CHAPTER 3

Trade in goods and services

KEY MESSAGES

Australia and China are and will remain deeply complementary bilateral trading partners. The bedrock of this trade has been China's demand for Australia's mineral and energy exports. The structural transformation of China's economy implies a structural change in the composition of bilateral trade.

Modelling undertaken for this Report indicates that while Australia will continue to supply China with minerals well into the future, the relative importance of high value-added goods and services in Australia's export basket will increase. This transformation will, by itself, lead to fast growth in trade between Australia and China in real terms, much of it in services. Australian companies can be a source of the high-quality food and health products that Chinese consumers increasingly demand. Even more promising is the expansion of the services trade beyond education and tourism, to services such as healthcare and finance, where Australian experience and expertise can assist with the development of China's own services sector. China, meanwhile, will continue to move up the value chain into higher value-added manufacturing and services.

Even in a pessimistic scenario, in which average Chinese growth is below 5 per cent over the next 10 years, the modelling suggests that Australian exports to China would still grow in real terms by 28 per cent and Chinese exports to Australia would grow by 20 per cent. A 'baseline' scenario has Australian exports growing by 72 per cent and Chinese exports by 41 per cent over the same period. But there will be much stronger outcomes — growth of 120 per cent in Australia's exports and 44 per cent in China's — if the two countries succeed in their ambitions for supply-side structural reform.

- The potential of Australia–China trade will not be realised automatically. Australia does not enjoy the same natural advantage in services as it does in resources. Deeper, broader engagement at all levels of society will be necessary. Domestic regulatory reforms in both China and Australia will be necessary if both countries are to make the most of the opportunities.
- Recognition of professional qualifications, starting with traditional Chinese medicine and engineering, will add new trade potential. One reform that offers large potential gains would be to establish recognition of professional services qualifications from the other jurisdiction. By the end of 2017, the side letter to ChAFTA on skills assessment and licensing is due for review. To help make the most of this review, the Australian and Chinese governments should coordinate engagement between accrediting regulatory bodies.
- E-commerce channels are now providing a channel for Chinese consumers to find niche products and services. Regulators on both sides should cooperate, particularly concerning food and healthcare products, to encourage mutual recognition of standards that allow this trade to be scaled up.
- Reflecting the nature of regional and global supply chains, extending the tariff reductions committed to in ChAFTA through to RCEP negotiations will help sustain China's industrial up-skilling.

- In order to capitalise on demand from Chinese tourists, Australia could consider removing restrictions on domestic aviation services that make international routes to the country less commercially attractive. This would not only have positive direct impacts on the competitiveness of the aviation industry in Australia, but would encourage more flights from China that would boost Australia's tourism industry.
- At the national level, the Strategic Economic Dialogue provides a mechanism alongside ChAFTA for high-level official engagement. The Australia–China State/Provincial Leaders Forum and sister-city relationships provide more local channels for engagement.
- Within the community, the Chinese diaspora in Australia is a valuable agent for building engagement and trust, as are civil society organisations and peak business groups.

Economic prosperity in Australia and China depends on international trade. Trade allows countries to specialise in areas of comparative advantage, encourages them to exploit economies of scale, and obliges them to compete with the best the world has to offer in foreign and domestic markets. By increasing competition, trade boosts productivity, fuels innovation, makes consumers better off through improved choice and lowers input prices for producers.

Australia and China are deeply complementary trading partners. Australia has a large natural resource base relative to its population. Australia therefore specialises in the production of primary goods for export, and uses the proceeds to purchase labour-intensive and other manufactured goods. Conversely, China has a large labour supply, but relative to its population has smaller endowments of natural resources and accumulated capital. For this reason, China's industrial development was built on labour-intensive production, which it exchanges with Australia for imports of scarce resources.

In 2014, Australia and China each imported an equivalent of 21 per cent of their GDP, and exported 20 and 24 per cent respectively (OECD 2016). China is now Australia's largest trading partner. It became Australia's single largest source of goods imports in 2006 (replacing the United States, Figure 3.1A) and the largest market for goods exports in 2009 (replacing Japan, Figure 3.1B). The total value of bilateral trade, including goods and services, was in 2015 A$156 billion (ABS 2015b). In 2009–2010, China overtook the United States as the largest overseas purchaser of Australian services. The value of Australia's services exports to China increased from A$1.1 billion in 2000–2001 to A$8.8 billion in 2014–2015, as China's share of Australia's services exports rose from 3 per cent to 14 per cent (ABS 2016c).

The relationship is naturally asymmetric because of the relative size of the two countries. Australia is only China's seventh-largest import source and 14th-largest export destination (DFAT 2016c). Even though Australia is already an economically developed country, its entire population is roughly the same as that of Shanghai. The Chinese economy inevitably dwarfs Australia in scale, despite its much lower levels of per capita income.

This asymmetry means that even small changes in China's economy can have profound impacts on Australia. By contrast, Australian policy choices or economic performance have little impact on China, which has no shortage of other countries competing to supply its huge domestic market. For this reason, Australia needs to ensure that its policies enable flexible markets that can adapt quickly, allowing domestic businesses to remain competitive in response to changing global circumstances. Waiting for global agreements, or holding out on economic liberalisation as a bilateral negotiating tactic, would mean missed opportunities for Australia.

Australia's role as a low-cost, high-quality and reliable provider of raw materials needed for China's growth makes Australia a much more important trading partner than could be expected based on scale alone. Beyond this, Australia can assist China in its own economic transformation to a services-based economy. This is an area where Australian experience may be helpful. Australia's services sector accounts for more than 70 per cent of its real gross value added (ABS 2016e). Outside of mining, the fastest-growing industries in Australia over the last 25 years have been in knowledge-oriented industries such as information media, telecommunications, finance and professional services. There has also been substantial growth in major services industries such as education and tourism (ABS 2016e).

Australia's merchandise trade by trading partner

Figure 3.1A: Export share

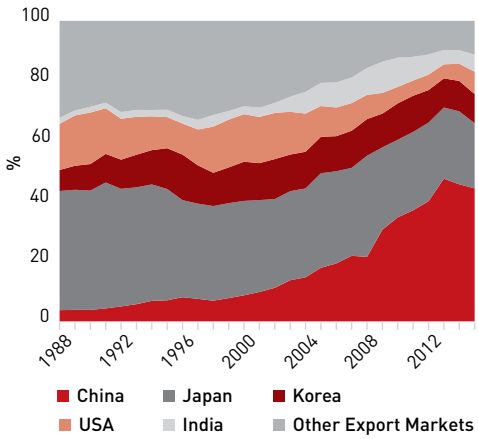
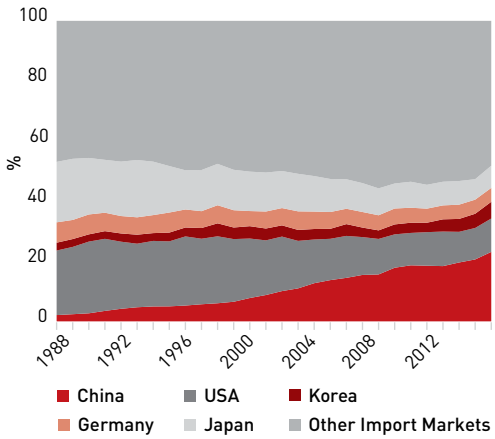


Figure 3.1B: Import share



Source: Calculated from ABS 5368.0 2016a.

ChAFTA, which came into force in December 2015, will lower the costs of bilateral trade across resources, manufacturing and services. But ChAFTA is, in many respects, like opening a door. The opportunities of this open door will not be fully realised until further work is done. The two countries therefore need to use the platform established by ChAFTA to develop their respective economic strengths in a mutually beneficial way. In addition to an overarching Joint Commission which is scheduled to meet at least annually to review overall implementation, ChAFTA creates committees dealing with investment, trade in services, financial services, movement of natural persons, trade in goods, sanitary and phytosanitary measures, technical barriers to trade and intellectual property.

Through these forums, ChAFTA should be thought of as a living document that can facilitate many of the policy suggestions from this Report. In particular, Australia can help meet the changing needs of China as it shifts to a more sustainable model for economic development, moving up the value chain with a larger services sector and a growing middle class. The goal of this is not to create any artificial trade preference between Australia and China, but to create an environment in which both countries can more easily develop their respective advantages for mutual benefit. That benefit can extend beyond bilateral trade, and Australia and China can

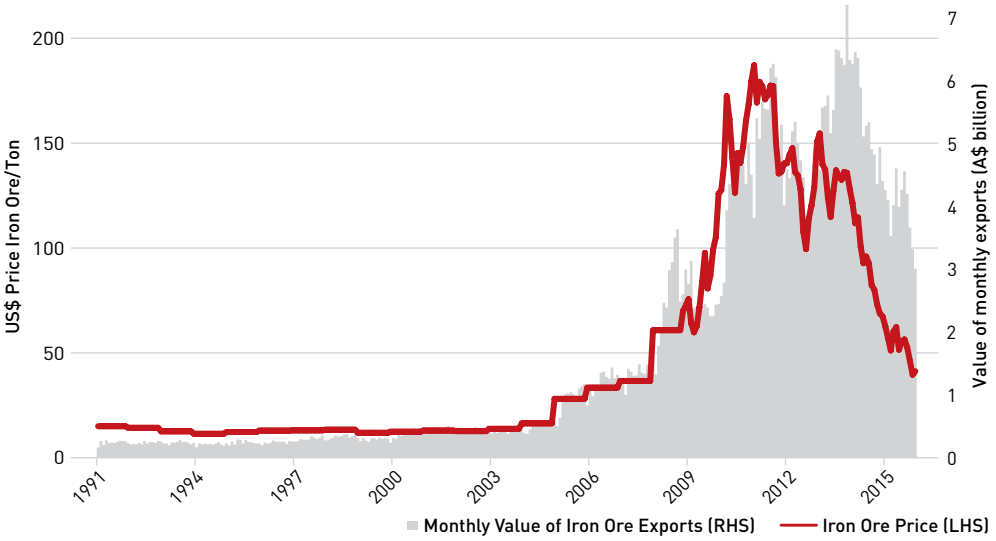
jointly pursue trade strategies that expand regional integration to spread the gains from trade through countries involved in the Regional Comprehensive Economic Partnership (RCEP), and eventually a Free Trade Area of Asia and the Pacific (FTAAP) (see Chapter 7).

The resources trade

The unprecedented scale and speed of China's urban construction, as well as China's dominance in manufacturing, have demanded tremendous mineral and energy resources, particularly steel (Garnaut 2012). The main inputs to steel are iron ore and metallurgical coal, both of which Australia has in abundance at high quality and low cost. Prior to the 2000s, Australia's main exports to China had been agricultural, with iron ore accounting for just 15 per cent of the value of Australian exports to China in 2001 (DFAT 2011).

Australian iron ore helped fuel China's investment boom in the early 2000s. While the global financial crisis caused a brief slump in 2008, the resources-intensive nature of China's investment-led growth helped Australia avoid the recession that gripped other advanced economies. As iron ore prices peaked in 2011, Australia's iron ore exports were worth A$44 billion, or 57 per cent of the total value of Australian exports to China. By the end of 2015, the iron ore price had fallen to one-quarter of its peak, in response to increased global supply and slowing demand growth in China. However, increased export volumes and the declining value of the Australian dollar mean that the total Australian dollar value of iron ore exports has remained well above historic levels (Figure 3.2) and Australia's total share of China's iron ore imports has been increasing.

Figure 3.2: Iron ore price and export value



Source: Price, IndexMundi - China import Iron Ore Fines 62% FE spot (CFR Tianjin port), US Dollar per Dry Metric Ton, Monthly Export, and Australian Bureau of Statistics cat no. 5368.0 Table 12B 2016a.

The prices of commodities are determined through the interaction of global demand and supply, including the recent effects of Chinese investment overseas to expand that supply while reducing the resource-intensity of growth on the demand side through improved efficiency. Because the price of commodities impacts both Australia and China greatly, better understanding price determinants and the effect of supply responses should be one of the priorities for joint academic research between Chinese and Australian academic, government and business partners.

