Small grey rhinos: understanding Australia’s economic dependence on China

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Executive Summary

Australia lives with an acute ‘fear of abandonment’. In security terms this fear has underpinned Australian foreign policy settings for decades. Recently, doubts about the reliability of the United States as Australia's security guarantor have sent Australian government ministers on a mission to convince America that ongoing – and expanded – engagement with Australia’s neighbourhood is in its own interests.

These days Australia also fears economic abandonment by China. This arises from the possibility of being cut off from voracious Chinese demand worth nearly seven percent of GDP, an exposure that can lead to claims that Australia’s economy has become ‘too dependent’ on China.

The usual prescription to address Australia’s China risk is greater diversification. But this misunderstands how economic ties are formed. Unlike security ties, the pattern of Australia's external economic engagement is mainly determined ‘exogenously’ by market forces – economic complementarities and purchasing power – not elected officials or bureaucrats sitting in Canberra. While diversification ought to be vigorously pursued with traditional customers such as the US and Japan as well as with up-and-comers like India and Indonesia, the reality is that none of these countries – individually or collectively – offer the potential to substitute for the scale of demand that China injects into the Australian economy, now or into the foreseeable future. Such are the complementarities and scale of purchasing power expected to be added to China’s economy that many Australian industries will need to grapple with more exposure to China, not less.

A more extreme policy to deal with Australia’s China risk would be to try to force a decoupling. But given that trade is mutually beneficial, this would necessarily be costly to Australia’s prosperity. Other countries would also be happy to pick up any trade opportunities with China that Australia left on the table. Further, economic interdependence with China helps to manage and reduce security risks by keeping China engaged in multilateral frameworks and disciplines. In contrast, China-specific tariffs, quotas and outright bans would represent an abandonment of Australia’s international treaty commitments and its oft-stated commitment to supporting an international rules-based order.

What is needed is a rigorous analysis of the risks that exposure to China presents. Economic risks are sometimes described as ‘black swans’, shocks that are made more challenging by the fact they cannot be foreseen. Alternatively, there are ‘grey rhinos’: obvious yet perhaps neglected threats. This paper argues that Australia’s China risks are of the ‘grey rhino’ variety. The first is that Chinese economic growth could experience a ‘hard-landing’, causing demand for Australian goods and services to fall. The second is that a shift in the structure of Chinese demand could be unfavourable to the industries in which Australia excels, limiting the scale of trade opportunities. The third is that China could use economic links to punish Australia over political disagreements.

Evidence is presented showing each of these ‘grey rhinos’ risks to be relatively limited, at least at more aggregate levels. The visibility of Australia’s China risks, as well as their likelihood and scale of impact, suggests they are largely capable of being managed with appropriate contingency planning.

The key takeaway is that Australian government policymakers and businesses are justified in focusing on the opportunities that economic engagement with China presents, while putting in place mechanisms to protect their interests in the event of disruption.
1. Introduction

Experienced foreign policy practitioner and commentator, Allan Gyngell, writes that Australia lives with an acute ‘fear of abandonment’ (Gyngell, 2017).

In security terms this fear has underpinned Australian foreign policy settings for decades. Recently, doubts about the reliability of the United States as Australia’s security guarantor have sent Australian government ministers on a mission to convince America that ongoing – and expanded – engagement with Australia’s neighbourhood is in its own interests.

These days, Australia also fears economic abandonment by China. This arises from the possibility of being cut off from voracious Chinese demand worth nearly seven percent of GDP, an exposure that can lead to claims that Australia’s economy has become ‘too dependent’ on China. Despite being the world’s sixth largest country in terms of land area, Australia is only the 53rd most populous. This means Australia’s prosperity is intrinsically linked to world markets. So long as Australia’s dependence on China as a customer was coming off a low base, China’s own growth model appeared sustainable and the two countries enjoyed stable political relations, few concerns were raised. The prosperity that economic ties with China delivered was front and centre. But nowadays China buys $134 billion of Australian goods and services each year (2.3 times that of Australia’s second largest customer, Japan (Australian Bureau of Statistics [ABS], 2019)), China’s growth has fallen to its slowest pace in nearly 30 years (Smith, 2019), and until recently, Australian ministers were unable to secure visas to visit China owing to political tensions between the two countries (Hewett, Smith and Coorey, 2018).

2. Australia’s economy doesn’t get to choose

The usual prescription to address Australia’s China risk is greater diversification. Last year The Sydney Morning Herald’s Political and International Editor, Peter Hartcher, wrote of Australia’s economic dependence on China (Hartcher, 2018):

What to do about this? As with any area of excessive risk, the simplest response is to diversify. That’s why Australia must look to fast-growing markets such as India and Indonesia.
But this misunderstands how economic ties are formed. Unlike security ties, the pattern of Australia’s external economic engagement is mainly determined ‘exogenously’ by market forces – economic complementarities and purchasing power – not elected representatives or bureaucrats sitting in Canberra. While diversification ought to be vigorously pursued with traditional customers such as the US and Japan as well as with up-and-comers like India and Indonesia, the reality is that none of these countries – individually or collectively – offer the potential to substitute for the scale of demand that China injects into the Australian economy, now or into the foreseeable future.

