

# Perspectives from China and the implications for Australia

## Economic Research Paper by James White, Analyst

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- The emergence of China may be the single most important event in Australia's economic history. As such travelling to China offers a valuable insight into the opportunities and challenges Australia's economy is likely to face in coming years.
- Observing industrial China up-close changed many of the views I had previously held. In particular, the level of domestic demand is substantially lower than I had thought and the desire of policymakers to lower export reliance is limited.
- The stimulus has been aggressively implemented boosting infrastructure and residential property construction. But the application of the stimulus highlights the inefficiency of capital allocation.
- Despite global pressure to lower China's excess savings and reliance on exports, government policy seems to clearly support further export driven growth.
- The weakness of domestic demand is driven by the low wages outside of the export sector and the high savings rates of all Chinese households. Contrary to popular thought, however, much of the savings seems to be focused on property rather than health and pensions.
- China's dependence on exports has negative implications globally, in particular, continued savings imbalances and the continued displacement of manufacturing jobs from developed economies, such as Europe, to China.
- The impact of the stimulus on global commodity demand is immediately obvious in any Chinese city. A boom in construction of residential property and infrastructure is a key support for the belief in a permanently higher level of price for Australia's export commodities.
- China's political stability is crucial to its economic stability. To me, the greatest threat to stability is the growth of a consumer driven society that starts to limit the role of the state and family in Chinese life.
- China is undergoing a remarkable shift in transport; focused on rail and air to increase the efficiency and regional integration of the economy. There is also a revolution in car ownership and manufacturing that is likely to have a global impact.
- China's expanding economy has substantial positive implications for Australia but there are two areas where policy making is going to become increasingly difficult; Chinese investment and the allocation of capital and labour.

Figure 1: Map of China



**Land Mass:** 9.5 million sq km – 4<sup>th</sup> largest

**Population:** 1.34 billion people – largest

**GDP:** US\$7.97 trillion purchasing power parity basis – 3<sup>rd</sup> largest

**GDP per capita:** US\$6,000 purchasing power parity basis – 133<sup>rd</sup> highest

**Languages:** Standard Chinese or Mandarin, Cantonese, Shanghainese, Hokkien-Taiwanese, Xiang, Gan, Hakka dialects, minority languages (see Ethnic groups entry)

**Provinces:** 23 provinces and 4 municipalities (Beijing, Shanghai, Tianjin and Chongqing)

**Transportation:** 482 airports (15<sup>th</sup> highest), 77,834km of railways (3<sup>rd</sup> highest), 1.9 million km of roads (3<sup>rd</sup> highest), 110,000km of waterways (highest)

## CONTENTS

1. Introduction
2. China's macro-economic backdrop
  - The implementation of China's stimulus
  - Continued government support for exports
  - China's low domestic demand multiplier
  - The implications of an export dependent Chinese economy
3. China's commodity demand
4. Chinese politics
5. Transport
6. The implications for Australia
  - Chinese investment in Australia
  - Allocation of resources in Australia

## 1. INTRODUCTION

The emergence of China may be the single most important event in Australia's economic history. In coming years China's influence will shape Australia's wealth but also how and where we live. It will make us rich relative to much of the developed world but also raise social issues, particularly of fairness. As such understanding China better through travel is crucial to determining how some of these issues may play out. For these reasons I recently travelled to China. The trip included a round of meetings in Beijing, Shanghai and Hong Kong and two weeks touring the back blocks of industrial China including the Three Furnace cities of Wuhan, Chongqing and Nanjing.

My meetings provided me with a solid back drop to China's current economic environment, the impact of the large monetary and fiscal stimulus programs, the near-term outlook for growth and the nuances of Chinese commodity demand. The journey through central China, meanwhile, provided an insight into the Chinese domestic economy. In particular, my visit to the city of Wuhan in central China, did much to change the way I think of China.

Wuhan is a sprawling mix of three formerly independent cities: Wǔchāng, Hànkǒu and Hànyáng, each established on the China's longest river, the Yangzi. Wuhan's central position on one of China's most important transport routes makes it a good example of the economic transformation occurring in the other cities of provincial China. It's not hard to be impressed by Wuhan. Its city skyline is dominated by the glass plate buildings of any developed economy. Its retail precinct is home to a range of Western and Chinese brands, while the ferry crossing the Yangzi dodges in and out of barges full of coal and iron ore, very probably from Australia. The city has a brand new railway station, built at a cost of RMB14 billion (A\$2.25 billion), with 20 rail lines and 11 platforms constructed with 60,000 tons of steel. Its property market, as in many second, third and fourth tier cities, is booming both in price and supply. Indeed, one real estate agent reported selling 180 apartments of 1,000 in the first day of sales.

