

PROCEEDINGS

Global Forces 2011

ASPI International Conference, 10–11 August

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Executive Director's introduction

This was the sixth *Global Forces* Conference organised by the Australian Strategic Policy Institute since the inaugural event was held in 2005.

The conference is an important milestone in our events calendar and provides a unique opportunity in this country to bring together a range of leading international and Australian strategic thinkers with Australian policymakers, policy advisers, commentators, and interested observers.

Global Forces is designed to make a contribution to public debate about Australia's strategic priorities, and to present different perspectives to our policy community. Our hope is that the views presented here will bring fresh insights to the critical strategic issues of the day and that our discussions will help to generate new policy thinking.

We are pleased that we have again attracted a very impressive array of international and Australian speakers for this conference.

Our practice in the past has been to avoid building the conference agenda around a single theme. Rather, we have sought to address the key strategic issues impacting Australia whether they were global, regional or domestic in scope or provenance. We have generally looked at global issues, security arrangements, and Australian policy responses.

The program for *Global Forces* 2011 is consistent with this approach.

Our focus in this conference was on issues such as:

- Shifting power dynamics—both globally and regionally—and the implications for the system of international order, the exercise of leadership within that system, and its economic underpinnings
- Winds of change in the Middle East
- Global and Australian economic realities
- Australia in a changing world.

Peter Abigail

Executive Director

Keynote dinner address

Power and leadership in the 21st century

Dr Parag Khanna

The topic is indeed very broad: power and leadership in the 21st century. Therefore, in fact, it can be answered so quickly that you can all go home now. The answer is the G20, right? We should all invest our energies in pulling together the key great powers and rising powers into one new steering committee to lead the world and that will solve all of our problems.

Of course, I'm saying that incredibly sarcastically and facetiously because part of what motivates me is to look at the long history of ideas, solutions and proposals that are neat, simple and wrong, and to challenge them. What I am starting to do in some of my work is to even get a bit more philosophical about it; not just pointing to these singular sort of misleading paths, but to think about what it means for the history of our political thought. Because for about 250 years since Immanuel Kant, and through thinking on global governance and world order, we have been trained—even lulled—into believing that progress and evolution in global governance manifests itself in ever more centralised universal types of bodies. So from the Concert of Europe, through the League of Nations and the United Nations, and now the G20 there seems to be this arc, very rational arc, towards centralised kind of systems that allow us to identify a source of universal justice and authority.

What I'm starting to challenge is that entire legacy. I think that what globalisation, in particular, as a phenomenon is doing is turning that one core psychological and philosophical assumption that we have entirely on its head. And that we are now grappling, not just in the post Cold War era, but in what I'm going to describe to you as the fifth way of globalisation, with the need to comprehend a world in which that entire foundational assumption of what global governance should be and is completely turned on its head. So I want to give you a much more complicated answer than 'the G20' because I think quite a few other people—none of whom fortunately are here tonight—would have given that lecture. But I am aspiring to give a much more complex and therefore hopefully more accurate view of how the distribution of power is taking shape.

I believe that we all appreciate structural change. Structural change is when you move from a unipolar to a multipolar system or a multipolar to a unipolar. That there are more powers in the world is now beyond dispute. What people appreciate much less is systems change, and systems change is a change in the nature of the units in the system; so moving beyond just thinking about states themselves. When you bring structural change and systems change together, that's the kind of complexity that we now have to face and the kind of complexity that I want to present tonight.

The context, as I mentioned—and the change that is the key driver—is globalisation: a term that so many of us are surely sick of already. You've been hearing it for a couple of decades now. It either means everything or nothing. I want to recover some seriousness around it and produce something of what I think is a relatively broad but digestible arc to understand why it is that what is happening now in globalisation continues to make it such a relevant phenomenon. It begins by going back about 1,000 years. Now perhaps there is a 15,000 year or more story of globalisation, most certainly in a demographic and technological sense, which are fundamental aspects of globalisation. But let me start with the point in history at which there was a discernable ritualised transregional trading

system or system of exchange across regions that became a pattern. That was about a thousand years ago with the Silk Road. Marco Polo, Ibn Battuta, and other explorers traversed from East to West and the Silk Road formation was mutually beneficial. It really also covered North Africa, certainly the Italian city states outwards towards China and back. This to me was globalisation 1.0—these days everything has to be in the sort of dot com kind of language.

It was on the back of this that colonialism again conferred the advantage to European mercantile powers, the ‘discovery of the new world’, the creation of an increasingly global commercial and political, and geopolitical hierarchy. To me that was globalisation 2.0. On the back of that, the industrial revolution conferred greater advantage to northern Europe, particularly Great Britain and then eventually the United States. The post-industrial revolution and the formalisation of a world economic exchange more than had been the case before, brings us really into the 20th century, at which point you have the rise of formal economic institutions such as the General Agreement on Tariffs and Trade which became the World Trade Organization and eventually after World War II the Bretton Woods bodies. What’s noticeable here is that towards the late 20th century the rise of the so-called emerging markets—China and India, through their economic reforms and liberalisation—enter the picture. This to me is globalisation 4.0 and most people would still argue that this is effectively the sort of period in globalisation’s arc that we’re in.



The thing is that globalisation here still isn’t really global. Up until relatively recently, just 15 or 20 countries dominated 80–85% of the world economy and trade. What is really changing now—and it’s certainly accelerating as we speak—is that globalisation is actually going global. Now we are entering the age of total globalisation where there is universal participation in this process. It is still not on equal terms but that is increasingly the

case; the playing field is being levelled in a variety of ways. This is going to have very dramatic consequences. When you marry capitalism, technology and the universality of the process into the 21st century, I think this is the fifth wave of globalisation that we need to understand.

This too is not uncontroversial because three times in the last decade we have heard people talk about the end of globalisation, the retrenchment of globalisation, the backlash against globalisation—9/11 and East/West suspicion was meant to unwind, unravel globalisation. It didn’t happen. People said that the collapse of the World Trade Organization’s Doha round would lead to a reversal of globalisation because we did not have that single global trade deal, and we still don’t. Then, of course, the global financial crisis of 2008. So three times in the last decade you’ve turned on the television or opened your op ed pages and you have read ‘End of globalisation is coming’. Yet, in the last decade commodity prices have boomed, and world trade has skyrocketed. Foreign investment most certainly took a big hit after the financial crisis. That too is climbing up. Global financial stock has increased. By almost all relevant measures globalisation continues to advance. So it withstands these structural shocks and obstacles and therefore is an important underlying condition.

Part of that notion of everyone participating and everyone connecting to everyone else, as illustrated in the slide, is that there really is a global exchange of commodities, resources, knowledge, capital and so forth that is linking all regions of the world to each other.

Globalization carries on in all directions



Western economies, whether it's Western Europe or the United States, have now developed a certain anxiety or fear, and even a backlash, against globalisation. As you know, the surveys suggest that Americans now are in favour of trade protectionism while the Chinese and Indians are very much for open trade. Globalisation is not going to stop just because Western powers may become antsy about it based on their economic conditions.

Globalisation is continuing because this interregional pattern of exchange is connecting emerging markets to each other as well. When Latin America deals with Africa and deals with East Asia, that too is globalisation. Just because globalisation is no longer synonymous with Americanisation or Westernisation, it doesn't mean it's stopped at all. These patterns are continuing to expand between all regions.

By Land



It is happening in four ways. The first is by land—the Silk Road is being resurrected, but there are many such routes and they are made of iron and steel, they're made of railways and oil pipelines. On the slide is a map of the Trans-Asian railway network that is being developed. Every month that one produces a slide like this requires adding another line because new tracks are being laid down. Asian economies such as Korea, China and others

are investing massively in this rail infrastructure to build this new sort of Silk Road connecting China and Korea, all the way across Russia, Central Asia and so forth, from Turkey to Europe and beyond, reaching all the way down to Singapore. So this physical infrastructural renewal across Eurasia is a major example of a deepening continuation of interregional globalisation patterns through this physical connectivity.

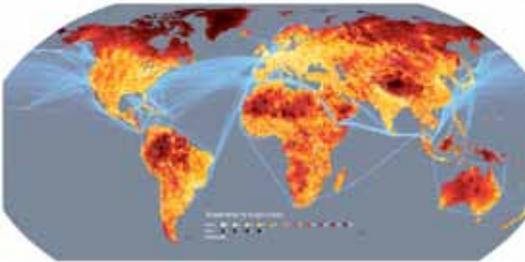
By Air



It's also happening by air. A number of major passenger airports or international airports are being built in emerging markets such as developing countries. This slide is dated because it should have Lagos and Nairobi and other places. If you were in West Africa ten years ago and wanted to go to East Africa

you'd have to fly through London or Paris. Today there are more airline hubs in Africa than ever before. You can now take non-stop flights from South America to Africa. Australia is also more connected to the other regions as well. So this is another example of how globalisation is carrying forward in this interregional sort of way.

By Sea



From: European Commission, and Research Gate

It is also happening by sea because—as everyone in Australia surely knows—90% or some very substantial percentage of world trade is still conducted by sea. Massive investments are being made in new port developments around the world, and new canals are being deepened and dredged. Investments are being made in massive supertankers or super supertankers. So

seaborne trade is yet another continuous example of how globalisation is carrying on.

Then you have to add the cyber dimension, the internet trunks, and fibre optic cables that are laid down between regions. This is another slide that dates quickly. Because here too this kind of connectivity, cyber connectivity, across regions is deepening as well and connecting regions to each other which then enables, and facilitates exchange in goods and services. So you have this distribution and ability to connect across regions that really does continue radically in this globalisation 5.0.

And in Cyberspace



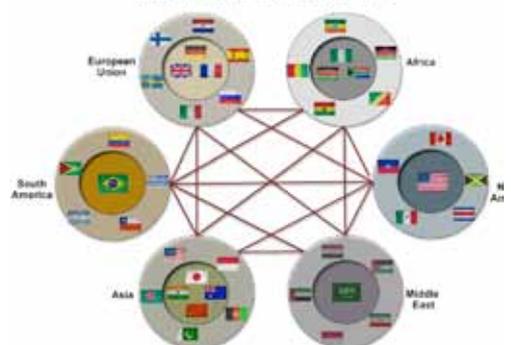
It is that globalisation that I believe has had an underappreciated but accelerating impact on geopolitics. Absent globalisation I don't know how we could've so quickly moved from this map of the world in the 1990s, when twenty years ago then President George H W Bush stood at a granite podium at the UN General Assembly and declared the new world order.

That was a unipolar world, meant to be a multilateral, UN-centric world and a state-centric world. In such a short amount of time who could've anticipated that the world would look like this. This is what I call the global marketplace.

The World of the 1990s



Today's Global Marketplace



Regions of the world are able to freely connect, relate, exchange and develop alliances and relationships with each other. But it is taking on this pattern of regional clusters as well. Within those clusters there are certain anchor states, no doubt. But the shift again from a world in which major strategic relationships are routed through Washington towards a world of more or less coequal regional centres is really a very radical change that's happened in such a short amount of time. So this is the multidirectional diplomacy in today's geopolitical marketplace.

A World of Regions, not Nations



Now, I put a lot of emphasis on these regional clusters because I believe those who are exploring and examining power transitions tend to look only at the state level. I think that is problematic. To just point to and say, 'America's in decline and China's on the rise'. Or, 'The East is replacing the West and the Pacific is replacing the Atlantic'. I think these

are all overstated kinds of things. I think that the regional dimension of power transition needs to be taken much more seriously. Indeed, great powers globally aren't really respected or appreciated or don't really thrive, as such, until they have managed to either stabilise, lead or build credibility within their own regions. This is something that countries like Brazil have struggled with in the past and are starting to overcome. India continues to struggle with this because of instability in its own region.

Regionalism is important for a number of reasons. One of them—and I'll get to it more towards the end but I'll state it briefly now—is that we have more countries in the world than ever before. When the United Nations was founded there were around eighty countries in the world and we have about 200 today. They are not equally sovereign coequal state units. Many countries in the world are poor, landlocked, very artificial post-colonial kinds of states. Without this regional agglomeration they will have a very hard time surviving economically and in terms of resource. So this deepening regionalisation institutionally is one of the largely overlooked or ignored patterns in diplomacy today. It is largely premised on the model of the European Union, even though the European Union seems to obviously be in dire straits right now. But, nonetheless, the notion of super-national cooperation, or even just transnational economic cooperation in trade and finance is extremely important for the majority of smaller, weaker countries in the world.

Now, none of them perhaps will ever reach the kind of depth that the EU has, but there is a demonstration effect. It's not for nothing that the term 'union' is used so often: African Union; Union of South American Nations, which is a relatively new development. Some speak of the East Asian community and say it will eventually become an Asian union. I was surprised when Kevin Rudd was one of the first to actually use that term. Again, the African Union is not going to look like the European Union overnight, but there are now African development banks, African Union peacekeeping forces; the kinds of institutional developments that one simply would not have expected a relatively short time ago. This regionalism is very important. I include the Gulf Cooperation Council as well. So there's a variety of these regional formations that I think are extremely important. Again, the more countries you have in the world the more you will see this kind of regional formation.

Now, the economic data in the world today very strongly underpins this move towards regionalism. There is a belief—or at least there was until a couple of years ago—that the American citizen is the consumer of last resort in the world and that without exports to the United States emerging market economies like China would have a very hard time surviving. But, in fact—this little box at top right, that’s Asian exports to North America, to United States and Canada.

Regional Blocks are Forming and Decoupling



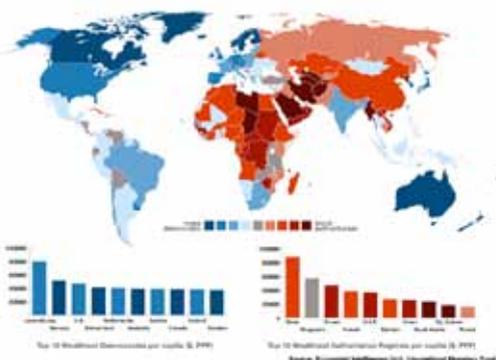
The future of the entire world economy does not in fact depend on this box. There is a radically overstated view in the West and the United States about America’s truly anchoring role in the world economy. As we see in terms of currency trading and a variety of other metrics, slowly and with a great deal of uncertainty, there is a shift underway. That is the great debate about coupling versus decoupling. I’m not an economist but

I lean towards the position of those economists who believe that there can be a certain degree of decoupling as emerging markets grow so quickly and their trade with each other grows so much that there is ever less dependence on exports purely to Europe and to the United States. But what’s interesting here again also is the volume of trade that is intraregional. Now, trade across countries is still technically globalisation, but it is this regional dimension that so often gets neglected from our views of that.

Another thing that’s interesting when you look at the assumptions about what globalisation was supposed to be in the 1990s in terms of being politically homogenising, we used terms like ‘end of history’ to capture that sentiment—but a funny thing happened on the way towards that end of history. It’s that in terms of political models we still have a tremendous amount of diversity.

I created this slide just to demonstrate how hard a climb it still is towards any kind of universality of democracy. If you plot the top ten wealthiest democracies and non-democracies you still see quite a distribution around the world.

Who's On Top? Democracy vs. Authoritarianism



But what’s more interesting is to plot the degree of state intervention in the economy versus GDP growth, according to the EIU and the World Bank.

You find that the high growth economies such as China, Qatar, Singapore and others tend to be those that do practice some degree of state capitalism. What used to be not just a democratic consensus or ideology, but also one around the Washington consensus in

terms of economic policy, has also now become a much more level playing field as well. Things like capital controls, declaring national champions, having subsidies for main industries, all of these are

America such that they could in fact be industrially competitive with Asia. So you do, in fact, see American companies moving back from China, which is getting more expensive, and risky from a currency and political standpoint, to Mexico and Latin America again. So I think that the West certainly cannot be counted out but it needs to be redefined.

Now the East is, of course, highly problematic in that it isn't homogenous in this way. Of course it's not in any way unified in the way that the West is at least a three-pillared zone of peace. But the focus is on, of course, the zone of overlap into which of course Australia also falls. But what used to be considered the West's backyard, an exclusive sphere of influence, Africa and the Middle East, is now very much an area in which Western and Eastern powers coexist. The share of African trade and foreign investment in Arab trade investment provided by China and India has grown very, very strongly. With some Arab countries China is already the number one trading partner. So I think that what we're seeing is East and West really meeting in the middle in this area. Of course, again, Australia feeling like it belongs to multiple cultural and geopolitical spheres simultaneously.

If you take this together, a regional-centric pattern as well as the whole rising powers issue in geopolitical transitions, you still—to my mind—are functioning in the realm of structural change. As I said at the very beginning, I believe that we have to graft a whole new layer of analysis of global change into our analysis, and that has to bring in systems change. This brings me back to the key actor of the medieval world, of the world of globalisation 1.0, and that was of course the city state. The city has become the new meme, I think, in international relations, and even in global economic analysis. It's the new sort of zeitgeist trend or issue that everyone is talking about. And perhaps with good reason because as of last year or the year before more than half the world's population lives in cities, a vast majority of the world economy is driven by cities.

Cities are the Locus of Innovation



Here what you see are the forty key economic centres in the world. But if you take the top forty which represent over a quarter of global GDP today, you see that the majority of them are concentrated in the West.

The Top 40 Cities Represent 25% of Global GDP



But if you now plot the largest forty cities by population size and economic growth, you see how much they shift in this way. So five or ten years from now, given the demographic and the growth rates, you can well imagine what is really driving what we perceive at the macro level as rising state powers is really driven by the rise of particular identifiable, discernable cities.

Top 40 Cities by Population Size and Growth



Again, in the Middle Ages it was cities, and city states that were key actors. I don't think that we can have any more in our minds, or in our analytical frames, just a static analysis or a matrix of power that assumes that territorial size and natural resource endowment correspond automatically to great power; or that military power always dominates and trumps other kinds of power; or that influence can carry the same weight in other regions

that it does in one's own.

So when it comes to these city states, what I think is fascinating is the extent to which one can observe cities beginning to practice their own diplomacy. I fully expect, as someone who's committed to the branch of international relations theory that's called neo-medievalism, I fully expect the resurrection of a certain kind of Hanseatic League, which refers to the Baltic North Sea Area city states in the 12th, 13th and 14th centuries. That was not only a trade alliance but also a defence pact with military force. In fact, there are interesting examples of that already underway. I come from New York City and, as it turns out, my mayor Michael Bloomberg actually does operate an intelligence service that he sends overseas to conduct its own forensic operations; something that came to light relatively recently. We have read in papers recently about the formation of private mercenary forces by Abu Dhabi and they're using Blackwater Worldwide and other companies. You see diplomatic acts, financial and otherwise, taking shape between Abu Dhabi and Singapore and other cities as well.

So I think this city diplomacy is a new dimension that is starting to take shape. The sovereign wealth funds of cities are now participating in huge private equity deals, which many are calling land grabs, in Africa and the Middle East to secure agriculturally fertile land to feed their wealthy and growing populations as well. So I think that from the issues of trade to security, intelligence and so forth, there is a very active intercity sort of diplomacy that is missed when we speak strictly of international relations.

But now I want to talk about companies and communities as well. These are to me the four C's: countries, cities, companies and communities.

This is a well known cliché that really goes back to before the financial crisis. The top 100 economic actors in the world, about half of them are in fact companies. Even after the financial crisis that still remains the case more or less, with Walmart still coming in at the top, larger than all but twenty-one national economies in the world. And not many of these are state-owned companies. Only about four of the top forty or so of those companies are state-owned enterprises.

Of the Top 100 Economic Entities, 40 are Corporations

- | | |
|------------------|-------------------------|
| 1. United States | 25. * |
| 2. Japan | 26. * |
| 3. China | 27. Saudi Arabia |
| 4. Germany | * |
| 5. France | 34. Royal Dutch Shell |
| ⋮ | 35. Exxon Mobil |
| 22. Walmart | ⋮ |
| 23. Sweden | 45. Japan Post Holdings |
| 24. Norway | * |
| 25. Austria | 50. Sinopec |

Source: Compiled by Steven Weber from data from World Bank, Fortune

What's important here though is not to create this either/or distinction. The point of a neo-medieval framework is not to create again an either/or choice between states versus cities versus companies and other actors. But rather to show they're layering in a much more complex kind of system. In fact, what we learned in the financial crisis is not just that some companies have overreached in a deregulated environment and therefore need to be reined back in by the state. What

we learned much more fundamentally is the co-dependence of the public and private sectors. For those who know the economy of Great Britain, what the British learned—much to their dismay—is that some 45% of their national economy is based on the activities of just the private banks in London city, which is just one corner of the city of London. So it's quite staggering, the extent to which the state—which is to say governments—really do rely on the private sector.

That applies even more, of course, for developing economies for whom the largest pool of capital available for their growth and development is not official foreign assistance but, in fact, private capital markets—whether it is foreign investment, debt markets and so forth. So the point is that the private sector is here to stay. It is still the engine of job creation, growth, and innovation, in the world. The sort of tug-of-war that we hear about between Washington and Wall Street in the US context is not very fruitful. The countries that are going to thrive in the future are going to capitalise on their cities and their companies and whatever services and investments the government can provide in a synergistic kind of way.

But just to prove the point, in August 2011 trading on Wall Street saw for exactly one hour, Apple was the single largest company in the world by market cap. It overtook Exxon for exactly one hour and then Exxon just traded higher again. In the latest *Fortune* magazine's Fortune 100 list they had a little feature on Apple showing that its cash stock was greater than the GDP of about 130 countries. It, unlike most of those countries, has absolutely no debt of any kind. So it was a remarkable resilience in a way to being a non-territorial, non-state actor, which does denote and connote a certain amount of power in a context where territory isn't everything.

The Corporate War Chest Grows



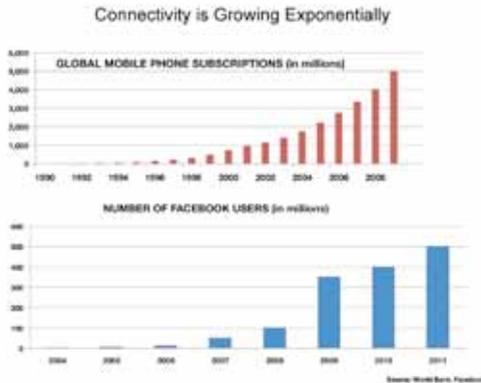
\$76.2 billion in cash; no debt



Ecuador
Bulgaria
Sri Lanka
Costa Rica
.....
and 130 other
countries

The fourth C is communities. We've been able to speak about ethnic identity, religious identity and so forth for a long time, but what's interesting now with digital connectivity is the number of mobile phone subscribers, and the increasing numbers of Facebook users. In about ten years time we'll live in a world where every single individual

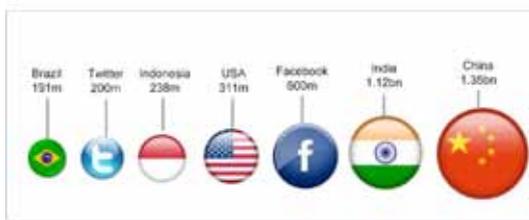
has their own mobile phone, or at least the family unit or maybe the small village unit, or there will be a Grameenphone operation to be able to connect almost every single person in the world to everyone else in the world.



technology does and what connectivity does is allow us to have multiple identities simultaneously beyond just the national. It can strengthen religious, diasporic, ethnic, corporate and generational identity, or identity in support of certain causes. It is not either/or.

That has happened in a remarkably short amount of time. The question that it raises: is there another layer of identity onto which we can graft our thinking when it comes to geopolitical change? Some people say that Facebook is the equivalent of the third largest country in the world and Twitter is up there as well. Who knows, two years from now Facebook may have two billion users.

What social media does, what information



Is Facebook the 3rd largest country in the world?
Or a gateway to multiple identities?

What we're seeing are those who have the resources and the means to be connected are able to flourish in multiple simultaneous ideational kinds of states. So I think countries, cities, companies, communities of various kinds, are simultaneously flourishing today. That has implications for how we think about loyalty and how we think about what

constitutes an authority in the world. This is where neo-medievalism comes back in because the big mistake in thinking about diplomacy is to hold the state or governments as the sole legitimate participants in diplomacy.

In the Middle Ages, which is in some ways the period of history in which what we think of as modern diplomacy was born, diplomacy took place among a wide variety of authorities. Diplomacy is not about sovereignty. Many of you come from the foreign ministry so this may come as a surprise to you. At least in your day-to-day sort of intercourse it is, by and large, the relationships among governments and your interlocutors and equivalents from other countries. But diplomacy is about the relationship between authorities. You can have corporate authorities, religious authorities, educational authorities; a wide range of authorities. In the Middle Ages all of those authorities, particularly in Europe, granted each other the rights of legation—even monasteries and so forth. That again is becoming the case when you look at the ways in which public-private partnerships, for example, are thriving with respect to issues of global public good.

So I believe we live in a world of infinitely multiplying kinds of authorities that are engaging in diplomacy with each other in some regions and in some context and some issues, more so than in others. But most certainly it is a diplomatic environment that is more populated than ever before, and certainly not just about the interactions among a finite number of states. Again, particularly in a world where the more states you have, the more you have to question the extent to which they are coequal, cosovereign, or even meaningful. If nothing else, that is also what we are observing

in the process of this Arab Spring unfolding. This is part of the discussion; the collapse of the post-colonial states and characteristics of those countries in terms of over-population, decaying infrastructure and so forth. That is not limited to the two dozen states of the Arab world. Most of the world is made up of post-colonial countries and most of those countries today really do face many of the same circumstances. So what we're calling the Arab Spring today could be another decade or two, or three decades long process of state collapse, failure and reconstitution across most of the post-colonial world. I can't imagine anyone takes that as good news, but there's no doubt in my mind that, with these circumstances being common across perhaps 100 countries in the world, it doesn't just stop with the Arab Spring. So in that context, a wide variety of new centres of power can emerge.

So how do we manage this? Well, I began with a joke about the G-X formulations, and I'll continue to have a little bit of fun at their expense.

The G8, of course, is no longer necessarily even a relevant body. Some have called it group therapy for Western leaders. The G20 is having a hard enough time managing just financial regulation and coordination of that, let alone burdening it with climate change, the Iranian nuclear issue and Palestinian statehood. So I think the G20 has its limits as well. Of course it's also bogged down—although its more efficient than alternatives—it's bogged down by having a number of countries involved in it that aren't necessarily systemically relevant, such as Argentina and South Africa and so forth.