Figure 1 shows that over the past decade, exports to China have increased by $78.5 billion. In comparison, exports to Japan and the US have been stagnant, and those to India and Indonesia have only risen by $5 billion.

Such are the economic complementarities and scale of purchasing power expected to be added to China’s economy that many Australian industries will need to grapple with more exposure to China, not less. The Australian government’s own projections see an additional $21 trillion in purchasing power being added to China’s economy by 2030. This compares with $12.2 trillion for India, $5.4 trillion for the US, $2.5 trillion for Indonesia and $0.7 trillion for Japan (Department of Foreign Affairs and Trade [DFAT], 2017). China already accounts for 27 percent of international visitor spending in Australia (Tourism Research Australia, 2018), even though reportedly only 8.7 percent of the Chinese population hold passports (Jing Travel, 2018), compared with 42 percent in the US (McCarthy, 2018).

Market forces are leading to a strengthening of economic ties between Australia and China across the board. Even when minerals and fuels are excluded, Australia’s exports to China have risen by $36.8 billion over the past decade. This compares with $9.8 billion for Japan and the US combined, and a fall of $843 million for India and Indonesia.

Australia’s exposure to China is also not simply a by-product of the resources boom. Figure 2 shows that even excluding minerals and fuels, Australia’s exports to China have risen by $36.8 billion over the past decade. This compares with $9.8 billion for Japan and...
the US combined, and a fall of $843 million to India and Indonesia. The key point is that market forces are leading to a strengthening of economic ties between Australia and China across the board. Thus, the best that even concerted attempts at diversification might practically achieve is a small dilution in China’s share of Australia’s total exports.

A more extreme policy to deal with Australia’s China risk would be to try to force a decoupling. But given that trade is mutually beneficial, this would necessarily be costly to Australia’s prosperity. Other countries would also be happy to pick up any trade opportunities with China that Australia left on the table. Further, economic interdependence with China helps to manage and reduce security risks by keeping China engaged in multilateral frameworks and disciplines (Armstrong and Drysdale, 2018). In contrast, China-specific tariffs, quotas and outright bans would represent an abandonment of Australia’s international treaty commitments and its oft-stated commitment to supporting an international rules-based order.

What is needed is a rigorous analysis of the risks that exposure to China presents.

Box 1. Malcolm Turnbull on trade ties with the US and China

In 2014, then-US Secretary of State, Hillary Clinton described Australia’s extensive trade ties with China as a ‘mistake’ (McGeough, 2014):

“It’s a mistake whether you’re a country, or a company or an individual to put...all your eggs in the one basket. [This] makes you dependent, to an extent that can undermine your freedom of movement and your sovereignty, economic and political.”

When then-Australian Communications Minister, Malcolm Turnbull was pressed for a response to Secretary Clinton’s assessment, he observed (Turnbull, 2014):

“I’m sure that we’d love to export vast quantities of iron ore to the United States but they’ve never shown any enthusiasm in buying them.”

Box 2. India isn’t ‘another China’

Working to promote improved market access with countries other than China is in Australia’s interests. New multilateral trade agreements such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), and the potential Regional Comprehensive Economic Partnership (RCEP), as well as the negotiation of new bilateral free trade agreements with India, Indonesia, the UK and the EU, are positive developments.

Owing to its huge population and comparatively untapped economic potential, India has attracted particular attention. In 2018 the Australian government commissioned a formal report by a former DFAT head, Peter Varghese, to facilitate deeper, long-term economic engagement with India (Varghese, 2018). The Varghese report said that ‘a strong economic relationship with India strengthens Australia’s economic resilience’. This is because ‘India – a large and young population – adds balance and spreads risk in Australia’s economic relationships’.

But the reality is that any diversification provided by economic ties with India will be limited. The Varghese report set an ambitious target to treble Australian exports to India from the current $14.9 billion (ABS, 2019) to $45 billion by 2035. While a significant jump in a bilateral context, this remains modest compared with the $134 billion that Australia exported to China over the past year.

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3. Black swans or grey rhinos?

Economic risks are sometimes described as ‘black swans’, shocks made more challenging by the fact that they are not foreseen. Alternatively, there are ‘grey rhinos’, obvious yet perhaps neglected threats (Reuters, 2019). When policymakers and commentators say that Australia is ‘too dependent’ on China, the basis for their assessment varies. There are, in fact, three distinct risks generally raised. The fact that these risks are readily categorised points to them all being of the ‘grey rhino’ variety.

In May last year, Philip Lowe, Governor of the Reserve Bank of Australia (RBA) stated (Lowe, 2018):

As the economic relationship between our two countries broadens and deepens, developments in China are having a material impact on more and more Australian industries.

This has been interpreted by some commentators, such as Jacob Greber, economics correspondent at The Australian Financial Review, to mean (Greber, 2018):

Never forget; if China goes down hard, there’s a good chance Australia will too.

