CHAPTER 1

Strategic importance of the relationship

KEY MESSAGES

There is no economic or geopolitical future for China, Australia or the world that would not be improved by China's sustained and balanced economic growth. And yet the future direction of Chinese growth will be very different from that over the past four decades. The forces of change that have already unleashed a wave of consumption growth are affecting the relationship with Australia profoundly. Economic reform and liberalisation can intensify the ongoing change in the structure of the Chinese economy and, while these changes imply a less heavy reliance in Australia on the resource sector for economic growth, there are opportunities for growth that will require substantial repositioning of policy and commercial strategies by both countries and the development of a still closer relationship between the two countries.

The structural transformation of the Chinese economy as it grows toward high-income status will be fuelled by domestic reforms that make the allocation of resources more efficient and by the opening of the capital account, a step that should be undertaken incrementally and with due caution. China will reorient its economy towards domestic consumption. Australia's challenge, meanwhile, is to counteract the fall in real incomes that has resulted from the fall in commodity prices as Chinese demand slows, and to invest in filling the infrastructure gaps that will act as a brake on productivity and income growth if left unaddressed.

The recent history of the growing ties between the two countries shows that the determined pursuit of a deeper relationship yields tangible benefits. The institutions and policy frameworks that have emerged to provide structure for the relationship in recent years provide a strong starting point for the next phase of the Australia–China partnership.

Both countries have invested heavily in their partnership. The path-breaking record of the Australia–China partnership in opening the resource trade, foreign investment, regional cooperation initiatives and China's accession to the WTO provides a legacy on which to build new international standards into their bilateral trade, investment and all other dealings. Their high-level Comprehensive Strategic Partnership and ChAFTA are major institutional assets (embodying mutual trust and practical commitment) that can be deployed to manage change over the decades ahead. Still closer engagement and institutional arrangements are needed to capitalise on the opportunities that these foundations present.

ChAFTA is a blueprint for initial change, not an end-point in the bilateral relationship. A joint work plan for achieving change will not only define progress in the bilateral trade, investment and commercial relationship over the coming decade; it will also provide the foundation for Australia and China pushing liberalisation and reform in the Asian region and setting out the pathway towards reform and strengthening of the global trade and economic systems. Precedent exists in institutional frameworks such as the 1976 Basic Treaty of Friendship and Cooperation between Australia and Japan for a comprehensive bilateral treaty to provide an overall guiding structure for the Australia–China relationship as it matures.

The scale and significance of developments that are now taking place — especially in China through its transformation towards a high-income economy — recommend deeper bilateral institutional arrangements between Australia and China. These would build on existing bilateral frameworks with bold new bi-national initiatives, including in the areas of investment, tourism, people movement, science, and educational exchanges. They will need to capture opportunities in the relationship, and manage the inevitable risks and processes that are a consequence of large-scale change.

Both countries should work together to strengthen the established regional economic cooperation arrangements and to secure the framework of political confidence and security within which economic prosperity can be attained. But there are gaps in regional policy strategies that Australia and China must now work more actively with regional partners to fill. The Australia–China relationship is anchored in global institutional and political arrangements. Australia has a direct and important stake, in partnership with China, in working to ensure China's success in the assumption of its role of shared leadership in global economic affairs.

In the coming decade, Australia's relationship with China will be a top policy priority. Trade with China accounts for almost a quarter of Australia's overall trade, with China absorbing almost a third of Australia's total merchandise exports (DFAT 2016e). China is the fifth-largest source of foreign direct investment into Australia and for many Australian businesses China represents an enormous growth market (ABS 2016f). While Australia is China's seventh-largest source of imports, Australia is also a major and reliable source of strategic industrial raw materials and high-quality inputs, from iron ore to education, which China needs to fuel its industrialisation and urbanisation. The relationship between Australia and China is integral to their other important international relationships.

With remarkable success in the achievement of higher incomes and wages in China, the pace of growth is slowing as ready supplies of low cost labour are exhausted. The shift in China from export- and investment-led growth to growth based on domestic demand, and especially domestic consumption, has contributed to the decline of the Australian resources boom.

As China's growth model and focus shifts and Australia seeks to define a prosperous economic future less reliant on its resource base, big changes are bound to occur in the relationship. Some big changes have already taken place and new opportunities are emerging for both countries. The transformation towards productivity and innovation-led growth, financial market reform and capital account openness will propel China's deeper integration into the global economy. A richer China with a more open services industry will gain new standing among the major economies of the world. Australia's shift to more human capital-driven growth, together with the changes in China, provide the opportunity to forge new complementarities between the two countries, profoundly reshaping their bilateral relationship over the decade ahead.

As production in some of China's heavy, resource and energy-intensive industries is peaking, the price of Australia's exports of commodities such as iron ore and coal has fallen. As economic rebalancing towards consumption and service sector-led growth continues, the share of heavy industry in the Chinese economy will inevitably decline. Yet Chinese demand for resources and energy will remain large as urbanisation continues in China and Australia's share in China's resource imports, which has risen as prices have fallen, is likely to stay high. As one of the world's leading and most competitive suppliers of a range of industrial inputs, Australia will remain a major anchor in China's external resource security. Increasingly, however, the trade relationship will diversify beyond commodities into a wider range of goods and services. The two countries' investment and financial integration will become deeper and more sophisticated. Australia can aim to become a major supplier of knowledge, skills and products supporting China's next stage of development, which involves an emphasis on high value-added industries, innovation and clean production processes. Industrial restructuring and upgrading in China will see China's machinery and equipment exports become more important to Australia and will diversify Chinese investment into tourism, finance and infrastructure.

Australia and China have played a key role in economic cooperation in Asia and the Pacific, regions which include economies that are the fastest-growing and most dynamic centres of global economic activity. Through regional and multilateral forums, both countries have worked closely to promote development, stability and stronger regional cooperation. They have a deep intersection of interest in strengthening established regional arrangements, such as APEC, the ASEAN Plus frameworks and the East Asia Summit, and in global institutions, especially the G20. They also have a shared interest in securing the framework of political confidence and security within which economic prosperity can be attained.

The growth of China's importance in the world economy has occurred very rapidly and has brought with it new capacity, responsibilities, expectations and challenges in managing its interdependence with the rest of the world.

