

# Industry Brief

## Australia - China Trade: Realizing the Potential

*Like an idea whose time has come, the much-anticipated mutual benefits from the economic relationship between Australia and China are becoming increasingly evident. Previous export-led growth, and heavy government investment, have provided the foundation for a surge in China's domestic demand, which has fuelled the acquisition of more raw materials and consumer goods from many of its trading partners, including Australia. This brief looks at the recent rapid expansion in Australia's merchandise trade with China, the industry sectors most affected, and addresses the question; can this pace of growth continue?*

### The pace of trade has increased

In 2002-03 China was Australia's fourth largest export destination, with exports rising 13%, or nearly \$1 bn, to \$8.8 bn – 8% of total merchandise exports. Exports have grown at an annual average rate of 14.5% over the past ten years. Moreover, the pace has accelerated, with exports averaging over 22% a year for the past four years.

China was also Australia's third largest source of merchandise imports in 2002-03, with imports rising 22% to \$13.8 bn – 10% of total imports. Import growth over the past 10 years has been in excess of 20% a year, edging up to around 23% a year over the past four years.

Australia has consistently run a deficit on merchandise trade with China, which has widened over the years, to reach almost \$5 bn in 2002-03, equivalent to around 57% of export revenue from China.

From China's perspective, Australia was its 12th largest destination for merchandises exports in 2002 and its 10<sup>th</sup> largest source of imports.

Services trade has grown less rapidly than merchandise trade. In 2002-03 China was Australia's seventh largest services export market (\$976 mn), taking 3.1% of total service exports. Services exports to China have risen at nearly 15% a year over the past 10 years.

China was Australia's ninth largest source of service imports (\$923 mn) in 2002-03, providing 2.8% of total service imports. Over the past ten years service imports from China have risen at around 12% a year.

### Trading raw materials for consumer products

As would be expected, Australia's exports to China are concentrated in the primary sector, particularly raw materials and energy, although 'chemical and related products,' as well as 'pigments, paints and varnishes,' have broken the \$100 mn barrier, with the 'electrical machinery and appliances,' 'machinery and equipment' and 'paper and paperboard' categories not far behind.

### Australia's major merchandise exports to China are:

\$A mn	2002-03	2001-02	Ann % chg
Iron ore	1690.7	1380.4	22.5
Wool	1308.5	1320.0	-0.9
Alumina*	1082.0	1016.0	6.5
Crude petroleum	527.4	313.5	68.2
Coal	215.3	158.6	35.8
Aluminium	212.3	190.2	11.6
Barley	212.3	356.8	-40.5
Copper ores	182.2	236.2	-22.9
Pig iron	177.2	142.7	24.2
Non-ferrous base metal waste	172.6	132.5	30.3
Pigments, paints, varnishes	137.1	129.4	6.0
Chemicals & related products	135.4	119.4	13.4
Hides & skins	131.1	156.4	-16.2
Food & live animals	108.8	80.1	35.8
Electrical machinery & appliances	94.8	53.1	78.5
Machinery & transport equipment	93.7	82.1	14.1
Paper & paperboard	93.7	95.4	-1.8
Copper	92.6	91.6	1.1

\*The Australian Bureau of Statistics does not release details of Australian alumina exports by country of destination. Data provided in this table is from the Department of Foreign Affairs and Trade website, for 2002 and 2001 calendar years.

The top performing exports to China (excluding any confidential items) over the past four years have been:

- iron ore, up \$927 mn;
- wool, up \$752 mn (but flat in 2002-03);
- crude petroleum, up \$421 mn;
- pig iron, up \$177 mn;
- non-ferrous base metal waste, up \$160 mn;
- pigments and varnishes, up \$93 mn;
- copper, up \$88 mn (but flat in 2002-03);
- chemicals and related products, up \$78 mn;
- hides and skins, up \$77 mn (but down in 2002-03).

On the other hand, Australia's imports from China comprise a broad array of consumer goods. These are classed mainly as 'elaborately transformed

manufactures, although most would be described as basic rather than high-tech manufactures.

