Australia's new trade agenda

SEPTEMBER 2022

AiGROUP

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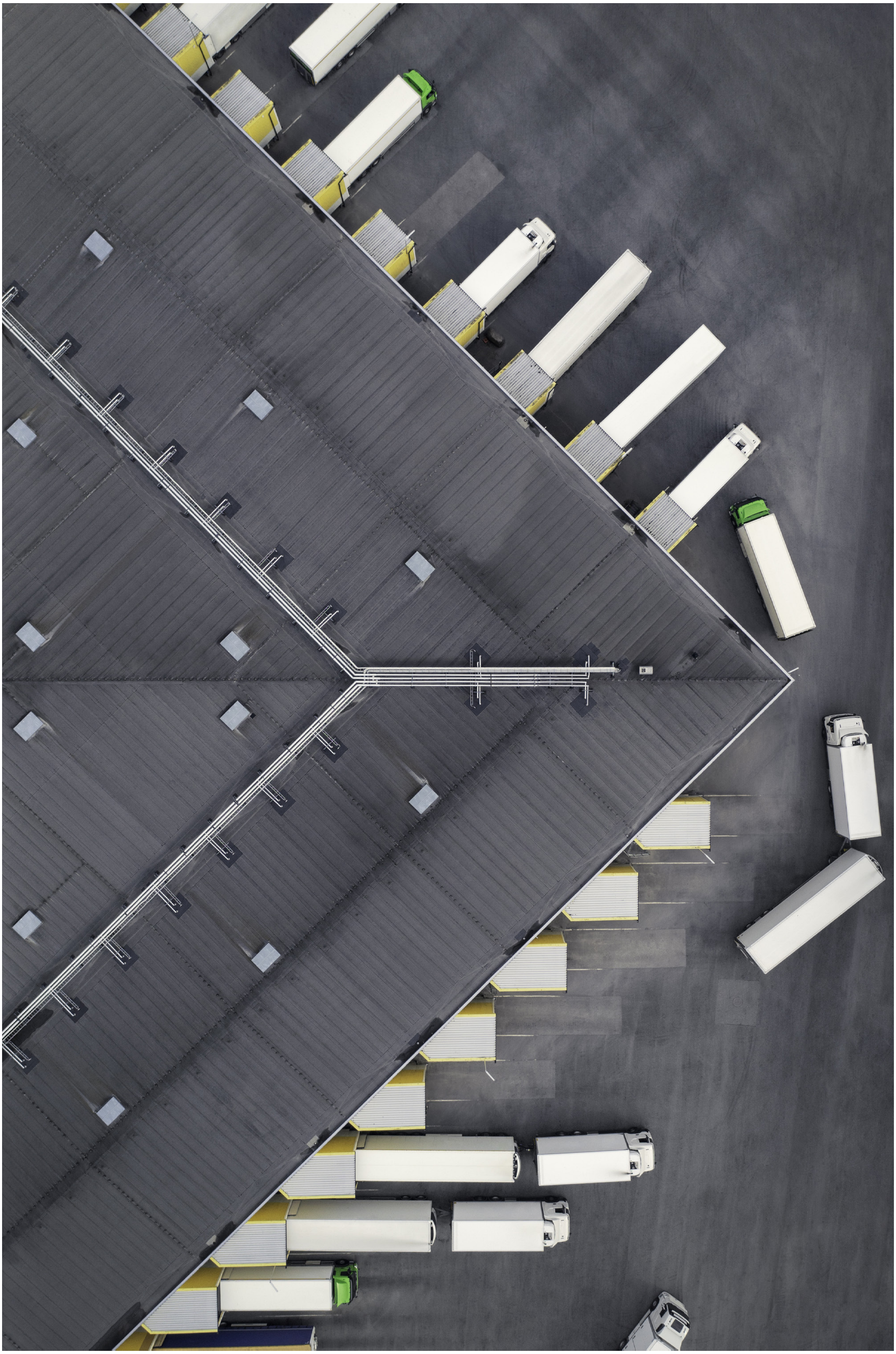

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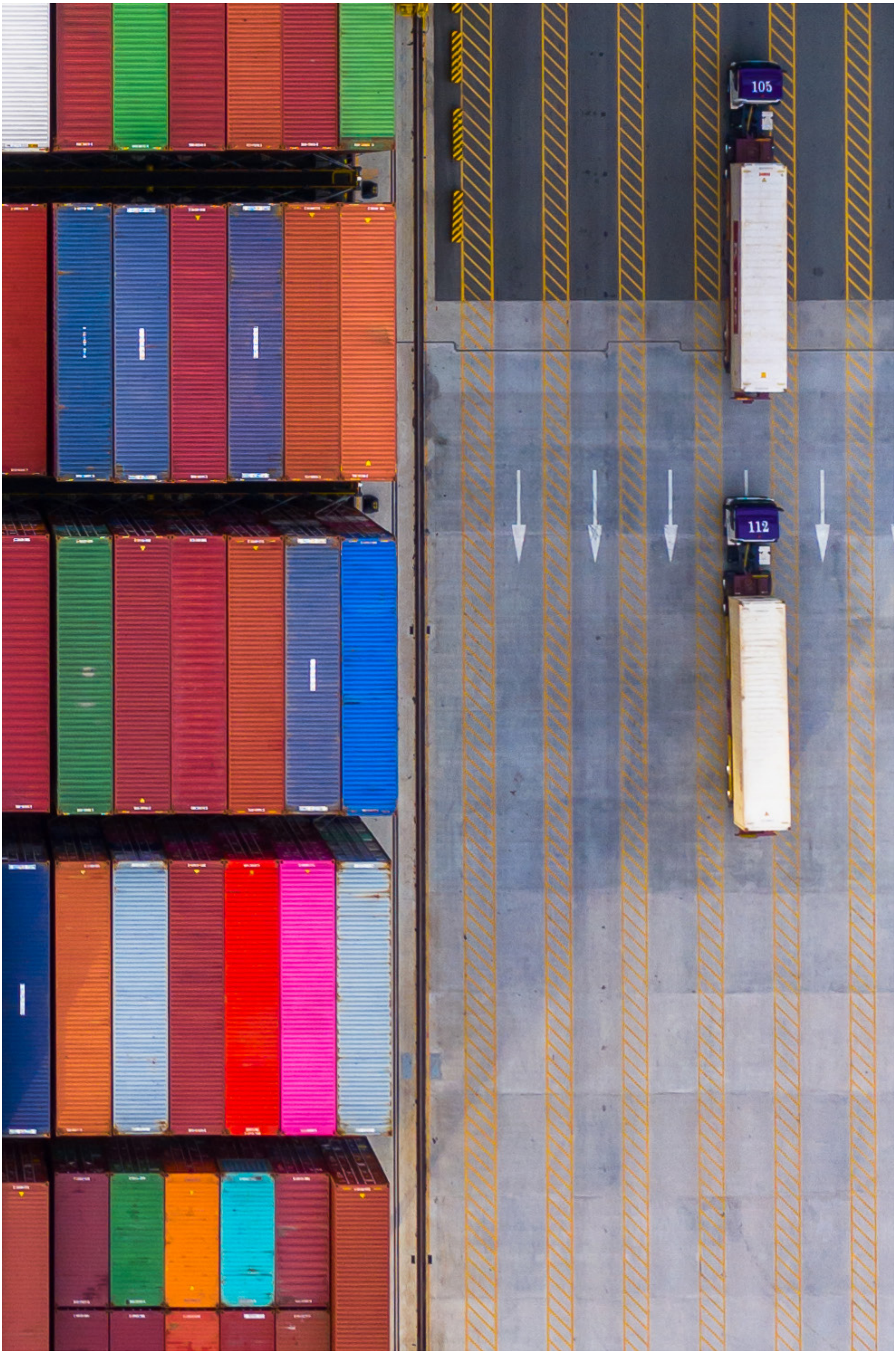
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Foreword

Modern Australia's wealth depends on trade. Whether it is through our world-class export industries, or connection to global supply chains, all Australians benefit from our trade linkages to the world.

