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AUSTRALIA AND CHINA – GRASPING OPPORTUNITIES IN AN UNCERTAIN WORLD

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I would like to acknowledge the assistance of Sam Hurley in preparing this address. All errors remain my own.

Introduction

Thank you for the opportunity to be here today.

This Conference occurs in what we might euphemistically describe as 'interesting' times. Indeed, for anyone with a passing awareness of global issues, 'interesting' doesn't do it justice. The forces currently shaping, and shaking, the global economy – including excessive debt, deleveraging and deficient demand in major advanced economies, shifts in global industrial structure and comparative advantage, and the continued transformation and re-engagement of the emerging economy giants – are all interacting in ways which create great risk, but also great opportunity.

We have seen the consequences of inconsistency between underlying international competitiveness and fiscal policies result in excessive debt and fear of sovereign default in Europe. The result is playing out on a daily basis, with marked volatility in equity markets and a sharp decline in risk aversion.

Other forces, like the re-emergence of China and India, are more like the shifting of tectonic plates, slow moving but profoundly altering the global landscape.

As these forces play out, the decade ahead looks to be a particularly volatile one for the global economy.

Today I want to focus on China and on its role in the complex phase of economic adjustment which lies before us. This will cover both China's own difficult policy choices as it seeks a more sustainable growth model but also the implications of China's emergence, both in terms of patterns of growth and production but also in the approach to international architecture and policymaking needed to accommodate China's rise.

Before turning to China, though, let me make a few brief observations on the current situation and draw out some implications for the global financial architecture.

Global economic developments

The proximate causes of the acute financial market volatility over recent months are well known: unsustainable sovereign debt positions among certain euro area economies; policy responses that are manifestly inadequate given the scale of the debt and related financial sector vulnerability; an ongoing fear that political institutions are incapable of implementing the right responses; and a growing recognition that the recoveries in both the US and Europe will be weaker than previously expected.

However, these growth and debt concerns ultimately reflect an underlying competitiveness problem. In short, in Europe, and to a lesser extent the United States, there is a fundamental mismatch between tax and transfer policies and the structural policies that drive competitiveness and growth, the result being weak fiscal positions and ensuing financial sector fragility.

In Europe, poorly designed labour market and social policies have led to these competitiveness imbalances, which are exacerbated by a common currency. In the US, in his State of the Union address, President Barack Obama described America's current economic and competitiveness malaise as this generation's 'Sputnik moment'.

Despite a decade in which economic growth and job creation were artificially inflated by a damaging housing bubble, we can have confidence the US system will drive the innovation and investment needed to spur competitiveness and growth. However, the US' medium-term fiscal challenge remains to be addressed and success will take time and sustained political commitment.

On the other side of the Atlantic, after "mucking around with this for 18 months", as the Treasurer so aptly described it yesterday, the Europeans are now much more aware of the need for action. It will be important that a sustainable solution to the financial and sovereign debt crisis is unveiled in the next few weeks, but the competitiveness challenge will take much longer to address.

As a result, three years on from the depths of the global financial crisis the recovery in broad swathes of the developed world remains tepid at best. As of the June quarter this year, in five of the seven 'major advanced economies' – that is, in all of the G7 except Germany and Canada – real GDP still remained below pre-crisis levels.

The US, where the recession began in December 2007, is almost halfway to its own lost decade.

In the euro area, the combined investment level in Greece, Ireland and Portugal has fallen by almost 40 per cent, while in the rest of the euro area investment has fallen by more than 10 per cent. Together with unemployment that still averages 10 per cent across the euro area, this suggests a very real risk of a permanent decline in Europe's already anaemic rate of potential growth.

Given this extremely weak lead from the G7 economies, overall growth for advanced economies as a whole has been disappointing. Based on IMF forecasts, by the end of 2011 real advanced economy GDP will be barely 1 per cent higher than the levels at the end of 2007.[1]

[1] In contrast, Australian GDP is 7 per cent higher than at the end of 2007, an outcome matched or exceeded by only 5 other advanced economies (Taiwan, Singapore, Hong Kong, South Korea and Israel).

