OPINION:

The economics of geopolitics for small states

David Skilling, Straits Times, 5 November 2016

The return of big power geopolitics is squeezing small countries

After several decades of a remarkably supportive external environment for small open economies, the world is becoming much more challenging.

World trade has not grown over the past 18 months, driven largely by weak import demand from emerging markets. Singapore is highly exposed to this sluggish trade environment, with exports of over 200% of GDP. Indeed, Singapore's non-oil domestic exports were down by 5% in the year to September. The sustained period in which global trade growth consistently exceeded world GDP growth seems to be over.

There are several reasons for this, ranging from a sluggish global recovery to the increasing localisation of production as automation makes global supply chains less necessary. The rising incidence of protectionist sentiment is also a contributing factor, as seen in the collapse this week of the Canada/EU trade deal as well as the rhetoric around Brexit and the US Presidential election. The more challenging domestic politics of globalisation is likely to constrain the external growth potential of small economies like Singapore.

These dynamics are amplified by the tighter relationship between international economics and international politics. Although great power politics was never completely absent from international commerce, it has become more explicit in today's multipolar world. This is particularly true in Asia, the geopolitical cockpit of the world, and it is an issue to which Singapore is particularly exposed.

Economic agreements and institutions are often expressions of great power politics as well as being economic instruments. The TPP (Trans Pacific Partnership), for example, in addition to its economic merits, has been described as the economic arm of the US pivot to Asia. And its likely demise will have a geopolitical as much as an economic impact. Similarly, the AIIB (Asian Infrastructure Investment Bank) and OBOR (One Belt One Road) initiatives have both economic and geopolitical objectives.

At a minimum, this creates a more complex operating environment for small economies. Small countries need to work to keep options open and to balance multiple relationships. The multilateral system, in which trade liberalisation was conducted primarily through the WTO, was a preferable system for small states. For one thing, small countries now need to invest more to be on the inside of as many groupings as possible: for example, participating in RCEP (the Regional Comprehensive Economic Partnership) as well as TPP, and being early to join the AIIB.

And as bilateral and regional agreements increasingly replace multilateral deals, geopolitical considerations increasingly determine the nature of the agreements that can be achieved by small countries. The absence of large markets means that the attractiveness of small countries depends to a greater extent on strategic considerations. This has been less the case for Singapore because of its hub status and the absence of sensitive sectors like agriculture. But it is instructive to consider the case of New Zealand: the first developed country to secure a free trade agreement with China (part of what the Chinese call a 'model' relationship with a developed country) but unable to secure a bilateral trade deal with the US, partly because of lingering political tensions.

There is also a more direct sense in which small countries are economically exposed to geopolitical conditions. There are many examples of small countries being squeezed by larger countries during periods of diplomatic tension. This can be seen in the recent public exchanges between Singapore and China on Singapore's stance with respect to the South China Sea, with some Singapore firms reporting that they are concerned about potential commercial risks.

These commercial pressures are not unique to Singapore. Around Asia, there are numerous episodes in which geopolitical tension has led to reduced trade and investment flows. Over the past weeks, Western brands like McDonalds have reported weak sales in China as a consequence of consumer protests related to the US stance on the South China Sea. And there is evidence from the past decade that trade flows between Japan and China trade flows reduced significantly after periods of bilateral political tension.

The manifestly asymmetric nature of bilateral relations between large countries and small open economies creates particular exposures. A failure to align on issues that matter to large countries can result in economic consequences. For example, after the 2010 Nobel Peace Prize was awarded (by a Norwegian committee) to a Chinese human rights activist, Norway's salmon exports to China were restricted, resulting in very significant losses of market share.

Given New Zealand's growing economic exposure to China, it is perhaps no accident that New Zealand's Deputy Prime Minister last week cancelled a meeting with democracy activists from Hong Kong. Indeed, researchers have documented meaningful reductions in national exports to China in the two years after top leaders of various countries met with the Dalai Lama.

The implication is that the external economic risks of small countries like Singapore are not limited to a weak global economy but also include the state of their international political relations. And, as an aside, these realities will also greatly complicate life for post-Brexit UK as it scours the world for new trade agreements.

So how should small economies respond to these new realities? Adroit diplomacy can only take a country so far. Even with the best diplomacy, tensions will emerge from time to time that can lead to small countries being squeezed. One important element of the small economy response is to encourage market diversification to reduce exposure to geopolitical risk. Examples of these strategies include New Zealand (including emphasising ASEAN markets), Israel (rebalancing towards Asia to broaden beyond the US and Europe), and European countries reducing their exposure to Russian imports and exports.

Singapore already has a relatively diversified set of export markets and investment destinations: ASEAN takes about 20% of Singapore's goods exports, China 15%, and the US and the EU together take over 20%, with a long list of other important markets. Singapore's physical position at the cross-roads of Asia, and its role as a regional and global hub, gives it options that many other countries in Asia do not have. Even so, this more challenging geopolitical environment will likely challenge Singapore's external growth model.

Along with other small economies, post-independence Singapore has benefited substantially from a relatively benign geopolitical environment, which supported intense globalisation in an open, liberal, rules-based system. The return of big power politics, and the increased contingency of cross-border trade and investment flows on the state of the political relationship, could impose substantial economic and political costs on small advanced economies.

Singapore has some significant domestic economic policy choices to make in order to adapt its economic model to delivering strong outcomes at the income frontier. But managing these external issues effectively matters at least as much for Singapore's ongoing prosperity.

About the author

Dr David Skilling is the founding Director of Landfall Strategy Group. David advises governments, companies, and financial institutions in several small countries, and writes regularly on global macro, globalisation and geopolitics from a small country perspective. David has recently served as Senior Advisor to the Secretary of Foreign Affairs & Trade in New Zealand, and as a Fellow at Singapore's Civil Service College. Previously, David was an Associate Principal with McKinsey & Company in Singapore, as well as being a Senior Fellow with the McKinsey Global Institute. Before joining McKinsey, David was the founding Chief Executive of the New Zealand Institute, a privately-funded, non-partisan think-tank. Until 2003, David was a Principal Advisor at the New Zealand Treasury. David has a Ph.D. in Public Policy, and a Master in Public Policy degree, from Harvard University, as well as a Master of Commerce degree in Economics from the University of Auckland. David was named as a Young Global Leader by the World Economic Forum in 2008.

About Landfall Strategy Group

Landfall Strategy Group is a Singapore-based research and advisory firm that provides advice on strategic issues to governments, firms, and financial institutions, particularly in small advanced economies. We provide distinctive perspectives on emerging global trends, working with decision-makers to understand key global changes and how governments, firms, and institutions should respond and position themselves in the emerging global economic and political environment.

contact@landfallstrategy.com

www.landfallstrategy.com

twitter: @dskilling

LANDFALL
STRATEGY GROUP