These connections were badly interrupted during the pandemic. But as they are being re-established in 2022, we observe that the global trading system is rapidly changing.

Emerging technologies are changing what we trade and how we trade it. Geopolitical tensions are threatening the integrity of global rules. Supply chains – once taken for granted – need to be rebuilt with resilience in mind.

The trading environment Australia faces in the 2020s will be radically different to the past.

This Ai Group report 'future casts' these changes. It identifies five global-level trends that will shape the what, how and who of trade through the 2020s and beyond.

It also maps what these trends mean for Australia's trade outlook. Government and businesses must now rethink their strategies for success in a changing global environment.

If we can get our trade settings right now, we can ensure Australia remains a great trading nation well into the future.

Innes Willox
Chief Executive
Australian Industry Group

AustralianSuper is pleased to support Ai Group's Australia's New Trade Agenda report.

As Australia's leading superannuation fund, AustralianSuper invests both globally and in Australia in the interests of 2.7 million members.

We partner with over 360,000 employers and have invested over $100 billion in Australia, so we understand the success of the Australian economy, and Australian businesses, depends on the success of our trade sector and our connections to the world.

As we reconnect to the global community in 2022 Australian business needs insight and support to be ready for the opportunities and challenges that lie ahead.

Australia's New Trade Agenda builds on Ai Group's longstanding leadership in supporting Australia's dynamic trade-engaged businesses.

The report identifies the trends and implications for Australia's trade over the next decade. It charts how global trends pose both risks and opportunities for government, business, workers and households to grow and prosper.

I know the insights will be useful for policy makers and businesses as we adapt to a changing global context, in the interests of all Australians.

Paul Schroder
Chief Executive
AustralianSuper

Australia adapts to changing trade system

Over the last three decades, Australia has benefited from positive trends in the global trade environment. Progressive liberalisation has lowered formal barriers to trade, allowing Australia to develop world-class export industries in the resources, services and technology sectors. The creation of international trade institutions – at the global and regional levels – has provided a rules-based foundation that has depoliticised trade relations. Trade expansion has created integrated and competitive global supply chains, which have greatly lowered the cost of imported goods for households and industries.

This supportive external environment has allowed Australia to prosecute a trade strategy focused on 'market opening'. Using bilateral and multilateral trade negotiations, Australia has been able to secure access into many fast-growing markets, particularly in Asia. Business responded to this opportunity by developing new export sectors, participating in dynamic global value chains, and establishing a commercial presence around the world. The dramatic growth of Australia's good and services exports – which tripled to $519 billion p.a. in the two decades to 2021 – is testament to the success of this market opening strategy.

However, as the world emerges from the pandemic, new trends are rapidly reshaping the global trade system in more challenging ways. Emerging technologies – particularly in the digital and clean energy sectors – will shift the trade focus away from goods and onto technology and services. Frictions associated with COVID have revealed the fragility of hyper-extended global supply chains, demanding more resilience-focused strategies for industry. Increasing geopolitical conflicts are also affecting the trade system, with trade wars and sanctions, rising protectionism, and the emergence of exclusive trade clubs now a fact of life.

The global trade agenda of the 2020s will be radically different from the past.

This Ai Group report identifies five emerging trends that will define the next decade in the global trade system. They are protectionism and geopolitics, digital transformation, carbon pricing, the emergence of trade clubs and supply chain resilience (Table 1). Each of these trends are relatively new and have not been prominent on the global or national trade agenda in recent years. But as technological, economic and political shifts continue, they will be the core issues that policymakers and businesses will need to confront in future.

These five trends pose challenges for Australia's economic interests. Some – such as rising protectionism and geopolitical conflicts – directly threaten the open and rules-based trade systems on which our economic success relies. Others will instead impose new competitive pressures, with digitalisation and carbon pricing requiring change to the form of our trade engagement with the world. Supply chain disruptions are already imposing costs on the Australian economy. A failure to recognise and adapt to these trends will put Australia's economic future at risk.

However, these trends also offer new commercial opportunities. Digitalisation can be used to reduce the tyranny of distance between Australia and our main trade partners, and unlock competitive advantages in our services and technology sectors. Trade clubs provide an opportunity to resuscitate international trade cooperation, and shape the rules of the road in the industries which will define the 21st century. Carbon pricing will allow Australia to benefit from natural endowments of renewable energy, and offer low-carbon products to partners undertaking the energy transition. If we seize these opportunities, they will allow us to future-proof our engagement with the global economy.

Five trends in the global trade system

Protectionism and geopolitics

Global dynamics: rising protectionism and geopolitical conflicts are erecting new barriers to trade.
The challenge: how to protect open and rules-based trade arrangements in a more contested political context?

Digital transformation of trade

Global dynamics: digitisation is creating new products and services to be traded, as well as changing how conventional trade is conducted.
The challenge: how to update existing trade practices for the digital era, and to create new arrangements for digital-only products?

Plurilaterals and trade clubs

Global dynamics: with global-level negotiations stalled, small groups of governments are creating plurilateral 'trade clubs' for specific issues.
The challenge: How to build trade clubs that strike the right balance between inclusiveness and ambition?

Carbon pricing in trade

Global dynamics: to prevent 'carbon leakage', governments are establishing systems for pricing the carbon embedded in traded goods.
The challenge: how to ensure carbon pricing does not stray into protectionism, and systems can be integrated across markets?

Supply chain resilience

Global dynamics: economic and political strains have undermined the integrity of global supply chains, and are likely to persist into the post-COVID era.
The challenge: how to develop new policy and business strategies that can ensure supply chain resilience in an era of dislocation?

These trends demand a fundamental reappraisal of Australia's trade strategy. For policymakers, it will mean moving beyond the market access strategy that has defined past trade successes. Instead, government will need to manage growing political risks, shape emerging rule-making initiatives, and make judicious choices about new partnerships. For business, it will mean reconfiguring trade strategies to adapt to contemporary opportunities and risks. Trade ties will need to be diversified, commercial strategies will need to be updated, and a higher premium will need to be applied to 'trusted' relationships.