Then, of course, some say there should be a G3 or a G2. G2, I think, is perhaps the single most dangerous formulation or term in all of popular media and international relations discourse today. No more dangerous a term really at all because the entire notion of a G-X is meant to connote a club or a grouping that is committed towards progressive rules-based common global governance order. We see what happens when the US and China get together; they can't exactly agree on much. So my clever designer guys have made the table to show just how little faith I have in the notion that the G2 is going to be that axis of global stability. If anything, it could very well be the opposite.



The approach I advocate in my own work is something that's much more hybrid, multilayered, whatever you want to call it. But I certainly think it is one premised on building coalitions of the willing among those authorities—whatever type they may be—that are relevant and have the right resources for a given issue. So when it comes to

developing clean energy, you find that BP and Tata Solar may be involved. When it comes to labour rights and reducing emissions, Walmart is a systemically relevant player. And so on and so on. When it comes to combating infectious diseases the Gates Foundation of course deserves mention. So I think very functionally about global governance. I don't think that institution comes first. I think the problem comes first and I think the relevance of actors needs to be assessed case by case. Today, with the openness and transparency and technology that we have in the world, these coalitions are in fact being built very rapidly. I hold a lot more faith, in fact, in some of these types of what some call flash diplomacy or Wiki diplomacy, than I do in some of the existing multilateral institutions which often just exist because they exist. Inertia is really a driving force in their perpetuity.

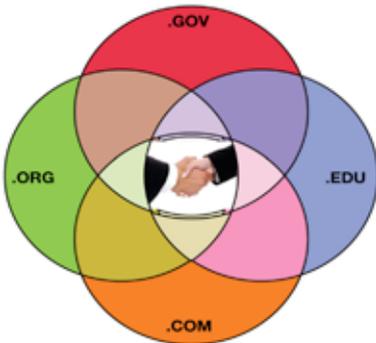
From Old Diplomacy to New Diplomacy



So, mixing this with the previous point, when we think about global governance we have to think about the supply side and the demand side. Most of the countries in the world are recipients of global governance; recipients of aid, recipients of norms rather than producers of them, whereas much of the production of new norms and resources that are committed to global public goods is actually coming from

a range of actors, both state and non-state. So when it comes to the sort of progressive diplomacy that exists, it is already very much a multi-actor kind of arena featuring these kinds of partnerships among governments, civil society organisations, companies very much, and even the academic sector. If I could add a fifth circle I would make it dot G O D—dot God—because, of course, religious actors and their resources also play a major role both good and bad in global governance.

Success Hinges on Inclusive Partnerships



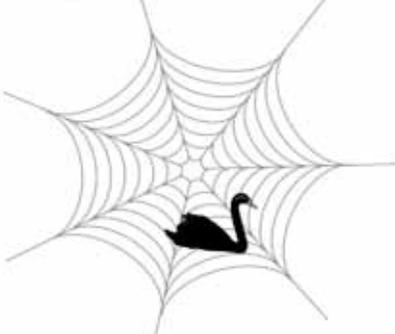
What is the goal of that governance? This is my final point. What we're seeking is not necessarily again that one silver bullet centralised body that solves all the world's problems.

Our goal is to have a world that is resilient. We're obsessed with this idea of black swans, those one-off events that derail progress, stability and so on. You don't prevent black

swans by building a new headquarters for an international organisation in Geneva or New York.

You build resilience by having webs of connectivity so that you have multiple pathways to reach your goal. A good example of it is the case of African farmers. Ten years ago, if you were to have a conversation about 'How do you help African farmers get out of poverty?' you would say 'Oh, well, it really is up to the EU and the US to cut their farm subsidies, otherwise there's just no way'. Well, the EU and US haven't really cut their farm subsidies, but why is Africa thriving, at least in relative terms? Because it is now exporting to many other emerging markets. It has multiple pathways to accomplish its goal and reaching markets and developing.

Resilience: Make Webs to Prevent Black Swans



Resilience is about having those multiple pathways, and I like to think of a spiderweb as being a fairly resilient sort of entity because when you poke it, it actually doesn't fall apart.

SESSION 1: Grand patterns and global influences

Strategy and contingency

Professor Hew Strachan

When I got the program, the title given to me was 'The lost meaning of strategy revisited'. The lost meaning of strategy was the title of an article which was published seven years ago, I think, in *Survival*. I was trying to remember how long ago it was, but it seemed a long time ago anyway. That in turn had been derived from my inaugural lecture at Oxford, which was certainly 10 years ago, and that itself was derived from ideas which had been germinating before the 9/11 attacks. So I thought, quite honestly, it was time to move on.

I say that for another reason and that is because the impact of the article—and I presume the reason that ASPI's been anxious to get me here—was such that it actually proved to me the principle of right time. If I'd written that article when the idea had actually come into my head, which had been some time in the 1990s, it would've had no impact whatsoever. But because I was too idle to get around to putting it onto paper until 2004, then of course it struck a chord. In 2004, the US-led coalition seemed to be losing its way in Iraq. There was a disconnect between the political ambitions of Bush and Blair and the military's capacity to deliver on those ambitions. There was also a disconnect between the sort of war that the US said it and its allies were fighting and the sort of war that they were actually getting into. So the need to understand strategy was becoming imperative.

I'd be tempted to say that at one level things look different in 2011. Defining the meaning of strategy has become a deeply fashionable subject. Strategy has become the tool of choice when we want to judge and when we want to criticise the relationship between governmental ambitions, military action and political outcomes. Let me just give you the example of what's happened in Britain. In 2003 Britain committed itself to the war in Iraq without any sign whatsoever of independent strategic thought. More culpably in 2006 Britain committed itself to sending troops to Helmand in southern Afghanistan without thinking through the implications of its existing commitments in Iraq and, moreover, it began to draw down its forces in Basra the following year, just as the United States was ramping its forces up in Baghdad. So again there was not much sign of independent strategic thinking.

Then things changed at two levels. First of all, within the Ministry of Defence, a strategy unit was created, although anybody who's here and knows anything about the Ministry of Defence will say very quickly that the strategy unit doesn't do strategy. The Chief of the Defence Staff set up a body called the Strategic Advisory Panel on which I serve and which has met once so far this year, which in itself may say something. At the political level, the then Labour government produced the first national security strategy in 2008. It revised it in 2009 and almost the first thing the new coalition government did last year was produce its own national security strategy alongside the strategic defence and security review in October.

But you've already perhaps picked up from my cynicism a question in my mind as to whether things really have changed, despite the signs of institutional progress. The defence review cancelled Nimrod, the airborne surveillance system, and got rid of aircraft carriers and the Harrier force. These seem to be exactly the assets the UK needed when early this year, and very soon after the review,

the British alongside other NATO allies committed itself to the intervention in Libya. We can be pretty sure that one thing the national security strategy last year did not anticipate was that the UK would be exercising military power over North Africa.

So at least for the first half of 2011 in British eyes the relationship between the use of military power and the political ends which the government is seeking have remained as elusive as they have looked at various points over the last decade. The British Government stands accused in most of the British press of behaving unstrategically in that its actions over the last six months have gone against the current of its own defence policy, and it stands accused of failing to think strategically in that it had not addressed the relationship between ways, means and ends.

So the question that I want to pose today, at least the first question I want to pose today is: what good is strategy? It does not, it would seem, belong in the real world. Strategy, we are told, must deal with the unexpected, with the contingencies of policy. Yet, all the UK Government says when it is accused by the British press of not thinking strategically is that it always intended its defence policy to be adaptive and flexible. Its critics say, on the other hand, that the government is shooting from the hip and not thinking through the consequences of its own actions. What we confront is that the acceptance of the unexpected—to use the clichés of every nation’s defence policy—in, to carry on with another cliché, an uncertain world, means we end up driving a coach and horses through our current expectations of what strategy can do.

What are those expectations? Strategy is characteristically orientated towards the future. It is a declaration of intent and an indication of the possible means required to fulfil that intent. But what is often somewhat unclear and certainly murky is its understanding and definition of that future. How far ahead is strategy looking? To pick a few current national strategies, not entirely at random: most of them look at least 10 years ahead, not least because that is the minimum procurement cycle for most equipment. The French Defence White Paper of 2008 looked forward to 2025. The Australian Defence White Paper of 2009 looked forward to 2030. The US Joint Operating Environment Paper of 2010, produced under Jim Mattis’s direction, looked forward to 2035. The New Zealand Defence White Paper also looks forward to 2035. The UK’s Strategic Trends Paper, which was used allegedly to underpin the national security strategy and the defence review, is even more ambitious and looks forward to 2040. Indeed, David Richards, the Chief of the Defence Staff in Britain, told the House of Commons Defence Committee in January of this year that ‘the grand strategy, as we would define it, is looking at the world as it is going to be in 2030 or 2040 and deciding what Britain’s place in that world is’.

That is exactly the prevailing orthodoxy as to what grand strategy is. The prevailing orthodoxy, that is to say, principally preached in the United States. Paul Kennedy may be a Brit but he has presided over the grand strategy course at Yale since its inception in 1998. He wrote in a book he edited on grand strategy in 1991 that:

The crux of grand strategy lies therefore in policy. That is, in the capacity of the nation’s leaders to bring together all of the elements, both military and non-military, for the preservation and enhancement of the nation’s long-term—that is in wartime and peacetime—best interests.¹

Kennedy penned those words just as the Cold War was about to end, a process hastened by the economic penalties suffered by the Soviet Union as it sought to match US defence spending. Only three years before in 1988, in the *Rise and fall of the great powers*, Kennedy had highlighted the

Paul Kennedy (ed), *Grand strategies in war and peace* (New Haven, 1991), p. 5

pressure on failing empires to increase defence expenditure beyond their economic resources. But his final chapter, which he called ‘the problem of number one in relative decline’ addressed the challenges which confronted Washington not Moscow. Indeed, almost immediately it looked as though Kennedy had got it badly wrong. Most Americans could scoff at the pessimism which he had expressed because, with the Soviet Union in dissolution, the United States was the dominant and, indeed, possibly the only global power.

But now, as we look at the rise and fall of the great powers just over 20 years on in 2011, Kennedy’s view of strategy looks much more prescient. He looks to have been rather more right than he might care to have been. The United States has even accelerated its own relative decline by military spending which has served to increase its debt and engaged in wars whose course and outcomes have, if anything, lowered its prestige rather than maintained them or even enhanced them. If the wars in which the United States has engaged over the last decade are part of a grand strategy that is orientated towards some distant future 20, 30, even 40 years out, then grand strategy is in danger of being delusory. The presumption within grand strategy is not just that it is orientated towards some distant future, but also—at least if it is to have purchase in policy—that it is designed to avert decline, and even that it can make the future better than the present.

I’m tempted to advance a general proposition—I’m quite happy to be challenged on it—that emerging states have less need of grand strategy as they forge their empires than do satiated empires anxious to hold on to what they have acquired. Britain had no idea of grand strategy in 1815; but it began to develop some ideas by 1870, as it confronted competition both within Europe and outside Europe. Three consequences seem to follow from this vision of grand strategy. First, for the United States and, indeed, for most of the rest of the Western world, strategy has come to be about controlling risk rather than exploiting it. Jim Mattis, when he wrote the foreword to the JOE document in 2010, began by saying, ‘In our guardian role for our nation, it is natural that we in the military focus more on possible security challenges and threats than we do on emerging opportunities’. Similarly in the United Kingdom the British National Security Strategy of last year has as its principal innovation a risk register. Look at chapter three of the 2009 Australian Defence White Paper, which is entitled ‘Managing strategic risk in defence planning’.

So what we’re doing with strategy is using it to mitigate the impact of change in the interests of stability. The cynic might argue that in that case strategy therefore also represents the triumph of hope over experience. A grand strategy which becomes implicitly defensive and inherently reactive contravenes the standard orthodoxies of so-called military strategy, which stress the value of taking the initiative not least through the offensive. The military approach to strategy exploits risk rather than sets out to minimise it. So today’s grand strategy is at odds with the tenets of traditional military thought.

The second observation I’d make is this, that for the United States in particular such a utilisation of grand strategy confronts it with a logical absurdity. Americans, after all, still see themselves as the democratic and progressive power par excellence. This creates a tension between its domestic self-definition and its external status. Its use of strategy today supports an agenda that is conservative, not least because it recognises that change may not be in the interests of democratic powers dependent on the workings of a free-ish and somewhat fragile market.

Thirdly, establishing too close a relationship between strategy and the very long term does not allow for the unexpected, does not allow for the Arab Spring or, 10 years ago, for the 9/11 attacks.

Now, of course strategic thought pays lip service to the need to deal with the unexpected. The Australian Defence White Paper of 2009 is a case in point. 'The challenge for defence planning' it says, 'is to meet the challenges of an uncertain strategic future'. As I've already said, and as that same white paper also says, one of the reasons for stressing the long term with strategy is the length of the procurement cycle. It is now accepted that equipment is likely to be used in roles which are different from that for which it was first designed. Ironically, therefore, one of the pressures in the escalation of equipment costs is the very need to produce equipment flexible enough to cope with the expectations of the unexpected. So the tail wags the dog.

So how do we resolve the strategic paradox, the tension between the long term strategy and the immediate pressures of the unexpected, which events like the Arab Spring and the intervention in Libya have highlighted? The UK Government's pre-emptive response to this line of questioning is contained in the foreword to the national security strategy, signed by the Prime Minister, in which he says, 'In an age of uncertainty we need to be able to act quickly and effectively to address new and evolving threats to our security'. So without a clear vision of a specific threat to the United Kingdom, last year's defence review focused on the means to meet a range of threats which it called 'the adaptable posture'. That is just what every other national strategy and every other national defence policy aspires to do.

Since the end of the Cold War, adaptability and flexibility have been watchwords which have accompanied most attempts to produce a coherent long-term strategy. In the United Kingdom the 2010 defence review actually looks very similar in philosophy to the defence review of 1998, which it was allegedly replacing. Both of them rest on a maritime–air expeditionary capability and assume interventions of short duration. It is just that the 2010 one flies in the face of recent experience. But, in fact, none of our national strategies have been very adaptive or very flexible in practice. The standard criticism of the UK, that it failed to adapt between 1998 and 2010 and failed to have a fresh defence review in that time, is indicative of the point. But so too is the much vaunted US Field Manual 3-24. Even if that was not written as a statement of strategy, it has become one. The notion that amazingly the United States Army has proved itself wonderfully adaptive when confronted with the changing character and circumstances of the war in which it finds itself fighting is strange. Up to a point, at least by comparison with other armies in the alliance, that is true. But think: by December 2006 the United States had been involved in this sort of fighting for four years, in other words the equivalent of the duration of its experience in the Second World War. I don't really call that fast moving. It's still slow adaptation.

So while we conclude that we cannot actually have our cake and eat it, should we cynically argue that if grand strategy is orientated to the long term but nonetheless has very limited predictive value it is therefore valueless? Should we put strategy alongside economics—with no apology to any economists here—as a pseudoscience? Have we got ourselves into a position where strategy effectively abdicates responsibility when confronted with the unexpected.

To understand the problem we need to unpack strategy a bit more and bring it back to its roots in war itself. Strategy—and I've already alluded to this in passing—strategy as understood by 19th century generals would not have been vulnerable to any of the three criticisms which I highlighted just now. First of all, strategy was not designed to be reactive but proactive. Secondly, strategy, by the same token, was about changing things rather than about preserving the status quo. Thirdly, because strategy functioned in the realm of war and in time of war, it inherently existed in a world of uncertainty, and that was precisely where it was designed to fulfil its functions best.

The strategic thinker who best captured this approach to strategy was Clausewitz. He would not have understood what we call national security strategy as strategy. He would not have called strategy what Paul Kennedy called strategy. For him strategy was the use of the engagement for the purpose of the war. In other words, strategy was consequentialist for Clausewitz. One thing followed another, and outcomes and events shaped the next step. Strategy drew on what had happened in order to decide what to do next. As he put it, 'Only great tactical successes can lead to strategic ones'. It is worth remembering, as current exponents of grand strategy rarely do, that these were very important facets of the exercise of grand strategy in the Second World War, the time at which that phrase grand strategy really came into currency and was effectively applied. Churchill and his chiefs of staff were certainly conscious that what they were doing was grand strategy.

One element in doing that—but not the only element and I'll come to the other one at the end of what I'm saying—one element in their thinking consisted of what to do today in the light of events, of the situation on the ground, and of real-time intelligence. Grand strategy was then as much reactive as prudential; as much an exercise in flexibility and adaptability in the short term as a narrative projected onto the future. It is this aspect of strategy which current strategic thinking seems to have lost. This is the sort of strategy which shapes events in Libya, or reacts to them.

Clausewitz also helps us to think about the understanding of grand strategy as we now define it, although of course he didn't use that term. The most important book in *On War* is not book one—whatever Peter Paret and Michael Howard might say—but book eight, the book which Clausewitz called 'War Plans' and in which he expresses his mature thoughts on the relationship between war and policy. It discusses war plans in ways that are indeed purposive and prudential, like grand strategy today, but sets them in the real world because what concerned Clausewitz as he wrote that book, very shortly before he died, was the impact of the 1830 revolutions in Europe. What he had to consider was how Prussia might engage in a European war if France, once again, upset the balance of power, as it had done before 1815 and as the revolution suggested it might have the opportunity to do again. In other words, our great work on strategy on war ended in book eight with a real plan set in a specific set of circumstances. So the conclusion is, ironically, an attempt to put this phenomenon of war, which Clausewitz often describes in terms that evoke chaos, friction, and confusion, into a logical framework, as an attempt to put shape on how you manage chaos, confusion, and put it in a purposive and prudential format.

Now most people today, when they think about that aspect of strategy, tend not to associate it with Clausewitz—of the two great strategic thinkers that came out of the Napoleonic wars—but with Jomini, with his great rival. You might argue—and indeed I think I probably would argue, at least this morning in the mood that I'm in—that Jomini has been more influential over the long term, and certainly more influential in US strategic thinking, than Clausewitz ever has been. Jomini thought that strategy was a science, subject to a set of maxims or principles, and he thought that if you thought through where you wanted to go you could effectively settle much in advance. His case studies in military history were an example of reverse engineering. He would say, 'This is the outcome' and then work back from the outcome to where the whole process had begun. In other words, if the plan was right it would lead to victory, even if the battle itself was in the realm of chance and contingency, at least it could be set in a strategic narrative that was coherent. That Jominian vision of strategy was exactly how the subject was taught at most military academies in the 19th century. That was also what shaped the war plans of the European armies in 1914.

Now, those war plans were not strategy as we would understand the term today, simply because there was no allowance for economic mobilisation, political direction and so on. These were operational plans for single campaigns designed to achieve decisive success through manoeuvre according to certain operational principles, and they largely ignored the impact of tactics, on the one hand, and the contingent effects of battle on the other. From today's perspective we would call them not war plans but campaign plans. But then, significantly, we might also describe the plans for Afghanistan in 2001, for Iraq in 2003 and for Libya in 2011 as campaign plans, not as war plans. Despite the outcomes of those campaigns in 1914, and despite the fact that they had not delivered quick victory as they had promised, planning remained an integral part of our understanding of strategy and, indeed, of armies' understandings of strategy. Planning was how strategy found expression in peacetime. It provided jobs for general staffs who might otherwise be sitting idly doing nothing very much, both before 1914 and in the interwar period.

Moltke, the elder, may famously have said no plan survives the first contact with the enemy, but that didn't stop him trying to anticipate what the first contact with the enemy would be like or spending most of his professional military career in war planning.

After 1945, the possession of nuclear weapons increased this tendency to plan. It may be hard to see successive strategic integrated operational plans as Jominian, but that is in one sense exactly what they were. I think that in 2011 we too easily see the Cold War as Clausewitz's moment in terms of strategic thought. Clausewitz seemed to be given fresh life after 1945 for four reasons.

First of all because it was easy to equate his concept of absolute war with a new and different concept which was that of total war. Secondly, because his idea that war is an instrument of policy, even though Clausewitz thought of this as a way of explaining how war was to be conducted, could be applied to ideas of nuclear deterrence, even if that meant what you were doing was taking it away from Clausewitz's context of the course of a war and applying it to the causes of a war. Thirdly, because the corollary of the focus on the relationship between war and policy was its use in American theories of civil-military relations, principally by Samuel Huntington, which allow for the subordination of military professionals to civilian control. Fourthly, because of the evolution of the ideas of limited war, especially in the hands of people like Robert Osgood in the late 1950s, which paradoxically interpreted Clausewitz as the founder of the idea that war could be fought for more restricted objectives than annihilation.

But my point this morning will be highlighted exactly by that argument: the argument about limited war in the context of nuclear weapons and of the Cold War. Limited war was something that preoccupied Jomini much more than it preoccupied Clausewitz. Jomini says a great deal about the shape of strategic thought during the Cold War for five reasons. First of all, limited war is a key theme running through his *Précis de l'art de la guerre* and gets much more attention than it ever gets in Clausewitz's *On War*. Clausewitz seemed to doubt whether man could really turn the clock back now that he had seen absolute war in reality. By contrast, Jomini was desperate to think of ways of turning the clock back to an era when war had been more manageable and less awful, and thought through ways in which that might be rendered possible.

Secondly, Jomini presumed that rationality could be applied to war precisely because he saw strategy as a science governed by unchanging principles. The reasons that we now criticise Jomini are very similar to the standard criticism that we would tend to level at nuclear deterrence. That is to say, its presumption of rationality in engaging with threats that are irrational and

disproportionate. Thirdly, Jomini was attacked in his own day for neglecting the fact that war was a reciprocal business, for failing to appreciate sufficiently that the enemy was a reactive entity who wouldn't necessarily sit there like a lemon waiting to be cut up. Instead, he should have seen the enemy as more adaptive. But that criticism, that he assumed the enemy would conform to his own expectations, was exactly the criticism made of US nuclear deterrence in relation to its expectations of the Soviet Union. Too much mirror imaging was going on. Fourthly, the stress on the threat of war within nuclear strategy rather than on its conduct, put the weight on planning—hence the importance of the Single Integrated Operational Plan, which presumed—as Jomini's historical narratives had done—that the plan could be carried through the exchange of blows to deliver a victorious outcome. Fifthly, Jomini's attention to strategy as science put the weight on what would now be called the operational level of war, and also assumed that this could be and should be independent of policy, that strategy in a military and operational sense was a self-contained entity.

In the Cold War doctrine at the operational level similarly worked its way into strategy at its interface with policy. The more esoteric mechanics of deterrence, things like counterforce, counter-city, first and second strike, all of them were operational ideas which were then cloaked with political significance. Another example of the same point: in 1984 Barry Posen's influential work on the sources of military doctrine, a study of Britain, France and Germany between the two world wars, argued that national style in the conduct of operations had determining effects on the policies which the governments of those nations had then adopted.

So what I'm really saying is that two consequences followed for our understanding of strategy from the Cold War. The first was this: that Jomini's understanding of strategy, which was located in what we would now see as the operational level of war, was applied also in the context of what was now called grand strategy. The second was that strategy in the Cold War became located above all in the business of planning, precisely because there wasn't much by way of real operations—thank goodness—in order to test the assumptions of the nuclear planners. So the conflation of what NATO calls military strategy with what we now call grand strategy, and today's belief that strategy has a long term and predictive quality, are both above all products of the Cold War.

During the Cold War grand strategy in this sense had a clear enemy, a clear geographical focus, and grand strategy provided a form of continuity that did indeed run for more than 40 years. So it created our expectation that grand strategy has predictive, stabilising and long-term qualities. Strategic studies in the sense which Paul Kennedy understands them came out of that experience. Although operational experience and real war had little corrective effect, the potential operational applications of the use of nuclear weapons underpinned the whole edifice. So military strategy was assumed to have similar qualities and even effects to those of grand strategy. Nuclear planning lay at the heart of strategy in the Cold War, and the possibility that planning could therefore deliver effective strategy followed.

Now, and I'm concluding, now we hear a great deal—at least in the UK and in the US—about the need to move on from the legacy arsenals of the Cold War. What we hear rather less about is the need to move on from legacy thinking. Harry Yarger has argued in his *Little book for big strategy* of 2006, that strategy is not planning and that we have confused the two. 'Planning makes strategy actionable' he writes. 'Planning takes a gray world and makes it black and white. Planning is essentially linear and deterministic'. Yarger locates planning in the realm of operations. He says, to quote him again, 'In modern war, winning battles is a planning objective; winning wars is a strategic objective'. He probably overstates the case. Planning may not be strategy but we certainly need an

awareness of strategy in order to plan. As Clausewitz put it, 'Since all information and assumptions are open to doubt, and with chance working everywhere, the commander continually finds that things are not as he expected. This is bound to influence his plans, or at least the assumptions underlying them. If this influence is sufficiently powerful to cause a change in his plans, he must usually work out new ones. We need planning to embrace chance, chaos and the unexpected, knowing that it will not remove any of these things from war but knowing too that planning will minimise their part in it and allow for their effects'.

If strategy is orientated towards the future, and yet planning is not strategy, what then is the role of strategy? This is where we come back to Clausewitz's image of war as a total phenomenon: his notion of confusion, chaos and chance. Gary Hart, former senator and, I have to say, former visiting fellow at All Souls, in his book *The Fourth Power* written in 2004, defined grand strategy as follows: 'It is meant to be a coherent framework of purpose and direction in which random, and not so random, events can be interpreted, given meaning, and then responded to as required'. What is striking about that definition, unlike Kennedy's, is that it recognises that strategy may be proactive but that it cannot be predictive. Hart, after all, had served on the senate commission which warned of the possibility of a terrorist attack on the United States before 9/11, but neither he nor it was heeded. Strategy occupies the space between a desired outcome, presumably shaped by the national interest, and contingency. It directs the outcome of a battle, or of another major event, to fit with the objectives of policy as best it can. It also recognises that strategy itself may as a consequence have to adapt to events. Essential here is the need for flexibility and adaptability; the need for real time and short-term awareness, as well as long-term perspectives, and the need to balance the opportunity costs of both.

A long term view of strategy is of course precisely what keeps powers in a war despite setbacks, mounting casualties and even defeats. In that sense it is the counter-narrative, the one that says that it's precisely because of losses that the fight must be continued rather than ended; the argument that actually says the higher the cost, the greater the commitment to continuing the fight. But within war the approach to strategy has also been to integrate short-term shocks and the interactive effects of enemy action.