Whatever the fluctuations in global prices, the sheer volume of Chinese resource demand will keep resources as the bedrock of bilateral trade for decades. Even at slower rates of economic growth, the size of the base to which that growth applies means that overall demand will still increase by a significant amount in absolute terms. There are still hundreds of millions of Chinese who will move to cities. This migration, coupled with higher levels of income and consumption for urban residents, could sustain Chinese demand for apartments, highways, railways, bridges and cars (Berkelmans and Wang 2012; Wilinks and Zurawaski 2014). Although China's richest cities suffer from traffic congestion, overall car ownership in China is low. A continued shift in manufacturing from textiles, clothing and footwear to higher value-added electronics and machinery will also support resource demand. China produced 603 kilograms of steel per person in 2014, but peak steel demand could reach 700–800 kilograms per person in the mid-2020s depending on the spread of automobile ownership, the prevalence of high-rise construction and the pace of technological change (McKay et al 2010). China's steel producers operate in a highly competitive market — continued reliance on market mechanisms to deal with any short-term overcapacity in steel production is the best way to make sure that the supply will adjust to meet demand (Hubbard 2015).

Much of these resources will continue to be imported. China's dependence on imported iron ore rose from 50 per cent in 2005 to 81 per cent in 2015. Australia's share of these imports rose from 41 per cent in 2008 to 64 per cent in 2015 (Russell 2016). As prices have fallen, Australian iron ore producers increased their share of the Chinese market. In fact, even as China's steel production declined by 2.3 per cent in 2015, the volume of Australia's iron ore exports to China increased by 9.8 per cent (Roberts et al 2016).

Chinese demand for Australian resources extends well beyond iron ore. The composition of China's resource consumption is likely to change as its manufacturers move up the value chain and its middle class continues to grow (Box 3.1). For example, greater demand for whitegoods, consumer electronics and lightweight electric vehicles will increase demand for Australian copper and bauxite (the mineral from which aluminium is produced), and require more thermal coal, gas and uranium for power generation. Australia supplies half of China's imports of metallurgical coal, another key ingredient in steel. ChAFTA is already assisting Australian resource exporters, having eliminated the tariff on metallurgical coal in December 2015. It also removes Chinese tariffs on steaming coal, copper, aluminium, nickel, zinc and titanium, either immediately or over a four-year period. This could reduce costs of delivering Australian minerals and energy to China by A$600 million per year (Minerals Council of Australia 2016).

BOX 3.1: MORE THAN ORE

China's consumption of copper and aluminium has increased by 16 per cent annually over the past decade, making it the world's largest consumer of both commodities. In 2014, China bought 46 per cent of Australia's copper exports, worth A$1.8 billion, and 74 per cent of Australia's total nickel exports, worth A$0.6 billion. China's machinery, automobile and home appliance industries are key drivers of aluminium demand. Australian exports of aluminium oxide to China make up 89 per cent of total world aluminium oxide exports. And Australian exports of aluminium metal to China are 19.1 per cent of total world aluminium exports (Minerals Council of Australia 2016). As China increases production of more sophisticated manufacturing goods its demand for aluminium will also increase. The scale of China's aluminium smelting capacity makes it difficult for other nations to compete for supply of the primary metal, but Australia remains a major supplier of the bauxite and alumina required to feed those smelters.

China's imports of LNG will grow as China seeks cleaner energy sources by reducing dependence on coal. Australia is currently one of the world's three largest uranium exporters, and has had an agreement since 2006 to allow uranium exports to China. While trade statistics on uranium are not publicly available, the volume of Australian uranium exports to China (around 500 tons a year) is reportedly less than exports to the United States, the EU, Japan or South Korea (World Nuclear Association 2016).

Australia was China's second-largest supplier of coal in 2015, after Indonesia. Australia supplied 35 per cent of China's total import tonnage (Figure 3.3A). Australia is China's largest supplier of liquefied natural gas (LNG), supplying 28 per cent of China's rapidly growing imports in 2015 (Figure 3.3B).

Figure 3.3: Chinese imports from Australia and rest of world

Figure 3.3A: Coal (Tons)

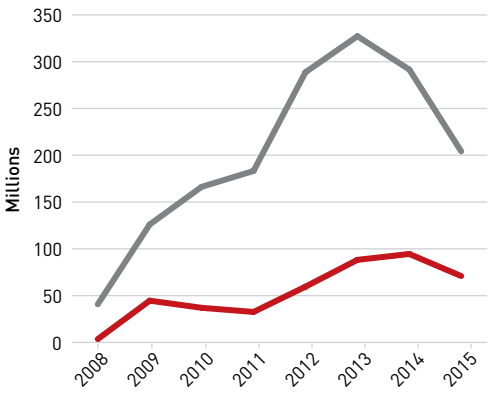
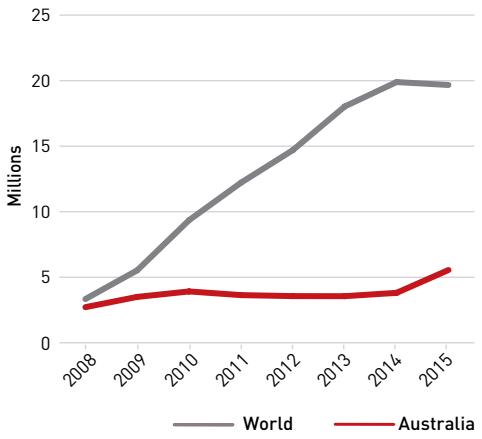


Figure 3.3B: LNG (Tons)



Source: China General Administration of Customs 2016.

Projections across a range of commodities suggest that food and LNG are likely to rise in importance as a share of Australia's exports to China, while iron ore and base metals are likely to fall as a share of total commodity exports (Table 3.1).

Table 3.1: Actual and projected exports of commodities to China

Share of commodity exports to China by value (per cent)				
	2005	2015	2025	2035
Growth scenario	Actual	Estimated	Projection	Projection
Iron ore	47.3	57.9	51–51.5	43–47.5
Base metals	25.1	13.2	13	12–13
Coal	4.3	8.7	9.5–10	11–13
Natural gas (LNG)	0.0	5.4	10	12–14
Food	5.8	8.6	9	9.5–11

Source: Roberts et al 2016.

The Australia–China resource trade relationship echoes the evolution of the Australia–Japan relationship since the 1960s. While Australia's resources trade is private, since 1976 there has been an official treaty-level recognition between Australia and Japan of each country's 'mutual interest in each being a stable and reliable supplier', discussed further in Box 3.2 (Dee 2006). The 2014 Japan–Australia Economic Partnership Agreement affirmed this principle in a chapter that ensures the stable supply of energy and minerals. This commitment is important, because while global trade disciplines are strong with respect to restricting import bans, multilateral rules against export restrictions are not as robust.

BOX 3.2: RESOURCE SECURITY AND GLOBAL TRADE

All economies require access to energy and mineral resources for industrialisation, urbanisation and growth. To ensure stability of their own economy, some countries adopt policies to ensure resource stability, which may include strategic stockpiles of resources or, in extreme cases, policies tending toward autarky. But these policies are often insufficient to meet demand, and can only be done at very high cost. They forgo the gains that can be had from global trade on open markets consistent with comparative advantage.

But international trade is not without its risks. Raw materials may be abundant in, or need to transit through, politically unstable or dangerous parts of the world.

The resource partnerships between Australia and the countries of Northeast Asia over the last 60 years is a powerful example of how resource security can be achieved through open markets, in a stable geopolitical setting and in the context of mature political relationships. The ability of downstream resource users to invest directly into Australia's resources adds the reassurance that resources will be available, while expanding supply for global markets.

As pointed out in Chapter 1, the geographical orientation of the Chinese economy has changed fundamentally, from being continentally self-contained to being the largest maritime economy in the world. Import dependence has grown as commodity prices have fallen and high-cost domestic supplies become less attractive industrial inputs. The reductions in costs and gains in efficiency from increased reliance on international markets have freed up capital for investment elsewhere in the Chinese economy and made better use of state resources. This development has naturally and steadily drawn China into the maritime economy, including the construction of huge sea freight capacities, interest in maritime scientific and weather research, and concern about securing international supplies. As it is one of the world's largest maritime resource suppliers, Australia reciprocates these interests.

Policy thinking about the implications of China's maritime economy has failed to keep pace with this change. The major effort to redress this deficiency that is now under way in China would be assisted by collaboration between Australia and China on the implications of growing resource dependency for resource security, maritime resource development and protection, maritime scientific and weather research, and Australian participation in China's Maritime Silk Road initiative. Working together on these and other joint interests in the maritime economy, given both countries' deep mutual interests in this subject, should be seen as a top priority for both governments. The initiative can commence under the established framework for cooperation between China's National Development and Reform Commission (NDRC) and the Australian Treasury, and bring in other agencies and research organisations as it develops. This could include building on the excellent cooperation between both countries on Antarctic research.

Resource security is important for China in ensuring ongoing inputs for its economic growth. This does not mean security from international markets. A treaty-level commitment between Australia and China not to arbitrarily restrict Australian resource exports would help reinforce China's confidence in the ability of open markets to provide resource security while reducing costs and improving efficiency through increased competition. This would both be good for China as a recipient of Australian raw materials, and good for the Australian resources industry, which could make long-term plans with confidence. This commitment would be the core of the proposed Australia–China Comprehensive Strategic Partnership for Change.

Agricultural trade

Even before China's reform and opening in the late 1970s, the postwar Australia–China trade relationship had begun in agriculture, with large-scale Australian wheat exports to China from 1960 (Wilczynski 1965). Mineral exports to China overtook agricultural exports in the 2000s, but Australia still plays an important role in China's agricultural market. China has also become a significant exporter of agricultural products to Australia. The location of the two countries in different hemispheres means that counter-seasonal products can be traded to fill domestic supply gaps. The proximity of the two countries allows for products to reach markets quickly and in quality condition. And Australia's track record as a safe and reliable source of high-quality produce shows that it can help meet the food safety demands of Chinese consumers.

Australia's exports of agricultural primary products to China grew steadily through the 2000s before more than doubling in value between 2009–2010 and 2013–2014, when they reached A$9.6 billion. In 2010–2011, China overtook Japan to become the most important export destination for Australian agricultural primary products. China's share of Australia's total agricultural exports grew from 6.4 per cent in 2000–2001 to over 20 per cent in 2014–2015 (Austrade 2016b).

Australian exports of wool and grains to China were each worth more than A$2 billion in 2014–2015 (Figure 3.4). Australia is China's largest source of wool imports. Australian beef exports to China have grown, from a low base, at a rate of more than 200 per cent a year and were worth more than A$736 million in 2014–2015. China is Australia's second-largest market for dairy exports, which grew an average of 20 per cent annually over the past five years (and were worth A$295 million in 2014–2015) (Australia–China Business Council 2015). Australian wine exports have focused on the Chinese market for more than a decade. China's wine import industry was valued at A$2.1 billion in 2014–2015. Australia is China's second-largest wine supplier by value, with exports valued at A$269 million in 2014–2015 (DFAT 2014b). China has also tapped the expertise of foreign winemakers and has been expanding its own domestic production over this time, which is why growth opportunities for Australian winemakers come from focusing on the premium market rather than bulk wine exports.

Agricultural trade has grown despite Chinese tariff barriers and non-tariff measures. WTO data show that while China's trade-weighted average tariff rate in 2013 was just 4.6 per cent, it was 13.5 per cent for agricultural goods (WTO 2016b). ChAFTA removed some of these barriers. For example, tariffs on beef that previously ranged from 12–25 per cent are being eliminated (DFAT 2014b). Under ChAFTA, the Australian dairy industry will now receive even more favourable treatment than that negotiated by New Zealand with China in their 2008 free trade agreement.

One of the key drivers for opening up China's agriculture to further trade is to ensure long-term food security through access to open markets. Chinese agriculture still tends to be relatively small-scale and non-commercial, although there are now major agricultural operations in the private and public sectors that are expanding their influence in China and abroad. As more arable land passes into urban use, Australia's highly productive firms and extensive land can buttress China's food supplies. In the same way that Australia has proved to be a reliable partner for Chinese energy and minerals demand, so too can Australia be a valuable partner in supplementing China's food security.

Developing the capacity necessary to meet China's demand, even at the margin, will require significant investment in Australian agribusiness, some of which may be financed by Chinese investors, as discussed in Chapter 4 (Australia–China Business Council 2014).

Volume growth is not the only indicator of potential. Australian agriculture also offers premium opportunities to serve China's growing middle-income consumers. Moreover, according to the BCG China Consumer Survey 2016, food safety tops the list of consumer concerns, ahead of health care, education and the environment. The results are particularly stark for younger Chinese consumers, with 63 per cent of those aged between 18 and 25 expressing dissatisfaction with food safety (Walters and Kuo 2016).

