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LOWY INSTITUTE PERSPECTIVES

CHINA AND THE INTERNATIONAL ECONOMY

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China and the international economy¹

Mark P Thirlwell

Remaking the world economy

In its December 2004 report *Mapping the Global Future*, the National Intelligence Council - the US intelligence community's 'center for midterm and long-term strategic thinking' – makes the judgement that the likely arrival of China as a serious global player will 'transform the geopolitical landscape,' noting that 'most forecasts indicate that by 2020 China's gross national product (GNP) will exceed that of individual Western economic powers except for the United States.'² While transformation of the geopolitical landscape may still – just – be a judgement about the future, the emergence of China as a new economic power is *already* reshaping the global economy. In recent years China has become a steadily more important determinant of global growth, of world export and import volumes, and of the price of major commodities such as oil. China's increasingly central place in the international economy has also been evident in heated debates over the bilateral trade deficit with the United States and the future status of China's exchange rate peg to the US dollar that have occupied policymakers since the start of the new millennium.

At the same time as remaking the world economy, China is having an even greater impact in its immediate neighbourhood. Beijing's growing political and particularly economic weight are exerting on the rest of East Asia a gravitational pull that is serving to mould both regional trade flows (a trend visible in the current expansion of intra-regional trade and proliferation of international supply chains) and regional institutions (seen for example in the growing role of ASEAN+3 and the spread of regional preferential trade deals).

For Australia, this transformation in the global and the regional economies within which we work and trade is creating both challenges and opportunities. The rest of this chapter outlines some of the ways in which China is changing our external environment, and then concludes with some thoughts about implications of the bilateral relationship, leaving a more detailed review of the latter to the following chapters.

¹ This paper was originally prepared as the overview chapter for the CEDA research paper *China in Australia's future*, launched on 18 May 2005. A copy of the full report is available from the CEDA web site <http://www.ceda.com.au/New/Flash/index.html>

² National Intelligence Council, *Mapping the global future*. Washington DC, 2004. p9

History lessons

Economic history tells us that the entry of new economic players into the world economy can have dramatic, and not always happy, consequences. Martin Wolf, for example, argues that the rise of the US economy in the late nineteenth century ‘had devastating consequences for the liberal economic order’ of the day, as a rapid increase in the supply of cheap US grain prompted European agricultural protectionism, US trade policies further militated against free trade and US economic instability rocked the prevailing international monetary system. Wolf goes on to suggest that ‘China is for labour-intensive manufactures what the Americas were for grain: a competitive new supplier with nigh-inexhaustible potential’ and by implication poses similar challenges to the international system.³

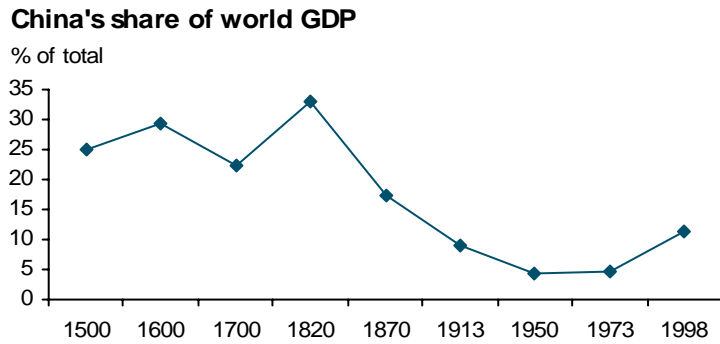
Undoubtedly, the rise of China does carry with it potential for the significant disruption of the established economic order. Yet the historical experience with the United States shows us that such periods of transition also bring with them great opportunities. Closer to home in terms of both geography and time, this is certainly the lesson that Australia can draw from its own experience in the second half of the twentieth century, an experience which indicates that the rise of new Asian economic powers – Japan, Korea, Taiwan and the ASEAN tigers – can provide an important lift to our own economic prospects.

Economic history also tells us that China’s current emergence as a global economic power is perhaps better characterised as China’s *re*-emergence. Work by the economic historian Angus Maddison estimates that China may have accounted for almost one-third of world GDP in 1820.⁴ The following century-and-a-half saw that share dwindle to less than 5% as the Atlantic became the locus of international economic activity (Figure 1). The global economy is currently experiencing a process of global reorientation, as economic weight in the international economy shifts back towards China, from whence it departed in the nineteenth century.

³ Martin Wolf, China must adapt. *Financial Times*, 18 November 2003. Germany’s emergence as a contender for economic and political leadership in the nineteenth century is another example of a major disturbance to the global status quo.

⁴ Angus Maddison, *The world economy: a millennial perspective*. Paris, Development Centre of the Organisation for Economic Co-operation and Development, 2001.