I said I would return to Churchill and Alan Brooke in the Second World War. The reason for doing so is that they looked to the long term in their planning but they moderated their views in the light of daily news and real-time intelligence. So it wasn't just that they proceeded in terms of short and immediate contingency, but they also interpreted the pressures of real time events through the prism of long-term objectives and they matched one to the other. They accepted that war was chaotic and confused, but they also knew that the best way to master it was through planning. Strategy was the sum of both, not just the latter. As Harry Yarger has put it, 'strategy provides a coherent blueprint to bridge the gap between the realities of today and a desired future'.

At the moment we see strategy so much in terms of ends that we neglect ways and means, and so reverse engineer from potential outcomes back to current predicaments. At the operational level that way of thinking produced the concept of effects-based operations, now discredited and now largely—I say 'largely' because I still see its influence sometimes in the British Ministry of Defence—abandoned. Until we wake up to the same fallacy within strategy we shall continue to see events in more 'unexpected', 'revolutionary', and 'destabilising' terms than we should. We shall also not get the value from strategy that we can or which we need.

Winds of change in the Middle East

Dr Leanne Piggott

Thank you for the opportunity to speak to the important changes currently underway in the Middle East. Since December 2010, we have witnessed a wave of domestic political upheaval referred to as the 'Arab Spring' sweep across the region from Morocco to Oman. These 'winds of change' were sparked by the death of a young Tunisian man, Mohamed Bouazizi, whose story of humiliation and hopelessness at the hands of a corrupt and morally bankrupt regime became a metaphor for the denial of freedom and dignity which feeds the sense of grievance felt across much of the Arab world.

The long-term causes of the region's political unrest include increasing deficits in individual freedom, human rights, the rule of law and gender equality; nepotism and corruption among ruling elites who have amassed immense personal wealth at the expense of the wider population; and high unemployment, exacerbated by the region's 'youth bulge'. Short-term triggers include food price spikes that tipped those already suffering the effects of widespread unemployment and housing shortages into open revolt.

Before turning to examine these events in more detail, I would like to make two brief introductory points and then set my topic for this morning into the broader context of the conference's theme.

My first point relates to how, here in 'the West', we might be thinking about events unfolding in the Middle East. There is much optimism and hope that the 'winds of change' we have witnessed in Tunisia and Egypt will trigger a domino effect in the way peoples of the Middle East are governed, replacing authoritarian regimes with democratically elected governments. Although it is too early to say how events in the region will play out, it's important to avoid delusional expectations. For one thing, patrimonialism, a system of governance in which the ruling elite control all aspects of society, including politics and business, is deeply entrenched in the region and will be very difficult to budge, at least peacefully.

Accordingly, whilst democracy might indeed come to the Arab world eventually, we should not expect it to be an orderly process. Indeed, events in Bahrain, Libya, Syria, and Yemen, all point to more violence on the horizon. The situation, both locally and regionally, will more than likely only get worse before it gets better and we can expect either more violence, or, at a minimum, a less orderly and more chaotic transition of power than might have been hoped for.

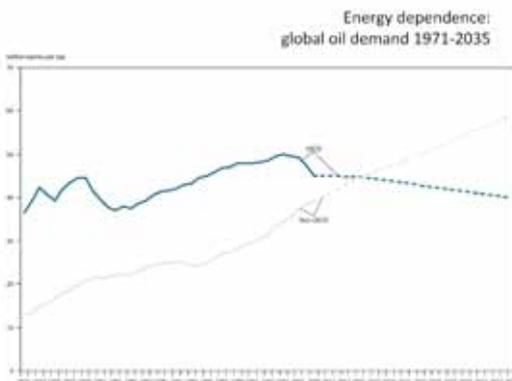
My second point is that while many are focused on political change, we cannot lose sight of the more fundamental importance of macro-economic reform, which will be necessary if the region's economies are to be integrated into the globalised market place of the twenty-first century and provide the level of economic and employment growth so crucial for medium to long-term stability. Without a significant increase in employment opportunities, continuing social and political instability is assured and may worsen. Economic growth cannot come from fiscal policies alone, nor can the government provide sufficient employment to address the region's chronic unemployment. Jobs will need to be created within the private sector. This will in turn necessitate major reform in the education sector, which at present does not teach adequately the knowledge and skills required for successful employment in a modern, open economy. Yet, as with other sectors within a patrimonial system, the obstacles to educational reform are substantial.

Whether the necessary changes come peacefully or through violence are of significance not just for the region but also for global security. An escalation of regional violence might play out politically, for example, through the knock-on effect of a surge in global terrorism, and economically through global oil markets.

Indeed, it is energy security, in this instance the security of global oil supplies, which brings into focus wider, global concerns about the stability of this geostrategic region. History has shown that conflict here can have a very negative impact on global oil prices and in turn the global economy as a whole. In a period of anaemic economic recovery from the 2008–9 global financial crisis, potential impacts on global oil prices are of particular concern. I'd like to say a little more about this before returning to the details of current unrest in the region.

The importance of the supply of Middle East oil, or more specifically Gulf oil to the global market cannot be overstated. This, in turn, links the global economy to events in the Middle East. Let me show you a few graphs to highlight this point.

The first graph shows the relationship between economic growth and oil demand since the 1970s, comparing OECD countries with non-OECD countries, the latter including, of course, China and India. The projections go until 2035.



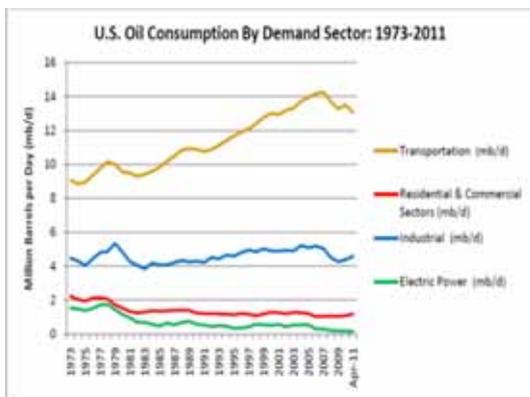
Two points of particular interest emerge: first, oil demand peaked in the developed world in around 2005; and second, oil demand in the developing world is increasing, and is expected to continue to increase for the foreseeable future.

At first glance, this would suggest that the security of oil supply sources should be a diminishing concern for the developed world.

Why, then is the price of oil still such a major issue for OECD countries, in particular the United States, which still holds first place in the list of oil importing countries?

It is important to note here that while America's import of oil has reduced slightly over the last few years—time will tell if this is in direct response to the slowing of its economy generally or merely as a result of the global financial crisis—the big story in the reduction of oil consumption is that of the EU, where oil demand peaked around 2005 and has been in continual decline since 2007. This is in large part due to a reduction in oil consumption in the transportation sector, which is the major source of oil demand the world over.

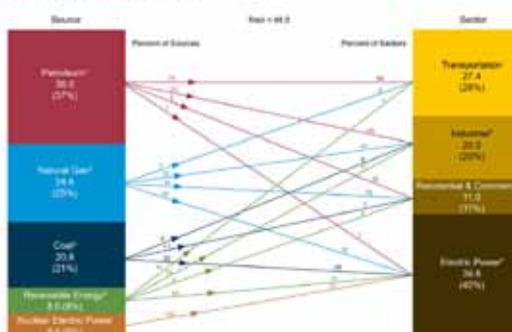
This trend is yet to take off in the US. As can be seen in the next graph that shows which sectors in the US economy rely on oil for their energy source, transport is by far the largest consumer:



The next graph, sourced from the US Government's Energy Information Agency, makes even more explicit the dominant role that oil plays in America's energy security story.

U.S. Primary Energy Flow by Source and Sector, 2010

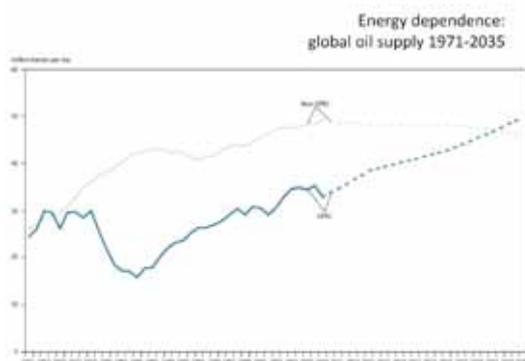
Source: EIA, Annual Energy Review 2010



You will note that 71% of all oil (here displayed as petroleum) used in the United States goes to the transportation sector, while 94% of energy used to fuel transportation is petroleum. When you consider the fact that the US needs to import some 50% of the oil it uses, you can see why its economy, so dependent upon transportation to move products and people across its large open spaces, is affected negatively or positively by the price it has to pay for oil, a price, set by a global, not domestic, market. The forces that

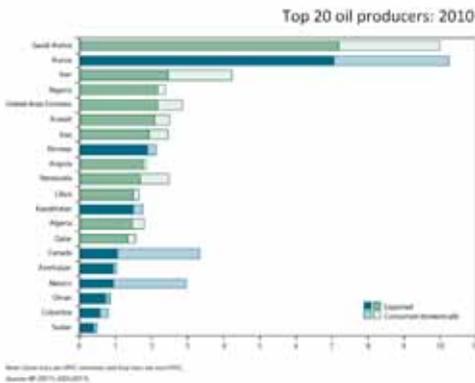
impact on the global price of oil, therefore, are (and have been since World War II) of the greatest concern to US policymakers, as they are increasingly for the oil importing states of the Asian region, notably, China, Japan, and South Korea, and of course India.

Thus, the 'winds of change' in the Middle East clearly have implications for the global oil market from the supply side. The following graph shows what's been happening in the supply story from the 1970s, again projecting through to 2035.



You can see that while non-OPEC producers (which include the big international oil companies like Shell, BP etc) are thought to have reached their peak in increased capacity to produce, the opposite trend applies to OPEC members, including all the major oil-producing states of the Middle East, namely, those located in the Arabian/Persian Gulf.

Let me drill down a little further on the details of who is producing oil for the global market. As can be seen from this next graph, the Gulf states feature prominently.



Of the top 20 oil producers, Saudi Arabia has the largest known reserves of conventional oil supplies. Note how much oil is consumed domestically, especially by Saudi Arabia, which is a growing concern for the Saudi government as its population increases and subsidies on energy are expected.

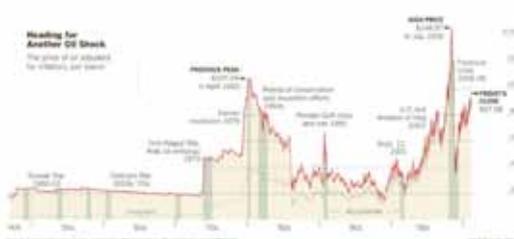
When we compare the global demand graph with the global supply graph I showed earlier, together with this last graph showing the placement of the Gulf states in the list of top producers, it would not surprise you to learn that within the broader geopolitics of the global oil markets there is an increasing nexus between the oil-importing states of our region and the oil-producing states of the Gulf, which is captured in the following table:

Importing State	Percentage of oil imported from Gulf states, 2009	Primary source/s
China	47	Saudi Arabia and Iran
India	61	Saudi Arabia and Iran
Japan	77	Saudi Arabia and UAE
South Korea	74	Saudi Arabia

China depends on the Gulf for nearly 50% of its oil imports. India, South Korea, and Japan depend on the Gulf for an even higher percentage of their oil imports. This has an important knock-on effect for Australia due to our own dependence upon the economic growth of our regional trading partners.

For China and India, whose economies are becoming increasingly dependent upon oil consumption (and in turn oil imports), there is a lesson for policymakers from past oil price spikes and the impact these have had on the US economy and, through it, the global economy. In the graph below, the correlation between conflicts in the Middle East—both intra- and inter-state—and oil price spikes can be seen.

Regional dynamics: ME conflicts and global oil prices



The green columns indicate recessions that have followed a significant rise in oil prices, with 1973 as a well-known case study. I should quickly point out that economists continue to debate the **nature** of the relationship between oil price spikes and recessions, but there is a consensus that a relationship does exist.

Very recently, while conflict in Libya has resulted in an increase in oil prices, it does not look as though this will be sustained, as the following slide suggests.

The Libyan crisis: impact Q1 2011



While Libya is an important producer of high quality oil, most of its imports go to Europe and the impact on the wider global market has therefore been limited.

To summarise, if the context for this presentation on the ‘winds of change’ in the Middle East is a conference on 21st century global forces, I hope I have thus set the scene, using the lens of a most important

global commodity, to show why current unrest in the Middle East is indeed of global significance.

What, then, has been happening in the region that has led to this optimistic term, the ‘Arab Spring’?

Let me begin with some of the common factors that are at the root of the political unrest across the Arab world. I mentioned at the very outset the nature of the entrenched governance systems—the term I used was ‘patrimonial’—from which ruling elites derive enormous privilege and accumulate substantial wealth. To ask ruling elites to relinquish their stranglehold on power and their sources of unearned wealth in order to facilitate a program of liberalisation and, more substantially, democratisation, is a very big ask indeed, and one that the elites will continue to resist forcefully for the foreseeable future. It is unlikely that the relatively peaceful transition of leadership witnessed in Tunisia and Egypt will be the norm in the region.

A second factor common to the political economies of the region is the predominance of rentier states. These are states whose economies are largely dependent on ‘rents’ from the disposal of their natural resources. The oil-producing states of the Middle East depend on oil (and gas) revenues. Jordan, which lacks substantial oil and gas reserves, depends on foreign aid. Patrimonial systems of governance and the high dependence on oil and gas revenues has resulted in a lack of diversity in the region’s economies, all of which feature a dominant government sector and a weak and underdeveloped private sector. The result has been slow if not stagnant employment growth, in a region with an unusually large youth demographic, to which I referred earlier as a ‘youth bulge’. Coupled with an education system that currently fails to train students for employment in today’s highly competitive job market, it is not surprising that a feeling of hopelessness and public discontent is widespread across the region.

Local dynamics: similarities

- Low economic growth + high population growth



= High youth unemployment

21% in Lebanon; 30% in Tunisia; 32% in Morocco

Unsurprisingly, the discontent is particularly acute among the youth of the Middle East, a region that has one of the highest percentages of the population under the age of fifteen, as captured in the graph. So too, is the correlation with high youth unemployment. Youth unemployment in Lebanon is at 21%, in Tunisia at 30%, and in Morocco at 32%.

When we dig a little deeper, disparities quickly emerge between the so-called ‘haves’ and ‘have nots’ in the region—between the oil and non-oil producing states—in regard to resources available to balance their budgets, generate employment for their youth and provide compensation for lack of political freedoms through minimal or no taxation and heavily subsidised basic resources (energy and food) as well as generous welfare including free education. The differences between the ‘haves’ and ‘have-nots’ is captured in the following graph by way of those states that can and cannot meet their annual budgets.

At the local level: differences

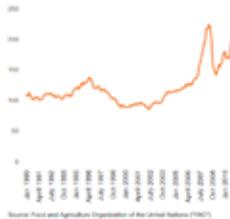


Although not represented on this graph, Tunisia, too, is a non-oil producing state and falls squarely within the ‘have nots’ camp. On the eve of the events that seemingly triggered the waves of unrest across the region, Tunisia was a classic case study in representing each of the factors underpinning regional discontent that I listed at the outset of my

presentation, captured here in the next slide.

Winds of change: economic pressures and authoritarian governance trigger political unrest and demands for change

- High food prices (80%)
- Unaffordable housing
- Unemployment
- Growing gap between rich and poor
- Corruption
- Nepotism
- Lack of legitimacy



The graph on the right hand side shows what has been happening to food over the past decade. Note the price volatility during the period leading to, during, and after the GFC. At current high costs, some 80% of earnings are spent by the region’s poor on food. When prices rise sharply and large numbers of the population cannot afford to feed themselves, unrest is inevitable, thus highlighting why

food security in this part of the world is a factor in regional stability.

Unaffordable housing is an added source of discontent, a direct result of inadequate construction activity which has failed to produce sufficient housing to keep up with population growth.

Unemployment is another factor, about which I have already spoken. To provide just one example, Egypt will require a minimum 6% increase in GDP per annum to create a necessary 650,000 jobs each year to absorb new entrants onto the job market. This is what will be required to prevent the current unemployment rate of 12% from getting even worse. However, this year only a 1.5% increase in GDP is expected.

Meanwhile, the ruling elite are becoming increasingly wealthy through monopolies on housing and other industries at home and investments in businesses abroad. Rampant nepotism and corruption provide another layer of impediments to economic growth, factors that also limit the prospects of young people attaining a good job based on merit, not connections.

Despite these common denominators that underpin the current social unrest in the region, each state has experienced and responded to pressures for change differently. Importantly, the response of the leaders who were the first to face demands for political change provided lessons in ‘change

management' for leaders who subsequently came under challenge, a point I will return to in a moment.

The events that unfolded in the Middle East from December 2010 until the present are, I'm sure, well known to this audience so I will not repeat them here in detail. Suffice to say that the public protests that began in Tunisia quickly spread eastwards across North Africa and into the Arabian heartland between Syria to Yemen. They have been largely youth-led and facilitated by social media. Government responses have been mixed. In Tunisia and Egypt the presidents departed peacefully from office after losing the support of their military forces. In Morocco, Jordan, and Oman each government acted swiftly to engage in dialogue and negotiate change. Governments in oil-rich Kuwait and Saudi Arabia took pre-emptive action by providing substantial funds in unemployment and housing benefits.

In Bahrain an initial group of protesters retreated in the face of a government crackdown during which a small number of them were killed. However, violence continues in this small Gulf state as the government, supported by its Saudi neighbour, continues to respond to demonstrators with force. In Syria, the regime grimly clings to power as forces that remain loyal to the government shoot and shell demonstrators, killing many hundreds. In Libya the violence has morphed into a civil war between government and NATO-backed opposition forces with most predicting an imminent end to the Gaddafi regime.

In Yemen, meanwhile, clashes between anti-government forces and those who remain loyal to the president are driving the state towards total collapse. As already noted, the potential knock-on effect of a surge in regional and global terrorism is a key concern for those monitoring events. Even before the outbreak of the 'Arab Spring', Yemen was on the verge of collapse from three decades of failed governance and corruption under President Ali Abdullah Saleh, and from a drawn-out rebellion in the north and a secessionist movement in the south. Under these conditions, one of the more lethal branches of the al-Qaeda network, 'al-Qaeda of the Arabian Peninsula' (AQAP) has been able to flourish, plan and conduct terrorist attacks within and beyond Yemen's borders.

Iraq's precarious future also makes it vulnerable to terrorist attacks by al-Qaeda. Whilst the contagion of popular uprisings has not spread to Iraq, if the timing and nature of the US troop withdrawal is not managed well it could lead to a reactivation of domestic political violence, risking further upheaval in an already volatile regional environment.

Indeed, the political unrest in the Middle East has come at a time when the US is faced with crippling foreign and domestic debts that will significantly limit its capacity to influence events in the region. Its response to the Libyan war is a possible indication of the future direction of its policy in the region. America led the effort to gain international endorsement of military intervention and then stepped back to allow other forces to take the lead. It remains to be seen whether this approach will weaken US efforts to undermine Iran's clandestine nuclear weapons and long-range missile programs.

The Iranian regime has been unnerved by ongoing dissent within its own borders and by Syrian protests against the Asad regime in Damascus, Iran's chief ally in the region. The less secure the Iranian regime feels, the greater urgency it is likely to attach to its nuclear program and pursuit of a nuclear weapons capability.

Left unchecked, these dynamics will become an increasing source of instability in the region, especially if Israel decides to act militarily to mitigate the Iranian nuclear threat. At least in the short term, a war in the Gulf will do more to destabilise the region than Arab domestic unrest and intra-state conflicts.

The purported rapprochement between Hamas in Gaza and the Palestinian Authority in the West Bank makes it less likely that the Israeli–Palestinian conflict will end any time soon. With political unrest on all its borders, Israel will be feeling a growing sense of encirclement as it, too, questions the future in the region of the US, its long time ally. This is not a political or security environment that is conducive to the Israelis or the Palestinians forging the kind of compromises that are necessary to conclude a peace settlement.

The extent to which all of this unrest and change will play into the hands of the Islamists will not be known until the first round of elections is held later in the year. Egypt is a very important country to watch, not only because of its size—it is the largest of the Arab states—but because of its historic role as a game changer in the region. Here the Muslim Brotherhood, Egypt's major Islamist party, is strong and relatively well organised, far more so than other opposition groups and therefore they have a good chance of winning a majority of seats in an open and free election. How the military regime—which is still in power in Egypt irrespective of Mubarak's resignation—will respond to such an outcome is unknown, but to expect a peaceful transition of power is, in my opinion, naive.

Events in Egypt, in particular the decision of Mubarak to step down peacefully, and his subsequent arrest and imprisonment, along with other family members, has provided an important lesson, what might be referred to as the 'Mubarak factor', for other rulers who are faced with similar calls from the populace to step down and allow democratic elections to take place. What I mean by the 'Mubarak factor' is that your likely fate if you go peacefully will not be pleasant. So better to fight it out, at least this increases one's chance of avoiding jail and possible execution.

Let me conclude by returning to one of my opening comments. While the winds of change move across the Middle East we must temper our expectations and remain, while hopeful for a peaceful transition to a more democratic system of governance in the region, realistic about the many obstacles that lie ahead. The transition from authoritarianism to a more open and liberal political and economic system can typically play out over years, perhaps decades, as entrenched leaders resist relinquishing their privileges and making the structural changes required to address the challenges faced by the region, in particular, its chronic unemployment and widespread poverty. Some 100 million jobs need to be created across the Arab world over the next ten years merely to absorb the number of young people who will enter the job market, and this is before inroads are made into the current high rates of unemployment. Basic services and housing, and stable food and utility prices also need to be provided. If these expectations remain unfulfilled, public revolt is likely to intensify. Some people will turn to political extremism with the potential to usher in another long period of conflict and stagnation, if not further decline.

Global and Australian economic relaties

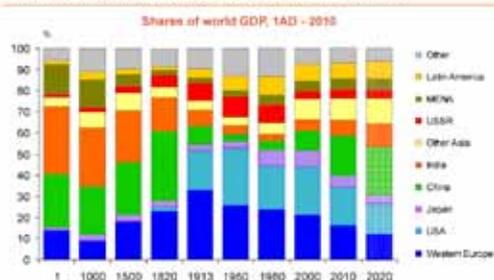
Mr Saul Eslake

Perhaps, given what people were saying here yesterday and over dinner last night about the likely content of my presentation, I should start with a disclaimer that's common in financial market circles but not usually in places such as this, namely that what follows does not constitute investment advice. Moreover, since I don't work for a big bank any more, there's not much point in suing me if you ignore that disclaimer, act on something that you think I've said here, and then find that you've lost money.

However, before we get to some discussion, as we inevitably must, of the implications of the turmoil on financial markets of the past week, I actually do want to begin in the same spirit as some of the other speakers have been doing yesterday and again this morning, by talking about something more important than turmoil on financial markets, something which is set in a much longer historical perspective.

I believe, as I said here last year and at almost every presentation of this nature I've given over the last two or three years, that the most important thing happening in the global economy in recent years, now, and for the foreseeable future, is the shift in the 'centre of economic gravity' from West to East. You'll notice that I put the word '**back**' in parentheses in the heading on my first chart, because it's helpful in understanding what is meant by this term 'shift in the centre of economic gravity'. What other people sometimes describe as the 'emergence' of countries like China and India is, I think, more realistically grasped if you recognise that these countries are actually reclaiming the places in the international economic pecking order that they've occupied throughout most of recorded human history.

The most important thing happening in the world economy is the shift in the centre of economic gravity (back) from 'west' to 'east'



To highlight that point what I've shown here is the shares of world GDP accounted for by different regions or countries going back to the year 1 (AD). Now, let me provide another 'health warning' here. For most of the period shown on this chart the collection and compilation of economic statistics was not accorded a particularly high priority. It is true if you think about it, bearing in mind that

Tuesday was a census day in Australia, that the events that Christians associate with the birth of Jesus Christ were triggered in part by the collection of a census across the Roman Empire. So there were some statistical collections done around the time of the beginning of the chart. But for the most part the data shown here is the result of a lifetime of work by the late Angus Maddison at the OECD and subsequently at the Groningen Growth and Development Center in the Netherlands, backcasting on the basis of whatever information is available, estimates of GDP going back to this period.

You can see that at least up until around 1800, China and India were the world's largest economies. They were that partly because they've always been, as they are today, the world's largest populations; but also because at least from the demise of the Roman Empire in the 5th century to

around 1500 or 1600 they were also the world's technological leaders. For that millennium, Western Europe was living under the tutelage of the medieval Catholic Church, an institution which sent people to the torture chamber if they thought the Earth revolved around the Sun, and forbade people from borrowing or lending at interest if they were followers of that church.

In part as a result, there wasn't too much by way of per capita GDP growth, as we now understand that term, happening in Western Europe for more than a thousand years. During the same period, India and China had invented and were using paper money, gunpowder, cotton ginning, the manufacture of silk, the concept of zero and the idea of a meritocratic civil service.

It wasn't really until Western Europeans began to start thinking for themselves about why the world was as it was, began to develop the rudiments of what we know today as the capitalist system and, in particular, towards the end of the 18th century began to harness energy for purposes other than heating, that what we now comprehend as economic development (per capita GDP growth) actually began to take place. Of course, the rise of manufacturing prowess and the military power that went with it subsequently enabled Western Europeans to occupy, conquer or in other ways (without occupying and conquering) influence economic and social developments in other parts of the world, including of course China and India.

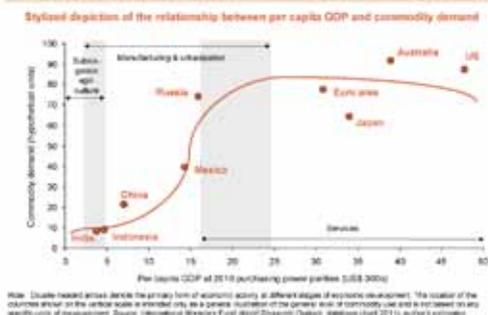
China itself from about 1500 went through a long period of political and economic stagnation and decline, partly because during the later Ming and certainly under the Qing empires it turned its back on the connections it had previously developed with other parts of the world, that Parag Khanna last night described as 'Globalisation 1.0'. For the first half of the 20th century it spent 50 years at war with itself or with the Japanese, and then had another 25 years of murder and mayhem under Mao Zedong.