**Australia's major merchandise imports from China are:**

\$A mn	2002-03	2001-02	Ann % chg
Computers	991.5	752.8	31.7
Toys, games & sporting goods	893.5	695.5	28.5
Clothing of textile fabrics	770.7	719.5	7.1
Women's & girls clothing (including knitted)	866.1	775.7	11.7
Footwear	623.2	557.0	11.9
Telecommunications equipment	493.2	359.7	37.1
Furniture	456.8	323.5	41.2
Men's & boy's clothing (including knitted)	548.7	524.7	4.6
Computer parts	374.7	278.7	34.4
Other articles of plastics	333.5	306.8	8.7
Household-type equipment	330.8	278.8	18.7
Manufactures classed by material	311.9	252.4	23.6
Other metal household equipment	190.7	160.9	18.5
Other textile manufactures	309.5	238.5	29.8
Non-metallic minerals n.e.c.	308.1	256.6	20.1
Sound or video recorders	300.3	185.1	62.2
Travel goods, handbags	296.6	280.1	5.9
Chemicals & related prod's	296.0	290.4	1.9
General industrial mach'ry	292.3	227.7	28.4
Other electrical machinery	288.9	239.6	20.6
Electrical machinery and appliances	275.2	210.6	30.7
Photo/optical equipment and clocks	250.1	249.0	0.4
Other manufactures of base metal	249.2	196.4	26.9

The top performing imports from China over the past four years have been:

- computers, up \$818 mn;
- women's and girls' clothing (including knitted, up \$471 mn);
- toys, games and sporting goods, up \$438 mn;
- telecommunications equipment, \$348 mn;
- furniture, up \$345 mn;
- clothing of textile fabrics, up \$286 mn;
- sound or video recorders, up \$252 mn;
- footwear, up \$236 mn;
- men's and boys' clothing (including knitted), up \$154 mn;
- computer parts, up \$267 mn;
- other articles of plastic, up \$129 mn;

- household type equipment, up \$115 mn;
- manufactures classed by material, up \$174 mn;
- other textile manufactures, up \$162 mn;
- non-metallic minerals, up \$155 mn;
- chemicals and related products, up \$153 mn;
- general industrial machinery, up \$170 mn;
- other electrical machinery, up \$184 mn;
- electrical machinery and appliances, up \$165 mn;
- photo/optical equipment & clocks, up \$159 mn;
- other manufactures of base metal, up \$143 mn.

**Australia's third largest trading partner**

China is now Australia's third largest trading partner for merchandise trade. Five years ago it was number five and ten years ago only number eight. Amongst Australia's major exports in 2002-03, China was the number one market for Australian: barley, wool, oils and fats; non-ferrous base metal waste; pig iron; pigments, paints and varnishes; and veneers, plywood and particleboard. It was the number two market for exports of hides and skins; iron ore; paper and paperboard; and photographic supplies.

The pervasiveness of Chinese goods in the Australian market is evident in this list of Australian imports for which China was the number one source in 2002-03: paper manufactures; textile yarn; clothing and footwear; other textile manufactures; aluminium; other manufactures of base metal; other metal household equipment; office machines; computers; radio broadcast receivers; electricity distribution equipment; household type equipment; furniture; travel goods and handbags; other articles of plastic; and toys, games and sporting goods.

**The forward impact on key Australian commodities**

It is clear from Australia's merchandise export profile that the minerals and metals sectors will be the main beneficiaries of continued strong demand from China. However, some areas of agriculture and some manufactures will also be impacted significantly.

The near term outlook for Australian primary sector exports to China is drawn from recent forecasts by the Australian Bureau of Agriculture and Resource Economics (ABARE):

**Grains** – Wheat production in China has declined from 123 mn tonnes to an estimated 86 million tonnes over the five years to 2003-04. In response, the Chinese government is encouraging farmers to increase grain output, which should have

an effect in 2004-05. Coarse grain production in China also is expected to increase in 2004-05, by 7% to 130 million tonnes, including malting barley, as Chinese beer consumption recovers. (Even with forecast increases in Chinese production, the post-drought recovery in Australian production should see a substantial increase in Australian exports to China in future, relative to 2002-03.) Over the longer term, rising incomes should lead to increased Chinese demand for coarse grains (malting barley and livestock feed), as well as oilseeds to produce vegetable oils.

**Wool** – The appreciation of the Australian dollar and weak processor demand in China, as well as the impact of the SARS virus on retail consumption, have constrained wool exports to China since 2001. This placed downward pressure on prices through 2003. Wool export volumes to China are expected to remain steady in the near term, but the forecast is sensitive to A\$ appreciation. Over the four years from 2004-05, wool export volumes to the world are forecast to rise 3%-4% a year, on average. (China, as the prime export market and, with rising incomes, should at least match this moderate growth.)

