Australia’s China Challenge

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[acknowledgements]

Introduction

I am very honoured to be invited here to Brisbane this evening to give the CEDA annual address. At the time the invitation was extended to me early this year, I warned the organisers that by November I would no longer be Australia’s Ambassador to China. I’m pleased that they felt that I would still be able to make a contribution to the subject of Australia-China relations just the same.

When I was preparing my remarks for this evening, I was reminded of the first CEDA annual national address I ever attended. It was in the late 1970s in Melbourne and the speaker was the economist, little known then in Australia, Mancur Olson.

At that time Olson had a certain cult status among economic liberal think tanks and media commentators for his book, which I had studied in undergraduate economics, *The Logic of Collective Action*. It was about how groups formed to create and capture rents – industry lobbyists for tariff protection or subsidies, trade unions, etc – to change distributional outcomes.

His message was that this type of collective behaviour was very harmful to economic growth. It was a message with a powerful resonance in the Australia of those days – with our then high tariffs, quotas, subsidies and rigid, inflexible labour markets.

Olson went on to publish in 1982 a remarkable historical extension of his thesis in his book, *The Rise and Decline of Nations*. It told how nations, having grown and become comparatively wealthy, become sclerotic as interest groups form over time to capture rents. These rents are then used to entrench the interest groups through the political process. Who then compete over distributional outcomes at the expense of productivity growth. And so, with falling productivity, nations decline.

When we look at today's mess in the European single currency area, the lost decades of growth in Japan, and political deadlock in Washington over necessary fiscal budget reform, it would seem Olson had much to say about the state of the world today. This is a worthy subject of debate and I'm sure many university essays and theses are being written on the subject as we meet here this evening.

My purpose in recalling Mancur Olson's CEDA speech, however, is not to reflect on the state of the world as such but rather on how far Australia has changed since that time in directions that Olson would welcome.

Australia and New Zealand were prime examples of sclerotic economies in decline. We were sclerotic compared with Japan then, certainly the United States and many countries in continental Europe – but not, of course, with the United Kingdom from where we had inherited so much of our institutional arrangements for collective action.

Back then listening to him, his message seemed incredible and the policy prescriptions far fetched. We knew Australia would not pull down its tariff walls, privatize national champions and free up the labour market.

It was a lonely life then for people in think tanks, universities and some in the media who stood against the conventional wisdom and said we must adapt and change. Bodies like CEDA, and later the National Farmers' Federation, kept making the case for reform. Over time, enough people came to share these big thoughts and our poor economic performance reinforced the need for change.

As Olson's book on the *Rise and Decline of Nations* was coming off the press, Labor parties in Australia and New Zealand were preparing to again govern their countries. In one of the great quirks of modern history, it was Labor in government on each side of the Tasman which ushered in over a decade of unprecedented economic reform and liberalization, and the internationalization of their economies in the process.

And in another quirk of history, around the same time policies of economic reform and opening the economy were being adopted in China. These would have a profound effect not just on the lives of everyone in China but on the international system as a whole, and most importantly on Australia.

Australia and China

Australia's own reforms helped to position us to take advantage of explosive growth in north-east Asia, at first, in addition to Japan, it involved the so-called newly industrializing economies of South Korea, Taiwan, Singapore, and Hong Kong. This was based on the deep economic complementarities between Australia and north-east Asia, which today so massively underpin our economic relationship with China.

With remarkable vision, in 1989, then Prime Minister Bob Hawke commissioned the former Ambassador to China, my first Ambassador in China, Ross Garnaut, to prepare a report on Australia's economic integration with north-Asia, called *Australia and the North-east Asian Ascendency*.

The purpose of the report was to sustain momentum domestically within Australia for further liberalization of the economy so that we could more fully participate in north-Asia's growth. For the first time, Australia was provided with a coherent, international framework in support of domestic economic reform. The external and internal were drawn together, and the issue of the international competitiveness of Australia was now central to domestic policy discussion.

China was seen in the report as an emerging economic power that would one day be of immense importance to Australia. But back then it was difficult to imagine just how important China would become and - in Ross Garnaut's phrase – pass the "laugh test".

The Cold War was just starting to recede, the Soviet Union still existed, China was in a period of deep introspection following the violence of the PLA against its own people on the roads leading to Tiananmen Square, and the world which we used to call "the West" was imposing a variety of sanctions on China.

And then sitting in a little office in the old DFAT building there was Ross Garnaut on Bob Hawke's instructions, saying we had to take painful policy decisions to ready Australia for China's return to it's longstanding historical position as one of the world's great economies.

Viewed from this perspective, it all seems so improbable.

