

LOWY INSTITUTE
FOR INTERNATIONAL POLICY



AUSTRALIAN VOTER'S GUIDE TO INTERNATIONAL POLICY

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The Lowy Institute for International Policy is an independent international policy think tank based in Sydney, Australia. Its mandate ranges across all the dimensions of international policy debate in Australia — economic, political and strategic — and it is not limited to a particular geographic region.

Its two core tasks are to:

- produce distinctive research and fresh policy options for Australia's international policy and to contribute to the wider international debate.
- promote discussion of Australia's role in the world by providing an accessible and high quality forum for discussion of Australian international relations through debates, seminars, lectures, dialogues and conferences.

The views expressed in this paper are the authors' own and not those of the Lowy Institute for International Policy.

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AUSTRALIAN VOTERS' GUIDE TO INTERNATIONAL POLICY

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The 2007 election in Australia will be about a great deal more than the international policy issues that we deal with at the Lowy Institute.¹ Issues of much more immediate concern to voters, like the economy, health, education and industrial relations, are likely to dominate. Perhaps only climate change and nuclear power and Australia's continuing military involvement in Iraq and Afghanistan (with the associated questions about our relationship with the United States) will have much of a profile in the campaign. And in the case of the first two, the debate is as likely to be about their domestic as their international aspects. Other matters will come up in speeches and debates (the way we deal with terrorism, foreign aid, the structure of the defence force, arms control and disarmament). More will be ticked off, to little general attention, in the lengthy policy platforms of the major parties. But short of another unexpected global crisis — another 9/11 or natural disaster like the Indian Ocean tsunami — it seems safe to assume that international issues won't be centre stage for the Australian electorate in 2007.

But even if they do not feature prominently in the campaign, the international policy choices the next Australian government makes will still help shape the prosperity and security of the country. In a globalised world, almost everything governments do has an international dimension. Take something as traditionally personal and local in focus as health care. That now involves decisions about recruiting medical staff from overseas, recognising overseas qualifications, and, as we saw in the debate about pharmaceutical benefits under the Australia-United States Free Trade Agreement, it engages questions of international trade policy. And (as we have been reminded by the outbreak of equine influenza) pandemic diseases, which have no regard for international boundaries and can only be addressed effectively through international cooperation, are among the most troubling potential shocks to the domestic health system.

At an even deeper level, the capacity of the Australian economy to deliver the services that the Australian people want will depend heavily on the continuing growth of the global economy, including the openness of the world trading system which drives the demand for Australian resource and services exports. In this area, too,

the international policy choices of the Australian government will be significant.

So developments in the outside world, and the Australian government's policy responses to them, have an impact that goes well beyond the rarefied world of international diplomacy. It is worth understanding, testing and judging the ideas our political leaders have for dealing with them.

Australia's geographical position, adjacent to both the economic powerhouses of Asia and the fragile states of the South Pacific, its strong alliance with the United States, the structure of its economy, its history, culture and the attitudes of the Australian public all combine to set the parameters within which Australian international policy generally operates.

As a result of three years of Lowy Institute polling, we have a pretty good idea of what Australians think about their international environment and how their thoughts are changing. The Lowy poll for 2007 was released in August 2007 and is available on our website www.lowyinstitute.org.

It's basically a good story. Australians feel optimistic and secure. They are confident they can compete internationally. The polling reveals general public support for the broad national consensus which has shaped Australian foreign policy over half a century. This might be defined as a healthy alliance relationship, close relations with our Asian neighbours, support for an open international trading system, a defence force which can operate in our own neighbourhood and, where necessary, work with allies further afield, and a generally activist approach to diplomacy.

Australia's power to shape world politics is limited. As the world's 14th biggest economy, but with just its 49th largest population, Australia has sufficient global weight to influence outcomes, especially when they affect us directly, but not to determine them. (As we have seen in Iraq, not even the United States, still the only nation in the world which can deploy effective political, military and cultural power across the globe, can do that).

But setting out the limits to what an Australia government can do — or in most conceivable circumstances would want to do — internationally is not in any way to argue that it has no choices or that these choices are not important. The history of

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Australian foreign policy shows plenty of examples of Australian government decisions which have altered our national trajectory and/or influenced the broader global environment. In recent decades the negotiation of the Chemical Weapons Convention, the formation of APEC, the interventions in East Timor and Solomon Islands and the negotiation of the Australia-United States Free Trade Agreement are all examples.

Neither is it to say that both political parties will act in the same way. The traditions of the Coalition and the Labor Party are different. The Coalition emphasises (for the most part) bilateral relationships, strong defences, alliance solidarity, old friendships, cultural affinities. Labor (for the most part) places more weight on multilateral diplomacy, international cooperation as a means of achieving security, relations with Asian neighbours.

Except at the most breathless levels of political polemic, however, Australian foreign and security policy is not binary. For example, I have never met anyone who thinks the Australian defence force should be structured solely around the defence of the Australian continent; equally, no Australian I know thinks that our alliance with the United States requires total subservience to the policy positions of any given US administration. In real life, the most important questions for Australian governments are essentially about balance and weight.

Most government decisions (and some of the most significant they can make) are not about high-flown declaratory principles at all but about the allocation of resources: where the money goes and who gets to administer it. With the resources we have available to us, what are the choices we should make to preserve our security and expand our prosperity? Where is the money best directed? How much should go towards making us stronger domestically and how much towards making us stronger internationally? And what gives us strength internationally? Our defence force? Our diplomatic service? Other attributes of our 'soft power' like cultural influence? Presumably most people would agree that a balance between them is needed, but where should the balance lie?

Sometimes, governments set out deliberately to shape policy outcomes. The Keating Government's 1995 decision to convene the Canberra Commission on the Elimination of Nuclear Weapons, or the

Howard Government's pursuit of the Australia-United States Free Trade Agreement are examples. Sometimes, as with terrorism after September 2001, events impose themselves on the international agenda almost without warning. And sometimes policy is shaped from outside government and the foreign policy élite by the emergence of issues in the public mind to which politicians are forced to respond. Climate change seems to be one of those.

This report outlines the global issues we at the Lowy Institute think the next Australian government is going to have to deal with. Our objective is to help Australian voters formulate the questions that need to be asked of our leaders as they seek our support to govern. We have tried to look beyond the headlines to the deeper issues that require attention and the real-world decisions that the next government will have to take. The focus is on the short term — the next five years — rather than the next half century.

The contributors are all from the Lowy Institute, but as you will see there is no single Lowy Institute view of the world. Our research staff speak in their own voices and hold different positions on some of the key issues of our time. All we attest to is that the work we publish is relevant to the issues with which the world is grappling, well researched and well tested, not least as a result of the robust debate that goes on within the Institute itself. So this report is not a policy prescription for an incoming Australian government to follow but a guide for voters who, like us, believe that Australia needs to be as conscious of, and responsive to, the large external events that shape our world as to the domestic issues which usually preoccupy us, and that it is worth trying hard to get them right.

The first chapter is by Owen Harries, a Visiting Fellow at the Institute, and one of Australia's most distinguished international commentators. He looks at just what sort of world he thinks the next Australian government will be dealing with.

¹ By international policy we mean all those areas of government activity — traditional foreign policy, international security, defence policy, international economic policy and so on — that encompass the Australian government's interaction with other parts of the international system.

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Owen Harries is a Visiting Fellow at the Lowy Institute

We're going to run these bastards down. We're going to lead, and everyone else is going to follow.

– George Tenet, Director of the CIA, after September 11, 2001.

If the trumpet gives an uncertain sound, who shall prepare himself to the battle?

– 1 Corinthians, Chapter 14, Verse 8. New Testament.

At the beginning of the new millennium, a mere seven years ago, it was widely assumed that the character of the coming epoch would be determined by the interplay between two closely related and mutually reinforcing phenomena: American hegemony and globalisation.

