

# EASTASIAFORUM

ECONOMICS, POLITICS AND PUBLIC POLICY IN EAST ASIA AND THE PACIFIC

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## An age of sanctions

**Nicholas Mulder** Asia's economic heft sustains Russia's economy

**Tania Voon** Testing the limits of WTO law

**William A Reinsch & Emily Benson** Semiconductor supply chains

**Hosuk Lee-Makiyama** US industrial policy the flipside of sanctions

**Nicholas R Lardy & Tianlei Huang** US–China decoupling ... and more

**ASIAN REVIEW: Yusuke Ishihara on Japan's grand strategy**

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Quarterly

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## From the editors' desk

Global trade stands at a crucial crossroads. The multilateral trading system that underpinned globalisation for three-quarters of a century is becoming sundered by power politics and fogged by mistrust.

Global growth is projected to decline this year and remain anaemic. Inflation, the rising rivalry between the world's two largest economies and Russia's invasion of Ukraine weigh heavily on the global outlook.

The war underscores how easily and quickly the trading ties between nations, once the measure and symbol of their comity, can be undone and weaponised. The conflict gummed up global supply chains, sending energy and food prices soaring. These shocks triggered too an unprecedented suite of economic sanctions, as governments threw their trade and investment heft behind their arsenals on the ground.

Sanctions and their ilk are at the juddering edge of systemic fragmentation. The trend predates the Ukraine war. Over the past decade, nations have increasingly turned to economic coercion and trade protectionism to meet geopolitical upheaval.

China has flung sanctions at Lithuania and embargoed trade with Australia and others. The United States has used trade barriers to confront Beijing's rise. The breakdown of the dispute settlement mechanism at the World Trade Organization stymies the ability of economies to find solutions.

This issue of *East Asia Forum Quarterly* details the impact of sanctions as they rip well beyond the battlefield. It interrogates how far sanctions have succeeded in hobbling Russia's war machine and questions their deterrent value outside of conflict or universal application. It details how supply chains have reshuffled around the reach of regulators. It asks how nations are using currencies to plumb opportunities created by the conflict. It explores the rising use of national security exceptions to multilateral accords and the disproportionate impact sanctions have had on the most vulnerable populations.

The world is at an inflection point no less profound than the postwar ruins which created the modern global trading system in 1947. As a new landscape fraught with uncertainty emerges, sanctions and trade weaponisation have become the hallmarks of an age of geoeconomic fragmentation. If they portend a return to global conflagration, we hope these essays suggest ways to choose another course.

Our *Asian Review* section features Asian commentary on Japan's transition away from the Yoshida Doctrine and Australia's AUKUS arrangement.

**Chuin Wei Yap and Samuel Hardwick**

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## CONTENTS

### 3 NICHOLAS MULDER

Asia's economic heft sustains Russia's economy

### 6 CRAIG KENNEDY

Russian oil exporters cast a shadow on Western sanctions

### 8 HOSUK LEE-MAKIYAMA

US industrial policy the flipside of sanctions

### 10 TOM WESTLAND

The false logic of sanctions as deterrents

### 13 TANIA VOON

Testing the limits of WTO law

### 15 WILLIAM A REINSCH AND EMILY BENSON

Chipping away at global semiconductor supply chains

### 17 MARTIN CHORZEMPA

Overuse of financial sanctions risks dollar's role

### 20 YUSUKE ISHIHARA

**ASIAN REVIEW:** Japan's grand strategy as a declining power

### 22 ARISTYO RIZKA DARMAWAN

**ASIAN REVIEW:** Australia's defence ambitions need Southeast Asian trust

### 26 DURSUN PEKSEN

The human rights effect of economic sanctions

### 28 SUSANNAH PATTON

What's next for sanctions on Myanmar?

### 30 BENJAMIN KATZEFF SILBERSTEIN

The complicated truth about sanctions on North Korea

### 32 M HABIB ABIYAN DZAKWAN AND NOVIA XU

Indonesia's decarbonisation agenda and Russian sanctions

### 34 STEWART PATERSON

Circumventing economic sanctions

### 36 NICHOLAS R LARDY AND TIANLEI HUANG

Is US-China decoupling heading in a dangerous direction?

Footage of Russian President Vladimir Putin meeting Chinese President Xi Jinping at the Kremlin is broadcast on a giant screen at a shopping area in Beijing (2023).



# Asia's economic heft sustains Russia's economy

NICHOLAS MULDER

**T**HIRTY-SEVEN countries have imposed economic sanctions on Russia since its invasion of Ukraine in February 2022. The breadth of this campaign has few precedents in recent history. The sanctions covering finance, energy, technology, travel, shipping, avionics and commodities are aimed at one of the 10 largest world economies. Yet the economic pressure on Moscow is by no means as hermetic as previous anti-war sanctions campaigns, such as the UN

sanctions against Iraq after Saddam Hussein's 1990 invasion of Kuwait.

One year after their imposition, several things are clear. Sanctions have damaged the Russian economy and its future growth prospects. But they have neither caused its collapse nor helped to end the war in Ukraine.

Much attention has been devoted to how US dollar dominance facilitates Western financial sanctions. But the mixed results of the economic campaign against Russia demonstrate

that a powerful countervailing trend has gone largely unnoticed: the rise of Asian commercial power as a facilitator of trade diversion that blunts Western sanctions.

Modern economic sanctions were created in the early twentieth century at a time of undisputed European mastery of the world economy, a mantle subsequently passed to the United States. This Western economic dominance lay behind the expansion of sanctions during the Cold War

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COVER PHOTO: Semiconductors are made in a workshop in Suqian, Jiangsu province (2023). PICTURE: CFOTO / Sipa USA.

period. But the global economic centre of gravity has since moved towards the East.

In 2021, Asian economies constituted 39 per cent of global nominal GDP, making them the single largest continental bloc. Asian exports constituted 36 per cent of global exports, while the five largest Asian economies together—China and Hong Kong, Japan, South Korea, Singapore and India—accounted for a quarter of all global imports. Asia today constitutes three-quarters, and China and India fully half, of global year-on-year GDP growth.

**T**HE 2022 sanctions campaign against Russia has exposed the strategic consequences of this shift. Sanctions against Moscow were intended, as one US National Security Council official put it, as a form of economic ‘shock and awe’. Yet after a brief financial crisis, Russia rerouted much of its trade towards Asian economies and weathered the initial sanctions onslaught.

Asian economies have acted as alternative destinations for Russian exports as well as new sources of imports. Trade links with China, India, Turkey, Gulf states and Central Asian countries have buoyed the Russian economy. Bilateral trade between Russia and China grew 29 per cent in 2022 and 39 per cent in the first quarter of 2023. It may reach US\$237 billion by the end of 2023—a sum larger than China’s total bilateral trade with economies such as Australia, Germany or Vietnam. In 2022, Russian trade with the United Arab Emirates rose by 68 per cent while trade with Turkey increased by 87 per cent. Russo–Indian trade surged by 205 per cent to US\$40 billion.

Export diversion has been a lifesaver for Russian energy sales,

which constitute a large share of its trade. In January 2022, European countries imported 1.3 million Russian barrels per day while Asian customers purchased 1.2 million. By January 2023 Russian sales to Europe had dropped below 100,000 barrels per day but exports to Asia had surged to 2.8 million.

Asian demand has more than substituted for the loss of oil exports to Europe. India has become the single largest purchaser of Russian seaborne crude, buying more than 1.4 million barrels per day since the beginning of 2023. Chinese importers are not far behind, buying between 800,000–1.2 million barrels per day in 2022. In one year, India, China, Turkey and the Gulf states have entirely replaced European demand for Russian oil exports.

Asian exporters have also filled part of the gap left by Western suppliers of advanced manufacturing and high-tech equipment. Chinese firms now account for 40 per cent of new car sales and 70 per cent of smartphone sales in Russia. The withdrawal of Western foreign direct investment has severely impacted the domestic car industry. Russia has shifted to importing used European and Japanese cars through third countries, with new cars mainly coming from China.

China and Hong Kong have become key suppliers of microchips, which Russia began to stockpile before the war. In 2022, Russian companies shifted to importing more advanced chips, with the value of semiconductor and electronic circuit imports rising by 36 per cent between January and September compared to 2021. It remains to be seen how effective these import channels will be in the long run. But in the short run Western export controls on technology have not created a chip famine in Russia.

Russia’s trading partners in the

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... after a brief financial crisis, Russia rerouted much of its trade towards Asian economies and weathered the initial sanctions onslaught

Eurasian Economic Union have also played a role in bypassing technology export restrictions. Central Asian economies are active as conduits of parallel imports and transit trade. The European Bank for Reconstruction and

Development concluded that while Russian trade with the United States, United Kingdom and European Union has dropped significantly, 'EU [and] UK exports to Armenia, Kazakhstan and Kyrgyzstan... increased markedly' in a pattern 'consistent with [the] rerouting of trade to Russia.'

This rerouting effect through Central Asia is noticeable in imports of machines and chemical products. By October 2022 year-on-year increase in exports to Russia from China, Belarus, Turkey, Kazakhstan, Kyrgyzstan and Armenia nearly equalled the fall in European, US and UK exports to Russia.

By acting as ersatz suppliers to the Russian economy, as substantial new customers for its commodity sales and as a price-setters for Russian oil exports on global markets, Asian economies have considerably reduced

the impact of Western sanctions. While the sanctions have lowered Russia's growth potential, its economy has been sustained by a major trade realignment. The participation of Japan, South Korea, Taiwan and Singapore in financial and technology sanctions has had little effect, partly because commercial ties between these East Asian states and Russia continue in manufacturing and energy trade. Asia's sanctions-blunting commercial power therefore rests primarily with China and India and several Middle Eastern and Central Asian economies. These geoeconomic realities seem bound to complicate the future Western use of sanctions. [EAFQ](#)

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PICTURE: REUTERS / OLESYA ASTAKHOVA



An employee works at Gazprom Neft's lubricant plant in Omsk (2022).



Oil tankers and shipping vessels sail near the port city of Nakhodka, Russia (December, 2022).

# Russian oil exporters cast a shadow on Western sanctions

CRAIG KENNEDY

**I**N JANUARY 2023, Russian President Vladimir Putin instructed senior Kremlin officials to find solutions to something he termed the *'diskont'*—a problem he feared could 'cause issues with the budget'. Putin was referring to the deep price reductions or 'discounts' Russian oil exporters have been forced to offer to willing buyers amid Western sanctions.

With oil exports the largest contributor to Russian state revenues,

these discounts are a cause for concern. They are largely to blame for a 25 per cent year-on-year contraction in Russia's budget revenues for January and February. That period also saw a 52 per cent spending increase, mostly caused by Russia's full-scale invasion of Ukraine. The result is a mushrooming deficit that threatens to erode Moscow's economic resilience.

These discounts are a direct result of the European Union and G7 oil

sanctions against Russia and have proven more challenging for Moscow than many anticipated. They have reduced Russia's current revenue and can also curb future windfalls should prices rally.

But the Kremlin has been developing countermeasures to thwart sanctions. Chief among them is assembling a 'shadow fleet' of tankers able to transport Russian oil with impunity. Though Moscow's shadow

fleet has been steadily expanding, it will likely be years before it is large enough to shield all Russia's exports from sanctions. But as the shadow fleet expands, these tankers—many ageing and poorly maintained—pose an increased risk of oil spills in coastal regions from the Baltic to the Sea of Japan. To counter these threats, coalition policymakers and coastal states will need to take robust action.

Russian oil sanctions consist of two separate embargos. The first is an EU/G7 ban on Russian oil imports, which has forced Moscow to find new buyers for nearly three-quarters of its oil exports. For an exporter of Russia's size, this has proven a challenge. For 140 years, Russia has looked to Europe as its principal export market. Its sprawling oil infrastructure is primarily designed to move oil westward, with over 80 per cent of seaborne exports plying European waters. Sanctions are forcing these cargoes to be shipped to less familiar markets that are more constrained and remote.

