaged, such as the disabled or the elderly, have longer-term support. Such a balancing act is easier said than done, but this chapter has argued that the most successful response to the challenge will be to continue the reform agenda so ably pursued between 1983 and 2003, but neglected since then.

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### Endnotes

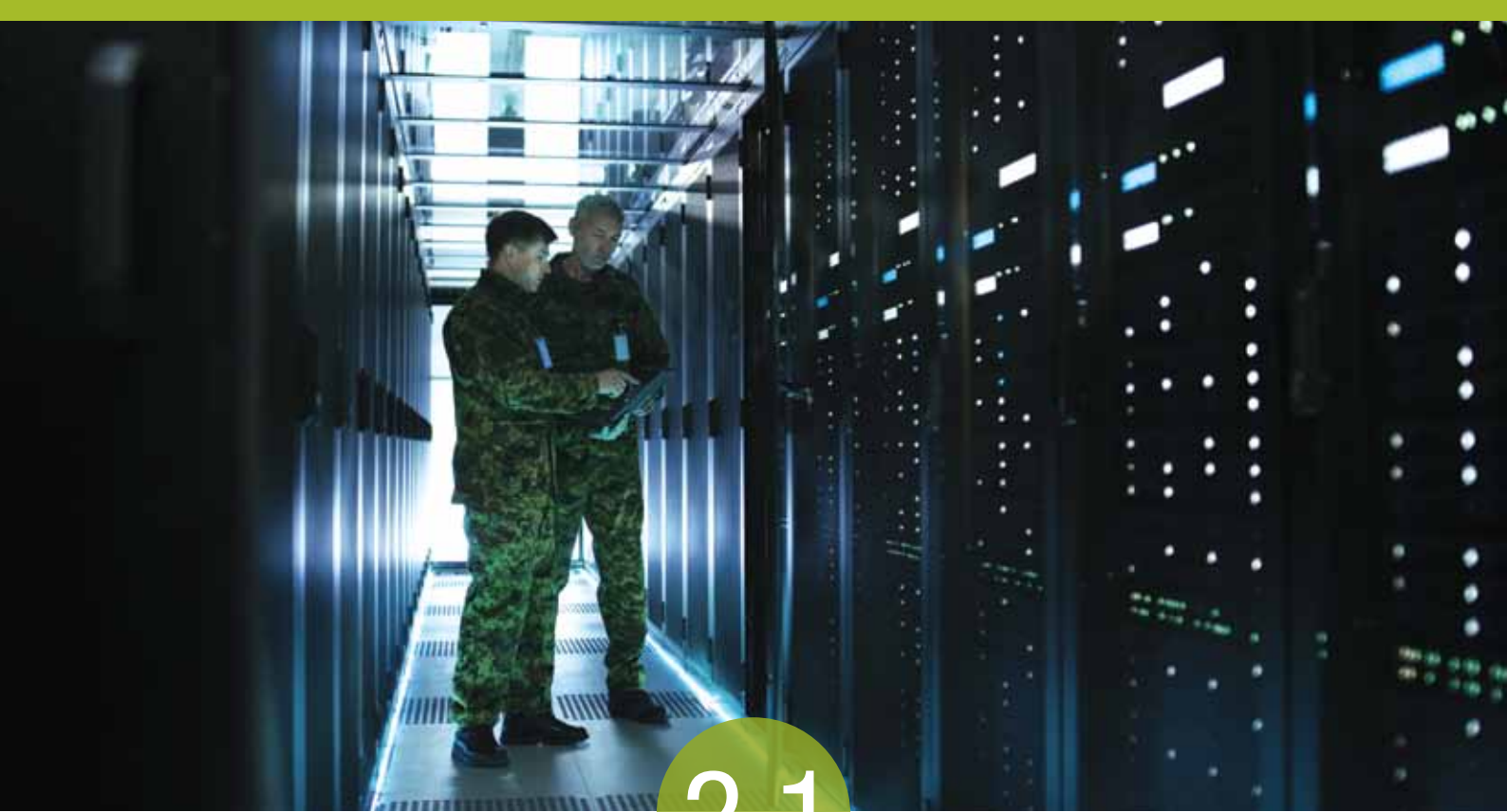
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SECTION  
2

GLOBAL  
security





# 2.1

## Are Australian responses to the change in global security adequate?

Professor Michael Wesley

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With terrorism remaining the most disruptive transnational challenge to global security and the threat of cyberattacks continuing to rise, Australia's traditional sense of remoteness from international security trends no longer applies. This chapter looks at the complex and evolving threats to global security and Australia's responses to them.

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## Introduction

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The global security picture has evolved in important ways over the past year, potentially signalling a self-reinforcing process of transformation of global security trends that could well accelerate over the near and medium terms. Some of the dynamics of global security are consistent with trajectories that have been apparent for some decades – principally the overall decline in inter-state wars in parallel with the rise and persistence in civil wars and sub-state political violence. But others are genuinely new, such as the rise of coercive but non-violent rivalry between powerful states. Even more concerning is the way in which interstate rivalries, transnational threats and sub-state violence have begun to significantly affect each other. If these trends continue, they will accelerate the recent tendency of global security affairs to infect and affect what have hitherto been seen as non-security realms.

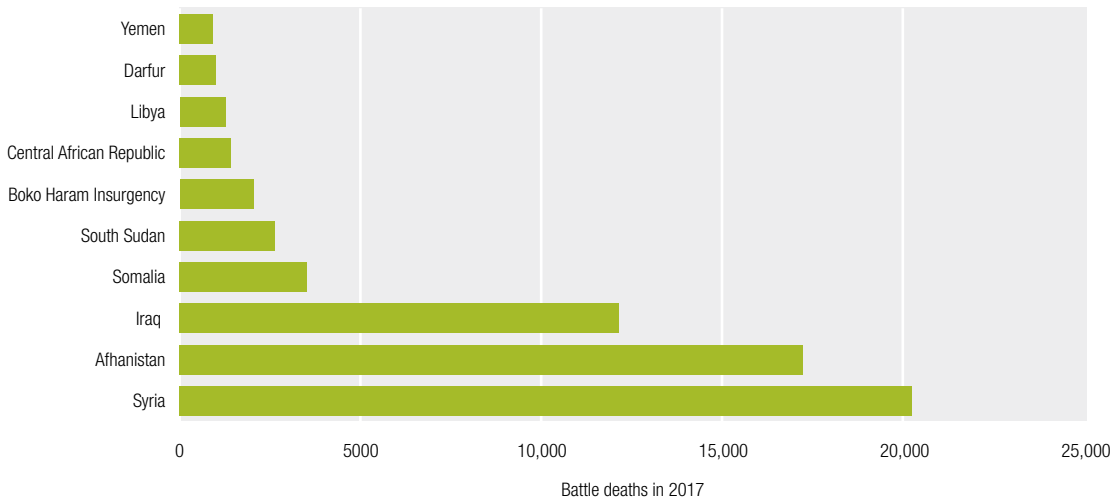
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## Intra-state conflict and global security

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For the past half century, the frequency and deadliness of inter-state wars has been declining, while the prevalence and fatalities of conflicts within states has been either rising or steadily high. While the end of the Cold War saw an absolute decline in both the number of civil wars and the number of people killed in those wars, the second decade of the 21st century has seen a steady rise in both the number and deadliness of intra-state wars. The year 2014 saw the number of deaths due to civil wars exceed 100,000 for the first time in a quarter century.<sup>1</sup>

**FIGURE 1**  
**TEN MOST DEADLY CIVIL WARS, 2017**



Source: The International Institute of Strategic Studies Armed Conflict Database <https://acd.iiss.org>

The past year has seen a decline from the 2014 peak, but the number remains stubbornly high. Of the ten most deadly civil wars over the past year, six are less than a decade old and nine have begun during this century. They are heavily concentrated in five sub-regions: Central Asia, West Asia, North Africa, West Africa and East Africa.

Two trends make the past year's major civil wars significant for security. The first is the deliberate use of terrorism and forced mass migration as battle tactics by the militants involved. Syria, Afghanistan/Pakistan and Iraq have seen the highest frequency of terrorist attacks (predominantly suicide bombings) and the highest numbers of terrorism-related casualties over the past year. The impact of these terrorist tactics outside of these countries has been the deliberate use of terrorist attacks in third countries as part of the general strategy of the insurgent/terrorist groups, often connected to the actual or perceived involvement of these third countries in the civil wars they are fighting.

The eruption of major internal conflicts in Iraq and Syria after 2014 led to major people movements into neighbouring countries such as Turkey and Lebanon and more broadly into Europe. These latter movements into Europe conflated with longer-term flows of people fleeing conflicts in sub-Saharan Africa, leading to between one and two million people entering Europe by the end of 2015. This coincided with statements by the Islamic State group that it would flood Europe with refugees, among which would be up to 4,000 jihadist fighters.<sup>2</sup> The movement of refugees into Europe has been destabilising to that region, with recent refugees being both the perpetrators and victims of terrorist attacks in Europe over the past year. It is also arguably one of the major factors contributing to the higher volatility of European politics over the past 12 months, particularly in terms of the surge of support for far-right political parties and movements.

The second broader trend is the increased tendency of neighbouring or extra-regional powers to become involved in the fighting in civil wars, often supporting opposing sides in the conflict, leading to major intensification of inter-state tensions. Emblematic of this trend has been the complex

cocktail of external intervention involved in the Syrian civil war, with Russia, Iran and Lebanese Hezbollah supporting pro-regime forces; the United States and its allies supporting moderate opposition forces; and Turkey battling Kurdish independence forces. Also significant are Iran's and Saudi Arabia's backing of opposing forces in Yemen and new allegations that Russia is supporting Taliban forces in Afghanistan that are fighting US and NATO troops.

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## Transnational security challenges

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Transnational security challenges are those dynamics that flow across national borders to challenge the safety and stability of states and regions. These are not new issues, many having been identified as the “dark sides of globalisation” in the 1990s. But transnational challenges are themselves evolving quickly, often in response to the accelerating development of information and communications technology which enables new techniques and contexts to be exploited by the malevolent, the desperate and the greedy. And by their nature, transnational flows and capabilities are often the transmission avenues among different sites and types of conflicts.

Terrorism maintains its status as the most disruptive transnational challenge to global security during the past year. The number of terrorist casualties is down from the peak year of 2014, but the tempo of attacks over the last 12 months has remained constant. The highest casualties from terrorist attacks are within civil war zones – Syria, Iraq, Afghanistan/Pakistan, Somalia, Libya, Ukraine and Yemen. However, it has arguably been the less frequent and less lethal attacks in Europe and North America that have captured attention and had the greatest effect on global politics and markets.

Terrorist tactics have continued a trend of bifurcating into more and less complex variants. The Islamic State, various al-Qaeda affiliates, and the Taliban have honed the techniques and tactics of complex and spectacular terrorist attacks over years of internal warfare, and increasingly they are able to share these tactics with other like-minded groups. Recent evidence shows that Islamic State has also been able to plan and execute out-of-theatre attacks such as the Berlin Christmas market attack of December 2016. At the opposite end of the spectrum of complexity are the “lone wolf” attacks, often carried out by perpetrators claiming to support a jihadist movement, but without any direct involvement of that movement. These attacks are typically carried out with “everyday” weapons – cars, trucks, knives – or with firearms, and often claimed by Islamic State or another group after the fact. Because of their lack of complex planning and reliance on easily obtainable weapons, and the self-radicalised nature of many of their perpetrators, these attacks are much more difficult for security forces to detect and prevent.

