Why this love triangle works

August 15 2011, By Professor Geoffrey Garrett

The carnage on global stockmarkets following the US's debt ceiling fiasco and credit downgrade will only make Australians think about the country's future even less in terms of the US and even more in terms of China.

The US appears to be in terminal decline, pulled down by a staggering economy, a bankrupt government and a dysfunctional polity. And as the US seems to be dragging down the rest of the West with it, Chinese demand for Australian minerals and energy looks like our best chance to stay afloat. At the same time, geopolitical frictions between waxing China and waning America seem to get only more intense, potentially making our neighbourhood a much more dangerous place.

The bottom line, so we are told, is that Australia finds itself at the pointy end of an unstable triangle with China and US, laying waste to the grand strategy of better relations with China layered on the bedrock of the US alliance that has served Australia so well in recent decades.

Not so fast. All this agonising is bad public diplomacy. The more Australians worry out loud about the instability of the country's China-US balancing act, the less stable it is likely to become. Australian hand-wringing is certainly raising eyebrows in high places. In Beijing, some worry that Australia thinks of China as a necessary evil: economically essential but politically unpalatable and geopolitically threatening. In Washington, there are worrying whispers that Australia may drift away from its US alliance the way New Zealand did in the 1980s.

But, more importantly, agonizing over challenges to Australia's geopolitical triangle ignores the very real fact we are part of a vibrant economic triangle with China and the US that is a big win-win-win for all three countries, not only economically but also in terms of shoring up geopolitical stability. Odds are this triangle will remain Australia's best bet for capitalizing on the upside of globalisation as well as for minimizing the downside.

The notion of a positive sum economic triangle may strike people who study the trade statistics as wrongheaded, if not bizarre. Australia is winning from its booming relationship with China because of its healthy and growing trade surplus with the world's new growth engine. But the same approach says Australia is losing from its economic relationship with what is still by far the world's biggest economy because our trade with the US is decreasingly important and increasingly imbalanced in America's favour. Finally, the conventional view is that the US is losing big time from having the world's largest and still growing trade deficit with China.

This zero-sum thinking about bilateral trade is bad economics. All the textbook will tell you is that it is only a country's overall trade balance that matters and that import competition helps consumers and increases efficiency at home. But a focus on inter-country trade also overlooks what is really going on in today's global economy, in which cross-border investment is at least as important as trade, and both trade and investment are dominated by multinational corporations slicing up the value chain across the world.

The only side of the economic triangle the trade focus gets remotely right is Australia-China. Last year, China was by far Australia's largest export destination ($64.4 billion), almost as big as our next two largest export markets, Japan and South Korea, combined. Australia's exports to China have more than trebled since 2005, constituting a whopping threefifths of the country's total export growth during that period. These exports are dominated by iron ore ($34.7bn last year) and (mostly coking) coal ($5.2bn), which China then makes into steel to build the buildings, bridges, airports and railways that are the backbone of its economic miracle - all the more so since China's colossal infrastructure investment-led fight against the global financial crisis in the past couple of years.

China sells Australia, like the rest of the Western world, a lot of manufactures. But, unlike in the US and Europe, these are more than offset by our minerals exports. As a result, Australia ran a trade surplus with China last year of $23.4bn, whereas it ran a trade deficit of more than $6bn with the rest of the world. In Europe and the US, trade deficits with China are a big chunk of their global trade deficits.

Much less well known when it comes to Australia-China is the fact two-way investment is growing much faster than trade, though starting from a near zero base.

In 2005, total Chinese investment in Australia was $2.2bn. By last year it had mushroomed to $16bn. Australian investment in China has grown apace, quintupling from $2bn to $10bn during the same period. So today iron ore and coal dominate Australia's China story. But the script is likely to look very different a decade from now. Liquefied natural gas exports from the North West Shelf and the Gladstone basin are poised for explosive growth once the massive local facilities are built, with China the biggest market.

The World Energy Outlook forecasts that China's demand for gas will increase by 6 per cent a year during the next 25 years, compared with 0.5 per cent for the Organisation for Economic Co-operation and Development. This growth would take China from today's 2.7 per cent of global gas consumption to 8.7 per cent by 2035, and this could see

Australia replace Qatar as the world's biggest LNG exporter.

With respect to investment, Chinese entities want to invest in Australia not only to secure the country's energy future but also because the financial upside to Australian investment is so promising. As with companies across the world, Australian companies salivate at the prospect of serving China's hundreds of millions of new middle-class consumers and helping with the greening of the Chinese economy in addition to selling the country minerals and energy. And, as with companies across the world, they know the best way to sell in China is to be in China.

Australia's economic ties with the US are night and day from those with China. But they are important and need to be interwoven into Australia's China narrative.

Australia's relationship with the US is dominated by investment, and American investment in Australia far outstrips Australian investment in the US. There is lots of good news in the American story, but the trade statistics make it hard to see the wood for the trees.

When John Howard signed the Australia-US free trade agreement in 2005, he said Australian exports to the US would boom. But Australian exports to the US last year ($14.5bn) were only $700 million higher than they had been in 2005, a far cry from the China bonanza. The fact global trade slumped 30 per cent in the GFC had a lot to do with this. But across the same period Australian imports from the US grew from $28.5bn to $32.5bn, blowing out our bilateral trade deficit last year from $14.7bn to $18bn - evidence that the Howard government sold the country a bill of goods, the critics of the FTA are quick to conclude.

Mainstream international economists would respond that imports are good, not bad.

While Australia has the resources so much in demand in China, the US provides much of the large-scale and complex transportation, mining and earth-moving equipment needed to extract and export those resources. minerals and energy. GE, for example, is a key player in the Australian mining and energy economy, selling, servicing and financing high-end machinery such as turbines, locomotives and drilling equipment to the extent that Australia (with NZ) represents the third largest revenue volume for GE in the world.

