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Australia–China Economic Relations

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Introduction

China's growth and change are driving dramatic structural change in Australia. Despite the fact that Australia's per capita income is much higher than China's, the continuation of rapid growth in China is exposing a series of policy challenges for Australia, particularly matters of regulatory reform. Many of these are directly related to key areas of interest in the relationship with China, and the manner in which Australia responds will affect the evolution of this relationship. There is also a risk that the boom conditions will not last and the opportunities created by growth in China will be wasted.

That China will continue to grow at high rates is a widely held expectation.² But China faces a series of structural challenges and its response to these challenges will also affect the evolution of the relationship with Australia.

Growth in the movements of capital and people is a part of the change in the relationship. China has become a big investor in Australia, and there are now significant movements of people in both directions. The aim here is to document some aspects of these developments. The next section reviews recent changes in the trade and investment flows and then some features of the resources boom in Australia. Following this is a discussion of foreign direct investment (FDI) flows and people movement. The chapter concludes with a review of Australia's three challenges: the 'now' challenge, the 'end of the boom' challenge, and the challenge of grasping new opportunities.

Trade and investment flows

There is a high level of complementarity between Australia and China, and China is increasingly important in world trade. Not surprisingly, China has become Australia's top-ranked merchandise trade partner, taking over from Japan as an export destination and from the United States as a source of imports.

Merchandise exports to China in 2010 were A\$58.4 billion (25 per cent of the total) and imports from China were A\$39.3 billion (19 per cent). The shares of the top-five partners in exports and imports are shown in Figures 12.1 and 12.2. China took over the number-one position in 2009 as an export destination. The growth in the importance of India is also noteworthy. In import transactions, while China's share is rising, the share of Japan and of the United States has been falling. The rising share of Association of South-East Asian Nations (ASEAN) economies in imports is also of interest.

In 2009, China was the world's largest exporter with a share of 9.6 per cent, and the second-largest importer with a share of 7.9 per cent (WTO 2010). China's share of Australian exports was more than three times its world import share, which provides a further illustration of the intensity of the relationship.

Figure 12.1 Shares of Australian exports to the top-five destinations, 1994–2009

Source: CEIC Data Company Ltd, New York.

Figure 12.2 Shares of Australian imports from the top-five origins, 1994–2009

Source: CEIC Data Company Ltd, New York.

The main Australian export items to China in 2009–10 were iron ore (A\$25 billion), coal (A\$5 billion), copper (A\$1.7 billion) and wool (A\$1.5 billion). Clothing, computers, telecommunications equipment and toys make up the bulk of the import transactions (DFAT n.d., 2010b). Chinese exports to Australia are, however, diversifying—for example, while constituting a small share of exports to Australia (less than 1 per cent), fresh food products became important in the Australian summer, and certainly more noticeable. There was a vigorous debate about the threat to apple growers in Australia early in 2011 following the arrival of Chinese apples into Australian shops ‘for the first time since 1921’ (AAP 2011; Murphy 2011).

Australia's resources trade has been reoriented to China. By 2009, China accounted for more than one-quarter of Australia's total resources exports (metal ores, minerals, fuels and metals—including gold), followed by Japan (20 per cent), India (10 per cent) and Korea (9 per cent). In 1999, China accounted for less than 5 per cent of total resources exports and Japan accounted for 23 per cent (DFAT 2010a).

Australia on the other hand is of lesser importance as a trading partner to China, although the relationship is intense. It is the eleventh-ranked export destination, accounting for less than 2 per cent of China's exports (Australia's share of world merchandise imports is 1.3 per cent and it is ranked number 19 in the world). Australia ranks higher as a source of imports—at number seven, with a share of 4 per cent (1.2 per cent of world merchandise exports and ranked twenty-third in the world).

The services relationship with China is also deepening. China is now Australia's number-one export destination. Australia's 'services exports' to China were valued at A\$5.8 billion, or 11 per cent of the total, in 2009–10. Imports were A\$1.6 billion, or 3 per cent of the total. The main export items were education-related travel (expenditure in Australia by overseas students) and other personal travel—or tourism. The main import items were tourism (Australians travelling to China) and transport (shipping, for example). China is the eighth-most important source of services imports. Sales of services to China are likely to be significantly understated. The data reported in this paragraph are cross-border transactions and not sales from services affiliates offshore.

Foreign investment flows from China have surged in recent years. By 2009, the stock of Chinese investment (of direct and portfolio flows) in Australia was A\$16.6 billion and the FDI stock was A\$9.2 billion. China is outside the list of leading foreign investors in Australia in terms of the size of the stock (a total of nearly A\$2000 billion in 2009, in which the United States and the United Kingdom together account for half and Japan for another 5 per cent), but in 2009 it was ranked fifth in terms of the inflow, after the United States, the United Kingdom, Netherlands and Japan. Table 12.1 shows the value of the inflows, according to Australian Bureau of Statistics (ABS) data, rising to nearly A\$5 billion in 2009. Australian investment in China has fluctuated but remains small: by 2009, the stock of all flows was A\$6.3 billion with the FDI stock valued at A\$2.4 billion.