Of course, the other side of the global economic story is one you will also be familiar with – the ongoing strength of the emerging world, and particularly emerging Asia.

This has been particularly visible post-crisis, but in truth the strength of the emerging world has been apparent for some time. Between 2001 and 2007, developing economies on average contributed around two-thirds of annual global growth – up from less than half in the 1990s. Over the five years to 2016, the IMF is forecasting the developing world to account for around 75 per cent of global growth.

In turn, over that period the bulk of developing world growth – around two-thirds – is expected to come from developing Asia, with China expected to be responsible for lower than two-thirds of that – or around one-third of global growth.

These changes obviously have important implications for the global centre of economic gravity, which continues to shift from West to East.

International architecture

These global economic trends mean that we have to manage an international environment where expectations around representation, engagement and behaviour in international forums are changing (and where such expectations can sometimes be mismatched).

Greater economic weight for emerging economies will bring greater geo-strategic weight. However, these shifts in global power balances should not be seen in simplistic terms as a clear transfer of power, prestige or influence.

Greater economic weight should bring greater representation for emerging economies if our global institutions are to retain legitimacy. That is why

Australia has been a staunch supporter of IMF quota and governance reform for well over a decade.

However, for emerging economies greater representation and greater integration into the global economy also bring greater responsibility, more difficult policy choices and a greater expectation that they will contribute to the provision of global public goods.

For its part, the global financial crisis made clear that the United States can no longer provide a global market of last resort for consumer goods. It is increasingly looking to others to share the burden in ensuring a sustainable global recovery. Indeed, given its current domestic preoccupation, the US cannot be expected to singlehandedly lead the push for solutions to problems besetting the global commons.

But what should we expect of the new powers?

Improving the representation of developing economies through the pursuit of quota and governance reforms at the IMF and World Bank is important but representation does not guarantee effectiveness. For effectiveness of these institutions to be improved, emerging economies will have to be willing to play a significant part in resolving the challenges facing the global economy.

Indeed, by virtue of its sheer size, no major global public policy issue will be capable of resolution without China. But if China and the other large emerging economies are not seen as engaging constructively, their interests, as well as ours, will ultimately suffer.

The emergence of the G20 at Leaders' level has been crucial in providing a forum through which emerging economies can make a contribution to addressing global challenges. It brings all the major economies into a

manageable forum. But just as with the IMF and World Bank, the legitimacy of the G20 depends critically on its ability to deliver results.

The recent G20 Finance Ministers' Meeting stressed the need to have a comprehensive response to the European sovereign debt crisis to avoid further contagion. This will require further measures to boost the European Financial Stability Facility – the October 23 meeting of the European Council will be critical in this regard – as well as ensuring that the IMF is adequately resourced to respond as needed. This plan to address the immediate crisis should be supported by a 'roadmap' of reforms to strengthen global growth – including a commitment to boost domestic demand in emerging economies through enhanced exchange rate flexibility.

As a trade oriented economy, and one that would not be in any smaller global grouping that emerges if the G20 fails, Australia has a vital national interest in the success of the G20, which explains the emphasis placed on these current meetings by the Prime Minister and the Treasurer.

Development challenges ahead for China

Our region is right at the centre of the transformative rise of emerging economies. Indeed the reintegration of almost 3 billion people into the global economy that we are seeing in China and India is an event without precedent.

It is tempting to weave a very general narrative encompassing both China and India but China started its reform process more than a decade before India, and India is a fascinating challenge in its own right. But as China is larger, has grown faster, and is more integrated with the global economy, it will be the main focus today.[2]

[2] While I will leave a deeper consideration of India for another occasion, it is worth noting that Treasury now has a senior officer posted in New Delhi. Treasury has been represented in Beijing since 1994.

We're all familiar with the broad outlines of the China story – and the implications for Australia.

It is fair to say though, that this story is occasionally portrayed somewhat crudely.