**Oil** – China is expected to be the main driver of global oil consumption growth. After increasing by 10% in 2003 to 5.5 mn barrels a day, China's oil consumption is forecast to grow by 6% in 2004, and by an average 6% over the succeeding five years. (While strong growth in Australia's crude petroleum exports to China in 2002-03 occurred in the face of declining crude production, the outlook for further strong growth would appear to be limited by continued declines in production in the short term.) The potential for increased China exports should improve in 2005-06, with ABARE's forecast rise in total crude petroleum exports, as a consequence of new production being available for export.)

**Coal** – Growth in China's steel consumption has dented its capacity to export metallurgical coal. In fact, there has been a rapid rise in China's imports of metallurgical coal, which reached 2.6 mn tonnes in 2003, a rise of 55%. With continued strong consumption in prospect imports are forecast to rise to 4.5 mn tonnes in 2004. (As the largest exporter of metallurgical coal, Australia is well placed to benefit from the continued growth in China's - and indeed global - demand for this commodity with new production capacity expected to come on line.) Total metallurgical coal export volumes to the world are forecast to rise by over 6.5% in 2004-05 and to average 2.5% growth a year for the next four years.

**Iron Ore** - Over the five years to 2009 China is expected to account for some 40% of the growth in world steel production. In 2004 China is expected to account for nearly half the increase in world steel production, reflecting robust growth in construction

activity and manufacturing. Domestic production will not keep pace with demand, and China's need for steel will support production elsewhere.

China's steel consumption will continue to provide a market for Australian iron ore exports, as higher freight rates will favour nearer suppliers. Even with a lift in iron ore production, China is expected to import 20 mn tonnes of iron ore in 2004, following a 36 mn tonne rise (32%) in 2003. Over the next five years China's iron ore imports are forecast to rise by 68 mn tonnes, or 40%, to 235 mn tonnes. Total export volumes of Australian iron ore are forecast to rise by 14% in 2003-04, to 206 mn tonnes, and by 8% in 2004-05; this will be followed by steady growth of around 3.0% a year for the succeeding four years. The real value of total exports of Australian iron ore is forecast to ease marginally in 2004, before rising by some 10% a year over the next two years and then easing slightly. The above forecasts would also suggest continued good export prospects for Australian pig iron.

**Alumina** - Aluminium production in China has been responding to rising industrial production. However, near term production growth is likely to be hindered by capacity limitations and rising alumina costs. On present trends, China could account for 20% of world production in 2004. Aluminium consumption in China grew by 29% in 2003, to 5.4 mn tonnes – accounting for over one-half of the growth in global consumption. In years to come China is expected to continue to account for a major portion of global aluminium consumption growth, with average annual growth of 6% forecast for China to 2009. In the near term forecast growth in consumption of 14% in 2004 and 7% in 2005 reflects an expected continuation of demand in China's construction, transport and packaging industries and the upgrading of power networks in urban areas.

Australia is well placed to support China's push to increase aluminium production, especially with new alumina capacity coming on stream in 2005. In 2003-04 and 2004-05, Australia's total alumina exports are expected to be broadly steady at around 13.6 mn tonnes. Between 2004-05 and 2008-09, however, alumina export volumes are forecast to rise by an average 3.8% a year. The real value of alumina exports is forecast to rise by 1.6% a year from 2003-04 to 2008-09. In 2003-04 a decline of about 1.8% is expected, reflecting A\$ appreciation.

**Copper** – China's reported copper consumption rose by 10% in 2003, excluding drawings from the large stockpile built up in 2002. China's economic expansion has been in copper intensive industries, e.g. construction, telecommunications and electronics manufacturing. With the expectation that industrial production will continue to grow by around 10% in 2004 and 2005, significant growth in copper consumption is expected also. From 2006

onward global copper consumption is expected to grow at 3.9% a year – above the long-term growth rate – and China will account for a significant part of that growth. By 2009 China is expected to account for 27% of world copper consumption, which is forecast at 19.4 mn tonnes. (The benefit to Australian exports looks like being limited somewhat in the medium term due to only modest growth in capacity.)