Only two large buyers remain for Russian crude—China and India. Before February 2022, China was buying nearly 20 per cent of Russia's exports and it has since stepped up imports modestly. The big buyer of Russia's crude—absorbing more than half—has been India, which previously imported almost no Russian oil. Lack of competition at scale has given Indian traders powerful bargaining leverage to extract the deep discounts that are worrying Putin. The longer distances to market have also boosted Russian freight costs, further shrinking Moscow's bottom line.

Moscow has taken two measures to combat the discounts. One is to ease the glut of Russian crude by announcing a cut in exports. The other is to sell more to China to

regain pricing leverage. But additional deliveries to China must come from Russia's distant Baltic and Black Sea ports because China-bound exports from its Pacific ports are close to capacity. This means higher freight costs and an undesirable increase in Russia's tanker needs. That makes Russia even more vulnerable to the second EU/G7 embargo—a so-called 'price cap' which bans EU and G7 entities from providing shipping services for any Russian seaborne oil priced above a certain value. For crude oil, this capped price is currently US\$60 a barrel. The price cap seeks to limit Russia's ability to reap windfall revenues from high oil prices while avoiding the supply shock an unconditional ban on shipping services would cause.

**R**USSIA'S tanker needs are immense and meeting them without relying on European marine services is a challenge. From vessel finance to fleet ownership, Europe plays an outsized role in all aspects of global oil shipping, particularly in the complex area of mandatory oil spill liability insurance. Some 95 per cent of the global fleet is insured by a sophisticated not-for-profit network of mutual assurance societies called the International Group of P&I Clubs (IG).

The IG insures industry-wide liabilities that are too large for the commercial insurance sector to cover. Because it is based in Europe, the IG requires insured vessels to comply with the price cap as a condition of coverage. Complying with sanctions is the trade off that shipowners take for what is an indispensable part of their business model.

Russia has increasingly turned to a marginal group of tankers—the so-called 'shadow fleet'—to reduce its IG-insured fleet dependence. Shadow

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[Russia's] sprawling oil infrastructure is primarily designed to move oil westward, with over 80 per cent of seaborne exports plying European waters. Sanctions are forcing these cargoes to be shipped to less familiar markets that are more constrained and remote

tankers normally spend most of their service life as IG-insured vessels in the mainstream fleet. But in the final years before they are retired, many tankers are sold to second-tier operators who sweat them for cash.

Some operators are anonymous 'shadow' investors based outside EU/G7 countries and pursue a risk-friendly business model where IG policies are replaced with coverage from niche, low-transparency insurers. While some insurers are reportedly undercapitalised and offer inferior policies, they compensate shadow-tanker shipowners through relaxed insurance standards and a laissez-faire approach to sanctions that allows them to pursue lucrative business in Iran, Russia and elsewhere.

Since the summer of 2022, the number of shadow tankers

transporting oil from Russia has been growing. Over the coming months, these vessels will pass through crowded maritime chokepoints in Europe and Asia laden with oil. A September 2022 collision in the Singapore Strait highlights the danger they pose. As their numbers continue to grow, so too does the risk of a catastrophic spill.

Despite its swelling shadow fleet, Russia still relied on IG-insured tankers for over 60 per cent of its exports in March 2023. So far, this has cost Russia little, since most of its oil continues to trade below the price cap. But if prices rally, Russia may have to choose between cutting exports or prices. It may try to avoid this choice altogether by underreporting transaction prices—a scheme it appears to be pilot-testing on some cargoes already.

Oil sanctions continue to take a toll on Russian revenues, but Moscow is stepping up its evasion efforts. Coalition policymakers can counter these efforts by ratcheting down the price cap and enhancing oversight. Coalition countries should also encourage Russia's remaining large importers to resist Russian pressure for kickbacks, offsets or other compensation lest such practices increase pressure for secondary sanctions. Finally, to combat the heightened risk of a catastrophic spill, coastal states will need to push for an end to lax enforcement of safety regulations for shadow tankers. [EAFQ](#)

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# US industrial policy the flipside of sanctions

HOSUK LEE-MAKIYAMA

**A** NATION can be transformed.' With those stately words, US President Joe Biden signed the *Inflation Reduction Act* (IRA) into law in August 2022. Despite the fractured state of US partisan politics, the Democratic Party guided the largest energy subsidy in US history into being with a new national ethos for greening the economy while tilting global competition in the United States' favour.

The IRA is part of a broader policy agenda with the *CHIPS and Science Act* that provides US\$280 billion in federal funding for research and the fabrication of logic and memory chips inside the United States. The *Infrastructure Investment and Jobs Act* also funnelled US\$700 billion into electrification, renewable energy and digital infrastructure and has already funded 20,000 projects since 2021.

Understandably, there is some consternation over the market-distorting effects of Washington offering Beijing-style direct subsidies for those willing to bet on the Democrats' 'Make It in America' agenda. While governments with cash to spend—like members of the European Union—have pledged their own net-zero industrial plans and chips subsidies, Asian leaders, like Indonesian President Joko Widodo, have hinted at trade remedies to

protect Asia's budding electric vehicle industry against unfair market practices abroad.

US industrial policy is not just transformative for the United States—but also for Asia, and intentionally so. The United States will subsidise hydrogen investments twice over: first for its production and again when it is used by energy-intensive industries across Asia, such as steel, aluminium, chemicals and heavy manufacturing. Such double-sided stimuli will change the parity of competition against China and with allies and net importers of energy like India, Japan, South Korea and Vietnam. Carbon levies, currently under consideration, will also hamper exports from countries like Malaysia or Indonesia.

These subsidies also have some broader macro effects on Asia. While Trump-era tariffs created little or no jobs at home, the 2017 US tax reforms incentivised US multinationals to repatriate trillions from East Asia back into the domestic economy. The IRA will funnel these profits into investments rather than shareholder dividends. The United States is already the largest recipient of foreign investments—thanks to its position as the world's most productive economy by some margin—and the IRA will divert more capital from East Asia into the United States.

But the Biden administration's industrial policy trifecta is not just an



innovation moonshot of the 1960s. There is also an ideological shift—which National Security Adviser Jake Sullivan describes as the ‘new Washington consensus’—from a productivity-driven economic policy towards a statecraft-led one that aims to secure a comfortable lead over any rival on emerging technologies. If US sanctions are designed to stop China from ever landing on the Sea of Tranquillity, the subsidies are the flipside of the same coin.

But today’s geostrategic competition is also a challenge different from that of the Cold War. Unlike the Soviet Union, China is deeply integrated into global production networks with well-diversified fiscal revenue. The United States would never be able to outspend it.

Nor is China the only rival. The puzzlement over whether electric vehicles from US allies—but commercial rivals—like Japan or

Germany qualified for IRA tax credits showed how distinguishing allies and adversaries is a second-order priority for US legislators. Other subsidies favour 5G equipment from a private consortium led by US cloud companies and Chinese military contractors—such as ZTE, Inspur, Phytium and H3C—over trusted South Korean and Nordic manufacturers like Samsung, Ericsson and Nokia.

But perhaps the most conspicuous plans pertain to moving manufacturing of high-end processors and dynamic random-access memory chips to the United States. The market leader, Taiwan Semiconductor Manufacturing Company, estimates that the construction costs are likely to be at least four times higher than they would be in Taiwan due to skill shortages and administrative red tape. Its CEO, Morris Chang, candidly called the US effort to bring chipmaking home an ‘exercise in futility’.

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But the Biden administration’s industrial policy trifecta is not just an innovation moonshot of the 1960s

Absent of commercial logic, such endeavours seem eerily similar to Beijing’s attempt at forced technology transfer, especially in light of US export controls towards South Korean and Taiwanese owned microchip manufacturing plants in China.

Given such negative outlooks and global ramifications, it is an open question whether Biden’s gamble will

PICTURE: REUTERS / JONATHAN ERNST



US President Joe Biden and Energy Secretary Jennifer Granholm attend a video conference for electric battery industry grant winners (Washington DC, 2022).

pay off.

Many economists are negatively disposed to US industrial policy as markets inevitably make better informed and diversified bets on future technologies than government officials. Postwar activist policies in Japan, South Korea and Taiwan were successful because they redirected scarce resources into sectors that held more long-term promise. They then ceased to be productive once the countries matured into dynamic market economies.

East Asian countries could shield their ministries from lawmakers and lobbyists representing special interests. Elsewhere, industrial policy is prone to failure in stakeholder systems like the United States or China, where lobbying has been elevated to performance art. Auto

bailouts, Cray supercomputers, solar panels and attempts to synthesise fuel from coal failed because the government supported unviable ideas or companies that were politically well connected.

In contrast, innovations often labelled as successful—from the early breakthrough in semiconductor technology in the 1960s to COVID-19 vaccines—were not thanks to the White House betting on the right technology or company, but the results of broader support for scientific research.

In the coming decade, the United States will spend US\$100 billion annually on industrial support, a sum larger than the entire government expenditure of Singapore. While many programs will fail, a few projects may prolong US industrial pre-eminence—

especially if the incentives are carefully designed to exploit Asia and Europe's struggle with higher energy prices.

As Samuel Huntington said of the United States' relative industrial decline against Japan back in 1988, 'the United States is unlikely to decline so long as its public is periodically convinced that it is about to decline.' Such aversion to defeatism—real or imagined—is indispensable in mobilising the nation into something previously unthinkable, or even slightly un-American, like industrial policy. [EAFQ](#)

*Hosuk Lee-Makiyama is Director of the European Centre for International Political Economy and Senior Fellow of the Singapore Institute of International Affairs.*

## GLOBAL SCORECARD

# The false logic of sanctions as deterrents

TOM WESTLAND

**O**VER a year ago, a long-telegraphed war began between Russia and Ukraine. On paper, the odds were lopsided. Russia had the second most powerful military in the world, according to the Global Firepower rankings in 2021, while Ukraine ranked between Vietnam and Thailand. At the start of the conflict, many analysts expected a short, brutal

war and Russian annexation.

What we got was a long, bloody war, with the sides much more evenly matched. Predicting the outcome is hazardous, but it is not out of the realm of possibility that Ukraine will end up reclaiming control over not just the Donbas but perhaps even Crimea.

Exhausted by two decades of essentially fruitless warfare in the

Middle East, the United States had neither the appetite nor the resources to become directly involved, especially not with another nuclear power. The Biden administration and its allies in Europe and Asia instead leaned heavily on non-military forms of pressure and, in particular, on one of the most comprehensive packages of economic sanctions in history. These included



Protestors in London demand the supply of air defence and anti-missile systems, implementation of further sanctions including bans on energy trade, exclusion of all Russian banks from the SWIFT payment network and help for refugees on the 11th day of Russian invasion of Ukraine (March 2022).

freezing Russian assets—such as the foreign exchange reserves held by the Russian Central Bank in foreign central banks—and the expulsion of Russian banks from the SWIFT interbank network. Major restrictions on goods and services trade were also imposed.

The sanctions, obviously, did not stop the war, but they have evened the odds. The days when a middle-income power like Russia could hope to be self-sufficient in military production are long gone, particularly given the technological requirements for modern weaponry. Western sanctions have crippled Russia's ability to replenish its arsenal, and this has made a real difference for Ukraine. It is now increasingly likely that Russia will have to severely limit operations in order to conserve ammunitions that it cannot replace at the rate it needs. The medium-term impact of the sanctions

regime on technology-intensive sectors like aviation is also starting to tell.

The long-run consequences of Russia being so thoroughly unplugged from the global exchange of technology can be seen in the estimates of potential GDP growth. A country of its income level—per capita income is roughly on a par with that of China—ought to be able to manage respectable rates in the mid-single digits. Instead, Russia can look forward to a gloomy future of 1 per cent growth, all while the population is both ageing and shrinking.

**S**O, three cheers for sanctions? Even from the point of view of the United States and its allies, the scorecard is not so clean. Most obviously, the turmoil in global commodity markets, as Russian gas in particular has been withheld, has

shown that disconnecting a quite large country from the world economy will come with serious consequences. A sober analysis would show that these consequences could be contemplated in the event of armed conflict—a Chinese invasion of Taiwan for example—but should not become a regular tool of statecraft.