India suffered under 300 years of British colonial rule which left them with a love of bureaucracy and cricket, the English language and a railway system that worked some of the time. But beyond that it wasn't particularly good for India's economic development either. India, of course, became independent in 1948 and suffered under different versions of socialism imposed by three generations of the Nehru dynasty before they had a crisis in 1991.

By 1980, therefore, China and India, which 1,000 years earlier had had higher standards of living than Western Europeans, had per capita incomes that were only 5% of the people in Western Europe and the United States. Partly because modern technology allowed people in India and China to become increasingly aware of how far they'd fallen behind—not only the former colonial powers but also other Asian countries closer to them such as Japan, Singapore, Taiwan and Malaysia who'd started out on a course of economic development rather earlier than China and India began to do—the governments of China and India, in very different ways not only from each other but also from other Asian economies, embarked upon sets of economic policies that have delivered to their populations rates of economic growth of between 6 and 10% per annum over 30 and 20 years respectively. Although those countries have experienced economic cycles, and they will continue to do so over the next 20 or 30 years, I don't think there's any compelling reason to expect that either of them is going to be deflected from the general set of economic policies that have served them and their people so well. Remember that during this period—since 1980 in China, since 1991 in India—more people have been lifted out of poverty than at any other time in human history. As I say, they'll go through cycles but I think it's reasonable and sensible to assume that they will continue to grow at rates that are well in excess of those that have become the norm in the Western world.

This has some particular implications for the prices of commodities and for Australia as an exporter of commodities. My next chart shows a stylised depiction of the relationship between commodity demand and per capita income across different countries over time. History tells us that, roughly speaking, countries whose per capita income is below about US\$2-3,000 (in today's prices) are typically dominated by subsistence agriculture, and the people living in such economies spend most of their income on food, clothing and rudimentary housing, the commodity content of which is close to zero. There's no relationship between such movements in per capita income as there are, and commodity prices for countries in that stage of economic development. Once per capita income exceeds about US\$2-3,000 per head, and until it starts to exceed somewhere between US\$18,000 and US\$25,000 per head in today's prices—with the precise figure depending on the distribution of that income as well as its average—people spend most of their additional income as it grows on consumer durables and housing, while governments tend to spend most of the additional revenue they have on urban infrastructure and, to some extent, on defence. All of those things are very intensive in their use of commodities: both to make them in the first place and to keep them operating subsequently. So during this second stage of economic development per capita income and commodity demand are very positively correlated with one another.

Economies typically pass through a stage of development during which the 'commodity intensity' of growth rises sharply before tailing off

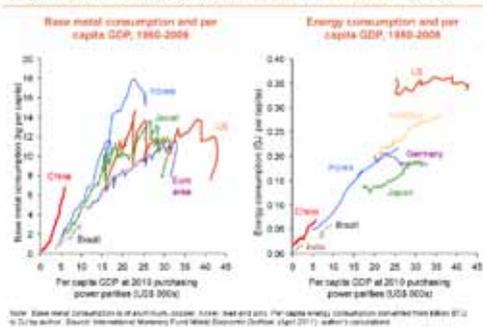


Once per capita income moves past a range of between US\$18,000 and US\$25,000—and again, the precise figure for a different country will depend on the distribution of that income as well as its average—additional household income tends to be directed increasingly towards services: health, education, financial services, entertainment, travel, recreation and the like; while government revenue tends to be directed

increasingly towards the provision of human or personal services, and the commodity content of both again becomes close to zero. So once per capita income starts to move beyond about US\$18-25,000 (in today's prices), the demand for commodities tends to level off. It doesn't increase as per capita income rises.

If we look at particular commodities, as my next slide does, I show base metals in the left-hand side and energy on the right-hand side. You can see how that trajectory has played out over time. Now, obviously at any particular point in time where a country sits will also depend on the composition of its economy and to some extent, particularly as regards energy, the pricing policies of its government. So, for example, Korea and (not shown here) Taiwan have much higher levels of metal intensity than other countries with similar per capita GDPs because their manufacturing sectors are much larger than other countries with similar per capita incomes.

The stylized relationship between per capita GDP and commodity demand plays out to varying degrees for various countries and commodities



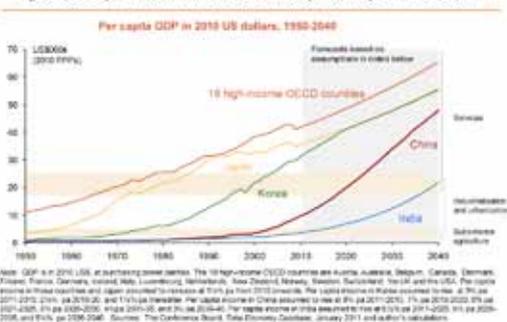
The US, and to some extent Australia, are more energy intensive than other countries with similar per capita incomes because energy policy in those countries mandates that energy is relatively cheap; whereas in Japan and the EU, taxation policy dictates that energy is relatively expensive. But across a broad range of commodities, including agricultural ones, the stylized 'S-shaped' relationship between per capita income and

commodity demand per unit of GDP, or per head of population, plays out very strongly.

China entered the 'zone' of rising commodity intensity per unit of GDP around 2002, when its per capita income in real terms first crossed this US\$2-3,000 threshold (in 2011 dollars). As you'll see, it's no coincidence that was when what had been a 50 to 100 year downward trend in commodity prices in real terms began to turn around. On reasonable projections about China's future per capita growth—which do *not* assume that it continues at 9% per annum but rather, if you can read the small print at the bottom of the next chart, assume that it gradually steps down to about 3.5% per annum by the twenties/thirties—China will remain in that 'zone' until at least 2019 and won't begin to exit it until perhaps 2024.

India only entered that 'zone' in 2007; and on plausible assumptions about the rate of India's per capita GDP growth—which will be lower than China's in part because of its different model of economic development and partly because the population denominator of that figure is growing much more rapidly in India than in China (indeed, in China, as most people know, population growth will peak within the next 10 to 15 years and then start to decline)—India will remain in this 'zone' of high commodity intensity at least until the 2030s. So for the foreseeable future a growing proportion of economic growth in the world is going to come from countries where per capita consumption of commodities is unusually high.

China and India still have a very long way to go before they reach the range of per capita incomes where 'commodity intensity' starts to decline



The supply side of commodity markets matters as well.

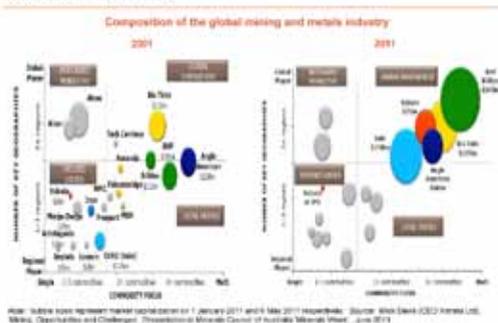
Here is a chart that I've borrowed from a presentation a year or so ago by Mick Davis, the CEO of Xstrata, one of the world's biggest mining companies. It makes the point that even as recently as 10 years ago and certainly 20 or 25 years ago, the global mining industry was very fragmented. Most mining

companies produced one or two commodities in one or two countries. And those mining companies were run by former geologists and mining or petroleum engineers who 'got their jollies', whenever they got their hands on a lot of cash, by finding and digging up more stuff. They paid little attention to the impact that their decisions about higher production had on the prices of the things they were producing. That's partly why commodity price cycles prior to this one tended to be relatively brief.

Prices went up—the source of that increased demand was never as big as that coming from China and India today—but producers responded to it quickly by increasing production and so prices came down.

As a result of a decade or two of consolidation and merger activity, the global mining industry is now dominated by about five companies that produce a broad range of commodities in many countries. And today, mining companies are typically run by people with accounting backgrounds or MBAs. They ‘get their jollies,’ when they get their hands on a big stream of cash, by doing things that raise the share price of their companies—that is, paying out increased dividends, buying back shares or taking over other mining companies.

The global mining industry is much less fragmented than it was even as recently as a decade ago



Note: Bubble sizes represent market capitalization of 1 January 2011 and 1 May 2011 respectively. Source: Anglo American, BHP Billiton, Vale, Rio Tinto, Freeport-McMoan, and other mining companies. (Source: International Monetary Fund, 'The Economics of Natural Resources: Mining, Opportunities and Challenges', Washington, D.C.: International Monetary Fund, June 2011)

The first instinct of mining company executives and boards today when confronted with a big increase in prices or cash flow is not to increase production—although that is happening now, as it’s become clear that the source of the demand that’s pushed up commodity prices is both large and likely to continue for a long time to come. So supply is beginning to increase. But one of the other key differences about this commodity price

cycle compared with the previous ones is that producers have some market power, which they haven’t had in previous commodity price cycles, and they’re using it.

The long-term downtrend in commodity prices in real terms ended about a decade ago



Note: All indices expressed in US\$ and indexed to US\$ consumer price index, rebased to 2005 = 100. Source: International Monetary Fund, The Economist, Thomson Reuters, authors' calculations.

I said earlier that it was no coincidence that the long-term downward trend in commodity prices in real terms that some people think has been going on since the late 1900s, but has certainly been going on with only one or two interruptions since just after the end of the Second World War, was decisively turned around about 2002. Although things to some extent got out of hand in 2007–08 and were punctuated during and after the global

financial crisis, that upward trend in commodity prices has since resumed.

Even the declines in commodity prices that have occurred over the last week haven’t altered the underlying upward trend in commodity prices that has been in place for the past 10 years.

Now, I do not want to suggest that this trend is going to continue unabated. Personally, I think commodity prices are in most, though not all cases, close to peaking in real terms, in part because with a much greater delay than in previous commodity cycles, for the reason I mentioned before that market suppliers have some monopoly power.

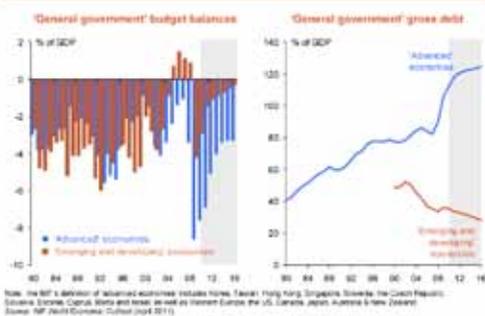
Supply is now starting to increase and will increasingly match the growth in the demand for it, thus in most cases putting a lid on prices, and perhaps, in some cases, starting to bring them down.

But I would argue that for as long as China, in particular, and to some extent India remain in that ‘zone’ of per capita incomes where commodity demand is very tightly and positively correlated with growth in per capita incomes, commodity prices are going to remain high by the standards of the last 50 years.

One of the lingering consequences of the global financial crisis has been to accelerate the transition of economic power from West to East that I referred to at the beginning. That’s because, with very few exceptions of which fortunately Australia is one, the global financial crisis has left Western economies hobbled by levels of public debt that are unsustainable—whereas, with very few exceptions, most emerging market economies of any significance are not so constrained.

Most major Western countries face a choice between laying out a credible plan to raise taxes and/or cut government spending over the medium term, thereby avoiding a sovereign debt crisis; or alternatively, fooling themselves into thinking that they don’t need to do that now, having a sovereign debt crisis and then having to raise taxes and cut government spending by more, under considerably more pressure than if they had done it voluntarily.

‘Advanced’ economies’ debt mountains will curtail their growth prospects whether they deal with them promptly or not



Britain has made the former choice. Greece, among others, made the latter choice. The US came dangerously close to making the second choice, until last Tuesday—and they may still go down that path. Even Japan, I don’t believe, will be completely exempt from these factors, even though their current very high rates of domestic saving to some extent insulate them from market pressures that would otherwise have brought these decision points forward.

Inevitably, the need to raise taxes and/or cut government spending by large amounts over the next 10 years will constrain the rate of growth in major Western economies for a long period of time. And it’s possible to get the timing of these decisions wrong. Take them too soon—as for example Europeans are, in my view, in danger of doing and perhaps the Americans could—and you could bring on renewed downturns in economic activity in the short term. But even over the medium term these decisions have to be made at some point, and the inevitable result will be weaker growth in the Western economies than would otherwise be the case. Hence, as I said, accelerating this transition of economic power and might from West to East.

That is at the core of the turmoil that we’ve seen in financial markets over the past week or so. We’ve seen stock markets decline, bond yields in the United States fall to almost as low as they got to during the global financial crisis, notwithstanding that the rating agencies don’t regard the US as an AAA credit any more. Quite clearly by their behaviour, financial markets continue to regard US Treasury bonds as one of the safest investments in times of crisis that there is. The Swiss franc has taken on renewed lustre as a safe haven. The Australian dollar has been dumped, to some extent. It has fallen from over \$1.10 to at one point just below parity. It’s an interesting reflection, though, on the times that when we say that the Australian dollar could go through parity, these days we mean it’s going down rather than, as for most of my career as an economist, meaning that it was

going up. But it hasn't fallen nearly as much as it did during the financial crisis, when it dropped by 30 cents in three months.



The gold price has continued to rise. It hit almost US\$1,800 an ounce. That continues to be a safe haven for people with a variety of fears; be it recession, inflation or default on debt by sovereign governments. Perhaps encapsulating all these, what Alan Kohler refers to as 'the fear index' in his ABC News presentations; the index of the volatility of S&P 500 share price index futures contracts that are traded in Chicago has over the past

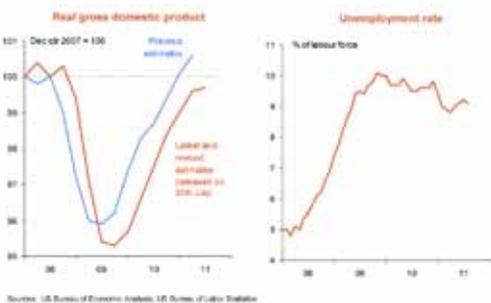
week spiked up to its highest level since the aftermath of the collapse of Lehmann Brothers in September 2008.

All of these things reflect a growing fear on the part of investors that the US and Europe may be lapsing back into recession. That, in Europe's case, may be accompanied by sovereign debt defaults which could in turn morph back into a banking crisis, given the amount of government bonds that European banks hold. Whereas that's not a major risk in the United States because American banks are now much better capitalised than they had been leading into the financial crisis—for that matter, most companies are considerably more profitable than they were then—and nor is there now, at least not until 2013, any serious prospect given to the likelihood of the US defaulting on its government debt. But there is certainly a concern that both sides of the Atlantic could find themselves back in recession.

If we look at the United States, one of the things that has prompted this renewed concern about the risk of recession was figures released the weekend before the deal was done between the Administration and Congress to avoid a technical default on its debt but which, precisely because markets were focused on that, this data didn't get, at least initially, the attention it deserved. That was the annual release of revised estimates for US GDP over the preceding three years combined with the first estimate of GDP growth for the June quarter.

Those figures told us three things. First, that the recession that followed the financial crisis was deeper than previously expected. GDP contracted from peak to trough by more than 5%—the deepest recession, by a wide margin, the US has experienced since the 1930s. Secondly, it told us that the subsequent recovery had been softer than previously expected. Previously we thought that the US economy had regained the level of GDP it had on the eve of the financial crisis in the December quarter of last year. Now we're told that it still isn't there yet. Third, we learnt from those figures that real GDP in the first half of the year had barely grown at all, at a rate of 0.8% annualised over the first two quarters of this year.

The US recession induced by the financial crisis was deeper than previously recognized, and the recovery has been weaker than thought



That fits rather better with the fact that, after dropping by just over a percentage point during 2010, the unemployment rate has been drifting up again over the last six months. That now looks more consistent with the revised picture of economic growth that we were presented with the weekend before last. If we look at shorter term indicators for the US, they're also consistent with the idea that the US economy has stalled, after what was never a particularly strong recovery. Some of the things that did drive what recovery there was, such as an upswing in business investment, seem to be losing steam. House prices, which stabilised during 2009, have, since the expiry of some tax credits for first home buyers in the middle of last year, started to drift down again. Economies in some ways are a bit like riding a bicycle. If you cease to ride at a velocity that is consistent with moving forward, then if something else comes along it's much easier for you to fall over. The US economy is at this stage—of what's been a very weak recovery so far—very vulnerable to any kind of external shock, which certainly a default by the US Government on any of its obligations would have been. Perhaps psychologically—even though I think its importance is somewhat overrated—the decision by Standard & Poor's to strip the US of its AAA credit rating may have been a psychological shock even if it wasn't particularly an economic one.

And the US economy has been softening since the first few months of this year



On the other side of the Atlantic, while Greece has been saved yet again for perhaps another 15 months from what I believe is the inevitability of default, market attention in the past week has shifted towards Spain and Italy—countries which are far too big for Germany to bail out, even if they were so inclined. The European Central Bank was expected last Thursday to have announced a program under which it would buy Spanish and Italian debt. It didn't, with the result that yields on Spanish and Italian debt spiked to above 6%, a level which the markets believe those countries can't afford to service for any length of time. The European Central Bank announced on Monday morning, our time, that they would now buy Spanish and Italian debt—which they have since been doing, and the yields on that debt have dropped by a full percentage point. Had they done what they had said they were going to do on Thursday night, rather than Monday morning, there might not have been anything like the turmoil we've experienced over that interval and since.

It's another indication for financial market participants of just how inept has been the response of European authorities to this sovereign debt crisis since it first came to attention in April/May last year, when it emerged that for a decade the Greek Government had been lying about the extent of debt that it had run up and how it had run it up over the previous decade.

The most recent Greek bailout seems to have calmed markets' fears about Greece – but attention has shifted to Italy and Spain



When we look at Europe more broadly what we see is that the countries whose sovereign debt is of such greatest concern have spent the last decade, whilst they were sheltering within the Euro zone under the financial prudence of Germany in particular, have been egregiously losing their competitiveness. They can't regain that competitiveness as they used to in previous eras by devaluing their respective currencies. Exiting the Euro zone

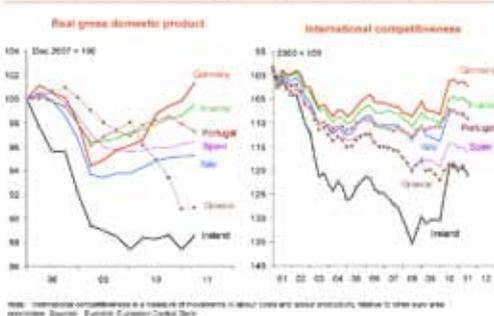
would be a logistical, legal and financial nightmare and it's unlikely ever to happen.

In my view, it's more likely that the Germans would exit the Euro zone and reintroduce the Deutschmark than it would be that the Greeks either leave it or are expelled and have to reinvent a new drachma. Germany's economy is actually booming, partly because it's undergone two decades of painful restructuring after the reunification in 1989 and is now benefiting from a Euro that, because of the travails of its member partner countries, is much weaker than an independent Deutschmark would have been. But the rest of Europe, and particularly the countries with unsustainable levels of debt, are experiencing very deep recessions because the only way they can restore their competitiveness is through a 19th century style of deflation, which I suspect may be politically unsustainable over the medium term let alone economically unsustainable.

The other big thing that worries financial markets about the possibility that the US and Europe may lapse back into recession is that the authorities on either side of the Atlantic don't have the tools to respond to it. They can't cut interest rates, because interest rates are already close to zero. Actually, the European Central Bank could unwind the increases in interest rates that it ill-advisedly put through over the last six or so weeks, but even cutting European rates by half a percentage point wouldn't do much. Nor can governments do fiscal stimulus because, as I've already noted and as everyone else agrees, they are in no position to borrow one more dollar or one more Euro given how large their debts are.

Indeed, one of the factors potentially tipping these economies back into recession is that, on both sides of the Atlantic, governments are already doing fiscal austerity.

The 'PIIGS' countries need to restore their competitiveness vis-à-vis other Euro area economies in order to regain sustainable growth

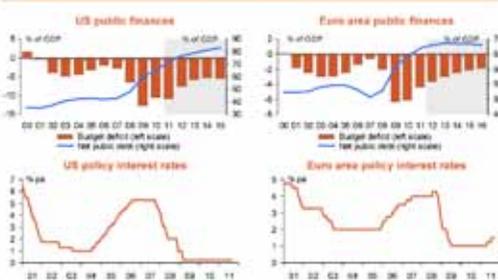


Although the deal reached between Congress and the Administration last week falls way short of what would be required to stabilise the US federal budget deficit, there's an awful lot of fiscal austerity going on at the state and local level in the United States, which is certainly detracting from any prospect of a strong recovery in employment.

Central banks on either side of the Atlantic could well do further rounds of quantitative easing—that is, electronically printing money as the

Fed has now done in two distinct instalments. There's no doubt that's good for financial markets—which is probably why financial markets are squawking for more quantitative easing. What's not at all clear from recent experience is whether that kind of unorthodox monetary policy does anything to promote economic recovery. That remains very much an open question, but it's about the only thing that central banks can do to appear to be seen to be responding to the pressures that are now emerging on the major North Atlantic economies.

On either side of the North Atlantic, governments and central banks don't have much 'ammunition' to fight a second recession



Source: IMF World Economic Outlook (April 2011); US Federal Reserve; European Central Bank

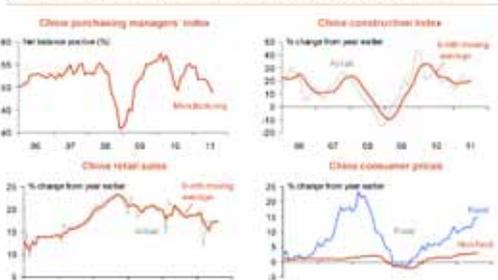
The risk is that if they can't do anything effective against a renewed downturn into recession—which, let me emphasise, is not my central forecast but I can see that the probability of it is by no means zero—then any recession that follows could be much longer than the recession which followed the financial crisis that began in 2008.

From an Australian perspective, of course, the US and Europe don't matter nearly as much as they once did. Australians will feel the pain, through their superannuation funds, of falls in foreign share prices as well as in Australian share prices that echo those falls. There are, of course, some trade links between the US and Europe and Australia that are still important. There's an indirect link too through China because the US and Europe are China's major export markets, and so China will feel inevitably some consequences of any recessions that might occur on the other side of the world.

But from an Australian perspective the important thing is that most of what we sell to China goes not into the exports which China sends to other parts of the world, but it goes into their domestic demand: into their housing, into their urban infrastructure, construction and the like.

Although China's economy is slowing some as the authorities there seek to get on top of what is undoubtedly a potentially socially destabilising inflation problem, there's no evidence that I can see that China is on the cusp of a hard landing. Moreover, if it turned out that they were, then although almost certainly the Chinese authorities couldn't and wouldn't respond on as grand a scale as they did to the downturn associated with the financial crisis, they have both the will and the capacity to ensure that China's economy, if it does look like having a hard landing, rebounds again reasonably quickly. So I think that Australia's trading relationship with China will continue to be an important backstop for our economy in the face of what may be an extended global downturn.

China's economy is slowing a bit – as the authorities try to quell inflation pressures – but there's no suggestion it's on the cusp of recession



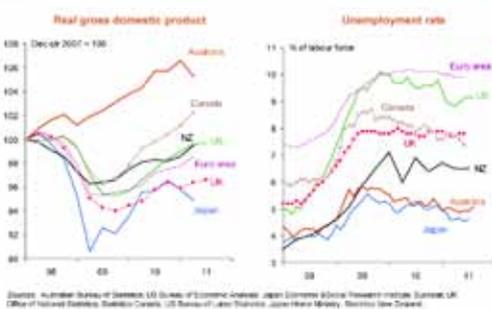
Source: HSBC China National Statistics Bureau, IHS GII

Of course, our experience since the end of the financial crisis has been very different from that of most other major Western economies. As I mentioned before, the US still hasn't regained the level of economic activity it had on the eve of the financial crisis. With the exception of Canada, neither has any of the other major Western economies that we

normally compare ourselves with. Most other major Western economies are still grappling with unemployment rates that are the highest they've had since the recessions of the early eighties or early nineties.

Japan's unemployment rate is misleadingly low because Japan's labour force is now declining and because many of those who've lost their jobs in Japan over the last 18 months, particularly those who've lost their jobs following the tsunami and earthquake and the shutdown of part of Japan's electricity supply, have simply dropped out of the workforce altogether and aren't reflected in the unemployment figures.

Australia's economy has continued to perform more strongly than those of other industrialized nations



By contrast, Australia's unemployment rate, which only rose by one and three-quarters per cent during the financial crisis, has for the last six months been below the 5% level that since the mid-1970s Australians have regarded as consistent with full employment.

I mentioned before—and this figure highlights—just how much more correlated Australia's economy is with China's and how less correlated it is with the United States than, for example, at the time of our last recession in the early 1990s. That obviously means that if China does have a hard landing we'll be more adversely affected by it than almost any other country in the Western world.

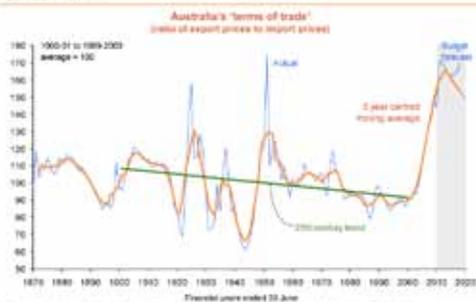
Australia's economy is now more closely correlated with China's than with the United States*



But, as I said, I think the probability of China having a hard landing and not being able to do anything about it is in both dimensions of that pretty small. China's economy will continue to work much in our favour. Of course, one of the ways in which it is working in our favour is through that dramatic turnaround in the trend in commodity prices that I mentioned a few moments ago.

As Glen Stevens has pointed out in numerous speeches, Australia's terms of trade, the ratio of export to import prices, is the highest it's been for over 140 years. Or, more colourfully, as Glen Stevens has put it on a couple of occasions, 'whereas five years ago Australia could get 2,000 flat screen TVs for every shipload of iron ore, today we can get 22,000 flat screen TVs for every shipload of iron ore'. That's partly because the price of flat screen TVs has continued to decline but, of course, more importantly because the price of a shipload of iron ore has gone through the roof. As you can see in the next chart, both the Reserve Bank and the Treasury think that the rise in our terms of trade has peaked. That's almost certainly right.

