Remaking supply chains

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For all the limelight they get in an era of great power competition, supply chains are no more than a paraphrase for economic networks linking producers to consumers. In the last quarter-century of globalisation, supply chains became a measure of human achievement, a marvel that crossed nations, cultures and ever-higher topographies of specialisation in technology and international factors of production.

Geopolitics today leads a range of factors, including the pandemic and war in Europe, driving changes to how supply chains will be structured. Supply chains are no longer simply a sequence of business logic. They are becoming subordinated to statecraft and the rising forces of protectionism and national security.

The dense webs of economic interdependence that underpinned one of globalisation’s least acknowledged achievements, and their part in lifting 1.2 billion people from poverty in a single generation, are being reengineered away from multilateral cooperation.

A new understanding of chokepoints has emerged in this supply chain reshuffle. Some, from Suez to Bab al-Mandab, are literal. Others are more complex, such as worries about critical minerals and cutting-edge technologies in a world of geopolitical uncertainties.

This issue of East Asia Forum Quarterly details how far and fast global supply chains have had to morph to keep up with new customers more powerful than the mere consumer. It poses the irony of how digital innovation has never been better placed, or more poorly positioned, to amplify the contributions of trade to global peace. It interrogates the methods and consequences of governments walling off large sections of their economies. It warns of how supply chains reflect the drift from international rules.

We hope these essays expose the cost of the global economy’s retreat behind fences that restrict the gains that sophisticated supply chains bring from international specialisation.

Our Asian Review section features analysis of Southeast Asian hedging strategies, the critical role for international cooperation in Southeast Asia’s energy transition and Indonesia after Prabowo Subianto’s election.

Chuin Wei Yap and Jason Tabarias
Supply chain changes need a globally coherent policy response

KEITH ROCKWELL

The restructuring of global supply chains has multifaceted and complex origins. The COVID-19 pandemic, climate change, automation and geopolitical tensions have all contributed to reshaping companies’ international distribution and trading patterns. Each of these issues alone would make the prospect of improving supply chain resilience daunting. No country alone can easily fix all of them.

Making matters even more complex are the underlying political factors that shape supply chain restructuring. Governments say they want to make supply chains more resilient and sustainable. But they are less clear about whether this means addressing environmental shortcomings and labour abuses, ensuring supplies of critical materials and components are not controlled by adversaries or whether it reveals a desire to shift jobs onshore. Often, it means all of them.

What is clear is that trading patterns—the best indicator of supply networks—are changing substantially. In a 2023 survey, 67 per cent of global retailers and manufacturers said they had shifted to other suppliers, while
two-thirds said that further shifts were likely. This often means sourcing from a different country or shifting to domestic suppliers. According to the Kearney 2024 reshoring index report, North American companies are moving rapidly to reshore operations away from lower-cost Asian countries. US imports from 14 Asian countries fell by US$143 billion in 2023 to US$878 billion.

Global COVID-19 lockdowns severed entrenched channels of product sourcing and laid bare weaknesses in the once-hallowed just-in-time supply chain approach. In 2021 the European Central Bank estimated that from November 2020 to September 2021, world trade would have been 2.7 per cent higher and global manufacturing output 1.4 per cent greater had global supply chains not been derailed by the pandemic.

Crises often induce panic and the initial response to COVID-19 was a classic case of what not to do in such circumstances. Governments’ border closures made it more difficult to obtain the vital medicines, medical products and care needed to fight the pandemic.

Russia’s 2022 invasion of Ukraine and the subsequent response from NATO and its allies further ignited a desperate search for new sources of oil and gas, grains, fertilisers, iron, steel and critical minerals. With traditional markets slammed shut due to sanctions, Russian producers redirected exports to China, India, Brazil and other emerging countries where their commodities were snapped up quickly.

These shifts largely centred on commodities that are relatively easy to find elsewhere. When Europe turned off the tap on Russian gas, it swiftly turned to liquefied natural gas imports from the United States and elsewhere. But as countries climb the technology ladder, onshoring and friendshoring become more complicated. Vast, US taxpayer-financed measures like the Inflation Reduction Act and the CHIPS and Science Act were designed in no small part to address what US President Joe Biden’s administration sees as supply chain vulnerabilities.

At the heart of the Biden administration’s anxiety is the world’s dependence on TSMC, which supplies 61.2 per cent of the market for high-end semiconductors. Other examples abound. The drive towards electric vehicles (EVs) has been complicated by the fact that supply chains producing EVs—and especially the batteries that power them—are firmly rooted in China.

Of all the factors pushing companies to shift production and supply, growing geopolitical tensions top the list. Writing for the World Economic Forum, Simon Evenett points out that 2023 filings to the US Securities and Exchange Commission indicate that 75 per cent of internationally active companies believe geopolitical tensions are the most pressing consideration when making business decisions or assessing risk.

These bilateral tensions between the United States and China are particularly vexing for businesses because the economies of the two countries are intertwined, and anticipating the next wave of economic sanctions is challenging. The United States’ disregard of WTO rules also deprives entrepreneurs of the transparency and predictability those rules were designed to provide. The United States has slapped restrictions on exports to China of artificial intelligence, high-end chips and quantum computers while applying import curbs on China’s
exports of steel, EVs and solar panels. Washington is also leaning on its allies to follow suit, badgering EU countries to buy less from China and the Netherlands and Japan to cease shipments to China of high-end lithography equipment.

Unfortunately, what we have seen is a myriad of ad hoc policies driven by nationalist politics. The OECD has proposed sound advice to its 38 member countries—keep markets open and enhance the tools, like e-commerce, that can facilitate more efficient movement of goods and services. But striking multilateral trade agreements has never been more difficult. The WTO failed to dissuade big players like the United States, India and the European Union from hoarding vaccines during the pandemic. Then in March 2023, India and Indonesia forced the near-term termination of a 25-year-old WTO prohibition on duties on e-commerce transmissions.

International organisations have likewise proven ill-equipped at addressing the question of national security. The handshake agreement at the WTO not to invoke national security when creating barriers to trade, nor to challenge such measures when they were invoked, is in tatters. The UN Security Council is frequently paralysed by its permanent members’ vetoes.

In an era when international cooperation is viewed with deep suspicion, uneasiness about global supply chains is understandable. Underpinning the drive for the reconfiguration of supply chains is the ill-defined notion of national security. As the global economy fragments, resorting to the national security rationale provides governments with a relatively straightforward explanation for contravening international obligations. But lumping government responses under one umbrella does little to address the underlying problems that require changes to supply chains. Each factor warrants a tailored policy response.

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MUCH ink is being spilled on predictions of ‘deglobalisation’ and restructuring of supply chains, but frenzied commentary over trends such as ‘reshoring’ and ‘nearshoring’ tends to obscure the reality that trade flows have always been fluid and that global trade is back to pre-pandemic levels. This recovery remains fragile. Geopolitical tensions, spillover from regional conflicts, rising populism and protectionist policies are putting unprecedented pressure on globalisation.

The prospect of a complete breakdown in relations between the United States and China adds weight to any pessimism. Each day brings further threat—or the reality—of unilateral trade measures. While legitimate concerns may undergird these measures, such as climate considerations, the net effect is chipping away at governments’ faith in the global rules-based trading system. The alternative to holistic reform is almost too awful to contemplate. An April 2024 International Chamber of Commerce (ICC)-commissioned study found that WTO dissolution would have dire consequences for developing economies, decimating their exports by 33 per cent and lowering GDP by 5.1 per cent by 2030.

In that scenario, the trade-led convergence that has enabled developing countries to grow their economies would disappear. This would also hit producers in advanced economies by reducing supplier access, exposing developed countries to increasing volatility and higher consumer prices.

Countries that do not enjoy elevated levels of integration into global supply chains would be further disadvantaged by any erosion of the multilateral trading system. Given the catalytic role of trade in job creation, the implications for global poverty reduction would be profound.

In this age of digital innovation, the world has never been technically better placed to conduct trade more efficiently. Technology underpins all modern supply chains, including the internet of things, big data, machine learning and artificial intelligence. This shift to digital technology calls for the movement of data and information across borders, with all stakeholders depending on seamless and uninterrupted information flows.

Full implementation of the 2017 WTO Trade Facilitation Agreement ... is more relevant than ever.
across companies and countries.

To secure supply chain resilience and efficiency, governments must promote policy coherence and harmonised digital rules, increasing the urgency for robust WTO action. As a start, an agreement containing disciplines that will address digital trade barriers and facilitate digital trade must be reached and implemented at the WTO.

Work is already going into accelerating the development of a globally harmonised, digitalised trade environment. The ICC Digital Standards Initiative is engaging the public sector to progress regulatory and institutional reform, and mobilising the private sector on standards harmonisation, adoption and capacity building.

Trade facilitation remains key to functioning supply chains. Delays at borders hinder cross-border trade at every level, both regional and international. Full implementation of the 2017 WTO Trade Facilitation Agreement—which has already increased trade by over US$230 billion—is more relevant than ever.