The Hawke/Keating reforms, Garnaut's vision of sustained economic growth in North Asia, especially China, and what it could mean for Australia if we prepared ourselves well, these were big thoughts that underpinned bold and creative domestic and international policies.

Today, China's rise and rise requires an equally expansive and bold vision if we are to continue to realize the potential of our economic complementarities.

Australia's China challenge is to think big and long term about our relationship with China and what we can realize out of that relationship to the benefit of Australia.

Trade and Investment

In 1991, when I concluded my first, almost-five-year stint at our Embassy in Beijing, our bilateral trade was some $2 billion. This year, at the end of my second five years, it was over $105 billion. It more than doubled during my term. China is today our single biggest export market, having overtaken Japan in 2009. The important point about this is not only the size, but the fact that no country will again overtake China as our biggest export market unless China collapses.

As our major export market, and therefore our major foreign source of wealth and jobs, China greatly overshadows all others. The Chinese market alone is worth more to Australia than our 3rd, 4th, 5th and 6th export markets – namely South Korea, India, the US and the UK combined. Australia's exports to China last year were almost as big as our exports to Japan and South Korea combined and more than three times greater than our exports to India.

China's demand for our education and tourism services similarly greatly overshadows that of any other country. In the year to May, Chinese full-fee paying students accounted for just on 30 per cent of all students, way ahead of the next biggest group which was not India, as you might expect from all the attention given to it, but Malaysia, which accounted for just 8 per cent.

Tourism is a similar story with some half a million Chinese tourists visiting each year. China is the second biggest source by number, but is the biggest by how much people spend. So in terms of tourist revenue, China is the single biggest source.

Chinese direct foreign investment is growing as we all know very rapidly. While for historical reasons Chinese stock of foreign investment in Australia is still quite small, ranked about number 8, last year China was the third biggest in terms of flow. Over the past five years, more than 220 Chinese foreign investment projects have been approved by the FIRB, accounting for over AUD65 billion.

Apart from the big contribution this makes to Australia's living standards and government revenue, Chinese investment is also bringing into production new resources.

It is almost all Chinese investment that is developing the magnetite iron ore deposits of Western Australia – which previously had been ignored by the major miners – and the seam-coal gas in Queensland and NSW. So Australia's stock of exploitable resources has been expanded by Chinese foreign investment and the Chinese market.

Will it continue?

These are just the headline numbers and examples of how China's growth has contributed to Australia's well being and why our terms of trade are at historical highs.   It all far far exceeds the most optimistic forecasts made by Garnaut and others back in the late 80s and early 90s.

Australia has now so comprehensively hitched itself to China's fortunes, that we inevitably are in for a white-knuckle ride.

Of all the remarkable things China has achieved over the past thirty years of reform, it has not abolished the business cycle. We are at present in a tightening phase of the cycle as the government seeks to reduce inflationary pressures and let the air out of so many speculative bubbles. This is just one of a number of such cyclical adjustments over the past three decades. And already we're seeing official inflation numbers moderate and talk again of a possible easing of credit restrictions.

Running through these cyclical fluctuations, however, is a strong secular upward trend. China has at least five major drivers of continuing productivity growth, which will see, in the absence of some shock to the system, China's GDP quadrupling over the next 20 years.

At this point, I probably should declare that as a director of Fortescue Metals Group I have a direct interest in this issue. But I am on the record as having made these same points as Ambassador in a number of different speeches over the past couple of years.

In no particular order, the five main sources of sustained productivity growth are:

Rural to urban migration, which will continue apace. Over the next 20 years, some 300 million people will move out agriculture into urban areas. At present, just 50 per cent of China's almost 1.4 billion people live in cities. China's urban population will rise to some one billion. As people move to cities, their productivity rises and for those left behind in agriculture their productivity also rises.

China arguably is still well inside the global production possibility frontier. China has decades of catch-up ahead of it. It is also still a poor developing country. China's automobile consumption is just 30 for every thousand people, compared with 600 per thousand in Europe and close to 1000 per 1000 in the US.

China can for many years draw down on the global stock of technology, research and production management. I have, for example, been to most of the major steel mills in China. In all but one, the core equipment is imported, mainly from Germany. This by the way may help to explain why the German economy is doing so much better than its European neighbours. The same story can be told of fast-trains, where the critical element of the bogies, which ultimately determine speed, are made by Alstrom in France.

China has invested massively in transport infrastructure. Over the past decade, it has replicated Eisenhower America of the 1950s and covered the country in efficient six-lane highways. More recently, its massive investment in very fsst trains has been subject to a lot of criticism from both within but mainly from analysts outside China. On any net present value accounting measure, the investment in the high-speed network could be hard to justify. But China is still a country in which some 60 per cent of all freight movements consist of one commodity, namely coal. It would seem that moving people off dual use lines to free capacity for freight would also make a big contribution to productivity growth.