Unfortunately, that is precisely what policymakers around the world are now not only contemplating but putting into practice. Export controls are often considered an entirely separate phenomenon from sanctions, but economically speaking they are very similar. Controls on 'sensitive' products—like extreme ultraviolet lithography machines that are necessary to produce semiconductor chips—have been put in place to prevent 'Western' technology from reaching China. Washington, not content to impose its own bans, is

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Washington, not content to impose its own bans, is strong-arming its allies into complying with a far-reaching set of restrictions

strong-arming its allies into complying with a far-reaching set of restrictions. Beijing's obvious response is to speed up its own plans to develop a relatively autonomous semiconductor industry.

It is sometimes argued that it might be possible to devise a regularised system of sanctions to deter bad behaviour that would not necessarily need to be put in place: a financial nuclear deterrent. A resurrected Cold War logic of mutually assured destruction does not, however, translate neatly to the logic of economic sanctions. In the case of nuclear weapons, the first state to push the button will unavoidably suffer the consequences of a nuclear war.

If a would-be antagonist of the United States is aware of the likely actions that Washington might take in the event of a conflict—seizing its financial reserves held overseas, for example—the antagonist nation will do everything to ensure that it does not face these penalties prior to the outbreak of conflict. Some costs are unavoidable, but many can be blunted or minimised with adequate preparation.

The upshot of this fact is simple: a world in which sanctions are routinely expected is one in which sanctions will become ineffective.

IN A world in which sanctions and export controls become a banal tool of interstate competition, they will not only lose their potency; they will end up damaging the global order they are supposed to protect. The Biden administration likes to suggest its new approach that combines aggressive industrial policy at home with strong economically coercive measures abroad will, in the words of the US National Security Advisor Jake Sullivan, 'build a fairer, more durable global economic order'.

It is difficult to tell whether American policymakers believe their own hype, but surely no one else does. While it is legitimate to contemplate the use of sanctions in a scenario in which China turns to military means to resolve the Taiwan question, the export controls imposed by the West have little deterrent value.

The region with the most to lose from this scenario is undoubtedly Asia, which lies at the heart of a global economy built on the free movement of goods and capital, following economic rather than political logic. While some countries might gain from the relocation of foreign investment away from China towards more politically friendly territory, overall, an economic order that is ruled by geopolitics will make the region, which is dependent on a production model characterised by complex international value chains, poorer.

The great and underappreciated achievement of Bretton Woods was—at least within that part of the world subject to its disciplines—to divorce security concerns from economic ones. A country like Japan, the object of lingering animosity and suspicion in many parts of Asia and the Atlantic, was incorporated into the global economy through a system of clear rules that were in the mutual interests

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... an economic order that is ruled by geopolitics will make the region, which is dependent on a production model characterised by complex international value chains, poorer

of both Japan, as a rising economic power, and the established powers of Europe and the United States.

The endeavour to incorporate Japan into the rules-based order was so successful that it is easy to forget that it was not inevitable. The challenge of finding a durable *modus vivendi* between China and the United States is admittedly of another order of magnitude. But the catastrophe of the interwar years is a sobering reminder of what happens when a rules-based order breaks down.

No set of institutional rules can prevent a country from behaving irrationally, as Russia did. But the economic order can be organised around principles which maximise the benefits of peaceful engagement. Resurrecting and strengthening that order is the most important task facing Asia and the world. [EAFQ](#)

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# Testing the limits of security exceptions

TANIA VOON

**G**ROWING use of economic sanctions by numerous countries today has increased the significance of WTO security exceptions, which allow members to retain otherwise WTO-inconsistent measures—such as discriminatory tariffs or import quotas or bans—on grounds of national security.

In four cases since 2019, WTO panels have ruled on WTO members' invocation of security exceptions. These cases ended almost 25 years of silence on the meaning of the security exceptions in the WTO dispute settlement system. Even before the WTO, the security exception was hardly mentioned in the WTO's predecessor, the General Agreement on Tariffs and Trade 1947.

The approach of these panels has been to grant some deference to WTO members in interpreting and applying security exceptions, while maintaining jurisdiction and requiring an objective analysis of whether respondent members are justified in invoking them. Simply pointing to generalised concerns about human rights or excess capacity has been insufficient.

This approach may prevent the security exceptions from devolving into an unmonitored justification that is open to abuse. A more deferential and less exacting interpretation could seriously undermine the benefits of progressive trade liberalisation, including significant tariff reductions, achieved since 1947.

The panels' rulings are nevertheless

likely to increase US intransigence towards the WTO dispute settlement system and the organisation itself. The WTO Appellate Body, which comprises seven individual members, is already non-functional because the United States continues to block the appointment of new members—with the term of the most recent member having expired in 2020.

In *Russia–Traffic in Transit*, adopted without appeal in 2019, the WTO panel accepted Russia's invocation of the security exception in Article XXI(b)(iii)

of the General Agreement on Tariffs and Trade 1994 (GATT).

In *Saudi Arabia–IPRs*, Saudi Arabia was partially successful in invoking the corresponding security exception in Article 73(b)(iii) of the Agreement on Trade-Related Aspects of Intellectual Property Rights. As Qatar and Saudi Arabia agreed to terminate their dispute without adoption of the report, it lacks formal legal status but may nevertheless be informative.

In late 2022, WTO panels rejected the United States' invocation of

PICTURE: REUTERS / JONATHAN ERNST



US President Joe Biden and World Trade Organization Director-General Ngozi Okonjo-Iweala speak as G7 leaders as enter the Schloss Elmau castle in the Bavarian Alps during the 48th G7 summit (2022).

GATT Article XXI(b)(iii) in *US–Steel and Aluminium Products*—in disputes brought by China, Norway, Switzerland, and Turkey—and *US–Origin Marking*. The United States appealed these reports ‘into the void’ in early 2023.

**I**N THE absence of any indication from the Appellate Body on the interpretation or application of security exceptions, and with only one adopted WTO panel report, what do we know? WTO panels refuse to accept the argument—put forward by Russia and the United States—that WTO security exceptions are ‘self-judging’ or ‘non-justiciable’.

GATT Article XXI(b) provides that ‘[n]othing in this Agreement shall be construed to prevent any Member from taking any action which it considers necessary for the protection of its essential security interests.’

According to the panel reports, the words ‘which it considers necessary’ are qualified in two main respects. First, they are followed by subparagraphs limiting the kind of actions covered. For example, under Article XXI(b)(iii), action ‘taken in time of war or other emergency in international relations’. A panel will

determine objectively whether the challenged actions fall within the relevant description.

Second, panels will not give absolute deference to a member’s assertion that their actions are necessary for the protection of their essential security interests. A WTO panel will assess the plausibility of the member’s articulation of its essential security interests as well as the connection of the challenged measures to those interests. The cases also indicate the kinds of circumstances that may amount to an ‘emergency in international relations’ and the kinds of measures that may be necessary to protect ‘essential security interests’.

In *Russia–Traffic in Transit*, the panel found that ‘the situation between Ukraine and Russia since 2014’ constituted an emergency in international relations, defined as ‘a situation of armed conflict or of latent armed conflict, or of heightened tension or crisis, or of general instability engulfing or surrounding a state.’ The panel found plausible Russia’s contention that it implemented measures restricting transit of goods from Ukraine across Russia to protect its ‘essential security interests’.

In *Saudi Arabia–IPRs*, the panel found that an emergency in international relations began between Saudi Arabia and Qatar when Saudi Arabia severed all ‘diplomatic, consular and economic relations’ with Qatar. The panel accepted Saudi Arabia’s argument that it implemented ‘anti-sympathy’ measures—preventing a Qatari corporate group from obtaining counsel to enforce its intellectual property rights in Saudi Arabia—to protect its essential security interests.

In *US–Origin Marking*, the panel found that a US requirement that goods imported from Hong Kong be

marked ‘China’ rather than ‘Hong Kong’ fell outside the exception in GATT Article XXI(b)(iii) because concerns about the ‘human rights situation in Hong Kong’ had not ‘escalated to a threshold of requisite gravity to constitute an emergency in international relations’.

Similarly, in *US–Steel and Aluminium Products*, the panel found that additional import duties imposed by the United States on derivative steel and aluminium products were not justified under GATT Article XXI(b)(iii) because ‘concerns regarding global excess capacity in steel and aluminium’ did not ‘ris[e] to the gravity or severity of tensions on the international plane’ necessary to constitute an emergency in international relations.

**T**HESE rulings demonstrate that the security exceptions provide some scope for WTO members to define their own essential security interests, as well as the measures necessary to protect those interests. Yet panels have been unafraid to undertake an ‘objective assessment’ of the existence of an emergency in international relations and the validity of claimed connections between challenged measures and security interests in the context of such an emergency. Panels have sought an appropriate balance to prevent abuse of exceptions, which could otherwise allow members to circumvent their WTO obligations.

The panels’ refusal to accept the US position that ‘[i]ssues of national security are political matters’ beyond the reach of WTO disputes is likely to increase US resistance to negotiations on Appellate Body appointments.

The United States has suggested it will seek an authoritative interpretation of GATT security exceptions. Such interpretations may

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WTO panels refuse to accept the argument—put forward by Russia and the United States—that WTO security exceptions are ‘self-judging’ or ‘non-justiciable’

be adopted with agreement by three-quarters of the WTO's 164 members. The likelihood of reaching such an agreement is low.

Absent a WTO Appellate Body, pressure may increase on the Multi-Party Interim Appeal Arbitration Arrangement (MPIA). The 53 WTO members party to the MPIA include Australia, Brazil, Canada, China the

European Union, Japan, New Zealand and Singapore. Two cases have been finalised and eight are continuing in that forum.

Notwithstanding US non-participation, the MPIA could still contribute to the interpretation and application of the WTO security exceptions. MPIA rulings are binding on relevant parties and could also

be persuasive in the WTO dispute settlement system. [EAFQ](#)

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## NEW US RULES

# Chipping away at global semiconductor supply chains

WILLIAM A REINSCH AND  
EMILY BENSON

**O**N 7 October 2022, the US Bureau of Industry and Security issued new regulations on exports of semiconductors and certain semiconductor manufacturing equipment. The rules attempt to block Chinese access to high-end artificial intelligence chips through a combination of new controls on software, people, knowledge transfers, manufacturing equipment and US components integrated into foreign products.

The new rules are a significant shift in an export control policy that the United States has been pursuing for nearly 30 years. The previous policy was designed to keep adversaries, primarily China, one or two generations behind the United States technologically. Under this policy, the United States would raise the level of

controls as new technology emerged, before releasing older generations for export.

In other words, the controls were a deliberate moving target. That had three effects. China was denied access to the most advanced technology. US companies were able to sell older technology to China and use the revenue generated for research and development. And the provision of older US technology to China reduced the incentive for the development of Chinese alternatives.

Deteriorating relations between the United States and China as well as the realisation that the third point above had diminishing returns—China embarked on its own path of independent technology development many years ago—led to the new US rules being implemented. The

main difference in the new policy is the creation of a technological line of control that the current US administration does not intend to move.

The United States has shifted its

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The United States has shifted its policy from simply trying to keep China behind to actively seeking to degrade its military capabilities

policy from simply trying to keep China behind to actively seeking to degrade its military capabilities. Maintaining export controls at the same level regardless of future technology developments means that the universe of controlled items and technologies will become much larger over time. It also means that enforcement will become more difficult and the cost to US producers will increase.

The short-term impact of the new rules appears to be fairly small for chip makers, since a relatively small number of chips were directly affected. But

it has been larger for the equipment manufacturers, who have a significant market in China. Assessing the long-term impact requires examining three questions. What will be the effect of the new rules on US company revenue? Will the new controls accelerate China's policy of indigenous technology development? Will the new controls eventually lead to 'designing out', a scenario where other countries develop products that contain no US technology and are therefore outside the scope of US export controls?