Table 12.1 Foreign investment flows from China to Australia, 2005–09 (A\$ million)

Investment from China to Australia	2005	2006	2007	2008	2009
Foreign investment	30	1281	2681	2489	7845
Direct investment	–58	244	23	3187	4991

Source: ABS (2009).

The resources boom

Global demand growth for resources as well as food is reflected in the change in the composition and direction of Australian trade. The resources share of exports is now 57 per cent, compared with 41 per cent in 2005 (Christie et al. 2011). This shift reflects both price and volume changes.

Australian terms of trade have never been higher since Federation (Stevens 2011). The price of iron ore has increased at an average annual rate of 23 per cent since 2005 and the price of coal at 8 per cent (in Australian dollars).³ Australia's terms of trade are 65 per cent

above the average twentieth-century level and 85 per cent above the trend of the twentieth century had that continued (Stevens 2011). As a result, Australian gross domestic product (GDP) in nominal terms is about 13 per cent higher than it would have been (Stevens 2011).

The volume of exports of iron ore has grown at 10 per cent a year and of coal at 5 per cent a year since 2005. The major structural changes in trade have been the surge in iron-ore exports to China (a fivefold increase since 2005 to more than 250 mt), the growth in coking-coal exports to China in 2007 (on top of steady growth in exports to India) to between 20 and 30 mt, and a more recent rise in thermal-coal exports to China in 2010. China has become the second-largest destination for liquefied natural gas (LNG) exports.

Growth in China, and to a lesser extent India, has been a driver of higher resources prices (Orsmond 2011). Growth in China involves not only industrialisation but also the employment of rural labour and therefore a rapid rate of urbanisation (Song 2010). China has now entered what Song calls the mid-phase of industrialisation, which is more energy and minerals intensive than the more labour-intensive early phase. This has contributed to the 'sudden surge in China's demand [for] energy and resources since 2002', which has contributed to the higher price level than otherwise, with the low short-run supply elasticities in minerals and resources. While well endowed with resources in absolute terms, China's endowment is poor in per capita terms and has led to its rising demand being reflected in purchases from offshore. China, Song reports, shifted to become a net importer of oil in 2003 and coal in 2009.

At the same time as contributing to higher minerals and energy prices, China's industrialisation has increased the supply of manufactured goods and prices have remained lower than otherwise. These shifts of higher resource prices and flat or even lower manufactured product prices have been especially beneficial to Australia, given its endowment of the factors of production and its patterns of trade. They are reflected in the composition of Australia's trade with China summarised above.

Song asks how long this boom will last. Assuming continuing high GDP growth, Song refers to work on the Kuznets curve for steel, according to which China will not reach peak steel consumption per capita until 2024, and possibly longer if it follows a trajectory similar to that of Japan. Steel output in 2024 would be about 1 billion tonnes or more, compared with 600 mt now, which indicates strong growth in demand for steel and suggests continuing growth in demand for other minerals and energy. The question for Australia, however, is the supply response in world markets. This question and issues around the sequence of structural adjustments occurring in Australia are discussed in more detail below.

A theme of this chapter is that changes in the relationship with China are driving not only structural changes but also debate about policy in Australia. An example is the taxation of resource rents. A consequence of higher prices was higher profits in the resource sector, which led to debate over the distribution of resource rents and to a significant change in taxation policy. The concern is that the new arrangements might not have solved problems in the previous taxation arrangements and at the same time created new ones.

Previously, Australia levied taxes on resource projects in place in the form of company income tax as well as royalties, linked to sales. State governments managed the royalties, and firms in the resources industry were concerned that higher prices and profits would trigger higher royalty rates, which would be difficult to reverse later if prices were to fall. Royalties are inefficient since they induce mines to close earlier than otherwise. In May 2010, the Government proposed a profit-based tax, the initial version of which was highly controversial. Following the change in government, the industry negotiated a new form of this tax, which applied only to coal and iron ore (Government of Australia n.d.).⁴ The States continue to collect royalties that are to be paid immediately, while losses, including credits for royalties paid, are carried forward at a specified rate of interest. When profits are low and there are insufficient profit tax payments against which to credit the royalties, the mines will continue to close too soon. Other criticisms of the new tax are that it discourages cost reductions by miners, induces higher levels of capital intensity, flattens out production over time and penalises high-risk projects (Pincus 2011). The tax is also argued to fall less heavily on some types of companies than others.

Capital flows: investment in minerals

Data on capital flows are available not only from the ABS but also from reports of approvals and announcements. The approvals data come from the Foreign Investment Review Board (FIRB) and, as usual, they exceed the data on actual flows reported by the ABS (see Table 12.2).

