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The Rise of China

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Introduction

The rise of China as a global economic superpower has been driven by a unique combination of factors. In recent decades, market oriented policy reform, complimented by significant investment, productivity gains and demographic transition, has fuelled an unprecedented increase in aggregate output. Achieving an average annual GDP growth of approximately 9% since 1980, triple the OECD average, China has grown rapidly to usurp Japan as the world's second largest economy.¹ This essay will explore the factors that will continue to shape China's growth prospects, as well as the complex implications of this growth profile for the Australian economy.

Economic Policy

Economic policy reform is a fundamental driver of growth in China. Beginning with the rise of the Communist Party in 1949, centralised planning had burdened the Chinese economy with crippling misallocation of resources, price distortions and low productivity.² Since 1978, consecutive leaders have implemented market oriented reforms designed to improve economic efficiency.³ These policies have included the gradual decollectivisation of agriculture, privatisation of state controlled industries, allowing private ownership and promoting international trade and foreign direct investment. Although these reforms may seem elementary from a Western perspective, they have effectively exposed the Chinese economy to the efficiency and growth potential of the free market, incentivised labour and the rational allocation of resources. The prospect of further reform, particularly in relation to state control of key industries and strict regulation of investment and currency markets, should continue to facilitate improvements in efficiency and output in the future. More than any other factor, economic reform has provided the core foundation for economic growth and prosperity in China.

Investment

China's growth is heavily dependent on capital accumulation and investment. Prior to its recent expansion, the Chinese economy was primarily focused on agriculture, with low levels of capital stock and an underdeveloped industrial sector. From this position, increases in output have been driven by investment in industrial plants, machinery, equipment and infrastructure.⁴ This

¹ The World Bank, World Data Bank, *World Development Indicators*, 09/07/2012

² Hu Z & Khan M, Why is China Growing so Fast?, *IMF Economic Issues*, April 1997

³ Thomas S, China's Economic Development from 1860 to Present, *Forum on Public Policy*, 2008

⁴ Sahoo P, Infrastructure Development & Economic Growth in China, *Institute of Developing Economies*, Discussion Paper, October 2010

structural transformation in the Chinese economy is reflected by the fact that fixed asset investment has increased at an annual rate of 22% over the last three decades.⁵ Fixed capital formation is now such an integral component in Chinese growth that the investment to GDP ratio has increased to 48% in 2011 from only 28.8% in 1980 (Figure 2).⁶ A significant proportion of these investment projects have been in low cost manufacturing, which has generated a 10 fold increase in industrial output and an 8 fold increase in the value of exports since 2001.⁷ It is clear that large scale investment has been at the centre of China's economic expansion, however, there are concerns regarding whether this growth model can be sustained.

China's reliance on investment to drive growth is often viewed as a critical economic weakness. Many commentators observe that the level of investment in China is disproportionate to other sectors of the economy and unsustainable in the long term.⁸ Despite the apparent merits of this argument, there are a number of key indicators that suggest investment in China should remain buoyant. Although investment and capital accumulation is growing at an extraordinary rate, it is important to recognise that growth is a relative measure and China began this period of expansion with extremely low levels of capital stock. Even after decades of growth, public infrastructure is still limited and capital stock per person in China remains only 8% of the US and 17% of South Korea.⁹ Furthermore, high levels of investment are appropriate given that China's main industries, such as manufacturing, are quite capital intensive, particularly when compared to the service oriented economies of other nations. In contrast to many developed countries, investment as a percentage of China's GDP is also less than its national savings rate, which is currently 51.4% of GDP (Figure 3).¹⁰ Although the risk of an investment bubble should never be ignored by Chinese regulators, these factors suggest that the level of investment in China is sustainable.

