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Abstract Australia-China trade and business relationships have been growing significantly in recent years but still have only limited coverage of the Chinese economy. This paper attempts to assess the future benefits to Australia of Chinese growth and associated risks for Australia in the long run. To the extent that the commodities boom continues Australia benefits. However, any disruption to that boom may have severe consequences for the Australian economy. At the same time, the continuation of the boom may be distracting Australia from other potential opportunities that exist in China. As a country that seeks to have balanced economic growth, there are arguments in favour of spreading the risk and to position Australia to take advantage of new opportunities, particularly in the services sector.
How Can Australia Benefit from China’s Economic Reforms?

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Abstract

Australia-China trade and business relationships have been growing significantly in recent years but still have only limited coverage of the Chinese economy. This paper attempts to assess the future benefits to Australia of Chinese growth and associated risks for Australia in the long run. To the extent that the commodities boom continues Australia benefits. However, any disruption to that boom may have severe consequences for the Australian economy. At the same time, the continuation of the boom may be distracting Australia from other potential opportunities that exist in China. As a country that seeks to have balanced economic growth, there are arguments in favour of spreading the risk and to position Australia to take advantage of new opportunities, particularly in the services sector.

I. Introduction

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There have been many remarkable events of economic significance in the last two decades of the 20th Century. The demise of almost all socialist regimes has been possibly the most significant. Within this context, economic reform in China stands out because it happened without any apparent economic crisis and because it has largely been considered successful (Pyle 1997; Shen 2000; Naughton 1995). In 1979, after three decades of an authoritative central planning system (and just a few years after the death of its architect Mao Ze Dong), the Chinese authorities decided to gradually (and to some extent methodically) open up the economy to the influence of domestic and international market forces (Pyle 1997; Shen 2000).

In recent years, Australia’s trade and business relationship with China has been growing steadily. China was ranked as Australia’s second largest partner (only after Japan) in merchandise trade in 2005-06 - compared to tenth in the mid-1990s (Australian Bureau of Statistics, cat. no. 5368.0, 2007). This bilateral relationship is expected to be closer in the foreseeable future. The primary objective of this paper is to assess the future benefits of Chinese growth and associated risks for Australia in the long run. In more specific terms, there are three principal questions addressed in this paper. First, to what extent has Australia benefited from economic reform in China? Second, what are the future benefits of economic change in China that might accrue to Australia and, if so, will they be ongoing or temporary? Finally, what are the major risks to Australia in its economic relationship with China?

II. Opportunities and Threats from an Australian Perspective

China’s integration into the world economy appears to have had little impact on Australia until relatively recently. Australia mainly exports natural resources and agricultural products to China and imports manufactured goods from China. This impact, on the export of metal ores and coal, is illustrated in figure 1 which shows the sharp jump in the export of these commodities following the increase in demand from China. Indeed, Weemaes (2005) reports that Australia was China’s largest source of imported coal, iron ore and nickel ore in 2005. However, the surge in the export of these commodities is said to underpin much of Australia’s sustained economic performance since 2000 and expectations of future prosperity are being increasingly built on it. The questions arise, therefore, as to whether or not the mining export boom
to China can be maintained and is it all that China has to offer us? We consider each of these two issues in turn.

**Figure 1**

![Graph](image)

2.1 *The Export Commodity Boom*

There can be no question that the mining industry in Australia has benefited significantly from developments in China. It is also reasonable to expect that demand for Australian ore and coal will remain strong into the foreseeable future. This is notwithstanding some potential risks. These include: (a) the risk of a cyclical economic downturn in China, (b) a risk of a decline in China’s demand for resources as the resource-intensive phase of China’s economic development wanes, (c) a risk that the government of China will move away from the development of a market economy and (d) the risk of a political upheaval which debilitates the Chinese economy for some years.

**Cyclical risk**

Capitalist or market economies are subject to periodic swings. Whilst China is currently booming it is accepted that a downturn will eventually arrive. Evidence from the past (Figure 2) clearly shows that China has not been immune from swings in economic activity and prices. The pattern apparent throughout most of the period in which China has been developing its market economy (since 1978) is one of periodic...
accelerating inflation which has been severely and effectively contained by the advent
of sharp downturns in the rate of economic growth (although negative growth has
been avoided). The downturns in the rate of growth of economic activity have usually
resulted from the application of relatively crude instruments of monetary policy or
direct regulatory intervention (EIU 2007).