Foreign Investment Review Board-approved Chinese FDI projects surged to more than A\$7 billion in 2005–06 and remained high the following year compared with previous history. In 2007–08, the value of approved projects returned to levels similar to 2005–06 and then in 2008–09 quadrupled. This occurred in the face of the global financial crisis; total approvals from China numbered only 57 in 2008–09, but the value of approved projects in the minerals sector increased dramatically. Total approvals for projects from all countries fell following the financial crisis—from 8354 in 2007–08 to 604 in 2008–09. Despite the effects of the financial crisis on overall investment approvals, the value of approved projects from China remained more than A\$16 billion in 2009–10. Total approved Chinese-investor projects since 2005–06 were valued at just more than A\$60 billion, of which A\$53 billion (or nearly 90 per cent) was in minerals or resources processing.

While China did account for the largest value of project approvals in the minerals sector in 2008–09, China generally ranks number three after the United States and the United Kingdom. For example, over the same period, total approved projects from the United States were valued at A\$197 billion but the minerals sector accounted for only A\$67 billion or 34 per cent. Even so, this planned investment from the United States exceeded that from China.

Other data on FDI projects in which China is involved are available from information on announcements of projects contained in the Zephyr database.⁵ There were 89 merger and acquisition (M&A) ‘deals’ completed in the resources sector over the period 2007–10, the total value of which was reported to be about A\$36 billion. This amount is far greater than the ABS reported capital flows, but less than the value of approved deals in the FIRB

data. One reason for the difference, apart from valuation methods, is the location of the foreign investor—investments might be managed by Chinese firms based in other countries. According to the reporting dates in Zephyr, the focus of deals by Chinese investors is shifting: iron ore dominated deals in 2007 and 2008, then oil became more important in 2009, and deals in 2010 were dominated by gold projects.

The ownership of Chinese companies involved in the deals was also reviewed. Another policy debate in Australia has been about investments from China by consumers of the output of the projects and by state-owned enterprises. By inspection of the web sites of each company involved in the deals and using other sources, it is estimated that over the period 2007–10 the lower bound estimate of public ownership is 73 per cent, although it could be as high as 84 per cent. As Drysdale and Findlay (2009:374) point out:

State-owned firms in China are increasingly subject to the disciplines of the market at home. They have preferred access to domestic credit through the state-owned banking system but on terms that are, given that distortion, increasingly commercially based...Chinese companies in which the state has a stake are publicly listed at home and increasingly in Hong Kong and abroad. Corporate organisation and corporate governance in China is in a state of transition and is evolving towards a system increasingly governed by market institutions.

Indeed, the latest (Twelfth) Five-Year Plan (2011–15) calls for further listing.

According to the Zephyr database, investments in 2010 were much lower than in previous years, since the value of deals completed in that year was only about one-quarter of that in 2009; this figure is difficult to check, since, for example, FIRB data now available refer only to the first half of 2010. Overall outflows from China, however, continued to grow in 2010, including in M&A activity.⁶ A fall in investment in Australia, if correct, points to a dramatic shift in investment strategy by Chinese investors. Any such shift would most likely be linked to the uncertainty in the application of Australian policy. Drysdale and Findlay (2009) argued that ‘additional requirements’ on resources projects, which were originally introduced in 2008 and which led to the rejection of some projects, created greater ‘uncertainty about the treatment of Chinese FDI in the resources sector [which] is, at the margin, likely to damage the potential growth of the sector and Australia’s full and effective participation in the benefits from Chinese economic growth through the growth of its market for industrial materials’ (p. 378). They argued that these additional considerations were not required; however, these considerations have been retained in a new format in the latest version of the policy, dated January 2011. Government-to-government arrangements for routine consultation between Australian and Chinese authorities to deal with competition policy questions and with issues of corporate governance and financial transparency are preferred (Drysdale and Findlay 2009).

Table 12.2 Chinese investment in Australia by industry, as approved by the Foreign Investment Review Board, 1993–2010 (A\$ million)

Year	Number	Agriculture, forestry and fisheries	Manufacturing	Mineral exploration and resource processing	Real estate	Services and tourism	Total*
1993–94	0	0	0	0	0	0	0
1994–95	927	0	1	42	426	52	522
1995–96	267	0	6	52	137	31	225
1996–97	102	10	3	5	176	17	210
1997–98	0	0	0	0	0	0	0
1998–99	0	0	0	0	0	0	0
1999–2000	259	35	5	450	212	10	720
2000–01	0	0	0	0	0	0	0
2001–02	237	0	47	20	234	10	311
2002–03	0	0	0	0	0	0	0
2003–04	170	0	2	971	121	5	1100
2004–05	206	2	0	39	181	42	264
2005–06	437	0	223	6758	279	0	7259
2006–07	874	15	700	1203	712	11	2640
2007–08	1761	0	0	5448	1491	121	7479
2008–09	57	0	82	26 416	n.a.	59	26 599
2009–10	1766	0	198	12 946	2421	717	16 282

n.a. not applicable * includes financial sector projects

Source: Updated from Drysdale and Findlay (2009) from Department of Treasury (Various years).