The Chinese economy accounted for less than 3 per cent of global GDP in 1980 (OECD 2013a). It is now the second-largest economy in the world in nominal terms, accounting for 13 per cent of global GDP in current US dollars, and its GDP is larger than that of the United States in real purchasing power parity terms (World Bank 2016). China became the single largest contributor to global growth in 2007 and has maintained that position ever since (Yueh 2015). China is the world's largest goods trader and is also the world's second-largest importer of goods and services, making it a major element in global demand for traded goods and services (Austrade 2015a; World Bank 2016).

Until recently, China was mainly a rule-taker in the global economic system. Since the late 1970s it has benefited enormously from opening its economy and participating in the post-Bretton Woods system. China's role in global economic governance remained passive, constrained by the small size and low capacity of its economy. Now China is growing out of this stage and is therefore becoming more active in the provision of global public goods. The transition to joining the ranks of global rule-makers is not automatic or easy for either China or the global system. But China is now actively participating in global governance and actively assuming its international responsibilities and duties. An important opportunity is China's chairing of the G20 in 2016.

Australia has a direct stake in working, in partnership with China, to ensure China's success in the assumption of its role of shared leadership in global economic affairs. There is special value in the development of this partnership because of Australia's unique role in the region as well as its closeness to the United States. The value of the partnership includes the chance of working with China in the development of its contribution to the provision of international public goods, both through established international institutions such as the IMF, the WTO, the World Bank and new international institutions such as the AIIB. It also includes Australia's working together with the established and emerging powers to build new platforms to coordinate a range of global economic policies within the G20 and to manage the challenges to sustainable growth from climate change and other environmental issues.

This is a critical moment in a far-reaching global economic transition. Australia and China have a vital opportunity to define how they will shape the future course of their relationship in a deliberate way, establishing some common reference points to help manage it purposefully, as they have with some success in the past, rather than muddling through in the future.

Capturing the full benefit of the economic relationship will depend on how both the public and private sectors in Australia and China engage in and develop the relationship. Managing the risks and uncertainties that can impact on the economic relationship will be important. As a starting point, getting the most for both countries will require a functional understanding among policymakers, corporate leaders and the broader community of the changes that will shape China and Australia in the next 10 years. This Report can play a role in this. The understanding that has been built through this work can be embedded in institutional forms to help facilitate better management of the relationship. ChAFTA represents a major step in putting in place stronger institutional arrangements for the development of trade and investment links. But a relationship of the kind that will be required by the changes in both economies, their economic cooperation in the region and their partnership in global affairs in coming decades, demands substantial joint policy initiative and strengthened institutional frameworks (both government and private).

In 1976, Australia signed a Basic Treaty of Friendship and Cooperation with Japan, an agreement which set out the principles underpinning their bilateral relationship, defined key areas of cooperation, and pledged to enshrine and preserve the principle of non-discrimination in economic relations. Since its signing, the Treaty, and the mutual confidence that it gave both Japan and Australia, has provided the framework within which closer ties have forged. The opportunity for evolving a similar framework to underpin the Australia–China relationship should not be passed up. ChAFTA can provide the beginnings for such a framework.

Economic transformation in China and Australia

China

The Chinese economy is undergoing a major transformation after nearly 40 years of high-speed economic growth. China's rapid economic rise has been fuelled by market-oriented reforms and economic liberalisation that helped reduce the distortions in resource allocation in the economy. The reform was more thorough in the goods market than in factor markets for land, labour, capital and energy, which remained under tighter state control. This growth model encouraged investment in manufacturing capacity and infrastructure.

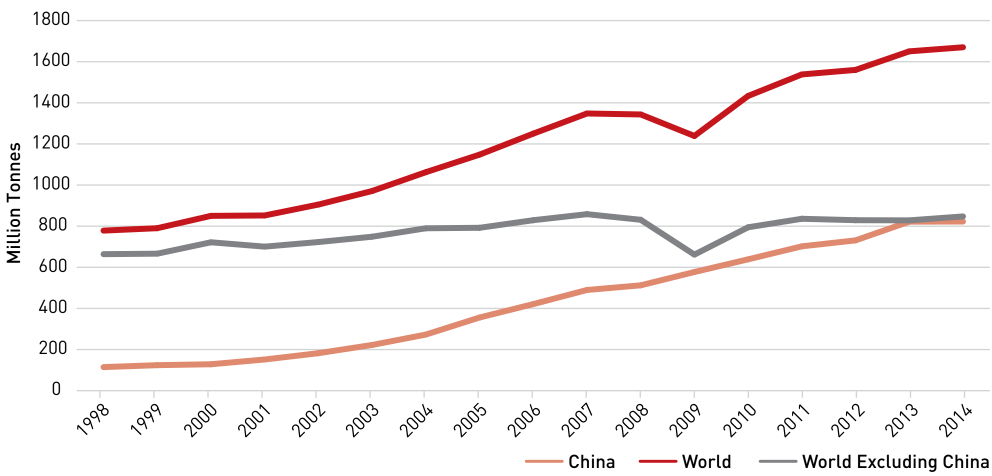
With real GDP growth at around 10 per cent per annum from the 1980s, manufacturing output is now larger than that in any other economy in the world. China accounted for a quarter of world manufacturing output by 2015, up from less than 3 per cent in 1990. Chinese consumption has dominated the global markets for industrial raw materials (World Bank 2016). The expansion of the iron and steel industry, for example, which produced over 800 million tons of crude steel in 2015, or more than six times as much as it did in 2000, lifted the Chinese share in world iron ore consumption from 14 per cent in 2000 to an estimated 65 per cent in 2015 (Figure 1.1). This surge in Chinese demand drove a more than five-fold rise of prices in the years from 2000–2008 in the scramble for additional supplies of iron ore (RBA 2012).

Australia's established competitiveness in international resource and energy markets, relative geographic proximity and close engagement since China's economic opening in the 1970s, made Australia a natural and complementary partner in China's trade and industrial transformation. Australia has been an anchor in Northeast Asian resource security and a pioneer in the export of high quality resources to China. Australia became China's principal supplier of imported iron ore, coal and a range of other industrial raw materials over these years. In 2015, Australia supplied 64 per cent of China's imported iron ore, for example, compared with the 43 per cent it supplied in 2010 (Ng 2016). The relationship with China saw massive investment in the Australian resource sector in the first decade of the 21st century, and strong growth in Australia throughout the global financial crisis when growth in other industrial economies languished.

While China's investment-led growth delivered astonishing outcomes, it also led to structural imbalances that increasingly threatened sustainable growth and stability.

