Asia's Role in Australia's Economic Future

The following is the text of the Tenth Annual Sir Edward 'Weary' Dunlop Asialink Lecture delivered by the Governor, Mr IJ Macfarlane, Sydney, 16 October 2003.

I would like to start by thanking the University of Melbourne's Asialink Centre for inviting me to deliver this lecture commemorating such a distinguished Australian as Sir Edward 'Weary' Dunlop. It is a great honour, and I will devote the major part of my lecture tonight to Australia's economic relations with Asia – a theme of which I am sure he would have approved. But before moving on to the main topic, I would like to follow normal practice by saying a few words about the person whose memory we are honouring. In doing so, however, I intend to follow up on a couple of unusual connections that occurred to me as I was preparing the lecture. I do not intend to dwell on Weary Dunlop's achievements or his place in Australia's history or folklore. I assume that everyone here tonight is familiar with these.[1]

Instead, I ask your indulgence to start by drawing what you may find is a tenuous connection between Weary Dunlop and two important economists, one he may or may not have met, the other he certainly did meet.

The first economist was Professor LF Giblin, who was Australia's foremost economist in the inter-war period. Since he held a chair in economics at Melbourne University in the 1930s, the two men may have met, but there is no record of them having done so. But if they had, it would have been an interesting meeting because from what we know from their biographies, they had some remarkable similarities. Both were big strong men and natural leaders. Both had excellent minds and rose to the top of their professions. Both were decorated for their courage in war – Giblin in the first world war, Dunlop in the second. Both were outstanding sportsmen in the same sport – rugby. If Dunlop, the Victorian, playing rugby for Australia is a sporting oddity, what of Giblin, the Tasmanian, playing rugby for England during his Cambridge days?

The connection with the other economist of note was only recently revealed, and I am indebted to Professor Leeson of Murdoch University for his excellent detective work. When Weary Dunlop and Sir Laurens van der Post, amongst others, were in the Japanese prisoner-of-war camps in Indonesia and Thailand, they tell of the miniaturised home-made wireless that they used clandestinely to keep up with the course of the war. This device had been cobbled together by a fellow prisoner of war – a New Zealand officer in the RAF. That officer

1. For those who are not, the relevant references are *The War Diaries of Weary Dunlop*, Penguin, 1990, and *Weary: The Life of Sir Edward Dunlop*, Sue Ebury, Penguin, 1995.

we now know was Flight Lieutenant AWH (Bill) Phillips[2], known to economists the world over as the inventor of the 'Phillips Curve'. Phillips had been trained in New Zealand and Australia as an electrical engineer, had spent time in Asia before the war, spoke fluent Cantonese, and only embarked on a career in economics after his discharge from the RAF when the war ended.

Output Growth

Enough of these biographical curiosities. I will now turn to the main subject of my lecture tonight which is the role of Asia in Australia's economic future. I think for most of the past two decades, there was general agreement on the importance – if not the primacy – of Asia in Australia's economic future. But this agreement suffered a couple of setbacks in the 1990s. First, Japan, the biggest Asian economy and the one which had been the main driving force, fell back into a period of very slow growth at the beginning of the 1990s. Second, the Asian crisis which started in mid 1997 and lasted for about 18 months, severely dented many people's confidence in Asia's future.

This event – the Asian crisis – had a profound influence on opinion for three or four years. Many people saw it as evidence that the 'Asian miracle' had feet of clay after all. There was a widespread view among western observers that the crisis was the inevitable result of severe governance deficiencies in Asian countries, and that these deficiencies would hold back further economic development. During the 'tech boom' and the period of infatuation with the 'new economy' in the late 1990s, perceptions of Asia suffered again as its economy was compared unfavourably with more technologically advanced western economies, especially the United States.

We now know that governance deficiencies were not confined to Asia, and that some countries that were pointing the finger had governance deficiencies closer to home to worry about. The infatuation with the 'new economy' also resulted in a bubble, the bursting of which has been exerting a dampening influence on world economic growth for the past three years. We also know that during the period when many Asian countries were suffering from the crisis, one important Asian country – China – was powering ahead. Now the dust of the Asian crisis has largely settled, it is worth sitting back and taking a fresh look at Asia's place in the world economy, and particularly its place in Australia's economic future.

