Submission to the Inquiry into Diversifying Australia's Trade and Investment Profile

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About us

China Policy Centre is an independent, non-profit research organisation based in Canberra. We aim to inform and promote public discussion and policy debate on China issues.

The authors of this submission both have extensive experience working on China issues across government and academia, including on China's economic statecraft, and political economy. As former Treasury officials, both authors have worked on the Australia-China economic relationship.

This submission reflects the views of the authors and focuses on the Australia-China economic relationship.

Recommendations

1. The Australian Government should not intervene in the market to reduce over-reliance on trade with China without a clear calculus of the costs and benefits in all domains of these interventions.
2. Increase the Australia's political system's resilience to foreign coercion by reducing the influence of businesses and sectoral interests on politics.
3. National security budget should be used to support industries and businesses being coerced by foreign powers.

4. Use national stockpiles or domestic manufacturing to ensure the supply of essential strategic goods such as medical supplies. Trade diversification is an ineffective mean.
5. Invest more in higher education to ensure universities serves the public interest by being less reliant on income from international students.

Over-reliance on China?

Given that China accounts for a quarter of Australia's total international trade, is Australia overly reliant on trade with China? The answer to this depends on one's assessment of the balance of risks and rewards of trading with China. But a few points should be highlighted.

First, the Australia-China economic relationship is an interdependent one that benefits both sides. While Australia is less relatively important to China than the other way around, Australia supplies goods that are essential for China's continued development. Seen from the perspectives of policymakers in Beijing, China is also reliant on Australia.

Second, having one country dominating its international trade is nothing new for Australia. It is not an anomaly. The United Kingdom, the United States and Japan have all played that role vis-à-vis Australia in the past.

Third, limiting economic engagement with China or government-directed trade diversion from China is not cost-free. In fact, depending on the execution, it could have significant costs for Australia's economy.

Indeed, in economic terms, in the words of Shiro Armstrong of the Australian National University, "reducing reliance on China as a form of risk mitigation is akin to asking for a pay cut in the fear that a pay rise might not be permanent."[1]

However, there may be non-economic arguments for reducing trade reliance on China, such as on national security grounds.

In determining whether to intervene and what forms intervention may take, Australian policymakers should give due consideration to both the costs and

[1] Shiro Armstrong, "Don't decouple, better manage the risks of China trade," *Australian Financial Review*, 15 March 2020.

benefits of these policy actions.

Leverage

Market dependency on China is a problem if Beijing can use it as a leverage to influence political decision-making in Australia. More than a third of Australia's exports go to China. However, just because a large proportion of Australia's exports goes to China does not necessarily mean that China has leverage over Australia.

We need a clear understanding of the mechanism by which the Chinese Government can coerce and/or induce Australian businesses in order to affect political decision-making in Australia. The following three conditions would make China's economic statecraft attempts more effective in Australia:

1. China has market power in a particular sector or sectors, that is, if China is a near monopoly (dominating the supply) or near monopsony (dominating the demand);
2. The Chinese Government can control or heavily influence business decisions in a sector, for example, through state-owned enterprises or sectors dominated by few big companies (political economy in China); and
3. The targeted sector is politically powerful in Australia (political economy in Australia).

Market power

Leverage comes from market power, and that's on a sector-by-sector basis. If China is a global monopoly supplier of certain products, then China could threaten to cut off supply. This will affect Australian businesses or consumers, at least in the short-term. A recent example was China threatening to cut off medical supplies to certain countries amid the COVID-19 crisis.

However, this approach could backfire for China over the long-run. For example, in 2010 China restricted exports of rare earths in order to put pressure on the United States and Japan. In response, production in other countries ramped up. As a result, the market for rare earths has become more competitive and China lost the monopoly status in rare earths. A similar outcome with respect to medical supplies could occur in the wake of COVID-19.

The concerns around market dependency in Australia is mostly around what China buys, not what China supplies. Sectors where China is the monopsony are at greater risk of coercion from China. This is because businesses in these sectors have few alternative customers.