China's reforms now aim to remove those distortions, especially in the financial market, and nurture consumption- and service-led growth. The Chinese government is also implementing measures to close down capacity in heavy industries, such as iron and steel, that does not embody best-practice production technology or environmental protection. This entails substantial costs of adjustment and the need to manage economic as well as social dislocation. The focus of growth is now on the 'new economy'. The change in gear from double-digit to single-digit growth is expected to put the economy on a more sustainable, but still relatively high, long-term growth trajectory over the coming decade.

Figure 1.1: Chinese and global steel production



Source: World Steel Association 2015.

Among the national economic policy commitments that are likely to have the most profound effect on China's relations with Australia and other countries is the Chinese government's 13th Five Year Plan commitment to build an open economic system, deepen financial system reform, liberalise financial markets and accelerate the realisation of Chinese capital account convertibility.

Capital account liberalisation is essential to making China's renminbi a truly global currency and increasing China's role in international finance. Inclusion of the renminbi in the IMF's Special Drawing Rights basket is a first step in this process. For the renminbi to become a truly international currency, however, China needs to have an open capital account. But the significance of capital account liberalisation is much more wide-ranging than renminbi internationalisation.

Financial reform and capital account liberalisation are central to rebalancing the Chinese economy and fostering innovation and productivity growth. Market reforms and market-determined interest rates and exchange rates will correct the misallocation of capital that has until now favoured particular regions, state-owned enterprises and the state banking sector, and crowded out financing and investment from the more dynamic private sector. Healthy and well-managed financial institutions are at the heart of financial and economic stability. These changes will help China to move through the so-called 'middle-income trap' and to become a high-income society. Capital account liberalisation could also assist with geopolitical stability in the region through greater economic and financial integration.

The scale of China's cross-border trade and investment payments and the importance of using market mechanisms (in particular a fully flexible exchange rate and a robust and more efficient financial market) to manage the interaction between the domestic and international economies effectively require the move to an open capital account.

Liberalising China's capital account is an enormous challenge and it will take time. The nervousness in international markets about Chinese stock market volatilities and the move to a new foreign exchange rate regime with more flexibility against a currency basket over the past year is a harbinger of the difficulties in managing this policy change. The overriding lesson of financial history around the world is that transitions are never easy or smooth. This has been no less true in China than it has been in other economies that are in the process of profound transformation. There has to be policy trial and error, and there will inevitably be some missteps, but all countries have an interest in ensuring that China's reforms succeed.

The process of capital account liberalisation needs to be incremental, built on robust institutions and markets, and carefully staged and timed to avoid potentially substantial financial and foreign exchange risks. This is not just a technical economic challenge. Integration of China into international capital markets requires China to have a much more open, transparent and predictable set of institutional arrangements to build international confidence in dealing in Chinese financial assets, and this will push at the envelope of political reform.

The trajectory of growth is slowing in this transition. Manufacturing and export growth is slowing. While China will remain a big exporter, export growth is likely to slow as the structure of exports is upgraded. The massive urbanisation that has already taken place in China will continue as the rate of urbanisation — now at 56 per cent of the population — still lags behind that in many developing economies with similar income levels, let alone that in advanced economies (CCTV 2016). This requires continuing, albeit slower, expansion of infrastructure investment. New investment will also be driven by the need for clean energy and environmental protection.

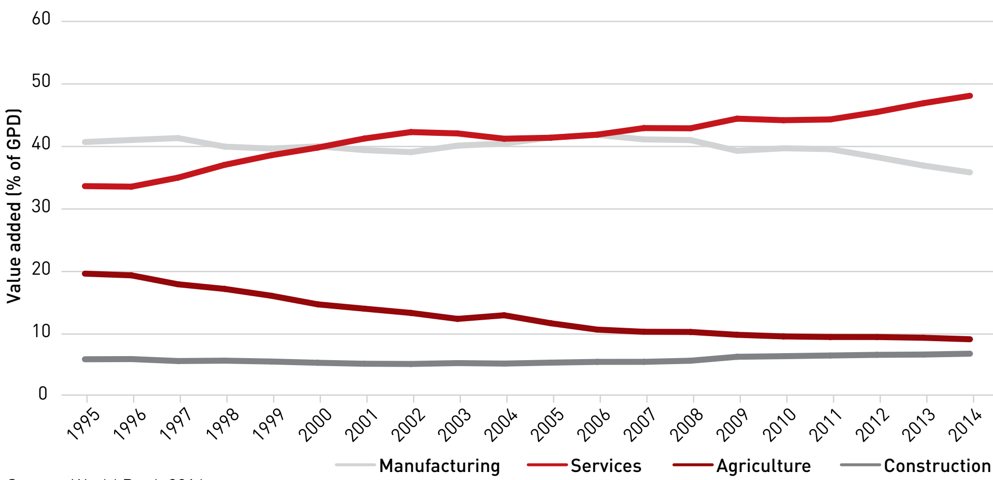
Higher Chinese wages as the labour market has tightened, as well as the removal of some distortions that favoured investment rather than consumption, have meant that growth is increasingly driven by consumer demand. This trend has been underway for some time, with consumption now overtaking investment as the main growth driver (Prasad 2015). Services already account for over 50 per cent of national output, while manufacturing has fallen towards 30 per cent (Figure 1.2).

The constraints on labour mobility, and inter-provincial fiscal and income disparities, continue to bifurcate the geographic pattern of Chinese economic development, meaning that inner provinces have lower incomes and lower rates of urban development. If economic constraints with a negative geographical impact were relaxed, these inner provinces could become a source of strong potential future growth. The timing of policy and institutional reforms that reduce these distortions will affect the impact of future growth on China's external economic relations, including with Australia.

China's 'new normal' growth path — with its structurally declining but still relatively high growth rate, partially tightening labour market, shift to consumption-led growth, and steady shift to services away from manufacturing — will fundamentally change China's interaction with the international economy.

There will continue to be growth opportunities in the Chinese market over the next decade as new business opportunities emerge. China's growth will likely remain at more than twice the global average growth rate. Despite moderating rates of growth, China will continue to make a sizeable contribution to global growth, as it will be growing off a much larger base than a few years ago. Seven per cent growth in China now is equivalent to an addition to income of 10 per cent just five years ago. China's growth rate was 6.9 per cent in 2015, much lower compared to growth of 10.6 per cent in 2010, but in both years China still added RMB3.8 trillion to global GDP (in constant 2010 RMB). Since 2008, China's contribution to global GDP each year has been equivalent to an economy around the size of Mexico or three-quarters the size of Australia.

