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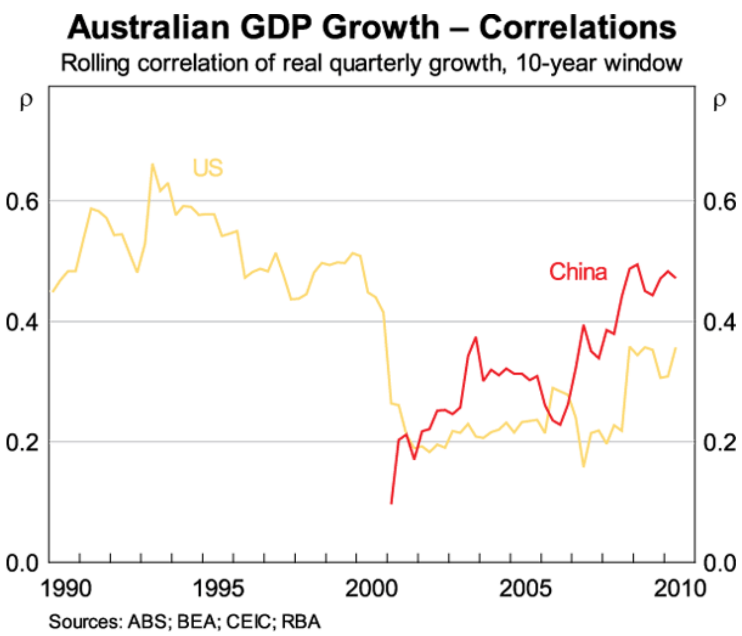
Dancing with the dragon

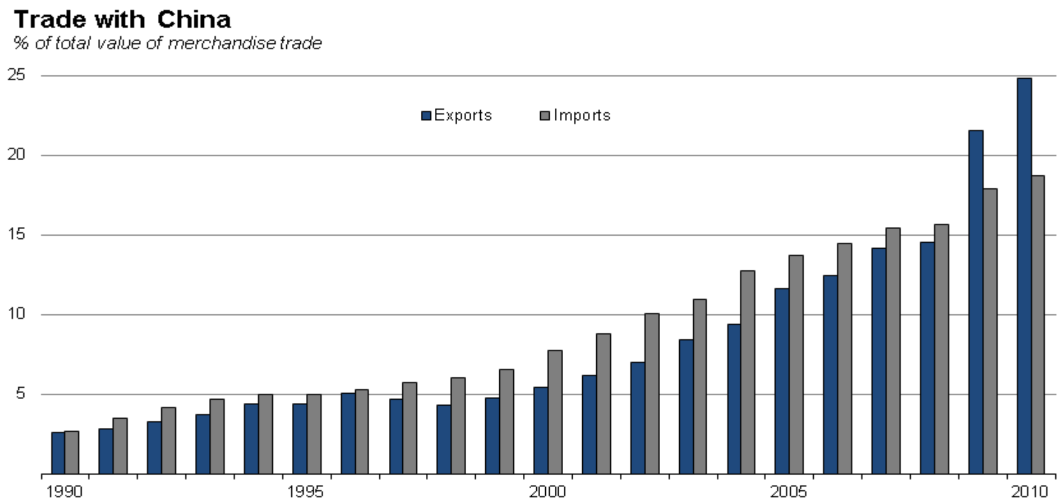
China's huge appetite for resources is reshaping the Australian economy

Speaking last September, Philip Lowe, the Assistant Governor (Economic) at the Reserve Bank noted that economists at the central bank used to spend a lot of time trying to work out why quarterly changes in Australian output were so highly correlated with quarterly changes in US output. No longer: the correlation between the two series has fallen. Instead, movements in Australian GDP are now increasingly correlated with movements in Chinese GDP, as Australia's economic trajectory has succumbed to China's gravitational pull:[1]



In Australia's dance with the dragon, the big driver has been the resources trade and the key channel of influence has been the terms of trade (the ratio of export to import prices).

The speed of change has been quite dramatic. Back at the start of the 1990s, China was the destination for only about two and a half per cent of Australian merchandise exports, and a bit over two per cent of Australian imports. Just two decades on, and in 2010 China took almost 25 per cent of total Australian exports and was the source of about 19 per cent of Australia's imports, accounting for almost 22 per cent of total merchandise trade. In the same year, China accounted for roughly seven per cent of Australian services trade. China is now Australia's largest trading partner, its most important export market, and its biggest source of imports.