On some tellings, the rise of China and Asia is inexorable and will inevitably take Australia along for the ride.

On others, we're hopelessly exposed to a supposedly imminent China collapse. In the meantime, if you believe what you hear, every strong feature of the Australian economy comes with a 'Made in China' stamp.

The truth is that the China story and outlook is formidably complex and that these complexities matter deeply for both Australia and the world.

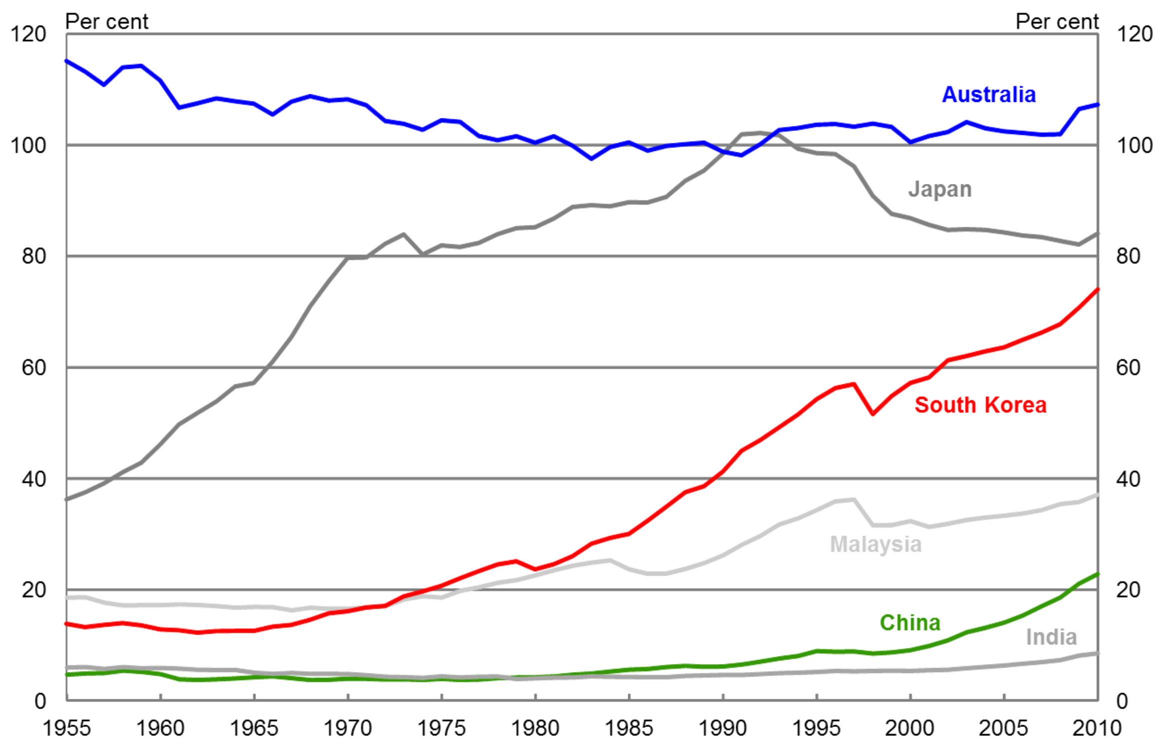
Recently my predecessor Dr Ken Henry has been tasked by the Prime Minister to lead the work on a White Paper on *Australia in the Asian Century*. The very fact of such a project reinforces just how important the rise and transformation of Asia is to Australia, and underlines the importance of understanding the economic, social and strategic changes which are underway in China, India, Indonesia, Vietnam and elsewhere in the region.

For its part, Treasury has often been portrayed as eternally optimistic on the Chinese economy – in fact, our analysis is far more nuanced than that.

In the short-term, while there are certainly risks – not least the vulnerable international outlook – we believe that the outlook for China is strong and that a 'hard landing' is unlikely. Domestic demand continues to grow strongly and China has much policy space should there be a major slowdown in global growth.