Currently, these questions cannot be fully answered, but there are some

hints at what might happen. With respect to US company revenue, the immediate impact is likely to be small on chip manufacturers and large on equipment makers. Over time, as the universe of controlled items grows, the negative revenue impact will also grow and US companies could find themselves strapped for capital. This will adversely affect their research and development expenditure on future generation technology to the competitive detriment of companies.

With respect to China's policies, the new US rules will almost certainly accelerate China's plans for indigenous technology development. Those were already underway, but the sweeping nature of the new rules will push China to move more quickly. A report to the 20th Party Congress in October 2022 included the mandate to 'achieve greater self-reliance and strength in science and technology'. They may also increase Chinese overcapacity of legacy chips that would further reduce revenue for US firms.

The third question is harder to predict. We have seen the 'design out' phenomenon before—most notably in the case of commercial communications satellites in the late 1990s and early twenty-first century. In the short run, there do not appear to be any countries capable of developing chips or equipment entirely free of US technology, but the 'short run' in the semiconductor industry is a matter of a few years.

As US controls cover more and more items, the incentives to develop non-US alternatives will grow and we may see a repeat of the satellite episode, which saw the US satellite industry's global market share shrink from 75 per cent to 25 per cent in a few years.

In the long term, the rules could present significant challenges to US

PICTURE: CFOTO / SIPA USA

Semiconductor packaging materials are prepared for domestic and international markets at the Class 100 clean workshop in Hai'an, Jiangsu province (2023).





companies in maintaining market share and revenue expectations. US companies will inevitably face more competition from China as it continues down its own path of independent development, and companies could also face new competition from other sources lured into the market by the US export constraints. That will not be an immediate issue since entry barriers in this industry are very high in terms of both capital and technological expertise. But the longer the controls stay the same or expand in scope, the more likely it is that competition will grow.

This situation presents opportunities for other Asian nations from two opposite directions. First,

as existing companies seek to remove Chinese content from their supply chains, they will look for alternative locations for manufacturing. Southeast Asia is an obvious choice, though the opportunities vary in individual countries. Second, new entrants to the market seeking to develop products without US technology could look to Asia as a suitable location for parts of their new supply chains.

Several countries in the region have significant experience both in manufacturing chips and in other parts of the supply chain, including assembly, testing and packaging. Japan has already joined the United States in applying additional controls on semiconductor products, and others, such as South Korea and Taiwan, are

under increasing pressure to join. As the United States considers the effects of the current and future controls, it must take into account not only the limitations and costs of the controls but also the political and economic costs it is asking allied countries to incur. **EAFQ**

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## CURRENCY HEGEMONY

# Overuse of financial sanctions risks dollar's role

MARTIN CHORZEMPA

**A**FTER a record-breaking wave of new sanctions on Russia, a longstanding debate on whether the overuse of sanctions 'endangers the dollar's reign' has resurfaced. There is no easy answer, as the basic premise of whether sanctions are being overused is subjective and depends as much on politics as economics.

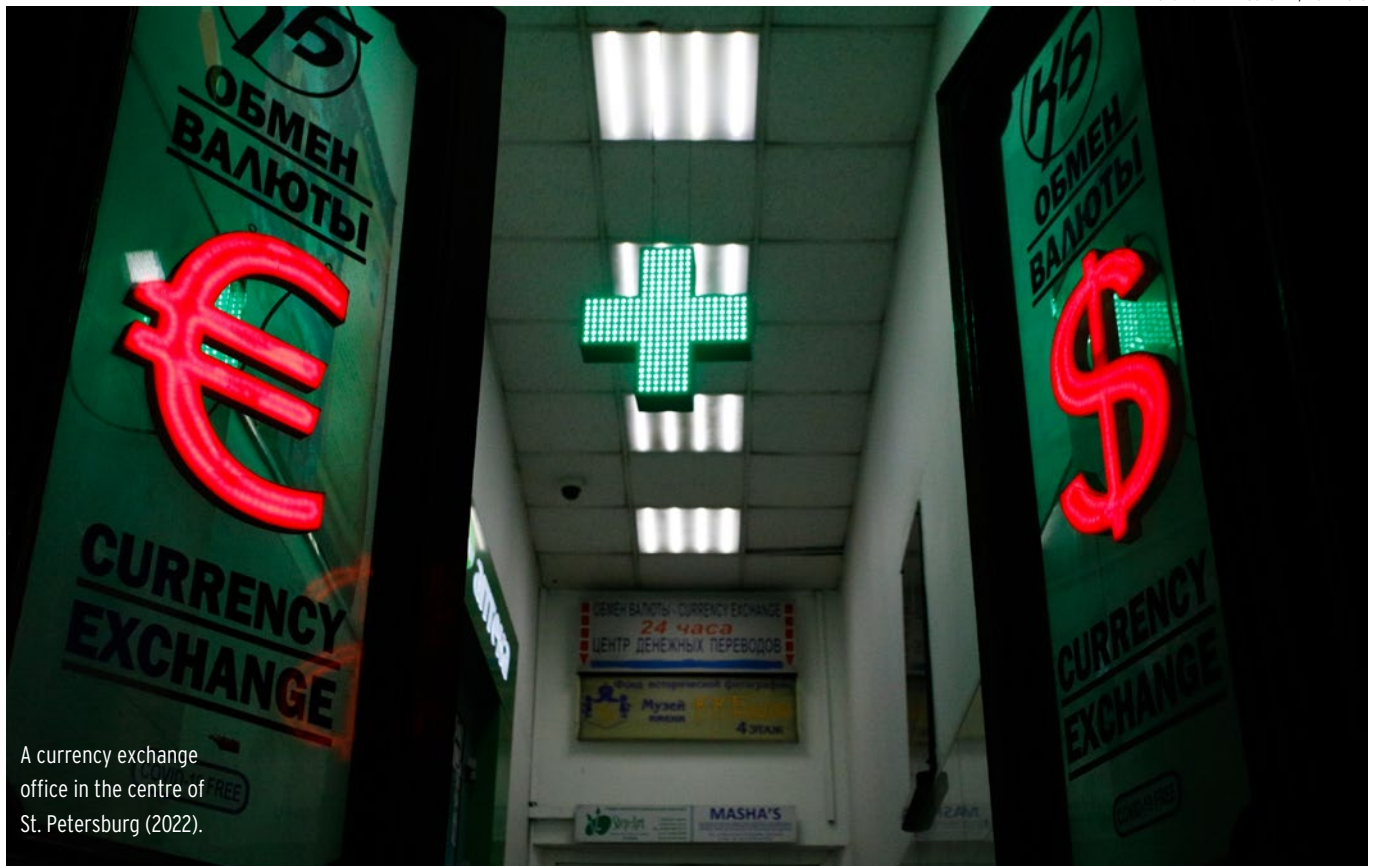
Even if there is widespread agreement that overuse is occurring, it is not clear that the costs and risks of future sanctions justify creating

an alternative to the well-oiled global dollar machine.

One exception would be the risk of sanctions that the United States might impose on mainland China in the case of a military action related to Taiwan—as it and a coalition of countries imposed sanctions on Russia in the wake of its invasion of Ukraine—which would force countries to choose between connecting with the global dollar system or with China. Countries may try to build alternatives to the US

dollar system to avoid being forced to make such a choice—whether or not they would succeed.

US sanctions apply beyond its borders, leading most firms to abandon sanctioned entities rather than risk being sanctioned themselves. Despite a flood of sanctions on Russia in 2022, it is hard to see much of a dent in dollar dominance. The dollar is near its historical peak—88 per cent of foreign exchange transactions involve the dollar on one side. The RMB's



A currency exchange office in the centre of St. Petersburg (2022).

jump from 4 per cent to 7 per cent in the past three years has come at the expense of other currencies, not by eroding the dollar's share.

Almost 58 per cent of global reserves were held in dollars at the end of 2022, nearly the same as before the Russian invasion of Ukraine. Powerful

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The impacts of different sanctions vary widely and not all sanctions create frictions that make others question use of the dollar

network effects mutually reinforce the dollar's role. Trade in dollars and borrowing in dollars means that actors want to accumulate dollar reserves to ensure that even on a rainy day, they can afford their imports and interest payments. The United States has the deepest capital markets in the world, accessible through an open capital account.

China is less reliable due to controls that keep capital within its borders. For most countries, the US dollar's liquidity means that it is often cheaper, safer and more efficient to handle trade in US dollars. The ecosystem around the dollar means that risks to exposure can be easily hedged and there are plenty of good assets in US dollars to invest in before they are needed. Despite the US debt ceiling mess and other issues with US

institutions, the US treasury market is considered a 'risk-free' asset.

Sanctions are the textbook example of 'weaponised interdependence' when the central node of a network exploits that position for its own interests. But it is difficult to say how weaponised sanctions really are. The impacts of different sanctions vary widely and not all sanctions create frictions that make others question use of the dollar.

Cases like North Korea and Syria have involved a high degree of international consensus. But US unilateral action in other cases have created friction, even with allies. When the United States backed out of the Iran nuclear deal and reimposed sanctions, European countries were furious that Washington could stop their firms from doing business with Iran. And, despite strong political

will, efforts to create a sanction-proof financial institution for business with Iran proved fruitless. Daniel McDowell's book on sanctions and the US dollar, *Bucking the buck*, concludes that 'dollar dependence remains the reality, even for sanctioned regimes.'

**S**ANCTIONS on Russia send a mixed message. They seem to weaken the US dollar, leading countries who fear future sanctions to diversify their currency choices. While many countries have not joined the sanctions, the major reserve currency issuers have, even Switzerland. Countries that fear sanctions may learn from Russia's case that diversification away from the US dollar does not provide the protection they might hope.

Barry Eichengreen and others have found that while reserves are gradually being diversified away from the US dollar, only a small share has gone into RMB. Throughout Asia, countries are developing more ways to trade and invest using their own currencies, but that trade tends to be small and expensive. Though the People's Bank of China sees a future with directly

connected central bank digital currencies, these are in their infancy. It is not clear whether they can reduce dollar use enough to be impervious to sanctions.

Even if Washington shelved sanctions, currency diversification would continue because it is largely driven by other concerns like the global impact of US monetary policy. One can liken the thinking on currency to the global discussion on supply chains, where there is an increased willingness to incur costs to reduce excessive reliance on one supplier or country.

While not unique to US dollar transactions, concerns about global financial infrastructures like the SWIFT messaging system, which, though located outside the United States, ejects sanctioned entities from its network, have not led to viable alternatives. China's Cross-Border Interbank Payment System is not a real substitute for SWIFT and relies on SWIFT for much of its messaging.

The greatest threat to the global currency system is the possibility of sanctions on China, a dog that mostly has not barked so far in the US-China

trade and technology war. While many of China's top technology companies—like Huawei—find themselves on export control and investment ban lists, the US treasury department has declined to put them on the sanctions list. Being sanctioned would make them radioactive for global business and spark a backlash from countries suddenly unable to service their networks.

Some countries might disagree, but current US policy has rightly been careful to avoid using excessive unilateral sanctions, especially on China. Such sanctions might make building and moving to a real alternative to the US dollar actually worthwhile. Large-scale China sanctions would be far costlier and less likely to enjoy the widespread international support that the Russia sanctions have. US policymakers need to be very clear-eyed that broader China sanctions would prove an important risk to the international role of the dollar. **EAFQ**

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Shigeru Yoshida signing the 1951 San Francisco Peace Treaty.

# Japan's grand strategy as a declining power

YUSUKE ISHIHARA

**T**HE Yoshida Doctrine is no longer fit to understand Japan's grand strategy. This precept emerged under former prime minister Shigeru Yoshida as an interim grand strategy in the aftermath of Japan's defeat in the Second World War to realise the country's economic redevelopment.

To focus on the overriding priority of the time, the Yoshida Doctrine prescribed that Japan maintain two principles in its strategy. First, the continuation of a US military presence to guarantee Japan's national security. Second, to eschew a resource-

consuming and politically destabilising military build-up. To implement the latter principle, Japan gradually established a number of policy self-restraints, such as a defence budget ceiling of 1 per cent of GDP and the choice not to acquire long-range missiles and nuclear weapons.

