CHANGING CHINA Lecture

Lowy Institute & Australia-China Council

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Ladies and Gentlemen……Michael, Malcolm, Lowy Fellows, ACC representatives, distinguished guests:

Thank you for having me here and for honouring me with the invitation to deliver this inaugural Changing China lecture. ....the story behind me being here goes back over 2 years (originally suggested by Graham Fletcher) and I am flattered that ACC and Lowy were willing to wait so long for me to be able to do this. I hope you don't come regret it after you've heard what I have to say!

There is an aphorism about economists which I think equally applies to so-called China experts…..and that is that for every China expert there is an equal and opposite China expert! Personally I often refer to the old Sufi parable about the 3 blind men who are asked to describe an elephant………..(the Chinese of course claim the parable as their own, *xia zi mo xiang*)……this is useful good analogy as China is truly elephantine in extent and complexity and presence….and we all of us have a propensity to grab the piece of the elephant nearest to us and then try to extrapolate from that. Against this background you may have to forgive me the odd generalization this evening.

……and may I wish you all a Happy Year of the Tiger. In the Chinese zodiac Tigers are regarded as very brave, highly competitive and rather unpredictable……a bit ominous perhaps but as with all astrology, much depends on how you choose to interpret the signs. And this is perhaps one of the key themes that I want to talk about this evening – how we interpret the signs. My primary theme of course is *Changing China* and I am going to beg your indulgence as I take a good piece of my time to reflect upon 30 years of change – I strongly believe that China's present status can be better put in context by clearly understanding where she has come from - perhaps a neglected aspect of much current discourse. I will also look at the recurring question of the sustainability of China's developmental model, discuss the way we in the western world observe China, and talk a little about Australia's unusual situation in relation to China.

As you can imagine, for someone who has lived 31 years in China – virtually all of my adult life – the topic, Changing China, is interesting to me. I have been lucky in being a not terribly well-qualified, but very interested and privileged spectator of one of the great transformations in human history and one of the most significant eras of China's long and spectacular history. And I happened to land there just as this era began, an era in which China started along the path to resume what the Chinese think of as their rightful place in the world.

But I want to emphasize that I do not come to you this evening as a polished academic researcher and I am not particularly given to spending time in discussion of the major theoretical or hypothetical aspects of the way in which change in China is observed. I am a lay observer. My reference points and comments are derived from my personal experience of China over 3 decades and I offer them to you in that context, and to some extent with that as a caveat.

So on that basis I will offer a bit of a narrative, a few observations, and to then, by way of hopefully making a contribution to what is a fairly important discussion for Australia (and the rest of the world), make a few assertions based on having watched China from fairly close up over a long period of time.

So how did this situation develop, how did we get to where we are now and how did China achieve what is by any standards a staggering transformation?……from the surly, impoverished Orwellian isolation of the 1970s, to the fast-growing, dynamic, neon-lit, tech-savvy, increasingly affluent, 2nd largest economy in the world……..from backwater basket case to leading light in a generation, and on an order of magnitude unprecedented in human history, based on an apparent disregard of developmental orthodoxy and with an ongoing momentum that is causing not a little disquiet in its many manifestations in the global economy, in global forums and in its relations with global counterparts.

Sitting here in a cosy think tank with people who are curious about China because of China's critical importance to our trade and to our businesses, and which importance has in the last 18 months escalated well beyond the anticipated because of the GFC and due to the fairly dismal outlook for most of the other major economies in the world, it is very easy to forget that China appears to have arrived on the world's economic stage in something of a rush in the fairly recent past. Not many in the developed world were paying much in the way of rigorous attention to China even 5 years ago. Certainly, there were only a few who were closely attentive of China's presence 10 or 15 years ago. And only a handful very strange and pathetically misguided people were interested in China back in 1978!

At that time China's economy was about the size of Australia's. Chinese policy-makers were constrained by lack of experience, ideological orthodoxy and a woefully inefficient centrally-planned macro-economic legacy, and were far less educated, worldly and open than the current crop of leaders, and the process of Reform and Opening was new-born and fragile – but at that point some key decisions were made in pragmatic Chinese fashion which were to underpin and characterize the unique economic, social and national transformation that we have witnessed in the past quarter-Century.