Since 2004, both countries' dairy industries have been involved in an official dialogue (DFAT 2012). But moving from formal dialogue to large-scale delivery of new supply will require investment, services and infrastructure. A 2012 joint report between the Australia and Chinese ministries responsible for trade and for agriculture identified the construction of breeding facilities, as well as dairy farms, as possible opportunities for Chinese investment in Australian agribusiness.

Part of the premium value of Australian food products in China is Australia's track record in supply-chain management and food safety. For Chinese investors, partnering with recognised Australian brands and businesses can help them realise the full value of their output. For Australian businesses, partnering with Chinese investors helps with distribution channels within China, whether directly to retail consumers or as inputs for other parts of the Chinese food industry.

Despite these opportunities, investors in Australia from China face a much stricter threshold for investment in agribusiness (A$55 million) compared to other sectors (where the threshold is over A$1 billion) or compared to other FTA partners from Chile, New Zealand and the United States, as well as other TPP members should the TPP come into force. While this screening threshold does not necessarily prevent investment going ahead, it adds extra costs and risks to investments that would expand trade and develop rural Australia. Barriers to Chinese investment are considered in Chapter 4.

New opportunities for bilateral trade

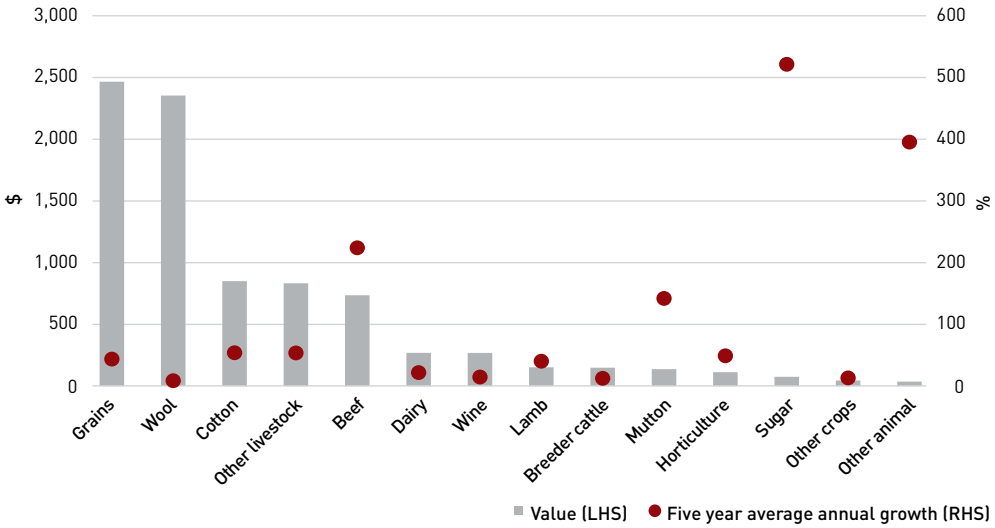
The mining boom benefited Australians directly employed in the resource sector, boosted government tax receipts and increased the purchasing power of Australians overseas through a stronger Australian dollar. Australian households could afford to import more, and much of this import demand was met by China. By 2014–2015, almost one-third of Australia's imports of elaborately transformed manufactures — a category that includes clothing, motor vehicles, machinery and paint — came from China, up from just 10 per cent in 2000–2001 (ABS 2002; DFAT 2016c).

But the high Australian dollar also reduced the competitiveness of other Australian exports, particularly in manufacturing. Indeed, the rapid rise of Chinese manufacturing, with hundreds of millions of low-cost Chinese workers entering the global economy for the first time, inhibited wage growth in the lower end of manufacturing around the world.

The boost in Australia's national income from the resources boom cushioned Australia from some of the costs that come with industrial restructuring. However, Australia now faces significant policy challenges if it is to maintain its living standards while adjusting to much lower commodity prices. In particular, Australia's resource endowments and position in Asia provide limited competitive advantage to Australian business when compared to competitors in other developed markets in Europe and North America.

The flexibility of Australia's floating exchange rate regime, which allows the dollar to fall in value as commodity demand eases, is an important channel for making non-resource sectors more competitive. But policymakers need to make sure that labour markets are flexible enough to enable creation of jobs in emerging industries, that workers are able to acquire the skills required to find new employment in emerging industries, and that faster-growing regions receive adequate infrastructure investment. The removal of obstacles to Chinese capital to develop Australia's productive capacity in areas of growing Chinese demand would be of benefit to both countries and strengthen their overall relationship (see Chapter 4).

Figure 3.4: Australian agricultural exports to China (A$ million, 2014–2015)



Note: Free on board value, Grains includes oilseeds and pulses.
Source: ABARES 2016.

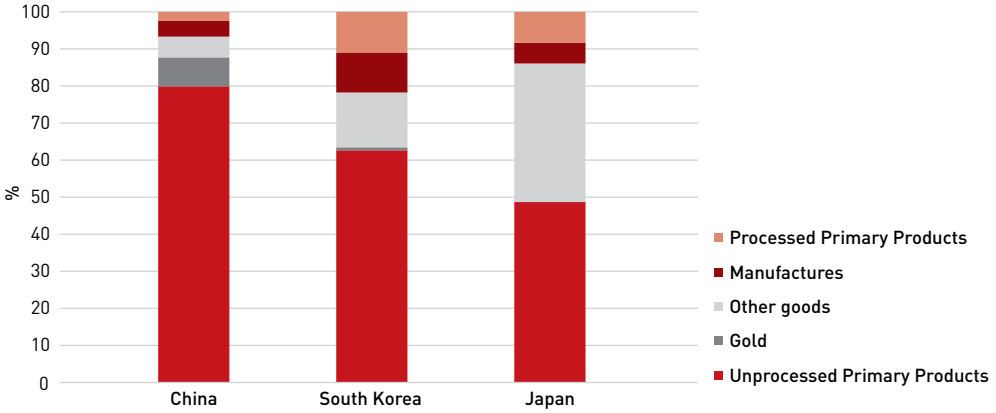
As ChAFTA comes into effect, over 86 per cent of Australia's goods exports to China (by 2014 value) will enter duty free. This will increase to 94 per cent by 2019 and 96 per cent by 2029 (DFAT 2016d). This is an important opportunity to diversify Australia's exports to China. In 2014, more than 85 per cent of Australia's goods exports to China were in unprocessed primary products and gold.

Comparing this figure with Australian exports to high-income Northeast Asian economies shows that while primary exports comprise an important share of exports to these other countries, there is also a large role for processed primary products, especially foods (Figure 3.5). This suggests that there is a significant opportunity for Australian agribusiness to transform raw unprocessed food and livestock into safe and respected brands of high-quality food, wine and dairy products to export to China in the future. Australia is also a large potential source of ingredients used in Traditional Chinese Medicine (TCM).

The value of Chinese online retail sales of goods and services in 2015 was RMB3.9 trillion (US$592 billion), an increase of 33.3 per cent compared with 2014. This growth is due primarily to lower prices, greater product variety, better product information, more reliable seller reputations and faster delivery times compared to traditional retail shopping. The pent-up demand for quality Australian goods in China is evident in the growing volume of Australian goods retailed directly and indirectly in China through e-commerce channels.

Chinese consumers demand foreign goods for their quality. According to Nielson research, Chinese online shoppers imported US$16.3 billion of foreign products in 2014 (Burbank 2014). In 2014, Australia Post and the Chinese e-commerce giant Alibaba agreed to a deal that allows Australian brands to sell directly to Chinese consumers through leading Chinese online retailer TMall (ABC News 2014) (Box 3.3). Popular purchases from Australia include health food products, infant formula, cosmetics, organic foods and sheepskin boots. An advantage of this arrangement is that it guarantees to the Chinese consumer the authenticity of the good and provides a guaranteed supply chain for sellers.

Figure 3.5: Australian goods exports to Northeast Asian economies



Note: The export of 'other goods' includes confidential uranium exports.
Source: DFAT 2015c

The opportunities presented by the internet and e-commerce need to be closely studied. Government agencies responsible for innovation policies on both sides should partner with industry to identify and remove barriers to the full adoption of this new technology. Moreover, the policies that affect cross-border e-commerce need to be carefully communicated on each side. For example, sudden recent changes to the enforcement of China's Customs and Duties Law were mistakenly but avoidably perceived by some as a crackdown on foreign competition, rather than the closing of a tax loophole (Manuel 2016).

Although changes to China's e-commerce market were widely anticipated, the rollout of these changes was conducted without adequate consultation with key stakeholders. This resulted in confusion in the market, and led to adverse impacts on suppliers. This has been a learning experience. These guidelines have since been revised and a grace period allowed in order to minimise unintended consequences and allow for sellers and suppliers to adjust to these changes. Closer cooperation between Australian and Chinese customs authorities could help ensure that these kinds of actions are better communicated and understood. It could also ensure that regulations are commonly understood and consistently applied between all stakeholders.

Even outside e-commerce channels, there is a strong flow of health food products that are bought at retail outlets in Australia and posted to China (Battersby and Zhou 2015). Small-scale retail can be attractive partly because of the high number of Chinese with friends and relatives in Australia, and because these low-value personal imports into China avoid the need to undergo the often-onerous product and food-safety testing that would be required for commercial imports. While formal tariff barriers are reduced under ChAFTA, the need for product testing and certification within China increases the costs of larger-scale trade in agriculture and processed food products. Therefore, Australian companies can also be successful in complementing e-commerce delivery channels with a traditional 'bricks and mortar' presence (see Box 3.4).

Removing barriers to, and lowering the cost of, commercial-scale imports, as well as guaranteeing the integrity of bilateral supply chains and product quality, should be a priority for Australia–China trade cooperation. When the enforcement of domestic standards on

imported goods is more rigorous than it is for locally produced goods, this constitutes a de facto trade barrier. There are opportunities to reduce these discrepancies, based on an overarching principle that the purpose of such regulations is to protect domestic consumers, not domestic producers. Indeed, one reason for the popularity of e-commerce in Australia–China trade is Australian producers of food and nutritional products not being able to access Chinese consumers through traditional channels because of high tariffs and protracted product registration and accreditation processes.

BOX 3.3: ALIBABA GROUP OPENS NEW MARKETS FOR AUSTRALIAN EXPORTERS

Alibaba Group has provided an electronic bridge for Australian exporters into new Chinese markets.

The value of China's e-commerce market exceeded US$600 billion in 2015. Of this, Alibaba accounted for around US$485 billion in e-commerce sales, or over 80 per cent of the total. This figure makes Alibaba Group the largest retail e-commerce company in the world. By the 2020 fiscal year, Alibaba aims to be the first company to have a retail market scale of over US$1 trillion.

Australian exporters have achieved success by tapping into Alibaba Group's e-commerce platforms including Tmall, Tmall Global, 1688.com, Taobao and Alibaba.com.

Australian products are increasingly popular on Chinese e-commerce channels. Alibaba sees strong and growing demand for a range of products such as dairy, premium foods, healthcare, skincare, and mother and baby products.

Each year, Alibaba runs the largest shopping festival in the world, the Double 11 Shopping Festival, on 11 November. In 2015, Australia ranked fifth among 41 countries globally on Tmall Global, with one Australian vendor, Chemist Warehouse, recording sales worth RMB10 million (over A$2 million) in just the first 46 minutes of the Festival.

Alibaba Group has also forged a strategic partnership with Australia Post. Australia Post's Tmall store provides a solution for exporters, particularly small and medium enterprises, to access some of the 420 million active Chinese consumers across Alibaba Group's platforms.

Alibaba Group plans to open an office in Australia at the end of the 2016 to better support its Australian clients and assist more Australian companies in accessing the Chinese market.

To level the playing field further, China could unilaterally recognise Australia's high food safety and quality standards, and expedite the approvals of Australian food exports to China. This would be a win–win policy: it would benefit Chinese consumers through lower prices and benefit Australian producers through lower transaction costs. Both countries should aim to ensure that Chinese consumers can access safe products at low cost from around the world. The relevant chapter of ChAFTA on sanitary and phytosanitary measures can help ensure that quarantine rules do not pose an unnecessary obstacle to trade. However, there are opportunities to go further in building trust and understanding on both sides, including through direct exchanges of officials.

BOX 3.4: BLACKMORES' CHINA ENTRY STRATEGY

Blackmores is a market leader in the natural vitamin, herbal and mineral supplements market in Australia, with strong market positions throughout Asia.

