

Australia and Economic Cold War – Drifting into the New Paradigm

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Dr Heather Smith, National President AIIA
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Thank you, Auntie Violet, for that warm welcome to country and allow me to pay my respects to elders and acknowledge all Aboriginal and Torres Strait Islander colleagues here with us today.

Shadow Minister for Home Affairs, Senator The Honourable Jonathon Duniam;

Your Excellencies, Members of the diplomatic corps;

Distinguished speakers, panellists and guests.

It's always a pleasure to acknowledge former President of the AIIA, John McCarthy, the AIIA Fellows here today and my fellow AIIA board directors.

This year has seen quite a lot of change in the national board of the AIIA. I particularly wish to acknowledge and thank our retiring ACT President, Heath McMichael and Victorian President, Richard Iron for their leadership and outstanding contribution over several years in furthering the mission of the AIIA in their respective roles and nationally through their role on the AIIA board.

Also having retired this year is our long-standing Vice President, and previous Victorian President, Zara Kimpton who leaves an enormous legacy. More on Zara shortly.

Just prior to the federal election this year Prime Minister Albanese released the unclassified version of the independent review Richard Maude and I co-led into Australia's Intelligence Community. ¹ We wrote this prior to the US election. We thought we painted a stark strategic picture of the world Australia faces – one more volatile, more contested and more fragmented. And how these threats were being amplified by technological change.

We said we faced a dangerous international environment and a growing need to defend ourselves against threats to our democracy, social cohesion and essential infrastructure. In describing this environment, we said more nationalist populist governments in both Europe and the US could alter some of our current foreign and economic policy settings.

What we didn't foresee was the extent of United States commitment, and speed, to start a trade war; to retreat from the post war international order it created; that it would treat friends and foes alike; begin to dismantle some of the cultural, intellectual and political foundations that have underpinned its success; adopt a restrictive immigration

stance; and, arguably, undermine the very foundations of its democracy, rule of law and free speech.

And that all of this would open the door for China to accelerate its ambitions to become the regional hegemon. While it is debatable whether China is now close to achieving this, at the very least, the US no longer has primacy in the Indo-Pacific.

As Farrell and Newmann put it in *Foreign Affairs* recently: ‘every [US] administration is forced to build the plane as it flies, but this is the first one to pull random parts from the engine at 30,000 feet’.²

It seems trite to say much has happened since we gathered here a year ago. While an end to the Ukraine-Russia war remains elusive, the peace arrangement brokered by President Trump between Israel and Hamas provide hope that we have seen the end of the horrors of the past two years, and might offer the first realistic prospect of a durable peace in the Middle East.

What is unprecedented is the way in which that conflict was imported into the domestic politics of countries far removed from the Middle East, including Australia, where the rise of antisemitism and associated violence has deeply tested our social cohesion and polarised our politics in ways that may never heal.

Meanwhile, the spectacle of the coalition of the autocrats in Beijing as President Xi presided over his military parade – perhaps the Yalta moment of the 21st century – was audaciously designed to visually draw a line under Pax Americana and signal the arrival of the multipolar era, with China at the centre.

Shortly thereafter, President Trump’s attitude towards the US-designed and led multilateral system was on full display at the United Nations General Assembly, while President Xi announced to the world that China would be a force for stability in a chaotic world, defend multilateralism and shape global governance for the many, not just for the few. We will see.

Amid all this turmoil and uncertainty, the global economy has proved surprisingly resilient, largely because the tariff deals struck by the US have been less than initially expected, the front-loading of imports in anticipation of more prohibitive trade measures and because business has, initially, absorbed the flow-on costs rather than passing them onto consumers.

But these are temporary buffers and costs will mount overtime. As the IMF has said, uncertainty about the stability and trajectory of the global economy remains acute, especially when combined with the long-standing global structural challenges.³

However, it is the changes underway in the global financial system that will be more consequential that the distortions wrought on a global trading system already fragmenting and increasingly protectionist.

The international financial system since the GFC has been transformed and interdependencies have intensified, with government bond markets at the centre, the increasing role of private credit markets and non-bank institutions, and the emergence of the largely unregulated cryptocurrency market.

The risks to US financial stability have risen with an emerging view that the US economy is worryingly bifurcating - in a financial bubble driven by the AI boom, whilst the rest of the economy is slowing, as labour markets and consumer confidence weakens, and inequality widens.