Productivity

China's economic performance has been underpinned by consistent productivity gains. Despite high levels of investment, the Chinese capital to output ratio has remained relatively constant since the early 1980s. By way of contrast, total factor productivity (TFP) has increased at an annual rate of approximately 4% for the last three decades.¹¹ To put this achievement in perspective, most developed nations have averaged TFP growth of 1% annually over the same period (Figure 4). The improved efficiency in China's utilisation of labour and capital resources has been crucial in driving economic growth. Although large scale investment has driven aggregate output, China has

⁵ HSBC Global Research, *China Inside Out*, February 2012

⁶ The World Bank, World Data Bank, *World Development Indicators*, 09/07/2012 and The Economist, *Free Exchange: Capital Controversy*, 14 April 2012

⁷ HSBC Global Research, *China Inside Out*, February 2012

⁸ Collinson P, *China: Is it a big bubble about the burst?*, The Guardian, 27 April 2012

⁹ The Economist, *Free Exchange: Capital Controversy*, 14 April 2012

¹⁰ Institute of Developing Economies, *Infrastructure Development & Economic Growth in China*, October 2010

¹¹ The Economist, *Economics Focus: Secret Sauce*, 12 November 2009

been able to maximise its growth rate by achieving significant advances in productivity. Maintaining this level of efficiency growth may prove challenging, however, productivity should continue to improve as workers benefit from greater education and training, as well as the effect of upgrades in machinery and technology. On this basis, productivity gains should continue to make a positive contribution to China's economic growth.

Demographics

Urbanisation is a major factor shaping China's economic growth. Over recent decades, a large proportion of the Chinese population has shifted from residing in rural communities to living and working in large cities. 51% of China's population currently live in urban areas, compared to 19.3% in 1980.¹² This demographic transformation has been vital in China's rapid economic expansion as residents of cities supply the workforce required in large scale industry and are able to specialise in a certain type of labour, which substantially improves efficiency.¹³ Aggregate demand is also boosted by increased consumption spending as people move away from self-sufficient agriculture. The structure of China's economy means that matching the urbanisation rate of advanced nations is unrealistic in the short term, however, as the economy continues to develop, growth will be enhanced by people consistently moving to urban areas.

Although demographic change has contributed to China's success, sustained economic growth is threatened by an aging population. Improved life expectancy due to modern medicine, combined with the unique "one child" policy, will drastically transform the structure of China's population. In particular, the proportion of the population aged over 65 is expected to increase from 8.8% in 2010 to approximately 25% by 2050.¹⁴ The significant shift in the composition of China's population will force policy makers to grapple with a shrinking relative labour force, as well as the financial burden associated with supporting an increasingly large percentage of the population beyond retirement.¹⁵ Furthermore, China's economic model is acutely reliant on an abundance of cheap labour. This competitive advantage is crucial in many key drivers of growth, most notably in manufacturing, and may gradually be eroded as the labour force contracts and wages rise. Although an aging population is a real issue in China's long term growth, there are many advanced economies that will soon endure the worst effects of population restructuring, for example, Germany's dependency ratio is 31% and is forecast to increase to 50% by 2035.¹⁶ From this perspective, China is

¹² HSBC Global Research, *China Inside Out*, February 2012

¹³ Fung E, *Forces Driving China's Economic Growth Beyond 2012*, KPMG, February 2012

¹⁴ World Health Organisation, *Healthy Aging in China*, 7 April 2012 and Chen Wi, *Future Population Trends in China: 2005-2050*, Monash University, September 2009

¹⁵ Banister J, Bloom D & Rosenberg L, *Population Aging & Economic Growth in China*, Harvard University, *Program on the Global Demography of Aging*, March 2010

¹⁶ European Commission, *Eurostat*, Old Age dependency Ratios, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php?title=File:Old_age_dependency_ratio_on_1_January_of_selected_years.PNG&filetimestamp=20110609135954

actually quite fortunate as policy makers will be able to observe the experience of these nations and develop strategies that should soften the impact of demographic change on economic growth.