Much is made of the concept of the "Beijing Consensus" developmental model and this idea is credited with being a kind of guiding principle of China's progress over the last two decades. Personally, I prefer to subscribe to the idea that China has more or less muddled through, on the basis of Deng Xiaoping's wonderful aphorism *guo he mo zhi shi tou* (crossing the stream feeling for the rocks with your feet). This idea best articulates the ideology-free and pragmatic approach to policy-making that epitomized Deng's insightful leadership in getting the reform process underway after years of Mao Zedong's ill-conceived tinkering. But beyond pragmatism there are some key precepts which have distinguished Deng's intuitive thinking and separated China's development strategy and outcomes from those which had been pursued (mostly unsuccessfully) by many other nations in the developing world.

One of the keys to creating a basis for developmental momentum was an understanding of what had and had not worked in the developing world until that time. The Chinese perceived that the post-WW2 Atlantic Alliance-dominated Bretton Woods institutional model of development had been good for North America, Europe and Japan but had not been good for the 3rd World. At that time, South Asia, Africa, the Middle East and South America were all chronically poor and heavily indebted, with no real prospect of meaningful progress. Capital and technology were both controlled by the wealthy western nations and Japan. The global trading system, by virtue of the GATT rules, was heavily loaded in favour of the developed nations. The fact that this might have been due to some degree to the manoeuvring associated with the Cold War was neither here nor there to the Chinese leaders. After nearly 3 decades of economic mismanagement, punctuated by Mao's disruptive political upheavals, China was clearly among the poor countries of the 3rd world and was only a geopolitical feature in global affairs, not an economic presence in the least. Deng and his colleagues, prudent Chinese to their bootstraps, first perceived that borrowing money and being in debt was simply not a good thing in terms of national development and they determined to avoid it. They also saw clearly that rapid flows of capital were highly disruptive and that currency fluctuations were fundamentally inimical to the stability that was in their view essential for sustained economic development.

The elegant Chinese solution from these deliberations was to maintain a closed capital account. This was augmented by a policy of limited sovereign borrowing, mainly long-term borrowing for poverty-alleviation goals, from the likes of the World Bank. Of course these decisions did put a ceiling on Chinese growth rates in the early part of the Reform and Opening Period in the 1980s, but the Chinese found other growth drivers latent in the inefficiencies of the Chinese economy – and the objective of overall stability was worth the sacrifice in the long run, and arguably still is.

The other policy precepts that the Chinese leadership adopted were based on a very frank assessment of what China had to work with as a basis for development. The country was geographically enormous and had the world's largest population, infrastructure was shoddy or non-existent, there was a limited industrial base with virtually no modern technology, manufactured goods were poor quality, shortages existed for nearly everything, most people lived in the rural areas, there was very little trade with the outside world, very little domestic investment, next to no foreign investment, and agriculture had been reduced to near-subsistence by the ideology-based policies of the Cultural Revolution. The morale of the nation was depressed and capacity for initiative and innovation was systematically repressed. The entrepreneurial spirit had been completely stifled. The education system had been virtually dismantled and the intellectual capacity of the nation was severely degraded. Economically, China was moribund. Millions of people were hungry. And there wasn't any money in the state coffers to stimulate growth or invest much in anything. In other words, the Chinese leaders of the late 1970s and early 1980s had inherited a very grim situation and did not have much to work with.

Deng and his economic advisors, realizing that there were no quick fixes that didn't bring longer term issues, decided to aim policy at the things where they could at least prompt some early reinvigoration in the domestic economy. Most notably they introduced the Contract Responsibility System in the rural areas which effectively decommunalized agriculture and liberated farmers to recover their productivity to more normal pre-Cultural Revolution levels.

They also identified clearly that development and modernization was dependent on the availability of capital and technology. China was desperately short of both so a critical part of the Reform and Opening process was the strategy of re-engaging with the outside world in order *attract the things that China did not have* (i.e. technology, capital, foreign exchange) *by virtue of leveraging the thing that China did have* – and what China had was potential. China's potential was embodied in her huge population, i.e. large pools of low cost labour and a potentially massive market. In the early 1980s there was in fact an explicit policy discussion about the "Two Shortages" - capital and technology - and people still talk about Deng's 'deal' by which he traded access to China's huge market for access to technology and capital.