Low and middle-income countries have come a long way in fulfilling their trade facilitation agreement commitments, but many still require assistance to finish the job. A failure to connect developing economies to global markets threatens to cut them further adrift, stifling economic opportunity and reversing previous gains. Likewise, lack of implementation undermines supply chain optimisation in these countries, hindering competitiveness.

To support low and middle-income countries in this endeavour, the ICC co-leads the Global Alliance for Trade Facilitation with the World Economic Forum and the Center for International Private Enterprise. With the support of the governments of the United States, Germany and Canada, this entity uses the trade facilitation agreement to address obstacles to trade in an inclusive, sustainable way through public–private partnership. The alliance approach to meaningful trade facilitation initiatives involves buy-in and ongoing engagement from both government and business, from project inception through to post-completion, recognising a shared responsibility in promoting frictionless trade.

This spirit of public–private cooperation must be brought to bear against today’s drift away from agreement and adherence to international rules and regulations. The WTO remains the best conduit for multilateral trade cooperation and future initiatives hinge on its reform and strengthening. Business as the real engine of economic growth and innovation needs to be engaged as a genuine partner—one that delivers on the concept of multi-stakeholder cooperation.

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Is geopolitics transforming global value chains?

Simon J Evenett

The fact that cross-border value chains are commercially significant is beyond contest. The claim that geopolitical rivalry between some nations is intensifying is oft-repeated and appears plausible. But are we certain that geopolitical rivalry has profoundly rewired global value chains? Has convincing evidence linking the driver to the effect been provided for such a far-reaching phenomenon? Deeper consideration of a number of factors suggests a corrective is in order.

First, the driver. Interviews conducted with 13 firms with international operations in the preparation of a 2024 White Paper by the World Economic Forum uncovered a remarkable finding. Among business people, there was no common understanding of what ‘geopolitics’ is. In fact, there were 12 different understandings, and corresponding examples, of what constitutes a geopolitical act—almost as many understandings as firms interviewed. While some of definitions of geopolitics overlapped, the driver is quite diffuse. The upshot: analysing the impact of geopolitically motivated policy change is not like analysing an import tariff hike which can be neatly and accurately captured as a continuous independent variable.

Geopolitical-driven trade and investment policies expose gaps in the skillsets of most international trade research economists, many of whom have shown little serious appetite for getting inside of the ‘black box’ of traditional and opaque commercial policy decision-making. Few trade researchers make investments in institutional knowledge, which is at a premium now that multiple bureaucratic interests seek to shape trade policy around.
geopolitics. That journal referees haven’t demanded much institutional understanding reinforces the cycle of underinvestment in what is really going on.

This underinvestment is particularly problematic when studying the impact of geopolitics on global value chains. Central to an understanding of geopolitical acts are certain motives—making public policy based on relative national position, for example—that may clash with other motives in countries’ public decision-making processes. Moreover, motive is hard to pin down empirically, introducing doubts as to whether a particular policy decision studied is, in fact, a geopolitical act.

Another problem compromising the analysis of the impact geopolitical factors on global value chains relates to data. There has been much analysis of global value chains in the 21st century, including heroic mapping exercises by the Bank of International Settlements. But as we learned during the COVID-19 pandemic, there are simply no comprehensive datasets accessible on the many tiers of suppliers that international companies engage with.

That many companies know, at most, only the first two tiers of their own suppliers—direct suppliers and their respective suppliers—hampers the econometric study of knock-effects with supply chains. Comprehensive transaction data on what firms’ source, from where, and on buyer behaviour is rarely available—for good commercial reasons, a firm’s supply chain can be a source of competitive advantage and is its customer base. Perhaps the most we can expect here are excellent case studies.

Disruption further confounds econometric identification strategies. National economies and regions of the global economy have been hit by a series of disruptive events, the beginning of which can be dated to the global financial crisis. Not all of these events were caused by ‘geopolitics’—though they have in some cases induced geopolitical responses. After all, the term ‘polycrisis’ has arisen for a reason. Empirical study seeking to identify impacts of this nature will have to control for other disruptive events and, critically, the growing uncertainty caused by a sequence of such events. The latter is hard to measure as it is almost certainly sector- and firm-specific.

The direction of causation poses another challenge to analysts. Have the corporate decisions underpinning the commercial footprint of global value chains influenced the assessment of geopolitically influenced policy options by officials or vice versa? The following example crystallises the problem.

Canada was the first G7 nation to revoke Russia’s and Belarus’s most-favoured-nation status in order to impose 35 per cent import tariffs on Russia following its 2022 invasion of Ukraine. That was relatively cost free for Ottawa given how little the country trades with Moscow. But it became evident that certain EU member states which traded a lot more with Russia dragged their feet in imposing sanctions—to say nothing of turning a blind eye to sanctions circumvention. Reverse causality cannot be ruled out. The strength of prior commercial ties might in fact shape geopolitics.

Differential impact is another difficulty. It is often claimed that US firms are shifting some sourcing out of China. But research conducted by the Global Risk Institute has found that this is not the case for supply chains serving Canadian markets. Firms on the same continent appear to be reacting differentially to geopolitical factors. This calls into question the generality of the looming ‘great reallocation’, as one prominent paper puts it.

When combined with data availability gaps, such differential impact can lead to misleading narratives. The least-worst data on global value chains pertains to firms operating in the United States, and more research papers will almost certainly be written on this nation’s cross-border supply chains. But that does not mean that US corporate decisions are being replicated elsewhere. This is worth bearing in mind when reading future surveys of the academic literature. The risk lies in overgeneralising trends in geopolitics based on US corporate responses.

Those who disagree the tenor of this corrective might argue: ‘Don’t make perfect the enemy of the good’. This may well be true so long as it is understood that international trade economists are operating at the margins of their available knowledge and evidence base when making claims about the impacts of geopolitics on cross-border supply chains. It would be a different issue altogether if the studies purporting to show these impacts were arcane. But cherry-picked research findings are likely to be used by those with an interest in painting a certain picture of geopolitical impacts on global value chains.

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Paperless trade powers developing countries’ access to global supply chains

KATI SUOMINEN

Trade costs have fallen globally in the past 200 years on the back of reductions in tariffs and non-tariff barriers, trade facilitation initiatives and lower transport and communications costs. This has facilitated the rise of regional and global supply chains that have enabled companies, even in poorer East Asian countries, to supply large multinationals, increase sales and drive economic growth and development.

Yet one important cost and barrier remains—the paper-based trade documents required at borders by government agencies, freight forwarders and logistics providers. Many nations have yet to provide electronic documents with the same legal standing as their paper-based counterparts. Nor have they fully implemented the WTO’s Trade Facilitation Agreement, which is essential for ensuring fast border clearance processes required to operate supply chains across many countries.

Sub-Saharan Africa, South Asia, the Middle East and North Africa are furthest behind. By 2023, countries in these regions had adopted, on average, fewer than 66 per cent of the trade facilitation and paperless trade practices mapped by the UN. Eight of 14 East and Southeast Asian economies still trail developed nations in the adoption of paperless trade and trade facilitation measures.

The payoffs from paperless trade and digitisation of border processes are especially beneficial for small businesses in developing nations. These businesses have limited capacity for complex and time-consuming manual paperwork and currently depend on access to supply chains and e-commerce for their growth.

Estimates suggest that global shipping costs would decrease by 18 per cent and exports could increase by 13 per cent a year if trade documents were digitised. Another study found that a 10 per cent improvement in paperless trade implementation in the Asia Pacific region would result in a six per cent reduction in trade time.

A digitised border process would multiply these trade gains. In Costa Rica, investments in an electronic single-window system—allowing traders to submit data to a single agency—generated US$16 in economic gains for every US$1 invested. Trade processed through the single-window system grew 1.4 per cent more than trade subjected to the paper-based alternative.

Digitising bills of lading would remove further friction from world trade—using paper-based bills of lading adds US$11 billion to the logistics industry’s operating costs each year. Additionally, e-invoicing would cut trade invoice management and processing times from 40 to 13 minutes.

By eliminating physical documents and storage requirements and facilitating document verification, paperless trade would also make trade procedures greener. For example, the United Nations Economic and Social Commission for Asia and the Pacific found that full digitisation of trade documents could save up to 13 million metric tons of paper, equivalent to planting over a billion trees globally.

Digitised trade documents would also promote transparency in supply chains and transactions through the development of standardised datasets.
Records (MLETR). This legislative instrument confers legal recognition to electronic transferable records and provides electronic trade documents, such as electronic bills of lading, with the same legal standing as their paper-based counterparts.

The G7 economies are taking practical steps towards MLETR. In 2023 the United Kingdom adopted MLETR in its Electronic Trade Documents Bill and Germany, France and Japan are working towards its adoption.

The G7’s commitment to digital trade documents is globalising—it was endorsed by South Korea, Australia and smaller jurisdictions like Bahrain, Abu Dhabi, Kiribati, Belize, Papua New Guinea, Peru and Paraguay.

