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Australia - China Relations Institute 澳大利亚-中国关系研究院

Who is Australia's most important economic partner?: The case for China

James Laurenceson

August 29 2017



This article appeared in The United States Studies Centre's *Debate Papers* series on August 29 2017.

Ask the average Australian whether China or the US is Australia's most important economic partner and you'll likely get a bewildered look – it's China, of course.

By 2013, 76 percent of Australians were already convinced that China was number one, compared with just 16 percent choosing the US.¹ Public opinion reflects China's enormous contribution to Australia's trade and higher incomes. In 2011, then Governor of the Reserve Bank of Australia (RBA), Glenn Stevens remarked:²

The proverbial pet-shop galah can by now recite the facts on Australia's trade with China and our terms of trade, which are at a level not seen in over a century.

The last time Australia had a bilateral trade relationship as significant as its one with China now was back in 1952-53 with the UK.³ Such is the scale of trade that financial markets have long been of the view that the Australian dollar is one of the best proxies for bets on China itself.⁴

Over the past 12 months China snapped up Australian goods worth \$95 billion, a record high, and eight times more than that bought by the US.⁵ Goods imported from China totalled \$61 billion, more than double that from the US. And what has become apparent more recently is China's voracious demand for Australian services, worth \$11.3 billion in 2016, although the US continues to be a much bigger source of services imports.

- 1 Alex Oliver, *The Lowy Institute Poll – 2017*, Lowy Institute for International Policy, Sydney, 2017 <<https://www.lowyinstitute.org/sites/default/files/documents/lowy-2017-pollreport-web.pdf>, June 2017>.
- 2 Glenn Stevens, Economic conditions and prospects – address to the Economics Society of Australia (Queensland) 2011 Business Luncheon, June 15 2011 <<http://www.rba.gov.au/speeches/2011/sp-gov-150611.html>>.
- 3 Mark Thirlwell, How dependent are Australia's exports on China?, Austrade, February 2015 <<https://www.austrade.gov.au/News/Economics-at-Austrade/how-dependent-are-australian-exports-on-china>>.
- 4 James Mackintosh, 'The Aussie/dollar rate as a proxy for bets on China', *FT.com*, June 15 2017.
- 5 Australian Bureau of Statistics, International Trade in Goods and Services, Australia, June 2017, August 3 2017 <<http://stat.data.abs.gov.au/>>.

The net result is that while the US delivers Australia its largest bilateral trade deficit, \$23 billion in 2016, China is responsible for its largest surplus, \$31 billion.⁶ Most economists regard bilateral trade balances as inconsequential. But Chinese fondness for everything from Barossa Valley wine, sight-seeing on the Great Barrier Reef to studying at the University of Western Australia likely helps to explain why more Australians hold a favourable view of increased trade with China than the US.⁷

Public perceptions around the value of the US economic relationship have further suffered from empirical evidence that Australia is worse off as a result of the Australia-US Free Trade Agreement.⁸ Also not helping are the aggressive tax minimisation strategies pursued by some giant US multinationals,⁹ along with the US government's refusal to join Australia, China and 69 other countries in signing a new multilateral convention to close international tax loopholes.¹⁰

The fact that in the 2016 presidential election campaign both Donald Trump and Hillary Clinton supported a withdrawal from the Trans-Pacific Partnership raised fresh doubts about whether the US still shares Australia's commitment to advancing multilateral rules-based trade. That the Trump Administration now appears willing to use domestic legislation to pursue trade retaliation rather than the World Trade Organization's dispute resolution mechanism only adds to these fears.¹¹

Yet despite all this, some commentators conclude that the Australian public have it wrong. Niels Marquardt, the CEO of the American Chamber of Commerce (AmCham) in Australia has claimed:¹²

No other nation looms as large as America when the total economic relationship with Australia is considered...Public opinion typically undervalues the critical role investment plays in creating prosperity and raising living standards.

Australia's Foreign Minister Julie Bishop has taken up this idea and constructed a metric of relative economic importance. If the stock of investment is added to flows of trade, then the US comes out on top:¹³

...the United States remains our single most important economic partner. When you combine two-way trade and investments, it stands at over \$1 trillion.

James Carouso, the chargé d'Affaires and the current head of the US Embassy in Australia has touted the same metric:¹⁴

...the US is Australia's leading economic partner; our bilateral economic engagement is at \$1.9 trillion and growing.