Yet somehow this shiny, modern and bustling city contains within it the tensions China faces. The large commercial buildings are empty; indeed the tallest has never opened. Its retail precinct, though active, highlights the dynamics of China's hyper-competitive retail sector where many stores are derivatives of more established Western and Chinese brands (from Nike, for example, comes Li Ning and Erke). It is a resource dependent economy reliant on other countries to maintain its growth and the race towards industrialisation comes at the cost of a city shrouded in brown air.

Figure 2: empty commercial property in Wuhan



Figure 3: Coal barges on the Yangtze



Wuhan's tensions and contradictions helped to shape and change my view of China, and its impact on the global economy and Australia. While China will add to global commodity demand, which is expected to create a permanent shift in the prices of Australia's key commodities, it is likely to further displace economic activity in developed economies and maintain the current global savings imbalances.

## 2. CHINA'S MACRO BACKDROP

Prior to visiting China, I saw it as an emerging economy with a strong domestic economy, where exports played only a secondary role. The best evidence for this had come in the past twelve months as China's economy had continued to grow relatively robustly, despite recession in the global economy. China, simply, could not be export dependent, but it is.

There are three aspects to my changing view of the Chinese macro-backdrop:

- the implementation of China's economic stimulus
- continued government support for exports, and
- the role of exports in driving domestic activity.

### The implementation of China's economic stimulus

The implementation of China's economic stimulus has been remarkable. The allocation of enormous volumes of capital in a short period of time allowed China to circumvent, at a macro level, the impact of the global recession that was felt in collapsing exports.

There were two parts to the Chinese stimulus package; a focus on releasing bank lending to fund infrastructure and property construction, and a fiscal program aimed largely at increasing consumption.

The effectiveness in the short term must be judged on the ability of the stimulus to get people back to work, keep export-focused factories open and maintain a macro-economic growth rate of above 8%, while in the long term it will be measured by the increased efficiency the infrastructure creates and the value of the added capacity.

China will achieve certain aims, both in the short and long term. The threat of large scale unemployment has receded and, while graduates are finding it difficult to secure work, there are also labour shortages in some areas. Furthermore, the focus on transport and social infrastructure will create substantial long-term benefits for the domestic economy. Transport infrastructure is opening new domestic markets, particularly by creating a two-way trade in resources and manufactured goods between China's east and west. Improved social infrastructure, including schools and hospitals, is capable of increasing the productivity of the labour force and lowering the requirement for precautionary savings.

However, the super-charged nature of bank lending growth in 2009 (RMB8.7 trillion (A\$1.4 trillion) has been lent in the year to September 2009 compared to RMB8.5 trillion (A\$1.35 trillion) for the two years from January 2007) highlights the broader issue of inefficient capital allocation in China. Prior to arriving in China, I viewed this remarkable rise in bank lending as the consequence of looser lending standards allowing supply to meet a large pool of potential demand. In China, it became clear that demand was largely created by bank pressure. Together with more relaxed lending standards than Australia is used to, anecdotal evidence suggests the possibility of bank's pressuring clients to take on credit, even when it may not be required.

The result is that a large share of the credit extended has been left on deposit or invested in more liquid markets such as equities or commodities. This leaves the more liquid asset markets vulnerable to monetary tightening. The Chinese equity market has already exhibited its skittishness to a monetary tightening in the form of a 23% fall from peak-to-trough in August. For commodities, the crunch may come in early 2010 as speculative buyers of industrial metals repay or refinance short-term loans from early 2009.

More damaging are the long-term capital allocation decisions, including the creation of over-capacity in many industries and the potential for a large boom-bust cycle in property if loose monetary policy is maintained. China is aware of the over-capacity issues, with the central government recently targeting the steel, cement, flat glass, chemically processed coal, poly-silicon and wind turbines industries.

The poor allocation of capital is due to the high savings rates of both households and corporates, and the interest rate subsidy paid to state-owned-enterprises (SOEs). SOEs access bank capital at artificially low rates thanks to Chinese households being forced to earn very small returns on their savings, due to a cap on deposit rates (currently at 1.71% for 3-months and 2.25% for one year). This subsidy allows companies to inflate profits and, in a roundabout way, support employment. SOE profitability crowds out investment in private firms, an issue that has recently been at the forefront of policy making.