Another post-COVID-19 digital trade milestone was in the realm of payments and trade finance. The October 2021 publication of the Uniform Rules for Digital Trade Transactions (URDTT) established a framework for participants in digital trade transactions, where electronic records are used to evidence the underlying sale and purchase of goods or services.
To transform world trade, paperless trade, MLETR, URDTT, standardised electronic bills of lading (eBL) and trade documents must be adopted by the main traders, intermediaries and corridors covering the bulk of world trade. If adopted by the G7, Australia, the Netherlands, Belgium, South Korea, Mexico, Singapore and China, 58 per cent of world trade would be covered. In many countries, MLETR adoption is in progress and could help overcome some governments and businesses’ concerns about the validity of eBLs and security and help move to a standardised global legal framework that recognises and enforces eBLs. URDTT’s adoption is shackled by corporations’ aversion to change existing workflows and documents. By adopting paperless and standardised trade transactions, developing countries would add to this total and significantly change their destinies in global supply chains.

Paper-based trade documentation and a lack of standardisation have too long compounded the costs of shipping goods between countries. This issue is now exacerbated by mismatches in the supply and demand for shipping services and inflationary pressures in the global economy. Paperless trade and digital standards would go a long way in ensuring transparent and secure trade transactions, particularly benefiting countries where trade still involves piles of paper, stamps and handwritten signatures.

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FORGING RESILIENCE

When does industrial policy reduce supply chain risk?

JASON TABARIAS AND SAMUEL HARDWICK

A RAFT of policy announcements in developed and developing nations shows that industrial policy is back and is once again a major tool for achieving three widely held policy aims.

The United States’ Inflation Reduction Act (IRA) and CHIPS and Science Act, India’s Make in India policy and Indonesia’s commodity export bans are prominent examples of major industrial instruments that seek to stimulate flagging domestic economies post-COVID, support the energy transition and reorient global trade in response to geopolitical tensions.

There is also resurgent global interest in supply chain resilience led by the wake-up calls nations received during the COVID-19 pandemic. While regional cooperative responses—such as Pillar II of the Indo-Pacific Economic Framework on supply chains—are slowly forming, supply chain outcomes are also explicitly or implicitly part of many recent domestic industrial policy efforts.

Subsidies to support onshoring or friendshoring—or restrictions on trade to boost local production—sit alongside and across the economic stimulus, green transition and geopolitical reconfiguration policy triffecta. Governments employing domestic industrial policies to expand into new markets are banking on the support of others looking to diversify their supply options.

A challenge with using industrial policy for multiple purposes is that the stated aims can conflict with each other. The IRA, for example, sought to use conditions on tax credits to boost
electric vehicle (EV) uptake while favouring vehicles and inputs from friendly nations. The conditions posed major problems for EV manufacturers even in allied jurisdictions like the EU and South Korea. While loopholes were eventually added to the law, dulling its trade impacts, the tension between low-cost emissions reduction and geopolitical decoupling remains.

Even in the national security domain, industrial policies have trade-offs which affect resilience. Export controls may be used to keep sensitive technologies out of an adversary’s hands. But they come at a cost, penalising firms that make cutting-edge technology and potentially encouraging the adversary to step up their own innovation efforts. In a less rules-based world, green technology is not the only area where subsidy races are intensifying.

That doesn’t mean industry policy has no place in building more resilient supply chains. These policies have both positive and negative international spillovers. On the plus side, with open trade and investment settings, they can spur technical change that crosses borders, lowering costs throughout the supply chain and enabling more firms to start producing.

Wind power technology is one example. Denmark began producing wind turbines in the 1980s, supported by price guarantees and favourable tax treatment but not trade restrictions. The subsidies helped firms learn by doing and were probably worth their costs. This know-how spread through Danish direct investment in Spain and Germany. In 2002, reflecting first-mover advantage, 92 per cent of exported wind turbines came from Denmark. Ten years later, Germany accounted for 38 per cent, Denmark for 22 per cent and Spain for 13 per cent.

Today, capital and know-how are flowing from China and the United
If industrial policies complement competitive markets, trade and capital flows remain open and spillovers are managed cooperatively, they may be a source of global resilience.

States into regional producers of green technology and its inputs. Examples include Australia’s nascent lithium refining industry or EV manufacturing in Thailand and Malaysia. Openness among these ‘third countries’ is essential to reap the benefits.

But it does not always follow that having more sources of supply in world markets leads to lower global risk. The negative international spillover effects from industrial policy are well known. A subsidy in one country can harm competing producers in another or crowd out competition in third markets, even if those competitors are more productive. Exporting without the support of a large government becomes harder. Supply chains can become less flexible and less competitive.

China’s entry into and eventual dominance of markets in steel, shipbuilding and photovoltaic cells are key examples and a topic that follows President Xi Jinping on world visits including his May 2024 trip to Europe. Distinguishing overcapacity from genuine technical leadership and economies of scale—such as in EV manufacturing, which has also benefited from massive state support—can seem a matter of perspective.

Amid geopolitical tensions and with a hamstrung multilateral trading system, countries’ responses to supply chain risk have often been attempts to divert trade from China. The central plank of Make in India is a China Plus One strategy, in which Indian manufacturers are positioned as supplementary to Chinese supply. Indonesia’s nickel export ban was partly justified as a response to Chinese domination of nickel processing.

These efforts may appear to address the policy trifecta while diversifying global supply. The question is whether they enhance or diminish the competitiveness of their respective markets. If policies to diversify end up precluding the emergence of new sources of supply, there will be a resilience cost. If support becomes entrenched and fails to foster competition, the result can be an expensive supply bottleneck. These are the risks of seeking to emulate China’s strategies.

A concentrated global market does not necessarily mean vulnerable supply chains. For commodities traded on international exchanges, new buyers and suppliers can be found quickly, even if a dominant player restricts trade. Even markets for natural resources—in which countries are constrained by what they have in the ground—can shift away from dominant states over time as global rare earths exports since 2010 show.

But in other cases, the traded product may be highly differentiated and specialised and finding an alternative will take longer. Or as diesel exhaust fluid shortages in 2021 demonstrated, a critical input can be hit by a perfect storm of shocks and intervention is needed to stave off shortage. In cases like this, open trade policies coupled with stockpiles can be an appropriate option, insuring against risk while retaining flexibility.

The multilateral trading system has the potential to manage negative spillovers in a way that maximises global outcomes, including on supply chain resilience. While the political will for comprehensive WTO subsidies reform is absent, governments should seize opportunities at the margins. Policymakers would be better positioned for action on this issue if they knew more about the size of spillovers, which would require broad disclosure of data on competition and on supply chains themselves.

Attempts to achieve multiple policy aims through industrial policy while simultaneously reducing risk was always going to be a tricky move to pull off. If industrial policies complement competitive markets, trade and capital flows remain open and spillovers are managed cooperatively, they may be a source of global resilience. If policies limit competition and the spread of technology, they are likely to be a source of vulnerability.

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Proponents of the United States-led hub-and-spoke alliance system must have been excited by Philippine President Ferdinand Marcos Jr’s visit to the White House on 11 April 2024 and the presidents’ historic trilateral summit with Japan’s Prime Minister Fumio Kishida the same day. It would seem that more spokes are being tied together, anchoring and advancing the hub beyond traditional bilateral links.

The Philippines is aligning itself more closely with Washington and Tokyo while expanding mutual engagement with Australia, Canada and Europe. Some commentators believe Manila is a bellwether for Southeast Asia, in particular claimant and littoral states of the South China Sea disputes, who will, sooner or later, follow in the Philippines’ footsteps and align fully with Washington and ‘like-minded’ partners to counter-balance Beijing.

This may well be wishful thinking. Under the current circumstances, the majority of Southeast Asian states are likely to persist in hedging, rather than join with Washington and other Western powers against Beijing. Hedging is best understood as a pragmatic policy to mitigate risks and maintain fallback options, rather than a fence-sitting or opportunistic act.

The conditions pushing the Philippines to return to the old alliance-first approach are not shared by other ASEAN states. An alliance-first or full-balancing policy is adopted when two conditions are present—the presence of a direct, clear and present
threat and the availability of support from a reliable and robust ally. In the case of the Philippines under Marcos Jr, both conditions are clearly present and each is amplified by domestic political incentives, such as playing up the Chinese threat and privileging the US alliance to boost elite legitimation while undermining internal political foes.

Such conditions are not present for the other ASEAN states. Most Southeast Asian states do not consider China—at least not yet—a black-and-white threat, while the United States is not that straightforward a patron. Countries are like-minded on some issues, but less so on others.

Another key reason is what I call the ‘impossible trinity’. Like all sovereign actors, Southeast Asian states want to maximise security, prosperity and autonomy. But it is impossible for non-great powers to maximise all three goals simultaneously with a single policy and a single patron. Of the three goals that smaller states seek—freedom from security threats, from economic challenges and from autonomy erosion—only one, or at most two, can be attained through a single approach.

Take an alliance, or military alignment with mutual defence commitments. While this approach maximises security and often prosperity, the asymmetric nature of a defence pact inevitably presents the junior ally with risks of autonomy erosion and dependence.

Both risks have wider repercussions. The erosion of external autonomy leads to the erosion of internal authority, while a rigid alliance and dependence also expose the junior ally to the danger of alienating the opposing power. Then there is the danger of abandonment. Alliance is no panacea and there are trade-offs, drawbacks and downsides to all policy approaches.