And so, with these policies in place, things slowly began to move. Agricultural productivity and rural incomes rose strongly in the 1980s - important because the large rural population was a key constituency for the CCP. Industrial reform proceeded more slowly, foreign investment and trade only grew modestly. In the government there was resistance to change and much debate about the path of reform and the pace. In society there were tensions developing as the side effects of reform created dislocations – food price inflation appeared again (always something that makes people nervous in Zhongnanhai), economic growth, although modest and from a low base, caused China's antiquated infrastructure to creak and stress, bringing more inflationary pressures.

Change is hard to manage anywhere anytime but change on the scale of China, politically tentative and impeded by legacy, is fraught with risk. Tiananmen Square in 1989 was the point at which the stresses of a decade of change and uncertainty, the unpleasant side effects of clumsy early reform policies and the constrictions of limited capacity coalesced in a moment of popular expression. Personally, I don't see the Tiananmen demonstrations as being about democracy. It seems to me that it was about anxiety. It was about inflation. It was a reaction to change - change imposed, change not well understood, not well enough communicated and change poorly managed by a government not fully aligned around the need for or nature of the change………

In my view, and irrespective of the judgments one might reasonably make about how the government handled the Tiananmen protests, it is to Deng Xiaoping's everlasting credit that, after Tiananmen, instead of ditching the reform process and taking China back into central planning (which would have been an understandable reaction), he led the Party senior leadership into a review and recalibration of the Reform and Opening Policies and with his famous 'Nan Xun', his Southern Tour in the Spring of 1992, blew away the last hesitations about whether or not China would continue to embrace change.

This did not mean that the capacity limitations which caused problems in the late 1980s suddenly went away, quite the opposite. The shortcomings of a dirigiste investment-led transition economy with limited infrastructural and intellectual capacity became very apparent again within a couple of years of Deng's Southern Tour in the inflationary spike of 1994 and the nervy politically-kneejerk withdrawal of credit from the economy in response. But they did learn their lessons from that experience and they kept going. The population, particularly the urban dwellers neglected in the 80s, got more attention and were made better off in the 90s and thus became more supportive of reform. The other factor not often identified in this process is the way that change itself became more commonplace, more the norm. The Chinese people got used to change. And popular reaction to change was dealt with more promptly and more benevolently, relatively speaking.

At some point, in the second half of the 90s, the dynamic of China's growth began to shift fundamentally. The leadership, especially Prime Minister Zhu Rongji, had been very bold in driving necessary reform through the entire structure of the state and the economy. Infrastructure development was better-planned and moving faster, bureaucracy was being reduced (48 Ministries reduced to 29! Try doing that in Canberra), there was vigorous and highly disruptive reform of the SOEs (some 46 million employees effectively made redundant in the space of 3 years), the start of financial sector reforms began with the sequestering of the NPLs into the AMCs, a massive and abrupt housing reform program, ongoing refinements in FDI regulation, the emergence of private sector firms, the beginnings of the service sector, and active engagement in WTO accession negotiations, etc.

By the turn of the decade China was beginning at last to experience economic growth that was not as dependent on artificial policy supports or as reliant on government investment. The government no longer had to drive growth they just had to manage it. Companies were beginning to be profitable. Trade volumes were rising and foreign exchange was flowing in. The urban population, as the beneficiaries of rising incomes for the previous decade and of housing reform in 1997/98, had substantial savings, had some modest collateral by virtue of the housing reforms and now had access to future income streams by virtue of the availability of mortgages (none were available in China until 1998). Demand for new residential housing rocketed and the developers willingly responded.

In simple terms, the Chinese economy went from one which had to be pushed along at high growth rates in order to manage dislocations caused by the reform process, to one which had self-sustaining growth based on the liberation of latent demand, improved living standards, a large savings pool, rising affluence and the simple drive human aspirations. It took them 20 years of doing some very hard yards to get it rolling but this last decade has seen the beginning of the payoff. The Chinese government's issue in recent years has been one of managing the economy's propensity to overheat rather than supporting growth, and that, axiomatically, implies a major adjustment in the way the key policy agencies have had to think about economic management.