Implications for Australia

Australia will continue to reap the benefits of China's positive economic growth profile. It has been well documented that China's expansion has fuelled demand for raw materials used in construction and manufacturing. Driven by this unprecedented demand, base metal prices have risen dramatically, with the price of iron ore and coal increasing by 962% and 247% respectively in the last ten years (Figures 5 & 6).¹⁷ Endowed with substantial natural resources and geographically close to China, Australia is uniquely positioned to take advantage of this continuing opportunity, supplying the Chinese economy with vast quantities of iron ore, coal, copper and other commodities. In a relatively short period, China has grown to become Australia largest trading partner, accounting for 27.3% of exports (Figures 7-9).¹⁸ The relative increase in the market price of Australia's resource exports is also reflected by the near doubling of the nation's terms of trade over the last decade (Figure 10).¹⁹ Although the mining industry represents only 7.2% of GDP, Australia's recent economic prosperity has been fundamentally driven by growth in mining and related services.²⁰ The continued strength of the Chinese economy has generated extensive investment that should further strengthen Australia's growth prospects. At present, there is approximately \$260 billion committed to capital expenditure in the Australian mining industry.²¹ Ultimately, Australia will continue to benefit from its unique exposure to China's economic growth, however, the implications of the commodity boom are not entirely positive.

The most concerning aspect of China's growth is the risk that the broader Australian economy may suffer from "Dutch Disease." Since 2009, the Australian dollar has appreciated by 30% against the US dollar, while making similar gains in respect to most global currencies (Figure 11). This process has been driven by strong demand for Australian commodities, as well as the high yield differential between Australia and other developed economies. The increase in the Australian dollar has severely impacted on industries not directly exposed to the commodity boom, including domestic manufacturers, tourism, non-resource exporters and companies that derive earnings overseas.²² The obvious effect of a high dollar is that Australian goods and services are rendered less competitive on international markets. This downturn in demand is also exacerbated by domestic competition from cheaper imports. The impact of the high dollar has significantly undermined the financial performance and future viability of many Australian businesses. Prominent companies that

¹⁷ IMF Research Department, *Primary Commodity Prices*, 06/07/2012

¹⁸ Department of Foreign Affairs & Trade, *China Factsheet*, June 2012

¹⁹ Australian Bureau of Statistics, *Key National Account Aggregates*, March 2012

²⁰ Department of Industry, *Key Facts: Australian Industry*, 2011

²¹ Bureau of Resources & Energy Economics, *Investment in Australia's Mining Industry*, 24 May 2012

²² Corden W, *The Dutch Disease in Australia*, ANU Working Paper, November 2011

have reported lower earnings or closures due to the high dollar include CSL, Bluescope Steel, Toyota, Caltex and Billabong.²³ The pressure imposed by the rise of the Australian dollar is not necessarily a concern for policy makers; currency markets are floating and the appreciation has been the result of rational market forces. The real risk for Australia is that if the dollar remains high for a prolonged period, the nation's broader economic base will be eroded to the point that there will be few industries remaining that are capable of sustaining economic growth after the commodity boom eases. The impact of Dutch Disease on the Australian economy represents a complex downside risk in China's continued expansion that must be addressed by policymakers to ensure that Australia does not lose its broader economic foundation.

Managing the wealth generated from the resource boom will remain a highly contentious issue. Commodities are a unique and sensitive driver of economic growth due to the often widespread opinion that natural resources belong to all Australians and that the benefits of the resource boom should be shared throughout the economy.²⁴ This ideological approach to managing natural resources has recently given rise to a number of issues including foreign ownership and taxation of mining activities. Australia has historically relied heavily on foreign capital to finance investment projects and many of the nation's largest mining operations are either wholly or jointly owned by overseas entities, including Xstrata, Alcoa and Minmetals.²⁵ Despite the contribution made by these companies to the Australian economy, there is invariably heated public and political discussion when further foreign ownership is proposed, such as Rio Tinto's potential alliance with Chinalco in 2009.²⁶ An equally passionate debate arose in 2010 when the Federal Government announced its intention to tax the profits of resource companies in order to achieve a greater distribution of mining income.²⁷ Irrespective of their merits, these issues will likely remain at the forefront of Australia's political agenda in the future and should not be ignored when considering the implications of China's continued economic growth.

Conclusion

The emergence of China as a global economic superpower has been driven by multiple forces. China's economic fundamentals remain strong and Australia should continue to benefit from its unique exposure to China's positive growth profile. The sustained commodity boom ultimately represents an extraordinary opportunity for the Australian economy, however, it is important to recognise that there are certain issues and complex risks that will need to be managed in the future.