Poor allocation also seems to be a function of both the nature of competition and a focus on production and revenue growth rather than on other financial return metrics. Competition is ferocious and price based. Such is the derivative nature of many markets where competition limits the incentive to product differentiate. This is most obvious, to Western markets, in the retail sector where high streets are flooded with sportswear clothing shops with very little to distinguish

them. It's also evident in cars, where many Chinese models may be easily recognised as copies of common American and European brands. The nature of competition means profits are driven by volume rather than margin growth.

It also seemed the case that Chinese firms have a principal aim of churning off as much cash as possible rather than creating long-term wealth. Partly, this seems a function of the conspicuous spending of many wealthy Chinese. One contact made the point that while there is now a subway line from his apartment to his office, he still uses his car because he needs to be seen in the car.

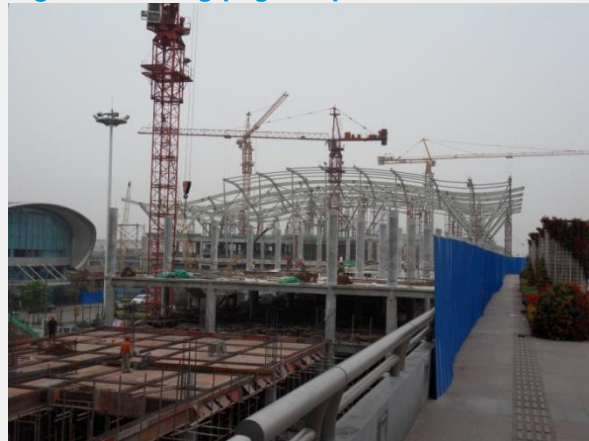
The feeling I had of the stimulus was that it was a like-for-like replacement of the activity lost from exports; a combination of high savings and developing economy status had saved the economy from recession. The success of this strategy seems to incentivise a continued reliance on exports and high savings as the next cycle plays out and adversely impacts China's export markets.

Its success the next time, however, is unlikely to be as clear. The stimulus has been most effective in the poorer central and western provinces, rather than the more industrialised eastern provinces. As poor provinces develop, the ability to stimulate growth through fixed asset investment in the absence of export demand diminishes, as Taiwan, Korea and Japan have recently experienced. There are two ways of demonstrating this. First, statistics show growth has been 4.5% for the eastern provinces compared to 6.8% for the year to June 2009. Second, the photo below shows the re-building of the Nanjing city walls. It seems to be what you do when you're a rich coastal province handed a lot of cash and no more obvious projects available. This strategy also has global consequences.

**Figure 4: Re-building Nanjing's city walls**



**Figure 5: Chongqing's airport extension**



### Continued government support for exports

Global imbalances describe the high savings of some economies, including China, Japan, Germany and the oil-exporting economies, and the high spending of economies such as the US, UK and Australia. Policy makers around the world believe that a period of more sustainable global growth would require an end to these imbalances. Such a change requires China to lower its trade surplus through stronger domestic demand growth relative to export growth. Dominique Strauss Kahn, the Managing Director of the International Monetary Fund has said:

*...the responsibility for powering the global growth engine will fall on other countries, particularly those that relied on export-led growth.*

While recently US Federal Reserve Chairman Ben Bernanke said:

*For their part, to achieve balanced and sustainable growth, the authorities in surplus countries, including most Asian economies, must act to narrow the gap between saving and investment and to raise domestic demand. In large part, such actions should focus on boosting consumption.*

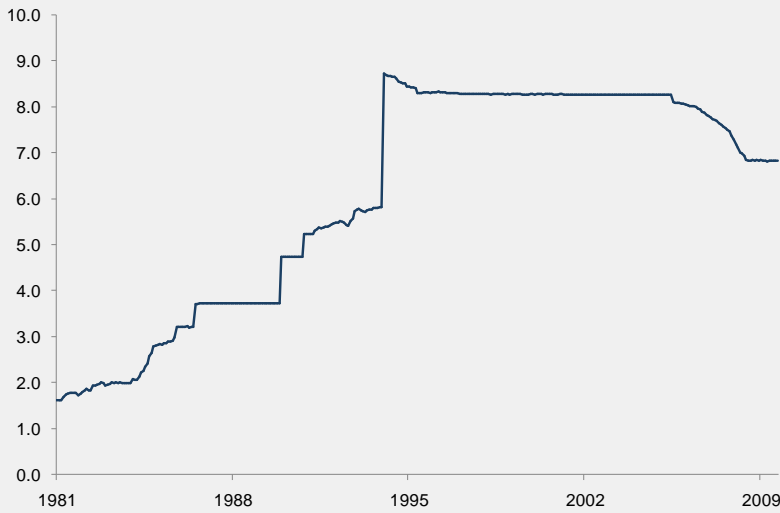
China is an important part of this global re-balancing. Its current account surplus, a measure of its excess savings, was the highest of any global economy in 2008 according to the IMF. Economists and policy makers believe higher household consumption through better funded social and health welfare programs and a more advanced pension system, funded through returning SOE profits to the central government, would help achieve this.