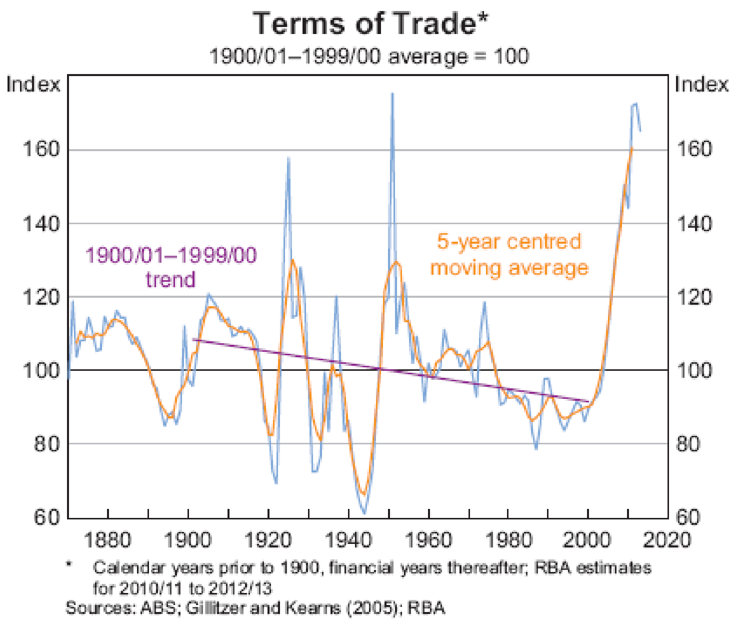


Source: ABS and author's calculations

Australia's bilateral trade with China falls squarely into the classic pattern of comparative advantage: Australia tends to export resources and import manufactured products.[2] In 2009/2010, for example, more than 85 per cent of Australian merchandise exports to China comprised primary products. The most important of these were iron ore and concentrates, accounting for some A$25 billion, or about 54 per cent, of the A$46.4 billion of Australian merchandise exports to China. Exports of coal accounted for a further A$ 5 billion (roughly another 11 per cent of the total). On the import side, major items included clothing (A$3.8 billion or ten per cent of the total), computers (A$3.5 billion, ten per cent) and telecom equipment and parts (3.4 billion, nine per cent).[3]

In 2009/10, China was Australia's largest market for iron ore and concentrates by some distance – accounting for almost 72 per cent of all Australian ore exports (Japan, in second place, accounted for just over 17 per cent of the total). China was also the largest export market for copper ores and concentrates (taking more than one quarter of all exports) and one of the top three export markets for Australian coking coal.[4]

Chinese-powered demand for Australian commodities has contributed to a big increase in the price paid for these resources, with global prices for iron ore increasing at an average annual rate of 23 per cent over the 2005-2010 period, and prices for coal rising eight per cent (A$ terms).[5] Volume growth has been smaller than price growth, but still substantial: back in 2003, Australia was shipping around half a million tonnes of iron ore each day. Now daily shipments exceed one million tonnes, and if projected new capacity comes on line, the figure is forecast to climb to perhaps two million tonnes a day within the next five years.[6]