The Yoshida Doctrine's original economic purpose was achieved by the 1970s, though Tokyo retained it due to a number of considerations, including assuaging its regional neighbours' worries about its potential military menace as it became the region's

largest economic power.

The continuation of the Yoshida Doctrine was far from easy. Many Japanese leaders had serious discomfort with its foundation: the useful, yet constraining, security treaty with Washington, which legally sanctioned a US military presence in Japanese territory. While some Japanese policymakers did imagine Japan's future without the security treaty, Tokyo judged that the country should stick to the alliance. One reason for this was to contribute to regional stability by rendering its self-

restraints more credible in the eyes of neighbours.

To complement this reassurance, Japan also exercised self-restraint in regional multilateralism by carefully avoiding any outright leadership and respecting Southeast Asian countries' initiatives. This reassurance logic from the Yoshida Doctrine survived the end of the Cold War.

Yet for the last decade, some key assumptions underpinning the Yoshida Doctrine have become outdated because of Japan's relative decline. 'Declinism' is an unstated thesis in Japanese domestic debates on its foreign strategy, but its influence on the country's strategic thinking and practices is unmistakable in two respects.

First, Japanese leaders' imagination about their available military options has stretched as Japan's self-restraints have eased. Tokyo's recent decisions to acquire long-range missiles and abolish the 1 per cent GDP ceiling for defence spending, which reversed decades-old policy positions, are exemplary of Japan's changing view on the reassurance imperative.

Second, though, Japanese leaders' imagination about Japan's broader strategic options has shrunk. Unlike during Japan's economic ascent, no members of the Japanese government are entertaining departing from the defence treaty with the United States. They instead emphasise how Japan's eroding self-restraints will bring Tokyo and Washington even closer as military allies. A weakened Japan can hardly imagine any other option but to embrace the United States, especially in dealing with a rising China's strength.

Tokyo's willingness to further strengthen its military alliance with Washington does not mean Japan simply supports US pushback against

China. Despite Japan's relative material decline, it seeks a comprehensive influence on Washington's thinking.

Japan's acquisition of longer-range strike capabilities, combined with the growing geopolitical importance of its location next to Taiwan, is making Tokyo an essential ally for US–China strategy. This allows Japan to have greater say in strategic discussions and coordination. As a close ally, Tokyo has also been voicing its concerns about Washington's democracy-versus-autocracy narrative and signalling its reservations about the US-led Indo-Pacific Economic Framework.

Tokyo's attempt to relax self-restraints and expand its influence is not only observable in Japan–US bilateral interactions. The same trend emerged earlier in Japan's regional economic diplomacy. The most obvious example is the leading role played by former prime minister Shinzo Abe's government in saving the Trans-Pacific Partnership after the US withdrawal in 2017. Abe was not constrained by regional suspicions about Japanese ambitions or a desire to avoid backlashes.

**A**S THESE common trends suggest, Japan's emergent grand strategy focuses on mitigating the negative impact its diminishing material strength has on its international influence by overturning many longstanding self-restraints. Still, Japan is yet to address many crucial questions before its new grand strategy can be fully described, let alone be conceptualised.

One of the main questions is whether Japan could use the elevated influence it anticipates to better manage the tension-prone bilateral relationship with China. Relaxed self-restraints, a stronger US–Japan alliance and more active regional

diplomacy all constitute a signal to Chinese leaders that Japan remains a formidable neighbour, despite its relative decline, with which even a vastly superior China must coexist.

To emphasise this 'coexistence' message, Prime Minister Fumio Kishida's government held a summit with China's leader Xi Jinping and established a direct hotline between the two countries' defence organisations. Further progress on Japan's China policy—beyond these symbolic steps—could produce a positive spillover effect on other aspects of its grand strategy. It would make East Asian states more comfortable about partnering with Japan and give Tokyo greater confidence in steering the US alliance. The elevation of Japan's influence would also add further pressure on China to take Japan more seriously.

If Japan succeeds, its emergent grand strategy as a declining power may become more than an attempt to balance China. As Kishida alluded, his gaze is set not on 'a converged single set of values', but on creating a *modus vivendi* in Asia which would at least prevent regional disagreements from escalating into catastrophe and enable peaceful coexistence, including between Japan and China. Whether and how Japan can cultivate results in this endeavour, despite its decline, will shape the nature of the country's emergent grand strategy and its effect on the transitioning order in Asia. [EAFQ](#)

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*The views expressed in this article are the author's own and do not represent the official positions of NIDS.*

# Australia's defence ambitions need Southeast Asian trust

ARISTYO RIZKA DARMAWAN

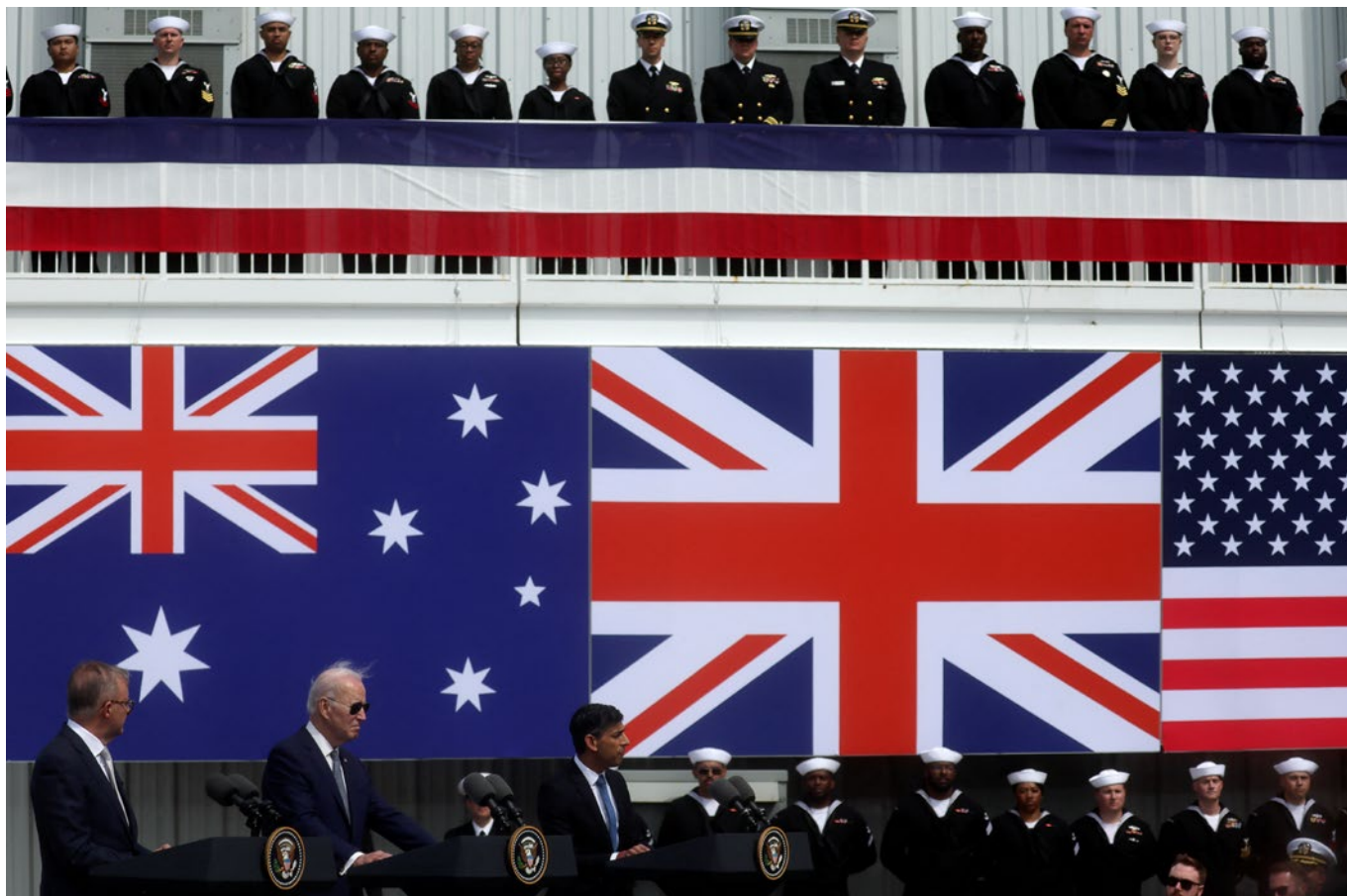
**I**N SEPTEMBER 2021, the Australian government announced the AUKUS security pact alongside the United Kingdom and the United States. AUKUS and its implications are the subject of some debate both in Australia and in neighbouring Southeast Asia. The speculation on the potential consequences of

the arrangement among Australia's neighbours stems in part from its lack of prior consultation with them.

There are three important issues that Australia needs to take into account if AUKUS is successfully to achieve its goals of bringing peace and stability to Southeast Asia. First, Australia should build trust with

its Southeast Asian neighbours, especially those countries that are critical to the success of the AUKUS agreement. Second, Australia must also ensure that AUKUS complies with international law. Third, it is important for Australia to commit to building a peaceful and stable relationship with China.

PICTURE: REUTERS / LEAH MILLIS



US President Joe Biden, Australian Prime Minister Anthony Albanese and British Prime Minister Rishi Sunak deliver remarks on the AUKUS partnership following a trilateral meeting in San Diego (2023).

Despite ongoing debate, the March 2023 Joint Leaders Statement on AUKUS formally committed to the project's going ahead. The statement noted that 'Australian military and civilian personnel [will] embed with the US Navy, the Royal Navy, and in the United States and United Kingdom submarine industrial bases to accelerate the training of Australian personnel.' It is important now to make sure that AUKUS can achieve its goals of providing more security and stability to the region and to ensure that Southeast Asian concerns about AUKUS potentially destabilising the region do not play out in practice.

The debate about AUKUS in Australia has mostly centred on whether it is worth spending up to AU\$368 billion (US\$245 billion) on nuclear-powered submarines.

Critics of AUKUS also argue that it is more important for Australia to pursue more strategic security cooperation with its neighbours in the Asia Pacific rather than with the United States and the United Kingdom. But AUKUS supporters argue that AUKUS is a strategic way for Australia to deter China's growing military influence in the region. Supporters believe the defence arrangement will bolster stability in the Asia Pacific and argue the AU\$368 billion price tag is justifiable.

One of the main concerns among AUKUS critics is how Australia's neighbours in Southeast Asia have reacted. As with other contentious regional issues, Southeast Asian countries do not all share the same position on AUKUS, as Ian Storey and William Choong have pointed out. Different historical experiences, national interests and political preferences have led some countries in Southeast Asia to welcome AUKUS, while others have strong concerns.

The Philippines, through its national security establishment, seems to welcome the trilateral arrangement. Vietnam and Singapore seem to support AUKUS implicitly, though Indonesia and Malaysia are more critical.

This is hardly surprising. Countries that welcome AUKUS are those that tend to welcome an extra-regional military presence in the region, particularly in the South China Sea. The Philippines, Vietnam and Singapore have traditionally welcomed such activity, while Indonesia and Malaysia have doubts and concerns. Indonesia, arguably one of Australia's most important neighbours, has historically been uncomfortable with the presence of extra-regional powers, thinking that goes back to the government of former Indonesian president Sukarno.

**I**T IS in Australia's interest to gain the trust and confidence of its neighbours. In the past, there has been a strong drive in Canberra to position Australia as part of the Asia Pacific. But if there is suspicion and distrust—particularly in Indonesia—it will be difficult for Australia to build deeper ties with the region.

The important question for Australia is how to build trust with Southeast Asia after AUKUS. Ensuring that there is transparency and strengthening communication with its neighbours is crucial. When AUKUS was announced many Southeast Asian countries were taken aback by a lack of prior consultation. There are now signs that Australia is trying to improve communication with its Southeast Asian counterparts.