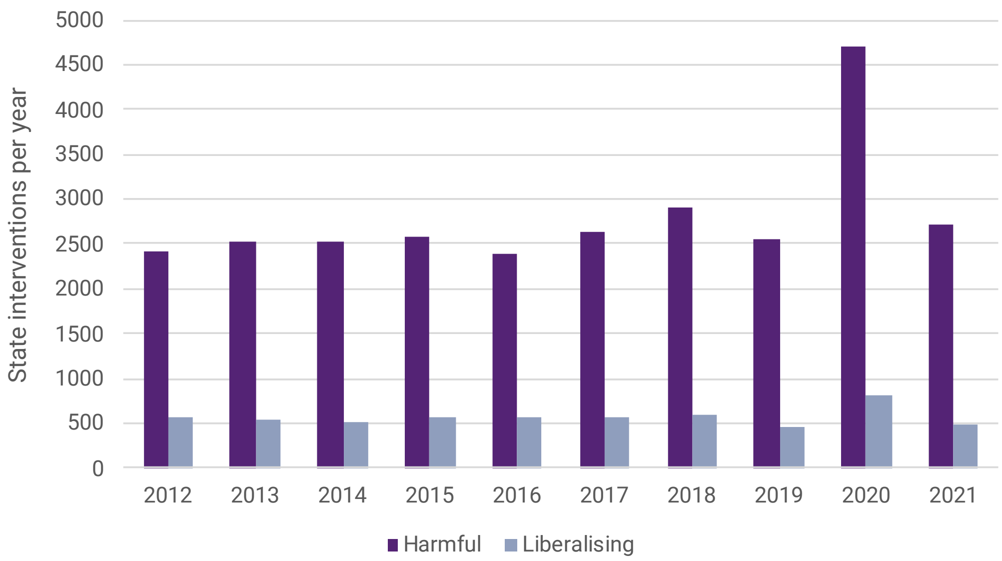
This Ai Group report provides a map for navigating the new trade agenda. It examines the five global trends, identifies risks and opportunities, and maps a new policy and commercial agenda for the coming decade. By reorienting our trade agenda now, Australia can best position itself to be the type of trading nation that will succeed in the new global trade environment of the 2020s.

Protectionism and geopolitics

For two decades following the end of the Cold War, a trend towards trade liberalisation swept the world. Most governments reduced their levels of protection, either unilaterally as part of domestic economic reforms, and/or as a result from joining groups such as the WTO and regional trade agreements. Global tariffs slowly fell, dropping from a peak of 8.6 percent in 1994 to only 2.6 percent by 2017. This liberalising trend provided enabling conditions for open economies, particularly Australia and its peers in Asia, to rapidly expand their trading activities.

However, in the last decade this liberalising trend has reversed. Starting from the Global Financial Crisis, many began reimposing policies which restrict or distort international trade. According to data compiled by Global Trade Alert, in the last decade governments have enacted 27,949 policies which are 'harmful' to trade, against only 5691 'liberalising' measures (Figure 1) – a five-to-one ratio in favour of protectionism. Unlike in the past, tariffs are no longer the principal tool of 21st century protectionism. Subsidies, local content requirements and anti-dumping duties are now the most common barriers, with tariffs accounting for only a quarter of the harmful policies.

Figure 1 Global trade interventions, 2012-2021



Source: Global Trade Alert Dynamics Database, https://www.globaltradealert.org/global_dynamics

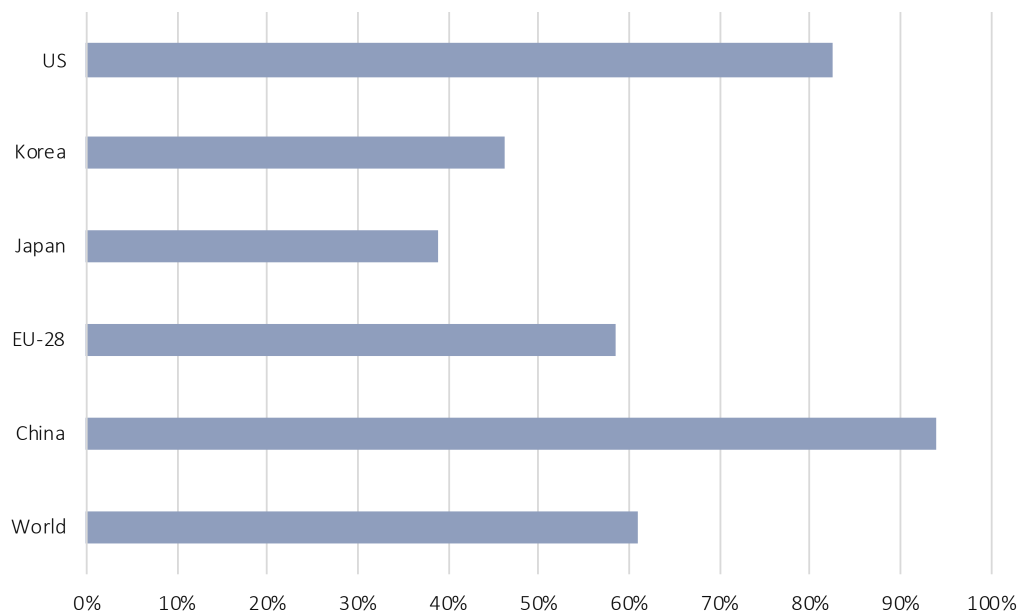
One reason for this return to protectionism can be found in domestic politics. This is particularly evident in recent US trade policy, which has used tariffs (Trump) and "Buy American" provisions (Biden) to protect politically-favoured domestic industries. It also arises due to reflexive responses to deteriorating economic conditions, seen during the COVID pandemic when the number of trade-harming interventions doubled in 2020. In other cases it stems from the rising weight of so-called 'state capitalist' economies, such as China's heavy use of subsidies to state-owned enterprises to promote its industrial and technology policy objectives.

However, the deteriorating geopolitical environment has also contributed to trade distortions. During periods of political conflict, many governments deploy trade barriers as a diplomatic (rather than economic) tool to coerce or pressure partners. Recent examples include:

- The US-China trade war, which since July 2018 has seen escalating tariffs applied to approximately two-thirds of bilateral US-China trade.
- China's coercive use of trade bans during diplomatic disputes, which has been targeted against nine countries: Australia, Canada,Japan, Lithuania, Mongolia, Norway, the Philippines, South Korea, and Taiwan.
- Financial, trade and commercial sanctions against Russia in response to its invasion of Ukraine, which have been applied by sixteen countries (including Australia) and the EU.

Protectionism and geopolitics are regularly interrupting normal trade flows.

Figure 2: Share of Australian exports affected by harmful trade measures, 2018



Source: Global Trade Alert Coverage Estimates, https://www.globaltradealert.org/data_extraction

The turn towards protectionism is already affecting Australia's trade relationships. In some cases they directly affect trade flows: such as when China has imposed bans on our exports, or where Australia has applied sanctions against Russian-made imports. But in others, the impact is felt indirectly. for example, US tariffs on Chinese steel and aluminium, are also an indirect tariff on the Australian iron ore and bauxite used to make these products.

Estimates by Global Trade Alert indicate that in 2018 some 61 percent of Australian exports were affected, either directly or indirectly, by global trade distortions (Figure 2). For our top trade partner, China, the figure was 91%.

Existing trade policy tools will struggle to address these forms of protectionism. Many of the new barriers being erected – particularly subsidies and local content requirements – are not subject to strong disciplines in either WTO or bilateral trade agreements.

And when they do breach rules, redress through formal mechanisms is not a realistic option. WTO disputes routinely take several years to complete, and the high costs of litigation mean they can only realistically be brought for the most significant of cases. Geopolitical trade barriers, such as sanctions applied on national security grounds, are usually exempt from rules. Industries affected by these new trade barriers will need to develop new strategies to mitigate these risks.

