Geoeconomic Brief #2 — Towards a Geoeconomic Framework

- **Most geoeconomic strategies require state intervention, and the state-market divide varies around the world based on differences in political institutions and economic structure.**
- **Geoeconomic tools can be used to target multiple objectives, which should collectively aim to maximise "national interest" — defined as some combination of prosperity, security and values.**
- **Assessing the effectiveness of geoeconomic strategies is difficult, but policymakers need to explicitly articulate and balance the trade-offs between competing national interests.**

As outlined in Brief #1, policy making in this new era of geoeconomics requires innovative and flexible thinking about how to maximise the opportunities from global engagement while managing the risks arising in a rapidly shifting geopolitical, economic and technological landscape.

Many geoeconomic strategies require state intervention in markets to manipulate or disrupt commercial transactions. Given China's economic system, it is natural ground for the Chinese government to use state ownership, state-directed credit, state planning and numerous other interventions to pursue its broader policy goals. Moreover, Chinese private companies appear to be more responsive to political influence than Western companies. For example, the fact that Huawei could not reject a request from Beijing has been cited as a justification for refusing the company's participation in the construction of 5G networks in Australia. The Trump Administration has also disrupted markets, using sanctions, tariffs, and export controls, for domestic political and strategic purposes.

But not all geoeconomic strategies require intervention. For example, cultural phenomena like Hollywood, Bollywood or Korean bands build soft power for their respective countries. Non-intervention can also be a geoeconomic strategy to demonstrate certain values. In addition, geoeconomic strategies are not necessarily zero sum (where one country loses — in economic, political or strategic terms — while another wins).

To make these points clear, we present a simple classification of geoeconomic techniques, divided into two broad categories: "carrots" and "sticks". We list a set of economic tools that can be utilised to apply these techniques in practice, explaining how these can be used either offensively or defensively to achieve a range of possible objectives. We close with the wide array of factors that need to be considered when assessing policy effectiveness within this geoeconomic framework.

Geoeconomic Techniques

Many techniques that may prove effective in achieving a potentially wide-ranging set of non-economic objectives. These techniques can be divided into two broad categories: sticks and carrots.

Technique 1: Sticks

Economic tools used to **coerce/deter/interfere** with a target government, company or individual, by imposing or threatening to impose costs on the target, in order to cause policies and actions that align with the interests or objectives of the acting state.

Recent examples include:

1. PRC's response to Seoul's 2016 decision to deploy a missile defence system over Beijing's objections. This inflicted substantial costs on the South Korean tourism industry, along with conglomerate Lotte, and other industries.
2. PRC's censorship of NBA broadcasts and suspension of business deals, following an NBA Executive's support for pro-democracy activists in Hong Kong on social media.
3. US tariffs on China, triggering the trade war in pursuit of "Making America Great Again" and penalising China for "unfair" and "illegal" trading practices.
4. US export controls on Huawei and other Chinese technology firms, targeting in some cases those providing 5G networks and operating surveillance systems in Xinjiang (with numerous objectives including calling out human rights abuses against the Uyghurs).
5. US sanctions on Iran, including the "weaponising" of the SWIFT electronic payment system.
6. Japan's export restrictions on key chemicals used in high-tech sectors in South Korea, following a dispute over compensation of Korean forced labour in Japan during World War II.

Technique 2: Carrots

Economic tools used to **induce/persuade/influence** a target government, company or individual, by providing or promising to provide benefits to the target, in exchange for policies and actions that align with the interests or objectives of the acting state.

Recent examples include:

1. The Trans-Pacific Partnership promoting free trade for partner countries, which according to former US Defence Secretary Ash Carter is "as important as new aircraft carrier".
2. India's increased aid and investments in Mauritius, Maldives, Seychelles and Sri Lanka to "enhance security and growth for all the region" and reduce levels of Chinese debt in these countries.
3. China and Taiwan's investment and other pledges to the Solomon Islands in exchange for diplomatic recognition.
4. Australia's Pacific Step-Up promoting both economic development and security in the region, alongside broader democratic and institutional objectives.

What one country may describe as a carrot, another may see as a stick. The Belt and Road Initiative (a geoeconomic strategy drawing on a wide range of economic tools) is one example. Promoted by Beijing as a win-win economic development plan to deliver prosperity and growth to all partner countries, it is seen by some other states as Beijing's grand plan to "trap" countries in China-funded debt and hence increase its coercive powers over them. Another example is the TPP (and its successor), classifiable as a carrot from the perspective of included members, but as a stick by excluded countries (notably, China).