Having digested the gyrations of Trump's 'tariff escalate to de-escalate' strategy following 'Liberation Day', global equity markets have been stunning indifferent to the assault on the institutions and policy frameworks that underpin their very existence and success – seemingly high, as Edward Luce put it, on the AI gold rush, crypto deregulation and the prospect of a return of easy money.⁴

This, combined with US public debt at its highest since WWII, and the 'big, beautiful bill', that contains no real growth enhancing initiatives but which erodes US fiscal sustainability, should be raising alarm bells as to whether the foundations are being laid for the next global financial crisis.

To some, like Jamie Dimon, it's a question of not if, but when.

How might this unfold? The key risk is liquidity stress in government bond markets if a future auction of sees demand fall short of supply, spiking bond yields with higher interest costs for US borrowers. This would undermine confidence in the US Treasury market, creating large scale disruption to global financial markets, interest and exchange rates.

Holding US assets can no longer be thought of as entirely safe as investors price in greater risk and consider diversification as trust in institutions frays. If this were to gather momentum the implications for global capital flows would be dramatic. As Paul Krugman notes, 'markets act as if everything is normal until it's blindingly obvious that it isn't'.⁵

And note, as the risk of a crisis is increasing, the global ability to respond is decreasing. Such an event would take place without any of the cooperative international economic architecture and coordination used to manage the fallout during past financial crises. Recall it was the faith in the US and its institutions that led us through the Asian Financial Crisis and the GFC.

This raises a related question – are we seeing the beginning of the end of US financial exceptionalism?

Though the USD's position has become more vulnerable, its unlikely to be challenged while US financial markets retain their unrivalled depth and liquidity and while China retains capital controls.

But the US is damaging the institutional framework underpinning the dollar's dominance and trust of domestic and foreign investors in the dollar-based financial system.

Further undermining of the US Federal Reserve's independence will erode confidence in its ability to deliver on its role of ensuring low inflation and unemployment - the key driver of investors' trust in the USD. If, as seems likely, the next Federal Reserve chair toes the line on the Administration's objective of lower interest rates and a lower USD in the belief it will rebuild US manufacturing. They will find it won't. And they will preside over an erosion of the Fed's authority in global finance.

Markets have also lasered in on understanding China's longer term economic resilience vis-a-vis the US and whether the US has underestimated China's capacity, adaptability and leverage to withstand a prolonged trade war.

As we have seen, China has more leverage and more retaliatory options than the US. Around half of China's exports to the US are products for which the US has limited alternatives.

Though lagging in some key technologies, China's industrial and technological strength is transforming it into a powerhouse of the global economy. The UN estimates in five years China will account for 45 percent of global industrial output, up from around a third today.⁶ China has shown its adeptness at rapid innovation, with state industry policy subsidies on an unprecedented scale, and with the deep infrastructure and political ecosystem to endure pain to ensure resilience.

The economic weaknesses and deep structural challenges embedded in China's growth model of self-sufficiency and technological dominance are well known.

If the US can harness the productivity benefits of the AI economy, and limit the damage to its dynamic innovation ecosystem, then it will retain its edge in critical areas. If it continues to undermine the foundations of its economic power, as *The Economist* says, the impact is likely to be a grinding diminution of competitiveness and the advent of a new set of vested interests embedded throughout the American economy.⁷

It has been repeatedly evident that the US doesn't appear to be able to sustain an escalation ladder when dealing with China. Xi does, and he's used it more effectively. Xi knows what Trump fears most is the rising price of money in the Treasury bond market. The current playbook of Washington seeking commercial détente suits Beijing over the geopolitics of strategic deterrence.

The rest of the world, including Australia, are now caught in dangerous crossfire as both look for disruptive ways to exert leverage over the other's economy, as we have seen on rare earths and semiconductors and in competing demands for foreign firms to comply with Chinese or US law.

In the absence of guardrails to this sectoral decoupling we are in a race to the bottom. And especially if this brinkmanship extends to the weaponisation of finance. While it is unlikely the US would precipitate this for fear of the impact on financial markets, China has stepped up its campaign to de-dollarise by accelerating the internationalisation of its currency, as evidence by BHP being compelled to settle 30 percent of its sales to China in yuan.

Adrift in a new paradigm

To say that Australia is not well positioned for this world is an understatement. It's lonelier and more fraught for us – as demonstrated by both our key strategic partner and our key economic partner having engaged in economic coercion against us.

The world Australia faces is increasingly undemocratic, grievance-driven, aggressively interventionist and multipolar.