Figure 1: China's economic performance in the (very) long run

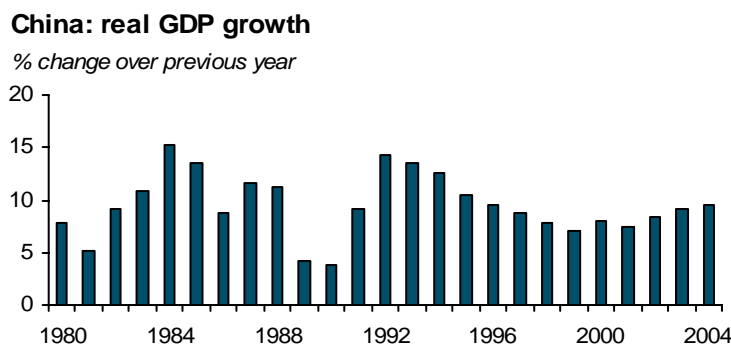


Source: Maddison (2001)

A growing global impact

China's current progress towards centre stage in the world economy is in large part a product of the economic reforms that got under way in the late 1970s. These in turn helped deliver an extremely impressive growth story: China has been one of fastest growing economies in the world since 1980, with real GDP growth averaging over 9% per annum between 1980 and 2004 (Figure 2). Moreover, this strong aggregate growth performance has also translated into impressive gains in output per head, with GDP per capita over the same period rising by more than 8% a year on average, with important positive implications for global poverty levels.

Figure 2: China's recent growth performance



Source: IMF World Economic Outlook database September 2004 and press reports

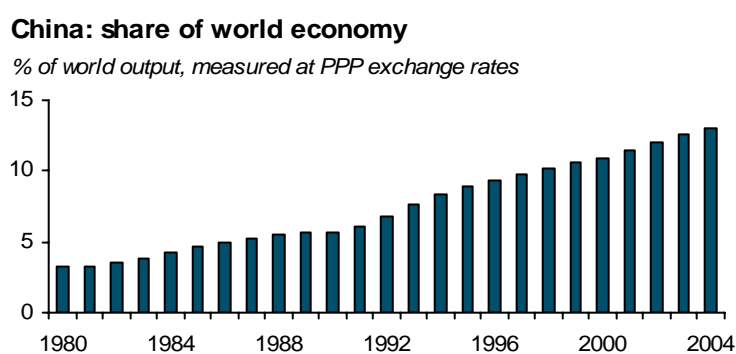
Detailed explanations of China's economic success are available elsewhere, but one simple version of the story is that the impressive growth performance reflects the benefits of economic catch-up after decades of under-performance, with economic liberalisation playing the role of

facilitator. The high tempo of activity has been supported by the large-scale transfer of labour out of underemployment in the rural sector and into more productive uses. High domestic savings rates and access to global markets (particularly since WTO membership in 2001) and to foreign capital (through high rates of foreign direct investment) have also been important contributory factors.

One significant consequence of this sustained period of rapid economic growth is that China has become an increasingly important driver of *global* growth prospects. During 2001-2003, for example, China accounted for about one-quarter of world growth when output is measured at purchasing power parity (PPP) exchange rates.⁵

A second consequence has been the steady rise in China's relative importance in the world economy. If world output is measured at PPP rates, China has seen its share rise by almost 10 percentage points between 1980 and 2004 (Figure 3).⁶

Figure 3: China's growing weight in the world economy



Source: IMF World Economic Outlook database September 2004

⁵ Eswar S Prasad and Thomas Rumbaugh, Overview, in *China's growth and integration into the world economy. IMF Occasional paper No 232*. ed. Eswar S Prasad. Washington DC, International Monetary Fund, 2004.

⁶ PPP exchange rates are constructed exchange rates that equate the cost of a typical basket of goods across countries. In other words, they make adjustments to take into account the fact that the price of non-traded goods and services (such as a haircut) will tend to be much lower in China than in (say) the United States. By attempting to 'correct' for this difference, measures of global output shares using PPP exchange rates give much higher weights to developing countries like China than do output shares measured at market exchange rates: China's share of world output at PPP rates is much larger, and rising much faster, than market rate measures. Which measure is more appropriate? Market exchange rates have the big advantage that they are visible in the market place, rather than being theoretical constructs, and moreover are the rates at which international transactions actually take place. So for purposes of measuring a country's immediate impact in the world economy, they are the more relevant metric. PPP rates are generally taken to be a better source of guidance for judging relative standards of living. However, market rates are subject to significant volatility, and hence a country's share of world GDP can move around dramatically with changes in current market sentiment. According to economic theory, market rates should over time converge on PPP rates. Hence there is a case for looking at PPP rates as a guide to longer term trends.

By 2003 China was the world's second largest economy in PPP terms, accounting for 12½% of global output (Table 1). True, if world output is measured using market exchange rates, China's relative position looks less impressive, with its economy accounting for a little less than 4% of world output, making it the world's seventh largest economy in 2003.⁷ But even on this measure China was closing rapidly on the UK, France and Italy in the three places above it, and seems destined to soon be in the number four spot.