The essence of the first risk is straightforward: owing to a heavy exposure to China as a customer, if the Chinese economy experiences a sharp growth slowdown – a so-called ‘hard-landing’ – demand for Australian goods and services will fall.

A different risk has been expressed by Andrew Charlton, a senior economic advisor to former Prime Minister Kevin Rudd (Charlton, 2014):

The one thing everyone agrees on – including the Chinese themselves – is that the investment-led growth model cannot continue. This is the critical point for Australia. Whichever path China takes, the resources-intensive investment boom will slow down, with consequences for our exports.

The following year and in similar vein, Ross Garnaut, a former Australian ambassador to China and currently a professor of economics at the Australian National University (ANU), warned that ‘Australia’s resources boom was a China boom’ but this was set to unwind because ‘[China’s] demand for steel and therefore iron ore and coking coal is concentrated overwhelmingly in investment rather than consumption’ (Garnaut, 2015).

The essence of the second risk is also clear: Chinese economic growth increasingly driven by consumption could be unfavourable to the industries in which Australia excels, limiting the scale of trade opportunities.

Then there is the third risk expressed most prominently by strategic and national security commentators: China could use its economic links with Australia to punish it over political disagreements. In 2016, Peter Jennings, the head of the Australian Strategic Policy Institute, warned (Jennings, 2016):

We’ve never had a greater dependency with any country...The risk that creates for us is if Beijing wants to adopt politically coercive policies, it’s in a fairly strong position to do so with us because of that level of trade dependence.

In 2017, Rory Medcalf, Director of the National Security College at the ANU, wrote that the reason Australia needs to worry about China is because its authoritarian political system means that it ‘tends to link its commercial and political demands on other countries’ (Medcalf, 2017).

When policymakers and commentators say that Australia is ‘too dependent’ on China, the basis for their assessment varies. There are, in fact, three distinct risks generally raised. The first is that of a sharp growth slowdown in China’s economy. The second is that of consumption rather than investment driven growth. And the third is that of economic coercion.
4. Big or small grey rhinos?

The fact that Australia’s China risks are ‘grey rhinos’ rather than ‘black swans’ is of little comfort if they are high likelihood, high impact events that are not able to be managed with appropriate contingency planning. However, the proceeding analysis suggests this not to be the case.

4.1. Grey rhino one – a ‘hard-landing’ in China’s economy

Although Chinese economic growth has now slowed to less than seven percent from double-digit rates last decade, this has been relatively orderly and no ‘hard-landing’ has been forthcoming. The Australian Treasury (2019) forecasts that China will continue to grow at six percent in 2019-2020.

While a sharp growth slowdown in China remains a low probability event, given Australia’s trade exposure to China, the possible consequences of it eventuating warrant interrogation. In the absence of case study evidence, economic modelling provides the best available guide.

In recent years a number of modelling scenarios have been produced, drawing on a range of methodologies. In 2017, research by Deloitte Access Economics pointed to severe local consequences (Deloitte, 2017). If China’s growth fell from 6.5 percent to less than three percent, Australia’s national income would fall by seven percent and there would be 550,000 fewer jobs in Australia than would otherwise have been the case. In the long run Australia’s economy would be two percent smaller than had the negative Chinese shock not occurred.

In response to a fall in Chinese GDP by one percent, most studies see Australian GDP responding by around 0.1 percent. That is, in a ‘hard-landing’ scenario where Chinese GDP turned out to only be three percent larger next year, compared with an expected six percent, Australia’s GDP might be around 2.6 percent larger, compared with the trend growth rate of three percent.

But most other, more recent studies point to a more benign outcome (Table 1). In response to a fall in Chinese GDP by one percent, none of the other studies see Australian GDP responding by greater than 0.2 percent. The impact is more typically put at around 0.1 percent. That is, in a ‘hard-landing’ scenario where Chinese GDP turned out to only be three percent larger next year, compared with an expected six percent, Australia’s GDP might be around 2.6 percent larger, compared with the trend growth rate of three percent.

On his finding that a three percentage point fall in Chinese GDP growth would only cause Australian GDP growth to fall by between 0.15-0.24 percentage points, Nicolaas Groenewold, an economics professor from the University of Western Australia, remarked (Groenewold, 2018):

> While not trivial, given Australia’s current growth rate, these estimates are hardly enough to justify prophecies of doom.

Several of the studies listed in Table 1 also place the Australian implications in an international context.

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<th>Chinese shock</th>
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<td>A fall in China’s GDP growth by one percentage point (pp)...</td>
<td>Inoue, et al. (2018)</td>
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<td>Groenewold (2018)</td>
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Note: the specific shocks modelled in the studies differ. For example, while Cashin, et al. (2016) report the short run response to a one percent fall in China’s GDP, the short-run response shown in Karam and Muir (2018) is the result of a four percent fall. For presentation purposes and to assist interpretation, the response for all studies has been standardised to the impact of a one percent (one percentage point) fall in China’s GDP (growth).
Contrary to the perception that Australia is uniquely exposed to China, the local response to a Chinese ‘hard-landing’ is found to be no greater than in that of other high-income countries such as the US, Japan and Korea.