As we all now know, over the last 25 years (especially in the last 15 since the 'Nan Xun' and certainly in the last 7 or 8 years) what I call the *'potential-leveraging' model* became the model by which China was able to attract very large volumes of foreign direct investment capital - accompanied by equipment and technology and the management knowhow embedded therein. It took some time to build up momentum (partly because of China's volatility in the late 1980s and partly because the rest of the world was at first reluctant to respond positively to the model, for very good reason) but eventually the lure of China's potential, either as a low-cost base from which to export or as a domestic growth market of potentially extraordinary scale, was just too hard for foreign investors to resist. Nice side-effects for China included inflows of modern equipment and management techniques as well as the access to the export markets and brands that came with foreign investment. On top of this they kept on with the process of what were really politically very courageous reforms in the domestic economy and the whole thing eventually moved to self-sustaining status………..driven, for the most part, by domestic investment and consumption. FDI and exports, although notable, should not, in my view, be over-stated as drivers of Chinese growth.

And if you doubt the sustainability and momentum of China's growth story, just think back for a moment on the challenges that China's economy, in transition and muddling through in many ways, has had to face – just getting the reform process itself started in the early 1980s, inflationary pressures in the late 1980s, the Tiananmen Square protests and the aftermath, another bout of very high inflation in 1993 and the slamming on the lending brakes in 1994, SOE reform in the mid-late 90s (46 million people displaced), the Asian Financial Crisis in 1998 (when China alone did not depreciate her currency), the 2001 global dotcom recession, 4 months of virtual paralysis with SARS in 2003, overheating and inflationary stresses of 2004/05 (remember the blackouts and dire predictions)………in 2008 there were snowstorms of unprecedented historic proportions, riots in Tibet and the associated geopolitical tensions, a massive earthquake in Sichuan that killed 80,000, 4 major typhoons and massive flooding, 100 year droughts in the north (the Yellow River ran dry), tectonic electoral change in Taiwan, North Korean missile launches and A-bomb tests, economic overheating and food price inflation, then the global financial and trade crisis from September onwards, etc. all in one year………oh, and by the way, they still did 9% GDP growth, they responded the GFC with an unmatched agility in terms of policy adjustments and stimulus………*and* they hosted the Beijing Olympics too. In 2009 China has more or less led the world economic recovery (to Australia's relief) by recovering and maintaining strong growth in spite of a major negative contribution from net exports……

…. these guys are good, these guys are muddling through quite well………so why is it that people still ask questions about China's sustainability as if this whole extraordinary national transformation is somehow some kind of macro-economic Potemkin Village?

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Let me now try to look at how the outcomes generated by the policies of the Reform & Opening era are informing policy-making now and allow me to suggest that China has recasting the developmental model to fit the needs of a second era of national transformation.

China's "Two Shortages" of the 1980s, capital and technology, have been for all intents and purposes, addressed. China is now arguably the world's most capital-adequate economy - a huge domestic savings pool ensures that they are more than capital self-sufficient (in fact increasingly an exporter of capital), China has the world's largest sovereign store of foreign reserves, has access to a great deal of technology (much of it by virtue of that which has already been brought in, transferred in joint ventures or directly purchased) – and of course China now has plenty of money to buy almost any technology they need or to invest in the development of technologies they require. Chinese spending on R&D is soaring, the number of Chinese patent filings, domestically and overseas, is enormous and rising very rapidly and quality issues are being addressed. And they've put 3 blokes in space and brung them back, among other things…….

Of course the overall macro and national development situation is still a work in progress and there is still a large part of the Chinese population who are still poor by any standard and who are patiently waiting for their turn to enjoy the benefits of China's developmental success and there is a vigorous debate about how Chinese fiscal and forex surpluses should be used. But Chinese policy-makers face their domestic developmental challenges from a much-changed standpoint than their predecessors did a quarter of a century ago or even 10 years ago. And the challenges they face now are themselves different.