²³ West M, Dollar's Rally Far From Done, *Sydney Morning Herald*, 4 April 2011

²⁴ House Standing Committee on Economics, *Report on Minerals Resource Rent Tax*, November 2011

²⁵ Investment Reference Group, *A Report to the Commonwealth Minister for Resources and Energy*, April 2011

²⁶ Coorey P, Chinalco Question Not Just About Investment, *Brisbane Times*, 18 May 2009

²⁷ International Resource Journal, *Tackling the Australian Super Tax*, Volume 2 Issue 7, July 2010

Appendix 1

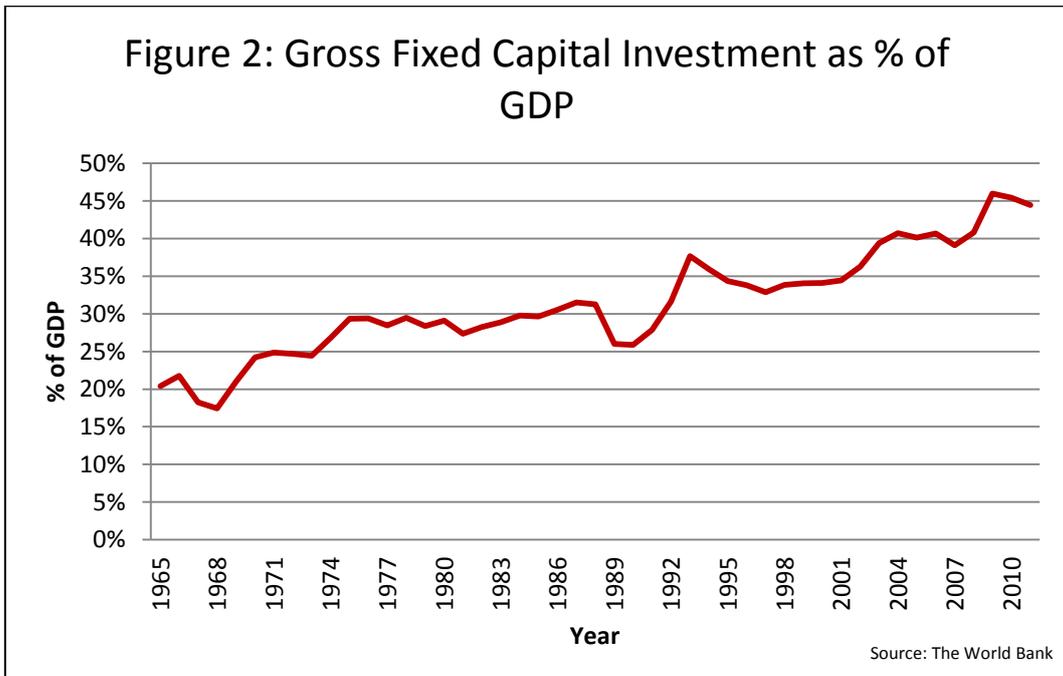
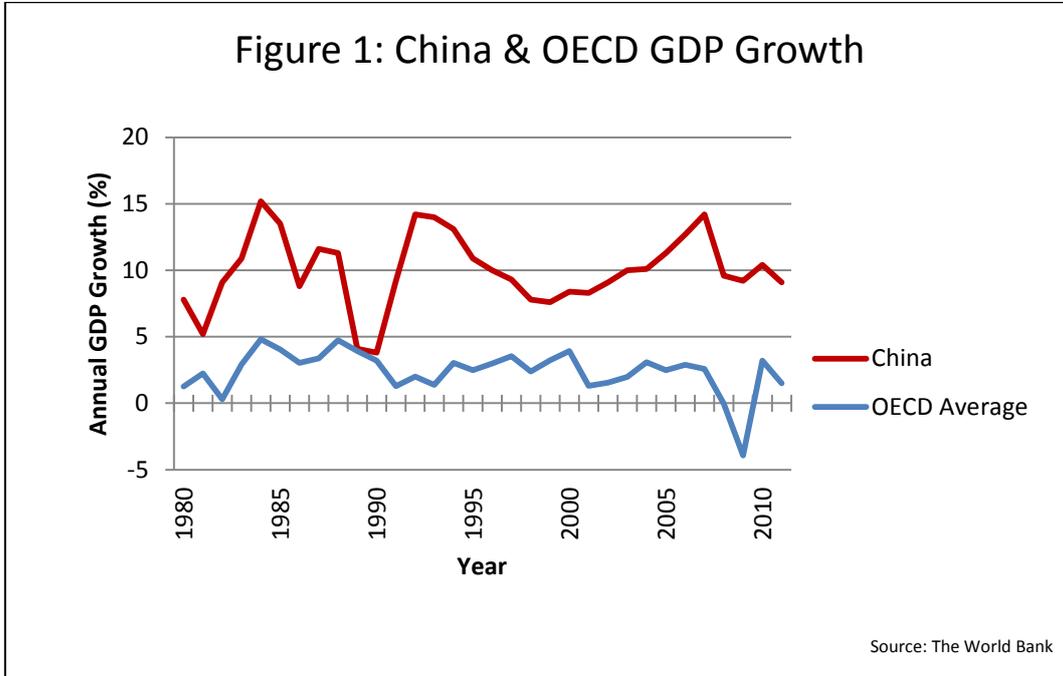
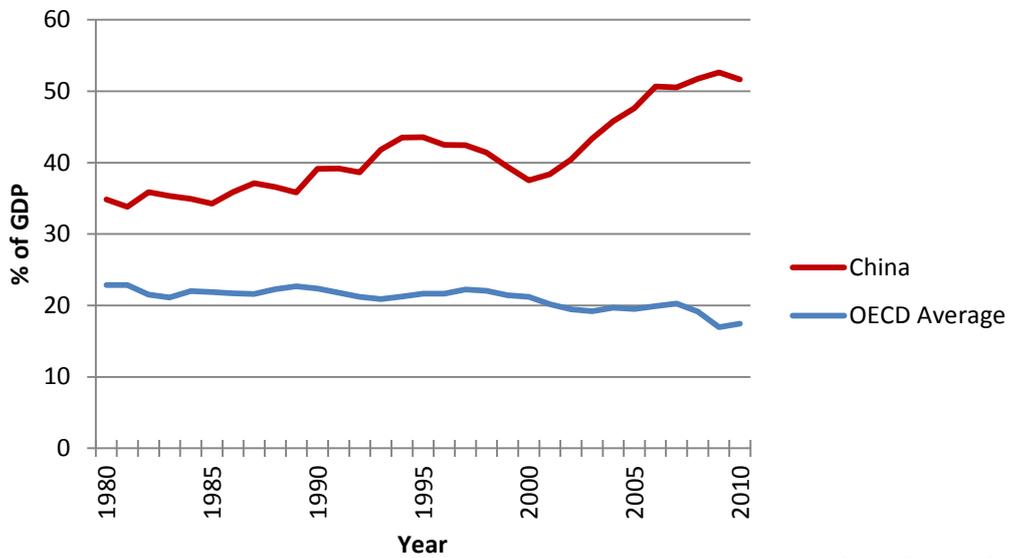
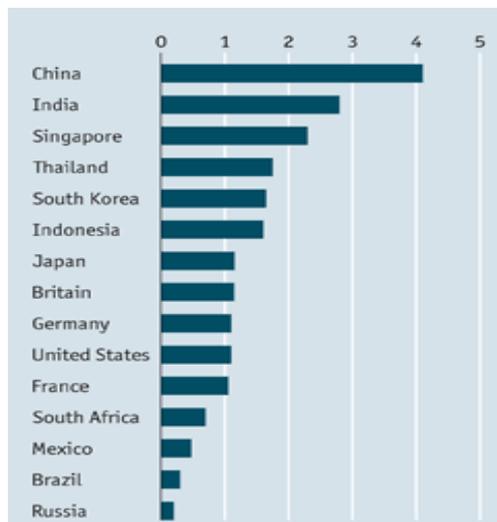