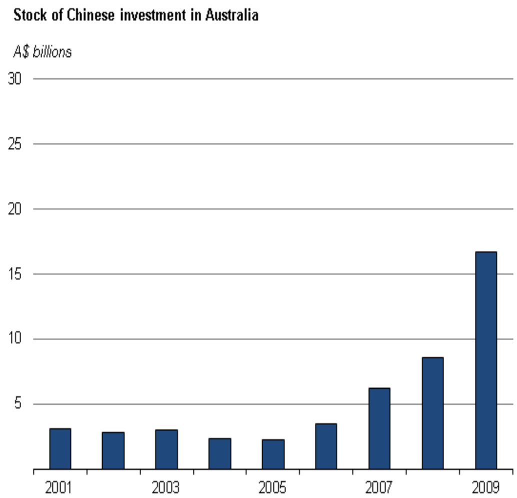


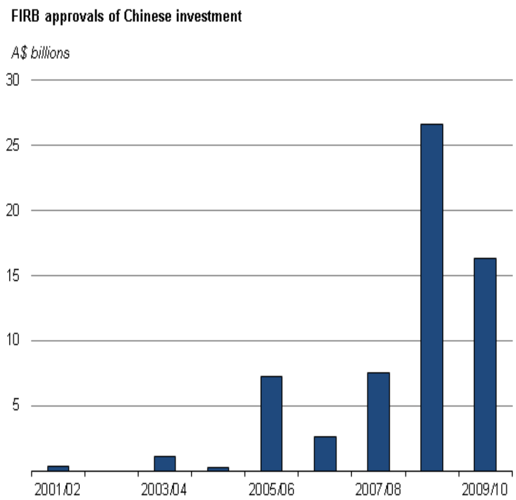
Source: Stevens, *The resources boom*. (2011)

One major consequence of these developments is that Australia's terms of trade, measured on a five-year moving average basis, are now higher than at any point since Federation. Or, as RBA governor Glenn Stevens explained it last year: while five years ago a shipload of Australian iron ore was worth about the same as roughly 2,220 flat screen TVs, by 2010, the same load was worth about 22,000 TVs, partly due to TV prices falling, but mainly thanks to the spike in the price of iron ore.[7]

This China-led rise in the terms of trade is reshaping the Australian economy in a wide range of ways, contributing to an increase in national income (and hence Australian living standards) and a change in the structure of national comparative advantage; delivering a big boost to state and federal government tax receipts and a bonanza for the resource sector companies that comprise a significant proportion of the Australian share market; exerting upward pressure on the (nominal and real) exchange rate; and sparking a major investment boom in the mining sector.

There are also new steps to be learned in Australia's dance with the dragon. So, for example, a growing channel of economic influence is Chinese investment. True, according to ABS data, the stock of Chinese total investment remains very small: as of end 2009 it was just A$16.6 billion, or a bit less than one per cent of the total stock of foreign investment. (This compares to a stock of A$514.7 billion – or 27 per cent of the total – of US investment, still Australia's largest foreign investor.) But recent flows suggest that China's hitherto negligible role as an owner of Australian economic assets is now changing, with Chinese investment in 2009 climbing to A$7.8 billion, or about five per cent of total inflows that year.





Sources: ABS 53520.0 Supplementary Statistics and FIRB annual reports, various issues

More Chinese money will follow: investment approvals from the Foreign Investment Review Board (FIRB) show approvals of Chinese investment rising from A$2.6 billion in 2006/07 (less than two per cent of approvals by value) to A$26.6 billion in 2008/09 (16 per cent), making China second only to the United States in value of total approvals. In 2009/10 this fell back a bit to A$16.3 billion (about 12 per cent of approvals by value), but this was still enough to leave China as the third largest investor by country of approval.

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[1] Philip Lowe, *The development of Asia: Risk and returns for Australia.* Address to the NatStats 2010 Conference, Sydney, 16 September, by the Assistant Governor (Economic) of the Reserve Bank of Australia. Sydney, Reserve Bank of Australia, September, 2010.
[2] Australia also exported some A$5.8 billion of services to China in 2009/10, of which A$4.4 billion comprised education-related travel.
[3] See DFAT's China country fact sheet, available at http://www.dfat.gov.au/geo/fs/chin.pdf.
[4] *Exports of primary and manufactured products Australia 2009-10,* Department of Foreign Affairs and Trade, Canberra, December 2010.
[5] Virginia Christie, Brad Mitchell, David Orsmond and Marileze van Zyl, The iron ore, coal and gas sectors. *RBA Bulletin* 2011.
[6] Glenn Stevens, *The resources boom.* Remarks at the Victoria University public conference on The Resources Boom: Understanding national and regional implications, by the Governor of the Reserve Bank of Australia. Melbourne, Reserve Bank of Australia, 23 February, 2011.
[7] Glenn Stevens, *The challenge of prosperity.* Address to the Committee for Economic Development of Australia (CEDA) Annual Dinner, Melbourne, 29 November, by the Governor of the Reserve Bank of Australia. Sydney, Reserve Bank of Australia, November, 2010.