The key Reform and Opening policies which were implemented in the 1980s and driven with tenacity for over 25 years have achieved a great deal – but these policies are now arguably obsolete. This creates the context for reviewing many of the existing developmental orthodoxies – just one example, when utilized foreign investment accounts for only 1% of China's total investment and China really has all the capital they need, and while FDI still running at US$90 billion per year by virtue of the attractions of China's domestic market growth potential, why should China have policies which incentivize foreign investment? ....especially when a lot of that investment has gravitated towards the production of low value-added exports or has enabled the transfer of energy-intensive or polluting industrial capacity from overseas into China.

And this is just one aspect of the new challenges facing the current Chinese leadership – others include the imperative of addressing the broad social justice agenda, environmental concerns, energy consumption, industrial optimization, healthcare, financial sector reform, education, developmental imbalances between urban-rural, East-West, the rich-poor divide, etc.

So in respect to economic and developmental priorities now, Chinese government thinking has been forced to shift - from the 1980s policy imperatives of thinking about the "2 Shortages", how to leverage China's potential and how to maintain growth in order to sustain the reform process, starting from several years ago, policy priorities now more reflect a "Quality over Quantity" agenda which emphasizes many social justice elements. Back in April 2006, President Hu Jintao said, "We are not pursuing higher speed growth but rather the efficiency and quality of growth, the transformation of the growth model, resource consumption efficiency, environmental protection and the improvement of living standards." That says it pretty clearly……….although I'm not entirely sure that everyone either in China or the West were paying as much attention as they should have……

One effect of this new policy intent on foreign investment and exports, is that the discussion in Beijing now derives much from the "2 Highs, 1 Low" construct – i.e. *high* energy consumption and *high*ly polluting processes combined with the fact that much such activity is *low* value-added – the prevalence of this kind of industrial facility is an unintended side-effect of 2 decades of being, and perhaps needing to be, relatively indiscriminate with respect to inbound investment. Even high-tech assembly production (eg. iPods, DVD players, etc.) are low value-added in terms of net value retained in China's economy……and modern Chinese policy-makers know this. Another factor, somewhat grating on Chinese pride, is the fact that, at least in Chinese eyes, almost every sector where foreign investors have been able to participate in China domestic markets, they have dominated.

Naturally, most foreign investors don't see things quite this way, but I can assure you that this kind of viewpoint does now characterizes Chinese policy thinking. And, from a Chinese developmental perspective, dispassionately assessed, these conclusions are essentially valid. When the matters at hand are those involving national interest and national development, fairness is not a consideration. FDI and exports have always been seen merely as means to achieving China's own developmental ends. China has always openly talked about *li yong wai zi,* "utilizing" FDI. If you want confirmation of what I'm talking about, have a good look at the evolution of the Ministry of Commerce Foreign Investment Catalogue in recent years and note how it has evolved in the last few cycles. You can see that there has been a clear migration in the Catalogue among which industries are categorized as "encouraged", "permitted" or "prohibited". And recent developments, such as the new Anti-Monopoly legislation and the way in which it is being enforced, also give you some further confirmation that we are in a new era of a more discriminating trend with respect to FDI.

Another feature of China's rapid development over the past 15 years or so, in business/commercial/industrial terms, has been that, as a result of massive investment, high rates of growth, rising absolute consumption brought on by rising affluence and strong export growth to a booming world market, China has moved industrially from widespread structural inadequacy in just about everything (capital, technology, basic materials, manufactures, food, etc.) in the 1980s to the relative surplus of capacity that we now see across almost every major industry in China. This has been (and still is) a transition economy, the market mechanism for allocating capital efficiently is immature, and in a high growth context companies are able to build lots of capacity…..and, until recently, they've been more or less able to sell what they made……either domestically, or when capacity caught up to domestic demand, they could sell into export markets. In a post-GFC world exports have dried up and so it is very apparent that there is too much capacity in many areas. Not only that, industry structure is skewed by the number of participants in most industries, many of whom are sub-optimal in terms of scale, technology, energy-efficiency, product mix, market position, environmental performance, safety, productivity, etc. With relatively slower rates of growth set become the new norm and the prospect of a material export recovery still some way off, something has to change. Not that the government is totally averse to having some surplus capacity – keeping prices low for the general populace and having margin pressure converging with policy intention to consolidate and optimize industries are both quite acceptable side effects from the point of view of Beijing officialdom.