The digital transformation of trade

The adoption of digital technologies is increasingly shaping the global trade agenda. Digitalisation is fundamentally changing the mechanics of international trade, by developing new products to be traded and new platforms for their exchange. As digitalisation progressively spreads across all sectors of the economy, it will become an increasingly important enabler for successful trade policy and strategies.

The concept of "digital trade" is often misunderstood. A common misperception is that it is simply about trading in digital products – such as software, data or creative works like music and film. But the agenda is far broader, and compromises all forms of trade affected by digitalisation. This includes trade in goods, which are increasingly sold over the internet and managed across borders using electronic means. It also includes trade in services, both when the service product is digital and/or is delivered via digital means. It also comprises the cross-border data flows that enable these commercial linkages.

Digitalisation provides many benefits for trade-engaged businesses. For goods, it allows exporters and importers to more easily find new partners, and can dramatically lower the cost of doing trade. Digitalisation is even more important for services, which are often harder to trade than goods. It unlocks new forms of digital cross-border delivery – known as "mode 1" services trade – that are easier and lower-cost than establishing an in-market presence. It also creates entirely new products to be traded, including data-based services and creative works. During the pandemic, digital technologies proved an essential lifeline in keeping trade flows open when physical borders were closed.

What is digital trade?

"Digital trade" is more than just trade in data. It comprises all forms of trade affected by digitalisation:

Goods: Where goods are sold over the internet such as via e-commerce platforms; and electronic facilitation such as paperless trading and digital certificates.

Services: Where services are digitally delivered such as legal, financial, educational and consultancy; or where the service is a digital product including software, music, films and apps.

Data: Where data is transmitted across borders, either as a commercial activity in its own right, and/or to support other activities. Includes business-to-business and machine-to-machine data flows.

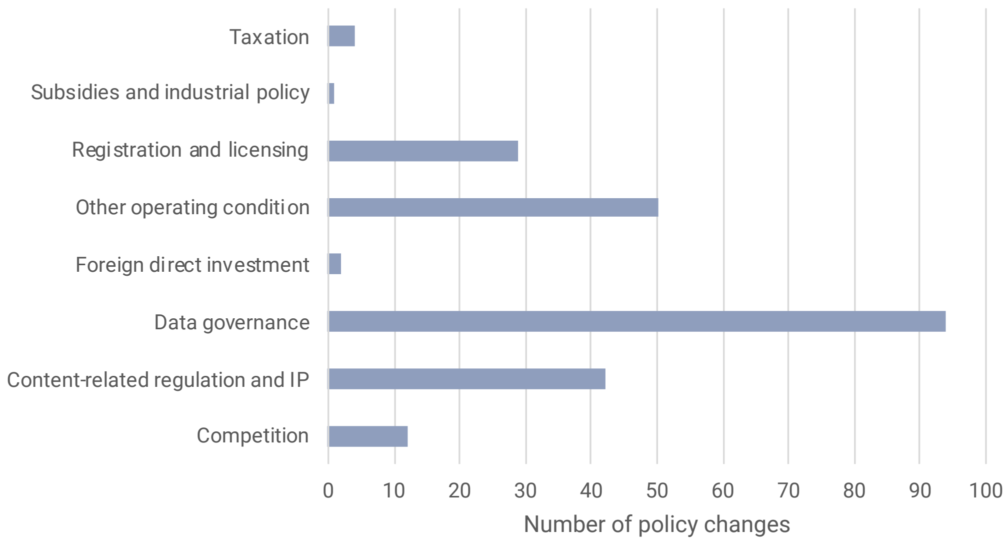
There is a pressing need to update international trade rules for the digital age. Most trade instruments follow a template set many decades ago, which focuses on 'conventional' trade barriers – tariffs, quotas, and customs procedures. These do little to address barriers to digital trade, where rules for data stewardship, intellectual property, electronic documentation and services regulation are more important. As a result, very few trade agreements are "digital-proofed". There is a need to develop agreed and transparent standards for the digital trade patterns that will become dominant in the coming decades.

Recognising the challenge, many new-generation trade agreements now include digital provisions. The first was the Trans-Pacific Partnership (TPP) of 2015, which was the first major trade agreement to include an e-commerce chapter specifically oriented to the digital trade agenda. Since then, digital issues have become a focus of most major trade negotiations. The WTO launched e-commerce negotiations in 2017, the Regional Comprehensive Economic Partnership (RCEP) of 2021 included digital provisions, and in 2020 the Digital Economy Partnership Agreement (DEPA) entered into force. For its part, Australia has included digital trade provisions in all bilateral agreements since the Australia-NZ-ASEAN FTA of 2010.

However, the quality of these new digital trade rules leave much to be desired. Most FTAs focus on simpler and lower controversy digital issues, such as paperless trading and electronic authentication. Fewer extend to online consumer protection and data privacy standards. And very few address the most significant digital trade issues - cross-border data flows and data localisation rules – which are increasingly being used as a form of 'digital protectionism' by many governments. With digital now a ubiquitous feature of modern trade agreements, the next step is to ensure the content and quality of these provisions is fit-for-purpose to facilitate digital trade.

There are also risks of 'global fracture' in the regulations governing the digital economy. As digitalisation proceeds rapidly, governments are rapidly updating their domestic regulations. According to Digital Policy Alert data, the G20 and EU governments made 222 regulatory changes that affected the digital economy in 2021 (Figure 3). Nearly half of these changes relate to 'data governance', comprising issues such as data protection, data transfer and cybersecurity regulations. Policy reform in the digital economy is vitally important and overdue. But with no international standards in place to harmonise these changes, they are likely to lead to inconsistencies in global digital governance, erecting further barriers to digital forms of trade.

Figure 3: Regulatory changes affecting the digital economy in the G20 and EU, 2021



Source: Digital Policy Alert Database, https://digitalpolicyalert.org/

New institutions and modalities will be required to properly address digital issues. While the inclusion of digital in bilateral FTAs is welcome, it is arguably insufficient given the inherently global nature of digital transactions. Yet slow progress in WTO negotiations in recent years means expectations of new global-level rule-making should also be very modest. The most likely path for digital trade negotiations therefore lies in plurilateral modalities – smaller groups of reform-ready countries – which can build consensus around norms, set standards, and specify rules between likeminded countries. WTO e-commerce negotiations and expansion of the DEPA agreement are the leading mechanisms today. The success of these efforts will be instrumental in ensuring a rule-governed digital trade economy.

Plurilaterals and trade clubs

In the 21st century, global-level trade agreements have proven very difficult to complete. While the GATT completed eight negotiating 'rounds' in its five-decade history, since its conversion into the WTO in 1995 not one comprehensive round has been finalised. Longstanding talks on environmental goods and dispute settlement are in deadlock, while significant divisions remain over emerging issues such as carbon pricing. After many years of poor negotiating outcomes, expectations for new trade rule-making in Geneva is low.

Governments have begun exploring a new approach to global trade negotiations: plurilateralism. This modality – where a subset of the WTO membership negotiates rules for a specific sector or issue – is now viewed as a leading way to restart progress. Plurilateral negotiations allow a smaller group of 'reform ready' countries to negotiate and implement new trade rules, without having to secure agreement amongst 164 WTO members. Plurilateral agreements are designed with an open structure, allowing new participants to gradually join over time.