In the long term we are optimistic about the ***potential drivers*** of strong growth in China, given by the large scope for urbanisation and industrialisation ***(Chart 1)***.

Chart 1: GDP per capita (per cent of OECD-15 average)



Note: OECD-15 = Australia, Austria, Belgium, Denmark, Finland, France, Iceland, Ireland, Netherlands, Norway, Sweden, Switzerland, UK, US and Canada.
Source: The Conference Board Total Economy Database and Treasury.

However, while the potential is there, continuation of strong growth in China isn't pre-ordained. The medium term policy challenges China faces are daunting and even when the right policy decisions are made there will be risks in implementation.

As a result, we tend to describe a picture 20 years hence where, through the prism of history, even a highly successful China is seen as having had a rising trend in GDP but with significant economic cycles of a sort not seen over the last two decades.

On the international front China's trade and overall balance of payments surpluses – and related issues around the valuation of the RMB and China's massive accumulation of foreign reserves – are major sources of tension and potential instability in the global economy and at the same time serious inhibitors to more balanced growth.

The major domestic policy challenge facing China is the handover from investment to consumption-led growth. In 1980, investment accounted for around 35 per cent of Chinese GDP, and private consumption around 50 per cent. By 2010, these numbers had effectively swapped: consumption 34 per cent of GDP, investment 49 per cent.

Looking at the developmental experience of other economies, a sharp fall in the consumption share of GDP is exactly what we expect at the levels of per capita income through which China has been progressing over recent decades.

However, 34 per cent of GDP is an extraordinarily low consumption share of GDP by any reference point. Both major advanced economies and emerging and newly-industrialised in the region typically have shares around the mid 50s or higher.[3]

None of this is to say consumption growth has been slow in China. Indeed, over the last 5 years, private consumption has expanded at an annual rate of around 13 per cent in nominal terms. But investment has grown even faster – particularly following the infrastructure-heavy stimulus package introduced during the global financial crisis.

There are a range of factors behind this imbalance between investment and consumption, but central among them is that China has an industrial structure

[3] At levels of GDP per capita similar to China's today, Taiwan, Korea and Malaysia all had a consumption/GDP ratio of around 50 per cent, while Hong Kong was at 65 per cent.

which, by design, systematically favours capital over labour, and corporations or SOEs over households and predominantly privately-owned small and medium enterprises.

The undervalued nominal exchange rate encourages investment for export production, while at the same time reducing consumer purchasing power. Suppressed deposit and lending interest rates reduce earnings on savings while artificially lowering capital investment costs, even as a lack of financial market development funnels savings into low-return deposits and reduces consumers' ability to access credit and smooth consumption spending out over time. Regulated input prices favour corporations. State-owned-enterprise dividend policy promotes retention and reinvestment of funds at the expense of greater dividends and an improved tax take.

And yet despite all this the real exchange rate appreciates, as it must. But this occurs through higher inflation, which brings with it another set of issues for policymakers.

Layered on top of this suppression in the labour income share of GDP are a range of other factors which drive high rates of precautionary savings. These include a *hukou* or residency permit system which entrenches vulnerability of rural migrant workers, limitations in the healthcare system, and broader weakness in social safety nets.

Given the systemic nature of these factors, what are the prospects for rebalancing the role of investment and consumption in driving Chinese growth?

The good news is that urbanisation will continue to shift surplus rural labour into more productive industrialised sectors in the years ahead, driving increased wages and living standards. This increasingly urban population will, as incomes

continue to rise, divert an increasing share of total spending away from basics like food and into durable goods and, importantly, services.

However, to boost the labour share of income these forces will need to be supported by reforms to lift minimum wages, free-up factor prices, progress financial market liberalisation, and improve the tax and transfer systems. Other reforms, particularly to residency laws, credit markets, pension systems and healthcare, also need to be taken further to reduce the need for precautionary savings.