In February 2023, before the Australian, UK and US leaders' statement on the AUKUS partnership was issued, Indonesian Foreign

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### Critics of AUKUS

also argue that it is more important for Australia to pursue more strategic security cooperation with its neighbours in the Asia Pacific rather than with the United States and the United Kingdom

Minister Retno Marsudi and Defence Minister Prabowo Subianto met with their Australian counterparts, Minister for Foreign Affairs Penny Wong and Minister for Defence Richard Marles, to discuss strategic security issues in the Indo-Pacific. AUKUS was high on the agenda with Indonesia's diplomats reiterating 'the importance of transparency in AUKUS cooperation and the importance of a commitment to nuclear non-proliferation'.

In March 2023, after the AUKUS joint statement was issued, Australian Chief of Navy, Vice Admiral Mark Hammond, visited Jakarta as part of a Southeast Asian tour. In Jakarta, he met Admiral Muhammad Ali, the Chief of the Indonesian Navy. In a public lecture at Universitas Indonesia after the bilateral meeting, Admiral Muhammad Ali said that the Indonesian Navy believe that AUKUS will comply with international law. Even though Indonesia's concerns remain, there has been a softer tone

from the Indonesian side since this meeting.

Australia has been more transparent regarding the development of the AUKUS submarines. For instance, the latest Defence Strategic Review outlines Australia's AUKUS strategy in some detail. This trend of transparency is very important for Australia and Southeast Asia going forward. The best way to gain and retain trust from its Southeast Asian neighbours is through intense communication and transparency.

It is also important for Australia to comply with the rules and principles of international law. Australia has been careful to emphasise the nuclear-powered submarines will not carry nuclear weapons. Australia has argued that AUKUS will not violate any of Australia's obligations under the Treaty on the Non-Proliferation of Nuclear Weapons (NPT) and will comply with all International Atomic Energy Agency (IAEA) safeguards.

But discussions are ongoing at the IAEA and NPT Review Conference on whether AUKUS potentially violates obligations on the transfer of nuclear explosive devices and whether this could be considered a violation of the safeguard regime under the IAEA and

NPT. Some countries, particularly China, might question whether the transfer of nuclear material to Australia potentially violates the treaty.

**D**ESPITE the ongoing technical discussions at the IAEA and the NPT Review Conference, Australia has responded by reiterating its position that it will comply with international law. Australia has also given assurances that it will not be seeking to build any nuclear weapons-capable submarines in the future.

Aside from meeting its obligations to the NPT and IAEA safeguard regimes, Australia must also comply with international law on the passage of submarines under the United Nations Convention on the Law of the Sea (UNCLOS). It is expected that Australia's nuclear-powered submarines will likely pass through Indonesian waters. Members of Indonesia's parliament have expressed worries about the submarines passing through the Indonesia's Archipelagic Sea Lanes.

The right of passage of submarines is regulated under UNCLOS which provides three regimes for a submarine to pass through another state's waters. The regimes include Archipelagic Sea Lanes passages, innocent passages and the transit passages. Under these regimes, Australia's nuclear-powered submarines would be able to pass through Indonesian waters in times of peace. But there are different obligations associated with each of these passages.

If the submarines pass through the designated Archipelagic Sea Lanes of Indonesia, or the straits typically used for international navigation, they can remain submerged. But if they are passing through territorial waters or archipelagic waters other than through designated sea lanes, they are required

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Even though a counterbalance to China's growing dominance in the region may be of benefit, an increasingly tense relationship between Australia and China is one of Southeast Asia's biggest concerns

to navigate on the surface and show their flag. Observing this legal regime is important for Australia not only to remain compliant with UNCLOS, but also to gain trust from Indonesia as its immediate neighbour.

Ensuring that AUKUS complies with such international laws is important for Australia to achieve its goal of ensuring peace and stability in the region. If the countries in the region view Australia as violating any of the rules of international law, they may well begin to consider Australia a threat to regional stability.

For AUKUS to promote stability, Australia must commit to ensuring a peaceful relationship with China too. Even though a counterbalance to China's growing dominance in the region may be of benefit, an increasingly tense relationship between Australia and China is one of Southeast Asia's biggest concerns.

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Countries that welcome AUKUS are those that tend to welcome an extra-regional military presence in the region, particularly in the South China Sea



## ASIAN REVIEW: AUKUS

In September 2021, shortly after the AUKUS announcement, Malaysian Prime Minister Ismail Sabri Yaakob set out these concerns. He said AUKUS might ‘provoke other powers to take more aggressive action in [the] region, especially in the South China Sea.’ It seems that Malaysia’s concern is not that AUKUS might threaten Malaysia but that China will respond to AUKUS by behaving more aggressively in the region, particularly in the South China Sea.

The Malaysian Prime Minister’s concerns are likely shared by all Southeast Asian countries. No Southeast Asian country, even those who welcome AUKUS, wants more tension and political escalation in the region. How Australia and China

work on their differences and whether they are able to commit to a peaceful relationship will be key elements in maintaining peace and security in the region.

Many Southeast Asian countries want a solution to China’s intimidatory actions in the region, especially when it comes to the South China Sea disputes. AUKUS might provide deterrence to China’s threat and force China to behave according to international law. But China is also one of Southeast Asia’s most important economic partners, even though it is in Southeast Asia’s interest to have the United States and its allies—including Australia—as reliable partners.

AUKUS needs to be able to deter China from threatening and bullying

its Southeast Asian neighbours. At the same time, it needs to be careful not to escalate political tensions which could lead to open conflict in the region. Any conflicts between Australia and China would be disastrous for the region. Building and maintaining trust through transparency and compliance with international law will be critical to managing this balancing act. [EAFQ](#)

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PICTURE: AAP IMAGE / RICHARD WAINWRIGHT



Australian Minister for Defence Richard Marles boards the *USS Asheville*, a Los Angeles-class nuclear powered fast attack submarine (Perth, 2023).

# The human rights effect of economic sanctions

DURSUN PEKSEN

**E**CONOMIC sanctions have assumed a prominent role in global politics since the turn of the twenty-first century. With a lack of public support for military interventions, policymakers have increasingly turned to the non-violent coercive tool of sanctions to address major crises such as Russia's invasion of Ukraine and political violence in Venezuela.

But what effects do these popular coercive instruments have on human rights in target countries? Evidence

shows that sanctions lead to increased levels of political repression by target governments.

Sender states usually justify the use of sanctions by arguing that external trade and financial restrictions will force target governments to alter their policies in line with sender demands. Target governments may face a significant decline in their capacity to rule due to restricted access to essential military and economic resources. Reduced access to these resources then undermines the government's ability to project

power. They may subsequently have less capacity to commit repression and eliminate domestic dissent to their authority.

In this scenario, sanctions-induced economic pain and shrinking resources could also decrease a target leader's ability to provide selective inducement to their support base in return for their loyalty. Selective enticements could include tax breaks, access to scarce luxury goods, better housing and higher salaries. In the event that they no longer benefit from selective incentives, regime loyalists

PICTURE: DANIIL DANCHENKO / NURPHOTO



An anti-war protester is detained in Moscow during a demonstration against the war on Ukraine (2022).

and other key public figures might choose to defect from the ruling coalition and join anti-regime groups.

In addition, citizens who incur the economic costs of sanctions could develop more grievances against their government. Mounting grievances stemming from dire living conditions could help anti-regime groups to recruit more supporters and mobilise against an incumbent government. According to this logic, the reduced coercive capacity of target regimes coupled with emboldened opposition should lead to less state repression and better human rights conditions overall.

But sanctions rarely operate in the way this logic suggests. The adverse economic and humanitarian effects of sanctions in target countries is well-documented. It is also unlikely that leaders in target countries like Iran, Russia and Venezuela are directly bearing the intended costs of coercion. This is largely because they use shrinking public resources in their favour to evade sanctions and keep their ruling coalitions intact, while their citizens suffer disproportionately.

Targets can also gain access to sanctioned resources through

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From a policy standpoint, sanctioning states should ensure that human suffering and other adverse effects of sanctions do not outweigh the intended political gains

third-parties that are willing to bust sanctions. Just as Yugoslavia did during the 1990s, some target regimes will even use smuggling and other black-market channels to gain access to scarce goods.

Accordingly, most target governments will continue to have enough state capacity to commit repression. As target leaders escape the costs of external pressure, there is often no discernible change in the balance of power between the incumbent leadership and opposition groups.

**S**ANCTIONS can in fact inadvertently lead to more state repression in target countries. Target leaders often feel threatened by foreign pressure as they interpret sanctions as a direct threat to their political survival. They therefore resist sanctioning country demands for policy reforms to avoid looking weak in the eyes of their supporters.

Leaders targeted by sanctions also have more incentive to curtail basic human rights and democratic freedoms. The use of repressive means against citizens is one way for a regime to communicate to its support base and the broader public that it remains defiant against domestic or external challenges to its authority.

Even in cases where sanctions incite anti-regime protests and violence, target governments may respond to dissent using repressive means such as violent crackdowns on protests and political imprisonments. Some leaders might even use sanctions as a pretext to justify restrictions on human rights. In Cuba and Iran for example, leaders paint sanctions as an infringement of their sovereignty and national integrity and defend the suppression of domestic dissent under the pretence of maintaining domestic unity.

In some cases, sanctions can also contribute to the deterioration of human rights in target countries by undermining the state's ability and willingness to monitor and screen its bureaucratic agents. Since target leaders operate with less resources under sanctions, they might change spending priorities at the expense of certain government programs. This can include budget cuts to the oversight capabilities of security, police and other bureaucratic agencies. Left unmonitored, it is more likely that security and police forces will commit human rights abuses such as torture or the use of excessive force against peaceful demonstrators.

Sanctions are often considered to be a non-violent and relatively peaceful tool. But the track record suggests that they are likely to do more harm than good when it comes to human rights conditions in target countries.

From a policy standpoint, sanctioning states should ensure that human suffering and other adverse effects of sanctions do not outweigh the intended political gains. Given the relatively low success rate of sanctions in attaining their objectives, it is even more imperative for policymakers to consider the possible human rights impact of sanctions. While sanctions might be construed as a lesser evil, it is still the policymakers' responsibility to design sanction regimes that minimise harm to civilians and prevent long-lasting economic dislocation and political instability. In cases where sanctions have been in place for years with no desired change in target regime behaviour, policymakers should consider lifting them to minimise the sanctions-induced instability and civilian harm. [EAFQ](#)

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# What's next for sanctions on Myanmar?

SUSANNAH PATTON

**F**OLLOWING the 2021 coup, Myanmar has experienced more than two years of violent and repressive military rule. Sanctions have been a central plank in the responses of the United States and European countries.

While there is scant evidence that sanctions will shift the junta from its destructive and repressive course, a lack of alternative options to influence

outcomes in Myanmar means they are likely to remain a feature of the response by Western countries.

A sharply worsening situation provides more context for sanctions against Myanmar. According to the Office of the United Nations High Commissioner for Human Rights, nearly 80 per cent of townships have been affected by conflict since the coup, with around 3000 people

killed by security forces and more than 17,000 detained. All political parties, including the National League for Democracy, have been dissolved. Former state councillor Aung San Suu Kyi has been sentenced to 33 years imprisonment. In 2022 Myanmar executed four prisoners, with hundreds more death sentences imposed.

This brutal record has shocked the world, including Western countries that had pinned hopes on Myanmar as a positive case of democratic transformation in the decade leading up to the coup.

The United States and European countries were quick to use sanctions as a key part of their response. The first US sanctions were imposed just 10 days after the coup. The United States has since imposed nearly 20 rounds of sanctions on Myanmar, targeting military leaders, their families, business entities associated with the military, state-owned enterprises, arms brokers and suppliers of aviation fuel. It has timed sanctions announcements to coincide with the anniversaries of the coup and other international events, such as International Human Rights Day.

The European Union and United Kingdom have also imposed multiple rounds of sanctions. EU restrictive measures, imposed over six separate rounds of sanctions, were applied to 93 individuals and 18 entities, while the United Kingdom has sanctioned 34

PICTURE: THOMAS DE CIAN / NURPHOTO



A protester holds up a pro-democracy sign at a protest at the Myanmar Embassy in Bangkok (2023).

individuals and 27 entities.

