

# FINANCIAL REVIEW

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International relations Emphasis on trade with the US highlights the tensions between Australia's economic interests and national security, writes Christopher Joye.

When the Foreign Minister, Julie Bishop, boldly told AFR Weekend that Australia's "best economic friend" was "undeniably the US" and, pointedly, not our biggest trading partner, **China**, the stark rank-ordering of relations sent another shock wave through Beijing.

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It was especially difficult for **Chinese** officials to stomach after Prime Minister Tony Abbott had declared that its arch-rival, Japan, which is a smaller trading partner and makes nothing like **China's** contribution to Australia's immigration intake, was actually Australia's "best friend in Asia".

Many economists, policymakers and academics have assumed that because the value of exports and imports flowing between Australia and **China** swamps all other states, the world's most populated country is naturally our "most important" economic ally.

The emphasis on trade has accentuated an emerging debate about tensions between Australia's economic interests, presumed to rest with **China**, and our national security, which largely relies on the goodwill of America—via the ANZUS alliance—given Australia has no nuclear deterrence capability and has, in the view of some US officials, chosen to "free-ride" off their taxpayers' far higher per capita defence expenditure.

In the week since Bishop's comments, AFR Weekend has asked top analysts whether they agree with her approach of accounting for both trade and investment, and publicly signalling a hierarchy which puts the US at the top.

HSBC's chief economist, Paul Bloxham, says "both trading and investment linkages with other nations are welfare-enhancing".

"Trade allows economies to focus on their comparative advantage in terms of production. Borrowing and lending to the rest of the world allows investment in growth opportunities that might otherwise not be funded due to lack of savings.

"Without strong trading relations with Asia, Australia may not have had access to cheap manufactured goods which have undoubtedly lifted our living standards. Without strong financial relationships with the West, Australia would not have had as much investment in the **mining** sector, which is now boosting our incomes."

Factoring in trade and investment, as Bishop did, presents a striking contrast to the conventional method. Analysis by AFR Weekend shows that while **China** is undoubtedly Australia's top trading partner, it sits fourth behind the US, UK and Japan once you recognise investment. Disparity in investment

While Australia invests \$434 **billion** into the US, both directly and via superannuation, we are investing only 9 per cent, or \$20 **billion**, into the comparatively closed **Chinese** economy, which has historically posed rule of law and property right challenges for foreign business.

Americans are responsible for \$618 **billion** of investment into Australia. In contrast, the **Chinese** have allocated just \$23 **billion** here. Other major funders of the debt and **equity** used by Australia's private and public sector enterprises include the UK (\$496 **billion**) and Japan (\$126 **billion**).

Catherine Tanna, a Reserve Bank of Australia board member and chairman of gas **company** BG Australia, says the US is crucial to developing Australia's emerging gas industry.

"The US and their companies have contributed a great deal to the technical capability of the industry in Queensland," Ms Tanna says.

BG, a British **company**, is investing more than \$20 **billion** in LNG projects in Queensland, including a joint venture with US **energy** giant ConocoPhillips, which has multiple investments in the state.

Yet analysts say that crudely summing, dollar-for-dollar, the "flow" of trade with the "stock" of investment is misleading. There is a difficult-to-disentangle duality between the activities, which makes differentiating between Australia's interactions with **China** and the US awfully hard. **Chinese** demand drives growth

"**Chinese** demand, particularly for our commodity exports, has been the biggest factor that has driven Australia's continued economic growth through and since the GFC," says Monash University's Stephen King.

"But we can only produce these exports with foreign investment in mines, railways, ports, processing plants, and so on. And that investment comes from the US and, to a lesser extent, the UK. So both are required for long-term prosperity in Australia and we cannot have one without the other."

UBS's chief economist, Scott Haslem, concurs. "It's not clear to me that it's beneficial to try to distinguish between whether the US or **China** should be considered Australia's 'most significant economic relationship'," he says. "Both countries are at the top of such a list, if there was one."

"**China**'s dominant trade position is embodied in the fact that they take about one-third of all our exports—the most of any country—and likely set the price of three-quarters of our goods exports, while the US plays a much more significant role in inbound investment and is the largest economy in the world."

Haslem highlights that movements in US **equity** and bond markets, and the US Federal Reserve's policy decisions, which exert tremendous influence over the global price of money, are also the biggest external drivers of Australian asset prices.

"But **China**'s impact in this area has intensified over recent years, as we see from current market jitters around rising leverage and non-performing loan risks in its financial system," he says.

Westpac's **China** watcher, Huw McKay, agrees that "the US dominates pricing and sentiment in **equity** and bond markets". He notes, however, that "monetary policy in the US impacts this pricing directly in real time, whereas **China** affects Australia's pricing indirectly and with a lag through its impact on their demand for our resources". **China** trumps US

McKay says he weights "**China**'s real economy impact far higher, as fundamentals will assert their influence on asset prices over time". And he thinks that while "**China**'s financial footprint is tiny relative to its real economic footprint", this will "change as it liberalises its capital account and it gravitates towards more natural shares in financial transactions globally".

One economist who definitely disagrees with Bishop's rank-ordering is Barclays' Kieran Davies. "The US has important financial links with Australia, but **China** trumps the US as the most significant economic relationship for Australia," he claims.

"The rapid industrialisation of **China** and associated lift in living standards has underpinned the largest and longest commodities boom in Australia's history, providing an unprecedented boost to Australia's income."

"Some of this windfall is cyclical and the best of the boom is well behind us, but **China**'s transformation has led to a structural rise in commodity prices that will continue to benefit Australia for many years."

Combined with **China**'s role as the leading global manufacturer, which has kept a lid on consumer prices, Davies says this "makes **China**'s policy settings hugely important to Australia, as the management of its economy will be a major influence on our medium-term outlook".

There is no unanimity on how Australia's ties with each nation might evolve over time.

UBS's Haslem believes that while "it's easy to think **China**'s 'influence' could grow, there is just as much chance that the US's influence will grow faster, through its ability to better utilise advances in 3D manufacturing and cloud technology in an environment of lower (shale-induced) **energy** prices".

Professor King predicts that Australia's "current 'export dependence' on **China** will fade in the next decade". "This basically reflects that I do not believe **China** can keep growing for another 10 to 15 years at its current pace. So **China** will still be a key Asian trading partner, but I would expect other countries –possibly India and African nations–to emerge."

On the other hand, HSBC's Bloxham sees "Australia's economic relationship with **China** growing much larger over coming years".

"This is already set in train for the next five years, as new capacity comes on line in the resources sector to meet **Chinese** demand. But Australia's links to **China** are also expected to broaden, with strong demand for tourism and education services, as well as agricultural products, as **China**'s middle class incomes rise."

Missing from this analysis is the fact that ongoing trade with **China** is predicated on a stable national security environment. Financial market commentators frequently take security as an exogenous given, when history suggests that major power conflict is a constant. If security is a condition precedent for prosperity, then there is a case that Australia's indivisible economic and defence nexus with the US supersedes all others.

Bishop was right to point out the hazards of trade-based judgments of Australia's relations and the need to acknowledge investment. Singling out America as our "best economic friend" is nevertheless a more contentious claim that only stacks up by simplistically imputing equality between the trade and investment data. It is easier to embrace if one thinks security enables trade and investment.

with John Kehoe

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