A number of plurilateral trade negotiations are now underway. The technique was first used in the 1980s, but in recent years a raft of new plurilateral negotiations have been launched, on environmental goods, e-commerce, investment facilitation, domestic services and appeals arbitration (Table 2). The latter two are completed and now in force. In addition, two plurilaterals outside the WTO framework – the Digital Economic Partnership Agreement (DEPA) and the Indo-Pacific Economic Framework (IPEF) – have also been launched in the Indo-Pacific region.

Australia is a party to all these plurilaterals except DEPA, and with Japan and Singapore co-convenes the WTO e-commerce negotiations.

A plurilateral approach provides several advantages over global-level trade agreements:

- Allow 'reform ready' countries to move ahead without waiting for universal consensus, while also providing a wider and consistent reach than negotiating many bilateral agreements
- Facilitate agreement on new trade issues – particularly in the digital and environmental domains – that have proven contentious or sensitive with some countries
- Enable 'outside the WTO' arrangements for trade issues that require more legal flexibility

But plurilaterals also come with their own challenges. They are harder to negotiate than bilateral deals, which have a simpler bargaining logic of 'swapping' concessions. If negotiated within the WTO, and requiring a formal change to WTO rules, plurilaterals may be blocked by non-participating members. The current group of plurilaterals also focuses on regulatory reforms, and do not address market access issues. While this lowers the negotiating bar, it also raises the question of how to incentivise new participants without market access benefits being on the table.

Plurilaterals will also produce a more complex global system of overlapping 'trade clubs'. Unlike the integrated GATT/WTO, a plurilaterals-based system will contain rules that apply only amongst likeminded subgroups. It will require governments to be strategic regarding their negotiating priorities, balancing the imperative for ambitious reform against the need to bring many partners into the tent. It will also require businesses to adjust commercial strategy to a less-integrated trade system, prioritising relationships with those that are part of the same plurilateral structures.

Table 2 Past and current plurilateral trade negotiations

Name	Issues	Status	Membership
WTO Agreement on Civil Aircraft	Elimination of tariffs on civil aircraft, their sub-assemblies and components.	In force since 1980	33 WTO members
WTO Government Procurement Agreement	Agreement requiring open, fair and transparent competition in agreed government procurement sectors.	In force since 1981	48 WTO members
WTO Information Technology Agreement	Lower or eliminate tariffs on a range of technology products, including electronics, telecom equipment, semiconductors, software and their components.	In force since 1996	81 WTO members
WTO Environmental Goods Agreement	Negotiate an agreement to lower or eliminate tariffs in environment-related products, such as clean energy, energy efficiency, pollution control and treatment products.	Negotiations 2014, suspended 2016	46 WTO members
WTO E-commerce Negotiations	Develop rules for digital trade, including cross-border data flows, data localisation, paperless trading and consumer protection	Negotiations since 2017	86 WTO members
WTO Investment Facilitation for Development	Develop a framework for facilitating investment, focused on policy transparency and streamlining administration.	Negotiations since 2017	98 WTO members
WTO Domestic Regulation of Services	Reforms to domestic services regulations to lower administrative and regulatory barriers for service exporters.	Completed 2021	67 WTO members
Multi-Party Interim Appeal Arbitration Arrangement	An alternative mechanism for resolving WTO disputes that proceed to appeal. Established as a stopgap as the Appellate Body became inquorate and unable to hear new cases.	Established March 2020	52 WTO members
Digital Economy Partnership Agreement	A modular agreement to promote domestic policies and regulations that support digital trade. Governments may join the entire agreement or adopt select.	Completed 2020, seeking new participants	CL, NZ, SG. ROK and PRC seeking membership.
Indo-Pacific Economic Framework	A US-led framework to develop new rules and standards in the Indo-Pacific. Focus on digital trade, supply chain resilience, infrastructure and green technology, and tax and transparency issues.	Discussions launched 2022	US-led, engagement remains open

Carbon pricing in trade

The global energy transition will soon demand transformations to the international trade system. As governments seek to meet net zero carbon emissions targets, many are implementing domestic carbon pricing to support the uptake of renewable energy. However, international trade poses a challenge to these schemes. As products manufactured abroad are not captured by domestic carbon prices, there exists a risk of 'carbon leakage', where imports from countries without such schemes are not covered.

With around a quarter of global emissions embodied within traded goods, there is an evident need to close this 'trade gap' in carbon pricing schemes.

Carbon border adjustment measures (CBAMs) are the proposed solution. Under a CBAM, a government levies a charge on imported goods that contain embodied carbon, equivalent to the price that would be paid if the good was manufactured locally. How this charge is levied depends on the carbon pricing scheme in question, with differences based on whether it is via an emissions trading scheme (ETS) or direct tax.

CBAMs are not tariffs but an equalising charge, designed to 'level the carbon playing field' between domestic and foreign goods.

EU CBAMs explained

Sectoral coverage: Aluminium, cement, electricity, fertiliser, iron and steel. Intention to expand coverage to broader range of products.

Cost: Importers must buy CBAM certificates for their liable emissions. Certificate prices pegged to the EU ETS at time of import. Certificates cannot be traded or banked past one year.

Carbon accounting: Scope 1 (direct) emissions only. To be verified by an EU-accredited entity. If no data available, use national average for country of origin, or data for worst 10% of EU emitters.

Deductions: Liability reduced by amount of carbon price already paid in country of origin. Also reduced by amount of free allocation under the EU ETS.

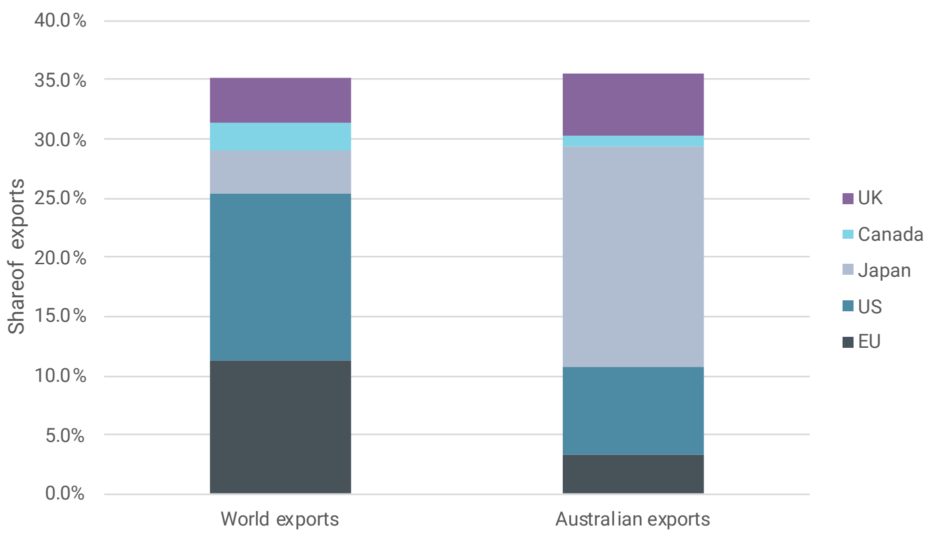
Timeline: Commences as a reporting requirement in 2023, liabilities to commence in 2026.

The EU was the first to adopt CBAMs, proposing an initial scheme in 2021 focused on the most carbon-intensive products. Costs are tied to prices in the EU's ETS, with phased-in implementation by 2026. If the import has already paid a carbon price in its country of origin, this will be deducted from the liability. The scheme initially covers five products but is likely to be expanded over time to include more carbon-intensive goods.