While these findings might run contrary to common perceptions – such as that China single-handedly ‘saved’ Australia from the global financial crisis (GFC) – there are in fact several straightforward reasons why a sharp Chinese growth slowdown may not be calamitous for the Australian economy.

First, Australia has a flexible exchange rate that depreciates at the first hint of Chinese economic weakness, making exports overall more internationally competitive. This exchange rate flexibility, along with other explanations such as macroeconomic policy stimulus, all contributed to the Australian economy’s resilience during the GFC period (Makin, 2016). Second, a negative shock in China cannot spill over to Australia via the channel of investment. Only three percent of Australia’s investment abroad is hosted by China, compared with 29 percent in the US (ABS, 2017). Third, while exports to China now exceed $130 billion, this figure is vastly eclipsed by the $1.8 trillion in demand for Australian goods and services that comes from domestic sources (ABS, 2019), as well as exports to countries other than China of $280 billion (DFAT, 2018).

Of course, the conclusion that a Chinese ‘hard-landing’ may be manageable at the aggregate national level does not discount uneven impacts in particular geographical regions or economic sectors. For example, Figure 3 shows that while goods exports to China account for six percent of Australia’s GDP, this ranges from 1.5 percent in New South Wales to 24 percent in Western Australia. Nonetheless, the risk to a state like Western Australia remains a ‘grey rhino’ in that it is an obvious threat, albeit a much bigger one than for the country as a whole.

4.1.1. Managing the risk of a Chinese ‘hard-landing’

• Responding to a negative shock from abroad isn’t a new or unusual challenge for the Australian economy. During the 1970s, 80s and 90s it was often remarked that ‘[w]hen the US economy sneezes, Australia’s catches a cold’ (Crosby and Bodman, 2005). Nowadays, automatic stabilisers...
such as Australia’s flexible exchange rate mean the domestic economy is better protected from external shocks, whether they emanate from the US or China.

- The other standard response to external shocks is macroeconomic policy stimulus. Here the imperative is for Australia to maintain sufficient policy space to support such a response. Australia currently has a budget deficit of $4.2 billion and is projected to reach budget surplus in 2019-20 (Treasury, 2019). While this means Australia’s fiscal policy capacity remains fairly healthy compared with many other countries, it is also more indebted now with net debt at 19.2 percent of GDP (Treasury, 2019), than at the start of the GFC when net debt was only 3.8 percent of GDP (Treasury, 2008). Maintenance of fiscal discipline can ensure that these policy options are preserved.

4.2. Grey rhino two – consumption-driven growth in China

In 2010, consumption accounted for 48 percent of China’s GDP. By 2017 this had grown to 54 percent. In 2018, consumption was responsible for 76 percent of China’s GDP growth (CEIC Data, 2019). Yet to date data show that any negative impact on Australia’s exports resulting from a structural shift in Chinese expenditure has been limited.

An increased emphasis on consumption-driven growth in China has been accompanied by a levelling off in Chinese steel production but not a decline. And China’s imports of Australian iron ore have continued to grow as foreign-sourced iron ore displaces domestic production. This is consistent with the forecasts of Australian resources companies themselves (Stinger and Ingles, 2018), as well as academic research that finds China’s steel production likely won’t peak until the mid-2020s (Mackay, et al., 2010).

Changing expenditure patterns are also not the only structural change taking place in China. Another is increased emphasis on improving environmental outcomes. This is seen in China’s booming demand for relatively clean energy sources such as Australian liquefied natural gas (LNG). From less than $1 billion in 2012, Australia now sells China more than $7 billion (Department of Industry, 2018). China’s emergence as a hub for electric vehicle production has also boosted Chinese interest in other Australian minerals exports such as lithium (The Economist, 2017). In addition, consumption-driven growth in China has been a boon for Australia’s non-minerals and fuels exports, such as food and beverages, as well as services. The latest data show non-mining goods exports to China reaching $43.8 billion, up 142 percent from five years ago. Services exports now stand at $16.9 billion, up 137 percent over the same period (Figure 4).

Whether consumption-driven growth in China will eventually undermine Australian aggregate exports remains to be seen. However, a recent study that might provide some answers comes from economists at the RBA (Ma et al., 2017). The authors first confirm that Chinese consumption has a significantly lower import intensity than Chinese gross capital formation (i.e., investment). They then model an overnight, 15 percentage point rotation in Chinese domestic expenditure from gross capital formation to consumption using 2011 GDP shares as the baseline. In other words, while the size of China’s economy is assumed to remain constant, the consumption share of GDP rises from 50 percent to 65 percent of GDP and gross capital formation share falls from 48 to 33 percent.