Figure 1.2: Sectoral value added as a percentage of Chinese GDP



Source: World Bank 2016.

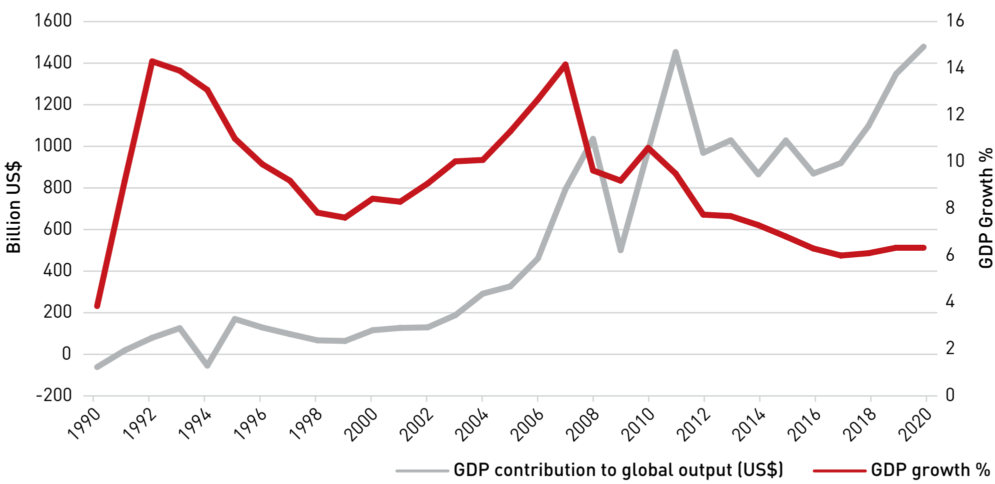
As Figure 1.3 suggests, the IMF expects that China will continue to add more each year to global GDP over the coming decade (in US dollars). China is likely to remain the biggest contributor to global GDP growth for the next five years, adding more to global output than the United States, or more than India and all of the other Asian economies put together.

The huge scale of China's economy today, nonetheless, needs to be understood in the context of its ambitions for growth in the future. China's per capita income is still not high, being only 24 per cent of that of the United States or 34 per cent of the OECD average (OECD 2014a). Chinese policymakers have to manage the transition to higher incomes and keep closing this gap in the coming decades.

Australia

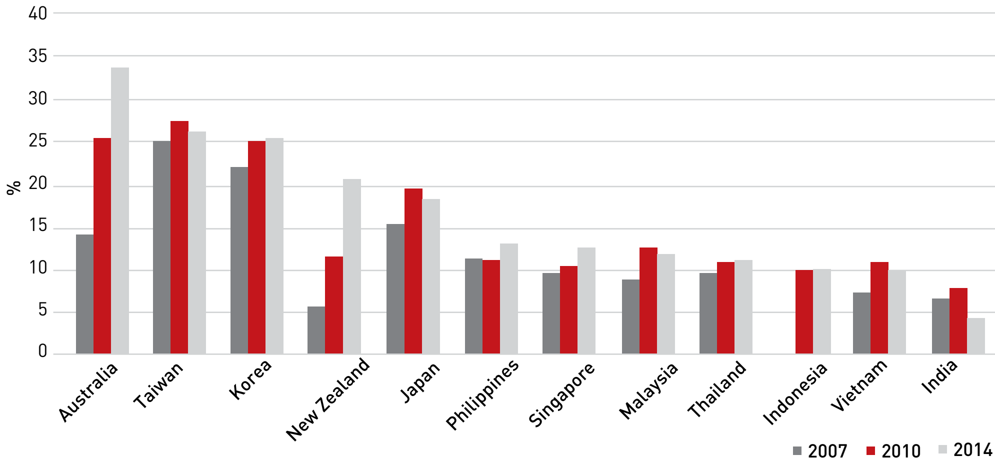
China's remarkable expansion through the first decade of the century brought strong growth in Australia's mining sector. Growth in Western Australia approached growth rates in China during some of these years. Australian income growth and household living standards benefited from the terms-of-trade-induced strength of the Australian dollar as import prices fell. Half the rise in Australian incomes during the mining boom resulted from the boost to Australia's terms of trade (Downes et al 2014). It was not only the Australian mining sector that benefited from Chinese growth: Australia's education exports and tourism services grew strongly, accompanied by sharp rises in China's share of these markets (Austrade 2015b). China's share of Australian exports grew strongly and is higher than that of other major export customers (Figure 1.4). While the economy as a whole unambiguously benefited from the mining boom, some sectors, such as trade-exposed manufacturers, saw demand for their products fall because of Australia's elevated exchange rate. As dramatic as they were, these changes were part of a long-term structural adjustment in the Australian economy that was already well underway and would have substantially occurred even without the mining boom.

Figure 1.3: China's GDP growth (RHS) and its contribution to global output (LHS), 1990–2020



Source: IMF 2015.

Figure 1.4: Exports to China as a share of total exports, Australia and other major exporters



Source: Gruenwald, Conti and Rana 2016; UNCTAD 2015.

Slower growth in Chinese demand for, and increased global supplies of, industrial raw materials have sent iron ore and other commodity prices dramatically lower. The drop in prices has caused the share of commodities in China's imports to contract. But Australia has increased its share in China's imports of industrial raw materials (although import values have dropped sharply) because Australia continues to be one of the world's most competitive suppliers of commodities like iron ore. New energy projects, in the gas and uranium sector, will also come on stream in the near future. But growth in resource exports to China is unlikely to return to the rate seen during the 2000s, and prices are likely to remain subdued.

As in past commodity cycles, prices have fallen (along with the terms of trade) as new mines have come online in Australia and around the world, dragging Australian real incomes down at the same time. This trend is likely to continue, although there is likely to be volatility around this trend. Australia will overcome this drag on income growth only through its own economic transformation and through lifting productivity across the whole economy.

Successful adjustment and sustained growth over the coming decade will require a shift in Australia's economic structure back to a more normal trajectory: away from an abnormal expansion of the resource sector (even if energy demand continues to grow) towards resumption of growth in the share of services, high-end manufacturing and high value-added agricultural production. This structural change, as well as Australia's strong population growth through migration, will need large-scale renovation of urban infrastructure, investment in inter-urban transport and communications (because of growing urban congestion and national connectivity deficiencies), new infrastructure investment and integrated land use planning in the north of the country (because of the location of new agricultural and development opportunities there), and investment in innovation, research and education.