Blackmores launched in China in 2012 and has established itself as a premium natural health brand with Chinese consumers. Before launching in China, Blackmores spent more than two years researching the market. This involved extensive use of the services of Austrade and DFAT to understand the regulatory environment, to meet relevant Chinese government agencies, to connect with industry organisations and to assess potential partners and market-entry models.

Unlike many foreign firms who saw rapid growth in China's vitamins and dietary supplements market as a short-term trading opportunity, Blackmores' relationship with China has been positioned for the very long term. The company established a Wholly Owned Foreign Enterprise (WOFE) in Beijing and subsequently established branch offices in Shanghai and within the Shanghai Free Trade Zone.

Blackmores has absorbed from its long history and experience in other Asian markets — the company has been in Thailand and Malaysia for 40 years — that success in the region requires the recruitment of strong locally engaged teams in each market who are responsible for its brand. Since 2012, Blackmores has built a team of 30 staff in China with offices in Beijing, Shanghai and Guangzhou, with another soon to open in Chengdu.

Blackmores distributes through the traditional 'bricks and mortar' retail trade, has an extensive online presence and over 3200 offline distribution points covering first-tier and second-tier cities. The company has a wide-ranging presence on all major Chinese e-commerce platforms (domestic and cross-border), including Tmall and JD.com as well as strategic partnerships with VIP.com and Netease. The company serves more than 20 key e-retailers and thousands of Taobao and WeChat stores through Free Trade Zone distributors. Blackmores has also undertaken broad channel expansion to cover chain pharmacy, independent pharmacy, health and beauty stores, supermarkets, hypermarkets, medical, TV shopping, duty free outlets, department stores and corporate sales.

Blackmores strongly supported the entry into force of ChAFTA, which strengthens the long-term commercial ties between Australia and China. ChAFTA not only delivered the elimination of tariffs on Australia's pharmaceutical, vitamin and health supplement products but also contains a built-in agenda to address non-tariff barriers to trade between Australia and China.

This situation could be improved by the increased sharing of technical expertise between regulators in Australia and China, including staff exchanges. Such exchanges would help build capacity, familiarity and trust with each other's regulatory systems.

The next stage for bilateral trade

The opportunities for both China and Australia are large, if policymakers are proactive in pursuing the reforms necessary to achieve them.

ChAFTA offers a framework through which Australia–China initiatives in reform and liberalisation across all areas — merchandise trade, services trade and investment — can be advanced. The bilateral liberalisation of commodity market access delivers some immediate benefits. These benefits are important to the growth of agricultural trade, for example, but they will also be dependent on improving the bilateral investment regime and achieving the liberalisation of complementary services. Given the big shift in the structure of the Australia–China relationship that this Report highlights, many of the potential gains from ChAFTA will only be realised through securing reform and opening of trade in services as well as reform of investment policies. It is difficult, in any case, for liberalisation of trade in services to be narrowly bilateral and only providing special if limited benefit to either Australia or China in each other's market. Reform that increases the productivity of services markets requires comprehensive domestic institutional reform. But ChAFTA opens the door to trialling services reform with Australia in China and has the potential to be at the leading edge of China's economic reform program. There is potential for ChAFTA to deliver benefits beyond the border for domestic reform in both countries.

Modelling undertaken for this Report bolsters this case. First, the gains are estimated from the full preferential merchandise trade liberalisation that is potentially available under the ChAFTA framework, using standard GTAP techniques (Gretton 2016). (In Chapter 4, this will be extended to consider the gains to be had from liberalisation that is more comprehensive, including services and investment). The present simulation shows that the removal of all tariffs preferentially between China and Australia yields modest but important output gains to each country. In the long run, it could increase Australia's GDP by 0.22 per cent and lift China's GDP by 0.11 per cent (Table 3.2). This simulation measures the maximum possible gain under a fully comprehensive ChAFTA agreement, not the gains from the agreement that is currently in place. It presumes that the two countries will move to 100 per cent bilateral tariff removal in their merchandise trade, and that there are no negative effects imposed by rules of origin or other regulations to enforce preferences. The ChAFTA agreement currently in place is in fact still subject to carve-outs and product-specific rules of origin and will not yield these gains fully, but this measure can be regarded as the outer limit to potential gains from ChAFTA-focused merchandise trade liberalisation.

Table 3.2: Simulated effects of reducing remaining tariffs to zero

	Australia		China	
	GDP	Gain as proportion of full world MFN liberalisation	GDP	Gain as proportion of full world MFN liberalisation
Simulation	per cent change	per cent of full gain	per cent change	per cent of full gain
Australia–China bilateral	0.22	23	0.11	4
Australia unilateral	0.56	60	0.03	1
China unilateral	0.12	13	2.28	78
RCEP open liberalisation	0.88	94	2.37	81
World MFN liberalisation	0.94	100	2.94	100

Source: Gretton 2016.

By way of comparison, and to define the parameters of gains from using ChAFTA as a lever for broader regional and multilateral liberalisation, modelling is done to simulate liberalisation through a comprehensive Asian free trade agreement — RCEP. And, as a benchmark, an estimate is made of the benefits to Australia and China from multilateral merchandise trade liberalisation.

If RCEP brings comprehensive merchandise trade liberalisation based on open regionalism, Australia's GDP could increase by 0.88 per cent and China's by 2.37 per cent. If all tariffs were removed globally, Australia's GDP could increase by 0.94 per cent and China's by 2.94 per cent. Australia can achieve 60 per cent of that global merchandise trade liberalisation scenario by unilaterally removing tariffs. China can achieve 78 per cent of the global scenario by removing its tariffs. These scenarios are simply simulated to estimate the different magnitudes of potential gains under alternative trade policy strategies.

The structure of bilateral trade

Not only is the volume of trade between China and Australia set to increase, its structure will change as well, depending on the ways in which the Chinese economy itself is transformed.

The growth trajectory of China's economy will be one of the biggest stories in the global economy over the next decade. Not only will it matter for the living standards for Chinese people, it will also impact on China's trade with Australia and the rest of the world.

Taking into account possible developments in both economies as well as in the rest of the world, what is the structure and scale of Australia–China trade likely to look like in the next 10 years? To answer this question, growth and its structure over this period is modelled under three different sets of assumptions using GTAP (Sheng 2016).

In the period until 2020, International Monetary Fund (IMF) growth projections are used, after which three growth scenarios for China are projected using United Nations population projections and the global competitiveness index as a proxy for quality of institutions. In the first 'business as usual' case, China's GDP grows at an average annual rate of 5.0 per cent a year from 2021 to 2025 with annual average labour productivity growth of 5.2 per cent offsetting an annual average decline in the working-age population of 0.2 per cent (Table 3.3).

An optimistic, or reform-based, scenario would see Chinese institutions converge upwards to the quality of South Korean institutions, with growth then averaging 6.1 per cent to 2025. A final, stagnation case would see growth fall to 3.1 per cent per year as Chinese institutions converge downwards towards the quality of Turkish institutions. The growth rate to 2020 is from the IMF and is the same for all three projections, at 6 per cent from 2016–2020.

The structure of bilateral Australia–China trade is projected to 2025 under the three growth scenarios. The world is split into 12 regions and 16 sectors, which are comprised of 10 manufacturing, two agricultural and four service sectors. The results are shown graphically in Figure 3.6.

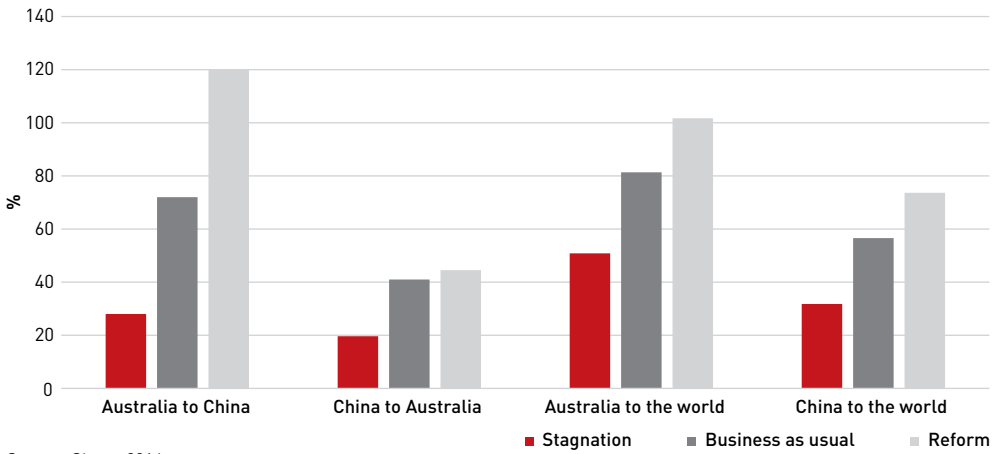
Table 3.3: Decomposition of Chinese GDP growth under three growth scenarios

	Historic 2011-2015	IMF Outlook 2016-2020	Projection 2021-2025
Business as usual			
Growth	7.5	6.0	5.0
Productivity	7.3	6.3	5.2
Working population	0.2	–0.3	–0.2
Reform scenario			
Growth	7.5	6.7	6.1
Productivity	7.3	6.9	6.3
Working population	0.2	–0.3	–0.3
Stagnation			
Growth	7.5	5.0	3.1
Productivity	7.3	5.8	3.3
Working population	0.2	–0.3	–0.2

Source: Hubbard and Sharma 2016.

Under the business as usual scenario of an average of 5.73 per cent growth per year from 2016–2025, Australian exports to China grow from US$84.0 billion in 2014 to US$145 billion in 2025, or 72 per cent in constant value terms over the decade. Chinese exports to Australia increase from US$41.0 billion to US$58.0 billion, or 17 per cent. Total Australian exports increase from US$295 billion to US$535 billion while total Chinese exports increase to US$4.04 trillion from US$2.58 trillion. China's share in Australian exports falls slightly to 27.1 per cent (from 28.5 per cent) while Australia's share in China's exports falls from 1.6 per cent to 1.43 per cent.

Figure 3.6: Real growth in exports from China and Australia under three Chinese growth scenarios



Source: Sheng 2016

The extraction sector, which includes metals, minerals and various other natural resources, is the largest sector for Australia comprising of 70.6 per cent of exports to China and 46.6 per cent of total exports in 2014 (Table 3.4). The relative importance of this sector falls in 2025 to 58.7 per cent of Australia's exports to China and 36.0 per cent of total exports.

The growth in Australia's exports to China is driven mainly by services, which more than double as a proportion of total trade, led by transport, telecommunications, computer and information services. Currently the Australian services export sector is largely education and tourism, with education accounting for 4.9 per cent of Australian exports to China (of the 8.0 per cent that the transport, travel and tourism sector accounts for). Under the business as usual scenario, education and tourism grow to 11.9 per cent of Australian exports to China, of the 19.6 per cent that the broader transport, travel and tourism sector accounts for. Agricultural exports also rise substantially.

Table 3.4: Actual and projected shares of exports by sector

	2014				2025 Business as usual			
	Aus to China	Aus Total	China to Aus	China Total	Aus to China	Aus Total	China to Aus	China Total
Grains and Crops	2.5	4.5	0.4	1.4	3.0	4.8	0.3	0.9
Livestock and Meat Products	4.8	6.0	0.5	0.7	6.4	6.9	0.5	0.6
Mining and Extraction	70.6	46.6	2.3	2.1	58.7	36.0	1.5	0.9
Processed Food	0.6	1.9	1.2	0.9	0.8	2.5	1.1	0.7
Textiles and Clothing	0.0	0.2	21.7	16.3	0.0	0.2	20.0	15.0
Leather, Wood and Paper products	0.6	0.9	4.5	3.1	0.5	0.7	4.7	3.4
Petroleum and Chemical products	8.2	8.7	14.1	12.1	6.3	8.5	10.7	8.6
Metal products	2.9	4.4	9.0	7.2	2.2	3.2	7.8	6.1
Motor vehicles and transport equipment	0.1	1.6	4.8	4.1	0.1	1.8	5.3	4.5
Electronic equipment	0.2	0.9	14.1	22.2	0.1	0.2	15.1	26.0
Other machinery and equipment	0.7	2.9	19.6	18.4	0.5	3.3	27.9	25.7
Other manufacturing	0.0	2.9	3.0	2.5	0.0	3.8	2.1	1.8
Utilities and construction services	0.1	0.4	0.1	0.6	0.1	0.5	0.1	0.6
Transport, travel and tourism	8.0	12.9	3.7	3.7	19.6	19.7	2.2	2.0
Financial, insurance and business	0.5	1.8	0.4	1.1	1.1	2.5	0.2	0.7
Other services	0.3	3.3	0.6	3.6	0.6	5.2	0.5	2.6
Bilateral trade share (% of trade with world)	**28.5**		**1.6**		**27.1**		**1.4**	

Source: Sheng 2016.