Australia's 'terms of trade' are at their highest sustained level in at least 140 years



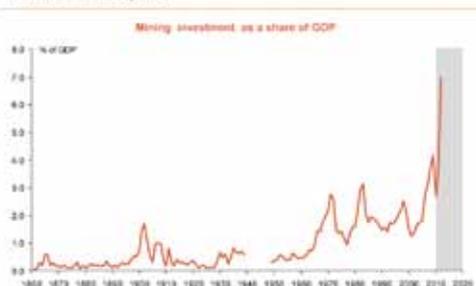
Source: Glenn Stevens, 'The Challenge of Prosperity', Address to CEOA Annual Dinner, 20th November 2010; Martin Felsman, 'Opportunities, Challenges and Implications for Policy', Address to Australian Business Economics, 17th May 2010

But even as they come down some, they're likely to remain high by historical standards. In order to capitalise on what, when you think about it, is really a once in human history opportunity, created by the industrialisation and urbanisation of the two most populous nations on the planet. There won't be any Chinas and Indias after these ones, and the other economies that (hopefully) will go through a similar process of industrialisation

and urbanisation—Indonesia, Brazil, African economies—are both significantly smaller than China and India in terms of population, and are likely to be suppliers of many of their own commodity needs or, indeed, commodity exporters, rather than importers of commodities as China and India are.

So in order to capitalise on this once in human history opportunity, Australia's mining industry is undergoing its largest expansion in more than 150 years. This combination of higher prices for a larger volume of Australian commodity exports is going to produce substantial increments to Australia's national income over 10 to 20 years. The problem is that history tells us that we will probably stuff that up.

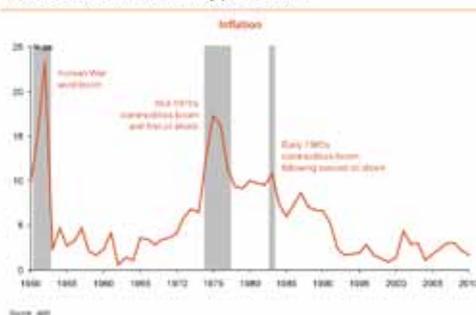
Mining investment is now larger, as a proportion of GDP, than at any time in the last 150 years



Source: Rio Tinto, 'Mining Booms and the Australian Economy', Address to Rio Tinto Institute, 20th February 2010; RBA, 'Statement on Monetary Policy', February 2011. Both available on RBA website. Shaded area denotes recession based on monthly US GDP. Shaded area denotes periods of double-digit inflation (as defined in May 2011). Annotations are related to the graph subject at an individual point in time.

Every mining boom Australia's had in the last 80 years has ended in, among other things, a burst of double digit inflation, leading inevitably to a serious recession shortly thereafter.

Australia's three episodes of double-digit inflation since World War II have co-incided with commodity price booms



Source: ABS

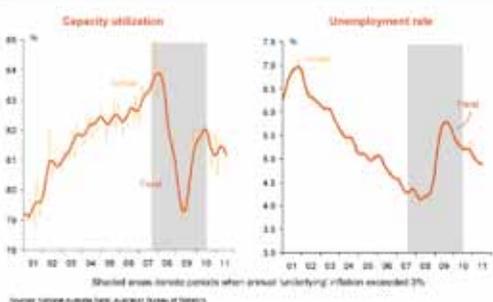
The highest inflation Australia's ever had was more than 20% under the Menzies government around the time of the Korean wool boom in the early fifties. The second highest was at the fag-end of the commodities boom partly driven by the industrialisation and urbanisation of Japan, peaking under the Whitlam government at an inflation rate of just under 17%. The other episode of double digit inflation we had was associated with the rather briefer resources boom that followed the second oil shock which Malcolm Fraser wrongly thought would get him out of jail at the 1983 election, but

which was associated by 20% wage claims filed by the Metal Workers Union and 10% inflation.

To be sure, there've been a number of important changes in the way the economy operates since this last sorry episode. We no longer have a fixed exchange rate. We do have an independent central bank that can't be dictated to by politicians fearful of the electoral consequences of even a small increase in interest rates. And we don't have a system of centralised wage fixation that guarantees that the double digit wage increases that mining companies could afford to pay their workers are translated into similar wage increases for other sectors whose employers couldn't afford them.

Nonetheless, the fact that Australia's underlying inflation rate got up to almost 5% in the September quarter 2008 shows that there is still a very significant risk. We simply don't have the spare capacity in the Australian economy to have both a mining boom and continued growth in consumer spending at the rate we were having before the onset of the financial crisis at the same time. If we sought to do that we would have a fourth instance of a commodities boom ending in a bout of double digit inflation.

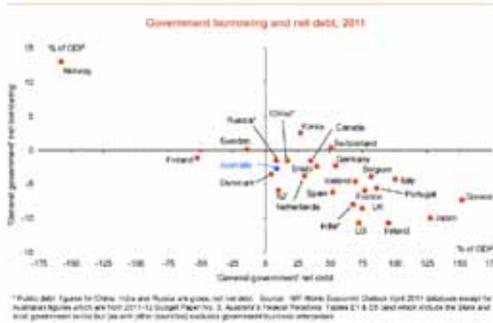
The 'mining boom' is getting under way again at a time when there's only a small amount of 'spare capacity' in the Australian economy



We don't have a public debt problem in Australia, despite the best efforts of the opposition to confect the idea that we do. Australia's well placed, if the need arises, to do fiscal stimulus again. Hopefully, we would have learnt some of the lessons from some of the poorly executed fiscal stimulus programs deployed last time.

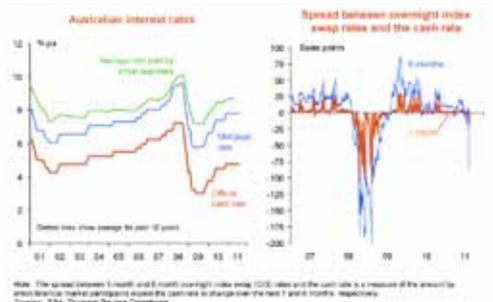
Indeed, I think if we're faced with a long global recession there's a good case for doing some big ticket, long-term infrastructure spending rather than handing cash out to households—although I acknowledge that worked last time—or small ticket infrastructure spending.

Australia does not have a serious public debt problem



We also have considerable scope to do monetary easing. The financial markets are fully expecting that interest rates will be cut substantially over the next six months, by more than a full percentage point. At the moment I think they will be wrong. But nonetheless their expectations remind us that if the Reserve Bank needs to cut interest rates, they have plenty of scope to do so, which most other central banks don't.

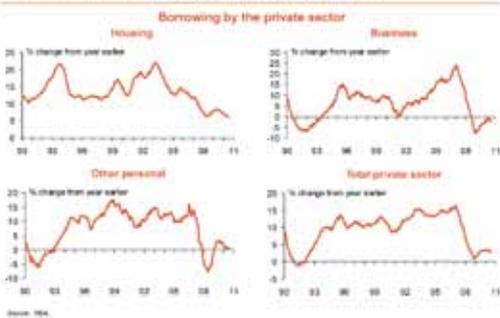
The RBA has given itself ample scope to cut interest rates in the event that the economy deteriorates sharply – and markets now expect it to ...



It's an open question, however, whether if they did cut rates people would borrow, businesses would borrow, as enthusiastically as they did after the rate cuts during the financial crisis. The rate hikes of the past 18 months have certainly put a dampener on

housing activity and, desirably from the Reserve Bank’s point of view, stemmed what threatened as a destabilising rise in house prices of between 15 and 20% during 2009–10.

... although even if the RBA did cut rates aggressively there's no certainty that households or business would borrow more



I don't have time to make the point here but I would continue to assert that although Australian house prices are now softening as the unsustainable rise in house prices induced by the fall in interest rates and the, in my view, extremely unwise increases in assistance to first home buyers after the financial crisis are reversed out. But I think there's very little danger of Australia experiencing the kind of falls in house prices that occurred in the

United States or in parts of Europe.

One of the points of Australian vulnerability to any subsequent or near term downturn in the global economy is that consumer sentiment and household spending are much more fragile than they were on the eve of the last financial crisis. Despite the fact that Australians have far less to worry about than Americans as regards either their job security or their future tax bills, and despite the fact that Australians have suffered much smaller declines in net wealth than Americans have, they are now almost as pessimistic as American consumers and are saving twice as high a proportion of their income as American households are doing.

'Cautious' Australian households are saving more assiduously than their American counterparts – despite much better fundamentals'



From the point of view of managing the pressures associated with the resources boom, that is a very convenient thing to have occurred, but it obviously has come at the expense of some parts of our economy. Consumers recognise that it's a good time to buy stuff because stuff is cheap. But they're still not doing it because they also think it's an even better time to be putting money in the

bank or paying down debt, which many people probably now think with the benefit of hindsight has been higher than can be considered desirable.

Even though consumers think it's a good time to be buying major household items, they aren't doing it – they're saving instead



The stronger currency, driven in part by weakness in the dollar but also by the relative strength of Australian interest rates, the strength of commodity prices and the willingness of global investors to take on what are usually considered risky assets, is having an adverse impact on other important parts of Australia's economy such

as manufacturing, tourism and higher education. Those too add to the vulnerability that Australia’s economy faces in the event that we face a renewed downturn in the major North Atlantic economies.

A weak US\$, high commodity prices, relatively high interest rates and an appetite for currency risk are keeping the A\$ above parity with the US\$



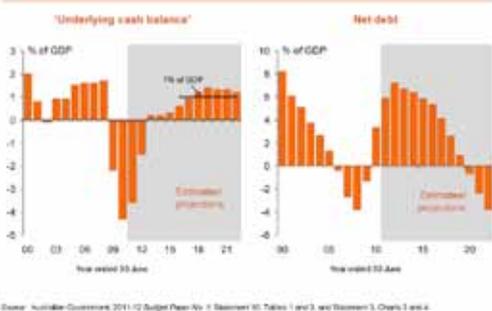
The strong A\$ is having an adverse impact on 'trade-exposed' non-resource sectors such as manufacturing, tourism and education



As I said before, we do have the fiscal capacity to respond to that, and it would be the height of foolishness, in my view, if in the face of a downturn of the global economy the government were to insist that the budget must return to surplus in 2012–13 come hell or, as we saw after the Brisbane floods, high water.

From a longer term point of view what worries me is the reluctance of either side of politics to commit to higher levels of public saving on the assumption that we don’t have a world economic downturn again and that the mineral boom continues. The present government’s fiscal strategy says that the disciplines, such as they are, that it’s observing over government spending and revenues will only apply until the budget surplus returns to 1% of GDP, which on present forecasts will be by 2016–17.

From a medium term perspective it's worrying that the Government proposes to relax its 'disciplines' once the surplus gets to 1% of GDP



What that effectively implies is that once that target—an arbitrary one at that—has been reached, whoever’s in power at the time will feel free to give away (in the form of tax cuts or untargeted welfare handouts) any revenue that might otherwise have resulted in budget surpluses of more than 1% of GDP—thus, potentially, putting the same upward pressure under demand inflation and interest rates

as occurred during the last term of the Howard government and the first budget of the Rudd government. There could be nothing more guaranteed than that to ensure that we squander this opportunity in the same way that we have the previous three ones, and to ensure that this generation of Australians failed to leave anything from this once-in-human-history opportunity to future generations of Australians.

The way to avoid that consequence, in my view, is for Australia to follow the path laid down by countries like Norway and Chile and establish some kind of sovereign wealth fund.

One other factor which makes our economy vulnerable is the deterioration in our productivity performance over the last decade. When visiting economists came to Australia in the late 1990s

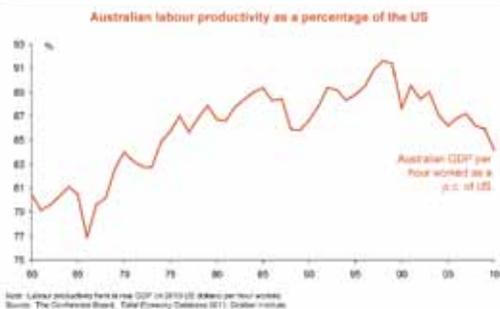
and proclaimed an Australian economy miracle—as Paul Krugman among others did—they were referring in particular to the dramatic acceleration in our productivity performance during the 1990s. That in turn was partly the result of our enthusiastic uptake of ICT, but it was more due, as every study of this period has shown, to the results of the pursuit by governments of both political persuasions of policies explicitly designed to improve what had up till then been a pretty ordinary productivity performance.

Australia's labour and multi-factor productivity growth rates slowed significantly during the 2000s



were often politically difficult reform policies have been given up as a result of a decade of neglect.

Relative to the US, Australian labour productivity is back to where it was in the mid-1970s



Not only has there not been any productivity enhancing reform since at least 2000 in this country, but instead over the subsequent decade we've had a tidal wave of productivity stifling legislation and regulation—much of it based on the apparent belief that it's both possible and desirable to eliminate, through legislation and regulation, any risk that might have occurred once, notwithstanding the costs of doing so relative to the benefits, and without there ever being any assessment of the probability of those risks, whatever they are, from repeating themselves.

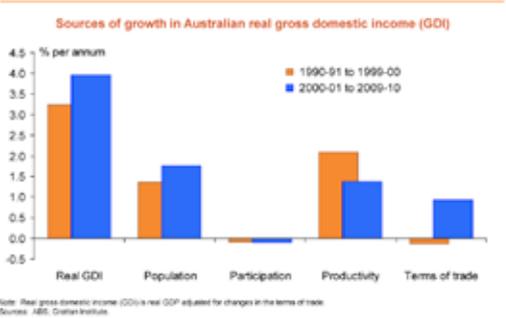
As a result, we've become an exceptionally risk-averse society, one in which business leaders, among others, spend far more time worrying about what could go wrong and very little time pursuing the kind of technological or knowledge advances or organisational changes that would result in renewed rates of productivity growth.

No one cares about that because, as happened in this country in the sixties and seventies, the consequences of our poor productivity performance have been more than obscured by a combination of faster population growth and the gains that have come to us through the urbanisation and industrialisation of our principal trading partners. That may well continue for another decade.

My concern is that if and when—or when, because it's not a question of if—the mining boom comes to an end, Australia's economic future may look far more like what we experienced between

1975 and 1992, when the consequences of our previous neglect of productivity came home to roost, than any of us would wish for our children or grandchildren.

The impact of slower productivity growth on living standards has been masked by population growth and the rise in the terms of trade



Summary

- **The most important medium term development in the global economy is the shift in the centre of economic gravity from west to east**
 - the industrialization and urbanization of China & India will run for another 15-25 years
- **One of the lasting consequences of the 'GFC' has been to accelerate that shift**
 - largely as a result of the unsustainable levels of public debt with which most Western governments are now burdened, and struggling to deal with
 - recent renewed financial market turmoil in part reflects a belated recognition that the outlook for economic growth in most Western economies is pretty bleak
- **There's no convincing reason to think that Asia will slip into recession**
 - China's economy is slowing a bit, not a lot
 - Asian demand for Australian commodities is primarily driven by domestic spending
- **'Mining boom Mark II' is likely to continue**
 - and one of the key challenges facing Australia is how to avoid 'stuffing it up', as we have done with every commodities boom we've had in the last 70 years
- **Australia is in some ways more vulnerable to an external shock than 4 years ago**
 - in particular, because of slower growth in household spending
 - but Australia remains well-placed to counter any externally-driven downturn
- **Australia's other major Achilles heel is our appalling productivity performance**
 - which calls for a renewed program of regulatory reform, more and better-targeted investment in skills and infrastructure, and a much better innovation effort

Explaining China's international behaviour: Muddling through, or guided by a grand strategy

Professor Wang Jisi

China needs a grand strategy to guide its foreign relations but currently goes without a written national security strategy report. China's foreign policy and international behaviour are decisively driven by, and consistent with, its domestic priorities. In the Mao Zedong years, when domestic politics was characterised by class struggle, China carried out the 'revolutionary diplomat line' centred on fighting imperialism and hegemonism, or the United States and the Soviet Union. When Deng Xiaoping set up economic development as the central task of the country, Beijing defined its foreign policy as safeguarding a peaceful environment for economic growth. In the last few years, China has been preoccupied with a more complicated domestic agenda, including building a harmonious society and transforming the pattern of economic development, which means reducing social tensions and restructuring the economy in order to emphasise domestic consumption and improving social welfare. Its foreign policy has to be somewhat readjusted to reflect the new domestic needs. Meanwhile, China's foreign policy has to respond to the fast changing international environment.

In the interests of time I won't go through that summary of the major dot points but simply thank you for the opportunity to share all those thoughts with you and hope that they've been relevant to your thinking about the strategic challenges facing the world and Australia over the next decade.

My presentation attempts to answer three questions. First, what are, in Chinese eyes, the most important changes in the world today that will likely shape a new worldview that may possibly make an impact on China's international behaviour? Second, what is the so-called 'grand strategy'—should there be one—that China is likely to carry out given its domestic priorities and international surroundings? And third, what are likely to be the ramifications of this strategy, especially those related to the Asia–Pacific region?

A precautionary note at this moment is that there are so many divergent views among Chinese strategic thinkers and policy analysts, and I can only speak for myself and do not pretend to represent any collective view.

I. China's new international environment

One major factor that has caused the many readjustments of China's foreign policy since 1949, especially its policy toward the United States, is Chinese assessments of the international strategic structure. After the Tiananmen political storm and sea changes in the Soviet bloc in 1989, Deng Xiaoping called for a cautious, non-confrontational approach toward the United States, which is widely known in China as *tao guang yang hui*, or 'keeping a low profile.' To a large measure, this approach was premised on the fact—and the assessment—that China's power and international status were far below those of America, and that the global balance at that moment tilted toward Western political systems, values, and capitalism. Deng's ideas and policies regarding the United States were followed for two decades by the two successive leaderships headed by Jiang Zemin and Hu Jintao.

Since 2008, several developments and events have reshaped China's views of the international structure and global trends. First, many Chinese believe that their nation has ascended as a first-class power in the world and should be treated as such. China has successfully weathered the global financial crisis that, in Chinese eyes, was caused by the deep deficiencies in the US economy and the global financial order dominated by the US dollar. China has surpassed Japan as the world's second largest economy. The Chinese took pride in holding the Beijing Olympics in 2008 and the Shanghai Expo in 2010, along with some other big events, that were unprecedentedly grandiose. China's outer space projects and newly produced advanced weaponry have also contributed to its self confidence. It has been announced that China has finished building its first aircraft carrier. China is also taking on the world's only large commercial aircraft producers Boeing and Airbus with its first homegrown passenger jet, which is scheduled to make its test run early next year.

Second, the United States is portrayed in China as well as elsewhere in the world as a declining power. America's financial disorder, alarming deficit and unemployment rate, slow economic recovery, and domestic political polarisation are but a few indications of its decadence. Although China's leadership has not reached the conclusion that America's superpower status is seriously challenged, the general public in China sees the lack of confidence and competence of the United States in the global stage. In 2003 when America launched the Iraq War, its GDP was 8 times as large as China, but today it is only less than 3 times. It is a question of how many years, rather than how many decades, before China replaces the United States as the largest economy in the world.

Third, the tilted power balance between China and the United States is part of an emerging new structure in today's world. While the Western world at large is faced with economic setbacks and social dislocations, rising powers like India, Brazil, Russia, and South Africa join China in challenging

the Western dominance. G20 is replacing G8 as a more effective and probably more viable international mechanism. The IMF, the World Bank, and other international organisations and regimes have to take the aspirations and interests of the emerging powers more seriously. Two senior Chinese economists are taking a leading position in the World Bank and IMF respectively.

Finally, it is a popular notion among Chinese political elites that China's development model provides an attractive alternative to Western democracy and political values, while many developing countries that have introduced Western values and political systems are undergoing disorder and chaos. The China Model or Beijing Consensus features an all-powerful political leadership that effectively manages social and economic affairs, constituting a sharp contrast to some countries where 'color revolutions' often lead to national disunity and Western infringement on their sovereign rights. The current upheavals in the Arab world are closely watched in China. On the one hand, some are alarmed that the undesirable repercussions would affect China's internal stability. On the other hand, few have the confidence that the chaotic situations in various Middle East countries would soon lead to political stability and fast economic growth. After the announcement of withdrawing American troops from Afghanistan and the death of Osama bin Laden, the United States may continue to be tied up in the Middle East and not be able to shift its strategic focus to China. Therefore, those upheavals may prove to be a heavy blow to the Western world rather than to China.

Obviously, the above Chinese observations are not readily shared in the West. Many of China's political elites, therefore, suspect that it is the United State, rather than China, that is 'on the wrong side of history'. It is also strongly suspected that the United States is attempting to maintain its hegemonic power in order to prevent the emerging powers, in particular China, from achieving their goals and enhancing their statures. America's international behaviour is increasingly depicted against this broad background. For example, the United States is attempting to strengthen its strategic alliances with Japan, South Korea, Australia and other Asian-Pacific powers, and to drive a wedge between China and some neighboring countries over such issues as the South China Sea disputes.

The perceived changing power balance between China and the United States has prompted many Chinese to expect, and aspire for, a more 'can-do' foreign policy. According to them, if Beijing in the past was somewhat tolerant regarding US arms sales to Taiwan and military surveillances around China's borders, it should now have enough capacity and resolve to 'punish' such American deeds. Many propose a more defiant response to Western political, economic, and diplomatic pressures.

While China's international behaviour is said to be more aggressive, arrogant, and triumphalist by the outsiders, it is perceived within China as being too soft, too timid, and passive and cowardly. This evident contrast may help explain the seemingly more assertive Chinese official rhetoric versus the continued prudence in China's actual behaviour in foreign relations.

II. The top leadership's definition of China's core national interests and foreign policy objectives

Under these new circumstances, what should be China's grand strategy? First, let me provide some ideas of Chinese official thinking based on publicised statements.

Any country's grand strategy must answer at least three questions: What are the nation's core interests? What external forces threaten them? What can the national leadership do to safeguard

them? Whether China has any such strategy today is open to debate. Over the last three decades or so, China's foreign and defence policies have been remarkably consistent and reasonably well coordinated with the country's domestic priorities. In recent years, China's power and influence relative to those of other great states have outgrown the expectations of even its own leaders.

Under President Hu Jintao, Beijing has formulated a new development and social policy geared towards continuing to promote fast economic growth while emphasising good governance, improving the social safety net, protecting the environment, encouraging independent innovation, lessening social tensions, perfecting the financial system, and stimulating domestic consumption.

With that in mind, the Chinese leadership has redefined the purpose of China's foreign policy. As Hu announced in July 2009, China's diplomacy must 'safeguard the interests of sovereignty, security, and development.' Dai Bingguo, the state councilor for external relations, further defined those core interests in an article in December 2010: first, China's political stability, namely, the stability of the CPC leadership and of the socialist system; second, sovereign security, territorial integrity, and national unification; and third, China's sustainable economic and social development.

Apart from the issue of Taiwan, which Beijing considers to be an integral part of China's territory, the Chinese Government has never officially identified any single foreign policy issue as one of the country's core interests. In 2010, some Chinese commentators reportedly referred to the South China Sea and North Korea as such, but these reckless statements, made with no official authorisation, created a great deal of confusion. In fact, for the central government, sovereignty, security, and development all continue to be China's main goals. As long as no grave danger threatens the CPC leadership or China's unity, Beijing will remain preoccupied with the country's economic and social development, including its foreign policy.

III. Disputes of China's grand strategy among Chinese political elites

The need to identify an organising principle to guide Chinese foreign policy is widely recognised today in China's policy circles and scholarly community, as well as among international analysts. However, defining China's core interests according to the three prongs of sovereignty, security, and development, which sometimes are the intentions, means that it is almost impossible to devise a straightforward organising principle. And the variety of views among Chinese political elites complicates efforts to devise any such grand strategy based on political consensus. It is interesting to note that in Chinese publications and websites there are increasingly divergent and even opposite views with regard to strategic visions and policy proposals.

One popular proposal has been to focus on the United States as a major threat to China. This notion is based on the long-held conviction that the United States, along with other Western powers and Japan, is hostile to China's political values and wants to contain its rise by supporting Taiwan's separation from the mainland. Its proponents also point to US politicians' sympathy for the Dalai Lama and Uighur separatists, continued US arms sales to Taiwan, US military alliances and arrangements supposedly designed to encircle the Chinese mainland, the currency and trade wars waged by US businesses and the US Congress, and the West's argument that China should slow down its economic growth in order to help stem climate change. This view is reflected in many newspapers and on many websites in China (particularly those about military affairs and political security).

To me, this proposal is essentially misguided, for even though the United States does pose some strategic and security challenges to China, it would be impractical and risky to construct a grand strategy based on the view that the United States is China's main adversary. Few countries, if any, would want to join China in an anti-US alliance. And it would seriously hold back China's economic development to antagonise the country's largest trading partner and the world's strongest economic and military power. Fortunately, the Chinese leadership is not about to carry out such a strategy. Premier Wen Jiabao was not just being diplomatic last year when he said of China and the United States that 'our common interests far outweigh our differences.' During his state visit to the United States early this year, President Hu pronounced a strong resolve for China to construct a cooperative partnership with the United States based on mutual benefit and mutual respect.

Well aware of this, an alternative school of thought favours Deng's teaching of '*tao guang yang hui*,' or keeping a low profile in international affairs. Members of this group argue that since China remains a developing country, it should concentrate on economic development. Meanwhile, they argue, keeping a low profile in the coming decades will allow China to concentrate on domestic priorities.

Although this view appears to be better received internationally than the other, it too elicits some concerns. Its adherents have had to take great pains to explain that *tao guang yang hui*, which is sometimes mistranslated as 'hiding one's capabilities and biding one's time,' is not a calculated call for temporary moderation until China has enough material power and confidence to promote its hidden agenda. Domestically, the low-profile approach is vulnerable to the charge that it is too soft, especially when security issues become acute and as nationalist feelings surge in China.

Some thoughtful strategists appreciate that even if keeping a low profile could serve China's political and security relations with the United States well, it might not apply to China's relations with many other countries or to economic issues and those nontraditional security issues that have become essential in recent years, such as climate change, public health, and energy security. Beijing can hardly keep a low profile when it actively participates in mechanisms such as BRICS, the informal group formed by Brazil, Russia, India, China, and the new member South Africa. A foreign policy that insists merely on keeping China's profile low cannot cope effectively with the multifaceted challenges facing the country today.

IV. Ongoing changes in China's strategic thinking

Four ongoing changes in China's strategic thinking may suggest the foundations for a new grand strategy.