So, against this background and looking forward from now, what can we expect of policy and developmental priorities in China?

There will be a re-emphasis on China's domestic priorities – some 200 million Chinese people have been made 'comparatively affluent' by virtue of China's reforms…….this means that there are 1.1 billion people still waiting for their chance at affluence – as Hu Jintao's statement shows, there is already an increased emphasis on social justice and a shift towards quality versus quantity in economic development. This implies permanently slower growth rates (the small contribution of net exports becomes even smaller but growth occurs off a larger base – it is now a US$5 trillion economy), industrial restructuring (consolidation, optimization, higher value-added), more attention and implementation on environmental performance and energy efficiency, perhaps paradoxically in many people's minds there will be continued market reforms (i.e. use of the price mechanism, competitive supply/demand pressures and restraints at the outbound Customs Barrier, etc. in order to achieve policy objectives), use of China's capital and forex stockpiles to support infrastructural expansion and industrial optimization, to support R&D, to support the acquisition of technologies, to support or facilitate the secure supply of energy and raw materials. And obviously, in line with the social justice agenda (and in the interests of social & political stability), we should expect an acceleration of policy-driven initiatives in the development of social welfare, pension schemes, healthcare, rural development, etc.

We should not expect any real central-level policy support for further industrial capacity expansion. We should not expect China to encourage investment in energy-intensive or polluting industries or in low value-added export industries. As in many countries around the world, China's policy-makers will wrestle with a clear tension between openness and protectionism…….but domestic priorities will triumph.

The imperatives that drive China's developmental model have shifted as a function of successful policy outcomes. Policy is changing (has been changing) to adjust to the new circumstances. Much of China's policy-making is deliberate and very intentional, some of it has to be more ad hoc and in response to short-term imperatives. The current leadership of President Hu Jintao and Premier Wen Jiabao came to power nearly 8 years ago with a slightly different view of the world to their predecessors and it is apparent that they are both generationally disposed to a (slightly) more humanist and social justice development agenda. (In my view, that's what Harmonious Society really means) They are responding to different challenges than those faced by their predecessors. The legacy they inherited gave them a self-sustaining economic growth model and the financial resources to take policy in new directions, but they also inherited unforeseen and unintended negatives embedded in the growth model and, until quite recently, have found it difficult to gain much traction in pushing changes to the model – nobody listens to the government in an economic boom. So, paradoxically, the global financial crisis, the recession that the world has lived through, the export slowdown and the impact of these on China's economy over the last 12-15 months, while requiring a good bit of ad hoc policy-making, may also well precipitate the acceleration of policy implementation in the direction of the quality over quantity developmental model.

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So what are the implications for Australia and for our relationship with China?

While it hasn't always been smooth and while we have recently been forced to think harder about the implications of being a supplier to China, Australia has done well out of China's economic ascent. A thoughtful man said to me recently that many in Australia have to date 'only seen China as a source of rapid enrichment rather than as a real long-term partner'. There is something in that statement, but it does take two to tango. Australia's China relationship of the last decade has been very beneficial and relatively undemanding for the broader commercial, political and general population. Australia has cruised along on the crest of a trade – we have moved on from the slight naivety surrounding the concept of a 'special relationship' back in the 80s and early 90s and we have developed a narrative around the idea of 'complementary economies'. We have applauded the Chinese government's role in delivering rising affluence to millions. Politically, Australia has played a broker's role in engaging China – the 6 Party Talks on the Korean Peninsula had an Australia hand in their nurture, Australia got the Chinese to participate in a UN peacekeeping role for the first time (in East Timor), Australia worked hard to bring China into APEC and Australia has been something of a go-between or supporter of Chinese aspirations in a range of other areas. This was, for the most part, a blend of commendable *realpolitik* and genuine interest in integrating the emerging regional power. China's less attractive traits were still critiqued from Australia, but in a manner slightly more measured and restrained than that of our counterparts in the US and Europe. In recent years China was popularly rated among Australians as less of a risk to global peace and prosperity than the US! But in recent years, things have changed…. ………both in terms of popular perceptions and in political and commercial reality.