Figure 3: Gross Domestic Savings as % of GDP



Source: The World Bank

Figure 4: Average Annual TFP Growth 1990-2008



Source: The Economist, UBS, OECD

Figure 5: Iron Ore Price

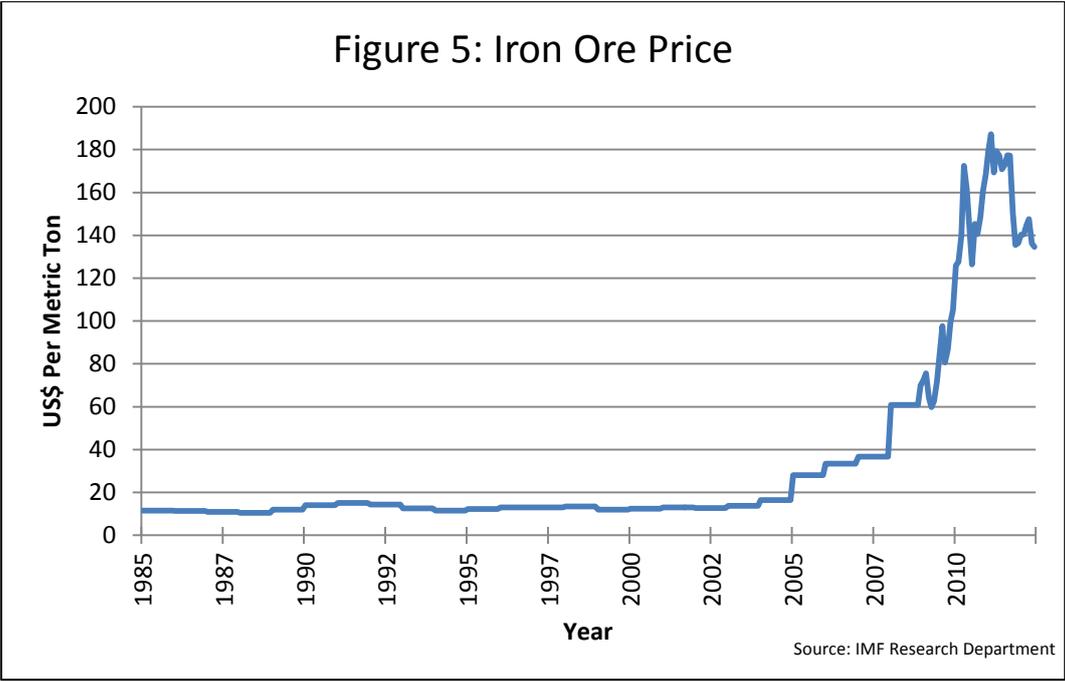


Figure 6: Coal Price

