

LOWY INSTITUTE PERSPECTIVES

**THE CHINESE ECONOMY:
IMPACT ON KOREA AND AUSTRALIA**

OUTCOMES REPORT

DR MALCOLM COOK

AUGUST 2005

The Lowy Institute for International Policy is an independent international policy think tank based in Sydney, Australia. Its mandate ranges across all the dimensions of international policy debate in Australia – economic, political and strategic – and it is not limited to a particular geographic region. Its two core tasks are to:

- produce distinctive research and fresh policy options for Australia's international policy and to contribute to the wider international debate.
- promote discussion of Australia's role in the world by providing an accessible and high quality forum for discussion of Australian international relations through debates, seminars, lectures, dialogues and conferences.

Lowy Institute Perspectives are occasional papers and speeches on international events and policy.

The views expressed in this paper are the author's own and not those of the Lowy Institute for International Policy.

OUTCOMES REPORT

The Chinese Economy: Impact on Korea and Australia

Friday, 5 August, 2005

**Lowy Institute for International Policy
31 Bligh Street, Sydney**

**Prepared by Dr Malcolm Cook
Program Director, Asia & the Pacific**

Conference purpose: On 5 June 2005, the Lowy Institute, with the Australia-Korea Foundation, hosted a conference looking at how the rise of China economically is affecting the Australian and Korean economies and Australia-Korea economic relations. The conference was made possible by the support of Macquarie Bank and the Korea-Australia Foundation, which hopes to hold a follow-up conference next year in Korea.

We chose this conference topic for five interconnected reasons: 1) The Australia-Korea economic relationship is one of Australia's most important and yet it garners very little attention, 2) the rise of China economically is an epochal change to the regional and global economy that is still in its early stages, 3) the Korean and Australian economies are two of the most sensitive to the rise of China and its economic future, 4) Korea-Australia economic relations run the risk of being ignored in the rush to focus on China, and 5) at the same time, the rise of China offers new opportunities for stronger Korea-Australia cooperation. The conference did not address security issues and the Korean peninsula situation, as these are widely discussed elsewhere and would have clouded the focus on the under-reported and under-analysed economic issues discussed.

Rather than providing a thorough rendition of the conference proceedings, this brief report will highlight some of the general themes that linked the conference discussions together. The conference consensus was that the impact of China's economic rise on Australia and Korea is still in its formative stages, generating more questions and debates than consensus opinions. As with the conference, this report will follow the Chatham House rule of non-attribution.

China focus While the conference was organised by Korean and Australian organisations, the vast majority of the day was spent discussing China and China's future. The interest in the rise of China, its significant impact on Australia and Korea, and the large number of questions it poses, meant there was little time left to discuss Australia-Korea relations. Obviously, Korea-China and Australia-China relations are more dynamic and a higher priority for Australia and Korea than Korea-Australia relations. This fact reinforces the significant risk that the rise of China may lead other more stable regional relations to be forgotten in the rush to engage with and understand China. Traditional barriers to closer Korea-Australia economic relations, like Korea's difficulty in even considering an FTA with Australia, are becoming more salient, especially in the light of China's active regional economic diplomacy and its willingness to engage in FTA negotiations.

Defining the "new" China From the welcoming dinner to the end of the conference, participants discussed the dimensions of China's economic rise, how the "new China" works and what it will become. Three aspects were repeatedly mentioned and largely agreed upon.

- *China's re-emergence:* What the world and Korea and Australia are witnessing is not the "rise of China" but the re-emergence of China as the primary power in East Asia and a significant global power. In the 1820s, China accounted for close to one-third of global output and was the undisputed leading country in East Asia. It then suffered a steady and sharp decline economically in comparative terms until the mid-1970s. Today, China, using market exchange rates, still accounts for only 12.7% of global output in purchasing power parity terms. China in many ways is simply in the early stages of regaining its long-held regional and international position. This historical dimension is a useful guide for how Chinese leaders and the Chinese population perceive their changing global and regional position and for considering how large and significant China will become. China's re-emergence, as with its previous pre-eminence, is linked to its economic openness and international integration. In 2004, 57% of Chinese exports come from foreign firms operating in China.
- *Primary partner:* China is, or will likely be, the primary trading partner for all the countries in East Asia, replacing Japan and the United States. China is already South Korea's principal economic partner and largest destination for foreign direct investment. For Australia, China is the second largest export market – after Japan – and the third largest trading partner – after Japan and the United States. Many believe that within the decade, China will be Australia's major trading partner. For Korea and Australia, among many others, trade with China is growing faster than any other major trading relationship. For Korea, while exports to the United States are declining, exports to China are growing rapidly. Korean student flows to China are rising rapidly while student flows to the United States and Japan are declining. For Australia, China represents the fastest growing tourist and international student markets. However, unlike the Koreans, Australian firms have been very hesitant to invest in China.
- *Global force:* Reflecting the size and rapid growth of China and its historical position, China is a significant global economic power. China's re-emergence has been a significant labour supply and raw resource demand shock to the global economy. China has added roughly 200 million more people to the globally engaged workforce. It is estimated that Chinese growth alone

accounted for over 20% of global growth in 2004 in purchasing power parity terms and is a major factor behind the historically high world growth rates we have witnessed in the last quarter century.

China's rapid economic growth, centred on energy-intensive production, has also been a major driver in the changing global terms of trade and in the sharp upward movement in energy prices. One participant noted that, largely due to new Chinese and Indian demand, global oil markets will need to add another "Saudi Arabia" to global supply by 2010 or face soaring energy prices. China is the world's largest recipient of greenfield foreign direct investment, but Lenovo's purchase of IBM's personal computer division and CNOOC's failed bid for Unocal are two headline-grabbing harbingers of China's new role as a source of global FDI.