Table 1: Selected indicators of China in the world economy (2003)

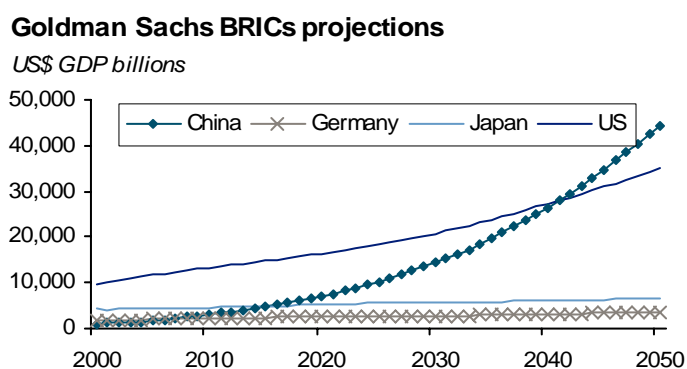
Indicator	Value	Source
GDP at market exchange rate	US\$1,409.8 b	World Bank
Rank in world economy	# 7	
Share of world output	3.9%	
GDP at PPP exchange rate	\$6,435.8 b	World Bank
Rank in world economy	# 2	
Share of world output	12.5%	
Population	1.28 b	World Bank
Rank in world economy	# 1	
Share of world total	20.5	
Merchandise exports	US\$437.9 b	WTO
Rank in world economy	# 4	
Share of world total	5.8%	
Merchandise imports	US\$413.1 b	WTO
Rank in world economy	# 3	
Share of world total	5.3%	
Inward foreign direct investment flow	53.5 b	UNCTAD
Rank in world economy	#1*	
Share of world total	9.6%	

* Technically, China ranks behind Luxembourg, reflecting the latter's status as host to large financial holding companies.

⁷ China probably moved into sixth place in 2004.

Moreover, on current trends, China is on track to become an even more significant player. For example, a much-cited report by Goldman Sachs in 2003 estimated that by 2020 China could overtake Japan to be the second largest economy in the world in US dollar terms, and by 2049 could even displace the US economy from the number one spot (Figure 4).⁸

Figure 4: One scenario for China in the world economy



Source: derived from Appendix II in Wilson and Purushothaman (2003)

Sustaining China's growth

Can China continue to sustain a healthy pace of economic growth? While the economy is unlikely to be able to maintain the breakneck pace of activity recorded in 2004, when real GDP soared by 9.5% and warning signals were sounded about overheating, there are strong grounds for expecting China to be able to sustain high growth rates beyond the next decade. Fundamentally, China is still a relatively poor economy in global terms, which leaves plenty of scope for economic catch-up with the developed world, and the combination of high savings and investment rates and an ample supply of relatively cheap labour should continue to provide the resources needed to power this process.⁹ Work by the IMF looking at the historical experience of Japan and other East Asian economies during their phases of integration into the world economy suggests that not only are China's output growth rates not exceptional by regional standards, but also that China's share of world GDP at market exchange rates is still significantly below Japan's and not greatly above that of the other East Asian economies, at similar stages of the integration process.¹⁰

⁸ Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICs: the path to 2050*. Goldman Sachs Global Economics Paper No.99, 2003.

⁹ On World Bank data, China's gross national income per capita in 2003 was just 13% of the US level using PPP exchange rates or less than 3% at market exchange rates.

¹⁰ International Monetary Fund, *The global implications of the US fiscal deficit and of China's growth*, in *World Economic Outlook April 2004*. Washington DC, International Monetary Fund, 2004.

On one reasonably conservative estimate, China's potential growth rate could run at around 7.5% on average during the second half of the current decade.¹¹ Other estimates suggest a range of 6-9%.¹²

Of course, even if China's *potential* growth rate is set to stay high, there remains a risk that the economy will fail to live up to this potential. As Professor Ross Garnaut has noted, while China may be *likely* to perform relatively strongly, 'success may be broken at any time by inadequate responses to immense challenges.'¹³ And the challenges *are* immense. Beijing will have to continue to pursue reform of the financial and state enterprise sectors while at the same time managing the associated financial and social risks. In this regard, the economy's ability to absorb the labour released by structural reforms is set to be a particularly pressing challenge over the next decade, along with policymakers' ability to manage growing income inequality and any associated pressures for political change.¹⁴

At the same time, continued integration with the world economy will also pose significant risks as well as great opportunities. Past experience suggests very few emerging markets have been able to complete the international integration process without suffering a financial crisis of one form or another: for China to avoid the same fate not only will its policymakers have to be extremely skilful, they will also have to be extremely lucky.¹⁵ A key question for the future then becomes how effectively will China's social, political and economic institutions respond to such a crisis. In other words, would China's response to a financial crisis (should one eventuate) look more like Malaysia's or Indonesia's?