However, several other governments are currently exploring CBAMs. The US, Canada, UK and Japan have all discussed or proposed similar schemes, designed to integrate with their own carbon pricing. If they follow the EU's suit, CBAMs will become a structural feature of the global trade system. The five proposers currently account for a third of global imports (Figure 4). It would also open opportunities for system linkages, with common CBAM standards the bridge that connects carbon prices in different markets.

Australia's trade will be directly affected by the uptake of CBAMs. Australia is an exporter of steel and aluminium – both of which are covered by the EU scheme – and from 2026 will be required to buy CBAM certificates. It is highly likely that the EU scheme, and others being proposed, will expand to a wider range of carbon-intensive products. Mineral resources, including products associated with renewables such as lithium, copper and rare earths, are highly likely to be included. Irrespective of Australia's own adoption of carbon pricing, resource exporters will face an incentive to decarbonise their operations to protect their position in CBAM markets.

Figure 4 Share of exports to CBAM proposing countries, 2020



Source: Author's calculations, from UN Comtrade database

Australia will also face indirect CBAM effects through value chain dynamics. While Australian steel exports to the EU are minimal, our main Asian trade partners – China, Japan and Korea – will be significantly affected. As Asia's steel industries depend on Australian iron ore and metallurgical coal, the impost of EU CBAMs will flow back along the value chain as reduced demand the Australian mining industry as well. As CBAMs expand to additional markets and sectors, more Australian exports will come under the indirect influence of these schemes.

While CBAMs are theoretically elegant, in practical terms they pose complex design problems. How can we verify carbon content of an import, where there is often no independent and product-specific data to determine accurate charges? What should be the sectoral scope of CBAMs – narrowly focused on carbon-intensive products, or more widely applied to all traded goods? And how might different CBAM rules be internationally standardised, given they originate as extensions of different national carbon pricing schemes? If governments implement different solutions to these technical questions, there is a risk that CBAM inconsistencies will become a major new barrier to trade.

How CBAMS restructure global trade will depend on future international negotiations over the design.

CBAMs may also be used as a trojan horse for protectionism. Depending on how technical elements are designed, CBAMs can be implemented in a protectionist manner. Sectors may be chosen not for their carbon-intensity but the desire to protect local manufacturers. Provisions for measuring carbon may deliberately restrictive, or levies could be set higher than domestic carbon prices. At present, the proposed American CBAM scheme would be inherently protectionist, as the US lacks a domestic carbon price which requires equalisation for traded goods. Striking the right balance in CBAM design is essential to ensure much needed carbon pricing does not bleed over into protectionism.

The supply chain resilience agenda

Supply chain disruptions are a new and unexpected challenge for the global economy. For many years, businesses have been accustomed to highly responsive global supply chains, capable of delivering needed products nearly on-demand. But in the wake of the COVID pandemic, nearly all industries are reporting serious supply chain interruptions. From high-tech products like semiconductors to staple commodities like cereals, it has become increasingly hard to secure regular supplies of needed goods.

These disruptions are multi-dimensional, with a wide variety of causes. While much attention in Australia has been focused on domestic logistics issues – including for groceries during COVID lockdowns – the supply chain crisis is in fact global, and has deeper causes than the pandemic:

- Reduced international connectivity – both air and sea freight – due to the pandemic, with an associated five-fold increase in container shipping charges
- Russia's invasion of Ukraine and corresponding trade sanctions – which have seen food, mineral and energy prices spike to historic highs
- Increasing levels of protectionism – particularly in critical goods like food and pharmaceuticals – which has reduced the supply of products available for export
- China's ongoing battle against COVID, where a reliance on lockdowns has greatly disrupted the factory production and logistics central to global value chains

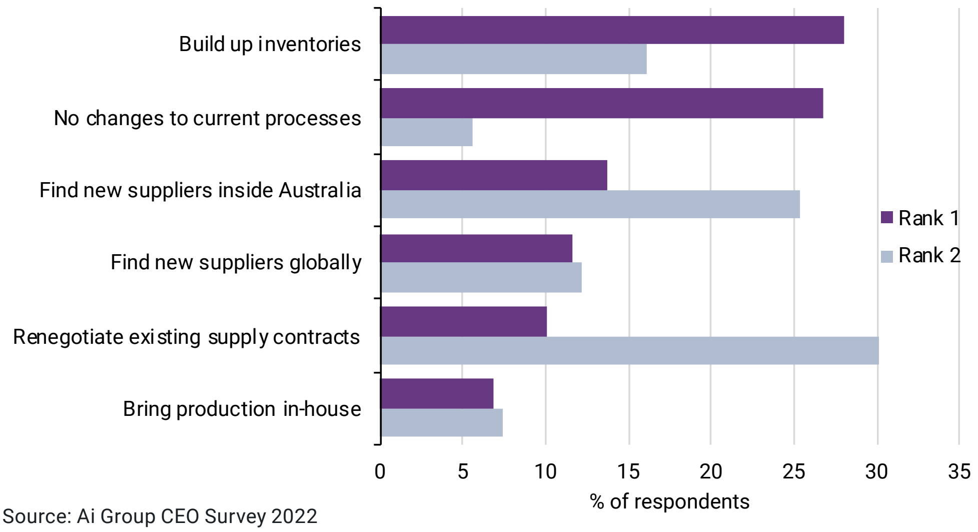
Supply chain disruptions are having a material effect on Australian industry. In April 2022, 41% of Australian businesses experienced supply chain disruptions, with much higher figures in manufacturing and its adjacent sectors (such as retail and construction). A third of affected businesses reported disruptions significant enough to impact on revenue. These impacts are also worsening despite the easing of Australia's COVID restrictions, with the number of affected businesses rising since 2021.

Figure 5 Australian businesses experiencing supply chain disruptions, by sector

Source: ABS Business Conditions and Sentiments April 2022

Businesses also have a limited range of options to meet these challenges. According to Ai Group data (Figure 6), most Australian businesses have responding by increasing inventories or renegotiating existing contracts. While these strategies build short-term resilience, they do little to alleviate the underlying reliance on fragile global supply chains. Comparatively fewer have diversified their local or foreign suppliers, reflecting a lack of near-term options. And very few are bringing production back in-house, as Australia's lacks the scale to competitively produce many all inputs the economy requires.

Figure 6 Australian business responses to supply chain disruptions, 2021



Source: Ai Group CEO Survey 2022

Supply chain disruptions are likely to be a structural reality for the medium-term. Short-term issues like reduced international connectivity will gradually recede as economies emerge from COVID. But others have longer-term political drivers. The global turn towards protectionism precedes the pandemic by many years; while geopolitical interruptions to trade are a function of increasing conflict between great powers. China's path out of COVID also remains unclear, with its public health response in 2022 now relying on ever stricter lockdowns in its major commercial and industrial centres.

Global supply chains are unlikely to automatically 'bounce back' in the near-term.

Improving supply chain resilience has therefore become a major item on the business agenda. It has led to a sharper focus on supply chain in corporate strategies, and a move away from arm's length and 'just-in-time' logistical models. One noteworthy development is backwards integration – seeking long-term contracts with and/or investment in key suppliers – to better secure inputs. An example is automakers building relationships with resource companies, to ensure access to critical minerals such as lithium needed for the transition to electric vehicles.