People movement

An important feature of the bilateral relationship is the movement of people. In the late nineteenth century, the Chinese were the dominant Asia-born group in Australia, but their share then fell to a low point in the early 1980s (Hugo 2008). By 2006, however, the Chinese once again became the largest Asia-born group, accounting for 1 per cent of the population. Settler arrivals from China since 1950 show a small movement in the 1950s then two decades of virtually no settlement, and then 'spectacular gains' in the mid-1990s following the treatment of students who were granted temporary protection visas in 1989 following the Tiananmen Square protests, which were then converted to permanent residency (Hugo 2008).

In more recent years, there has been another surge in the number of settlers, so that China-born immigrants have risen from a rank of tenth among settlers in the early 1990s to third in 2005–06 (Hugo 2008). Table 12.3 shows Chinese arrivals 'from offshore' have risen from nearly 7000 in 2001–02 to nearly 17 000 in 2009–10 and to nearly 12 per cent of the total of such arrivals.

Settlers arriving from offshore do not provide the only channel for additions to the population. In 2009–10, 33 per cent of permanent additions to the population came from 'onshore' migrants—those who initially come as temporary residents then apply for permanent migration. Table 12.3 also shows onshore arrivals since 2001–02. Arrivals from China via this route have risen from more than 3000 in 2001–02 to nearly 9000 in 2009–10. Their share in total additions from China has fluctuated from 32 to 45 per cent. China accounts for nearly 13 per cent of the total onshore arrivals.

Considering both sources, more than 25 000 people were added to the China-born population in 2009–10, or about 12 per cent of the total. China in that year matched the United Kingdom for the first time as a birthplace of additions to the population; other significant countries of birth were India (more than 23 000) and New Zealand (more than 18 000). Previously, and since 2007–08, arrivals of India-born had exceeded those from China.

In 2009–10, of the total arrivals of 140 610 people in Australia from offshore, nearly 75 per cent came in the migration program, the balance being the humanitarian program and New Zealand citizens. Of those in the migration program, 59 per cent were in the skilled-migrant category and the balance in the family category. The orientation of Australian migration policy has shifted significantly since the skilled migrant share was less than one-quarter in 1995–96 (Hugo 2008). Recent published data are not available for China but Hugo (2008) reports that 60 per cent of migrant arrivals of China-born people in 2003–04 were in the skilled category (not including onshore additions to the population). Hugo also refers to data that show migrants from China are found in the top-three occupational categories in terms of skills (managers and professionals), and notes the extent to which students from China in Australia transfer to permanent residence.

Table 12.3 Permanent additions to Australian population of China-born, 2001–10

Year	Onshore		Offshore arrivals		Total		Onshore as a percentage of total additions
	Number	Percentage of total onshore additions	Number	Percentage of total offshore arrivals	Number	Percentage of total additions	
2001–02	3180	13.4	6708	6.2	9888	7.5	32.2
2002–03	3369	10.5	6664	7.1	10 033	8.0	33.6
2003–04	4532	11.8	8784	7.9	13 316	8.9	34.0
2004–05	4903	11.2	11 095	9.0	15 997	9.6	30.7
2005–06	7403	15.4	10 581	8.0	18 084	10.1	40.9
2006–07	9811	18.9	12 009	8.5	21 820	11.4	44.9
2007–08	8249	14.5	12 959	8.7	21 208	10.3	38.9
2008–09	7889	11.8	15 803	10.0	23 692	10.6	33.3
2009–10	8722	12.8	16 644	11.8	25 366	12.1	34.4

Source: Updated from Hugo (2008) from DIAC (Various years).

Movements to Australia that are not permanent are also significant and of interest. Temporary arrivals could be visitors (tourists, short-stay business visitors and those visiting friends and relatives), temporary residents (including long-stay business visitors, managers, specialists, technical workers, and so on, with length of stay at least three months and up to four years) and students (which presumably includes returning students). Data on these temporary arrivals are shown in Table 12.4.

Table 12.4 Temporary arrivals from China and in total, 2005–10

Year	Origin	Visitors	Temporary residents	Students
2005–06	China	263 811 (7.1)	9105 (2.8)	63 415 (20.5)
	Total	3 730 555	321 631	309 780
2006–07	China	300 235 (7.9)	11 381 (3.1)	73 191 (20.9)
	Total	3 804 735	368 546	350 097
2007–08	China	320 796 (8.7)	13 300 (3.2)	90 908 (22.2)
	Total	3 702 370	420 045	409 136
2008–09	China	290 876 (8.2)	13 174 (2.8)	107 294 (22.1)
	Total	3 534 280	474 827	485 342
2009–10	China	303 920 (8.4)	14 578 (3.1)	128 685 (26.3)
	Total	3 612 606	466 971	489 766

Note: Percentage of the total in parentheses.

Source: DIAC (Various years).

In the five years since 2005, visitor numbers from China have fluctuated by about 300 000, or 8 per cent of the total. In the first part of the decade, however, short-term arrivals from China more than doubled (Hugo 2008:Table 9). The number of temporary residents (which includes longer-stay business visitors) has grown but remained at about 3 per cent of the total; China was ranked at number 11 in this category in 2009–10. China ranks more highly as a country of origin of short-stay business visitors (Hugo 2008).