Figure 2

China: Changes in Output and Prices
% change

The Chinese government has never been able to apply macroeconomic policy in order
to avoid wide swings in economic activity in the ways in which it has been practiced
in the west. This is because China lacked the prerequisites of sophisticated monetary
and fiscal policy weapons. The People’s Bank of China (PBC), China’s central bank,
is not an independent institution. It operates under the guidance of the state (Shen
2000) and can only offer token resistance if the policies of the PBC conflict with the
policies of the various levels of government (Yusuf 1994). Throughout most of the
post-reform period, the PBC has been hamstrung by an exchange rate regime in which
the RMB has been pegged to the US dollar (Ma 2000; Shen 2000).

For much of the reform period, the Chinese government has been unable to implement
conventional monetary policy through intervention impacting on interest rates
because of its fixed exchange rate policy (EIU 2007). Rather, monetary policy was
administered through the management of credit. When government wished to run a
contractionary monetary policy, government simply instructed the state-owned banks to cease making loans. Since most of the loans by state-owned banks were to state-owned enterprises (SOEs) the activity of the SOE sector was almost immediately curtailed resulting in significant economic disruption to a single sector of the economy. Fortunately, the need for the continuation of this type of monetary control is receding. In July of 2005, the RMB was permitted to begin to appreciate, slowly, against the US dollar, signalling a move towards a more flexible exchange rate regime (EIU 2007). Research by Basu et. al. (2006a) indicated that young Chinese tended to support a floating exchange rate and although the older Chinese supported a pegged system their influence on policy can be expected to gradually wane.

More effective macroeconomic management is also presaged by the development of more effective tax regimes. Allsop (1995) has noted that pre-reform, fiscal policy was an unsuitable instrument for economic management in China. This was because its main function was to allocate resources to ensure that the central plan’s targets were achieved in each sector. Taxation was unimportant as the Government derived its income from the transfer of revenue from SOEs. Moreover, Government expenditure consisted primarily of the allocation of funds to expenditure units in accordance with the dictates of the central plan (Allsop 1995). Under such a system, taxation, in the western sense, was hardly necessary and Government expenditure primarily reflected the Central Government’s control over the economy’s resources (Xu 1996).

Changes in the structure of taxes in China were not seen as a reform priority until well into the 1990s. Prior to this time, only minor ad hoc measures designed to support the agricultural and industrial reforms were implemented. There was no comprehensive or long-term reform (Ma 2000). “True” tax reform took place during the third phase of China’s economic reform from the mid 1990s. The objective of this reform was “unifying the tax code, simplifying the tax system and its administration, and strengthening the macrocontrol capability of the central government…” (Xu 1996, pp. 375). The reform of the tax system saw the establishment of four principal tax bases – taxes on transactions, income, property and resources (Wang 2000, pp. 30-31). Of these, taxes on transactions (including a value added tax) were the most important (Wang 2000 and Xu 1996).
While the tax structure was a problem, commentators generally agree that the pre-reform system of tax administration (and expenditure authorities) was an even greater issue. Indeed, both Ma (1997) and Xu (1996) argue that reform to the tax administration and collection procedures has had a greater impact on post-reform China than the changes in the taxes themselves.

Unfortunately, in the early stage of economic reform, and notwithstanding the reform of the tax system, state sector revenues in China actually decreased. This was due to, and coincided with, the decline in the importance of SOEs and was compounded by the fact that, despite the new taxes, the taxation system remained undeveloped, inefficient and subjected to abuse (Ma 2000). However, the EIU (2007) argues that the government is increasingly bringing these problems under control. Of more importance to the EIU are the constraints placed on fiscal policy by the inability to bring under control off-budget expenditure items such as defence, a large implicit pension debt resulting from an unfunded defined-benefits pension system and support to the SOEs in the form of “soft loans” issued by the state-owned banks. Nevertheless, the EIU (2007) concede that the authorities were able to successfully conduct an expansionary fiscal policy to support GDP growth at the time of the Asian financial crisis – something they could not have implemented ten years earlier.

These developments in fiscal and monetary policies cannot ensure that the Chinese economy will not again be plunged into recession in order to stem an inflationary surge, but it does make it less likely. To the extent that a recession in China may occur, the impact on Australia is likely to be significant if Australia continues to rely on a booming minerals sector to sustain its economic performance.

