



# The **Asialink** Essays

Published by Asialink, Sidney Myer Asia Centre  
The University of Melbourne Parkville 3010 Australia

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Published April 2009

## **CHINA: NEVER MIND THE PANIC**

### Australia-China links and the global crisis

**Rowan Callick**

Australia and China were about the only countries in the region that did not slide into recession during the Asian financial crisis of 1997–98. What of the more crippling global downturn in 2008–09? At the start of 2009, there was still a possibility that both might again avoid that fate. But by April, the signs of distress were so clear that whether the technical data comprising a recession – successive quarters of negative growth – were triggered or not, the economic and social damage would be severe.

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**“It would be in the interests of the world as a whole if China concentrated on consuming more and the US concentrated on producing more.”**

Australia, as a mature, open economy, appeared to be more vulnerable to the global infection. But for China, which had been growing at a breakneck 13 per cent in 2007, the prospect of a fall below 8 per cent in 2009 appeared even more troubling – for it had already seen at least 20 million migrant workers forced to return jobless after their factories closed, to their home villages and towns in the countryside. And the better-educated were far from immune. Well into 2009, more than a million young Chinese women and men who had graduated the previous September, were still scrabbling for work. Empathetic Premier Wen Jiabao told Beijing students about to graduate at the end of 2008: “If you are worried, I’m more worried than you.”

Neither Australia nor China are suffering for the same reason as the Americans and Europeans, whose finance sectors have collapsed. Their troubles in each case stem mostly from their “real economies” – and Australia has been substantially infected, in this sense, from China, whose demand for its commodities has temporarily dwindled, dragging down prices along with volumes of exports. Both countries are applying the same solutions: local stimulus packages.

The G20 summit in London in early April saw China gain clout in the mechanisms of world financial structures, in the International Monetary Fund and in the development of the G20 itself as a broad-based grouping that includes Australia as well. But the summit could not “solve” the real-economy challenges, because these require fundamental cultural as well as policy change within the leading nations – which of course do now include China.

China is suffering as the world’s factory, because the world no longer has the money or the appetite to buy its products. It is also suffering because over the last five years and despite its leaders’ rhetoric about shifting from the pace of growth

to the quality of growth, it has been unable to take the tough decisions and implement the reforms needed to broaden the base of its economy, to build domestic demand and to create a services sector commensurate with its size. Services provide about 34 per cent of its economy, less than half the comparative size of Australia’s services sector. And China was reluctant to let its currency, the yuan, appreciate to the extent the market envisaged as being appropriate – which would have armed consumers with more cash, especially for imports - instead ensuring its rise was restrained, in order to help exporters. It has also maintained its strict control of the convertibility of the currency on the capital account, only allowing free convertibility for trade, on the current account.

And it has still taken only tentative steps towards constructing a welfare net without which most consumers remain too nervous to spend substantially, because they fear potentially crippling unemployment, sickness or homelessness in the family. China’s State Council or Cabinet announced earlier this year spending of 850 billion yuan (\$A 172 billion) by 2011 to provide universal medical services, as an extension of the stimulus package. But this would only provide \$A 44 per person per year, within a health system where costs are not substantially different for the consumer than in Australia. The 850 billion yuan is also likely to contain building costs, management and other expenses. So its impact is likely to be modest.

ANZ’s chief economist Saul Eslake said recently: “The Chinese are giving serious thought as to whether re-creating that model of export-led growth is what they want. It would be in the interests of the world as a whole if China concentrated on consuming more and the US concentrated on producing more.”

And prominent independent economist Andy Xie, based in Shanghai, says in China's most influential business magazine, *Caijing*, that a full global recovery requires China and the US to complete sufficient structural reforms to create a sustainable growth cycle. He warns that the stimulus packages of the two countries, including inventory restocking, "will not address the structural imbalance within or between them. Indeed, the stimulus prolongs the unbalanced growth model that got us into trouble in the first place." Xie says that "for the global economy to find a new and sustainable growth path, the necessary changes are that the US expands production and China expands consumption." He says that the US is stimulating consumption again, and China investment again, because they already have the systems to do so, and these are well-trodden policy paths. But these are not strategies that will help reorientate their economies, or that of the wider world, in a way that's now sorely needed.