China's challenges Befitting the rapid integration of the Korean and Australian economies with China and China's status as a developing, transitional economy, much of the conference focussed on the serious challenges facing the Chinese economy and government and how these affect China's relations with Korea and Australia. The conference's generally optimistic tone and its focus on China's economic opportunities were counterbalanced by a serious note of concern over China's political, economic and social stability and sustainability. These concerns were particularly prevalent in the respondents' presentations and in the final open plenary session.

- *Political challenges:* Many participants felt that the most serious long-term challenge for China's re-emergence was the growing gap between rapid economic reform and rising wealth, and the lack of political reform or openness. This was the only time that political factors entered into the day's discussions. Can China's one-party political system effectively manage all of the social and political tensions associated with very rapid, unequal growth? The rising number of local disputes and popular riots and the endemic problems of corruption were highlighted as examples of these increasing strains. China's political system has done quite well managing these strains but they will become greater, and some participants felt too diverse and complex, for the present political system to address. Chinese political stability was seen to be particularly sensitive to sharp downturns in economic growth.

Internal problems of managing economic growth and its social ramifications were seen as the greatest risk factors, rather than international diplomatic issues like Taiwan and North Korea. These political strains have already led to examples of bad economic policy, including very expensive infrastructure projects in the poorer western parts of China that have little productive potential. China's rapid economic growth and its uneven spread are also aggravating local government-central government relations which is a key factor in Chinese corruption and political uncertainty. On the positive side, the Chinese political system has been able to produce a large number of effective and internationally savvy economic managers and the central educational institutions have adjusted their curricula to face China's new challenges.

- *Economic challenges:* A wide range of domestic economic weaknesses came up that together present a massive agenda for China's government and economic managers. This wide range reflects the strains of rapid growth and the economic challenges of developing and transitional economies. China's dysfunctional financial system poses the greatest short-term (5-10 year)

economic problem. China's ascension to the WTO means that China will have to open up its financial system significantly and change its monetary policy quickly.

China's rapid economic rise has been driven by massive domestic investment that is associated with China's abnormally high savings rate and the inability of Chinese to diversify investment overseas. Credit is very cheap in China, significantly raising the chances for large and fragile bubbles, and serious overinvestment in unproductive areas. China's stock market is very small and under-performing, while much of its technically insolvent banking system is tied to funding uncompetitive state-owned enterprises. When China does open up its financial system, there could be a sharp outflow of capital from China by investors seeking to diversify.

The other range of economic challenges mentioned are examples of the "problems of success" and the problems associated with very rapid economic growth in a relatively unskilled developing economy with a limited legal infrastructure. These challenges included serious bottlenecks and shortages in the electricity grid and in the water system, and problems with rising urban wages and localised manpower shortages, particularly in skilled areas. Some Chinese urban areas now have higher wage structures than Thailand, while the massive inflow of rural workers to urban areas is slowing down. Fortunately, many of these pressures can be addressed within China by more labour-intensive, price-sensitive production moving inland from the red-hot coastal provinces.

- *Social challenges* The myriad social challenges facing China are intimately linked with its economic and political problems. The social challenges both feed into these problems and are aggravated by them. The most sobering moment during the conference was when one participant noted that 56% of female suicides globally take place in China, while China's total number of suicides is growing rapidly. The growing number of localised political protests and riots are manifestations of China's growing economic and social inequality, and the inability of the legal and political system to satisfy people's demands. China is better seen as a series of partially integrated economies and societies ranging from the urbanised, internationalised Shanghai elite to the very poor and unconnected interior provinces, with all the centrifugal forces this situation represents.

Differing views Reflecting Australia's and Korea's different economic profiles and historical relations with China, the conference highlighted differences in how Australia and Korea perceive China's re-emergence. In general, Australia has a more positive, optimistic view of China's economic rise, while Korea sees more potential problems. This difference carried over into comments on the impact of China's rise on Korea-Australia relations.

- *Korean view:* The Korean economy may be the economy outside "greater China" that has been affected most by China's recent economic dynamism. Korea's economic integration with China is much deeper and more comprehensive than Australia's, and Korea's new engagement with China is returning Korea to its historical norm. Korean firms have been some of the most aggressive in expanding into China, while at the same time fearing that China will take over Korea's niches in the global economy and potentially dominate Korea. The rise of China is seen as a double-edged sword. In this

sense, Korea's view of China is similar to Southeast Asia's view. Korea also worries that China's economic growth and its demand for mineral imports may complicate relations with Australia, particularly if Chinese and Korean firms compete to buy into Australia's large resource firms. However, China's new economic role has sparked discussions in Korea about a China-Japan-Korea FTA and greater engagement with Southeast Asia.

- *Australian view.* Australia's view of China's new economic position feeds directly from the strong complementarities between the two economies. Australia does not have a large manufacturing base that competes directly with China, but rather has a dynamic primary sector and strong niches in global services that fit almost perfectly with China's import surges. China is the main reason that Australia is benefiting from its best terms of trade in more than 30 years. Australia's largest worries are not Chinese competition and continued growth but what a slowdown in Chinese growth would mean for Australia. While Korea's economic relationship with China is one of concentration and competition, Australia's is one of complementarity and diversification. Australia's view of China's economic growth may be the most optimistic and least encumbered in the region.

LOWY INSTITUTE

FOR INTERNATIONAL POLICY

WWW.LOWYINSTITUTE.ORG