China has made policy steps in this regard through subsidies for the purchase of appliances by rural households and is aiming to increase welfare and pension insurance for the 55% of the population (mainly rural households) not currently covered.

These measures, however, are relatively limited when matched with the continued support for exports. China seems unwilling to break its dependency on what has been a successful domestic policy, irrespective of global instability. Indeed, the success of the past eight years, where exports have added to growth in good times and provided the savings to support growth in bad times, make it difficult for China to reverse policy easily.

The principal policy supporting exports has been the maintenance of a stable RMB relative to the US\$. Following the initial period of appreciation from July 2005 to July 2008, the RMB has effectively been pegged to the US\$ at a rate of RMB6.84. In the same period, the US\$ index has been very volatile, appreciating dramatically until March 2009 before beginning a rapid depreciation. With indications of further US\$ depreciation ahead and no change in Chinese policy expected, the exchange rate will continue to support export industries in China, particularly against European competition.

**Figure 6: Chinese RMB:US\$ exchange rate**



In the course of my trip I observed other indications of government support for export industries, notably in Chongqing, a city in Western China famous for its role as the Nationalist Government's capital during the war with Japan, along with its spicy food and current construction boom. In Chongqing I met the General Manager of a local SOE. The General Manager, a native of Hong Kong, is mandated by the central government to purchase companies internationally that may support the activities of SOEs in the Chongqing region. His primary targets are resource firms; however, his focus is shifting to distribution companies to expand the international markets available to manufacturing SOE's in the region.

On a train from Nanjing to Shanghai, in China's east, I sat next to an executive of an export garment manufacturer going to meet a French clothing retailer. The French company was planning to shift the manufacturing of its more elaborate clothing products to China from France. He described conditions for exporters over the year. His company, with customers in the US, Canada and France, had started to see demand pick-up, though not to levels seen prior to the crisis. He said that customers had begun to ask for smaller lots at lower prices, though the more regular smaller lots meant demand was growing.

He outlined the support his company had received from the local Jiangsu provincial government in the wake of the crisis. The government had encouraged firms to upgrade their plant and equipment, to employ more sophisticated techniques and to upgrade the skills of senior management through external training courses. Rather than accept the shift of garment and footwear jobs to lower wage economies, China was helping its firms become more competitive.

**Export jobs drive domestic demand**

China's domestic economy is export dependent; commercial office property is largely vacant, the best paid of the average urban Chinese are factory workers, the Chinese have a low propensity to consume and the multiplier from domestic activity and investment is low due to high savings rates.

On first sight, many of the big central and western cities of China come across as similar to their counterparts in developed economies; bustling urban centres with commercial office buildings and factories on the outskirts. On my first visit to China in 2007 this seemed very impressive. But on further examination China's economy seems less robust. Often these large commercial buildings - Nanjing has the seventh tallest building in the world - are empty, few more than a symbol of development rather than an important part of a city's commercial heart. Vacancy rates in China

are very high. In Beijing with a relatively market for office space vacancy rates are still above 30%. In second tier cities, vacancy rates are closer to 50%. Low demand for office property seems evidence of a weak knowledge and service economy and highlights export dependency.

This is also seen in the wage differentials between factory workers and others in urban areas. A common question I had for many of the people I met was how much they, or people in their city, get paid? It was clear from the answers that the best paid among China's urban masses, were the factory workers. Generally, factory workers would tend to earn between 2 and 3 times more than their counterparts in domestic service type jobs. In Chongqing, factory workers would earn around RMB2,500 (A\$400) per month, compared to RMB1,000 (A\$160) for domestic jobs. In industrial Hebei, the doughnut shaped province with Beijing in the middle, steel workers would earn around RMB4,000 (A\$645) compared to less than RMB1,000 (A\$160) for most others. In Shanghai, monthly wages in factories reached around RMB5,000 (A\$810) compared to RMB2,000 (A\$320) to RMB3,000 (A\$480) for other workers. Supporting a narrowing in wage equality in China requires more jobs in higher paid manufacturing industries.

As an aside on wages, the government has been increasing the pay substantially of public servants, particularly in the army and police forces. Soldiers received a 50% increase in pay through the stimulus package. The government also introduced a ready reserve type program for university students. Undergraduates can take two years out of their university course in return for a lump sum payment of RMB80,000 (A\$12,900). The Shanghai government has also been aggressive in raising the pay of the police force. Wages for the Shanghai police are now RMB12,000 (A\$1935) per month, compared to an average Shanghai wage of around RMB5,000 (A\$800).