Transforming world trade

While much attention is paid to China's future status in the world economy, it's already exerting an important influence. This is particularly true with respect to international trade, where China has become a much more influential player over the past two decades, and particularly since the

¹¹ Paul Heytens and Harm Zebregs, How fast can China grow?, in *China: competing in the global economy*. ed. Wanda Tseng and Markus Rodlauer. Washington DC, International Monetary Fund, 2003.

¹² See Box 2.3 in International Monetary Fund, The global implications of the US fiscal deficit and of China's growth.

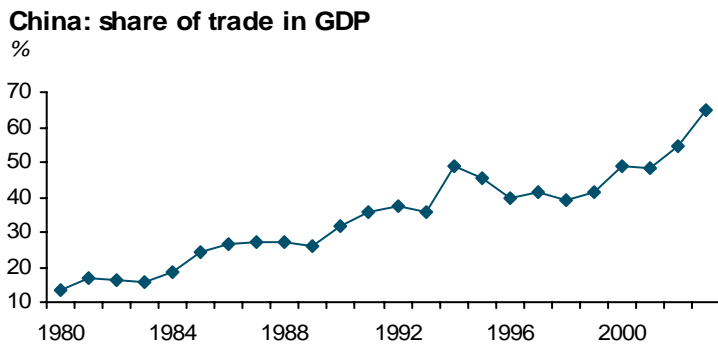
¹³ Ross Garnaut, China: new engine of world growth, in *China: new engine of world growth*. ed. Ross Garnaut and Ligang Song. Canberra, Asia Pacific Press, 2003. p3

¹⁴ On the employment challenge see Ray Brooks, Labour market performance and prospects, in *China's growth and integration into the world economy*. IMF Occasional paper No 232. ed. Eswar S Prasad. Washington DC, International Monetary Fund, 2004.

¹⁵ For example, to return to the case of the emergence of the US economy in the nineteenth century, it has been estimated that the US experienced some 10 boom-to-bust cycles over this period. James Kyngé, How long can China continue to boom? *Financial Times*, 23 March 2004.

turn of the century. This in turn reflects the way in which China's development model has placed a high degree of emphasis on integration with the rest of the world. Evidence of the way in which policy has bet on international integration can be seen in the way in which the share of trade (exports plus imports) in China's output has more than quadrupled between 1980 and 2003 (Figure 5).

Figure 5: China's increasingly open economy



Source: World Bank World Development Indicators online

Growing openness to the international economy has been associated with a growing place in that economy: China's share of world merchandise exports has jumped from less than 1% in 1980 to almost 6% in 2003: its share of world merchandise imports over the same period from 1% to 5.3% (Figure 6). As a result, by 2003 China had become the world's third largest importer and its fourth largest exporter.

Figure 6: China's growing share of world merchandise trade



Source: WTO statistics database online

The rapid gain in export market share is a reflection of very strong export growth: during most of the second half of the 1990s, China's merchandise exports grew at twice the pace of world exports, an achievement they repeated in 2003.¹⁶ Since 2000 China has also been the single most important contributor to the growth in overall global trade.

As with GDP growth, questions have been raised over the sustainability of China's rapid trade – particularly export – growth. Again, the same set of comparisons with its East Asian neighbours suggest that China's potential for further growth remains substantial. Thus the recent performance of China's exports has been similar to that displayed by other regional economies in terms of growth rates, while China's actual share of world trade has been below that achieved by Japan or the so-called Newly Industrialised Economies (NIEs) of North East Asia at similar phases in their integration process. However, China's much greater size than its regional predecessors indicates that its ultimate influence on the world economy could well be an order of magnitude larger than these past examples of integration.¹⁷

The world's factory?

This growing presence in international trade has been felt particularly sharply in global manufacturing, where China's comparative advantage lies in the production and export of labour-intensive products. The increasingly integrated nature of the world economy is allowing producers in the rest of the world to take advantage of this, and one result has been that a leading role in China's export performance to date belongs to foreign direct investment (FDI). Between 1994 and mid-2003, a period which saw China's exports roughly triple in value, so-called 'foreign invested enterprises' (subsidiaries of global corporations and joint ventures) accounted for 65% of the growth in exports.¹⁸ In 2003 China became the world's largest recipient of FDI inflows, attracting more than US\$53 billion of financing, or just less than 10% of total world FDI inflows (Figure 7). UNCTAD estimates that the stock of FDI in China now stands at US\$505.5 billion.¹⁹

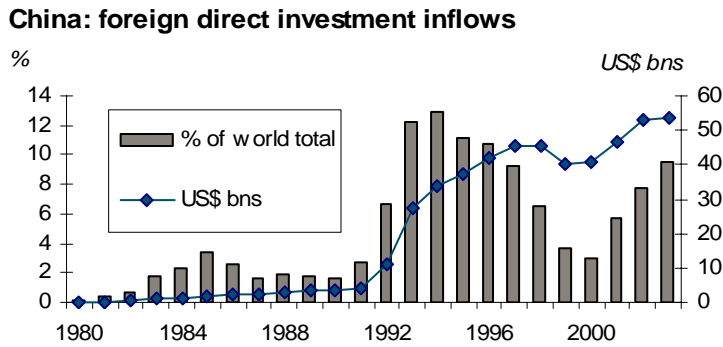
¹⁶ World Trade Organization, *World Trade Report 2004*. Geneva, World Trade Organization, 2004. p1.