These changes, through a relatively flexible labour market and responsive capital market, are already taking place, but major challenges remain in undertaking tough reforms that make the economy more flexible and help to restructure and upgrade industry. Moreover, the markets in which these opportunities lie for Australia are fiercely contested internationally and Australia does not have the same established advantage as it has in natural resources. Unless

Australia's private and public sector investment becomes smarter, and unless Australia can mobilise capital at home and from abroad to invest more efficiently in infrastructure, it is unlikely to achieve the 3 per cent GDP growth that it has commonly enjoyed over the past few decades. It will not be an easy task — total productivity growth has been stagnant for some years — and while there are signs of improvement, it needs to improve further.

How effectively these changes are managed will shape the future of the Australia–China economic relationship.

Strategic partnership for change

In managing the change anticipated over the coming decade, both the public and private sectors can draw upon substantial assets that already exist in the established bilateral relationship. The Australia–China relationship is distinguished by a history of political commitment at the highest levels, since diplomatic recognition, to a partnership that has embraced China's openness, its reform and its economic rise. Development of the relationship has also been facilitated by Australia's open economy, strong institutions and rich mineral endowment, Chinese perceptions of Australia's business-friendly environment, as well as Australia's good standing with other countries. Though they have different political and social systems, both countries accept this difference and respect each other's achievements, including the remarkable elevation of living standards and improvement in social conditions through economic reforms and liberalisation that both countries have put in place over the past four decades.

The deep complementarity of the established economic relationship and the high political commitment to its development by both countries provide a secure foundation on which to build a new and dynamic partnership.

Australian and Chinese political leaders have invested heavily in the relationship and are now committed to its elevation as a strategic partnership through regular high-level leadership dialogues.

Maintaining the closeness in the relationship at the top leadership level is a priority for both governments. It is a signal of political trust and good intention in the partnership.

ChAFTA is in place — the most open and liberalising such arrangement that China has entered into with any developed economy and one which goes further in its partner country liberalisation than Australia's previous agreements.

What do the big changes in the structure of both economies mean for their bilateral relationship and its management over the coming decade?

As consumer incomes rise and preferences shift, the new patterns of Chinese consumption will drive higher growth in imports of recreational services (like tourism), educational services, health services and financial services. The consumption and import of high value foodstuffs, in which Australia has a strong comparative advantage, are expected to grow rapidly over the next few decades. For example, the real value of beef consumption in China is projected to rise 236 per cent between 2009 and 2050 (ABARES 2014). ChAFTA opens the door wider to grow the trade in markets for high value goods and services. ChAFTA offers the prospect of significant gains in Australia's share in markets for imports across the board, from dairy products and health products to education and tourism (see Chapter 3).

ChAFTA opens the door to new opportunities in the services trade, in investment, in tourism and in the commodity trade; but there are many obstacles to realising these opportunities that still need to be overcome. The obstacles have to do with how commercial parties relate to regulatory institutions beyond national borders. They also have to do with building deeper private bilateral business networks and associations to facilitate business between the two countries. There is a review process built into ChAFTA — in this sense, ChAFTA is a living agreement. Yet the nature of the arrangement embedded in the agreement is that it is reactive to specific problem solving — rather than strategic in its purpose, seeking opportunities through the agreement and beyond (see Chapters 4, 5 and 6).

As China's industrial upgrading gathers pace, Australia's imports from China will be increasingly dominated by higher-value appliances, equipment and machinery. Many of China's exports, of course, involve substantial value-add from other countries in the region, including Japan, South Korea and the United States. A large proportion of Japanese brand imports, from example, now arrive in Australia via China.

China's commitment to freeing up investment abroad in the past decade (the 'going out' strategy) saw Australia emerge as a leading destination for Chinese outbound direct investment. The reforms that are now being put in place in the financial market have already seen Chinese banks and non-financial enterprises lift investment in Australian assets. In the coming decade, these reforms and wider liberalisation of the capital account could fundamentally change the structure of economic relations between the two countries.

Financial market reform and capital account liberalisation will also fundamentally change China's standing and role in the global economy — and its influence and importance in the Australian economy. It will increase the size and range of Chinese assets held by Australian institutions and corporations, as well as the portfolio of Australian assets held by Chinese institutions and enterprises. It will see China's currency used more extensively in international transactions and borrowing. Chinese households and institutions, not only enterprises, will increase the portfolio of assets they hold in Australia and elsewhere.

Arrangements that build confidence in undertaking foreign investment in each country are a priority. Despite the progress made in ChAFTA, there remains confusion about the treatment of Australian and Chinese investors under the other country's foreign investment regimes. Policies that enshrine no discrimination against the same class of foreign investment across foreign investment sources and entrench the national treatment principle need to be the anchors of each foreign investment regime. Mechanisms for direct collaboration in sharing information and data on investment and investor activities need to be put in place between the relevant agencies in each country.

The new phases of Chinese and Australian growth and their changed international circumstances require a new model of economic collaboration which encompasses an update and overhaul of the institutional arrangements that support Australia–China engagement.

An institutional framework that dynamically drives bilateral strategic engagement, promoting the new opportunities for trade and investment in the relationship through and beyond ChAFTA, will provide substance at the working level to the strategic partnership between the two countries at the top.

The task is to capitalise on and manage change. It will require energising and deepening the institutional arrangements that are already in place between Australia and China to:

build trust around common interests in economic and political relationships; manage the uncertainties that inevitably arise through change; and develop the up-close commercial and business engagement needed as the structure of the economic relationship shifts towards services and consumers.

This is a national task for each country. It is also a bi-national task that embraces new undertakings and agreements.

The framework of a new model for economic collaboration would include joint mechanisms and working groups that build upon established partnerships in government such as the Comprehensive Strategic Partnership, the Strategic Economic Dialogue and the Joint Ministerial Economic Commission at the leader and ministerial levels, as well as official agency partnerships such as that between the Australian Treasury and China's National Development and Reform Commission (NDRC) and the ties that are growing between the Reserve Bank of Australia (RBA) and the People's Bank of China (PBoC). These partnerships should draw upon business and outside expertise, as required, to:

- advise in the development of the Comprehensive Strategic Partnership dialogues;
- support joint taskforce or working group activity on issues flowing from the dialogues or other bilateral initiatives;
- work with state and provincial authorities in developing initiatives in the relationship;
- encourage programs of research within and beyond government on all aspects of the relationship;
- engage with the business sectors in both countries in undertaking its work;
- promote joint training and the development of long-term working associations in key areas among the officials of both countries; and
- reflect upon community interests and concerns.