Students

The arrival of students from China in Australia has doubled in the past five years, and China's share of student arrivals has risen to more than one-quarter. Figure 12.3 shows a longer time series of student arrivals.

Figure 12.3 China-born student arrivals in Australia, 1991–2010

Note: Figures for 2000–01 not available.

Sources: DIAC (Various years); Hugo (2008).

The total number of international students in Australia has increased more than thirteen-fold in this decade (Table 12.5). The China share rose from less than 6 per cent at the start of the decade to 20 per cent by 2005, and China has since retained that share. Hugo (2008) stresses the ‘nexus between Chinese non-permanent migration, especially that of students, and eventual permanent settlement in Australia’. He argues in favour of that route to residency—in the context of the shift in Australian migration policy to a focus on skills—because of the value of the experience of having lived in Australia, the contribution of local education to language skills and the value of the Australian qualification to employers.

Estimates from China show that at the end of 2010 there were 1.27 million students from China living overseas.⁷ Of these, 284 700 ‘new students began their overseas studies’ in 2010, which was a 24 per cent increase from 2009 (‘China: more than 1.2 million Chinese studying abroad’, *University World News*, no. 168, 24 April 2011, <<http://www.universityworldnews.com/article.php?story=20110421200341899>>; Jia 2011; ‘Market data snapshots: People’s Republic of China’, *Australian Education International*, vol. 16, May 2007, <http://www.aei.gov.au/AEI/PublicationsAndResearch/MarketDataSnapshots/MDS_No16_China_pdf.htm>. In 2007, the three leading destinations were the United States (16 per cent), followed closely by the United Kingdom (14 per cent) and Australia (13 per cent).

Table 12.5 Stock of Chinese and international students in Australia, 2000–10 (as of 31 March)

Year	China	Total	Percentage China
2000	7415	130 801	5.7
2001	7420	102 331	8.4
2002	13 565	110 572	12.3
2003	23 991	186 102	12.9
2004	35 576	204 794	17.8
2005	43 367	213 892	20.3
2006	49 831	234 844	21.2
2007	55 550	265 999	20.9
2008	70 106	327 188	21.4
2009	81 567	400 656	20.4
2010	94 310	425 861	22.1

Sources: DIAC (Various years); Hugo (2008).

Factors that might have contributed to the rise in the importance of Chinese students in Australia include the attractiveness of and promotion of Australia compared with competitor countries (particularly the United States after 2001), the scope for onshore migration (since reforms in 1999), the incentives for students to study at ‘regional’ universities since 2005, and the overall increase in outbound student movement from China (Hugo 2008).

A current critical domestic policy issue in Australia is the treatment of international student visas. Migration risk—that is, the risk that people arriving in Australia will not abide by the conditions of their visa—appears to be an important determinant of policy on visas. The concern is that people apparently arriving for one purpose, such as study, might actually have in mind another goal, such as work or settlement. To manage this risk, students are allocated to different risk categories, which are associated with different requirements with respect to visa applications. There are five levels: ‘Assessment Level 1 represents the lowest immigration risk and Assessment Level 5 the highest. The higher the Assessment Level, the greater the evidence an applicant is required to demonstrate to support their claims for the grant of a student visa’ (DIAC n.d.).

Recently some risk levels for Chinese students were reduced from Level 4 to 3; currently the categories for China are English language intensive courses for overseas students (ELICOS), 3; schools—4; vocational education and training (VET)—4; higher education—3; postgraduate research—2; and non-award—3. Research students are regarded as lower risk, which contributes to the scope for research cooperation with Australia. Visas for school students are assessed more stringently, despite some reports that Chinese families are deciding to send their children for international study at an earlier age (Ning 2011).

Further tests are applied to check whether applicants for student visas are ‘genuine’ students, including proof of access to funds for living costs (raised from A\$12 000 to A\$18 000 from January 2010). Also since 2010, there have been changes in the list of preferred occupations for migration and changes in the points test for migration.

While there might be some risks associated with issuing particular visa categories, assessing that risk requires consideration of both the consequence of the occurrence of the events of concern and the consequences of the risk-screening systems put in place. People who come to Australia for training or education might seek to work or settle in Australia. This ‘problem’ has to be weighed against the cost of the implementation of the risk-control measures, which dissuade the movement of all students.

The Knight Review (Government of Australia 2011) is examining student visas. The discussion paper for the review asks questions about the risk-assessment process and also about features of the process that add to the burdens on students applying to Australia, including the length of the application process, demonstrated access to funds and the application charges. In other aspects, Australia appears relatively less restrictive, such as with respect to caps on hours of work.