The United States was the confident possessor of overwhelming all-round power. It was 'the benign superpower' that would provide the stability and security necessary for globalisation to proceed and thrive. In its turn globalisation would ensure the worldwide spread of America's economic practices, technologies, culture and values. Indeed for many influential writers on the subject — Tom Friedman in his huge best-seller, *The Lexus and the Olive Tree*, for example — globalisation seemed to be a virtual synonym for Americanisation. The French Foreign Minister at the time, Hubert Vedrine, agreed: 'American globalism ... dominates everything. Not in a harsh, repressive, military form, but in people's heads.'

It is worth bearing this quite recent picture of the world in mind in order to appreciate fully how different things are now. The United States and the American people are experiencing a crisis of confidence. The country is bitterly divided and uncertain as to how it should proceed. Obsessed by immediate problems, there is little evidence of far-reaching strategic thinking, or of that much prized American commodity, 'vision'.

In the rest of the world, anti-Americanism is at an all-time high. But it is not so much that America is feared and hated; a superpower can comfortably cope with a lot of that. What is

more serious is the loss of respect and credibility that is evident, the diminished prestige and authority, and consequently a reduced ability to lead, persuade or overawe.

All this has resulted from an astonishingly inept American performance over the last few years. That in turn reflects the cumulative effect of a combination of factors: the profound shock of 9/11; the resulting outrage which had the effect of causing the country to behave in a fashion that in some ways betrayed its own best values; hubris, and the embracing of a doctrine which was so ambitious that it guaranteed failure; and an administration guilty of incredible incompetence in the implementation of policy. (The world witnessed a superpower that claimed to be able to fix the world, even as it failed miserably for months on end to deal with the impact of a hurricane on one of its cities).

Does this matter for anyone apart from the Americans themselves? Well yes, it does. For one thing, to have a superpower that does not command respect is likely to tempt others to frustrate or ignore its will generally, and that is a dangerous state of affairs. For another, the less it is respected the more likely is the superpower itself to take drastic, and possibly reckless, action to remedy that state of affairs.

But perhaps the most dangerous consequence of a continuing loss of confidence in and by America is that we would be left with a leaderless world. For there is no alternative leader in sight in the foreseeable future. The other developed Western countries lack the energy, confidence and will for the job. So does Japan. China has great potential, but has limited recent international experience and for some time it is going to be preoccupied coping with the consequences of its own extraordinary economic growth and the urgent problems that presents. The same is true of India. Russia possesses great destructive power and huge energy reserves; but while it has re-emerged as a serious player, it has no global leadership credentials. The United Nations? Even if one ignores its many grievous faults, that institution is a forum, not a principal actor. A concert of

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powers? But the creation and functioning of such a concert itself requires authority and leadership on someone's part, so the problem remains. There is no other immediate plausible candidate for that leadership if the United States can no longer fill the role.

But there is going to be an urgent need for leadership in a world that is changing rapidly and is already experiencing serious tensions. Globalisation requires new economic and political ground rules, and providing them is going to be more complicated than merely extending or tinkering with existing Western ones. There is the specific and urgent issue of global warming. The problems associated with mass, uncontrolled human migration are mounting. Many experts believe that nuclear proliferation is now a more urgent matter than it has ever been, and that the prospect of weapons in the hands of an increasing number of states with weak governments and poor security and control systems is imminent. And, of course, there is the continuing problem of global terrorism, which is real enough even if it is sometimes grossly exaggerated.

If leadership is urgently needed, and if there is really no plausible alternative to America for the role, the questions arise: How badly damaged is the United States? Will it recover reasonably quickly, or does the damage go deep, perhaps too deep for recovery?

Opinions, even serious informed opinions, vary widely. At one extreme there are those who blame everything on the ineptitude of the Bush administration and believe that all will be well once it goes. At the other are those — for example, the much-respected analyst, Pierre Hassner — who believe that what is happening represents the end of a brief, and partly illusory, period of American dominance, and may indeed mark the beginning of the de-Westernisation of the international system. The former view is superficial, the second at best premature.

There is more wrong with America than the Bush Administration. As we witness a presidential election process that now extends over two years and involves the expenditure

of hundreds of millions of dollars, and as we reflect on the mediocre result that such a process can produce, it is evident that there is something seriously dysfunctional about its political system. (The Democratic Party starts as favourite in the next election; the two leading candidates for its nomination at this stage have no significant experience in international affairs). Again, it is not any cheese-eating Frenchman but Irving Kristol, the distinguished father of William and the founder of neoconservatism, who observed not so long ago that there are 'clear signs of rot and decadence' in American culture, and that the most urgent priority for Americans should be to put their own house in order. And it is a respectable American enterprise — the Pew Global Attitudes Survey — that has recently reported findings that depict today's United States as increasingly hostile to international trade, foreign companies, and immigration. A strange state of affairs in a country that virtually created today's global economy and that is made up of the children of immigrants.

All that being said, however, one of the most striking features of American history is the country's ability to recover quickly from adversity and its own errors — witness the rapidity of its recovery from the Civil War, the Great Depression, and, more recently, the Vietnam War. Whether it can do so again, after the débâcle of the Bush Administration, has a claim to be the key question of our time, bearing in mind that recovery in this context must mean a return not only of confidence but of judgement, prudence and an understanding of the world.

It is a question of particular importance for Australia, which has invested so heavily in its alliance with the United States.

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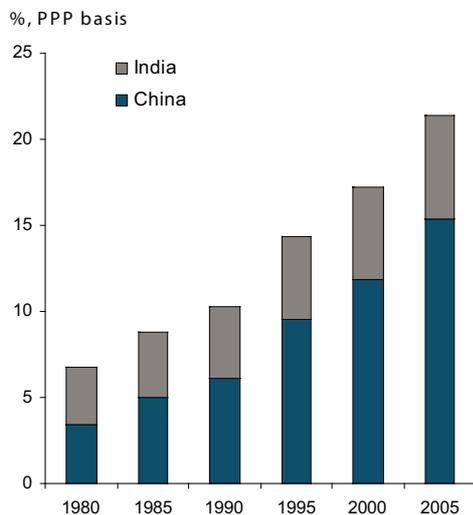
Mark Thirlwell is the Director of the International Economy Program at the Lowy Institute

Forged by the fall of the Berlin Wall, the liberalisation of markets for goods, services and capital, and the economic transformations of China and India, the new global economy has been a particularly agreeable environment for Australia. The emergence of new, competitive suppliers of the goods, services and assets we buy has been accompanied by the arrival of fresh, dynamic sources of demand for those we sell. The unprecedented durability of the present expansion, now almost 17 years old, is testament to the overwhelmingly positive consequences of the current international economic conjuncture. The pairing of the 'Australian model' and the global economy at the start of the 21st century seems in many ways to be a match made in heaven, disturbed only by the recent rumbles arising from newly nervous financial markets as they discover, yet again, that for all its other benefits, globalisation has not abolished risk.

We are in the early years of a period of profound transition for the international economic order, as the consequences of the ongoing redistribution of economic weight across the world economy, driven by the globalisation-powered rise of China and India, are starting to make themselves felt. Managing the resultant stresses and strains will be essential if the good times are to be sustained. Moreover, not everyone attending the global party is having a great time, while others are still waiting for their invitations to arrive. Reconciling the former and including the latter also need to be on the international policy agenda.

The challenge of managing the strains of success is apparent in the case of international trade, one of the two main pillars supporting the new global economy. Recent years have brought a steady rise in the share of international trade in world output.