Many of these issues are recognised in the 12th Five-Year Plan, which emphasised the importance of boosting domestic demand, and especially consumer demand; boosting the services share of GDP; reducing social inequality; and achieving targets for minimum wage and overall incomes growth.

However, the impact of the 12th Five-Year Plan will depend crucially on effective design and implementation of these policies. The targets are encouraging, but the market mechanisms and the political will necessary to achieve them need to be developed and applied. And just like in Western democracies, success will require China's leaders to tackle stubborn vested interests.

Moreover, in managing these reforms and transitions China will need to maintain solid economic growth and avoid further increases in inequality, while operating in an international environment likely to be characterised by slow growth in major advanced economies and ongoing economic uncertainty and volatility.

Next year’s leadership transition is an added complication. The next generation of Chinese leaders will need to walk a fine line between maintaining stability and continuity and positioning China for continued sustainable growth.

Clearly, the transition that China faces between now and 2020 is a complex one. The strong long-term outlook for growth that we see in China doesn’t imply consistently strong growth, or rule out major fluctuations around the positive longer-term story.

If you look back over the last 100 years of strong GDP growth in the US – the US Century if you will – it is clear that there were some major deviations around that trend. Unfortunately, we are in the midst of one now. Shocks and policy missteps do occur, even in economies with strong growth potential, and China will be no different.

Moreover, the broader economic history of the last 100 or so years teaches us that countries have often experienced difficulties in progressing from middle to upper income status.

There are some important success stories (including in Asia) that suggest we should be sceptical about a fully-fledged ‘middle income trap’, whereby some emerging economies become stuck in the transition between labour intensive, low-cost manufacturing led growth and a more advanced capital-, knowledge- and services-intensive growth model. However, it’s equally apparent that economies like Japan and Korea have faced some major shocks along the way to high income status.

Similarly, while there are good reasons to be optimistic about the eventual ‘convergence’ of emerging economy incomes towards advanced economy levels, this process doesn’t happen by default.

There have been cases where economies and incomes have plateaued well before traditional convergence theory would suggest. It is relatively easy to identify a broad sweep of policy or institutional conditions which are associated with sustained longer-run growth. However, as Harvard economist Dani Rodrik recently argued, it is harder to be clear on the exact policy changes that are needed to deliver these conditions.[4]

On a more positive note, China's urbanisation, industrialisation and growth still has some way to run before it reaches 'middle income trap' territory. And China's strong reform credentials over recent decades suggest that while the process will be challenging, it is capable of making the structural adjustments needed to drive its economy through the next phase of its development.

It is also worth noting that, by virtue of the sheer size of the Chinese economy, the additional annual impetus to global GDP from China will remain substantial even as growth rates slow.

Purely as an illustration – assume that China's economy was to double in size again over the next decade (implying average annual real growth of around 7 per cent) and then grow at around 5 per cent annually in real terms thereafter. The initial year of 5 per cent growth would be the equivalent of adding to world demand an economy the size of Indonesia today.

Implications for Australia

Let me turn to the implications of China's development for Australia.