Our fear of abandonment, as Allan Gyngell described so well, has never been more palpable.

Adam Posen describes it as the US having switched from global insurer to extractor of profit, having ripped up the post WWII insurance contract of underwriting global public goods. The most impacted are allies, like Australia, who bought into the system and were freed up to spend less on securing their future.⁸

Our desire for a strategic equilibrium in the Indo-Pacific would seem to no longer be achievable. Indeed, we are now in a state of strategic disequilibrium that will be the norm for some time.

Our bilateral policy framework of 'stabilisation' also seems precarious as Beijing undoubtedly will seek to test what it has called our 'two-faced' policy as we juggle our economic and strategic interests. We should be under no illusion that China will act in anything but its own interest and that it will be ruthless in doing so. At the same time, it is not in our economic interest, nor our region's, that China's economic rise be contained, even if it could be.

So, in this world of great power politics, can Australia maintain a degree of agency?

In my view, yes, but suggesting we can have complete strategic independence is an illusion. That said, we must come to terms on how to construct and use our agency to prepare for greater strategic autonomy.

However, our public and indeed private strategic discourse on the US remains narrow, binary and circular – focussed on the centrality of the alliance and AUKUS as our strategic saviour rather than framing it as a national endeavour with huge upside for industrial transformation of parts of our economy.

Little attention is given to understanding the longer-term implications for Australia of the internal dynamics of the US. As this audience knows well, conservatism and isolationism run deep in American history and the national psyche – from the ‘Know-Nothings’ anti-immigration party of the 1800s to the America First Committee of the 1940s.

We have seen a weaker version of US style anti-elitism playing out in Australia with the culture wars against our universities, migration, and diversity and inclusion. While this may be satisfying to some, it’s an indulgence that detracts from the efforts needed to respond to the external threats and position us for the future.

Respondents to public polling by the Lowy Institute reflects the contradictions of our national circumstances.⁹ Trust in the US has fallen dramatically and has been falling for the past 15 years. Yet a large majority of Australians still regard the alliance as central to our security and think the US will come to our defence if we are attacked.

Australians are cautious towards China and divided on our economic engagement, despite China having fuelled our growth and rising living standards over the last quarter of a century. Most think China could be a military threat in the next two decades, with half supporting an increase in defence spending, without identifying how it will be paid for. More than half of the respondents assume China will be the most powerful country in a decade and lead technologically compared to the US. And most would prefer goods to be made in Australia even if it costs more, even though our services sector is 80 per cent of our GDP.

To exercise our agency, as a nation we need a mindset shift - to think differently about our interests and place in the world. A new global landscape is taking shape. Yet relative to Europe and others in our region, it is striking how slow we are in preparing for a new paradigm.

As I said, we need to be hedging by planning for greater strategic autonomy, as distinct from strategic independence.

Let me be clear, this does not mean turning away from the US. But it does mean inoculating ourselves by taking out a more comprehensive insurance policy than in the past, meaning more self-reliance, more defence spending and sovereign defence capability, and more hedging of our interests through new coalitions and partnerships, whilst continuing to support regional partnerships.

As I have said in this forum previously, what we do at home to build our resilience and competitiveness should be just as important as how we plan for the defence of our nation. We must get our economic house in order, and quickly. If we don’t, we significantly limit our strategic flexibility.

We are not without agency. Australia’s stable political system, Westminster system of government, our proximity to and enmeshment in the fastest growing region of the

world, a sound financial sector and macroeconomic frameworks, including a flexible exchange rate, has enabled the economy over several decades to adjust to crises.

And we have been effective in leveraging our geography in our defence and intelligence relationship with the US, even though most Australians would not know this.

But for too long we have underinvested in the foundational elements of our nation that are required to better position us for a new world - whether it be sovereign science and technology capability, a diplomatic footprint that reflects our global interests, defence spending that reflects our strategic circumstances, an industry policy that enables future growth rather than protecting the past, a migration policy that truly focuses on bringing in the best and brightest, or a concerted rather than piecemeal strategy that positions us for sustained major power competition in the Indo-Pacific.

On this last point, despite the naysayers, the current Government deserves credit for its approach to date.

This aside, over the years we have been incremental and ad hoc in our approach to economic reform, too reliant on China to fund our rising incomes, and too sanguine about the security umbrella of the United States to protect us. Taken together we have become a complacent country, without a comprehensive insurance policy in the face of unprecedented global transformation.