Table 3.5: Actual and projected share of exports by sector in alternative scenarios

	2025 Reform				2025 Stagnation			
	Aus to China	Aus Total	China to Aus	China Total	Aus to China	Aus Total	China to Aus	China Total
Grains and Crops	3.4	4.8	0.1	0.3	2.8	4.6	0.3	0.9
Livestock and Meat Products	10.3	8.0	0.0	0.0	6.2	6.5	0.5	0.5
Mining and Extraction	62.2	41.5	0.4	0.2	59.1	39.1	1.2	0.6
Processed Food	0.7	2.3	0.8	0.5	0.8	2.4	1.1	0.8
Textiles and Clothing	0.0	0.2	16.5	10.7	0.0	0.2	21.1	15.5
Leather, Wood and Paper products	0.5	0.9	2.5	1.7	0.5	0.8	4.7	3.4
Petroleum and Chemical products	3.2	7.3	12.9	9.5	6.6	8.1	10.2	8.2
Metal products	1.5	2.7	8.3	5.9	2.5	3.3	7.4	5.8
Motor vehicles and transport equipment	0.1	1.7	2.1	1.7	0.1	1.7	5.0	4.3
Electronic equipment	0.1	0.3	14.2	21.6	0.1	0.3	16.5	27.4
Other machinery and equipment	0.2	2.4	34.8	28.9	0.7	3.4	27.1	25.1
Other manufacturing	0.1	4.0	0.8	0.6	0.1	3.8	1.9	1.6
Utilities and construction services	0.1	0.4	0.1	0.6	0.1	0.4	0.1	0.6
Transport, travel and tourism	16.8	17.3	3.1	2.5	18.8	18.3	2.1	2.0
Financial, insurance and business	0.9	2.2	0.3	0.8	1.1	2.3	0.2	0.7
Other services	0.1	4.0	3.1	14.5	0.6	4.8	0.5	2.6
Bilateral trade share (% of trade with world)	**31.1**		**1.3**		**24.1**		**1.4**	

Source: Sheng 2016.

Under the China reform scenario, total Australian trade and Chinese trade are larger than the business-as-usual scenario. Chinese exports increase to US$4.48 trillion, compared to the US$4.04 trillion case under the business-as-usual scenario. Chinese exports to Australia are roughly the same under both scenarios, at US$59.1 billion in 2025. Total Australian exports are projected to be US$595 billion in 2025, larger than the business-as-usual case and driven mostly by the increase in exports to China. Australian exports to China increase from US$84 billion to US$185 billion, or just over 120 per cent, in constant value terms.

Australia's exports to China are projected to be US$185 billion in 2025 under the reform scenario compared to US$145 billion a year given business as usual. Under the stagnation scenario with Chinese growth significantly contracting after 2020, Australian exports to China are projected to be US$107 billion, still a 28 per cent increase in constant value terms. Yet total Chinese exports will be over US$1 trillion less in 2025 under this scenario.

The structure of Australian exports to China does not change significantly under each scenario because under all scenarios the impact of structural change in the Chinese economy is powerful. The mining and extraction sector will be less important, while services and agriculture will grow in importance in all circumstances (Table 3.5). The total share of each country in the other's trade will not change greatly in any scenario: the share of China in Australia's exports will decline slightly from 28.5 per cent in 2014 to 27.1 per cent in the baseline case and increase to 31.1 per cent in the reform case; and the share of Australia in China's exports will fall from 1.6 per cent in 2014 to 1.4 per cent in the former case and 1.3 per cent in the latter.

The share of textiles and apparel in China's exports to Australia was 22 per cent in 2014. That is projected to fall to 20 per cent under the business-as-usual scenario and 17 per cent under the reform scenario. If growth in China stagnates, the share is projected to be 21.1 per cent. Electronic equipment, with a share of 14.2 per cent in 2014, exhibits a similar pattern. The share of textiles and apparel in China's total trade tells a similar story: higher growth scenarios indicate successful industrial transformation and upgrading, with low-skilled manufacturing becoming less important. A failure to transform the structure of the Chinese economy results in the growth stagnation scenario.

Education services will be a major Australian export to China under all three growth scenarios, accounting for between 10 per cent of total exports in the stagnation scenario and close to 12 per cent in the reform scenario. Even if growth stagnates in China, education exports will triple to US$12 billion in 2025. Under the reform scenario, education exports will be as high as US$18.6 billion.

The transformation of China's trade with Australia

China's industrial up-skilling is already underway, as shown by the shifting composition of Chinese exports to Australia. Twenty-five years ago, Chinese exports to Australia were predominantly lower value-added goods such as household equipment, textiles, clothing and footwear. Over that time, China's export economy has progressed from being a low-end producer of textiles and assembler of simple goods, to being a high-end producer of far more sophisticated electrical and machinery products.

Much of the lowest-skilled factory work that boomed in China's coastal provinces and special economic zones has now either moved to less-developed inland regions or to other lower-wage countries. While the absolute value of all categories of Chinese manufacturing to Australia has grown, the share contributed by sophisticated engineering products, such as machinery, has risen from less than 10 per cent to almost half of all imports since 1990 (Table 3.6).

Australia's falling barriers to manufacturing imports have assisted this evolution. In 1991, the weighted average of effectively applied tariffs on manufactured imports into Australia was 10.5 per cent; by 2002 it had more than halved to 4.3 per cent, and in 2014 stood at 2.5 per cent (World Bank 2016). ChAFTA will eliminate almost all tariffs on imports of Chinese manufactures after 1 January 2019.

The effective manufacturing tariffs applied to Chinese goods around the world also fell over this period, lowering the cost of China's entry into regional and global production networks. Weighted average tariffs on imports of manufactures were 36 per cent in 1992,

falling to 13 per cent in 2001 and 4 per cent in 2014 (World Bank 2016). Lowering the cost of manufactured imports provides cheaper parts and components for subsequent exports of more elaborate goods.

Table 3.6: The changing nature of Chinese manufacturing exports to Australia

	1990		2000		2010		2014	
	A$	Percentage share in total	A$	Percentage share in total	A$	Percentage share in total	A$	Percentage share in total
Simply transformed manufactures	77,509	6.5	461,961	5.4	1,942,412	5.2	2,879,711	5.8
Engineering products	100,168	8.4	1,907,341	22.1	17,255,046	45.8	23,279,101	47.0
Other elaborately transformed manufactures	1,014,804	85.1	6,245,133	72.5	18,494,832	49.1	23,335,877	47.1

Source: DFAT 2015c.

Upgrading Chinese manufacturing through regional supply chains

Chinese manufactured goods are not strictly 'made in China' but rather 'made in Asia', or 'made in the world' once global supply chains involving parts, components and intellectual property are considered. Yet while a contractor in China assembles Apple's iPhone and iPad products, the contribution of Chinese labour to these products' final retail value was less than 2 per cent in 2011 (Kraemer et al 2011). Even for a tiny component such as a Light Emitting Diode (LED) manufactured in China, 28 per cent of the value-added is estimated to come from outside China (UNCTAD 2015). For a product as simple as a rubber tyre made in China, the Chinese share of value added is just under 77 per cent.

The emergence of regional and global supply chains reveals the limits of bilateral trade arrangements that focus only on removing formal tariff barriers among potential export markets (Productivity Commission 2010). When tariffs on intermediate and unfinished goods cascade through many different countries before producing a finished product, the unilateral reduction or removal of import tariffs helps an economy remain a competitive base for global production networks.

Trade agreements that seek to entrench preferential treatment for particular bilateral trade flows further compound these inefficiencies, and encourage other nations to compete on the basis of policy distortions rather than economic fundamentals. In addition, the costs of delays at customs and disruptions to logistics make it difficult to reap the full efficiencies from truly integrated trade.

Broader trade agreements provide the greatest welfare gains, and so multilateral trade liberalisation through the WTO would provide the greatest gain to global welfare. The consolidation of existing bilateral preferential trade agreements into RCEP is a practical intermediate step. RCEP could form the foundation for defining the pathway towards a FTAAP that is not just regionally but globally liberalising.

One promising prospect for improving bilateral trade logistics is China's OBOR initiative, which aims to improve infrastructure connectivity in the region. This should help boost trade by lowering transaction and transport costs. Australian and Chinese cooperation in the AIIB is also a welcome and practical step toward reducing transport costs. The AIIB was founded to help finance infrastructure investment in the region, which could include finance for infrastructure development in Northern Australia under OBOR arrangements. More detailed discussion of areas in which Australia and China can cooperate to advance regional and global economic diplomacy is set out in Chapters 7 and 8 of this Report.

Delivering services to Chinese consumers

China's domestic reform agenda provides a strong case for allowing Australian companies to compete directly in China's services markets. The Decision of the current Central Party Committee's Third Plenum in 2013 — a meeting that introduces a five-year economic reform agenda — focused on the development of the services sector, including finance and healthcare services. This has been encapsulated in the five priorities for the 13th Five Year Plan of innovation, coordination, green development, opening-up and sharing.

The growth of China's middle class is driving growth in the bilateral services trade (Productivity Commission 2015). According to one long-term estimate, the proportion of China's population in the middle class could rise from around 10 per cent in 2009 to over 40 per cent in 2020, and more than 70 per cent in 2030. This equates to over 850 million Chinese people entering the middle class within the next two decades (Kharas and Gertz 2010). This means that Chinese consumers will spend more of their discretionary income on services. Some of these services, such as tourism and education, may be provided to Chinese overseas. But Australia can also assist China in developing its domestic services sector (see also Chapter 5).

The potential for increased services imports in China takes on added significance for Australia given the particularly high contribution of value-added services to the Australian economy. While a large proportion of the profits of the Australian resources boom accrued to overseas investors in mining companies, more services exports translate directly into more Australian jobs. From 2002–2011, from the start to near the peak of the resources boom, the value-added in Australia's services exports actually exceeded that of minerals exports (Kelly and La Cava 2014).

Tourism and education services in Australia

Chinese demand for Australian services has so far been concentrated in travel services for education and tourism (Box 3.5).

In 2015, education-related travel from China to Australia was worth A$4.8 billion (ABS 2016a). There are more than 136,000 Chinese students in Australia, more than one-quarter of the international student population (DFAT 2016b). The long-run significance of this sector is even higher than these statistics suggest given the Australian brand awareness, family tourism expenditure, professional relationships and migration opportunities that accompany international educational exchange. This story is told in greater detail in Chapter 4.

BOX 3.5: CHINESE TOURISM IN AUSTRALIA

In 2015, annual Chinese tourist arrivals to Australia exceeded one million for the first time, accounting for 13.8 per cent of total international arrivals. According to Tourism Research Australia, in the period through to 2025, China will account for 60 per cent of growth in inbound tourism expenditure in Australia. By 2017–2018, China is expected to become Australia's largest tourism market in terms of inbound tourist numbers and tourist expenditure, overtaking New Zealand (Tourism Research Australia 2016).

Chinese visitors have been the driving force behind recent increases in tourist arrivals and spending trends in Australia, with China now Australia's primary source of inbound tourism expenditure (Tourism Research Australia 2014). In 2000, travel from China accounted for just 3.5 per cent of international travel expenditure in Australia; in 2015, it accounted for 22 per cent (ABS 2015b, 2016a). In 2014–2015, total expenditure by Chinese visitors increased by 29.8 per cent in real terms and the number of visitor nights rose 18.8 per cent to 39 million (Tourism Research Australia 2016).

These trends are encouraging, but come alongside potential challenges as well as opportunities for further growth. Since the global financial crisis, the Australian dollar has weakened more sharply against the New Zealand dollar, the Singapore dollar and the Chinese renminbi, than it has against the US dollar or the British pound. This has made Australia relatively more attractive for tourism than other countries in the region in recent years (Terlato 2015). But the short-term nature of such advantages highlights the importance of developing a tourism industry that is robust to global economic uncertainty.