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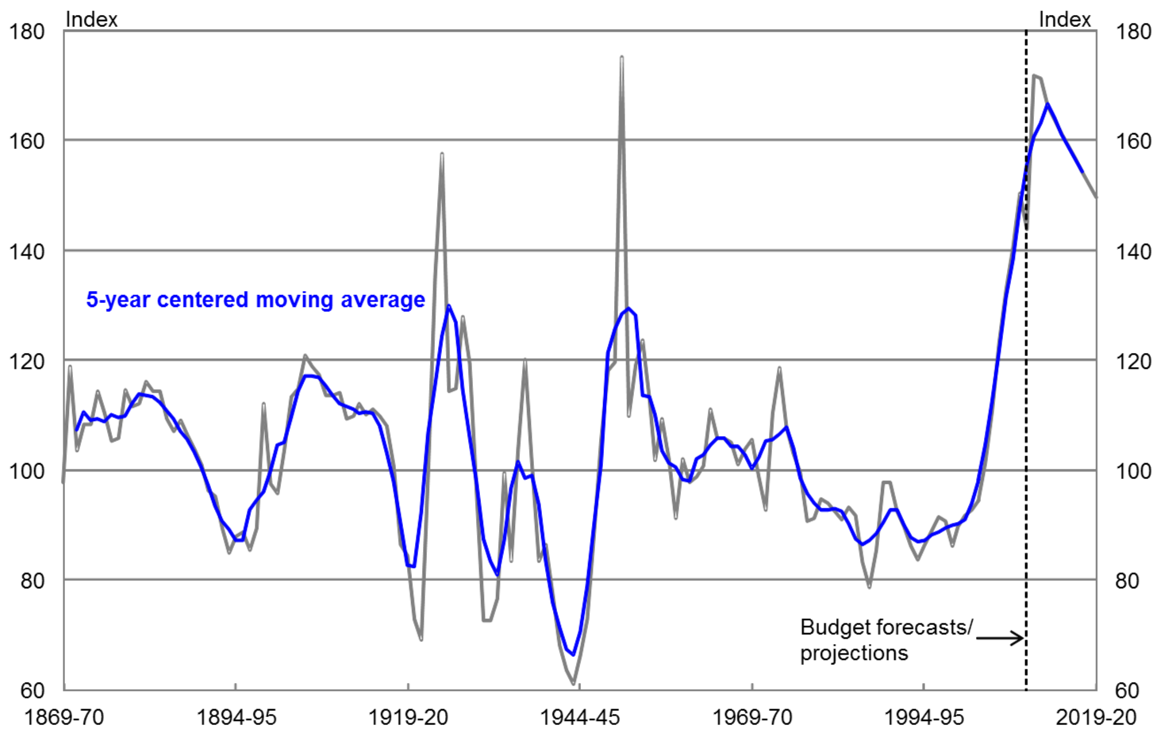
[4] See Rodrik, D 2011, 'The Future of Economic Convergence', Paper prepared for Jackson Hole Symposium of the Federal Reserve Bank of Kansas City, August 2011.

We're all familiar with surging Chinese demand for resources pushing Australia's terms of trade to record levels and resulting in a vast investment pipeline of around $430 billion – equivalent to around 30 per cent of nominal GDP! ***(Chart 2)***

Chart 2: Australia's terms of trade



Index 1900-01 to 1999-00 = 100
Source: ABS Catalogue Number 5206.0, RBA and Treasury.

However, with the high dollar, trade exposed industries outside the resources and energy sector have come under great pressure. Competitiveness has been lost and skill shortages have emerged – while manufacturing gets the media attention, key service exporters like tourism and education have also been hard hit. ***(Chart 3)***