The first transformation is the Chinese Government's adoption of a comprehensive understanding of security, which incorporates economic and nontraditional concerns with traditional military and political interests. Chinese military planners have begun to take into consideration transnational problems such as terrorism and piracy, as well as cooperative activities such as participation in UN peacekeeping operations. Similarly, it is now clear that China must join other countries in stabilising the global financial market in order to protect its own economic security. All this means that it is virtually impossible to distinguish China's friends from its foes. The United States might pose political and military threats, and Japan, a staunch US ally, could be a geopolitical competitor of China's, but these two countries also happen to be two of China's greatest economic partners. Russia, which some Chinese see as a potential security ally, is far less important economically and socially to China than is South Korea, another US military ally. It will take painstaking efforts on

Beijing's part to limit tensions between China's traditional political–military perspectives and its broadening socioeconomic interests. The best Beijing can do is to strengthen its economic ties with great powers while minimising the likelihood of a military and political confrontation with them.

A second transformation is unfolding in Chinese diplomacy: it is becoming less country-oriented and more multilateral and issue oriented. This shift toward functional focuses—counterterrorism, nuclear nonproliferation, environmental protection, energy security, food safety, post-disaster reconstruction—has complicated China's bilateral relationships, regardless of how friendly other states are toward it. For example, diverging geostrategic interests and territorial disputes have long come between China and India, but the two countries' common interest in fending off the West's pressure to reduce carbon emissions has drawn them closer. China is faced with a dilemma over the South China Sea issue with some Southeast Asian countries. Whereas they are regarded as friendly neighbours, China's claim of territorial rights is not to be given up.

Changes in the mode of China's economic development account for a third transformation in the country's strategic thinking. Beijing's preoccupation with GDP growth is slowly giving way to concerns about economic efficiency, product quality, environmental protection, the creation of a social safety net, and technological innovation. Beijing's understanding of the core interest of development is expanding to include social dimensions.

The fourth transformation has to do with China's values. So far, China's officials have said that although China has a distinctive political system and ideology, it can cooperate with other countries based on shared interests—although not, the suggestion seems to be, on shared values. But now that they strongly wish to enhance what they call the 'cultural soft power of the nation' and improve China's international image, it appears necessary to also seek common values in the global arena, such as good governance and transparency. Continuing trials and tribulations at home could also reinforce a shift in values among China's political elite by demonstrating that their hold on power and the country's continued resurgence depend on greater transparency and accountability, as well as on a firmer commitment to the rule of law, democracy, and human rights—all values that are widely shared throughout the world today.

All four of these developments are unfolding haltingly and are by no means irreversible. Nonetheless, they do reveal fundamental trends that will likely shape China's grand strategy in the foreseeable future.

V. How to address threats and safeguard national interests

Having identified China's core interests and the external pressures that threaten them, the remaining question is: how can China's leadership safeguard the country's interests against those threats? China's continued success in modernising its economy and lifting its people's standards of living depends heavily on global stability. The recent political unrest in North Africa, in particular Libya, has already lessened a large part of China's economic stakes there. Thus, it is in China's interest to contribute to a peaceful international environment. China should seek peaceful solutions to residual sovereignty and security issues, including the thorny territorial disputes between it and its neighbours.

Although the vast majority of people in China support a stronger Chinese military to defend the country's major interests, they should also recognise the dilemma that poses. As China builds its defence capabilities, especially its navy, it will have to convince others, including the United States,

Australia, and China's neighbours in Asia, that it is taking their concerns into consideration. It will have to show a willingness to join efforts to establish security structures in the Asia–Pacific region and safeguard existing global security regimes, especially the nuclear nonproliferation regime. It must also continue to work with other states to prevent Iran and North Korea from obtaining nuclear weapons. China's national security will be well served if it makes more contributions to other countries' efforts to strengthen security in cyberspace and outer space.

China has been committed to almost all existing global economic regimes. But it will have to do much more before it is recognised as a full-fledged market economy. It has already gained an increasingly larger say in global economic mechanisms, such as the G-20, the World Bank, and the International Monetary Fund. Now, it needs to make specific policy proposals and adjustments to help rebalance the global economy and facilitate its plans to change its development pattern at home. Setting a good example by building a low-carbon economy is one major step that would benefit both China and the world.

A grand strategy requires defining a geostrategic focus, and China's geostrategic focus is Asia. Today, East Asia is still of vital importance, but China should and will begin to pay more strategic attention to the west. The central government has been conducting the Grand Western Development Program in many western provinces and regions, notably Tibet and Xinjiang, for more than a decade. It is now more actively initiating and participating in new development projects in Afghanistan, India, Pakistan, Central Asia, and throughout the Caspian Sea region, all the way to Europe. This new western outlook may reshape China's geostrategic vision as well as the Eurasian landscape.

Still, relationships with great powers remain crucial to defending China's core interests. Notwithstanding the unprecedented economic interdependence of China, Japan, and the United States, strategic trust is still lacking between China and the United States and China and Japan. It is imperative that the Chinese–Japanese–US trilateral interaction be stable and constructive, and a trilateral strategic dialogue is desirable. More generally, too, China will have to invest tremendous resources to promote a more benign image on the world stage. A China with good governance will be a likeable China. Even more important, it will have to learn that soft power cannot be artificially created: such influence originates more from a society than from a state.

VI. Conclusion

If an organising principle must be established to guide China's grand strategy, it should be the improvement of the Chinese people's living standards, welfare, and happiness through social justice. It should not be the ultimate national goal for China to surpass the United States as a superpower in the world. I do not envisage any strategy to be written down as an official document, but China's strategic choices are confined to the factors I presented above.

To be sure, faced with so many difficult and complicated problems in global affairs and strikingly diversified voices in China, the Chinese leadership's strategic visions and decisions are subject to different interpretations, and its actions will look more like muddling through than following grand designs and plans.

How other countries respond to the emergence of China as a global power will also have a great impact on China's internal development and external behaviour. China can rightfully be expected to take on more international responsibilities. But then the international community should take on the responsibility of helping the world's largest member support itself and 'muddle through.'

SESSION 2: Australia, the West and the region

Why the West rules — for now

Professor Ian Morris

I'd like to talk to you this afternoon about a book I wrote that came out last year, called *Why the West rules for now: the patterns of history and what they reveal about the future*. By background, I'm an historian and an archaeologist. I've worked mostly in Greece and Italy, the Mediterranean Basin more generally. I probably seem an odd choice to bring to the ASPI conference to talk about global forces in 2011, but I got interested in why the West came to dominate the world because this question was fundamental to the rise of the academic discipline of classics that I was trained in. Back in the 18th century, classicists offered an answer to this question. The argument they came up with was that if you look back to ancient Greece, two and a half thousand years earlier, you see that the ancient Greeks created a unique culture, full of vitality, creativeness, and inventiveness. This culture the ancient Greeks created, these 18th-century scholars argued, was then picked up and spread around Europe by the Roman empire, elaborated in the Renaissance, and passed down to modern times to the pinnacle of Western civilisation, which is Western Europe.

One of the biggest implications of this theory that ancient Greece made the West was that the West's increasing domination of the world was locked in in the distant past. Eighteenth- and 19th-century Western domination, the theory ran, was determined by very ancient forces and appeared to be a permanent situation.



However, as the 20th century rolled on, this long-term lock-in theory was challenged more and more by a range of competitors. For ease of reference, I like to call these short-term accident theories. The short-term accident theorists tended to say, 'Everything that those long-term people say, it's all wrong'.

The arguments against the long-term theories really picked up steam in the academy in 1980s and particularly the 1990s, and the

challenges to the old theories were driven largely by the increasing importance in the world of Japan and China. Their economic success undermined older ideas, and a bunch of new theories bubbled to the surface, suggesting that there's nothing locked in about the Western domination of the world. Nothing about it was determined deep in the past. Western domination, the newer theories suggest, was the outcome of a fairly recent set of accidents that tipped the West into an industrial revolution first, giving the West the ability to project power globally.

Over the last 15 or 20 years, the arguments between these schools of thought became very, very intense. I've read a fair amount of the stuff that's written—although by no means all of it—and the general sense I get is that the different groups of scholars are talking past each other. They're defining the key terms differently, using different methods, and applying different standards of proof. As a result, their arguments rarely connect directly.

As I started thinking more seriously about these problems, in the middle of the last decade, I came to feel increasingly that if we were going to have a sensible debate, what we really needed was some shared language and shared common ground for what the debate is actually about. I came to the conclusion that the debate is really about what, in my book, I call social development.

Social development is just a shorthand expression for the ability of societies to get things done in the world, to master their intellectual and physical environments and achieve the outcomes that they want from the world. In principle, at least, social development is something we ought to be able to measure and compare across time. If we could do that, I felt, it would become possible to make these long-term lock-in and short-term accident theories confront each other a bit more directly, by looking at the overall shape of history and seeing which theory describes it better. If the long-term lock-in theories are broadly correct, we should expect to see Western development diverging from that of the rest of the planet very early on; but if the short-term accident theories are broadly correct, we should expect Western development to look very like that in the rest of the world until very recently.

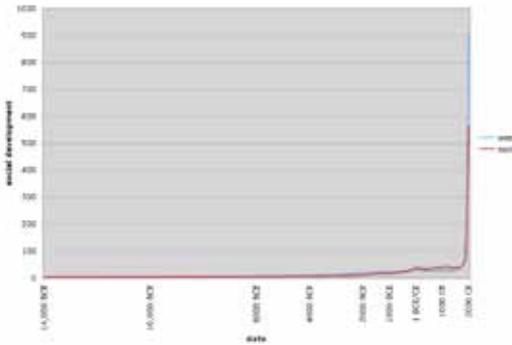
I wasn't optimistic enough to think that a numerical index for measuring social development over long periods of time would simply provide an objective answer to the question. There are so many assumptions involved in constructing numerical indices in historical studies that you can never make a serious claim that what you're doing is purely objective. But, having said that, I suspect that the most valuable thing about the numerical approach is that it forces you to be *explicit*. Even if you're not being objective, and people can always challenge the assumptions you do have to define exactly what it is you're measuring, how you're measuring it, why you're assigning a particular score on the basis of a particular kind of evidence. Then other people, if they don't like what you're doing, can look at it, criticise it, and suggest something different.

So what I decided to do was to ask whether there was something about Western social development that was different from what went on in the rest of the world, going back far into the distant past, or whether, in fact, the explosion of Western power and wealth really was a very modern phenomenon. The best way to do that, I felt, was by constructing a long-term index measuring social development in different parts of the world.

Now, some people (like me) love fiddling around with hundreds of graphs and charts, and I spent many months doing just that. I'm not going to bore you with all the details of what I did. I explain it a little bit in my book *Why the West Rules—For Now*, and I'm publishing a whole new book in 2012 called *The Measure of Civilisation*, which talks about nothing but the social development index. For now, though, I'll just say that what I ended up doing was to simplify the arguments by concentrating on just two parts of the world, what I just described as the Eastern and Western regions, and comparing their social development over a 15,000 year period. I chose 15,000 years because that takes us back to the end of the last ice age, which I think was a key turning point in world history. This was the point at which we begin to see very distinctly different ways of life emerging in different parts of the world.

What I asked was: if we take the two regions in the world that over the last 15,000 years have consistently had the highest levels of social development, which are an Eastern region (beginning in what we now call China, and expanding out from there) and a Western region (beginning in what we now call Southwest Asia, in the borderlands of Iran, Iraq, Turkey, Syria, and down the Jordan Valley), what sort of pattern does that produce?

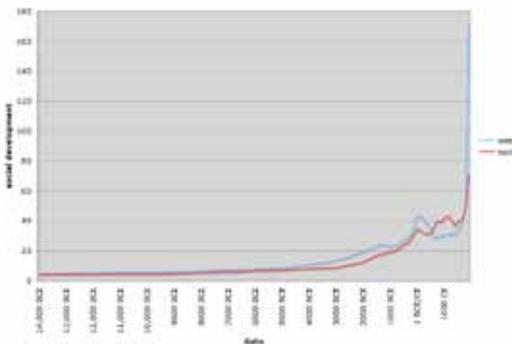
The index produced a graph showing levels of social development in East and West across 15,000 years, with the maximum possible score for societies in the year 2000 CE set at 1,000 points. Earlier societies score lower. And this is what the graph looked like:



The obvious thing about this graph is that it's rather difficult to see much going on in it. But that, in fact, is a large part of its value. I think there are two big things going on here. First, the Eastern and Western lines really seem very, very similar. This seems like a problem for the long-term lock-in theorists, who claim that the West has been distinct since time immemorial. Second, there was a dramatic change around the year 1800 CE, where the

lines shoot up almost vertically. But in fact the second of these observations, that the lines shoot up vertically around 1800, largely explains the first of the observations, that the lines look so similar. The Western score in the year 2000 CE is 906 points on the index, and to fit that on the graph, we have to compress all the earlier scores into a very small space at the bottom of the graph. It's not that nothing was happening before 1800; it's just that we can't see it.

The next graph just shows you exactly the same set of data, but ends in the year 1900 CE. What we see here is that there's actually quite a lot going on in the previous 15,000 years of history. History is not quite as simple as it seemed in the last graph.



A couple of quick comments about the patterns that we see here. First, we can now see that the Western line has been higher than the Eastern line for 90 percent of the time since the end of the last ice age. That, I think, is an interesting observation in itself; it's a very long-term observation. Second, the Western score was not ahead of the Eastern for 100 percent of the time since the end of

the ice age. This too is important: long-term lock-in theories imply that the blue line is *always* going to be higher than the red line, but it's not. From roughly 550 to 1750 AD—an enormous period, of 1,200 years—Eastern social development was higher than Western. For the whole of what Europeans call the Middle Ages and Renaissance, China is very much the centre of the world. This was the golden age of pre-modern Chinese invention and technology. This is a problem for the long-term lock-in theory. If the long-term lock-in theories really work you shouldn't have 1,200 years when Eastern social development was so much higher than Western.

There are other patterns in this graph too. Unlike the first graph, which made it look like social development was virtually stagnant for 15,000 years and then exploded, this one shows that it has been increasing across almost the whole period since the end of the ice age; it's just that through most of history the rate of growth has been imperceptibly slow. The graph also shows that there

were some periods when the upward movement of development accelerated, but also some when it levelled off, or even collapsed. If we really want to explain why the West rules (for now), we need to understand all of these phenomena.

I won't go on about all these patterns this afternoon, though if you want the full joys of the social development index, what you need to do of course is read my book. Right now, I just want to touch on four points about these arguments, which I think might be interesting in this context.

The first of these points is the explanation for this long-term pattern in social development. The explanation, I think, all comes down to one word: geography. History has not been driven by great men, or by culture, or by religion, or even by accidents. Although history is full of chaos and confusion, as we were hearing in this morning's talks, it's not these things that drive the long-term pattern. The biggest thing we've learned from genetics and archaeology in the last 15 years is that people are basically the same wherever we find them. Because of this, the societies that these very similar humans create all tend to develop along roughly the same lines. What makes the differences between these societies is the fact that the places they're in are different. It's geographical differences that have driven the different rates of changes in social development.

But what makes the story more complicated—and what made me write a 750-page book to provide this one-word answer—is that geography itself is a complicated matter. Geography determines social development, but at the same time social development determines what geography means. It's a two-way street, and it's the back-and-forth between geography and social development that make the centres of power and wealth shift around the world throughout history.

There are plenty of examples of what I mean. Leanne Piggott's comments about oil in her paper this morning actually fit the bill very well. Having all the oil in the world didn't really help people very much in the 17th century, when there wasn't a heck of a lot they could do with it. And having all the oil in the world may once again not help a nation very much in the late 21st century, if the oil-dependent economies innovate their way out of this dependence. Geography drives development, but development changes what geography means.

The most important example in history so far, I think, is the Atlantic Ocean, and I want to say a couple of words about it.

Through most of history, up till about the year 1400 AD, the main geographical impact of the Atlantic Ocean was as a great barrier between the Old World and the New World. Through most of history, living in northwest Europe was a great geographical disadvantage. You were stuck out in the Atlantic Ocean, which was the edge of the known world, far from the centres of action in China, India, and the Mediterranean. But after 1400—very abruptly, in the larger scheme of things—the Atlantic switched from being a barrier into being a superhighway. Part of this was driven by changes in organisation, as new types of states and markets developed, but the major transformation was the appearance of new communication technologies, new kinds of ships. Thanks to new maritime technologies (initially developed in China and on the Indian Ocean, but rapidly diffused across Eurasia) the Europeans were able to turn the Atlantic into the famous triangular trades that you see illustrated in this map.

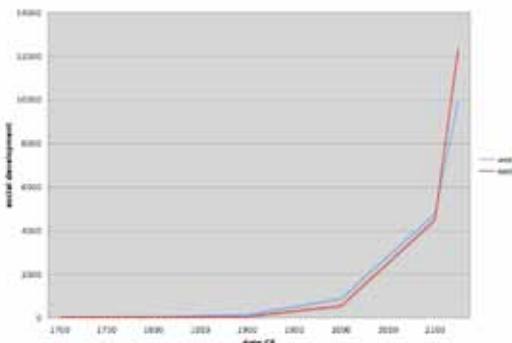


The Atlantic turned into a sort of a Goldilocks ocean. It was big enough that the continents abutting it had very different kinds of societies and natural resources, but small enough that by the 17th and 18th centuries European ships could zip around it, trading goods back and forth, setting off an extraordinary process of change. It was the change in the geographical meaning of the Atlantic that drove Europe into having a scientific revolution, an enlightenment, and an industrial revolution. It wasn't that Europeans were cleverer or more industrious than the Chinese or the Indians or the Arabs; it was the new meaning of Atlantic geography that sets off these revolutions.

As the 18th and 19th century wore on, technologies continued to change, and the meaning of the Atlantic kept changing with them. The Atlantic Ocean had effectively been shrinking since the 15th century, initially turning North America into a very important periphery to a European-dominated global economy; but as steamships, railroads, and the telegraph came in during the 19th century, North America changed from being a periphery into being an economic core in its own right. By 1900 it was beginning to displace Europe from the top of the pile.

In the 20th century, the shrinking of the world accelerated, and even the vastness of the Pacific Ocean ceased to be a problem. When the British started colonising Australia in the late 18th century, a large part of its appeal was that it was so far away, but in the 20 century the Pacific, like the Atlantic 300 years earlier, went from being a great barrier to being a great communication highway. And as geography changed its meanings, East Asia began to be drawn into the American-dominated global economy—until, by the end of the 20th century, East Asia is beginning to emerge as a new core in its own right, just as the USA had done a hundred years earlier. Geography and its changing meanings explain why the West rules—for now.

Now, that leads me onto the second of the points I'd like to draw out of my book. If I'm right, the implication is that once we've identified the motor behind the pattern of history, we ought to be able to project trends forward and get some sense of where things are going next. The next graph is an attempt to do just this.



Obviously, all kinds of assumptions are involved in making projections. For this graph I made very conservative assumptions, assuming simply that Eastern and Western social development will continue to increase across the 21st century at the same pace that they increased across the 20th. In reality, the pace of development seems to be accelerating, not staying stable, so any projection based on the assumption of linear

change will need to be modified; but this at least sets some parameters. If rates of change remain stable, Eastern social development will gain on Western, and will catch up—you should make a note of this in your diaries—in 2103. That's a nice, implausibly precise prediction to take home.

Given the assumptions behind this graph, what we should actually interpret it as meaning is that the second half of the 21st century we will see the West's lead in development over the East narrowing rapidly. I think what Saul Eslake said in his paper this morning was right: in terms of GDP growth, we're talking about years rather than decades for China catching up with the US. But social development is a much broader measure than this, and we're looking at a longer-term process.

The first implication of my book, then, is that the 21st century will see the West's lead over the rest of the world declining and then disappearing, but the second implication is that the process is being driven by geographical forces which are basically beyond the control of individuals or individual governments. Improving Australian productivity, revaluing the Renmimbi, and strengthening treaties within the EU are all important, in that they affect the shape of the curves and the precise point at which the lines intersect; but none of them are actually driving the process. Whatever our leaders decide, and whoever we vote for, geography will continue changing its meanings, and the West's lead will continue to erode.

The most important strategic decisions in the 21st century will be about how to manage this process, not about how to reverse it. We might, in fact, liken the position of Western governments to that of Byzantine rulers, nicely analysed by Edward Luttwak in his recent book *The Grand Strategy of the Byzantine Empire*. After the fall of the Western Roman Empire in 476, the geostrategic tide steadily turned against the Byzantine Empire; and yet it survived for another thousand years, and for much of this period was one of the wealthiest and most influential regions in the world.

The third point I'd like to pull from my book is also about the point where the Eastern and Western lines cross on the last graph. I've already talked about where the lines cross on the horizontal axis, in the year 2103. But we should also look at where they cross on the vertical axis, which is around 5,000 points on my social development index. Getting from the cave paintings of Altamira, 20,000 years ago, to the ASPI conference here in Canberra in 2011 represents an increase of about 900 points on the index; but the very conservative assumptions I make here imply an increase of 4,000 points during the 21st century. Four times as much change as we've seen in the entire history of the world since the end of the ice age.

That's a fairly mind-boggling prediction. The obvious question is: what would a world at 5,000 points look like? One thing we can be sure of: a world at 5,000 points will be so different from the world we currently live in that it's hard for us to imagine what it's going to look like. Many of the kinds of strategic issues that we worry about now will sure seem meaningless if the world does go to 5,000 points. Debates over the relative power and wealth of the East and West may just seem beside the point by 2103.

The fourth issue I'd like to draw out of my book, though, is more of a question: *will* the world reach 5,000 points? My graph of 21st-century social development scores rests on the assumption that 20th-century trends will continue, so we also have to ask ourselves what might prevent them from continuing. If we look back at the graph showing social development just till 1900, we can see a lot of ups and downs. Periods in the past when social development increased particularly rapidly were often followed by periods when it steadied off and even declined. Historians regularly call the periods of decline 'dark ages'. They were eras of great social collapses. The most spectacular

example was in the early 1st millennium AD, corresponding to the fall of the Roman Empire and the collapse of the Han Dynasty in China.

Whenever there's been a major collapse over a very large region in the past, the same set of five interrelated forces—the five horsemen of the apocalypse, I like to think of them as—has always been involved. Mass migrations that people are unable to control; the spread of new epidemic diseases (often very closely tied to the mass migrations, which merge disease pools that had previously been separate); state failure, which often comes as a direct consequence of the migrations and the epidemic disease; famine, which is usually linked tightly to state failure; and climate change, which in past times has been a kind of a wild card, not directly related to the other factors but always involved somewhere in the mix.

Now, you don't need me to tell you that these are five forces that people are talking about a lot in the early 21st century, and pretty much all of them have come up in the discussions that we've already had this morning. The possibility of the 21st century seeing a disastrous social collapse is very, very real. In some ways, the 21st century might be like a rerun of these great collapses we've seen in the past. In another way though, I suspect that if we are headed in the collapse direction, it'll differ dramatically from any previous collapse, for one obvious reason. The Romans didn't have one of these:



And we have a lot of these. I'm sure many of you all recognise this picture, of the biggest atmospheric nuclear test that ever happened, a 50-megaton Soviet bomb known as Tsar Bomba, detonated in 1961. Between 1986 and 2011 the number of nuclear warheads in the world fell by 95 percent, and we no longer have enough to kill everyone in the first few weeks of a war; but we've still got enough to kill most people, and we can ramp up and

build enough to kill the rest of the people very, very quickly if the mood takes us. That suggests to me that if we're headed in the social collapse direction, this is going to be a collapse unlike anything humanity has seen before.

To conclude: I think we can learn two big things from history. The first is that there's no new thing under the sun, as the Bible put it. The challenges we face today are very like those that have run right through the human past. History reveals the patterns that drive the world, and it allows us to project them forward to get some sense of what's coming next. But when we do this, we discover that the second lesson of history is that history teaches us nothing. The changes we're looking at in the 21st century may be like those in all previous centuries, but they'll be happening on such a scale and at such speed that the coming 100 years will be unlike anything that humanity's experienced before. These changes are going to dwarf anything that's happened previously. As I was writing *Why the West Rules—For Now* I in fact realised that that's not actually the most important question to be asking. A hundred years from now, this question, I suspect, is unlikely to be one that people are taking very seriously. It seems to me the 21st century is going to be a kind of great race, but not a race between West and East. Rather, it's going to be a race between transformations which will turn humanity into something we have trouble even imagining, and transformations which might just destroy humanity altogether. Which way we go will depend on our strategic decisions.

Australia in a changing world: modernisation, nationalism and geopolitics

Associate Professor Neville Meaney

In preparing for this forum and thinking about the theme I might take up in my paper I was struck after reading a wide range of scholarly journals on international relations and international politics by how much attention was being given to issues of economic and social change in the developing world, especially in East Asia. At the same time I was even more struck by the comparative scarcity of articles dealing with modernisation and nationalism, and it seemed to me that it might be a useful exercise to go back and look at the rise of modernisation and nationalism in the Western world and Japan to see whether there were any lessons or insights which might help Australia to understand more fully the future pattern of geopolitics in the East Asian region.

I approach this task with some trepidation. I am fully aware that history is full of surprises and that prophecy is the business of charlatans. Nevertheless as rational beings we have no choice in planning for the future but to draw upon the knowledge of the past, no matter how imperfect it may be, in our decision-making. And it is with a keen sense of its shortcoming and limitations that I have put together this paper.

The paper has three parts. The first deals with the relation of modernisation to nationalism, the second with the Western experience of nationalism, and the third with the relevance of that Western experience of nationalism to East Asia's modernisation and Australia's future strategic planning.

Modernisation and nationalism

Modernisation is the general term used to sum up the great forces which, beginning in Europe in the 19th century, first remade the Western world and now is in the process of remaking the rest of the world. The Enlightenment movement with its belief in human reason and human progress provided much of the intellectual underpinning for this transmogrification. With the application of science and technology to agriculture and manufacture, transport and communications, business and administration, the world of self-sufficient face to face village communities which defined traditional Europe and which from generation to generation had reproduced itself, disappeared. The old economic and social order could not resist the dynamic energy of these interlocking and mutually reinforcing changes. As peasant farmers and local artisans were drawn into and overwhelmed by modernisation's impersonal sectional, national and international economic systems they were confronted by a crisis of identity.

Modernisation brought with it a need for new ideas of self and society. It challenged deeply engrained assumptions that the past prescribed the future, that a person's birth and family status predetermined their role and place in society and it encouraged people to seek self-fulfilment and self-realisation, a view sometimes expressed in that very modern catch cry, 'you can be what you want to be'. Yet while these changes might seem normal and natural for those, like ourselves, who take these patterns of living and thinking for granted, this was not the case for those who had grown up in a world bounded by the cycle of the seasons and a fixed social order which gave them a settled sense of belonging.