Terrorist groups have also continued to spread their “franchises” outside of their prime areas of combat over the past year. Al-Qaeda's offshoots in the Arabian Peninsula and Maghreb have been active for over a decade, while Islamic State

has spawned “wilayats” in Libya, Afghanistan and Sinai. With the group’s retreat in Iraq and Syria, security agencies have been much concerned with the prospect of “foreign fighters” leaving those battlefields and returning home to carry out attacks. With significant numbers of Southeast Asians having travelled to fight in the Levant, the prospect of returning jihadists beginning a terror campaign in Southeast Asia has been high. In May 2017 these fears were realised when a major urban battle erupted in the southern Philippines city of Marawi, where local authorities had attempted to arrest a local leader who had been anointed its “emir” in Southeast Asia by Islamic State. The battle for Marawi rightly alarmed governments in Australia’s region. The sophistication of the jihadists’ urban warfare tactics, the influx of significant numbers of “foreign fighters” to join the conflict, and the prominence given to the battle in jihadist propaganda all raised the real prospect that Islamic State has established a significant foothold in Southeast Asia.

Perhaps even more dangerous than the export of violence is the highly sophisticated information operations of Islamic State and other radical jihadist groups. The use of the internet and other social media tools, using slickly packaged propaganda materials, has been a hallmark of Islamic State’s success in radicalising supporters, attracting foreign fighters, and inspiring sympathetic terrorist attacks in third countries. This propaganda is designed to play on the frustrations of minority communities, just as the steady tempo of terrorist plots and attacks are designed to polarise societies anxious about immigration. This poses an ongoing challenge to diverse, liberal and democratic societies in preserving their animating values.

The past year has seen the highest levels of population displacement on record, with 65.6 million people currently forcibly displaced worldwide.

Of these, 22.5 million are estimated to be refugees and 10 million are stateless people. Fifty-five per cent of the total refugees in the world today are from the conflict zones of Syria, Afghanistan and South Sudan.<sup>3</sup> While over a million refugees have flowed into Europe, the major hosts of people fleeing war zones are neighbouring countries: Turkey (2.9 million), Pakistan (1.4 million), Lebanon (1 million), Iran (979,000) and Uganda (940,000). Major flows of people fleeing conflict have led to increased tensions between states. In Europe, the Schengen Agreement has come under severe strain as member states have lost faith in the EU’s ability to secure its external borders and have turned to protecting their national borders instead. In Southeast and South Asia, the eruption of conflict in Myanmar’s Rakhine State has led to large movements of Rohingya Muslims into Bangladesh and other countries, leading to tensions between Bangladesh and Myanmar and between Myanmar and some of ASEAN’s Muslim members.

The spread and rapid evolution of information and communications technologies has enabled a varied and changing array of transnational challenges. The possibilities of complex and serious crime have increased exponentially, while placing

“The past year has seen the highest levels of population displacement on record, with 65.6 million people currently forcibly displaced worldwide. Of these, 22.5 million are estimated to be refugees and 10 million are stateless people.”

the ICT infrastructure on which societies increasingly depend at substantial risk. Over the past year, the most serious threat has arisen from the expanding use of “ransomware”, or computer viruses that shut down users’ access to their information systems until a ransom is paid. One recent study reports that over 60 per cent of Australian businesses responding to the survey reported experiencing at least one ransomware incident during the last 12 months.<sup>4</sup> Of those affected by ransomware attacks, 57 per cent reported paying the ransom. “Phishing”, or the sending of duplicitous emails, is by far the most popular method of delivering malware, and there is a clear trend that phishing emails are becoming much more sophisticated – in terms of making it much harder to spot their inauthenticity.

Another dangerous trend has been the stealing of personal data collected by government agencies and companies, with a view to selling or using this data for criminal or coercive purposes. As the modern economy and governance moves towards collecting and storing personal data on ICT systems, societies, organisations and individuals are becoming increasingly vulnerable to data theft. A collapse of public trust in data collection and storage systems could potentially have enormous costs for business and government.

Criminals are not the only actors interested in using global communications connectivity for malicious purposes. States are very aware not only of their own vulnerabilities to cyber attacks, but also of the vulnerabilities of their rivals. While many states have developed potential capacities towards using offensive cyber capabilities under conditions of conflict, there is mounting evidence that a small number of states is already using cyber capabilities offensively. The most high profile of these is Russia, which has in the recent past used cyber attacks as an element of coercive strategies against Georgia, Estonia and Ukraine. Over the past year, there have been a growing number of claims that agents of the Russian state have used social media to influence domestic politics within the United States and several European countries.<sup>5</sup> There is also substantial evidence that a Russian hack was the source of a massive and damaging leak of emails from the Democratic National Committee.

“As the modern economy and governance moves towards collecting and storing personal data on ICT systems, societies, organisations and individuals are becoming increasingly vulnerable to data theft.”

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## International rivalries

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Since the Global Financial Crisis, global power transition trends that have been in train for decades have become increasingly manifest. A century that began amidst almost universal acknowledgement of the “unipolar moment” of American global supremacy has turned into a chronicle of the United States’ relative decline against rising and resurgent challengers. These challenges to American primacy have occurred against the backdrop of the possession of nuclear weapons by most of the world’s major powers, and the increasing integration of national

economies, both of which substantially raise the potential costs of major wars between the great powers. This has drawn the global security environment towards a dynamic of rising non-violent rivalry between powerful states.

One manifestation of these rivalries has been the resurgence of territorial disputes, particularly in the form of border disagreements and irredentist claims. Two of the most dangerous territorial disputes are in the western Pacific – the Senkaku/Diaoyu Islands stand-off between Japan and China, and the South China Sea dispute between China, Taiwan, Vietnam, the Philippines, Malaysia, Brunei, and potentially Indonesia. Both have been relatively quiescent over the past twelve months in comparison to the preceding years. In their place, another potentially dangerous border dispute arose between China and India. In June, Indian forces intervened to stop China building a road across what India sees as the territory of its ally, Bhutan, on the Doklam plateau in the Himalayas. The stand-off dragged on into its third month, amidst escalating rhetoric from Beijing and New Delhi, before the two Asian giants agreed to withdraw and de-escalated the dispute in September.

Another manifestation of inter-state rivalries has been a rising tendency for states to intervene in civil wars, often using these interventions to fight “proxy wars” against their rivals. This has occurred in the Middle East and Ukraine, and arguably in Afghanistan.

A third vector of great power rivalry has centred on competition over the alignments of smaller states. One interpretation of China’s assertiveness in the East and South China Seas has been that it has been partly motivated by Beijing’s desire to stress American alliances in the western Pacific, by calling into question the credibility of

“Two of the most dangerous territorial disputes are in the western Pacific – the Senkaku/Diaoyu Islands stand-off between Japan and China, and the South China Sea dispute between China, Taiwan, Vietnam, the Philippines, Malaysia, Brunei, and potentially Indonesia.”

US security commitments to its Asian allies. Potentially, China is challenging the United States to go to war over several small island groups in the western Pacific claimed by its allies, the Philippines and Japan. There has been some speculation that Russia has been similarly working in Europe to loosen the cohesion of NATO and the European Union.

There is mounting evidence that power rivalries are being increasingly carried out through the use of various economic means, or “geoeconomics”. The backdrop to this is growing American and Japanese anxiety about China’s surging economic performance, and their own relative displacement from the centre of the Asia-Pacific economic order; a development that has accorded China the status of the major trading partner of most countries in the Asia Pacific (many of which are aligned in security terms with the US). At the same time that China feels that its relative economic power and importance are not matched by its relative status and influence in global economic governance.

Under President Obama, the United States increasingly characterised the Trans-Pacific Partnership trade agreement in terms of its rivalry with China. While President Trump withdrew the United States from the TPP in January, this does not mean that the new administration has rejected geoeconomics as a way of asserting its interests. Over the tenure of the Trump administration, the United States has repeatedly threatened China with trade measures, even if it has not followed through on these, and has used actions such as the announcement of arms sales to Taiwan to signal dissatisfaction with China's actions in relation to North Korea.

For its part, China has announced a series of international economic initiatives that have apparent strategic implications. Foremost among these is the Belt and Road Initiative, ostensibly a massive infrastructure building project connecting China to Asian and European markets, but which has been interpreted as furthering China's power ambitions in a range of ways. The integration of smaller economies to the big, dynamic Chinese economy via infrastructure links can potentially impact the strategic alignment and dependence of smaller neighbouring countries. Certainly, some Asian countries, such as Myanmar and Sri Lanka, have elected to change their domestic and international policy settings partly due to fear that they were becoming exclusively tied to the Chinese economy via infrastructure links.<sup>6</sup>

Not all aspects of rising international rivalry are non-military. The past year has seen global arms spending increase for the first time since 2011, to \$1.68 trillion. The major contributors to this increase are the United States (up by 1.7 per cent), Russia (up by 5.9 per cent), China (up by 5.4 per cent) and Europe (up by 2.6 per cent).<sup>7</sup> Australia's region, Asia/Oceania, saw a rise over this period of 4.6 per cent. Deeper analysis shows that the predominant trends in military spending are towards maritime-oriented weapons systems: ships, submarines, missiles, aviation, surveillance systems. The prospect of increasing maritime military competition around some of the world's most crowded littorals and busiest trade corridors is a major challenge to global security.

Another conventional threat that has intensified over the past year has been North Korea's acceleration of its push for nuclear missiles. The years 2016 and 2017 have seen an intensification of Pyongyang's testing of both nuclear devices and missiles, featuring three of North Korea's six nuclear tests (including two allegedly fission devices) and 20 missile tests (five in 2016; 15 in 2017). As significant as the tests have been their location, with several of the missile flights transiting over Japan and heading towards the US territory of Guam. In response to Pyongyang's programs, the United States has intensified its rhetoric against North Korea, mobilised additional forces towards the Korean Peninsula, and intensified its pressure on China to increase sanctions against its ally. North Korean dictator Kim Jong Un has responded to Washington's threats in kind, leading to broad concern about the prospects of war in Northeast Asia.



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## Australia's responses

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Australia, despite its traditional sense of remoteness from international security trends, has been highly responsive to the complex and evolving dynamics of global security. Since August 2014, Australia has contributed around 780 personnel as well as military aircraft to the US-led coalition operations against Islamic State in Iraq and Syria. These have been divided into an Air Task Group, taking part in air strikes against Islamic State and in support of Iraqi and moderate opposition forces in Syria; a Special Operations Task Group advising Iraqi armed forces; and Task Group Taji, charged with building Iraqi military capacity. Australia maintains a small force of military trainers in Afghanistan supporting the work of that country's armed forces against jihadist forces there.