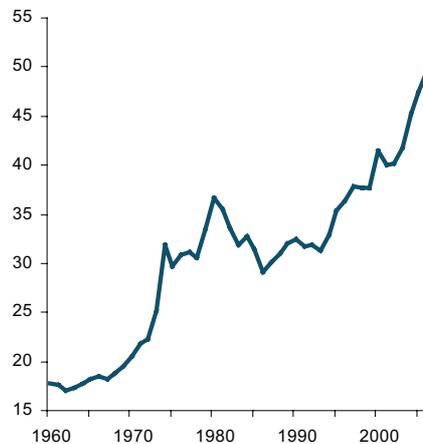
Chindia's growing share of world output



Source: IMF World Economic Outlook database

So is there anything for practitioners of international economic policy to do other than sit back and enjoy the good times while keeping a watchful eye on the antics of the financiers lest they spoil the party? In fact, there are more than enough issues even beyond the turbulent credit markets to keep them occupied.

Booming world trade
merchandise trade as % of world GDP



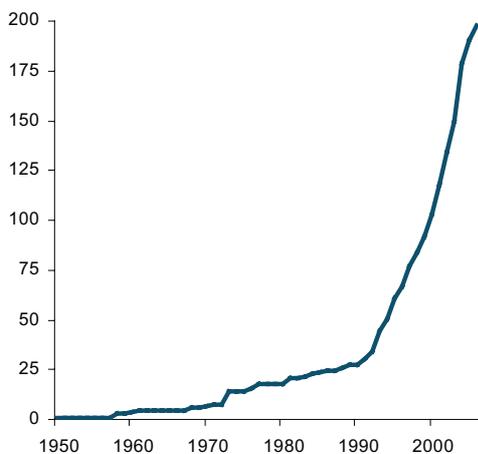
Source: World Trade Organisation and author's calculation

Yet paradoxically, deepening trade integration has occurred at a time when the multilateral trading system, the ultimate guarantor of the process, has been under mounting pressure. In particular, the Doha round of trade negotiations has lurched from one crisis or stalemate to the next, with the prospect of progress fading all the time. Optimists argue that a final collapse of the negotiations would be no big deal. The magnitude of gains on offer is likely to be small, and anyway, trade has quite obviously continued

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to expand throughout the repeated failure of the trade talks to gain traction. But there is a powerful asymmetry at work here, as while the upside of a successful Doha round is indeed likely to be modest, the downside of failure could turn out to be substantial, at least in the medium run. The first irrevocable breakdown in ongoing multilateral negotiations since the creation of the GATT in 1948 would threaten the credibility of the current international trading system, risking the gradual erosion of that system's checks and balances. Finding a way to rejuvenate the multilateral system should be a priority for the world economy, and the next Australian government will have to think hard about how it helps the world pick up the pieces after Doha.

Proliferating PTAs
PTAs notified to GATT/WTO, cumulative, by date of entry



Source: World Trade Organisation

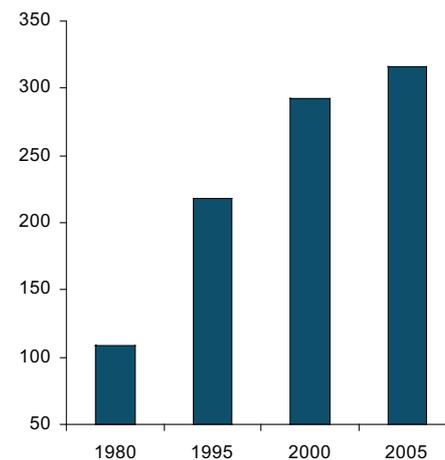
Meanwhile, the pursuit of preferential trade agreements (PTAs) has been virtually every economy's Plan B in response to Doha disappointment, and as a result the number of such agreements has exploded. Australia has joined the rush and is currently negotiating a swathe of new arrangements. Here the next government will face a decision over Australia's declared preference for so-called comprehensive, 'WTO-plus' agreements, and a preference on the part of some key negotiating partners to see the deals in a more symbolic light. Choosing either to compromise on the former to secure a deal, or risk the diplomatic fallout from rejecting the latter is likely to be a test for the

ASEAN, China and possibly Japan PTA negotiations.

Negotiating capacity must become a constraint to the present strategy at some point, if it hasn't already, and trying to make sense of the resulting spaghetti bowl (or noodle bowl in the case of East Asia) of overlapping yet inconsistent arrangements of widely varying quality and coverage is now another pressing item on the international policy agenda. The policy issues could become even more pointed in the event of the emergence of competition between rival trade blocs. Consider, for example, if Canberra had to choose between membership in an expanded NAFTA or an East Asian trade arrangement against a backdrop of worsening trans-Pacific trade tensions.

If trade integration has been one pillar of the global economy, financial market integration has been the other. Indeed, the recent history of globalisation has arguably been driven more by finance than by trade. Once again, the international economic architecture has struggled to keep up with market-led integration, and bodies like the IMF are now in the early stages of trying to re-invent themselves.

The rise of global financial capitalism
Financial assets as % of world GDP



Source: McKinsey Global Institute

The current bout of financial market jitters serves as a reminder that this new era has been accompanied by a series of financial 'accidents', including the 1994 Tequila crisis, the 1997 Asian Financial crisis, the 1998 LTCM panic, and the 2001 equity market meltdown. Yet calls to rethink the international

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financial architecture, heard most strongly after the Asian crisis, have so far come to nothing.

Australia has already staked out a pro-reform position in the form of support for redistributing voting power in the IMF and promoting the role of the G-20. The next government will have to consider how to continue and develop these themes, as well as think about Australia's role in an emerging regional financial architecture.

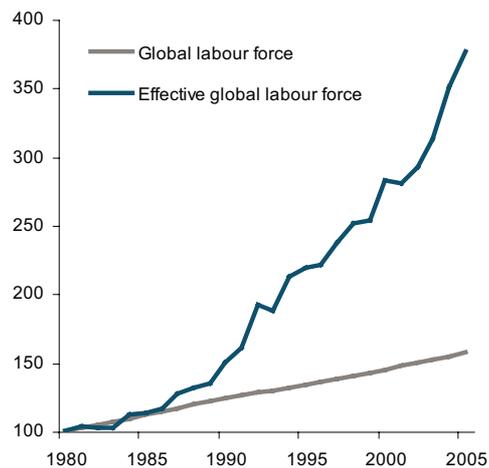
Intriguingly, one source of demands for new international financial regulation has been the recent attention paid to so-called Sovereign Wealth Funds or SWFs as vehicles for increased investment by emerging markets into the developed world. Washington has asked the IMF and World Bank to establish a code of good practice for SWFs, and Brussels is reportedly considering Europe-wide guidelines. Australia already has the Foreign Investment Review Board (FIRB) and Foreign Acquisitions and Takeovers Act. If projections about the wall of money pushing into rich-country assets from emerging markets prove accurate, then this machinery may get a serious workout in coming years. In particular, a future Australian government is likely to have to decide how to deal with SWF-/China-based bids for major Australian companies.

To some extent, the labour market is the missing third pillar of the global economy. In contrast to the efforts made at liberalising international flows in goods, services and financial assets, barriers to labour mobility have remained substantial, with immigration in particular remaining tightly controlled. Given the persistent international disparity between incomes, the compressing effect of the demographic transition on many rich world labour forces, and the spillover effects from liberalisation in other markets, the pressure for greater labour market integration will grow, despite the obvious political obstacles. In this light, a key policy issue is set to be the role of visas for temporary workers in dealing both with domestic skill shortages and in providing support for neighbouring economies.

In fact, national labour markets are already increasingly integrated, thanks to greater trade and financial openness, the rising 'tradability' of many previously sheltered service sector jobs, and the growth of offshoring. The IMF, for example, has

recently estimated that the growth in economic openness and the rise in working-age populations in emerging markets, particularly in East Asia, mean that the effective global labour supply quadrupled between 1980 and 2005, with most of the increase coming after 1990. While this development has been positive for the world economy overall, its implications for income distribution and job security in the developed world have contributed to some of the current rich-country backlash against globalisation.