The high incomes of manufacturing workers are channelled into the high national savings rate. This high savings rate reflects household concerns over pension and health welfare but also constrains the growth in domestic demand because of the low propensity to spend. The argument goes that increasing state provision for pensions and health would unlock substantial domestic demand. From my observations, and statistics, this seems unlikely. First, the uncovered 55% of the population are generally from rural areas, with low incomes and as such contribute little to the economy. Second, urban Chinese save to buy property.

Property has two principal attractions for the Chinese; they want to consume more of it and it is seen as a better store of wealth. This increased consumption of property is observed nationwide. It means that despite low population growth, rising urbanisation, higher consumption and incomes mean residential construction should remain strong. Property has also emerged as an important asset class. Returns are greater than for cash deposits while it lacks the volatility of the narrow and relatively shallow equity market.

In a way, property may offer the best opportunity for China to re-balance its economy. By increasing the availability and size of mortgages and lowering the requirement for a deposit, China can mobilise savings domestically. Allowing greater leverage in residential property would enable households to get their savings into property at a low level and also help raise property prices, so increasing wealth, and driving higher household consumption. It would come with risk but there is a long way between where Chinese mortgages currently sit and those in developed economies.

Low incomes in domestically oriented industries combined with high savings propensities drive the low multipliers from the strong domestic infrastructure investment now being observed. Employment in infrastructure is limited to relatively lowly-paid migrant workers who live cheaply and save furiously with the aim of returning to their native areas where they will be able to purchase property. In addition, many of the projects have built in over-capacity in anticipation of continued strong economic growth. As such, these projects do not substantially improve the economy's efficiency, with payback likely to come over the next decade rather than the next year.

### **The implications of an export dependent Chinese economy**

The implications of China's continued export dependency seem to be threefold.

First, while China can afford to continue to buy growth through stimulus for another two years, it does need global growth to return in order for it to re-build reserves, through export sales, and so cope with the next global slowdown.

Second, China is as likely to displace global demand as add to it. This is likely to be seen, for example, in the steel industry. In coming months, China will return to being a large steel exporter. Its competitive advantages of a stable US\$ exchange rate and low cost of capital enable it to make its over-capacity problem into a global problem. Furthermore, as developed economy steel mills wind-up production, the Chinese, already running at capacity, are capable of meeting near-term demand. This leaves the tough decisions of cutting production and employment as the problems of other economies, particularly European economies with a strong euro. The global economic recovery is likely to be of greater benefit to China, while the displacement may slow the cyclical recovery and constrain growth in the medium term as the costs of structural change arise.

Third, and probably most importantly, the global imbalances, created by China's structurally high savings rate are not disappearing in the course of this cycle. As a result, the world will need to learn to efficiently and effectively invest at low rates of return for the long term. This seems a likely recipe for future disaster.

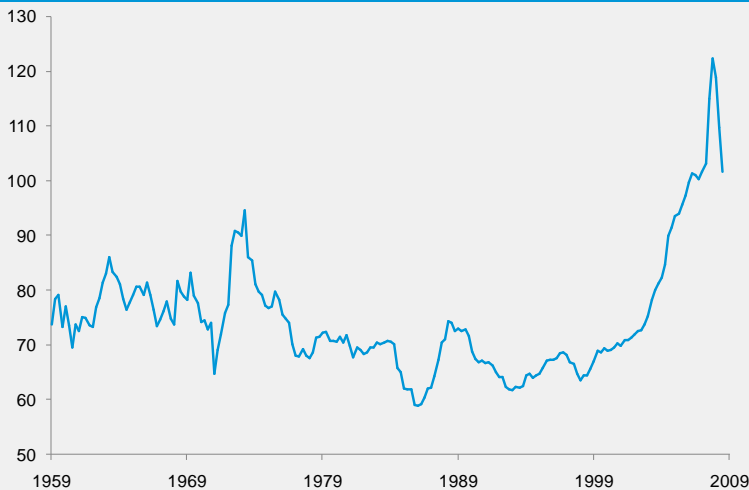
For Australia, the impact of a strong industrial China is largely positive. Australia's manufacturing industry will continue to decline, but the strong terms of trade will encourage business investment and aid export growth.

### 3. CHINA'S COMMODITY DEMAND

A key thesis for Australian economists, and particularly the RBA, has been the permanent shift to a higher level in the Australian terms of trade (Australia's export prices relative to import prices) as a result of the rise of China. My trip to China did nothing to dispel this thesis, in my mind, though there will be cycles.