I propose to start this task by looking at the world economy and asking the question – which regions are increasing their share of output, and which regions are finding that their share is falling? I will use a long-running IMF database for the comparisons, the results of which are shown in Tables 1 and 2.

No-one should be surprised to find that over the past 20 years Asia's share of world output has risen noticeably, or that the share of the developed OECD countries has fallen. Note that I include Japan in the latter group because it is a developed high-income country and as such has been a member of the OECD since the 1960s. While much of the rise in the share of Asia is due to China, even when it is excluded, the rest of Asia's share still rises from 7.8 per cent to 12.2 per cent over the two decades.

In the above comparison, I chose a 20-year period because it gives a good idea of how longer-term trends have developed. If we instead chose the past five years for the comparison, we would be choosing Asia's worst period, that is the one that contains the Asian crisis. As a result, we might expect to find a different conclusion. But even here, the same picture emerges – Asia's share of world output has risen from 22.3 per cent to

2. Sir Laurens van der Post refers to him in his book *The Night of the New Moon*. Weary Dunlop also referred to him in his published war diaries (entry for 5 November 1942) and confirmed in conversation with Leeson that Bill Phillips was the New Zealand RAF officer who built the wireless.

Table 1: Asian Output (excluding Japan)
Per cent

	Share of world output(a)			Change in share	
	1982	1997	2002	1982–2002	1997–2002
China	3.76	10.27	12.67	237	23
India	3.00	4.28	4.77	59	11
Korea	0.81	1.67	1.77	119	6
Indonesia	1.17	1.87	1.58	35	–16
Taiwan	0.53	0.99	1.01	89	1
Thailand	0.58	1.08	0.95	64	–12
Philippines	0.82	0.69	0.68	–17	–1
Malaysia	0.26	0.47	0.45	72	–5
Hong Kong	0.29	0.42	0.40	39	–5
Vietnam	0.20	0.34	0.37	80	8
Singapore	0.13	0.24	0.24	92	2
Total	**11.56**	**22.32**	**24.88**	**115.3**	**11.5**
Total (ex China)	7.79	12.05	12.22	56.7	1.4

(a) PPP basis

Source: IMF World Economic Outlook Database

Table 2: OECD Output
Per cent

	Share of world output(a)			Change in share	
	1982	1997	2002	1982–2002	1997–2002
US	20.78	21.32	21.10	1.6	–1.0
Japan	8.32	8.20	7.11	–14.5	–13.3
Germany	5.45	4.78	4.43	–18.7	–7.3
France	3.95	3.25	3.20	–19.1	–1.7
UK	3.52	3.23	3.12	–11.3	–3.5
Italy	3.92	3.26	3.04	–22.4	–6.6
Canada	2.08	1.95	2.02	–3.1	3.2
Spain	1.86	1.73	1.76	–5.3	1.7
Australia	1.08	1.11	1.15	7.3	4.0
Netherlands	0.98	0.91	0.89	–9.8	–2.3
Belgium	0.75	0.62	0.59	–20.9	–4.5
Sweden	0.62	0.49	0.49	–21.8	–1.1
Austria	0.56	0.48	0.46	–17.5	–4.2
Switzerland	0.63	0.48	0.45	–28.7	–7.4
Greece	0.47	0.38	0.40	–15.2	3.1
Portugal	0.41	0.38	0.37	–10.2	–2.2
Denmark	0.40	0.35	0.33	–16.4	–5.1
Norway	0.31	0.31	0.30	–3.1	–5.1
Finland	0.33	0.28	0.29	–13.1	1.1
NZ	0.21	0.17	0.17	–19.2	–2.5
Total	**56.60**	**53.70**	**51.66**	**–8.7**	**–3.8**

(a) PPP basis

Source: IMF World Economic Outlook Database

24.9 per cent. It is true that most of this growth is due to China, but even without China, Asia's share rises slightly. Thus, the conclusion is that, whatever time period we choose, Asia's share of world output is rising.[3]

Before we leave the tables, it is worth having a look at the performance of OECD countries in more detail. Over the 20-year period from 1982 to 2002, there are only two significant OECD countries that have increased their share of world output – Australia and the United States.[4] I have used this fact before to try and cheer up my fellow citizens who for a long time were inclined to assume that we were slipping behind. When we shift the comparison to the past five years, Australia still comes out looking good. We have increased our position more than any other significant OECD country, and the only other ones to show an increase over this shorter period were Canada, Greece, Finland and Spain.