Kerry Stokes competes in Australia's mining machinery markets through his ownership of the booming Australian franchise of the US-based Caterpillar.

Australians can lament that the country does not make this equipment at globally competitive prices. But they should be glad American companies such as Caterpillar and GE do, and are selling and servicing locomotives, trucks, drilling equipment, earthmovers and turbines in Australia at volumes and quality needed to meet the mushrooming demand.

Turning to investment, the scale of Australia-US ties is immense and growing. Across the period from 2005 to last year, US investment in Australia increased by more than $200bn, from $334bn in 2005 to $550bn last year : equivalent to about half of Australia's gross domestic product. Today, American investment constitutes more than one-quarter of all the foreign investment in Australia, nearly $80bn more than the No 2 investor, Britain, and more than $530bn more than China in 12th place.

US investment is likely to continue to grow as American multinational firms look to foreign markets to generate ever more of their revenues.

Last month, Origin Energy and US-based ConocoPhillips announced it was full-speed ahead with their first $13bn of a planned $19bn LNG plant in Gladstone based on coal seam gas, with the remaining $6bn slated to be committed by early next year. While Origin will sell some coal seam gas domestically for power generation, all of the LNG will be for export. And China is the biggest export market, with a 20-year, $90bn gas supply deal with Sinopec as well as a 15 per cent investment stake in the project, giving Origin-Conoco sufficient comfort to pull the trigger on their enormous joint-venture.

Similarly, US-based Peabody's and European ArcelorMittal's $4.7bn hostile takeover bid for Macarthur Coal is based on the fact Macarthur is the world's biggest miner of coking coal, with China its dominant buyer. Fortescue Metals is relying heavily on $1bn to $2bn of American debt financing for its Pilbara expansion, with most of the iron ore destined for China in long-term supply contracts, with the world's largest steelmaker, Baosteel, leading the way.

These multi-billion-dollar investments are dwarfed by Chevron's Gorgon and Wheatstone LNG projects. Gorgon is the US energy giant's largest investment and the largest resource project in Australia. The $43bn Gorgon project is under construction and will begin operations in 2014.

The final Wheatstone investment decision is expected later this year, with speculation that its final price tag may exceed $20bn.

Most of Chevron's Australian gas is destined for export, with its main initial markets in Japan and South Korea. Of course, the Japanese and South Korean economies are very tightly integrated with China these days. But as the Chinese gas market grows and matures, the temptation for Chevron to enter it will surely grow.

Given all this big-ticket mining and energy action, it is not surprising that Australia is a hot investment banking market. In fact, Dealogic estimates that in the first half of this year Australia was the third largest location for mergers and acquisitions in the world, with an announced deal volume of $US73.5bn ($71.5bn), behind only China (slightly more than $US80bn) and the US (more than $US500bn). Goldman Sachs was the most active investment bank in Australia, advising on almost half of the total deal volume, followed by JPMorgan. There was only one non-US bank in the top five, Europe's UBS.

The expertise, experience and balance sheets of the big American banks are clearly in high demand here, in addition to American capital.

All this shows not only that American investment as well as exports to China are of critical importance to the Australian economy; it also shows that Chinese exports and American investment are two sides of the same coin. Australia needs American capital to make the most of its natural resources bounty via exports to China because of the substantial fixed costs of investment in the necessary plant and equipment. American investment - foreign direct investment, portfolio and debt - is attracted to Australian projects because of the big upside of selling Australian minerals and energy into China.

The facts about this win-win-win triangle are compelling. But as talk of a GFC II rises, questions should be asked about its sustainability. There are three potential areas for concern. But the odds are good for the continuation of Australia's sweet spot between Chinese demand and American investment for the foreseeable future.

The first concern is that the US economy is on the verge of another recession, with employment, housing and consumer statistics in worse shape for longer than at any time since the Depression. It is hard to see light at the end of America's dark tunnel. But there are real bright spots in the US economy. They just revolve around multinational firms doing business offshore rather than creating jobs in the US. Estimates are that

US corporates are sitting on more than $US2 trillion in cash that they are unwilling to invest at home until the domestic consumer comes back. But they continue to be ready and willing to invest abroad, and Australia's China play remains very attractive.

The second worry is that China's economy is potentially whipsawed between domestic overheating and too many non-performing loans and the need for more stimulus to offset slumping demand in Europe and the US. China reacted to GFC I with its own substantial fiscal and monetary stimulus, and Australia was a key beneficiary. Would China react the same way to GFC II, given the debt incurred and the inflation it set off in 2009-10? If not, Australia would be at the front of the firing line. But everything we know about the Chinese government says it still has the capacity, incentive and will to execute another infrastructure investment boom should it be needed to keep growth at 8 per cent or higher. Big advantage Australia.

Finally, China's fighting words about US fiscal policy after its credit downgrade are just the latest example of Sino-American frictions, ranging from trade and currency to intellectual property and market access to Taiwan and Tibet. But there is a remarkable thing about this ongoing war of words: cool heads seem always to prevail in Beijing and Washington. China continues to buy more treasuries; Americans continue to buy more Chinese goods; American multinationals continue to invest more and operate more in China. The third and biggest side of the Australia-China-US economic triangle is sturdier than many think. This is good news for China and the US. It is also good news for Australia.

At the end of the day, Australians are bound to worry about whether the country can continue to balance its relations with both. There are sure to be real geopolitical challenges. And today's near-panic about the global economy certainly doesn't help. But the foundations of the win-win-win

Australia-China-US economic triangle are strong. When worry and woe are all around us, we should remember that Australia is well placed to weather the storm because of its place in this triangle.

Provided by University of Sydney

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