¹⁷ International Monetary Fund, *The global implications of the US fiscal deficit and of China's growth*.

¹⁸ Stephen Roach, *Getting China right*. Morgan Stanley Special Economic Study, 2003.

¹⁹ United Nations Conference on Trade and Development, *World investment report 2004: The shift towards services*. New York, United Nations, 2004.

Figure 7: FDI inflows to China



Source: United Nations Conference on Trade and Development (UNCTAD)

China's attractiveness as a destination for FDI is due in large part to its big domestic market and cheap labour costs, along with relatively open FDI policies. Of particular importance to the FDI story have been investors from Hong Kong SAR and Taiwan who together with Singaporean investors have accounted for more than half of FDI flows to China.²⁰

To date the main impact in the market for manufactured goods has been felt at the lower value end. But over time China has moved from a focus on exports of textiles, footwear, clothing and toys during the early 1990s to a greater emphasis on exports of transport and machinery, including electronics.²¹ This steady progress of China up the value chain has led some to fear that China is becoming competitive across the whole spectrum of manufactured products, pointing to a high share of high-tech and industrial exports as evidence that the whole of global manufacturing is destined to relocate to China. As we have already noted, however, many of these exports are produced by foreign-owned rather than Chinese firms, and the latter remain heavily dependent on the import of designs, parts and components.²² This means that while China is a now potent competitor across a wide range of manufacturing sectors, it is also a key import market for other manufactured products.

²⁰ Wanda Tseng and Harm Zebregs, Foreign direct investment in China: some lessons for other countries, in *China: competing in the global economy*. ed. Wanda Tseng and Markus Rodlauer. Washington DC, International Monetary Fund, 2003.

²¹ Thomas Rumbaugh and Nicolas Blancher, International trade and the challenges of WTO accession, in *China's growth and integration into the world economy. IMF Occasional paper No 232*. ed. Eswar S Prasad. Washington DC, International Monetary Fund, 2004.

²² George J Gilboy, The myth behind China's miracle. *Foreign Affairs* (July/August) 2004.

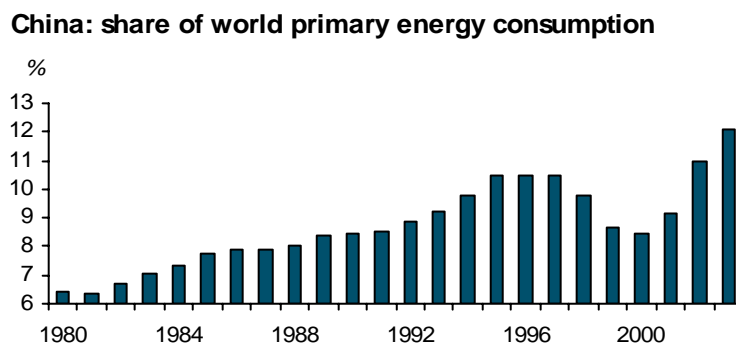
Fuelling the dragon

The impact of China in those markets in which it has a comparative advantage as a *supplier* is to push down the relative price of products and increase the degree of international competition. This is good news for consumers, and for those economies who are net importers of such products, but is obviously much less welcome for those countries competing in the same markets as China.

At the same time, however, China is also an increasingly important source of *demand* in markets for resources and energy. China is now the world's largest consumer and importer of many industrial raw materials, displacing the United States as the largest market for copper, iron ore, aluminium, platinum and other commodities. China is also a growing importer of agricultural commodities, having recently displaced Japan as the number two market for rubber imports, and in the future is likely to become an increasingly important source of demand for food imports.²³

International energy markets are also subject to a growing Chinese influence. China's economic boom has been powered by industrialisation, with a major role for energy-intensive sectors as iron and steel and chemicals. One consequence is that China is now the second largest consumer of energy in the world (Figure 8). The International Energy Agency in its latest World Energy Outlook predicts that China's share of world primary energy demand will increase from around 12% now to 16% by 2030, and that China will account for 21% of the growth in energy demand over this period.²⁴

Figure 8: China's growing energy demand



Source: BP (2004)

²³ David Hale, China's growing appetites. *The National Interest* Summer 2004.