For those uprooted from this traditional life modernisation was a profoundly traumatic experience. They increasingly found themselves living in great metropolises, alone in a mass society and at the mercy of economic and social conditions which were in a constant state of flux. In these circumstances they were at a loss to know how to connect to this disturbing and strange world and looked for ideas of social identity which would give meaning to their new mobile lives. And various ideas appeared to fill this need. Karl Marx who understood modernisation as exploitative capitalism called on its greatest victims, 'the workers of the world', to unite. But this international identity, while it had some influence in socialist movements and labour organisations could never overcome the appeal of nationalism. In this struggle for the modern mind the idea of culture nearly always trumped that of class and the idea of the people nearly always trumped that of the proletariat.

Nationalism's myths linked the past that had been lost with the disturbing present and the promise of a golden future. The major Western historians of the 19th century in their multi-volume works gave a scholarly authority and romantic aura to these new ideas of belonging. These historians traced out a teleological narrative of their respective peoples who each had from their origins in forests or on frontiers shared common blood, language and customs and had over time been engaged in a noble struggle against traditional overlords and foreign masters. Through state-sponsored mass education and mass literacy these ideas were rapidly spread and they were readily embraced. Nationalism had a powerful attraction for the modern imagination. It offered an intense social identity as a salve for the trauma of modernisation's isolation and anomie. In the nation the new moderns found the community that would make them whole and give them fulfilment, even if this should require self-sacrifice. It was a quasi-religion with its hymns and rituals, saints and martyrs, sacred sites and holy days. Its prophets and high priests spoke of the national 'soul'.

In the nationalised states it was the sovereign people not the hereditary princes who were the source of authority and as De Tocqueville pointed out after visiting America in the 1830s to study democracy the sovereign people could be more tyrannical than any crowned head of Europe. On the one hand in a caste based society the monarch and his subjects were divided by station and status and consequently there was always a gap between the two which qualified the subject's duty to his superior and could even justify rebellion. On the other each citizen in the nation was in principle an equal member of the people and to oppose the people was to be unfaithful to one's best self, to the very community through which one realised one's true self. George Bancroft the great American nationalist historian declared that 'The voice of the people is the voice of God', and so to betray the people was to commit the ultimate treachery for which there was no forgiveness. It was because of this assumption, inherent in nationalism, that denouncing a fellow citizen for example as being 'un-American' came to carry so much moral force. As nationalism came to inform Western societies people, with some exceptions, could only feel complete in a state composed of only and all those who shared the same cultural and racial myth, and so outsiders were often expelled or persecuted.

With the coming of nationalism the nature of war underwent a revolution. Modernisation not only provided the means for inventing and constantly improving technically advanced weapon systems but also produced a new attitude towards war. Nationalism roused popular feeling over issues of ethnicity and territory. Questions of national pride stirred up competition among the great powers as they vied for supremacy. National sentiment was a major cause of the outbreak of World War I and World War II. Wars became total as nation was pitted against nation in a struggle for survival.

The Western experience of nationalism

The end of the Great War ushered in the high era of European nationalism. This conflict had brought about the dissolution of the dynastic empires and the Paris peace conference had adopted the principle of national self-determination in drawing up new frontiers, a decision which in many respects only confirmed what the various ethnic groups in the midst of the war had already achieved for themselves. National self-determination did not, however, bring peace. On the continent where, compared to the British and Americans, most nations had come late to modernisation they felt the insecurity and anxiety more intensely. Many embraced authoritarian and totalitarian forms of government and accepted the rule of leaders who gave the alienated and disoriented order and purpose. This tendency to look for a strong answer to modernisation's socio-psychological problem was compounded by contingent factors such as irredentist movements and the Great Depression. In Germany's case the Weimar democracy was associated with the humiliating defeat in the Great War and as a result when the crisis moment arrived it lacked deep roots and strong loyalties which could be called upon to resist the allure of a tyrannical nationalism.

Even more than its predecessor World War II was the great nationalist war. And the most extreme example of nationalism's power over citizens' minds and lives can be found not in Nazi Germany but in Imperial Japan, the only Asian country that following the Western model had become a modern state. Japan, like Germany, had come late to modernisation. Determined to avoid the fate of other Asian peoples it had set out in the late 19th century to build up its economic and military power on Western lines. Though at the end of World War I Japan had adopted a form of parliamentary government it did not last. Ultra-nationalists supported by the armed forces denounced it as corrupt, divisive and foreign. With the coming of the Great Depression the democratic experiment was replaced by a fascist-type regime which focused loyalty on the divine emperor as the personal embodiment of the spirit of Japan. It instilled into the Japanese that they were a unique race superior to all others.

This nationalist creed was drilled into Japanese soldiers. They carried with them as part of their equipment a booklet, the *Senjinkun* or *Field Service Code*, which exhorted the men never to forget that for a Japanese death was preferable to surrender. And in the Pacific War the very small number of Japanese who became prisoners of war—most of whom were wounded and unable to resist capture—bears witness to the potency of these beliefs. For those who ended up in the enemy's hands the shame was intolerable. Most gave false names so that their families would not know that they had betrayed the Emperor and during their imprisonment they wrote no letters home and received no letters from home. Their sole aim was to seek death and so make peace with themselves. As a result in POW camps some attempted suicide, others engaged in provocative acts seeking a showdown with their captors and yet others thought of breakouts. But it was at a POW camp in Cowra, New South Wales where these nationalist beliefs were carried to their logical, if horrific, conclusion. In 1944 there were 1104 non-Commissioned officers and other ranks held in the camp and on 4 August learning that the Australian authorities were preparing to separate the NCOs from the other ranks the great majority agreed that the time had come to launch the long-planned breakout which had as its only aim to court their own death.

Of the 234 who died 183 were killed by gunfire and the rest committed suicide, some with the help of comrades. Two threw themselves under a Sydney bound train. Others when captured pleaded

with their Australian guards to shoot them. Kanazawa Ryo, their leader, in trying after the event to explain the POWs behaviour, declared that 'It was the Japanese spirit which we always have in us which was the reason for the breakout.' These Japanese POWs were willing to accept the most extreme demands of nationalism and to redeem their honour by committing a form of *seppuku*. Contemporary suicide bombers only sacrifice their lives for the purpose of inflicting damage on the enemy.

By the end of World War II the victorious English-speaking countries had come to believe that their liberal nationalism was normal and that the type of nationalism practised by the defeated Europeans and Japanese were a perversion, arising from adventitious factors. On this assumption the British in granting independence to their Asian and African colonies had left them with model constitutions based on the Westminster system of parliamentary government. The Americans for their part gave the newly-independent states very generous economic assistance to hasten on modernisation or what was called nation-building. Despite the example of Germany, which at the point of the Nazi coming to power had been the most highly educated country in Europe, the Americans believed that with the creation of an educated urban middle class the Third World countries would quickly become liberal democracies and side with the West in the Cold War. Yet in the event nearly all the constitutions were ignored or subverted and military regimes, one party states and ethnic and tribal conflicts, became the dominant pattern and most of these new states opted to stay neutral in the East–West conflict.

Simultaneously the West itself was entering into a post-nationalist stage. The democratic Europeans were coming to terms with the psychological anxieties brought on by modernisation and were learning to live with the permanence of change. Spurred on by World War II's great costs in lives and treasure and the need to revive their economies, the French and Germans, formerly the chief antagonists in the wars of nationalism, founded a European Economic Community which grew by stages into a European Union. The EU has come to possess all the institutions of a state and many of its functions. It defines itself in terms of civic values. New members are required not only to have some geographical affinity but also liberal constitutions and respect for human rights. This new political community is not based on a European myth of race and culture but on a liberal ideology of tolerance and openness. Even though individual members still retain power over key areas of policy such as defence, taxation and education they eschew the exclusiveness of the past and see themselves as multi-cultural societies. The old nationalist histories which had been the source of inspiration for these societies as they modernised now gather dust on bookshelves or are treated as documents for scholarly research. Nationalism in Europe has ceased to be a dominant influence in defining state and society.

I'll now turn to East Asia, which is in the early stages of modernisation, to see whether East Asia is likely to follow the Western example and if so what are the possible consequences.

For this purpose I propose to look at China and Indonesia, the nations that are most important for Australia's economic and strategic security. I want to see to what degree the West's experience with modernisation and nationalism offers any insights that might be helpful in assessing these nations possible future role in the Asia–Pacific region.

To take China first

There is a large body of opinion which holds that the 21st century is to be the Asian or Asia–Pacific century and that China will be the prime driving force in creating a new regional order. In the eyes of many, Napoleon’s famous prediction that when the sleeping giant China awoke it would shake the world seems to be about to come true. It is widely held that if China’s GDP continues to grow at the rate achieved in the last three decades it will by 2030, if not earlier, overtake that of the United States. This has led to many commentators forecasting that China, like all rising great powers, would in due course demand its place in the sun.

This conclusion, based on a simple linear projection of China’s economic development and a similarly simple assumption that China could parlay, ignores internal social and political dynamics. The Chinese have not yet experienced the normal booms and busts of capitalism. They have not seen a major economic recession let alone a great depression though some argue that the protests leading up to the Tianamen Square massacre were precipitated by an economic downturn. If such a major nationwide economic crisis does take place it is likely that all the tensions inherent in modernisation will come to the fore and the Communist Party’s claim to a right to govern will be tested to the full.

It is doubtful whether the Communist Party will be able to retain its ‘Mandate of Heaven.’ As we have seen people need myths to connect them to society and to legitimise their allegiance to the state. But these myths have to be credible. While the Marxist philosophy of the Chinese revolution still informs the rites and symbols of the state this definition of China has to a very large extent lost its virtue. In schools and universities the required courses on Marxism are no more than formalities. In the country at large the practice of capitalism has made a mockery of the promise of communism.

The Communist leaders, recognising this, have already taken steps to strengthen their claims to be nationalists. They suppress ethnic Tibetan, Uighur and Mongolian secessionists in their outlying provinces, defy Western critics who make heroes of Chinese intellectual dissenters and denounce Japan’s school readers that downplay its imperial past, especially its responsibility for the Nanjing massacre. Indeed the latest Chinese history textbooks in Shanghai make gestures towards a new nationalist sensibility. The controlling narrative is no longer set in terms of class warfare, of the Marxist dialectic of slavery, feudalism, capitalism and socialism but rather takes the evolution of Chinese civilisation, of its 5,000 years of continuous history, as the central unifying principle. They have to a large extent expunged the peasant revolts from the story and instead heap praise on those who have fought for national unity and harmony.

What will proceed from this discarding of the post-1950 revolutionary myth is unclear. Some Western scholars, especially Americans, are inclined to see liberal economics leading to liberal politics and the Chinese moving step by step towards something approaching a Western-type democracy. If these optimists prove to be correct then Francis Fukuyama’s claim that the fall of the Soviet Union marked ‘the end of history’ might seem more plausible. But lacking any experience of multi-party democracy, peaceful transfers of power, loyal oppositions, separation of the executive and the judiciary this Western vision does not seem to offer a feasible prospect.

The more likely outcome is that the Communist party will by attempting to exploit a widely shared folk memory of a 200-year history of humiliation at the hands of Western and Japanese imperialists remake itself as an anti-Western nationalist party. But whether this transition would, following the pattern of the Soviet Union, be achieved without stirring up internal divisions is an open question. Much will depend on the People's Liberation Army. If the ideological revolution were carried through peacefully then the new rulers might create an authoritarian or totalitarian nationalist regime not unlike those that spread through Europe in the first half of the last century. If this were to be the case then it would in all likelihood suppress even more rigorously the non-Han ethnic communities in the western provinces, annex Taiwan, push more forcefully for control over the disputed rocky outcrops and the surrounding seabed resources in the South and East China seas and demand respect for the Chinese diaspora in Southeast Asia. The first is fully within its power. The second, analogous to Hitler's march into Austria, might well be accomplished without American intervention. The third would be riskier in that it would stir up anti-Chinese feeling along the whole western Pacific seaboard and would create a much greater possibility of American intervention. The last, though responding to strong domestic national feelings, would, if the Chinese were to attempt to use force, face them with logistical difficulties and would have the effect of uniting Southeast Asia against the Chinese, and cause the Americans to take counter measures. This latter alternative though, in form it might have some similarities to Nazi Germany's claims on Sudetenland, is not for a number of reasons comparable. Would the hubris of superpower nationalism tempt China to take great risks? Would it replicate the fanaticism of the Japanese in the era of the Pacific War? Probably not. Any military confrontation between China and America though begun with conventional weapons would have within it the likelihood of escalation to a nuclear war and both superpowers being haunted by the memory of the Cuban missile crisis are not likely to take risks which carried the possibility of a nuclear war.

Australia's 'arc of instability' and Indonesia

Since the end of the Pacific War, Australia's national security planning has been concentrated first and foremost on its archipelagic frontier which stretches from Indonesia in the west to Fiji in the east. It is this immediate neighbourhood for which Australia must take prime responsibility and it is for this reason that it is the prime concern of policymakers. All these island states have in the post-independence era had much trouble in establishing fixed and efficient forms of governance. Indeed around the turn of the 21st century they were subject to so many disturbances, such as the Asian financial crisis, the overthrow of the Suharto military regime in Indonesia, the East Timorese struggle to free themselves from Indonesia, the breakdown of law and order in PNG, the violence and anarchy in the Solomons and the military coup in Fiji, that some reporters and politicians referred to the whole region as an 'arc of instability.' Though with the seeming settlement of the major problems this rather patronising phrase has now disappeared from the lexicon of defence and diplomacy nevertheless it does sum up an unhappy truth about these states. The people of these former Western colonies are suffering from the trauma of a compressed form of modernisation, including physical dislocation, political instability and socio-psychological anxiety. Thus it is important for Australian policymakers to recognise that these problems are not just passing difficulties but structural ones arising out of modernisation.

To illustrate the nature of this peculiar Australian strategic challenge it is fitting to take the case of Indonesia. Indonesia overshadows all the other island states. It has ten times the population of Australia and is the fourth most populous country in the world. Its GDP is only 60% of Australia's but with a 6% annual growth rate it is fast closing the gap. It contains extensive reserves of energy and mineral resources and has a substantial and diversified industrial sector and, like Australia, has a seat at the G-20 meetings of the world's leading economies. It is the dominant power in ASEAN, possesses a 300,000 strong armed-force and apart from PNG is Australia's nearest neighbour.

From the time that Indonesia gained its independence Australia has seen its neighbour as its most critical national security problem. Dangerous differences have arisen over many issues, including the fate of Netherlands New Guinea, the Konfrontasi of Malaysia, the Indonesian annexation of Portuguese Timor, the infringement of PNG's borders and the East Timorese struggle for independence. Australia, since the initial clash over West New Guinea, has managed its Indonesian relationship with considerable skill. Even at the time of the Konfrontasi when Australian soldiers were fighting against Indonesians in the jungles of Borneo, Canberra did not break off diplomatic relations with Jakarta, did not halt its aid programs nor force Colombo Plan students in Australia to return to Indonesia. It was also very hesitant in committing its troops knowing that when the British departed it would be left to deal with the legacy of Indonesian ill-will. Moreover at these tense moments successive Australian governments have used their influence to discourage the press from embarking on anti-Indonesian crusades. As a result, these sharp differences that carried within them the possibilities of major conflicts were resolved without lasting damage to the relationship.

Since America's defeat in Vietnam and Britain's withdrawal from East of Suez, Australia has at every opportunity tried to improve the relationship with Indonesia. Australia's 2009 Defence White Paper repeats in substance the principles of post-1975 defence reports. It asserts that Australia's defence should be based on 'the principle of self-reliance', that its immediate neighbours are not a source of threat to Australia and that Southeast Asia, including Indonesia, is of great strategic importance because any attack on Australia must come from the north. In addition it has a very positive view of Indonesia's development over the last decade, especially its multi-party democracy, economic reforms and cooperation in fighting terrorism. The White Paper envisaged that Indonesia would be a secure and cohesive partner in the region.

There remains, however, some difficult problems, all of them connected to the bigger problem of nationalism.

First, there is the problem of Indonesia's political stability. It is questionable whether Indonesia's present liberal democracy will survive the testing times that lie ahead. Since independence it has experienced four distinct political forms of government, a federal democracy, a 'guided democracy', a New Order military dictatorship and finally a liberal democracy. The belief that once a liberal democracy is established it will necessarily endure is too easy an assumption. Western liberal democratic forms have difficulty in establishing themselves when adopted by a society with a very different culture. In Thailand, Cambodia, the Philippines, Sri Lanka and Pakistan their experiments with liberal democracy have not given these states political stability. Liberal democracies need more than written constitutions and elections. They require popular acceptance of quite complex institutions and conventions. Indonesia's independence leaders were not like India's founding

fathers educated in British universities where they were introduced to the Westminster tradition of parliamentary government, a tradition which has been passed on to subsequent generations of their compatriots.

Second there is the secessionist issue. While Indonesia has no reason to fear external threats it is highly probable that it will continue to be troubled by secessionist movements. Already President Yudhoyono, in order to make peace with the Aceh rebels in northern Sumatra, has granted the province a very large measure of autonomy. As a result of the bargain Indonesian troops have been withdrawn from the province, a former rebel has been elected governor and elements of Sharia law have come into force. Whether this degree of independence will satisfy the Acehnese is a moot point. Whatever the outcome the peace terms do challenge the integrity of the country and weaken the authority of Jakarta.

Papua at the other extreme of the island nation also has a separatist movement though it is not as well organised as its Aceh counterpart. From the 1970s some indigenous Papuans unhappy with being under Jakarta's rule have been engaged through OPM (Organisasi Papua Merdeka or Free Papua Organisation) in a struggle for independence. Yudhoyono has granted Papua the status of an autonomous province and the right to elect their own government but since Javanese migrants are said now to outnumber the native people this will not appease the insurgents. It is possible to imagine that OPM will in the future attract more sympathy from their fellow Melanesians and Christians across the border in Papua New Guinea. Such a development, however, would carry great danger for Port Moresby. If the Indonesians responded aggressively, it would also pose a serious problem for Australian decision-makers. It was this problem which for the Indonesians was at the core of the 2006 Lombok agreement in which Australia promised to 'respect and support' Indonesian 'territorial integrity, national unity and political independence' and not to support any persons who were engaged in separatist activities. The Indonesians fear that Australia will, following the East Timor precedent, provide refuge for fleeing rebels and thereby become a support base for the independence movement.

Third, there is the problem of Indonesia's nationalism. Unlike China it does not have the ingredients for a unique narrative about a people of common blood and common culture. At the establishment of the Republic there was a search for a philosophy to give meaning to the nation. Almost from the outset the *Pancasila*, five principles—belief in God, a just and humane world, the unity of the nation, consensus democracy and social welfare—was adopted for the purpose and incorporated in the Constitution. But the *Pancasila* derived from a Western liberal tradition. It did not give the Indonesian people a mythic past of their own which defined them as a unique nation and legitimised their territorial boundaries.

By the time that President Suharto came to power the era of the founding fathers was over and the appeal of anti-colonial nationalism was fading. Challenged by separatist insurgencies in Aceh, East Timor and Irian Jaya, Suharto recognised that *Pancasila* could not, in its then form, provide the national cement which could keep the nation together and so he set up a Culture and Education Department to 'indigenise' the *Pancasila*. The Department 'found' long established native sources, mostly in Java, for all five principles, and so claimed that these values were derived from Indonesian

tradition. This nationalist version of *Pancasila* was spread through the universities and the military training schools and has been widely welcomed.

But this version of a secular nationalism may, as in some other predominantly Islamic countries, have to contend with a religious alternative. Since the fall of the Suharto regime Islamic parties have entered politics and attempted to amend the Constitution to oblige all Muslims to abide by Sharia law. But even though the country is almost 90% Muslim the national parliament rejected the proposal. Even if the main Islamic parties did have a majority in parliament it is unlikely that the army would accept a theocracy. Indonesia is undergoing a massive modernising process and is suffering from acute social dislocation, uncontrolled internal migration, and mega-urban sprawl. What Jakarta will do under pressure from the ensuing socio-psychological anxiety remains an open question the answer to which will have important repercussions for Australia and its relations with Indonesia. Indeed it might turn out to be the key strategic issue which Australia will have to face in the future.

Coming to the end I have to admit that carrying out this analysis of East Asia in the light of the history of Western nationalism I have not taken into account the great difference in the international framework between that time and this. Today there are many world institutions such as the IMF, the WTO and the UN. Unlike the League of Nations, the United Nations has a universal membership and has a very active role not only in humanitarian, social welfare, health and cultural affairs but also in peacekeeping and peace enforcing. Furthermore as a result of the globalisation of the world's economies and the widespread systems of digital communication peoples have connected across frontier barriers and are linked by an extensive range of professional and other activities. There is also a growing awareness that nations have a common interest in cooperating to solve problems that affect the survival of the planet, such as global warming, environmental destruction, pandemics and spread of WMD.

But even after making some allowance for these global ideals and interests, it is important to recognise that the process of modernisation in East Asia, as in other parts of the world, is still proceeding, and it seems not impossible, looking back at the Western experience, that the developing great powers like China and Indonesia might still adopt an aggressive nationalism that would disturb the peace of the region and even bring about military conflict. It might therefore seem wise for Australia to take this potential threat into account when making geopolitical assessments and deciding on strategic policy.

Australia's next Defence White Paper: an ASPI update

Major General (Retd) Peter Abigail

Introduction: policy as prologue

In this final presentation we turn our attention to the realm of policy, and the responses crafted by the Australian Government to the patterns and influences we have considered in earlier presentations and discussions.

Given that this Conference coincides with work being undertaken within the Department of Defence to update the 2009 Defence White Paper—albeit by means of revised and classified Defence Planning Guidelines which won't be seen in the public domain—it seems appropriate that we look at some of what might be considered.

So my task is to canvass some of the issues in this 'ASPI Update' and, as is often our practise, to pose some questions to be considered in the lead up to the next Defence White Paper, which is forecast to be released in the first quarter of 2014.

But, before I get to those questions I will revisit the foundations established in 2009, and look at some of what has occurred since.

Defence White Paper 2009

Strategy

The Defence White Paper, titled *Defending Australia in the Asia Pacific Century: Force 2030* and released by the Rudd government in May 2009, received a mixed reception both in Australia and overseas. It has been described variously as 'confused' yet 'overly prescriptive'; 'naïve' but 'unnecessarily belligerent'; and proposing a force structure that is 'insufficient for the declared tasks' but, nonetheless, 'underfunded'.

It was clearly a political document designed to marginalise the Coalition on strategic policy, return to 'classical' themes concerning the use of force, reverse the more contentious elements of the Howard defence policy, and rebuild the linkages between strategy, force development and resources.

Its key messages are classical ones: the main role of the ADF is to engage in conventional combat against other armed forces; Australia and its immediate neighbourhood are our top strategic priorities; and maritime forces should be at the core of our defence force.

Self-reliance remains at the centre of our defence policy but is to be bolstered—a 'self-reliance plus' approach—that will provide strategic weight to cater both for the direct defence of Australia and our unique interests and a capacity to do more when required in pursuit of shared strategic interests, within the limits of resources.

In sympathy with this shift the geographic force structure determinants for the Australian Defence Force (ADF) were expanded: from the seemingly-rigid Defence of Australia construct that had applied since 1987, to Australia and the neighbourhood, and even beyond, allowing capability enhancements for wider regional contingencies.

I won't rehearse the full analysis of strategic trends that underpinned the policy outcomes. They have been covered by other speakers and our earlier discussions. Suffice to say here that the White Paper described a highly complex and uncertain strategic picture of the Asia–Pacific Century.

One characterised by: fewer reliable 'pillars' in the global system; questions about the trajectories of Asia, China, Japan, and Indonesia; increasing multi-polarity driven by changing patterns of economic power and political influence; and, tensions where the interests of the US, China, Japan, India and Russia intersect.

The White Paper recognised two possible futures for Asia, two for US strategic primacy, two for China, two for Japan, and two for Indonesia. It concluded that there can be many plausible futures for the Asia–Pacific, 'strategic shocks should be expected at some stage in the foreseeable future', and 'the range of uncertainties is disconcertingly wide'.

It judged it too early to tell what might happen and therefore prudent to hedge against adverse outcomes. Nonetheless, the darkest clouds on our strategic horizon—when fundamental changes to the strategic order might be realised—were assessed as beyond 2030.

For the authors of the White Paper the one constant in this changing world was found in the South Pacific where economic stagnation, political and social instability, weak governance, crime, natural disasters and climate change worries would continue to attract Australia's historical, humanitarian and strategic interest.

Australia's abiding strategic interests within this highly-variable composite were confirmed as: a secure Australia, a secure immediate neighbourhood, strategic stability in the Asia–Pacific, and the maintenance of a stable, rules-based global security order.

Nothing really exceptional in any of that.

But, in one sense, the Defence White Paper was ground-breaking. It was the first public policy statement by a US ally that attempted to come to terms with the power shifts underway in the Asia–Pacific and raise questions about the durability of US strategic primacy. It lifted what had been academic, commentarial and officials' discourse into the realm of declared policy and, therefore, attracted quite a bit of attention, particularly in Beijing and Washington.

Implicit strategic objectives

Much of the commentary about the 2009 Defence White Paper focused on the coverage of China, its rise and the implications for regional security. This was understandable, but somewhat overplayed.

To my mind, the White Paper narrative is not just about China and the United States, although they are obviously important factors. It is also about the growth in general across the region of a range of countries, including India, whose populations, economic and military power, and influence are set to rise in ways not previously seen in the modern era.

This trend will see a relative decline in our economic standing and the steady erosion of Australia's relative strategic weight and military capabilities compared to our region. In concert with the increasing availability of advanced military technology the maintenance of Australia's military capability edge is highly questionable.

So, the government focused appropriately on our security solution and the challenge these strategic trends present to; first, our strategic aspiration to be self-reliant and play a significant role in regional security affairs; second, the challenge to our long-held strategic assumption about the durability of US strategic primacy in the Asia–Pacific; and third, the challenge to the key strategic enabler of providing or securing the resources needed to develop and sustain the requisite defence capabilities throughout all phases of the economic cycle and out to 2030.

I contend that responding to these challenges lies at the heart of our defence strategy in the form of three implicit—but undeclared—strategic interests or objectives:

- Ensuring Australia’s strategic weight and role in the region
- Managing shifts in United States’ strategic primacy in the region
- Sustaining adequate Defence funding.