Quadrupling the effective global labour force
Labour force index, 1980=100



Source: IMF World Economic Outlook

Managing this backlash is another important item on the international economic policy agenda. After more than two decades of the pursuit of pro-globalisation policies, significant parts of the developed world are now having second thoughts about the benefits of globalisation. One result has been that the political gains to be derived from promoting more liberalisation appear to be shrinking relative to the payoffs derived from advocating policies designed to temper or modify the forces driving international economic integration. There have also been growing demands for the imposition or intensification of labour, environmental and product safety standards as applied to international transactions. Such calls are set to get louder, and will provide another important element in the international economic environment facing Canberra.

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**Rory Medcalf is the Director of the International Security Program
at the Lowy Institute**

In defence and security policy, the next Australian government will find tough choices thrust upon it. Under the Howard Government, the Australian Defence Force (ADF) has become better resourced and prepared. But that alone won't enable the country to escape the many dilemmas ahead.

The most important security decisions in the years to come aren't likely to be about how to shape Australia's military, since most of that work is underway: many major acquisition decisions have been made, for example, expanding expeditionary options with strategic lift aircraft and ships. There is broad bipartisan consensus on the need to balance Australia's limited forces between national defence and the projection of power in pursuit of wider interests. The Opposition has come to accept most of the government's capability decisions. Labor's criticism of the government's 2007 Defence Update document, its argument that a new and comprehensive defence 'white paper' is long overdue, and its call for a focus on the challenges in the neighbouring 'Arc of Instability' all should be seen in that context. So should the government's claims that it has euthanased a purportedly narrow 'defence of Australia' doctrine associated with Labor. In any case, both sides of politics intend to commission a white paper in the next term.

The intriguing choices ahead will be about how, where and why to use this changed force. By funding and extolling a more powerful military, the government has reinforced expectations that the ADF will always be available for contingencies near and far. But the ADF will remain relatively small, struggling to reach its target of 57,000 personnel. So some expectations of Australian help, on the part of the United States and others, will sooner or later be left starkly unmet.

Australia is becoming accustomed to being a busy, if not overstretched, military power. The security problems identified by the government in the 2003, 2005 and 2007 updates are now a familiar checklist of worries, which both sides of politics broadly deem important: Islamist terrorism, nuclear proliferation, fragile states in the 'Arc of Instability', new 'asymmetrical' ways of war that make us vulnerable, great power tensions, and more. Over time, some

issues rise or fall in prominence; they interact in different, dangerous ways; individual leaders and strategies colour the scene. Yet overall the strategic picture has begun to seem static. Paradoxically, in an age of rapid change, there now seems a familiar suite of security challenges against which we can rationally reshape our national capabilities for the decades ahead.

If comfort is drawn from this, it will prove false and short-lived. The next Australian government will find that the real mark of its strategic environment is deepening uncertainty. Much will remain familiar — like the central importance of states in the world system, the role of armed force, and the dominant power of the United States. Yet this will mask accelerating change, and the likelihood of shocks: pandemic or financial crisis, massive natural disaster or rapid climate change, energy shocks, mega-terrorism, inter-state war, or the collapse of a fragile state.

Any of several major issues in world security could well reach a crisis point in the years ahead. Iran, Iraq, Afghanistan, the Korean Peninsula, and China-Taiwan relations are all delicate situations where Australian interests are engaged. If any of these took a serious turn for the worse, the ensuing policy dilemmas for Australia, especially over whether to participate in fresh US-led military action, could be acute. Such prospects, although unlikely, cannot be dismissed as fanciful. For example, the next year in China-Taiwan relations will be troubled: Taiwan will hold elections in which sensitive questions of identity and independence will invariably arise, along with a controversial referendum about UN status. There is no guarantee the Beijing Olympics will restrain China's response. Turning to the Persian Gulf, informed observers are becoming persuaded that the US or Israel are increasingly serious about considering force as an option against Iran's nuclear ambitions and its destabilising activities in several regional states.

So the next Australian government will have many reasons to renew diplomatic efforts to reduce the chances of any power's resorting to large-scale war. More broadly, it will need to be mindful of the risks of instability as power balances change, especially as

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China and India rise. So fresh thought will be needed on Australia's security diplomacy with major powers — including in relation to dialogues, exercises and military capability questions — and especially in the context of our role in the US alliance system in the Asia-Pacific. At the same time, Canberra may want to look for ways of reconciling the cold reality of great power politics with neglected agendas of nuclear non-proliferation and the empowering of international institutions. There is scope for initiatives to improve Asia's motley 'architecture' of multilateral forums for discussing security problems and reducing the risks or impacts of conflicts between states.

But some wars are with us already, and the reluctance of many other US allies — especially in Europe — to put troops in harm's way will increase the pressure from Washington for Australia to sustain its role in Iraq and expand it in Afghanistan, in the latter instance sharing daily risk on a larger scale and increasing the chances of combat losses. The next Australian government will very likely have to cope with public opinion in the face of multiple Australian casualties.

Many looming security-related decisions, though, will be less dramatic than immediate questions of war. The basic limits of Australia's capabilities — even with one of the world's 12 largest defence budgets — mean that Australian governments will increasingly have to prioritise national security interests and choices. The country's globalising interests will continue vastly to outgrow its power, so many risks and problems will have to be tolerated, managed, or left primarily in the hands of others. For example, promises to help Australian nationals caught up in conflict or disaster, wherever they may be, will sooner or later have to be qualified or broken. Even with annual defence spending increases of about 3% in real terms — promised by both sides of politics — Australia will struggle to retain its relative military power in the region and the world, as some other economies and defence budgets continue to grow faster, our overseas commitments accumulate and our personnel shortages bite.

A key defence capability question is how to finish (or redirect) the transformation of the ADF, including whether to stick with the Joint Strike Fighter as the new mainstay of our air force, on

which a final decision is due in 2008. One question is whether a future government will develop one of the newly-ordered large transport ships as Australia's first aircraft carrier since 1982. More broadly, the next government will want to review our response to increasing military capabilities in Southeast Asia, a region where Australia faces no known conventional threat and yet where Canberra is determined to maintain an edge, at great expense. Recent Russian arms deals with Indonesia have highlighted this issue, but the reality is that Australia's capability lead is huge, and relations with Jakarta are on a good track. Conversely, Australia's next few governments may find themselves having to work hard to reassure the region of our benign intent, as the ADF's potent new platforms and systems prominently enter service.

Finally, the next government will need to review the effectiveness of Australia's major security activities in its near neighbourhood. In Southeast Asia, cooperation against terrorism, including in policing and intelligence, is an ongoing success. The challenge will be to consolidate the gains and not to become complacent about possible rekindling, relocation or metamorphosis of radical Islamist violence and ideology. Meanwhile, Australia's stabilisation and nation-building operations in East Timor and the Solomon Islands will come under increased strain and scrutiny if further progress in security, governance and development is elusive. Judgments will need to be made about whether a 'staying strategy' would be more fitting than an exit one; how to ensure the desired effects are achieved, including through the right balance of military, police, aid, diplomatic and other civilian engagement; and whether deployed Australian personnel are sufficient in number and properly prepared — for example in cultural and language skills — for the work required. The possibility is also likely to increase that Australia, as the only large regional player, will be called on for more stabilisation or disaster relief efforts in other South Pacific countries, further stretching the nation's capabilities.

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Anthony Bubalo is the Director of the West Asia Program at the Lowy Institute

The parameters of Australian policy on Iraq and Afghanistan will continue to be set by the American reality in these two countries. And the reality is that America is losing in Iraq, is treading water in Afghanistan, but cannot withdraw totally from either in the short to medium term.