Table 1 provides an (incomplete) list of the economic tools available for implementing these techniques. While both carrots and sticks are usually directed at *foreign* targets, they can be directed at *domestic* targets as well. For example, the Chinese government may subsidise Chinese companies to incentivise them to operate in certain sectors or countries, with objectives that include supporting "national champions" but also broader influence goals as well (such as lobbying to the host government for favourable policy decisions). Meanwhile, the recent expansion of US government export controls limits

US exports of certain inputs to Huawei and other Chinese technology companies, thereby hurting domestic companies with broader national security objectives in mind.

Table 1: Examples of sticks and carrots

	STICKS	CARROTS
Trade	• Tariffs • Export Controls • Quotas • License denial • Blacklists • Boycotts • Sanctions • Threats of the above	• Subsidies • Licence granting • Favourable tariff discrimination • Direct purchases • Green cards • Free trade agreements • Promises of the above
Capital	• Asset freezes • Aid suspension • Taxation • Discouraging/banning/placing limits on foreign investment • Threats of the above	• Providing aid • Investment guarantees • Taxation (favourable) • Encouraging private capital • Cheap credit for enterprises to "go out" • Promises of the above
People	• Visa, migration and study/research/entrepreneurial restrictions	• Visa, migration and study/research/ entrepreneurial encouragement

Offensive and Defensive Strategies

Carrots and sticks may be offensive or defensive in nature, or sometimes both. For example, is the US decision to block Huawei a defensive move due to Huawei's relationship with the Chinese state and China's pursuit of technological primacy? Or is it an offensive move, motivated by the US government's intention to protect its own technology companies to preserve US primacy?

"Offensive" does not always imply aggressive or dominating. The TPP and the BRI, for example, have been presented (by Washington and Beijing respectively) as friendly and embracing. There is also debate over which of these was "defensive" and which was "offensive".

Defensive strategies aim primarily to counter the negative impacts of a rival's geoeconomic sticks and carrots. These strategies (many of which could also be used offensively) include:

1. Market diversification, to reduce the domestic economic and political costs from a foreign government's coercion;
2. Improving the bilateral relationship with a would-be coercing state, to reduce the likelihood that they will use coercion against your state, companies or citizens;
3. Promoting and strengthening global/regional competition laws, include developing institutional resilience and flexibility; and
4. Strengthening the domestic political, economic and social institutions and norms to maximise transparency and allow the system to correct itself.

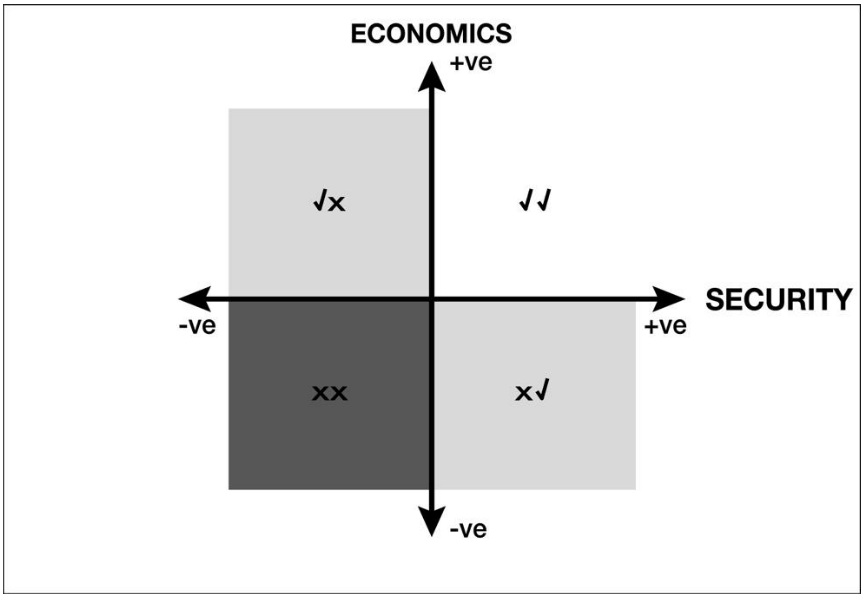
Effectiveness

Assessing the effectiveness of any given geoeconomic policy is far more challenging than assessing the effectiveness of a purely economic or security policy.