In its own region, Australia has been progressively moving towards providing similar types – if not levels – of support to the Philippines in its conflict with IS affiliates in the southern Philippines. In September, Defence Minister Marise Payne announced ADF training support for Philippines Armed Forces, to complement the contribution of Orion surveillance aircraft and humanitarian assistance to the region. Given the Philippines' sensitivity about foreign forces on its soil, it is unlikely that Australian forces will play more front-line combat roles there as they have in the past in Iraq and Afghanistan.

In response to the transnational threat of cyber attacks, Australia has progressively strengthened its defensive and offensive capabilities. In April 2016, the government launched a comprehensive cybersecurity strategy, allocating resources towards enhancing technical cyber defences, cyber partnerships with private industry, and raising cyber security awareness in broader society.<sup>8</sup> In June 2017, the government announced the creation of a new cyber warfare unit, ostensibly to take the fight to cyber criminals, but no doubt to enhance Australia's own capabilities to deter states threatening its own national security sensitive cyber systems.

Terrorism and other complex transnational threats have motivated the largest reorganisation of Australia's national security architecture in 40 years – the creation of a single Department of Home Affairs including Australia's major policing, domestic intelligence and border security agencies. The move has been motivated by the Prime Minister's doubts that Australia's decentralised system of security agencies is best structured to address the fast-evolving, complex and interdependent threats of terrorism, cyber-threats, criminality and foreign espionage and interference. The structure, resourcing, and staffing of the new super-Department were unspecified, left to a Task Force within the Prime Minister's Department to work through. There is little option but to defer judgement on the wisdom of the changes and their net effect on Australia's national security.

Australia has responded significantly, though not comprehensively, to the rising power rivalries in its region. The release of the much-delayed 2016 *Defence White Paper* in February 2016 confirmed that the government is committed over the long term to responding to the growth in military spending in its region. The White Paper commits Australia to increase defence spending by six per cent in real

terms by fiscal year 2017–2018 to \$34.7 billion, with an intention of increasing defence spending to two per cent of GDP by 2021. The bulk of this spending, matching regional trends, is directed towards maritime-oriented capabilities, the most significant of which will be 12 long-range, conventional future submarines.

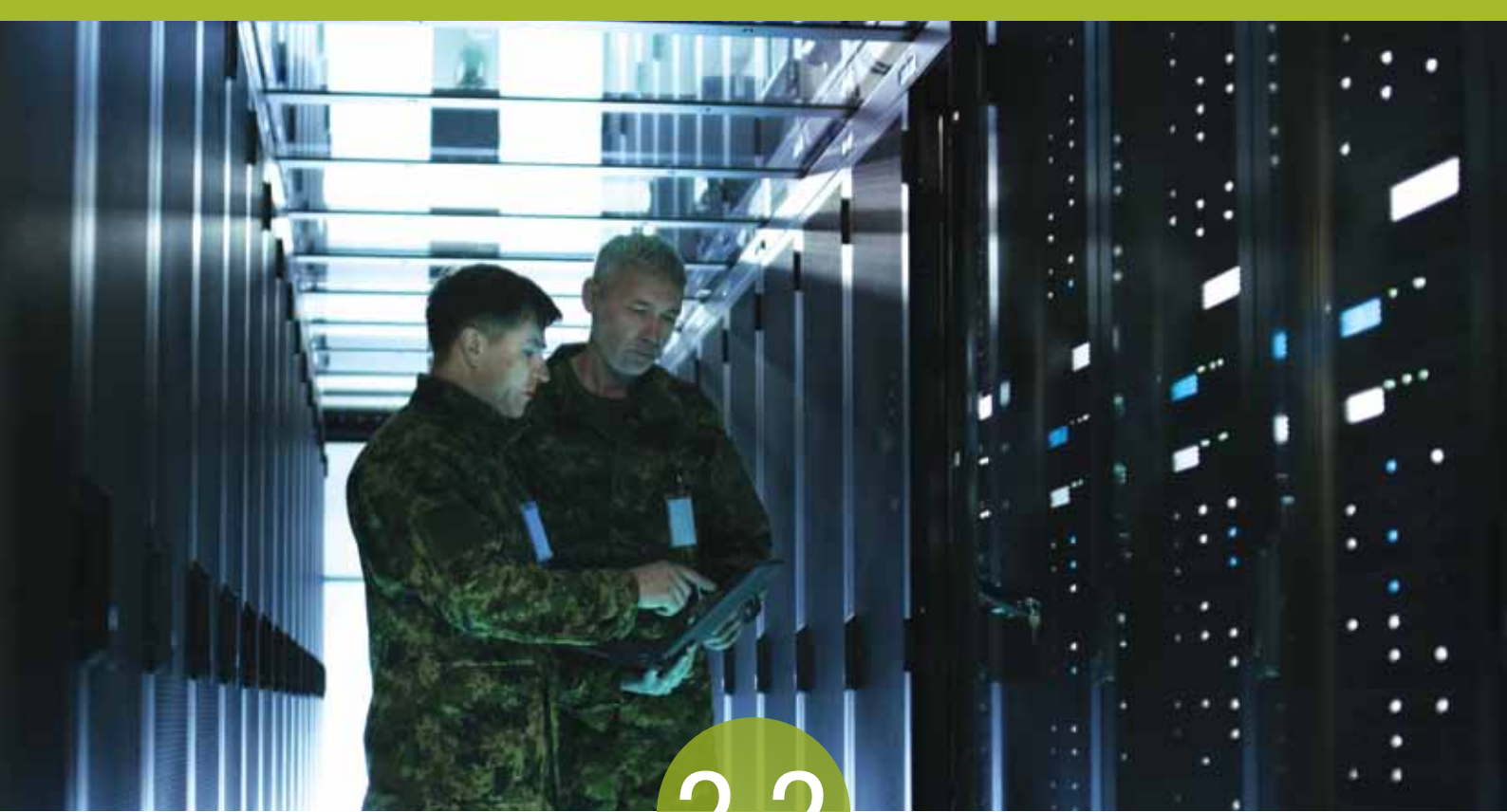
Australia's security partnerships have also evolved to deal with new uncertainties in its security environment. As Australia's economic relationship deepens with China, a country ever more obviously seeking primacy in the Asia Pacific, Canberra has sought to broaden its alliance partnership with the United States. This was particularly exemplified by the Gillard Government's 2011 decision to allow the rotation of US Marines forces through Darwin. Despite the uncertainty of US policy in the region under the Trump administration, the Australian Government has remained a staunch supporter of US policy in the region, especially in relation to North Korea. At the same time, Canberra has been building "alliance-plus" relationships with like-minded US partners and allies such as Japan and Singapore in recent years. Australia's courting of India as a strategic partner has resumed in earnest, though with uncertain results.

Where Australia appears relatively ill-prepared is in its readiness to deal with unconventional sources of influence. The tenor of debate in Australia about Chinese investment, and influence on Australian political parties and universities has reached unprecedented levels over the past year, arguably reflecting a lack of preparedness or clear strategy in Australia for countering unwelcome influence. It is not unreasonable to assume that Australia may well be already a prime target for non-violent rivalry among the great powers; however, its political and economic regulatory settings remain designed for a world of uncontested western primacy. This is arguably Australia's most serious vulnerability in the years to come.

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# 2.2

## Are Australia's responses to cyber security adequate?

Professor Greg Austin

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This chapter examines the increasing importance of cyber security to national security policy and what steps are being taken by Australia and other nations to increase their capabilities in this space.

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**Professor Greg Austin** is recognised internationally for ground-breaking work over two decades on China's international security policy and more recently for work on international and national aspects of cyber security. He has held posts in government, academia and non-profit organisations in London, Brussels, Hong Kong and Canberra. He has led consultancy projects for the UK Cabinet Office and the Australian Government. As a Vice President of the EastWest Institute, Professor Austin took a leadership role in developing new policy programs, including the internationally prominent Worldwide Cybersecurity Initiative. His latest book, *Cyber Policy in China* (Polity 2014) was launched at the Brookings Institution in Washington DC in December 2014. He is a Professor at the Australian Centre for Cyber Security at the University of New South Wales Canberra and a Professorial Fellow with the EastWest Institute. He has a PhD in International Relations and a Master of International Law from the Australian National University.

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## Introduction

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Australia's place in global security affairs took a sharp turn in June 2017 when the government of Prime Minister Malcolm Turnbull announced creation of the country's modified version of a US Cyber Command. The organisation would be called the Information Warfare Division (IWD) of the Australian Defence Force (ADF), subordinated to a new Joint Capabilities Group (JCG). The move followed the 2016 *Defence White Paper* which foreshadowed a near doubling of defence expenditure in the decade, including 1700 new military and civilian posts in cyber or cyber-related roles. This was supported by an announced spend of \$400 million over subsequent years on cyber or cyber-related activities. But there are likely less visible but additional significant funds for research in the budget of other programs. This chapter explains the background and places it in the context of the country's national innovation potential.

The Australian Government places great importance on military security in cyber space both for its own sake and for its potential role in international collaboration for mutual economic benefit and national economic prosperity. The Australian Defence Force is on the cusp of a revolution as it prepares to reorganise for cyber-enabled warfare; and the Australian cyber security industry is set for significant growth. The military shake-up comes two decades late, and the country faces some security penalties because of the delay. Ironically, the country also stands to gain from the delay as related technologies have moved very rapidly. What once seemed like a discrete sub-sector in the civil economy (cyber security) has now become transformative of national defence as it blends into other technologies like robotics and advanced artificial intelligence, including exploitation of big data and high-performance computing.

There is a key distinction to make at the outset. Cyber security for national military defence is a very different phenomenon from cyber security for the defence of enterprises and individual citizens (the civil sector). The Australian Government has staked much in public on development of civil sector cyber security capabilities, through industry promotion and development of a much-needed national skills base. This is a sort of techno-nationalism (protectionism) that is somewhat out of touch with the realities of a globalised knowledge economy in which US and European firms dominate. Many services for cyber security in Australia are already provided remotely (offshore) through system and network monitoring. In stark contrast, the needs for military defence and national security in cyber space can only be met by a sovereign, non-globalised knowledge economy open to the outside only through our closest intelligence allies in the “five eyes” community (the United States, United Kingdom, Canada, New Zealand, and Australia). Australia can and should compete in niche areas in the globalised civil sector economy of cyber security, but it will be the developments in areas of sovereign capability that will provide a quantum leap to our industrial base in the civil sector. This is a key lesson from the political economy of cyber security in Israel and, to a lesser extent, in Taiwan.

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## Pathway to revolution

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The chronological departure point of the policy turn toward the cyber military revolution occurred sometime after the 2013 *Defence White Paper* was published. That document noted merely that “Defence will continue to integrate cyber capabilities into routine planning and command and control processes in addition to maintaining and remediating the networks and systems”<sup>1</sup>. The concept of “information superiority” or “information dominance”, central to the US understanding of the cyber military revolution, does not explicitly appear in the 2013 White Paper. It painted a picture of a defence organisation hamstrung by tight budgets and outgunned in the region. An earlier White Paper, in 2009, had foreshadowed that Australia needed “to be more capable in this area by 2030” and that “the risk of cyberattack is even greater than we had first thought”. It reported that the government had “decided to invest in a major enhancement of Defence’s cyber warfare capability” but it talked of “information superiority” for decision-making only, suggesting “modest capability developments, while keeping open the option of enhancing our capabilities”.