We are yet to move the dial on productivity growth – our performance is now the second lowest in the OECD. This is not new – our productivity performance has declined consistently over the last few decades. The recently convened Economic Roundtable by the government clearly recognised this, but just how much political will exists for comprehensive reform remains to be seen.

Self-insuring will require greater sovereign capability. But getting the balance right on industry policy will not be easier given our history of protecting declining industries and our fragmented innovation system.

In the Intelligence Review, Richard and I said structural changes were needed in the Australian bureaucracy to enable government to better balance multiple interdependent economic and national security objectives. This change was needed because of the inevitable fiscal and societal trade-offs we face in ensuring our economic and national security.

That is why we recommended Treasury play a broader and deeper role in advising on economic security decision-making that, pleasingly, the Government is pursuing. Treasury is the only agency that can bring broad and integrated economic perspectives and decision-making frameworks to ensure advice to government now, and into the future, encompasses all relevant national interests.

Because having multiple and loosely-defined goals – whether to create manufacturing jobs, build national capacity, promote national security, or accelerate the clean energy

transition – will always be a difficult balancing act, but particularly so given our lack of scale and market power.

And as recent calls by some in the political class for a revival of Australian manufacturing show, the political economy concerns of industry policy interventions haven't changed. This is despite the clear evidence of the past that sound macroeconomic policy along with a policy-driven incentive structure that can mobilise and align private sector capital with national priorities, is what really drives productivity and hence growth in living standards.

Yet, after decades we have yet to move the dial on some of the foundational elements of growth - R&D spending, where we still rank well below the OECD average, and private sector investment, that continues to be weak.

External partnerships like AUKUS Pillar II offer the potential to enhance our advanced technological capabilities but will take time to come to fruition and currently lacks alignment with other initiatives that would create sovereign scale and capability.

In our review, Richard and I also concluded that a bolder approach was needed in the form of the creation of a national security investment fund, along the lines of In-Q-Tel in the US and the National Security Strategic Investment Fund in the UK.

My point here is that we will have to move beyond rhetoric into action, and much faster than our political and bureaucratic decision making currently allows. Our lack of progress on our munitions and liquid fuel stocks is a case in point. And while the landmark agreement on rare earths between Australia and the US represents a political watershed in the bilateral relationship, as someone who was involved in the early stages of our critical mineral's strategy, it has taken us, and the US, way too long to get to this point.

Perhaps nothing best illustrates our propensity to underinvest in our future than in our approach to our understanding of the Indo-Pacific. As recent research has shown, enrolments in Asian languages are at their lowest levels in decades. Our take up of second language learning is amongst the lowest in the developed world.¹⁰ We seem unconcerned that China studies in Australia have gone backwards, not helped by some who don't seem to accept that furthering our understanding of China does not mean agreeing with its ideology, governance model or policies.

If we had pursued that approach in decades past with the Soviet Union, we might never have had George Kennan writing as 'Mr X' in *Foreign Affairs* in 1947. And without the knowledge of Kennan and others, the Cold War could have played out very differently.

Surviving the era of weaponised interdependence

The global order is now permanently changed. There is no going back. The only certainty is uncertainty.

One of the questions we pose today is whether the promise of a stable, rules based international order is something still worth fighting for in an era of weaponised interdependence?

I would say yes, but the question is how? If we are to have an effective international system it requires the building of, and adapting to, a different type of multilateralism, rather than attempting to renovate the old system. The existing structures seem incapable of reform as shown by the absence of progress over the past two decades.

The narrative that globalisation is to blame for western economic woes is now firmly entrenched, even if the evidence is mixed and not reflective of Australia's experience as one of world's greatest beneficiaries.

According to the Edelman trust barometer, the developed world, including Australia, is now in a crisis of grievance.¹¹ This grievance transcends the disillusionment with political leadership to a distrust on the democratic system to deliver for its citizens. Only 1 in 5 think the next generation will be better off and 1 in 2 young adults approve of hostile activism as a viable means to drive change.

A more plural, fairer and inclusive system will need to emerge.

However, the global shift towards mercantilism won't lead to a better system that addresses entrenched inequality in the US, or the legitimate claims for a greater voice of China and the developing world. This is a path that leaves everyone worse off.

Countries will need to find a new balance between their national interests and international interests. Except for China, most countries are struggling with this, as evidenced by having played straight into the US' hands by entering bilateral negotiations, despite trade being a positive sum game.