Governments are also directing industrial policy towards addressing supply chain challenges. Some have announced subsidies to support the 'onshoring' of critical goods, such as in pharmaceuticals and semiconductors. Others have adopted export restrictions, particularly in the politically sensitive agriculture sector. Unfortunately, these policies compound the problem by introducing additional barriers to already fragile global networks. Restoring resilience will require new and more effective policies to be developed that support supply chains in the face of a more challenging global context.

Implications for policy strategy

For two decades, Australian trade policy strategy has focused on opening markets through FTAs. Beginning with Singapore in 2003, the Australian Government began negotiating bilateral trade agreements with key partners. Aimed at securing market access for exports ignored in WTO agreements – particularly agriculture and services – the strategy has proven very successful. Australia has now secured bilateral FTAs with all our major trade partners, and been a leading player in negotiations for the mega-regional CPTPP and RCEP trade blocks (Table 3).

However, this FTA-led trade strategy has reached a natural limit. Once Australia completes current negotiations with the EU and UAE, there will be only one significant partner – Taiwan – without an FTA in place. Almost 90% of two-way trade will be 'covered' by a bilateral or regional FTA. As a result, the FTA-led strategy of the past now faces diminishing returns. Any remaining prospective partners will make a very marginal contribution to overall trade patterns.

Nor are bilateral FTAs effective to address the issues defining the future trade agenda. All of the trends identified in this report are global in scope, and not easily tractable within a bilateral structure. Digital trade rules provide an illustrative example. As e-commerce markets are fundamentally global, rules within bilateral agreements lack the reach necessary to properly govern this emerging sector. Indeed, they may exacerbate the problem if they create a patchwork of inconsistent rules, which will inhibit rather than enable digital transformation in business.

Table 3 Australia's two-way trade with FTA partners, 2021

	Rank	AUD billions	Share total trade	Bilateral FTA?	Regional FTA?
China	1	270.8	34.4%	2015	RCEP
Japan	2	84.8	10.8%	2015	CPTPP & RCEP
EU	3	66.9	8.5%	Negotiating	
US	4	50.9	6.5%	2005	
Korea	5	49.4	6.3%	2014	
Singapore	6	28.4	3.6%	2003	CPTPP & RCEP
India	7	27.5	3.5%	2021	
Taiwan	8	23.0	2.9%		
Malaysia	9	21.8	2.8%	2013	RCEP
Thailand	10	21.8	2.8%	2005	RCEP
New Zealand	11	18.3	2.3%	1983	CPTPP & RCEP
Vietnam	12	16.7	2.1%		CPTPP & RCEP
Indonesia	13	15.8	2.0%	2020	RCEP
UK	14	11.9	1.5%	2022	
Hong Kong	15	6.8	0.9%	2020	
Canada	18	4.7	0.6%		
UAE	20	4.5	0.6%	Negotiating	
Mexico	21	3.8	0.5%		CPTPP
Chile	33	1.2	0.2%	2009	CPTPP
Peru	51	0.4	Neg.	2020	CPTPP
Memo: ASEAN		113.4	14.4%	2010	RCEP
All FTA partners		715.3	91.0%		

Source: Author's calculations, from DFAT Trade Statistical Pivot Tables, https://www.dfat.gov.au/about-us/publications/trade-statistical-pivot-tables.

Australia therefore needs a new trade policy strategy for success in the 2020s and beyond. This new strategy will no longer be based on securing export market access, but on establishing international frameworks for the types of trade – both imports and exports – that will soon be dominant. It must move beyond convention trade barriers like tariffs, to focus on the regulatory settings that structure trade markets. It is most likely to be successful if pursued through smaller clubs of likeminded partners.

First, Australia will need to make regulatory issues the top trade priority. The main obstacles to trade today are non-conventional issues, such as subsidies, local content rules and domestic regulations. And for issues such as digitalisation, carbon pricing and supply chain resilience, solutions lie in finding harmonised approaches that enable rather than constrain trade flows. The question is how Australia, as only a medium-sized economy, can play a meaningful role in negotiations for regulatory rules?

Australia's recently released Digital Trade Strategy illustrates an effective way forward. Rather than focusing on markets or products, the strategy outlines a regulatory agenda to structure future negotiations. It identifies the key benefits and barriers facing digitalisation, and outlines twelve core rule areas and Australia's preferred solutions to these problems. Developing similar strategies for other trade domains will help provide focus for both our domestic policy reform and our negotiating agenda.

Second, we will need to make judicious choices about the makeup of trade clubs. Plurilateral negotiations may provide the best way to overcome global-level deadlocks, but also come with a scale-ambition trade-off. Smaller clubs, such as the three-member Digital Economy Partnership Agreement (DEPA), deliver more ambitious results but lack scale. Large clubs, such as the 86-member WTO e-commerce negotiations, trade better inclusivity for reduced ambition. Getting this trade-off right will prove critical if plurilateral negotiations are to have global impact rather than being club goods.

The DEPA provides a useful example of how to navigate this trade-off. It is a highly ambitious digital agreement, but is also designed in a 'modular' fashion with ten distinct packages. Reform-ready governments may join the entire agreement, while those with less capability can choose to initially adopt only some of the modules. This allows for ambitious rule-making among a small group while preserving extensibility over time. This modular approach could fruitfully be applied to other plurilateral negotiations as they become more common.

Finally, Australian trade policy will need to be more attune to political risks. With both protectionist and geopolitical trade barriers now being erected, political risk will weigh on trade strategy far more than it has in past years. Way to incorporate this into policymaking include:

- A preference for 'trusted' negotiating partners, who are likely to uphold agreed commitments, and settle disputes in good faith when they arise
- Investment in 'defensive' capabilities, such as utilising international trade law to challenge harmful trade practices, both individually and in concert with likeminded partners
- Assisting businesses to understand and appraise political risks to their trade, and providing support to diversification efforts that can reduce these risk

These strategies cannot mitigate political risks entirely. But they can ensure that trade policy is attune to the growing challenge of political risk, and takes action to minimise its impact on Australia's economic and commercial interests.

Implications for commercial strategy

Australian businesses have benefited from a positive trade environment since the 1990s. A global trend towards liberalisation, and Australia's successful negotiation of many FTAs, have opened new export markets. The growth of complex global supply chains has improved access to and lowered the cost of needed imports. Rapid growth in Asian economies has created buoyant demand for products – particularly resources, education and services – in which Australia was globally competitive.

Unfortunately, the outlook for trade-engaged business in the 2020s is more challenging. The trend towards liberalisation is turning back to protectionism, while growing geopolitical conflicts should be expected to periodically interrupt normal trading relationships. The supply chain challenges which emerged during the pandemic are likely to become medium-term challenge. And the emergence of new types of trade, and new rules for how it is done, will require a rethink of commercial strategies.

Successful commercial strategies in this new environment will look very different to those of the past.

There is no one-size-fits-all model for how businesses will need to adjust. The five trends identified in this report each affect different industries and markets in different ways. Businesses will need to evaluate how these trends impact current and future operations, identify specific risks and opportunities, and recalibrate commercial strategies accordingly. Several broad principles can help guide the recalibration process.

