

**AUSTRALIA AND CHINA: RISKS IN A GOOD STORY**

**Ross Garnaut  
Professor of Economics  
Research School of Pacific and Asian Studies  
The Australian National University**

**Honorary Professor in the Chinese Academy of Social Sciences**

**Australian Ambassador to China 1985-88**

**Paper presented at the CEDA Conference, *The China Story – Resources & Beyond 2004*, Perth, 27 August, 2004.**

Western Australia is reaching for an important element of its destiny. It has now, more than ever, a rapidly expanding economy, prospering from the integration of its resources with its favourable location near China, India and Southeast Asia.

Pamela Statham-Drew's recent biography reminds us of Captain James Stirling's emphasis on this destiny, in selling the idea of a settlement on the Swan River to the Admiralty and the Colonial Office. The interaction between Perth and towns further north with China, the Malay archipelago, India and Japan featured prominently in the new colony's seventy years of life before the Australian Federation. The interaction with neighbouring Asia was set back by young Australia's retreat into itself in the first two thirds of the twentieth century, with the White Australia Policy, high protection, and a generally fearful approach to Asia.

All that has changed for Australia over the past four and especially the past two decades. And nowhere is the change seen more clearly than in the transformation of the economic performance and the educational and cultural landscapes of Western Australia, and the faces in the streets of Perth.

The reorientation of the Australian economy and society at first had Japan at its centre. The iron ore producers of the Pilbara pioneered not only the Australian

minerals trade with a rapidly growing Japan, but a new and confident approach to international business in Japan itself. Greatly expanded relations with Korea and Taiwan followed in the 1970s, and, in many ways more intimately, with greater interpersonal interaction, with Southeast Asia from the 1980s.

The growth of China, and Western Australia's leading role in Australia's response to it, ensures that this story will continue through the first half of the twenty first century, on a scale that challenges the ambitious appetites of Western Australians. China has rapidly become the second largest market after Japan for Australian exports and is likely to become the first over the next decade. Western Australia accounts for half the new export activity.

I gave a public lecture at the University of Western Australia in March this year, the first of a series of six by the Western Australians who have served successively as Australian Ambassador to China during the two decades of rapid expansion of the economic relationship. I noted that Sino-Australian relations in the nineteen eighties developed in the context of far-reaching policy reform and structural change in both countries. The internationalisation of the Australian economy and its re-orientation towards the rapidly expanding opportunities in East Asia was of historic importance for our own country. The market reform and internationalization of China that emerged in the 1980s was of historic importance for the global economy. The coincidence of these

Australian and Chinese developments in the 1980s helped to reinforce the new trends in both countries.

The Australian Government in the early years of Australian and Chinese reform identified a powerful Australian interest in the success of Chinese movement towards a market economy, deeply integrated into the international economy. The benefits would be greatest for Australia if Chinese trade expansion were embedded in an international institutional environment that secured non-discriminatory access to China's expanding markets, on the basis of agreed international rules, rather than through the exercise of power.

Neither Australian nor Chinese interests at this time were seen as being served by any element of special or discriminatory treatment. No special privilege on trade was sought beyond an opportunity to compete. No security treaty, no formal rights beyond those available to other members of the Asia Pacific and global communities. Premier Zhao Ziyang did suggest and Prime Minister Bob Hawke accepted in Beijing in February 1984 that Australia and China should strive to make their relationship a model for countries with different social systems and at different levels of development. The goal was to establish a "model" relationship in the literal sense, that it would be sensible for anyone else to do the same.

Within this framework, close personal relations were established between Australian and Chinese leaders and officials at this time that have been maintained reasonably well ever since, with the temporary exception of a year or so immediately after the 1989 tragedy in Beijing. This has provided an umbrella under which officials, businesspeople, university-based scholars and entrepreneurs in the arts could break new ground in bilateral relations and in China's open policies.

This was the framework within which Australia worked closely with China over several years to secure APEC membership of the three Chinese economies, and over a decade and a half to secure their membership of the WTO. It was the framework within which China chose Australia for its first direct foreign investments abroad, including the joint venture with Hammersley Iron to build the Mt Channar iron ore mine in the Pilbara. It was the framework within which the two countries managed the complex issues around the establishment from a zero base large-scale movements of Chinese to Australia as students, migrants and tourists.