**Risk of a fall in the Demand for Resources**

The inevitable cyclical nature of economic activity and the variable ability of governments to deal with fluctuations aside, is it likely that China’s economic development will bring the country to a point where China’s demand will move away from the resources of oil and coal? In our view, this is unlikely in the next twenty to thirty years.
There remains great diversity on a regional basis in China. For every region that is booming there are others that have yet to experience the benefits of economic reform. Indeed, data reported by EIU (2007) from the China Statistical Yearbook (2006) enables us to calculate that in 2005 annual income per head in Shanghai was over RMB 51,000 whilst it was just over RMB 5,000 in another part, Quizhou. The mean provincial income per head was just over RMB 16,000. There are continuing inequalities in development that have been created in the process of reform (Basu et al 2006b).

This economic inequality is not something that is simply accepted by the Chinese people. While Shanghai is not China, the people of Shanghai are, at least to some extent, a reflection of the aspirations of people throughout China. Basu et. al. (2006a) observed that even the older Chinese have begun to see that the concentration of development in the coastal areas has become a problem and tend to look to the Government to resolve the resulting inequality. The younger generation, on the other hand, whilst recognising the inequality, are far more confident that it can be resolved through the application of market principles rather than government intervention. Interestingly, these findings were consistent between the developed and underdeveloped areas of the country. The inhabitants of poorer areas (e.g. Changchun) were found to be as inspirational as their counterparts in developed cities (e.g. Tianjin) (Basu et. al. 2006b).

There is no question that the Chinese Government has responded to the call for action in the development of the inland provinces. Addressing the issues of regional inequality was declared a priority of the eleventh five-year plan for 2006-2010 (EIU 2006). While it is not expected that the reduction of the existing inequality can occur quickly and while there are many problems to be overcome, the process will undoubtedly ensure the long-term continuation of the demand from China for the resources Australia currently provides. This view is re-enforced by Edey (2007) who notes that China’s income levels have not yet attained the same levels as Japan even when its growth rate slowed. He concludes that until such levels are attained China will continue growing at a round 10 percent per annum.
Risk of movement away from the market

With respect to the third issue, it is true that China is not a democracy and probably will never be a democracy in a western sense. However, this does not mean that the government of China is not pursuing the development of a market economy that will make China a global economic power. It is very unlikely that China will turn away from its attempts to build a strong market economy. China is actively expanding its bilateral and multilateral relationships with a wide range of nations and groups of nations. Asia Pulse (2005) reported that China was pursuing 23 free trade agreements (FTAs). China had reportedly notified to the WTO the signing of four agreements in June 2006 (WorldTradeLaw.net 2006). These include a framework agreement with the Association of South East Asian Nations (ASEAN) in July 2003 which will result in an FTA by 2010 (EIU, 2006); with the Original members of the Bangkok Agreement (Bangladesh, India, the Lao People’s Democratic Republic, the Republic of Korea and Sri Lanka) in January 2002 which provides for the introduction of trade concessions; with Hong Kong in January 2004; and with Macao, also in January 2004. Both were in pursuit of closer economic relations. China is also seeking to enter a FTA with Australia (Basu et al 2006a, 2005). In addition, China is a member of Asia Pacific Economic Cooperation and founded the Shanghai Cooperation Organisation (SCO) with Russia, Kazakhstan, the Kyrgyz Republic and Tajikistan in 1996 which was aimed at boosting regional trade.

Further evidence of China’s ongoing commitment to a market economy is found in their espoused compliance with the requirements of the WTO. The EIU (2006) argues that entry into the WTO changed the way China managed its economic reform process, moving it from ad hoc changes to a strict timetable for implementing market reforms. China’s apparent adherence to this timetable and its compliance with WTO requirements has provided more confidence amongst western trading economies than would have been the case had China not succumbed to WTO membership.

Moreover, there has been a clear recognition of the market system within China - both politically and constitutionally, The CCP formally adopted, in 2002, the ideology of what is known as the “Theory of the Three Represents” This refers to the CCP
representing the “foremost productive forces” and which, according to EIU (2006), is designed to “legitimise the party’s turn towards capitalism and to allow private entrepreneurs to join the party”. In 2004, this ideology was also written into the constitution and amendments made to guarantee private property rights (EIU, 2006). Most recently, the National Party Congress of 2007 passed the property law to come into effect on October 1 and it is reported that “property of the state, the collective and the individual is protected by law, and no unit or individuals may infringe upon it” (Callick 2007).