Canada and Australia have also imposed some sanctions, though Australia did so only belatedly, on the second anniversary of the coup. New Zealand does not have autonomous sanctions but has imposed travel and other political restrictions on the regime.

**T**HERE is little indication that these sanctions have changed the behaviour of the junta. Myanmar's military has a lengthy history of surviving sanctions and declared from the outset that it could weather international sanctions. In the two years since, there is little to indicate a change in mindset. Instances of brutality have escalated. In April 2023 the Myanmar military killed an estimated 168 people in an airstrike.

The challenge that sanctions on Myanmar face is that the junta is far from friendless. There is diplomatic support from Russia and China—both permanent members of the UN Security Council—who would veto any sanctions resolution or arms embargo. China is Myanmar's major economic partner and source of investment, while Russia is an increasingly important supplier of military equipment, including aircraft.

Myanmar also has diplomatic support from neighbouring countries, including India and Thailand. Both countries see maintaining ties with the junta as the best way to protect their interests. Thailand is also the largest importer of natural gas from Myanmar.

Beyond this support, even countries that are less friendly to the junta—such as Japan, Singapore and other Southeast Asian partners—do not support sanctions on Myanmar. Singapore has remained resolute in arguing that the situation in Myanmar

will only be resolved by actors within the country. But in 2023 Singapore announced that it would prohibit the transfer of arms and dual-use items to Myanmar, despite the absence of UN Security Council authorised sanctions.

This means that sanctions will remain a tool used by only a handful of countries, led by the United States. That limits the political as well as practical impact of restrictive measures, as sanctioned entities and individuals can continue to operate with impunity in permissive jurisdictions.

Even with these limitations, the United States, European nations and other likeminded countries such as Canada are likely to implement further sanctions on Myanmar. One possibility is that although they may be aware that sanctions cannot change the calculus of the junta, they can deprive the regime of revenue or other resources—such as aviation fuel—in the hope that this helps incrementally weaken the military and strengthen the hand of opposition forces.

Another possible indirect benefit of sanctions—from the perspective of the United States and its partners—may be their 'deterrent' value in discouraging coups elsewhere. If would-be coup-makers in other countries see the impact of international condemnation on individuals associated with Myanmar's coup, or on the economy, they may be more cautious about flouting democratic norms.

A more cynical interpretation is that repeated sanctions announcements enable the United States to present itself as 'doing something' with little risk or cost to itself. Realistically, the United States and other Western countries have little leverage or influence over Myanmar's trajectory. Though the United States Congress recently passed the *Burma*

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Myanmar's military has a lengthy history of surviving sanctions and declared from the outset that it could weather international sanctions

*Unified through Rigorous Military Accountability Act* which authorises the provision of non-lethal assistance to Myanmar's resistance and pro-democracy organisations, the Biden administration has been cautious about doing so. By contrast, sanctions keep the United States at arm's length from involvement in the conflict.

Rather than formal sanctions being a game changer, decisions by private sector actors may be more influential. Since the coup, many international companies have withdrawn from the Myanmar—notably Japan's Kirin beverage conglomerate and energy multinationals such as Woodside, Chevron and Total. The absence of overseas energy companies to develop new offshore gas fields could have a bigger impact on Myanmar's domestic economy and export revenues than any foreseeable sanctions regime. These decisions are driven not just by business considerations, but by activism from within Myanmar and the international NGOs that have called for boycotts and divestment. **EAFC**

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# The complicated truth about sanctions on North Korea

BENJAMIN KATZEFF SILBERSTEIN

**O**N THE surface, sanctions seem to have had little impact on North Korea's behaviour. At the time of writing, the world is waiting for the launch of a new North Korean military spy satellite that Supreme Leader Kim Jong-un announced on 19 April 2023.

North Korea is under one of the harshest multilateral sanctions regimes of any country in the world. But the country still circumvents sanctions regularly through complex smuggling operations at which it is by now very adept. This situation raises questions about whether sanctions on North Korea have failed.

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A common misperception is that, were sanctions to be lifted, North Korea would open its doors to foreign investors who would flock to the country for its strategic geographic location and cheap labour

It is true that sanctions have not reached the stated political goal of inducing North Korea to give up its nuclear weapons. The country has made impressive advances in missile technology and is evidently capable of acquiring the necessary technology despite sanctions. The 'spy satellite' launch would be one of around 30 missiles tested in 2023.

Though North Korea has ways to evade sanctions, this does not mean sanctions have no impact. Sanctions interplay with domestic governance and economic systems in ways that are complex and often hard to fully evaluate. The alternative to sanctions is not an open, liberal and free-trading North Korea, but likely a slightly more well-off version of its current state.

The issue of evasion illustrates why the impact of sanctions is so hard to evaluate. Sanctions-evading actions are not rare events, but are institutionalised within North Korea's economy. Since the 1970s, North Korea has systematically smuggled alcohol, tobacco, drugs and other contraband through its diplomatic networks abroad. These activities continue today and with North Korean capabilities expanding into the cyber realm, sources of illicit income will likely continue to constitute an underestimated part of the regime's hard-currency revenue flows.

But sanctions evasion and smuggling are very expensive

activities. For Chinese, Taiwanese and Singaporean trading companies and entities to risk smuggling oil to North Korea, Pyongyang must pay a massive risk premium on its purchases. North Korea has to pay well above market prices to give sellers a reason to take the risk of arrest and prosecution for sanctions violations.

The same is true for illicit North Korean exports. Sanctions do not stop coal exports entirely, but they slash the prices that North Korea can charge. Any buyer—almost always China—will only risk importing from North Korea if prices are cheap enough to outweigh the risks. Even prior to the harsher sanctions levied in 2016 and 2017, China, through its position as a virtual monopoly buyer, consistently paid below-market prices for North Korean coal. This dynamic is likely even stronger today, as Chinese imports of coal and other sanctioned North Korean goods continue but go mostly unrecorded.

Despite North Korea's evasion tactics, sanctions are indisputably hurting the North Korean economy. The country's exports are estimated to be worth only a few hundred million dollars per year—much smaller than its trade losses. The UN Panel of Experts estimated, for example, that North Korea earned around US\$370 million from sanctions-violating coal exports in 2019. This is only a fraction of the US\$1.19 billion it earned from

such exports in 2016, before the harsher sanctions.

The civilian impact of sanctions is unclear. On one hand, sanctions have likely dealt a harsh blow to labour-intensive industries like textiles, where a high proportion of workers are women, resulting in increased unemployment and lower wages. The falling incomes of North Koreans working in sanctioned industries substantially dampen the wider economy. On the other hand, there is no evidence that sanctions have driven up the price of food or other essential goods.

Sanctions have undoubtedly worsened North Korea's food shortage by hindering imports of fertiliser and spare parts for agricultural equipment. North Korea's own border closure, though, likely also provided

an obstacle to foreign trade. But the impact of sanctions on North Korea's food system is minimal compared with the regime's refusal to undertake basic reforms in agriculture. The government bristles at dismantling collective farms or letting farmers sell their products on open markets.

Trade by evasion should logically become easier and cheaper. For sanctions to be effective against North Korea, China—which constitutes more than 90 per cent of North Korea's foreign trade—would have to implement them. As US–China tensions continue to grow, reasons for China to implement sanctions on North Korea are diminishing.

Reports of North Korean trade deals in weapons and labour with Russia in the wake of Russia's invasion of Ukraine are already circulating.

Very little is confirmed about these transactions, but there is evidence to support increased economic exchange between the countries. Earlier this year, satellite imagery from the border area indicated that Russia was increasing oil exports to North Korea while exporting unknown goods that could be arms destined for the Wagner Group.

But this does not change North Korea's situation. Combined with its poor global reputation, sanctions will continue to make North Korea dependent on a very small number of trade partners—mainly China and Russia—who can charge highly unfavourable prices.

None of this is to say that the current thinking on North Korea sanctions is without serious flaws. The demand that denuclearisation should

PICTURE: KCNA VIA REUTERS



A fire assault drill takes place at an undisclosed location in North Korea (2023).

come before any relief on sanctions, for example, is unrealistic. But many also exaggerate the possible gains of abolishing sanctions. A common misperception is that, were sanctions to be lifted, North Korea would open its doors to foreign investors who would flock to the country for its strategic geographic location and cheap labour.

Removing sanctions would not change the basics of North Korea's economic system. Despite a permissive attitude towards markets during former Supreme Leader Kim Jong-il's reign and the first few years of Kim Jong-un's, harsh state control over the economy best serves the regime's political and social goals by allowing it to control the distribution of resources. Sanctions

hurt, but removing them is no silver bullet for political or economic progress. [EAFQ](#)

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## WAR WITH CONSEQUENCES

# Indonesia's decarbonisation agenda and Russian sanctions

M HABIB ABIYAN DZAKWAN  
AND NOVIA XU

**M**AY 2023 marked 15 months since Russia launched military action against Ukraine. Not only does the confrontation have devastating impacts on the battleground, it has also hurt many developing countries economically. The turmoil in international energy markets, including through the effect of economic sanctions imposed on Russia, has challenged energy and decarbonisation policies around the world.

Since February 2022, 21 developed countries have hit Russia with 180 trade-related sanctions, 155 financial institution-related sanctions and 173 sanctions on Russian individuals. These extensive economic sanctions have hurt but not deterred Russia militarily. Indonesia's 'free and active' foreign policy draws the

line at condemning violations of international humanitarian law, providing humanitarian assistance to affected communities and attempting to mediate peace talks between the warring parties. This stance has helped Indonesia navigate some of the undesirable ramifications of the

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In short, the negative impact of Russian economic sanctions on global decarbonisation appears limited to certain regions

conflict and its geopolitical elements.

What has been the effect on Indonesia?

Unlike disruptions to the decarbonisation agenda in Europe, there has been no similar experience in Indonesia, as there is no direct energy linkage in Russia–Indonesia relations. In-person meetings between Indonesian President Joko Widodo and Russian President Vladimir Putin in 2016, 2018 and 2022 did not seek to build that relationship. Nor was climate change on the agenda as leaders focused on Indonesia's palm oil products, tourism, food supply chains and counterterrorism.

The closest link between Russia and Indonesia's attempts to reduce greenhouse gas emissions came about through their nuclear cooperation with the signing of two agreements. One



in 2015, between Indonesia's National Nuclear Energy Agency and Russia's Rosatom, sought capacity building and research. The other in 2017, between Indonesia's Nuclear Energy Regulatory Agency and Russia's Rostekhnadzor, involved regulatory development.

This bilateral nuclear cooperation has had little practical effect on Indonesia's decarbonisation efforts. Russia provides neither funding nor technology for nuclear-fired power plants in Indonesia. On the Indonesian side, the government has decided that it will not blend nuclear into its energy mix before 2032.

**T**HE indirect effects of global energy market turmoil are more consequential. Despite attempts to shift the world's energy systems away from fossil fuels, the demand for non-Russian fuel is expected to reach a new high.

In January 2022 Jakarta, surprisingly, executed a full ban on coal exports. But when international coal prices fell to US\$220 per ton in February the ban was quickly reversed. Between May and December 2022 coal prices had skyrocketed above US\$420 per ton. As a result, Indonesia's coal production increased to 685.6 million tons in 2022—12 per cent higher than in 2021 and the highest since 2014. Indonesia's coal export volumes also rose in 2022, with 360.3 million tons of coal exports generating a total export revenue of US\$46.7 billion.

International oil prices also increased sharply, hitting their highest level since 2014 at US\$125 per barrel in April 2022, with global oil subsidies rising around 85 per cent as a result. Because Indonesia's economy relies heavily on commodity export markets—especially oil and coal—the disruption played into Indonesia's decarbonisation agenda.