On the other hand, China would not have great leverage where there are many other importing countries for particular goods and services. Even if China stops buying from Australia, it merely creates a trade diversion — China will likely increase imports from another exporter country, while Australia will increase exports to another importer country. Australian businesses will be affected, but only in the short-term as it switches customers.

Political economy in China

A clear understanding of China's political economy, especially the role of the ruling Chinese Communist Party, and its influence and interaction with businesses, is critical.

China could only use businesses as effective coercive tools if it can direct businesses in China to do its bidding. As the state has a high degree of power in China's economy, it has much greater capacity than Australia for influencing private business decisions.

It is easier for the Chinese Government to affect business decisions in scenarios where the industry is dominated by a few big players, especially if these businesses are state-owned enterprises. On the other hand, if the sector is more competitive, then enforcement may be more difficult, but still possible.

Government directing or intervening in business decisions confers cost on the businesses. However, the Chinese Government has a great capacity to support domestic businesses and absorb any costs.

Political economy in Australia

To influence political decision-making in Australia, sectors that are more important politically are more likely to be targeted by Beijing. Political influence is transmitted through lobbying, often by Australian businesses whose exports to China are sizable and important financially.

Given the choice, China is more likely to target businesses in industries such as resources or agriculture. Targeting the higher education sector will not be as effective, as vice-chancellors and academics do not hold as much political power as farmers or CEOs and shareholders of mining companies.

The political system in Australia needs to be more resilient to business influence and lobbying, in order to counter political coercion from foreign powers. The Australian Government should consider assisting domestic businesses that are targets of coercion by China for political purposes, using the counter-interference budget.

Business risks

Australian Government should manage potential risks associated with political influence, especially coercion, arising from trade dependency. In managing other risks, the Australian Government needs to clearly distinguish between risks to individual businesses or sectors on the one hand, and risks to the national economy on the other.

Generally, it is not the government's role to manage business risks associated with over-exposure to China. If individual businesses wish to rely on China for supply or demand, then it is up to the individual businesses to manage these risks. Business failures are part and parcel of doing business.

The COVID-19 experience has demonstrated that sectors considered not over-exposed to China (for example, the hospitality industry) can still be severely affected by developments in China. Reducing exposure to China would not have helped these sectors.

For risks to the broader Australian economy from a potential severe downturn in the Chinese economy, existing economic policy tools such as monetary and fiscal policy, as well as a flexible exchange rate will help in offsetting the negative consequences.[2]

Indeed, an effective and robust macroeconomic framework is critical to Australia's economy in general as well as in managing potential shocks to the Australia-China economic relationship.

[2] See research by the Reserve Bank of Australia on Spillovers to Australia from the Chinese Economy, 20 June 2019.

Strategic goods

On strategic goods such as medical supplies, recent events have shown that trade diversification would not help Australia. Countries after countries, including Australia's allies and partners, have restricted exports of essential medical supplies as the COVID-19 crisis unfolded.

In this type of situations, Australia cannot rely on other countries, even those that have close bilateral and economic relations with Australia. National stockpiles and domestic manufacturing are more effective ways to address this issue than trade diversification.

Higher education: a special case

Australia should consider ways to diversify the international student cohort.

Beijing is unlikely to coerce Australia through putting pressure on Australian universities for three key reasons. One, China's relationships with the United States, Canada, and the United Kingdom, the competitors to Australia in higher education, are not much better than its relationship with Australia. Two, directing student flow is difficult due to the dispersed nature of students and intermediaries. Three, higher education sectors have little political power in Australia.

However, there are other reasons why market diversification makes sense in higher education. Currently, universities are overly reliant on income from international students. Universities should be considered a public good, providing benefits to Australian society, including Australian students.

Australian students benefit from a diverse international student body on campus because it exposes them to diverse cultures and perspectives. It becomes a problem if an overwhelming portion of students in a class are international students from one country.

For this reason, the Australian Government should help and encourage the universities to become less reliant on income from international students. The universities themselves should also work towards diversifying the international student profile.