Research by Basu et. al. (2005; 2006a) found a trend in favour of the market. Younger Chinese, in particular, were very supportive of freeing up markets and were more open and outward-looking than older Chinese and wished to encourage higher levels of capital inflow and the associated access to new technology. However, both young and old acknowledged the importance of China’s entry into the WTO and were convinced of China’s sincerity in pursuing its obligations under WTO. In sum, they were eager to be involved in the global economy and convinced that China could compete under a market system.

The risk of political turmoil
Unfortunately, the risk of an extremely disruptive political change continues to exist in China. In the past, the apparent mechanism for dealing with dissent was repression - as exemplified by the deaths in Tiananmen Square in 1989. However, the authorities do seem to have learned some lessons from this period and have demonstrated a willingness to adapt. There can be no question that increased economic freedom brought with it increased demands for political freedom with the latter being harshly dealt with. More recently, the extension of economic freedom has continued but the country’s style of leadership has changed. The IEU (2006) reports that there is a far greater level of collective decision-making amongst senior authorities than had been evident in the past with the result that decisions have been “the outcome of debate and compromise”.

Perhaps the leadership has recognised that totalitarianism would lead to further disasters. It has certainly recognised that China is a very unequal society and that
perhaps the most difficult issue confronting authorities is how to deal with the displacement of the so-called “rural workers”. The authorities are certainly pursuing vigorous policies designed to address the economic development of rural areas and the raising of health and education standards. However, that has not reduced the number of protests – with the official number rising from 10,000 in 1994 to 87,000 in 2005 (EIU 2006). Failure to deal appropriately with this problem could have very disruptive political and economic consequences.

2.2 Opportunities not to be missed

In all likelihood Australia’s export commodity boom, fuelled by demand from China, will continue for some time yet. However, there appears to be little evidence that Australian industry is fully grasping all of the opportunities presented by China’s economic reforms.

Australia is a major producer of food. A trend observed in China has been the rise in the importation of food as a result of the reduction in agricultural tariffs following entry into the WTO (EIU 2006). This is an area where Australia has failed to fully seize the opportunity. ABARE (2006) reports that there are significant changes taking place in the demand for food in China largely because increased affluence there has given rise to the demand for “greater quantities of meat, dairy and seafood products” which China’s farmers are unlikely to be able to supply because of the pressures being felt by water constraints and land degradation. These changes have enhanced the potential for developing a greater export trade in food to China. In 2004-2005, exports of grain to China grew by 160 percent helping Australian food exports to China grow by 85 percent (Australian Food News, 2006). As a result, Australia’s food exports to China grew from 3 percent of total food exports in 1990-91 to 5 per cent in 2004-05 (Australian Food News 2006). However, such growth, from a relatively low base, only serves to underscore the potential that remains.

With respect to manufacturing exports, Basu et. al. (2005) canvassed some of the negative attitudes that arose in the context of discussion over a FTA with China. However, although dire predictions of Australian job losses are still being put forward by opponents of the FTA there is beginning to appear now some more positive
statements on the prospects for the development of our trading relationship with China. This is to be expected. In manufacturing, China’s comparative advantage is in the mass manufacture of labour intensive products. However, while domestic capacity is certainly growing, China tends to import more complex and sophisticated manufactured goods to meet the needs of the domestic market and to support its own industrial expansion (Weemaes 2005). Pickworth (2007) reports that nearly 4,000 small to medium sized manufacturers from Australia are exporting heavily to China – usually into selective niche markets. The Age (2007) also supports the prospect of niche marketing of manufactured goods to China and points to the need for automotive parts (China has the world’s highest sales growth for cars and will be the world’s second biggest automobile market by 2010 (Weemaes 2005). This is true despite that fact that automotive parts manufacturers are resisting tariff reduction in Australia and fear the FTA because of cheap Chinese parts being imported into Australia. The concern is generally with basic components of little technical sophistication, yet, even with these there is an opportunity for Australian automotive parts manufacturers will move to China, manufacture there and then import into Australia. With respect to products that require sophisticated manufacture, there remains substantial opportunities for Australian manufacturers in Australia as Australian companies have developed considerable expertise in this area. Edey (2007) also points to recent successes in high valued areas like pharmaceuticals, professional and scientific equipment and industrial machinery as showing the way for Australian manufacturers.