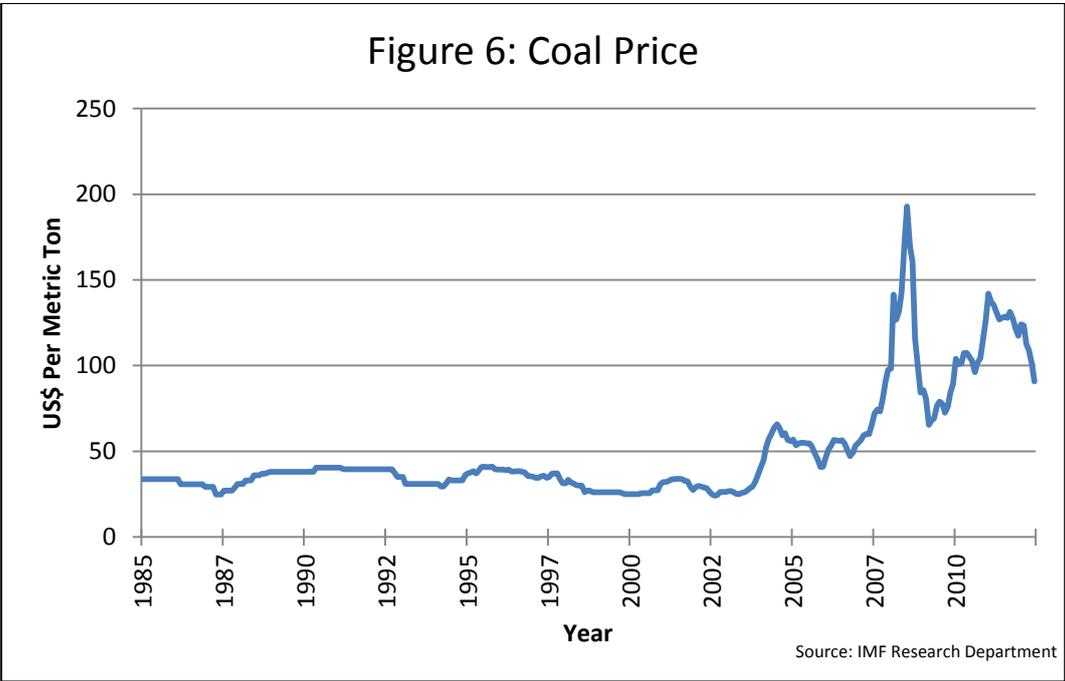
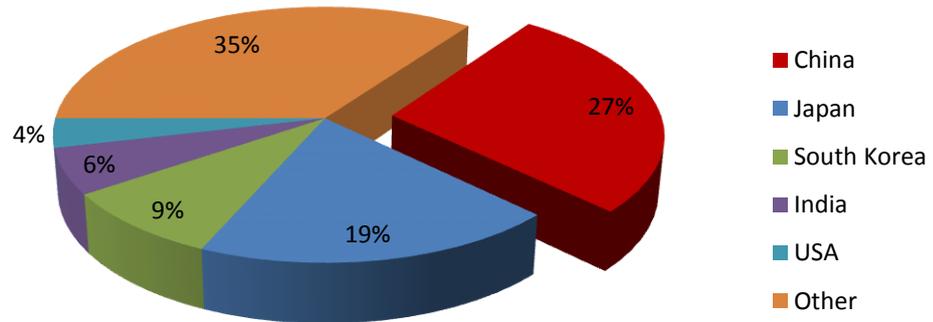
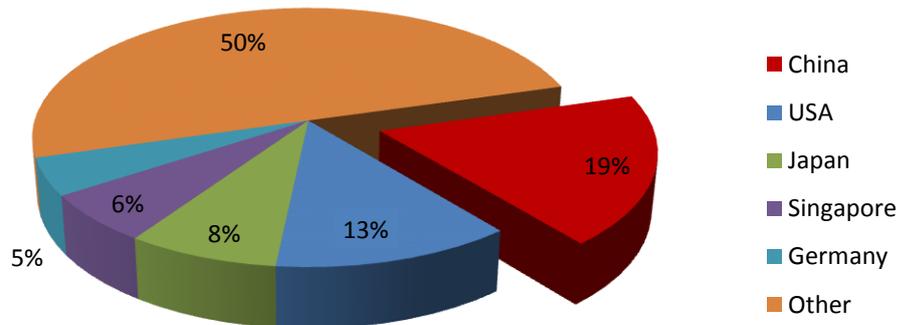


Figure 7: Australia's Main Export Destinations



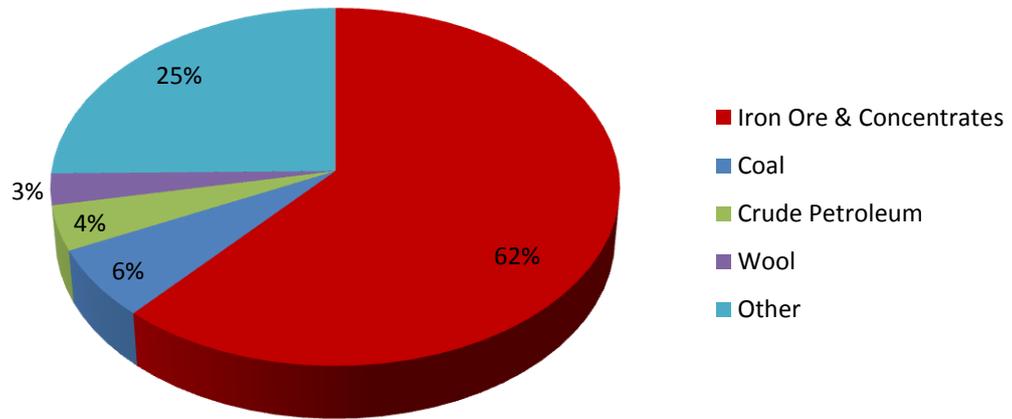
Source: Department of Foreign Affairs and Trade