Researchers at US focused think-tanks in Australia such as the Perth USAsia Centre and the United States Studies Centre (USSC) have also been prominent in contesting the assessment that China is

6 Department of Foreign Affairs and Trade, Australia's direction of goods & services trade – calendar year (from 1987 to present), August 2017 <<http://dfat.gov.au/trade/resources/trade-statistics/pages/trade-time-series-data.aspx>>.

7 United States Studies Centre (USSC), *Survey on America's role in the Indo-Pacific 2017*, USSC, Sydney, May 2017 <<https://www.ussc.edu.au/analysis/the-asian-research-network-survey-on-americas-role-in-the-indo-pacific>>.

8 Shiro Armstrong, 'The costs of Australia's 'free trade' agreement with America', *East Asia Forum*, February 8 2015.

9 Adam Creighton, 'Technology giants pay 1% tax', *The Weekend Australian*, May 20 2017.

10 Miranda Stewart, 'New tax treaty will close loopholes that allow multinationals to avoid tax', *The Conversation*, June 13 2017.

11 Shawn Donnan, 'Trump administration triggers trade investigation of Chinese intellectual property theft', *Australian Financial Review*, August 20 2017.

12 Niels Marquardt, 'America and Australia: economic ties as strong and important as security ties', *The Strategist*, August 14 2014.

13 Julie Bishop, 'US-Australia: the alliance in an emerging Asia', January 22 2014 <http://foreignminister.gov.au/speeches/Pages/2014/jb_sp_140122.aspx?ministerid=4>.

14 James Carouso, 'US-Australia relationship as essential and vibrant as any time', *The Australian*, June 3 2017.

the undisputed number one.¹⁵ Aside from the scale and technology benefits of American investment, another figure highlighted in a new USSC report is the sales of Australian companies in the US:¹⁶

Australia exports to the United States in 2016 were worth \$US9.5 billion – a fraction of the \$US60.6 billion that Australian-owned companies in the US made in sales in the same timeframe.

In other words, the sum of Australian exports to the US and the sales of Australian companies in the US stands at around \$US70 billion. This is not far off the value of Australian exports to China.

One motivation for pushing back against the view that China is Australia's most important economic partner is provided by AmCham's Niels Marquardt:¹⁷

...a recent United States Studies Centre (USSC) survey determined that Australians prefer increased trade with China more than increased trade with the United States. Our concern is that public perceptions such as these can lead to perverse impacts on policy formulation.

Exactly what these perverse impacts might be is not clear. That the US runs a massive trade surplus with Australia has already been noted. And on investment, Australia's policies are indeed discriminatory but they are discriminatory in favour of the US. For example, a privately-owned American company can buy parcels of agricultural land in Australia each worth up to \$1.1 billion without ever needing the Commonwealth Treasurer's approval. For Chinese companies the approvals threshold is cumulative and set at a mere \$15 million.¹⁸

Some also appear anxious that public opinion might influence Australian foreign policy in undesirable ways. Rory Medcalf, Head of the National Security College at the Australian National University warns:¹⁹

The risk is that Australians will buy the story that their economy is so comprehensively dependent on China that Australia cannot afford to cause China much difficulty on security and political issues, even when our interests diverge.

The argument follows that if the general public could be persuaded the US is Australia's most important economic partner as well as its security ally, then the political environment for pushing back against those advocating for a foreign policy that exercises "greater independence within or at times without the alliance"²⁰ would become easier.

But some of the metrics used to elevate the status of Australia's economic relationship with the US struggle for rigour.

Yes, the *stock* of two-way investment between the US and Australia now stands at just shy of \$1.5 trillion.²¹ But this is a sum that has taken many decades to accumulate. Accordingly, it can hardly be

15 Kim Beazley and Ian Satchwell, 'Our economic relationship with the US is both deep and wide', *Australian Financial Review*, March 13 2017; Richard Holden, Simon Jackman, Jared Mondschein, 'By the numbers: how the US is Australia's indispensable trading partner', *Australian Financial Review*, May 3 2017; Richard Holden and Jared Mondschein, 'Why the United States is Australia's indispensable economic partner', *Australian Financial Review*, August 14 2017; Simon Jackman, 'There is no substitute for US-Australia economic mateship, not even China', *Australian Financial Review*, August 21 2017.