²⁴ See International Energy Agency, *World Energy Outlook 2004*. Paris, IEA, 2004. p265

One energy market where China's presence has been making itself particularly felt in recent years is the oil market. China's demand for oil has doubled over the past decade, and in 2003 China overtook Japan to become the world's second largest oil consumer, accounting for 7.6% of global oil consumption.²⁵ Preliminary data for 2004 suggest that China contributed to almost one-third of the estimated increase in global consumption, as Beijing's imports of oil jumped by 0.6 million barrels per day to 2.1 million barrels per day.²⁶ This in turn contributed significantly to the fastest annual increase in global oil consumption since the 1980s.²⁷

Finally, as well as needing to fuel development through imports of resources and commodities, China also needs to import services and ideas. Thus while most of the focus on China's emergence to date has been on manufacturing and resources, there are also likely to be significant implications for services and intellectual property. Some commentators for example have argued that intellectual property could potentially be a major winner from the China market.²⁸

Forging a new regional order

So far the focus has been on how China's emergence is reshaping the international economy. But – thanks to the logic of geography – the greatest impact of China's growing economic weight is being felt in the surrounding region. The rising importance of China to East Asia (and particularly to the region's emerging market economies, with Japan treated as a somewhat different case) has prompted two alternative interpretations. One is that China and the rest of the region are comrades that share mutual benefits from growing incomes of Chinese consumers. The other interpretation sees China and other regional economies as competitors, producing goods that are relatively close substitutes and hence competing in key third markets like the United States.²⁹

The proposition that China represents an important new source of demand for the rest of East Asia is one that is certainly being borne out by the data. In its latest regional update, for example, the World Bank notes that in 2002 and 2003 China was by far the largest source of export market growth for many of the rest of the region's economies. In 2003 growth in exports to China and Hong Kong accounted for 50-60% of the overall export growth enjoyed by Korea

²⁵ BP. *Statistical review of world energy 2004*. BP 2004:

<http://www.bp.com/subsection.do?categoryId=95&contentId=2006480>.

²⁶ International Energy Agency, *World Energy Outlook 2004*. p64

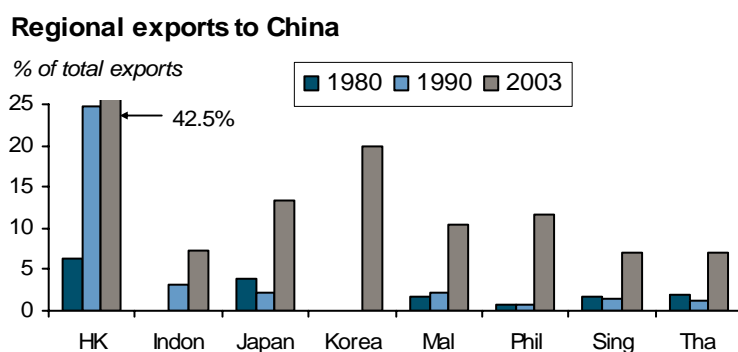
²⁷ *Ibid.* p83

²⁸ See for example Andy Xie, *The Chinese decade*. Morgan Stanley Asia/Pacific Economics, 2003.

²⁹ John Fernald and Prakash Loungani, *Comrades or competitors? On trade relations between China and emerging Asia*. Chicago Fed Letter March 2004 The Federal Reserve Bank of Chicago, 2004.

and Taiwan, and about 25% in economies like Malaysia and Thailand. Moreover, regional economies have been steadily gaining market share in China's imports over time, reflecting a growing level of economic complementarity, with 2001-2003 witnessing a 'remarkable jump' in the degree of integration: China now sources over 60% of its imports of industrial high tech and transport machinery, equipment and components from Emerging East Asia. The Bank notes that while the NIEs have been some of the biggest beneficiaries of this trade in parts and components, Malaysia, the Philippines and Thailand are also enjoying strong export growth.³⁰ At the same time, Southeast Asia has also been able to benefit from China's growing demand for commodities, with strong growth in the export of crude rubber from Malaysia and Vietnam, cork and wood from Malaysia, and vegetables and fruit from Vietnam, for example.³¹

Figure 9: China's importance as a market for East Asia



Source: calculated from IMF Direction of Trade Statistics

The result of this process has been the emergence of a new international division of labour in East Asia. Thus many regional producers no longer export final products to markets in the advanced economies outside the region, but instead ship parts and components to China where they are assembled and then shipped out through local affiliates. At the same time, large sections of the region's labour-intensive industries like clothing and textiles have also been relocated to China. By 2003 China had become a major export destination for virtually all of the region's economies (Figure 9). At the same time, exports from China have increasingly replaced sales from other regional economies in markets like the United States and the EU.³² In other words, it is possible to find evidence for both the 'comrade' and the 'competitor' views of China-regional relations in the data.³³

³⁰ World Bank, *East Asia Update*. Washington DC, World Bank, 2004. p13

³¹ Ibid. p16

³² World Trade Organization, *World Trade Report 2004*. p1

³³ Most economic modelling in this area has been done in the context of predicting winners and losers from China's accession to the WTO. Much of this tends to find that 'on balance' the industrialised and

China's growing regional presence is also being felt in the region's structures and institutions, including the emergence of ASEAN+3 as an important part of the regional architecture.