The overall impact on Australia is found to be negative and, as expected, the costs are largely borne by the mining sector. In contrast, agriculture, forestry and fishing, food and beverage manufacturing and education and tourism services receive a boost. While the overall impact is negative, its scale is put at only around 0.3 percent of Australia’s gross value-added, or GDP. Recall that Australia’s trend rate of annual GDP growth is around three percent. In practice, structural change in China’s economy will also occur more gradually (even if at a faster rate than in recent years) and China’s economy will continue to expand. This expansion will lead to increased demand for imports. And if minerals exports were to fall, the Australian dollar as a ‘commodity currency’ would depreciate, providing...
a further boost for non-minerals goods exports and services. During the mining boom, the flipside to this scenario – referred to as the ‘Gregory effect’ – occurred as the Australian dollar appreciated alongside rising commodity prices, crowding out exports from other sectors of the economy (Norman, 1977).

The RBA research also found that the overall impact on Australia from a shift in the structure of Chinese expenditure is in the middle of the pack internationally. This again serves to dampen the concern that Australia is uniquely exposed to developments in China.

4.2.1. Managing the risk of consumption-driven growth in China

- Australian industry can be supported to capitalise on the emergence of new growth engines in China’s economy.

With a shift towards consumption-driven growth, perceptions of Australian consumer goods and services being ‘clean and green’ provide an advantage for Australian consumer-oriented industries (Austrade, 2018). An ANZ report published in November 2016 found that Australian agriculture will require an additional $109.2 billion of capital by 2025 merely to maintain its current share of exports. By 2050, the industry would face a $1 trillion investment shortfall, which if addressed could yield an additional $0.7 – $1.7 trillion in exports over the next four decades (ANZ, 2016). Domestic investors, however, are reluctant to invest in agriculture (Rollins, 2017). Thus foreign investment is required to fill this gap, especially from China since Chinese investors are particularly attuned to what Chinese consumers want. In light of the China-Australia Free Trade Agreement (ChAFTA) signed in 2015, the Australia-China Bilateral Investment Treaty (BIT) could be reviewed to ensure inconsistencies between the two are addressed (Zhou, 2017). Additionally, despite a lack of clear economic justification, Chinese investment in agribusinesses are subject to a lower threshold for Foreign Investment Review Board (FIRB) screening than investors from countries such as New Zealand and the US (Zhou, 2017). The Australian government could consider addressing this anomaly.
4.3. Grey rhino three – an angry China

Total exports to China account for nearly seven percent of Australia’s GDP. China’s exports to Australia amount to just 0.4 percent of its GDP. These days the argument that this asymmetric exposure gives China coercive leverage is made most prominently by strategic and national security commentators. However, the proposition originated from a political economist, Albert Hirschman (Hirschman, 1945). Hirschman argued that the gains a country like Australia earned from selling to China could be turned into losses if these sales were interrupted. The reasoning is that if the gains from exporting to China are a ‘carrot’, curtailment of Australian imports by China – and the subsequent losses incurred by the Australian economy – are a ‘stick’ to be used as punishment when Canberra does not do as Beijing wishes.

The concern is salient because China has shown it can use economic links to respond to political disagreements. Perhaps the clearest recent case was in 2017, when in response to Seoul agreeing to deploy a US missile shield, Chinese tourist numbers to Korea plunged as an unofficial ban was placed on group tours. Korean companies in China were also subject to ad-hoc ‘safety audits’ and ordered to ‘temporarily’ close (Hernandez, Guo and McMorrow, 2017). For some Korean companies such as Lotte, the retaliatory measures taken were significant enough to prompt the sale of their entire China-based operations (Kim, 2019).

In addition to economically coercive measures, China has instigated diplomatic freezes with countries with which it has a political dispute, and in an even more alarming turn, detained their citizens with less-than-transparent justification (Cecco, 2018).

Taken together, such actions raise fears that China cannot simply be regarded as a ‘normal’ economic partner. Rather, its authoritarian government makes it a different type of nation-state that warrants a correspondingly different type of economic engagement (or perhaps disengagement).

At the same time, China’s position as an economic superpower cannot be wished away and engagement does bring real economic benefits. Moreover, it is not excusatory or dismissive of Chinese bad behaviour to note that there are lessons from historical and international experience with economic coercion qualifying the risk an angry China presents.

First, the claim by Medcalf at the ANU that China has a predilection for coercion stemming from its authoritarian political system deserves interrogation by weighing its actions against those of democratic great powers. In particular, how to explain widespread unilateral American tariffs and sanctions (British Broadcasting Corporation, 2019), non-compliance with WTO rulings (Reich, 2017) and its present undermining of the institution’s dispute settlement body (Beinart, 2019)? A report by the Center for New American Security begins with the simple observation: coercive economic measures are now a central tool of US foreign policy (Harrell et al., 2019). The US under President Trump is also striving to cut a trade deal with China that would see US LNG, beef and wine replacing the Australian product in China’s energy sector and supermarkets (Carr, 2019).

Second, when China implements measures, they tend to be narrowly-focused rather than of threat to the broader trade relationship. In the Korean example for instance, while the Korean tourism industry suffered a decline, total goods exports from Korea to China were actually increasing (Figure 5). The same was true during other commonly cited episodes of Chinese economic punishment such as those involving Norway in 2011 and the Philippines in 2012.