The general conclusion from these comparisons is that Asia has been, and still remains, the world's fastest growing region and that Australia has done well compared to other high-income developed OECD countries. The two facts are, of course, not independent.

Trade and Investment

But that still leaves open a number of questions. Have our exports become over-reliant on Asia? Alternatively, have we kept up our share of Asian imports? Has the closeness of our trade linkage been mirrored in the capital markets? And are we well placed to adapt to future changes in patterns of growth, as we appear to have done in the past two decades? These are the questions I will address in the remainder of my talk tonight.

More than half of Australia's exports go to Asia, and the proportion has not greatly altered over the past two decades (Table 3). It rose in the 1980s to peak at 59 per cent in 1996/97, then fell back slightly as the Asian crisis had its effects to a figure of 55 per cent in 2001/02. Within this relatively stable total, there has been a clear fall in the share going to Japan, and a commensurate rise in the share

Table 3: Australia's Merchandise Exports by Region
Share of total

	1981/82	1991/92	1996/97	2001/02
Asia	48.8	58.0	58.9	54.9
Japan	27.8	26.5	19.5	18.8
NJA	21.0	31.5	39.4	36.1
NJA ex China	18.2	28.8	34.9	29.7
China	2.9	2.6	4.5	6.4
EU	12.7	13.0	10.3	11.9
US	11.0	9.5	7.0	9.9
Other	27.5	19.6	23.8	23.2
Total	100.0	100.0	100.0	100.0

Source: ABS

3. If we take a long enough sweep of history, this should not surprise us. Angus Maddison, who is the favoured authority on economic growth over the long run of history, records that in 1820 Asia, excluding Japan, accounted for 56 per cent of world output (and China alone, 33 per cent). By 1913, Asia's share had fallen to 22 per cent, with China down to 9 per cent.
4. Plus two very small economies – Ireland and Luxembourg.

going to non-Japan Asia (NJA). The other thing that stands out is that the share going to China, while clearly increasing, is still quite low. Moreover, when we look at these exports to Asia and compare them to the total imports that these economies are taking in, we see that Australia's share is quite small – less than 5 per cent in most cases, and only 2 per cent for China (Table 4). Clearly, there is a huge amount of room for expansion here.

Table 4: Australia's Share of Merchandise Imports
Per cent of total; year to May 2003

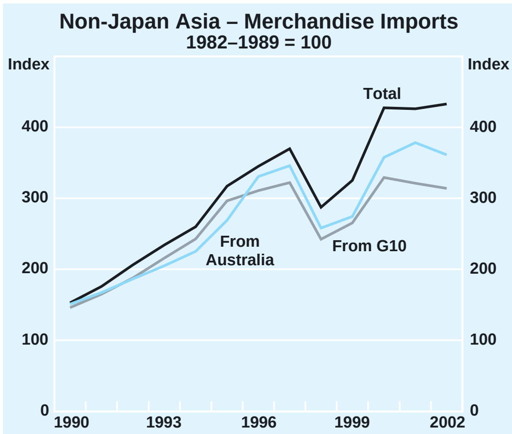
China	1.9
Hong Kong	0.9
India	2.2
Indonesia	5.2
Korea	3.7
Malaysia	1.6
Philippines	1.5
Singapore	2.0
Thailand	2.3

Source: IMF *Direction of Trade Statistics*

One of the major characteristics of the development of Asia over the past decade has been the increase in cross-border interdependence of production, as China became the centre for labour-intensive phases of manufacturing using intermediate inputs manufactured elsewhere, which were then re-exported as finished manufactures. As a result, there has been a large increase in intra-Asian trade, particularly between China and its neighbours. This intra-Asian trade, which is predominantly in manufactures, has grown more quickly than trade between Asia and the rest of the world. It mirrors a general shift in the trade patterns of developing economies which are now predominantly exporters of manufactured goods. As recently as 1980, only 25 per cent of the exports of developing countries were manufactures; now the figure is well over 80 per cent – for Asian countries, the figure is likely to be over 90 per cent.