Shen Minggao, the chief economist at *Caijing*, says: "The state investment plan is sunshine for heavy industries and state owned enterprises, but cannot shield light industry and small and medium businesses. This is likely to aggravate the tendency for China to become more dependent on heavy industry." This reinforcement of patterns of state control, of "policy loans" by state banks to the emerging government champions, and of a focus on pouring concrete and steel, may help restore Chinese demand for Australian resources in the short term – and there were some signs of this in January and February – but at the cost of the development of China's more flexible, innovative and job-creating private sector.

Australia is also suffering from its own reform challenges. Its governments, both state and federal, have in recent years failed to follow through earlier reform periods, and productivity has not improved adequately. Its export performance is inadequate. The drive by Austrade to double the number of firms exporting from 4 per cent of the country's total, produced disappointing results. And of course Australia is suffering from commodity prices falling with global demand, including from China.

Australia has invested insufficiently in infrastructure, while China has been rushing – ever since Deng Xiaoping ushered in 30 years ago its glorious *kai fang*, open door, era – to catch up in infrastructure and other areas with the rest of East Asia, to make up for those wasted decades under Mao Zedong.

Australia became, following its own *kai fang* epoch launched by Bob Hawke 26 years ago, an open economy thriving on trade. It isn't fully open, it is not performing up to its full potential, but what trade growth there is, is the main driver for pushing the country's growth along.

And what Australia does with China, has come to matter crucially.

Asialink, the Melbourne Institute of Applied Economic and Social Research at Melbourne University, and PricewaterhouseCoopers have together developed an Asia engagement index, launched by Trade Minister Simon Crean, which starts to quantify such relationships.

The index assembles and calibrates data about trade, investment, research and business development, education, tourism, migration and humanitarian assistance. It is anchored in 1990, when the measures of engagement with the 25 leading countries in Asia and also with the rest of the world, are each assessed at 100 points.

**Australia's engagement with China since 1990 has multiplied an astonishing 16 times. This China connection is not totally new, of course. The cherished Australian expression 'dinkum' may have derived from a description for 'real gold' used by Chinese miners in the mid 19th century Victorian gold rush: *jin zhen*.**

Since then, Australia's engagement with Asia has multiplied four times, that with the rest of the world three times, and that with China an astonishing 16 times.

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It was these rushes that galvanised Chinese interest in Australia, and forged a contact that ebbed and flowed over the following century and more – through the "white Australia" era that reached its zenith around the time of Federation, in the early 20th century – but has re-emerged, in momentous mutual interest.

In the last financial year, China bought 14.9 per cent of Australia's exports, making it the second biggest buyer after Japan. And exports contributed about 20.7 per cent of Australia's gross domestic product.

Commodities dominate Australia's exports to China, especially iron ore, almost half the total \$27 billion. Australia imports \$31 billion products on the other side, a more diverse menu with clothing, telecommunication gear, computers, toys and sports goods the biggest categories.

Treasurer Wayne Swan told senior cadres at the central communist party school in Beijing last year, that Australia's mining output – "important as it is" – accounts for just 7 per cent of gross domestic product, about the same share as 20 years ago, while farm output comprises about 3 per cent.

**This relationship with China is too important a relationship, and those resources too vital a strategic asset, to leave to panicked shareholders and financial institutions. Australia is dealing here, not with diverse private firms with conflicting commercial interests, but with a cohesive state which believes rightly that 'development is the irrefutable argument.'**

Mr Swan said: "We also make fare machines for Beijing's subways, we make synthetic turf for your sports fields, we make solar heating for your remote areas. We sell you cosmetics, integrated circuits, water treatment systems, piston engines and mining software."

Australia's services trade is puny in comparison with its trade in goods, comprising just \$4.4 billion exports. Fortunately, while comparatively modest, this consists overwhelmingly of revenue from students and tourists – vital components for our future relationship of course, and in both cases springboards for growth in other sectors too. Australia imports just \$1.4 billion services from China.

If Australia were to lose a full 25 per cent of its exports to China, which would be a terrible blow, coming after export growth of 18 per cent in the last financial year, this would cost the country about 0.6 per cent of its GDP.