Australian policy documents up to 2013 stuck with the decades-old view that Australia could maintain a technical edge over its regional rivals that might help compensate for smaller numbers. The 2013 White Paper observed that “superiority in combat and other military operations will hinge on continual technological advancement... providing significant strategic, operational and tactical advances to offset our strategic and fiscal challenges”. But there was no significant attention to the emerging cyber military revolution globally. In mid-2015, ADF sources reported that they were impatient for change in cyber military capability and that the government was holding them back.

There are several domestic and international factors that separately or in some combination help to explain the radical shift that formed through 2016 and was announced in 2017. The Liberal National Party coalition government, led by the “national security” Prime Minister, Tony Abbott, was elected in 2013. In December 2013, the Islamic State of Iraq and Levant (ISIL) began its rapid military advance into Iraq, supported by globally prominent internet-based propaganda. In March 2014, China declared its intention to do everything it could to become a “cyber power”, including consequential changes in military strategy and organisation in 2015. It was in May 2015 that China issued its first ever information warfare strategy, declaring, as the United States had done almost 20 years earlier, its commitment to the war-fighting principle of information dominance.

At the same time, through 2014 and 2015, the ADF was confronted by Russian military cyber operations as the Australian Government intervened robustly in the investigation of the Russian missile attack on MH17 and subsequently decided to deploy RAAF assets to operate in Syrian air space, where Russian military aircraft were also involved in combat. In September 2015, Malcolm Turnbull, the country’s first high-tech leader (four to five decades too late), replaced Abbott as Prime Minister. In 2014 and 2015, the United States undertook its most intense effort ever to lobby Australia to do more to counter what it saw as the China threat in the South China Sea and to work with Japan, including on military uses of cyber space, to stand up to China.

Before Abbott came to power, Defence probably did not feel it could divert scarce resources to what they felt was an experiment in military evolution. His commitment to raise Australian defence spending to two per cent of GDP lifted that budget constraint. The change was probably also facilitated by a serendipitous alignment among the military chiefs, following appointments of senior officers who have distinguished themselves by their commitment to major reform in the direction of new information warfare capabilities, and creating the intellectual and policy environment that goes with that. The easing tempo of overseas combat commitments by late 2014 probably also facilitated the change.

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## Australia will re-arm for cyber-enabled war

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While the big spend foreshadowed by Abbott and announced by Turnbull almost certainly unleashed Defence to look more radically at the “cyber command option”, this interest would have been enabled, dictated even, by important developments in the military forces of two countries of immense importance to Australia: China and the United States. As mentioned, both took radical decisions in cyber war policy that threaten to leave the rest of the world, Australia included, even farther behind them.

China’s “Military Strategy” published in 2015 says that cyber space and outer space are the new commanding heights of international security and strategic competition. By the end of 2015, China had begun a revolutionary transformation of its armed forces to execute the new cyber military strategy. Two examples

may suffice. First, it announced changes to the People's Liberation Army (PLA) command structure to support greater integration of joint operations and intelligence so essential to cyber war. This was a catch-up policy modelled on the US armed forces. If the reforms are implemented effectively, China's war fighting power in all domains, including naval operations, could be light years better than it is today.

Second, as the "Military Strategy" foreshadowed, this recrafting of command structures will take on a uniquely Chinese aspect that has high appeal in the light of traditional doctrines of "people's war" and "active defence". The armed forces in combat will be expected to operate on a model of distributed authority that assumes a loss of central command resulting from cyber attack by a superior enemy. This is captured in the strategy when it calls for reducing central command authority to foster the conditions of victory in cyber-enabled war under the rubric of "self-dependence" of military units ("you fight your way and I fight my way"). But it will be embodied in practice in the rapid development of cyber militias (citizens' cyber forces) which will provide China something of an edge in its race to begin to match US full-time uniformed capability. This imperative means that the civilian workforce of specialists in cyber security is now de facto an arm of national security policy on an emergency basis in a way that it never was before.

For its part, the United States, has also quickened the pace of its cyber military development with its own radical elements. Its strategy has for two decades been premised on information dominance through cyber effect operations as the foundation for what it has called "prompt global strike" for nearly a decade. This is a strategic objective in war, not just a tactical or theatre-level ambition. In 2015, the Pentagon issued a new "Cyber Strategy" and Cyber Command issued a new planning document, titled *Beyond the Build* foreshadowing cyber options in all phases of military combat. A Pentagon Law of War Manual, also issued in 2015, and prepared with input from Australian military lawyers, says it is lawful for a country in wartime to undertake pre-emplacement of "logic bombs" in an enemy country's networks and information systems.

The most important lesson for Australia from the Pentagon documents from 2015 is that to be effective in cyber-enabled war a country needs to plan for it, structure its forces accordingly, train them for it and develop the foundations for public engagement in it. Another set of lessons is that the government must now look to shore up other foundations of capability, defence and resilience for cyber war, ranging from critical infrastructure protection to industry-based research and development and developing a civilian cyber workforce. The novel element here is that the peacetime entanglement of civil and military cyber space activities has implications for warfighting in cyber space that are very different from the classic military notions of a military/civilian divide or the divide between front line combat and the home front (or rear areas).

"The most important lesson for Australia from the Pentagon documents from 2015 is that to be effective in cyber-enabled war a country needs to plan for it, structure its forces accordingly, train them for it and develop the foundations for public engagement in it."

The United States and China are determined to create conditions in cyber space that in wartime could undermine the effectiveness of the weapons systems, deployed units and military-related civil infrastructure of an enemy as quickly as possible. They want to disable enemy cyber systems in the early stages of hostilities, or even on a pre-emptive basis. In wartime, or as war seems imminent, the countries will seek to conduct wide-ranging and large scale cyber attacks against an adversary's warships, military aircraft and ground forces – as well as civil infrastructure that supports them. The aim will be to use cyber attacks on navigation and control systems to prevent the warships from sailing or the military aircraft from flying to the maximum extent possible, or to degrade their normal deployment. Such capabilities, not fully present in any country, but definitely imminent, present almost insurmountable challenges to the security of middle powers like Australia.

To respond to the emerging environment, Australia will need to develop complex systems of decision-making for medium intensity war that address multi-vector, multi-front and multi-theatre attacks in cyber space, including against civilian infrastructure and civilians involved in the war effort. The country does not now possess such capabilities, nor is it close to achieving them. It has not even begun planning for most of them. This can be a growth area for Australia's cyber security industry.

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## How urgent are cyber military capabilities for Australia?

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Most Australian citizens see the primary security threats in a traditional (non-cyber) mold and as coming from terrorism, refugees arriving by boat, or China's navy. These three focal points of Australian threat perceptions have several things in common. They are the ones that the mass media and the country's political leaders like to discuss most. They are also easy targets for the non-specialist. They also speak to Australians' fear of the unknown.

There should be no mistake. Terrorism is a serious threat inside Australia, but the threat is on a much smaller scale than in many countries. The federal government spends not much more than \$1 billion per year, possibly up to \$2 billion, on active measures to counter it while spending around \$35 billion on military-related threats and activities. A case can be made for shifting the public rhetoric away from terrorist threats to a much more nuanced approach to the threatening technological environment that Australia faces in military uses of cyber space.

The weakness in the recent past of Australia's political elites in discussing the emerging threats with any degree of sophistication was evident in the surprising about-face by the current government when it finally acknowledged in November 2016 the seriousness of the cyber threats facing the country. In a speech to the National Press Club, the new Cyber Security Minister, Dan Tehan, told the country that Australia needed to be prepared for a "cyber storm". The prior and far less



threatening position was captured very well in 2015, when the Australian Cyber Security Centre reported that “Australia has not yet been subjected to any activities that could be considered a cyber attack”<sup>2</sup> (defined as an attack “seriously compromising national security, stability or prosperity”.)

We can compare this persistently anodyne Australian script prior to November 2016 with the language of President Obama in March 2016: “Significant malicious cyber-enabled activities” from outside the country “continue to pose an unusual and extraordinary threat to the national security, foreign policy, and economy of the United States”<sup>3</sup>. He made this statement in formally declaring the continuance of a national security emergency in cyber space that he had declared for the first time one year earlier.

In contrast to the trio of publicly perceived threats above (terrorists at home, boat people and the Chinese navy), a case can be made that Australia faces the most dangerous international security environment it has seen for decades. We can recall the period from the Cuban Missile Crisis of 1962, through the Indonesian mass murders of 1965 and 1966, and the Tet offensive in South Vietnam in 1968, to the Soviet threat to attack China with nuclear weapons in 1969. Perhaps the period 1975 to 1979 runs a close second in terms of grave threats to Australia, marked as it was by the Khmer Rouge genocide in Cambodia that began in 1975, and which led to the Vietnamese invasion of Cambodia in 1978, which in turn culminated in a short-lived Chinese invasion of Vietnam in 1979, followed by years of cross-border tension and artillery bombardment.

Terrorists, China’s navy and boat people might be serious security concerns for today but they are not the main security threats to national wellbeing that Australia and its regional partners now face. No government, Australia included, can secure itself against external or internal enemies unless it is prepared to have difficult, sustained, well-informed and transparent conversations with its citizens about the complex threats the emerging enemies represent. This includes the level of development of war-fighting technologies and the impact of such technologies on the continuing relevance of Australia’s existing weapons systems and combat platforms. Such conversations on the technological and cyber space implications for Australia are all too rare from any side of politics, and in fact might be said to be almost non-existent.

“In contrast to the trio of publicly perceived threats above (terrorists at home, boat people and the Chinese navy), a case can be made that Australia faces the most dangerous international security environment it has seen for decades.”

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## National Innovation Strategy as a response

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On a more positive note, foundations for the necessary changes have been laid. In April 2016, Malcolm Turnbull released the country's *Australia's Cyber Security Strategy*, with a sub-title *Enabling innovation, growth and prosperity*. The strategy delivered a mature and nuanced framework and held out some promise for redressing important deficiencies in the country's posture, but exclusively in the civil sector.

On the credit side, the strategy's eight-page action plan, along with its indicators of success, is ambitious in its scope. Novel measures include joint public-private threat assessment centres in the states and a series of new appointments, including an Assistant Minister, a Special Adviser (both reporting to the PM) and an ambassador for cyber affairs (all now in place). The strategy also included funding for a "cyber security growth centre" to foster indigenous industrial capability and research and development in the sector. There were also radical commitments to widen the services of the Australian Signals Directorate in the Department of Defence to meet private sector customer needs.

The inclusion of so many concrete "announceables" in the strategy was a pleasant surprise. The plan is an historic achievement. On the other hand, apart from mentions of terrorism, it does not openly discuss key sources of malicious activity in cyber space from nation states. The strategy did not have a spending plan adequate to address the pace and scale of emerging threats from state actors to the digital economy or national security, especially in the military sphere.