From 2004, Australia's terms of trade rose in a steep trajectory until the beginning of the current global economic crisis. In the midst of the crisis prices began to fall dramatically. This was most evident in base metals, where prices ended up down as much as 45% in Australian dollar terms. The fall in bulk commodities was less dramatic but still steep, with contract prices for iron ore falling between 30% and 35%, depending on the customer. The fall has proven temporary, however, reinforcing the idea of the secular Chinese growth story.

**Figure 7: Australian terms of trade since 1959**  
(value of exports relative to imports)



There are two legs to the structurally higher terms of trade in Australia; the secular growth story in China and the strategic advantages of Australia's resources.

The current construction boom in China is remarkable. Arriving into Shanghai in the early evening it was impossible to not be struck by the activity being undertaken in the city. The road from the airport maglev train to the downtown area is dominated by the construction of an eight-lane elevated expressway and an underground transport network while, elsewhere in the city, roads are being improved and sidewalks dug-up and replaced. This is in addition to a property construction boom and Shanghai's hosting of the 2010 World Expo. In this way Shanghai is both an outlier and a leader.

The Shanghai World Expo 2010 has a construction budget of US\$80bn (A\$88 billion). This compares with the US\$40bn (A\$44 billion) spent on the Beijing Olympics, according to one estimate. As such the spending on Shanghai is unique and unlikely to be replicated ever again in other cities. That said, a large proportion of the spend will occur in urban infrastructure including new roads and underground rail, that in time will be common to many other large Chinese cities. There are currently 56 cities in China with populations of greater than 1 million people and 17 cities in the top 100 globally.

Property, too, has enormous potential for strong growth with two drivers; continued urbanisation and larger floor space requirements. China's urbanisation rate is expected to reach 49.2% by 2015 from 40.4% in 2005, suggesting that in the period the residential space will increase by 4.6bn sq ft.

Finally, commodities demand is increasing through higher consumption of consumer durable goods including appliances and cars. Partly, this demand has been brought forward by government stimulus, but as incomes rise households can continue to spend more money on these products. The growth has been strongest in the rural sector. Research from UBS shows that fridge ownership has risen to 30 per 100 rural households in 2008 from around 12 per 100 in 2000. Similarly, colour TV ownership is now higher than 90 per 100 rural households compared to just over 50 per 100 households in 2000. This process of higher consumption of durable white goods will persist and, over time, a strong replacement cycle will also emerge.

This demand for urban infrastructure, residential property and consumer durables underpins the demand side of the price equation. The supply side is also favourable for Australia. There are two core elements to this; the high quality of the Australian resource product and the competitiveness of freight from Australia.

Australia's key bulk resources, iron ore and coal, are of a higher quality than domestic resources available to China. Australian iron ore, particularly that produced by the majors, is generally of the highest quality. Grades in China are rarely as strong as the grades of 60% Fe plus in Australia. Australian iron ore producers are also generally in the bottom quartile of the global iron ore cost curve.

China's coal imports have surged from 40.1 million tons in FY08 to 86.5 million tons from Q109 through to Q309, accounting for a substantial portion of the regional seaborne trade. However, import volumes still represent only a small portion of domestic requirements; China's annual coal production is around 2.8 billion tons. The head of China's National Energy Administration recently stated that China will not intervene to limit coal imports so as to conserve its coal resources. Indeed, the government imposed exports taxes on thermal and coking coal in early-2007.

The freight differential between the cost of transport between China's western provinces and its eastern industrial heartland and between Australia and the east coast allows Australian resources to capture large market share in the eastern provinces. Transporting resources from say Shaanxi province in central China to the east coast requires a train journey to the north-east coast, a ship journey south and then a further transfer inland. The total cost is approximately US\$25 compared to a current bulk freight rate from Australia of approximately US\$12-15.

#### 4. POLITICS

It's easy to identify the more obvious threats to China's political stability: Tibet and other minority areas and rising wealth and income inequality. But perhaps the greater threat is the change delivered through economic and market development.

I see three layers to a nation; the state, society and the family or individual. In Western democracies, society probably plays as large a role in forming opinion and direction as either the state or family. In contrast, Society in china has traditionally played a relatively limited role, with a strong central government and family driving behaviours. This can be seen in the strong Han Chinese support for quelling rebellion in the outlying provinces such as Tibet and Xinjiang. It is also seen in the support parents provide for children keen to enter the housing market.