The continuity in policy and economic change in Australia, China and the bilateral relationship over the past two decades is remarkable. The one awkward break in high-level political relations, after Tiananmen, had only a small and temporary effect on the expansion of substantive relations. The structure of the Channar agreement on investment and trade in iron ore was

followed in fine detail in the natural gas contracts. The continuity extends to personnel involved in the relationship: the current Chinese President, Hu Jintao, was identified by the Embassy as a young leader with promise eighteen years ago, and made an extensive visit to Australia as a guest of government long before he was known at all in other Western countries.

Growth in each economy and in bilateral trade has been at or beyond the highest expectations of the early reform period. My speech on being made an Honorary Professor at the Wuhan Iron and Steel University in early 1988 was made famous by the then new Premier, Li Peng. I said at Wuhan that the advantages to the Chinese iron and steel industry of using much more high quality imported iron ore were so large, that it was likely that by the end of the twentieth century, China would be importing 40 million tonnes a year. The Premier responded indirectly soon after that, in a speech to the Chinese industry. He noted that “some foreigners said” that China would be importing 40 million tonnes per annum, but that they were exaggerating the possibilities. The data now reveal the error in my 1988 speech as being in understatement. From around 14 million tonnes in 1990, Chinese iron ore imports rose to over 40 million tonnes in 1995, around 70 million tonnes in 2000, and nearly 150 million tonnes in 2003.

Services export expansion from Australia, led by education and tourism, has exceeded initial expectations most of all.

The exceptionally strong growth in Australian total exports to China since 2000 is the more remarkable because it has been strong at a time of declining Australian exports to other destinations.

There have been some areas in which earlier hopes have not yet been realized. Grain was identified by the Australian Embassy in the mid-eighties as one of four industries (alongside iron and steel, non-ferrous metals and wool), in which Australia could reasonably aspire to exports exceeding one billion dollars per annum. So far, it is the only one of the four not to make it. China's continued strong growth in consumption, and the entry into the World Trade Organisation (which makes China unlikely ever to descend into the high agricultural protection that was adopted earlier by Europe, the United States, Japan, Korea and Taiwan as they became rich), underpin good prospects for grain and other broadacre agricultural products, so long as the WTO remains influential. Manufactured exports beyond the processed metals have also been disappointing, after a promising start. For manufactured exports, the rise and then stagnation has much in common with the pattern for total exports from Australia.

Most important of all for the long-term relationship, the Australian human resource base for managing the China relationship has grown steadily in scale and quality over the past two decades. Australians of Chinese background

leaven universities, Government Departments and businesses. A new generation of Australians is growing up with close relations with China and Chinese a normal part of their personal and professional lives. Many Australian organizations are now deeply experienced in managing complex issues in China.

This is a good story. It is likely to get much better. There are still many hurdles in the path of the Chinese economy sustaining growth over the decades that must still be crossed before China has secured the productivity and living standards of a developed country. But the hurdles ahead seem less daunting than many that have already been cleared.

Australia and Western Australia have so much at stake in the continued success of China and the China-Australia relationship that it is worth reflecting on the risks, so that we can build strategies to minimize them. In these introductory remarks, I will say a little about what I see as five main risks, and what we should do to manage them. I will focus on the economic risks to China continuing to perform well economically; the risk that Australians' commitment to the relationship will swing too widely through the inevitable ebb and flow around the generally high water of Chinese economic growth; that geo-strategic tensions, and in particular conflict with the United States, will upset China's relationship with Australia and perhaps its approach to economic development; that the inevitable domestic political stress associated

with sustained rapid economic growth will upset the story of continuity; and that the deterioration of the multilateral trading system that has served China, Australia and the Sino-Australian relationship well over the past two decades will weaken our opportunity to compete on even terms with competitors in the Chinese market.

The purely economic risks to continued expansion in the Chinese economy are probably the least of the five. A relatively unproductive state enterprise sector continues to absorb excessively the capital available to the economy, and holds growth below what would otherwise be sustainable. The retrenchment in 2004 was needed most of all in the heavy industries in which state enterprises are dominant, but has fallen disproportionately on private domestic enterprises and on light industry. The famous weakness in the banking system is overwhelmingly attributable to lending to state-owned businesses, and the flow of credit to these firms continues.

The private sector has been accorded higher legal status in recent years, and has been the intended beneficiary of reforms to level the playing field in competition with state-owned businesses. The private sector continues to expand much more rapidly than state-owned firms, despite the continuing but mostly unintended discrimination against it. All but the largest state-owned firms are disappearing through restructuring in various ways. Much less capital

will be wasted through excessive investment in inefficient state-owned businesses a few years from now.