Because China and the US will continue to play by their own rules I agree with Mike Froman, writing in *Foreign Affairs*, that to sustain some fraction of the global economy's prior openness the best option may lie in crafting a system made up of coalitions of the like-minded, which together constitute a network of open plurilateral relationships,¹² combined with minilateralism where countries come together perhaps temporarily to address specific problems more quickly.

Some groupings will be mechanisms for ongoing regional cooperation and trade integration such as APEC, RCEP, CPTTP and ASEAN frameworks.

Other coalitions would focus on securing supply chains in the name of national security, like the US-Australia rare earths agreement and the US extension of this cooperation to some ASEAN countries.

Others might be new coalitions for sectoral openness. Australia has been here before. Our establishment of the Cairns Group in the 1980s, in bringing together a diverse

political and economic group, was in response to aggressive US and EU agricultural subsidies.

And as Froman says, such world of variable geometry of plurilateral agreements will be messy, inefficient and trade diversionary. But it could be more politically sustainable and help put the guardrails around burgeoning unilateralism and prevent national security considerations completely dominating.¹³

The sounds of crickets

To conclude.

This is the most difficult international set of circumstances Australia, and our leaders have faced in the post-war period.

All of the institutions that matter to us are being disrupted and all at once.

Recent bilateral meetings and regional summitry have seen the Prime Minister deftly pursue Australia's interests with great agency and skill.

But the recent US-China one year trade truce stabilising the relationship its only likely to be temporary. Continued bilateral tensions will remain a permanent feature of the relationship, punctuated by cycles of tit-for-tat escalation.

We are also still none the wiser of where the US' role in the Indo-Pacific is headed, beyond seeking to stymie China's economic rise. Is the end state a grand bargain over Taiwan? Or is it the pursuance of a more comprehensive containment and deterrence strategy in the event of a conflict over Taiwan?

As we stand here, Australia's ambition of continuing US leadership and engagement in maintaining a military balance of power in the Indo-Pacific seems unlikely to be delivered, given US disregard for alliances, regionalism and multilateralism.

Regardless of who is the next president, the US can no longer be assumed to be a predictable ally. Nor can we assume it will seek to lead. In this new world, China will use the next few years to fill the leadership void. It is, as Paul Kelly has said, bizarre that Xi outsells Trump in presenting a great power narrative to the world.¹⁴

The diabolical choices that confront us of seemingly being caught in a pincer between China and the US should be starting to dawn.

If the US-China geostrategic rivalry cannot be contained, we will need to choose. In the end, sustained growth and prosperity depends on the rule of law, secure property rights and independence of institutions. So, while the US is truly troubling at present, China is more so.

In my view we simply have not laid the foundations to be able to exist in this volatile and uncertain world where we are dancing on the head of pin.

As I have said before, this is not a time for incrementalism given the inter-generational consequences.

Eventually, we will need a national conversation involving all of us – commentators, media, community and not just government - to address all of this and be upfront with the Australian people.

And yet all we are hearing today is the sound of crickets.

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- ¹ Commonwealth of Australia, Department of the Prime Minister and Cabinet, 2024 Independent Intelligence Review, 2025.
- ² Henry Farrell and Abraham Newman, The Weaponised World Economy, Foreign Affairs, August 19, 2025.
- ³ International Monetary Fund, World Economic Outlook, October 2025.
- ⁴ Edward Luce, America's accelerating exit from itself, Financial Times, September 9, 2025.
- ⁵ Paul Krugman, Why aren't markets freaking out? August 28, 2025. <https://paulkrugman.substack.com>
- ⁶ United Nations Industrial Development Organisation, Industrial Development Report 2024.
- ⁷ Would an all-out trade war be better? The Economist, September 18, 2025.
- ⁸ Adam S. Posen, The New Economic Geography, Foreign Affairs, August 19, 2025.
- ⁹ Ryan Neelam, Lowy Institute Poll Report, June 6, 2025.
- ¹⁰ Philipp Ivanov, The Renewed Case for Asian Literacy, Asia-Pacific Development, Diplomacy and Defence Dialogue, 25 September 2025.
- ¹¹ 2025 Edelman Trust Barometer, <https://www.edelman.com/trust/2025/trust-barometer>
- ¹² Michael B.G. Froman, After the Trade War, Foreign Affairs, August 11, 2025.
- ¹³ Ibid.
- ¹⁴ Paul Kelly, China's vision for the world finally unleashed, The Australia, September 5, 2025.