Australia's refined copper output is forecast to fall by 13% to 469 kilotonnes in 2003-04 due to a refinery closure in New South Wales. The forecast is for this to be followed by average growth of 4.7% a year for the three years to 2006-07, with no growth in the next two years. Growth in export volumes therefore, will be confined to ores and concentrates, with refined copper not expected to exceed the level of 359 kilotonnes in 2003.

The outlook for other key exports such as chemicals and paints is tied to trends in China's industrial production and construction activity, which have experienced boom conditions. However, the validity of any growth projections for Australian mineral, energy or manufacturing exports will be heavily influenced by government economic policy in China.

#### **China's government aims to cool the economy.**

The explosive nature of China's recent growth has been a developing concern for the government. GDP growth of 9.1% in 2003 has drawn attention to energy and raw materials shortages, as well as transportation bottlenecks. While maintaining sufficient economic expansion to sustain employment growth remains the authorities overriding concern, they want to apply the brakes to the economy early, in order to avoid the need for a more dramatic slowdown later on.

The revised, more modest, GDP growth target is 7% - still consistent with double-digit growth in industrial production, exports and imports. Measures being introduced by the government will target specific sectoral and regional problems, acting both to reduce demand and increase capacity, as appropriate. Credit restrictions were introduced last year on lending for apartments, and subsequent measures tackled capital spending in particular sectors. Bank reserve requirements have also been increased to restrain lending growth. The net impact of these measures on the economy is hard to predict.

**Frank Foley**  
**Economics@ANZ**  
**Email: [foleyf@anz.com](mailto:foleyf@anz.com)**

Ideally, China's growth will slow moderately, maintaining healthy demand for imports. However, as China does not possess the mechanisms to attempt a fine-tuning of economic activity there is a significant risk the authorities will be unable to engineer a 'soft landing,' with the economy eventually being slowed more sharply than desired, and requiring some re-stimulation.

#### **Increased competition from Chinese imports**

On the imports side, the range of Chinese merchandise available on the local market provides competition across a wide range of Australian manufacturing. Those industries will be most adversely affected through price competition. The only manufacturing sectors likely to be largely unaffected by the growth in imports from China are those with relatively low import penetration rates viz. food/beverages, printing/publishing and non-metallic mineral manufacturing (mostly building materials). Those industry sectors having the highest import penetration rates are most likely to be significantly adversely affected, notably 'machinery and equipment' and 'textiles, clothing and footwear.'

#### **Conclusion**

Trade with China has surged in recent years, with growth in imports outstripping export growth. Energy and raw materials exporters have been the largest beneficiaries of China's demand for imports, while those Australian manufacturing industries most open to trade have faced increased price competition from China's exports. The 'natural fit' in Australia/China trade points to further substantial trade growth over the medium term; and the developing confidence apparent in the Sino-Australian economic relationship, as evidenced by the exploration of a free trade agreement, suggests the relationship will broaden and deepen in future.

Having said this, it seems probable that recent rapid growth rates in demand for some Australian commodities will not be sustained, given the Chinese government's desire to cool activity before pockets of overheating spread, thereby avoiding a more harmful contraction in economic growth further down the track.

(A more detailed look at the impact of growth in Australia-China trade on specific local industry sectors will be the subject of another economic brief.)

ANZ is represented in:

**AUSTRALIA by:**

Australia and New Zealand Banking Group Limited  
ABN 11 005 357 522  
10th Floor 100 Queen Street, Melbourne 3000, Australia  
Telephone +61 3 9273 6224 Fax +61 3 9273 5711

**UNITED KINGDOM by:**

Australia and New Zealand Banking Group Limited  
ACN 005 357 522  
Minerva House, PO Box 7, Montague Close, London, SE1  
9DH, United Kingdom  
Telephone+ 44 207 378 2121 Fax+44 207 378 2378

**UNITED STATES OF AMERICA by:**

ANZ Securities, Inc.  
(Member of NASD and SIPC)  
6th Floor 1177 Avenue of the Americas  
New York, NY 10036, United States of America  
Tel: +1 212-801-9160 Fax: +1 212-801-9163

**NEW ZEALAND by:**

ANZ Banking Group (New Zealand) Limited.  
Level 10 215-229 Lambton Quay Wellington, New Zealand  
Telephone +64 4 496 7000, Fax +64 4 496 7360

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