Following international oil price increases, Indonesia raised the retail price of subsidised fuels. Subsidised fuel prices increased 20 per cent on average in September 2022. This could be considered the positive side of the war induced oil price hike as it created momentum for Indonesia to reduce the fuel subsidy burden and encourage the use of cleaner energy alternatives, however indirect or minimal.

With rising commodity prices, Indonesia has reaped windfall

revenues from commodity exports. The windfall revenues can be used to offset the impact of international price fluctuations on the government's budget or invest in public goods, such as infrastructure development, social welfare programs and healthcare.

But Indonesia needs to exercise caution when it comes to disbursing windfall revenues even though it may provide a short-term boost to the economy. The new revenue stream may not be sustainable in the long

PICTURE: ADITYA IRAWAN / NURPHOTO



A campaigner for energy transformation in Indonesia is pictured with the solar panels installed at his home in Special Region of Yogyakarta (2022).

run due to fluctuating international coal prices and the global transition towards clean energy.

More recently, prices of most commodities have been steadily declining, with oil prices coming down to US\$76 per barrel and coal falling below US\$170 per ton, as of May 2023. The government needs to manage these funds responsibly and effectively. This includes proper allocation and investment in programs that promote sustainable growth, as well as ensuring transparency and accountability in the use of funds.

In short, the negative impact of Russian economic sanctions on global decarbonisation appears limited to certain regions. Indonesia's geopolitical non-alignment and its limited energy relationship with Russia limit the effects on its decarbonisation trajectory.

In the longer term, anticipating the future impacts of Russia's economic decline and how Indonesia's economy will have to rely less on fossil fuels or carbon-intensive resource-based products and exports are strategic priorities. As are cultivating high value-added clean technology and setting an international standard for low carbon-intensive products so that Indonesia can position itself for success in the transition to a green economy. **EAFQ**

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# Circumventing economic sanctions

STEWART PATERSON

**C**HINA has made clear its discontent with the role of the US dollar in the international economy and its intention to internationalise the RMB as an alternative international currency. A popular narrative tells us that as China is now the world's second-largest economy, the largest trading nation and the largest trade partner to 120 countries, it is inevitable that the RMB will play a larger role in the international economy. A side effect of the move to a more RMB-centric international economy will be the loss of US economic power. If the United States continues to weaponise its dollar hegemony, this is only bound to accelerate the diminishment of the dollar. The United States would be best served by refraining from using economic statecraft to pressure countries to adhere to its wishes.

China has already developed the 'financial plumbing' required to facilitate the internationalisation of the RMB. The country has developed an alternative cross-border payments system (CIPS) to rival Fedwire and the Clearing House Interbank Payments System. China's Alipay and Tencent pay have also now been widely adopted abroad. And since 2020 China has been trialling its Digital Currency Electronic Payment network, which has the potential to accelerate international use of the RMB.

Perhaps more telling than what China *has* done to facilitate the

international use of the RMB is what it has not done. As China has internationalised its own balance sheet, it has remained decidedly dollar centric. China is still wedded to a policy of exchange rate targeting and requires large dollar reserves of its own—in part because of the high propensity for domestic capital flight—which is problematic when it's promoting greater international use of the RMB. China is yet to liberalise its capital account to make the RMB freely exchangeable—a prerequisite for reserve currency status.

China's capital markets remain underdeveloped with both regulated and limited foreign participation. Foreign issuances denominated in RMB remain small. Nor has China shown a willingness to become a net supplier of RMB to the world by running current account deficits, preferring instead to lend RMB to other central banks through swap arrangements. While China has facilitated the use of the RMB in trade, it remains a long way from having the overarching macroeconomic structure that would make it a contender for reserve currency status.

This is important because it is through trade that countries earn the foreign exchange required to service their foreign currency denominated liabilities. Earning RMB through trade is a risky way to earn income to service a dollar denominated debt. There is no sustainable dichotomy between

the currency denomination of trade and the currency denomination of a country's foreign assets and liabilities. The majority of the world's foreign currency debt is denominated in US dollars and very little is denominated in RMB.

These observations strongly challenge the narrative that the dollar is in decline and the RMB will replace it in the international economy. Many of China's largest trading partners, such as Hong Kong and Saudi Arabia, continue to operate on a de facto dollar standard. The RMB has gained greatest traction among countries, such as Iran, that have strong geopolitical reasons for abandoning the dollar.

With the ratcheting up of Western sanctions against Russia, many countries in the southern hemisphere

have expressed a desire to reduce their dollar dependency. Not least among these has been the disclosure that Saudi Arabia and Brazil will use the RMB for bilateral trade with China. In both cases, China enjoys considerable monopsony power, being the largest importer of hydrocarbons, soy products and iron ore.

Despite the speculation, China's progress appears limited. According to SWIFT data, transactions denominated in RMB accounted for less than 1.5 per cent in December 2022—slightly more than those denominated in Australian dollars and less than those denominated in Swiss francs. This puts RMB in a distant 7th place. The US dollar accounts for nearly 48 per cent of the total.

There are two reasons why the RMB's diminutive market share in

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A popular narrative tells us that as China is now the world's second-largest economy, the largest trading nation and the largest trade partner to 120 countries, it is inevitable that the RMB will play a larger role in the international economy

PICTURE: REUTERS



A Chinese clerk counts US dollar notes over RMB yuan notes at a bank in Hai'an city (2019).

cross-border payments using SWIFT might not be a fair reflection of the RMBs use in trade. First, not all cross-border transactions use SWIFT. Estimates by ANZ's China research team suggest that about 20 per cent of transactions settled using China's own CIPS system do not use SWIFT.

Second, the total size of the cross-border payments market—around US\$170 trillion per year—is about 8 times larger than world merchandise exports at US\$22 trillion. If one assumes the vast majority of international RMB usage is trade related and not asset related—which seems reasonable given the low foreign participation rate in RMB-denominated asset markets and China's dollar centrality when it comes to their foreign assets—it might be that about 5 to 7 per cent of world

trade is already denominated in RMB, although such estimates need to be treated with caution. CIPS itself saw a 75 per cent growth in settlement volume in 2021 to about 80 trillion RMB or US\$13 trillion.

Some might interpret this level of RMB usage as disappointing. But if a collateral purpose of RMB internationalisation is to immunise China from potential Western sanctions while providing sanctioned countries with a work around and to provide efficiency gains in bilateral trade, then it is highly satisfactory from a Chinese perspective. The return of Russian oil exports to above 2019 pre-war levels demonstrates that sanctions, though supported by countries representing more than half the world's GDP, have lost some of their efficacy even while the US dollar

remains hegemonic.

The ability to cut selected institutions out of the SWIFT system is a powerful tool of economic statecraft. But it must be remembered that trade took place before SWIFT was established and it is still possible—albeit more inconvenient and expensive—to conduct trade without SWIFT today. If China is outside the sanctions, an RMB-based financial ecosystem helps facilitate and reduce the costs of sanction circumvention—as it was, in part, designed to do. **EAFO**

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## TECHNOLOGICAL RIVALRY

# Is US-China decoupling heading in a dangerous direction?

NICHOLAS R LARDY AND  
TIANLEI HUANG

**T**HE US and Chinese economies are closely interconnected, but their ties are eroding. Despite record levels of US-China bilateral trade in 2022, the trading relationship is becoming less interdependent. Rising tensions between Washington and Beijing are driving US and Chinese investors away from each market.

Perhaps the most consequential

aspect of US-China decoupling is in technology. Security competition between the United States and China is increasingly embedded in approaches to domestic industrial and technological development. This tech war will hurt both economies and have profound global implications.

Bilateral trade between the United States and China continues to expand

despite the trade-war tariffs and escalating tech restrictions that the United States has imposed on China. But bilateral trade expansion is slowing and is growing at only one-fifth the pace of the overall US trade expansion. The share of US imports coming from China has declined, while China has shifted some imports of foreign goods away from the United States. The



US President Joe Biden shakes hands with Chinese President Xi Jinping on the sidelines of the G20 leaders' summit in Bali (2022).

composition of US–China bilateral trade has also shifted away from goods with the highest tariffs.

Data on bilateral trade alone does not show the full picture of US–China commercial ties. Since the tariff war began, China's direct investment in Southeast Asia has skyrocketed—reaching US\$128 billion in 2020. US imports from Southeast Asia are also expanding rapidly.

But China's share of the imported content in Vietnam's exports nearly doubled from 2017 to 2021. Similarly, Chinese firms elsewhere in Southeast Asia source a large share of the parts and components in their US exports from China. The Chinese content of US imports from Southeast Asia is likely on the rise, offsetting the

slowdown in direct US imports from China.

Cumulative direct investment in China by US firms reached US\$124 billion in 2020, according to data from the Office of the United States Trade Representative. But the 25th annual China Business Survey by the American Chamber of Commerce in China shows that a declining share of US companies see China as an investment priority because of rising tensions, a lack of regulatory consistency in China and rising costs of labour.

The survey also shows that though most US firms operating in China plan to stay, a rising share are considering shifting supply chains out of China—including Apple and Google.

Prospects of US investment in China are clouded by potential US restrictions on outbound investment to China. The Biden administration is concerned that US investors may be helping to advance Chinese technology in critical sectors and is developing a mechanism to constrain the flow of US investment into China. But because US firms constitute a relatively small portion of total foreign direct investment, such a screening scheme will only be effective if other states are involved. The difficulties of convincing others to develop similar programs may be causing the delay in the launch of a US outbound investment screening scheme.

Private and state-owned Chinese firms are facing greater scrutiny in

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Rather than designing export restrictions to keep China's critical technologies a generation behind that of the United States, the US objective is now to freeze China's current level of technological development

the United States. The Committee on Foreign Investment in the United States has seen its investigations involving Chinese investors surge since 2021. Among all jurisdictions, investors from China face the most scrutiny. The most recent high-profile case involves TikTok, whose CEO was recently grilled by the US Congress. The company now faces the risk of being banned in the United States unless it splits from its Chinese parent

company ByteDance.

US–China decoupling in technology is undoubtedly intensifying. Beginning with Trump's restrictions on US exports to Huawei in 2018, the United States has been stepping up its tech restrictions on China in the past five years. By the end of 2022 about 400 Chinese persons on the Specially Designated Nationals and Blocked Persons list were prohibited from engaging in any transactions involving US persons.

**I**N MARCH 2023, 665 Chinese companies on the US Entity List were subject to restrictions on the flows of certain technology and goods from the United States. China responded with its own Unreliable Entity List in September 2020. So far only two US aerospace and defence companies are listed and prohibited from trading with or investing in China.

US–China technological decoupling escalated in September 2022 when US National Security Advisor Jake Sullivan announced a profound shift in US economic policy on China. Rather than designing export restrictions to keep China's critical technologies a generation behind that of the United States, the US objective is now to freeze China's current level of technological development. As the US tech frontier continues to expand, the gap between the two countries would widen, causing China to fall further behind.

In October 2022, the Biden administration announced export restrictions on certain equipment and services to Chinese semiconductor companies, aiming at slowing China's ability to produce advanced chips—a US national security concern. Japan and the Netherlands have joined the US effort in restricting exports

of semiconductor manufacturing equipment to China.

Given the stated US goal in maintaining 'as large of a lead as possible' in semiconductors, quantum computing, artificial intelligence and other critical sectors, it is not surprising that China's President Xi Jinping has stated that the United States attempts to contain, encircle and suppress China. China is now pouring hundreds of billions of dollars into cutting-edge technologies to achieve self-sufficiency. The West's economic sanctions following Russia's aggression against Ukraine worry Chinese leaders who fear similar sanctions could be applied to China if it pursues reunification with Taiwan.

Technological decoupling raises serious concerns about global growth in the short and long term. A 2021 IMF study identifies three direct channels where technological decoupling can affect global growth—reduced global trade flows, misallocation of resources and less cross-border knowledge diffusion.

Together with trade fragmentation and 'friend-shoring', technological decoupling can lead to significant economic losses globally. The drive for self-sufficiency is costly and success is not guaranteed. Reining in technological nationalism is in the United States and China's interests, but the political reality in both capitals is making rational policy formulation extremely difficult. **EAFO**

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