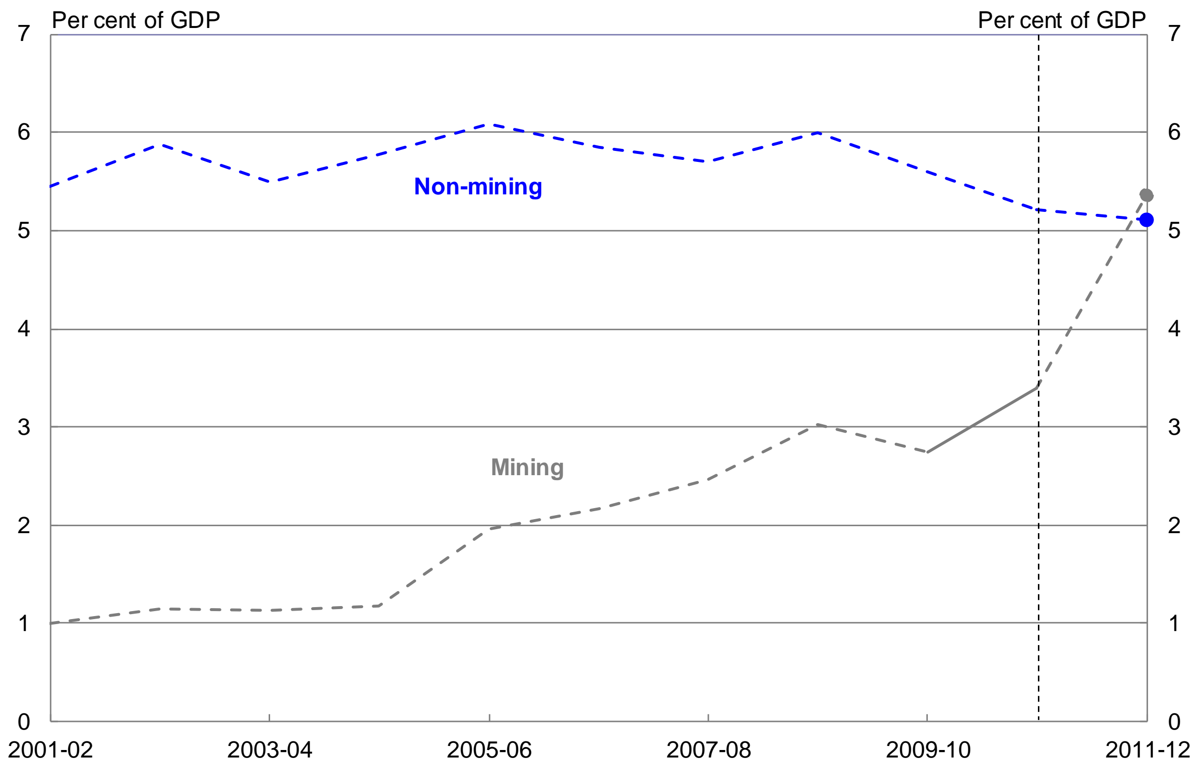
Chart 3: AUD-USD exchange rate

Source: RBA.

While this is a source of considerable community anxiety, it is an inherent part of a successful transformation. We have to accept that labour and capital need to be deployed differently and that some sectors and firms will need to grow more slowly so that others can expand more rapidly. ***(Chart 4)***

Australia's policy settings need to facilitate these changes, rather than trying to impede them. This means policies that promote investment, innovation, education and skills – policies which can increase our ability to innovate and capture new opportunities and which will deliver the productivity gains needed to continue to lift living standards. Even if our terms of trade were to remain at their current historically high levels – which, to be clear, we do not expect – the period of windfall gains for national income from an *increasing* terms of trade is over, meaning we will need faster productivity growth to sustain growth in living standards in the future.

Chart 4: Mining and non-mining investment intentions share of GDP



Note: Estimates for 2011-12 from ABS CAPEX survey, and based on the long-run average realisation ratios.
Source: ABS Catalogue Numbers 5206.0, 5625.0 and Treasury.

Australia's trade linkages with China also expose us to policy mis-steps or major fluctuations in China's growth.

There is nothing new in this – we've been reliant at other times on markets in the UK, US and Japan. What's new is that unlike China, those countries were not themselves trying to manage their own massive structural transformation – and it is this that heightens the probability of mis-steps.

As a result, Australia must retain the flexibility to adjust to temporary shocks, a flexibility which has been a defining feature of our strong economic performance in recent decades. The flexibility of the currency, the independence of the RBA, a strong medium term fiscal framework, a strong and well-regulated financial sector and an ongoing structural reform agenda – all of

these are fundamental to Australia's ability to manage the impacts of external volatility at home.

Australia should also be doing all that it can to reduce external sources of volatility. This includes playing a constructive role globally, including through the G20 and other multi- and bi-lateral fora, to encourage international cooperation and smooth rebalancing towards more sustainable growth models.

Australia must also be awake to the longer-term opportunities flowing from sustained growth in China and emerging Asia more broadly. If the resources boom is the first wave of impacts on Australia, the transition to higher incomes and consumption-led growth promise two more:

- Higher demand for our agricultural commodities as higher incomes lead to changing food consumption patterns; and
- Opportunities for rapid growth in the services demanded by increasingly affluent societies.

