Asian engagement calls for careful policy
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The Australian
16 December 2010
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For all of globalisation's vaunted ability to erode borders, dismantle barriers and overcome distance, geography still matters.

The persistent relevance of the real estate agent's mantra, ``location, location, location'', is apparent in Australia's modern economic history, in which a crucial feature has been the ongoing process of economic integration with east Asia.

Sure, this is a story that has now been running for more than half a century. Australian resources have helped power successive economic takeoffs across the region as Japan, Korea and China have relied on imports of raw materials from our mines and quarries. But it's a story that still has some considerable way to run.

It is growing more, rather than less, important and will provide us with some challenging policy choices in the years ahead.

East Asia already accounted for about 45 per cent of total Australian goods and services trade at the turn of the millennium.

By last year, the region's share had risen to more than 52 per cent, and was worth almost $264 billion.

The big driver of this increase is China, with the dragon's share rising from less than 6 per cent of our total trade in 2000 to almost 17 per cent by last year.

Last year, also, India became our third-largest export market and seventh-largest trading partner, giving south Asia a growing role in Australia's trade profile.

Compared with trade, the investment relationship has lagged.

Last year, the stock of inward investment from east Asia was only about 12 per cent of the total here, and the region accounted for less than 9 per cent of the total stock of outward investment, a lower figure than at the start of the decade.

Still, there are signs that the gap between the bilateral trade and investment relationships is closing. According to the Foreign Investment Review Board, east Asian economies together accounted for more than one third of its approvals by value in 2008-09, with China in second place overall.

India was also among the top 10 source countries.

With the emerging economies of east and now south Asia still among the fastest-growing in the world, and with most of them still in the very early days of expanding their outward investment, the baseline scenario for Australia is for both trade and investment ties to increase, especially the latter.

Most of the policy choices created by this scenario involve managing the problems of success.

Australia has already done extremely well out of emerging Asia's economic takeoff, a payoff that's visible in our surging terms of trade and in an economic growth that has now been running for an unprecedented two decades.

As this year's OECD Survey points out, Australia is one of only two OECD economies to avoid a recession in the aftermath of the global financial crisis.

A range of factors explain that resilience, many of them home-grown, but the OECD and the IMF in its own report for this year on Australia are both careful to emphasise the contribution of our deepening integration with the fast growing economies of emerging Asia. Indeed, according to one recent estimate, rapid regional growth may have contributed as much as 25 per cent of the total increase in Australia's real output over the past decade.

The economic benefits of our economic integration with the region lie not just in the past.

One piece of IMF research concludes that Australia's potential economic growth over the next decade is likely to be among the fastest in the developed world, due in large part to deepening ties with Asia's emerging economic powers.

Another IMF study reckons the future growth dividend from our trading ties with the region could yet be even bigger than the benefits already enjoyed. This is all good news, but even good news comes with qualifications. There are at least three complicating factors to consider: the consequent changes in Australia's economic structure, the changes in our risk profile, and the interlinked strategic and economic, or geo-economic, consequences.

The first has received the most attention, typically in the form of references to the two-speed economy. Surging demand from emerging Asia has pushed up commodity prices, supercharged our terms of trade and switched the forces of comparative advantage into fast-forward.

The result is a structural shift towards the resources sector, and a consequent redistribution of economic resources across industries and states.

As the often painful lessons from past resource booms attest, managing this transition will test our policymakers, a prospect that has been the subject of a steadily growing series of speeches from Treasury and the Reserve Bank.

Next, there is the change in our national risk profile. As our economic future is tied into the closely related fortunes of the emerging Asian economies and the commodity cycle, the price we pay for higher economic growth may turn out to be an increase in economic volatility. There are at least two reasons for suspecting that this might be the case.

First, while emerging economies are typically faster-growing than their developed economy counterparts, they also tend to be more subject to economic shocks and large swings in growth.

That said, the global crisis has just reminded us that rich countries are far from immune to shocks. Still, the Australian economy will be increasingly exposed to things going wrong in the region, an exposure that also involves non-economic risks, including, for example, the vagaries of North Korea.

Second, history tells us that commodity prices are typically volatile and prone to periods of boom and slump.

The final challenge relates to the geo-economic consequences of the rising economic importance of the emerging Asian economies.

To date, this development has mainly been the concern of a strategic community fascinated by the fact that our most important trading partner is also a rival of our most important ally. As a consequence, the strategists have been fretting that what in the past was a mutually supportive process of commercial and strategic interaction in the case of, say, Japan or Korea, has now become a potentially divisive force.

This strategic aspect is important, but it's far from the end of the matter. There is also a point to be made here about the nature of the dominant regional growth model, basically state-led development.

This design feature applies across most of the region's economies, ranging from the very successful family business that is Singapore Inc to the more recent and more abrasive version of state capitalism as applied by Beijing.

Again, a prominent role of state-led development has long been a characteristic of the region, but the growing economic importance of emerging Asia is giving it added weight in the world economy. Moreover, as our regional economic integration continues to deepen, understanding what the rise of this model means for Australia's own economic strategy will be critical.

Some early signs of this have come in the form of the debate over Chinese state-backed investment in the resource sector, the policy issues raised by the part-government-owned SGX's bid for the ASX, and in some of the concerns about overseas investment in Australian agriculture. Until now, each of these issues has been treated separately.

In reality, however, they are linked by a common question: to what extent, if at all, does Australia need to alter its rules and policy settings as we integrate with economies that typically use a quite different rulebook for playing the international economic game?

Working out the correct answer to this question is going to matter a lot, not least since there are risks both ways.

On the one hand, there is the real danger of over-reaction. After all, our economic policies have delivered prolonged prosperity, and it would be foolish to risk throwing away those gains.

Against that, however, we do need to test the assumption that a change in the nature of our external investors and economic partners requires no adjustment at all on our part.

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