

Introduction

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Between 2000 and 2015, China moved from being Australia's eighth largest trading partner to its largest. Iron ore exports rose from 33 million tonnes per year to 624 million tonnes. The fact that Australia weathered the global financial crisis without experiencing a prolonged slowdown is commonly attributed to our close economic relationship with China. Australia is not alone in this respect. Many small, open economies, particularly in Asia, have become increasingly integrated with the Chinese economy as it has grown rapidly over the past decades. China is now the largest trading partner for 45 economies around the world, including the majority of Asian economies.

Reflecting this importance, and to advance our knowledge of the large Asian economies in our region, the Reserve Bank established an Asian Economies Research Unit in 2009. Part of its brief was to conduct in-depth research on the Chinese economy. Of course, research from an office in Sydney can only get you so far in understanding a complex economy like China's. In recognition of that, the Bank also established an office in Beijing in 2011 to complement the work of our Sydney-based researchers and provide a flow of information from those 'on the ground'. Despite what we have learnt about China, there is still much that we do not know. The papers presented at our 2016 conference and collected in this volume represent an attempt to fill some of these gaps.

These papers set out the views of pre-eminent experts on the Chinese economy – their analysis of the past and their thoughts on the future. Notably, while there is much they disagree on, there was agreement that China is at a critical juncture. The Chinese economy, after growing strongly for many years, is now going through a period of transition. The growth and investment associated with China's rapid industrialisation is slowing. There are many important policy decisions to be made in the near future and the potential for economic disruption is rising. Will China be caught in the 'middle-income trap'? Or will it continue its development like Japan and South Korea have done before it? Will the economy successfully rebalance from its heavy emphasis on investment towards consumption-led growth? And what might the implications of success on this front look like for economies that have grown dependent upon supplying China with the raw materials for its investment spending?

The first set of papers in this volume focus on what has been happening in China over recent decades. They look at the process of reform and rebalancing that has occurred and provide some thoughts on likely future developments. Harry X Wu presents new estimates of productivity growth across industries in China and finds that such growth has been quite slow. Furthermore, he finds that productivity growth has been lower in industries most affected by government intervention. Thus, he concludes that 'disentangling government from business and allowing the market to correct the cost structure of industries is the key to solving China's structural problems'.

Nick Lardy takes a different approach to analysing growth in China through the reform era, which started approximately four decades ago, but, nonetheless, reaches similar conclusions. He

documents the significant contribution of private firms to growth in China over the past decades and notes two worrying recent trends. First, private investment has slowed significantly. While some of this is likely to have been due to slowing growth, he notes that the slow reduction in barriers to entry is also a significant factor. Second, he notes that there is a large productivity gap between the state and private sectors, which has increased since the returns on the assets of state companies began falling precipitously in 2008. He notes that this has been associated with a rapid increase in indebtedness for state-owned companies over the same time frame and that this should be a real source of concern.

Similarly, Barry Naughton starts by noting the significant challenge faced by China in grappling with the end of its rapid growth phase. He argues that there is little evidence of significant reform in recent years and that the opportunity to pre-emptively rebalance has largely been missed. Thus, the task faced by policymakers is much harder than it could have been. While he cautions against being too pessimistic, he makes it clear that the challenge is large.

Finally, among the first set of papers, Wing Thye Woo considers the possibility that China will succumb to the 'middle-income trap'. He identifies a number of different reasons why a country might fail to escape the 'trap' and discusses what he sees as the most significant risks for China. Along with Harry X Wu and Nick Lardy, Wing advocates for faster convergence to a modern market economy and an encouragement of private sector entrepreneurship. But he also points to a significant risk associated with rising inequality and a breakdown of social cohesion. It is a risk, he emphasises, that has already been implicitly acknowledged by the Chinese Government through its emphasis on promoting a harmonious society. He suggests that addressing this challenge will require an increasing use of free elections, monitoring by a free press and adjudication by an independent judiciary.

The second set of papers in this volume turn their attention outwards to the likely implications in other countries of rebalancing and reform in China. Roberts, Saunders, Spence and Cassidy focus on China's effect on commodity markets and the likely consequences for Australian trade. They start with a detailed discussion of a number of commodity markets and China's role in them. They then project possible changes in Chinese demand for commodities based on historical patterns seen in other similar countries. They conclude that the demand for iron ore is likely to fall in coming years while the demand for energy and food is likely to increase. The net effects on Australia and other trading partners of these changes are unclear but they suggest, contrary to more pessimistic views, that there is likely to be significant ongoing demand for Australia's exports from China.

Turning from commodity markets to financial markets, Alfred Schipke of the International Monetary Fund (IMF) presents some work on the possible effect of Chinese capital account liberalisation on global investment flows. He first notes that, compared to countries at similar levels of per capita income, China has a relatively closed capital account. Thus, he suggests, it seems reasonable to expect substantial changes in China's openness over coming years. He notes that the typical experience when a country liberalises their capital account is for there to be substantial net outflows. Given the size of China's economy and financial system, this could have significant implications for the rest of the world. To help manage this process, Alfred points to the recommendations the IMF has issued on capital account liberalisation, which, he notes, China has largely followed to date.

The final two papers both take a much broader look at the possible effects of Chinese reform and rebalancing on the global economy. They look at the linkages between domestic rebalancing and China's external position. Ma, Roberts and Kelly consider the likely effects of China's rebalancing for its trade patterns, while Golley, Tyers and Zhou use a dynamic numerical model of the global economy to consider the implications of changes in Chinese fertility and savings that might flow from recent policy reforms.

Ma, Roberts and Kelly find evidence that rebalancing from investment-led growth to more consumption-led growth is already occurring in China. Using input–output tables they show that this rebalancing could increase China's current account surplus under a number of scenarios. Using global input-output tables they suggest that, without a significant reorientation of international trade flows or prices, domestic rebalancing could generate substantial headwinds for exports to China by its major trading partners.

Golley, Tyers and Zhou consider the effect of changes in Chinese fertility and saving patterns for both Chinese and global growth. They find that success in raising fertility or lowering savings is a double-edged sword. While GDP might be higher with higher fertility, GDP per capita is lower. While a rebalancing of the economy towards consumption might seem like an opportunity for trading partners, and see a reduction in China's external imbalance, the long-run effect – when combined with the demographic changes – is to lower total consumption. They find that, while most regions of the world would be modestly worse off under these scenarios compared with a baseline, India stands to benefit.

Many of the themes raised in the individual papers were drawn together in a panel discussion at the end of the first day of the Conference. The panel addressed a number of the challenges facing China in the coming years from demographic transition, through the rebalancing from investment towards consumption to deregulation of the financial sector. While all panellists agreed that the challenges were significant, there was a diversity of opinion on the likelihood of the challenges being successfully surmounted. A summary of that discussion is included in this volume.

On balance, the papers presented at the Conference depict a sobering picture of the future. Many things might go wrong as China navigates the transition from rapid industrially led growth towards a more consumption-led economy. Even success on some policy fronts might have unanticipated consequences. But, as noted by one panellist, China has overcome many such challenges in the past so there is some basis for being optimistic about the future. This is an important perspective when considering the implications for trading partners like Australia. Not only has China navigated policy challenges associated with its rise, but so have its trading partners. And if we have managed these, we should have some confidence that we can navigate China's maturation as well. But doing so will not be effortless. In that respect, it is hoped that the papers in this volume provide some insights that can make that task a little more manageable.