By investing so heavily in transport infrastructure, China's government is knitting together a patchwork of regional economies. In doing so, it is opening the possibility of China's becoming for the first time in its long history a single integrated market, with all the possibilities of regional specialization according to comparative advantage. We hear little today of the dire warnings by foreign analysts of just a few years ago about China being rent apart by insurmountable regional inequality of income between the littoral and interior provinces.

One of my favourite trivial-pursuit, after-dinner, questions is to ask when, where and by whom in all of China's three or more thousand of years of continuous history was the first bridge built across the Yangtze River. The answer usually surprises: in 1956, at Wuhan, by the Soviet Union.

Much is written these days about the greying of China's population. The concern is that China will become grey before it becomes wealthy. The worry is that China will get caught in a low-level equilibrium trap, like Japan but at much lower per capita income. By 2015, China's dependency ratio will begin to rise. This should be of concern. China will lose it's demographic advantage, something that India will retain for many generations, along with the US and even Australia so long as we can maintain a relatively open immigration policy. Offsetting this, however, is China's massive investment in education.

Again, the numbers are unprecedented. According to China's National Bureau of Statistics, in the decade to 2010 China nearly tripled the number of people with higher education from about 3 per cent to almost 9 per cent. Whether they can all find jobs is now a new and pressing challenge for the Government. But from the perspective of long-run structural change, it is significant that those entering the workforce today are manifestly much better educated than those whom they are replacing.

The fifth major driver of productivity growth is something relatively new but something that may well prove to be decisive, as it was in Australia in the 1980s. China is in the process of internationalizing its currency, the Renminbi. Full currency convertibility is a long way off, and a freely floating currency is a different issue entirely – many currencies have been, like the Australian dollar until 1984, convertible but not floating. China is, however, making its currency more and more useable outside of the country. In the long tradition of China's reforms, it is doing this incrementally, piecemeal, by trial and error but the direction is set and will be continued.

To be sure, many substantial difficulties need to be addressed, including with the banking sector and regulatory arrangements. But the process has been put in train and it will haltingly and falteringly pull through reform and liberalization of China's capital account. To the extend this proceeds, the productivity gains from a more efficient allocation of capital between internal and external uses will contribute significantly to sustaining productivity growth over the next twenty years or more.

So notwithstanding the immense challenges China faces, it is probably safest to base business or public policy on the assumption that in twenty years the Chinese economy will be at least four times bigger than it is today. It is only necessary to grow at annual average rate of 7.5 per cent to double GDP in a decade. Clearly that will happen this decade and most likely in the next as well. Over the past 33 years of reform and open door policies, China has maintained an annual average growth rate of just on 10 per cent.

The downside risks to China's quadrupling its GDP over the next twenty years are obviously both political and environmental. As a one-party authoritarian state, the possibility of some deep shock to the political institutions is real. The difficulty is to assign a probability to it. Anyone can say there is a risk, as indeed there is. But the key analytical question is what probability would one give it?

In the 1980s, many analysts and commentators, year after year, would say that China's reforms would end in tears. When Tiananmen happened in June 1989, many said they had been proved correct. That China's depressing historical cycles had again re-imposed themselves on its modern experience. I'm pleased to note that the Australian Embassy in Beijing at the time, through a speech in Hong Kong given by the then Australian Ambassador, David Sadleir, was the first to say that the shocking events of that year would have no impact on China's reform and opening policies.

From where I sit in Beijing, and having been there during some of the events like June 4, all I can say is that while the possibility of another existential crisis obviously is there, one would have to assign a very low probability to it as of now.

On the environment, this is real and serious. One is encouraged that the Chinese government is also concerned and the current 12th FYP has strong policies to address environmental issues. China is investing massively in green energy, renewables and nuclear, and in green cars and so on. But one insurmountable fact remains: China is currently about 68 per cent dependent on coal. China has the world's largest coal reserves, it is the world's biggest coal producer and consumer. Transport constraints notwithstanding, for China coal is the most readily available and hence cheapest source of energy.

On all the most optimistic forecasts for uptake of renewables, nuclear, and for energy conservation, China will still be at least 60 per cent dependent on coal as the main source of primary energy in 20 years. So how sustainable will the Chinese economy be, when it is four times bigger than it is today, and still at least 60 per cent dependent on coal?

An efficient answer to clean coal technology will need to be found. Meanwhile, clean natural gas from a variety of sources – which Australia will increasingly supply – will become an ever more important component of China's energy mix.

So there are downside risks, and more than what I've just mentioned. None, however, convinces me that in just twenty years the Chinese economy will not be at least four times the size it is today.