Australia's relationship with China has many component parts, but much as you would all of course expect me to suggest that resources are quite important, I struggle to develop a view that can credibly argue that our relationship with China is truly underpinned by any more critical element…………so let's talk a little about resources.

China's growth has come upon us suddenly, and nowhere is a better example of unpreparedness and reluctance to take China seriously than the resources sector. As an industry we really did struggle to believe that China was finally arriving as a source of sustained demand (the sustainability question yet again!) - we were happy to see demand improve and prices rise but we had a hard time believing that the demand would be there again next year. The Chinese, with their unreliable statistics, suspicion of foreign suppliers and negotiations-motivated opaque forecasting, didn't help matters much. They had their old reflexes, we had ours. We were all fighting the last war. Believe me there is plenty of blame to go around.

The resources sector was a very unsexy sector until China happened, now of course resources is the topic du jour. For over 20 years the sector experienced serial real price decline and very low growth. Raw materials buyers, under pressures of their own in a low-growth western world dynamic, continued to force prices down. There was structural surplus capacity in almost every commodity. The natural outcome in such circumstances is self-evident – companies consolidate to achieve greater economies and the industry consistently disinvests…in exploration, in talent, in new capacity, etc. And all of the affiliated industries disinvest too – engineering companies, equipment suppliers, tire manufacturers, even universities………. When the upturn came no-one really believed it had legs so there was a lag of several years between the advent of real new demand and the supply-side investment in the capacity to needed to respond. And there was a further lag between that investment going in and the actual availability of material volumes of new supply – this is the phase we are in now. Of course, in a global market, when supplies are short prices rise.

There's lots of discussion, particularly on the part of Chinese buyers of iron ore, about the extent to which supply is controlled or concentrated in the hands of a few companies. I cannot tell you how wide of the mark that kind thinking is in terms of being truly the wrong thing to focus on. But China is new and relatively inexperienced as a participant in global commodities markets, and even newer and less experienced as a participant in global resources sector M&A. It is going to take a little time for Chinese players to work their way up the learning curve – they are very smart, they will do it, but they will make some mistakes and there will be some 'unfortunate misunderstandings' along the way. This is a critical matter from an Australian perspective and is going to take a lot more time than I have tonight to discuss properly.

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Wen Hsiang, a Manchu statesman and Prime Minister of China in the 19th Century, once said to some foreign visitors, “You are all too anxious to awake us and to start us on a new road, and you will do it; but you will all regret it, for, once awaked and started we shall go fast and far – farther than you think – much farther than you want!”

So, as you’ve heard me say a few times already, I think the first and most important issue to deal with is how far China is going to go, i.e. the sustainability of China’s developmental model. I’ve tried to use that extensive earlier narrative of the past 30 years to demonstrate that there are very substantial foundations under China’s economic development, that China is not an artificial construct of the last 5-7 years or some smokescreen of fabricated statistics as is often implied. We can nitpick all we like but China is here stay. Our problem is increasingly not so much one of continuing to (over-)analyse China’s sustainability as one of simply accepting China’s permanence and putting our efforts into making the necessary adjustments in the way we respond.

In Australia, China’s sustainability really matters. While we have done a lot of good things in terms of running our own economy prudently, being able to export resources to China is a substantial component of our status as one of the few economically robust OECD economies. Therefore, if China were to slow dramatically we have a problem. By contrast, China’s economic impact on many of our developed-world peer nations is much less complementary and more that of a competitor. And I think this leads to a degree of ambiguity or even schizophrenia in the discussion and commentary about China in Australia. We have a propensity to observe and analyse China from the perspective of the liberal democratic market economy western world post-WW2 Bretton Woods institutions Atlantic Alliance-dominated US-led hegemony. We have been a part of that hegemony, not a leader but a follower, and a beneficiary. China is unequivocally a significant threat to that hegemony, the nature of which is exacerbated by the fact of being an ancient civilization with its own values and worldview, distinct and different from those which have been globally dominant through the 19th and 20th centuries. The nature of China's interaction with that hegemony has been characterized by the Western world's almost unrelenting criticism of China, China's imperviousness to that criticism and the success of China's developmental model by virtue of ignoring that criticism and most of the unrequited advice that came with it. The point is that Chinese are not really beholden to the existing world order, they clearly wish to see some changes in that order and they now have the influence to prompt those changes. We, in Australia, by virtue of munificent economic geology, are in the awkward position of being a beneficiary of China's emergence while the power and influence of our traditional allies is potentially being eroded by China's emergence.