Given the conditions the majority of ASEAN states face, these trade-offs are unacceptable. Unlike the Philippines and some of the United States’ ‘like-minded’ allies, the ASEAN states’ external outlooks remain in ‘shades of grey’. The weaker states continue to view both superpowers as sources of problems but also sources of support and solutions, albeit in different domains, to different degrees and for different reasons.

Accordingly, Southeast Asian states, except the Philippines, decline to embrace an alliance as the principal instrument of their external policies. While Vietnam and the older members of ASEAN, including Thailand, the other US treaty ally in Southeast Asia, have opted to partner with Western powers on defence and in other domains, they have also been cautious in ensuring that these arrangements are not about siding with one power against another. These ASEAN states have done so by forging partnerships in an inclusive but selective manner, forging closer partnerships in selective domains with different powers depending on their relative convergence of interests.

Indonesia, for instance, chooses to expand economic and strategic cooperation with China including through participation in Belt and Road Initiative projects, military exercises and high-level dialogues, while continuing to further develop its longstanding ties with the United States and other Western partners. Like other ASEAN states that have benefited from the accelerating China Plus One approach to investment, Indonesia has been cautious in offsetting the risks of being entrapped into any exclusive strategic bloc or supply chains by insisting on an open, inclusive diversification strategy.

Such a pattern of alignment choices may be more fragmented, less coherent and therefore less effective than a full-fledged alliance. But in the absence of a clear-cut threat, such an approach is more desirable because it allows states to maximise other goals like prosperity and autonomy while still keeping their security options open. Not putting all one’s eggs in the US-led alliance basket also enables regional states to hedge against the risk of abandonment, especially in the shadow of the possible return of former US president Donald Trump to the White House.

Hedging may not last forever and carries its own drawbacks. But hedging is at present the most logical choice for smaller powers in Southeast Asia and elsewhere seeking to strike an acceptable balance vis-à-vis the impossible trinity of security, prosperity and autonomy.

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OUTHEAST Asia is facing a pivotal moment in its energy sector. With a 4 per cent annual increase in energy demand and the challenge of reducing fossil fuel dependency, transitioning to clean energy is critical to meeting the region’s global climate goals.

ASEAN currently contributes about 5 per cent of global emissions, and projections by the International Energy Agency suggest its CO2 emissions could rise to 2.4 gigatonnes by 2040—a 71 per cent increase from 2018. The need for robust and immediate action in transitioning to sustainable energy sources is urgent and international collaboration is an essential element of the journey.

To meet the target of 23 per cent renewable energy in its primary supply by 2025, ASEAN needs to invest around US$27 billion in capacity annually. With the world’s youngest coal fleet, averaging just 14 years old, the region faces an expense of at least US$277 billion to retire these plants early. Financial challenges will be especially severe for major coal economies like Indonesia, which requires around US$97 billion to meet its on-grid power sector emission reduction targets by 2030. There is also a critical shortage of the skilled professionals and robust institutions required to develop and enforce effective energy policies.

The message from the region is clear: it needs significant financial international cooperation is critical to Southeast Asia's clean energy transition

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and technical support for the energy transition.

International cooperation is important as it can mobilise the power of collective action, it offers financial aid and it fosters confidence among countries by reinforcing the idea that they are not alone in facing these challenges.

The Philippines, Indonesia, Thailand and Vietnam have already included international support as a condition for achieving higher emission reduction targets in their Nationally Determined Contributions.

Preliminary efforts in international cooperation, such as the Southeast Asia Energy Transition Partnership, the Asia Zero Emissions Community and the Asian Development Bank’s Energy Transition Mechanism, are in place. The G7-led Just Energy Transition Partnerships have announced initial funds of US$20 billion for Indonesia and US$15.5 billion for Vietnam. But further efforts are needed to accelerate the energy transition.

The region is rich in opportunities for further collaboration. Countries could boost bilateral cross-border electricity trade, with significant economic and environmental benefits, particularly when based on solar and wind power. The Asian Development Bank’s US$692 million financing for a 600 megawatt wind power project in Laos, aimed at exporting energy to Vietnam, is a prime example. The Laos–Thailand–Malaysia–Singapore Power Integration Project would also improve multilateral trade efforts.

Adopting successful policy frameworks from neighbours can advance renewable energy adoption. For instance, Vietnam’s increase in solar and wind energy—accounting for 13 per cent of its electricity mix in 2022 and up from nearly zero in 2017—sets a commendable example.

With the introduction of the EU’s Carbon Border Adjustment Mechanism (CBAM), it will be crucial to align this policy with broader energy transition strategies to adhere to global climate principles and mitigate potentially adverse impacts. ASEAN could benefit from a collective approach to negotiate with the EU, seeking more favourable CBAM conditions and support for the region’s carbon reduction efforts.

While implementing a common carbon tax or emission trading scheme across Southeast Asia may not be a feasible way to mitigate CBAM impacts, member countries would benefit from studying the approaches of peers like Singapore and Indonesia to develop their own domestic carbon pricing mechanisms.

The commitment to net-zero emissions is robust across the region, with Indonesia, Vietnam, the Philippines, Singapore and Brunei aiming to phase out coal power by the 2040s.

International assistance is crucial to achieving net-zero emissions. This assistance must go beyond financial assistance and extend to enhancing local capacity in policymaking, technical expertise and public awareness. Countries can strengthen these efforts through bilateral cooperation and multilateral engagements, for example in ASEAN and by building on existing initiatives like the Southeast Asia Energy Transition Partnership and the Asia Zero Emissions Community.

The significant roles played by neighbours like Australia, China and Japan, as well as global players like the EU and the United States, highlight the interconnectedness of trade, investment and geopolitics in energy transition.

These countries can contribute through exports of low-carbon products like green hydrogen, renewable energy technologies, solar panels, batteries and electric vehicles—benefiting from Southeast Asia’s growing markets for electric vehicles and renewable technologies.

The benefits of engaging with Southeast Asia extend beyond trade. By deepening relationships with this economically and geopolitically important region, countries outside the region can also strengthen their geopolitical positions.

As Australian Senator Jenny McAllister noted in a speech at the Australia–Vietnam Green Economy Summit in Ho Chi Minh City in April 2024, ‘When our partners prosper, Australia prospers. And nowhere is this truer than in the clean energy transition.’ This principle is applicable to other countries engaging in similar transitions. Australia is setting up a A$2 billion (US$1.3 billion) investment financing facility aimed at boosting investment in Southeast Asia—part of a broader range of economic initiatives unveiled at the ASEAN–Australia Special Summit in Melbourne in March 2024. Energy transition projects are a priority investment interest.

The energy transition in Southeast Asia is part of a global endeavour that promises mutual benefits through enhanced international cooperation. Those who act first stand to gain the most. EAF
Prabowo pitches a broad political tent on unsteady democratic ground

LIAM GAMMON

IT HAS been more than 25 years since the end of the Suharto regime, yet Indonesia’s democracy is still just young enough to be delivering firsts. Susilo Bambang Yudhoyono became the first directly elected president in 2004 and Joko ‘Jokowi’ Widodo’s election in 2014 marked the first transition from one directly elected president to another.

And in the wake of his landslide win in February 2024’s presidential polls, Defence Minister Prabowo Subianto has his turn to create a new precedent by being the first democratically elected president who benefited from the clear backing of the outgoing administration. Indonesia is now seeing a handover of power far more stage-managed than ever before, one that bears all the signs of the declining quality of Indonesia’s democracy.

In February’s presidential election, the Widodo administration’s efforts to get Prabowo over the line included an unprecedented level of favouritism that violated norms of electoral fair play. In the lead up to his inauguration on 20 October, Prabowo is seeking to consolidate the benefits of Widodo’s patronage by forging a broad coalition of political parties to support his government and signature welfare programme.

Prabowo Subianto addresses a campaign rally in Bogor (March 2019).
programs. Widodo, knowing that Prabowo will have the upper hand when he’s sworn in, is meanwhile trying to future-proof his influence base by extending his political dynasty. With the elections over and accountability in the rear-view mirror, parliamentarians are using the national legislature’s lame duck period to ram through surprise legislation that damages the independence of the judiciary, reverses military reform and compromises civil liberties and press freedom.

These moves strengthen expectations that, assuming benign economic conditions, Prabowo will be a popular and authoritative president from the beginning. The enhancement of presidential authority that Prabowo inherits from Widodo bodes well for his ability to achieve his signature development policies. But it also reinforces the sense that the defects of Indonesian democracy will grow more entrenched as elites work to roll back institutional reforms to insulate them from scrutiny from the judiciary, the press and the public.

When Prabowo was elected in February 2024, it was clear that he owed the scale of his victory to Joko Widodo’s support. In the latter half of 2023 Prabowo had consolidated an alliance with Widodo, appointing the president’s eldest son, Gibran Rakabuming Raka, as his running mate.

With his son running alongside Prabowo on a platform of ‘more of the same’, Widodo had his police force lean on local officials to recruit them into a get-out-the-vote effort for their ticket and made tactical use of the state welfare budget to drum up goodwill for them. Prabowo’s opponents and liberal civil society found this favouritism scandalous and unsuccessfully pushed for a parliamentary inquiry into the election’s conduct.