Dee (2010) has demonstrated how sensitive student flows are to these conditions. Dee finds a significant statistical relationship between the policy regime applying to arriving students and the movement of students. She considers an economy with barriers to the inward movement of students who were at the average of the sample she examines. She finds that if that economy were to liberalise completely, it would attract about two and a half times more students. Dee also finds that the policies affecting commercial presence in the home countries of students who study abroad have significant effects on student movements. She reports that barriers to the inward movement of foreign campuses boost the number of students from the source economy seeking overseas enrolment. Conversely, a source country that is confronted with barriers to the movement of its students could consider reform of its own policy on commercial presence.

There is another link to the distribution of rents in this set of policies. Dee conjectures whether some of the barriers (that act like quantitative restrictions) imposed by exporting countries (those that host international students) also assist the institutions providing these services to charge higher fees. In this way, they can capture any rents available and use that income to cross-subsidise their other activities, including research. A more efficient arrangement is to finance research directly, rather than through cross-subsidies funded by the imposition of an export tax.

Tourists

Tourism is also growing in both directions. Tourism Minister, Nick Sherry, is expecting China to become number one in terms of the number of arrivals and their expenditure within a few years (Sainsbury 2011). China has recently declared itself to be Australia’s most valuable ‘visitor’ market (visitors stay less than one year), with estimated expenditure in 2010 of A\$2.5 billion, growing by 21 per cent in 2010 compared with 2009. The total number in 2010 was 453 800 (24 per cent higher than in 2009), with China accounting for 13 per cent of total spending by visitors.⁸ Chinese ‘visitors’ now also spend more nights in Australia than arrivals from any other country. The United Kingdom is second on the list in terms of visitor nights. The number of individual visitors is, however, higher from New Zealand, the United States and the United Kingdom.

Outbound movements from China have increased nearly three times in the past decade—from 9.2 million in 2000 to 25.8 million in 2009 (Tourism Australia 2010).⁹ Australia's share of this total is about 1.4 per cent, according to Tourism Australia (compared with Australia's share of world arrivals of 0.6 per cent). Australia's share of travel to a defined set of competitors (including Western Europe, the United States, Canada, New Zealand and South Africa) was 11.5 per cent (of total departures of 3.2 million).

A critical policy issue for Australia in this sector is the treatment of air transport services between Australia and China. Australia has committed itself to the 'ultimate objective' of an open-capacity arrangement with China but currently capacity levels are capped. These have increased from 14 500 seats a week in 2010 to 18 500 in March 2011, and 22 500 in February 2012.

A recent agreement on air transport with China allows airlines to offer an extra 2500 seats a week to the major destinations if they also provide stopovers at regional airports. Sandilands (2011) points out that foreign carriers that provide such a service would not be able to pick up local traffic under the restrictive regime in Australia, so the opportunity for an injection of competition into the domestic market is lost. At the same time, this provision also has the effect of taking international-origin passengers away from airlines operating on domestic routes who would otherwise have carried those passengers.

By February 2012, there will be about 1.2 million seats a year in each direction on direct services. It is difficult to estimate the true origin–destination traffic on the Australia–China routes accurately and therefore to compare this with the seats available on direct services, since there are many routes to destinations in China, including via Singapore and Hong Kong. In 2010, however, an estimate based on ABS data of people with Chinese residence arriving in Australia plus Australian residents departing for China was 790 400. This number, compared with the 1.2 million seats available, indicates that there is space for the direct traffic within this capacity. Even so, an open-capacity arrangement remains preferable for two reasons. One is to allow for growth without further requirements for negotiation and the other is because there is the prospect of passengers travelling via China to and from other destinations, which adds to the competition with the regional and global networks.

Sandilands (2011) points out, for example, that China is an important intermediate point and is well positioned for flights to Europe from Australia, or as part of a longer route for traffic from Eastern Europe and Russia into Australia. The latest memorandum of understanding with China allows Australian carriers to serve additional points beyond those in China, making this track to Europe possible. The problem is that the Europeans have to agree to this as well as China, and in the latest negotiations on a European Union–Australia open-skies agreement, the European Union has reportedly asked that restrictions on foreign ownership of Qantas be lifted as part of the deal (Creedy 2011). These issues in the air transport market provide further interesting illustrations of the way that China's growth and Australia's response have exposed flaws in Australian regulatory systems.

Challenges for Australia

Previous sections have identified some specific policy issues that have become more important in Australia as its relationship with China evolves, in relation to taxation, student visas, aviation policy and resource-rent taxation. There is also a series of broader challenges over time, related to the structure of the economy. These are the ‘now’ challenge, the ‘end of the boom’ challenge and the ‘new opportunities’ challenge.

The ‘now’ challenge relates to the response to increases in the price of minerals and energy in world markets, which have translated into higher prices for those items in Australia and hence in incomes, also creating strong pressure for resource reallocation. With a flexible exchange rate, the response is a real appreciation of the Australian dollar. Other traded goods sectors shrink while the non-traded goods sector expands in response to higher demand following the rise in income.

This adjustment occurs at relatively low cost because of the use of the exchange rate mechanism (an alternative would have been inflation). That cost would, however, be even lower if factor markets were more flexible—for example, if relative wages were allowed to change across occupations and if mobility was higher. Continuing reform in Australia can make an important contribution to labour-market flexibility. This is the first part of the ‘now’ challenge. Included in this portfolio is the management of migration, including from China, and its links to students enrolments.