Third, Chinese coercive measures are generally short-term in nature. To again take Korea as an example, Chinese tourism quickly bounced back in 2018, in spite of the fact that Seoul refused to remove the US missile shield which created the political tension in the first place (Jennings, 2018).

Fourth, some events frequently cited as examples of Chinese economic coercion are contested. The frequently referred to claim that China used export bans on rare earth metals in 2010 to punish Tokyo in response to Japan arresting a Chinese ship captain in disputed territories is one such example (King and Armstrong, 2013; Wilson, 2017).

In summarising the international empirical evidence on Chinese economic statecraft, University of Sydney northeast Asian politics expert James Reilly observed that Chinese retaliatory measures are usually ‘more bark than bite’. Another way of putting this is that such measures are generally designed to send a message, rather than inflict actual economic harm.

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Turning specifically to Australia, in March 2017 the ANU’s Medcalf conceded that despite Canberra previously having ‘seriously annoyed’ Beijing, it ‘hadn’t directed economic pressure specifically at Australia’ (Medcalf, 2017). But given more recent tensions in the bilateral relationship, the possibility that Australia might face economic retaliation for its choices needs to be taken seriously. Reinforcing this possibility, in 2018 the Chinese Embassy in Australia issued ‘safety warnings’ to Chinese tourists and students (Law, 2017) and there were also reports of Australian wine and beef facing delays at Chinese ports (Hunter and Crowe, 2018). Some Australian businesses at the coalface formed the view that these developments were part of a Chinese government response to political tensions (Smith, 2018). Fears of Chinese economic retaliation were made worse in May 2018 when a nationalistic Chinese tabloid editorialised that it was time ‘to make Australia pay for its arrogant attitude toward China over the past two years’ and suggested it was ‘reasonable’ to ‘cut a few imports from Australia’ (Global Times, 2018). In 2019, reports emerged raising the possibility that Australian coal was suffering discriminatory delays at Chinese ports (Needham and Latimer, 2019).

Aside from potential instances of economic punishment, there are cases of new economic opportunities being quashed. For example, political tensions meant that in 2018 the Australia Week in China, an annual business event, did not proceed (Hewett, Smith and Coorey, 2018). The scheduled upgrade of ChAFTA has stalled (DFAT, 2018). In March 2019, Andrew Robb – a former Australian trade and investment minister who subsequently worked as a consultant for a Chinese company, Landbridge – recounted that investment proposals he had been involved in during the previous year were binned because ‘the relationship between Australia and China had become so toxic...’ (Borrello, 2019).

In response to such developments, it was reported in May 2018 that Australia’s then-Foreign Minister, Julie Bishop, had raised the port delays and safety
warnings with her Chinese counterpart, Wang Yi, who ‘didn’t acknowledge that they were a deliberate government act’ (Hartcher and Needham, 2018). Then-Minister Bishop added that she didn’t expect such incidents would continue. And indeed, reports subsequently emerged indicating that some of the Australian companies previously experiencing problems had since seen these eased (Hunter and Crowe, 2018). In September 2018, The Australian Financial Review’s China correspondent, Michael Smith assessed that (Smith, 2018):

The nightmare scenario envisaged by Australian businesses in China of a backlash against their imports or operations failed to materialise. Instances of possible economic coercion also occurred against the backdrop of data showing that during 2017 and 2018 Australia’s overall trade relationship with China was thriving. This prompted then-Trade and Investment Minister, Steve Ciobo, to refer to reports of port delays and the like as being only a ‘trade irritant’ in the broader context (Hunter and Crowe, 2018):

...when you put it in the context of where trade is going, when you look at the growth we’ve had of beef and wine exports, I think it is important that we don’t mischaracterise what is happening.

Australian goods exports to China finished 2018 up 18 percent on a year earlier. At a more disaggregated level, solid growth was recorded even in those areas where specific concerns were raised. Exports to China of wine were up 18 percent (Wine Australia, 2019), beef was up 48 percent (Meat & Livestock Australia, 2019), Chinese student enrolments were up 14 percent (Department of Education and Training, 2018) and Chinese tourist arrivals were up six percent (ABS, 2019).

On the delays that Australian coal is currently facing, there are other possible explanations apart from political punishment, such as protection being extended to China’s domestic coal industry (Smith, 2019). In any case, China’s customs statistics show that in the first three months of 2019 China’s total imports of Australian goods stood at $US26.9 billion. Coal only accounted for $US2.4 billion. And this was down just $US175 million from the same period last year (CEIC Data, 2019). Moreover, Australia’s coal exports to China can be re-routed to alternative destinations. In other words, if coal is being used to send a message, it is a relatively quiet one.

Of course, these general qualifications of Chinese coercive behaviour would be of little comfort to an individual Australian company that was targeted, like Korea’s Lotte was in 2017. That said, the latest survey evidence from Australian companies with capital deployed in China does not point to widespread concern: 60 percent said they expected to increase their investment in China this year and 82 percent were positive about their China operations over the next five years (Australian Chamber of Commerce Shanghai, 2019). And while egregious, the possibility of such targeting is essentially a sovereign risk, a contingency familiar to all Australian companies with international operations. If an Australian company chooses to avoid dealing with China based on their risk evaluation, then it is ultimately China that loses as productive Australian capital and expertise go elsewhere.