But the voters were unbothered. Buoyed by the post-pandemic economic recovery and the wave of election-season welfare spending, Prabowo built dominance across all key demographics over the course of the campaign, with his popularity spanning urban–rural divides, genders, geography and generations. His message also notably resonated with young voters. Exit polls showed that he won 71 per cent of under-27s, who make up roughly a quarter of the electorate.

Prabowo is seeking to lock in this dominance by building an unprecedentedly broad party coalition ahead of his inauguration. While all Indonesian presidents have sought to minimise the prospect of pushback against their programs by forming bloated party coalitions, Prabowo has openly flagged his ambitions to be the first president to build a governing coalition that encompasses all parties in the parliament.

It is completely plausible that he might achieve that goal. Parties that supported his opponents in February’s election have not

Indonesia’s President-elect Prabowo Subianto arrives at the Japanese Prime Minister’s office in Tokyo (April 2024).
wasted time in striking deals to join Prabowo’s coalition in exchange for representation in the cabinet. To make room for these patronage appointments, moves are underway to amend legislation to allow for the expansion of minister-level positions from 34 to 40. Even the largest party, the Indonesian Democratic Party of Struggle (PDI-P)—of which President Widodo is an estranged member—is more likely than not to join the fold, possibly after October’s change of presidents.

PDI-P’s leadership remain furious with Widodo after he withheld his endorsement of the party’s own candidate in favour of supporting Prabowo. But over time the financial and political costs of being shut out from power and patronage opportunities under a popular president grow more salient.

With Prabowo’s alliance with the outgoing president holding strong and the support of party elites assured, work is now in place to ready the framework for Prabowo’s signature election promise, a national program of free school meals. Widodo’s technocrats have scaled the program down from its grandiose campaign-period version, which was estimated to cost almost 2 per cent of GDP per year.

Indonesian Finance Minister Sri Mulyani Indrawati has backed the program and pledged to include a generous allocation for the program in the draft 2025 budget, set to be introduced to parliament just ahead of Prabowo’s inauguration.

Experts might wonder whether Indonesia’s significant problems of childhood malnutrition and stunting might be more efficiently addressed through improvements to the targeting and generosity of existing cash transfer and food aid programs—or whether the poor households burdened by the high prices of healthy food might benefit from reforms to protectionist agricultural policies.

But regardless of how well it delivers in terms of health and educational outcomes, Prabowo’s school meals program has big political potential. The Widodo decade—marked by the steady expansion of subsidised healthcare, social security and cash transfers—has confirmed how important the success of such programs is to a president’s popularity. If financed and administered well enough, Prabowo’s school meals could be as important a political asset for him as Brazil’s Bolsa Familia cash transfers were for the Lula da Silva government or the ‘30 Baht’ program of subsidised health care was for former Thai prime minister Thaksin Shinawatra.

Beyond establishing the framework for the school meals program, the transition period is seeing developments that could shape Prabowo’s presidency in important ways, as Indonesia’s parliament uses the post-election session to push legislation that chips away at key achievements of the reformasi era, the post-Suharto regime years.

Proposed revisions to the Armed Forces Law would give the president new powers to allow the appointment of serving military officers to civilian offices, extending the co-optation of the military into areas of civilian administration, a notable feature of governance under Widodo. Prabowo, a former general in Suharto’s army, will have few ideological qualms about using the military as an instrument of policy delivery and political control. Indonesia faces the gradual reintroduction of at least some of the dwifungsi or ‘dual function’ role that the military took during the Suharto regime era.

Meanwhile a proposed revamp of broadcasting laws would increase the powers of the conservative Indonesian Broadcasting Commission to oversee content and would restrict the broadcasting of investigative journalism scoops. This latter prohibition is clearly aimed at the journalism outlet Tempo, which has branched out into podcast and video content, as well as a crop of new digital media outlets that report more critically than the mainstream press on Indonesia’s political and business elite.

Judicial independence is also in the firing line. After the election, the parliament has moved forward with changes to legislation governing the Constitutional Court. The court’s emergence as a check on the executive and parliament after its establishment...
in 2003 was one of the key achievements of the reformasi period.

While the quality of its decisions has declined and it has been hit by corruption scandals, the court has still shown a willingness to defy the institutions—the parliament, the president, and the Supreme Court—who are by law allowed to each nominate three of the Constitutional Court’s nine justices. The rules proposed would allow the nominating institution to sack judges at the halfway point of their 10-year terms, with inevitable consequences for the independence of their decision-making.

Observers have noted the irony that legislators have moved against the Constitutional Court while its reputation is at a nadir following a decision that was all too convenient to the government. In October 2023, while President Widodo’s brother-in-law was its chief justice, it created a legal loophole that allowed the president’s son Gibran Rakabuming Raka to stand as Prabowo’s running mate.

The Supreme Court has also handed down another ruling that opens the way for Widodo’s second son, Kaesang Pangarep, to run in the Jakarta gubernatorial election as part of a wave of subnational elections scheduled for November 2024. Reports suggest that the outgoing president is leaning on party leaders in the government coalition to support Kaesang running as deputy governor on the government aligned ticket in the Jakarta race, which would give him a national platform comparable to that which his elder brother will have in the vice presidency. Widodo’s son-in-law, Bobby Nasution, is also expected to run for the governorship of North Sumatra in the November local elections.

With the gamble that Widodo made on putting his son forward as a vice-presidential candidate having paid off, November 2024 will see a test of the electorate’s appetite for more dynasty building—and it will give an indication of how far a Prabowo administration is willing to use its powers of pork-barrelling and legal coercion to give its favoured local candidates a leg-up, with a view to consolidating its influence within subnational governments at the beginning of its term.

HE signs all point to a strong start to Prabowo’s presidency, not least because he won an unprecedented electoral mandate for an incoming president. With the support of the majority of political parties—and possibly all of them if PDI-P is co-opted into government—opposition to the administration will be concentrated in an increasingly marginalised progressive civil society and intelligentsia.

Within this consolidated coalition there will be few barriers to its members colluding to further reduce the ability for the media, civil society and voters to scrutinise their exercise of power, and on matters of major policy strategy they will have the incentive to defer to Prabowo if he remains popular.

The prospect of Prabowo maintaining a high baseline level of popularity among low-income voters through strategic use of welfare programs is directly linked to the outlook for the quality of democracy and governance standards. The Widodo years have shown that voters will tolerate a remarkable degree of democratic backsliding if a president is delivering on their expectations in terms of propping up their standards of living and not being personally identified with corruption.

Prabowo’s plans to replicate some key parts of the Widodo governing formula—choking off elite opposition by co-opting parties into cabinet, while burnishing his own popularity by delivering on his key campaign promises—will foster the conditions for his government and its allies to get away with further weakening civil liberties, watchdog institutions and the limitations on the military’s domestic role.

There is no policy silver lining to be found amid these shifts. There is instead an increasingly clear symbiosis between the imperatives of presidential coalition maintenance, Indonesia’s endemic public sector corruption and the frequent orientation of policymaking around serving rent-seeking interests. The reason Prabowo can co-opt opponents into his cabinet so easily is because those parties’ need for cash and government resources to fuel their patronage machines makes gaining control over ministries a strategic priority—one that can outweigh the principle of staying in opposition to represent a voter base that voted against the serving president.

The opportunities for corrupt accumulation of patronage resources by parties and other interest groups is the glue that holds these oversized cabinet coalitions together. Just as it has been over the Widodo decade, the political success of Prabowo’s presidency and the unlikelihood of his making serious progress on Indonesia’s governance challenges are two sides of the same coin.

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UNLOCKING ECONOMIC POTENTIAL

Strategically reforming India’s role in global value chains

VEERAMANI CHOORIKKADAN

India stands on the cusp of a transformative opportunity to become a major player in global value chains. With a vast pool of low-wage labour, India has a natural comparative advantage in participating in backward-linked global value chains, where imported inputs are used to produce goods for export. Engaging in these value chains could create millions of jobs, accelerating the shift of surplus labour from agriculture to more productive activities in modern manufacturing.

India’s size and labour abundance make it an attractive destination for multinational enterprises seeking to lower costs and diversify supply chains. To capitalise on this potential, India has implemented policies aimed at positioning itself as a primary...
Over the past decade, India’s trade policy framework has been changed significantly to attract globally competitive companies. An assembly hub for manufactured exports. Key to this effort are liberal foreign direct investment (FDI) and trade policies, a favourable investment climate, low service link costs and flexible factor markets. Despite these efforts, further improvements are necessary.

Over the past decade, India’s trade policy framework has been changed significantly to attract globally competitive companies. Notable measures include the Production Linked Incentive scheme, corporate tax cuts, simplification of labour laws, bankruptcy reforms and recalibration of import tariff structures. Additionally, India has opened various sectors to 100 per cent FDI through the automatic route and entered free trade agreements (FTAs) with the United Arab Emirates, Australia and the European Free Trade Association. Negotiations are also underway with the EU, the United Kingdom, Canada, Israel and the Eurasian Economic Union.