Some (but not all) of the effects of higher prices for resources could be quarantined if some of the rise in income was captured through taxation and consolidation into a sovereign wealth fund—a portion of which might be invested offshore. So far that is not happening, although households and governments seem to be saving a bit more now than in the previous decade. As Stevens (2011) points out, allowing ‘a good deal of the income growth to flow into saving’ already seems to be happening at the household and firm levels.

Meanwhile, tradable sectors open to world markets are forced to adjust, and the costs of that adjustment are significant. Those open sectors will incur fewer adjustment costs if they can raise their productivity growth; they could continue to release factors of production to the sectors where output is growing but still have the chance to continue in business in the long run. This requires new technology and new ways of doing things. These responses at the firm level are the second part of the ‘now’ challenge.

The debate in Australia on finding new sources of productivity growth has recently been much more vigorous—this is especially important to sectors under pressure to adjust to the boom, including other export but non-resource sectors such as education and tourism. The recently released Gillard Government *Trade Policy Statement* has a large section on the ‘patchwork economy’ and a discussion of why an economic reform program to restart economic growth is ‘essential’. Making the adjustments that contribute to productivity growth will also be easier now in the time of boom conditions than otherwise.

Policy and institutional reforms are therefore important responses in Australia to the Chinese resources boom even in the short term.

In the longer term, the question is on the supply side, and the response of producers of the resources that China demands. According to newspaper reports (FitzGerald 2011), Goldman Sachs recently predicted price falls in iron ore from US\$170 a tonne to US\$80 tonne by 2015. This presumably relates to the fact that, over time, higher world prices have led to the entry of new firms into those booming industries. There are, in the case of many minerals, alternative suppliers. Their entry causes world prices to fall again—maybe even back to their original level. Australian firms might continue to supply, as many would remain competitive at the lower prices—that is, they are not the marginal suppliers. But the sector will stop growing and will stop pulling in factors from other sectors.

Income will also drop back a bit, since the rent component is lower. The adjustment in spending patterns is associated with a real (and nominal) depreciation with a flexible exchange rate. There is subsequently a reallocation of resources from non-traded sectors back to traded sectors (other than minerals and energy).

In this second-round adjustment, the sectors previously squeezed might recover somewhat. But the initial squeeze and its reversal could be very costly unless: 1) it is anticipated; and 2) the costs of adjustment in both directions can be reduced. This is the 'end of the boom' challenge. Stevens (2011) comments further on this longer-run story. He points out that lowering the cost of responding to the possibility of a reversal of the current patterns of structural change requires the maintenance of flexibility and the ability to adapt in the economy. This perspective reinforces the value of adopting a productivity-growth promoting reform agenda in the short term.

The third challenge is that of taking advantage of the new opportunities. Their origin is in structural changes in China, which are discussed by Zhang (2011) in his review of the Twelfth Five-Year Plan. Zhang argues that the new plan implies a new development model for China. He observes that for some time there have been calls for China to shift from a GDP and export-oriented model of development to one that is more focused on wellbeing at home and with less environmental impact. He argues that these calls now have greater urgency because of the risks and imbalances that are emerging. The Twelfth Plan calls for a higher consumption share of output, a higher services share of output,¹⁰ reductions in consumption of water and energy per unit of output, reductions in carbon emissions and greater non-fossil fuel consumption, better management of social services, regulation of monopolies and 'improved government efficiency and credibility'. Changes in these directions are not likely to retard the urbanisation process, or the industrialisation in western regions that is driving much of the resources demand. But they do offer new opportunities for Australian business, particularly in the services sector, where Zhang reports opportunities in medicine, education, finance and banking, but also with respect to government institution building—their design, implementation and operation. Australian business will benefit from an understanding of the forces for change in China and also the policy environment in which these new business opportunities arise, particularly the regulatory systems applying in the services sector.

The rules of the international trading and investment systems provide a framework in which these opportunities might be grasped. An element of that framework is the free-trade agreement (FTA) that has been negotiated with China since 2005. The report on the fifteenth round of negotiations is dated July 2010 and the published summary of those

discussions indicates the work that remains to be done. The focus of the negotiations is not clearly connected with the likely changes in the structures of the Chinese economy and the opportunities they might create. Nor is it clear that the negotiations are responding to the regulatory issues identified here and highlighted in the new dimensions in the economic relationship with China—namely, the regulation of FDI, visas for students and capacity on air transport routes.

In the recent trade policy statement, the remark on the FTA with China was that there was an impasse. Proposals to ‘unlock the negotiations’ were to be discussed when the two trade ministers met for the annual Joint Ministerial Economic Commission in mid-April 2011.