The economic challenge posed by Beijing appears to have been one of the factors that have persuaded the region to consider preferential regional trading arrangements as a useful way of managing economic relations with their increasingly important neighbour.³⁴ When China proposed a Free Trade Agreement (FTA) between itself and ASEAN in November 2000, this was interpreted by some as Beijing seeking to provide reassurance to a region wary of the new trading power emerging to its North.³⁵ The China-ASEAN trade accord which was signed in November 2004 marks a significant step towards the planned FTA.

The combination of greater economic regional integration together with signs of a more active Chinese economic diplomacy has even led some commentators to see the long-term potential for the 'recreation of the kind of strategic centrality that China enjoyed at the height of imperial rule, when Asian states paid tribute to Beijing and recognized its pre-eminence in return for favourable terms of trade.'³⁶ And not surprisingly, these gambits in the field of economic diplomacy have in turn had their own repercussions, with Japan for example also joining the move towards forging regional trade agreements as Tokyo frets about being left behind by Beijing in the race for regional influence.

newly industrialising economies in East Asia benefit from a greater role for China in international trade, with the evidence more ambiguous for the economies of Southeast Asia. For example, Ianchovichina, Suthiwart-Narueput and Zao suggest that as major suppliers to China both Japan and the NIEs will benefit from an improvement in their terms of trade and a rise in production and exports as China's demand for intermediate inputs and final products expands – as suggested by the World Bank report cited above. For the ASEAN economies however, the same authors judge that while the Chinese market will represent sizeable opportunities, including through participation in links in global production networks, the similarity in export structures also suggests increased third market competition, particularly in sectors like clothing and textiles. Elena Ianchovichina, Sethaput Suthiwart-Narueput and Min Zao, Regional impact of China's accession to the WTO, in *East Asia integrates: a trade policy agenda for shared growth*. ed. Kathie Krumm and Homi Kharas. Washington DC, World Bank, 2004. pp26-27. See also Elena Ianchovichina and Terrie Walmsley, *Impact of China's WTO accession on East Asia*. World Bank Policy Research Working Paper 3109. Washington DC, World Bank, 2003. And Elena Ianchovichina and William J Martin, *Economic impacts of China's accession to the WTO*. World Bank Policy Research Working Paper 3053. Washington DC, World Bank, 2003.

³⁴ Other probable factors include the proliferation of such agreements elsewhere in the international economy, concerns about the direction of trade policy in major markets like the United States and EU, and disappointment with the progress offered both by the multilateral system and by APEC.

³⁵ See for example Joseph Yu-Shek Cheng, The ASEAN-China Free Trade Area: genesis and implications. *Australian Journal of International Affairs* 58 (2) 2004. p258

³⁶ See for example Michael Vatikiotis and Murray Hiebert, How China is building an empire. *Far Eastern Economic Review*, 20 November 2003.

The bilateral economic relationship

Inevitably these trends in the global and regional economies have significant implications for Australia. The following chapters explore some of these ramifications in detail, but here it is worth noting that the bilateral relationship is already of great and growing importance.

One area where this is clearly visible is in trade flows, where the global and regional story of a rising Chinese presence is also clearly apparent in the two-way trade between Australia and China (Figure 10). In terms of merchandise exports, for example, in FY1979/80 China was the destination for around A\$845 million of Australian exports, or about 4½% of the total, making it Australia's sixth largest export market at that time. By FY2003/04 Australian exports to China had risen to A\$9.9 billion and accounted for 9.1% of total exports, with China overtaking the United States to become Australia's second largest merchandise export market.

The same trend is visible in Australia's imports: China was the source of just under A\$200 million of merchandise imports (a bit over 1% of total imports) in FY1979/80, making it Australia's sixteenth largest import source. As of FY2003/04 imports from China had risen to A\$15.3 billion, almost 12% of total imports and enough to make China the third largest import source.

Figure 10: Australian trade with China



Source: Direction of Australian Trade, Department of Foreign Affairs and Trade (various issues)

The importance of bilateral merchandise trade flows is continuing to grow; by the end of calendar year 2004 exports to China had risen further, to A\$11 billion, and imports from China

were up to A\$17.9 billion, taking China into second place as a source of imports.³⁷ Existing and likely future deals for the export of Australian energy to China – exports from the North West shelf to Guangdong province are expected to begin in 2006 – will continue to boost the value of Australian exports in coming years.