The OECD’s FDI Regulatory Restrictiveness Index reflects this shift, showing a decline in India’s FDI restrictiveness from 0.33 in 2010 to 0.21 in 2020, making India by this measure less restrictive than China. India has also performed better than China in terms of inward FDI flows as a percentage of gross fixed capital formation and GDP in recent years.

Previous studies suggest that India has not benefited fully from its earlier trade agreements, likely because they were signed with nations with similar economic structures, limiting trade opportunities. To maximise gains from FTAs, India should partner with more developed countries. These nations, with their advanced capital and technology, complement India’s labour-abundant economy, enhancing its participation in backward-linked global value chains. India’s recent focus on FTAs with advanced economies aims to enhance complementarities and create new opportunities, particularly in labour-intensive exports.

Historically, FDI inflows into India have been primarily market seeking rather than export promoting. To shift this trend and enhance FDI’s contribution to export growth through global value chain integration, India must address the longstanding issue of an inverted import duty structure. This structure, where the duty rate on final products is lower than on components, makes domestic manufacturing economically uncompetitive. Recent National Budgets have attempted to correct this by reducing import tariffs on essential components, leading to promising outcomes such as India’s transition from a net importer to a net exporter of mobile handsets.

The Production Linked Incentive scheme, introduced in selected sectors, aims to overcome constraints in achieving manufacturing scale and integrating Indian industries into global value chains. It provides incentives based on incremental sales over a stipulated period. Well-designed industrial policies are essential, especially for sectors facing market failures due to learning-by-doing externalities, logistics costs and demand limitations.

The scheme can facilitate the development of sectors through positive externalities, dynamic comparative advantage and increasing returns, particularly in innovative, technology-driven and emerging domains. While the scheme is an effective intervention for market failures, sector selection should be based on economic logic, not political or industrial pressures. High-tech sectors like semiconductor manufacturing and AI-based products may justify production subsidies, whereas traditional sectors like textiles, auto components, food products and white goods do not. Given that production processes in many industries are structured within global value chains, it may be more effective to tie Production Linked Incentive scheme incentives to incremental value added rather than focusing solely on production or sales value.

To sustain export growth, India’s potential to integrate into global value chains and become a major manufacturing hub hinges on continued policy reform.
Estimates suggest that the gap between India and China in world export market share is primarily due to India's lack of specialisation and scale—referred to as the intensive margin. Conversely, India has matched China in terms of diversification—extensive margin—across products and markets, distributing its exports over many products and trading partners. India's low intensive margin is attributable to its limited participation in global value chains and a bias in its specialisation towards capital- and skill-intensive industries, rather than labour-intensive industries.

India's economic reforms in the 1990s and 2000s focused on removing entry barriers in product markets. But eliminating exit barriers for firms and ensuring flexible factor markets are also crucial for India to gain from specialisation and scale expansion. Rigidities in these respects obstruct resource reallocation, hindering specialisation and integration into global value chains. Several studies identify these rigidities as major obstacles to India's export performance in labour-intensive manufacturing.

To address these challenges, several Indian states have initiated labour market reforms since 2014. These include increasing the size threshold for the Industrial Disputes Act from 100 to 300 workers, redefining factory size thresholds and raising the threshold for the Contract Labour Act. The reforms aim to create a more flexible labour market, essential for boosting labour-intensive manufacturing.

Future reforms should also prioritise tackling land market rigidity. Streamlining land acquisition processes, clarifying land ownership rights and implementing transparent land use policies are crucial for reducing entry barriers for businesses and facilitating efficient resource allocation. Incentivising land consolidation and facilitating land leasing arrangements can unlock untapped potential for agricultural and industrial development, fostering a more dynamic and competitive economic landscape.

India's potential to integrate into global value chains and become a major manufacturing hub hinges on continued policy reform. By addressing structural issues such as the inverted tariff structure and labour and land market rigidities and focusing on appropriately designed industrial policies, India can position itself as a major player in the global manufacturing sector, creating jobs and driving economic growth.

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DECOUPLING COSTS

The productivity effects of Australia’s withdrawal from supply chains

JENNY GORDON

A USTRALIAN trade is concentrated at both the beginning and end of international supply chains. Australia mostly exports commodities—raw materials for transformation into industrial goods—and imports finished products, some of which are inputs into domestic production processes.

Beyond supplying raw materials and consuming finished products, Australia’s low economic complexity means it does not play a significant role beyond the beginning of supply chains. Australia’s withdrawal of commodities would disrupt other countries to the extent that they cannot find alternative sources of raw materials. With the exception of iron ore, the widespread availability of export commodities means Australia has little scope to use the threat of decoupling as a deterrent to other countries weaponising trade. Similarly, the small scale of the Australian market means a threat to ban imports is unlikely to be a major loss for most of its trading partners.

Given the inability to use the threat of decoupling as a deterrent, the justification for decoupling must be that it improves Australia’s resilience to disruptions in trade—for any reason. But Australia’s low levels of economic complexity means that import replacement will take time and
require considerable investment.

Given the extent to which China is integrated into global value chains, does replacing international supply with domestic production that still needs imported inputs improve economic resilience? And what would be the cost to productivity?

Productivity rises when inputs are combined more efficiently, producing more output for the same level of inputs. For large fixed investments, such as mines, productivity rises due to economies of scale. Production ramps up until capacity is reached. But more important for productivity is how scale enables new technology and innovation in the production and delivery of output to market.

Adopting new technologies often involves a changing mix of inputs. This is mostly via a rise in capital inputs—including intangible capital, such as skills from learning by doing—relative to labour. Scale allows labour and capital to be combined more efficiently.

A classic example is the labour-saving technology of backhoes replacing shovels. A person and shovel are the most efficient approach to digging one hole, but the backhoe and skilled driver are much more efficient at digging many holes. Scale justifies increased investment in more sophisticated technology and in the skilled labour required to apply it.

The returns to scale from rising utilisation of capital and labour, and from adopting better technology, are the source of improvement in productivity. Technology applied at scale in mining, along with rich ore deposits, has made Australia one of the world’s most efficient producers. The same narrative applies to agriculture, where scale has justified investment in new production techniques, plant varieties and animal genetics.

These returns to scale apply even more to digital technologies than to physical equipment. Unlike investing in bigger and more automated backhoes, it is almost costless to scale up digital technologies. While productivity gains from mass production remain important, largescale data processing systems that support tailored design are an increasing source of productivity growth.

Connectivity that is embedded in products and improves performance—such as software updates in electric vehicles—is a new source of productivity growth, albeit one reflected in quality more than directly in productivity statistics. Here, too, scale matters. The unit cost of a software update—that is, productivity improvement—falls with the number of connected products.

Withdrawing from international supply chains reverses the productivity gains from scale through lower utilisation rates and adopting less efficient, smaller scale technologies. These effects are direct when replacing efficient imported products with less efficient domestic production and indirect when part of a broader protectionist trend that reduces demand for exports.

Australia’s small market means that production scale, and consequently productivity, will be lower even with the best technology at that scale. Withdrawing from international supply chains should be limited to products where technology is less scale dependent or there is export potential. If import bans are used to support domestic production, the forces of competition are also dampened. This only reduces firms’ incentives to improve their technology. Ways to expose firms to competition need to be devised. Unlike many other countries, Australian governments have resisted the temptation to use import tariffs or bans to promote domestic production.

For domestic production to improve resilience, any essential imported inputs—and the inputs into these products—must also not be at risk. The impact of import replacement on resilience is product dependent. What matters is the market concentration in any of the essential inputs in domestic production that are vulnerable to disruption. This risk must be assessed before any decoupling is justified.

There is an additional cost to decoupling—gains to trade come from comparative advantage, as well as the scale and specialisation that scale enables. Comparative advantage harnesses differences in the relative abundance of resources to make trade mutually beneficial. Countries with surplus labour have a comparative advantage in labour-intensive production. Those with abundant mineral deposits have a comparative advantage in mining.

Withdrawing from international supply chains reverses gains from

Australia has benefited enormously from rapid economic growth in Asia, which has driven demand for products where Australia has a strong comparative advantage.
Japan’s plan to restructure global supply chains

YUQING XING

GLOBAL value chains have become integral for manufacturing and trade in the 21st century but their efficiency has been undermined by shocks emanating from the US–China trade war, the COVID-19 pandemic, the war in Europe and rising geopolitical tensions. In the post-pandemic era, a focus on strengthening the resilience of supply chains and protecting national security has been driving the reconfiguration of global value chains.

As early as 2005, the Japanese government proposed the China Plus One strategy to Japanese multinational companies to hedge against the risks of chilling bilateral relations between China and Japan. At the time, the response of Japanese companies to the proposal was lukewarm. This time is different. Shocked by the contagious effects of the COVID-19 lockdowns in China, the administration of former Japanese prime minister Shinzo Abe budgeted 245.6 billion yen (US$1.56 billion) to help Japanese firms relocate production on shore or to Southeast Asia.