Meanwhile, the vulnerability of the banking system is being corrected slowly, through banking reform, some increase in discipline on borrowing by state businesses, and increasingly from the rise of private including foreign financial institutions. In the meantime, a reasonably strong fiscal situation ensures that the Government is able to protect state banks from financial crisis.

None of this is to say that Chinese economic expansion will be without fluctuations and occasionally a sense of crisis. The instruments of macro-economic management remain crude. The excessive demand expansion that raised growth above sustainable rates in the year just past has been only partially corrected by the tightening of bank credit since February. There is likely to be further tightening of direct controls on investment by state-owned businesses in heavy industry, which in their nature are arbitrary and damage long-term economic growth. The stops and starts in the flow of resources to business reduce allocative efficiency, with disproportionately large effects on suppliers of industrial raw materials. But Chinese savings rates, augmented by the largest flow of private direct foreign investment to a single economy that the world has ever known, ensures that economic growth can be maintained at high average rates, even if much domestic capital is invested wastefully.

The international mood about economic growth in China fluctuates far more widely than the reality. With the sole exception of the aftermath of Tiananmen, to which reference has already been made, economic reform has followed a remarkably steady path. There have been variations in the rate of policy change, and from time to time retreat from experiments that seemed to have failed. But the main movement has been consistently and powerfully in the direction of reform to expand the role of markets for goods and services and to integrate domestic into international markets.

As with reform policy, so it has been with economic performance. Average growth rates in international trade and investment and domestic output have consistently exceeded both the claims of government and international expectations. But international business and media and to some extent official perceptions have swung widely with variations in the pace of policy reform, real economic performance, and the rumours emanating from Hong Kong, Beijing and Shanghai.

The most successful investors have recognized the underlying steadiness of reform policy and growth. Australians has been amongst the steadier observers, assisted by a well-informed and mostly analytically strong input from the Department of Foreign Affairs and Trade. But we have not been immune from the mercurial changes in dominant expectations amongst our American friends, and these seem to have become more influential in recent years.

We are currently going through a period of high optimism about the China relationship, underpinned by strong Chinese output and trade growth and the associated rapid expansion of Australian exports. This has contributed to a buoyant mood in the political relationship that has encouraged higher ambitions for Sino-Australian cooperation in many spheres.

This is mostly to the good, because it encourages innovation in the relationship that can permanently expand the gains. But there is a downside. The expansion will not continue for long at the rate of the past few years. There probably will be no decline in the value of Australian exports to China through the retrenchment that commenced early this year, but some hopes will be disappointed. There is a risk of disillusionment, the withdrawal of professional resources from the relationship, and political mistakes.

The point to remember is that the general tendency of Chinese growth and Australian opportunity in it is highly favourable, and is worth investing heavily to secure. But it is not as favourable as the foreign mood at the best of times, and not as bad as the external mood at the worst of times. The wise course is a steady one, reacting to long-term tendencies rather than year-to-year fluctuations.

The geo-strategic risk to sustaining economic growth has been highlighted in the popular discussion in recent days, through the reaction to Foreign Minister Alexander Downer's comments on tensions in the Straits of Taiwan. There has been some talk of war in the Taiwan Straits. War has low but not zero probability. Its consequences would be devastating for the Chinese and Asia Pacific societies and economies, for China-Australia relations, and possibility for Australia's survival as a sovereign entity. A low probability of disaster on this scale warrants serious discussion and analysis. Official Australians became quietly acquainted with the potential costs of tensions a long way short of war over the Taiwan issue in the early months of the current Government, when official relations were briefly frozen by China after Australia sent naval vessels into the Straits.

For these reasons, the Foreign Minister did us all a service last week in raising the worst of the possibilities in public in Beijing. He has been criticized heavily for the terms in which he discussed the Taiwan issue, and for raising it at all.

Mr Downer has been criticized too harshly. While he could have chosen more appropriate words, in indicating that Australia would not automatically follow the United States into war over Taiwan, he was indicating that Australia would be exercising independent judgement. It is crucial that Australia does so, for the sake of Australia-China and Australia-Taiwan relations, for the security and

prosperity of Australia, and for the health of the relationship with the United States as well.