In its simplest form, a starting point could be to implement a policy if it has both positive economic and security benefits (top right quadrant in Figure 1). Likewise, if a policy has both negative economic and security benefits, it makes no sense to implement it (bottom left quadrant).

The remaining two quadrants are where decision making becomes difficult, with either economic benefits coming at the expense of security costs (top left quadrant) or vice versa (bottom right quadrant). Further complications arise because of the variety of people and departments involved in a policy decision which often have different attitudes toward risks and rewards, different time horizons (for example, the electoral cycle versus the "long run"), and different judgements about the merits of risk mitigation and alternative policy options.

Figure 1: Economics and Security



Box 1: Huawei

> *Australia's and UK's respective decisions on Huawei's involvement in their 5G networks illustrates some of these complexities. Australia's decision to ban Huawei indicates the perceived security risks were assessed to outweigh the economic benefits of using the lowest cost provider and that no suitable mitigation efforts could outweigh these risks (top left quadrant). UK's decision to restrictively use Huawei indicates the opposite, that the economic benefits were assessed to exceed the security costs given its assessment that other mitigation efforts could be undertaken (also top left quadrant). Different appetites for risk and different understandings of the risks are just two of the factors that can explain these alternative standpoints.*[1] *The timing of decision making is also important – for example, during the COVID-19 pandemic the UK has decided to review its previous decision.*

Of course, it is far more complex than that. Assessing effectiveness of geoeconomic tools requires a clear (if not necessarily public) understanding of the multiple objectives, and channels through which the

[1] See these alternative assessments: Marcus Willet, Senior Adviser for Security, IISS (International Institute for Strategic Studies), 28 January 2020 and Mike Burgess, director-general of the Australian Signals Directorate, quoted in 27 March 2019.

technique may work in practice, along with an assessment of the (short- and long-term) costs and benefits, compared against alternative policy options (including the do-nothing option).

A country is likely to have greater geoeconomic power — and hence more effective geoeconomic strategies — when it commands **market power.** This is not simply about the size of the national economy (although bigger is likely to be better), but more to do with a high share of production in specific industries or sectors (monopoly power at the extreme), and/or a high share of demand in particular sectors (monopsony power). It is this market power that may give one country **leverage** over another — that is, bargaining power arising from the asymmetric dependencies between two countries.

Building market power in specific industries is one possible offensive geoeconomic strategy, which could possibly be acquired through industrial or technology policies. Both the US and China are using an array of policies for this reason to build up or sustain their own market power, from the PRC's violation of international rules around intellectual property, to the US violation of international rules around tariffs. It is not obvious that a middle power like Australia has either the capacity or desire to be an effective player at that same game. On the flip side of building one's own market power are efforts to deconcentrate market power of another actor, as in the defensive moves against China's 5G expansion. Here, middle powers, in conjunction with others, may have a larger role to play.

However, market power does not guarantee that one national government will have **leverage** over another government, company or individual. This is because wielding leverage is complicated by the fact that market power is ultimately held by the participants in the market, the producers and consumers. Translating market power into geoeconomic leverage requires intervening in markets and controlling the behaviour of actors, often trying to make them do things that are not in their individual commercial interest.[2] While it may be easier (though not always straightforward) for governments to use their own state-owned enterprises to do their bidding, many of the most important high-tech sectors are dominated by private companies, whose interests will less often align with the state.

Perhaps the most important factor in determining success or failure is resolve. Even where large economic gains or losses can be offered or inflicted, if a target government — supported by its population — values the underlying political issues more than the economic gains/losses caused by geoeconomic activity, it will not change its behaviour. Just as having the world's largest military does not guarantee victory in war where an adversary has the resolve to resist no matter the cost, having a large economy or market power does not automatically imply geoeconomic power.

The conceptual framework for geoeconomic analysis presented here facilitates a greater understanding of the mechanisms through which governments can use economic instruments strategically. Ultimately however, success will always be a question of politics.

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[2] See William Norris, in *Chinese Economic Statecraft: Commercial actors, grand strategy and state control,* 2016: Cornell University Press, pp. 21-25 and Chapter 2 for an discussion on the five factors affecting the state's capacity to *affect* the activities of its companies abroad — the number of firms in the market; degree of state unity; degree of alignment between state and company interests; ownership structure of the company; and relative resources of the state and company.