On some projections, by the end of this decade there will be an additional 1.2 billion middle class consumers in Asia, making the region the single largest middle class market in the world.[5]

The opportunities that come with this are tremendous. But just as it took world's best expertise to transform our mineral wealth into the mining boom, it will take world's best business and policy approaches to make the most of our favourable geography.

[5] Kharas, H and Gertz G, 2010, 'The New Global Middle Class: A Cross-Over from West to East' in C Li (ed), China's Emerging Middle Class: Beyond Economic Transformation, Washington, DC, Brookings Institution Press.

Geography is important, but it doesn't give us a free pass to Asian middle class markets. Competition will be intense, with more countries able to provide the goods and services these Asian consumers will demand.

Australia's success in positioning for Asia's middle class is not pre-ordained. To make the most of these opportunities, Australia will need to pursue a broad-based agenda to increase productivity, innovation and both labour and management skills. In short, an agenda which will assist not only to ease the structural shifts of today but pave the way for the structural change of tomorrow.

We also need to bolster Asian literacy – in a literal sense, as well as commercially and culturally.

And we need a continuation of strong inflows of foreign direct investment, not just in our natural resources sector but also in our agricultural, tourism, infrastructure and education sectors. Given the scale of our investment needs, the alternative is either lower rates of Australian consumption or greater inflows of shorter term capital, with all the consequences that brings.

Conclusion

As I said at the outset, we live in interesting and complex times. The global economy is in the midst of a century-defining shift. The Asian region is right in the middle of that shift with China at its heart, and Australia is intimately interconnected with Asia and with China in particular.

The major changes already in train have had significant benefits for people right around the world. Hundreds of millions have been lifted out of poverty in Asia. Hundreds of millions in the advanced world have benefited from the boost to real incomes which has come from lower manufactured goods prices.

But significant transitions like these don’t happen without tensions and costs. Shifting patterns of global comparative advantage have forced some difficult structural changes in many advanced economies over recent decades – including the shift away from manufacturing employment in some industries where competition has hit hardest.

In the US and Europe, underlying issues with competitiveness have manifested in part in the burgeoning sovereign debts which are a defining feature of today’s global outlook. Social and economic strains are likely to be compounded by a prolonged phase of fiscal consolidation and adjustment. And inevitably, there will be pockets of political fallout.

Likewise, to continue its drive towards middle and high income status, China must manage its own set of transitions and adjustments: to a more market-determined currency, higher wages, more costly capital, and higher value added industries.

When we think about these sorts of changes – both within economies, and between them – there is a temptation to fall into a winners-losers, zero sum analysis. But we should resist this.

Internationally, for instance, the shifting in economic and geopolitical weight from West to East is often portrayed as a ‘rise and decline’ – as an absolute loss of power, prestige and influence by the US and Europe.

But the US is in no danger of losing its superpower status. Moreover, the US, Europe and other advanced economies like Australia stand to reap ongoing benefits from China’s economic rise. All of us have an abiding interest in having China at the table of global governance, in encouraging Chinese economic reform, and in facilitating China’s growing role as a responsible stakeholder internationally.

Similarly, although China itself is reaping vast and deserved rewards from its economic growth of the last three decades, its transformation won't be without pain. China's next stage of growth will require difficult reforms. China is already facing increased competition from cheaper labour offshore and pressure to innovate and move up the value chain. It too will have to deal with the political, economic and social impacts of structural change.

China's opening up isn't all one way. China has changed the world, but in the process the world is also changing China. Further globalisation means more pressure for market-based reform – and, ultimately, more benefits for both China and the world around it.

In all countries there will be difficulties in this sort of transition process. The costs can be concentrated, and there are always sensitivities in dealing with change, risk and uncertainty.

But whether it's Australia, China, the US or Europe, the forces at work are irreversible. Acknowledging them, adjusting to them, and harnessing them to our benefit, is the only way to deliver increased wellbeing to each nations' citizens.

Thank you.