HSBC's John Edwards says: "If we look at exports alone and China's influence on us solely through exports, then exports to China have accounted for, say, 2.5 per cent of Australian output in the last three or four years. China's contribution is primarily through the mining sector. But that has contributed only 7.6 per cent of output growth in the last five years, about the same as its share of GDP." He says the story in export volume terms has consistently fallen short of expectations – underlining the need for Chinese inputs now to help build the new infrastructure, especially in Western Australia, required to boost production.

The main impact of China on Australia's economic growth has come through pushing up the terms of trade – the ratio of the prices of exports to those of imports. It has pushed up the prices of exports and pushed down the prices of Australia's imports. And China's demand has also forced Japan, Korea, Taiwan and

other buyers to pay more for the same commodities. Its competitiveness in manufacturing similarly forced other manufacturers to lower their prices. But now, Eslake anticipates, Australia's terms of trade will return to what they were in 2004 or 2005.

What of the investment front, now the focus of so much attention? Australia has only modest investments in China, \$5.2 billion in 2007, making it the 14th largest investor. Australia's biggest single investment in the Chinese world generally, is the \$1.2 billion Macquarie paid three years ago for 40 per cent of Taiwan's third largest cable TV company.

Again in 2007, China had \$6.2 billion invested in Australia, making it the 17th largest. This latter figure has soared, though, thanks to the investment in mining companies, principally in Western Australia.

Investment is increasingly the fulcrum around which other economic engagement, including trade, hinges. China needs to invest offshore for many reasons, including to set its capital to work to compensate for its growing demographic challenges due to the one-child policy.

Shanghai-based Paul Glasson, the chief representative in China for the Australia China Business Council and a leading consultant to Chinese companies investing in Australia and to the banks that fund them, says: "The drivers for Chinese investment in Australia's resources are broad. These include medium to long term security of resource supply; the need for economic and social stability, and full employment by ensuring Chinese industry can keep growing rapidly; wealth creation; management of the risk of further inflation; foreign savings diversification; risk management; increasing the global market share of China's state owned enterprises; executive development; and political ambitions.

"The most inescapable truth is that China does not have enough resources to support its people long term. Nor can it, at present, gain these resources at a cost that will allow it more evenly to distribute its wealth, fully employ its people, guard against inflation, and govern without dependence on others."

A good example of a potential "win-win" investment is the \$750 million joint venture coal gasification project between Australia's HRL – the successor body to the former State Electricity Commission of Victoria – and Harbin Power. They have proposed to develop together a 500 megawatt power station in Victoria's LaTrobe Valley – a template for similar generators in China, and the first new base load station in Victoria since 1990. Four months ago, Zhang Ping, the immensely powerful director of the National Development and Reform Commission, spent a day in the LaTrobe Valley talking over the deal. Funding from Chinese sources is expected soon.

A recent trip to Australia by Lou Jiwei, executive chairman of sovereign wealth fund China Investment Corporation, at the invitation of the Future Fund, is likely to lead to some of CIC's \$200 billion assets being deployed here.

Such increased mutual investment requires a calm and clear understanding of the overall relationship between the countries.

It has been characterised most often in the past as "complementary." That implies, in this case, that Australia is the source of raw materials and China of manufactures. But both have more to offer than that. While this focus remains at the core, the countries tend to neglect some of the ways in which each excels. China produces, for instance, some high quality horticultural items, Australia some sophisticated manufactures. The countries compete of course in such areas; in this regard, the priority should be to ensure

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an environment for fair competition, so that the best supplier gains the bigger market share in both countries. They need to shift their relationship beyond mere complementarity.

But China's understandable concentration on Australia as a source of raw resources remains implacable, and has indeed been enhanced by opportunity. Glasson said in mid February: "Australia has the resources China wants, the quality is good, the prices are low right now. The countries are close, relations are good." Clearly, China's State Council, its Cabinet, believed that it had picked the bottom of the market, the optimum time to pick up distressed assets, a call that may well come to prove true.

Questions, however, were raised at the same time in Australia that this relationship with China is too important a relationship, and those resources too vital a strategic asset, to leave to panicked shareholders and financial institutions. For Australia is dealing here, essentially, not with diverse private firms with conflicting commercial interests but with a cohesive state which believes rightly, as Deng said, that "development is the irrefutable argument."