In Iraq, the US 'surge' is working, but the surge is a strategy not a solution. It was designed to buy time for political reconciliation between warring Iraqi factions and for economic reconstruction. Militarily, the surge is not sustainable beyond the middle of 2008, so the window of opportunity it levered open will soon close. But so far, neither the reconciliation nor the reconstruction that it was meant to catalyse is occurring in any significant way.

In fact, Iraq's fastest growing exports are the terrorism tactics — notably suicide bombing — now being used to great effect in Afghanistan. The situation there is marginally better than Iraq. There is little risk, for example, that the Taliban will return to Kabul in the short term and therefore, to the nominal seat of national power. But there is also little prospect the current Karzai government will exercise real authority, competence or legitimacy much beyond Kabul any time soon.

The United States cannot, however, afford to leave either Iraq or Afghanistan precipitously. In both cases, but especially in Iraq, early withdrawal would see dramatic increases in violence and refugee outflows and hand a victory to international terrorists. More particularly, such a move would cede greater influence to Iran in a region containing 60% of the world's known reserves of oil and 40% of its gas.

Most Republicans and Democrats already agree about staying in Afghanistan. But beyond the political theatre currently being played out in Washington over the pace of any US drawdown in Iraq, neither mainstream Republicans nor Democrats are calling for total immediate withdrawal from there either — at least not yet. The result is likely to be an ongoing US military presence in Iraq of anything between 60,000 to 130,000 troops for the next three to five years to, depending on the size of the force, provide security, hunt al-Qaeda, train Iraqis and deter Iran.

This is a recipe for muddling through at best. The Iraqi state is gone and little is being built in its place. The Iraqi Army is getting better, but is still utterly dependent on the United States. Gradually reducing already stretched US forces will make those remaining in Iraq even more vulnerable. As Israel found in southern Lebanon in the late 1990s, when reduced to a largely defensive posture, all you do is take casualties.

Nevertheless, more out of fear of the consequences than hope for the future, there is, in the words of one respected US commentator, a 'tenuous case for strategic patience in Iraq', and the same could be said of Afghanistan. This poses three key questions for any new Australian government:

First, how to manage an alliance expectation that Australia remain in Iraq and Afghanistan, probably for the life of the next Australian government. Decisions will be required on whether to maintain, withdraw or reshape current commitments.

In Iraq, a decision will be needed on whether to renew the deployment of the Overwatch Battle Group at Tallil by June 2008, or to re-role it given the relatively benign security environment in which it is operating. In Afghanistan, the future of Reconstruction Task Force in Oruzgan is already in question given the possibility that the Dutch forces with which it operates may depart. Should the Netherlands withdraw critical elements, such as air support, the government would be forced to decide whether to withdraw the Task Force, move it to another sector or even to increase the size of the Australian presence in Afghanistan to make up for lost Dutch capabilities.

The death of an Australian soldier in Afghanistan may bring into sharper focus the fragile nature of public support for Australian involvement in that war. Once seen as the 'good war' to Iraq's 'bad war' this year's Lowy Institute poll found that opinion is now evenly split. Further casualties could limit the next government's options when considering the future of Australia's military presence there.

Decisions on Iraq and Afghanistan will not, however, just be a case of navigating the last year of the Bush Presidency. The party affiliation of the US president may change in November 2008, but

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US interests will not. As the foregoing implies, any new president will have limited scope to withdraw quickly from Iraq or Afghanistan. A Democrat might even try to multilateralise Iraq as a way of reducing the pressure on US forces, meaning a greater, not a lesser, expectation of a continuing Australian contribution. Likewise in Afghanistan, growing calls for withdrawal on the home fronts of some NATO contributing countries mean more pressure on Australia to stay, if not to increase its presence.

Second, the US focus on Iran will intensify and will be accompanied by expectations of rhetorical and perhaps even practical Australian support. The United States and others in the international community are already exercised by Iran's nuclear program. But the US will also want to mitigate, as far as possible, the negative consequences of its failures in Iraq, most notably by ensuring Iranian power and influence are contained.

The result will be even more diplomatic and possibly even more military action by the United States over the next two to three years targeting Iran. There is already bipartisan support in the United States for additional diplomatic and economic sanctions. In the final year of the Bush Presidency a limited military strike cannot be totally ruled out either. At the very least the US will be looking for political support from Australia for any of these actions. While a request for military support in any US strike on Iran is less likely, the use of Australian naval forces to enforce a sanctions regime or to protect sea lines of communication in the Gulf is possible.

Third, the circumstances of Australia's engagement with 'West Asia' — the Middle East, Central and Southern Asia — have changed quite dramatically in the last five years, but in many respects government policy is still catching up. Any new government must think more deeply about how the region fits into Australia's strategic priorities and what this means in terms of policy responses.

Even if the region's importance was simply a function of the alliance relationship — something that is unlikely to change — the government would still need to decide whether West Asia is the best place to use Australia's limited military and diplomatic power in support of the alliance.

But energy security, international terrorism and Australia's growing trading relationship with the Gulf, in particular, also mean that the region's importance to Australia today goes beyond simply the execution of alliance obligations. In this respect a new government will need to decide on the best balance of approaches to securing Australia's strategic interests in West Asia, whether via cooperation with the United States, or through other bilateral or multilateral means.

Martine Letts is the Deputy Director of the Lowy Institute for International Policy

Creative and uncomfortable policy choices ahead

An incoming Australian government will need to assess the changed global nuclear environment and develop strategic policy options to protect and project our interests. Some of these options may be controversial and unpopular.

Nuclear weapons proliferation and the threat of weapons of mass destruction in the hands of terrorists are at the top of the global security agenda. Global demand for nuclear energy is a significant, if partial, solution to the global problems of climate change and has put pressure on the comparatively contained nuclear world we have lived in so far. These and related developments have implications for Australian policy settings over the next five years. They traverse our non-proliferation policy, its intimate relationship with our role as a major supplier of uranium, our strategic relationships with the United States and major Asian powers, and our own decisions on the role nuclear weapons will play for the future security of Australia.

Australian nuclear policy was shaped by the strategic circumstances of the 1970s. The policy saw no sustainable case for the development of an advanced indigenous nuclear capacity, and saw Australia leading the world in implementing strict, best-practice standards for the export of uranium. Australian nuclear policy was premised on the belief that by becoming a significant player in the nuclear fuel cycle we could play a meaningful role in the international non-proliferation regime (without needing to accept any of the unpalatable by-products such as returned nuclear waste). It was also premised on the belief that the legal regime of the Nuclear Non-Proliferation Treaty (NPT) signed by most nuclear and non-nuclear countries provided a sustainable framework to deal with proliferation.

The Switkowski enquiry into Australia's nuclear future and parliamentary enquiry into uranium exports cover only part of the territory facing the next Australian government. For one, the Switkowski report is premised on the international proliferation environment remaining stable, which it is not.

Global proliferation threats from weapons of mass destruction (WMD) are on the rise. The pressure of nuclear proliferation is the most intense. This encompasses North Korea and Iran's ambitions as well as the strategic modernisation of the nuclear forces by the established nuclear powers. Great power strategic tension and competition is increasing. As US/China strategic competition grows in our region, the US has engaged India as a strategic counterweight to China. The US/India nuclear cooperation agreement is a concrete expression of that approach.

If the US-India deal succeeds we will see the emergence of the first acknowledged nuclear great power outside the NPT, with Australia possibly supplying uranium to it. If the North Korean and Iranian programs cannot be managed, we may have as many nuclear-weapon states outside the NPT as within it. And if geo-strategic change in the Middle East and North Asia continues along its current trajectory, several countries in the region may feel pressured to rethink the nuclear positions they established in the late 1960s and early 1970s.

