

China rising

Comments delivered at the WPO event 'China: the hungry dragon'
20 October 2005
The Apparel Group, Sydney

Mark Thirlwell
Lowy Institute for International Policy

I'm lucky enough to be director of the international economy program at the Lowy Institute and one of the key functions of my program is to identify, monitor and analyse key trends in the international economic environment within which Australian businesses and Australian policymakers operate. China's economic emergence is not only one of these trends; it is clearly one of the most important.

Although, strictly speaking, what we are seeing today is not so much China's economic *emergence* as its *re-emergence*: China probably used to account for around one-third of the world economy in 1820 and – provided that the economy continues on its current course (a key assumption) – then we look to be headed back to a China-centric world.

Indeed, we're already on the way. China's *current* importance to the world economy can be established by a few facts:

- Last year, China was the world's second largest economy when world output is measured on a purchasing power parity basis, and accounted for around one-quarter of world growth.
- In 2004, China also accounted for around 6½% of world merchandise exports and 6% of world imports, making it the third largest trading economy in the world. It was also the *largest* contributor to the growth in world trade.
- In the same year, China was the world's second largest recipient of foreign direct investment, the holder of the second largest stock of foreign exchange reserves, and the second largest overseas holder of US government securities.

Of course, as anyone who has ever read a financial statement disclaimer knows, there are dangers in relying too much on straight-line forecasts based on past performance, and the policy challenges still facing Beijing remain substantial and should not be downplayed. But I think that the reasonable base case scenario (and other scenarios *are* possible) is one in which the Chinese economy continues to become an even more important driver of the international environment in coming years.

What does this mean for the world economy? One way to think about this question is to draw on historical parallels.

Perhaps the most obvious of these is the meteoric rise of another East Asian economy – Japan – in the second half of the previous century. For example, the evolution of China's share of world exports since 1980 looks quite similar to the profile displayed by Japan after 1950: China's share of world export markets today is roughly the same as that of Japan in the mid-1970s.

But there are at least two big differences between these experiences.

- First, by the mid-1970s Japan's labour force was roughly half that of the United States in size. In contrast, China's labour force last year was more than five times larger than the US labour force.
- Second, in the mid-1970s Japan's income per head was roughly two-thirds that of the US level (measured on a purchasing power basis). China's income per capita last year was less than 15% of the US level.

These two big quantitative differences imply that China's *potential* for reshaping the world economy is significantly greater than that of Japan. And of course Japan's rise was itself something that compelled a fairly large degree of adjustment in the world economy.

In fact, perhaps a closer historical parallel will turn out to be the rise of the US economy in the nineteenth century. Ultimately, that process culminated in a fundamental transformation of both the prevailing international economic and political structures. Accommodating a new economic superpower requires both economic *and* political adjustment.

China's rise is likely to have similar implications, influencing the structure and composition of trade flows, the international division of labour, the makeup of international economic institutions, and the global geo-strategic balance.

Turning back to the present, China's impact *today* is probably most apparent in global goods markets, through its participation in international trade. (China's role in financial markets is also becoming steadily more important, as was evident all of the attention paid to Beijing's exchange rate policy, for example.)

In terms of world trade, we can think of China's emergence in terms of positive supply and demand shocks.

The **supply** shock comes from the power of China's export machine: according to WTO statistics, by 2003 China accounted for more than 7% of world manufactured exports, including 23% of world clothing exports, 16% of world textile exports, and about 13% of world exports of office machines and telecommunications equipment.

The **demand** shock comes from China's rising industrialisation and urbanisation, which in turn are feeding a growing demand for resources and energy. Last year, for example, China is estimated to have accounted for half of the growth in worldwide demand for metals, and more than one-third of the global growth in oil consumption.

The combined effect of these two shocks is to change world relative prices: the supply shock places downward pressure on some prices, while the demand shock places upward pressure on others. This is good news for some and less welcome for others, depending on the export and import mix of particular economies.

Moreover, China represents a supply (and a demand) shock in markets other than the goods market. For example, at a global level, China also represents a significant labour market supply shock (particularly for lower skilled labour), while in the market for intellectual property, for example, China looks more like a demand shock.

Again, there will be winners and losers from these changes.

For example, one obvious set of 'winners' from China's economic rise to date have been resource-rich economies, while potential losers are sectors in those economies that compete with China in the production and export of labour-intensive manufactures. Other 'winners' include consumers of the products China exports – both firms and households – and producers of skills and services that are in demand in a rapidly growing economy.

The good news for us is that when it comes to economies, Australia is one of the winners. In fact, because of our particular mix of exports and imports, the China-induced relative price shock is particularly evident in our terms of trade, the ratio of our export to import prices. In recent years this ratio has risen faster, and reached a higher level, than at any time for more than 30 years (since the commodity boom in the early 1970s). According to the Reserve Bank of Australia, the effect has been to boost our real income by about 1½ percentage points of GDP in each of the past two years.

We are likely to continue to see this benefit in the future, as China continues to industrialise, urbanise, and become wealthier. This should imply continued demand not just for resources and some rural sector products, but also demand for services and higher-end manufacturing as well.

This in turn implies continued economic integration between the two economies. In 2004-05 China became Australia's second largest (merchandise) trading partner, the destination for 10% of our exports, and the source of 13% of our imports, with a total of A\$32.8b of bilateral trade. China was also our sixth largest export market for services (A\$1.3b). In all, more than 3,000 Australian companies now export to China. True, the bilateral investment relationship is currently much smaller, but this too seems likely to grow.

In other words, just as the Australian economy surfed the development wave of Korea and Japan in the second half of the previous century, so can we look forward to surfing the development wave of China in the first half of the current century. It should make for an interesting ride.