Despite Chinese consumers ranking Australia first out of all countries in 'aspiration', 'awareness' and 'intention' to visit, Australia ranks only 10th in actual visitation, behind more-established competitors such as the United States and France (Tourism Australia 2015b). The expansion of air connections, wider marketing operations in China and the accessibility of tailor-made travel experiences to Chinese visitors will be essential in narrowing this gap (Tourism Australia 2011). Australia's tourism sector must seize the opportunities offered by recent tourist activity and the favourable opinion of Chinese visitors to cement Australia as a premier destination in the longer term.

Tourism Research Australia forecasts the share of Chinese leisure arrivals in Australia to grow from 13 per cent in 2014–2015 to 17.9 per cent in 2017–2018 and 27.2 per cent in 2024–2025. This would see the number of annual Chinese leisure tourist arrivals more than treble from 684,000 in 2014–2015 to 2.6 million in 2024–2025 (Tourism Research Australia 2016).

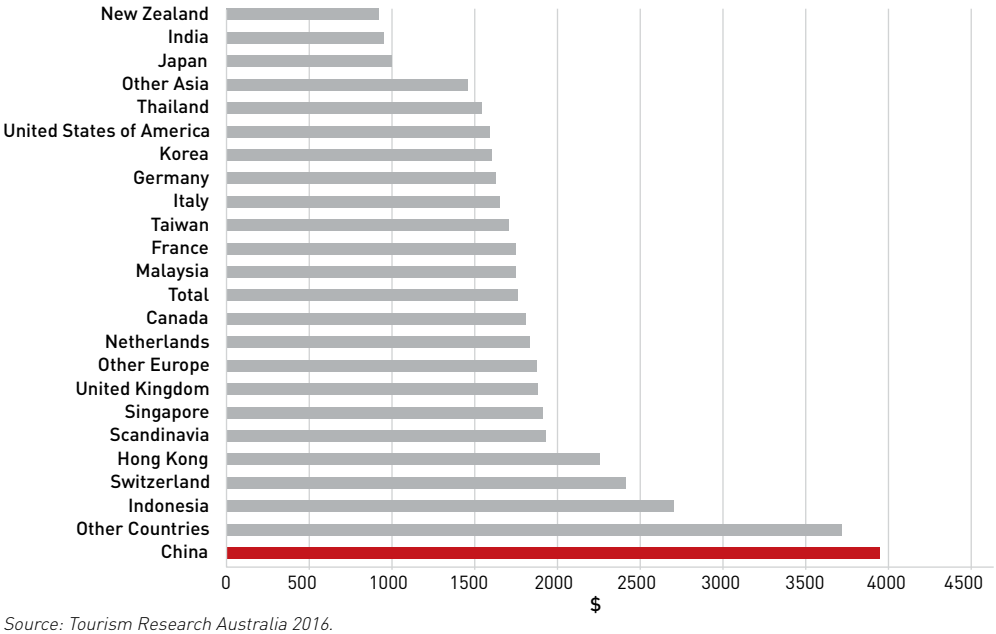
In 2011, the China National Tourism Administration and the Australian Government signed a Memorandum of Understanding (MoU), continuing Australia's Approved Destination Status (ADS) and committing to support cooperation in tourism through an annual dialogue. Australia and New Zealand were the first Western countries to be granted ADS in 1999 and Australia's delivery of the scheme is highly regarded in China. The official-level Australia–China tourism partnership was reaffirmed in April 2016, with a new MoU on Strengthening Tourism Cooperation being signed as part of Australia Week in China. The 2016 MoU builds on the 2011 agreement and covers industry cooperation, labour and skills development, investment, research and infrastructure.

During the 2016 Australia Week in China, national leaders announced the bilateral Year of Tourism for 2017. Designating 2017 a 'Tourism Year' is an excellent opportunity to increase people-to-people links through tourism. It will focus the Chinese government (and media) on Australia and strengthen the Australia–China tourism relationship. A number of events are planned for 2017, including Australian participation in the Beijing International Film Festival and Chinese participation in the Virgin Australia Melbourne Fashion Festival and Australia's Chinese New Year celebrations.

In order to ensure the current rapid growth in the inbound Chinese tourism market remains sustainable, and the benefits of this growth are distributed beyond Australia's gateway cities of Sydney and Melbourne, the Australian government is striving to increase the geographic dispersion of Chinese visitors. Dispersal spreads the opportunity, prosperity and demand from Chinese tourism, and is being achieved through measures such as improving tourism infrastructure in rural and regional areas and the introduction of a Work and Holiday Arrangement that allows 5000 Chinese participants each year. This program enables Chinese with tertiary education and English skills to experience a working holiday in Australia. It will boost demand for tourism services and help address shortages of bilingual workers available to the tourism industry as the industry seeks to service growing numbers of Chinese visitors.

While Australia is attractive to tourists because of its natural environment, tourism around the world is fiercely competitive. The scope of people-to-people links between China and Australia are a huge asset for Australia. Chinese visiting their friends or relatives in Australia not only strengthened these people-to-people ties, but spent an average of almost A$4000 per visit in 2015 (Figure 3.7). By contrast, Chinese holidaymakers coming to Australia just for tourism spent A$2389 per visit, close to the average spend of all holidaymakers in Australia.

Figure 3.7: Total average spend of foreigners visiting friends and relatives in Australia, 2015



Source: Tourism Research Australia 2016.

When Chinese visitors are not coming to visit friends and family, then Australia will have to compete for Chinese tourists with established destinations in Southeast Asia, Europe and North America. This means that Australian tourism providers need to focus on ensuring a quality experience that is adapted to the Chinese market. But the payoffs from attracting new visitors can be large once the connection between China and Australia is established. In a 2016 survey of 514 recent Chinese visitors to Australia, nearly half were repeat visitors. Three-quarters of surveyed visitors intended to visit again or come back for tertiary education, 48 per cent were interested in real estate investment, while 41 per cent and 24 per cent, respectively, were interested in the further purchase of Australian goods and services in China (LEK Consulting 2016).

The survey found that tourism is a first step to much deeper economic engagement. Chinese visitors' average annual spend on Australian products rose by 40 per cent after visiting Australia. The report recommended that Australian government and businesses need to act to harness the full potential of Chinese tourism and that Australia needs to ensure that: it remains an attractive travel destination so that visitor numbers continue to grow; visa-application processes, where appropriate, are smooth and easy to navigate; Australia's airports and transport facilities are among the world's best; and the Australian workforce grows its Chinese-language capability.

Australia is in an Asian time zone, but Berlin and Paris are both closer to Beijing than Brisbane. This highlights the importance of direct air connections that respond to traveller demands. Many flights from China to Australia still require time-consuming connecting flights, both domestically and via Asia. Authorities in Australia and China signed a milestone air services agreement in January 2015, tripling and in some cases abolishing caps on the number of seats for passengers from some of China's biggest cities (Minister for Trade and Investment 2015). Tourism agreements between South Australia and China Southern Airlines are another way to facilitate this (Williams 2016). But Australia could do more to ensure that profitable routes are available to Chinese carriers. This would include removing restrictions that prevent foreign carriers from flying domestic passengers or cargo on domestic legs of international flights — effectively tripling aviation capacity between Chinese and Australian major gateway locations. The air services agreement also provides for unrestricted access between China and Australian regional airports. While this arrangement has made significant aviation capacity available, China is one of Australia's fastest growing visitor sources and more can be done to ensure aviation capacity will foster future growth in visitation from China.

Removing these restrictions would make it easier for Chinese tourists to see more of Australia, and expand capacity in Australia's domestic aviation markets without requiring additional capital investment from Australian airlines. Given that this reform is directly beneficial to Australia, it should not be contingent on reciprocation in the developing Chinese aviation market. Better connectivity would also further open up the Chinese tourism market to Australians wanting to experience Chinese food, culture and history, as well as economic and social progress (Box 3.6).

To provide better services to Chinese visitors, Australia has improved visa arrangements by reducing documentary requirements and waiving interview requirements. Australia has introduced a three-year multiple entry visa as standard for eligible Chinese business visitors, and eligible Chinese tourists applying through an agent via an online trial. Additionally, Australia is now trialling the online lodgement of visitor visa applications; this service is expected to be rolled out fully by the end of 2016. A trial of 10-year visitor visas for eligible applicants in China is also expected to begin by the end of 2016, along with the implementation of a Chinese language lodgement option. Under the Developing Northern Australia White Paper visa initiatives, Australia began a priority 48-hour processing trial for visitor visa applications from Chinese passport holders in March 2016.

BOX 3.6: AUSTRALIAN TOURISTS IN CHINA

Australian outbound tourism is relatively larger by volume than its inbound tourism (Tourism Research Australia 2016). In 2015, Australian residents made 9.5 million overseas trips, spending a total of A$32 billion abroad. In 2015, Australia ranked 10th in international inbound tourism expenditure, valued at US$23.5 billion (behind Italy but before Hong Kong).

In 2015 Australian residents made 422,800 trips to China, meaning China is Australia's sixth-largest destination market. Those destined for China comprised 4.5 per cent of Australia's total resident departures, behind destinations such as Thailand (5.8 per cent), the United Kingdom (6.3 per cent), the United States (10.7 per cent), Indonesia (11.7 per cent) and New Zealand (13.4 per cent). Tourism Research Australia forecasts that Australian outbound tourism will grow at an average of 3.7 per cent per annum from 2014–2015 to 2024–2025, reaching 13.3 million overseas trips in 2024–2025.

From 2000 to 2015, visits to China have increased from 2.7 per cent to their current 4.5 per cent of Australian international travel (ABS 2016c). The value of goods and services acquired through Australians' travel to China for personal reasons increased by 392 per cent between 2000 and 2015. Over the same years, business and education travel grew significantly, but at slower rates — 203 per cent and 115 per cent respectively (ABS 2015, 2016a).

As of December 2015, Australia is the 16th most common source country of China's inbound tourism. Per capita, it ranks seventh, ahead of Japan, Canada, the United States and the United Kingdom (CNTA 2016).

Air connectivity improvements are a major factor behind the growing numbers of Australian tourists in China, as is the size of Australia's Chinese diaspora and the extent of people-to-people links. Wendy Wu, owner of Australia's largest tour operator to China, took 10,000 passengers in 2013 (up from just 16 in 1994). 'The majority of our customers,' said Ms Wu, 'say they want to go to China because their Chinese neighbours, friends, relatives and colleagues have talked about it and said they had a wonderful time there' (Karnikowski 2013).

Against this backdrop, there should be great potential for China to compete for a larger share of Australian tourism expenditure. Like Australia, China could improve its competiveness through measures facilitating tourist mobility, including more flexible and preferential visa arrangements (see Chapter 4). Many such arrangements would represent reciprocation of existing Australian initiatives. The bilateral Year of Tourism in 2017 also provides an excellent opportunity for China to promote its tourism attractions to Australian tourists. However, these promotions could go beyond traditional realms like food, culture, history and natural scenery, to showcase new attractions including China's state-of-the-art infrastructure in high-speed rail and metropolitan subway systems. These new tourist attractions would not only increase convenience for Australian travellers, but also provide opportunities for more Australians to experience China's economic development and social progress. Deeper community understanding is critical to the building of mutual trust and partnerships and facilitating flows of commercial opportunities between the two economies.

Developing China's services sector

The next step in implementing ChAFTA, which has the potential to help drive the transformation of China's domestic services industry, is to further open up the Chinese services market to competition from Australian companies. The Chinese services market is not as open to foreign competition as Chinese goods markets, and even absent formal barriers to trade, service providers often face stiff 'behind the border' barriers in the form of local restrictions on licensing and professional accreditation. The domestic provision of services often depends on complementary arrangements allowing foreign direct investment, as well as rules facilitating the movement of people.

Much of the hard work in enhancing these sectors requires major domestic policy reforms that are already underway in China. These reforms recognise that the biggest gains from trade liberalisation occur not from market access overseas but from allowing other countries to participate in domestic markets. Australian services providers are not big enough global players that they will be able to swamp Chinese incumbents. Nevertheless, their agility and experience in developed markets can help bring competitive pressure and know-how to Chinese domestic markets, and help prepare Chinese companies for future competition. Australia successfully executed a similar strategy in liberalising its financial markets 30 years ago.

While Australian financial institutions may be able to play a role in delivering financial services directly to Chinese consumers, they have more of a role to play in lowering the costs of trade between Australian and Chinese companies. This includes by supporting settlement or trade directly between the Chinese renminbi and the Australian dollar, providing products to hedge currency risk (particularly as China's foreign exchange regime becomes more flexible), and fostering integration with Chinese payment systems such as UnionPay and Alipay. ChAFTA also created a Committee on Financial Services. Opportunities for cooperation in financial services are further explored in Chapter 5.