The NPT's authority is being eroded by friends and foe alike. Lack of compliance with its disarmament provisions; perceived rewards for bad behaviour or for staying outside the regime altogether; insistence on the 'inalienable rights' of states to develop nuclear energy which shortens lead time to breaking out of the treaty; ease of withdrawal from the treaty and lack of effective enforcement or selective enforcement through the Proliferation Security Initiative (PSI) are key examples. The NPT seems too rigid and inflexible to deal with today's strategic realities. Still, we are afraid to amend it, lest its remaining authority unravel completely.

It is important not to overstate the threat and to grasp the opportunities offered by the current situation. The world is not (yet) awash with nuclear-armed states. Most of the states of concern within and outside the NPT were already identified a few decades ago, and some have disarmed. And those which have the weapons do not want others to have them. Now is the time to engage countries which have stayed outside the NPT to support the global non-proliferation enterprise, and to modernise the network of nuclear governance instruments.

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Australia should play a role in this process of renewal. A country of our size continues to have strong interests in a stable, functioning international rules-based system to deal with the global nuclear proliferation threat. Australia has a proven record in shaping international policy and proliferation control mechanisms for all classes of WMD. This is an area where Australian interests, know-how and record give us an opportunity to shape the debate and the rules.

We need to focus on areas where we have real prospects of influencing outcomes. We play a limited role in the current crisis surrounding Iran's nuclear ambitions, nor do we have a leading role in preventing nuclear terrorism.

As holders of 40% of the world's known reserves of uranium in a world hungry for clean energy, we have leverage which we should not waste. However matching our non-proliferation interests with our broader strategic and economic interests is a challenge for future Australian governments. It is tempting for Australia to take advantage of a window of opportunity to meet the demand surge now. Renewed interest in nuclear power worldwide may accelerate exploration efforts and our competitive advantage may be relatively short-lived. This increases pressure on us to act quickly to accelerate uranium exports, with consequences for our non-proliferation policy.

This is already happening. Uranium exports to China and Russia fall within the strict letter of the law, but are not in the spirit of our restrictive policy of the past, which favoured countries with solid non-proliferation records. Uranium sales to India make sense given its voracious energy needs. Indian access to efficient energy sources with a low carbon footprint is important to all of us. Yet the deal has undermined our wider non-proliferation objectives because it has asked for very little in return. It goes to the heart of the letter and spirit of our nuclear export policy and will have a major impact on the integrity of the global regime controlling nuclear trade, given Australia's high-profile promotion of best practice controls.

Australia is a member of the Nuclear Suppliers Group (NSG) which harmonises export controls on sensitive nuclear and dual use equipment, materials and technologies to prevent their diversion

to non-peaceful use. Those guidelines include NPT membership for all countries other than the established five nuclear powers as a prerequisite to nuclear supply. Australian and US sales of uranium to India are linked, among other things, to the NSG's agreeing to exempt India from its guidelines.

Quite literally, the NSG's decision will depend on what conservative suppliers like Australia and Canada decide to do. It is possible that the NSG will formally consider this matter within the next eight months, making it the first really sensitive nuclear policy action an incoming Australian administration will have to manage. India knows this. If Australia reneges on the deal or opposes granting an exemption of the NSG guidelines, it may put India/Australia relations in the freezer for some time. An incoming government should review the opportunities presented by uranium sales to India to extract firm commitments which at least match those of the official nuclear weapon states and which engage India in strengthening the global non-proliferation regime through concrete measures such as the cessation of nuclear testing and support for Fissile Materials Cut-Off Convention negotiations.

An Australian nuclear policy review will require a hard-headed assessment of whether the NPT is up to contemporary challenges and whether the current enforcement mechanisms are adequate. We need to think of ways to renew the effectiveness of the NPT without hastening its collapse. If we cannot amend it, how do we broaden its inclusiveness and effectiveness — e.g. by creating a new category of Protocol states for India, Pakistan and Israel? We will need to conduct a careful cost benefit analysis of maintaining strict export control regime standards versus a more pragmatic approach which brings outsiders into the camp of proactive non-proliferators.

If we want to gain economically from the emerging nuclear age, while continuing to support non-proliferation, we must be willing to consider some unpopular decisions, such as taking back nuclear waste, for which Australian geological structures are highly suited.

We can reinforce the logic of nuclear restraint by forswearing the option to enrich uranium. It does not make economic sense and would send the wrong signal to the world and our region. Regional fuel

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supply arrangements under IAEA supervision are a more palatable option.

Our diplomatic credit with the US and China can be used to urge them to stabilise their strategic relationship and to prevent a nuclear arms race in our region from which no one is likely to gain. Our influence is more limited when it comes to the larger question of nuclear disarmament, although we can certainly urge the nuclear-weapons powers to revive the spirit of Reykjavik as called for in the Wall Street Journal article, A World Free of Nuclear Weapons, signed by Kissinger, Schultz, Perry and Nunn.

Other, more visionary policies also warrant further study. A 'Manhattan Project' for meeting global energy needs which are environmentally sustainable and proliferation neutral is no longer a fanciful notion.

A thorough nuclear policy review should also consider which strategic circumstances might lead to Australia's revisiting the nuclear weapons option. As extreme as this may sound, failure to sustain and strengthen our current non-proliferation regime may force us to consider such an option. In the current strategic circumstances, no government could leave such an eventuality entirely out of mind.

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Dr Michael Fullilove is the Director of the Global Issues Program at the Lowy Institute

Australia's alliance with the United States is one of the most prominent features of our political and policy landscape. In political terms it generates huge public interest and helps to inform what voters think about the political parties' suitability for office. In policy terms it is important to our security and prosperity: furthermore it is a prism through which we approach other foreign policy issues. Sometimes it is a proxy for the general character of foreign policy which a government will run.

The next Australian Government will need to consider a number of issues relating to the US alliance, the first being the overall tone to strike. The forthcoming federal election *will not* determine whether Australia remains a close ally of the United States: a century of consistent diplomatic and military practice tells us that it will. Australia is arguably Washington's most reliable ally: the only country to fight beside the US in every major conflict of the 20th and 21st centuries. Both major Australian political parties agree on the advantages Australia derives from the alliance: the promise that we would be protected from a strategic threat, unlikely though that may be; the interactions with US military forces and their technologies that keep the ADF sharp; and privileged access to American intelligence and thinking.

However, although the election will not affect the health of the alliance it may affect its temperature. Leaders come and go, and their passage informs their country's bilateral relationships. The new British Prime Minister Gordon Brown has already telegraphed that his government will conduct its relations with Washington in a more businesslike, arms-length fashion than under his predecessor Prime Minister Tony Blair. Similarly a change of government, or of leader, in Canberra would likely change the atmospherics of our own alliance with the US.

The Australian prime minister will also need to consider how to manage that alliance in light of shifts in Australian public opinion. The 2007 Lowy Institute Poll indicated that President George W. Bush himself causes 69% of Australians to have an unfavourable opinion of the United States. More worryingly for those who support the relationship (as

opposed to those who like this particular president), support for the US alliance appears to have waned slightly in recent years: although 63% believe it is very or fairly important for Australia's security, this number is down from 70% in 2006 and 72% in 2005. In last year's poll, 69% of respondents felt that Australia takes too much notice of US views in our foreign policy.

The election may illuminate the limits to Australian support for the use of force by the United States. The Bush Administration is now running a much more orthodox, even multilateral foreign policy than it did for most of its first term. Nevertheless there are still circumstances in which Washington would use force to achieve its foreign policy objectives, and in that case it would probably look to Australia for material or moral support. Quite apart from our deployments to Iraq and Afghanistan, then, which are considered elsewhere in this guide, Canberra would need to decide whether to extend its support to any new operations, which would of course depend on the costs and risks of the operation.