There are several reasons that help to explain why any economic retaliation taken by China against other countries, as well as Australia, has been modest, and is likely to remain that way.

First, the conceptual premise that asymmetry in trade exposure provides coercive leverage is not clear-cut. Bargaining theory makes the point that rather than starting from a position of strength, any country wanting to coerce a trading partner faces an uphill battle (Wagner, 1988). This is because Beijing wants Canberra to make decisions that Canberra itself regards as costly to its own interests. Accordingly, Australia could be induced to align with Chinese preferences only if China were to compensate it sufficiently for doing so. And if China were to do so, then because ‘...both would be made better off by such an agreement, neither could be said to have been coerced’ (Wagner, 1988). The more probable outcome, however, is that China will be unable or unwilling to offer this level of compensation, reducing the incentive that Beijing has to make demands in the first place.

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Rather than starting from a position of strength, any country wanting to coerce a trading partner faces an uphill battle. Australia could be induced to align with Chinese preferences only if China were to compensate it sufficiently for doing so. The more probable outcome, however, is that China will be unable or unwilling to offer this level of compensation, reducing the incentive that Beijing has to make demands in the first place.

Acquiescing would also only invite more coercion. Last year the DFAT Secretary Frances Adamson put the Australian government’s position towards coercion plainly (Riordan, 2018):

> While we may express views in a variety of ways, sometimes very publicly, sometimes behind the scenes, the government cannot be in a position to tolerate the exercise of coercion.

Second, Australia is afforded a level of protection from Chinese economic retaliation by the World Trade Organization (WTO). In 2010 Japan took action against China in the WTO in the case involving rare earth metals. The WTO found in favour of Japan and China complied with the ruling (Wilson, 2017). When Korea faced economic retaliation from China in 2017, it immediately notified the WTO that China’s actions may be in violation of its trade agreements (Reuters, 2017). Such recourse to the WTO raises the reputational costs to China even before any legal process begins. Hirschman himself foreshadowed a WTO-type solution to the conundrum he posed wherein larger states might wield economic power to coerce smaller ones (Hirschman, 1945):

> …the exclusive power to organise, regulate, and interfere with trade must be taken away from the hands of single nations. It must be transferred to an international authority able to exercise this power as a sanction against an aggressor nation.

Third, Hirschman later admitted a further shortcoming to his original proposition, namely, that fears stemming from an economic exposure would prompt smaller countries to hedge these risks. The original Hirschman contention underestimates the capacity of smaller countries to mitigate risks arising from economic dependency. Hirschman (1978) conceded that:

> …[an] economic disparity generates a disparity of attention, or at least of high-level attention to use the language of bureaucratic politics, and this disparity now favours the dependent country: that country is likely to pursue its escape from domination more actively and energetically than the dominant country will work on preventing this escape.

By way of illustration, Wilson (2017) notes that after Japan assessed it was vulnerable to China disrupting the supply of rare earth metals, ‘[d]efensive counter-measures were hurriedly put in place. These included a US program to build domestic REM [rare earth metal] production capabilities, Japanese efforts to sponsor new REM mines in third-party countries, and a landmark trade dispute launched against China at the World Trade Organization.’

In his 2012 analysis of Australia’s broader strategic response to growing economic dependence on China, James Reilly concludes (Reilly, 2012):

> Australia has responded to deepening economic dependence upon China with classic balancing strategy: strengthening security ties with its Asian neighbours and the United States while bolstering its military capacity.

The 2017 Australian Foreign Policy White Paper continues this approach, outlining an agenda for balance in the region (DFAT, 2017):

> Australia will also work more closely with the region’s major democracies, bilaterally and in small groupings. In addition to the United States, our relations with Japan, Indonesia, India and the Republic of Korea are central to this agenda.

> More dramatic economic retaliation against Australia can only come at a cost to China’s own interests and reputation. Blocking trade is a lose-lose action.

Finally, more dramatic economic retaliation against Australia can only come at a cost to China’s own interests and reputation. Trade is, by definition, mutually beneficial. Blocking trade is therefore a lose-lose action. Further, China is not without its own vulnerabilities. For example, in 2013 Reilly noted (Reilly, 2013):

> Small grey rhinos: understanding Australia’s economic dependence on China
In fact, Australia enjoys considerable economic leverage over China. As then-Prime Minister Kevin Rudd reminded Parliament in 2011: ‘In quality, price and proximity, the iron ore Australia provides to China is without peer, and not easily replaceable elsewhere on the world market.’

Since 2011, China’s dependence on Australia has risen from 40 percent of total iron ore imports to more than 60 percent (CEIC Data, 2019). China’s import dependency extends beyond iron ore to energy resources like oil and LNG.

As former Australian Ambassador to China, Geoff Raby, observes, China is ‘utterly dependent’ on world markets for raw materials (Raby, 2018):

> From the mid 1990s, China...went from being largely self-sufficient as a resource or energy source, to becoming a significant importer, to becoming a major net importer and in many cases the biggest importer in the world.