Capability focus

In terms of Australia’s policy responses to a changing strategic environment—one offering potentially fundamental changes—the White Paper focused almost exclusively on Defence capability.

But, it’s worth noting that the force structure proposals were based more on replacements and prudent planning rather than a strategic imperative: most new capability funding was (and is still) scheduled for the 2020s. This leaves open considerable flexibility to the government: there are still at least six federal elections, four defence white papers and eighteen budgets before we reach 2030. But the scheduling also signals a lack of urgency which is, perhaps, evident in the delays in the progression of a number of major capability projects to date.

The capability proposals were designed to confront the two challenges—to our strategic aspiration and our strategic assumption—by strengthening our self-reliant capability. This would enhance our middle-power status and capacity to act in our own interests unilaterally and remain an active player in regional security affairs, whilst also helping sustain US military predominance in the wider Asia–Pacific if needed.

The focus for new capability proposals was clearly on the Navy for a number of reasons: the challenges presented by the shifting power framework would necessarily play out in the maritime domain; the timeframe to 2030 embraced a period in which virtually all the Navy’s ships would need replacing, the Air Force had been addressed previously and was facing the most ambitious program of fleet replacements since the Second World War, and the Army’s focus was devoted to its ongoing operational commitments.

Nonetheless, the government did also put a ‘toe in the water’ in the way of hedging investments on a range of what it termed ‘emerging capability priorities’: that is, high-end warfighting capabilities such as space capability assurance, ballistic missile defence and counter-WMD capabilities.

Resources and reform

To pay for all of this the government declared its commitment to a funding model that continued the Howard government’s pledge of 3% real growth to 2018/19, then stepping down to 2.2% growth until 2030, with price indexation set at 2.5% across the entire period.

There was also recognition that the ‘good times’ were over, and Defence needed some serious ‘trimming’. The vehicle for this is the Strategic Reform Program which requires Defence to free up some \$20 billion over ten years to be reinvested into new capability.

The net result of these measures was that, in May 2009, funding for Defence was set to increase by some \$130 billion over the period to 2030. My colleague, Dr Mark Thomson, was quick to point out that this would not be enough to deliver and sustain the proposed capabilities.

It’s important to note that the process of finalising the 2009 Defence White Paper ran in parallel with the unfolding drama of the Global Financial Crisis. The ensuing turmoil didn’t impact on the analysis or capability proposals advanced in the defence policy document because the crisis was seen as transitory in strategic terms. But its effects became obvious when two weeks after the White Paper was released the Federal Budget deferred over \$9 billion in expenditure to beyond 2016.

Finally, for those who like to present the notion that Australia will at some stage need to make a choice between its primary economic partner and its primary security partner, in my view the government signalled its ‘choice’ in the Defence White Paper: and it’s a choice based on growing concerns about the security environment, common values, shared strategic interests, defence and security benefits, and strategic culture.

What has changed since 2009?

So change came quickly upon the implementation of the Defence White Paper. And, more has happened since; in a strategic context, on the global economic front, and through the government’s review of Defence practices. I’ll mention just a few issues.

China’s ‘charm offensive’ stumbled

The most notable strategic development in the past couple of years has been China’s increasingly assertive position in territorial disputes which has unnerved many of its Asian neighbours. The ‘charm offensive’, which has been the hand-maiden of the doctrine of ‘peaceful development’, stumbled as Chinese military and diplomatic actions ranging from the Korean peninsula, to Japan, to the Yellow and South China Seas ignited concerns about China’s behaviour and future possibilities.

For a period during 2009 and 2010 the ‘fog’ of uncertainty that characterised the Defence White Paper’s assessment lifted briefly, and it seemed that the ‘darker clouds’ might be closer than we thought. Things were certainly happening faster than had been anticipated.

At ASPI we noted this increased assertiveness in our dialogues with Chinese counterparts which included a new narrative built around the ‘20 years of strategic opportunity’ first foreshadowed by Deng Xiaoping.

The combination of China’s confidence in successfully weathering the worst of the Global Financial Crisis, the apparent debilitation in Western economies, and the strategic distraction of the United States beyond East Asia, seemed to add an edge to the opportunities available to China during the coming decade or two. This included the Taiwan Strait and a sense that the balance of military capabilities in that area was swinging in China’s favour and limiting US options.

China's rapid military modernisation is attracting increasing attention throughout the region. Whilst on one level their military development plans are both transparent and rational—the idea of defending your maritime approaches should resonate with an Australian audience—on another level they remain opaque and concerning, particularly when looking at strategic intentions and capabilities with strategic reach, including in cyberspace.

But, China's future will not be a simple linear progression towards regional dominance: the country faces more concerns internally than externally; it must contend with other strong regional players; and it is, in a strategic sense, alone. China's military is still a work-in-progress and the relativities will remain in favour of the US and its allies for many decades to come. And, importantly, China is tightly integrated into the international system and shows no sign of becoming a revisionist power.

China might have over-reached in 2009–2010. They might have been 'testing the responses' of other nations. They certainly attracted attention and prompted some push-back by regional neighbours as well as the United States. More are becoming attuned to the need to strengthen existing and emerging relationships as a strategy to deter Chinese adventurism. Having stumbled, the question is: can the Chinese regain the initiative?

It's worth remembering that power and influence are about getting one's way; whether through deterrence, dissuasion, cooperation, persuasion or coercion.

Many regional countries, including Australia, fear coercion by China (if not now, then in the future) and would prefer to operate in the dissuasion – cooperation – persuasion middleground. And, in this space behaviour is more important than words. But, it's not likely that China will secure all its strategic interests through diplomacy alone.

Hoping for the best is not a strategy. In the emerging Asia all would prefer a strategic balance rather than predominance by any one power.

And the sensible approach towards China is to accept its great power status, accommodate its expanding needs and interests, build a constructive relationship focusing on shared interests, and to hold it to account in the rules-based international order.

US 'awakening': a recalibration of strategy and 'reinvigoration' of regional relationships

China's behaviour, and the regional reactions to its assertiveness, has run in parallel with a recalibration of US strategy and a reinvigoration of regional relationships to reassure its allies and friends that America remains engaged in the Western Pacific.

Since 2009 a steady stream of US officials has carried messages of reassurance around the region. And, in late 2010, the President and his Secretary of State visited ten regional countries, including Japan, Korea, Vietnam, India and Australia. This heightened engagement has been unambiguously welcomed by most regional nations.

It's reasonable to conclude that the United States and China are in the initial stages of a serious strategic competition in the Western Pacific, the outcome of which is unpredictable.

Australia has confirmed its strategic 'choice'

And, Australia has confirmed the strategic 'choice' implied in the 2009 Defence White Paper.

Through the Australia – United States Ministerial Meeting in Melbourne in November 2010, the Prime Minister’s speech to the US Congress in Washington and recent announcements about Australia’s Defence Force Posture Review being linked to the US Global Posture Review, the message has been clear.

Australia is very much on the front foot in encouraging and supporting US engagement in the region, and is prepared and preparing to do more within the alliance and beyond to maintain strategic stability in the Asia–Pacific.

It is noteworthy that Paul Wolfowitz, in a recent speech in Sydney, saw an important role for Australia as a true US ally in the region—and reassurer—as it had been in the late 1970s.

The Indian Ocean is getting more attention

The Defence White Paper flagged the increasing importance of the Indian Ocean region in Australia’s strategic calculus because of the growing power of India, the critical trade routes flowing through it, the increasing fragility of some littoral states, including Pakistan, and the prospect of the region becoming a venue for strategic competition between great powers.

Pakistan is emerging as the key strategic concern and threat to stability.

The Horn of Africa and the southern Arabian Peninsula have become a focal point of concern about international terrorism, piracy and illegal trafficking.

India’s potential greatness and strategic ‘balancing’ role remain well short of being realised and the country suffers from a wide range of internal ‘issues’ that delay its development. Nonetheless, India’s economic growth is impressive and efforts to enhance Australia’s strategic relationship with the world’s largest democracy should be pursued.

Australia’s upcoming leadership role in the Indian Ocean Rim Association for Regional Cooperation (IOR-ARC)—as Vice-Chair to India’s Chairmanship of the forum until 2013, when Australia will take over as Chair—could provide opportunities for some coordinated action on shared interests.

Australia’s attention to Indian Ocean affairs is on the up-swing. The recently announced Defence Force Posture Review will examine options for increased military presence in the region, looking both on-shore and at our off-shore territories. This review will be coordinated with the US Global Posture Review in considering options for increased use by US forces of Australian facilities in Northern and Western Australia.

Indonesia starting to contemplate its future role

The great power strategic competition is starting to ripple through Southeast Asia, compelling the nations of ASEAN to give more priority to international security issues. The South China Sea disputes are the central concern of the claimant states and have energised the group to seek multilateral crisis management solutions. Progress is slow and halting although headway is being made.

Within ASEAN, Indonesia’s political and economic development is lifting it back towards the position of pre-eminence it enjoyed two decades ago, and this is prompting an internal discussion about the nation’s future role, regionally and more widely.

Australia's relations with Indonesia continue to improve—despite occasional diplomatic 'hassles'—and there is much to be gained from continuing encouragement and support for Indonesia's reform and development programs. And, there is also much that could be gained from a significant enhancement of our strategic partnership under the terms of the Lombok Agreement.

Arab 'Spring': too early to tell

The post-post-colonial revolutionary movements sweeping across the Arab 'world' caught many by surprise, but are yet to realise their desired outcomes. Perhaps, we are still looking at the 'seeds' and not the 'fruits' of revolution.

However, it is reasonable to predict that the underlying sentiments of the protesters will not fade away. The region—stretching across North Africa to the Persian Gulf—faces an era of ongoing instability, mixing the politics of oil with the politics of religion, interspersed with potential geopolitical realignments.

This carries global implications given the strategic importance of the region and the potential for further distraction of the United States away from its Asian 'awakening'.

Global Economic Crisis (Mk 2)?

One of the global implications could be to compound the difficulties of recovering from a further global economic downturn—if not recession.

The picture looks grim and should the worst happen the West could face a decade of economic difficulties and dissipation of power; whilst a global contraction would have adverse impacts on all parties to Asia-Pacific security. The open question might be one of relative impacts.

Force 2030 will be late, anyway

Whatever the outcome for the global economy, one program much closer to home seems destined to fall short of its declared intent. Force 2030 will probably be delivered late.

The deferrals of billions of dollars in procurement funding and delays in decision-making for major capability projects have already put the Defence Capability Plan well behind schedule. The bow-wave of unspent funds now laying five-to-ten years out dwarfs the expenditures achieved over recent years.

This raises serious questions about the capacity of the Defence enterprise to deliver that additional capability in the time remaining, should it still be required.

Eight questions leading to the next Defence White Paper

Which brings me to the other questions I suggest should be considered before we leap into the next White Paper process.

Some are drawn from points made earlier; others are more derivative.

All have a strategic dimension, although four might be termed grand strategic issues, and four look at matters of capability.

All are framed by the premise that by 2014 we may well have moved from a prudent planning approach towards one driven more by strategic imperatives.

In framing these questions I've assumed the continuing application of the implied strategy and unstated strategic objectives I attributed earlier to the 2009 Defence White Paper:

- Ensuring Australia's strategic weight and role in the region
- Managing shifts in United States strategic primacy in the region
- Sustaining adequate Defence funding.

And I note that we should have some answers from the reviews directed by the Minister for Defence, such as that on the ADF Force Posture.

The first question deals with our national identity and strategic culture, picking up on a theme introduced in the recent ASPI publication, *Forks in the river*.

Does Australia seek security from Asia, security with Asia, or some selective combination?

The 2009 White Paper tells us: we take sovereignty and freedom of action seriously; we're still nervous about our neighbours; we're nervous about US abandonment; we like rules-based orders at the global level, but trust power closer to our shores; and, we still think of our defence as 'core issues plus add-ons'.

It focuses on enhancing the US alliance and our self-reliance and mentions, almost in passing, the hierarchy of strategic relationships we have in the region.

Perhaps, we need to think more deeply about the types of strategic relationships we might need with the new Asia.

And, as an aside, the next Defence White Paper should have a companion national security strategy and foreign policy white paper.

What are the strategic implications of an extended global economic contraction?

This might not happen, but if it does we need to do some serious thinking about the strategic implications.

An extended contraction—say, up to five years or so—might not change the fundamental strategic order in the Asia-Pacific. But, it must have some significant impacts at the margins in the resources available for security solutions, and the priorities, scale and timing of military capability developments.

US military spending is already set to decline by a significant proportion to help address the national debt problem. This must reduce the military options available to the President and will also likely raise the costs of defence equipment to US customers.

In China, an extended economic crisis could compound the problems faced by the leadership and heighten domestic instability. It could, possibly, embolden the leadership to further exploit these '20 years of strategic opportunity'.

More widely, economic constraints might lead nations to look for more bang-for-the-buck in capability options and, perhaps, even increase the attractiveness of a 'game-changer' like nuclear weapons.

For Australia, the subsidiary question might be: How much is 'enough' Defence spending?

What more can we do to maintain strategic balance in the Asia-Pacific region over the next 15 years?

If the 'darker clouds' are moving closer and strategic imperatives rising then the next fifteen years could be the critical period for the strategic balance in the region.

The confluence of internal pressures in the emerging great powers, shifting power relativities, economic constraints in the West and the potential for adventurism or misjudgement could present serious strategic challenges sooner than has been anticipated.

Admittedly, a lot would have to change for this to occur and there is no certainty it would lead to conflict, but the challenge of maintaining stability through effective 'balancing' could test the resolve of many nations in the region.

How can we best reassure the United States?

The political, financial and economic pressures in the United States are said to be undermining the predictability of decision-making processes. The 'isolationist' thread in US strategic thinking is finding new voice after years of costly wars, economic downturn and mounting debt.

The recent reinvigoration of US engagement and reassurance of regional countries is a positive development, but not irreversible.

Australia is a strong advocate for strengthening US engagement in the region and the stabilising role the US has played over many decades. The US alliance remains a key pillar in our security policy.

How, then, might Australia be Paul Wolfowitz's 'important reassurer' in coming years?

How might we collaborate more closely? Do we have a shared strategic concept for the Asia-Pacific?

What capabilities should we focus on? Should alliance considerations be a force structure determinant (not just a capability 'enhancer') for the ADF?

How should our Army be optimised?

The 2009 Defence White Paper was equivocal about a wide range of possibilities in our strategic future, but remarkably definitive on three points. The first was the capability requirements for the new submarine, and the second was the embargo on nuclear propulsion for that vessel (even though that might be the best way of meeting the capability requirements).

The third point related to Army capability and excluded being prepared to deploy to the Middle East, central and South Asia, or Africa 'to engage in ground operations against heavily armed adversaries located in crowded urban environments'. This was interpreted as meaning <no Fallujahs>.

But, a shaft of ambiguity was introduced—a bet each-way—when it was conceded we would only do that if the government was convinced the ADF had the required capabilities, and the Australian population supported such a deployment. Was this meant to be a geographical or capability exclusion? I don't know, but it couldn't have helped those involved in planning the future Army.

This didn't matter so much at the time because the Army was fully focused on sustaining its efforts in various overseas theatres, and fighting the war it was having in Afghanistan. This effort exposed imbalances in the Army force structure and created considerable churn across the force. More was needed, but the 2009 Defence White Paper was not to address that issue. Rather, the Army was told to complete an internal rebalancing to offset the most significant shortfalls in capability.

When the next White Paper is being crafted we will also be approaching the time when the major Army effort in Afghanistan should be finishing. It will be time then, if not sooner, to make some decisions about the future shape and capability of our Army, and an opportunity to redress some continuing shortfalls in capability.

Obviously, the future Army will need to have an amphibious-orientation—given the pending introduction into service of the LHDs—and, preferably, be structured to provide more manageable rotations of deployed forces.

But, there's another issue that I think warrants consideration; and that's the over-reliance on Special Forces that seems to have become almost a belief-system—based on capability and risk-management considerations—in governments since 2001. This has led to an unnecessarily heavy burden of combat deployments being carried by the Special Operations Group and its individual members. Admittedly, it has been carefully managed by Army leaders and, apparently, few soldiers complain. But, it's not sustainable in the longer term.

Without question, there will always be some tasks that should be undertaken only by highly capable Special Forces. Beyond that there is a spectrum of roles and tasks—the Commando set, if you like—some of which could reasonably be undertaken by other infantry soldiers.

There might need to be some up-skilling and re-equipping of the standard infantry battalions to meet the requirement, but I'm old enough to remember section commanders who could call for and adjust artillery and mortar fire, call in air strikes, and arrange aeromedical evacuations.

The benefits to the Army and the nation of not relying so much on Special Forces would be a broadening of the base from which troops could be drawn for the types of operations needed on the modern battlefield.

Now, let me finish with a few less controversial questions.

Should Australia have a national capability to design, build, integrate and sustain bespoke submarines?

We seem set on a course that will see submarines play an increasingly important role in our maritime capabilities. If we are likely to continue to have a unique capability requirement for our submarines, then we need to take a more holistic approach to the problem.

If no one else designs and sells suitable conventional submarines—and that remains a design parameter for Australia—then we should consider a capability-based (as opposed to project-based) approach.

We would then be dealing with a strategic decision and a national commitment: one that is not only about capability imperatives, but also 'who we are' as a nation. And, we would probably also be committing to continuity of capability and seamless production lines involving at least twelve boats in the Navy fleet.

If, on the other hand, we are open to nuclear propulsion we might design and build only one more class of submarine.

Does the ADF have the capacity to be parent services of bespoke advanced systems and capabilities?

This is a question I hope the Coles review will address. The experience of the *Collins Class* submarine suggests there is more than enough blame to go around.

But, perhaps more importantly, the Australian Defence enterprise simply didn't understand the enormity of the challenge of being a parent Navy of an orphan platform.

What ADF capability development, other than for current operations, is urgent?

Are we moving from 'prudent planning' to 'strategic imperative' in any of our capability proposals?

Conclusion

Many of you will probably have your own set of questions concerning the next Defence White Paper. These are mine.

The important point in raising them nearly three years before the next White Paper is due is that we shouldn't be waiting for the flag to drop on that process. These types of issues should be dealt with as part of the routine strategic and capability assessment processes.

Contributors

(Biographies as at August 2011)

Dr Parag Khanna

Parag Khanna is a leading geostrategist, world traveler and author. Presently a Senior Research Fellow at the New America Foundation, he is author of the international best-sellers *How to Run the World: Charting a Course to the Next Renaissance* (2011) and *The Second World: Empires and Influence in the New Global Order* (2008). In 2008, Parag was named one of Esquire's '75 Most Influential People of the 21st Century,' and one of fifteen individuals featured in WIRED magazine's 'Smart List.'

Parag served in the foreign policy advisory group to the Barack Obama for President campaign. During 2007 he was a senior geopolitical advisor to United States Special Operations Forces in Iraq and Afghanistan. From 2002-5, he was the Global Governance Fellow at the Brookings Institution; from 2000-2002 he worked at the World Economic Forum in Geneva; and from 1999-2000, he was a Research Associate at the Council on Foreign Relations in New York.

Professor Hew Strachan

Hew Strachan is Chichele Professor of the History of War and Fellow at All Souls College, Oxford. He is also Director of Oxford Programme on the Changing Character of War, and was Professor of Modern History at the University of Glasgow prior to coming to Oxford in 2001. Professor Strachan's research focuses on military history from the 18th century to date, including contemporary strategic studies, but with particular interest in the First World War and in the history of the British Army. He is the author of several highly acclaimed books on military history, including *European Armies and the Conduct of War* (1983), *The Politics of the British Army* (1997), and *The First World War: Volume 1: To Arms* (2001) which was also produced as a multi-part documentary series for television. Additionally, Professor Strachan is a Fellow of the Royal Society of Edinburgh and the Royal Historical Society. In 2010 he chaired a task force on the implementation of the Armed Forces Covenant for the Prime Minister.

Dr Leanne Piggott

Leanne Piggott is a specialist on Middle East security issues as well as oil market supply and demand security. She is the author of the book, *The Arab-Israeli Conflict: A Timeless Struggle*. Her other recent publications include *The Evolving Terrorist Threat to Southeast Asia: A Net Assessment*, a jointly authored book published by the RAND Corporation.

Leanne is a member of the Editorial Advisory Board of the Department of Foreign Affairs and Trade.

Mr Saul Eslake

Saul Eslake worked as an economist in the Australian financial markets for 25 years, including as Chief Economist at McIntosh Securities (a stockbroking firm) in the late 1980s, Chief Economist (International) at National Mutual Funds Management in the early 1990s, and as Chief Economist at the Australia & New Zealand Banking Group (ANZ) from 1995 to 2009.

Since leaving ANZ in August 2009 Saul has had a part-time role as Director of the Productivity Growth Program at the Grattan Institute, a non-aligned policy 'think tank' affiliated with Melbourne University, and also since January 2010 as an Advisor in PricewaterhouseCoopers' economics practice.

He is on the Boards of the Australian Business Arts Foundation (which promotes partnerships between business and the arts), and Hydro Tasmania (Tasmania's electricity generating business); chairs the Tasmanian Arts Advisory Board (which advises on the distribution of State Government grants to artists and arts companies); and is a member of the Australian Government's National Housing Supply Council, the Australian Statistics Advisory Council, and the Tasmanian Premier's Digital Futures Advisory Council.

He was a member of the Howard Government's Trade Policy and Foreign Affairs Advisory Councils, and of the Tourism Forecasting Committee. He also served as a member of the Rudd Government's Long-Term Tourism Strategy Steering Committee in 2008-09.

Saul writes a fortnightly column for the business pages of the *Melbourne Age* and *Sydney Morning Herald* newspapers, and undertakes a number of other freelance speaking and writing engagements.

He has a first class honours degree in Economics from the University of Tasmania, and a Graduate Diploma in Applied Finance and Investment from the Financial and Securities Institute of Australia. He has also completed the Senior Executive Program at Columbia University's Graduate School of Business in New York.

Professor Wang Jisi

WANG Jisi is dean of the School of International Studies, Peking University, and director of the Center for International and Strategic Studies, Peking University. He has been a member of the Foreign Policy Advisory Committee of the Foreign Ministry of China since October 2008, and president of the Chinese Association for American Studies since 2001. Professor Wang's scholarly interests cover international relations theory, US foreign policy, Chinese foreign policy, and China-US relations. He has published numerous works in these fields.

Professor Ian Morris

Ian Morris is interested in understanding why the west has dominated the earth for the last few centuries. He began his career as an archaeologist and historian of ancient Greece, studying early texts and excavating sites around the Mediterranean Sea, but in recent years he has moved toward larger-scale questions and an evolutionary approach to world history. He has written or edited eleven books. The most recent, *Why the West Rules ... For Now*, asks how geography and natural resources have shaped the distribution of wealth and power around the world across the last 20,000 years and how they will shape our future. Morris' ongoing projects include a book on slavery and globalization, a study of western civilization co-authored with historian Niall Ferguson of Harvard University, and a volume of the forthcoming *Cambridge History of the World*.

From 2000 through 2006 Professor Morris directed Stanford University's excavation at Monte Polizzo, a native Sicilian town of the seventh and sixth centuries BCE. As well as suggesting new ways of thinking about how indigenous peoples responded to ancient Greek colonialism, the project's finds have also opened up new perspectives on the similarities and differences between periods of imperial expansion in ancient to modern times.

Morris came to Stanford from the University of Chicago in 1995, and since then has served as Associate Dean of Humanities and Sciences, Chair of the Classics Department, and Director of the Social Science History Institute. He also founded and has directed the Stanford Archaeology Center. His teaching includes classes on world history, ancient Greece, slavery, and archaeology. He has appeared on numerous television shows and his prizes and awards include fellowships from the Guggenheim Foundation and National Endowment for the Humanities.

Associate Professor Neville Meaney

Neville Meaney is an honorary Associate Professor of History at the University of Sydney. He has a long-standing research interest in international history, especially the way in which ideology, culture and geopolitics have interacted to shape the character of Australia's relations with the world. He has published widely in the field and his most important recent publications are a two volume *History of Australian Defence and Foreign Policy*, Vol.1, 'Search for Security in the Pacific, 1901-14' and Vol.II, 'Australia and World Crisis, 1914-1923' (Sydney University Press, 1976-2009); *Towards a New Vision: Australia and Japan across Time* (University of New South Wales Press, 2007); chapter on 'In History's Page: Myth and Identity' in Deryck Schreuder and Stuart Ward, eds, *Australia's Empire* [Oxford History of the British Empire Companion Series] (OUP, 2008); A.R. Davis Memorial Lecture, 'The Problem of Nationalism and Race: Australia and Japan in World Wars I and World War II', *Journal of the Oriental Society of Australia*, Vol.42 (2010), 1-30. He has held a number of research scholarships, including a State Department Distinguished International Visitor Award, an Australian-American Educational Research Foundation Senior Research Scholar Award, an Australian-Japan Foundation Research Award and an Australian National Library Harold White Fellowship. He has also contributed solicited opinion pieces for the *Australian Financial Review* and *The Australian*.

Major General (Retd) Peter Abigail AO

Peter Abigail joined ASPI as Director in April 2005. Prior to that he spent 37 years in the Army before retiring in 2003. Following promotion to Major General in December 1996, he served in a range of senior leadership appointments in the Defence Organisation. As Assistant Chief of the Defence Force (Policy and Strategic Guidance) and then Head Strategic Policy and Plans (Australian Defence Headquarters) (1996-1998) he was responsible for key aspects of Defence policy, military strategy and capability development. As Deputy Chief of Army (1998-2000) he was responsible for managing the Army and its interaction with other Defence stakeholders. In his final appointment, as Land Commander Australia (2000-2002), he commanded all of the Army's operational forces, full time and reserves, including those that were committed to operations in East Timor, Bougainville and Afghanistan.

During his appointment with ASPI he has been a member of the Defence and National Security Advisory Council to the Minister for Defence, The Hon. Dr Brendan Nelson MP, and a member of the Defence White Paper Ministerial Advisory Panel for the Minister for Defence, The Hon. Joel Fitzgibbon MP. He was appointed to the ASPI Council in March 2007.

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ASPI
Level 2, Arts House
40 Macquarie Street
Barton ACT 2600
Australia

Tel +61 2 6270 5100
Fax + 61 2 6273 9566
Email enquiries@aspi.org.au
Web www.aspi.org.au

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