The question for Australia then is whether our exports to Asia are growing as fast as those of other countries into Asia. It is difficult to answer this with precision, in large part because of gaps and inconsistencies in data, but the approximate calculations we have made suggest that our exports are keeping up (Graphs 1, 2 and 3). These graphs look at imports into non-Japan Asia and its two biggest economies – China and Korea. As already established, the relevant question for us is whether imports from Australia are growing as fast as imports from other countries outside the region. The data we have suggest that this is the case; imports from

Graph 1



Source: IMF *Direction of Trade Statistics*

Graph 2

Source: IMF *Direction of Trade Statistics*

Graph 3

Australia have grown faster than imports from the G10 countries. This is less true for China, where our performance is more or less in line with the G10 countries, but for Korea, imports from Australia have grown a lot faster than their imports from G10 countries.

As we would probably expect, when we look at the breakdown of Asian imports by category, it is in categories such as food, fuels and crude materials that Australia's performance has been particularly strong. Imports of these goods to China and Korea from Australia have grown much more quickly than their total imports. Australia has been increasing its exports of manufactures into Asia as well, particularly to China, but this is from a very small base. Exports of manufactures to China grew at an annual rate of 22 per cent over the past five years, but even then they represent only 4 per cent of our total manufactured exports.

In summary, I think these comparisons show that we have been doing reasonably well. Our pattern of international trade is strongly integrated into Asia, and apart from a small downward adjustment due to the probably temporary effects of the Asian crisis, the trend is stable. There appears to be a lot of upside potential in the trading relationship with China, given our low market share in that country.

When we come to financial integration, however, the story is very different because we do not have a high propensity to buy Asian financial assets (Table 5). I have always been struck by the contrast between the closeness of our trading relationship with Asia and the lack of closeness in our financial integration into Asia. Australian direct investment in Asia, that is owning or having a controlling share in Asian companies, has always been relatively small. We have always been more comfortable running businesses in the United States, Europe (especially the United Kingdom) and New Zealand. What is perhaps more surprising is that the share of direct investment going to Asia has fallen over the past decade,

Table 5: Destination of Australia's Foreign Direct Investment
Per cent of total stock as at 30 June

	1982	1992	1997	2002
US	13.1	26.3	28.0	47.8
European Union	17.2	34.9	37.4	22.2
Japan	na	0.5	0.3	0.2
Non-Japan Asia	34.6	16.4	12.6	7.4
Other	35.1	21.8	21.7	22.4
Total	100.0	100.0	100.0	100.0
Memo: Total Australian foreign direct investment				
$b	5.8	44.8	89.0	156.3
Per cent of GDP	3.5	11.0	16.8	22.0

Source: ABS

particularly over the most recent five years. During this most recent period, the share of our direct investment going to the United States has risen sharply, which is not unique to Australia – the strong performance of the US economy during the stock market boom years around the turn of the century attracted significant direct investment from all developed economies, and portfolio investment from everyone.

While Asia is a very big player in the world of international trade and is also a major recipient of direct foreign investment, it receives very little portfolio investment. Financial markets generally in the region are not well developed, and portfolio investment is costly and involves investors taking risks that are hard to evaluate. The lack of development is reflected in the low weights for the region in the global market indices which drive so much of the allocation of portfolio investment in the present world: Asia accounts for less than 4 per cent of the Morgan Stanley MSCI global equity index – the most widely used – and an even smaller share of global bond market indices. In both cases, the shares are very much lower than the region's 25 per cent share in world GDP. Needless to say, the share of Australia's outward portfolio investment going to Asia is also quite small, accounting for only 10.9 per cent of our portfolio investment in 2002.