This framework would also include a bi-national initiative to establish an Australia-China (Ao–Zhong) Commission for boosting high-level research, scientific, political and community exchanges to build the capacities in both countries for comprehending and realising the opportunities in what will become an increasingly up-close relationship. This bi-national government effort will be partnered by business, government departments, states and provinces, as it is in a similar though less comprehensive way than envisaged here by the Australian–American Fulbright Commission.

These arrangements will underpin the Australia–China Strategic Partnership for Change. The initiatives and standards that both countries develop pragmatically within that framework should also be consistent with their international and regional ambitions and responsibilities.

This framework will take time to put in place, but this process can begin immediately.

It will require institutional innovation in building the capacity for engagement step-by-step in each bureaucracy, through training and exchange. But this Report demonstrates the will and the incentive to make it work, in the interests of both countries. It will require partnership with the business, academic and think tank sectors. The framework must be guided by enunciation of the understandings and principles identified in this Report to which both partners aspire in the conduct of their relationship. The collaboration established between the China Center for

International Economic Exchanges (CCIEE) and the East Asian Bureau of Economic Research (EABER) and their government and non-government partners in both countries through this Report provides a natural and useful foundation for continuing this initiative.

Strengthening the framework for national government institutions to develop the relationship will be ineffective if it is not complemented by ongoing initiatives at the state and provincial level, and by building capacities through educational and research institutions and across the community. Much of the interaction between Chinese and Australian business and governments in each country takes place at the local level. Much of the community engagement takes place through state and provincial level programs and through sister-city relationships and educational exchanges delivered at the grassroots level. The people-to-people associations established through these programs are frequently the foundations of business and community partnerships that drive initiative and the development of the relationship. The sharp growth in tourism between the two countries is full of potential to strengthen people-to-people links, understanding and appreciation of each other's culture, circumstance and country.

There is a range of models of successful engagement across levels of government and across the community — through the organisation of state and provincial level programs, business associations, youth and professional dialogues, academic institutions and programs, cultural and artistic communities, and community and school-level exchanges. These are targets for development and promotion through the national and bi-national initiatives headlined above (see Chapters 3, 5 and 6).

Opportunities and risks

A critical element in the success of the Australia–China relationship over the coming decades will be the understanding of, and managing the uncertainties from, the huge changes taking place in both economies. These are changes that will transform both societies — with the national ambition in China to be on the way to living standards equivalent to some advanced countries by the end of this period — although their course is impossible to predict exactly. In 2025, China's economy will be much bigger than it is today and its institutions will continue to evolve from what they are today. Australia will also have changed significantly. A premise in the conduct of the relationship is commitment to shared ambitions for national change and to engage bilaterally in regional and global affairs in a way that manages effectively the adverse consequences of unforeseen or unwelcome change that will inevitably occur from time to time. The principles and common understandings outlined in this Report, and the arrangements and institutions that it recommends, are designed to manage both proactive engagement and unexpected shocks. The management of adverse change becomes easier when both countries are closely engaged and have the best access to information and analysis that is possible through such arrangements.

The opportunities in the relationship with an economy the size of China's are huge for many of Australia's biggest corporations, including an increasing number of firms and enterprises that were not touched by China's earlier growth phase. Nonetheless, they have to manage the risks of cyclical and structural change in the Chinese economy, as they do in other markets. Chinese policymakers used to worry about over-dependence on Australian suppliers of iron ore in the up-phase of the commodity boom, although those anxieties have subsided in its down-phase. Insurance against risk from high levels of resource trade dependence, of course, is provided by deep and intensely competitive international markets for these commodities (including energy). Chinese enterprises that undertake large-scale investment in Australia, especially when such investment is new or unfamiliar, inevitably face the same risks that other large-scale investors, Australian or foreign, have to face in the Australian or other markets. These risks are a normal part of any commercial relationship.

There are also risks associated with policy and institutional uncertainties. In economic and political systems that are evolving as rapidly as those in China, these risks are an important part of commercial calculation. In Australia, even though there are robust market and legal institutions, there are residual risks that relate to political, policy and institutional uncertainty, although most of them are legally contestable by foreign as well as national entities. China's accession to the WTO as well as its ongoing massive economic and legal reform serves to ameliorate these risks in China. An important objective in the development of the relationship, nonetheless, is to reduce governance-related uncertainties for enterprises and persons doing business in the other country. A goal in the relationship over the longer term should be to embed these protections in a comprehensive agreement or basic treaty between the two countries.

There is strong precedent for such a treaty framework. The Basic Treaty of Friendship and Cooperation between Australia and Japan, signed in 1976, committed both countries to cooperate on issues of mutual concern. Following decades of popular unease and political caution in the Australia–Japan relationship, this Treaty had a large and analytically measurable impact on growing the overall bilateral economic relationship even after the resources phase of bilateral exchange began levelling off (Drysdale 2006). It improved what were then politically controversial investment flows and led to consequent improvements in people movement, services trade and regional cooperation. The Australia–Japan Report that led to and was associated with the conclusion of the Treaty changed the institutional structures though which both countries engaged with each other, and laid a framework of collaboration on economic issues that led to the formation of APEC. Applying a similar approach to the Australia–China relationship could yield similar economic and political benefits.

The macroeconomic risks of volatility in China's larger economy can be managed within the macroeconomic and flexible exchange rate policies that cushion the domestic impact in Australia of such international economic shocks. Focusing on building stronger balance sheets of financial institutions and companies, both state-owned and private, is a foundation for crisis prevention and crisis resolution.

Systemic failures such as financial market crisis, should they occur in China as they did in the United States during the global financial crisis, will need to be managed through domestic and international mechanisms that provide lines of credit and regulatory disciplines to ameliorate or avoid them. The adequacy of these mechanisms is discussed in Chapter 8. Active partnership with China in regional and global economic cooperation, and in diplomacy to secure dynamic political stability in Asia and the Pacific, are key instruments for handling these risks.