By 2022 Japanese foreign direct investment in China had reached US$127.6 billion, the largest among Asian countries. Many Japanese multinational enterprises used the country as an export platform for the US market. The 25 per cent punitive tariffs imposed by the United States on Chinese exports and the possibility of escalation in the trade war raised the costs and uncertainty of operating in global value chains where China is the manufacturing and assembly base and the United States is the destination market. The ongoing US–China trade war has further motivated Japanese firms to diversify their supply chains.

In Japan the Ministry of Economy, Trade and Industry (METI) assists Japanese companies to reshore supply chains while the Japan External Trade Organization (JETRO) supports Japanese firms to shift their supply chains to ASEAN, India and Bangladesh. Between May 2020 and March 2022, METI subsidised 439 onshoring projects covering a range of sectors including medical equipment, auto parts, electronics and semiconductors. During the same period, JETRO approved 104 nearshoring projects and provided up to 5 billion yen (US$32 million) to each project. It has also coordinated with ASEAN to implement the nearshoring strategy to strengthen the supply chain resilience of Japanese companies.

In 2023, China accounted for 17.6 per cent of Japanese exports. The erosion of open trade and investment will slow both global growth and the demand for commodities.

It is in Australia’s interest to push back against this kind of protectionism. It is not only costly to domestic productivity for an uncertain improvement in economic resilience but also harms the development prospects of countries that deserve to prosper by harnessing their comparative advantages. The WTO Director General Ngozi Okonjo-Iweala has expressed this concern in her calls for reglobalisation.

The productivity cost of onshoring will vary by product. So will the extent to which onshoring reduces the risk of supply chain disruption relative to other approaches, such as stockpiles. With little strategic leverage to gain from deterrence, Australia’s calculus must be on the value of improved resilience relative to the higher costs imposed on consumers and taxpayers through lost productivity.

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It is also one of the largest hosts of Japanese foreign direct investment. Supply chain diversification aims to reduce Japan’s economic dependence on China and mitigate the risks of unstable political relations between the two nations.

The COVID-19 pandemic disrupted semiconductor supply chains and caused a severe shortage of semiconductor chips for the automobile industry, a pillar of Japan’s industrial economy. In 2021, the Japanese government published its ‘Strategy for Semiconductors and the Digital Industry’ which aims to rebuild the semiconductor industry with government subsidies. In 2022 the Japanese Diet passed the Economic Security Promotion Act, mandating the government to secure the supply chains of critical materials and maintain the stability of key infrastructure and national security.

The United States has designated China as a competitor and is attempting to reorganise global supply chains in semiconductors, electric vehicles and other high-tech industries with partners and like-minded nations. The dominance of global value chains in the world economy makes it unlikely for one country to build a sophisticated industry completely independent of foreign suppliers. Friendshoring is more realistic than onshoring.

Given its geopolitical significance and technological capacity, Japan is regarded as the United States’ most capable and reliable partner to jointly reconstruct global supply chains in strategic industries. In March 2023 the United States and Japan signed the Critical Minerals Agreement to strengthen cooperation in critical material supply chains and ensure that EV battery materials processed in Japan are not discriminated by the United States’ Inflation Reduction Act. In May 2023, US Secretary of Commerce Gina Raimondo and then Japanese Minister of Economy, Trade...
and Industry Yasutoshi Nishimura issued a joint statement advocating cooperation in creating a more resilient semiconductor ecosystem and developing the next generation of semiconductors. Japan has joined the United States’ semiconductor alliance and has adopted export controls on 23 semiconductor technologies.

The Japanese government is seizing on the momentum of supply chain reorganisation and US–China rivalry to revitalise its domestic semiconductor industry. Building resilient supply chains for national security also justified the Japanese government’s promotion of strategic industries through lavish subsidies.

The Japanese government has allocated 4 trillion yen (US$25.4 billion) to subsidise investment in the semiconductor industry—the largest among OECD countries in terms of GDP. Both Japanese and foreign semiconductor firms are eligible for subsidies. Taiwan’s TSMC received 1.2 trillion yen (US$7.6 billion) for its first two factories in Kumamoto enabling the production of more advanced twenty-eight to six nanometre chips.

Even the South Korean company Samsung, the archrival of Japan’s Sony, received a subsidy of 20 billion yen (US$127 million) to build a semiconductor research centre in Yokohama. With a subsidy of 920 billion yen (US$5.8 billion), Rapidus, a new chip venture founded by seven Japanese companies including Toyota and Softbank, aims to manufacture two nanometre chips in collaboration with the US company IBM in 2027.

The friendshoring strategy has strengthened coordination in industrial policies between Japan and the United States and elevated Japan’s role in global supply chain reorganisation, providing fresh impetus for Japan to re-industrialise and regain growth momentum. Japan can take advantage of its involvement in multilateral free trade initiatives, including the United States’ Indo-Pacific Economic Framework for Prosperity and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, to strengthen its regional leadership in building sustainable and resilient global supply chains.

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US Secretary of State Antony Blinken holds a meeting with Japan’s Minister of Foreign Affairs Yoko Kamikawa and Minister of Economy, trade and Industry Nishimura Yasutoshi during the APEC Summit in San Francisco, (November 2023).
India should support the WTO Investment Agreement

KARL P SAUVANT

At the WTO’s 13th Ministerial Conference in Abu Dhabi, 125 members—three-quarters of the WTO’s membership—cosponsored a request to integrate a new Investment Facilitation for Development Agreement (IFDA) into the WTO’s rulebook. Of these sponsors, 89 were developing countries, including 27 least-developed countries.

The IFDA is a plurilateral agreement and open to all WTO members but is binding only on its participants. India has long opposed the IFDA and it even led (so far) a successful campaign with South Africa to block its adoption under Annex 4 of the foundational Marrakesh Agreement at the ministerial conference.

Developing countries want the IFDA because it helps them attract not only more, but also more sustainable and impactful, foreign direct investment (FDI) to advance their economic growth and development. The agreement does this by improving two of the three factors that largely determine the decisions of international investors about the location of their investments—the quality and predictability of the regulatory framework affecting FDI and investment promotion.
For this reason, and not surprisingly, developing countries—currently led by Chile and South Korea—have steered the negotiations of the IFDA since the concept was first proposed by an expert group in 2015 and enshrined in a WTO Joint Ministerial Declaration in 2017. The finalised agreement explicitly refrains from dealing with market access, investor–state dispute settlement and investment protection. It also leaves entirely in the hands of individual WTO members what FDI policies they want to pursue. Under the IFDA, signatory countries are free, for example, to limit FDI inflows from a particular country, provide incentives, restrict FDI in certain sectors and handle investor–state disputes as they see fit.

The IFDA focuses entirely on technical matters related to the implementation of a country’s FDI policy in the interest of improving the investment climate and helping countries to attract more and better FDI. More specifically, it focuses on transparency, predictability and administrative procedures relating to the implementation of a host country’s FDI policy.

By way of example, the text of the IFDA encourages the publication of FDI-related laws and regulations, establishing a single online information portal, charging reasonable authorisation fees, using ICT and e-government, promoting the establishment of supplier databases, implementing supplier-development programs and promoting responsible business conduct practices. Developing countries also obtain special and differential treatment such as technical assistance and capacity building. They can determine for themselves the pace at which they implement individual provisions.

Countries can certainly improve their investment climate on their own, unilaterally. But for many countries, the IFDA brings a number of benefits. These include anchoring investment facilitation reforms in shared international commitments, which helps countries overcome domestic resistance to such reforms.

As a commitment device, the agreement sends a positive signal to international investors that a participating country is serious about attracting FDI. And for many developing countries, the technical assistance and capacity building provided for the implementation of the IFDA would be an important resource for improving their chances in the highly competitive global investment market. These benefits are crucial for many smaller developing countries, especially least-developed countries.

For India, an additional consideration comes into play. Several of the country’s firms are already significant outward investors and are poised to become even more.
India opposes the IFDA, arguing that the WTO’s lacks a mandate to deal with investment matters and that plurilateral agreements fragment the multilateral trading system. But the IFDA would build on the WTO’s General Agreement on Trade in Services which already covers FDI in services sectors—some two-thirds of global FDI—and the Agreement on Trade-Related Investment Measures. Both agreements were supported by India and explicitly address aspects of WTO members’ FDI measures. Addressing FDI issues is not a novelty for the WTO. The IFDA recognises that firms must first invest in order to trade and that a lot of trade takes place within global value chains and within the international production networks of multinational enterprises as intra-firm trade.

The inclusion of plurilateral agreements in the WTO’s rulebook is not new. It would just add plurilateralism to the Agreement on Government Procurement—for which India has observer status—and the Agreement on Trade in Civil Aircraft, both of which are already part of Annex 4.

Because of the WTO’s consensus requirement, India has the power to block the IFDA as a plurilateral agreement. But this is preventing many developing countries and the WTO’s 27 least-developed members to receive the technical assistance and capacity-building support needed to attract FDI. Should India continue to block an agreement desired by the vast majority of developing countries within the WTO, it risks damaging the goodwill of its fellow developing countries in trade negotiations, which could undermine its global standing.

