Open Multilateral Trade as a Source of Resilience against Economic Coercion

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Synopsis

- Economic integration can be a ballast against economic and political ups and downs and it constrains geopolitics.
- Enforceable international rules and trusted norms in the trading system help to diffuse economic and political power. They are an essential component in the armoury of smaller powers in managing risks.
- The multilateral trading system provides a buffer against policy shocks ensuring open, contestable markets make it harder to leverage economic tools for economic and political purposes while reducing the costs to countries that are targeted.

Major power strategic competition, the COVID-19 pandemic, rising protectionism and the challenge of new technologies have created a perfect storm of uncertainty for the global community. The multilateral economic system is under threat from the United States and China — the world's two largest economies and traders — abusing established rules and the gaps that need to be filled around existing rules.

The use of blatant economic coercion by China against Australia and Lithuania follows less obvious episodes against South Korea, Japan and others earlier. A more assertive China is flexing its economic muscle.

The United States used tariffs or the threat of tariffs to pressure Japan, China and the European Union into trade agreements — the latter two as managed trade deals that take them away from free trade. Other countries have agreed to previously outlawed voluntary export restraints to avoid US tariffs.

The enforcement mechanism of WTO rules has been made ineffective by the United States vetoing the appointment of judges to the dispute settlement system's Appellate Body. Former President Trump's America First trade policies are still in place under President Biden.

What can countries do to protect their interests in open markets and the multilateral system with the two major powers abusing established rules? And how can they protect themselves from the political whims of the big powers that bring trade coercion?

Neither China nor the United States has walked away from the WTO and the broader multilateral economic system. They are unhappy with some of the existing rules and settings — the US criticism of the WTO's dispute settlement system is not totally unfounded and China's voting rights in the IMF, for example, fail to reflect its importance in the institution. The two powers are in a contest to shape new rules where none currently exist.

Reform of the multilateral system is needed and only collective leadership can deliver it, given the transition underway to a multipolar world order. Leaving China and the United States to find an accommodation between themselves risks damaging the system. Great powers rarely consider the effects of their actions on smaller powers, even if they are allies.

Enforceable international rules and trusted norms in the trading system help to diffuse economic and political power. They are an essential component in the armoury of smaller powers in managing risks. Application of the body of trade law under the WTO is the primary international instrument for mitigating national risk in international trade.

Forums like APEC and the G20 are more important than ever, just as cooperation is becoming harder. Common interests can be prosecuted with mutually beneficial cooperation. Efforts to limit climate change are a clear example. Economic exchange is another if rules can be agreed in new areas like digital and cyber.

Australian exporters of barley, coal and other commodities that found they were suddenly locked out of the Chinese market managed to find other markets because the international markets were open and contestable. The multilateral trading system provides a buffer against these policy shocks ensuring open, contestable markets make it harder to leverage economic tools for economic and political purposes while reducing the costs to countries that are targeted.

Even when alternative markets or suppliers can be found, trade restrictions come at a considerable cost. Rules and norms can help limit that interference in the market and avoid those costs.

An open international market can punish arbitrary restrictions on trade. Two examples demonstrate the limit of intervening in the market to take advantage of dominant market positions for geopolitical or monopoly rent-seeking purposes. Intervening in the market may be politically attractive in the short term when supply is inelastic — when it is difficult for immediate substitutes and new supply to enter the market — but it increases market uncertainty and corrodes market power in the medium to long term.

China's restrictions on exports of rare earth elements to Japan in 2010, when it had a near monopoly with 97 per cent of global rare earth supplies, and Japan as its major customer, resulted in a loss of confidence in China as a reliable supplier. The critical minerals are important for high tech manufacturing. By 2012 Japan had reduced reliance on China to under 60 per cent and to roughly half by 2015 for its imports of rare earth elements. In 2015 Japan (with the United States and European Union) checked China in the WTO with China accepting the ruling against it. The market had responded well before the WTO could but China's stake in the rules-based system was clear.

Japan politicised the tightening of export controls against South Korea in 2019 for three key high-tech materials that are required for semiconductor, memory chip and OLED screens. Japan was the major global supplier and South Korea the largest importer. The uncertainty created by the Japanese measures led to active Korean policies to reduce dependence on Japan and for some Japanese companies to export to Korea from Europe or to shift production to South Korea.

With confidence in rules that constrain the ability to intervene in markets, reliance on one or a small number of key suppliers can result in a low risk-adjusted price. But even with market power, in industries with inelastic supply, intervening in international markets that cause uncertainty will bring a supply response.

Retaliating against interventions in the market is bound to compound the economic damage. Instead, in the face of economic coercion, understanding the constraints of open and contestable markets and working with other countries to appeal to established trade rules — or where they don't exist to create them — is the best defence.

Economic integration can be a ballast against economic and political ups and downs and constrain geopolitics. Rules help to keep those markets open and give countries confidence in integrating into the global economy.

The multilateral trading and economic system is at its weakest since its establishment in the aftermath of World War 2. The Bretton Woods institutions were created to avoid a repeat of the 1930s by restricting the use of economic tools for narrow or short term geopolitical gain and to act as a backstop against protectionism.

With the risk of rising protectionism as the world recovers from the COVID-19 pandemic and the major powers blatantly using their economic weight despite the rules, the rest of the world needs to work together to enmesh China and the United States into more rules and markets, not less.

This column summarises some of the arguments in a forthcoming report on Economic Tools for Statecraft and National Security.