Many of the Australian Government's new commitments were fairly generalised and lacked granularity, such as the intent to increase numbers for cyber security graduates, women in the profession, and school students "in the know". But the first annual review in April 2017 showed remarkably little progress on the education objectives, which are after all the foundation for any enduring change. In the medium term, we will need the government to provide some metrics on how many graduates in the field we actually need. We also need to see the baseline statistics for any future growth. In 2017, the government announced very modest funding to Australian universities to promote cyber security education (\$1.9 million over four years) and a more generous funding (\$50 million over seven years) for a cooperative research centre in protection of national critical infrastructure in cyber space. These are easy measures to announce and fund, but much harder to test and evaluate for their contribution to the national needs.

Australia has some way to travel yet before it graduates to a coherent national cyber security strategy fully informed by global realities and funded accordingly. Australia does not yet have a national strategy for developing a sovereign cyber

"... the first annual review in April 2017 showed remarkably little progress on the education objectives, which are after all the foundation for any enduring change. In the medium term, we will need the government to provide some metrics on how many graduates in the field we actually need."

security knowledge economy that can sustain the war-fighting needs of the country in cyber space.

The government and its military leaders might consider articulating a comprehensive set of policies around the following benchmarks that will have important beneficial flow-on effects for the national economy:

- A national innovation strategy that keeps the country at the forefront of international best practice in cyber technologies that can be applied in war;
- A military strategy for cyber-enabled warfare that takes account of the proven and estimated character of such an armed conflict, including public intelligence assessments of likely cyber war threats and a top-end (but credible) scenario;
- A strategy for sovereign cyber war capability and cyber survivability in a time of direct military confrontation with a major power;
- A capital procurement program centred on advanced cyber-enabled war capabilities, including space-based assets and new technologies of decision-making;
- A renovation of military institutions, training and education for cyber warfare;
- Necessary investments in niche technologies and research capabilities;
- A strategy for managing civilian-military divides and critical infrastructure protection in times of military conflict;
- A strategy for mobilising cyber-capable reservists or civilians in times of military crisis; and
- A sharp distinction between the national needs for cyber security as largely a civil domain set of issues and the needs for cyber-enabled war fighting capability.

Above all else, Australia needs to build a community of interest around the concept of cyber-enabled warfare with a recognised authoritative hub that can unite political, military, diplomatic, business, scientific and technical interests and expertise.

Such changes, long delayed, are becoming more urgent. We are now seeing an intensifying frequency of cyber attacks that sit somewhere on a blurred boundary between peacetime sabotage and political subversion on the one hand and, on the other, acts of war. We need only cite Russian political hacking in the United States, that Senator John McCain and other members of Congress described as an “act of war”, and authoritative press reports that the United States has sabotaged North Korean ballistic missile tests by cyber attacks. The claims follow public US admissions that its military capabilities include cyber sabotage of ballistic missiles in pre-launch and post-launch phase.

While further delay carries with it inevitable penalties in military preparedness, Australia may have been spared the most serious potential effects since we have not been involved in a major war with a comparatively high tech enemy since 1945. Though even in our most recent and ongoing war, the one with Islamic State, Prime Minister Turnbull went public on his view in January 2016 that the coalition was losing the battle in cyber space. This has only one meaning: the coalition security forces (including the ADF) did not exploit as fully as they should have the opportunities for digital war against the political operations of the enemy.

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## Prospects

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So what lies ahead as the ADF takes up the cyber military revolution? It may even benefit from a late start. The world is at the dawn of the cyber age and highly consequential military technologies are continuing to emerge at fast speed. Even Russia and China have been late to the cyber military revolution (though earlier than Australia). The reform task will be monumental. The organisational changes announced to date will be the easy part. The challenge will be consequential changes to military doctrine, organisation, training, material, leadership, personnel and facilities. How will we raise, train and sustain our new cyber forces?

The Defence Organisation admits that it has been serially and perennially challenged to roll out modern information technologies (IT) on a large scale. If the ADF makes revolutionary changes across the full spectrum of “raise, train and sustain” for cyber-enabled war, the Defence Department will need to make corresponding changes not only to its management of IT, but also its political strategising for such wars. The department may need its own Digital Transformation Office. It is to this area of policy that we can look for the biggest positive gains to the Australian economy from the cyber security revolution.

Malcolm Turnbull is the first Australian Prime Minister in office to provide strong public leadership on the revolutionary potential of the knowledge economy, including its military applications. The character of this transformation brings social costs along with economic opportunities. In delivering revolutionary change needed for the ADF in coming years to wage cyber-enabled war, Turnbull will need to be prepared to outflank inevitable opposition to the upending of traditional arrangements and priorities. This will be as true for obstacles raised within the ADF and the Defence Organisation, as for those raised in the Liberal National coalition parties.

As the cyber military changes gather steam, the ADF will need more money and more skilled personnel. In order to meet these costs, it is highly likely that Australia will have to revise current commitments to major weapons platforms, such as 12 new submarines being built for a total cost of \$60 billion over several decades. The battle for cyber capability in the ADF is just beginning. It will last for many years. And it will need politically tough and able Prime Ministers with a cyber age vision to see it through over one to two decades.

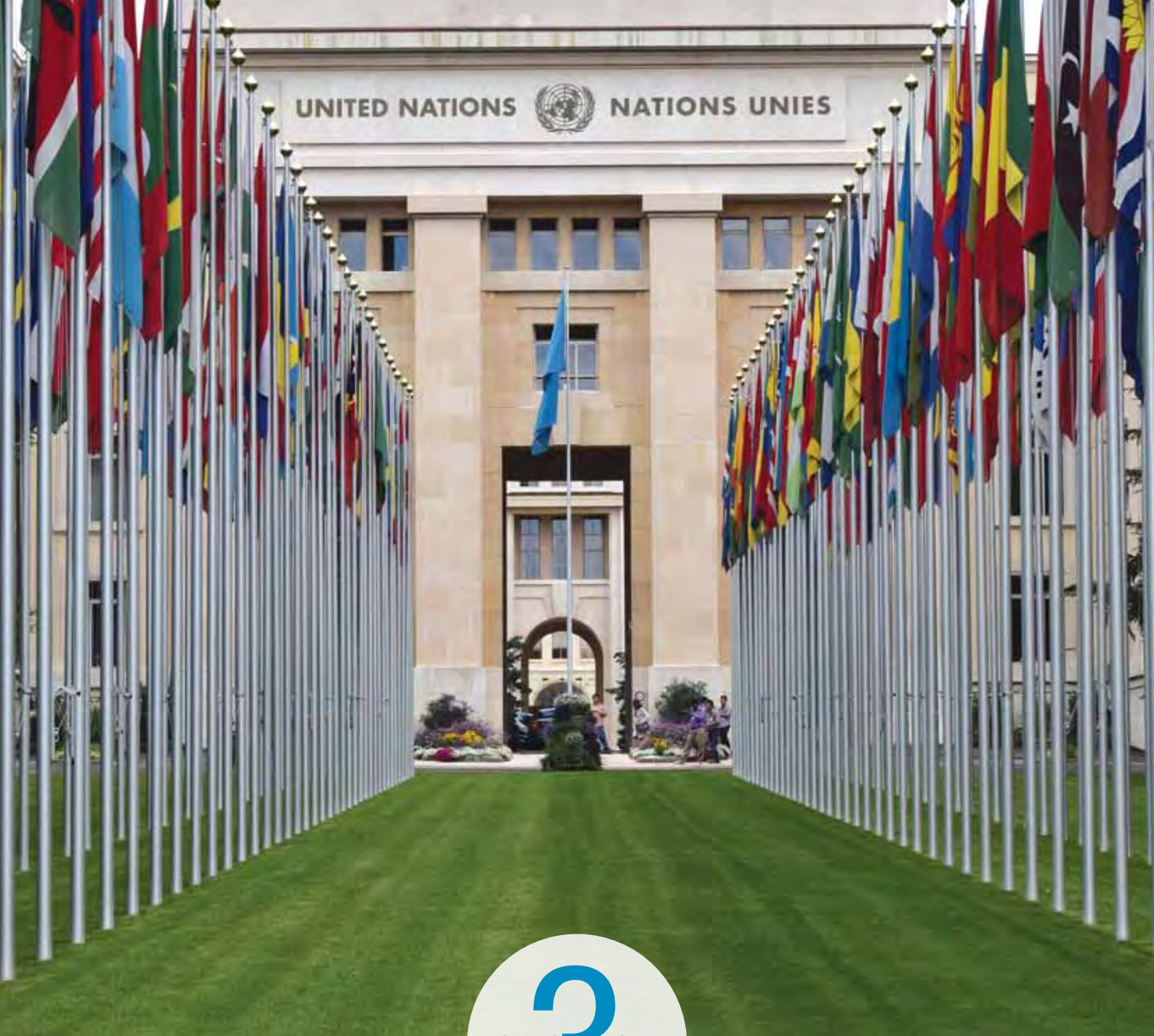
Australia is among the top 10 countries in the world for some aspects of research into security in cyber space. It is among the top scientific and economic powers of the world (as represented by its position in the G20 and its membership of the “five eyes” intelligence alliance led by the United States.) But to exploit this positioning and turn it to national economic advantage, we cannot have national economic policy “business as usual”. We cannot have education policy “business as usual”.

“In delivering revolutionary change needed for the ADF in coming years to wage cyber-enabled war, Turnbull will need to be prepared to outflank inevitable opposition to the upending of traditional arrangements and priorities.”

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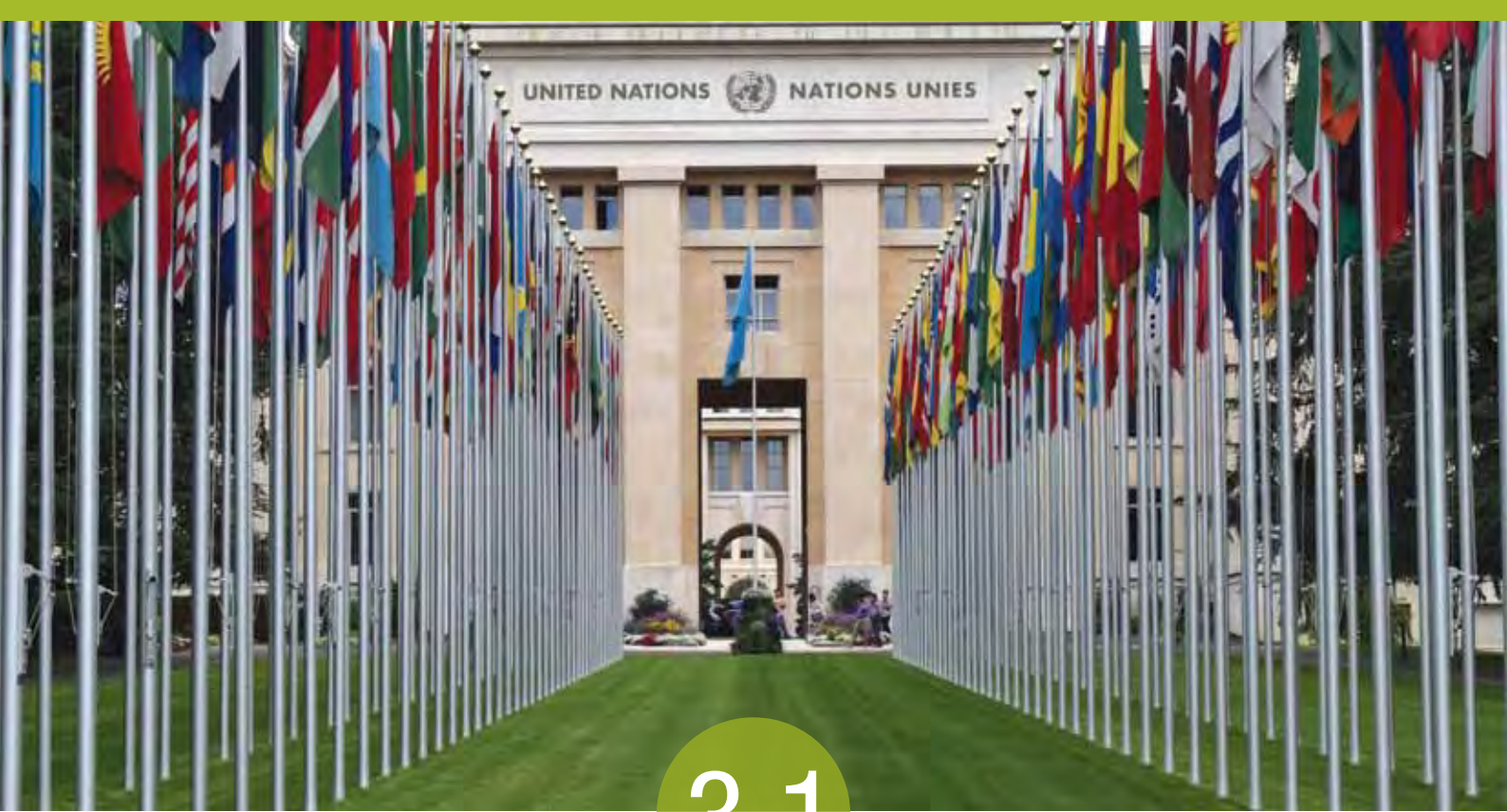
## Endnotes