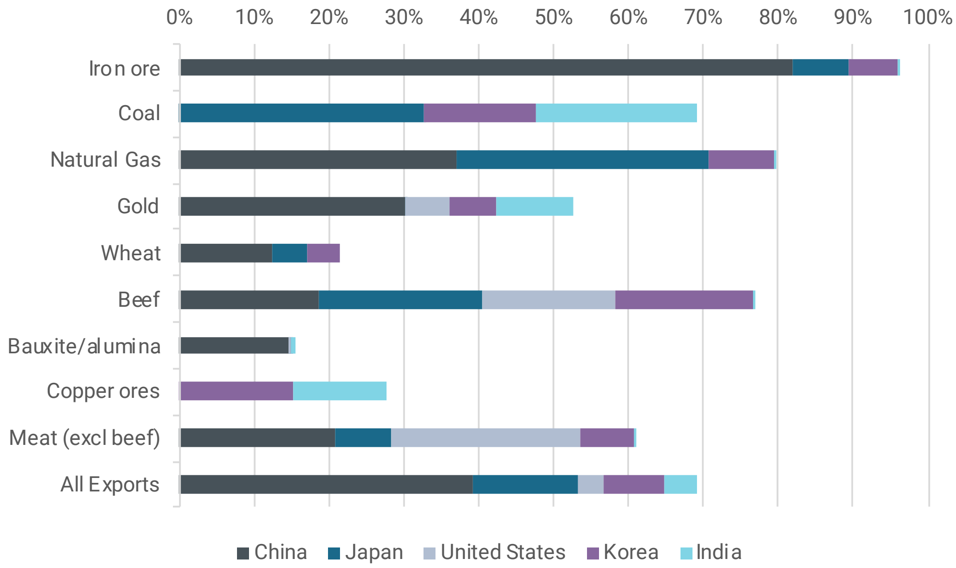
First, a stronger focus on supply chain issues will be required. Supply chain disruptions are the most immediate of the challenges identified in this report, and are materially affecting many Australian businesses today. Businesses are already responding with short-term strategies, focused on building inventories and seeking new suppliers at home and abroad. But with supply disruption likely to be a structural challenge for the medium-term, more substantive responses will be needed.

One option involves seeking greater 'control' over supply chains. This can be achieved building commercial linkages – such as long-term contracts, technology sharing and/or investment – with partners. These linkages bind the participants in global supply chains more tightly, and offer relationships that protect ties when unexpected shocks interrupt normal trade flows.

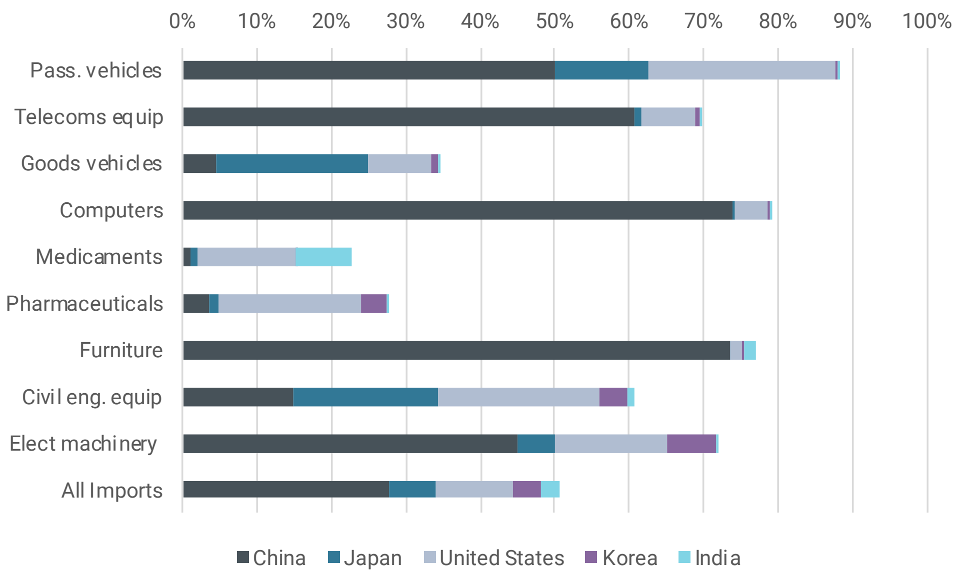
Second, businesses will need to place a higher premium on diversity in their trade relations. Political-type risks – such as protectionism and geopolitics – are largely outside the control of commercial strategy. But when businesses have highly concentrated trade relationships, the impact of these events is magnified. Building greater diversity into our trade is an insurance policy against political risks.

Importantly, trade diversification is about both products and markets. Australia presently has a very concentrated trade profile, where we export and import a small number of products with a narrow range of Asian trade partners. These two dimensions are linked – we depend on these Asian partners because they are either the principal global markets for our primary commodities, or the principal global suppliers of our needed inputs. So to diversify trade partners, we also need to diversify our economic structure. This involves thinking about where Australia's can find new competitive advantages in emerging industrial sectors.

Figure 7 Market concentration in Australia's top 10 exports, 2021



and imports, 2021



Source: Author's calculations, from DFAT Trade Statistical Pivot Tables, https://www.dfat.gov.au/about-us/publications/trade-statistical-pivot-tables.
Note: Excludes petroleum as trade partner data incomplete.

Third, businesses will need to adjust to new methods and new rules for doing trade. Digitalisation and CBAMs are key examples. Both are trends which will create new forms of trade – digital goods and embedded carbon – where there previously has not been significant international trade. And governments are quickly developing new rules for how these trades will be governed, initially via national-levels regulations, but soon through international agreements.

This poses both challenges and opportunities. They certainly pose new risks, such as if carbon pricing is implemented in a protectionist manner, or new digital regulations add additional friction for services traders. But they also open opportunities that previously did not exist. CBAMs allow products that can demonstrate their clean credentials to command a premium over competitors. Businesses that can transition to digital methods –to streamline trade, or market new digital products – will have a competitive edge in a shifting market.

Finally, there will be an emerging emphasis on 'trusted' economic relationships. During times of uncertainty, established relationships provide the foundation that can mitigate risks and hold trade together. The 'trusted trade' agenda can potentially take many forms, including:

- Augmenting important trade relationships with supportive business partnerships, such as investment, long-term contracts and technology sharing
- 'Friendshoring' – a supply chain strategy that involves seeking partnerships with companies and countries that are perceived as most reliable
- Orienting commercial strategy towards markets where stronger frameworks are in place, such as those which are part of the plurilateral trade clubs in which Australia is participating

These trusted trade strategies are complementary to diversification efforts – ensuring that when new relationships are formed, they are with partners who are likely to be most reliable.

About the Australian Industry Group

The Australian Industry Group (Ai Group®) is a peak employer organisation representing traditional, innovative and emerging industry sectors. We are a truly national organisation which has been supporting businesses across Australia for more than 140 years.

Ai Group is genuinely representative of Australian industry. Together with partner organisations we represent the interests of more than 60,000 businesses employing more than 1 million staff. Our members are small and large businesses in sectors including manufacturing, construction, engineering, transport & logistics, labour hire, mining services, the defence industry, civil airlines and ICT.

Our vision is for a thriving industry and a prosperous community. We offer our membership strong advocacy and an effective voice at all levels of government underpinned by our respected position of policy leadership and political non-partisanship.

With more than 250 staff and networks of relationships that extend beyond borders (domestic and international) we have the resources and the expertise to meet the changing needs of our membership. We provide the practical information, advice and assistance you need to run your business. Our deep experience of industrial relations and workplace law positions Ai Group as Australia's leading industrial advocate.

We listen and we support our members in facing their challenges by remaining at the cutting edge of policy debate and legislative change. We provide solution-driven advice to address business opportunities and risks.

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