The *raison d'être* for the \$30 billion foray by Chinalco – the corporation identified by China's government as its emerging version of a global diversified mining house, a new BHP - was explained in *Global Times*, owned by party newspaper *People's Daily*, in an article by Professor Liu Jipeng and Liu Yan, a researcher at the National Development and Reform Commission: "Chinalco's purchase has successfully prevented the merger of Rio and BHP, broken the monopoly of multinational giants, and protected our nation's core interests. It has also explored a new path for the globalisation of state owned enterprises, illustrating the capacities of government business."

The nature of this "new path" appears crucial to understand. China's ambassador to Australia, Zhang Junsai, aided this process with a coolly argued article published in *The Australian* on April 2, in which he said there are "a broad range of common interests," and no "fundamental conflicting interests." He says arguments against Chinese investment "are not surprising." But they should be conducted "in a rational and comprehensive manner... rather than using emotive language." The motivation of the investors is very simple: "They seek a long-term, sound and reliable supply of energy and resources."

Australia and China are capable of achieving much together, starting in the economic sphere, but then also beyond. However, to build a full, considered partnership, Australia needs equivalent access in China. And Canberra can, if it chooses, play a central role in insisting on access guarantees that will keep Australia in the centre of the frame, not sidelined as a passive recipient, a price taker, in the relationship.

The task of creating a more comprehensive and realistic understanding of what is at stake - the building block essential for good, constructive relations – is made much harder, because except for ANZ, almost no major company has direct Chinese or even Asian experience on its board or top management. This is a challenge for those Australians who are shareholders or who work in the corporate sector. The country's China expertise is thus not, at present, at the heart of Australia's commercial operations. It is brought – or bought – in as an adjunct, while the ensuing decisions are made by people without that Asian grounding.

But Australia does have in Kevin Rudd – his Chinese name Lu Kewen - a prime minister with such experience and understanding. This should help the federal government’s own continuing process of reviewing its China strategy.

And that is important because China indeed views this enmeshment as a matter of “core interests.”

Australia needs an informed national debate about where this vital relationship is heading, about where the national interest can be identified.

Such a national approach would likely include Australia’s seeking reciprocal access to invest in China – whether via the languishing free trade agreement talks, in which 13 rounds have already been held, or some other channel - not least for its vast funds under management, the fourth largest total in the world, thanks to the mandatory pension system created under Paul Keating’s direction.

Zhang Xiangchen, then China’s chief FTA negotiator, told me three years ago that at talks on the prospect of telecommunications investment access, a Chinese vice minister said that if his country opened its market completely, “Australia will kill our industry.” The Australian delegation leader responded, “We are too small to do that.” Dr Zhang said: “That’s a typical dialogue” in this FTA process. Sadly, and despite the excellent, persistent and patient work of the negotiators, it seems to have got little further. And cuts in the Rudd government’s first budget led to the loss at the Beijing embassy of the position of the FTA staffer there.

It is a frustrating feature of living in or visiting China, to meet so many smart, often young, dedicated Australians who have invested their savings and their lives in building operations there, chiefly in services – Australia’s main business strength. But lots have to remain “below

the radar,” they are limited in their growth potential, because there are too many non tariff barriers, too many obstacles, they lack the political capacity to develop their businesses as the market and their talents would otherwise see happen. This underlines the crucial need for levers to be pulled to make a comprehensive FTA deal more likely. For the needed reforms are unlikely to be achieved in any other way.

But Australia and China also have so much on which they agree, so much in common, including in economic terms.

In global terms, both countries depend on open borders, on freeing up global trade. Australia can tell its friends in the US Congress that their “buy American” campaign is futile and damaging, and its friends in India that banning Chinese toys for six months is similarly self-lacerating.

Finally: what will underpin and strengthen crucially the desired strong, mutual-interests based relationship between the countries, is to broaden it out and deepen it far beyond trade and investment.

The two peoples share especially closely, many human dimensions, including strong individualism and a certain sense of humour. Australians can contribute to this relationship, for instance, by sending more of their young people to study in China. And China can open its broadcasting parameters to the excellent Australia Network TV station being beamed by satellite through the rest of Asia.

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