In its foreign economic relations, Australia has given a very prominent place to Asia over recent decades. As a result, Australia is a member of a range of Asian regional institutions aimed at encouraging growth and trade. We at the Reserve Bank are also involved closely in a number of similar groups that bring the central banks of the region together. The main aim of these meetings is to find ways of encouraging the growth of Asian financial markets in order to emulate the success of Asia in the international goods markets.

One concrete outcome of such co-operation has been the establishment of the Asian Bond Fund, through which central banks in the region (including the RBA) have invested some of our foreign reserves in bonds issued by Asian governments. So far, the only bonds included have been those denominated in US dollars. In time, however, the central banks of the region hope to add bonds issued in local currency into the Asian Bond Fund. We believe that this will help regional bond markets develop greater liquidity and become attractive to a broader range of investors. In time, there should be an increase in investment flows both within Asia and between Asia and other economies. This is likely to see an increase in financial integration, but the process will be a slow one.

The Future

Of course, the global economy does not stand still and we do not know how the recent trends within Asia will develop. The story of the rise of China seems likely to have some way yet to run. But I doubt that the rise in importance of China, and its impact on Australia, will turn out to be the end of the story for Asia because the next chapter will probably contain a greater role for India. In terms of population, India is growing at twice the rate of China and fast approaching it in size. It is noteworthy too that India is now looking to the Asian region in its trade policy, recently concluding an agreement with ASEAN to eliminate most tariffs within eight years, at the same time as ASEAN is eliminating internal tariff barriers and concluding free trade agreements with China and Japan.

If India emerges as a second Asian engine of growth, Australia will face new opportunities and challenges. But we are well placed to respond to its increasing demands for imports of food, materials and intermediate goods. As with Korea, Australia has had a rising share over the past five years of India's imports of materials.

We must make sure that we have the flexibility to respond to this additional source of growth if it happens, just as we have responded to the shift from Japan to the rest of east Asia and then to China over the past two decades.

Concluding Comments

My main message – the importance of Asia to Australia's economic future – is not a new one, but it is one that people lost sight of for a while. But it will be different in the future in that China will assume an increasingly important role, just as Japan did in the 1960s and 1970s. In this sense, China is currently the big story, just as India will probably be the next. At the moment, there is great apprehension in the rest of Asia about China's rising dominance. Countries that compete with China as exporters of manufactures, and recipients of direct foreign investment, feel that they will be overwhelmed.

I think most people in Australia have welcomed the growing importance of China. This is in part because we do not see China as a competitor because we do not compete with them in low-tech high-volume manufacturing. We tend to see them as a complementary economy. I do not think we would be able to take the same comfort if we had maintained the old heavily-protected manufacturing sector we had in the first half of the post-war period.

This complementarity does not mean that Australia has to see itself as only a provider of resource-based products from our mines and farms. Manufactured exports to China, while they are small, are growing strongly. There is still plenty of scope for the further expansion of our high-value-added manufacturing and service exports. It is remarkable how much of the growth in international trade is intra-industry trade – that is two countries both exporting to each other within the same type of product. This is particularly true of manufacturing.

I will conclude my talk tonight with two small but concrete examples of how intra-industry trade between Australia and China is developing. These examples are drawn from the Reserve Bank's Small Business Panel, a meeting we have with small businesses originally designed to hear their views about finance, but now covering a wider range of topics. The two examples I will conclude with tonight are as follows:

- One member of the Panel, who runs a company producing petrol- and diesel-driven electricity generators, said he was experiencing a lot of competition for small generators from Chinese imports. However, he was doing better in the export market and had just won a tender for an important export order. When questioned, he revealed that it was for the Chinese army! As an aside, the engines on his generators are imported from Japan and Italy. This is symptomatic of the extent of intra-industry international trade that occurs these days.
- Another Panel member runs a company that installs wooden floors in Victoria using a special locking device between the floorboards. His Australian supplier stopped supplying the specially finished floorboards, and so he was forced to look elsewhere. Eventually, he came up with a system whereby he ships the bulk wood to Malaysia, they glue and machine it to his requirements, and he receives it ready for installation in Australia at 20 per cent below the price of his former supplier. He is now exploring the alternative of moving his source of supply to China at a probable saving of 50 per cent.