InScope

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The China story

The recently announced Federal Budget for 2010-11, which aims to have the deficit wiped out within three years, is in part based on assumptions that the China led mining boom will continue to benefit Australia for the foreseeable future.

In this edition of InScope, we will look at how Australia's trade links with China are currently boosting the economy and what may be ahead on China's horizon.

The Australian economy is now among the strongest in the world. While this is due in part to monetary and fiscal policy, there is no doubt that our close ties with Asia, in particular China, are a large contributor to this position.

China's demand for coal and iron ore increased substantially in 2009 thanks to the Chinese Government's stimulus package. Australia is a reliable supplier of many of these commodities and in some cases is a low cost producer. We also benefit from being close to China geographically, with China now our number one export partner.

In the short term, concerns are held over a possible slowdown in China in 2010 and the impact of the proposed introduction of the Resources Super Profits Tax. However, demand from China for Australian commodities is expected to continue in the medium term and may lead to increases in investment spending by mining companies as they expand production.

Knock on effects

Increased mining investment has a knock on effect for Australians through higher income levels and expected benefits to employment levels – the Treasury expects wages to increase by 3.75 per cent and employment to grow by 2.25 per cent for the year to June 2011.

The Federal Budget papers sum it up by saying, "While the global economic recovery is expected to be uneven, the outlook for the Australian economy is increasingly positive, with strong prospects for the Asian region expected to support rising terms of trade and a rebound in business investment."

Stability of growth

Just how strong are China's prospects for the medium term? Looking back on China's history we can see how the country has grown dramatically over the past 20 years.

- China's gross domestic product (GDP) has increased almost six-fold since 1990.
- In 1990 China accounted for just 2 per cent of global industrial production; today the figure is around 13 per cent.
- Ten years ago China was responsible for 15 per cent of global steel production; today it produces almost 50 per cent.

The table below shows how China's two year economic growth forecast compares to the US, Europe, Japan and World growth forecasts.

International economic growth forecasts

% yr	Actual 2009	Treasury 2010	Treasury 2011
USA	-2.4	3.0	2.5
China	8.7	10	9.5
EU	-4.1	0.75	1.25
Japan	-5.2	1.75	2.0
World	-0.6	4.25	4.25

Source: Commonwealth Treasury

However, a big question being posed right now is whether China can continue to grow strongly given the slow growth expected in Europe, which could lead to a slowdown in exports.

Naturally a slowdown in Europe and recent actions by government officials in China to cool the economy will have an impact on China's growth. On the positive side, growth out of the US has been stronger than anticipated. China now also has the capability to grow through domestic demand thanks to its population of 1.34 billion – around 70% of China's economic growth is from domestic sources rather than being reliant on export growth.

Solid economic indicators

The number of cars sold recently in China has been almost the same as the number sold in the US. This is in sharp contrast to the situation in 1998, when for every 100 cars sold in the US only 10 were sold in China.

China also graduated 4.5 million university students in 2007 compared to 950,000 in 2000. That outstrips US graduates by 1.8 million.

China's economy is forecast to grow by 10 per cent this year according to the IMF. However, officials have indicated that the biggest risks to the outlook are in rising property prices and higher inflation. While there are inflationary risks, China's policymakers have already put in a number of tightening measures to avoid overheating and this has started to have an impact. This is a positive measure, as more balanced and sustainable growth helps avoid a boom then bust scenario.

The outlook for iron ore and steel

It is expected that residential construction will surge as higher incomes increase demand for housing, and industrialisation and urbanisation continue. In addition to this, the Chinese central government is allowing the sale by local governments of 185,000 acres of land in 2010. This is compared to 85,000 in 2009. Of this land, 70% must be used for affordable housing. This provides strong support to the steel industry, with 50% of steel demand coming from the property industry.

For these reasons, China's steel growth is expected to remain strong in 2010. Total production in China is expected to rise to at least 640 million tonnes this year from 565 million in 2009. This however may be a near term peak as government stimulus for steel rolls back in 2011.

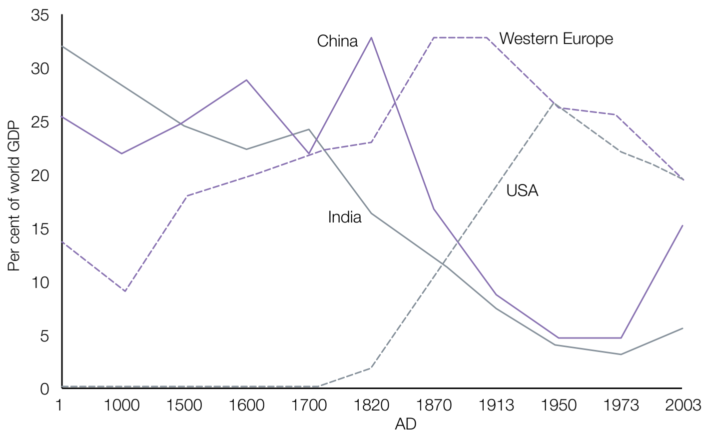
The continued growth of China's economy is a clear positive for Australia and will help support strong demand for our commodities like iron ore.

What must be balanced though is the difference between volumes and price. The continued expected demand from China is likely to see export volumes rise, but this needs to be balanced against expected additional supply. Australian mining companies are looking at expanding production to take advantage of China's demand. However, with more supply could come lower prices. While this levelling of prices will not end strong mining investment and employment in Australia, it will mark a transition phase.

Medium term outlook for China

Of course, strong growth in is not guaranteed, but over the medium term there are grounds for optimism about China's growth prospects. It is important to remember that at one point in time, China was the world's largest economy. As the chart below shows, it appears there could come a time when China will be the world's largest economy again. While volatility in economic growth in China is likely, China will continue to influence the Australian economy over many years to come.

Share of world GDP, 1-2003AD



Source: Maddison A, 2007, Contours of the World Economy 1-2003 AD, Oxford University Press.

Speak to us to understand how the Federal Budget or economic changes may affect your circumstances.

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