RESERVE BANK OF AUSTRALIA

AUSTRALIA'S FOREIGN TRADE AND INVESTMENT RELATIONSHIPS

Ric Battellino
Deputy Governor

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Thank you for the invitation to take part in this panel discussion.

Given the international focus of this session, I thought I would make some observations about the changes taking place in Australia's trade and investment relationships with other countries and what they mean for the domestic economy.

1. Facts on International Trade

Let me start with some facts on international trade. After a period of relative stability in the 1980s and early 1990s, Australia's trade relationships have changed significantly in the past decade. This has been driven by the rise of China and, more recently, India.

- China has now become Australia's largest export market, taking almost one quarter of our exports; 10 years ago, less than 5 per cent of our exports went to China;

- India has gone from being a relatively insignificant export market 10 years ago to taking 7 per cent of our exports now.

Interestingly, the rise in the share of exports going to China and India has not come at the expense of our other large markets in Asia – Japan and Korea. Rather, the offsetting decline has been in exports to the United States, New Zealand, South America and Africa. The result is that the share of our exports going to the Asian region, which was already high, has risen further, to around 70 per cent.

Many people have noted that, with China and India still at early phases of their economic development, it is likely that they will continue to grow strongly for many years yet, and so will their demand for resources. It is hard to argue with that conclusion, though we should keep in mind that, like all countries, China and India will experience economic cycles around this trend.

In the case of our imports, China has also increased its share sharply over the past decade, from 6 per cent to 17 per cent. While Europe as a whole, and the countries of South East Asia as a group, have larger shares, China is the single largest individual country supplying goods to Australia. China's growing share of Australian imports in recent years has mainly been at the expense of the United States and Japan, though part of this change in shares has been due to United States and Japanese companies relocating some manufacturing plants to China.

In short, over the past decade there has been a very significant refocusing of Australia's international trade towards China and, more recently, towards India.

2. Facts on Foreign Investment

In the public consciousness, China has also figured prominently when it comes to foreign investment. The facts, however, show that, even though Chinese investment in Australia has increased in recent years, it currently accounts for only a very small share of foreign capital invested in Australia.

Australian Bureau of Statistics (ABS) data indicate that, at the end of 2008, Australian assets owned by Chinese entities stood at around $8 billion. This is less than half of one per cent of total foreign investment in Australia, and puts China a long way down the list in terms of importance as a source of investment. Looked at from China's perspective, Australia accounts for an even smaller share of its total offshore investment – less than one quarter of one per cent. Furthermore, this share has not changed much in recent years suggesting that China's investment in Australia has grown in line with its accumulation of foreign assets globally. This would indicate that China does not have a particularly strong bias towards Australian investments.

The ABS figures probably understate the true level of Chinese investment in Australia, because they do not identify as Chinese any investment from China that was channelled through custodial accounts held in third countries (typically those in major financial centres like London). Any such investment, however, would be of a portfolio nature rather than direct investment resulting in the control of companies.

One of the reasons why China may be getting a higher public profile in the area of foreign investment is that in the past couple of years it has accounted for a large share of the proposals put to the Foreign Investment Review Board (FIRB). In 2007/08, for example, over 20 per cent of the *number* of investments approved by FIRB were from China. However, most of these entailed only small projects and, by *value*, the share was less than 5 per cent. The figures for 2008/09, while not yet available, are likely to be higher due to the approval of Chinalco's intended investment in Rio Tinto, though in the end that investment did not proceed.

When it comes to foreign investment, Australia's main relationships are still very much with traditional partners such as the United Kingdom and the United States. The largest holding of foreign investment in Australia is by the United Kingdom, reflecting a history of over 200 years of investment and the fact that, as a major financial centre, a lot of investment coming to Australia from other parts of the world is channelled here via UK funds managers. The United Kingdom accounts for 25 per cent of the outstanding value of foreign investment in Australia. The United States is not far behind, at 24 per cent. In terms of the flow of new investment, the United States has been by far the largest source over the past decade.

Investment in Australia by Asian countries, whether measured in terms of the stock outstanding or the flow of new investment, remains small in comparison. Japan is by far the largest Asian investor in Australia, with a share of 5 per cent; other Asian countries' investments in Australia are noticeably smaller.

If we look at Australian investment overseas, the relationship is even more skewed to the United States; over the past decade almost half of all the foreign investment by Australians went to the United States. Europe was the next largest destination for our savings, while the amounts going to Asia were relatively small.

As a broad summary, the conclusion I would draw from these figures is that while Australia is very much linked into Asia (and particularly China) in respect of trade flows, in terms of investment flows it is mainly linked to the United Kingdom and the United States.

3. What does this mean for the Australian economy and Australian markets?

Let me start with financial markets.

One does not have to follow financial markets too closely to know that developments in US financial markets have a big influence on our markets here in Australia. The correlation between the Australian and US stock markets, and between the Australian and US bond markets, is very high. Most mornings, one can get a pretty good idea of how the Australian share market will open simply by looking at what happened to US share markets overnight. Similarly, US news has an important influence on the Australian dollar exchange rate and on the price of many of the resources that Australia sells.

It used to be the case that the US economy also had a big influence on Australia's real economy. For much of my working life at the Reserve Bank, if one was able to pick what was happening to the US economy, one had a pretty good indication of what was going to happen to the Australian economy. Correlations between Australian and US GDP growth used to be very high.

US news still dominates the daily flow of economic and financial information from overseas, and so still plays a dominant role in shaping perceptions about what is happening in the world economy. But the correlation between the United States and the Australian economies has nonetheless declined noticeably over the past decade. In particular, the United States has had two recessions – one in 2001 and the current one – which have had a relatively muted impact on Australia.

There are no doubt many factors that have contributed to this. One of them is that the growing trade linkages between Australia and China are increasingly pulling the

Australian economy away from the United States towards China. China is our largest export market, and Australia is the largest supplier of bulk commodities to China, so our economies are becoming very intertwined.

Various people, including Glenn Stevens and Phil Lowe from the Reserve Bank and Ken Henry from the Treasury, have recently spoken about the implications of this for the Australian economy in the medium term. This topic is also attracting considerable attention in the media.

Three themes emerge when people look at these issues.

The first is that Australia will most likely face an extended period of prosperity in the years ahead. Some of this will come about through strong real economic growth, due, for example, to increased investment and higher export volumes. Some of it could also come via high commodity prices. If, as has occurred over the past five years, the supply chain involved in the production of resources in Australia (and elsewhere) struggles to keep up with rising Chinese demand, commodity prices will remain high. The fact that commodity prices are still at a level that is historically high, despite the severity of the global recession, indicates that the demand/supply balance in commodity markets remains fairly tight. It could tighten further as the global economic recovery gets under way.

A second theme is that this prosperity could put strains on the economy, and not all sectors may share in it. It is possible, for example, that some sectors of the economy will suffer as labour and capital are competed away by the faster-growing sectors.

In general, workers are likely to be in short supply, leading to strong demand for skilled migrants and therefore fast population growth. This, in turn, will have flow-on effects for housing markets.

Investment, which is already high by the standards of developed economies, will need to rise further. A large part of this is likely to be imported. Similarly, the financing of this investment will most likely require increased capital inflow. We could therefore see a widening in the current account deficit, possibly to higher levels than previously experienced, matched by increased capital inflow.

The third theme is that the forces affecting the economy could pose a number of policy challenges. Glenn Stevens dealt with these at some length in his talk last night, so I won't go over that ground again here. It is worth keeping in mind, however, that these challenges are about the medium term, not the immediate future. There is also no reason why they should be beyond our capacity to handle.