Explanations of the lack of progress are many and they include the difficulty of dealing with sensitive sectors in a bilateral agreement. An alternative approach is suggested by the following perspective on international commitments. Hoekman has argued,¹¹ in commentary on the World Trade Organisation (WTO) rather than FTAs in particular, that what matters is trade costs—lowering trade costs helps firms enter new markets and create new products: ‘[e]xpansion along the so-called extensive margin is an important mechanism through which trade supports higher economic growth.’

Hoekman argues that rules and trade policy bindings that reduce uncertainty and thus expected costs might be ‘more important to the investment decisions of firms and the welfare effects of trade agreements than a marginal reduction in the applied tariff affecting an existing trade flow’. He argues for action that squeezes out ‘water’, or the gap to actual policy, from existing commitments, extends services commitments, and lowers trade costs.

These arguments point to the value of a new focus in discussion with China on the trading system; the results of that discussion might be documented in a bilateral arrangement but it would be one that, by the nature of the commitments, could be applied to all trading partners and that could provide some groundbreaking material for WTO processes at the same time.

Conclusions

Australia has benefited substantially from the growth of the Chinese economy at this stage of China’s development. China has become Australia’s most important trading partner and has been an important driver of the growth of Australian resources exports. Its own competitiveness in manufactured products has provided low-cost imported goods for Australia and contributed further to the improvement in Australia’s terms of trade.

These shifts are associated with three significant challenges for Australia. They have also exposed flaws in Australia’s regulatory arrangements. Australia has so far responded in a slow and clumsy way to this situation.

The ‘now’ challenge for Australia is to manage the adjustment to the shift in minerals prices in the short term at lower cost. Contributors include reforms to add flexibility in the economy and to contribute to productivity growth in the sectors being squeezed. The more immediate policy response was not focused so much on these questions—although the

intensity of that debate has recently increased—but on taxation. There was a reconsideration of the ways in which the resources sectors were taxed. This led to a series of policy changes and, eventually, after considerable political turmoil, to a new system in which it is still not clear whether the fundamental problems of the preceding royalty arrangements have been resolved.

At the same time, the scope of the Australia–China relationship is shifting, including larger volumes of movements of both people and capital. This evolution has highlighted further areas for reform in the Australian economy, which relate to impediments to those movements. Foreign direct investment policy, policy on visas for visitors and especially for students, and policy on the allocation of capacity on air transport routes should be on the agenda for attention. To some extent, like the taxation debate, these too are related to the efforts to capture and redistribute the rents that Chinese growth has offered.

While minerals prices are currently relatively high, there is in the longer term the prospect of lower resources prices and the reversal of the current directions of pressure for adjustment. Accommodating this shift is the second challenge—that of the end of the boom. Responding to this challenge reinforces the case for economic reform in the short term.

At the same time, the structure of the Chinese economy is shifting and offers the scope for a series of new business opportunities for Australia. The extent to which they can be captured, in services, for example, depends in part of the features of the trading system that links the two economies. Negotiations on an FTA are attempting to shift that system but so far with little progress. A new focus—on likely structural changes in China and the prospects they offer and on current issues in regulatory systems in Australia—might provide new avenues of discussion. This could not only create mutual benefit but also lead to valuable contributions to the design of global arrangements.

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Endnotes

1. Thanks to David Kai Du for help with the data for this chapter and to Kym Anderson for discussion of some of the contents. Any errors are the author's.
2. The Pacific Economic Cooperation Council (PECC) report on the State of the Region 2010–11 expects China to grow at 9.5 per cent in 2011 and 2012 compared with 10.5 per cent in 2010 (PECC 2010). Respondents, in an opinion leader survey in that report, to the question of growth in China over the next 12 months compared with the past 12 were 46 per cent expecting stronger to much stronger growth and only 19 per cent expecting weaker to much weaker growth.
3. Food prices have also been rising since the early part of this century. This increase is a reversal of the trend of falling prices that was observed since the 1970s.
4. See Ergas et al. (2010) for an assessment of the new tax and Pincus (2011) for a summary.

5. See <<https://zephyr2.bvdep.com/version-201138/Home.serv?product=zephyrneo>> Another data source is the *Mayne Report*: see 'Every project that has Chinese investment', *Mayne Report*, 23 June 2010, <<http://www.maynereport.com/articles/2009/09/09-1244-6609.html>> Work was done to cross-check the *Mayne* list with the *Zephyr* list, which found two deals on each list not on the other.
6. According to UNCTAD data, FDI outflows from China rose to US\$68 billion in 2010 from US\$56.5 billion in 2009, and M&A activity increased from US\$21.5 billion to US\$29.2 billion.
7. UNESCO estimates the ratio of students abroad to total tertiary enrolments in China as 1.7 per cent.
8. Sometimes these visitor data are referred to as tourism data; however, this definition of visitors includes those in Australia for education and for business.
9. The World Bank indicators show a much higher number for outbound travel but the Tourism Australia data include only trips in which at least one night is spent outside China. Day trips to Hong Kong, for example, are excluded.
10. Official data on the output of services might understate its size, since many informal activities might not be counted.
11. See Hoekman's statement at: <cuts-tradeforum@googlegroups.com> (5 April).