Partners in regional and global affairs

More than on any other factor, economic and political stability in the 21st century will depend on how global governance adapts to the rise of China and other emerging economies, and to the role they play in shaping the architecture of global governance in the future. Australia and

China have a deep strategic interest in ensuring this international transition takes place in a manner that is constructive and benefits China, regional economies including Australia, and the world at large.

Strong, inclusive, rules-based and market-promoting global institutions are important to economic prosperity in both Australia and China. Both countries have benefited greatly from global institutions that were put in place at the end of World War II. The United Nations framework and the Bretton Woods-inspired economic institutions continue to serve as the foundations of global governance and have provided a framework for global stability and economic prosperity.

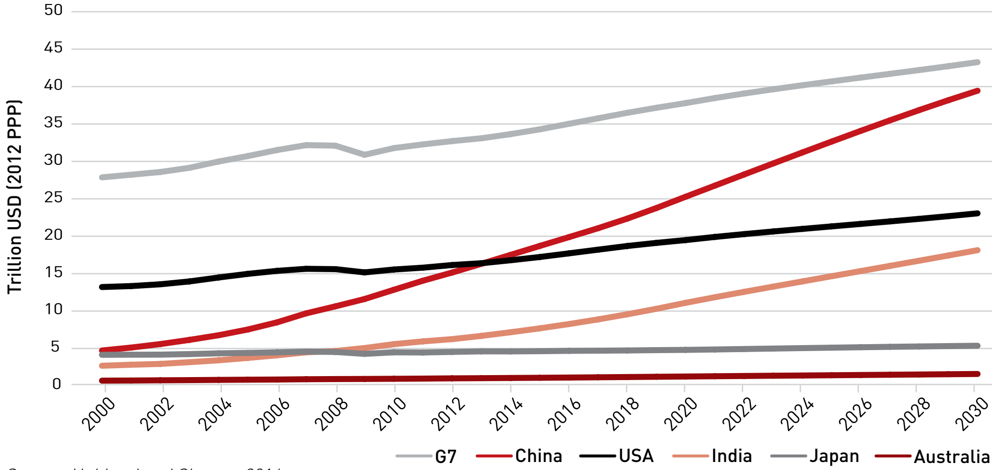
The system of global governance that these institutions underpin is not static. It must continue to evolve so as to comprehend new issues and stakeholders. The rapid change in the structure of the world economy and depth of global integration that has been delivered by economic openness and the communications and transportation revolution, has created enormous pressure to change and strengthen institutions for global governance. The global financial crisis saw the G20 Summit emerge as the preeminent forum for guiding this change.

No country alone can dictate this change: it must be forged through a consensus among all the countries that are affected and feel the need for change. But there are some areas in which collaboration between China, Australia and their partners in global institution-building will be of special importance in the coming decades.

Global governance is in part the result of what large economies do between themselves to manage their interaction with other economies and polities, as well as being the result of cooperative or collective action among the economic powers, large or small. In many ways China's own choices in international economic policy strategy now exert influence on the shape of global economic governance alongside the actions and initiatives China takes directly in collaboration with other countries through international forums and institutions. The relationship between Australia and China will thus be shaped by China's own economic policy strategies alongside the commitments that are made by both countries in global and regional settings. Australia and China have in the past, and should seek even more actively in the future, to be strategic partners in both theatres. There is no more obvious example of this in the past than China's choice to seek accession to the WTO and conform to its multilateral obligations. Bilateral political initiatives opened up trade with China before WTO accession. But participation in the WTO, not narrowly bilateral arrangements, is the cornerstone of the large and confident trade relationships that Australia and other countries have with China today. This system is under some challenge and both countries have a profound economic and political interest in working together and with partners to ensure that preferential regional and bilateral arrangements do not corrode the multilateral framework that is anchored in the WTO.

China's economic integration into the East Asian and global economy has occurred within a global framework that promotes free trade and investment. Australia has prospered under the same framework. Cooperation in the Asia Pacific region has been significantly directed to reinforcing global goals and objectives, such as when APEC was founded, to lend weight to trade liberalisation in the interests of Asia's emerging economies and agricultural exporters such as Australia. Regional cooperation in Asia and the Pacific fostered market-led integration. Asian economic cooperation has been inclusive, has avoided discriminatory arrangements that weaken the global system and has led regional political cooperation.

Figure 1.5: Asia's weight in the global economy



Source: Hubbard and Sharma 2016.

With the huge change that has taken place, and that will take place over the coming decade, in the structure of regional and global economic power (Figure 1.5), there is a need to rethink the role of regional cooperation as a pillar that supports an inclusive global economic system and manages new economic and political challenges.

APEC and the ASEAN Plus regional arrangements provide the foundational framework for regional cooperation. These arrangements and their evolution have been consensus-driven. They are characterised by inclusiveness, in terms of the global dimension of their agendas and their routine openness to dialogues with others. These principles are an enduring foundation for regional cooperation.

With the global processes of trade reform stalled and proliferation of preferential bilateral and regional FTAs, an immediate priority is to ensure new and existing trading arrangements such as the Trans-Pacific Partnership (TPP), Regional Comprehensive Economic Partnership (RCEP) and Free Trade Area of the Asia Pacific (FTAAP), are inclusive and complementary. In this context, both Australia and China have a large stake in the success of the ASEAN Economic Community (AEC), which was established before the TPP was signed. The AEC will be further developed in parallel with TPP domestic ratification processes. There is a crucial opportunity to simultaneously conclude RCEP and advance openness of the regional trade regime by strategic commitments to comprehensive trade and investment liberalisation that is supportive of the goals of ASEAN and inclusiveness across the Pacific and the world. The economic imperatives for cooperation have become more important and, so far, the flexibility of Asian regional arrangements provides an opportunity to connect existing arrangements in ways that allow them to address new challenges and opportunities.

The shift towards a more complex, multipolar order has created some new tensions, and different political allegiances have become a complicating factor.

The major challenges now facing the international community require innovative solutions promoted by effective regional coalitions that include China and the United States and thereby manage the US–China relationship, which is arguably the most important bilateral relationship in the world.

Four forces underscore the need for power-sharing, cooperation and policy adaptation in our region over the coming decade: transition in the geopolitical order; the shift in the structure of the financial geography of the region; the opportunities of changing technology; and the impact of climate change.

Geopolitically, territorial disputes and strategic rivalries have opened up tension in the Asia Pacific region. Managing competing interests in the South China Sea exemplifies the challenge there is as China projects its peripheral power. This is a testing time in which it will be critical to exert common sense on the shared interest between the United States and China in maintaining maritime security and regional stability, while managing strategic differences.