China is also keenly aware that its own actions are ripe for scrutiny at a time when it is seeking to enlist international support in its trade disputes with the US.

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### 4.3.1. Managing the risk of an angry China

- **Protecting and strengthening multilateral institutions like the WTO is a first order priority.** As a middle power, Australia depends on the protection afforded by such institutions. In cases of attempted coercion, a well-functioning dispute settlement body (DSB) is vital in ensuring that Australia is able to effectively contest any trade agreement violations. The WTO currently faces pressure by the US to undertake reforms, especially in the DSB (Miles, 2018). Australia needs to continue advocacy for an expeditious resolution to the current impasse in the appointment of new judges to the DSB and for the WTO overall.

- **Equally important is strengthening the bilateral architecture between Australia and China to support mutual trust and by setting agreed upon rules of engagement.** This includes the upgrade of ChAFTA given the in-built review mechanisms. The 2016 Partnership for Change: Australia-China Joint Economic Report, a joint study undertaken by the East Asian Bureau of Economic Research at the ANU and the China Centre for International Economic Exchanges in Beijing, recommended an upgraded policy framework more broadly between Australia and China. This consists of a range of measures, such as building on ChAFTA, joint policy working groups, and over the long term, embedding such measures into a comprehensive bilateral Basic Treaty of Cooperation (Drysdale, 2016). This treaty could aim to include the aforementioned update of the BIT, as well as to set out the principles on which bilateral engagement will be based going forward.

- **It should be recognised that any attempted coercion by the Chinese government will almost certainly be on a targeted basis.** As such, optimal Australian responses will be sector-specific rather than economy-wide.

For example, with respect to higher education, in October 2018 Peter Varghese suggested in a speech that Australian universities invest a portion of profits from international student fees in a future fund or endowment with the purpose of boosting financial resilience in the event of adverse shocks to market demand (Varghese, 2018). Such a ‘resilience fund’ could mitigate the short run costs of any Chinese government attempts to coerce Australia by restricting international student enrolments. The Australian government could also review funding commitments to tertiary education. In the same speech, Varghese noted that excluding the Higher Education Loan Program, federal funding as a proportion of university budgets averaged below 40 percent. Universities increasingly turn to international student fees as a revenue source to address this funding shortfall, which is the source of this coercive risk.

With respect to tourism, Australia could focus its marketing strategy on Free and Independent Travellers (FITs). The Chinese government is able to restrict tourism to targeted countries through the Approved Destination System (ADS), which
grants permits for Chinese agencies to organise group tours to Approved Destinations. However, Chinese citizens are also able to travel as FITs who are currently not subject to the ADS, rather than in groups. FITs already comprise the majority of Chinese tourists to Australia at 58 percent of the total (Minter, 2019). The sentiments of the Chinese diaspora (such as Chinese Australians and Chinese permanent residents) will likely be important in any decision-making on destinations for FITs. The Chinese government could still attempt to reduce the outbound flow of FITs through ‘safety warnings.’ If the Chinese diaspora holds positive sentiments with regards to safety and the overall attractiveness of Australia as a tourism destination, the effectiveness of ‘safety warnings’ as part of any attempted coercion could be reduced. Here, the challenge for the Australian government is to avoid explicitly or tacitly endorsing media reporting and commentary that tarnish the reputation or question the loyalty of the Chinese diaspora without the support of facts and evidence (Laurenceson, 2018).

5. Conclusion

Claims that Australia’s economy is ‘too dependent’ on China imply that economic ties present an unacceptable risk. However, this paper has shown that Australia’s China risks appear as small ‘grey rhinos’, at least on a more aggregate level. The visibility of Australia’s China risks, as well as their likelihood and scale of impact, suggests they are largely capable of being managed with appropriate contingency planning. The key takeaway is that Australian government policymakers and businesses are justified in focusing on the opportunities that economic engagement with China presents, while putting in place mechanisms to protect their interests in the event of disruption.

While the government is not responsible for the commercial sector’s sovereign risk management, it can avoid engaging in diplomacy that needlessly irritates Australia’s largest customer. For example, when introducing Australia’s new foreign interference laws, then–Prime Minister Malcolm Turnbull chose to single China out as a reason for their introduction. This attracted an angry Chinese response and delivered no Australian benefit. The Australian government can also disseminate the latest assessments from its diplomatic and intelligence network in order to inform risk management by Australian firms with commercial interests in China.

Explore new multilateral and bilateral trade pacts. While this would likely form part of the ‘diversification’ strategy advocated by some commentators, it is important to note that this can only be effective in the longer term and will be subject to market forces. Over time, it is possible that new market linkages can reduce concentration of exports in particular sectors to China.

To some extent there is overlap between Australia’s exposure to China and the limited range of industries in which Australia is internationally competitive, in particular, mining. This implies that market-led industrial policies promoting a more diversified domestic economy might have an added benefit of potentially contributing to a more diversified export structure, both in terms of products and destinations.
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