This status quo, however, seems increasingly vulnerable to the changing economy. An example of this is the formation of support groups for migrant workers. Migrant workers have few of the rights that registered urban dwellers have; including limited access to health and social welfare. As a result increasingly organised groups of migrant workers have emerged to provide many of these social support functions; including pooled medical care and support for those in hospital, prison or out of work. These groups establish organisation amongst a large group of people that may previously have been too disparate to have their concerns heard.

Society is also growing as a result of increased consumerism and advertising. Chinese advertising is at pains to avoid explicit use of words such as freedom, independence and individuality. But implicitly advertising is aimed at these concepts with ads extolling the virtues of these more western ideals. In combination with a generation of only children (as a result of the "one-child policy") that are commonly referred to as "little emperors", there is pressure on the values extolled by the Chinese Communist Party.

## 5. TRANSPORT

Travel in China is being substantially upgraded with air, rail and road all being supported by large spending programs.

Flying around China is a contrasting experience. The planes and airports are new (perfectly similar in design), plentiful and cheap. Yet, I was pretty happy to get on a Qantas flight to go home. Airports, and air travel, are remarkably important for emerging economies. In many ways planes are similar to mobile phones for emerging economies. Both provide a service, communication and transportation, without the high fixed cost networks of their predecessors. China and India, and particularly rural areas, benefit enormously from being able to circumvent the construction of high fixed cost networks. As such, airport construction has been a large part of the current stimulus package and will provide substantial benefits for the Chinese economy, particularly in driving stronger domestic demand. There are, however, some constraints to this rapid expansion that are relatively obvious to travellers in China. First, the sky is getting crowded. A regular message at airports was *'this flight has been delayed due to air traffic congestion'*. Second, the pilots could be better (and over time will be) with a number of hairy landings making the train a more relaxing mode of transport.

It's likely too, that the Chinese rail experience will improve rapidly as the stimulus rolls out a larger and improved network. There are two elements to the rail upgrade. First, China wants to further increase the capacity of its network to handle freight. China already transports a remarkable amount of its freight via rail. Its railways are the busiest and most efficient in the world; hauling 24% of the world's freight on 6% of the world's tracks. The upgrade is designed to open up western areas to eastern markets, particularly in coal and other resources. Second, the passenger rail network is being upgraded through the creation of high-speed routes between Shanghai and Beijing and Guangzhou and Beijing with the twin benefits of lowering travelling time and creating greater capacity for freight. Travelling along the route from Beijing to Shanghai it is possible to observe the construction of the elevated high-speed track. In some parts the track is near-completed, as in the photo on the following page, while in other areas the piles are only just being drilled.

While the expansion of road networks has been extensive in the stimulus period, particularly in urban areas, the biggest change has been the improvement in car affordability. China has emerged as the bright spot in the global automotive sector. While other major markets have shrunken in size, China has surpassed the US in auto sales for the first time. The Chinese car market is unique. The market is extremely fragmented with the five largest manufacturers holding 42% of the market. The largest domestic producer, Chery (yes it does sound like Chevy), holds 6% and the tenth largest, Geely (also Chinese), holds 3%. These local producers are creating small cars valued at between A\$5,500 to A\$10,000. One local manufacturer, BYD, is aiming to be a large manufacturer of electric cars. The emergence of these domestic companies marks a shift for China from the large global manufacturers. Chinese roads remain full of Audis for the elite and VW Santana's for the taxi drivers.

Figure 8: Contrasting motor vehicles



Figure 9: The Beijing to Shanghai high speed railway



## 6. THE IMPLICATIONS FOR AUSTRALIA

Aside from Australia's obvious benefit as a commodities exporter, there are some key implications for Australia. These include:

- role of Chinese investment in Australia
- efficient allocation of resources

### Chinese investment in Australia

Chinese investment in Australia was an important topic when I was in China; the detention of a Rio Tinto employee and the decision to not proceed with the Chinese debt funding of FMG's expansion were key. The importance, to China, was highlighted by my encounter in Chongqing and some other comments heard along the way.

In Beijing I met an Australian who, probably, works for the Chinese as a PR adviser on Australia. He told me that he was invited to China Investment Corp's office where there is a board with every global listed resource company and CIC's ownership share. He also mentioned that the Chinese are currently focused on small Australian explorers at the moment.

Also in Beijing, the Australian embassy suggested that requests to the Foreign Investment Review Board had risen again in September and there were currently 39 applications in the pipeline across a range of industries, not just resources projects.

Such is the role of Chinese and Japanese investment in Australia that some regions are beginning to be dominated by companies from these countries. China and Japan control, as owners, Western Australia's mid-West. They have part-funded the development of the Oakajee Port and are supporting railway and energy projects. They have control of the mid-west in the same way that BHP and Rio control the Pilbara, with the ability to determine which projects proceed and which do not.