Australia's role as a historical ally of the United States, combined with its geographical position in Asia and its deep interest in its economic relationship with China, opens a space for its leaders to play a vital role as an interlocutor with a compelling and sincere interest in the peaceful accommodation of China as a new power within the regional and global order.

Two major developments in the transition to a new financial geography of the Asia Pacific underline the need for greater regional cooperation. The first was China's move to establish the AIIB as an additional channel of development finance. The bank's creation came in the context of US delay in the implementation of the 2009 G20 agreement to widen IMF reform, including expanding China's voting rights in the IMF, and the obstacles to contributing additional equity to multilateral financial institutions to fill the huge gap in development financing. In 2015, the IMF agreed to include the renminbi in the Special Drawing Rights basket. The AIIB offers opportunity for proactive Australian partnership with China in building experience in the provision of an important international public good, and investment in infrastructure designed to promote regional economic integration. It is an opportunity that can now be actively embraced.

The second event was divergence in industrial countries' quantitative easing strategies, with the US Federal Reserve beginning to reverse easing and the European Central Bank and Bank of Japan both still committed to further aggressive easing. This divergence in monetary policy between the major reserve currency countries opens the prospect of a phase of dollar strengthening. As the Bank of International Settlements has pointed out, the Latin American debt crises of the 1980s and the Asian financial crisis of the 1990s were both associated with periods of strengthening of the US dollar. A strong dollar — particularly when the US economy is no longer the engine of import growth it was in the past — creates huge tensions and a dollar trap for emerging markets. Capital flows back to advanced markets tend to put a deflationary pressure on emerging asset markets. This will put pressure on regional economies and will require their close cooperation in the region.

Regarding technology advancement, technological disruption has proved more pervasive and damaging of traditional economies than was anticipated because it diffused power to new centres and weakened incumbents. Asian and Middle Eastern oil-producers' wealth is being undercut by innovations in shale oil and renewable energy technologies. These are issues on which there is a close intersection of interests between Australia and China, and their regional partners. As robotisation reduces the need for cheap and unskilled labour, governments around the world are finding it difficult to generate new jobs for growing populations of unemployed youth and low-skilled workers. At the same time, non-state players are using technology to create centres of social change or disruption or conflict that cannot be dealt with by national power with conventional tools. These are also issues on which both countries can encourage both regional and global dialogue.

Climate change is also responsible for major social upheaval, resulting in a high-pressure year for global governance institutions in the lead up to the Paris agreements. As water stresses, air pollution and El Nino effects became more marked across the world, global opinion swung enough to help the Paris COP21 negotiations on climate change reach consensus in December 2015. This outcome helpfully embeds concerted unilateral mitigation and is a testament to the urgency of consensus and cooperation in the war on pollution and climate change. The new consensus provides a basis for Australia and China to work with regional partners in developing cooperative strategies on putting in place the institutional, technological and policy innovations needed to address these problems.

Two priority areas for collaboration, building on China's G20 presidency this year, are developing a more cohesive global financial safety net and strengthening the multilateral trading system. While these priorities relate to trade and finance, other important areas for collaboration are on global energy governance and climate change. Australia and China's active participation within the G20 is crucial to all of these ambitions and both countries have incentives to bolster the G20 and build its role as the preeminent forum for global economic cooperation. Collaboration also needs to extend beyond the G20, for example in developing a new and proactive role for the WTO now that preferential arrangements are overtaking the multilateral trading system and trade liberalisation at the border is no longer the primary problem in the promotion of more open and contestable international markets. The question of how different regional arrangements such as the TPP, RCEP, AEC and the proposed FTAAP affect the global trading system are matters that the G20 should consider in the area of international trade.

The G20 is, however, the premier forum through which China can articulate its economic policymaking strategies and intentions. This is more important to other economies, which now need more information and analysis of developments in the Chinese economy to incorporate into the formation of their own economic strategies. This is not about securing China's place against other countries. The steps that China takes today will be of importance to Indonesia, India and Africa, with the lasting legacy of a more robust global system.

In the context of the big forces currently shaping the financial geography of the region and of the world, a more cohesive approach to the issue of infrastructure investment needs to be taken with a focus on improving intermediation between infrastructure investment opportunities and global savings (particularly from Asia and the big pension and superannuation funds in advanced economies) as well as project preparation and prioritisation. More sensitively, the G20 and regional dialogues provide an opportunity to open informal political dialogue on some of the stresses of technological progress, like energy transformation and cyber security.

The current pressures in international financial markets reinforce China and Australia's interest in a strong, inclusive and responsive global financial safety net, centred on the IMF. Fragmentation has presently reduced the safety net's capacity and agility to respond to crises, which reduces market confidence, acts to constrain trade and investment flows, and discourages economic openness

On trade, there is an opportunity to advance global trade reform and economic cooperation through leadership in Asian reform and liberalisation. While Australia and China cooperate at all levels of the global trading system, both countries gain the most from the multilateral trading framework and from trade liberalisation when it is multilateral rather than bilateral or preferential. Australia and China have a particular interest in ensuring the global trading system supports regional and global value chains by facilitating trade and investment flows across all borders, not just those confined to particular bilateral or regional arrangements, and working with regional economies in defining a pathway to globalise achievements in regional liberalisation and reform.

The East Asian members of the G20 can step forward in defining what role the region can play in reshaping global trade governance and ensuring a sustained and effective recovery.

There is opportunity to use regional arrangements such as RCEP to raise the standard for cohesive regional agreements, to push for better collaboration between the WTO and regional agreements, and to deliver ambitious commitments under the Trade Facilitation Agreement by giving the structural reforms that have been pledged in the G20 growth strategies a stronger trade focus.

Finally, on energy, the G20 has developed high-level principles on energy collaboration under the leadership of Australia, China and the United States. Existing institutions and mechanisms, like the International Energy Agency (IEA) and the stockpiling obligations under its treaty, are dramatically weakened through excluding China and other emerging market economies. But these countries, quite rightly, will want a say in the rules and norms that apply to them. Among other things, the G20 recognised the importance of making international energy institutions more representative and inclusive of emerging and developing economies. China can build on these small steps and, along with thinking about low-emissions transformation of energy, use its G20 host year to bolster global energy security through reforms to global energy governance.

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