The trading relationship is not just about goods. In 2004 China was also Australia's seventh largest services export market and its eighth largest source of services imports.³⁸ Of particular importance in bilateral services trade are education and tourism exports, which account for about two thirds of services exports. By 2003 China had become Australia's largest source of overseas students (with some 43,000 students) and in the same year over 176,100 Chinese visitors came to Australia (and 114,200 Australians visited China), with some forecasts suggesting that by 2010 the number of Chinese tourists visiting Australia each year will exceed one million.³⁹

China's influence in terms of shifting international relative prices is also shaping Australian economic performance. In September 2004 Australia's terms of trade (the ratio of export to import prices) reached a 30-year high, thanks to a combination of strong export prices (pushed up by higher global commodity prices – a reflection in part of Chinese demand) and import prices that have been constrained by intense (China-inspired) international competition in manufacturing (Figure 11). Moreover, with higher contract prices for bulk commodities (coal and iron ore) expected this year, Australia's terms of trade are expected to continue to rise in the near term.⁴⁰

In contrast to the deepening trading relationship, bilateral investment flows to date have been much more modest.⁴¹ Australian investment in China was A\$1.2 billion as of 30 June 2003, making it Australia's 18th largest destination for investment, while Chinese investment in Australia was A\$2.2 billion in the same year, giving China a ranking of 14 in terms of overseas investors.⁴² Even so, it is noteworthy that Australia was the location of the first significant overseas investments by China, with the joint ventures in the Portland aluminium smelter and

³⁷ Department of Foreign Affairs and Trade, *China: bilateral trade and investment fact sheet*, 2005.

³⁸ *Ibid.*

³⁹ Department of Foreign Affairs and Trade, *People's Republic of China country brief*, 2004.

⁴⁰ Reserve Bank of Australia, *Statement on Monetary Policy (February 2005)*RBA, 2005.

⁴¹ The contrast between a close trading relationship and a relatively more distant financial one applies to Australia's relationship with Asia more generally. See I J Macfarlane, *Asia's role in Australia's future*. *RBA Bulletin* November 2003.

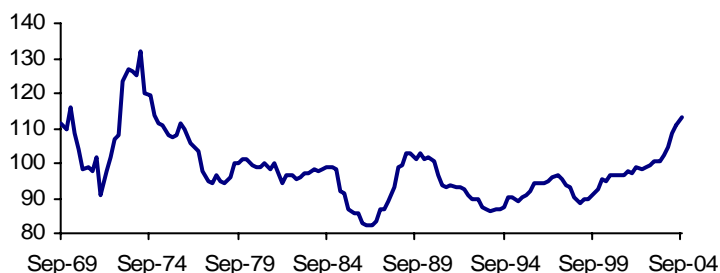
⁴² Department of Foreign Affairs and Trade, *China: bilateral trade and investment fact sheet*.

Channar iron ore mine in the mid-1980s, and China's existing interest in investment in the resources and energy sector, could well expand significantly in coming years.⁴³

Figure 11: The lift to Australia's terms of trade

Australia: terms of trade

Index 2002/03=100



Source: RBA web site

Building bilateral ties: what role for an FTA?

Finally, is there a role for economic diplomacy to further boost the bilateral relationship? Australia and China signed a Trade Agreement in 1973, one year after the establishment of diplomatic relations, and this has since served as the formal framework for the bilateral economic relationship. In a recent effort to build on this agreement, the two sides signed a Trade and Economic Framework (TEF) in October 2003. The TEF was intended to provide a basis for a further deepening of economic ties and included a commitment by both Canberra and Beijing to undertake a joint feasibility study into a FTA, which at the time of writing was due to be completed at the end of March 2005.

Preferential trade agreements – of which an Australia-China FTA would be an example – are controversial among economists, many of whom fear that they distort international trading relationships and threaten the health of the multilateral system. This broad debate about the intrinsic merits of such agreements rightly received a fair amount of attention during the negotiation of the Australia-United States FTA (AUSFTA). But following AUSFTA's entry into force at the start of this year, that particular debate seems to be pretty much over from an Australian policy perspective, at least for now: with three recent FTAs (agreements with the US, Singapore and Thailand) under its belt, Canberra has clearly climbed aboard the preferential

⁴³ Ross Garnaut, *Restoring old threads: deepening relations in the era of reform in two countries*. Paper presented at the Thirtieth Anniversary Conference of the China Education Centre, University of Sydney, 5 December 2002.

trade bandwagon, as indeed has nearly all of the rest of the region and most of the membership of the World Trade Organization. In this context, a trade agreement with one of our most important economic partners would seem to be an inevitable part of any serious FTA-based trade strategy.

A key policy question therefore becomes how best to use the proposed agreement to manage future relations with Beijing. This is particularly the case given that, as noted above, China seems set to become an increasingly important player in emerging regional economic structures, including regional trade agreements. Thus while the complementary nature of the two economies means that China is likely to be an important market for Australian exports of (in particular) energy and resources regardless of whether a formal trade agreement is in place or not, at its best a China-Australia FTA could aim to provide a framework which would allow policymakers on both sides to pursue closer collaboration on a series of economic issues (so-called 'deep integration') that could have significant longer term benefits in terms of binding the two economies together. Equally, however, it will be important to make sure that the content and structure of any FTA is such that ultimately it contributes towards regional (and ultimately global) trade liberalisation and integration, rather than becoming an obstacle to the same.

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