I have no problem with this, in principle. It is irrelevant to me who is paying royalties (though I would argue that given the relative attractiveness of Australian resources royalties should be higher, no matter the company) and the Chinese are paying for infrastructure and exporting product that in their absence would never have otherwise occurred.

I do, however, feel the price paid is too low. Again, I do understand the argument for selling to the Chinese at offered prices; often the asset is second rate and the premium is at a level that makes it attractive to sell and find better value elsewhere.

Instead, my concerns are of a more long-term nature. How do we best manage our relationship with China?

From my perspective, the Australian government is doing a good job. First, it's right that we encourage foreign investment in the same way we support free trade; we are large beneficiaries. Second, there does seem to be a push by the bureaucracy to enhance its China capabilities. The RBA is creating the language skills and data collection, while in Beijing I met a former federal policeman, now employed by DFAT, who was living with a Chinese family to improve his language skills.

The responsibility lies with the Australian private sector to continually improve its understanding of China, its economy and politics. Do we truly know the price at which the Chinese might walk away from a deal? How much leverage does Australia have over China? Is China likely to be the only large emerging economy with a deficit of both iron ore and coal in the next ten to twenty years? Truly understanding the answer to these questions will allow Australian asset owners to make decisions that will stand up in the medium to long term.

### Resource allocation

The impact of China on resource allocation in Australia has been clouded by the Global Financial Crisis. In this period the shift towards strong business investment in mining and energy projects has eased and labour markets in Western Australia and Queensland have endured the biggest falls in employment. In the prior period, however, Australia became a high investment economy by developed world standards. From 2000 to 2008 investment as a share of GDP has risen from 15% to 22%; an enormous shift in the way the Australian economy operates and the basis for strong future growth, if, as expected, markets for Australian commodities remain strong.

This trend of strong investment is likely to continue in the wake of China's demand levels through the global slowdown. The crisis has seemed to confirm demand levels for Australian resources from China with commodity prices quickly recovering to stronger levels in the wake of the crisis. This has allowed companies to increase their long-term price levels and so make investment cases more attractive. The addition of stronger developed world demand, despite being weaker than it could be, will only further increase the attractiveness of resource projects.

In the next ten years, Australia will also see an enormous growth in the value of its LNG exports. This will require substantial investment and was highlighted recently by the \$50 billion Gorgon LNG project on the North West Shelf. \$50 billion is approximately 5% of Australia's economic activity in 2009.

Australia is also attractive because of its stable political and regulatory environment and proximity geographically to both China and India. This is important for global resource companies when considering investment opportunities in Australia relative to other parts of the world, particularly Africa, where political and regulatory stability cannot be guaranteed.

The benefits to Australia of demand for its commodities are critical to its positive economic outlook. But, there will be substantial policy issues along the way, primarily the allocation of labour and capital. Job growth in Western Australia and Queensland is likely to return to the levels of 2006-08. The availability of the capital goods and commodities required to undertake the construction is also likely to become more limited. The consequences of strong labour and capital demand will flow to other states. In the absence of restraint from Australian households interest rates are likely to rise.

A strong resources market will make projects in other domestic industries and the residential market more expensive and less likely to occur. This makes sense given the lower returns in these sectors relative to mining and energy. Social policy, specifically in the areas of housing affordability, immigration and the environment, will be particularly difficult. In many places the lack of affordable housing could create internal migration away from the southern states to the mining states.

China will shape the Australian economy and politics in the coming decade. Generally, Australia will be a richer country, perhaps the richest in the OECD, but it will require a change in the way Australians work and importantly, for social policy, where they live.



Investment Markets Research

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au

For further information

[cfsinstitutional@colonialfirststate.com.au](mailto:cfsinstitutional@colonialfirststate.com.au)

Regional Managing Director, Australia and New Zealand  
 Joanna Davison +61 2 9303 7007

Institutional Business Development and Consultant Relationships  
 Matt Russell +61 2 9303 7024  
 Ali Karmali +61 2 9303 6070  
 Tracey McNaughton +61 2 9303 2965

Institutional Relationship Management

Liz Krajewski +61 2 9303 2927  
 Daniel Bristow +61 2 9303 6311  
 Helen Squadrito +61 2 9303 6142  
 Hugh O'Neill +61 2 9303 6116  
 Nadene Moore +61 3 8628 5615  
 Simon Good +61 3 8628 5681  
 Lucas Rooney +61 7 3328 5875

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