- 1 Australian Government Department of Defence, *Defence White Paper 2013*, Commonwealth of Australia, 2013, p 79.
- 2 Australian Government Australian Cyber Security Centre, *2015 Threat Report*, Commonwealth of Australia 2015, p 8.
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SECTION  
3

GLOBAL  
governance



# 3.1

## Are global governance structures still working?

Associate Professor Wesley Widmaier

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From the Great Depression came Keynesianism and from the Great Stagflation came Neoliberalism. This chapter looks at the rise and fall of these styles of economic governance and what economic constructs have formed in the US and Australia since the most recent Global Financial Crisis.

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**Wesley Widmaier** is an Associate Professor of Political Science at Griffith University in Brisbane, Australia. His research addresses the historical development of the international political economy, as ideas, institutions and interests have been reshaped across moments of stability, crisis and change. He has engaged these concerns across a range of publications, most recently in *Economic Ideas in Political Time: The Rise and Fall of Economic Orders from the Progressive Era to the Global Financial Crisis* (Cambridge University Press, 2016) and *Presidential Rhetoric from Wilson to Obama: Constructing Crises, Fast and Slow* (Routledge, 2015). He is currently lead editor of *Review of International Political Economy*.

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## Introduction

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In concluding his masterwork, *The General Theory of Employment, Interest and Money*, John Maynard Keynes cast ideas as the foundations of state and societal interests. Keynes held that “the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood... the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas”.<sup>1</sup>

In short, ideas tell us “who we are” and “what we want”. More formally, in economic policy terms, ideas reduce uncertainty, stabilise institutions, and shape interests in economic governance – particularly regarding the use and abuse of market power.

To be sure, Keynes did not view such ideas as self-reinforcing. Even ideas which *initially* reduce uncertainty might *subsequently* fuel a misplaced certainty, as overconfidence obscures the need for policy and market adjustment. Where such hubris fuels complacency, crises may result, as “the practice of calmness and immobility, of certainty and security, suddenly breaks down”.<sup>2</sup>

Such events might prompt renewed debate – albeit not immediate change. Indeed, as Keynes’ contemporary John Kenneth Galbraith noted, crises may initially lead agents to cling even more fiercely to their ideas: “Faced with the choice between changing one’s mind and proving that there is no need to do so, almost everyone gets busy on the proof.”<sup>3</sup>

The onset of crisis might initiate debate – which could take years or decades to resolve.



In this essay, I highlight this interplay of ideas, interests, and crisis, tracing the rise and fall of two sets of post-war ideas about economic governance. In the aftermath of the Great Depression of the 1930s, the Keynesian construction of a middle class interest in wage-driven demand yielded to the unsustainable accommodation of self-reinforcing wage-price spirals that collapsed in the Great Stagflation of the 1970s. In the aftermath of the Great Stagflation of the 1970s, the Neoliberal construction of a middle class interest in wealth-driven demand yielded to the unsustainable accommodation of asset-price bubbles, culminating in the Global Financial Crisis. In tracing these shifts, I juxtapose US perspectives (given the American hegemonic influence) and Australian perspectives (given Australia's frequent role as a "middle power" innovator).<sup>4</sup>

Having contrasted these perspectives, I conclude by stressing implications for global governance, suggesting that while the Neoliberal order has faced nationalist and populist reaction, debate over the meaning of the Global Financial Crisis and potential change remains – in historical terms – very much "in process" and ongoing.

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## The Keynesian order: from the Great Depression to the Great Stagflation

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Looking back on the 1920s, Charles Kindleberger famously explained the onset of the Great Depression by arguing that the UK lacked the ability, and the US lacked the will, to act as global economic leaders.<sup>5</sup>

Instead, they left the international economy subject to the constraint of the ostensibly self-correcting gold standard, which forced states running balance of payments deficits to implement austerity as a means to increase exports. Characterising these malign effects, John Maynard Keynes himself would later note that "Never in history was there a method devised of such efficacy for setting each country's advantage at variance with its neighbours' as the international gold standard".<sup>6</sup>

Nevertheless, in 1925, UK Chancellor of the Exchequer Winston Churchill would reject such warnings and opted to restore the pound to its pre-war value. In the US – still not yet aspiring to hegemonic status – a similar support for deflationary orthodoxies prevailed. In the aftermath of the Great Crash of 1929, Treasury Secretary Andrew Mellon would stress the need to "liquidate labour, liquidate stocks, liquidate the farmers, and liquidate real estate".<sup>7</sup>

Similarly, Australian debate would retreat from a Deakin-era commitment to wage stabilisation in favor of austerity as a means to repay British creditors. Keynes's rival Sir Otto Niemeyer would, acting as Bank of England emissary, urge Australian austerity. While it may be apocryphal, it has been said that when the Australian Speaker of the House of Representatives enquired as to how Niemeyer was finding his visit, Niemeyer replied, "That depends on whether you do as you're told".<sup>8</sup>

Given the shared US and Australian confidence in deflationary policies, the Roosevelt administration and Lyons governments would into the 1930s profess shared stresses on the need for austerity – and so each presided over anemic recoveries.

In terms of reform to institutions of global governance, it would not be until the 1940s that the Keynesian insights of the *General Theory* would find widespread acceptance, justifying the use of deficit spending to raise wages, prices and demand – and enabling cooperation through the International Monetary Fund and World Bank to limit deflationary pressures. In terms of domestic politics, this would entail breaking the power of finance – which had benefitted from the restraints of the gold standard – and bolstering that of labour – which would now benefit from wage increases. In the US, such shifts were presaged as the Banking Acts of 1933 and 1935 contained finance, the *Wagner Act* strengthened labour, the 1937 recession justified fiscal activism, and wartime controls demonstrated the scope for containing wage and price pressures. Upon completion of the conflict, the Keynesian order would receive a bipartisan imprimatur as Republican President Dwight Eisenhower recast his party as the Keynesian party of the middle class against Democratic labour supporters. Similar shifts would occur in Australia with the arrival of the Curtin and Chifley Governments, as their stress on wartime reconstruction facilitated the Keynesian goal of full employment. Likewise, paralleling Eisenhower’s appeals to middle class consumerism, the postwar Menzies Governments would renounce the ostensibly socialist tendencies of wartime Labor, even as they pursued Keynesian policies on behalf of the “forgotten” middle class. To be sure, aspects of the Australian settlement would persist. In particular, wage adjudication would play a key role in maintaining the exchange rate, to prevent wage “breakouts” from undermining the dollar. Providing a conceptual foundation, ANU economist Trevor Swan advocated the combined use of incomes policies, fiscal policy, and monetary policy to stabilise inflation, employment, and the exchange rate.<sup>9</sup>

“... despite the early successes of the Keynesian order, the solutions to past crises would contain the seeds of future overconfidence.”

Swan offered a vision in which “the *Treasury* will... control the volume of Demand... the *Bank* will... control the exchange rate, and... the *Court* will... control the Money Wage Level”.<sup>10</sup>

This institutional backdrop limited the need for restraint, with even the “horror budget” of 1951 and “Holt Jolt” of 1960–61 seeing unemployment rise no higher than three per cent.<sup>11</sup>

Yet, despite the early successes of the Keynesian order, the solutions to past crises would contain the seeds of future overconfidence. In particular, the contributions of wage and price controls to managing labour’s market power would be obscured by the perceived greater effectiveness of fiscal fine tuning. In turn, the need to maintain engaged with labour would give way to more technocratic dispositions. By the early 1960s, Keynes’ own larger institutional vision had in many ways yielded to a more technocratic Neoclassical Synthesis. This more formal framework justified reliance on fiscal fine tuning to stabilise a “Phillips Curve” trade-off between inflation and unemployment.<sup>12</sup>

However, such fiscal efforts would exhibit diminishing returns to the extent that fiscal incentives failed to make direct contact with wage-price expectations and could not restrain the market power of unions. For example, in the US, even as Vietnam-era spending increased and wage settlements escalated, US officials like Nixon adviser Paul McCracken urged only “gradualist” fiscal and monetary restraint as a means to lower inflation over 1969–1971, slowly tightening without depressing growth or employment trends. Similarly, in Australia, McMahon Treasurer Bill Sneddon suggested that policy could bring “inflationary forces under control by gradual means” by slowing the rate of spending increase in the 1971–72 budget.<sup>13</sup>

In this light, the Keynesian solutions to the Great Depression had evolved into the Keynesian causes of Stagflation, as a misplaced certainty in gradualist fine tuning obscured the role of labour’s market power in self-reinforcing wage-price spirals and currency depreciation – which persisted in rising even as unemployment also increased. Over the 1970s, fiscal policy accordingly often shifted from one target to the other. In Australia, where Whitlam doubled spending in pursuit of full employment, this fed inflation. But where Fraser cut spending in pursuit of price stability, this fueled unemployment. In the US, where Ford cut spending to enable wage, price and currency stability, recession deepened. But where Carter raised spending to boost employment, wages and prices soared. From the early debates over Vietnam spending onward, steadily eroding Keynesian legitimacy would yield to a new, Neoliberal order.