ChAFTA removes many 'at the border' constraints on both established and emerging aspects of the trade relationship. The challenge now is to address residual 'behind the border' barriers — the sizeable trade constraints that go beyond the scope of traditional bilateral trade negotiations. The key way to do this will be through ChAFTA's Trade in Services Committee, which will review the state of the services trade within two years and propose measures to increase trade in services. An example of bilateral opportunities is delivering healthcare services to China's ageing population (Box 3.7).

Part of its role is to ensure that the commitments that Australia or China might make to third parties in other negotiations are automatically extended through ChAFTA. Australia's Most Favoured Nation commitment extends to all service sectors. China's is limited to education, tourism and travel-related services, construction, engineering, securities, environmental services, services relating to forestry, computer and related services, and certain scientific and consulting services. This means that if Australia or China extends more favourable access conditions to other trade partners, then suppliers in the other country will automatically receive this better treatment.

One reform that offers large potential gains would be to establish recognition of professional services qualifications from the other jurisdiction. By the end of 2017, the side letter to ChAFTA on skills assessment and licensing is due for review. To help make the most of this

review, the Australian and Chinese governments should coordinate engagement between accrediting regulatory bodies, such as Certified Public Accountants Australia and the China Institute for Certified Practising Accountants in the field of accounting, and Australian State Bar Associations and the All-China Lawyers Association in the legal profession. Two other fields that could provide early gains are engineering and TCM (Productivity Commission 2015).

BOX 3.7: HEALTHCARE SERVICES

China's developing healthcare sector is struggling to keep up with the demand placed upon it by China's huge and ageing population (Austrade 2016a). There are over 202 million Chinese who are over 60, representing 15.5 per cent of the population. And this share is projected to increase to 24 per cent by 2050 (Xu 2016).

Australia's healthcare facilities are among the best in the world (Brown and van Nieuwenhuizen 2016), and ChAFTA will give them an advantage against their main competitors in the market: Japan and the United States. Australian exporters have the opportunity to service the Chinese market by providing:

- training and education programs for human resources;
- home care services;
- operation and management of seniors living/retirement villages/resorts;
- conceptual design and planning of institutional aged care, seniors living, retirement villages and resorts;
- quality health care products (that is, functional food, additives and nutrition, healthy food, assisted living and e-health products for the elderly); and
- infrastructure investment and operation (Austrade 2016a).

Traditional Chinese Medicine

China is also contributing to the development of new sectors in Australia. TCM in Australia is still a nascent industry, yet it has succeeded in attracting significant attention from government bodies and business. The range of recent advancements in regulation, collaboration and exchange will only lead to greater opportunities for Australian TCM research, development and export in years to come.

In November 2014, the University of Western Sydney (UWS) and the Beijing University of Chinese Medicine signed a MoU to develop Australia's first TCM integrative clinical service. The Australian prime minister and the Chinese president attended the signing ceremony.

The UWS National Institute for Complementary Medicine (NICM), which will operate the new service, hopes its research will lead to new treatments for outstanding medical needs and new medicines for global export. The NICM will also partner with Chinese researchers to run clinical trials on TCM (CRI 2015). The institution's capabilities should also be of interest to international complementary medicine companies wishing to prepare regulatory filings for other markets, such as in the United States and Europe (ATC 2014; Austrade 2014).

This MoU is one of a range of initiatives in recent years that have made Australia well placed to advance the production, regulation and market access of TCM in the future. In July 2012, Australia became the first Western country to institute mandatory national registration of TCM practitioners, a major institutional step for TCM development and quality control (CMBA 2012).

ChAFTA includes a number of provisions encouraging bilateral TCM collaboration and exchange between regulators, professional bodies and relevant government departments. The agreement encourages the development of mutually acceptable standards for TCM licensing and certification, as well as providing support for personnel movement, granting entry and temporary stay for four years to a quota of TCM practitioners.

In addition to the export of services such as clinical trials, some agricultural and medical bodies are exploring prospects for the Australian export of TCM goods. The Western Australian Department of Agriculture and Food has encouraged the growing of jujubes or Chinese dates, a common food and medicinal product, which can be grown in Australia counter-seasonally to China (DAF 2016). University of Queensland pharmaceutical researchers have pointed to the possibility of the export of cane toad products for TCM use (Milman 2015).

Building trust to achieve potential trade

A business-as-usual approach to the bilateral relationship will not be sufficient to capitalise on its full potential. The resources trade is predominantly conducted through large mining companies on the one side and Chinese SOEs on the other side. But this trade goes beyond the supply of bulk commodities to include targeted marketing, integrated supply chains and cross-cultural human resource management. This trade is built on a foundation of strategic trust to ensure that governments do not arbitrarily interfere with commercial relationships. Going beyond this, in the services trades for example, will require deeper understanding and institutional relations between Australian and Chinese organisations and people.

High-level official engagement

The Australian and Chinese governments have a role to play in removing barriers to trade, catalysing the commercial and social relationships from which beneficial exchanges can emerge, and establishing the institutions and trust required to lower barriers to trade. This is a hard task given the expanding pool of bilateral stakeholders. A larger number of smaller-valued trade transactions mean that industry players will be less organised and find it harder to attract attention at the official level, meaning that governments on both sides will need to take greater effort to consult with business.

At the highest level, a joint commitment to trade liberalisation should be proactive and extend beyond the implementation of ChAFTA. This work can be developed as part of the agenda for the Strategic Economic Dialogue (SED) between the two countries (Box 3.8). This dialogue brings together the Australian Treasurer and Minister for Trade and Investment for annual talks with the Chairman of China's National Development and Reform Commission (NDRC).

BOX 3.8: THE AUSTRALIA-CHINA STRATEGIC ECONOMIC PARTNERSHIP

When then Chinese executive vice premier Li Keqiang visited the Australian prime minister Kevin Rudd in October 2009, he stressed the role of 'dialogue, coordination and cooperation' in building Australia–China relations (Chinese Embassy Australia 2009). The Australia–China Strategic Economic Dialogue (SED), which provides such an opportunity for Australia, was announced in 2013. The first meeting in June 2014 was attended by the Australian Treasurer and Trade Minister, and the Chairman of China's NDRC.

At this inaugural SED in Beijing, the two countries established an Investment Cooperation Framework. The Framework goes beyond ChAFTA and creates new pathways for promoting the export of financial services, two-way investment in new sectors and identifying roadblocks for investors from both countries. There is tremendous opportunity to deepen the relationship at a number of levels, including by expanding services exports from Australia to China and improving investment opportunities.

The second SED, held in Canberra in August 2015, saw the two governments agree to further 'two-way investment to diversify our trade relationship and create opportunities in the services sector' (Treasurer of Australia 2015a).

This high-level political cooperation is practically supported by a MoU for cooperation between the NDRC and the Australian Treasury, which was first signed in 2008 (Australian Treasury 2008). Chapter 6 discusses how to energise these institutions.

While much has been done both in terms of international trade law and bilateral negotiations to remove formal barriers to trade, many of the barriers that remain occur at state/provincial, municipal and more local levels of government. It is often at these levels where national laws have to be implemented, and where local licensing practices and enforcement can have the effect of producing major, if sometimes unintended, barriers to international trade.

The premier forum for bilateral engagement at the state/provincial level is the Australia–China State/Provincial Leaders Forum. The Australian prime minister and the Chinese President opened the Forum. This institution should meet regularly, and possibly establish a standing secretariat that is able to support its work, share knowledge and coordinate the implementation of its commitments and initiatives between different levels of government.

The environment for managing and welcoming foreign investment projects is significantly influenced by how they are managed at the local level. A strong partnership between provincial and state governments, and dialogue with lower levels of governments and community stakeholders assists firms to discover trade opportunities and facilitate the investment that supports trade. Australian states have long had sister state–province relationships with China's most outward-oriented provinces (Table 3.7), and there are more than 70 sister-city relationships. Trade delegations led by the political leaders of Australian states and territories to China can help cement commercial ties (Box 3.9).

This can be taken further — although China only established diplomatic relations with South Korea in 1992, the two countries already have 154 sister-city relationships (Ren 2014). The relationship between Weihai, a town of 600,000 people, in Shandong Province, and Incheon, a city of 3 million in South Korea, is an exemplar of a sister-city relationship. More than 800 South Korean companies operate in Weihai, which is also home to 40,000 South Koreans (Zhao 2015).

State and provincial level governments can further bilateral links through more exchange programs for students, businesspeople and government officials. Victoria is currently taking the lead in establishing a 'Partnerships for Prosperity' strategy with China (Government of Victoria 2016). This involves strengthening cooperation on innovation with its existing sister-province, Jiangsu, as well as formalising a new sister-province relationship with Sichuan. The strategy includes targeted capacity building within business, government and education, as well as cultural engagement. Victoria wants to be the destination for 20 per cent of Chinese investment in Australia by 2026. Over the same timeframe, the Victorian government expects exports to expand, revenue from Chinese tourists in the state to increase, and post-graduate tertiary enrolments from China to grow by a quarter.

Table 3.7: Sister state–province relationships between Australia and China

Australian State or Territory	Chinese Province or Municipality	Relationship established
New South Wales	Guangdong	1979
Victoria	Jiangsu	1979
Tasmania	Fujian	1981
South Australia	Shandong	1986
Western Australia	Zhejiang	1987
Queensland	Shanghai Municipality	1989
Northern Territory	Anhui	2000
Australian Capital Territory	Beijing	2000
Queensland*	Guangdong	2004

Source: ACCCI 2001; AHFAO 2015; GFAO
** refers to a Friendly Cooperative Province rather than a 'sister' relationship.*

The American Chamber of Commerce in China (AmCham) conducts annual surveys of China's business environment, and releases an annual white paper for American business (AmCham 2015). Many of the detailed concerns raised by this organisation are likely to reflect the experience of Australian business in China. AmCham finds that foreign companies trading in China report that local regulatory environments and conditions matter. Central policies are not always uniformly enforced across China, and the institutions and infrastructure needed to get products to market, and the financial services required to facilitate trade, are not always well developed beyond China's first-tier cities. In particular, foreign companies often complain that regardless of tariff levels, their export operations become complicated by inconsistent and inefficient customs procedures and regulations at the local level. AmCham reports that there is a perception among foreign businesses that local governments favour local developers with regards to access to land and real estate.

Beyond the first-tier cities, an absence of international schools, multilingual health centres and international financial institutions can make it difficult for non-Chinese speaking foreigners hoping to do business (AmCham 2015). Some areas impose regulations and fees for importing international educational resources, including textbooks. Further opening up of the market for healthcare and education services would make it easier for international providers to offer these services to foreign visitors, therefore facilitating more business and investment connections. At a practical level, even different regional bureaux of the Exit-Entry Administration of China's Public Service Bureau interpret and apply regulations differently. This can cause visa problems for students and professionals.

States and provinces can play a leading role in driving practical cooperation (Box 3.9). Australian state governments already have an on-the-ground presence in China — New South Wales, South Australia, Queensland and Western Australia in Shanghai; New South Wales in Guangzhou; Victoria in Nanjing, Beijing and Chengdu; South Australia in Shandong — which can help deliver this engagement. Victoria's China strategy includes increasing resources for its network of government business offices by A$66 million, including the appointment of a new deputy commissioner responsible for Western China (Premier of Victoria 2016). Tasmania also recently capitalised on a visit by the Chinese President by launching 'Tasinvest', a promotion that attracted over 100 representatives of Chinese companies. Tasmania also signed a MoU on planning and cooperation with the China Development Bank, in order to facilitate Chinese investment in Tasmanian mining, agriculture, tourism and infrastructure (Premier of Tasmania 2014).

State–provincial and sister-city relationships should be forums in which to negotiate and resolve these issues, as well as to recognise professional accreditations (such as real estate broker licenses), and ensure transparency and consistency in granting local licenses and government approvals, including in banking and finance. Australian companies operating in China do not need any kind of preferential treatment, but they do need an assurance that the interpretation of laws and regulations at the local level is not being used to restrict competition. Opportunities for official visits and exchanges of state and provincial government officials, including with judicial and prosecutorial organs, can contribute to the trust and understanding needed to identify and resolve local regulatory discrepancies.