Neither Australia's legal obligations, nor its interests, nor its judgements about the realities will necessarily be identical with those of the United States over any conflict in the Taiwan Straits. Much would depend on how any crisis were to unfold. If a crisis emerged from a Taiwan initiative to push recklessly at the boundaries of independence, there would be no basis for automatic Australian military support for military action in Taiwan's defence. War is a bit less likely if both the Taiwan leadership and the United States know that this is the position of Australia and other allies and friends of the United States.

Neither would there be Australian or international sympathy for the People's Republic of China if it opted unilaterally to secure reunification with Taiwan through unprovoked military action. In these circumstances, the case would be stronger for Australian and other international military action in support of the United States. War is less likely if this perspective is widely understood by our friends.

The risks of serious domestic political disruption are further in the future, but will eventually be faced as urgent matters. They will have to be managed well if our greatest hopes for China and consequently for China-Australia relations are to be realised.

The starting point for understanding these issues is recognition that market-oriented economic development is inevitably a painful and sometimes traumatic process. It changes fundamentally the established domestic distribution of income. It challenges and churns elites. It renders obsolete institutions and ideas about society that had been cherished by large numbers of people.

Unless countervailing centres of power are established, there will inevitably be great concentrations of new wealth in an underdeveloped country experiencing rapid, sustained market-oriented growth. In China, with its surviving legacy of State power in the hands of a political party still governed internally along Leninist lines, there will be tendencies for capture of the State power by new economic elites.

The pressures for democratisation of the Chinese State are muted for the time being by Chinese popular anxiety about social disorder, and by recognition that the pattern of development in the reform era has delivered a vast expansion of personal freedoms and large increases in living standards. But they will become more intense. There is no reason why political change will necessarily involve major social and economic dislocation. That will depend on the quality of political leadership at crucial times. The management of these issues will have large implications for China's international partners. Foreigners cannot be

players on this stage with any confidence that interventions would be helpful to movement in directions that they favour.

Possibly the most important risk in the immediate future is to the international trading system that secures non-discriminatory access for Australian suppliers. This is not so critical for the unprocessed minerals that for the foreseeable future represent most Australian exports to China, as it is for manufactures (including processed metals), services and above all agricultural products.

Australia is an unlikely winner if political preferences rather than competitiveness on business criteria come to dominate trade decisions.

Countries in China's immediate neighbourhood would often be able to generate foreign policy reasons for securing preferred access over Australia, as ASEAN countries have already done for most agricultural products from January 1 this year. In contests of political power, the United States and to a lesser extent the European Union, Russia and Japan would carry more weight than Australia. If trade decision-making descends into tit-for-tat bilateralism, many developing countries will have fewer scruples than Australia about the abandonment of sound commercial principles.

The current position is unfavourable. The descent into preferential trading arrangements in the Asia Pacific region in recent years, and the momentum for many more preferential arrangements, presents an urgent policy challenge.

A new era of preferential trade opens early next year, when the Australia-US FTA comes into effect. Australia will then be doing something that is unusual in world trade history. It will be systematically discriminating in its import trade against the countries that are its most important export markets. Such rare circumstances have never before been sustainable, for Australia or other countries.

The Government's own study of the US-Australia FTA demonstrates that a large amount of imports currently drawn from China and other countries in Asia will come to be purchased from higher cost suppliers in the United States.

The need to remove the new discrimination against China is one motive for the current interest in a China-Australia FTA. A conventional FTA cannot solve the trade discrimination problem: there is no more rational reason for systematically discriminating in favour of the US and China against Southeast Asia, Hong Kong, Taiwan, Korea and India, than there is for discriminating in favour of the US and against China and the rest of Asia.

The removal of the problems associated with discrimination against countries that are Australia's major export markets, and weighty evidence that it would improve economic performance in itself, makes it essential to place comprehensive trade and investment liberalization, independently of tit-for-tat

exchanges in FTA negotiations, at the centre of our response to current structural weaknesses in the trading system. I recognize that the political base for genuine trade liberalization has been weakened greatly in recent years, and the first challenge is to rebuild political support for liberal trade.

Australia has contributed to the momentum behind preferential trading arrangements in the Asia Pacific, but its return to comprehensive trade liberalization would not reverse the damage that has already been done to the system. The perception that Australia will be damaged by exclusion from others' preferential arrangements will maintain pressure for new FTAs, first of all with China.

The main means of removing the discrimination against China in our trade and investment should be the completion of comprehensive trade and investment liberalization in Australia. This should then be the starting point for negotiation of an open trading arrangement with China. That is easier said than done, and is a subject for another day.