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## The Neoliberal order: from the Great Stagflation to the Global Financial Crisis

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Over the post-war Keynesian decades, wage and price growth had provided the foundation for sustained demand and growth – but at the ongoing cost of accelerating wage-price spirals and the eventual Great Stagflation. By the early 1980s, governments around the world sought to crack the back of inflation by breaking labour’s market power – and the Bretton Woods institutions (the IMF and World Bank, with the newly formed G7) would seek to promote not so much deficit spending and wage increases as austerity and wage deflation. Yet, to the extent that demand had to arise from somewhere, wage accommodation would yield to “wealth accommodation.” Put differently, the accommodation of wage-price spirals would yield to the accommodation of asset-price bubbles – and where such bubbles would burst across crises spanning the Latin American debt crisis in 1982 through the Mexican Peso Crisis in 1994, to the Asian Crises in 1997, and to the Global Financial Crisis itself, the IMF, G7 and later G20 would recurrently provide liquidity to stabilise the global economy.

Setting the stage for these shifts in the US, President Reagan’s rhetorical construction of the Great Stagflation not only cast government as “the problem” in causing stagflation but also discredited labour as he cast striking air traffic

controllers as “violating the law” in seeking wage gains. Such efforts combined with Paul Volcker’s Federal Reserve’s use of monetary restraint to break labour’s power, as US unemployment would top 10 per cent in the early 1980s. Yet, as noted, Neoliberalism was not simply a free market ideology. It required the promotion of demand through support for financial gains over labour gains. This support would be first provided after August 1982, when the Volcker Federal Reserve moved with the IMF to manage the spreading Latin American debt crisis – lest defaults take down American banks which were increasingly considered “too big to fail”.

In contrast, in Australia, the Hawke Government’s Prices and Incomes Accord initially sought a more negotiated route to wage-price restraint. Hawke would echo Deakin and Menzies as he situated an emerging Neoliberal international order in an Australian institutional context. Hawke established a set of Price and Incomes Accords to manage the labour market power that had driven the Great Stagflation, in a way that limited the inflationary effects of moves like the December 1983 dollar float. To be sure, Hawke’s successor Keating would place a greater stress on monetary restraint vis-à-vis the Accords, casting the 1990–1991 slump as the “recession we had to have”. Keating later suggested that “we were a decade late in doing for Australia what Paul Volcker did in America as Central Bank Governor”.<sup>14</sup>

However, in point of fact, Australian labour would not be broken to the degree that had been the case in the US – reflecting the continued weight of the Australian settlement. Perhaps most significantly in this light, John Howard’s attempts in 2008 at pushing through “WorkChoices” reforms would fail, reflecting the cultural stress on balancing the rights of capital and labour.

Into the 21st century, one might argue that Neoclassical Synthesis of the 1960s and associated “Phillips Curve” had been reincarnated as a New Keynesian support for monetary fine tuning guided by a discretionary “Taylor Rule”. Where fiscal fine tuning had once been ascendant, monetary fine tuning now reigned supreme, both as a domestic instrument wielded by the Federal Reserve and RBA and as the focus of multilateral coordination across the expanding G7, G8 and G20. Yet, the onset of misplaced certainty in this New Keynesian “Great Moderation” – marked by the perceived macroeconomic acumen of central bankers – carried costs by the early 2000s where the perceived market power of “too big to fail” financial firms had been obscured. Indeed, just as the fiscal activism of the 1970s had exhibited diminishing returns, the monetary activism of the 2000s now exhibited diminishing effectiveness. To the extent that intellectual stability obscured market instability, this set the stage for the onset of the Global Financial Crisis.

“Indeed, just as the fiscal activism of the 1970s had exhibited diminishing returns, the monetary activism of the 2000s now exhibited diminishing effectiveness. To the extent that intellectual stability obscured market instability, this set the stage for the onset of the Global Financial Crisis.”

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## The Global Financial Crisis, limits to utilitarianism and macroprudential possibilities

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In a context of technocratic certitude in a Great Moderation, the Global Financial Crisis spurred not simply a market crash. It represented a crisis of ideas, calling into question the Neoliberal consensus. Initially, however, these ideational implications were not recognised. Even leaders who recognised the anger of voters toward private financial institutions overlooked long-building grievances regarding wage stagnation, economic insecurity, and the “hollowing out” of the middle class. US President Barack Obama, UK Prime Minister Gordon Brown and Australian Prime Minister Kevin Rudd all believed that if they implemented the standard post-crisis economic playbook – cutting interest rates, rescuing vulnerable institutions, and more generally flooding markets with money – they would restore growth and be rewarded by voters. Indeed, in utilitarian terms, Obama, Brown and Rudd were “success stories”. Obama and Brown limited the effects of financial panic to relatively brief recessions. Rudd avoided any downturn at all – continuing the march toward the recent milestone of 25 years without an Australian recession.

Yet, apparent economic success does not inevitably translate into political support. Even as Barack Obama acknowledged voter anger, he did not act on it. In narrow terms, this was the smart thing to do. Reforms and regulation might – in 2009 – have depressed the risk-taking and private initiative necessary to resumed growth. As Obama would put it, his immediate imperative was to “do no harm”.<sup>15</sup> Yet, even if Obama was right in terms of resuming growth, he was wrong in political terms. Furthermore, once the urgency of the moment had passed, the political impetus for reform was substantially reduced. For example, the G20 played a key role in establishing a Financial Stability Board (FSB) meant to address concern for the accumulation of financial market power that represented a potential source of systemic risk. However, the FSB would not live up to expectations as a body that might have enforced more stringent capital adequacy standards, limits on executive pay, and other constraints on excessive risk taking. The FSB would instead play a largely normative role, defining standards but limiting enforcement. In this light, to the extent that Barack Obama had raised expectations of financial reform and then failed to deliver, one can see the sources of the “credibility gap” that laid the foundations for the Trump ascendancy, and the resulting backlash against global institutions from the Paris Accords to the Trans Pacific Partnership.<sup>16</sup>

“US President Barack Obama, UK Prime Minister Gordon Brown and Australian Prime Minister Kevin Rudd all believed that if they implemented the standard post-crisis economic playbook – cutting interest rates, rescuing vulnerable institutions, and more generally flooding markets with money – they would restore growth and be rewarded by voters.”

There are differences in economic performance worth noting across the US and Australia which in turn have implications for debates over global governance. Most importantly, US economic policy after the Global Financial Crisis entailed a sustained commitment to monetary stimulus from 2008 to 2015. This resulted in a rapid recovery of the US stock market – as the Dow Jones gained approximately 50 per cent from 2007 to 2017.<sup>17</sup>

To the extent that one identifies national economic performance with economic growth, this may appear impressive. However, to the extent that broader measures of economic wellbeing took longer to recover in the US – with unemployment remaining above 6.5 per cent until April 2014, and above five per cent through to January 2016 – one can see the sources of populist disgruntlement.<sup>18</sup>

“However, to the extent that broader measures of economic wellbeing took longer to recover in the US – with unemployment remaining above 6.5 per cent until April 2014, and above five per cent through to January 2016 – one can see the sources of populist disgruntlement.”

In contrast, to the extent that Australian Neoliberalism had a historically more moderate impact on wages – stemming from the legacy of the Prices and Incomes Accords – the Australian economy retained a space for wage increases and was less reliant on asset price increases. Indeed, the Australian Stock Exchange remained below its 2007 peak into 2017 – and unemployment never exceeded 6.5 per cent through to 2017.<sup>19</sup>

Moreover, to the extent that the RBA has maintained macroprudential restraints on housing prices, the Australian recovery arguably remains more resilient than its US counterpart. This contrast suggests that discussions of global governance reform should place less stress on macroeconomics alone, and more on the wider institutional and regulatory settings in which macroeconomic instruments are employed.

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## Conclusions: macroeconomic limits, market power, and maintaining legitimacy

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In sum, this analysis highlights the need to resist tendencies to technocratic hubris. First, macroeconomic mechanisms must be combined with regulatory instruments that can contain abuses of market power – lest Neoclassical Synthesis – or New Keynesian-styled technocratic hubris obscure the onset of self-reinforcing crisis. Secondly, when crises do occur, this analysis stresses the need to recognise the importance of popular legitimacy in securing the benefits of utilitarian policy successes – as policy results do not “speak for themselves”. Finally, in terms of future directions of policy change, it is worth noting that this analysis stands offered only a decade into the Global Financial Crisis. To the extent that it took nearly two decades to make sense of the Great

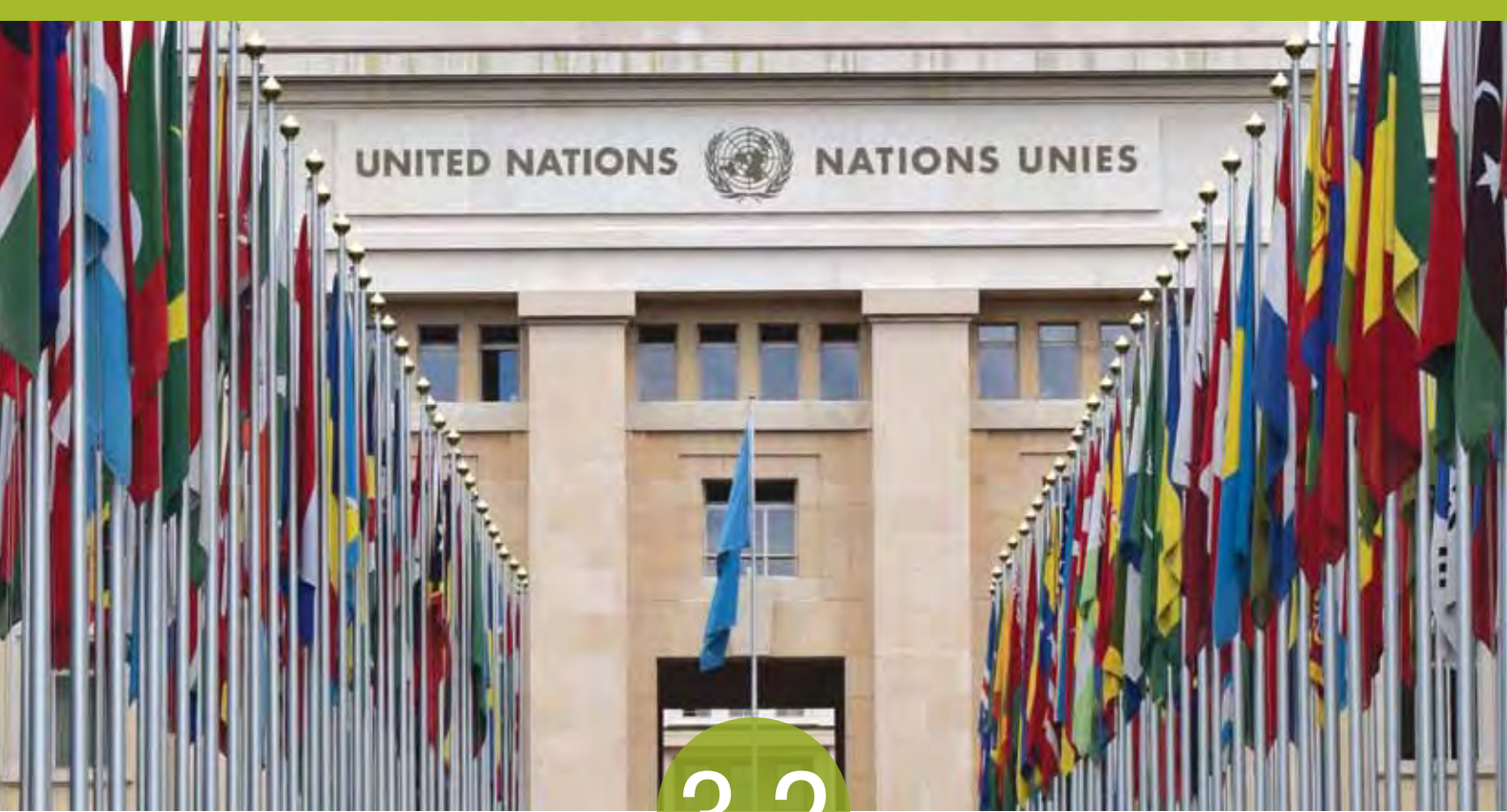
Depression and Great Stagflation, the ultimate construction of the crisis and its implications for any future global order remain in very much “in process”. Put differently, just as misplaced certainty and hubris can lead to overconfidence prior to crises, misplaced uncertainty and caution can obscure the scope for reform *within* crises. This suggests that scope remains for efforts to preserve the legitimacy of institutions of global governance, as the meaning of the Global Financial Crisis remains an ongoing social construction.