A number of reports highlight education and tourism as being amongst Australia’s largest export earners in services trade with China (Tisdell 2007; Weemaes 2005; The Age 2007). However, the potential for trade in services with China is much greater than the trade represented by these two areas and Australia’s Minister for Trade has recognised that this potential is often overlooked (Langdon-Orr 2006). Langdon-Orr (2006), commenting on information contained in DFAT (2005) points out that the proportion of the economy represented by services in China is not just low in comparison with Australia (and other OECD countries) it is also low when compared with economies that have a similar per capita income to China. The explanation reported by Langdon-Orr is that the former communist model emphasised the
production of industrial goods as the expense of services. China, therefore, has considerable catching up to do in the development of its services sector.

To some extent, this “catch up” has begun as the services sector has been rising faster in China than in most other countries. Much of this growth is the result of government policy following the announcement in the Tenth Five-Year Plan (2001-2005) to develop the services sector (DFAT 2005). During this process of catch up considerable opportunities are likely to be created for countries like Australia to export services to China. For example, architects, environmental designers and town planners are in demand in China (Weemaes, 2005) as are investment bankers, lawyers and professionals in port and recreation services (Age, 2007). In the short term, this development may be stimulated by the export of services and foreign direct investment in the Chinese service sector to meet growing domestic Chinese demand.

While there is a great deal of potential for the delivery of Australian service industries in China there are also some significant problems. DFAT (2005) has identified that notwithstanding China’s entry into the WTO, China continues to apply restrictions on ownership, business scope and geographical coverage of the service sector in China. The Chinese authorities continue to apply an “opaque” regulatory process and licensing arrangements. Service providers are frustrated by operating requirements, lack of legal transparency and a failure to apply laws consistently and to enforce laws on intellectual property rights.

III. Conclusions
China began its economic reform process in 1979, progressing steadily towards a market economy. The old structures of state-owned enterprises were retained but increasingly a private sector was allowed to emerge and become the dominant means of growth. This resulted in an inflow of funds from abroad – largely from other Asian economies – seeking to take advantage of China’s relatively cheap labour. Joint ventures were established which were largely oriented to export and China, which had previously had little involvement in international trade, began to emerge as a significant trading nation.
Under the reform approach, China’s economy continued to grow and the rising incomes of the Chinese people generated an increasing demand for consumer goods which had been relatively unknown. As well as importing these goods, companies began to expand domestic production to meet the rising domestic demand. This in turn gave rise to the need for basic products (such as steel) which China had little capacity to produce. However, from the late 1990s basic processing capacity expanded, giving rise to a significant increase in demand for commodities such as ore and coal. This continues today and Australia, to this point, has been one of the chief beneficiaries.

In all likelihood, the commodities export expansion in Australia will continue for some years. However, a number of risks are apparent. China, like all economies, is prone to cyclical swings in economic activity. This can be a major problem in the case of China as their weapons of macroeconomic control are not well-developed and may not serve to avoid swings in activity which could prove damaging. Fortunately, in recent years, changes in both fiscal and monetary policy have taken place, but it is still to be seen whether such policy weapons will be able to cope when put under pressure, particularly from rapid expansion which generates inflation.

Because China is starting from such a low market base and because many areas of China are still substantially underdeveloped, the risk of a downturn, or even a flattening, in the growth trend appears remote. Cyclical swings aside, the underlying demand for resources will continue. A factor that has been of some concern is the potential for China to regress from the pursuit of developing a market economy. However, the evidence is that the authorities are pursuing the extension of market principles. A far more worrying issue is the widening regional and personal income inequalities in recent years. Along with deteriorating public support in basic areas such as health and education expanding inequality can create significant discontent among the population. With its primarily centralised political system China might face a difficult task in controlling any major socio-political challenge to government authority. The history of other nations suggests that if violent change does occur, the economy will be one of the first victims.
In the current situation, Australia is confronted by both opportunities and threats. To the extent that the commodities boom continues Australia will benefit. But anything that disrupts that boom will have severe consequences for Australia. In addition, the continuation of the boom may be distracting Australians from other potential opportunities that exist in China. As a country that seeks to have balanced economic growth, policies that target the spreading of risk and taking advantage of an expanding services sector may better serve Australia’s future economic prospects in conducting trade and investment with China.

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