Figure 8: Australia's Main Import Destinations



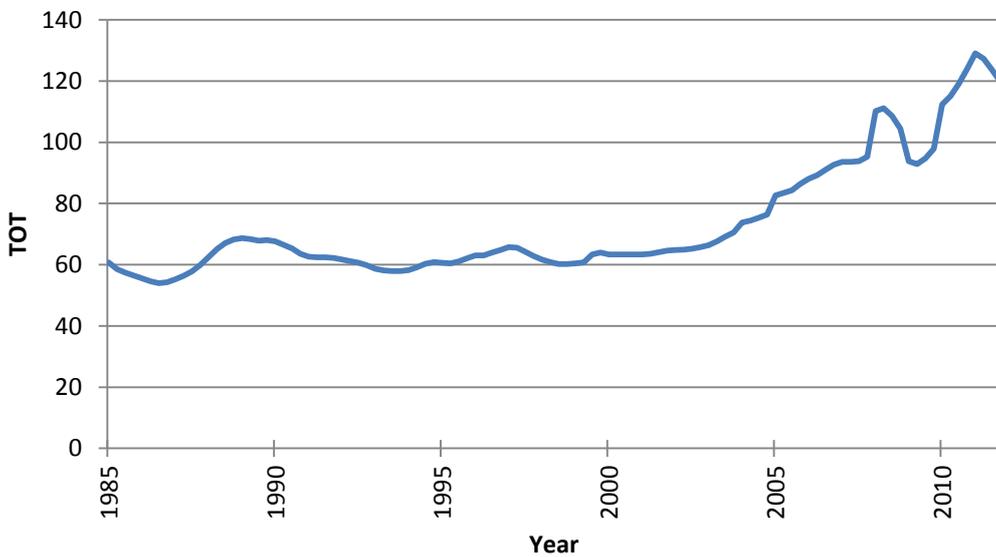
Source: Department of Foreign Affairs and Trade

Figure 9: Australia's Merchandise Exports to China



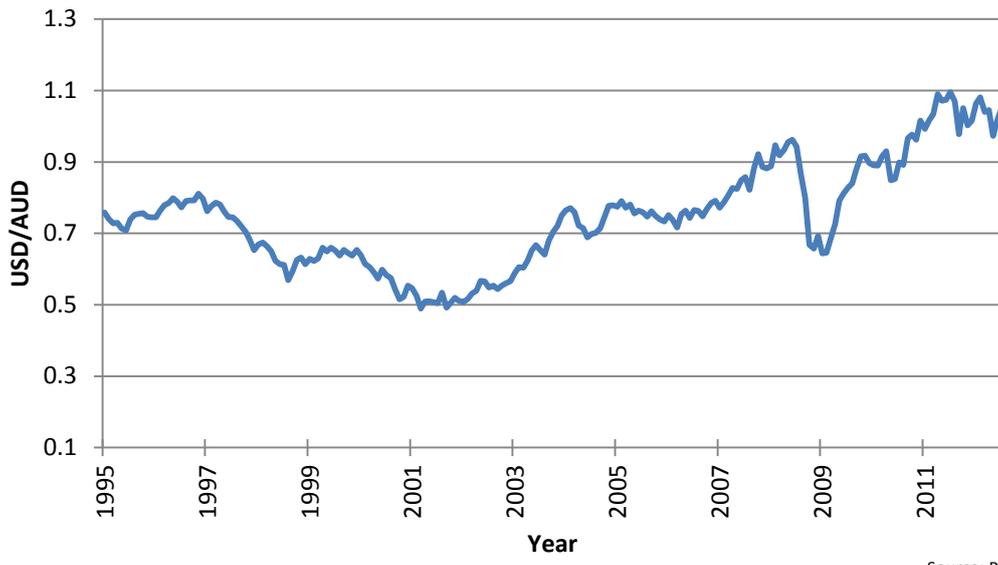
Source: Department of Foreign Affairs and Trade

Figure 10: Australia's Terms of Trade



Source: ABS

Figure 11: AUD-USD Exchange Rate



Source: RBA

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