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# 3.2

## The future of global governance

John W.H. Denton AO

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This chapter examines the fundamental changes occurring in global governance and the risks if traditional organisations do not reform.

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In 2015 Mr Denton was appointed as an Officer of the Order of Australia for his services to the business community, arts and rights of refugees.

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## Introduction

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After World War II, under the leadership of the United States, a series of institutions and mechanisms were established to shape a safe, stable and prosperous post-war world. These included the United Nations and its various agencies, the International Atomic Energy Agency, the IMF and World Bank, and the WTO (originally the General Agreement on Tariffs and Trade). With the overwhelming power of the United States as the final guarantor of security, this created a relatively stable system that enabled the creation of our globalised, connected, interdependent modern world.

Now we face a moment of historic transition. The zeitgeist can be summed up in one word: uncertainty – uncertainty about the geo-political and strategic environment and uncertainty about the global economy that depends upon it. The United States is undergoing a major shift from hegemonic superpower to first nation among many. While it will remain a formidable global force, it can no longer be taken for granted as the guarantor of global security and stability.

Meanwhile the global institutional architecture that worked so well after World War II is also under extreme pressure. In many respects it is a victim of its own success. We are seeing a backlash against the globalisation that was made possible by the post-war system focused on political and economic stability and trade liberalisation. And we are witnessing a democratic rebellion against global governance making incursions into areas that were once the domain of national sovereignty. Citizens are disillusioned with (what has been for many) the failed promise of globalisation to make everyone better off, and angry about the

imposition of rules and laws by absent, anonymous, non-democratic agencies. The British vote for Brexit and the US vote for Donald Trump as President are symptoms of this push back against globalisation and in favour of greater national sovereignty.

We need to review and modernise our global governance regime for the 21st century to avoid the risk of more than just a short-term backlash. We could even confront a wholesale fracturing and dismembering of the global system. If dominant states withdraw altogether from global systems, or even just limit their cooperation to a subset of global issues while asserting their interests in regional matters, then international norms and institutions will certainly erode. The international system could fragment rapidly toward contested regional spheres of influence. And a period of disruption and global disputation could unfold.

“We need to review and modernise our global governance regime for the 21st century to avoid the risk of more than just a short-term backlash. We could even confront a wholesale fracturing and dismembering of the global system.”

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## Implications for Australia

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Why should this matter to Australia? Well, as a middle-sized economy, Australia will always depend upon an international order that is stable, non-discriminatory and based on agreed rules rather than the exercise of unilateral power. That is why Australia played such a critical role in the formation of the United Nations, with Australia Foreign Minister H.V. Evatt championing the rights of the smaller powers against the great powers in both the General Assembly and the Security Council. It is still accepted across the Australian political spectrum that we benefit from a world that is based on the liberal values of civil, political and human rights and the principles of free trade.

Globalisation has created significant anxiety among many, but first we should be mindful of its many successes. According to data from the World Bank and other sources, the number of people living in extreme poverty (living on less than \$2 per day) has been dropping in absolute numbers since the early 1990s. Between 1993 and 2011, within just 18 years, the number in extreme poverty more than halved, from 1.3 billion to 600 million.<sup>1</sup> Given that the global population is growing rapidly, the percentage improvement has been even more dramatic. This achievement was only made possible by societies joining the global economy and participating in global processes, with China the obvious leader. Over the past 30 years, 81 other developing countries have achieved real reductions in the number of poor people despite increases in population – nations across Africa, South Asia, Central and East Asia, South and Central America, and the former Soviet Union. A related benefit of globalisation has been the dramatic drop in prices for many manufactured items, resulting in major improvements in lifestyle and comfort, especially for millions of people in wealthy nations.

But we must acknowledge that with this rapid change has come major global disruption. Nearly two billion workers, mostly from former communist nations, but also from other former state-managed national economies, have joined the global marketplace since the end of the Cold War. Many of them are skilled, educated and cheaper than similar workers in the rich countries. Roughly 30 million more join the global labour force every year. China alone has 950 million eager to work, while today all the rich nations have a combined workforce of about 720 million people. In our efficient global system, jobs tend to go to where the cheap workers are. That's why over the past 30 years rich nations have seen the sustained decline of manufacturing industries, including in Australia. The cost of this historic transition has not been carried by "elites". The burden has fallen upon communities outside the major centres, where manufacturing was the basis of economic and social stability and social mobility. Whole communities have experienced their real incomes stagnating or falling since well before the financial crisis of 2008.

These people were offered an implied bargain – a "citizens bargain" – that if they acquiesced in the opening up of their economy the benefits would certainly "trickle down" to them. But since that time, the developed world has suffered from low growth, increasing debt levels, and accelerating technological disruption. Pressure from immigration and displaced people (now more than 65 million globally) has grown.

Meanwhile the rise of algorithms and robots presage not the transfer but the wholesale elimination of many more traditional jobs.

Globalisation has also resulted in a decline of sovereignty within nations, and this is becoming a fundamental challenge. The United Nations and its agencies, including the WTO, were created on the basis of cooperation between independent nation states. As the globalised world has become more inclusive and interdependent, more nation states and many unelected actors have joined in the practice and process of global governance. The United Nations was established with just 51 nations but today that number has nearly quadrupled to 193. There are no fewer than 265 intergovernmental organisations, ranging from the World Health Organization and the International Energy Agency to the United Nations Office for Disaster Reduction and the International Bureau of Weights and Measures, and more than 8500 nongovernmental organisations (NGOs) with an international focus. In 1948 there were 41 non-government organisations that enjoyed a consultative status with the Economic and Social Council of the United Nations. Today that number is more than 4500, with a further 24,000 having a registered profile. (A cursory glance at the list reveals familiar and well-respected names such as the World Federation of Trade Unions, the Girl Guides and Scouts, Médecins Sans Frontières and CARE International but also many more esoteric ones like the International Society for General Semantics and the Trance Research Foundation).

"The United Nations and its agencies, including the WTO, were created on the basis of cooperation between independent nation states. As the globalised world has become more inclusive and interdependent, more nation states and many unelected actors have joined in the practice and process of global governance."

In a world of extreme inter-dependence, nations have pragmatically surrendered or “pooled” aspects of their own sovereignty to ensure agreement and effective decision-making. The legislative and regulatory burden associated with this global governance is enormous. At the end of the 20th century, according to one measure, there were a total of 82,000 publicised agreements, with the vast majority of these focused on economic issues but also including conventions on the ozone layer, climate change, whaling and law of the sea, humanitarian law, trade law and intellectual property law as well as arms control agreements.<sup>2</sup>

Meanwhile multinational corporations have broken out beyond national boundaries to become supra-national bodies spanning the globe, ignoring borders, and wielding enormous power. We know about the intense concentration of leading global firms in older industries like automobiles, aircraft, computers and telecommunications. Newer businesses are following the same pattern. As of late 2014, Google had 90 per cent of the global search market; Facebook had 75 per cent of social media; and Apple had 45 per cent of smart-phone web traffic. Companies of such global scale and mobility can easily evade national controls by moving their headquarters, human resources, investment programs and capital to wherever they find a more hospitable location. Even the United States is affected by this

“But it’s an open question whether sensible evolutionary reform of the current global system is likely or even possible in the current environment. The risk to these traditional organisations if they don’t reform is that they become a form of space junk – orbiting the planet long after they have outlived their usefulness.”

perceived loss of national control. The US Bureau of Economic Analysis estimates that the total retained earnings of United States companies held outside the United States now stands at around \$US four trillion, in a nation with a GDP of around \$16 trillion. This is primarily to avoid US corporate taxation.<sup>3</sup>

Sovereignty is not only handed over to global institutions. When nations form regional groupings, such as the EU, the African Union, ASEAN or NAFTA, they surrender some powers of decision-making to the authorities governing these organisations or mechanisms. Global authorities such as the IMF, the WTO and the International Court of Justice can even override state sovereignty in certain circumstances. Political leaders are now alert to the widespread democratic unease with this world order, in which citizens feel deeply disenfranchised. The Trump administration is making a virtue of creating walls, both real and virtual. This is a clear threat to global trading rules and the primacy and relevance of the WTO. In the UK, arguably Brexit was a repudiation of the EU’s freedom of movement policies and a rejection of what was seen as “stifling” rules and regulations. The new President of France, Emmanuel Macron, recently made a speech from the site of the world’s first democratic assembly in Athens, arguing that the EU needs to reform substantially to restore democratic sovereignty.

The irony is that the biggest problems we confront are now occurring on a global scale and will require global solutions. Climate change, global terrorism, health pandemics, population pressures and mass migrations, human trafficking and drug and illegal arms cartels – these are all global issues that will require effective global cooperation if they are to be properly addressed.

But it's an open question whether sensible evolutionary reform of the current global system is likely or even possible in the current environment.

The risk to these traditional organisations if they don't reform is that they become a form of space junk – orbiting the planet long after they have outlived their usefulness.

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## Conclusion

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Governments, business and civil society will need to come together to respond to the challenge of 21st century global governance. It is clear that we are operating in a new “context” requiring a superior level of advocacy and decision-making from leaders at all levels. So those of us with a stake in a successful global economy – that's all of us – need to be clear and effective advocates for globalisation over its alternatives, while recognising that changes need to be made to make globalisation work for the vast majority instead of just an elite few. Policies of isolation and protection will not and cannot be the answer to globalisation's discontents and downsides. We need to move quickly because if enough nations turn inward, focusing on protection and isolation, we face the risk that it becomes very difficult to achieve the required consensus to build effective and ethical global norms and institutions. Australia has always been a leading global advocate for civil, political, and human rights, the hallmarks of liberal values and US leadership since 1945. More than ever we need to activate the spirit of innovation, mutual respect, and ambition that led to the achievements of 20th century global governance if we are to address the enormous global governance challenges that we are likely to face in the 21st century.

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