BOX 3.9: STATE AND PROVINCIAL TIES

The first sister state–province relationship was established in 1979 between New South Wales and Guangdong province, and the annual NSW–Guangdong Joint Economic Meeting has been a key component of the relationship. In July 2008, the NSW government also signed a formal MoU with the Financial Services Office of the Shanghai municipal government to strengthen their relationship. Since then, the two cities have held an annual financial services symposium to grow their positions as financial hubs in the Asia Pacific. In June 2012, Guangdong's former party secretary visited Sydney, and in 2015, the NSW Premier Mike Baird hosted the current Guangdong Party Secretary Hu Chunhua, who was then received by the Australian prime minister as a guest of the Australian government in Canberra. Prior to the NSW premier's first official visit to China in 2014, NSW released its own China Engagement Strategy. The premier led a delegation to Guangzhou in November 2015 in order to discuss opportunities under ChAFTA. In April

2016, the NSW health minister travelled to China to promote new opportunities for health care providers and medical device manufacturers under ChAFTA. During this visit, the minister also attended Austrade's Australia Week in China 2016.

The Victoria–Jiangsu Joint Economic Committee first met in 1987. A number of Victorian projects in China have progressed through this Committee, particularly some relating to sustainable urban development. To celebrate the relationship's 35th anniversary, a MoU was signed between Regional Development Victoria and the Jiangsu Foreign Affairs Office in July 2014, launching the Victoria–Jiangsu Regional City Alliance. The alliance aims to strengthen multiple city-to-city trade and investment ties between the two states. Over 60 government and business leaders, including Jiangsu's vice governor, attended the launch. Following his visit to China in 2015, Victorian Premier Daniel Andrews proposed to send every member of his ministry to China before the next state election in November 2018. The premier intends to visit China every year in order to boost trade and explore further investment opportunities.

On top of this, Jiangsu and Victoria have a formal partnership between the Victorian Department of Education and Training and the Jiangsu Provincial Department of Education, and the Hamer Scholarship program for young Victorians to study Chinese language and culture in Jiangsu. Moreover, Monash University was the first Australian university licensed to open a campus in China, in partnership with Southeast University in Suzhou. As part of Victoria's new China Strategy, Victoria will also formalise its new sister-province relationship with Sichuan by the end of 2016.

Tasmania and Fujian province have had an active relationship since 1981. After the 2014 Australia G20 Summit, Chinese President Xi Jinping (a former governor of Fujian) visited Tasmania accompanied by the Fujian party secretary. The Tasmanian premier and the Fujian party secretary signed the Agreement on Establishing the Joint Committee for Cooperation and Development, an organisational body overseeing bilateral exchange, and committed to hold biannual meetings to discuss trade. The delegation was accompanied by representatives from eight Fujian companies, including Xiamen Airlines, the Zijin Mining Group and Xiamen Construction and Development Group. The inaugural meeting of the Joint Committee was held in March 2015 in Fujian and attended by the Tasmanian premier. Tasmania also signed a MoU with Fujian when Chinese President Xi Jinping visited Tasmania in November 2014, establishing a Joint Committee for Cooperation and Development.

In 2013, the South Australia Shandong Cooperation and Development Forum was established, with the inaugural Forum held in Jinan that April. The Forum is chaired by the South Australian premier and the vice governor of Shandong. The delegation included business leaders from the mineral, energy, agribusiness, wine and education sectors. MoUs advancing economic relations were signed with the Shandong Commerce Bureau and the Qingdao Bureau of Commerce. In May 2015, the Governor of Shandong, Guo Shuqing, welcomed South Australia's largest ever trade delegation led by the South Australian Premier Jay Weatherill. The premier released the state's updated China Engagement Strategy in May 2016 (Premier of South Australia 2016).

Western Australia has had a sister state–province relationship with Zhejiang province since 1987. In 1995, the Western Australia–Zhejiang Sister-State Economic Exchange Committee was established to oversee the economic aspects of the partnership. In September 2012, a delegation led by the Zhejiang governor visited Perth to celebrate the 25th anniversary of the relationship. In April 2014, a MoU was signed between the two parties on live cattle exports. The WA minister for regional development led a delegation in August 2015 to China to meet with Zhejiang provincial government officials.

Queensland and Shanghai have maintained a sister state-city relationship since 1989. To mark the 25th anniversary of this relationship in 2014, their two governments agreed to work together on urban development issues, strengthen information sharing in relation to the Shanghai Free Trade Zone, and expand cooperation and exchange.

The Australian Capital Territory (ACT) has had a formal sister-state relationship with Beijing since 2000. The scope of the ACT's engagement with China was expanded in 2014 with an economic cooperation agreement signed by the ACT chief minister and the mayor of Shenzhen.

Grassroots engagement

The next round of trade opportunities in services requires much more sophisticated engagement by tens of thousands of enterprises and entrepreneurs on each side (see Chapter 6). The Australia–China CEO Roundtable is the premier forum for this at the peak business level.

Opportunities exist to improve bilateral capacity in many services industries, including tourism and education, and professional services, where the delivery of high-value products depends on tailoring services to meet the demands of specific consumers. A deep understanding of consumer preferences is essential to providing niche services, and members of Australia's Chinese diaspora community are ideally placed to play a leading role (Box 3.10) This community is growing — the number of Chinese-born Australian residents more than doubled from 2004 to 2014 (ABS 2015b). The estimated Chinese resident population is currently around half a million (ABS 2015b). Ongoing migration from China to Australia (discussed in Chapter 4) helps meet Australian demand for human capital in fast-growing areas. Chinese accountants, advertising and marketing professionals, IT specialists and educators do not just bring technical skills, but also possess up-to-date knowledge of consumer preferences, business practices and market opportunities in China.

Whether Chinese-born, or raised in Australia with an awareness of Chinese culture and sensibilities, the Chinese diaspora community brings with it new and valuable opportunities to tailor local products and services to suit Chinese consumer demands. When Chinese-Australian business leaders make use of their linguistic, networking and entrepreneurial advantages, their colleagues and collaborators gain firsthand experience of the importance of developing culturally specific human capital, and the opportunities presented by China's continued transformation and growth.

BOX 3.10: CULTURAL CONNECTIONS AND BUSINESS OPPORTUNITIES FROM THE CHINESE DIASPORA

Chinese graduates can have transformative effects on Australian businesses. At one medium-sized wine producer in the Adelaide Hills, a Chinese-speaking employee began addressing occasional enquiries from China and translating tasting notes. The employee, a wine business postgraduate, soon took on a permanent position developing the business' 'strategy for China' — a position she had, according to the general manager, effectively created 'for herself'. Now, 36 per cent of that business' total revenue (approximately A$2 million) is accounted for by China.

Chinese-Australian business leaders can play a central role in strengthening and consolidating supply chains. One Chinese-Australian business owner described sourcing cardboard packaging for a client: 'They're so expensive here, but in China it's so cheap … [What's] really important for business is you have to hear the people. You have to know what they're thinking. And you have to know where the need is' (Rizvi et al 2016).

For example, the presence of Chinese workers in the South Australian wine industry has already begun to transform it. Wine producers throughout Australia, especially small- and medium-sized businesses, are keen to capture a share of the growing Chinese market, but they have limited ability to identify market opportunities and adapt to Chinese tastes. Chinese workers can provide the linguistic ability, multicultural business perspective and networking advantages needed to match producers to international consumers. Some recent Chinese graduates have even started their own export-focused wine businesses.

The Australia–China Youth Association (ACYA) and the Australia China Young Professionals Initiative (ACYPI) are exemplar non-government organisations. ACYA is supported by the Australian government through the Australia–China Council and has many institutional partners, particularly in Australian and Chinese universities. ACYA is dedicated to improving people-to-people ties through career and education services. It operates across 22 chapters, 17 in Australian universities and five in Chinese cities, and in 2010 launched the annual high-level Australia-China Youth Dialogue (ACYD).

In October 2015, the ACYPI surveyed more than one hundred of its own members as well as participants in the 2015 South Australia–Greater China Future Leaders Dialogue. More important than the business environment in either Australia or China, participants cited the 'lack of trust in and understanding of the other country' as the most important issue in the bilateral economic relationship. Australia's relationships with Japan and the United States were regarded as the least important issue in the Australia–China relationship (Egan et al 2015).

In its submission to this Report, ACYPI recommended investing in education (particularly secondary, tertiary and ongoing professional development), encouraging development of people-to-people-ties and maintaining an ongoing bilateral dialogue (on economics and other matters) as the key means of building this trust, and developing the relationship-specific human capital that is crucial to providing tailored goods and niche services to each other's markets.

These forms of state–provincial, sister-city and civil society cooperation are an underutilised resource for improving the overall bilateral relationship — as are peak business groups. The role of these bodies could be expanded and formalised into a new Australia–China Leaders Forum, which would be tasked with identifying practical areas for cooperation, and continue building the understanding and trust that is the basis of a true partnership.

Programs of cooperation among different layers of society will also be crucial in the development and maturation of each nation's 'brand' in the other country (Box 3.11).

BOX 3.11: BRAND AUSTRALIA AND BRAND CHINA

A country's 'brand' represents the promise, inherent value and reputation, real or perceived, that its name possesses in the eyes of overseas consumers, tourists, businesspeople and other foreign entities. What is China's idea of 'brand Australia', and, conversely, how do Australians perceive 'brand China', in economic, cultural, political and other senses?

Australia enjoys a positive brand image in China. Many Chinese believe that Australia is a 'friendly' place with pleasant weather and many open spaces. In recent years, Australian consumer products, including food, agricultural goods and health supplements, have become very popular with Chinese consumers as they are considered to be high quality, healthy and most importantly chemical-free, whereas the equivalent Chinese products are not. Australia is perceived as non-threatening, and there are few negative perceptions of the country in most Chinese people's view. But that can change. Incidents such as the problems surrounding Chinalco investments in Australia have an adverse impact on Chinese perceptions of Australia's 'brand', as would problems with Australian goods.

In Australia, there is a wider range of perceptions of China. Australians respect China's achievements in modern development. A recent poll across several countries suggests that 80 per cent of Australian respondents acknowledged China as a rising power. Elements of Chinese culture like Chinese food, kung fu and the hard-working ethic of the Chinese are also widely admired and welcomed in Australia's multicultural society. China's political system evokes anxieties and there are often negative reactions to Chinese investment in Australia, particularly in real estate. However unfairly, China's consumer brands are often perceived as cheap and of inferior quality, even though China now manufactures — and Australia now buys from China — a vast range of world-class products, such as the iPhone. Even though these are sometimes designed in the United States or Japan, they are 'made in China'. Quality whitegoods like Haier and Midea, as well as other foreign brands made in China, prove that China is capable of making world-class consumer products. This could help China enhance its own national brand in the process.

Governments can play a role in building a national brand. Organisations like Austrade and Tourism Australia work to enhance the trade opportunities in China of products and services that play on the Australian brand: milk powder, education and tourism, for example. For Chinese companies, the China Council for the Promotion of International Trade organises Chinese trade delegations to visit other countries. It also manages overseas trade shows for Chinese organisations and assists Chinese companies to attend overseas economic conferences, exhibitions and forums.

Developing a national brand is one way of developing soft power. This can sometimes take the form of cultural diplomacy initiatives, such as the Confucius Institutes set up around the world to promote Chinese culture.

On two recent global soft power rankings Australia was listed as the sixth most effective country at deploying its soft power, behind much more powerful countries such as United States, the United Kingdom, France, Germany and Japan (Monocle 2016; Portland Communications 2016). China lags behind on these rankings, with the country's soft power ranked at 21st and 30th in the Monocle and Portland Communications ranking, respectively. This implies that China's soft power score is out of sync with its overall economic and political accomplishments.

While these rankings are both conducted by Western organisations and may not portray sentiment towards Australia or China across the entire spectrum of cultures, it does ring true that, compared to the size of its population and economy, Australia carries significant weight in terms of soft power.

National brand changes, as countries develop and change. Both the Australian and Chinese governments have a role to play in fostering this familiarity through more people-to-people and cultural exchanges that will reconfigure perceptions and play an important role in the evolution of each countries' national brand in the other country. The nuanced mutual understanding that emerges from this will allow both Chinese and Australian citizens to gain the most in working together on the relationship.

The scope for a maturing and deepening of the bilateral trade relationship is clear. Australia will expand its exports in high value-added goods and services, though its resource abundance will continue to make it an important supplier of energy and minerals to China. However, realising the full potential of this relationship depends on active engagement on the part of public and private sectors in both countries, and on the vigorous prosecution of respective agenda for domestic reform.

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