16 United States Studies Centre, *Indispensable economic partners: the US-Australia investment relationship*, United States Studies Centre, Sydney, August 2017 <<https://www.usssc.edu.au/analysis/indispensable-economic-partners-the-us-australia-investment-relationship>>.

17 Niels Marquardt, 'From the American Chamber of Commerce' in United States Studies Centre, *Indispensable economic partners: the US-Australia investment relationship*, United States Studies Centre, Sydney, August 2017 <<https://www.usssc.edu.au/analysis/indispensable-economic-partners-the-us-australia-investment-relationship>>.

18 Foreign Investment Review Board, Monetary Thresholds, 2017 <<http://firb.gov.au/exemption-thresholds/monetary-thresholds>>.

19 Rory Medcalf, 'China doesn't hold the economic leverage over Australia that most people think', *Australian Financial Review*, March 27 2017.

20 James Curran, 'Fighting with America: why Washington needs a more discerning ally', *The Interpreter*, December 9 2017.

21 Australian Bureau of Statistics, International Investment Position, Australia: Supplementary Statistics, 2016, May 10 2017 <<http://www.abs.gov.au/ausstats/abs@.nsf/mf/5352.0>>.

compared to *flows* of trade that occur in a single year. Australian National University economist, Shiro Armstrong points to a more sensible measure of relative economic importance:²²

The correct way to construct a measure that included investment would be to add investment flows to trade flows as well as to take into account the whole range of other economic interdependencies (like migration) in gauging a partner's economic importance.

In 2016, trade and investment *flows* with China stood at \$178 billion. Those with the US were not only less than with China, they were less than zero, -\$27 billion. As usual, trade with China last year towered above that with the US. But American investors also pulled \$66 billion more out of Australia than they put in, while Australian investors dialled back their US asset holdings by \$25 billion.

The last time the US outperformed China on combined trade and investment flows with Australia was back in 2011.

And while the sales of Australian companies in the US might sound similar to Australian exports to the US, their impacts are very different. Australian companies in the US employ American workers and pay taxes to the US government. The benefits to Australia are limited to the flow of any repatriated profits and dividends, a small fraction of their \$US60.6 billion in US sales. In contrast, the \$106 billion that China pays for Australian goods and services feeds directly into the pockets of Australian households, as well as the coffers of state and federal governments.

We could replace one but not the other

Another key distinction between the two economic relationships is that there are often substitutes for US investment but not Chinese demand.

Many of Australia's biggest corporations regularly head to New York to raise capital. But London, Brussels, Tokyo, Hong Kong and Singapore would all welcome increased Australian business. The liquidity and breadth of US financial markets may make them the most convenient option. But that is a very different to them being indispensable.

The idea that US direct investment is indispensable is also dubious. True, the US stock of direct investment in Australia now stands at \$195 billion. But that compares with a total net capital stock in Australia of \$5.5 trillion.²³

Last year, in one prominent case of American direct investment in Australia, US fund manager Global Infrastructure Partners took a 40 percent stake in Australia's busiest port, The Port of Melbourne. But half of its contribution was actually sourced from China's sovereign wealth fund, China Investment Corporation.²⁴ And then there were the rival consortiums that included bidders from other countries that ultimately lost out.

Now consider the predicament if Chinese steel makers no longer needed Australian iron ore. There is no prospect of any other country, or even group of countries, stepping up and absorbing the 650 million tonnes that China currently does.²⁵

²² Shiro Armstrong, 'Embracing China as number one', *East Asia Forum*, March 30 2014.

²³ Australian Bureau of Statistics, Australian System of National Accounts, 2015-16, October 28 2016 <<http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5204.02015-16?OpenDocument>>.

²⁴ Jenny Wiggins, 'Port of Melbourne tops up CIC's local infrastructure, real estate basket', *Australian Financial Review*, September 20 2016.

²⁵ CEIC database <<https://www.ceicdata.com/en>>.

In 2014, then US Secretary of State, Hilary Clinton cautioned Australia not to put all its eggs in the China basket. Then Communications Minister Malcolm Turnbull quipped:²⁶

I'm sure that we'd love to export vast quantities of iron ore to the United States but they've never shown any enthusiasm in buying them.