The election of a new US president in November 2008 will probably produce a global sigh of relief. However, it will also pose challenges for the Australian Government. The alliance has achieved an unprecedented intimacy over the past half-decade. With the arrival of President Bush's successor, the relationship will lose some of its current emotional resonance. It may become less 'special'. Canberra will need to think about how to retain its current level of access in Washington if the new president is, for instance, an anti-war Democrat who has no tender feelings about Australia's participation in the Iraq war and is more interested in renewing ties with disillusioned European allies.

Australians may also need to consider how to react if the new president is intent on satisfying his or her protectionist colleagues in Congress. There is a new protectionism in the air in Washington, and several presidential candidates are running against free trade. The Australia-US Free Trade Agreement should provide us with some insurance against backsliding. However, if the broad consensus in favour of free trade were to collapse Australian economic interests could be threatened.

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Finally, the rise of China will increase the level of difficulty for Canberra. In recent decades Australia has enjoyed a congenial situation in which its biggest trading partner, Japan, is itself an ally of our strategic ally, the US. However, given the clip at which China is currently growing and the complementarity of the Chinese and Australian economies, China will soon overtake Japan. Then Australia's largest trading partner will actually be a peer competitor of Australia's principal ally.

The changing relativities do not just apply to trade, either: China's growing confidence, diplomatic dexterity and military power would, if plotted on a chart, produce a growth curve that is just as impressive as its economic results. Beijing's influence is growing in the oil-rich regions of Latin America and the Middle East, at the United Nations in New York and — most importantly for us — in Northeast and Southeast Asia and the Pacific. One of the next government's principal tasks, then, will be managing the US-China-Australia 'strategic triangle'. If that triangle turns toxic — for example in a dispute across the Taiwan Strait — the choices for Canberra could be excruciating.

Dr Malcolm Cook is the Director of the Asia & Pacific Program at the Lowy Institute

China's expanding economic and strategic weight is redefining the East Asian regional order and underpinning Australia's longest period of economic success. China is now our largest trading partner. Yet, in the next three to five years, the Australia-China relationship and China's reshaping of our region will potentially pose four policy challenges that could determine the future path of Australia-China relations and our place within East Asia and add a new dimension to Australia's relations with the United States and Japan.

The two broadest challenges are regional in scope. The first is an enduring one. China's rise has greatly complicated the network of Australia's most important bilateral relationships in East Asia. For the first time, Australia's main strategic partner globally, the United States, and its largest economic partner and main power in East Asia, now China, are not alliance partners but rather strategic competitors. Australia finds itself as the smallest and most peripheral point in a strategic diamond along with the United States, China and Japan, our three largest trading partners.

While Australia maintains 'best ever' relations with each of these global giants, the same cannot be said of US-China relations or Japan-China relations, both of which have become more tense and uncertain over the last decade. Beijing, officially and unofficially, is increasingly willing to question Australia's defence relations with Japan and the United States and to seek closer defence links with Australia itself.

The next government will have to resist pressure from China to give it a say over Australia's relations with either the United States or Japan. It will also have to ensure that our growing defence ties with each part of this strategic diamond are not misunderstood or misrepresented by others.

The second regional challenge is quite familiar but with a new China twist — how does Australia ensure that it is part of East Asia's economic and diplomatic integration rather than watching it as an outsider. China's rise has invigorated East Asian regionalism through the creation of the ASEAN + 3 grouping in 1997 and the East Asian Summit (which includes Australia) in 2005. China's growing regional diplomatic weight means that it will help decide

which of the three different regional groupings in East Asia — APEC, the East Asian Summit and ASEAN + 3 — rises to the top.

It is far from clear that Australia's interests here are congruent with China's. China favours ASEAN + 3 which excludes Australia. Taiwan's membership in APEC cools China's interest in this group, while Japan is taking the lead in the East Asian Summit. If, with Chinese sponsorship, ASEAN + 3 becomes the premier regional integration body with APEC fading into irrelevance and the East Asian Summit never building on its early beginnings, Australia would be on the outside along with the United States.

The third meeting of the East Asian Summit will be held in Singapore on 21 November. If the Australian election is over before this date, then the Summit would provide the Australian leader a great opportunity to discuss with Australia's regional partners the future of the region and Australia's plans for the next three years and beyond. If the election takes place after or on 21 November then Australia's chair will most likely be empty at this year's Summit where the future of the organisation will be top of the agenda.

The next Australian government should also push hard to conclude preferential trade deals with Japan and China and to launch one with South Korea as a hedge against any regional trade deal that excludes us. New Zealand is deeply worried that a Japan-Australia trade deal could seriously hurt its economy through its trade and investment diversion effect on New Zealand.

On the question of preferential trade deals, the next government may face the very difficult challenge of either aborting trade negotiations with China or signing up to a deal that is not comprehensive despite earlier assurances to the contrary. The negotiations since 2005 have moved very slowly with no discernable end in sight. This is not simply due to hard bargaining over sectoral interests but rather a fundamental difference in approach. Australia is pursuing a commercial deal covering all areas of the economy while China seeks a partial, politically palatable deal.

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Not signing a deal would certainly annoy the Chinese government, especially as this is its first negotiation with a major developed economy, and China is already copping a lot of international flak for its trade policy. Signing a partial deal that excluded major commitments in agriculture or services would weaken domestic and international support for Australian trade diplomacy and open up the government to charges of kowtowing to China for political reasons.

The final challenge is the most remote but could be the most damaging if it eventuates and one where there is no ready policy prescription. There is bipartisan support in Australia for a relationship with China that emphasises the great economic complementarity between the two countries while only acknowledging the significant political and ethical differences that divide them. There has been little or no debate in Australia about the fact that we are negotiating a trade deal with a one-party state led by the Chinese Communist Party. This sound, pragmatic approach could be threatened by an incident that focuses attention on these political differences.

Next year, the Beijing 2008 Olympics mean that many more Australians will be visiting China and our national attention will be focused on China. This increases the chances of Australian citizens finding themselves in legal strife in China at a time when the media focus on China is at an all-time high. What would the public reaction be to an Australian being convicted of a capital crime in China and facing the death penalty? The Van Tuong Nguyen case created a sudden, serious political management problem for both Singapore and Canberra, as did the Schapelle Corby case for Jakarta and Canberra. A similar case in China could cause similar populist trouble as our relationship with China is newer than that with Singapore and is not underpinned by similar strategic aims or a common link to British political heritage.

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Environmental stress from rapid economic growth, particularly in developing countries, will increasingly become a problem and generate considerable economic costs as well. Climate change is one manifestation of environmental stress and an issue that the world needs to urgently address. Another is rapid deforestation, particularly in Brazil and Indonesia. Deforestation causes significant stress on local environments as well as contributing to the global problems of loss of biodiversity and increasing greenhouse gas emissions. Deteriorating environmental quality is also a problem in China, where strong economic growth has rapidly increased energy use. However, it is not inevitable that strong economic growth be associated with deteriorating environmental quality. Well-designed incentives and clarity of property rights can lead to a positive relationship between the two.

The Kyoto protocol illustrates the danger of getting the policy prescriptions wrong. This protocol constructs a global framework that fails to take account of the tradeoffs between environmental outcomes and economic costs. It also does not adequately address the needs of developing countries, which have a long list of development issues to overcome in addition to their concern about the environment. The result is an agreement that sounds good in theory but has rendered a stalemate in global action for climate change because it ignores the uncertainty surrounding economic costs. A different framework that explicitly links the problems of greenhouse gas emissions and economic development is needed. An initial attempt at this is proposed by the Asian Pacific Partnership for Clean Development. This framework, however, has not been effective because it primarily focuses on voluntary actions around technology transfer alone. The problem for policy-makers is not just how to generate technology transfers but also how to build strong institutions and provide incentives for good environmental outcomes within countries.