Australia's China Challenge

China's growth challenges Australia in one very important way. And that is China's vast scale, and hence capacity to think big and act long term.

The trick for Australia is to understand the unique complementarities between us and how can we exploit them to our national advantage. To do so, Australia will need to change. We have done that before and can do so again.

Some examples suggest the possibilities for us, but there must be many more.

In the steel sector, we have vast deposits of iron ore and metallurgical coal. The problem has been that they have been on the opposite sides of the country and with our high internal transport costs have been uneconomic to combine and produce steel in commercially viable quantities.

China imports both from us, as well as natural gas which can also be used in steel production. China's steel production is now over 700 million tonnes, almost double what is was when I first went to China as Ambassador. Soon China will have a steel sector of close to one billion tonnes per annum. The world has never seen anything on this scale before and, of course, Australia will continue to be a major source of iron ore and coking coal. At same time, China's wages and costs are rising rapidly, especially in the eastern seaboard provinces where much of China's new steel making capacity has been relocated.

The challenge then for Australia is how do we make ourselves an integral part of the plans to restructure the Chinese steel industry? This is an historic opportunity for Australia to add value to our resources.

It is conceivable, if not at present obviously commercially viable, for early stage steel processing of slabs and billets to be done in Australia. I know at least one major Chinese company that would invest in a 10 million tonne steel mill in Australia, to process early stage product for export to other Asian markets for further processing, if it could use Chinese skilled labour for the construction stage of the project.

Another significant area for the future is in agriculture. China's per capita income in nominal terms has now passed $US4,500 and in purchasing power parity terms it is much higher again. At these levels of per capita income the demand for protein increases exponentially. This will come from animals, mainly beef.

The Trade Minister, Craig Emerson, recently spoke about this as a great opportunity for Australia. He made the important point that China will need to get its protein from somewhere. Australia has an enormous commercial opportunity but also an ethical responsibility, in view of our large land mass and small population, to help China meet its growing need for protein.

Chinese investment to supply Chinese markets will increase the total capacity of our agricultural sector. And areas that today are not profitable to bring into production because of high capital costs could well become attractive to Chinese investment.

We can throw many other ideas on the table.

It would seem that China could be invited to invest in building a city in the Pilbra. Water in northwestern Australia is not a problem. We can use it for agriculture but also to build new cities in Australia. With Chinese demand and capital there is no need to think of the eastern seaboard as the main areas of future development. Karatha I'm told is slready one of the busiest airports in the county. People should have the chance to live in that area as well as work there. So northern Western Australia and the Northern Territority become regions of substantial population growth.

China is frustrated at what it sees as Australia's poor infrastructure, especially ports and rails for bulk commodities. It would be keen to invest heavily in these areas if that expanded the supply of product going to the Chinese market.

Another example is high-speed trains in south-eastern Australia, perhaps from here in Brisbane to Melbourne. The air corridor between Sydney and Melbourne is said to be the second busiest in the world. The idea of very fast trains linking Sydney, Canberra and Melbourne was looked at quite seriously some years ago. It may be worth revisiting this and this time looking at Chinese capital and construction systems (China's high-speed tracks are built mainly on pylons thereby reducing the footprint and hence the land required).

Obviously, a key constraint on these ideas is the question of labour. It is not so much an issue of labour costs, as these projects tend to be very capital intensive. Rather it is an inadequate supply of necessary skills. Opening wider

Australia's skilled short-term migration scheme, especially for large-scale projects, would likely increase the demand for Australian workers, especially in service industries.

In a global economy labour also needs to move more freely than at present. This is not an issue about permanent migration or guest workers. Rather, it is about getting the job done as quickly and as efficiently as possible.

Conclusion

Australia can have first class infrastructure, high-speed trains, new cities in the west, greatly expanded agricultural industries and large-scale steel mills adding value to our resources. China's market is set to grow ever bigger. We do, however, have to be open to Chinese capital and skilled labour. The choice is there and should be the subject of ongoing vigorous public debate. Just as people came to understand the choice between a closed inward protected economy and an open outwardly oriented economy, so the issues raised here need to be much better understood so the choices and consequences are clear.

It is the sort of debate that CEDA has contributed so much to over the years and in doing so has done much to improve Australia. The challenge for Australia in China's growth over the next twenty years is not to stand back from it, or try to pretend it is not happening or will go away, or seek to build closer relations with smaller weaker states. It is to recognize the reality of it and the vast implications it holds for Australia, possibly more so than for any other country, and to imagine how we can use it to strengthen Australia and increase our prosperity. These are the core mandates of CEDA's work.

Again, many thanks for the opportunity to address you this evening.