Such scenarios across the Australian economy help to explain why one recent, independent economic modelling exercise reported the sobering finding that if China's growth rate slowed from the targeted 6.5 percent this year to less than 3 per cent, up to 500,000 Australian jobs could be lost.²⁷

China is where the growth is

China is also Australia's growth market. China's ravenous appetite for Australia's agriculture and services stems from its middle class, which Brookings Institute researcher Homi Kharas finds is on track to expand by an extraordinary 850 million between 2009 and 2030. In contrast, the North American and European middle classes are expected to be stagnant. In terms of global middle class spending, by 2030 China is forecast to account for 22 percent, three times greater than the US share.²⁸ Former Australian Foreign Minister, Bob Carr contends:²⁹

Nothing else on Canberra's agenda – talk about innovation, relations with India or tax cuts for business – competes with that statistic for its potential impact on Australian living standards.

And while there is a way to go, the investment landscape is similarly being transformed. The latest comprehensive survey data from Australian companies shows that over the last three years China has relegated the US to second position both as a direct investment source and an investment destination.³⁰

Simon Jackman, Chief Executive Officer of the USSC, points to robust investment between Australia and the US as stemming from a shared commitment to values such as liberal democracy.³¹ This is part of the story. But the main reason why the stock of Chinese investment in Australia is not larger is because China's financial opening is still in its early stages. China's stock of assets abroad (minus reserve assets) stands at just 30 percent of its GDP.³² The respective figure in the US is 125 percent.³³ On outbound investment, when Australian companies are asked why they targeted the US as their first overseas market, 85 percent cite a "familiar culture / language". Only 40 percent said the same about China.³⁴ The solution here is to invest in building Australia's "Asia capable leaders".³⁵

The growing economic weight of China and many of its neighbours is remaking the strategic balance of the Asia-Pacific region. Australia's relationship with the US will be a valuable asset for both countries in navigating these shifts. At the same time, Australian policy-makers should be clear that some of the

26 Malcolm Turnbull, Crawford School Forum Transcript: 'Global Realities and Domestic Choices', July 2 2014 <<https://www.malcolmturnbull.com.au/media/crawford-school-forum-transcript-global-realities-and-domestic-choices>>.

27 David Uren, 'Slowdown in China would cost 500,000 jobs, warns Deloitte', *The Australian*, April 12 2017.

28 Homi Kharas, *The unprecedented expansion of the global middle class*, Global Economic and Development at Brookings Working Paper 100, February 2017 <https://www.brookings.edu/wp-content/uploads/2017/02/global_20170228_global-middle-class.pdf>.

29 Bob Carr, 'The killer fact about China's middle class', *Sydney Morning Herald*, July 27 2017.

30 *Australian International Business Survey 2016*, Austrade, Sydney, 2017 <<https://www.austrade.gov.au/news/economic-analysis/key-publications/australias-international-business-survey-2016>>.

31 Simon Jackman, 'There is no substitute for US-Australia economic mateship, not even China', *Australian Financial Review*, August 21 2017.

32 State Administration for Foreign Exchange, The time-series data of international investment position of China, June 29 2017 <<http://www.safe.gov.cn/wps/portal/english/Data/Investment>>.

33 Bureau of Economic Analysis, US Net international investment position first quarter 2017, Year 2016, and Annual Update, June 28 2017 <<https://www.bea.gov/newsreleases/international/intinv/2017/intinv117.htm>>.

34 *Australian International Business Survey 2016*, Austrade, Sydney, August 2016 <<https://www.austrade.gov.au/news/economic-analysis/key-publications/australias-international-business-survey-2016>>; Mark Thirlwell, 'AIBS 2016 – a look at our data on investment flows', August 26 2016 <<https://www.austrade.gov.au/news/economic-analysis/aibs-2016-a-look-at-our-data-on-investment-flows>>, 26 August 2016>.

35 PWC, *Match Fit: Shaping Asia capable leaders*, August 2017 <<https://www.pwc.com.au/media-centre/press-releases/match-fit-asia-capable-leadership-aug17.pdf>>.

fiercest competition that our farmers, universities and hotels will face when seeking to sell to China will come from the US. Other countries can also be counted upon to pursue a mostly pragmatic approach in their China relations. Australia is entitled to do likewise. And pursuing Australia's national interest means recognising, as the Australian public already does, that the country's most important economic relationship is now with China.

Read the case for the United States by Jared Mondschein on the United States Studies Centre [website](#).

Professor James Laurenceson is Deputy Director of the Australia-China Relations Institute at the University of Technology Sydney.