Issues of environmental degradation often have implications well beyond local borders. Deforestation is an issue that clearly has local as well as global consequences. In developing countries deforestation is driven by the short-term economic gains from

logging and clearing of land for alternative uses. The problem has recently been further exacerbated as countries increase their use of bio-fuels as a solution to high energy prices. The use of bio-fuels in turn raises the demand for land under cultivation and further contributes to deforestation. Overall short-term gains from forest clearing are more certain than any long-term benefits from preserving the forest because of a lack of clear property rights. If forestry and land use are recognised as a sink for carbon then preserving forests would have a clear and immediate economic return. Deteriorating environmental quality, however, is not just a developing country problem. Policies in large industrial countries, such as the US ethanol policy, have effects that spill over into developing countries. Such policies fail to link the problem of climate change to the problem of energy security as well as creating a piecemeal approach to energy policy.

A decentralised system of national climate action built around a clear long-term price on carbon emissions allows domestic issues such as forestry and land use to be brought into the system within countries where this matters. This linking of problems at the national level is difficult under an approach like Kyoto because the Kyoto approach requires agreement from too many countries. However, it is possible to incorporate local problems into climate change policy under a system of national but coordinated carbon markets. In developing countries such as Indonesia and Brazil it is essential that a carbon trading market be established for global climate policy. This can be used to address problems in forestry. A carbon market in these countries would have a long-term goal for emissions that generates a long-term carbon price but with a short-term price cap for carbon to minimise the economic costs. Forestry, land use and other local environmental problems could be recognised as a source of annual permits (to support the price cap) that would be allocated each year once a certified forest was deemed to be a carbon store. If the forest were cleared the option to generate a permit would be lost with clear economic consequences.

Australia has great potential to contribute to a better global environment by proposing and

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encouraging the adoption of policies that promote economic growth and development as well as improved environmental outcomes. Australia may soon be adopting a national carbon pricing system with long-term carbon prices but where the government issues permits to cap the annual price of carbon emissions. The government could also certify that forestry permits from Indonesia may be traded in the annual permit market in Australia with the restriction that this is only possible while the carbon price is potentially rising above the annual safety value price. The existence of the Indonesian market, with verification undertaken for that market, and the fact that some of these forestry permits can also be traded in the Australian market, would greatly reinforce both systems. The payment for forestry permits would be a transfer from permit demanders to Indonesian foresters rather than to the Australian government.

What is not needed is a wholesale linking of markets into a global permit trading system. This could be counterproductive. Policies that recognise that forestry in some economies has externalities that benefit Australia are worth supporting. The Australian government has already started down this path with the recent announcement of a payment of \$50 million for forestry preservation in Indonesia. This could be enhanced by creating a more credible system of property rights within Indonesia over carbon, and by extension over forestry.

Rather than giving aid in the form of direct cash payments, the incoming Australian government needs to focus on building institutions for development that promote good environmental outcomes. Fundamental to this is the promotion of property rights and economic incentives that can enhance the development process in developing countries. A well-designed system based on carbon pricing but which incorporates other environmental issues specific to particular countries (particularly forestry) can lead to improved environmental outcomes that have national and global benefits.

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The South Pacific, especially the countries closest to Australia — Papua New Guinea, the Solomons, Timor Leste, Vanuatu — is the region where Australia is the major power and Australian policy decisions can make the most difference. Since the 2003 Australian-led regional mission to the Solomon Islands, the Australian government, with bipartisan support, has taken much greater responsibility for providing regional stability. This decision to get much more deeply involved was taken for the most challenging of reasons: declining social, economic and political indicators and rising fears of state failure (realised in the Solomons and Nauru) were felt to pose a threat to Australian national interests. Since the status quo was unacceptable, something more had to be done.

Australia's actions, actual and projected, in the Pacific are changing the nature and functions of our government agencies. The government has committed to doubling the Australian aid budget by 2010 to roughly four billion dollars annually with a strong focus on the Pacific, and Canberra is talking about staying deeply involved for decades or even generations. Kevin Rudd has committed a Labor government to an even more intimate involvement in states and societies of the Pacific. Recently, significant personnel increases to the Australian Defence Force and the Australian Federal Police have been justified by our growing responsibilities in the Pacific. These responsibilities, with their undetermined but distant time horizons, have reshaped the federal police's mission into an increasingly international one. Regional missions like East Timor and the Solomon Islands have stretched the resources of our defence forces and factored heavily in capability planning.

In the next three years, the Australian government will face four big questions in the Pacific that may prove difficult and costly to get right. The first will be how to strengthen AusAID, the Australian Defence Force and the Australian Federal Police to manage the increasing demands being placed on them. While the 2006 White Paper on aid commits to the doubling of aid, it speaks little of how AusAID will be reorganised to effectively absorb such a large and rapid increase in funds. The bipartisan commitment to stay deeply involved in the regional and national affairs of the

Pacific Islands for the long term, if lived up to, will place continuing personnel and operational pressures on federal police. The existing practice of calling on state police forces to provide personnel for major overseas deployments of uncertain length does not seem sustainable. Long-term stabilisation missions such as the Solomons and East Timor further blur the lines between defence, peacekeeping, policing and even social work, placing new training demands on our deployed security personnel and affecting their recruitment and retention.

The second question concerns the political limits of Australian engagement in the sovereign states of the Pacific and whether these will preclude Australian policy from achieving its desired outcomes. These limits are particularly important when considering further commitments, especially ones that require deeper intervention in the region's states and societies. In 2007 alone, the political leaders of the two major Pacific states — Papua New Guinea and Fiji — and the two Pacific states Australia is most deeply involved in — Papua New Guinea and the Solomon Islands — have accused Canberra of interfering in their sovereign affairs. Anti-Australian rhetoric is increasing across the arc of states to our northeast, often coming from senior political figures. These tensions could well intensify with the implementation of the recommendations in the 2006 White Paper that call for a deeper involvement of the Australian aid program in the political affairs of Pacific countries beginning with Papua New Guinea.

The third question is how will Australia deal with the growing economic and strategic interest of other powers in the Pacific. In the past few years, China, Japan, France, the European Union and Taiwan have all upped their involvement in the region. China now has more serving diplomats in the region than Australia while the Pacific is witnessing a sharp upsurge in mainland Chinese immigration. While Australia's interests in and commitment to the Pacific region are more profound than those of any other power, the growing role of others has already cut against Australian interests and policy. On the first day of the 2006 coup in Fiji, coup leader Commodore Bainimarama criticised Australian interference in

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Fiji and called for stronger relations with China. Taiwanese involvement in the 2006 Solomon Islands' elections contributed to the torching of Honiara. Greater foreign involvement in the Pacific has the potential to weaken Australian influence and policy effectiveness on the one hand or reduce Australia's exposure to it and the resulting financial burdens and image problems. It will be a challenge to ensure that we minimise the chances of the former and increase those of the latter.

The final question is whether Australia should open up its labour market more to Pacific workers. The region's poor record of job creation and its mounting youth bulge have led to growing calls from the region for Australia to open up its borders. The fact that some small Pacific countries face the prospect of being swallowed by rising sea levels adds a powerful moral impetus to these demands. The 2007 Lowy Institute Poll results indicate widespread popular support for a more open immigration policy with 65% of respondents seeing guest worker programs as a good way to fill labour market gaps and over 70% seeing them as a good way to help people from poorer countries. A continued unwillingness to open up our labour market could worsen Australia's relations with the peoples and states of the Pacific and undermine their willingness to accept further Australian involvement in their domestic affairs.

Australia's policies in the Pacific pose some of the most difficult questions for the next government. There is strong bipartisan support for Australia's role as the provider of regional stability at the cost of billions of dollars and huge administrative resources. Making sure the government spends these resources effectively and maintains support within the Pacific for a constructive Australian engagement in the region is a key requirement for the next administration.

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