So, in line with our compromised status, much of the discussion about China in Australia echoes the discussion in political and media circles in the US and Europe. I wrote a piece last year in which I attempted to assess the ways in which the Western world currently thinks about China. I identified the primary hub of most current discussion as being the issue of China's sustainability. From my own experience I know that this, in many and varied forms, is almost the only topic of conversation in business circles, among investors, in the popular media, in academia and among politicians. China’s unquestionably robust and sustained economic growth and increasing presence in our world doesn’t ever seem to dampen the suspicion that some kind of crash or collapse might be imminent. And this gives rise to a Janus-like anxiety – on one face, if China is sustainable and keeps going, the world order as we know it is very likely to experience fundamental change. On the other face, if China is not sustainable, we go back to the way things were. That would be a huge relief to many in the US and Europe but would no doubt be greeted in Australia with some ambivalence – we could live with that outcome in geopolitical/civilizational terms but the collapse of China would be disastrous for us in economic terms. Message to everyone in Australia – our little economic wagon is inextricably hitched to China’s success which means that our interests and those of our traditional allies and trading partners are diverging. That is a delicate spot to be in and we are going to need some real geopolitical and commercial agility in the years to come.

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Let me now make a couple of closing observations…….

I’m certainly not here to defend the obvious shortcomings of the Chinese government in terms of human rights, IPR, predatory mercantilist economic policy and commercial behaviour, etc. etc……there is a long list of things to critique about China which I haven’t covered tonight because it gets so well-covered elsewhere, everyday! Neither do I wish to overemphasize the idea of some kind of ominous looming hegemony of China……..my aim has been to talk about the simple reality of China as a massive, new, undeniable and sustainable feature of the global landscape, the likelihood of that, as a result of China becoming more influential and assertive, that landscape being distinctly different to what we have all been used to. There is a greater need for us in Australia to think clearly and deeply about China than is the case for many other countries……..and we need to be neither daunted nor in denial, we can't be blindly opportunistic nor vulnerable to being gamed to disadvantage……..it is undoubtedly a complicated and delicate position to be in and there are no trite soundbite-style easy answers. I would suggest that many currently popular constructs for observing China, the current pre-eminent Western world narratives, are generally wishful and simplistic, and are also not applicable to Australia's peculiar place in the new order of things.

Our first challenge is to become more comfortable with the complexity of the situation. Our second challenge is to come to terms with a new normal that includes China as a dominant presence. Our third challenge is to acknowledge and analyse the distinctiveness of Australia's status in the evolving world order. Our final challenge is to develop the responses that best serve our national interest over time, rather than responses that are either subservient to the wishful narratives of our civilizational brethren or that are too tempted by the siren song of mercantilist opportunism.

The Changing China that I have been privileged to observe over the last 30 years is characterized by several features – scale, complexity, diversity, dynamism, opacity. The virtues of the Chinese people – willingness to work hard, a reverence for literacy, a propensity to save – have been well-harnessed to the cause of national development in the past 30 years by the insights of Deng Xiaoping and nurtured through an unusually extended period of stability by a government that has muddled through with considerable agility and, by Chinese standards, benevolence. The change in China has been good for the Chinese people and it has generally been good for the world and for Australia. What we perhaps didn't anticipate is the extent to which the arrival of a wealthy and powerful China would be disruptive. But China is with us, China is not going away anytime soon, China will continue to change, China will inevitably become more influential and assertive of her national interests – the onus is on us to be good at reading the signs and agile enough to make the appropriate adjustments so that our national interests are also asserted and protected.

Thank You