India can also unlock the direct and indirect benefits of the IFDA by allowing its integration into the WTO rulebook as a plurilateral agreement. Unblocking the agreement is made easier by the fact that the IFDA was deliberately conceived as a plurilateral agreement open for acceptance by all WTO members. Its benefits would extend to all WTO members without imposing any obligations on non-participants. Even as a non-participant, India and its firms that invest abroad would benefit from the improvements made to participating countries in which Indian firms invest—all at no cost to India.

But India could go further and join the IFDA, making it a multilateral agreement. The overarching objective of the IFDA—improving host countries’ investment climates—would first and foremost benefit India’s domestic firms. A vibrant enterprise sector is, after all, the bedrock of economic development. Government authorities would be able to refer to the IFDA when contemplating regulatory reforms, which would make it easier for them to overcome domestic resistance to their implementation.

Furthermore, India joining the IFDA would send a signal to international investors that India is serious about better facilitating FDI inflows. This could energise the country’s Make in India program, help Indian firms integrate into global value chains and create the employment opportunities that India badly needs—important goals of the country’s growth strategy.

India’s government should seize the opportunity and support the IFDA to advance the country’s economic growth and development and strengthen its standing among its fellow developing countries. In the process, it would also strengthen the multilateral trading system and restore some faith in the WTO’s embattled rule-making function.

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Global value chains have featured as a development strategy in most emerging economies in the 21st century. But economic and political shocks now hinder their growth at both the regional and global level.

According to the World Bank, the growth of global value chains peaked in 2007 and dwindled after the onset of the 2007–8 global financial crisis. Post-global financial crisis, global trade growth has been subdued, a trend exacerbated by the onset of the COVID-19 pandemic. These global shocks are associated with inherent economic policy uncertainty. This has resulted in a ‘wait-and-watch’ problem for firms, where firm uncertainty induces inactivity and reduces their level of investment.
Economic policy uncertainty is becoming more apparent with strategic alliances driven by the United States and Europe such as the Indo-Pacific Economic Framework for Prosperity. These alliances represent attempts to isolate the technological and global value chain-related activities of China and contain technological change in East Asia. The brewing uncertainty fuelled by strategic alliances is creating investment uncertainty around the potential for offshoring, nearshoring and friendshoring.

Strategic alliances directly weaken the market-based and rules-based trading activities that drive global value chain efficiency and deepen regional integration. Decoupling affects both the backward and forward linkages of global value chain related activities and increases the vulnerability of both supply chains and domestic firm activities. The effects of this policy uncertainty are likely to be felt more by countries that are positioned higher up in the value chain compared to those lower down in regional and global value chains. The implications of strategic alliances will be more salient for countries like Indonesia, Malaysia, the Philippines, Thailand, Singapore and Vietnam as a result.

The behaviour of firms in response to uncertainty can also alter the landscape of global value chain-related activities in East Asia. Economic policy uncertainty is higher in global value chains than for other trade due to the interdependence of intermediate trade and interlinkages in global value chain activities.

This has a direct impact on the investment decisions of firms and can cause firms to choose to postpone their investments. A 2024 Jeffrey Cheah Institute paper on the impact of economic policy uncertainty on global value chain integration for Indian manufacturing firms showed that global value chain resilience and participation are dependent on firms’ ability to withstand economic shocks. That study also highlights that the entry and exit of firms from global value chain activities are likely to be affected by the uncertainties associated with global trade.

The key to mitigating economic policy uncertainty is to make global value chains more resilient to shocks and improve rules-based and market-based trade in the region.

Regional cooperation is vital to offsetting the effects of policy uncertainty stemming from global shocks and strategic alliances ...

The Regional Comprehensive Economic Partnership (RCEP)—the ASEAN-centred multilateral free trade agreement that is the largest free trade agreement in the world—is expected to provide the new rules-based institutional framework to ensure sustainable economic development in the East Asian region.

RCEP is a ‘living’ agreement and the RCEP Joint Committee has the potential to create a wider regional integration agenda to address pressing issues such as the environment, climate change, skills development, green transformation and the development of digital and smart urban centres. The built-in institutional features within the RCEP agreement—Chapter 18—that include ministerial meetings serviced by a joint committee could be used for the progressive liberalisation of regional and global trade and to address issues beyond trade and investment.

Cutting-edge firms participating in global value chains often have to participate in both manufacturing and
Leveraging global value chains is key to India’s economic prosperity

AMITA BATRA

THE past few years have been turbulent for global merchandise trade, with multiple crises impacting its fundamental propelling mechanism—global value chains. While the global financial crisis and natural disasters in East Asia triggered the restructuring of global value chains last decade, the trend towards reshoring and nearshoring gathered momentum with the rise of US–China trade tensions in 2018.

Since then, the COVID-19 pandemic and the Ukraine crisis have introduced a stronger imperative for global value chain relocation that aims to deliver greater resilience and economic security. Achieving resilience through reduced single source import dependence or the China Plus One global value chain diversification strategy adopted by large corporations has created significant opportunities for other emerging market economies. India could tap into substantial benefits from these opportunities if it shifts its trade policy towards more openness.

India’s integration with global value chains was limited in the 2000s—
and much lower than integration in ASEAN countries. This is true for both backward and forward global value chain integration and occurred despite an increase in the share of trade in India's GDP. In the 2010s, relative to other emerging market economies like Mexico and Vietnam, India's benefits in global value chain restructuring were small and mainly restricted to the machinery sector.

In the 2020s, there is a renewed and positive interest in the Indian economy as an alternative location in the China Plus One diversification by multinational corporations. This stems from both India’s good growth performance and global and regional conditions. These include increased competition in the trade and technology sectors due to the intensification of US–China tensions, the geo-economic fragmentation following the Ukraine crisis and India's strategic placement in the Indo-Pacific. Yet these factors alone do not imply definitive gains for India.

An open trade regime is essential to facilitate investment relocation and global value chain integration. India is relatively protectionist and less export-oriented compared to competing emerging market economies. India's average applied most-favoured-nation tariff for non-agricultural goods is much higher than other emerging market economies like Vietnam, which has been a leading beneficiary economy from global value chain relocation.

In the 2010s, relative to other emerging market economies like Mexico and Vietnam, India's benefits in global value chain restructuring were small and mainly restricted to the machinery sector.
Unlike Vietnam, India has seen a progressive increase in average applied most-favoured-nation tariffs in the manufacturing sector over the past decade. In global value chain sectors like electrical machinery and transport equipment, below average most-favoured-nation applied tariffs and a large number of duty-free lines allow imports of parts—for up to 89 per cent in electrical machinery in Vietnam, compared to 28 per cent in India—and facilitate efficient global value chain integration.

The number of free trade agreements (FTAs), the nature of partner economies and the depth and coverage of FTAs are among other elements that contribute to liberal trade environments that can support global value chains. While India has accelerated its pace of signing FTAs over the past couple of years, its tariff commitments in these FTAs have been less than the WTO-mandated liberalisation of ‘substantially all trade’. In its 2022 trade deal with Australia, India committed to liberalising around 70 per cent of tariff lines, in contrast to the 100 per cent committed by Australia.

India also includes a set of rules of origin based on the dual criteria of change in tariff heading and substantial value added in its FTAs. These strict rules of origin work against global value chain integration by restricting the preferential market access offered by an FTA. The change in the Customs Act in 2020 also makes the utilisation of FTAs more cumbersome by allowing for scrutiny by the Indian government regarding the origin of the imported product over the certificate of origin.

India’s FTAs are also not deep trade agreements. Inclusion of ‘WTO-Plus’ provisions on investment, intellectual property and environmental, social and governance issues signal a country’s commitment to upgrade its domestic regulatory policies to higher standards and undertake domestic policy reforms in these areas. But India is reluctant to include labour and environmental issues in its FTAs. Investment liberalisation in India’s FTAs draws upon its 2016 Model Bilateral Investment Treaty, which includes a complicated investor-state dispute settlement mechanism, making prior exhaustion of local remedies essential. Such provisions act as limiting factors in India’s attractiveness as a destination for relocating global value chains.

Other than Japan and South Korea, India does not have FTAs with developed countries. The FTAs with Japan and South Korea are under review and the FTA with Australia is only an early harvest trade deal. India is also not a member of any mega-regional trade agreements. India chose to withdraw from the Regional Comprehensive Economic Partnership negotiations, has not applied for membership in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and has opted to stay out of the trade pillar of the Indo-Pacific Economic Framework for Prosperity.

India introduced its Production Linked Incentive scheme in 2020. The scheme provides financial incentives to attract foreign investment and boost domestic manufacturing in 14 sectors for five years on an incremental basis. But the combination of financial incentives and protection through higher tariffs for both imported inputs and final goods in specified sectors is not likely to ensure an efficient outcome—in terms of either building complete supply chains or facilitating integration with global value chains.

This has been apparent in the electronics sector, which has seen some success in mobile handsets, particularly in the iPhone assembly units set up by Apple. Local content use in the sector remains small and contract manufacturers like Foxconn and Wistron have found it hard to negotiate joint ventures and survive in the Indian market. The November 2023 introduction of a monitoring system for imports of specific products in IT hardware manufacturing further adds an element of unpredictability to India’s trade policy.

India must substantially enhance its trade openness and trade policy predictability to take advantage of the relocation of global value chains.

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